

## Bank of England Launches Blueprint on New RTGS Service

***RTGS service to be interoperable with distributed ledger technology, to allow greater access and to provide sophisticated data interface for liquidity management.***

There is an important opportunity for early-stage engagement with the Bank of England (BoE) on the design of the future of the UK's payment systems. This *Client Alert* explains how the BoE's blueprint on its new real-time gross settlement (RTGS) service could impact the UK FinTech market. This development will be particularly relevant to direct users of the BoE's RTGS service, any non-bank payment service provider considering becoming a direct user of the RTGS service in the future, and stakeholders working on distributed ledger technology (DLT) settlement models.

### What is new in the blueprint?

The BoE published its blueprint for a new RTGS service on 9 May 2017, following a public consultation in autumn 2016<sup>1</sup>. The RTGS service, operated by the BoE, is the highest-level inter-bank payment system in the UK, settling around £500 billion worth of payments in sterling central bank money per day. The RTGS service supports settlement in a range of sterling payment schemes, and the service has expanded to capture payments in other systemically important infrastructures. In addition to the RTGS model currently used by the UK's high value payment system, CHAPS, RTGS supports:

- Real-time Delivery versus Payment (DvP) settlement for the CREST system in a series of very high frequency cycles throughout the day
- Pre-funded settlement arrangements for the Bacs and Faster Payments deferred net settlement schemes that eliminate settlement risk
- Net settlement without pre-funding for Visa, LINK, and Cheque and Credit

New technologies that have been developed to satisfy the demand of consumers and financial intermediaries for faster, simpler, cheaper and more flexible ways to make payments create new threats to users of the RTGS system, and to the stability of the system as a whole, as these require stronger protections and more resilient infrastructure. Accordingly, the BoE's blueprint aims to deliver a materially stronger, more secure and flexible sterling settlement system that simultaneously promotes innovation and competition. The renewed RTGS service is designed to respond to five of the BoE's key strategic drivers for change. Namely, the RTGS service must:

- Be capable of responding to the changing structure of the financial system, including the progressive unbundling of financial services provision and the reduced availability of agency payment services to smaller financial institutions
- Recognise end-users' demands for simpler and more resilient pathways for their payments
- Be capable of interfacing with a range of new payment technologies if or when they achieve critical mass
- Remain highly resilient to an increasingly diverse range of threats to continuity of service, such as cyber-attacks and technology-enabled fraud
- Have the capacity to support the future evolution of regulatory and monetary policy tools

Among the proposals, which include moving responsibility for the operation of CHAPS from Chaps Co to the BoE, are three proposals that could have a particular impact on the UK FinTech market. These are described in more detail below.

## **Interoperability with Distributed Ledger Technology**

The BoE's blueprint requires an entirely new technology architecture for the RTGS system. The BoE plans to define what that technology architecture will be during the course of 2017, with the intention that the majority of the new RTGS functionality will be live by the end of 2020. The BoE has confirmed that the new technology architecture will not be based on DLT, in light of the BoE's findings that the technology is not yet sufficiently mature to provide the exceptional robustness required for RTGS.

However, the BoE does clarify that the RTGS system will be built with the flexibility needed to ensure it can interface with DLT as and when DLT is developed in the wider sterling markets. This clarification is a very significant step, opening up the possibility of a DLT-based payment or securities settlement system interoperating with the RTGS service to access central bank money and reduce settlement risk on the DLT system. Settlement in central bank money is a key requirement imposed on payment and settlement systems by the international CPMI-IOSCO Principles for Financial Market Infrastructures. While the BoE blueprint does not provide any detail on the DLT models that will be eligible to interface with the new RTGS service, the blueprint does suggest that the service will be flexible enough to incorporate a range of innovative settlement models — provided that such models do not compromise the essential resilience characteristics of the system and that they meet the BoE's operational requirements.

