

RESERVE BANK INFORMATION AND TRANSFER SYSTEM

Same-day Settlement of Low-value Payments in RITS

Industry Consultation Paper

May 2008





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RITS

1. INTRODUCTION

This paper discusses an initiative proposed by the Reserve Bank of Australia (RBA) to provide additional functionality in RITS to allow ESA Holders the option of settling bulk low-value payments on an intra-day basis.

The RBA seeks to take into account the varying business requirements and views of RITS Members when planning new RITS functionality. To this end, the RBA canvassed industry views on same-day settlement of low-value payments by consulting individually with members of the Australian Payments Clearing Association Management Committee 2 (APCA MC2) in late 2007. The industry feedback provided in those consultations is incorporated in this paper.

Industry participants desire a modern and efficient network solution to exchange low-value payment information at a cost that is commensurate with the risks inherent in the low-value system. They want the same-day settlement solution associated with their exchange mechanism to facilitate transaction reconciliations, straight-through processing and same-day account posting. Industry participants also seek a means of mitigating any liquidity risk that might result from same-day settlement of low-value payments. There is no industry consensus on the best way to achieve these goals and to some extent they can be considered as separable components within a broader solution.

In response to industry feedback, the RBA plans to take an inclusive approach in developing functionality in RITS to enable the same-day settlements of low-value payments. The intention is to provide a flexible architecture that can accommodate a variety of network and settlement solutions, subject to practicality and demand for those solutions. The RBA plans to build functionality incrementally as industry consensus builds and integrated network and settlement solutions are developed. Potential solutions to industry concerns over issues such as liquidity will be developed and implemented over time.

A number of alternative means for the same-day settlement of bulk transactions have already been considered by the RBA. Of these, some offer considerable promise but are either partial (network only) solutions, or are not yet ready for implementation. These, and any other proposed solutions, will be considered for implementation, based on their merits and industry requirements, in due course.

One solution that is available now, and is proposed for the initial implementation, is a SWIFT solution – FileAct Copy. It allows the exchange of a single file between RITS Members using the SWIFTNet platform and the copying of settlement instructions to the RBA. Its implementation represents a first step in developing same-day settlement functionality for bulk payments in RITS. It does not preclude enhancements to the initial implementation or the use of additional settlement options.

The industry response to the concept of same-day settlement of low-value transactions using FileAct Copy has been mostly favourable, with some banks better placed than others to make the necessary adjustments to infrastructure and business processes (discussed later in this paper). On balance the RBA feels that there are industry-wide benefits to be had from proceeding with this project.

Use of the new functionality would be optional for RITS Members and its implementation would not prevent Members from continuing with their current settlement arrangements or pursuing alternative network solutions. Currently, the APCA Low Value Payments Industry Direction Project is exploring alternative settlement arrangements, amongst



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other issues, for the industry. The RBA FileAct Copy initiative provides a settlement option for low-value payments consistent with that body of work, by facilitating improved timeliness in value transfer and a reduction in settlement risk. Future development work is also being considered to enhance the low-value settlement facility to allow for multiple network feeds, payment offsetting and periodic release for settlement.

In order to progress this initiative, and to receive industry input into the use of FileAct Copy, the RBA is seeking expressions of interest from RITS Members to participate in a RITS Low-Value Same-day Settlement (LVS) Working Group. Representation is also being sought from APCA. The initial meeting of the RITS LVS Working Group is planned to be held in the middle of 2008, after which the RBA will publish a more detailed explanation of how FileAct Copy would be used with RITS. Development and implementation is currently planned for the 2008/09 financial year.

The next section of this paper describes the current payments settlement environment in Australia and discusses alternatives for settling low-value payments on a same-day basis, including details of how the FileAct Copy functionality might operate. The following section reports on the feedback provided by industry participants during the consultation phase. The paper concludes with a section outlining future directions for the project.



