

EBAday 2006 – Enroute to SEPA: vision, opportunities, realities

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Ladies and Gentlemen, Good Morning.

Let me first congratulate the EBA on deciding to hold this initial symposium, and to hold it in Frankfurt. The timing could not be more apt, given the current public policy discussions on payments in the European Union. And I can think of no better place to meet than Frankfurt, home to the European Central Bank, home to the largest national economy in Europe, and the birthplace of Germany's great visionary, Goethe.

Of course, in Goethe's day, there was no single European payments system, despite the efforts of his contemporary and acquaintance, Napoleon. Yet as a scholar, Goethe were he alive today would no doubt point out that SEPA will not be the first pan-European scheme for payments. Before Napoleon, the Italian and German private bankers fashioned cross-border settlement conventions in the 1300's and of course, the Romans solved the problem with their own unique approach to cross-border harmonization.

Even though JPMorgan Chase's founding dates from 1799, and we have been serving clients in Europe since 1854 and in Frankfurt from 1947, we cannot claim a role in any of these earlier versions of SEPA.

But in our own time, we have witnessed a revolution in the way our European clients think about payments. While 1999 was an historic milestone with the creation of a new single currency for 12 countries, in some ways, the real change has been more gradual and global.

Payments used to be a back office function – the result of another business transaction – for both customers and for banks. Certainly not glamorous and only of concern if something went wrong.

Today, we in Europe recognize that the payments business is crucial to our overall profitability. McKinsey estimates that the processing of payments account for almost a third of firm-wide operational costs in Europe. The same study found that something like a quarter of revenues is derived from payments and bundled products. But overall efficiency remains low – McKinsey estimates that only 9 per cent of bank profits come from payments. That generates a cost to income ratio of around 90% on average, and the McKinsey study states that the drag in payments profitability pushes the cost / income ratios for European banks from a possible 55% to around 64%.

The payments business is also of great interest to European and global regulators. The regulatory and compliance costs related to staying in the payments business have become a key factor in the profitability of the product.

The creation of CLS is but one example of how regulatory pressure has an impact. With strong implicit 'incentives' from central banks, the industry invested almost a billion dollars to build CLS in order to reduce settlement risk in foreign exchange markets.

Moreover, the authorities have recognized that banks and payment infrastructures have an importance beyond the industry in terms of social resilience. After the tragic events in New York, Madrid, and London, both governments and regulators have rightly encouraged the industry to treat the payments system as a crucial part of national infrastructure and hence almost as critical as any other element of national security.

And perhaps most important for us here in Europe is the overall impact on the business climate for our clients. The economic aspirations for the European Union depend on a sound and harmonized payments infrastructure. But as the Commission and others have recognized, the customer experience in any other 'single currency market' like the United States is very different from that in Europe. Payments are priced based on service features like delivery time. No one in the United States gives a thought to which state the payment needs to be sent. In absence of such an approach, bank mergers in Europe cannot be as compelling as they are in true single markets as the recent Incentives paper from the Commission points out.

Change is not always bad or to be resisted – Goethe reminds us that "Nature knows no pause in progress and development, and attaches her curse on all inaction."

And there are clear examples that a paradigm shift can also catalyze growth, irrespective of the initial impact on revenue or organizations.

At a firm like ours – the product of several large mergers – the experience has been instructive. When Chemical Bank and Manufacturers Hanover planned the first large in-market merger in the US back in 1991, we assumed that there would be some revenue loss from overlapping clients. In fact, the opposite occurred. Revenues rose dramatically, in part because clients chose to reward us with new business once they understood our new scale and potential.

Similarly, the European Commission in its just-released Regulatory Impact Assessment on securities clearing and settlement clearly believes that a truly harmonized and efficient single market will give rise to many more transactions – enlarging the overall market for settlement despite the impact on individual players.

Let me be clear: JPMorgan strongly supports the creation of a Single Euro Payments Area as a logical and necessary step in the progress towards a single market in financial services within Europe. Despite the prospect of increased growth in Europe during the last year, economic reform is still badly needed and the creation of a harmonized payments area is a critical element of that reform agenda.

The vision of the Commission and ECB is ambitious, but it represents a once in a generation opportunity for the banking industry and European economies. Perhaps thinking of his hero, Napoleon, Goethe wrote that "Boldness has genius, power, and magic in it." The European Commission and ECB are certainly bold: can we in the European banking industry match such boldness?

