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ANNUAL BANKING LAW

UPDATE 2020

Recent Legal Developments of Special Interest to Banks

Editors:

Charl Hugo and Sarel du Toit

CENTRE FOR BANKING LAW

UNIVERSITY OF JOHANNESBURG

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Preface

With apology to Pliny the Elder I wish to commence my preface this year with the saying *ex mundo semper aliquid novi*. My adaptation of his famous words by substituting for Africa, the word “mundus” (world), is that the novelty concerned in this case, the Covid-19 pandemic, does not appear to have hailed from Africa. It is, however, without doubt, the single factor that has most affected daily life throughout the world in 2020. It has affected banks and banking, and it has affected the *Annual Banking Law Update (ABLU)*.

The Centre for Banking Law has established a tradition in which it takes pride, of making the *ABLU* book available at an annual conference, which has since 2015 been sponsored generously by firms of attorneys that are heavily involved in banking law, or by one of the South African banks themselves. As conceptualised *ABLU 2020* was to follow the same path until the lockdown intervened. So, for the first time in many decades, there has been no conference. The volume you are holding in your hand, or scrolling through on your computer screen, is proof of the fact that, due to the commitment of all involved, the authors, the peer-reviewers and the publisher (Juta & Co), the pandemic has not halted the publication of *ABLU 2020*. As we look forward to next year (and *ABLU 2021*), however, I must admit to strong sympathy with the prayer of Thomas Nashe: “From winter, plague and pestilence, good Lord deliver us!”

The contributors are all from the academic domain. Most are senior academics, but impressive work by one doctoral and one LLM student has also found its way into the book. The contributors are from South Africa, the United Kingdom, France and Israel. All contributions were subjected to a double-blind peer-review process by two independent reviewers. Their remarks were communicated to the authors who, in light of the comments of the reviewers, improved their contributions accordingly to the satisfaction of the editor.

The mix of contributions is highly topical. The first (by Ruth Plato-Shinar) examines the question of who should bear the damage for fraudulent digital payments with reference to recent legislation in the European Union and Israel – both of which place their customers in a significantly better position than their South African counterparts, and raises the question whether the time is not ripe for this issue to be dealt with by the South African legislature. The second contribution (by Charl Hugo and Jessica Kobilski) explores the practice of “transferring” demand guarantees where the transfer relates not only to the proceeds of the guarantee but also to the right to call up the guarantee. They make the point that in agreeing to such a transfer, the applicant for the guarantee is in some instances taking on risks that may well be unpalatable. The third (by Andrew Haynes and Peter Yeoh) deals with legal issues arising from the use of blockchain-based products. They deal inter alia with the cost of blockchain, its application to shares and bonds and problems relating to its use (practical and in relation to criminal abuse). This is followed, in the fourth contribution (by Monica Vessio), by a ground-breaking article exploring central bank digital currencies, their benefits and risks and the regulatory issues relating to them. The fifth contribution (by Dunia Zongwe) focuses on monetary unions, and especially on what the Southern African Monetary Union can learn from its European counterpart and the Euro crisis. Against this background, he emphasises the importance of designing monetary unions carefully. Attention, in the sixth contribution (by Camille Grizet), moves to prudential banking regulation in France and South Africa from which the strong influence of the Basel Accords in both countries becomes apparent, although some differences, especially in relation to mutual and cooperative banks, are identified. The National Credit Act 34 of 2005 (the NCA), and in particular the powers of the debt restructuring court under the National Credit Amendment Act 7 of 2019, form the subject matter of the seventh contribution (by Corlia van Heerden). She argues that the power to tamper with contractually agreed interest rates and fees is not in harmony with the aim of the NCA to balance the rights of consumers and credit providers, and holds the potential of harming the credit industry to the detriment of all. In the final contribution (by Thabo Legwaila) the development of withholding tax on interest (that banks are required to pay over to SARS) in recent years is scrutinised. He concludes that this form of tax collection aligns the South African tax system with international tax practices and applauds the fact that it eliminates the need for re-characterisation of dividends, royalties and other income as interest, thereby easing tax administration.

I would like to convey my deep gratitude and admiration to the contributors, the four peer reviewers utilised and the publishers, Juta & Co (in the persons of Stephen Allcock, Sarah Johnston and Valencia Wyngaard-Arenz) for the commitment and high level of professionalism they have all shown to this book. An annual book on recent developments necessarily implies significant time pressure and the meeting of rather hard deadlines. The fact that the project has been brought to fruition bears testimony to the fact that these deadlines have been met. As editor I salute you all.

Finally, to the established loyal readers of *ABLU*, and to all new readers, thank you for your support. As in previous prefaces that I have written I conclude by expressing the hope (with some confidence) that *ABLU 2020* will contribute to a better understanding of banking law in South Africa and will stimulate research in this important field.

Charl Hugo
Editor
Centre for Banking Law
University of Johannesburg

23 November 2020

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Regulating liability for unauthorised digital payments: Insights for South Africa

RUTH PLATO-SHINAR*

Abstract

This contribution deals with risk allocation in cases of unauthorised digital payment transactions. Since in most cases the culprit cannot be found or sued for reimbursement, the main question in respect of unauthorised payments is, who should bear the loss: the payment instrument's user, the payee, or the payment service provider? While other countries chose to regulate this issue by legislation, in South Africa the main arrangement is included in the *Code of Banking Practice* (the Code) of the Banking Association of South Africa, which constitutes "soft law". In addition, the provisions of the Code provide customers with a much narrower protection in comparison to legislation that was enacted in various countries. Furthermore, the Code applies only to banks, in contrast to non-bank financial service providers. This contribution provides some insights for the South African policy makers, based on two statutory instruments that have lately been enacted in other jurisdictions on this matter: the Second European Directive on Payment Services (PSD2), and the Israeli Payment Services Law, 5779–2019. This contribution offers an outline of the risk allocation between the parties involved, whilst balancing consumer protection against commercial efficiency.

* * * * *

1 Introduction

Over the past several years, the payments landscape has undergone unprecedented change as a result of technological progress and global expansion. The advancement and expansion of both the internet and smartphones have led to a change in the nature of commercial activities, and to the development of innovative payment methods that enable customers to make remote payments without having to be physically present at the point of sale. Local and international payment service providers offer alternatives to the classic payment methods. Some of them offer a platform for retaining money with them in a payment account ("e-wallet"). Others offer alternative forms of payment, such as applications that are based on personal identifiers to authenticate the payer's identity. The common objective behind all these developments is to enable payments to be made easily, quickly and securely.[1]

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1 Plato-Shinar "The new Israeli Law on Payment Services: towards a new world of digital payments" 2020 (35) *BFLR* 351.

Advanced payment methods have many advantages: increased competition by bringing in new players providing payment services; reducing transaction costs; convenience for customers; and reducing money laundering and tax evasion. However, along with the aforementioned benefits, using advanced payment methods also bears a most severe risk: the accessibility and ease of use may impair the security of the payment transaction and expose the customer to fraud and misuse, either by the payee, or – more commonly – by a dishonest third party.

In order to enjoy the benefits of advanced payment instruments and reduce the risks involved, the existing legal infrastructure must adapt to technological developments and to the advancing methods of payment. Indeed, in various countries, we witness new legislation aimed at regulating the use of advanced payment services.[2] In addition, in some countries, the provision of payment services was perceived as requiring separate regulation, leading to the establishment of a designated regulator to be in charge of supervising the provision of payment services.[3]

This contribution deals with unauthorised payment transactions, that is, payments that were executed without the customer's authorisation or consent, as a result of fraud.[4]

Experience in South Africa, as in other countries, shows that unauthorised use of payment instruments is a common phenomenon, whose methods have become more and more sophisticated over the years. Cracking a secret code or password, fraudulently extracting the information from the instrument's user (by "phishing",[5] "vishing"[6] or "smishing"[7]), or sophisticated hacking of computer systems, are only a few of the methods aimed at accumulating information needed for misusing a payment instrument by a third party.[8] With the development of online trading and purchases through the payee's website or designated app, there is also concern that the payee, or those acting on its behalf, who were exposed to the details of the

[2] For example, in Singapore: Payment Services Act 2019 (No. 2 of 2019) *Government Gazette* 7. In Israel: Payment Services Law, 5779–2019, Laws of Israel 2019. In the UK: Payment Services Regulations 2017, SI 2017/752. In Germany: Gesetz zur Umsetzung der Zweiten Zahlungsdiensterichtlinie, Bundesgesetzblatt Jahrgang 2017 Teil I Nr. 48. 2446. European countries have lately enacted new laws following the second EU Directive on Payment Services: EC, *Directive 2015/2366/EU of the European Parliament and of the Council of 25 November 2015 on payment services in the internal market, amending Directives 2002/65/EC, 2009/110/EC and 2013/36/EU and Regulation (EU) No 1093/2010, and repealing Directive 2007/64/EC*, O.J. L. 337, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32015L2366&from=EN.

[3] For example, in the UK: The Payment Systems Regulator (PSR), which is a subsidiary of the Financial Conduct Authority (FCA), see online: https://www.psr.org.uk/. In Israel, the Commissioner of Financial Service Providers, see online https://mof.gov.il/hon/ArrangedFinancialServices/Pages/default.aspx (in Hebrew).

[4] This issue is further elaborated on in par 2.2 below.

[5] See SABRIC *Sabric Warns Consumers to Beware of Phishing and Malware*, https://www.sabric.co.za/media-and-news/campaigns/sabric-warns-consumers-to-beware-of-phishing-and-malware/.

[6] See Ombudsman for Banking Services *Beware of Vishing as Scammers Look for Spare Cash* (1-2-2020), https://www.obssa.co.za/press_releases/beware-of-vishing-as-scammers-look-for-spare-cash/.

[7] See SABRIC *Smishing*, https://www.sabric.co.za/stay-safe/smishing/.

[8] For the various methods of payment fraud see Banking Association South Africa *Bank Crime*, https://www.banking.org.za/consumer-information/bank-crime/; Budhram "Lost, stolen or skimmed: overcoming credit card fraud in South Africa" 2012 (40) *SA Crime Quarterly* 31.

payer's payment instrument, will also carry out unauthorised transactions by means of the payment instrument.

According to the South African Banking Risk Information Centre (SABRIC), the gross fraud losses on credit and debit cards issued by South African banks soared by 18% in 2018, compared to the previous year, and totalled R873.4 million. "Card not present" fraud on South African credit cards remained the leading contributor to the gross fraud losses, accounting for 79.5% of the total. In 2018, 23 466 incidents via banking apps, online banking and mobile banking amounted to R262.8 million in gross losses. In comparison to the previous year, incidents across these platforms increased by 75.3%.[9] Accordingly, in 2018, online banking was the top category of complaints submitted to the South African Banking Ombudsman, constituting 22% of all complaints.[10]

Since in most cases the culprit cannot be found or sued for reimbursement, the main question in respect of unauthorised payments is risk allocation – who should bear the loss? The possible risk-bearers are the payment instrument's user, the payee, or the payment service providers.

While other countries chose to regulate the issue of unauthorised digital payments by legislation, in South Africa there is no law containing comprehensive provisions on the matter.[11] The National Credit Act 34 of 2005 (NCA), insofar as it deals with the issue to hand, only applies to credit cards, and refers to unauthorised payments in one short section.[12] A broader arrangement, which applies to the diverse digital payment methods, is included in the *Code of Banking Practice* of the Banking Association of South Africa (the Code)[13] that constitutes "soft law".[14] A bank will be contractually bound by the Code where its provisions are incorporated into the agreement with the customer.[15] As part of the Code, the banks accept the jurisdiction of the Ombudsman for Banking Services as to three functions: to mediate, to make binding determinations based on the Code and on the law where appropriate, and to make recommendations in other circumstances including those based on equity.

[9] SABRIC *Annual Crime Stats 2018*, https://www.sabric.co.za/media-and-news/press-releases/sabric-annual-crime-stats-2018/.

[10] Ombudsman for Banking Services *Online Banking Fraud Keeps Banking Ombudsman on its Toes Two Years Running* (23-5-2019), https://www.obssa.co.za/press_releases/online-banking-fraud-keeps-banking-ombudsman-on-its-toes-two-years-running/.

[11] For a supporting approach, see Malan & Nagel "Reflections on cheques, payment instruments, phishing and codification" in Hugo & Kelly-Louw (eds) *Jopie Jurist, Mentor, Supervisor and Friend* (2017) 55, 62, 78.

[12] National Credit Act 34 of 2005 s 94(2). For criticism on the narrow consumer protection that this section provides, see Van der Bijl "The cloning of credit cards: the dolly of the electronic era" 2007 *Stell LR* 331.

[13] The Banking Association of South Africa *Code of Banking Practice* (2012) ss 7.6, 7.7, 9.3, https://www.banking.org.za/wp-content/uploads/2019/04/Code-of-Banking-Practice-2012.pdf.

[14] For views that envisage the Code as more than mere soft law, see Du Toit "Reflections on the South African Code of Banking Practice" 2014 *TSAR* 568.

[15] Malan & Nagel (n 11) 62. For such an incorporation see, for example, *National Australia Bank v Rose* [2016] VSCA 169. For other views see Roestoff "Payment systems" in Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) 243, 283, 284.

If a bank refuses to abide by a recommendation of the Ombudsman, the Ombudsman may publish the recommendation and the bank's refusal to comply.[16]

The question whether a code of banking practice can appropriately replace legislation is beyond the scope of this article.[17] However, even if we were to accept such a proposition, it should be noted that the arrangement set forth in the Code provides customers with a much narrower protection in cases of unauthorised use of their digital payment instrument, in comparison to legislation that was enacted in other countries. While in other countries the payment service provider bears most of the loss, under the South African Code the customer bears the largest portion of the risk.[18] Assuming that the goal is to increase the use of digital payment instruments by strengthening public confidence in the system, it is doubtful whether the current approach in South Africa will achieve this goal.

And, finally, the Code only applies to banks, in contrast to non-bank financial service providers.[19] As the use of digital payment methods grows and non-bank players – both local and international – enter into the field, a broader solution, which is not confined to the banking system, will have to be adopted.

The goal of this contribution is to provide some insights for the South African policy makers, based on two statutory instruments that have lately been enacted in other jurisdictions on this matter: The Second European Directive on Payment Services that entered into force in 2018 (the "EU Directive");[20] and the Israeli Payment Services Law, 5779-2019, which will enter into force in October 2020 ("Israeli Law").[21] This contribution aims to present an outline of risk allocation between the parties involved whilst, at the same time, seeking to balance consumer protection against commercial efficiency.

2 Regulating unauthorised use of payment instruments

Before exploring and analysing the statutory arrangements that apply to unauthorised use of digital payment instruments, it is important to refer to three preliminary issues that are at the heart of these arrangements: applying a uniform arrangement to all the digital payment instruments; the definition of the term "unauthorised use"; and the scope of consumer protection.

16 *Code of Banking Practice* (n 13) at 3.

17 On this issue see Deutch "Protection of the bank customer: by Statute or by ethical codes – which is preferable? An Israeli perspective" 2004 *De Paul Business & Commercial Law Journal* 419, 434–439. Geva & Plato-Shinar "Code of ethics: what does it add to bank regulation?" 2011 (27) *Bar-Ilan Law Studies* 261 (in Hebrew).

18 Schulze "Smart cards and e-money: new developments bring new problems" 2004 *SA Merc LJ* 703 715 (referring to credit cards); Schulze "E money and electronic fund transfers – A shortlist of some of the unresolved issues" 2004 *SA Merc LJ* 50, 58–59.

19 Schulze (n 18) 711.

20 (n 2).

21 ibid.

2.1 *A uniform arrangement*

In order to encourage people to prefer digital payments over traditional instruments, there is a need not only to provide users with broad protection, but also to increase the public awareness and understanding of the protective legal arrangement, and to create legal certainty. To this end, it is suggested to administer a uniform arrangement that applies to all the different digital payment instruments.

In addition, in order to enable the law to conform to the developing world of payments, and to prevent the creation of a legal vacuum due to the rapid pace of such developments, it is important that the term "payment instrument" is defined in a broad manner that maintains technological neutrality.

Indeed, this is the approach of both the EU Directive and the Israeli Law. The EU Directive defines a "payment instrument" as:

> "a personalised device(s) and/or set of procedures agreed between the payment service user and the payment service provider and used in order to initiate a payment order".[22]

Even more interesting is the definition provided by the Israeli Law:

> "A sequence of actions that a payer must take in order to give a payment instruction, whether this includes the use of an object or a verification detail or where it does not include such use."[23]

These definitions of a "payment instrument" are detached from the physical dimension of the payment instrument as a necessary component. Consequently, they do not require the use of an object or a card. Instead, the definitions refer to a "set of procedures" or a "sequence of actions" that the payer must take in order to give a payment order, whether this involves the use of an object (such as a payment card) or an identifier (such as a password, personal code, biometric details), or where it excludes such use.