The BoE's blueprint also indicates that the BoE expects the private sector, rather than the BoE itself, to develop DLT initiatives in this space. A number of private initiatives are currently being explored in the securities settlement space — ranging from DLT digital currencies, which are asset-backed at the central bank, to a DLT custody and securities settlement system. The BoE reportedly is actively engaging with the banking and FinTech community regarding many of these use-cases.

There are still significant challenges that would need to be overcome before such a DLT model could be adopted, including regulatory and legal structuring, as well as solving technical concerns with the technology, such as security, scalability, governance and data privacy, among others. Common standard setting to enable interoperability is also a challenge. Nevertheless, the BoE's proposal that the new RTGS system should be interoperable with DLT settlement models signifies the removal of a significant barrier to the adoption of DLT in the payment and securities settlement space in the UK. A policy issue that the BoE is likely to want to consider is whether a DLT settlement initiative that accesses central bank money through the RTGS system impacts the "mix" of commercial bank and central bank money in the economy.

If a DLT settlement initiative could move the dial so, for example, there would be the possibility of significantly more central bank money issued as a percentage of commercial bank money, this could be concerning to the BoE from a policy perspective.

The European Central Bank (ECB) also recently announced that it is entering into a public consultation on the future of the Eurosystem's RTGS services, but the current proposals do not specifically mention DLT<sup>2</sup>. However, the ECB has previously confirmed that it has established a DLT task force to consider the possibility of DLT interfacing with its Target 2 Securities settlement platform and it is likely that the task force will be feeding into the consultation process. Latham will continue to monitor these developments<sup>3</sup>.

For more information on DLT, please see Latham's [Client Alert on the FCA DLT Discussion Paper](#).

## **Direct access to the RTGS service for non-bank payment service providers**

Non-bank payment service providers (non-bank PSPs) are e-money institutions and payment service providers that do not take deposits. Non-bank PSPs cannot currently directly access the RTGS service, meaning they need to access the sterling payment systems through settlement agent banks with whom they compete.

Recognising the significant growth in the UK of the non-bank PSP market, and to help promote continued payments innovation by ensuring a competitive marketplace, the BoE is proposing to allow certain e-money institutions and payment institutions direct access to the RTGS service, provided the FCA has authorised the institutions in the UK. This access will enable non-bank PSPs to apply to participate in the key UK payment systems (such as the Faster Payments Service) so that they can compete on a non-intermediated basis with their bank competitors. The BoE predicts that this will lead to a more innovative payments market as it will drive up competition between banks and non-bank PSPs. It will also contribute to financial stability by: (i) reducing operational reliance on a small number of banks; and (ii) lowering the credit exposures between direct and indirect participants that can be generated by intermediated access to payment systems.

Notably, however, the BoE is not extending its credit or Sterling Monetary Framework access to non-bank PSPs, because PSPs are not part of the monetary policy transmission mechanism and they are not exposed to inherent overnight liquidity risk. PSPs will therefore need to pre-fund their RTGS exposures in prefunding accounts at the BoE.

The BoE anticipates that the first non-bank PSP will go live in the RTGS service in the second half of 2018 at the earliest. That step will be followed by an application process for direct participation into the key UK payment systems. Those payment systems will publish the requirements they will impose on non-bank PSPs, as well as details about their onboarding process, in due course.

In a separate but linked development, the Payment System Operator Delivery Group (PSODG), an independently chaired body set up by the Payment Systems Regulator and the BoE, has formally recommended to consolidate the operators of the three UK retail payment systems: Bacs Payment Schemes Ltd, Cheque and Credit Clearing Company, and the Faster Payments Scheme Ltd<sup>4</sup>. The rationale for the recommendation is to lower the cost and complexity for new challenger banks and non-bank PSPs, so rather than needing to connect to three systems, they would only need to connect to one. The chair of the PSODG, Robert Stansbury, has stressed that a single consolidated payment system operator would drive competition and ultimately lead not only to improved services for customers, but also new and innovative products. Once the plan has been reviewed and endorsed by the boards of the three

payment system operators, it is expected that the consolidation is likely to be substantially completed by the end of 2017.