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2. ALTERNATIVES FOR SAME-DAY SETTLEMENT OF BULK LOW-VALUE PAYMENTS

In Australia, low-value payments (including those made by cheque, direct entry (DE), and credit/debit card) are settled in RITS on a net deferred basis each day as part of the 9am Batch in RITS. The clearing process involves the exchange of files containing payment details during the day/night of the payment date in accordance with APCA Clearing System Regulations and Procedures. Final settlement of the net low-value obligations of RITS Members does not take place until the following day, giving rise to some residual settlement risk. These arrangements have been virtually unchanged since the introduction of 9am settlement in 1993. To date, the only alternative to this settlement process has been to settle payments individually on a Real Time Gross Settlement (RTGS) basis. However, this is neither a practical nor cost-effective means for Members to settle high volumes of low-value payments.

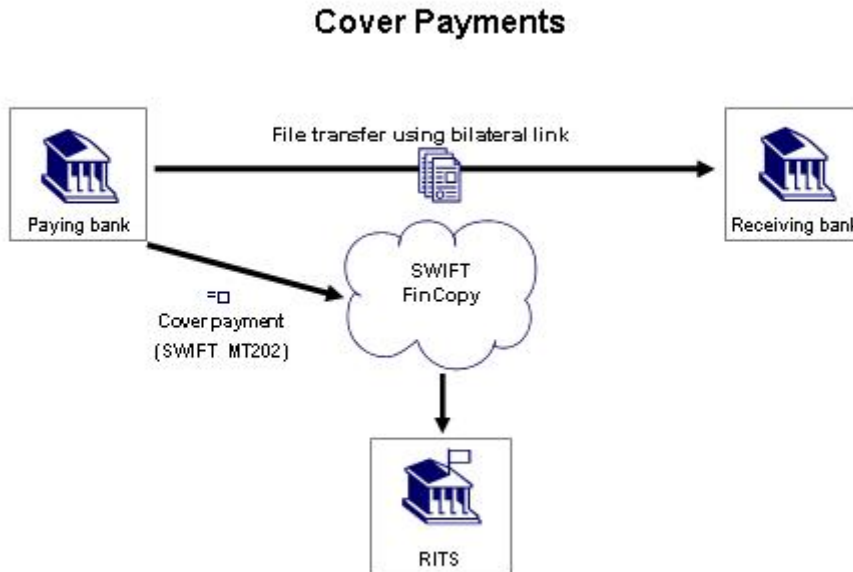
Various banks have at times expressed interest in the intra-day settlement of low-value items to help reduce the settlement risk inherent in the net deferred settlement arrangements and to provide customers with a more timely payment option. Although most individual payments are relatively small, some can be quite large, and the aggregate values and volumes settled on a net deferred basis have grown markedly over recent years. Settlement exposures can be large for individual banks. To address this growing issue, APCA MC2 has previously explored potential options to address settlement risk in direct entry payments and is currently re-examining this area through the Low Value Payments Industry Direction Project.

The scope of the initial RBA project is to develop functionality that enables multiple transactions contained within a single file to be transferred between two RITS Members and settled as a single payment in RITS. Subsequent enhancements might allow for payment instructions to be temporarily stored in RITS so that some multilateral offsetting of inter-bank obligations could be achieved. The resultant netted positions could then be periodically sent to the RITS queue for settlement using the existing RITS batch facility.

The RBA has considered various options for achieving the settlement of bulk low-value payments on a same-day basis. In doing so, the RBA has been mindful of providing increased choice for RITS Members in settling their low-value payments. The various options considered by the RBA for the initial implementation are briefly outlined below.

2.1 Cover Payments

An option that is currently available, but which is not actively used by Members, is to send cover payments concurrently with file exchanges. In this model, a clearing system member can exchange a file with its counterparty using existing bilateral links during the course of the day. Concurrent with the sending of the file, the Member independently sends a cover payment instruction (using a SWIFT MT202) to RITS for settlement of the obligation.



This model suffers from a number of shortcomings, which may account for its disfavour amongst participants. Importantly, payments and files under this arrangement are not linked in any way, so that reconciliations must be undertaken manually and are subject to considerable operational risk. The current options for sending cover payments (SWIFT MT202 or RITS cash transfer) are not well-suited to providing remittance information in a form that easily facilitates reconciliation.

For RITS Members that are not participants in the Evening Settlement Session, the MT202 cover payments must be submitted before the RITS Daily Settlement Session closes for new payments at 16:30, thus effectively ruling out some proportion of low-value payments.¹ Where the sender of the file makes a claim for payment from the Member receiving the file (i.e. direct debits), a bilateral arrangement must be agreed to ensure the paying Member sends the cover payment back to the file originator.