The general and sweeping wording of the term "payment instrument" in both jurisdictions encompasses all the modern payment methods, thereby creating a standard rule for all of them: plastic cards of all types, online payments, mobile payments, payment apps, and possible future not-as-yet existing instruments.

2.2 *Unauthorised use of a payment instrument*

Due to the numerous types of fraud that may take place in respect of digital payments, it is important to define the term "unauthorised use" of a payment instrument carefully, and apply the legal arrangement only to cases that fall within this definition. Other cases of fraud in respect of digital payments that do not meet this definition will not be subject to the underlying arrangement.

Under the EU Directive, an "unauthorized payment transaction" is a payment transaction that was performed without the consent or the authorisation of the purported payer.[24] The Israeli Law defines the term "unauthorized use" in a

[22] EU Directive (n 2) art 4(14).
[23] Payment Services Law (n 2) s 1.
[24] EU Directive (n 2) art 64(1) and (2).

different, yet similar, manner: "The use of a payment instrument or one of its essential components[25] by a person who is not entitled to do so in terms of the payment service contract."[26]

However, the scope of both definitions is insufficiently clear. Take, for example, a case where the genuine customer does authorise the payment, but he does so as a result of a deception and impersonation scam ("social engineering tactics"), where the criminal poses as a legitimate individual or organisation and convinces the naïve customer to transfer money to the criminal's account. While some sources classify such scams as "authorised payments",[27] others suggest including them under the term "unauthorised use", since the payer did not actually consent to the performed payment transaction.[28]

2.3 *Consumer protection*

As mentioned earlier, in order to increase public confidence in the modern payment instruments, a broad protection should be afforded to users of these instruments. The question arises as to who would be entitled to enjoy this protection.

Since the users of digital payments can either be a natural person or a corporation, consumers or non-consumers, both the EU Directive and the Israeli Law provide protection for the "payer"[29] (meaning – in cases of unauthorised use – the purported payer) or the "user",[30] whoever he/she/it shall be. By using such general terms, both legal systems are willing to provide protection for all types of payers.

Nevertheless, there is a distinction between various types of payers, as to the ability of the parties to contract out of the statutory arrangement.

The EU Directive distinguishes between a consumer and a non-consumer. A "consumer" is defined in the Directive as "a natural person who, in payment service

[25] An "essential component of the payment instrument" is defined as follows: "A component in the payment instrument, which is unique to the payer, including the object or verification detail that is used as part of the payment instrument, or a combination of such components, by which the one who has access to the component or combination of such components can give a payment order, provided that the component or combination of the components is specified in the payment service contract between the payer's payment service provider and the payer." See Payment Services Law (n 2) s 1. The components in the payment instrument can be physical components such as a plastic card, means that are used for identification such as a code or a biometric detail, or a combination of both. However, in order for any component (or combination of components) to be deemed "an essential component in the payment instrument", it must pass a double test: it must be unique to the payer, and one with which a payment order can be given.

[26] ibid.

[27] Cf UK Finance *Fraud the Facts 2019: The Definitive Overview of Payment Industry Fraud* 40, https://www.ukfinance.org.uk/policy-and-guidance/reports-publications/fraud-facts-2019. For discussion on authorised use see Booysen "Tackling payment scams: a comparative review" in Du Toit & Hugo *Annual Banking Law Update* (2019) 1.

[28] Steennot "Reduced payer's liability for unauthorised payment transactions under the Second Payment Services Directive (PSD2)" 2018 (34) *Computer Law & Security Review* 954 955; Plato-Shinar (n 1) 372.

[29] See the definition of "payer" in the EU Directive (n 2) art 4(8), and in the Payment Services Law (n 2) s 1.

[30] See the definition of the term "payment service user" in the EU Directive (n 2) art 4(10).

contracts covered by this Directive, is acting for purposes other than his or her trade, business or profession".[31] In respect of consumers, the statutory arrangement is *ius cogens*, forbidding the parties to contract out of it. Only when the user is a non-consumer can the parties deviate from the statutory arrangement, and agree on a different risk allocation in the contract between them.[32] Member states can determine that microenterprises be protected in the same way as consumers.[33]

In this regard, the Israeli Law provides protection for a wider scope of payers. It broadly prohibits contracting out of the statutory arrangement, unless it is to the benefit of the payer.[34] Only where the payer is a business whose annual sales turnover exceeds IL 30 million (about R130 million) may the parties stipulate other non-statutory rules.[35] In other words, the Israeli approach provides protection for small and medium sized businesses as well, encouraging them to use digital payments in their operation.

In contrast, the South African Code applies to personal and small business customers only.[36]

Under the EU Directive, even when it concerns consumers, the statutory arrangement may be contracted out of in respect of low value payment instruments, that concern individual payments not exceeding EUR 30 or a spending limit of EUR 150. This may take place where the payment instrument is used anonymously, or the payment service provider is not in a position for other reasons which are intrinsic to the payment instrument, to prove that a payment transaction was authorised; or where the payment instrument does not allow its blocking or prevention of its future use.[37] Such an exception does not exist in the Israeli Law, which provides broader protection for consumers in this regard.

3 The limited liability arrangement

3.1 *General*

In the case of an unauthorised use of a payment instrument, two models of risk allocation may be adopted. The first is the "damage absorption" model, according to which the party who can better absorb the loss is the one who should bear it. In our case, these would be the payment service providers. The second model is the "fault model", according to which the loss is borne by the party whose negligence caused the damage. If several parties have been negligent, the damage is apportioned among them according to the degree of their negligence.

The damage absorption model is comparable to insurance law and raises issues such as self-participation (deductibles), the customer's duty of disclosure and exceptions to the insurer's liability. In contrast, the model of fault is based on tort

31 ibid art 4 (20).
32 ibid art 61(1).
33 ibid art 61(3).
34 Payment Services Law (n 2) s 51*(a)*.
35 ibid s 51*(b)*.
36 *Code of Banking Practice* (n 13) at 3.
37 EU Directive (n 2) art 63(1)*(a)* and *(b)*.

law and involves issues such as contributory negligence, the duty to mitigate the loss and the validity of liability exemption clauses. Both models raise questions as to the burden of proof and the desirable mechanism for dispute resolution.

There are a few justifications for placing the liability for unauthorised payment transactions on the payment service provider:

First, the payment service provider is the party that can more efficiently and more effectively act to reduce unauthorised use, given its control over the design and activation mode of the payment instrument and its ability to use the technological measures required. In addition, the payment service provider can collect data and create intelligence that can be used to prevent future scams. Imposing liability on the payment service provider may incentivise it to take the systemic measures required and develop further means for reducing unauthorised use. It hardly needs to be said that such measures are beyond the reach of the customer.

Second, the service provider can better absorb the damage by spreading it among all the users of the payment instrument through the collection of charges. It should also be noted that the service providers usually have insurance to cover these cases. If, on the other hand, the payer is the one who has to bear the liability for unauthorised use, the extent of the damages may be such that he would not be able to bear it.

A third reason is connected to the digitalisation of bank services. Changes in the way in which banks perform their business have led to reduced human contact and the reduction of traditional banking settings, thus increasing the risk of deception by remote means. The extensive use of technology to provide payment services to customers has allowed for cost savings through the reduction of staff and closure of bank branches. It is not unreasonable, therefore, that banks, which contribute to the negative effect of these changes on their customers, will address the vulnerabilities that have arisen.[38]

Finally, taking most of the loss on their shoulders would benefit the banks no less than the customers. In recent years, banks all over the world have been involved in severe scandals that have led to an erosion of public trust and even to hostile feelings against them.[39] In order to restore public confidence in the banking system in general, and in the digital payment methods that it offers and encourages customers to use in particular, banks and other payment service providers should not thrust liability upon the customers, but cover the loss themselves.

Accordingly, both the EU Directive and the Israeli Law adopted the damage absorption model. They establish a quasi-insurance arrangement that places most of the liability on the payer's payment service provider (the "limited liability arrangement").[40] However, whereas the Israeli Law adopted the damage absorption

[38] Booysen (n 27) 17.

[39] Plato-Shinar "Law and ethics: the bank's fiduciary duty towards retail customers" in Russo, Lastra & Blair (eds) *Research Handbook on Law and Ethics in Banking and Finance* (2019) 214 215; Plato-Shinar & Borenstein-Nativ "Misconduct costs of banks – The meaning behind the figures" 2017 (32) *BFLR* 495 496–497.

[40] The payer's service provider is responsible to the payer, even if the party who is liable for the unauthorised use is another service provider that was involved in the same payment transaction but

model exclusively, the EU Directive also combines features of the fault model, by taking into consideration the user's gross negligence, as shall be explained below.[41]

In South Africa, the Code did not adopt a limited liability arrangement. Rather, it places most of the liability on the customer, but for a few exceptions where the payment service provider bears the loss. The Code was inspired by the fault model, imposing liability on the customer wherever he acted negligently (and not, necessarily, grossly negligently). Similarly, it imposes liability on the service provider where the loss may be attributed to its own negligence. This approach is not surprising, since the common-law rules that South African courts tend to apply in cases of unauthorised use reflect the model of fault as well.[42]

3.2 *The payer's notification*

Both the European and the Israeli limited liability arrangements are based on notice by the payer to his payment service provider, in the event of theft or loss of the payment instrument or its being unauthorisedly used. The notice is critical for the payment service provider, because only from the date of receiving it, can it act to mitigate the damage by preventing further use. However, there is a wide difference in the perception of the notice between these two legal systems. The approach of the EU Directive is stricter and much more formal than the Israeli approach.

The EU Directive obliges the payer to "notify the payment service provider… without undue delay on becoming aware of the loss, theft, misappropriation or unauthorized use of the payment instrument".[43] A breach of this obligation impacts on the liability of the payer for the loss incurred by the unauthorised payment. The user is entitled to rectification of an unauthorised payment transaction from the payment service provider, only if he notified the payment service provider without undue delay on becoming aware of any such transaction, and no later than 13 months after the debit date.[44] In addition, a failure to notify that constitutes gross negligence on the part of the user may result in full liability being imposed on the user for the damage.[45]

In addition to the obligation imposed on the user, the Directive also imposes corresponding obligations on the payment service provider. First and foremost, upon receiving the notification, the service provider must prevent all further use of

is not contractually connected to the payer. See EU Directive (n 2) arts 71(2), 73(2). The same applies under the Israeli Payment Services Law (n 2) ss 27*(a)* and 29*(b)*, which imposes the obligation to refund the payer on the "payer's service provider".

41 in par 3.6.

42 Malan & Nagel (n 11) 72 et seq.

43 EU Directive (n 2) art 69(1)*(b)*.

44 ibid art 71(1). The section also clarifies that the time limits for the user's notification do not apply where the payment service provider has failed to provide or make available the information on the payment transaction as required by the Directive. According to art 73(1), the payment service provider's obligation to refund the payer not only arises once it is notified by the payer, but also where it notes the unauthorised transaction itself. See Donnelly "Payments in the digital market: evaluating the contribution of Payment Services Directive II" 2016 (32) *Computer Law & Security Review* 827 834. Steennot (n 28) 958.

45 See par 3.6 below.

the payment instrument.[46] The Directive does not leave this issue to the discretion of the service provider, but determines it as a legally binding obligation.

Furthermore, the service provider must ensure that appropriate means are available at all times to enable the user to make a notification, or to request unblocking of the payment instrument.[47] It must provide the payment service user with an option to make a notification free of charge and to charge, if at all, only replacement costs directly attributed to the payment instrument.[48] Upon the user's request, the payment service provider shall provide him with the means to prove, for 18 months after notification, that the payment service user made such a notification.[49]

The Directive further states that, if the payment service provider does not provide appropriate means for the notification at all times, the user shall not be liable for the financial consequences resulting from use of that payment instrument, except where the user has acted fraudulently.[50]

The South African approach on this matter is similar, but less favourable to the customer. The Code expects the customer to notify his bank "as soon as possible" if he suspects one of the events mentioned in the Code.[51] The Code further states that the customer will be liable for the losses if he did not do so.[52] However, as to the obligations on the part of the banks, the banks only take upon themselves to publish the contact details which the customer should use to report unauthorised use; and upon receiving such a notification, to provide the customer with a reference number that serves as a proof of having reported the case.[53] This approach is not surprising, taking into consideration that the Code was drafted by the banks themselves.

In contrast, the Israeli Law treats the notice in a less formal manner. No duty is imposed on the user to give a notice to his payment service provider, and his right to rectification is not dependent on such a notice. The Law only incentivises the user to provide a notice, as shall be explained below. Accordingly, no obligations are imposed on the service provider in relation to the notification.

Having clarified the status of the notification and the related obligations under the two legal systems, we shall now explore the limited liability arrangements which are based on this notification. Both systems determine different results in the period prior to giving the notice and the period subsequent thereto, as shall be explained in the next sub-paragraphs.

46 EU Directive (n 2) art 70(1)*(e)*. Compare to the *Code of Banking Practice* (n 13) par 7.8.
47 EU Directive (n 2) art 70(1)*(c)*. Compare to the *Code of Banking Practice* (n 13) at 22.
48 EU Directive (n 2) art 70(1)*(d)*.
49 ibid art 70(1)*(c)*.
50 ibid art 74(3).
51 *Code of Banking Practice* (n 13) par 7.7.8–7.7.10 (urging the customer to notify), par 7.8 (imposing liability).
52 ibid par 7.8.
53 ibid at 22.

3.3 *Unauthorised use that occurs after notification*

Both under the EU Directive and the Israeli Law, as well as under the South African *Code of Banking Practice*, from the moment that the payer gives the notice to the payer's payment service provider, the payer does not bear any liability for unauthorised use of the payment instrument.[54] The assumption is that from the moment that the service provider is made aware of the loss, theft or unauthorised use, it can – and must – act to prevent future unauthorised use, either by freezing the existing payment instrument or in any other manner, and it is not allowed to shift its liability to the customer.

Based on the same logic, the Israeli Law also exempts the customer from liability when he terminates his engagement with the payment service provider or returns the payment instrument to the possession of the service provider. The customer will not be liable for unauthorised use that occurs after taking such actions.[55]

3.4 *Unauthorised use that occurred prior to the notification*

It may be assumed that, upon receipt of the customer's notification, the service provider will usually be able to block the payment instrument and prevent further use thereof. Therefore, most cases of unauthorised use will occur prior to the customer's notification – hence the importance of providing broad protection for the customer precisely in this period of time.

However, this is not the approach in South Africa. The South African *Code of Banking Practice* imposes full liability for such unauthorised use on the customer.[56] In contrast, both the EU Directive and the Israeli Law apply a limited liability arrangement that provides the customer with appropriate protection. Under the limited liability arrangement, he will only bear a fixed and rather small amount, similar to deductibles in the field of insurance. This policy of making a deduction is intended to reduce the moral hazard and ensure responsible behaviour by users.

According to the European Directive, the user will bear the amount of the payments actually made through the unauthorised use, up to a maximum of EUR 50.[57] As mentioned before, the user's protection is dependent upon the provision of a timely notification.[58]

In Israel the principle is similar, but its details are different, as follows. The payer shall bear the loss according to the lower amount between the following two alternatives:

[54] Payment Services Law (n 2) s 24*(b)*. EU Directive (n 2) art 74(3). This is also the approach of the South African *Code of Banking Practice* (n 13) par 7.8.2.

[55] Payment Services Law (n 2) s 25.

[56] *Code of Banking Practice* (n 13) par 7.8 (although not expressly mentioned); Roestoff (n 15) 277.

[57] The member states may reduce this liability, taking into account, in particular, the nature of the personalised security credentials and the specific circumstances under which the payment instrument was lost, stolen or misappropriated. See EU Directive (n 2) art 74(1).

[58] See n 44 above.

1. A fixed amount of NIS 75 (approx. USD 21) plus NIS 30 (approx. USD 8.50) per day, from the date on which the payer becomes aware of the theft, the loss or the unauthorised use, up until the date of giving notice. However, if the payer gives the notice within 30 days of the date the unauthorised use occurred for the first time, he will only be liable for a maximum amount of NIS 450 (approx. USD 127).

   The objective of the fixed amount is to incentivise the payer to protect the payment instrument and its essential components, because, if he does not do so and an unauthorised use occurs, he will be obliged to pay this amount anyway. The objective of the daily fine is to incentivise the customer to give the notice as early as possible, since the Israeli system does not oblige him to notify.

2. The amount of the payments actually made through the unauthorised use.[59]

To summarise, under both legal systems, instead of imposing full liability on the user, he is charged an amount that is fixed and relatively low, which is essentially similar to the deductible in the field of insurance.

