

SEPA Implementation and Migration in Austria Status of preparation and plans as per December 2006

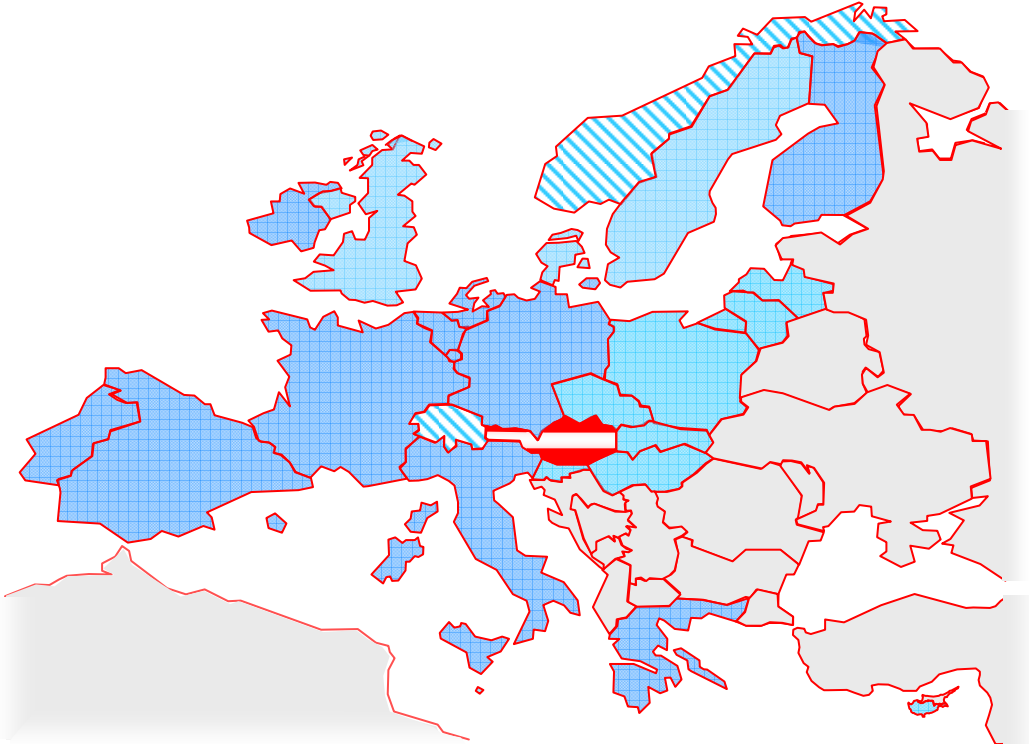


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(A) Summary

The implementation of SEPA is the logical consequence of the introduction of the common currency, the €. Through the SEPA activities the non-cash payment transactions will also be harmonized throughout Europe and this will create an encompassing domestic payments market and infrastructure throughout the Euro Zone. This will also affect those countries not yet having joined the common currency.

The European banks are trying to achieve this goal by "self regulation". However they depend on the help by legal harmonisation at the EU and national level. Rules for new SEPA wide payment instruments have been elaborated and have passed the decision making bodies of EPC. Frameworks for cards business and cash services have been agreed and published. Therefore the basic direction is already defined by EPC. Nevertheless complementary functions and agreements are still to be added.

The national banking communities have been asked to deliver a national plan for migrating their domestic payment systems to the new SEPA instruments and framework. The following pages outline the plans of the Austrian community, and the measures either already triggered or envisaged.

First of all, it must be stated that the vast majority of Austrian credit institutions support the vision of SEPA notwithstanding the implementation cost and foreseeable impacts on processing costs during the migration phase, potential revenue loss and stronger international competition.

For the national coordination of SEPA preparation, in spring 2005 a new committee was founded in Austria, the APC (Austrian Payments Council). It comprises the National Central Bank (OeNB), all major commercial and sector banks in Austria, the Austrian Bankers' Association and the Banking department of the Austrian Federal Economic Chamber. As a secretarial and infra-structural platform, STUZZA GmbH¹ is used.

The current national plans and activities clearly distinguish between two phases:

- (1) interface the SEPA payment instruments with the national payment system and convey common rules for using these instruments be it cross border or domestically.

