
LEGAL ASPECTS OF ELECTRONIC CLEARING AND SETTLEMENT

Payments Clearing and Settlement - Australian Framework

PETER SMITH

**Chief Executive Officer
Australian Payments Clearing Association Ltd, Sydney**

PAYMENTS CLEARING AND SETTLEMENT

Payments clearing is the process by which financial institutions, having received payment instructions from their customers, transmit these instructions to counterparty financial institutions. Settlement is the satisfaction of financial obligations between financial institutions which arise out of the clearing process.

Settlement in Australia is on a multilateral net deferred basis. Institutions settle, due or owing to the system, at 9:00 am on day two, for day one obligations, through transfers of exchange settlement account balances at the Reserve Bank.

This paper provides a framework for considering clearing and settlement issues by outlining Australia's payment systems and the regulatory structure within which institutions clear and settle. Particular reference is made to the issues of failure to settle and risk management because of their importance in driving contemporary development of clearing and settlement.

AUSTRALIA'S PAYMENT SYSTEMS

The systems used for making non-cash payments in Australia can be segmented as below:

- the paper, mainly cheques, system;
- the direct entry system;
- consumer electronic systems;
- high value electronic systems:
 - Banks Interchange and Transfer System (BITS);
 - Reserve Bank Information and Transfer System (RITS);
 - Austraclear.

This leaves aside financial EDI which is still in a fairly formative stage in its development in Australia.

Taken together an estimated 8 million or so domestic non-cash transactions are processed through Australia's payment systems each working day with an estimated value of over \$90 billion.

Payment systems can be classified a number of ways. APCA has adopted a specific structure for managing payments clearing in Australia (as noted below). In more general terms, payments systems are often classified as either large (or high) value transfer systems or small value transfer systems.

In Australia the paper system encompasses to a significant extent both small and large value transfers. This is less so, for example, in the United Kingdom and in continental Europe. In the United Kingdom this is accounted for by the switch from the use of high value paper to the use of the high value electronic system CHAPS, and in continental Europe it is largely accounted for by the dominance in a number of countries of the giro system for small value payments.

Australia does not yet have a widely accessible general purpose high-value electronic system and has not developed a giro system. As a result the cheque is used widely by businesses and individuals for both small and large value payments.

BITS is the only well developed general purpose electronic payments system in Australia which sits squarely in the large value area. Austraclear and RITS are as large value systems, but these are specialised systems designed primarily for processing payments related to security transactions rather than for providing general purpose payment services.

Another important feature which distinguishes some payment systems from others, and which cuts across the classification of large value and small value, is the status of each payment transaction within the system. Transactions in some payment systems are *irrevocable*; that is, once done they cannot be undone. An example would be an authorised credit card transaction. In some they are provisional in nature and subject to confirmation. An example would be a cheque deposit.

A brief description of each of Australia's payment and funds transfer systems is provided below.

Paper (Cheques and Payment Orders)

Cheques have traditionally been the predominant means of making non-cash payments in Australia. In recent years there has been a switch away from cheques for small-value payments towards card-based payments and towards the use of automated arrangements for crediting payrolls and debiting insurance premiums and the like and, for large-value payments, towards BITS, RITS and Austraclear. But cheques retain a significant place in the payments system. Cheque payments account for around 45 per cent of non-cash payment transactions by volume and 30 per cent by value. Around 4 million cheques and other paper debit items are handled by Australian financial institutions each day.

The Cheques and Payment Orders Act 1986 is the body of law governing the issuance and clearance of cheques and payment orders in Australia. Only banks in Australia may issue cheques in their own name. That is, cheques drawn on themselves as principals. Though currently under review, non-bank financial institutions (NBFIs) are not permitted under the Act, as it now stands, to issue such cheques. They may issue, and have drawn on them, payment orders. Payment orders perform exactly the same function as cheques but they have not proved to be popular. Very few institutions currently issue payment orders. For the most part, those NBFIs which wish to provide their customers with a "cheque" facility, issues cheques which carry their name but which are drawn on their bank.

Prior to December 1993, cheque clearing was under the jurisdiction of the Australian Clearing House Association (ACHA). The rules governing participation in clearing and the procedures to

be followed where largely contained in the Australian Banks' Clearing House Agreement 1977. Since December 1993, cheque clearing has been under the jurisdiction of APCA. The ACHA has now been dissolved.

Cheques in Australia are all "presented" physically by the collecting financial institution, directly or indirectly, to the bank on which they are drawn. Equally, dishonoured cheques are returned physically to the collecting institution. However, the Cheques and Payment Orders Act, as amended, allows full (external) truncation; that is, truncation of paper at the collecting point, provided notification is given of where the cheques are held and can be retrieved.