The EU Directive provides additional protection for the user. It releases the user from any liability where the loss, theft or misappropriation of the payment instrument was not detectable by the user prior to the payment,[60] namely, where the user was not in a position to become aware of such an event. Such an exception can apply in the case of hacking, and perhaps also in certain cases of phishing.[61] However, it is difficult to know how the exception of non-detectability will operate in practice, given that the Directive makes no reference to where the burden of establishing detectability lies.[62]

3.5 *The user's fraud*

As an exception to the limited liability arrangement, both legal systems justifiably determine that if the payer acted with fraudulent intent, he will bear full liability for the damage caused as a result of the unauthorised use.[63] The same approach exists in the South African *Code of Banking Practice*.[64]

In order to prevent false assertions about the customer's fraud to be raised by the payment service provider, the Directive demands that the latter communicates its reasonable grounds for suspecting fraud to the relevant national authority, in writing.[65] The preamble of the Directive suggests that there must be a "high suspicion" that the unauthorised transaction resulted from fraudulent behaviour, and that the service provider should be able to communicate objective grounds for this suspicion.[66]

59 Payment Services Law (n 2) s 24*(c)*.
60 EU Directive (n 2) art 74(1)*(a)*.
61 Steennot (n 28) 962.
62 Donnelly (n 44) 835; Steennot (n 28) 962.
63 Payment Services Law (n 2) s 26; EU Directive (n 2) arts 73(1), 74(1).
64 *Code of Banking Practice* (n 13) par 7.8.
65 EU Directive (n 2) art 73(1).
66 ibid recital 71 in the preamble.

3.6 *The user's negligence*

The Israeli Law does not refer to the question whether the user would bear liability where he acted negligently and this has caused or contributed to the damage. However, the Law explicitly states that the payer will not bear any liability for unauthorised use, besides that of the limited liability arrangement outlined in the Law.[67] In other words, even if the payer was negligent, for example in safeguarding the payment instrument or the security credentials, this will not impose liability for the unauthorised use on him.[68] A similar approach exists in American law.[69]

There are several drawbacks to this statutory arrangement. First, it creates an incentive for negligent behaviour on the part of the customer. Not only is this behaviour socially undesirable in general, but because of the insurance-like nature of the liability arrangement, cautious customers in effect subsidise negligent customers. In addition, customers with limited financial wealth subsidise the customers with substantial financial wealth, because the scope of using the instrument derives from the customer's financial wealth.[70]

On the other hand, this arrangement, that does not attribute any relevance to the user's negligence, has several advantages: protecting the customer who finds it difficult to bear the financial damage; reducing unnecessary litigation due to the ambiguity of the principle of negligence; and establishing clear and uniform rules of liability for implementation. The fact that payment instruments are a major source of profit for payment service providers, along with the latter's proven ability to defend themselves against the inherent risks of using payment instruments, also justifies imposing the liability on the payment service provider. Allowing payment service providers to raise allegations of customers' negligence may be adversely used by them to deny liability in cases that did not involve such negligence, knowing that customers do not have the resources and ability to proceed with a legal action against them.[71]

67 Payment Services Law (n 2) s 31.

68 It is interesting that the approach of the Israeli courts is different. An identical arrangement, that ignores the negligence of the customer, was included in a previous law – the Debit Cards Law, 5741–1981. In cases that dealt with unauthorised use of credit cards, the courts did examine the customer's behaviour and took it into consideration when determining liability. In cases where they believed that the customer was negligent in safeguarding the credit card or the PIN, they imposed the liability for the unauthorised use on him, notwithstanding the express provisions of the law. See Bachar "Unauthorized use of credit cards – Eroding consumer protection" 2007 (11) *Hamishpat* 321 337–339 (in Hebrew). His conclusion is based on decisions of the lower courts; the issue has not yet been brought before the Supreme Court. Since the new Law actually repeats the wording of the previous Debit Cards Law, it is doubtful whether the Israeli courts will change their approach on the matter and abide by the arrangement established in the Law.

69 15 US Code §§ 1643(d) 1693g(e).

70 Plato-Shinar (n 1) 373.

71 ibid.

In contrast to Israel, South Africa adopted the opposite approach. Under the Code, the customer is responsible for any damage caused by his negligence. This may apply if he fails to follow the safeguards set out in the Code, but not only.[72]

A similar, but less severe, approach was adopted in the EU Directive. According to the Directive, if the payer failed to fulfil one of the following obligations with intent or gross negligence, he bears all of the losses relating to the unauthorised use: *(a)* to use the payment instrument in accordance with the terms governing the issue and use of the instrument; *(b)* to notify the payment service provider, or the entity specified by the latter, without undue delay on becoming aware of the loss, theft, misappropriation or unauthorised use of the payment instrument; and *(c)* to keep the personalised security credentials safe.[73] The Directive allows member states to reduce the user's liability where he has acted with gross negligence, "taking into account, in particular, the nature of the personalised security credentials and the specific circumstances under which the payment instrument was lost, stolen or misappropriated".[74]

The concept of gross negligence is not defined in the Directive. Instead, the preamble of the Directive provides an indication of the possible application of the standard. It explains that more than ordinary negligence is needed, and gives the example of keeping the credentials used to authorise a payment transaction together with the payment instrument in a format that is open and easily detectable by third parties.[75] Nevertheless, the standard of care required is far from being clear, and is left to the courts in individual member states to determine.[76]

Courts in different member states have adopted quite different approaches as to what comprises gross negligence.[77] In civil-law member states, commentators identify significant variations in practice across countries.[78] In common-law member states, there is very limited data available on this issue. This may reflect more reluctance of service providers to assert gross negligence; or it may simply mean that cases are being dealt with in lower courts or through financial ombudsmen, whose decisions are not available to the public.[79]

72 *Code of Banking Practice* (n 13) par 7.8. The previous edition of the *Code of Banking Practice* was less harsh on the customer, imposing on him liability in cases of gross negligence, as opposed to mere negligence. See Schulze (n 18) 711.

73 EU Directive (n 2) art 74(1).

74 ibid; Donnelly (n 44) 835; Geva "Payment transactions under the E.U. Second Payment Services Directive – An outsider's view" 2019 (54) *Texas International Law Journal* 211 233.

75 EU Directive (n 2) recital 72 in the preamble.

76 Steennot "Allocation of liability in case of fraudulent use of an electronic payment instrument: the new Directive on Payment Services in the Internal Market" 2008 (24) *Computer Law & Security Review* 555 557.

77 Donnelly (n 44) 834.

78 Steennot (n 76) 557; Van der Meulen "You've been warned: consumer liability in internet banking fraud" 2013 (29) *Computer Law & Society Review* 713 714–715.

79 Donnelly (n 44) 834. In the UK, it was commented (in *obiter*) that gross negligence is not the same as subjective recklessness, though it may come close to it. See *Winnetka Trading Corporation v Julius Baer International* [2011] EWHC 2030 (Ch) par 16.

3.7 *Giving the instrument or the payment transaction components to a third party*

As mentioned before, the Israeli Law does not take into account the customer's negligence. Nevertheless, it refers to the situation where the payer "placed the essential component of the payment instrument at the disposal of another person".[80] In such a situation, the payer will be liable for the full amount of the damage caused as a result of the unauthorised use that occurred prior to giving notice, and he will not benefit from the limited liability arrangement.[81] This rule applies whether the unauthorised use occurred with or without the knowledge of the payer. It is assumed that when the payer has voluntarily delivered the essential component to another person, he has willingly taken the risk involved and therefore has to bear the consequences. However, the foregoing will not apply in either of the following cases:[82]

1. The essential component was placed at the disposal of another person under reasonable circumstances solely for the purpose of safeguarding it.
2. The essential component was placed at the payee's disposal for the purpose of giving a payment order by the payee.
3. The unauthorised use occurred after the essential component, that was at the disposal of another person, was stolen from him or lost by him.

In any of the above three circumstances, the limited liability arrangement will apply: the customer will not be liable for unauthorised use after a notice has been given to his payment service provider, while, with respect to the period preceding giving of notice, he will bear limited liability.

In contrast, under the EU Directive, such a situation where the user places the payment instrument or its security credentials at the disposal of another person, may be considered as gross negligence or an intent behaviour of the user. If so, he will have to bear the loss himself.[83] A similar result may apply in South Africa, under the *Code of Banking Practice*, which imposes liability on the user in cases of his negligence.[84]

A question arises as to situations of "phishing", where a fraudster manages to obtain the password and PIN from the user by impersonating another person or presenting a false purpose for which he supposedly required the information. Equipped with this information, the fraudster uses the payment instrument purporting to be the genuine customer.

Under EU law, the user will have to bear the loss if his behaviour is considered gross negligence.[85] The chances that the consumer will have to bear the loss are

[80] For the definition of this term see n 25 above.
[81] Payment Services Law (n 2) s 24*(d)*.
[82] ibid.
[83] Geva (n 74) 231.
[84] *Code of Banking Practice* (n 13) par 7.8.
[85] See par 3.6 above.

even higher under South African law, which imposes liability on the user in cases of "regular" negligence.[86]

In Israel, the answer depends on the interpretation of the term "to place [the payment instrument or its essential component] at the disposal of another person". On the face of it, in a situation of "phishing", where the user gave the fraudster the information of his own volition, he will be considered as someone who "placed it at the disposal of another person", and therefore will not be able to enjoy the limited liability arrangement. However, I am of the opinion that giving the information in these circumstances should not be considered as "placing it at the disposal of another person", in view of the fact that it was obtained fraudulently, without the user knowing the real facts, and therefore lacking intention or *animus contrahendi*. Since the objective of the Law is to encourage people to use the modern payment methods by providing broad protection in cases of unauthorised use,[87] the user should be allowed to benefit from the limited liability arrangement in cases such as these as well.[88]

3.8 *Strong customer authentication*

In recent years, the trend of making remote transactions through the internet or mobile phone apps has been steadily growing. Similarly, many customers use their bank's website or app to deliver payment instructions to the bank. Since in such digital remote transactions the risk of unauthorised use is much higher, a legal arrangement that conforms to the developing reality should seek to promote two goals: first, to incentivise payment service providers to employ appropriate security mechanisms in order to prevent unauthorised use of payment instruments; and second, to protect users of payment instruments where the service provider did not employ the required means.

It seems that both the EU Directive and the Israeli Law have adopted this view. They determined that if the payment service provider does not use the mechanism required, the customer will be exempt from liability for the unauthorised use.

The mechanism that is required in the EU Directive is "a strong customer authentication".[89] The Directive states that, where the payer's payment service

[86] ibid.

[87] Payment Services Bill 5778-2018, Bills 1154 at 1154.

[88] However, the approach of the Israeli courts on this issue is different. In cases that involved the previous Debit Cards Law, the courts ruled that negligence on the part of the customer in looking after his credit card amounted to "placing at the disposal of another". See Bachar (n 68) 337–339. Such a broad interpretation of the term "placing at the disposal of another person" could lead to the imposition of full liability on customers even in cases of phishing.

[89] Under art 97(1), a payment service provider is required to apply strong customer authentication where the payer accesses its payment account online; initiates an electronic payment transaction; or carries out any action through a remote channel which may imply a risk of payment fraud or other abuse. Under art 97(2), in remote electronic transactions, payment service providers are required to apply strong customer authentication that includes elements which dynamically link the transaction to a specific amount and a specific payee. Under art 97(3), payment service providers should have in place adequate security measures to protect the confidentiality and integrity of payment service users' personalised security credentials.

provider does not require a strong customer authentication, the payer shall not bear any financial losses.[90] A “strong customer authentication” is defined as:

> “an authentication based on the use of two or more elements categorised as knowledge (something only the user knows), possession (something only the user possesses) and inherence (something the user is) that are independent, in that the breach of one does not compromise the reliability of the others, and is designed in such a way as to protect the confidentiality of the authentication data.”[91]

Using a card or an app together with a PIN will satisfy this demand, but not either of them alone.

The Israeli Law chose a different arrangement to achieve the mentioned two goals, based on the concept of “a payment transaction with no document”. In digital remote transactions that constitute “a payment transaction with no document”, the payer will not bear the loss, on condition that he notified his service provider that the transaction was not performed by him, within 30 days of the date his service provider advises him of the charge.[92] “A payment transaction with no document” is defined as a payment transaction that was performed without an admissible “institutional record” which documents the verification of the payer’s identity through an “enhanced verification detail” and the payer’s consent to execute the payment transaction.[93]

An “institutional record” is a document, including computer printout, prepared by a business or any other entity providing a service to the public (an “institution”) during its normal course of business.[94] An institutional record will be admissible for proving the veracity of its content in any legal proceedings, if all the following hold true:

1. The institution maintains a practice, in the course of its routine operation, of documenting the event that is the subject of the record, in close proximity to its occurrence.
2. The method of collecting the data which is the subject of the record, and the method of documenting the record, testify to the veracity of the content of the record.

90 EU Directive (n 2) art 74(2).

91 ibid art 4(30). Steennot (n 28) 958–960. See also European Banking Authority *Opinion of the European Banking Authority on the Elements of Strong Customer Authentication under PSD2* (21-6-2019), https://eba.europa.eu/sites/default/documents/files/documents/10180/2622242/4bf4e536-69a5-44a5-a685-de42e292ef78/EBA%20Opinion%20on%20SCA%20elements%20under%20PSD2%20.pdf. On the requirements imposed on service providers to use security measures, see Commission Delegated Regulation (EU) 2018/389 of 27 November 2017 supplementing Directive (EU) 2015/2366 of the European Parliament and of the Council with regard to regulatory technical standards for strong customer authentication and common and secure open standards of communication, https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:32018R0389&from=EN.

92 Payment Services Law (n 2) s 29*(b)*. If 30 days have passed, the customer loses this protection, but will enjoy the limited liability arrangement mentioned above that may oblige him to bear a deductible. For comparison of the two sections see Plato-Shinar (n 1) 378.

93 Payment Services Law (n 2) s 29*(a)*.

94 Evidence Ordinance (New Version) 5731–1971, the definitions of the terms “institution” and “an institutional record” in s 35.

3. If the record constitutes a computer printout, it has been proven that the way in which the record was extracted testifies to its credibility, and that the institution adopts reasonable means of protection against penetration of computer material and disruption of the computer's operation.[95]

The Israeli Law refers to an institutional record that documents the verification of the payer's identity through an "enhanced verification detail".

A "verification detail" is a "unique detail of the payer that is intended to verify his identity",[96] such as information details (ID number, mobile phone number), code, password, biometric measures, token, or any other detail unique to the payer.[97]

An "enhanced verification detail" is a "verification detail that verifies the identity of the payer with a high degree of certainty".[98] An "enhanced verification detail" can be a single detail such as a biometric detail. However, it can also be a combination of several verification details, each of which, separately, does not ensure verification with a high degree of certainty, but all of them together do so.[99] The use of an enhanced verification detail is subject to the discretion of the payment service providers, and sometimes to the discretion of the payee through which the payment order is given.[100] In comparison to the definition of the term "strong customer authentication" in the EU Directive, in Israel the legislature chose to settle for a more general definition, allowing more flexibility for service providers.

"A payment transaction with no document" is, therefore, a payment transaction wherein there is no institutional record that contains an enhanced verification detail. Examples for such transactions can be an online transaction which is done with a merchant who does not keep institutional records, or an online transaction with a merchant whose institutional records do not include an enhanced verification detail. It can be assumed – and this is the objective of the Israeli Law – that the number of transactions that are deemed to be "payment transactions with no document" will diminish over the years, thereby resulting in an increase in the certainty and the reliability of the payment market.

95 ibid s 36. The institutional record can be made by the payer's payment service provider, as happens where a payer gives a payment order to his bank via the bank's website or designated app. It can also be done by the payee or the payee's payment service provider, in the case of payment by credit card at the payee's place of business, or where the payer executes a payment transaction on the payee's website.

96 See the definition of the term "verification detail" in the Payment Services Law (n 2) s 1.

97 Payment Services Bill (n 87) at 1161.

98 See the definition of the term "enhanced verification detail" in the Payment Services Law (n 2) s 1.

99 Payment Services Bill (n 87) at 1161.

100 This is subject to the provisions of s 10 of the Payment Services Law, which authorises the relevant government agencies to determine directives obliging the payer's service provider to verify the payer's identity by means of a specific verification detail, as shall be prescribed in the directives.

3.9 *Fault of the payment service provider*

Finally, I should mention another situation where the user should be exempt from any liability: where the loss was caused by acts or lack of action by an employee, agent or branch of a payment service provider or of an entity to which its activities were outsourced. Such an exemption is included in the EU Directive.[101]

4 Burden of proof

A complex issue is the burden of proof in respect of unauthorised payments. Two questions arise in this context: on whom does the burden fall; and what elements are required to be proven? For example, does the user have to prove the unauthorised use, or is it the payment service provider who has to prove that the payment transaction was authorised by the payer?

