NOTES / AANTEKENINGE

THE LEGAL AND REGULATORY FRAMEWORK OF THE NATIONAL PAYMENT SYSTEM (NPS) – PEELING THE LAYERS OF THE ONION*

1 Introduction

The ambit of the National Payment System (NPS) or "payment system" is described in the South African Reserve Bank *National Payment System Framework and Strategy 2010* (South African Reserve Bank 2006 (hereinafter "*Vision 2010*") as

> "the entire process of making payment, in other words, it entails the process (including but not limited to) that enables the payer to make a payment, the payer to issue a payment instruction via a payment instrument or other infrastructure, the institution to receive the payment instruction via clearing or otherwise, the process of clearing and settlement (where applicable), the beneficiary to accept the payment instruction, the beneficiary to deliver the payment instruction to an institution for collection, the institution to receive and deliver the payment collection into clearing and settlement, and the beneficiary to receive the benefit of the payment. Within the described process, banks, third-person payment providers, system operators, PCH system operators (PCH refers to a 'payment clearing house') and agents of payers and/or beneficiaries are included". (The terms "NPS" and "payment system" are used interchangeably to denote the wider payment system and not individual payment streams.)

In the first *Shrek* movie, the ogre described himself as complex and as having many layers, like an onion (see http://www.dreamworks.com). In order to understand the ogre, it is necessary to peel the layers of the onion. It is evident from the above description of the ambit of the NPS that it, like an ogre, is complex and has multiple layers. This note uses the concept of an onion to deconstruct the multiple layers of the NPS. These multiple layers are to the majority of people outside of NPS circles, including lawyers, a mystery. The note is, therefore, an attempt to demystify the legal and regulatory framework pertaining to the NPS by peeling the layers of the "onion".

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2 The onion – background

The first *South African National Payment System Framework and Strategy* (the *Blue Book* was published by the Reserve Bank in 1995) was published in 1995. This document was the culmination of intensive research and debate among the South African Reserve Bank ("the Reserve Bank"), the banking industry and other payment system stakeholders. Also commonly known as the "*Blue Book*", the document contained the vision, major objectives, strategies, fundamental principles and critical success factors for payment system reform for a period of ten years.

Prior to 28 October 1998, there was no legislation that directly governed the payment system in South Africa. The NPS was established, operated and regulated in terms of either the common law or in terms of selected provisions contained in certain South African legislation. The structures within the NPS, such as the (then) Clearing Bankers' Association (CBA), the erstwhile Automated Clearing Bureau (ACB), SASWITCH and the banks themselves were established in terms of the provisions of either the common law principles relating to the law of voluntary association, the Companies Act (61 of 1973 (hereinafter "the Companies Act")) or the Banks Act (94 of 1990 (hereinafter "the Banks Act")). The various memberships and other agreements were governed by the common law principles of the law of contract.

One of the NPS project objectives was that a sound legal foundation was needed in respect of the South African NPS, as the research undertaken at the time indicated that the legal framework pertaining to the payment system was inadequate to support the payment system enhancements as envisaged by the *Blue Book* (par 2.4.7 24). The objective required appropriate legislative provisions and an effective legal framework, which had to, *inter alia:*

- provide legal certainty with regard to the rights and obligations of the respective participants;
- provide a sound and enforceable basis for resolving conflicts between transacting parties, intermediaries and regulators;
- provide a legal foundation for clearing, netting and settlement arrangements between participants in each particular payment stream;
- create a legal environment in which specified criminal activities are to be reported; and
- provide legal clarity in bank curatorship and liquidation situations.

The major areas of inadequacies related to the establishment of a payment system management body, the finality and irrevocability of settlement, clearing provisions, control of payment intermediation, netting arrangements and rules and the supervisory powers of the Reserve Bank. This led to the enactment of the National Payment System Act (78 of 1998).

All the milestones set out in the *Blue Book* have since been met, such as the introduction of a real-time-gross-settlement (RTGS) system, called the South African Multiple Option Settlement (SAMOS) system (SAMOS is an inter-bank settlement system which provides the banks with multiple options, including liquidity optimising functions, and caters for the settlement of individual high-value transactions, batched retail obligations, as well as financial market obligations emanating from the bond and equity markets, thus enabling delivery versus payment (DvP); and for more detail on SAMOS, see http://www.resbank.co.za/ and access the National Payment System Department website). Other developments included the enactment of the NPS Act (78 of 1998 (hereinafter "the NPS Act")) and amendments to the NPS Act to pave the way for the official acceptance of the Rand as a Continuous Linked Settlement (CLS) currency in December 2004. (The NPS Act came into force on 28 October 1998 and was amended during 2004 to, *inter alia*, enhance the regulatory and supervisory powers of the Bank. The Amendment Act came into effect on 29 October 2004. See more detail on CLS in par 3 1 below.) The Reserve Bank has in the meantime developed *Vision 2010* which provides strategic direction for payment system development for the next period to 2010, including creating a level playing field for participants while simultaneously adhering to sound payment system risk principles and wider access to the NPS, *etcetera*. (The other strategic objectives are to enhance and maintain the safety and efficiency of the payment system; participate in SADC payment, clearing and settlement systems initiatives; enhance and maintain the interoperability and operational effectiveness of the payment system; increase general awareness of the features of the payment system; and enhance the structures for consultation and transparency in the payment system. For more detail see *Vision 2010* 7). The legal and regulatory framework has, to a large extent, remained the same, except as stated below.