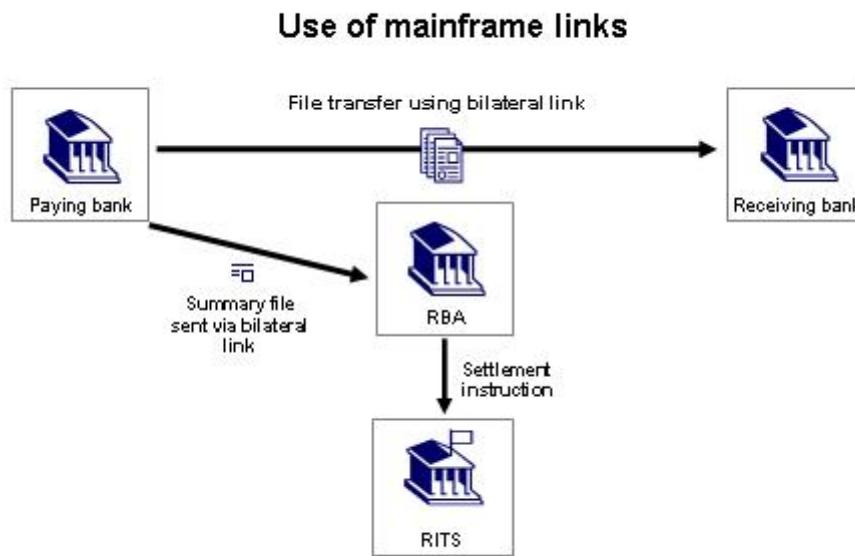
When discounting this process, or any enhancements to this process, as an effective long-term solution, the RBA also noted that it would not be possible to link these payments to the existing batch settlement facility or a netting calculator if the latter enhancement was developed.

The RBA notes that most of the issues with cover payments are related to the use of an existing MT202 standard for the cover payment rather than the use of a cover payment *per se*. The use of alternate SWIFT Message Types for cover payments, including the possible use of FileAct Copy messaging discussed below, could be an option used to overcome these issues if the SWIFT network were a preferred means for cover payments.

¹ Cut-offs for receipt of customer payments may need to be agreed in the implementation of other solutions.

RITS**2.2 Existing Bilateral Links**

This model of low-value same-day settlement utilises the existing bilateral links to exchange files between clearing stream members during the day. Members would independently transmit file summaries to the RBA, which could then be routed to RITS for individual file settlement.



This model suffers from the same major shortcoming of cover payments; that Members have no means of automatically linking the file transfer with RITS settlement. This is an issue that Members would need to resolve to enable within-day posting to customer accounts.

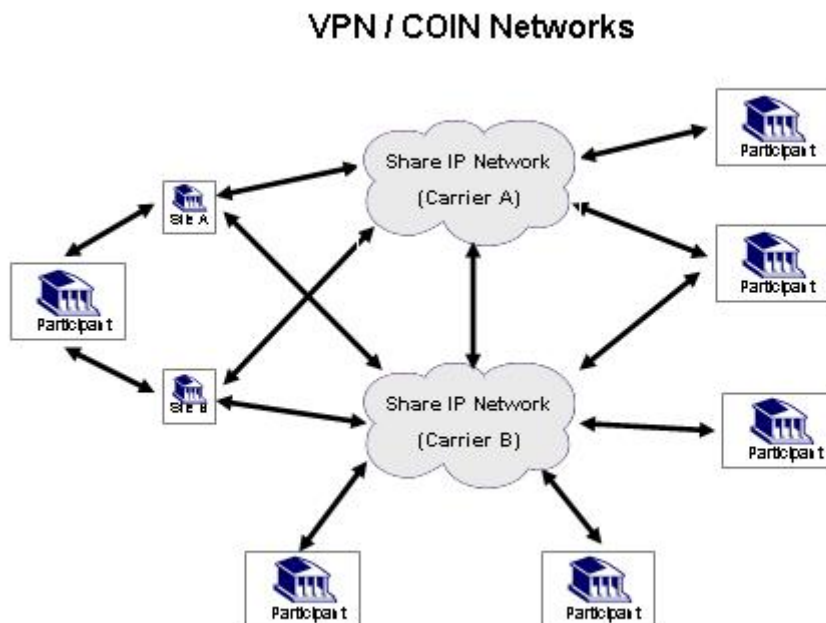
This model relies largely on the legacy bilateral network links already in place and would require the RBA to develop new functionality to accept a file summary (containing the inter-bank obligations) and re-route this to RITS for inter-bank settlement. Nevertheless, this may be an option if the industry is to continue use of these links and the RBA decides to proceed with developing a netting calculator for use with the existing batch settlement facility. Members without an existing file link to the RBA would need to set up a new bilateral link for this purpose.