According to the EU Directive, where the user denies having authorised a payment transaction, "it is for the payment service provider to prove that the payment transaction was authenticated, accurately recorded, entered in the accounts and not affected by a technical breakdown or some other deficiency of the service provided by the payment service provider".[102]

"Authentication" is defined as "a procedure which allows the payment service provider to verify the identity of a payment service user or the validity of the use of a specific payment instrument, including the use of the user's personalised security credentials".[103]

Moreover, where the user denies having authorised the payment, "the use of a payment instrument recorded by the payment service provider … as appropriate, shall in itself not necessarily be sufficient to prove … that the payment transaction was authorized by the payer …".[104] In other words, evidence as to the use of a payment instrument recorded by the service provider is an important element in meeting the required standard of proof. Nevertheless, standing on its own, such evidence creates neither an irrebuttable presumption, nor a rebuttable presumption that reverses the onus of proof as to whether the use was authorised. Rather, some corroboration is required.[105]

The EU Directive which, as shall be recalled, shifts the liability to the user in cases where he acted fraudulently or with gross negligence, refers to the burden of proof in respect of such allegations, as well. It states that "the use of a payment instrument recorded by the payment service provider … as appropriate, shall in itself not necessarily be sufficient to prove … that the payer acted fraudulently or failed with intent or gross negligence to fulfil his obligations …".[106] The Directive

[101] EU Directive (n 2) art 74(1)*(b)*.

[102] ibid art 72(1). If the payment transaction is initiated through a payment initiation service provider, the burden will be on the payment initiation service provider to prove, within its sphere of competence, that the payment transaction was authenticated. See also art 73(2).

[103] ibid art 4(29).

[104] ibid art 72(2).

[105] Geva (n 74) 230.

[106] EU Directive (n 2) art 72(2).

requires the payment service provider to provide supporting evidence to prove the fraud or gross negligence of the payer.[107]

In Israel, the Law is silent as to the burden of proof, leaving it to the general law of evidence. The courts that ruled on the matter based on the previous Debit Cards Law drew an analogy to the burden of proof in insurance claims. In the field of insurance, the rule is that the insured is required to prove that the insurance event occurred. If this is proved, the burden of proof passes to the insurer to prove circumstances that exempt it from paying the insured.[108] Likewise, in the case of credit cards, it was ruled that the payer must bear the burden of proving there has been unauthorised use. And if he proves this, the burden shifts to the credit card company to prove exclusions to its liability.[109] However, in practice, the courts have been lenient with the payers, given the difficulties involved in proving unauthorised use by a third party without their knowledge, and they have made do with *prima facie* proof.[110]

5 Charging the payee in the event of unauthorised use

In the previous paragraphs I dealt with the relationship between the payer and his payment service provider. It was shown that both under the EU Directive and the Israeli Law, the party who will usually bear the loss for the unauthorised use is the service provider. Another question that arises in this context is whether the payer's payment service provider will be able to pass the loss (through the payee's service provider) on to the payee.

As shall be recalled, the EU directive seeks to encourage the parties to use strong customer authentication. Therefore it determines that where the payer's payment service provider does not require strong customer authentication, the payer shall not bear any financial losses (unless he acted fraudulently).[111] Accordingly, the Directive further states that where the payee or his payment service provider fails to accept strong customer authentication, he/she/it shall refund the financial damage caused to the payer's payment service provider as a result of the unauthorised use.[112] Stated otherwise, if the payee or his service provider did accept strong customer authentication, he/she/it is protected and will not have to bear the loss.

The objective of the Israeli Law is similar but not identical, and its provisions – which also provide protection for payees – are much more detailed.

The Israeli Law seeks to protect merchants and businesses, by ensuring that the payment service providers do not use their excess power to charge the merchants for transactions that were denied by the payers. Therefore, the protection of the payee is provided only in cases where the payer's payment order is given by the

107 ibid. For elaboration see recital 72 in the preamble. A similar approach exists in the South African *Code of Banking Practice* (n 13) par 7.8.5.
108 Elias *Insurance Law* Vol 2 (2016) 1405 (in Hebrew).
109 Payment Services Bill (n 87) at 1180.
110 Plato-Shinar (n 1) 372.
111 See par 3.8 above.
112 EU Directive (n 2) art 74(2).

payee,[113] such as by using a credit card at a payee's online website or app. In addition, where the payment order is given by the payee, the payee has control of the payer's means of identification and can act to mitigate the risk. In contrast, where the payment instruction is given by the payer directly to his service provider, as in the case of a bank transfer, the payer's service provider is responsible for identifying the payer and not the payee. In such cases, the protection afforded to the payee will not apply.[114]

The principle established in the Israeli Law is to provide protection to the payee in cases where the payee was not objectively able to prevent the unauthorised use. In these cases, the parties which will bear the risk are the payment service providers (according to liability and indemnification arrangements established among themselves), and not the payee.[115]

The Israeli provisions are mainly based on the use – or non-use – of an "enhanced verification detail"[116] by the payee. The legislature's assumption is that if the payee used an enhanced verification detail, then it has done its utmost to identify the payer and to mitigate the risk of the payment instrument being used by someone other than the payer. Therefore, if unauthorised use has nevertheless occurred, for example through theft of the enhanced verification detail, it would be correct to impose the loss on the payment service provider.

According to the Israeli Law, the payment service providers (of either the payer or the payee) will not be entitled to charge the payee if one of the following holds true:[117]

1. For the purpose of giving the payment order, an enhanced verification detail was used.
2. The use of an enhanced verification detail for the purpose of providing the payment order is not possible with respect to that type of payment method.
3. The payment service providers do not enable the payee to request the use of an enhanced verification detail. For example, if the service provider provides the payee with a computerised terminal where use thereof does not require the identification of the payer on the basis of an enhanced verification detail.
4. Other circumstances that may be prescribed by the Minister of Justice.

To sum up, in the above four instances, the payment service providers will bear the loss caused by the unauthorised use themselves, according to the internal liability and indemnification arrangements established between themselves.

Finally, the Israeli Law prescribes that in the case where the payment service providers are indeed entitled to charge the payee according to the conditions of the aforementioned section, then they will not be able to do so by setting off money that the payee is entitled to receive from them, without the payee's consent.[118]

[113] Payment Services Law (n 2) s 32.
[114] Payment Services Bill (n 87) at 1183.
[115] ibid at 1156.
[116] For the definition of the term "enhanced verification detail" see the text at n 98 above.
[117] Payment Services Law (n 2) s 32.
[118] ibid s 32*(b)*.

6 Conclusion

In recent years, the use of digital payments in South Africa has been increasing, as has the rate of unauthorised use.

Unauthorised use of digital payment instruments raises the issue of risk allocation, namely, who will bear the loss. While other countries chose to regulate this issue in primary legislation, in South Africa it is included in the Code. Moreover, while other countries adopted legal arrangements that aim to provide consumers with broad protection, the South African approach is less favourable for customers.

This contribution has analysed two very recent and innovative statutes, which can serve as a source of inspiration for the South African policy makers, if they decide to reconsider the current legal situation: the EU Directive on Payment Services, and the Israeli Payment Services Law. Unsurprisingly, despite differences between these two systems, they share a common idiosyncrasy: providing broad protection for the digital instruments' users, aiming at increasing public confidence in the system and increasing the use of digital payments.

Hopefully, a future South African statute will achieve this objective and facilitate the development of the payment services market, aligning it with the dynamic technological reality and the ever-evolving world of payments.

A critical evaluation of the law and practice of transferring independent guarantees

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Abstract

As in the case of documentary letters of credit, the rules governing guarantees differentiate between "assignment of proceeds" and "transfer". In this contribution the authors explore the difference between these two concepts focusing mainly on "transfer" – an unfortunately named mechanism by which the transferee is enabled, not only to acquire the proceeds of the guarantee, but also to demand payment under the guarantee. The provisions of the relevant rules (especially the Uniform Rules for Demand Guarantees and the International Standby Practices) are dealt with and the risks to both the guarantor and the applicant for the guarantee are identified. The manner in which the rules attempt to mitigate these risks is considered. The authors contend that while the risks to the guarantor are mostly adequately mitigated by the rules, the same cannot be said for the risks to the applicant. This is especially the case when the guarantee is transferred to a remote transferee-beneficiary – that is a beneficiary who does not assume the rights and obligations of the original beneficiary in the underlying contract. Accordingly, applicants would be well advised not to agree to such guarantees.

* * * * *

1 Introduction

Transferring guarantees can be both a useful and important practice in commercial contracts. The transfer of such guarantees is, however, accompanied by significant risks which need to be understood and mitigated as far as possible. In some instances, the risks may be so large that it would indeed be unwise for guarantors and/or applicants to make use of this mechanism. It is our intention, with this contribution, to cast some light on what we regard as best practice in this regard.

First, however, it is necessary to deal with some terminology – specifically the terms "guarantee" and "transfer". They are both technical and crucial. As reflected in the title of our contribution, a "guarantee" refers to an independent (or demand) guarantee, which includes its functionally equivalent brother-instrument, the

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standby letter of credit[1] – that is a guarantee in which the guarantor's obligation to pay when the guarantee is properly called up, is primary and not dependent upon the obligation underlying it. The transferring of accessory, or suretyship, guarantees, where the liability of the guarantor is dependent upon the liability of the (principal) debtor in the underlying relationship,[2] falls outside the scope of this contribution.

Exactly what is meant by the "transfer" of a guarantee is dealt with in more detail below.[3] The term is a loaded one. In law it may mean different things. In relation to the "transfer" of letters of credit and guarantees difficult questions of legal theory arise including whether the term "transfer" is at all appropriate in this context, and, if so, what precisely is transferred, and what the legal consequences of this transfer are. The answers to most of these questions are jurisdiction specific, and are not explored in this contribution.[4] It is sufficient, for the purposes of arguments raised in this contribution, to note the existence of consensus in international practice, that "transfer" means more than the mere assignment or cession of the proceeds of the guarantee by the beneficiary: it includes "transferring" the right to call up the guarantee. Some commentators accordingly argue that nothing is actually transferred – the guarantee is "novated" by a substitution of beneficiaries.[5] So viewed the term "transfer" may be misleading in this context. Since the term is, however, well embedded in letter-of-credit and guarantee practice, we, too, shall use it. Although we deal with both transfer and the assignment of proceeds below, the focus falls more on transfer.

Further, by way of introduction, attention should be drawn to the often-encountered equation, in certain respects, of independent guarantees and commercial letters of credit. Most importantly, they share the same foundations – namely that the demand for payment must be in conformity with the requirements set out in the instrument concerned, and the independence of this instrument

1 See Hugo "Bank guarantees" in Sharrock (managing editor) *The Law of Banking and Payment in South Africa* (2016) 438 n 2; Kelly-Louw *Selective Legal Aspects of Bank Demand Guarantees* (2008 thesis Unisa) par 1.2.

2 On the important difference between independent and accessory guarantees, see Hugo "The interpretation of independent guarantees" in Roestoff & Brits (eds) *De Serie Legenda: Developments in Commercial Law Vol 1 Law of Specific Contracts and Banking Law* (2019) 74 et seq; *Minister of Transport and Public Works, Western Cape v Zanbuild Construction (Pty) Ltd* 2011 (5) SA 528 (SCA); *Mutual and Federal Insurance Company Ltd v KNS Construction (Pty) Ltd* [2016] ZASCA 87 (31 May 2016); Kelly-Louw "General update on the law of demand guarantees and letters of credit" in Hugo (ed) *Annual Banking Law Update (ABLU)* (2016) 43 et seq.

3 See par 3.1 below.

4 They are to be sought in the law of cession, negotiation, delegation and novation. See, however, Byrne with Maulella, Soh & Zelenov *UCP 600: An Analytical Commentary* (2010) 1334, who, in footnote 7, warn against applying contractual theories to the transferring of letters of credit. We would submit that the same holds true for the transferring of guarantees.

5 Affaki & Goode *Guide to ICC Uniform Rules for Demand Guarantees URDG 758* (2011) 89; Bertrams *Bank Guarantees in International Trade – The Law and Practice of Independent (First Demand) Guarantees and Standby Letters of Credit in Civil Law and Common Law Jurisdictions* (2013) 280–281. The term "novation" as used here refers to novation in the form of delegation in so far as it is intended to put a new party (the *delegatus*) in the place of the original party (the *delegans*). See in this regard Van Huyssteen, Lubbe & Reinecke *Contract General Principles* (2016) par 13.31.

(the letter of credit or guarantee) from the underlying contract.[6] Documentary letters of credit (often referred to as "commercial letters of credit", or simply "letters of credit" or "documentary credits") and guarantees do, however, fulfil respectively "different economic function[s]".[7] A documentary letter of credit is an instrument of payment and a demand guarantee, an instrument of security or guarantee.[8] Horowitz accurately puts it thus:

> "Letters of credit and guarantees share the characteristic of abstraction from the underlying agreement that called for their use. Nonetheless, they differ on one key respect. Letters of credit are primary both in form and intent. They do what they appear to do: serve as the payment method for the transaction. By contrast demand guarantees are primary in form, but secondary in intent. They bear the appearance of primary instruments, because they represent an on-demand form of payment. However they are secondary in intent, inasmuch as they serve a 'back-up', or standby, role."[9]

Both can be transferred in practice. Transferring a letter of credit serves a very particular purpose in international trade,[10] while transferring guarantees may serve various purposes,[11] giving rise to significantly different risks, depending upon the purpose of the guarantee concerned and of its transfer. Accordingly, while comparing the transfer of these two instruments may be conceptually useful in some respects, it is probably best not to emphasise their similarities much in this context.

There is, however, one important difference between letters of credit and guarantees that should be noted: it is the complexity of the document or documents that need to be presented to trigger payment. Letters of credit typically require several documents such as the commercial invoice (which is issued by the seller-beneficiary of the letter of credit) but also a number of third-party documents, namely a transport document, insurance document, quality certificate, certificate of origin and inspection certificate. In the case of a guarantee, however, there is mostly only one document, namely a demand by the beneficiary of the guarantee making certain specified allegations. Third-party documents are rare. It would therefore be fair to say that "fraudulent calls on guarantees are a greater risk than fraudulent claims for payment under a letter of credit".[12]

Also, by way of introduction, attention must be directed to the practice rules that may, or may not, govern the guarantee concerned, and its transfer.

6 Hugo (n 1) 438. For South African case law in point, see, *inter alia*, *Lombard Insurance Co Ltd v Landmark Holdings (Pty) Ltd* 2010 (2) SA 86 (SCA) par [20] and *Dormell Properties 282 CC v Renasa Insurance Co Ltd* 2011 (1) SA 70 (SCA) par 38 and 63. For English precedent see, *inter alia*, *Edward Owen Engineering Ltd v Barclays Bank International Ltd* [1978] QB 159 (CA); *Intraco Ltd v Notis Shipping Corporation (The* 'Bhoja Trader'*)* [1981] 2 Lloyd's Rep 256 (CA) 257.

7 Byrne *Standby & Demand Guarantee Practice: Understanding UCP 600, ISP98 and URDG 758* (2014) 196.

8 Hugo (n 1) 439.

9 *Letters of Credit and Demand Guarantees Defences to Payment* (2010) 227.

10 See par 2 below.

11 See par 4.3 and 4.4 below.

12 Hugo "Letters of credit and demand guarantees: a tale of two sets of rules of the International Chamber of Commerce" 2017 *TSAR* 1 15.

In this respect it should be noted that while commercial letters of credit are almost invariably governed by the Uniform Customs and Practice for Documentary Credits (UCP 600),[13] independent guarantees may be governed by either the Uniform Rules on Demand Guarantees (URDG 758),[14] or the International Standby Practices (ISP 98).[15] The provisions of the URDG 758 and ISP 98 (in relation to guarantees) and the UCP 600 (in relation to documentary letters of credit), in order to govern the instrument concerned, must be contractually incorporated. The provisions of these instruments relating to transfer are a major focus of this contribution. We also refer, in passing, to relevant provisions of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit (UNCITRAL Convention),[16] and the Provisions of the Supreme People's Court of the People's Republic of China on Several Issues Concerning the Trial of Disputes over Independent Guarantees (Chinese Rules)[17] (both of which may apply to a particular guarantee, as a matter of law). The provisions relating to the transfer of guarantees from each of these rule sets are quoted below as an annexure to this contribution.