3 The inner layer – settlement

3 1 Settlement and the settlement system

A settlement system refers to a system for the discharge of payment or settlement obligations or the discharge of payment or settlement obligations between participants in that system (s 1 of the NPS Act). The Reserve Bank settlement system, also referred to as SAMOS, is defined as the settlement system established and operated by, or under the control of the Bank (s 1 of the NPS Act). Settlement refers to the discharge of a settlement obligation, which in turn is defined as "indebtedness owed by one settlement system participant to another as a result of one or more settlement instructions" (s 1 of the NPS Act).

No person may participate in the Reserve Bank settlement system unless:

– such person is the Reserve Bank, a bank, mutual bank or branch of a foreign institution and in the case where a payment system management

body has been recognised, such person is a member of the payment system management body so recognised;

- such person is a designated settlement system operator (see s 3(4) of the NPS Act); or
- such person meets the criteria for participation in the Reserve Bank settlement system as established by the Reserve Bank in consultation with the payment system management body.

The term “Reserve Bank settlement system” was inserted in 2004 to distinguish between SAMOS and a “designated settlement system”. The latter refers to Continuous Linked Settlement System (CLS), which interfaces with SAMOS for the purposes of settlement of the Rand leg in foreign exchange transactions. The term “designated settlement system operator” refers to Continuous Linked Settlement Bank International (CLS Bank), which has been designated as such.

CLS Bank was established in the United States of America in 1999 by the Group of Twenty (G20) banks with the aim of reducing counterparty risk involved in the settlement of foreign exchange transactions involving counter payments. CLS eliminates the foreign exchange settlement risk through the introduction of Payment versus Payment (PvP) (PvP is defined by the Bank for International Settlements (BIS) as a mechanism in a foreign exchange settlement system which ensures that a final transfer of one currency occurs if, and only if, a final transfer of the other currency or currencies takes place; and see BIS Committee on Payment and Settlement Systems *A Glossary of Terms Used in Payments and Settlement Systems* 2003 40), that is, both legs of the FX transaction are simultaneously settled in CLS. (CLS went live in September 2002. CLS currencies include the Australian dollar, Canadian dollar, Danish krone, the Euro, Hong Kong dollar, Japanese yen, Great Britain pound, Singapore dollar, South African rand, Swedish krona, Swiss franc and United States of America dollar. For more detail on CLS, see their website at http://www.cls-services.com.)

CLS Bank, registered in the United States of America, operates as a multi-currency bank and holds a settlement account with the Reserve Bank, that is, a real-time-gross-settlement (RTGS) account in the SAMOS system.

The Reserve Bank applied to CLS Bank to be admitted in the third wave of currencies, which included the New Zealand Dollar, Korean Won and Hong Kong Dollar. The Board of Directors of CLS Bank endorsed the inclusion of the SA Rand as a CLS eligible currency when all the CLS Bank requirements had been met and designation of CLS as a designated settlement system and CLS Bank as a designated settlement system operator took place on 29 October 2004 (see the designation notice published in GN 2459 of *GG* of 2004-10-30). CLS went live in South Africa on 6 December 2004.

Two South African banks (Standard Bank and ABSA) are Settlement Members in CLS. Settlement Members have direct access to CLS Bank. They settle transactions across CLS on behalf of themselves and their customers (third parties).

3 2 *Finality and irrevocability of settlement*

The attainment of finality and irrevocability of settlement is vital within the payment system in order to avert a systemic crisis. Where one or more participants within the payment system are unable to settle its/their obligations within a bilateral or a multilateral net settlement system, or a real-time gross settlement (RTGS) system, the consequences for the participants, their clients, as well as the system as a whole could be devastating. An automated settlement system facilitates the circulation of large amounts of money throughout the day and if finality and irrevocability of such settlements cannot be assured, it may pose a major risk to the NPS and consequent financial instability. Since the inability of a bank to settle its inter-bank indebtedness is indicative of that bank's insolvency, one has to consider the provisions of the Companies Act, read together with the provisions of the Insolvency Act 24 of 1936 (hereinafter "the Insolvency Act").

Section 348 of the Companies Act provides that "a winding up of a company by the court shall be deemed to commence at the time of the presentation to the court of the application for the winding up". (The application is presented to court when it has been duly lodged with the Registrar of the Court. See in this regard *Venter NO v Farley* 1991 1 SA 316 (W) 320; *Wolhuter Steel (Welkom) (Pty) Ltd v Batu Construction (Pty) Ltd* 1983 3 SA 815 (O) 816; *Meaker NO v Campbell's New Quarries (Pvt) Ltd* 1973 3 SA 157 (R) 159-160; and *Rennie NO v South African Sea Products Ltd* 1968 2 SA 138 (C) 141-142.)

This provision renders the winding-up of a company retrospective to the date of the presentation to court of the application concerned. This means that all business conducted and dispositions made by the company after that date are treated in law as having occurred after the start of the winding-up process. This retrospectivity will, of course, operate only once the winding-up order is granted. (See *Kalil v Decotex (Pty) Ltd* 1988 1 SA 943 AD 961-962; and *Vermeulen v CC Bauermeister (Edms) Bpk* 1982 4 SA 159 (T) 162.)

Section 341(2) of the Companies Act further provides that "every disposition of its property ... by any company being wound up and unable to pay its debts made after the commencement of the winding up, shall be void unless the court otherwise orders".