¹ The STUZZA (Studiengesellschaft für Zusammenarbeit im Zahlungsverkehr) GesmbH is a company owned by the Central Bank and the major commercial banks of Austria. It was founded in 1991 with the goal to speed up domestic standardisation and cooperative interbank projects in order to reduce payment processing cost. Many of the currently used techniques in the Austrian payment system, e.g. use of EDIFACT as national financial messages standard, image transfer for paper-based payment orders and cheques, national standard for electronic banking and CT-based e-payments in Internet are results of the cooperation through STUZZA. Being already available, STUZZA has also been used to coordinate the necessary steps for Euro conversion both book-money and cash and has now been charged with the task of coordinating AT bank community activities for SEPA introduction and conversion.

(2) migrate, i.e. replace the current national payment services by the SEPA instruments.

While (1) has a clear deadline, i.e. at the beginning of 2008 and is being taken care of already for some time, activities concerning (2) must be seen in the context of how the SEPA instruments will be accepted by customers (not only those of Austrian banks) and how these instruments will be duly supported in other countries. In the end, no matter how fiercely promoted SEPA is, the market will decide. Therefore final decisions, e.g. like when to replace national service instruments, cannot be made right now, as many prerequisites are out of the influence and reach of the Austrian banking community. Nevertheless basic design of the migration is a part of the current activities and talks with major stakeholders have been started.

For goal (1) a commitment can already be given now, i.e. that all Austrian banks will aim at being reachable for the SEPA payment instruments by the start of 2008 and many of them (at least all those having high payment transaction volumes and the right customer base) will offer these instruments to their customers. However all these intentions and plans can only take into consideration rules and technical standards which have been published by September 2006. Still ongoing amendments and future changes will either not be considered unless they fit into the existing concept and can easily be supported by our conceptual departure point².

For goal (2), concepts for existing CT and DD³ services are maturing. From 2008 on there will be legacy and SEPA instruments to be serviced in parallel. For cost reasons no bank wants to maintain such a state forever. Sooner or later (at a point in the future not yet defined) the current domestic instruments will have to be replaced by SEPA alternatives or be phased out, even if some national habit and pride are attached to them. This also applies to the UN/EDIFACT data standard which is in use as national standard for payment messages.

Cash services have already been outsourced and centralised during the euro-conversion. Therefore, there is no immediate need for further action within the SEPA context.

For cards services there is no proprietary national scheme in place. The vast majority of domestic transactions (credit and debit) run under the international brands Mastercard and Visa. EMV conversion is ongoing with cards roll out practically completed and terminal conversion (both ATMs and POS) in time to achieve full SEPA compliance by 2010.

The separation of the functions "issuer", "acquirer" and "processor" has basically been resolved by selling the bank owned major cards processing company "APSS" to FDI.

Public authorities are alerted of the incumbent changes. They will be early users of the new SEPA payment instruments and will contribute to create critical mass.

² In other words, the Austrian Banks welcome last minute changes, if these help the implementation (e.g. error correction, further clarification), but cannot respond anymore to functional enhancements. The latter topic will be referred to later under "migration considerations".

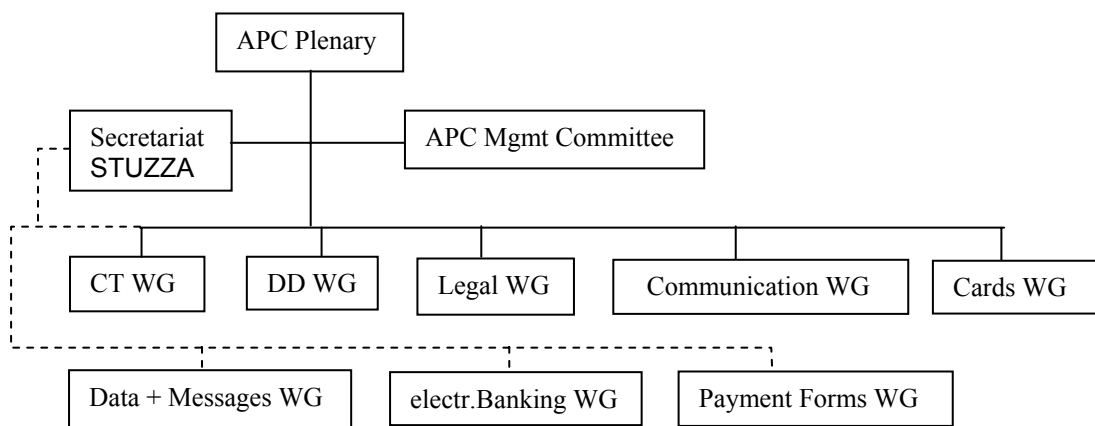
³ CT = Credit Transfer, DD = Direct Debit

(B) The common activities of the AT banking community.

A STUZZA working group for "Intra-EU payments" dealing with all aspects of these payments has been active since January 2002.

