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Issue brief

A Closer Look at the European Central Bank's TARGET Instant Payment Settlement System (TIPS)

What is behind the ECB's announcement to deliver a settlement infrastructure for instant payments, and what exactly is the ECB proposing?

In June of this year, the European Central Bank (ECB) announced its decision to develop and introduce a new service for the settlement of instant payments. The new service is called TIPS, which stands for TARGET instant payment settlement.

The June 12 ECB press release states that TIPS is scheduled to begin operating in November 2018 and will allow citizens and firms to make payments anywhere within the euro area in a matter of seconds.

Instant payment systems are evolving rapidly around the world, with some countries already considering second-generation systems while others, such as the U.S. and Canada, are following in the steps of pioneers like the UK, Singapore and Sweden. Moreover, in the Eurozone, a number of initiatives are coming to market under the SEPA Instant Credit Transfer (SCT Inst) scheme.

The benefits of instant payments are clear and have been widely covered. In this paper, we'll take a look at the ECB's entry into this market and its TIPS offering.

Background

Payment settlement between banks is usually the responsibility of a central bank, with the settlement of non-instant payment schemes ultimately managed through a real-time gross settlement (RTGS) system. Within the Eurozone, Target 2 is the RTGS system operated by the ECB, while EURO1 is the system operated by EBA Clearing. Instant payment schemes have disrupted the operation of this traditional model.

One issue involves the size of inter-bank settlement obligations resulting from instant payments between participants when the RTGS system is shut down overnight or on the weekend, and the central bank is unable to move money between the participants.

There are, of course, ways to address this issue, and central banks have taken different approaches in different jurisdictions.

One scenario used by many schemes today is where the central bank takes care of settlement processing by running multiple clearing cycles during the day on a netted basis and over weekends by defining settlement caps and asking for collateral pledges from participants to minimize settlement risks.

However, there is another scenario—one where each individual real-time payment is sent to a real-time settlement service that operates 24/7. This is the way the new instant payments settlement service in Australia will operate.

The European market

In Europe, managing instant payments is much more complex, given that every country has its own central bank and where the ECB has direct control over the central banks in the Eurozone (called the Eurosystem Central Banks). And, the introduction of SCT Inst, of course, further complicates matters.

When SEPA was launched nearly 10 years ago, the market was defined by the original vision set out by the European Commission and the ECB. That vision was to ensure the standardization of the euro denominated payments and encouraged competition, thus delivering lower transaction costs and promoting innovation. Both organizations wanted payments to become as easy as using cash across the entire Eurozone. SCT Inst is the next instalment of this vision.

The Euro Retail Payments Board (ERPB), which is chaired by the ECB, mandated that the European Payments Council develop the SCT Inst scheme for pan-European euro instant payments. The rulebook for this scheme was released in November 2016. A key principle was to encourage competition by allowing multiple providers. A number of these providers have indeed been announced, particularly at the national or country level, such as in the Netherlands, Italy and Spain. Others also have announced services to ensure interoperability and reachability across the Eurozone. For example, EBA Clearing announced its service, now called RT1, which is scheduled to go live in November 2017.

However, the settlement of SEPA instant credit was outside the scope of the rulebook. Those developing operational services in the Eurozone started to address the settlement requirement through their own local models, subject, of course, to ECB oversight. EBA Clearing's RT1 will use EURO1, for instance.

In hindsight, it is clear that the ECB began to look at how the settlement of instant payments in the Eurozone should work. It was worried about the proliferation of local in-country settlement models springing up across the Eurozone and leading to what it calls "fragmentation" and a lack of control with different and/or increasing settlement risks. As a result, it began exploring the development of TIPS through a task force that first met in October 2016 and a brief consultation earlier this year.

The outcome was the decision to proceed with the development of TIPS—announced, interestingly, one day after this year's EBA Day Conference in Dublin, Europe's largest gathering of European payment specialists.

The devil is always in the details

So, what's all the fuss about? At one level, TIPS is a settlement system full stop. As announced by the ECB, "The Eurosystem has decided to develop a new service for the settlement of instant payments. The TARGET instant payment settlement (TIPS) service will enable payment service providers to offer fund transfers in real time and around the clock, 365 days a year."

Given that the SCT Inst rulebook explicitly excludes settlement, the ECB response is clear—we need a settlement service, and here it is.

But, there are some interesting nuances in the ECB's announcement. Consider the following statements from its press release:

> "The ECB is responsible for the smooth and effective functioning of payment systems in the euro area. It already developed TARGET2, the Eurosystem's Real Time Gross Settlement System, used to process large-value payments in euro in real time. TIPS, as part of TARGET2, will help facilitate instant money transfers, offered via banks, so that citizens and firms can make instant retail payments across Europe."

> "By providing TIPS, the ECB will make sure that the demand for instant payments is met at the European level and further facilitates the integration of the euro area. The service will be developed in close cooperation with the banking industry in Europe and will be offered to banks at the low price of a maximum of 0.20 eurocent (€0.0020) per payment for at least the first two years of operation."

Additional supporting material from the ECB in June provides further clarification of what TIPS will offer and to whom. (Read the full article)

There are three specific points to note:

1. A settlement service with a clearing process

The supporting information states that:

a. A participant sends an SCT Inst payment transaction message to TIPS. (The participant also may be an instructing party acting on behalf of the participant or a reachable party.)

b. TIPS validates and reserves the amount to be transferred (conditional settlement).

c. TIPS forwards the payment transaction for acceptance to a receiving participant.

