



# Cross-Border Payment Systems and International Remittances

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# *Introduction*



# *Working Definitions*

- A broad definition would regard a cross-border payment as a transaction that involves individuals, corporations, settlement institutions, central banks or a combination thereof, in at least two different countries.
- Accordingly, three major categories of cross-border payment transactions that fit this definition would be:
  - *Payments that originate in some country and for which the destination (i.e., the final beneficiary) is some other country.*
  - *Payment transactions in which the origin and destination are both in the same country, but which use the payments infrastructure of at least some other country for settlement.*
  - *Cash payments.*

# *Working Definitions*

- Clearly, this list is not exhaustive.
- By shifting the analysis from the various transaction types into the systems through which cross-border payments are processed a narrower definition can be proposed as follows:

*“cross-border payments are transactions that affect the payment systems (including cash) of at least two countries”*

# *Large-value vs. low-value*

- Large-value, cross-border payments are generally (though not necessarily) related to financial market transactions, particularly foreign exchange (Forex).
  - On the other hand, Forex market transactions need not to imply a cross-border payment
- Non large-value cross-border payments more related to:
  - International trade of goods and services
  - Unilateral funds transfers from individuals residing in country X to other(s) in country Y (“international remittances”)
- Given the nature of this Seminar, this presentation will concentrate in low-value or retail cross-border payments

# *Cross-border Retail Payments*



# *Today's Picture*

- Customers expect a set of convenient, cheap, reliable and predictable instruments to cover their most important payments needs:
  - face-to-face-payments, one-off and recurring remote payments, ATM cash withdrawals
- While it can be said that many of these customer requirements are reasonably met in many countries at the domestic level, performance in most areas is poor for cross-border transactions
  - As recent as 2002-2003, the average fee applicable to retail cross-border transfers in the Euro zone was 100 times higher than that applicable to comparable domestic transfers



# *Today's Inefficiency*

- A “natural” explanation
  - with few exceptions (e.g. payment cards), payment infrastructures already in place are only domestic in terms of their scope; this is, they were developed for a monetary zone delimited by national boundaries.
- Additional issues:
  - Payment instruments being used
  - Involvement of a Foreign Exchange Transaction
  - “Different” risks
  - Supply factors (diversity of service providers)
  - Regulation (including customer protection) and Oversight

# Payment Instruments

- All over the world, cash continues to be the most relevant instrument for cross-border payments in terms of *volume* (number of transactions)
- As for cashless transactions, payment cards are the most relevant instrument in terms of *volume*
  - In the EU, cards account for approximately 85 percent of total cashless transactions.
  - In most cases, however, cards are still not used as payment instruments but rather for ATM cash withdrawals
  - Using cards for remote payments?

# *Payment Instruments*

- The relevance of cheques for cross-border payments is clearly decreasing
- With the payment system technology currently available, electronic credit transfers and direct debits appear to be the natural instrument for remote payments
  - Until relatively recently, only available through cumbersome and costly correspondent arrangements
  - Only in recent years, with the spreading of processing and messaging technologies, they are starting to become accessible to the average individual

# *Involvement of a FX transaction*

- Not necessarily the case
  - Cross-border payments in the Euro area, or payments between a dollarized country (e.g. Ecuador) and the US
- In some cases, more than one FX transaction, meaning more intermediaries
- Usually, large exchange rate spreads
- Interestingly, however, at present cross-border transactions between countries that use the same currency are not very different in terms of overall inefficiency (i.e. high cost) from transactions involving two or more currencies

## *“Different” Risks*

- The risks are actually the same than for domestic transactions, although the mix can be quite different
- Potentially increased legal risk
- Increased operational risk due to intensive manual procedures (i.e. lack of interoperability)
- However, fraud and other security and integrity concerns (e.g. AML/KYC) are regarded as the main risks
  - In the case of cards, cross-border fraud is approximately 20 times higher than domestic fraud.

# *Supply Factors*

- Increasing demand for cross-border payment services with enhanced flexibility, speed and geographical outreach
- Banks have not been able to cope with this
  - Banks strong in urban areas, where they have generally well-developed infrastructures and where generally payments involve “bancarized” sectors
- Thus, non-banking (or even non-financial) institutions hold an important market share in the different stages of the value chain
  - Proprietary messaging systems
  - Large distribution networks covering remote locations<sup>14</sup>

# *Regulation and Customer Protection*

- Transparency standards are particularly low for cross-border payments
  - Several implicit charges that are not clearly disclosed to customers (e.g., exchange rate spreads, charges applicable to the receiver)
  - Additionally, even when some information is provided it is difficult to calculate the cost and make comparisons. In other words, it is costly for customers to foster competition through customer research and comparisons
  - Minimum service levels, which, for example, give certainty on the time of accreditation of funds to the beneficiary, are practically non-existent

# *Oversight*



- Still no consensus that retail systems should fall under the direct control of the overseer
- Additional problems in the case of retail cross-border payments:
  - Overseeing non-financial payment services providers
  - Overseeing the full flow of a transaction would necessarily involve two or more national authorities



## *International Remittances*

- **KEY IDEA**: *Remittance services are part of the broader retail payment system both domestic and cross-border*
  - Remittances are cross-border retail payments with particular access requirements (on both the demand and supply sides)

# *Five Elements of a remittance transfer:*

## *CAPTURING*

- The sender can pay the capturing agent using any means of payment that is acceptable to both. This transaction is a standard domestic payment; nothing special about the fact that the service is a remittance.
- Identification of the sender is not technically necessary for the purposes of making the remittance per se, but will usually be necessary in order for the RSP or its agent to comply with AML/CFT regulations. However, the sender does need to provide the capturing agent with sufficient information to identify the receiver. The capturing agent sends this information to the disbursing agent; and the sender passes it to the receiver for the latter to claim the funds.
- The 'location' of the transaction between the sender and the capturing agent ('access point') is usually a physical location such as a local shop, post office, bank branch, fx bureau, etc. New technology makes 'virtual locations' such as the internet or mobile phones increasingly possible. The nature of the location affects the payment possibilities: for virtual locations it is likely to be necessary to use card payments, e-money or credit since physical instruments are not possible.