In spring 2005 a new committee, the APC (Austrian Payments Council), was founded in Austria in order to attribute due importance and allocate the needed priority to the SEPA process. The APC comprises the Austrian Central Bank (OeNB), all major commercial and sector banks in Austria, the Austrian Bankers' Association and the Banking department of the Austrian Federal Economic Chamber. As an infra-structural platform STUZZA GmbH is still used, their managing directors acting as APC general secretaries.

The decision making body of APC is the plenary to which the working groups "CT", "DD", "Legal", "Cash" and "Communication" report. These WGs interact with the other STUZZA working groups, e.g. "electronic banking", "Data and Messages" and "Payment Forms". The plenary and the management committee are chaired by the Austrian central bank..



While the decision when to offer SEPA Payment Instruments to their customers must be left to the responsibility of each individual bank, the 100% reachability for SEPA Payment Instruments is a common goal and has been declared as such by the Austrian Banking community. Therefore, all measures to achieve this goal are understood as "common" activities and are controlled by APC.

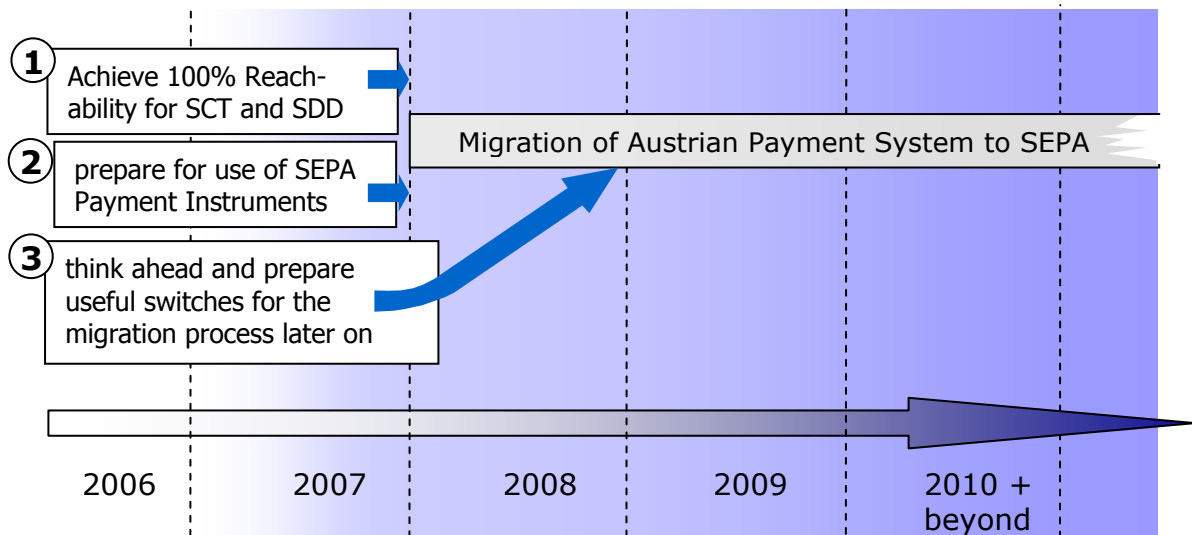
Other common activities are the creation of common basic prerequisites for the active use of the SEPA Payment Instruments in Austria, e.g. introduction of Creditor-IDs, template agreements between Creditor and Creditor-Bank for SDD, and so on.

Although not a dictate of the moment, general migration issues are also part of the common activities.

So far the focus of preparation for SEPA was on common understanding of the SEPA rules, on procedural and technical specifications and on the interbank-contractual area. These preparatory activities certainly will stretch into the first quarter of 2007 but then the focus will move to implementation, test coordination, progress monitoring and to communication and promotion activities.

Following from the above, the current work is split into three main tasks:

- (1) to ensure reachability for the new SEPA Payment Instruments (SCT, SDD) of all Austrian banks by 2008.
- (2) to prepare for the use of the SEPA Payment Instruments by Austrian banks, for both, Intra-Europe cross border and within Austria.
- (3) to set the useful switches for the migration process later on.



For both (1) and (2)

the work is characterized by high time pressure due to the late availability of the international rules and technical standards and the PSD still pending. The Austrian banks are trying to achieve the goals with a minimum of overall community costs. The effort is not equally distributed. Until 2008 some banks (mainly the direct participants⁴ but not necessarily limited to them) will have to do more than the others in order to make the common approach a complete success for the whole community. Their contribution to the community success is voluntary. By doing so they can gain an edge in the market.

