

## Answer Guidance for Chapter 23 Practice Questions

1. Explain the following terms and expressions:

- Money
- Gross settlement, net settlement
- Bi lateral netting
- Multilateral netting
- A bank account and a bank note are both ‘things in action’
- Repayment on demand

- Money is a store of value – in this sense a suitcase full of fivers under the bed or deposited with the bank is a source from which one may use it in money’s second function, as a means of payment, for example to buy something. How much you pay, say for a book like *Commercial Law*, exemplifies money’s third function, namely as a measure of value. Money denominates how much you pay for the book.
- Settlement, when used in connection with the transfer of funds, typically means the process whereby the payer’s bank makes a payment to the payee’s bank. Gross settlement occurs when the interbank settlement process is effected on a transaction by transaction basis, ie whenever a customer of one bank effects a payment to a customer of another. Net settlement occurs when the financial effect of a number of customer payments are aggregated and only the sum of the debits and credits represents the banks’ payment obligation/right.
- Bi-lateral netting occurs when two banks only are involved in net settlement.
- Multilateral netting occurs when more than two banks are involved in net settlement such that the payment obligations/rights of the participants are determined by aggregating the financial effects of all of the transactions to be netted so that each participant is either a net creditor or a net debtor in relation to the remainder of the participating banks.
- A thing in action is a piece of intangible property consisting of a legal claim against another. When we say that we have ‘money in the bank’ this is not true in the sense that somewhere in its vaults the bank has cash which belongs to us. What we have is a claim against the bank to deliver money to us (which depending on the contract between us may or may not be in the form of cash). However, cash itself, although tangible, is, at the same time as being a piece of paper or metal, also a right to claim money from the issuer. Cash is a promise to pay money which we can enforce by action if necessary against the issuing bank.
- Repayment on demand is a common term in loan agreements. It means almost exactly what it says. The creditor is entitled to repayment of the stipulated sum, if not immediately then

## Answer Guidance for Chapter 23 Practice Questions

within the very short period of time it would take the debtor to access the money from his bank, assuming of course the bank would be willing to give it to him!

Antimony Bank (A in Figure 23.1 ), Borax Bank (B in Figure 23.1 2. ), Chlorine Bank (C in Figure 23.1 ), and Deuterium Bank (D in Figure 23.1 ) are the only participants involved in a bi-lateral net clearing system. At the end of a clearing period, their obligations are shown in Figure 23.1 .

Antimony Bank's customers have received £100 more from customers of Borax Bank than customers of Borax Bank have received from customers of Antimony Bank. The net position between the two banks is therefore that Borax Bank must pay £100 to Antimony Bank. However, Antimony Bank's customers have received £200 less from Chlorine Bank's customers than customers of Chlorine Bank have received from customers of Antimony Bank. The net position between these two banks is that Antimony Bank must pay £200 to Chlorine Bank. Finally, Antimony Bank's customers have received £300 more from Deuterium Bank's customer than Deuterium Bank's customers have received from Antimony Bank's customers. Overall, therefore, Antimony Bank will make one payment (to Chlorine Bank) and receive two payments (from Borax Bank and Deuterium Bank). In a similar fashion, the net positions of the other participants can be determined from Figure 23.1. However, Deuterium Bank becomes insolvent before any settlement occurs and will pay its creditors only 10 per cent of what they are owed.

What is the effect of this insolvency on the other clearing participants?

Since Antimony Bank and Chlorine Bank will lose money through Deuterium Bank's default, can Antimony Bank and Chlorine Bank reverse the entries in their books of account with their customers who have received payments from Deuterium Bank's customers during the day?

What would the situation be if, instead of this being a bi-lateral clearing system, it had been a multilateral clearing system?

### Introduction

- This is very much a 'teaching tool' rather than a typical sort of question you might meet in an examination. However, it explores the concept of clearing systems which are an integral part of the commercial world. Indeed, the fear that clearing systems would fail as participants

## Answer Guidance for Chapter 23 Practice Questions

lost confidence in the solvency of their counterparties was a major reason why governments recapitalised banks during the recent financial crisis.

- In order to answer this question you will need to explain what a bi-lateral clearing system is and how it operates commercially and legally. You would then apply this information to the question to determine how the insolvency of Deuterium Bank affects the other participants.
- The question then asks you to explain at what point a credit to a customer's bank becomes absolute.
- Finally, the differences between a bi-lateral and multilateral clearing system need to be explained.