Often, however, a guarantee is not governed by any of the above rules.[18]

2 The transfer of letters of credit

The documentary letter of credit is the dominant method of payment in high-value international sale contracts. This instrument is an undertaking by *a bank* to pay the seller. The seller (as beneficiary of the credit) therefore has the benefit of looking towards a bank (as opposed to the buyer) for payment.[19]

13 Drafted by the Banking Commission of the International Chamber of Commerce (ICC), ICC publication 600 (2007). For an excellent brief background see "Editors overview" in Byrne (ed) *LC Rules & Laws: Critical Texts for Independent Undertakings* (2018) 1.

14 Drafted by the Banking Commission of the International Chamber of Commerce (ICC), ICC publication 758 (2010). For an excellent brief background see "Editors overview" in Byrne (n 13) 81.

15 Drafted by the Institute of International Banking Law and Practice (IIBLP) and indorsed by the ICC, ICC publication 590 (1998). For an authoritative brief background by the main drafter see "Editors overview" in Byrne (n 13) 29.

16 This convention, drafted by the United Nations Commission on International Trade Law (UNCITRAL), was adopted by the General Assembly in 1995 and became effective on 1 January 2000 in those countries that adopted the convention, namely Belarus, Ecuador, El Salvador, Gabon, Kuwait, Liberia, Panama and Tunisia. Again, a good brief background is provided by Byrne (n 13) 211.

17 The Chinese Rules (which bind a Chinese court in a manner similar to a precedent in the common-law tradition) were adopted by the Judicial Committee of the Supreme People's Court in July 2016 and came into effect on the same year. They were translated by the Institute of International Banking Law and Practice and published in Byrne (n 13) 317 et seq, where, again, a good brief background is provided. On these rules see also Hugo "Demand guarantees: Insights from the People's Republic of China" in Hugo and Kelly-Louw (eds) *Jopie Jurist Mentor Supervisor and Friend* (2017) 129 et seq.

18 Often guarantees do not incorporate the URDG 758 or the ISP 98, and are not subject to either the UNCITRAL Convention or the Chinese Rules. In such a case they must be interpreted as they stand. In fact, the overwhelming majority of guarantee cases before South African courts were concerned with guarantees that did not incorporate any of these rules (which may have played a role in why the matters had to come before a court in the first place). See in this regard Hugo (n 12) 17 et seq, in which he argues for wider use of the URDG 758 and ISP 98.

19 See in general Hugo (n 1) 403–414.

The *transferable* letter of credit was devised to enable the seller, as middleman in a string contract, to pay its[20] supplier with the same letter of credit.[21] The contract of sale between the buyer and seller will, in this situation, require of the buyer to procure the issuing of, specifically, a "transferable" letter of credit in favour of the seller. The issuing bank will typically nominate a bank in the seller's country (the nominated bank) as the bank that will pay the seller provided the seller meets the terms of the letter of credit (that is provided the seller delivers to the nominated bank certain stipulated documents – normally the commercial invoice, transport document, insurance document and certificates of quality, inspection and/or origin).[22] When it pays, the nominated bank does so as the mandatary of the issuing bank. As beneficiary of, specifically, the *transferable* letter of credit, the seller is entitled to request the nominated bank to make part of the credit available to a second beneficiary, who will be the supplier of the seller.[23] If the nominated bank does so, it essentially splits the amount of the letter of credit between the seller and the supplier; the supplier is payed the purchase price reflected in the contract between the seller and supplier, and the seller is paid its profit. When the nominated bank has done so (as mandatary of the issuing bank) it is then reimbursed by the issuing bank for the full amount of the original letter of credit.[24]

The "transferring" of a letter of credit in this sense, accordingly, means that two letters of credit come into being in the place of the original single letter of credit (by novation):[25] one in favour of the first beneficiary (for the amount of its profit), and one in favour of the second beneficiary (for the amount of the cost of the goods supplied by it to the seller/first beneficiary). The precise legal theoretical basis of this arrangement is not clear internationally,[26] but nevertheless generally works well in practice. It holds the advantage not only of enabling the seller to pay

20 Since in these types of large commercial contracts the parties are normally juristic persons, we opt throughout the contribution for using "it" as opposed to "he" or "she".

21 Byrne et al (n 4) 1331. See also Hugo (n 1) 430–432, and his update "Documentary credits and independent guarantees" in Du Toit (ed) *Annual Banking Law Update (ABLU)* (2006) 160 et seq.

22 Hugo (n 1) 395, 408–409, 414–420.

23 Hugo (n 1) 430.

24 Hugo (n 1) 431–432.

25 Byrne et al (n 4) 1334 footnote 7, however, warn against applying contractual theories to the transferring of letters of credit. On the form of novation see n 5 above.

26 From a South African perspective Oelofse *The Law of Documentary Letters of Credit in Comparative Perspective* (1997) 486–487 argues persuasively that as between the issuing bank and the second beneficiary the "transfer" establishes an independent obligation on the issuing bank to perform as against the second beneficiary in accordance with the new credit. As between the first beneficiary and the issuing bank the transfer of the credit has the legal effect of suspending the original credit for the duration of the period in which the new credit can be utilised by the second beneficiary. If it is not utilised the suspension falls away and the first beneficiary can enforce its rights against the issuing bank under the original credit (provided of course it can still procure the necessary goods and documents which may be problematic). See also Hugo (n 1) 432. For analyses from an English legal perspective see Malek & Quest *Jack: Documentary Credits* (2009) 313–315; Bridge *Benjamin's Sale of Goods* (2014) 2190; McKendrick *Goode on Commercial Law* (2010) 1112–1117.

for his supplies from the letter of credit procured by the buyer, but also to hide the identity[27] and the profit[28] he is making from the buyer.

The provisions of the UCP 600 in relation to transferring letters of credit should be viewed against this background. A transferable credit is described as a letter of credit that "may be made available in whole or in part to another beneficiary ('second beneficiary') at the request of the beneficiary ('first beneficiary')".[29] To be transferable in this sense the letter of credit must specifically state that it is "transferable".[30] A bank is only obliged to transfer a credit "to the extent and in the manner expressly consented to by that bank".[31] The bank that is normally requested to transfer the credit is the nominated bank,[32] but an issuing bank can also be requested to transfer the credit.[33] The bank that transfers the credit is then known as the transferring bank.[34] The UCP 600 further provides that a credit can be transferred in part to more than one second beneficiary provided partial drawings or shipments are allowed, but a third tier of beneficiaries is not allowed. In other words, a second beneficiary cannot request the "transfer" of the credit to a third beneficiary.[35] The transferred credit, moreover, "must accurately reflect the terms and conditions of the credit" with the exception of the amount, any unit price stated therein, the expiry date, the period for presentation of documents, the latest shipment date or given period for shipment "any or all of which may be reduced or curtailed"[36] in order to enable the first beneficiary to substitute documents – especially its own invoice for that of the second beneficiary.[37]

Almost as an afterthought, article 39, the very last article of the UCP 600, deals with a true transfer of rights by the beneficiary of the credit under the heading "Assignment of Proceeds", as follows:

27 Hugo (n 1) 432.

28 *Jackson v Royal Bank of Scotland* [2005] 1 Lloyd's Rep 366 (HL). See also Hugo (n 21 – *ABLU* 2006) 160 et seq.

29 art 38b.

30 ibid.

31 art 38a.

32 art 38b.

33 ibid. This provision was introduced into the UCP 600 to counter the effect of the judgment of the Privy Council in *Bank Negara Indonesia 1946 v Larisa Singapore Pte Ltd* 1988 1 AC 583 in which it was held that the earlier revision of the UCP that was then in force did not contemplate that an issuing bank could act as transferring bank, irrespective of the letter of credit being designated as "transferable". Accordingly, in that case, when the nominated bank refused to transfer the credit and the first beneficiary turned to the issuing bank, the court held that the issuing bank was not obliged to transfer the credit.

34 art 38b. The terminology "transfer" and "transferring" employed in the UCP 600 and the URDG 758 can be somewhat confusing, since the terms can refer either to the original beneficiary who requests the transfer or to the bank giving effect to the transfer. It is accordingly important to heed the context of each provision.

35 art 38d.

36 art 38g.

37 See art 38h, which provides: "The first beneficiary has the right to substitute its own invoice and draft, if any, for those of a second beneficiary for an amount not in excess of that stipulated in the credit, and upon such substitution the first beneficiary can draw under the credit for the difference, if any, between its invoice and the invoice of a second beneficiary."

> "The fact that a credit is not stated to be transferable shall not affect the right of the beneficiary to assign any proceeds to which it may be or may become entitled under the credit, in accordance with the provisions of applicable law. This article relates only to the assignment of proceeds and not to the assignment of the right to perform under the credit."

3 The transfer of independent guarantees

3.1 *Transfer*

The terminology of "transfer" and "assignment of proceeds" as used in the UCP 600 is replicated in the URDG 758.[38] The same terms and concepts also appear in the ISP 98, except that the word "transfer" is replaced in the ISP 98 by the phrase "transfer of drawing rights".[39] As pointed out by Byrne the two concepts (transfer and assignment of proceeds) are kept separate by both sets of rules.[40] This is a clear indication of the importance of the distinction.

The influence of the text of the UCP 600 on the drafters of the URDG 758[41] is evident in several respects. The definition of a transferable guarantee in the URDG 758 as "a guarantee that may be made available by the guarantor to a new beneficiary ('transferee') at the request of the existing beneficiary ('transferor')"[42] is reminiscent of the definition of a transferable credit in the UCP 600. Both sets of rules require the instrument to state specifically that it is "transferable" for it to be transferable.[43] Both sets of rules, moreover, require the consent of the issuer of the guarantee.[44] There are, however, also differences. The UCP 600, in the first place, does not allow a second transfer[45] while this is permitted under the URDG 758.[46] Secondly, while it is possible under the UCP 600 to transfer a credit to more than one second beneficiary (in other words it is possible to split the credit between different second beneficiaries),[47] the URDG 758 requires that the guarantee must be transferred "for the full amount" – in other words it cannot be split between different transferees.[48] Furthermore, the URDG 758 contains the following provision for which there is no counterpart in the UCP 600:

38 See the heading and art 33 passim. See also arts 9 and 10 of the UNCITRAL Convention, which employ the same terminology.

39 See the headings of par 6.01 and 6.06, and par 6 passim.

40 Byrne (n 7) 195–196.

41 See the introduction to the URDG 758, in which it is stated that the "drafting style of ICC's universally accepted … UCP 600" had been adopted.

42 See art 33c of the URDG 758 and art 38b of the UCP 600. See also art 10 of the Chinese Rules which is to the same effect.

43 See art 33c of the URDG 758 and art 38b of the UCP 600.

44 See art 33b of the URDG 758 and art 38a of the UCP 600.

45 See art 38d.

46 See art 33a.

47 See art 38d.

48 See art 33a.

> "a guarantee can only be transferred where … the transferor has provided a signed statement to the guarantor that the transferee has acquired the transferor's rights and obligations in the underlying relationship".[49]

Accordingly, as explained by Affaki and Goode, in order for a guarantee to be transferred under the URDG 758, "three cumulative conditions [must be] satisfied".[50] The first is that the guarantee must state that it is transferable and the first beneficiary must then request the transfer to a named second beneficiary. The second is that the guarantor must assent to that request expressly. Moreover, the transferring beneficiary is required to provide a signed statement showing the transferee's acquisition of the transferor's rights and obligations in the underlying relationship. Thus viewed, the transfer of a guarantee as contemplated in the URDG 758 does not constitute, in law, a cession or assignment, but a novation.[51] It creates a new guarantee between the guarantor and the transferee.

A comparison between the provisions of the URDG 758 and the ISP 98 manifests not only similarities but also differences. As in the case of a guarantee governed by the URDG 758, for "drawing rights" under a standby credit to be "transferable" in terms of the ISP 98, the standby itself must state that it is transferable, in which case it may be transferred in its entirety more than once, but may not be partially transferred.[52] Both sets of rules also provide that after transfer the demand for payment is to be signed by the transferee, whose name can be used in the place of that of the transferor on any other document.[53] The requirement that the issuer[54] must agree to the transfer is also present in both sets of rules, although significantly stronger in the URDG 758 than in the ISP 98.[55]

The most fundamental difference between the two sets of rules, however, is that the ISP 98 does not require any proof that the transferee has replaced the transferor in the underlying contract as does the URDG 758. We return in more detail to some of these similarities and differences below.[56]

3.2 *Assignment of proceeds in terms of independent guarantees*

Regarding assignment of proceeds, the URDG 758 merely provides that the beneficiary "may assign any proceeds to which it may be or may become entitled under the guarantee" and that this is the case irrespective of whether the guarantee is termed "transferable".[57] It further states that the guarantor is not compelled to

49 art 33dii
50 (n 5) 89.
51 Affaki & Goode (n 5) 89; Bertrams (n 5) 280–281. On the form of novation see n 5 above.
52 See art 33a of the URDG 758 and par 6.02a of the ISP 98.
53 See art 33f of the URDG 758 and par 6.04 of the ISP 98.
54 or, more precisely, in the words of the ISP 98 "the issuer (including the confirmer) or another person specifically nominated in the standby" (see par 6.02biii). This broader formulation ties in with the practice of standby credits (unlike independent guarantees) allowing for confirming and nominated banks as do commercial letters of credit. See further in this regard n 65 below.
55 See art 33b of the URDG 758 and par 6.02biii of the ISP 98.
56 See par 4.2.
57 art 33gi.

pay the assignee unless it has agreed to do so.[58] In their analysis of the topic, Affaki and Goode conclude that the "assignee of the proceeds of a guarantee does not become a party to that guarantee and cannot claim any rights in relation therewith, whether in terms of making a demand, agreeing to an amendment or otherwise".[59]

The ISP 98 deals with the topic in considerably more detail, which goes beyond the intended scope of our contribution. We confine ourselves to drawing attention to the following important point made by Byrne: "what is 'assigned' is the right to receive proceeds resulting from a drawing … but the drawing must be made by the named beneficiary".[60] Therefore, as Bertrams puts it in relation to the assignment of proceeds of guarantees in general, the "cooperation of the beneficiary/assignor … is, without question, indispensable" owing to the fact that the assignee is not "entitled to payment by merely calling the guarantee … and submitting a statement of default … by himself"; the "claim must be accompanied by a request for payment by the [assignor]".[61] Furthermore, the "right to payment (proceeds) under the guarantee does not arise unless and until the conditions of payment have been satisfied".[62] There thus remains an element of control (or at least involvement) by the assignor in the case of assignment, which does not exist in the case of transfer as the transferor is replaced as beneficiary of the guarantee by the transferee. This may be the rational basis for the simple process (in comparison to transfer): the guarantor is still dealing with the person with whom he originally contracted to deal with.

4 Evaluation of the transfer practices of independent guarantees

4.1 *Introduction*

In evaluating the practice of transferring guarantees, one needs to find the balance between the undeniable commercial value of this practice, on the one hand, and the equally undeniable potential dangers or risks associated with the practice. We navigate this problem below with reference to three issues which have been touched upon above: (i) the requirement that the issuer of the guarantee must consent to the transfer; (ii) the fact that, in contradistinction to documentary letters of credit, multiple transfers are permitted but not partial transfers; and (iii) the requirement (at least under the URDG 758) that the transferor's rights and obligations arising from the underlying contract should also be transferred.

58 art 33gii.

59 (n 5) 93.

60 *The Official Commentary on the International Standby Practices* (1998) 229. The late Professor Byrne, through his Institute of International Banking Law and Practice, was the driving force and main drafter of the ISP 98.

61 (n 4) 271.

62 ibid.

4.2 *The guarantor's consent*

Both the URDG 758 and the ISP 98 contemplate the guarantor's consent being given to the transfer of the guarantee.[63] Whilst this is an absolute requirement under the URDG 758 (in the sense that no guarantor is obliged to give effect to a request for transfer except to the extent that it has consented to do so),[64] the ISP 98, after stating emphatically that the standby may not be transferred "unless the issuer … agrees to and effects the transfer requested by the beneficiary",[65] goes on to point out that a refusal to transfer must be based on non-compliance with certain conditions. Paragraph 6.03 puts it as follows:

> "An issuer of a transferable standby …[66] need not effect a transfer unless:
> **a.** it is satisfied as to the existence and authenticity of the original standby; and
> **b.** the beneficiary submits or fulfils:
> i. a request in a form acceptable to the issuer …[67] including the effective date of the transfer and the name and address of the transferee;
> ii. the original standby;
> iii. verification of the signature of the person signing for the beneficiary;
> iv. verification of the authority of the person signing for the beneficiary;
> v. payment of the transfer fee; and
> vi. any other reasonable requirements."