For (3)

the intention is to combine migration with minimizing processing cost in the future where possible. Maybe not all existing instruments will have to be ported into SEPA. Some of the legacy instruments could be phased out soon, if the market will allow it. But phasing out or replacing instruments will have to be community decisions, otherwise one will never get rid of obsolete and costly procedures.

⁴ see next chapter...

(C) The approach to ensure nationwide reachability from 2008.

Given the late finalization and publication of the rules and technical standards, it cannot be expected that all Austrian banks will support the new SEPA xml ISO20022 standard by the start of 2008.

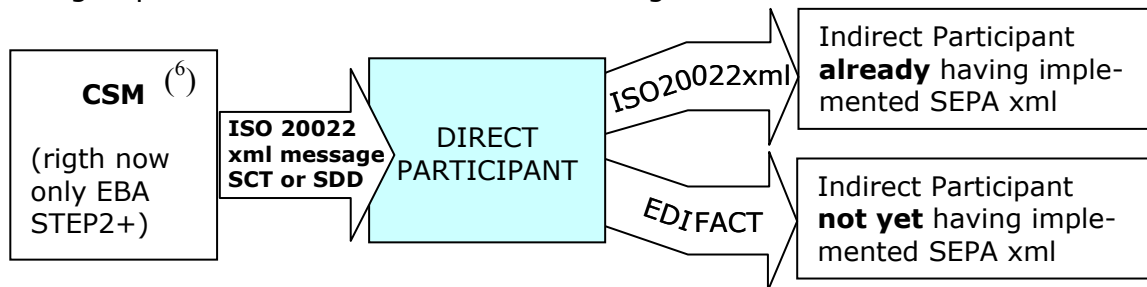
But the Austrian banking community intends to be reachable for the SEPA payment instruments SCT and SDD right from the start of 2008. In order to achieve this goal, the banking community is taking advantage of the following favourable circumstances.

- the international EDIFACT standard used as national data standard for payment messages
- the existence of a national Direct Debit scheme which – in terms of rights and obligations – can be mapped to the SEPA Direct Debit Scheme, CMF model.

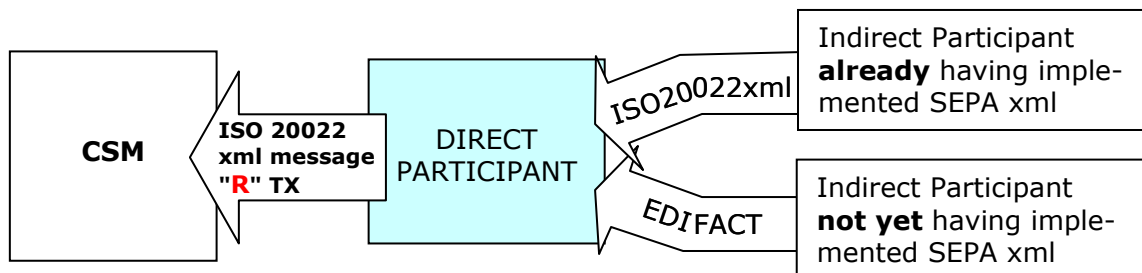
Since 1999 the Austrian banks have used UN/EDIFACT as a standard for both Customer to Bank and Bank to Bank. "R" transactions are also supported. The transition period (until the previous legacy national standard was phased out) lasted until the end of 2001. This was a nationwide investment just a few years ago⁵.

The financial EDIFACT message standard is wider than the ISO20022 xml standard. Hence it is relatively easy to map the SEPA and ISO20022 data to the national format without loss of information.

Therefore, one of the first measures is to provide conversion services by the direct participants of SEPA compliant CSMs to those indirect participants not yet having implemented SEPA native xml messages.



This conversion process also supports conversion for "R"-transactions.



⁵ The customers also had to migrate from the old standard to EDIFACT, i.e. they had to modify their ERP software at their own cost. In this context, an early and complete conversion to the new SEPA ISO standard has to be considered carefully. Sufficient transition periods will have to be provided for the customers.