2.3 VPN Networks

Another suggestion proposed by Members concerns the use of Virtual Private Networks (VPN) or Community of Interest Networks (COIN). One of these is shortly to be used by two Members for some low-value payment traffic. At this point in time its potential take-up for wider industry use is not yet known. Using this type of network solution, point-to-point links are replaced by a hub and spoke model utilising shared IP network facilities supplied by different telecommunications providers.

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These network solutions may provide efficiencies in the maintenance of communications links between Members.



If used more widely by Members for file transmission this type of network would be seriously considered by the RBA as an adjunct to its initial proposed solution. For example, RITS could receive file summaries over the VPN for inter-bank settlement. However, work would still be required to solve the problem of linking of files with settlement in RITS.

2.4 FileAct Copy

The SWIFT FileAct Copy service is a ready-made solution that is already in production and can be implemented in RITS relatively quickly. The FileAct Copy functionality enables multiple transactions that are bulked into a single file to be transferred between two RITS Members and settled as a single payment. This solution would automatically take advantage of SWIFT Security and does not necessarily require any changes to direct entry file formats presently used.

A small number of banks have previously expressed some interest in migrating from their current bilateral links for file exchange to use of SWIFT FileAct, as this offers improved resilience, security and operational efficiencies, albeit at a greater cost. Consequently, the RBA proposes to implement the SWIFT FileAct Copy solution as the first tranche of RITS functionality in the area of same-day settlement of bulk payments.

FileAct was introduced in 2003 when SWIFT migrated from X.25 networking technology to an internet protocol based communication platform – SWIFTNet. It enables files to be transferred between two parties, in any agreed format and containing large amounts of data. There are three operational modes for transferring files using FileAct, only one of which would allow the RBA to capture settlement information – the Store-and-Forward



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File Transfer Mode (SF Mode).

SF Mode involves SWIFT as an intermediary for the transfer of messages and files. The process is initiated by the sender of a file who transmits a 'put file' request to SWIFT. When SWIFT accepts the request, the file is transferred to SWIFT's central storage system and placed on the receiver's queue. The receiver then retrieves the file from its queue either manually or via an automated process.

SF Mode also allows for data from File Headers to be copied to a third party such as the RBA; this service is known as FileAct Copy and it will be used to send settlement instructions to the RITS queue. The File Header contains the summary business and technical information (such as date, paying and receiving bank, number of transactions and value to be settled) that is required to settle the transactions contained in the underlying files. It is up to individual closed user groups or 'communities' – such as the one that will apply to RITS – to determine the fields ('tags') of business data to be included in the File Header. This detail will be determined in consultation with the industry.

2.4.1 Y-Copy or T-Copy?

The FileAct Copy feature can take the form of Y-Copy or T-Copy (see examples in diagrams below). The choice of which model is most appropriate largely depends on whether the file is sent together with a payment instruction or with a payment request and whether Members require delivery of the file containing all transaction details before authorising payment.

Y-Copy

If Y-Copy is used, a file sent for settlement is held at SWIFT awaiting inter-bank settlement in RITS on the basis of information contained in the File Header. Where the sender is also making payment, it is analogous to the use of FinCopy for SWIFT PDS messages in RITS. On successful settlement, the file is released to the receiving Member and a confirmation sent to the paying Member. This model readily lends itself to sending a file of direct credits, with posting to customer accounts (if desired by the receiving Member) able to be automated on receipt of the file.