It would accordingly appear that, in the absence of any of the conditions quoted above, transfer cannot be refused – which, owing to the concluding words of the quoted paragraph of the ISP 98, we would submit, simply means transfer cannot be refused unreasonably.[68] In accordance with the Official Commentary to the ISP 98,

63 This is consistent with our interpretation of art 10 of the Chinese Rules.

64 art 33b. It is clear from this article that the fact that the guarantee issued by the guarantor is termed "transferable" does not mean that the issuer has consented to the transfer. This, too, is the position under the UNCITRAL Convention (see art 9(2)). There is support for this contention also in case law relating to letters of credit. See in this regard the *Bank Negara* case (n 33).

65 par 6.02biii. The portion omitted from the quote reads as follows: "(including the confirmer) or another person specifically nominated in the standby". The URDG 758 does not contemplate the use of confirming or nominated banks as does the ISP 98, and detailed consideration of the role of these banks falls outside the scope of this contribution. In this respect, however, it is of interest to take note that in the transferring of letters of credit, the consent required is that of the transferring bank, which is normally not the issuing bank (although it can be the issuing bank – see par 2 above) but the bank nominated to transfer. See art 38b of the UCP 600. Since the contractual relationship established by the transfer, however, remains one between the issuer of the guarantee or letter of credit, and the new beneficiary, it seems strange that the issuer's consent is not always required to address, for example, its obligations relating to knowing its customer (in the context of legislation introduced internationally to combat money laundering, terrorism financing and corruption) – issues touched upon below. See the text to footnotes 69–74 below, and the footnotes themselves. The same problem emerges in the context of the nominated bank agreeing to effect the transfer of a standby letter of credit.

66 Again, the omitted portion refers to a nominated person.

67 ibid.

68 Although this seems to us to be the plain meaning of the relevant (quoted) provisions of the ISP 98, we need to point out that the *Official Commentary* advances the following different view: "As indicated in ISP98 Rule 6.02(b)(iii) … the issuer or nominated person 'need not' effect the transfer. Rule 6.03 indicates the conditions which an issuer or a nominated person may impose upon a

the question whether a particular condition is reasonable or not "is to be determined from the perspective of the transferring person and the applicant".[69]

The question that arises against this background is why the consent of the guarantor is required. In dealing with this question it should be noted that, unlike in the case of assignment, "transfer reflects a complete transfer of the underlying rights related to the standby/demand guarantee"[70] – including, as mentioned above, the right to demand payment. A novation of the guarantee occurs by means of the "transfer";[71] the guarantor becomes contractually bound to a new beneficiary whom he may not know or trust. As Bertrams puts it, there is a "significant change of the terms of the guarantee" owing to the change in the "identity of the beneficiary".[72] The risks of uncontrolled transfer against this background are stated as follows by Affaki and Goode:

> "Guarantors could find themselves committed vis-à-vis new beneficiaries that are unknown to them and may not meet the guarantor's legal, regulatory or creditworthiness criteria for entering into a business relationship."[73]

In this regard, the obligations of banks in relation to money-laundering and anti-terrorist-financing legislation,[74] as well as their obligations in relation to international and domestic targeted financial sanctions,[75] *inter alia*, come to mind. The requirement that the issuer of the instrument must consent to the transfer provides an (adequate, we submit) opportunity to the bank concerned to mitigate the risk of becoming contractually involved with a party or a business that may fall foul of legislation of this nature.

Uncontrolled transfer holds, perhaps, even more significant risks for the applicant, an issue that we explore below.[76]

requested transfer *should it choose to effect the transfer* [our italics]." See Byrne (n 60) 237. This interpretation accordingly suggests that the issuer or nominated person is entitled to refuse the transfer for whatever (unreasonable?) reason. If this is the correct interpretation it is respectfully submitted that the drafting of the ISP 98 in this regard could have been clearer.

69 Byrne (n 60) 239.

70 Affaki & Goode (n 5) 197.

71 Affaki & Goode (n 5) 398. On the nature of this form of novation, see n 5 above.

72 Bertrams (n 5) 281.

73 (n 5) 398.

74 In this regard, legislation introduced internationally in conformity with the guidelines of the Financial Action Task Force which places emphasis on a risk-based approach and risk mitigation comes to mind. See in this regard Spruyt "The Financial Intelligence Centre Amendment Act and the application of a risk-based approach" in Hugo & Du Toit (eds) *Annual Banking Law Update (ABLU)* (2017) 19 et seq; Hugo & Spruyt "Money laundering, terrorist financing and financial sanctions: South Africa's response by means of the Financial Intelligence Centre Amendment Act 1 of 2017" 2018 *TSAR* 227 et seq. See also Affaki & Goode (n 5) 90.

75 One particularly problematic aspect in this regard relates to the obligations on banks in relation to both international and domestic sanction regimes to freeze payments owing to listed sanctioned individuals. See in this regard Spruyt "A legal analysis of the duty on banks to comply with targeted financial sanctions" 2020 *TSAR* 1 et seq. See also Affaki & Goode (n 5) 90.

76 See par 4.4.

4.3 *Multiple and partial transfers*

Irrespective of whether governed by the URDG 758 or the ISP 98, guarantees or standbys can be transferred multiple times, but a partial transfer is not possible.[77] In this regard, guarantee practice stands in direct contrast to letter-of-credit practice (which allows partial transfer but not multiple transfers). The reason for this differentiation arises from the purpose of the respective transfers.[78] In the case of a commercial letter of credit, multiple transfers are disallowed to protect the parties from a potential multiplicity of documents and the necessity for many amendments.[79] In regard to partial transfers, on the other hand, the purpose of the transfer of a letter of credit is to enable a seller to pay its supplier by means of the same letter of credit procured by the buyer in favour of the seller.[80] This necessarily involves splitting the original letter of credit into two new letters of credit[81] – one reflecting the supplier's price and the other the seller's profit. Moreover, it is possible that the seller manufactures a product from goods received from different suppliers, which would necessitate that the original letter of credit be split into even more parts.[82] Accordingly, the restriction of multiple transfers and the allowing of partial transfers both make sense.

Whilst commercial letters of credit almost invariably serve as instruments of payment in relation to international sales, a plethora of different contracts may underlie a guarantee or standby letter of credit. Any conceivable obligation can be secured in this manner. As a result, the purposes of transferring the guarantee may differ. "Typical"[83] scenarios identified by the commentators share the characteristic of not only the guarantee being transferred but also the underlying contract. Affaki and Goode put it thus:

> "Guarantees transferred in conjunction with the transfer of the underlying transaction perform a valuable service in secured financing. This is the case, for instance, in financial or operating leases for aircraft, ships or equipment (particularly high-tech equipment) or the leasing of real property, where lessors sometimes sell the leased property to a purchaser who legitimately expects to continue benefiting from a demand guarantee covering the lessee's obligation to pay the rentals. In such cases, the transfer of the underlying lease agreement provides the obvious solution. Equally widely used are guarantees transferred in conjunction with the trading of loan notes on the secondary market. Transferring the guarantee to the transferee of the loan enables it to benefit from the guarantor's assurance of the borrower's reimbursement obligation."[84]

77 See art 33a of the URDG 758 and par 6.02bi-ii of the ISP 98.
78 See Byrne (n 7) 196.
79 ibid.
80 See par 2.
81 As pointed out by Byrne et al (n 4) 1341, whole transfers are not impossible – they can arise in a situation where the seller no longer retains any interest in the letter of credit. This, however, would be most unusual.
82 Byrne et al (n 4) 1341.
83 Byrne (n 7) 197: "The typical transaction involves an agreement to transfer rights under the underlying transaction."
84 (n 5) 88. See also Byrne (n 7) 197.

Another example, from the construction context (construction guarantees have been by far the most prominent in South African litigation over the past decade), would be where the employer/owner who is the beneficiary of a performance guarantee procured by the builder, sells the property to a new owner, who steps into the shoes of the previous owner/employer also in relation to the construction contract.

In these contexts, it is clearly natural that only the transferring of the entire guarantee is contemplated.[85] Moreover, there does not seem to be any good reason to restrict the number of times that the guarantee can be transferred.[86] It is therefore submitted that the terms of the URDG 758 and the ISP 98 protect the interests of the different parties adequately in this respect.

4.4 *The transferring of rights and obligations arising from the underlying contract*

The "typical" scenarios for the transfer of guarantees referred to above all contemplate that the underlying relationship be similarly "transferred". In fact, as stated above, this is a requirement for a transfer governed by the URDG 758 – the transferor (that is the beneficiary) must provide to the guarantor a signed statement to the effect that the transferee has obtained all the rights and obligations of the transferor in the underlying contract.[87] Although this is typical, also for standby letters of credit,[88] there is no similar requirement in the ISP 98. Therefore, instruments governed by the ISP 98 can potentially be transferred to a new beneficiary without the rights and obligations from the underlying contract being similarly transferred. Moreover, it may be that the guarantee being transferred is not subject to either of these sets of rules, in which case the same holds true.

One such situation, which, anecdotally,[89] is not uncommon in large commercial contracts, is that the demand guarantee is transferred to the financier of the transaction. A syndicated loan, involving several banks working together in a special purpose vehicle (SPV), may, for example, fund a large construction project. In this type of situation, the banks may insist on the contractor's guarantee being made transferable and being transferred to the SPV. It is clear, in this scenario, that the transferee does not take over the rights and obligations of the employer/original beneficiary/transferor in the underlying construction contract. Such a transfer is

85 See Byrne (n 60) 233: "partial transfer would cause serious practical problems"; Affaki & Goode (n 5) 92–93: "Article 33(a) does not authorise partial transfers because potentially facing separate claims by multiple beneficiaries could create serious logistical problems for the guarantor"; Byrne (n 7) 197.

86 Byrne (n 60) 233: "Under standby practice, it is normal for transferable standbys to permit multiple transfers. For example, the beneficiary may be an indenture trustee who could be replaced numerous times over the life of the standby." See also Byrne (n 7) 197; Affaki & Goode (n 5) 93.

87 Art 33dii. See also Affaki & Goode (n 5) 91: "The effect of this requirement is that the underlying relationship itself must have been transferred by novation to the prospective transferee of the guarantee. It is not sufficient that the transferor has assigned its rights to the transferee: it is also necessary that the transferee shall have acquired the transferor's obligations."

88 Byrne (n 7) 197.

89 This assertion of fact is based on oral information received from a senior attorney working in this field.

clearly not possible under the URDG 758, but may be possible under the ISP 98, or where the guarantee is not subject to either of these sets of rules. In relation to precisely this situation Bertrams points out that the financier (the transferee of the guarantee) may be tempted to demand payment under the guarantee more in order to realise its security for the repayment of the loan than to realise its security for proper performance by the applicant of its obligations arising from the underlying secured contract with the transferor/beneficiary.[90] In our view this is a convincing argument. It also finds some support in the English case of *HLC Engenharia E Gestao de Projectos SA v ABN Amro Bank NV*,[91] a case that deserves closer scrutiny.

The underlying contract in this case was a turnkey contract. NPT was the employer.[92] EGP was a contractor that was required to provide a performance bond (guarantee) in favour of NPT.[93] The performance bond was provided by ABN Amro Bank.[94] The bond was not subject to any rules such as the URDG 458[95] or the ISP 98. Clause 2.1 of the bond read as follows:

> "If the contractor [EGP] shall be in default in respect of any of its obligations under the Contract … the Bondsman shall as a primary obligation and not as a surety forthwith upon first written demand made by the purchaser [NPT] describing the nature of the default and without proof of the said default or conditions, satisfy and discharge the amount or amounts identified in a demand … up to a maximum amount of … without any deduction for or on account of any set-off or counterclaim whatsoever and howsoever arising."[96]

The bond was subsequently transferred[97] by NPT to the Bank of Scotland (BOS), which had financed the contract. The transfer took place without notification of EGP. Many problems arose, which eventually led to NPT being placed under administration. Against this background BOS started exerting pressure on NPT to call up the bond. NPT refused to do so, and, in a letter to the contractor (EGP), explained its stance as follows:

> "Under the terms of our … Agreement with [BOS] we are obliged to act on their instructions in relation to the Bonds. We have received, as you are aware, an instruction to call for the Bonds but the Board have been unable to agree to this as we cannot say that you, the Contractor are in default and therefore in our opinion a call on the Bond is not justified."[98]

90 (n 5) 272.
91 [2005] EWHC 2074 (QB).
92 par 4.
93 par 4 & 5.
94 par 5.
95 The revision of the URDG in force at the time of this case.
96 par 5.
97 In the judgment the term "assigned" is used (see par 6), but it is clear that what was contemplated was not a mere assignment of proceeds – what was assigned to BOS was "all … [NPT's] rights, title, benefit and interest … [in the performance bond] and all moneys payable thereunder" (see par 17). There was no direct indication, though, that this included the right to demand payment from the guarantor.
98 par 16.

BOS thereupon called up the bond[99] leading to an urgent application by EGP restraining ABN from paying the bond, and BOS and NPT from receiving any payment.[100] The court granted the injunction. It based its judgment on its interpretation of the guarantee requiring a demand *by NPT*, that NPT could clearly never have made a legitimate demand since it did not honestly believe that EGP was in default, and that no valid demand could accordingly have been made by BOS in the circumstances of this case.[101] It further took the view that the demand by BOS was in fact fraudulent since "it appears that BOS knew or ought to have known that there could be no basis on which NPT could allege culpable delay on the part of EGP",[102] or that it had performed defective work.[103]

The case highlights the main dilemma of permitting the transfer of a guarantee without the transferee also replacing the beneficiary in the underlying relationship. This, we submit, relates to whether such a remote transferee-beneficiary should be able to submit a demand. Although independent, and a separate agreement, the purpose of a guarantee surely remains to secure the underlying obligations of the applicant. For this reason, as in the *HLC Engenharia* case, the guarantee will typically require that the beneficiary must allege,[104] and sometimes even particularise,[105] the default of the applicant that triggered the demand. This requirement significantly filters out frivolous or abusive demands, since, as Bertrams puts it, "the requirement to submit a statement of default will force … [the frivolous or abusive beneficiary] to commit a lie to writing, and there are many good reasons why the beneficiary should proceed with restraint"[106] – the main one being the well-established fraud exception to the independence principle. Any demand made without an honest belief of default is fraudulent.[107] The problem with allowing a remote transferee-beneficiary to submit a demand is clearly recognised and stated as follows by Bertrams:

> "The risk that the guarantee will in fact be called would increase substantially and, moreover, for reasons which may not be related to the underlying contract between the applicant and the beneficiary. An assignee, who has extended credit or has paid moneys in consideration of the assignment, is not likely to display the same degree of restraint as could be expected from the beneficiary/contracting party."[108]

99 par 17.
100 par 20.
101 par 27 & 28.
102 par 33.
103 par 34.
104 See for example par 5 of the *Guarantee for Construction* of the Joint Building Contracts Committee (JBCC) Edition 6.2 (May 2018). These standard form construction guarantees have featured in many reported South African cases.
105 See art 15a of the URDG 758: "A demand under the guarantee shall be supported by such other documents as the guarantee specifies, and in any event by a statement, by the beneficiary, indicating in what respect the applicant is in breach of its obligations under the underlying relationship. This statement may be in the demand or in a separate signed document accompanying or identifying the demand."
106 (n 5) 272.
107 *Guardrisk Insurance Company Ltd v Kentz (Pty) Ltd* ("*Guardrisk*") [2014] 1 All SA 307 (SCA) par [17]. See also in general on the fraud exception, Hugo (n 1) 449–451.
108 (n 5) 272.

Similar views have been expressed by other commentators.[109] Bertrams further points out that the practice of allowing a remote beneficiary to call up the guarantee "fundamentally alters the nature of the contract of guarantee" since, for all practical purposes, "it turn[s] the guarantee into a negotiable instrument, which it is not".[110]

The court's finding in the *HLC Engenharia* case, that the remote beneficiary could not make a valid demand, appears to be based mainly on interpretation of the guarantee in question itself. We doubt that the case provides authority for the contention that, as a matter of principle, a remote beneficiary cannot make a valid demand. The facts of the case do, however, raise the fundamental question whether, in circumstances where the transferor-beneficiary cannot issue an honest demand, a remote beneficiary should nevertheless be able to do so. If the answer to this question is affirmative, we submit that the risk of such a guarantee becomes unpalatable for the applicant. This would effectively mean that the legal protection provided to the applicant by the fraud exception to the independence of the guarantee would be severely curtailed. The remote beneficiary, who has no or insufficient knowledge of the underlying contract, would thereby be empowered to demand payment of a guarantee (to further its own separate interests)[111] where the transferor-beneficiary would not have been able to do so. The applicant would be exposed to a somewhat misplaced "negotiability concept" in that the new (remote) beneficiary would, under a novated guarantee, have stronger rights than the transferor-beneficiary. The guarantee, as envisioned by Bertrams,[112] would approximate a negotiable instrument.