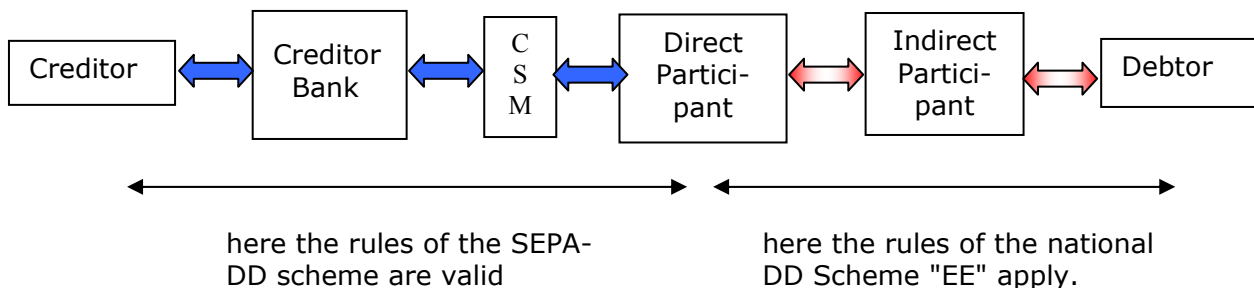
⁶ CSM = **C**learing and **S**ettlement **M**echanism for SEPA transactions.

This conversion service by the direct participants covers incoming transactions and provides technical reachability.

This technical reachability will be sufficient for SEPA Credit Transfer as no obligations going beyond the well-respected national CT-guidelines result from the SEPA CT rulebook for the scheme-participants⁷.

For SEPA Direct Debit (=SDD) more than technical reachability is needed. Today there are two national Direct Debit schemes in Austria, one is a CMF⁸ model, the older one a DMF⁹ model. In the following, the national CMF scheme will be referred to as "EE"¹⁰. In terms of core obligations and core rights of the involved parties, the EE corresponds to the SDD in its current version (2.2).

In order to achieve nationwide reachability for SDD, the national interbank agreement for EE will be modified¹¹ in order to allow SDD debits at the TX-receiving side (i.e. debtors bank). In case the indirect participant has not yet implemented the full range of the SDD scheme, the direct participants receiving a SDD transaction will be able to forward this transaction under the terms of the EE interbank agreement. In such case, we will have the following situation:



Thus, by passing on the transaction to an indirect participant not yet prepared for SDD, apart from a data format conversion also a procedural conversion takes place, without compromising the rights of the involved parties.

This procedural conversion is possible because the basic rights and obligations of the involved parties of both schemes correspond. Furthermore the current terms (periods) for EE are shorter than or equal to those for SDD. Deadlines for presentation and returns are both shorter in EE than in SDD. The right for refunds of the debtor is not restricted and the debtor bank can expect that returns, rejects and refunds will be duly honoured by the creditor bank. Thus, the debtor banks respecting the deadlines of EE can easily cope with the SDD rules. In addition the debtor bank is not obliged to check mandate data for each transaction, neither in EE nor within SDD.

On the other hand, this procedural "assimilation" of SDD into EE at the debtors' bank side does not mean that banks servicing the EE can actively trigger SDD transactions in the role of a creditor bank. For this purpose, they will have to

⁷ Possible limitations of credit transfer times will have to be respected according to PSD independently of the SEPA CT Rulebook.

⁸ Creditor driven Mandate Flow

⁹ Debtor driven Mandate Flow

¹⁰ Einzugsermächtigung

¹¹ This modification so far has been laid out but no yet agreed by all banks.



implement the scheme completely and bind their creditors to the rules of SDD. Also, the debtor banks accepting SDD transactions converted to EE cannot provide SDD specific customer services going beyond those of EE (e.g. checking the mandate data¹²).

Notwithstanding these limitations, this intermediate approach, together with the necessary data format conversion (see above), should be sufficient to achieve reachability for SDD. Opening the whole country to SDD at the debtors' side serves the goal of obtaining critical mass for SEPA DD transactions and therefore does not impede but rather assist migration.

The Austrian Central Bank (OeNB) will also offer the above described conversion services for domestic transactions from the start of 2008 within the functional frame of STEP-AT, i.e. a newly implemented clearing and settlement service, complementary to its access to EBA STEP2. Other banks, serving today as domestic clearing banks, are free to follow their example. Therefore, the approach described above will not be limited to incoming SEPA transactions from abroad but will also serve the growth of domestic SEPA compliant transactions.

¹² in the current EE mandate related data are not transmitted

(D) The support and promotion of SEPA compliant transactions by the Austrian banks.

The active offer of SCT and SDD in its native form to their customers must be left up to the business initiative of each individual bank. The Banking Community (i.e. the APC) can only provide common measures and common instrumental prerequisites. Nevertheless, it can be expected that the majority of Austrian banks will be early implementers of the SEPA payment instruments and will take an active part in the migration process.