T-Copy

If T-Copy, is used, the file is passed to the recipient concurrently with a settlement request (File Header) being sent to RITS for inter-bank settlement. This model could potentially be used for sending files containing debit transactions. This would allow the paying Member to scrutinise a file of direct debits before authorising inter-bank settlement. However, this may not be a common business requirement of Members.

The RBA understands that it is common to send files with a mix of credit and debit items and, depending on Members' business requirements, this may impact on which model or models are used. If the industry overall does not have a requirement for validation or authorisation of received files prior to inter-bank settlement, then it would be operationally sensible to use a single (Y-Copy) model.

Further industry consultation will assist in determining the preferred use of Y-Copy or T-Copy. The following sections provide illustrative examples only of how different models

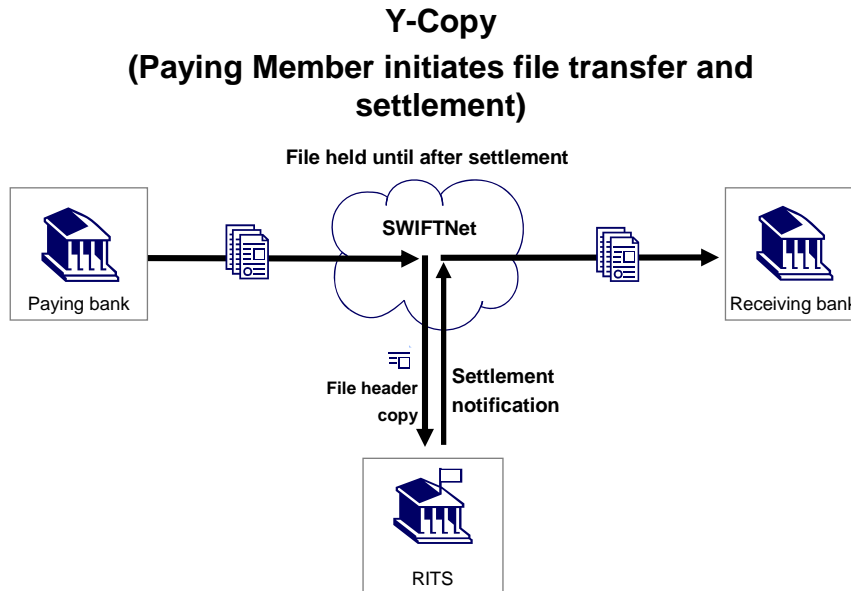


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could be used.

2.4.2 Example – Y-Copy of file of credits

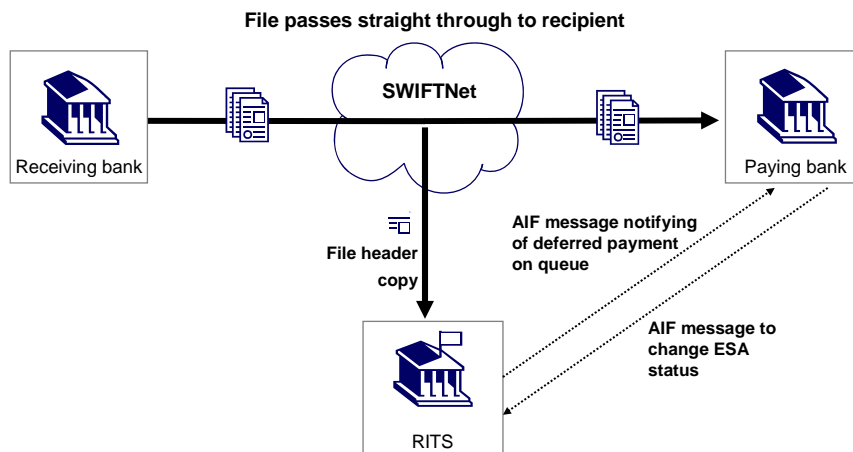
This example shows a case where the payer of funds is the originator of the file containing the individual transactions and Y-copy is used. The file is sent by the paying Member and is temporarily held by SWIFT while a copy of the File Header is delivered to RITS. The information contained in the File Header serves as a settlement instruction for RITS and a single payment is placed on the RTGS queue for settlement testing. This payment will be identifiable in RITS as a FileAct Copy transaction. The paying Member can control the debiting of its Exchange Settlement Account (ESA) through the normal status functionality in RITS. On settlement of the payment, RITS sends an authorisation response to SWIFT to release the file to the receiving Member. The receiving Member will receive a file containing multiple transactions, for which interbank settlement is achieved by a single payment.