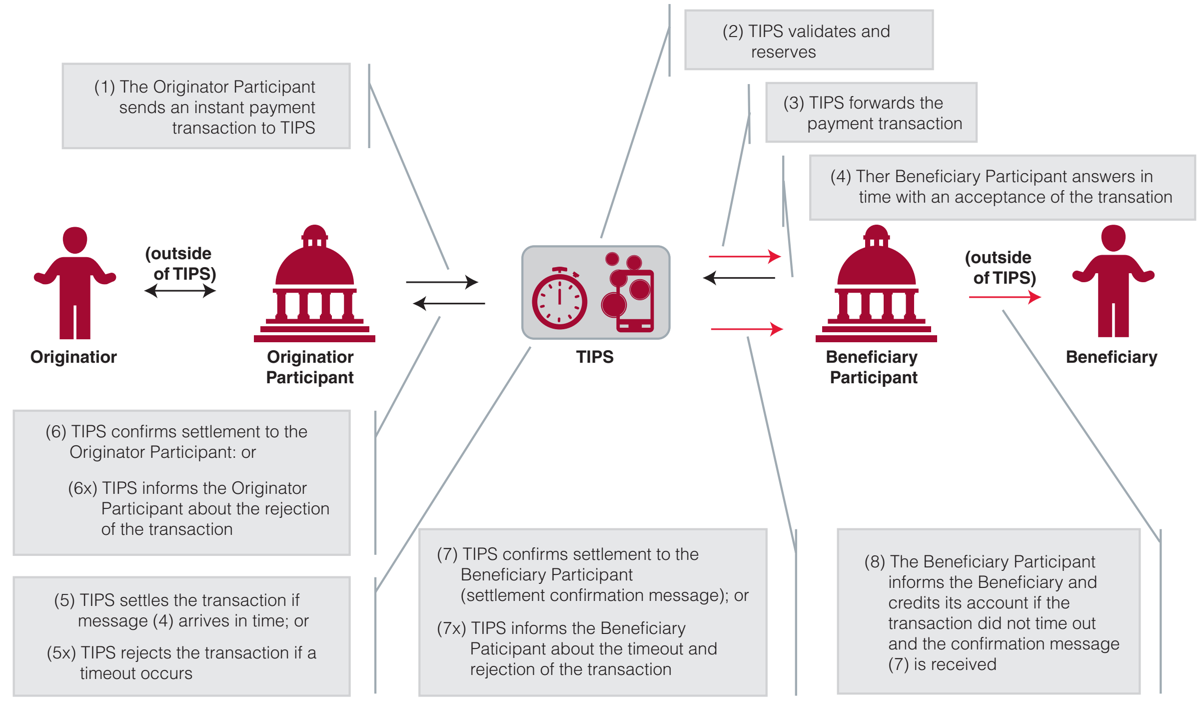
d. The receiving participant sends a positive reply message to TIPS.

e. TIPS settles the payment.

f. TIPS confirms the settlement to the sending participant.

g. TIPS confirms the settlement to the receiving participant.

TIPS - Instant payment transaction process flow



TARGET instant payment settlement

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The transaction flow depicted above would be the same any instant payments system would follow but with the settlement component included. TIPS is designed to do both clearing and settlement.

2. Pricing

The entry and maintenance fees for a TIPS account will be zero. Charges per transaction will be based on volume processed, but according to the ECB press release, "The Eurosystem will offer the service to banks at the price of a maximum of 0.20 eurocent (€0.0020) per payment for at least the first two years of operation."

This is going to create significant problems for any commercially driven organization that has to make a profit. Interestingly, the ECB announced the pricing before completion of the system's development.

3. Liquidity

According to the ECB press release:

> "In addition TIPS accounts can be funded/defunded during Target 2 operating hours, and there will be no opportunity cost attached to 'overfunding' TIPS account during the night, weekends or holidays because holdings on TIPS accounts will count towards the minimum reserve requirements in the same way as those on TARGET2 RTGS accounts."

This is something that other providers are unlikely to be able to offer, and yet it seems to be a very desirable feature for participating banks.

What does this mean for driving competition and innovation? The announcement of the TIPS service has the potential to have the exact opposite impact of the ECB's original vision. It has the potential to completely stifle competition across the Eurozone instead of promoting it, especially since it will be operated on a not-for-profit basis. The ECB will be entering the commercial market, but with an unfair advantage, and the fox is indeed now guarding the hen house.

How does this impact the EBA Clearing's RT1 initiative? That initiative has been under development for some time, and many banks and countries have expressed a commitment to it, with many more showing an interest in joining.

The future

This move by the ECB effectively positions the bank right at the heart of the pan-European instant payments infrastructure. It seems that this raises many more questions than it answers. How will the domestic Eurozone SCT Inst services now proceed? How will they now perform settlement? How many SCT Inst schemes will the Eurozone now need? Does a commercial bank join TIPS and, let's say a domestic scheme or RT1 and domestic scheme or, just TIPS?

TIPS doesn't rule out settlement in currencies other than the euro. Is this the first step towards trying to offer instant payment interoperability between other schemes in other currencies? Is this another step towards instant payments cannibalizing RTGS system payments for lower value payments?

This move really does raise more questions than it answers. It's a clear step away from the original concept of SEPA, namely to promote competition and drive innovation. In the months ahead, we need debate and transparency to work out the answers.

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