Use of BIC+IBAN instead of account-number+national bank-code¹³:

The Austrian banks and their customers gave a good example in 2003 adopting BIC+IBAN for cross border credit transfer transactions fast. The Austrian transactions accounted for almost 20% in EBA/STEP2 while the total Austrian transaction share within Euroland was just a tenth of that percentage. This was due to the fact that most of the transactions qualified for submission through STEP2.

IBANs can already be used instead of account number and national Bank Codes in Austria, if customers deliver their domestic payment orders as electronic data. But data-capture masks in many electronic and/or Internet banking applications have not yet been aligned nor have the domestic paper payment forms.

This will be covered by APC activities which have already started.

It should be mentioned that the Austrian banking community strongly supports the view that the BIC is only a bank-internal routing information and that the IBAN should be all the customer has to supply in the payment order. Therefore, they favour the IBAN-to-BIC database endeavours of EPC/OITS.

By use of an interbank agreement the Austrian banks intend to allow SEPA payments without BIC (IBAN only) if both ordering and receiving banks are within Austria.

Payment Forms

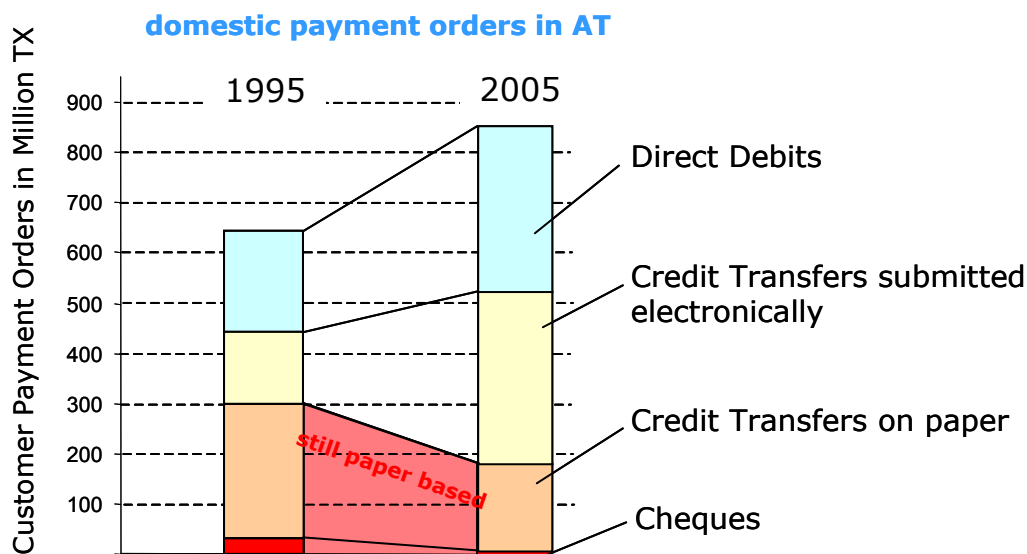
The Austrian banks – as many other European banks – do not favour the idea of a standardized European paper-based order form. The experiences with the ECBS standard " IPI "were traumatic. Apart from the language problems which do not facilitate a common layout, many countries have different data capture technologies in place. Any European standard would imply huge investments in an area all banks would like to phase out. Today the cross border payment orders stem mainly from Corporates and SMEs. The consumer part is negligible. Most of these orders arrive in electronic form. Thus the paper forms problem is

¹³ The national bank-code in Austria (and also in Germany) is called the BLZ (=BankLeitZahl)

rather domestic and should best be resolved at the national level addressing local needs.

Globally, all banks try to reduce the percentage of paper based payment orders in order to reduce processing cost. The Austrian banking community¹⁴ has been fighting the volume of paper orders for years with fair success.

The graphic below shows that within ten years the volume of paper based instruments in Austria has been reduced from roughly a half (46%) of the total volume to roughly a fifth (21%).



Despite the fast evolution of technology and the availability of internet access in most households, changing customer habits is a slow and cumbersome process. Therefore, a "European Paper Standard" would be the wrong signal. It would only undermine the endeavours of the banking industry.

Nevertheless the Austrian banks will introduce a new payment form which can be used for SEPA payments, both nationally and cross border by the start of 2008. It will also be usable as payment instruction which is printed by the creditor and sent together with or without an invoice to the debtor (These forms account today for roughly 85% of the paper volume finding its way to the banks' counters). In the medium to long term, the new form is meant to replace all other existing national payment forms.

Design¹⁵ of the new form has progressed well during the last months, detailed scrutiny from scanning experts' viewpoint and quality tests are still ongoing. Final decisions will be made towards the end of the 1st quarter of 2007.