To summarise from the above, we submit that the approach of the URDG 758 in this regard is a good one, and, should the guarantee not be subject to these rules, that applicants should be very reticent in agreeing to a transferable guarantee.

5 Conclusion

As in the case of letters of credit, the transfer of an independent guarantee can fulfil a valuable purpose, but the transfer exposes both the issuer of the guarantee and the applicant for the guarantee (the instructing party) to significant risks. The URDG 758, ISP 98, UNCITRAL Convention and the Chinese Rules all recognise these risks to a degree, and, accordingly, do not permit uncontrolled transfer of guarantees. The measure of control, however, differs significantly under the different sets of rules.

Where the rules require the issuer of the guarantee to consent to the transfer, it is submitted that the risks faced by the issuer are adequately mitigated.[113] In this

[109] See Affaki & Goode (n 5) 89.

[110] (n 5) 272.

[111] One needs to bear in mind in this respect the fact that all that is typically required to call up a guarantee is the written demand by the guarantor. See in this regard also the text to n 12 above.

[112] (n 5) 272 & 282.

[113] An exception may perhaps be found in the case of a standby credit, where not the issuing bank but the nominated bank "agrees to and effects the transfer" as contemplated in par 6.02biii of the ISP 98. See n 65 above in this regard. To prevent the issuing bank from becoming contractually bound to an unwanted beneficiary, owing to the nominated bank consenting to give effect to a transfer, it is

respect, as expressly stated in the URDG 758,[114] and recognised by inference in the ISP 98,[115] it is suggested that the mere fact that a guarantee is termed "transferable" should not be construed as consent by the issuer to its transfer. The term is regarded as merely indicating that the guarantee is potentially transferable and not that, without protective qualification, it may be transferred or that it is freely transferable.

It is suggested, however, that a transfer of a guarantee to a transferee-beneficiary who has not also replaced the transferor-beneficiary fully in the underlying contract, holds unpalatable risks for the applicant, and applicants will be well advised not to agree to such a guarantee. Accordingly, we support the approach taken in the URDG 758 in this regard. As Bertrams contends, allowing the free transfer of guarantees to third-party beneficiaries "would … turn these security instruments into negotiable instruments … and invite dubious trading practices".[116] In this regard, we submit that the practice of transferring a guarantee to a third-party financier of the underlying transaction is especially concerning.

At the risk of stating the obvious, it needs to be emphasised – because the point is often overlooked – that where a guarantee is not governed by any of the sets of rules considered in this contribution, the protection offered by the rules is not available either to the issuers of, or the applicants for, guarantees. One may, for example, ponder whether the guarantor, by terming the guarantee "transferable" can argue convincingly that its consent is still required for the transfer in the absence of the URDG 758 or the ISP 98 applying.

Against this background it is suggested that applicants and guarantors should carefully scrutinise the risks created by permitting the transfer of a guarantee before embarking upon this course. We also reiterate the call[117] that use of the URDG 758 or the ISP 98 will generally lead to better guarantee practice (fairer and more certain) in general, and specifically in relation to the transfer of guarantees. In the context of the transfer of guarantees, the use of the URDG 758 may be especially advantageous.

therefore suggested that any mandate given by an issuing bank to a nominated bank should include that the nominated bank must not agree to effect a transfer without the consent of the issuing bank.

114 art 33b. See also art 9(2) of the UNCITRAL Convention.

115 par 6.02a read with 6.02biii.

116 (n 5) 282.

117 See Hugo (n 12) 17–20.

Annexure

1 Article 33 of the Uniform Rules for Demand Guarantees 758

Transfer of guarantee and assignment of proceeds

a. A guarantee is transferable only if it specifically states that it is "transferable", in which case it may be transferred more than once for the full amount available at the time of transfer. A counter-guarantee is not transferable.

b. Even if a guarantee specifically states that it is transferable, the guarantor is not obliged to give effect to a request to transfer that guarantee after its issue except to the extent and in the manner expressly consented to by the guarantor.

c. A transferable guarantee means a guarantee that may be made available by the guarantor to a new beneficiary ("transferee") at the request of the existing beneficiary ("transferor").

d. The following provisions apply to the transfer of a guarantee:

i. a transferred guarantee shall include all amendments to which the transferor and guarantor have agreed as of the date of transfer; and

ii. a guarantee can only be transferred where, in addition to the conditions stated in paragraphs (a), (b) and (d)(i) of this article, the transferor has provided a signed statement to the guarantor that the transferee has acquired the transferor's rights and obligations in the underlying relationship.

e. Unless otherwise agreed at the time of transfer, the transferor shall pay all charges incurred for the transfer.

f. Under a transferred guarantee, a demand and any supporting statement shall be signed by the transferee. Unless the guarantee provides otherwise, the name and the signature of the transferee may be used in place of the name and signature of the transferor in any other document.

g. Whether or not the guarantee states that it is transferable, and subject to the provisions of the applicable law:

i. the beneficiary may assign any proceeds to which it may be or may become entitled under the guarantee;

ii. however, the guarantor shall not be obliged to pay an assignee of these proceeds unless the guarantor has agreed to do so.

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2 Paragraph 6 of the International Standby Practices 1998

6.01 Request to Transfer Drawing Rights

Where a beneficiary requests that an issuer or nominated person honour a drawing from another person as if that person were the beneficiary, these Rules on transfer of drawing rights ("transfer") apply.

6.02 When Drawing Rights are Transferable

a. A standby is not transferable unless it so states.

b. A standby that states that it is transferable without further provision means that drawing rights:
   i. may be transferred in their entirety more than once;
   ii. may not be partially transferred; and
   iii. may not be transferred unless the issuer (including the confirmer) or another person specifically nominated in the standby agrees to and effects the transfer requested by the beneficiary.

6.03 Conditions to Transfer

An issuer of a transferable standby or a nominated person need not effect a transfer unless:

a. it is satisfied as to the existence and authenticity of the original standby; and

b. the beneficiary submits or fulfills:
   i. a request in a form acceptable to the issuer or nominated person including the effective date of the transfer and the name and address of the transferee;
   ii. the original standby;
   iii. verification of the signature of the person signing for the beneficiary;
   iv. verification of the authority of the person signing for the beneficiary;
   v. payment of the transfer fee; and
   vi. any other reasonable requirements.

6.04 Effect of Transfer on Required Documents

Where there has been a transfer of drawing rights in their entirety:

a. a draft or demand must be signed by the transferee beneficiary; and

b. the name of the transferee beneficiary may be used in place of the name of the transferor beneficiary in any other required document.

6.05 Reimbursement for Payment Based on a Transfer

An issuer or nominated person paying under a transfer pursuant to Rule 6.03(a), (b)(i), and (b)(ii) is entitled to reimbursement as if it had made payment to the beneficiary.

6.06 Assignment of Proceeds

Where an issuer or nominated person is asked to acknowledge a beneficiary's request to pay an assignee all or part of any proceeds of the beneficiary's drawing under the standby, these Rules on acknowledgment of an assignment of proceeds apply except where applicable law otherwise requires.

6.07 Request for Acknowledgment

a. Unless applicable law otherwise requires, an issuer or nominated person
   i. is not obligated to give effect to an assignment of proceeds which it has not acknowledged; and
   ii. is not obligated to acknowledge the assignment.

b. If an assignment is acknowledged:
   i. the acknowledgment confers no rights with respect to the standby to the assignee who is only entitled to the proceeds assigned, if any, and whose rights may be affected by amendment or cancellation; and
   ii. the rights of the assignee are subject to:
      (a) the existence of any net proceeds payable to the beneficiary by the person making the acknowledgment;
      (b) rights of nominated persons and transferee beneficiaries;
      (c) rights of other acknowledged assignees; and
      (d) any other rights or interests that may have priority under applicable law.

6.08 Conditions to Acknowledgment of Assignment of Proceeds

An issuer or nominated person may condition its acknowledgment on receipt of:

a. the original standby for examination or notation;

b. verification of the signature of the person signing for the beneficiary;

c. verification of the authority of the person signing for the beneficiary;

d. an irrevocable request signed by the beneficiary for acknowledgment of the assignment that includes statements, covenants, indemnities, and other provisions which may be contained in the issuer's or nominated person's required form requesting acknowledgment of assignment, such as:
   i. the identity of the affected drawings if the standby permits multiple drawings;
   ii. the full name, legal form, location, and mailing address of the beneficiary and the assignee;
   iii. details of any request affecting the method of payment or delivery of the standby proceeds;
   iv. limitation on partial assignments and prohibition of successive assignments;
   v. statements regarding the legality and relative priority of the assignment; or
   vi. right of recovery by the issuer or nominated person of any proceeds received by the assignee that are recoverable from the beneficiary;

e. payment of a fee for the acknowledgment; and

f. fulfillment of other reasonable requirements.

6.09 Conflicting Claims to Proceeds

If there are conflicting claims to proceeds, then payment to an acknowledged assignee may be suspended pending resolution of the conflict.

6.10 Reimbursement for Payment Based on an Assignment

An issuer or nominated person paying under an acknowledged assignment pursuant to Rule 6.08(a) and (b) is entitled to reimbursement as if it had made payment to the beneficiary. If the beneficiary is a bank, the acknowledgment may be based solely upon an authenticated communication.

6.11 Transferee by Operation of Law

Where an heir, personal representative, liquidator, trustee, receiver, successor corporation, or similar person who claims to be designated by law to succeed to the interests of a beneficiary presents documents in its own name as if it were the authorized transferee of the beneficiary, these Rules on transfer by operation of law apply.

6.12 Additional Document in Event of Drawing in Successor's Name

A claimed successor may be treated as if it were an authorized transferee of a beneficiary's drawing rights in their entirety if it presents an additional document or documents which appear to be issued by a public official or representative (including a judicial officer) and indicate:

a. that the claimed successor is the survivor of a merger, consolidation, or similar action of a corporation, limited liability company, or other similar organization;

b. that the claimed successor is authorized or appointed to act on behalf of the named beneficiary or its estate because of an insolvency proceeding;

c. that the claimed successor is authorized or appointed to act on behalf of the named beneficiary because of death or incapacity; or

d. that the name of the named beneficiary has been changed to that of the claimed successor.

6.13 Suspension of Obligations upon Presentation by Successor

An issuer or nominated person which receives a presentation from a claimed successor which complies in all respects except for the name of the beneficiary:

a. may request in a manner satisfactory as to form and substance:
   i. a legal opinion;
   ii. an additional document referred to in Rule 6.12 (Additional Document in Event of Drawing in Successor's Name) from a public official;

iii. statements, covenants, and indemnities regarding the status of the claimed successor as successor by operation of law;

iv. payment of fees reasonably related to these determinations; and

v. anything which may be required for a transfer under Rule 6.03 (Conditions to Transfer) or an acknowledgment of assignment of proceeds under Rule 6.08 (Conditions to Acknowledgment of Assignment of Proceeds); but such documentation shall not constitute a required document for purposes of expiry of the standby.

b. Until the issuer or nominated person receives the requested documentation, its obligation to honour or give notice of dishonour is suspended, but any deadline for presentation of required documents is not thereby extended.

6.14 Reimbursement for Payment Based on a Transfer by Operation of Law

An issuer or nominated person paying under a transfer by operation of law pursuant to Rule 6.12 (Additional Document in Event of Drawing in Successor's Name) is entitled to reimbursement as if it had made payment to the beneficiary.

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3 Articles 9 and 10 of the United Nations Convention on Independent Guarantees and Stand-by Letters of Credit

Article 9. Transfer of beneficiary's right to demand payment

(1) The beneficiary's right to demand payment may be transferred only if authorized in the undertaking, and only to the extent and in the manner authorized in the undertaking.

(2) If an undertaking is designated as transferable without specifying whether or not the consent of the guarantor/issuer or another authorized person is required for the actual transfer, neither the guarantor/issuer nor any other authorized person is obliged to effect the transfer except to the extent and in the manner expressly consented to by it.

Article 10. Assignment of proceeds

(1) Unless otherwise stipulated in the undertaking or elsewhere agreed by the guarantor/issuer and the beneficiary, the beneficiary may assign to another person any proceeds to which it may be, or may become, entitled under the undertaking.

(2) If the guarantor/issuer or another person obliged to effect payment has received a notice originating from the beneficiary, in a form referred to in paragraph (2) of article 7, of the beneficiary's irrevocable assignment, payment to the assignee discharges the obligor, to the extent of its payment, from its liability under the undertaking.

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4 Article 10 of the Provisions of the Supreme People's Court of the People's Republic of China on Several Issues Concerning the Trial of Disputes over Independent Guarantees

Article 10 [*Transfer*]

Unless an Independent Guarantee states that it is transferable and specifies document(s) on the basis of which a new beneficiary can be determined, a People's Court shall support an Issuer's claim that it is not bound by the Beneficiary's transfer of its right to demand payment. Where there are special provisions in relation to the Beneficiary's transfer of its right to demand payment in the independent Guarantee, such provisions shall prevail.

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Legal issues arising from the utilisation of blockchain-based products in the 4th industrial revolution

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Abstract

This contribution considers the nature of distributed ledger technology, or blockchain as it is otherwise known, analysing its key elements, the reasons for its emergence and development and its potential importance. The method by which it functions is analysed together with a discussion of the facilities that are being developed on it. There is also a consideration of the legal issues arising from its operation and of the facilities that utilise it. Further, there is also a consideration of the cost issues involved in using blockchain and the particular factors arising when shares and bonds are issued on a blockchain system. Criminal factors inevitably arise with the development of any new regime and key elements of these are considered. Finally, there is also an analysis of the inherent problems arising with such a system and the current situation in which the world now finds itself with blockchain, and the future issues that seem to be emerging.

* * * * *

1 Introduction

Distributed ledger technology, or “blockchain”, operates as a public ledger showing all transactions that have operated upon it, though the identities of the participants using it are obscured. Essentially, there is a ledger which is distributed on the internet on a peer-to-peer network. It runs on the users’ computers, not on a central data base. Each transaction is a block that carries a cryptographic link to the previous one. Every addition of a new linked block to the chain extends it and thus makes it harder for a third party to steal another’s cryptocurrency or asset because the process of rewriting the sequence of transactions becomes progressively more complicated. The essential concept is not new, its history dating back to the start of the 1990s when Haber and Stornetta created a system of documented time stamps that could not be retrospectively interfered with.

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Together with Bayer they then incorporated "Merkle trees" into the design to facilitate this by the successive elements being constructed into a continuing block.[1]

Blockchain's potential is enormous because of the very wide range of transactions that can operate on it safely and cheaply. As a result, it is emerging as one of the most important potential developments in the commercial world.[2]

This contribution will consider:

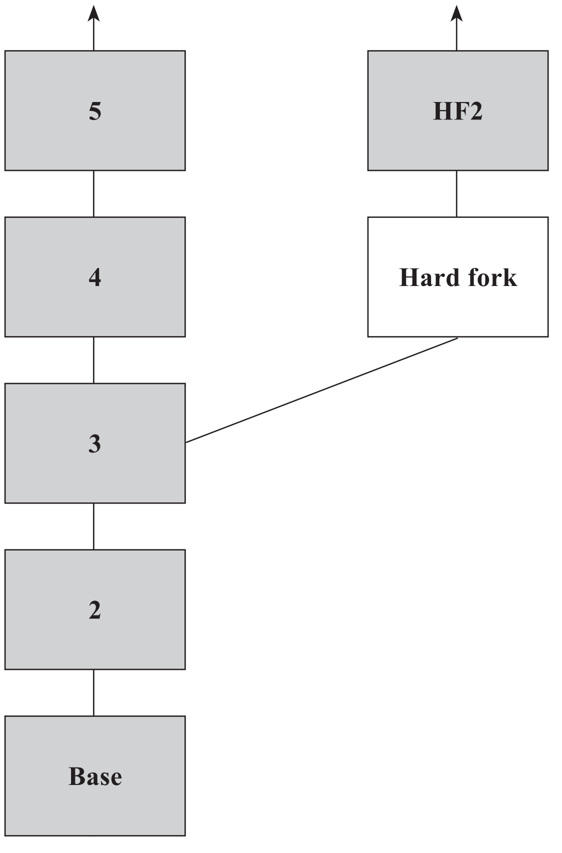
– the nature of the blockchain and the reasons for its current and future ongoing emergence;
– how it functions and the nature of the facilities that are designed to be built on it;
– legal issues relating to the operation of the blockchain itself; and
– legal issues relating to the facilities that use it, and, in particular, the extent to which existing laws and regulations may be applicable.