As the terms "disposition" and "property" are not defined in the Companies Act, the definitions of the Insolvency Act should be applied. The Insolvency Act defines the term "disposition" as including "a sale, lease, mortgage, pledge, delivery, payment, release, compromise, donation or any contract therefor, but does not include a disposition made in compliance with an order of court" and the term "property" as, *inter alia,* "movable or immovable property wherever situated within the Republic".

The definition of the term "disposition" clearly includes a contract for payment (estate *Jager v Whittaker* 1944 AD 246 250). It is also clear that the

conclusion that a contract to effect a payment is a disposition does not have the effect that the payment is not also a disposition (see in this regard *Klerck NO v Kaye* 1989 3 SA 669 (C) 674). Consequently, payments made by banks within the NPS in order to settle their inter-bank indebtedness will be dispositions of property as envisaged by section 341(2) of the Companies Act. Payments made by banks within the payment system that would be affected by the above-mentioned provisions would include both payments made within a RTGS system, as well as payments made in terms of a bilateral or multilateral netting arrangement (see s 5(1) of the NPS Act).

Consequently, payments made by system participants within the settlement system in order to settle their inter-bank obligations will be dispositions of property as envisaged by section 341(2) of the Companies Act. Payments made by system participants within the settlement system would be affected by the above-mentioned provisions, which provisions would render such settlements void.

The above-mentioned provisions could, therefore, affect certain settlement instructions of a failed bank and thus render such instructions revocable, thereby frustrating the principles of finality and irrevocability of settlement as envisaged by the NPS.

Prior to 1998 the position was, therefore, that where an application had been lodged for the winding-up of a system participant, all settlements made thereafter would upon the granting of the winding-up order be rendered void. This, in turn, would mean that all such settlements would have to be unwound and reversed within the automated settlement system. This would not only be virtually impossible to attain operationally, but if it were at all possible would also negatively affect other Reserve Bank settlement system participants and would have a detrimental affect on the system as a whole.

In order to overcome the above risk, the NPS Act provides that settlement is effected in money or by means of entries passed through the Reserve Bank settlement system or a designated settlement system (see s 5(1) of the NPS Act). The section further provides that a settlement that has been effected in money or by means of an entry to the credit of the account maintained by a settlement system participant in the Reserve Bank settlement system or a designated settlement system, is final and irrevocable and may not be reversed or set aside (see s 5(2) of the NPS Act). An entry to, or payment out of the account of a designated settlement system participant to settle a payment or settlement obligation in a designated settlement system, is final and irrevocable and may not be reversed or set aside (see s 5(1) of the NPS Act)).

The above provisions ensure the finality and irrevocability of settlement in respect of both settlements effected in the Reserve Bank settlement system and the designated settlement system (CLS system).

3 3 Liquidation or curatorship

3 3 1 Netting

Netting is a payment system practice and, until the promulgation of the NPS Act, was not a legal term. (This practice also occurs in the settlement of securities. For this purpose, see s 35A of the Insolvency Act, read with the central securities depository Rules issued in terms of s 39(2) of the Securities Services Act 36 of 2004.) The legal term that closely resembles netting is the term "set-off". The common law, however, only recognises set-off in a rigid set of circumstances. The common law requirements for set-off are briefly, that the two debts being set-off should be those of the persons agreeing to the set-off. Secondly, the debts being set-off should be of the same nature. Thirdly, the debts should be claimable, liquid or easily proved (for more detail on the common law requirements of set-off, see Van der Merwe, Van Huysteen, Reinecke and Lubbe *Contract General Principles* 3ed (2007) 547-550). Although the question of whether the netting of inter-bank obligations falls within the above-mentioned requirements could be debated, it can be argued that netting as practised by banks within the payment system is not set-off as envisaged or provided for by the common law, but is rather an innovation brought about by payment system practices and further developed as a result of technological advances. The NPS Act, therefore, defines the practice of netting and provides the payment system with legal certainty in the participation of these practices.

The potential legal obstacle in this regard was as a result of section 46 of the Insolvency Act, which essentially affords the liquidator of an insolvent estate the discretion to abide by or to disregard a set-off agreement entered into by an insolvent. (S 46 of the Insolvency Act provides the following in this regard: If two persons have entered into a set-off transaction; and one is sequestrated within six months after set-off has taken place; then the trustee of the sequestrated estate may abide by the set-off; OR if the set-off was not effected in the ordinary course of business, with approval of the Master, disregard it and call upon the person concerned to pay to the estate the debt that he would owe it but for the set-off.) Since netting was not a legal term and since it closely resembles set-off, the uncertainty existed that a liquidator might regard netting as set-off and might disregard such agreements, which may cause untold problems within the payment system or which may result in lengthy and costly law suits.

In a net settlement system, therefore, which is based upon bilateral or multilateral netting agreements between the participants, the insolvency of a participant would result in simultaneous creditors' claims. Set-off after a winding-up order of a company would in effect enable parties to obtain a benefit to the detriment of the other creditors, as their claims would be predetermined and settled ahead of the other concurrent creditors' claims. It follows that an agreement that would enable post-liquidation set-off is void in our law as being contrary to the *pari passu* or *par creditorum* principle.

Therefore, a payment clearing house (PCH) rule providing for the set-off after liquidation of claims between members would also be void.