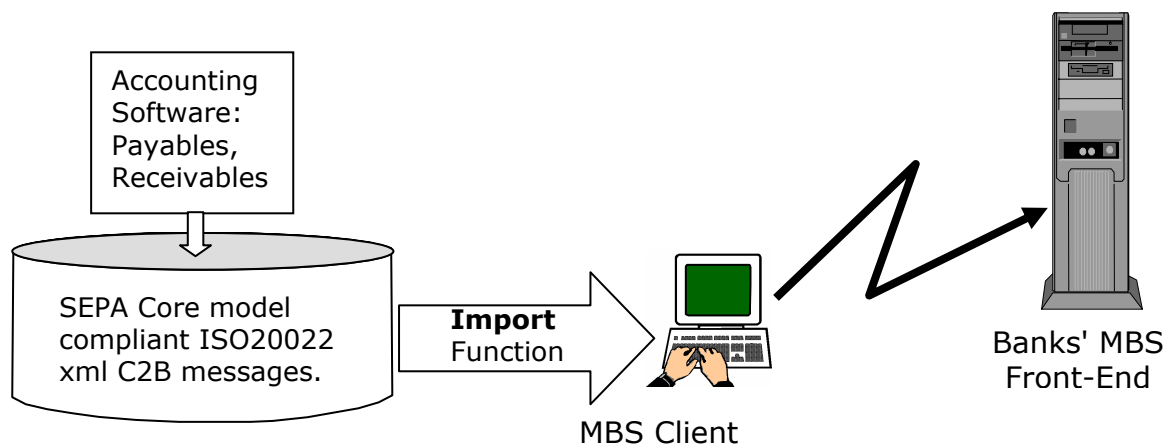
¹⁴ Renowned for their high paper percentage because postal figures were always included in the statistics while in other countries they were not

¹⁵ in loose cooperation with the German colleagues.

Electronic Banking

In 1996 STUZZA introduced a national standard for electronic banking - MBS¹⁶ - addressing primarily the needs of commercial customers. Since then, this standard has been continuously upgraded in terms of technology and functionality. The software used today is the version 4 of the standard. Most of the Austrian banks support this standard and offer MBS compliant products to their customers¹⁷.

A future version of MBS (to be rolled out in early 2008) is planned to provide upload and import facilities for SEPA ISO20022 xml messages generated by accounting software applications used by commercial customers.



This additional feature of an electronic banking instrument used nation-wide will ease the customer migration to SEPA payments.

Promotion

A common SEPA information campaign (independently of what individual banks do) is planned for 2007. The necessary though modest resources for STUZZA have been granted by the shareholders in the budget for next year. The slogans and lay-outs have yet to be agreed.

¹⁶ = **M**ulti**B**ank**S**tandard

¹⁷ As a result the customer can communicate with almost all banks through the same technical interface.

(E) Public Authorities

The SEPA preparation is part of an encompassing project whereby the payment applications of all ministries (departments) are concentrated in the Federal IT Centre managed by the ministry of Finance. In this project the SEPA specific updates of the various databases (e.g. replacing account numbers by IBAN) will be combined with a general quality check of the data.



Concurrently the interfaces to the servicing bank (Bawag PSK) will be refurbished as this bank has recently installed a new core banking software system.

Step by step all payment applications will be converted to SEPA, such as payroll, pensions for retired officials, pensions for disabled people, unemployment benefits, direct family allowances, alimony advance payments, direct debits for land registry and company register submissions, budgetary and housekeeping expenditures of the federal administration and university semester fees.

The list above is not exhaustive.

Roughly 2 % of the payment transactions are cross border payments, mainly for diplomats, foreign assignments and retired officials now resident abroad. The rest are domestic.

The first federal payment applications to run under the "SEPA flag" are scheduled for early 2008.

For some applications, the SEPA conversion is not feasible within the SEPA core model, e.g. tax payments where the transferred amount is split into several tax types and tax periods. To transmit this information within the payment transaction in a standardized and STP enabling way, the structured remittance information of EDIFACT is used in Austria today. This structure is not supported by the ISO20022 messages. For such services, other solutions will have to be found or an AOS¹⁸ will have to be defined and implemented.

Thus, the federal administration will be an early user of the SEPA payment instruments and will contribute considerably to create critical mass.

Other public areas like regional administration, municipalities and social security have yet to be won for the SEPA future.

¹⁸ AOS = Additional Optional Services, which are enhancement possibilities on top of the SEPA core model.