## Liquidity management

The BoE's consultation revealed that a number of RTGS service users would like to explore ways to streamline global liquidity management across currencies, time zones and payment systems. In its blueprint, the BoE refers to a number of proposed enhancements to the RTGS system that will contribute to facilitating global liquidity management, including: near 24/7 operating capability; cross-border payments synchronisation; and forward-dated and timed payment submission.

In addition, the BoE plans to move to a more sophisticated data interface for the new RTGS, which will introduce an external facing application programming interface (API). An API is a set of functions and procedures that allow the creation of applications which access the features or data of an operating system, application or other service. The API will allow users to develop sophisticated and automated real-time tools for accessing RTGS transactional and liquidity data if they wish to do so and these tools should enable users to manage their liquidity more efficiently.

The API could, therefore, generate demand for sophisticated algorithmic liquidity/collateral management solutions from RTGS users who do not have the capability or bandwidth to build these in-house. Enterprising FinTech companies may step in to offer these services directly to RTGS users, particularly when the RTGS membership expands to non-bank PSPs. The API will also be important in the future in providing an interface between the RTGS system and settlement models utilising new technology that need to access central bank money, for example, a DLT payment or securities settlement system.

The BoE also plans to set up a working group to further explore how a new RTGS service could help to facilitate the streamlining of global liquidity management, including re-examining arrangements for taking collateral to support intraday liquidity; and the related possibility of making greater use of cash as collateral, both in RTGS and across major global payment systems.

## Next steps

The BoE recognises the importance of industry engagement and co-ordination in further progressing the design of the new RTGS service. As the BoE enters the programme definition stage, it will begin to work with external stakeholders to set up external fora and other information-sharing channels, including:

- Holding two open industry events to present the information in the blueprint on 22 and 26 May 2017
- In the longer term, forming an advisory body, chaired by the BoE and with members drawn from a representative sample of RTGS stakeholders. This body will provide a forum to gather views from a diverse range of stakeholders on implementation
- Convening working groups of the representatives of all interested stakeholders to drive development of the new RTGS platform and to provide input on the BoE's analysis and proposals during the programme definition phase and beyond
- Considering how best to disseminate information from the advisory body and working groups to its wider constituency of stakeholders as part of a comprehensive communications and stakeholder engagement plan

This is an important opportunity for early-stage engagement with the BoE on the design of the future of the UK's payment systems and the BoE has expressly registered its intent to engage industry stakeholders in formulating the design of the new RTGS service. That design could have important implications for the businesses of existing bank users of the RTGS service, but also non-bank PSPs and the wider FinTech market. Broad industry engagement will help to ensure that the service is designed to meet the needs of these diverse stakeholders and the wider markets as a whole.

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## Endnotes

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- <sup>1</sup> Bank of England, A blueprint for a new RTGS service for the United Kingdom (May 2017) *available at* <http://www.bankofengland.co.uk/markets/Documents/paymentsystem/rtgsblueprint.pdf>.
- <sup>2</sup> European Central Bank, Executive Summary to the market consultation on the future RTGS services (May 2017), *available at* [https://www.ecb.europa.eu/paym/pdf/consultations/executive\\_summary\\_market\\_consultation\\_future\\_rtgs\\_services.pdf?700a095c1e184565fd61da4564ee6593](https://www.ecb.europa.eu/paym/pdf/consultations/executive_summary_market_consultation_future_rtgs_services.pdf?700a095c1e184565fd61da4564ee6593).
- <sup>3</sup> European Central Bank, Distributed Ledger Technology: role and relevance of the ECB (December 2016), *available at* <https://www.ecb.europa.eu/press/key/date/2016/html/sp161206.en.html>.
- <sup>4</sup> Payment System Operator Delivery Group Report, Final Report (May 2017) *available at* <https://www.psr.org.uk/sites/default/files/media/PDF/PSODG-Report-2017.pdf>.