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EBF contribution to the ongoing debate on a Central Bank Digital Euro

#3: How does a digital euro fit the payments landscape?

1. The EU payments market and the digital euro

1.1 Current payments market and challenges

The EU has an efficient, secure and well-functioning electronic payments market, where substantial efforts have been deployed to create a Single Market for payments. Today, for their retail payments, European consumers and businesses have access to a variety of payment methods and instruments to cover their different payment needs, including SEPA credit transfers and direct debits, instant SEPA credit transfers, debit and credit cards, and cash. They can initiate payments through a multitude of solutions and channels, for instance mobile banking, wallets, mobile payments, contactless payments, through Payment Initiation Service Providers and more. This reflects an active, competitive and continuously developing field, with new business models and new entrants becoming part of the ecosystem. In short, Europeans have ample choice and availability of payment methods for their purchases, be it in-shop, online or person-to-person.

Since the launch of the (physical) euro, alongside banknotes and coins, the European banking and payments industry, with the support of the authorities, has developed the Single Euro Payments Area (SEPA) to harmonise euro-denominated credit transfers and direct debits. Most recently, significant efforts have been deployed in the development of instant SEPA credit transfers, including supporting features such as Request to Pay (RTP[1]). In addition, Europe has a comprehensive and harmonised legal framework for payments that supports innovation, competition and a high level of consumer protection.

The European payments industry provides high-quality and cost-effective payment services and access to payment accounts to their clients. Banks protect their clients' payment accounts and payment transaction data in compliance with GDPR and (cyber)security requirements at all times, and their deposits in compliance with legal provisions on deposit guarantee. Banks have a long tradition in being excellent data custodians, trusted by their clients.

[1] A messaging functionality that allows a payee to request the initiation of a payment from a payer in a wide range of physical or online use cases that could add value especially to instant payments.

European Banking Federation aisbl

Brussels / Avenue des Arts 56, 1000 Brussels, Belgium / +32 2 508 3711 / info@ebf.eu

Frankfurt / Weißfrauenstraße 12-16, 60311 Frankfurt, Germany

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Payment transaction data is kept private and shared only in case of a legal obligation or when explicitly authorised by the customer[2]. Equally, payment services and systems provided by the private sector have proven very resilient also in crisis conditions (e.g. successfully accommodating the recent pandemic-induced rise in digital and contactless payments).

Having said this, we recognise the challenges that exist and lie ahead for Europe when it comes to payments: Europe does not currently have a 'homegrown' pan-European payment solution to be used at Point-of-Sale, e-commerce and P2P payments as this space is dominated by strong international actors. Furthermore, the role of non-European market participants and BigTechs will most likely increase further in payment-related activities and adjacent areas, such as open finance. In addition, global stablecoins and even foreign Central Bank Digital Currencies (CBDCs) could gain importance. All this in a context where economies and customer preferences constantly evolve and move towards increasing digitalisation, with the consequential development in digital payment needs.

European banks are rising up to this challenge and the European Payments Initiative (EPI) is promising to change the current dominance of non-European market actors and provide a substantial European alternative that satisfies new consumer demands, reinforces the Single Market and contributes to the strategic autonomy of the EU in the digital world.

An additional major upcoming project promoting instant payments that was initiated by the Eurosystem is the consolidation of TARGET2 and T2S, in terms of both technical and functional aspects. The new infrastructure will provide the EU with a new real-time gross settlement (RTGS) system improving liquidity management across all TARGET Services including TIPS, the spearhead of EU Instant Payments initiative. This change will serve as an important factor to support the next generation of payments services which continuously change due to evolution of technological, regulatory and consumer experience factors. The new infrastructure will rely on ISO 20022 messaging standard (same for T2S and TIPS). It is designed to support central liquidity management with tools to allow participants to manage central bank liquidity across TARGET Services in a harmonized approach (linked to dedicated cash accounts for the new RTGS system, T2S and TIPS), offering a new experience in automation of liquidity management.