2.4.3 Example – T-Copy of file of debits

When a Member sends a file requesting payment from another Member, as is the case with direct debits, one example would be to use T-Copy. In this example, the file is sent straight through to the paying Member for validation and authorisation. A File Header copy is delivered to RITS in parallel with the file transfer. The payment instruction is placed on the RITS queue with a deferred ESA status and a pre-settlement advice message is sent to the paying Member through the RITS Automated Information Facility (AIF) informing it of the new payment on the RITS queue. When the paying Member is ready for settlement to proceed, it changes the ESA status of the payment to active or priority and the payment is tested for settlement in the usual manner.

T-Copy (Settlement initiated by receiving Member)



2.4.4 Example – file of credits and debits

Where a file contains a mix of both credit and debit transactions, there are different options available which could be used in a Y-Copy or T-Copy model.

Option 1 – gross settlement debits and credits

In this option, a single file is sent but RITS uses the File Header information to produce two obligations for inter-bank settlement; the total of credits will be the settlement obligation for the sending Member and the total of debits will be the settlement obligation for the receiving Member. Each Member is able to independently set the ESA status of its payment obligation. Each payment obligation will be tested separately by RITS and, on settlement, post settlement advices will be sent as required.

Option 2 – settlement of the net amount

In this option, the gross debit and credit values contained in the File Header are settled simultaneously. The difference between the total value of credit items and debit items determines the net settlement obligation for the sending bank (if the value of credits is greater) or the receiving bank (if the value of debits is greater). The RITS queue will test the ESA balance of the paying Member against its net settlement obligation (i.e. net value of the transactions). This option would reduce the amount of liquidity required to settle the payments.

Both of these options remove the need for transactions to be extracted from customer files and sorted into separate files containing debits or credits.

2.4.5 File Copy for the header only

As noted above, the FileAct Copy solution may potentially provide an option for



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sending settlement instructions to RITS where files are exchanged via alternative paths. For a file sent via a bilateral or other network link, the header information could be put into an otherwise empty file and sent via FileAct Copy. The same settlement process as described above would apply but the file exchanged via SWIFT will contain only settlement information, not transactions. By routing the transactions through an alternate means, the SWIFT messaging costs for the cover payment would be reduced to the minimum FileAct Copy message charge. However, the message could be engineered to contain more meaningful settlement information than would be available to the Member using other SWIFT FIN messaging such as an MT202.

The advantage of using FileAct Copy for sending cover payment information is that the FileAct Copy header information will be designed specifically to integrate the clearing (network transmission) and settlement processes. It requires users to maintain access to the SWIFTNet platform as well as SWIFT FIN. An alternative integrated messaging solution for cover payments using SWIFT FIN could be considered if there was sufficient industry demand but this would require more development effort.

2.4.6 Pre and post settlement advices

In all the options described in this section, both parties involved in a bilateral file exchange may optionally elect to receive post-settlement advices through the RITS Automated Information Facility (AIF). In addition, a payer may optionally elect to receive a pre-settlement advice. These advices may also be used in non-SWIFT implementations.

2.5 Future Enhancements

Depending on the level of industry demand, the RBA will consider the addition of a "netting module" that would allow for offsetting of payment obligations. The multi-lateral netted obligations would be submitted to the RTGS queue as a batch settlement, at intervals during the day, based on the files sent. Members might have the option of selecting "Immediate Settlement" of a single file or "Timed Net Settlement" at nominated intervals. At these intervals, RITS could derive (from the file headers copied to RITS) multilateral net settlement obligations for each Member for all files sent for settlement at nominated times.



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3. CONSULTATION WITH RITS MEMBERS

This section reports on the matters raised in consultations. The two main areas of interest to Members were the opportunities to replace their existing legacy network infrastructures and the potential effects on liquidity management practices that might result. The impacts on customer accounts and Clearing System rules were also discussed. The cost of implementing and using FileAct Copy was identified by all Members as an important factor in determining its take-up by RITS Members.