One needs no magic, however, to look beyond the current deadlines of 2008 and 2010. What I would like to do this morning is share some of our thoughts on what the payments industry in Europe will look like in the more distant future, say 10 years out in 2016.

What will customers require?

How will the industry be delivering?

And perhaps, crucially, how will the payments infrastructure – schemes, conventions, regulations and practices – be governed?

To answer these questions, we reached out to our clients – the finance directors, corporate treasurers and technologists who do business with JPMorgan in Europe – for their perspectives. We also talked to regulators, market infrastructure providers and our correspondent banking clients.

My colleague Lori Hricik shared some of these perspectives with the industry in Rome earlier this year, and I think they bear repeating. Here is what we heard.

Finance directors and treasurers care about managing their working capital, so they envision 2016 as a time of better, faster, and cheaper means to manage their critical business processes and to optimize working capital. Payments are imbedded in these business processes so they expect real-time payments and information transparency – knowing exactly where a transaction is at all times – regardless of the country, instrument or channel by which it was originated. They see fewer banks, fewer payment systems, and – in the words of one client – worldwide, end-to-end standardization.

Standardization was also top of mind with technologists. They see 2016 as a time of common utilities, a single set of open standards, a single common interface into their various banks and the payment systems, and fully electronic transactions with Straight through Processing.

Regulators envision a safe and sound processing environment with the scale to enhance resiliency and liquidity management. They insist on fail-safe, best practices designed to discover and discourage all illegal payment activities. They expect the private sector to create an equitable and efficient medium for all commercial and consumer payment transactions.

Market infrastructures like SWIFT, the EBA, CLS, and TARGET see 2016 as a time of even greater cooperation and synergy. These providers believe that their collaboration will enable central banks to exit the processing business and focus more on oversight.

Last but certainly not least, there are the bankers. Bankers believe – or maybe I should say they hope – that banks will continue to be at the core of the payments industry, adding critical value to their clients' businesses. They see potential for greater efficiency and profitability by adopting new business models for payment services. And as McKinsey points out, payments profitability is a critical issue for European bank CEO's.

So 2016 will be a time of transparency, standardization, safety, partnership and efficiency. None of this is surprising.

But we then broadened our horizon and talked to some of the younger Europeans who represent the generation of leaders who will be in positions of authority in the business world 10 years from today.

While these young people are new to the business world, they are already experienced consumers. They just can't understand why making a payment is so complicated. All they want is a completely online, fully automated banking experience. They refuse to balance a checkbook. They want to use their mobiles to conduct all their banking – everything has to be totally electronic. Having a smart card payment chip in their mobile that eliminates the need for any other form of payment would be fine with them. They are not interested in infrastructure or security issues because, in their view, that's something for the bank to worry about. Convenience, simplicity and speed are what they care about.

Listening to these young people, it sounds simple and doesn't seem like this is much to ask.

If we were to build a payments infrastructure from scratch, would we build what we have today? Of course not. But more importantly, the next generation of Europeans – our children – see a very different payments landscape a decade from now. Let me suggest a few ideas for 2016 that some of you may think are far-fetched, and show you how each of them has some grounding in fact.

- 2016. There are no checks. None. In fact, you don't see as many cash registers in the stores because expensive coins and currency are rapidly becoming a rarity. Pushing a button on a mobile or tapping a card on a reader is the preferred way for consumers to pay. Corporate payments are 100% electronic.

In the G10 countries today, 70 percent of non-cash transactions are electronic – up from about 45 percent 10 years ago. Checks are in rapid decline while cards, EFT and other electronic payments are growing quickly.

The number of electronic transactions in the United States – 54 billion – is expected to double over the next five years, the equivalent, in transactions, of two Visa Internationals. In Europe, in 2004, over 84.5 billion electronic transactions were initiated, and a recent study by ACI predicts that volume will grow to 138 billion by 2009.

- 2016. Making a cross-border consumer payment anywhere around the world is as easy and speedy as making a local currency payment.

This doesn't mean that we will have a single world currency.

It does mean that consumers will trust each other enough to trade with each other outside of their local communities.