These public and private efforts require significant investments that should not be underestimated or duplicated, as stated by the ECB in the digital euro consultation paper issued in October 2020. An enabling regulatory and policy environment remains essential as for any investment, and particularly of this magnitude. An enabling regulatory and policy environment remains essential as for any investment, and particularly of this magnitude.

We also understand that in conducting the digital euro investigation phase the Eurosystem will take in full consideration that the 2-tiered monetary system, and especially banks, are essential for the flexible liquidity supply of the European economy (banks were a guarantor for fast adoption of the credit supply notably during the pandemic crisis), as well as that a digital euro could jeopardise this 2-tiered monetary

[2] Such as access to payment account data by licensed PSD2 Account Information Service Providers and Payment Initiation Service Providers, when the client has given consent to such providers.

system by disintermediating banks, which would in turn threaten the balance of the financial system and the stability of the European economy[3].

1.2 Impact of a digital euro to the EU payments market

The impact of a digital euro on the payments market would depend on its primary focus i.e., which use cases it will cover and its resulting design features. The EBF understands that these will be defined on the basis of the ongoing investigation phase, during which close dialogue with the market and relevant stakeholders will be conducted.

We identify the following main points for consideration as early as possible in the investigation phase:

- A comprehensive assessment should be carried out by the ECB and the industry regarding the investment required by European banks to enable a digital euro ecosystem as intermediaries and the use cases and business models around digital euro, also considering possible overlap and displacement of current payments systems in terms of usability and revenues. Facing a variety of use cases a digital euro could – or could not – serve, the debate does not yet allow for an understanding of investments required which however is a key determining factor for the successful creation and long-term operation of a digital euro solution. Digital euro investments would come on top of the ongoing investments for the developments of new payment features such as instant payments and RTP, and in the case of some banks, EPI. If the implementation costs of a digital euro for the private sector are not kept reasonable, with a return on investment, and the business models are not clarified with sufficient time to allow for sensible business decisions under long-term strategies, this will impede European banks' ability to innovate and, for instance, invest in developing pan-European payment solutions. In respect of use cases, a close cooperation between the Eurosystem and the banking sector could help identifying the most appealing ones. The use cases of a digital euro should be developed in the light of the existing offer of means of payments and ongoing developments by commercial banks.

- Payment solutions should continue to be developed by the industry to ensure that the digital euro is adequately embedded in the payment product offer that is already existing in the market. If paying with the digital euro is not sufficiently differentiated from the payment solutions already offered, it could either end up not being used (with the investments made both by banks and the ECB made in vain) or competing with commercial banks' payments offering, potentially crowding out other private payment solutions. A decreasing payments system diversity could lead to a hampered potential for innovation and a diminished resilience of the payment system. Clear distinguishing functionalities for the digital euro are needed, aiming for a demand that is not currently covered by existing or upcoming payments initiatives by the financial industry.

[3] As argued in EBF paper "#2: Impact on bank funding", https://www.ebf.eu/wp-content/uploads/2021/06/EBF_045159-EBF-Considerations-on-Digital-Euro-2-Impact-on-Bank-Funding.pdf

In addition, fair competition being fundamental also in the digital sphere: it is paramount that measures taken to promote the adoption of a digital euro are carefully designed so as to boost also the acceptance of alternative private electronic payment solutions by merchants, ensuring the availability of multiple options for consumers.

- Appropriate access to data for the involved intermediating bank is paramount to support the provision of secure and convenient financial services that respond to customer needs. In the context of discussions on open finance, data from digital euro transactions should not be precluded from being used to deliver value to the digital euro users, with adequate safeguards, as this would undermine the development of open finance and data economy in Europe.

  Data strengthens risk management, improves cybersecurity and consumer protection, and unlocks new opportunities for innovation and new services. The open finance concept reflects that customers should be in control of their data, and that valuable opportunities for data-driven innovation will come from reusing and combining data across services, sectors and different market participants, including the public sector. It is important to emphasize that access to data must always be done on behalf of and authorised by the customer or done on the basis of legitimate interest, in line with relevant privacy legislation, notably the GDPR. In turn, the data of transactions made in digital euro should be accessible to the intermediating entities. Based on user decisions, and with emphasis to the established banking secrecy, European banks can put the data to important use for the customers: payments fraud prevention mechanisms, money laundry control enhancements, product offering, credit assessment and more.