3.1 Infrastructure and Data Transfer

Low-value batch participants have generally been satisfied with the efficiency of their bilateral links, pointing out that they are inexpensive to run and carry no marginal cost for sending settlement instructions once the relatively large fixed costs have been met. Nevertheless, a number of Members are actively exploring alternative means of data transfer that will sustain payment operations into the future. In some instances this is because of technological obsolescence and in other instances because there are perceived cost advantages of consolidating data transfer networks.

Most Members recognised the high degree of security and resilience afforded by the SWIFT network but there was not universal support for its use in carrying low-value bulk payments. One Member raised concerns that using SWIFT as the service provider would increase the concentration risk in payment networks. There was also a suggestion that relinquishing ownership of the Member's infrastructure might lead to more lengthy delays in problem resolution. Cost was a key concern. A number of Members noted that the adoption of FileAct Copy would not immediately allow the decommissioning of bilateral links. It was noted that bilateral links are sometimes used for purposes other than payment clearing and settlement but not all Members fully understood the entirety of traffic that currently goes across their bilateral links. A couple of Members felt that maintaining multiple network connections, at least temporarily, might provide improved operational resilience.

It was pointed out in consultations that the migration of low-value payments to FileAct Copy could potentially be constrained because take-up is optional for Members. It may be the case that one Member favours using FileAct Copy but its counterparty prefers to continue with bilateral links or some alternative method. In contrast, some Members thought the functionality would lessen the barriers to entry for industry participants to become direct settlers of their low-value payments.

The RBA is aware that take-up of the new functionality may be limited, particularly in the first instance. Nevertheless, the RBA sees merit in providing an additional option for settlement which has attracted interest from some of the larger Members, and which, as a minimum, could serve as a backup facility (with small ongoing cost). Moreover, when considering alternative solutions in the future, the RBA will seek to achieve interoperability of network solutions wherever possible, for instance by allowing multiple network connections into the low-value feeder.

Members noted the wide range of payment types that could potentially be settled using the new functionality, recognising that SWIFTNet is able to carry any payment message within its file envelope. DE payments were universally seen to be the most suitable payment type for initial migration to the new functionality. Most Members appreciated the potential to enhance the current message content of the low-value payments, such



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as through adopting ISO 20022 standards. Members noted that there would need to be amendments to existing Clearing System Regulations and Procedures to incorporate the use of FileAct Copy for low-value settlement. Some Members touted the possibility of developing a new Clearing System for enhanced messages.

These types of payment message content and format issues are currently being contemplated by the APCA Low Value Payments Industry Direction Project. It is envisaged that the new flexible RITS functionality will provide one alternative means of achieving industry objectives.

3.2 Settlement Times and Liquidity management

The RBA indicated during consultations that the settlement of bulk payments through this functionality could occur at any time during the course of the RITS day. This might also include during the Evening Settlement Session. It would be up to RITS Members to decide the precise timing of when files would be transferred to counterparties for settlement. Some Members reported that their proprietary payment systems can only produce debit and credit files at certain times during the day and it would be convenient to exchange files at those times. Other Members suggested nominating pre-determined times for exchange either bilaterally or on an industry-wide basis as is currently the case with DE files.

The potential for payments to arrive late in the day was highlighted as an issue for a number of Members. Some Members expressed a desire to have the RITS Day Settlement Session extended so as to include some of their low-value payment files that are not normally available until after 4.30pm. Another alternative put forward was that all RITS Members become Evening Agreed. This issue will be discussed further with the industry and the RBA will take it under consideration.

On a related point, consultations also highlighted concerns about the implications for liquidity management. The additional inflows and outflows associated with intra-day low-value settlements are expected to require some adjustment in liquidity management by Members. Issues may also arise where payment instructions are received late in the day. Some Members suggested imposing rules on the timing and size of file exchanges. Others expect liquidity issues to diminish over time as the patterns, size and timing of low-value payments become more predictable and better integrated with existing intra-day flows.

The RBA is committed to working with the industry to find ways to ensure that liquidity concerns do not become an impediment to the same day settlement of low-value payments. The RBA's future plans to enhance FileAct Copy with multilateral settlement and netting should assist in this regard.