(F) Migration Considerations

Due to the reasons outlined underneath the Austrian banking community has not yet defined a replacement date for existing instruments (those being eligible for replacement by SEPA instruments). From start of 2008 for a yet undefined period they will support both, SEPA and legacy, in parallel.

The parallel support of different standards for practically the same service adds to cost and cannot be borne in the long run. Therefore, there is strong interest in finalizing the migration as soon as possible.

The following outlines the obstacles migration will have to overcome.

The banks can implement the SEPA payment instruments and offer them, but in order to make SEPA happen, the customers must use these instruments instead of the national instruments they use today.

The SEPA instruments ought to provide some incentive or advantage for the customer, such as

- they are cheaper than the existing alternatives or
- they are easier to use than existing instruments or
- they offer functions needed by the customer, not available in the existing products,

otherwise he/she will not move voluntarily and a critical mass will not be achieved. From this viewpoint, the Austrian starting conditions are not favourable.

- The Austrian domestic payment services market is at the bottom end of the European scale for both cost and prices. The banks' profits from payment services vary from slightly negative to just above zero¹⁹. Processing SEPA compliant transactions will not cost less than current transaction processing. For these economic reasons it will not be possible to noticeably differentiate the SEPA instruments from the legacy products in terms of pricing²⁰.
- For credit transfers, the SEPA scheme does not bring about anything which makes its use easier for customers. For direct debits, it is even the contrary, i.e. the existing national direct debit scheme is less cumbersome for the creditor (shorter time cycles, no mandate data capture) and yet guarantees the same security for the debtor (refunds).
- Additional functionality is not provided in the SEPA model. Using full UN/EDIFACT as a national standard, the Austrian banks currently provide the pass through of almost unrestricted remittance information, i.e. > 900 characters for text and practically no limit for structured remittance

¹⁹ Further cost saving potentials are mainly located in the concentration of processing (economy of scale) and are therefore of an infra-structural type. But outsourcing its own processing to another processing center, maybe controlled by a competitor, is a business decision of each individual bank and cannot be "agreed on" by the banking community. EPC itself has pulled out of any regulatory role in this context and the further evolution is left to the market forces. APC is not tackling this topic either.

²⁰ Certainly one could make the legacy products perceptibly more expensive, but in Austria such an approach is unthinkable for political and competition reasons.

information²¹. These features cannot be mapped to the ISO20022 SEPA core model²².

In addition, not all domestic payment services are addressed by the SEPA functional range as today, e.g. "cash by post"²³ or e-payments²⁴. But they cannot be abolished. Unless SEPA instruments broaden their scope these services can only be added to the SEPA instruments by way of community AOS²⁵ or just be left as such.

As already mentioned, cost savings potentials lie mainly in the infra-structural area. For the theoretical use of supra-regional clearing and settlement centres, the Austrian banks face another obstacle. For paper based orders they combine partial data capture with transfer of the image of the original form to the beneficiary's bank²⁶. Image transfer will certainly not be offered by supra-regional clearing facilities. The envisaged mid term strategy is to promote truncation and provide full data capture by the ordering bank for the residual quantity.

The Austrian banks will promote the brand of SEPA instruments. They will add AOS's to cover legacy functionality within the frame of SEPA transactions. As soon as possible the old national standards (even EDIFACT – though being a global standard and having been "forced" on customers only a few years ago) will be substituted by the SEPA ones.

But to be successful, the Austrian banks will need a pan-European momentum, such as SEPA success in the domestic area of neighbour countries, mainly Germany, and political support for the necessary measures.

²¹ Structured remittance information is used mainly for tax payments but also by a minority, 5% of the customers, for other purposes. But this is exactly the minority pushing for similar services at the European level.

²² not even to the full ISO20022 xml standard as today.

²³ important for disabled, old & retired people and those under the poverty threshold. The postman delivers the money. Today such payments can be triggered through any bank in Austria.

²⁴ Austria is one of the few European countries with a successful national credit-transfer based e-payments standard in place – a connection between e-commerce and internet-banking. The Austrian banks would appreciate more importance to be allocated to this topic within EPC.

²⁵ E.g. the before mentioned structured remittance information for tax payments. Other examples are payments to card acceptors (providing full information about charged fees and accepted and rejected transactions) and the "cash by post" payment.

²⁶ which can deliver a reproduction to the beneficiary and/or convert it into data for the beneficiary. The advantage of this approach is that extra processing costs can be charged to the interested party. For non-truncatable cheques image transfer is used too. But this is now more and more also implemented in other countries and is out of the SEPA scope.