  Banks should not be "de facto" disintermediated by a reduced role as front-end interface providers only or by a perception as limited "agents" responsible for AML/KYC checks without functionality in payment transactions, and service offering. It should also be considered that even only KYC/AML checking could not be provided without banks incurring costs for it and therefore necessitating the possibility of offering remunerated services to clients.

1.3 Considerations for design

Given the above, we consider the following aspects essential for the design of a digital euro:

- **Consistency with EC and Eurosystem's Retail Payments Strategies:** both the ECB and the Commission have put a high priority on the development of 'homegrown' pan-European payment solutions, benefiting from instant payments to increase the independence of the European payments market.

If a digital euro is envisaged as being primarily a payment ***currency****,* it will not and cannot address entirely the challenges posed by the dominance of incumbent global players, which are payment ***methods***, the main added value of which is the customer experience*.* It cannot be expected that European citizens who do their payments through these *methods*, consider the liability of the underlying currency (central bank vs commercial bank) as a factor of choice for their selection, at least in normal circumstances[4] since the EU deposit guarantee scheme protects the vast majority of consumer deposits. In turn, modifications of the payment object/currency do not address the changes of payment methods and competition by non-financial market players. It is only by competing on **the end-user experience** (i.e. the payment ***methods***), with innovative features and value-added services that Europe can have a chance at achieving the goal of reduced dependence. The ECB has indicated that it sees the digital euro as 'raw material' based on which supervised entities would build their digital euro product offering. The 'raw material' characteristic of a digital euro is relevant from the point of view of maintaining citizens' access to a central bank liability (which in itself may or may not be something that citizens are even aware of), but it will not be a determining factor in the success of a pan-European payment solution. The participation of the private sector - allowing intermediaries to innovate and develop value-added functionalities - is essential to develop a successful payment method.

We consider of the utmost importance that the ECB, together with the European Commission, clarify the overall vision and strategy of a future EU payments landscape, taking into consideration all ongoing innovation and developments in payments, in particular the interaction between instant payments and a digital euro. Given that the banking sector is increasingly adopting instant payments as a priority area in payments policy, this interaction is important and urgent to understand. The widespread adoption of instant payments will require investments not only by Payment Service Providers but also by merchants. A digital euro should neither displace the benefits of instant payments entirely nor multiply the investment required.

- **Cost and business models**. It is essential that banks intermediating digital euro are effectively able to build a sustainable business case and business models for a digital euro. There is always a cost in providing payment services, whether based on commercial bank money or central bank money, even in the form of banknotes and coins. Providers will have to bear costs related to infrastructure, to integration with current systems and to potential duplication of accounting and tracking-tracing due to the never-experimented separation in banking systems between electronic bank money and digital euro, which is never on the balance sheet of the PSP.

[4] However, in crisis circumstances there could be a destabilizing flight from bank deposits to digital euro, as argued in EBF paper "#2: Impact on bank funding", https://www.ebf.eu/wp-content/uploads/2021/06/EBF_045159-EBF-Considerations-on-Digital-Euro-2-Impact-on-Bank-Funding.pdf

Additionally, costs are also entailed for building and running an efficient acceptance network with both payer and payee interfaces. In order to allow for a dynamic and future-proof innovation in payments in the long-term, business models for intermediaries taking their role in offering a digital euro should be possible and left to the interplay of competition. Within the framework of fair competition in the market, the intermediaries need an opportunity to explore themselves business models with respect both to customer needs and operational demands. The current two-year investigation phase should include estimates of costs borne by the intermediating entities for the different scenarios.