APCA has a project underway to introduce presentation by means of the electronic transmission of cheque details and also dishonour, as applicable, by electronic transmission.

Direct Entry

The direct entry system allows approved organisations to make arrangements with their financial institution to credit or debit the accounts of large numbers of the organisation's employees or clients on a regular basis. A single counterpart cover payment in the form of an offsetting debit or credit, as the case may be, is made to the organisation's account, corresponding to the sum of these credits or debits.

Credits to accounts are irrevocable in nature and cannot be reversed. Debits, on the other hand, are provisional and can be dishonoured in somewhat similar fashion to cheques.

Consumer Electronic

The means for making payments which fall under the heading of consumer electronic, and which generate clearing, are electronic funds transfer at point of sale (EFTPOS) and Visa, MasterCard and Bankcard transactions. (Note, clearing is also generated when customers use ATMs other than their own financial institutions' for cash withdrawals.) Stored value cards, currently being piloted, also fall under this heading.

Banks Interchange and Transfer System (BITS)

BITS is a real time, large value electronic funds transfer system owned by the four major banks and the State Bank of NSW.

As a general rule, BITS payments are \$10,000 or more and include inter-bank money market and foreign exchange transactions, and corporate to corporate payments. Payments, once made, are irrevocable. Recipients receive immediate and clear funds.

Austraclear

Austraclear provides a central depository and registry for money market securities (private sector and semi-government securities) and a real time electronic system for transferring ownership of securities, without the need for the physical transfer of paper.

Reserve Bank Information and Transfer System (RITS)

RITS is an electronic system, established and operated, since August 1991, by the Reserve Bank, which allows Commonwealth Government Securities (CGS) to be transferred and settled simultaneously (ie on a "delivery versus payment" basis), in real time. It performs a similar function in respect of CGS as does Austraclear with private and semi-government securities. However, transactions on RITS are irrevocable when made. RITS transactions account for 95% of the market in CGS.

REGULATORY STRUCTURE

The regulatory structure governing payments clearing and settlement in Australia in respect of cheque and direct entry transactions falls under the jurisdiction of Australian Payments Clearing Association Limited (APCA). Rules to cover consumer electronic and high value electronic transactions will be implemented by APCA in due course. Parts of the Banking Act (eg section 64 dealing with settlement and Division 2 "protection of depositors") and the Cheques and Payment Orders Act also have application to elements of clearing and settlement, as do, in particular circumstances, the insolvency provisions of the Corporations Law and Part IV of the Trade Practices Act.

APCA is a non-listed public company, limited by shares and guarantee, APCA was established in February 1992. Its charter is to co-ordinate, manage and ensure the implementation and operation of effective payments clearing and settlement systems, policies and procedures. The company is not constrained, other than by law, in its activities. Its shareholding structure is unusual and was designed to provide an accommodating basis for its voting rules.

The Reserve Bank, and each of the four "major" banks holds one ordinary share, entitling each to one vote at shareholder meetings or their nominated director to one vote at board meetings. State and regional banks (as defined) can hold a class of voting redeemable preference shares which entitle them collectively to one vote. Other classes of voting redeemable preference shares can be held respectively by other licensed banks, and by building society and credit union bodies. Each of these constituent groups is entitled to one vote. Nine votes in total can be cast at shareholder meetings or at board meetings. With some exceptions, six votes are required to pass a resolution.

Under APCA, payments clearing arrangements are being structured into four "clearing systems".

The four clearing systems are as follows:

- Australian Paper Clearing System (APCS), covering the clearance of cheques, payment orders and other paper instruments.
- Bulk Electronic Clearing System (BECS), initially covering the clearing of direct entry payments.
- Consumer Electronic Clearing System (CECS), initially covering clearings which arise as a result of EFTPOS and inter-institutional ATM transactions.
- High Value Clearing System (HVCS), covering clearings which arise as a result of transactions on high value electronic clearing system(s).

Clearing systems are governed by management committees which report to APCA's board. The rules of each system cover conditions of participation - from broad membership criteria to detailed procedural matters. The rules for APCS and BECS include provisions for handling the risk of an institution failing to settle.

Two of the four clearing systems have been established. APCS was established in December 1993. BECS was established in December 1994. Application for authorisation of both arrangements was made under section 88 of the Trade Practices Act in respect of section 45 of the Act dealing with exclusionary provisions and provisions affecting competition, and section 47 dealing with exclusive dealing. Participation in each of the systems was authorised by the Trade Practices Commission.