# *Five Elements of a remittance transfer:*

## *DISBURSEMENT*

- Typically, the disbursing agent will pay the receiver in cash or by crediting a bank account but other means may also be used, as with capturing. The relatively underdeveloped payment infrastructure in some receiving countries may raise particular issues about the possibilities for disbursement.
- The disbursing agent needs to know whom to pay and how much to pay. It may also need other information – for example, the currency in which the payment is to be made or the mode of payment. Sometimes it may be possible for the sender to transfer other optional information.
- Identifying the receiver typically involves a combination of a sufficient level of authorization from the capturing agent (eg some form of secure message identifying the receiver) and evidence from the receiver about their identity (eg suitable ID and perhaps a transaction code). However, if the receiver has an account at the disbursing agent (eg where the agent is a bank), evidence of identity is likely to be the same as for any other transaction (eg to withdraw funds from the account, the receiver might use a payment card and PIN).

# *Five Elements of a remittance transfer:*

## *MESSAGING*

- The information from the capturing agent to disbursing agent will sometimes travel together with the funds – ie passed through the various intermediaries in the settlement process. Typically the case in an open service, where there is no direct relationship between the capturing RSP and its agent, on the one hand, and the disbursing RSP and its agent so there is no easy way for the two to communicate directly. Transferring information with funds can be difficult and time consuming if the different payment instructions in the settlement chain use different message formats (may involve expensive manual intervention).
- In other remittance services, the information will typically be transferred independently of the funds (eg directly from the capturing agent to the disbursing agent, with a copy to the RSP) by any one of a wide variety of means (eg public channels such as the internet, e-mail, fax, phone, mail or courier or proprietary communication channels such as intranets or interbank links). Of course, even if most information is transferred directly, enough information about the transaction must also travel with the funds for ID purposes when paying the specific remittance.

# *Five Elements of a remittance transfer:*

## *SETTLEMENT*

- A remittance is likely to involve a 'settlement chain' – a series of separate payments, each of which may be made differently. From capturing agent through to disbursing agent settlement normally takes place by means of a credit transfer from the payer to the payee's bank, with one of the payments being cross-border (typically by correspondent banking).
- The payments between agents and the RSP may be batched and possibly netted, although the scope for netting may be limited given the largely one way nature of remittance flows.
- Some RSPs may have bank accounts in both sending and receiving countries, in which case the cross-border element can be partially "internalized": the funds from the capturing agent are credited to the RSP's account in the sending country, the funds to the disbursing agent are paid from its account in the receiving country, and the RSP records this fact internally. However, again because of the largely one way nature of remittance flows, the RSP may have to transfer funds from the sending country to top up its account in the receiving country.

# *Five Elements of a remittance transfer:*

## *LIQUIDITY*

- Although settlement is a "chain", the transactions within it do not have to take place in sequence. For example, the disbursing agent may pay the receiver before it has received funds from the disbursing RSP. This is particularly likely with services where the receiver has a choice of where to collect the funds and thus where the RSP will not know which disbursing agent to pay until *after* the funds have been collected.
- To the extent the transactions in the chain do not take place in sequence, some credit risk is created (paying before being paid). There is also a need for liquidity. For example, if the disbursing agent pays the receiver before being paid by the RSP, the agent needs either to have sufficient funds or credit available. Providing liquidity has a cost. The increased speed achieved by providing liquidity is therefore likely to increase the overall price of the service.

# *The Single Euro Payments Area*



## *A look at the SEPA*

- In theory, with the adoption of the Euro domestic payments and payments between the countries of the Euro zone ought to be identical
- Up to 2002, however, this was not the case:
  - High costs when compared to domestic transactions
  - Relatively low STP rates
  - Lack of transparency
  - Poor performance for customers (cost, quality and time)
  - For cards, seamless domestic and cross-border processing, but significant price differences between domestic and cross-border



# *A look at the SEPA*

- The European Commission decided that a drastic political solution was necessary. In December 2001 the European Parliament adopted the “Regulation on cross-border payments in euros”
- Main features:
  - All fees applicable to card and ATM cross-border transactions in euros, up to Euro 12,500, must be identical to those being applied to domestic transactions
  - This same regime would apply to credit transfers starting on July 1, 2003

# *A look at the SEPA*

- To comply with this Regulation, the European Payments Council approved two key market conventions:
- The CREDEURO Convention
  - Establishes a basic bank-to-bank pan-European credit transfer that allows banks to give guarantees to their customers as regards information requirements, execution time and remittance information transmitted
- The Interbank Charging Principles Convention
  - A standard procedure for achieving end-to-end certainty in charging methods, and allowing for the instructed amount to be credit to the beneficiary in full<sub>26</sub>