The position would, therefore, have been that where two persons had entered into a set-off transaction, such set-off may be set aside under section 46 of the Insolvency Act if it occurred within six months of sequestration or if the set-off was effected other than in the normal course of the insolvent's business. The test to determine whether a transaction was performed in the ordinary course of business is an objective one. It needed to be established whether, having regard to the terms of the transaction and the circumstances under which it was entered into, such transaction would normally have been entered into by solvent businessmen (*Thomas Construction (Pty) Ltd (in liquidation) v Grafton Furniture Manufactures (Pty) Ltd* 1988 2 SA 546 (AD) 568*; Paterson NO v Trust Bank of Africa Ltd* 1979 4 SA 992 (A) 997; *Joosab v Ensor NO* 1966 1 SA 319 (A) 326; *Hendriks NO v Swanepoel* 1962 4 SA 338 (A) 345; and *Pretorius's Trustee v Van Blommenstein* 1949 1 SA 264 (O) 273).

In view of the provisions of section 46 of the Insolvency Act, as well as the *dicta* of the relevant case law on the subject (as per footnote above), it would appear that set-off effected under the rules of BANKSERV (see par 4 1 for more detail on BANKSERV) or under the NPS net settlement system, would be in the normal course of business. Such set-off should, therefore, not be possible to be set aside by a liquidator of the insolvent estate of one of the participants. In order to attain absolute legal certainty in this regard, however, netting had to be addressed in legislation.

A further issue in this regard was that section 46 of the Insolvency Act specifically provides only for bilateral set-off arrangements between two persons, and it was unclear what the position would be where three or more persons were to enter into a multilateral set-off arrangement.

To complicate matters, section 69(B) of the Banks Act provides that "Notwithstanding any provision to the contrary contained in this Act, sections 35A, 35B and 46 of the Insolvency Act … shall *mutatis mutandis* apply to the curator of any bank under curatorship and to such a bank as if the curator were a trustee of an insolvent estate and the bank were an insolvent or a sequestrated estate as contemplated in those sections".

The sections of the Insolvency Act that are referred to in section 69(B) of the Banks Act apply only to banks that have entered in specifically defined contracts within specifically defined markets. They do not apply to a bank's obligations or agreements within the payment system. It was, therefore, imperative to address the matter and to obtain legal certainty with regard to netting arrangements entered into by banks within the payment system where such a bank has been placed under curatorship (The moment of appointment would probably be determined by the date of the letter of appointment by the Minister of Finance in accordance with s 69(2) of the Banks Act and not the date of the *GG*, in which the Registrar announces the appointment in terms of the provisions of s 69(7) of the Banks Act).

This position had been addressed by the insertion of a definition of "*netting*" in the NPS Act and by rendering netting agreements and netting rules within the payment system as binding upon a liquidator or a curator, as the case may be, of a clearing or settlement system participant.

The NPS Act defines "netting" as, "the determination of the nett payment obligations between two or more clearing system participants within a payment clearing house or the determination of the nett settlement obligations between two or more settlement system participants within a settlement system".

Section 8 furthermore provides that the provisions of the section apply despite anything to the contrary contained in the law relating to insolvency, or in the Companies Act, the Banks Act, the Co-operatives Banks Act, the Postal Services Act or the Mutual Banks Act (see s 8(1) of the NPS Act). This overriding of "normal" principles is further strengthened by the exclusion of arrangements made in terms of section 8 in terms of section 35B of the Insolvency Act (see s 35B(4) of the Insolvency Act).

If a curator or similar official is appointed to a clearing system participant or a settlement system participant, the curator or similar official is bound by:

- any provision contained in the settlement system rules or in clearing, netting and settlement agreements to which that clearing system participant or settlement system participant is a party or any rules and practices applicable to the settlement system participant in relation to such agreements; and
- any payment or settlement that is final and irrevocable in terms of section 5(2) or (3) (s 8(2) of the NPS Act).

Similarly, a liquidator or similar official is bound by section 8(6). The effect of both subsections is to make any provision contained in certain agreements or rules and final and irrevocable settlements binding on a curator, liquidator, or similar official. As mentioned above, finality and irrevocability of settlements of both the Reserve Bank settlement system and entries to, payments out of, and settlement in the designated settlement system are ensured, which settlements are binding on the curator, liquidator or similar official in terms of section 8(2) and 8 (6).

A curator or similar official appointed to a settlement system participant may give written notice to the Reserve Bank to withdraw such participant's participation in the Reserve Bank settlement system (s 8(3) of the NPS Act). In this event, the settlement system participant will no longer be entitled to clear or participate in the Reserve Bank settlement system, other than for purposes of discharging payment or settlement obligations in accordance with the settlement rules or clearing, netting and settlement agreements to which such settlement system participant is a party or any rules and practices applicable to the settlement system participant in relation to such agreements.

Furthermore, section 8(4) provides that, "(w)hen an application for the winding-up of a clearing system participant or Reserve Bank settlement system participant is made, a copy of –

(a) the application for winding-up, when it is presented to court; and

(b) any subsequent winding-up order, when it is granted

must be lodged with the Reserve Bank as soon as practicable."

When such copy is lodged and the Reserve Bank settlement system participant in respect of whom a copy is lodged with the Reserve Bank is a designated settlement system participant, the Reserve Bank must as soon as practicable after having received the copy, notify the designated settlement system operator.