Furthermore, it cannot be expected that merchant/corporate acceptance of digital euro can be for free. Nevertheless, this acceptance is important and requires an understanding for onboarding of existing POS terminals via enhanced functionality, aiming for acceptance of all devices and wallets. Payment functionalities which are currently offered as part of value-added payment services (e.g. payment guarantee, chargebacks or dispute resolution in card-based payments) should also be considered as 'advanced' functionalities in a digital euro arrangement (and thus with the possibility of them being monetized). Lastly, some reflection about seignorage, which according to public statements by the ECB is expected to increase with the digital euro, could help in finding the right solution for these crucial issues.

- **Programmability and interoperability:** while it is not strictly needed for a central bank issued retail-purpose digital euro itself to be programmable, programmability of payments will be key in the future payments landscape and part of the value added by market actors. A variety of use cases can be envisaged, including possible changes of underlying economic interactions, such as machine-to-machine transactions and a growing number of Internet-of-Things devices, as well as the streamlining and simplification of processes that could also be achieved in a much more complicated manner without native programmability of money. Therefore, it is important to allow for the native programmability of digital euro payments. This could be a means to achieve the above-mentioned objective of differentiating a digital euro from current electronic payment services. Also, reflection is needed on the interoperability between digital euro and other payment instruments.

- **Use by businesses and corporates:** it is clear that in order to prevent any important displacement of bank deposits to digital euro deposits - with the consequential risks to financial stability and banks' economic functions - a hard cap for digital euro deposits is needed. However, such cap does not provide for a stand-alone solution to address risks and implications of a digital euro for bank funding and financial stability, suffering from recognizable drawbacks[5].

[5] See EBF paper "#2: Impact on bank funding", https://www.ebf.eu/wp-content/uploads/2021/06/EBF_045159-EBF-Considerations-on-Digital-Euro-2-Impact-on-Bank-Funding.pdf

The cap should be set at a level to correspond to an average individual's everyday payments needs, taking also into account in some way the differences of income and costs of living across the Eurozone member states. A digital euro with such a cap would however not make sense for business and corporate use, exceeding immediately the number of received funds in payment transactions from a large number of European citizens. Therefore, we believe that in-depth discussions are required on the general ability of businesses to hold digital euro. The debate of a digital currency needs to reflect that the payment ecosystem does not stop with a direct transaction between a consumer and a merchant. It needs to be carefully determined how businesses would be able to receive digital euros from their customers, and how a procedure could automatically convert them into commercial bank money.

- **Banks' role:**
    - In a two-tier system, where the ECB would issue a digital euro, banks and other regulated entities would distribute the digital euro, and customers would have a direct claim against the ECB. As such a set-up has never been used before for a digital currency, new features such as double accounting of commercial bank and central bank liabilities will need careful consideration, also in view of keeping costs to the industry at minimum.

    - Only regulated PSPs should be able to intermediate the digital euro. This is reflected by the 73% respondents to the ECB public consultation who explicitly stated that only regulated intermediaries should be able to distribute the digital euro. By *intermediation* of digital euro we understand both distribution as well as managing accounts and developing additional functionalities. Thus, the accounts/wallets where digital euros are held should be considered as payment accounts as defined in Article 4(12) of PSD2. Furthermore, intermediaries also acting as settlement agents should meet the requirements for payment system participants in the Settlement Finality Directive. It is essential that on this point the cash distribution model is not replicated, where non-licenced entities (such as independent ATM providers) are also allowed to distribute cash – without the same prudential rules that ensure stability of the system. We also believe that some reflection is needed as to the interlink between the digital euro deposits held by intermediaries and the client's commercial bank deposits.

    - The level of the digital euro cap should be carefully considered[6] to make sure that the digital euro is only used as a means of payment and not as a store of value, with a focus on consumer use cases. This would help to avoid a disintermediation of banks and its detrimental effects on the economy.

[6] See EBF paper "#2: Impact on bank funding", https://www.ebf.eu/wp-content/uploads/2021/06/EBF_045159-EBF-Considerations-on-Digital-Euro-2-Impact-on-Bank-Funding.pdf

This is all the more important knowing that today only about 20 percent of the euro banknotes in circulation are used for payment transactions in the euro area[7] and even with a relatively low cap, the digital euro can easily be used as a store of value rather than a payment instrument. This can be accelerated by differences in income and product/service costs across European Member States. It should also be clarified how the cap would work in practice (e.g. whether it would be an ongoing or time-limited cap).