You've all heard of eBay, the phenomenally successful online global trading platform where some 68 million active users can trade practically anything. People from all over the world buy and sell on eBay. But it's our understanding most of that buying and selling occurs within – not across – geographies... just 15 percent of eBay trades are cross border. This is likely one reason why eBay acquired Skype, a global Internet voice communications company that will give buyers and sellers a more personal and direct way to build relationships and, therefore, trust.

- 2016. There is no segregation between high and low value payments. A payment is a payment is a payment. The attributes of the payment determine how the payment is delivered to the beneficiary. Every link in the corporate supply chain is completely automated on an end-to-end basis. Next year's advent of the U.K.'s Faster Payments Service will not only deliver a near-real-time, irrevocable payment capability 24 by 7, 365 days a year, it is expected to drive the convergence of both high and low value payment schemes into a single clearing channel. Pressure from the private and public sectors coupled with technological change will force convergence.
- 2016. Payment pricing will follow what might be called the FedEx model. Federal Express charges 32 euros to have a letter delivered by 8am the next day between France and Germany, and just 3.5 euros to have that same letter delivered overnight, but later in the day. Big difference! Pricing can be a great modifier of behavior. In 2016, the faster the payment, and the greater the level of security, the higher the price of the payment.
- 2016. Payment transactions can be made on any networked communications device. That means PC, mobile phone, blackberry, Palm Pilot, voice recognition, television, ATM, pager, RFID tag, email, internet, whatever. And this means any payment, including micropayments.

Today, there are almost 500 million devices (most of which are computers) connected to the internet. In 10 years, there will be over 20 billion!

- 2016. Security issues have been largely resolved. Biometrics is the norm. Advances in high speed broadband access and the use of GPS chips in mobile devices have changed the way we secure the payments business. Clients are configured to authorize payments while away from the office, while some clients choose to approve payments only from specific locations. Whatever the authorization configuration, fraudulent payment activity is virtually nonexistent.
- 2016. Common standards are common! I am not implying that we will have a single global standard or a single global interface in 2016. What I do think we will have is more regional interoperability along the lines of what has occurred in the mobile phone industry.

In the late 80's and early 90's, the mobile phone industry had a number of different, and often incompatible, standards. To enable consumers to use a single mobile phone number worldwide, there was talk of launching multiple satellites. Fortunately, this was just talk. Instead, through industry partnerships, mobile phone providers developed bilateral and multilateral agreements, initially to carry each other's traffic, and later to recognize the local phone number of the mobile phone user. This is why today most mobile phone customers can use one number to make and receive calls around the world. A win-win for everyone.

You may think some of these ideas are unrealistic. But remember how the single currency was expected to reduce the number of global FX trades? According to the BIS, there were 568,000 FX trades in April of 1998. While this run rate dipped slightly in 1999, by April of 2004, the global rate was over 620,000. Remember the predictions of how CLS would destroy the treasury payments franchise? Has that happened?

Remember all the obstacles the euro encountered before it became a reality? It was a remarkably complex and emotional initiative. Yet, from the signing of the Maastricht treaty in 1992 to the 1995 Madrid European Council meeting when the new currency was named and given a January 1, 1999 launch date – events moved quickly and inexorably.

Why was this able to happen? I think it had everything to do with visionaries who understood the compelling benefits of monetary union. It took discipline, compromise, creativity and political consensus to achieve their vision. It may have taken a long time to come to a decision, but once the decision was made, change came swiftly.

Ten years ago, there was no PayPal. No eBay. No Google. Stored value cards, transponders, and the like, didn't exist.

In light of these experiences, I believe this vision of the future for payments is not a mirage. It is a concrete possibility.

This is precisely why it is crucial that SEPA be solidly grounded in real customer needs. At JPMorgan, our corporate workshops have indicated a strong desire on the part of our customers to work together with the banks to ensure a smooth transition to SEPA. They want to have a clear understanding of the changes they will be required to make and the practical implications.

There is also concern among our customers that the banking industry will not be fully ready for 2008. In this regard it is essential that we strive towards full reachability – new SEPA payments and direct debits can reach all customers at all banks across Europe.

As financial institutions, we need to move beyond merely debating multiple ACH's and mini-SEPA's and move collectively to promote a more efficient pan-European network of 2 to 3 clearing houses. These technical debates are in reality not about how we will differentiate ourselves or deliver value to clients. In the end, low-value ACH settlement across the euro zone will become very standard and likely to be commoditized. Let's focus our efforts on where the customer perceives value: for example, supply chain management.