A clearing system participant or settlement system participant in respect of whom a copy of the winding-up order has been lodged with the Reserve Bank must no longer be entitled to clear or participate in the Reserve Bank settlement system, other than for purposes of discharging payment or settlement obligations in accordance with the settlement rules or clearing, netting and settlement agreements to which such settlement system participant is a party or any rules and practices applicable to the settlement system participant in relation to such agreements (see s 8(7) of the NPS Act). In practice, the curator, liquidator or similar official will be bound to any settlements that are final and irrevocable and any transactions that are already in the system before the time of the announcement of withdrawal of participation.

Section 8(8) provides that, notwithstanding any written law or rule of law, a court shall not give effect to:

– an order of a court exercising jurisdiction under the law of insolvency of a place outside of the Republic of South Africa; or

– an act of a person appointed in a place outside of the Republic of South Africa to perform a function under the law of insolvency there,

in so far as the making of the order or doing of the act would be prohibited under this Act for a court in the Republic of South Africa or a curator or similar official or liquidator or similar official.

This provision extends the protection against South African curators or liquidators to foreign curator, liquidators or judgments.

There are a few motivations for deviating from the normal principles of liquidation as contained in the Insolvency Act read with the Companies Act. Firstly, the NPS requires that all payments made by a system participant via the settlement system, after an application for the winding-up of such a system participant has been lodged, should not only be regarded as being valid, but should also be regarded as being final and irrevocable up to the issue of the winding-up order. This exception is vital for purposes of ensuring the safety, efficiency effectiveness and stability of the payment system as a whole.

Secondly, the nature of the NPS is such that settlement system participants are constantly paying away and receiving funds. The effect of this interchange is that the exception will not of necessity have the effect of diminishing the estate of an "insolvent" system participant, but could well allow the estate to increase. One of the main purposes of the provisions of section 341(2) of the Companies Act, is to ensure that a company does not deliberately diminish its estate by disposing of its assets during the period as from the application for the winding-up to the issue of the winding-up order.

Thirdly, the exceptional rules will only be applicable to settlement system participants and only with regard to settlement instructions within the settlement system. It is submitted that it is in practice, highly unlikely that a settlement system participant will be able to dispose of its assets, with a view to effecting a disposition in contravention of insolvency law, via the payment and settlement system.

In the fourth instance, settlement obligations emanate from payment obligations that are generated by the clients of settlement system participants. The settlement of inter-bank obligations can be viewed as a service performed by settlement system participants on behalf of their clients, the general public. It can, therefore, be argued that it is also in the public interest that settlements in the payment and settlement system are in law regarded as final and irrevocable.

4 The middle layer – clearing

4 1 The meaning of clearing and the clearing system

"Clearing" constitutes the middle layer of the onion. In terms of the *Vision 2010*, accessibility for participation in various levels of the payment system is balanced with the reduction of risks in the payment system (see *Vision 2010* par 2.4.2 9). Technological advances have made it possible for large non-bank corporations that have more than one banker, to acquire the technology necessary to clear inter-bank obligations and to transmit only the netted result to the paying bank. Since this practice would conceal certain risks within the system, it could pose a systemic risk. In order to ensure that this is protected adequately, the term "clearing" is clearly defined in the NPS Act, as well as participation in the clearing system.

To this end, the NPS Act defines "clearing" as, "the exchange of payment instructions". In turn, a "payment instruction" refers to an instruction to transfer funds or make a payment (see s 1 of the NPS Act). A new definition of "clearing system participant" has been introduced in the recent amendments to the NPS Act pursuant to the Financial Services Laws General Amendment Act, 2008 (22 of 2008). Such "clearing system participant" is now defined as a "bank, a mutual bank, a co-operative bank, a branch of a foreign institution or designated clearing system participant that clears in a manner contemplated in section 4(2)(d)(i). A "designated clearing system participant", in turn, is defined as a person "specified in the notice referred to in section 6(3)(a)".

Furthermore, in terms of section 6 of the NPS Act, no person may clear payment instructions unless that person is a bank, a mutual bank, a designated clearing system participant, a co-operative bank or branch of a foreign institution that is allowed to clear in terms of section 4(2)(d)(i). Section 4(2)(d)(i) provide for so-called "sponsorship arrangements", in terms of which a bank either clears and settles on behalf of another bank, or such other bank does its own clearing, but its obligations are settled by the first-mentioned bank. Finally, such person may not clear in terms of the sponsorship arrangement unless, in the case where a payment system management body has been recognised, such person is a member of the payment system management body (s 3(5) of the NPS Act). It would therefore appear that a designated clearing system participant may clear if such a participant has been designated by the Reserve Bank in terms of criteria set out in section 6 (3), similarly to a designated settlement system.

At present there are quite a number of payment streams, which are actually individual payment systems, which allow for clearing of payment instructions through the clearing system or as a result of "on-us" payments. "On-us payments" refer to payment obligations that arise within the same bank and do not lead to inter-bank settlement (see *Vision 2010* par 3.4.2 11). However, clearing of the majority of payment obligations takes place pursuant to BANKSERV, the successor to the Automated Clearing Bureau (ACB). BANKSERV is a "PCH System Operator" (payment clearing house system operator) as defined in the NPS Act, as it clears on behalf of two or more (bank) settlement system participants. (See s 1 of the NPS Act. BANKSERV, established in 1993, is an Automated Clearing House that provides inter-bank switching and settlement services to the South African banking sector. It is wholly owned by the commercial banks in the country. For more detail on BANKSERV, see http://www.bankserv.co.za). It is licensed by the payment system management body, the Payments Association of South Africa, referred to as "PASA".