Some Members raised concerns about reciprocity of payments, suggesting that counterparties might only be willing to receive payments earlier in the day and pay out later. This type of gaming behaviour is observed on occasions in the RTGS system and industry participants are generally able to resolve these issues through bilateral discussions.

RITS Members would retain discretion over when they post to customer accounts if they chose to use FileAct Copy for interbank settlement. Current posting practices vary across Members, with some Members using 'memo' posting to update accounts during the day and some posting only on an overnight basis. It is expected that improved



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timeliness of low-value settlement will further assist Members at their option to provide some customers with better service through earlier access to funds.

3.3 Cost

Cost was raised as a major issue in most consultation sessions and the single most likely impediment to Members adopting the functionality. Participants generally considered their current arrangements to be very cost effective with a significant fixed cost but no marginal cost for increasing traffic volumes. In contrast, the implementation of FileAct Copy involves a one-off setup cost as well as ongoing usage charges from SWIFT. Members already using the SWIFTNet platform expect to be able to leverage off their existing infrastructure but still expect to incur some one-off costs for installation/configuration of software to enable the exchange files with SWIFT, engineering to populate the File Header with relevant data, and system/operational changes associated with the move from overnight processing of data to intra-day processing. SWIFT's current fee structure for using FileAct is based on the number of transactions within the file being transferred. At present SWIFT fees are set at €0.07 cents per payment plus a 25 per cent surcharge for T-Copy and a 50 per cent surcharge on Y-Copy. A minimum of 100 payments per file is charged.

Some Members suggested that the additional costs would be offset by the network benefits that accrue from using the service, including the reduced need to establish and manage additional links when new Members join the low-value clearing stream. It was also suggested that the additional costs would be covered by the additional revenue that the service could generate from customers. Other Members conceded that they have a limited understanding of their customers' price-elasticity of demand for reduction in settlement risk and improved timeliness of final settlement, and hence their ability to charge for these services.

Members were aware of the additional cost they would incur if forced to support multiple network solutions and most expressed a preference for a single industry solution.



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4. FUTURE DIRECTION

Most Members contacted during consultations shared a perception that the move to same-day settlement of at least some of the payments currently settled via the low-value clearing streams is inevitable. There were divergent opinions on the preferred means of exchange and settlement but most Members felt that the FileAct Copy project is a worthwhile initiative as a starting point. A number of Members felt that their internal payment systems and business drivers are sufficiently well-understood to enable immediate use of the new functionality. However, few Members were prepared to commit to using the new functionality immediately. Most Members felt constrained by the cost of implementing and using the functionality and/or the extent to which other participants in the industry adopted the new functionality.

Other Members felt that the timing of the project is a little premature and its timetabling should be contingent on the outcomes of the APCA Low Value Payments Industry Direction Project. However, the work suggested in this paper should not in any way constrain the output of that project; it is felt that these projects are complementary. Should an industry consensus on network and settlement issues emerge, the RBA will consider options to accommodate the industry's needs as required.

On balance, there seems sufficient support for the broader initiative to justify going ahead with developing an initial project, with its scope limited to settlement of a single bilateral file exchange. The specification of the initial project will be guided by industry feedback. More advanced development initiatives, as outlined above, will be considered in due course.

The RBA is now seeking to engage industry participants by convening a RITS LVS Working Group that will examine the use of FileAct Copy for settlement in RITS, including the business rules and practices within which the functionality would operate. Issues to be considered by the Working Group include:

- the applicability of Y-Copy or T-Copy, including whether there are business needs for file verification prior to inter-bank settlement;
- the type of transactions eligible for use in the facility;
- the design of the File Header;
- treatment of files containing credit and debit items;
- settlement timing and session eligibility;
- liquidity issues; and
- implementation arrangements.

The RBA intends to convene the initial meeting of the RITS LVS Working Group in July and will produce an updated discussion paper for industry comment in due course. Sub-groups may be convened as appropriate, for instance, to discuss liquidity issues or technical issues. Development work will proceed concurrently with the Working Group and implementation of the new functionality is currently planned for the 2008/09 financial year.

Interested participants are asked to contact the RBA before the end of June.



R I T S

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