We all know the industry has found it challenging to reach agreement on how to harmonize the basic features of the SEPA schemes. Politicians, regulators, and most importantly, customers, also expect us to modernize our systems while we migrate to a more harmonized payments model across Europe.

So, what do we believe is needed?

First, we need to buy into what I like to call the end game – to recognize the opportunity, whether through lower processing costs or increased business. Both are available and both will have to be realized if the benefits of SEPA are to be delivered.

Second, we need to identify those activities where we are prepared to collaborate and those where we compete. The recent SWIFT initiatives on trade and on corporate access are good examples of how we might agree the boundaries.

Third, we need to learn from experiences in other parts of our industry, both bad and good. CLS is just one example of how a complex industry initiative can be achieved once the governance issues are resolved.

Fourth, we need a dynamic road map and managed project plan. This was a crucial lesson for us in implementing four large bank mergers. The IT and operations executives from our respective firms, who are not here today, will be setting their 2007 budgets in three months. Do they have sufficient direction from the top on how to allocate resources?

And finally, we need a partnership approach with all stakeholders – this is not a journey we can make on our own. We must recognize where we need their help or where they need ours. Our corporate clients are already pointing out to us what they are keen to buy. If we ignore that input, we are leaving the future to the competition, and I am not referring to other banks.

We recognize that the devil is often in the detail.

But mastering the details is what the industry here in Europe can achieve – we have demonstrated this before when the euro was introduced and when euro notes and coins came into existence. The payments industry came together as the Heathrow Group to resolve practical issues. But who is going to steer this convergence?

Which brings one ultimately to the issue of governance.

Achieving the required amount of change – and properly balancing what is required in the cooperative space versus the competitive dimension – requires a change in thinking about how the European payments industry is governed.

Our collective experience with market infrastructures like SWIFT or CLS provides important lessons.

It may not require a Napoleon or the Roman legions, but it does require a sense of urgency and a sense of the common ground. And that sense of urgency and common accord should not have to wait until a Napoleon – perhaps a non-bank competitor in our case – sweeps across Europe with an alternative vision that finally unites us in defense.

For JPMorgan, it is as important to talk about governance – before the schemes and the new infrastructures become a reality – as it is to talk about what they will look like.

In fact, our common experience with CLS suggests that little can be effectively achieved in Europe without an agreement on governance first. Some combination of the elements and lessons from the recent history of the payments business will be necessary.

First – there must be an industry body sufficiently representative, well-governed, and most importantly, adequately funded and staffed, to decide the priorities and the new common ground – whether it be rules, interoperability, or the dimensions of the cooperative space. This could be built on the work already done by the EPC, but we all recognize that some change is necessary to make that group more effective.

Second, the larger banks must find a way to come together – to drive the overall industry vision – just as Europe's political leaders have come together in the past to tackle a common threat. Like it or not, it is typically the larger institutions that bear both the greater cost of implementing change as well as the greater regulatory pressure to achieve change. Frankly, our experience with CLS demonstrated that the larger banks cannot be complacent in looking for common ground if we are to avoid having a regulatory 'solution' imposed on us.

We came together at the launch of the euro, and in the days immediately following, to forge a new common operating model. Such was the Heathrow Group: a single forum, where banks took the initiative, and where decisions were taken.

Why not now? In this historic city? At this critical time? The members of the EBA have demonstrated a commitment to delivering workable solutions, but I'm not sure our vision has been broad enough. And if not now and in this place, then where? We risk losing time, money, and clients, if we do not begin to move faster. And if not the EBA, then what? Nature abhors a vacuum, and European governments and regulators already believe they know where that vacuum appears to be.

And if we choose to act more decisively now, and in this city, we believe it is vital to focus on governance first. My friends, none of this will be easy. It will mean compromise, collaborative effort, and taking many decisions and risks without a clear business case.

The experience of this industry, certainly at JPMorgan, suggests that embracing inevitable change as quickly as possible, is the only way to survive – and surprisingly, often leads to exciting new opportunities. And as Goethe wisely reminds us, we must strive against complacency and the path of least resistance – in his words:

The heights charm us, but the steps do not; With the mountain in our view we love to walk the plains.

The time has come to pick the mountain, and climb it together.
Thank you