In this middle layer, the payment system management body plays an important role. The role of this body is dealt with in the next paragraph.

4 2 The role of the payment system management body

The *Blue Book* required that a payment system management body should be established which would be open to all banks wishing to participate within the payment system. Increased access to the payment system is echoed in *Vision 2010* (see *Vision 2010* par 2.9). Membership should, furthermore, be subject to equitable risk-based entry criteria. Such a body would then be able to control its members and thereby effectively regulate the payment system. The Reserve Bank, as overseer of the payment system, is closely involved in such a body. The NPS Act ensures that the establishment and subsequent management of such a body conform to the principles as set out in the *Blue Book*. In this regard, the PASA was established by the banking industry during 1996 and has been recognised as a payment system management body by the Reserve Bank.

The NPS Act provides that "the Reserve Bank may recognise a payment system management body if the Reserve Bank it is satisfied that –

(a) the payment system management body, as constituted, fairly represents the interests of its members;

(b) that the provisions of the deed of establishment or constitution, as the case may be, as well as the rules, including rules relating to admission to membership, of the payment system management body are fair, equitable and transparent; and

(c) that the payment system management body will enable the Reserve Bank to oversee adequately the affairs of the payment system management body and its members and will assist the Reserve Bank in the discharge of the Reserve Bank's responsibilities, specified in section 10(1)(c)(i) of the South African Reserve Bank Act, 1989, regarding the monitoring, regulation and supervision of payment, clearing or settlement systems" (see s 3(2) of the NPS Act).

The Reserve Bank may withdraw its recognition of the payment system management body if it is no longer satisfied that the payment system management body complies with the requirements mentioned above and after it has consulted with the members of the payment system management body. The withdrawal of recognition will not affect any arrangements made, including rules and agreements, or authorisations given by the payment system management body prior to such withdrawal (see in this regard s 3(2A) of the NPS Act).

Apart from the Reserve Bank, the following may also be members of the payment system management body:

– a bank, mutual bank or branch of a foreign institution; and

– an institution or body referred to in section 2 of the Banks Act, 1990 and in paragraph (dd)(i) of the definition of "the business of a bank " in section 1 of the Banks Act

that complies with the entrance and other applicable requirements laid down in the rules of the payment system management body (see s 3(3) of the NPS Act).

The latter refers to bodies "exempted" or "excluded" in terms of the Banks Act. In terms of the 2004 amendments, these bodies or institutions could be granted limited membership of the payment system management body if they comply with the criteria for limited membership recommended by the payment system management body for approval by the Reserve Bank. However, the concept of "limited membership" has been removed from the Act through the use of another concept, namely that of designation of clearing system participant (see the amendments to sections 3, 4 and 6 of the NPS Act pursuant to the Financial Services Laws General Amendment Act, 2008). There has been considerable political pressure to broaden access of this layer to non-banks and the above amendments seem to give effect to such broadened access.

Section 4 provides for the objects and rules of such a payment system management body. It is important to note that the scope of the payment system management body has been broadened. The payment system management body may organise, manage and regulate, in relation to its members, all matters affecting payment instructions. This means that this extends from payer to beneficiary, in relation to its members. It is submitted that the broadening of access to the payment system has to be balanced by certain regulatory measures aimed at reducing risk within the NPS. This may have implications for the Reserve Bank as a regulator and PASA as the *de facto* co-regulator in this layer. The criteria for participation in the SAMOS system as established by the Reserve Bank in consultation with PASA would most probably have measures in place that will ensure the continued safety, efficiency and effectiveness of the NPS. The continued good working relationship between the Reserve Bank and PASA would be crucial.

5 The outer layer – payment

5 1 Payments to third persons and other non-bank players

The outer layer is occupied by payments. *Vision 2010* envisaged the broadening of access to the NPS to include both banks and non-banks (see *Vision 2010* par 2.9 for more detail on access to the NPS). This layer comprises individual payment systems and includes the payer, beneficiary and the payment networks which connect the clients (corporate and individual) with their banks, settlement system participants and/or "system operators". A "system operator" refers to any person who provides services to one or more settlement system participants in respect of payment instructions (see s 1 of the NPS Act). These services usually refer to technological services (see the definition in s 1 of the NPS Act).

The "non-bank" system participants are most prevalent in the outer layer. The NPS Act provides for non-bank participants by providing for payments to third persons.

Payment intermediation can be described as the practice in terms of which funds are entrusted by a payer to an intermediary who is required to pay those funds to a third person on behalf of such payer.

Where the intermediary is a settlement system participant, its activities will be regulated and supervised in terms of the provisions of the Banks Act or Mutual Banks Act. However, where the intermediary is a non-bank performing third party payment services on behalf of members of the public, as a regular feature of its business, the following situations arise:

Where the intermediary acts as the duly appointed agent of the third party (payment beneficiary), the legal rules pertaining to the common law rules of agency will afford the payer legal protection. For instance, where a customer (member of the public) effects payment of his municipality account at a retailer and the retailer has been duly appointed as the agent of the

municipality to accept payments on its behalf, the common law stipulates that, where the payer can prove payment to the agent (retailer), it will be regarded as being payment to the principal (municipality). Where the intermediary (retailer) becomes insolvent, the payments made to it by the public to settle third party (for *eg*, municipality) accounts, will be deemed to have been made to such third party. This will ensure that the public are protected with regard to such payments and that the principal (municipality) will have to recover all such payments from its duly appointed agent, the retailer (for more detail on the laws of agency, see Wanda "Agency and Representation" *LAWSA* vol 1 par 175ff). However, where the intermediary acts as the agent of the public to collect their funds and to pay their accounts to third parties on their behalf, the public are at risk. Prior to 2004, such practices were unregulated.