SETTLEMENT RISK

Settlement risk, refers to the risk of an institution or institutions failing to settle their clearing obligations when they fall due.

Settlement risk arises when settlement between financial institutions is "deferred"; that is, when settlement occurs after payment instructions have passed between them and after the recipient (or payee) institution has credited its customers' accounts or has otherwise paid away. The recipient institution, immediately on paying away, is subject to the risk that the paying institution may default on its settlement obligation.

It is possible also that if one institution fails to settle it might cause others to fail: so-called "systemic risk".

The importance of countering settlement risk is now widely recognised. For example, all but two European Community countries plan to have in place by 1997 real time gross settlement (RTGS) systems to eliminate settlement risk. A number of other countries have or are working towards introducing netting systems, or a combination of both.

RTGS Systems

In RTGS systems each (large value) payment instruction between financial institutions results in a real time, ie, immediate, counterpart flow of settlement balances held at the central bank. Depending on the system, such flows are pre-funded or based on credit, usually collateralised credit, extended by the central bank.

The alternative to RTGS systems is multilateral net settlement systems. Netting lessens the liquidity requirements of a payments system and, when allied with legally secure liquidity support and loss sharing rules, can effectively counter systemic risk, though it cannot entirely eliminate the risk as can RTGS systems.

Multilateral Net Deferred Settlement Systems

Multilateral net deferred settlement systems are systems in which the obligations of one party to another are set off on a continuous basis to produce for each party a single settling figure, usually at the end of each trading day, which they either owe to the system or owed by the system.

In net settlement systems, settlement is deferred, while the underlying payments, which together make up the settlement figures, have been made and are usually regarded as final and irrevocable. It is therefore important that the netting arrangements, and means to ensure settlement in a timely fashion in the event of failure, are legally secure and operationally robust.

The internationally accepted benchmark for evaluating the effectiveness of net settlement systems is set down in the Lamfalussy Report.¹ This Report lists six minimum standards for netting schemes.

- I. Netting schemes should have a well-founded legal basis under all relevant jurisdictions.
- II. Netting scheme participants should have a clear understanding of the impact of the particular scheme on each of the financial risks affected by the netting process.

¹ Bank for International Settlements 1990, *Report of the Committee on Interbank Netting Schemes of the Central Banks of the Group of Ten Countries*, Basle.

- III. Multilateral netting systems should have clearly-defined procedures for the management of credit risks and liquidity risks which specify the respective responsibilities of the netting provider and the participants. These procedures should also ensure that all parties have both the incentives and the capabilities to manage and contain each of the risks they bear and that limits are placed on the maximum level of credit exposure that can be produced by each participant.
- IV. Multilateral netting systems should, at a minimum, be capable of ensuring the timely completion of daily settlements in the event of an inability to settle by the participant with the largest single net-debit position.
- V. Multilateral netting systems should have objective and publicly-disclosed criteria for admission which permit fair and open access.
- VI. All netting schemes should ensure the operational reliability of technical systems and the availability of back-up facilities capable of completing daily processing requirements."

Australian Risk Management

Having initially proposed a high-value netting system to counter settlement risk the Reserve Bank and APCA are now developing an RTGS system.

The advantage of RTGS systems is that they *eliminate* settlement risk and can with greater legal certainty be linked internationally to counter "Herstatt risk" - the settlement risk attendant on the two legs of a foreign currency exchange transaction being settled in different time zones and therefore at different times.² The disadvantage of RTGS systems is their demands on accommodating liquidity to support gross settlement.

Netting systems are based on multilateral positions which might be susceptible to undermining in the case of liquidation - hence the need, as noted in the Lamfalussy Report, for them to have a well-founded legal basis. In the United States, for example, CHIPS is supported by legislation.

Depending on the circumstances, supporting legislation may need to deal with the "zero-hour" rule, with "cherry-picking", with set-off and with voidable transactions in order to ensure that irrevocable payments cannot be unwound, and that multilaterally netted positions and loss sharing rules hold up.

In Australia it was intended to support the proposed high-value netting system with legislation. Legislation is still being pursued to support the planned and current approaches to manage settlement risk across all payment systems.

Managing settlement risk in respect of low value payment transactions is, for obvious reasons, less of a concern. Nevertheless it is important to have certainty of outcome in payments settlement in general, to underpin financial stability.

Failure to settle provisions are included in APCA's APCS and BECS regulations. These are based on applying predetermined liquidity support and loss sharing rules in the event of failure, to ensure any burden of failure is shared in a way which minimises the possibility of systemic effects.

² Note, in this respect, the European Monetary Institute's "TARGET System", which envisages inter-linking of European RTGS systems in respect of cross-border EMU transactions.