### What is a bi-lateral clearing system?

- It is important to briefly explain that, on the authority of *Foley v Hill*, a bank account is a debt owed either by the bank to its customer if the account is in credit or owed by the customer to the bank if the account is overdrawn.
- It is also important to explain that, when a customer of one bank wishes to pay the customer of another bank, property does not pass between the payer and the payee. All that happens is that the payer's bank will inform the payee's bank that a payment has been received and request the payee's bank to credit its customer. Assuming the payee's bank actions this request, then the value of the debt represented by the payee's bank account will change, either increasing the bank's debt to the customer if the account is in credit or reducing the value of the debt to the bank if it is in deficit. Similarly, the payer's bank will debit the payer's bank account so that the value of their creditor/debtor relationship will also be adjusted. The outcome, however, is that were one to draw the balance sheets of the two banks immediately after the transaction, the payer's bank would show a decrease in liabilities (or an increase in assets if the account were overdrawn) whilst the opposite would be true for the payee's bank. To adjust the situation back to neutral there must be a settlement between the banks. In a system like CHAPS, settlement is effected through accounts the banks have with the Bank of England but each transaction is settled individually. An alternative, which CHAPS employed until 1996, involved bi-lateral clearing whereby the legal obligations of the banks were not calculated on a transaction by transaction basis but only at the end of each 'settlement period' when the aggregate of all debits and credits between the two parties would be calculated and the obligation expressed as a single net sum. The main advantage of this is that, if one of the bi lateral parties becomes insolvent there is no question of the solvent party having to settle each transaction in which it was a payer in full while in theory having the insolvent party meet its obligations under transactions where it was the payer only once its financial position was established and then paying only a fraction of the sum actually due. With bi-lateral clearing there are not a series of debts and credits but only one net sum due.

## Answer Guidance for Chapter 23 Practice Questions

### The effect of insolvency in a bi-lateral clearing system

- In our question therefore Antimony Bank and Chlorine Bank will make claims in the insolvency worth £300 and £600 respectively and can expect to receive only 10% of that and then only after the full financial situation of Deuterium Bank has been established which may take years. Borax Bank will have to pay £200 immediately.

### When does a payment to a customer's account become absolute?

- It is clear that a credit to a customer's account may only be conditional, becoming absolute only if, for example, the bank has received payment from the payer's bank. As *Tayeb* demonstrates under CHAPS, once a payment has been accepted by the payee's bank it is absolute, and this makes sense since, under CHAPS, there will already have been settlement at the Bank of England before the payee is credited – though, as *Tayeb* shows, there can be other considerations which might affect whether a payment is absolute, apart from the fear of the payee's bank that it will not be paid by the payer's bank. Typically, the terms of the agreement between the bank and its customer will establish when a credit has ceased to be conditional by determining the 'value day' the day on which the customer can draw upon the funds shown in the account.
- In our question we do not have enough information to enable us to know whether the banks could reverse the credits on their customers' accounts. What we can say is that absent mistake, illegality or fraud any CHAPS credits will be unconditional while with BACS transfers the payment becomes unconditional on day 3 of the BACS cycle. Similarly, *Momm* suggests that where there is no clearing involved, normally funds standing to the credit of an account at the end of the banking day are unconditionally credited.

### What is a multilateral clearing system?

- As the previous situation shows, the creditors of Deuterium Bank generally have benefited by the separation of the clearing relationships into 3 - £90 will be paid out but they will receive £200 from Borax Bank a net benefit of £110. However, if instead Antimony, Borax and Chlorine Banks had all been one big bank, then the net obligation of Deuterium Bank would have been £700 and it would have paid out £70.
- Multilateral clearing arrangements seek to reproduce this result in effect by establishing a net position on a bi-lateral basis and then netting off each of these positions against one another, reaching one 'net net' position as against all counterparties through the mechanism of the adjustment of each bank's account with a central clearer.
- Assuming the multilateral clearing system withstands any challenges to its validity, then the result would have been that Antimony Bank and Borax Bank should be credited with £200, each, Chlorine Bank credited with £300 in the books of the clearing system and Deuterium Bank should be debited with £700. However since only £70 will be received by the clearing

## Answer Guidance for Chapter 23 Practice Questions

system, that will have to be distributed amongst the participants in proportion to their claims, ie each will recover 10% of what they were owed.

- The effect of the system is therefore to spread the risk of default more evenly amongst the clearing participants. This, however, is to the detriment of the general body of creditors of an insolvent member compared with bi-lateral netting. In *Re BCCI No 8* the House of Lords held that multi lateral netting contravened the 'pari passu rule which requires debts to be set off on a bi-lateral basis. However *Re BCCI No 8* does not apply if the multilateral system in the problem is 'designated' under the Financial Markets and Insolvency (Settlement Finality) Regulations 1999 SI 1999/2979. In fact, it may well be that by making modest drafting changes to the clearing rules which applied in *Re BCCI No8*, the multilateral settlement system would not have offended the pari passu rule. What would be needed is that the agreement between the banks made it clear that the banks had no debt obligations other than that determined by the 'net net' position and that the double netting was simply the process whereby the debt obligations were quantified—see *International Air Transport Association v Ansett Australia Holdings Ltd*.