- **Privacy, anonymity and data usage:** Considering that it is likely that a digital euro would not be (completely) anonymous, there are certain points to look at regarding privacy and data usage. The digital euro should not aim for transaction data being accessible only to the ECB – data privacy should not be understood in the sense that the intermediating bank would not have access to the transaction data. As stated above, customers' payments data is kept secure with banks. The design choices for the digital euro should start from an acknowledgement of banks' vigilant treatment of customers' data and of the privacy and security that the data is subject to. Restricting intermediating banks' access to the data on digital euro transactions would have negative consequences. Banks need to continue to have access to transaction data amongst others for security, operational and fraud prevention reasons. In addition, their relationship model has proven to be more effective and less pro-cyclical than others for the provision of credit to the economy. The knowledge that banks have of their customers – and the resulting relationship – is a key factor of importance.

2. Conclusion

A digital euro would undeniably change the European payments market. At this stage of exploration, it is essential to clarify the long-term overall vision and strategy for the EU payments market, and not consider digital euro in isolation. The main challenges to the current payments market are the dominance of incumbent non-European market participants, the increasing importance of BigTechs in payments and adjacent areas, and the potential impact of global stablecoins and foreign CBDCs. The primary solution to these challenges that the authorities have been calling for is the development of a 'homegrown' pan-European payment method, to which the banking industry responded with initiatives, such as EPI. In any case, beyond and above this initiative, the objective of increased European sovereignty can only be achieved with competitive payment methods offered to the public by European PSPs. One of the main goals of the starting investigation by the ECB should be to define whether a digital euro would support this objective and how in practice it would add value to the EU payments landscape.

[7] ECB Occasional Paper: the paradox of banknotes: understanding the demand for cash beyond transactional use

European Banking Federation aisbl

Brussels / Avenue des Arts 56, 1000 Brussels, Belgium / +32 2 508 3711 / info@ebf.eu

Frankfurt / Weißfrauenstraße 12-16, 60311 Frankfurt, Germany

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The EBF paper series: A digital euro

The EBF is following with keen interest the European Central Bank (ECB) work on a digital euro. The industry shares the objectives of the ECB to support the digitalisation of the European economy and tackle sovereignty concerns that could be brought about by private sector stablecoins or foreign Central Bank Digital Currencies (CBDCs). This is a key topic for the European banking industry as it seeks to respond to the unprecedented speed of transformation in the area of digitalisation of the economy and payments, which has the potential to fundamentally change the current banking system. We therefore wish to constructively contribute to the discussion, so that the ECB and European banks work closely together in finding the best possible solutions to current and future challenges.

This paper is part of a series of contributions that the EBF makes to the ongoing discussion on a Central Bank Digital Euro (CBDE), continuously analysing the various aspects in the debate. Following the first two EBF papers on strategic considerations and impact on bank funding[8], this paper #3 advances the conversation to payments and relationship models.

As mentioned in all EBF papers, a CBDE should benefit European end-users and the economy as a whole, while avoiding any destabilizing effect on the financial system; it should also be very clear how it could go hand in hand with private payment and deposit solutions.

[8] Available for download here: DIGITAL EURO - EBF

For more information contact:

Alexandra Maniati
Director – Innovation & Cybersecurity
a.maniati@ebf.eu

Anni Mykkänen
Senior Policy Adviser – Payments & Innovation
a.mykkanen@ebf.eu

Julian Schmücker
Senior Policy Adviser – Digital Innovation
j.schmucker@ebf.eu

About EBF

The European Banking Federation is the voice of the European banking sector, bringing together national banking associations from across Europe. The federation is committed to a thriving European economy that is underpinned by a stable, secure, and inclusive financial ecosystem, and to a flourishing society where financing is available to fund the dreams of citizens, businesses and innovators everywhere.

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