Since the Post Office and Postbank are unique institutions providing third party payment services as described above, and since both institutions are established and regulated by an Act of Parliament, which includes the financial support by Government, the risks to the public are greatly reduced. For this reason it was recommended that the above-mentioned institutions be exempted from any provision that might prohibit or formalise the above-mentioned practices.

The payment intermediation process as explained above could not be implemented, hence the move to "payments to third persons" brought about by the 2004 amendments. The section has been amended from a restrictive provision to an enabling section. It provides that a person may, as a regular feature of that person's business, accept money or payment instructions from any other person for purposes of making payment on behalf of that other person to a third person to whom that payment is due, if

– the first-mentioned person is the Reserve Bank, a bank, mutual bank, a co-operative bank, a designated clearing system participant or branch of a foreign institution or a designated settlement system operator; or

– the first-mentioned person is the postal company defined in section 1 of the Post Office Act, 1958 or the Postbank as defined in section 51 of the Postal Services Act, 1998; or

– the money is accepted or payment made in accordance with directives issued by the Reserve Bank from time to time in terms of section 12 (see s 7 of the NPS Act as amended by the Financial Services Laws General Amendment Act, 2008).

It is evident from the above that the inclusion of the "designated clearing system participant" would further widen access to this layer of the onion as such clearing system participant would also be able to provide payments to third parties as envisaged in section 7.

6 Oversight of the onion

6 1 Powers of oversight

The Reserve Bank, as neutral agent, is best suited to oversee and supervise the NPS. In the past, although the Reserve Bank, as lender of last resort and ultimate settlement agent of settlement system participants within the payment system, has always had the right to oversee the payment system, its powers and duties were not defined. Where problems arose with participants within the payment system in the past, the Reserve Bank had to resort to moral suasion or a gentlemen's agreement in order to resolve the matter.

The powers conferred and duties imposed upon the Reserve Bank relating to its function of providing clearing and settlement facilities to banks are contained in section 10(1)(c) of the South African Reserve Bank Act (90 of 1989). This subsection provides as follows:

> "10 Powers and Duties of Bank
>
> (1) The Bank may, subject to the provisions of section 13 –
>
> (c) (i) perform such functions, implement such rules and procedures and in general, take such steps as may be necessary to establish, conduct, monitor, regulate and supervise payment, clearing and settlement systems;
>
> (ii) form, or take up shares or acquire an interest in, any company or other juristic person that provides a service for the purpose of or associated with any facility for or associated with, the utilization of any such payment, clearing or settlement systems;
>
> (iii) perform the functions assigned to the Bank by or under any law for the regulation of such payment, clearing and settlement systems; and
>
> (iv) participate in any such payment, clearing and settlement systems."

Subsection 10(c)(i) enables the Reserve Bank to establish, operate, oversee and regulate payment, clearing and settlement systems. Since there is a clear distinction between payment, clearing and a settlement system, it is necessary to augment the functions of the Reserve Bank in this regard and not to confine it to a clearing system only.

Subsection 10(c)(ii) enables the Reserve Bank to either establish or to take up shares in companies connected with payment, clearing and settlement systems. This could become necessary for the Reserve Bank to obtain either an interest or control in a company such as a central depository for the safe-keeping of securities, although this has not yet transpired in practice.

Furthermore, subsection 10(c)(iii) enables the Reserve Bank to execute the functions, powers and duties imposed upon it by the NPS Act and any other relevant law. It was also necessary to include the subsection, as the detailed powers and duties of the Reserve Bank relating to payment, clearing and settlement systems are contained in the NPS Act.

Finally, subsection 10(c)(iv) enables the Reserve Bank to participate in payment, clearing and settlement systems.

In this regard section 10 of the NPS Act provides that the Reserve Bank has access to any information relating to the payment system and the Reserve Bank settlement system and any person must on request provide such information to the Reserve Bank in such form and at such times as the Reserve Bank may require.

6 2 Directives

Besides the general powers of oversight in terms of section 10(1)(c) of the Reserve Bank Act as mentioned above, the Reserve Bank has the power to issue directives, in consultation with the payment system management body and other stakeholders (s 12(1)). Directives issued in terms of subsection (1) are "general directives", as opposed to the "remedial directives" which the Reserve Bank may issue in terms of subsection 3 (s 12(3)).

Provision is also made for the exclusion of a designated settlement system operator in the instance of a change in the payment system that may necessitate operational changes on their part (s 12(4)). Furthermore, provision is made for the cancellation of previously issued directives and an offence subsection (ss 12(5), (6) and (8)).

No directives issued will have retroactive effect (S 12(7)). Provision is also made for a grace period in respect of "general directives", as opposed to "remedial directives" which will become effective immediately (s 12(9)).

It is an offence to fail, refuse or neglect to comply with directives (see s 12(8)) and a person who is found guilty of such an offence is liable to a fine of R1 million or to imprisonment or to both such fine and imprisonment (see s 14(a)). In addition, the Reserve Bank may apply to the High court for an order to direct a person to comply with the Act or a directive issued in terms of the Act (see s 13A of the NPS Act).

To date, the Reserve Bank has issued three directives, to wit, in respect of banks involved in the collection of payment instructions in the early debit order PCHs (see Directive No 2 of 2006), in respect of system operators (see Directive No 2 of 2007) and in respect of payments to third persons (see in this regard Directive No 1 of 2007).

6 3 Oversight and the layers

It is evident from the above that the Reserve Bank has oversight powers in respect of the NPS in terms of section 10(1)(c) of the Reserve Bank Act. The purpose of oversight is to reduce systemic risk, which could result from legal, liquidity, credit, operational, settlement and reputational risk in the payment system (see par 3.2 in *Vision 2010* 11). The scope of oversight spans the entire process of effecting a payment. This entails the full process of enabling a payer to make a payment, by means of issuing a payment instruction via a payment instrument such as a debit or credit card, to the

beneficiary receiving the funds in terms of the payment. The scope therefore includes all participants, third-party payment service providers, system operators and agents. The oversight mandate also includes the payment system infrastructure. This infrastructure includes payment instruments, systems, applications, networks, payment, clearing and settlement systems from a technology perspective (see Directive No 2 of 2006).

The Reserve Bank uses the Bank for International Settlements (BIS) *Core Principles for Systemically Important Payment Systems* (Committee on Payment and Settlement Systems (BIS) 2001) (hereinafter "the *Core Principles*"). This can be accessed at http:/www.bis.org/cpss/; and see in particular, the public policy objectives to ensure safety and efficiency in systemically important payment systems as guidelines for the oversight of the NPS. In terms of these guidelines, the responsibilities of the central bank in applying the *Core Principles* are that the central bank:

– should clearly define its payment system objectives and should disclose publicly its role and major policies with respect to systemically important payment systems;
– should ensure that the system it operates complies with the *Core Principles*;
– should oversee compliance with the *Core Principles* by systems it does not operate and it should have the ability to carry out this oversight;
– should, in promoting payment system safety and efficiency through the *Core Principles*, co-operate with other central banks and with any other relevant domestic and foreign authorities.

The Reserve Bank, through its National Payment System Department, uses direct powers of oversight with regard to the inner circle, as the Act is administered, policy is driven through position papers and in certain instances, and directives are issued. This includes oversight at a macro and micro level. At the macro level, this is done through the NPS Act, directives and agreements, whereas oversight at the micro level consists of the compilation of profiles on settlement system participants, analyses of payment system risks and oversight visits. The benefits from micro oversight include a better understanding of the payments business of participants, building of relationships with the participants and enhanced management information (for more detail on the development of oversight on a micro level, see *Vision 2010* par 5.3).

With regards to the middle layer, the Reserve Bank is assisted by PASA in the discharge of its oversight duties. As stated above, the task of the Reserve Bank is enhanced by section 10 of the NPS, which provides for information that the Reserve Bank has access to in relation to the payment system and Reserve Bank settlement system (see s 10 of the NPS Act). As stated above (paragraph 4.2), the broadening of access to the payment would have a regulatory impact, which may change the way in which oversight has been conducted with regards to this layer in preceding years, unless the Reserve Bank and PASA decide to take a more indirect approach to oversight. Furthermore, as stated earlier, the criteria for participation in

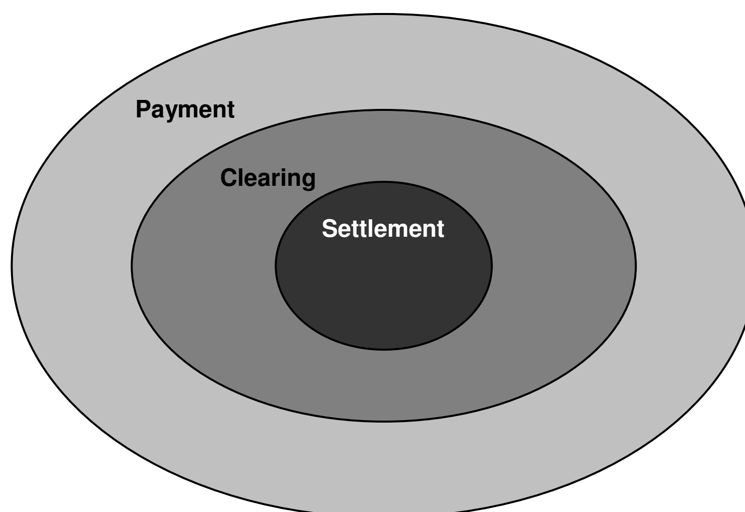
the SAMOS system as established by the Reserve Bank in consultation with PASA would most probably have measures in place that will ensure the continued safety, efficiency and effectiveness of the NPS. The continued good working relationship between the Reserve Bank and PASA would be crucial.

Oversight of the outer layer is in many respects "lighter", than with respect to the inner layer and includes policy direction through position papers, moral suasion and issuance of directives. However, if one bears in mind that contravention of directives is an offence, the consequences of non-compliance may be serious, as stated earlier (see the offences in s 14 of the NPS Act; and see also par 6 2 above).

It is evident from the above that the Reserve Bank uses its powers of oversight as stated in section 10(1)(c) of the SARB Act in all layers of the onion, but these powers manifest in different ways in the three layers.

7 Conclusion

The above is a brief summary of the different layers of the NPS "onion", the role-players and the legal and regulatory framework pertaining to the NPS. Concepts are explained and oversight roles highlighted. The onion can be illustrated as follows, which will hopefully add to further demystifying the NPS.



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