2 Distributed ledger technology

The construction looks like the diagram below. The central block at the bottom is the original arrangement and each participant adds their own block as they engage in a transaction. Each transaction includes the cryptographic hash of the prior block thus connecting them together. As shown, a separate fork can be added by someone adding a different software component, resulting in what is called a "hard fork". After that, transactions on the old software will be added to the previous structure and ones carried out on the new software will be added to the blockchain that has split off from the original construction. Either way, the blockchain becomes progressively longer and safer from interference after the event with each transaction. Thus, the structure looks like this:

1 Narayanan, Bonneau, Felten, Miller & Goldfeder *Bitcoin and Cryptocurrency Technologies: A Comprehensive Introduction* (2016); Haber & Stornetta "How to time stamp a digital document" 1991 (3(2)) *Journal of Cryptology* 99–111; Bayer, Harber & Stornetta "Improving the efficiency and reliability of digital time stamping" in Capocelli, De Santis & Vaccaro (eds) *Sequences II Methods in Communication, Security and Computer Science* (1993) 329–334.

2 This is not universally accepted. See, for example, Danielsson "Cryptocurrencies: Policy, economics and fairness" *Systemic Risk Centre Discussion Paper 86* London School of Economics 14.



Hard forks are not reversible because to do so would involve all the participants in updating. Once this is done, those who do not implement the alteration to their part of the blockchain can no longer use it. Thus, there is a change in the operation of the blockchain from that point and it splits into two separate operating systems. On the other hand, soft forks introduce voluntary changes to the software and can be reversed. They occur when the majority of the miners impose their approach on any dissenting minority. Once a blockchain has developed beyond a certain stage this becomes very difficult to implement because of the numbers involved.

The blocks themselves are each made up of a header, which is effectively an electronic fingerprint made up of a hash using standard cryptographic functions,[3] a time stamp and a hash of the previous block. Other information may be added to it. The protocol of the relevant cryptocurrency or asset will link these together sequentially. Finck[4] defines it as

[3] De Filippi & Wright *Blockchain and the Law: The Rule of Code* (2018) 22; Carter & Wegman "Universal classes of hash functions" 1979 (18(2)) *Journal of Computer and System Sciences* 143–154.

[4] Finck *Blockchain Regulation and Governance in Europe* (2019) 1.

> "a database that is replicated across a network of computers updated through a consensus algorithm [and] a shared and synchronized digital database that is maintained by an algorithm and stored on multiple nodes (the computers that store a local version of the distributed ledger). Blockchains can be imagined as a peer-to-peer network with the nodes serving as the different peers."[5]

It is:

> "…a purely distributed peer to peer system of ledgers that utilises a software unit that consists of an algorithm, which negotiates the international content of ordered and connected blocks of data together with cryptographic and security technologies in order to achieve and maintain its integrity."[6]

Or as Vitalik Buterin, the creator of Ethereum put it, it is:

> "a…computer that anyone can upload programs to and leave the programs to self-execute, where the current and all the previous states of every program are always publicly visible, and which carries a very strong cryptoeconomically secured guarantee that the programs running on the chain will continue to execute in exactly the way that the blockchain protocol specifies."[7]

Not all blockchains operate on the same basis: the variety is extensive and they can be public and permissionless, which was the original form in which they were created. Anyone can download and use the relevant software and create a new cryptocurrency or asset. Alternately, there is a private and permissioned version and there are also hybrid versions which are a mixture of the two. The private versions, as their name suggests, run on a private network or intranet. They have normally already been created to carry out a specific function and may operate inside a company or syndicate. By their nature those using the system are known and permission must be granted before someone can join in. Hybrid blockchains, as their name suggests, combine the two, and as Herian put it:

> "data from a closed network can be shielded by a registry layer and moved or released to permissionless blockchains for the purpose of allowing public scrutiny of or prescribed or specified data at a given point in time. The hybrid distinction also includes the option of using ledgers, most likely in permissioned form as an access control medium for other, additional registries or databases in off-chain or offline servers and storage infrastructures."[8]

Almost anything can be collected and progressed on distributed ledger technology; for example, a business or legal transaction can be developed from the initial contact, through the negotiations up to the final contract. If the parties later agree to amend the contract, it can be altered accordingly but any retrospective amendment is possible without the parties' agreement, so the risk of a party seeking to renege by challenging what had been previously agreed is removed. It thus has great potential for storing business and government records.

5 Finck (n 4) 6.
6 Drescher *Blockchain Basics* (2017) 35.
7 Buterin "Visions part 1: The value of blockchain technology" (Ethereum Blog, 13 April 2015) https://blog.etherium.org/2015/04/13/visions-part-1-the-value-of-blockchain-technology. See also Finck (n 4) 11.
8 Herian *Regulating Blockchain: Critical Perspectives in Law and Technology* (2019) 16.

The arrangement is open to access by third parties but is also encrypted, utilising both public and private keys. In the case of the commonest cryptocurrency, bitcoin, the transactions are checked, transacted and cleared and locked into the ledger on a time-stamped basis in a link with the preceding transaction every ten minutes.[9] For anyone to interfere with the process would require accessing the blockchain history and retrospectively altering it, which would be almost impossible at the current level of computer capacity and software development.[10]

This can also operate just as easily on a multi-lateral basis. For example, most of the population own credit and debit cards which facilitate paying for goods and services. The arrangement operates on the basis that the data which develops in such a system is owned by the company issuing the card. They also charge an annual fee and a percentage of the outstanding amount on the card. It is normally the case that the holders of these cards have an arrangement which facilitates their spending an amount that represents a debt to the credit card issuing company. An equivalent system could be created on blockchain whereby the payment system would operate on the basis that the payor and payee deal directly with each other on the blockchain. In practice the funds could move at a speed whereby the payment would be made within ten minutes and the confirmation of transfer of title would be returned at the same speed. It would still be possible for the person using the arrangement to obtain credit from third parties, but the credit provider would not need to become involved with the process and would no longer own the overall arrangement.

3 Costs

At present there are almost no overheads in utilising a blockchain-based system, although this could start to change once new coins cease to be issued by the arrangement concerned, for example, bitcoin. After that point it will be necessary to find a methodology to pay miners for each transaction to be verified, or an alternative arrangement be found to validate each transaction. Even so it is a system suitably designed for carrying out financial transactions. For example, all the financial transactions carried out by banks through the SWIFT system, or cheque clearing, can be carried out directly, and at lower cost by the parties to the transaction dealing directly with each other. In this context the potential of such an arrangement is greatly increased by the proportion of the world's population in developing countries not living in the vicinity of a bank branch. The general availability of iPhones and similar electronic access points opens such people up to all the financial arrangements available online, and where they are so constructed on a blockchain-based system. That said, unless the user has the capacity to run the blockchain operating system on the cloud, the size of the hard drive needed to operate blockchain means that such an iPhone would need to be linked to a powerful base unit, which at present may limit its use in poorer parts of the world.

9 Though in some cases, eg, Etherium, it is more frequent and can be carried out in a few seconds.

10 Tapscott & Tapscott *Blockchain Revolution* (2018) 6–7.

Fund managers can also operate on blockchain-based systems and thus reduce costs to the investors through reducing administration costs, the need for fewer intermediaries and, partly as a result of both of these, engage in significantly less administration. In addition, the automated real-time process available on blockchain, whereby the trades both self-clear and settle, will reduce costs further.[11]

Trade finance is an area where there is the potential for significant blockchain usage[12] and this was apparent from the feedback to HM Treasury's Cryptocurrency Task Force in the UK. The current arrangements involve letters of credit and/or bills of exchange being used as a vehicle for payment. In practice there are also time delays with the majority of letters of credit being initially rejected by banks for failure to be precisely accurate, often on quite trivial points of detail, because such a lapse in accuracy could technically make the claim a fraudulent one and, for this reason, the issuing bank may refuse to pay.[13] That said, the vast majority of such bills are settled within 48 hours, albeit at some inconvenience to the payee. On the other hand, if the payment system for a letter of credit and/or bill of exchange were to be constructed on a blockchain, the money could be released to the vendor at the moment of the delivery of the goods, with the process being self-checking and self-recording. There is evidence of steps being taken to implement precisely such an arrangement by the Monetary Authorities of Hong Kong and Singapore. They have provided what may be the first of many such steps in creating an international information highway to facilitate trade finance.

The initial design of the respective blockchain technologies is still at a fairly early stage and questions have been raised[14] as to whether there will be a trade-off between performance, resilience and privacy. Transactions currently take anything from ten minutes to an hour to be processed, which is significantly better than is the case when bills of exchange and letters of credit are used.

However, when compared with payment by cash or credit card this is still a significant time frame and reduces the attractiveness of blockchain-based currencies as media of exchange. Transaction costs for bitcoin have been assessed at varying between US$ 0.45 to US$ 55 per transaction.[15] The platform being used may also

[11] HM Treasury "The UK Investment Management Strategy II" (Dec 2017) 30 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/665668/The_Investment_Management_Strategy_II.pdf.

[12] Hong Kong Monetary Authority (HKMA) "Hong Kong and Singapore launch a joint project on cross-border trade and trade finance platform" (2017) (Press Release 15 Nov 2017) https://www.hkma.gov.hk/eng/key-information/press-releases/2017/20171115-6.shtml.

[13] *United City Merchants v Royal Bank of Canada* [1983] 1 AC 168 (HL); *Kvaerner John Brown Ltd v Lear Siegler Services Ltd* [2006] EWCA Civ 1130; and *Balfour Beatty Civil Engineering Ltd v Technical and General Guarantee Co Ltd* [2000] 68 Con LR 108. See also Haynes *The Law Relating to International Banking* (2018) 260–265.

[14] See, for example, HM Treasury, Financial Conduct Authority & Bank of England "Cryptoassets Taskforce: final report" (October 2018) 26 https://assets.publishing.service.gov.uk/government/uploads/system/uploads/attachment_data/file/752070/cryptoassets_taskforce_final_report_final_web.pdf.

[15] Danielsson "Cryptocurrencies: Policy, economics and fairness" (Version 1.2 Nov 2018) Systemic Risk Centre (SRC) Discussion Paper 86 London School of Economics 20 http://www.systemicrisk.ac.uk/sites/default/files/downloads/publications/dp-86.pdf.

involve extra fees. This compares with no cost for using cash and a nominal, indirect one for using credit or debit cards. That said, for international transactions the picture changes. The normal banking tool is SWIFT, which in comparison with cryptocurrencies is slow and more expensive, especially for recipients in developing countries. There are other cash transfer systems but the average cost of transferring US$ 200 is 7.1%, rising to 9.4% in sub-Saharan Africa.[16]

4 Shares and bonds

Companies raise finance by either selling shares, which provide a degree of equity in their business to those who will buy them, or by borrowing from banks or the open market by issuing bonds. Such share and bond offerings can now be made on blockchain and can potentially provide a far cheaper way for shares to be issued publicly. This raises the possibility of smaller companies going to market to sell shares than at present, thus hugely increasing the size of the share market. Legal issues still arise as share and bond sales normally have to be accompanied by a prospectus, a legal document setting out the finances of the issuing company, the details of the share issue and for what the funds will be used. Prospectuses are time-consuming and expensive to produce, requiring extreme care and accuracy because of the criminal and civil legal consequences that can be attracted if they are not completely accurate. Many offerings currently seem to be issued on the assumption that these rules do not apply if the share issue is carried out on an initial coin offering (ICO) basis but steps are currently being taken by regulators to disabuse issuers of this fact.[17] Once those in the market place understand this the costs will rise, but it will still be potentially much cheaper than a standard share issue. Very significant cost savings will still be made though from the reduction in investment bank fees, stockbrokers and sales agents as the online sales process will hugely reduce the expense of the share issue.

Likewise, a multi-party system such as a bond issue,[18] or ICO as they are called if the bond exists in the form of an e-currency offering, can all sit on blockchain. Over US$ 3 billion was raised in this way in 2017. That said, the same legal requirements regarding prospectuses crop up here and it is clear that market participants have also been cavalier in this context. The company wishing to raise finance therefore has to list any prospectus[19] on the blockchain. The lenders can submit payment and receive their title to the debt on the system, and, in due course, if they wish to sell title to the debt on to another person, which frequently happens, this will also take

16 Danielsson (n 15) 21.

17 US Securities and Exchange Commission (SEC) "Investor bulletin: Initial coin offerings" (Investor Alerts and Bulletins 25 July 2017) https://www.sec.gov/oiea/investor-alerts-and-bulletins/ib_coinofferings.

18 The issue of debt paper, normally by a corporate or government to raise finance at a stated interest rate for a set period.

19 The legal document advertising the details of the bond issue and the company issuing it. Alternately, if the bond is issued in high enough denominations to remove the risk of ordinary members of the public being able to afford them, a simpler and cheaper to produce document, called an "information memorandum" will be issued.

place and remain on the blockchain record. Repayment by the borrowing company can also then take place on the same system. In addition, the automated process is much cheaper to operate than the current process and reconciliation, settlement and record keeping are all automated with all parties sharing identical data.

However, for banks there is one downside as the existing system requires clearing houses for shares and also for derivative contracts. These can take three days to clear trades even though the trades themselves will usually clear in seconds. This should not be a problem once blockchain-based systems take over as the trades will self-clear. The current system does allow participants to engage in multi-lateral netting. This consists of the parties and the clearing house netting all trades off against each other by each trade being constructed of a sale by the seller to the exchange or clearing house and an immediate sale by the exchange or clearing house to the buyer. As a result the exchange is a counterparty to each deal, and in the event of a participant becoming insolvent, all the trades that remain outstanding will be offset against each other, thus hugely reducing the amount of money at risk to the other parties involved.[20] The relative ease with which LCH Clearnet was able to cope with the financial consequence of Lehman Bros' collapse is a good example. There were some issues with identifying the clients to whom certain uncleared trades related, and some delays in getting margin payments back to those who required it, but essentially the multi-lateral netting approach worked well in reducing the total amount of money at risk.[21]

What multi-lateral netting offers the banks is the opportunity to reduce greatly the amount of capital they have to hold in reserve against the trades they enter into, which is required by the Basel III banking capital requirements applied at present in all of the world's more advanced economies. In addition, reconciliation processes that can be both time consuming and slow can be avoided.[22] No doubt in due course amendments to the banking capital rules are likely in order to bring them in line with the financial risks that are left with the banks under a blockchain-based system.

Amending the banking capital rules would not be without risk though. Whilst it would significantly reduce costs in that the trading process would no longer need intermediaries, the market could end up in a decentralised financial world where trades are no longer centrally cleared and such a state of affairs "will simply be a collection of interwoven smart contracts that facilitate the buying and selling of blockchain based assets".[23] This would not offer the same facility as the present exchanges in holding capital against the risk of a participant becoming insolvent. Thus, the risk of a market failure, or at least a localised one based on one collection of interwoven blockchain-based contracts, would be much higher.

20 Haynes (n 13) 217.
21 Haynes (n 13) 219.
22 European Securities and Markets Authority (ESMA) "ESMA assesses DLT's potential and interactions with EU rules" (Press Release 7 February 2017) https://www.esma.europa.eu/sites/default/files/library/esma71-844457584-344_2017_press_release_dlt.pdf.
23 De Filippi & Wright (n 3) 102.

5 Criminal factors

Crucially, blockchain also makes it much more difficult for fraudsters to operate as they cannot go back later and hide the fraud. Any activity is recorded and clears itself, removing the need for traditional audit to verify it. Indeed, given the limited requirements placed on the auditor to be "a watchdog not a bloodhound"[24] in comparison with the inability of the blockchain system to do anything other than record accurately, the future system should be much safer, automatic and not require audit fees. "If the (blockchain) ledger says something is true then it is true."[25] That said, to have a checking and regulatory capacity that works properly, both auditors and regulators will need to be granted access rights to the distributed-ledger technology.

This makes blockchain and currencies based on it less attractive to criminals. With criminal funds, money laundering and terrorist finance there are many ways in which the criminals can hide their identity and the overall transaction. Blockchain records all the details of the trading and thus the capacity to hide what is going on becomes much more difficult, though there will remain the capacity for the person using the system to do so from behind a false identity. Even so, the police, tax authorities and intelligence services will be able to trace money flows back to their source. That said, some cryptocurrencies such as Monero and zcash are more difficult to police. Monero has an obfuscated public ledger which makes it extremely difficult to trace back. It hides the recipient of the deal and creates a new electronic address and a secret key for him or her.[26] Zcash[27] has a cryptography-based system to guarantee privacy but with a selective disclosure capacity built in. Its accounts cannot necessarily be traced and its blockchain does not store information concerning the source and destination of the "money". Thus, for money laundering and disclosure rules the owner can elect to release information or not.

The other criminal issue is that although criminals may find interfering with the blockchain process to be prohibitively complicated, there is still the possibility that with cryptocurrencies or other items of value based on blockchain those parties will engage in market manipulation. The other possible way of illegally obtaining money through the new system is to hack people's computers to access their codes as was discussed earlier.

What is already apparent is that blockchain-based systems do not fit neatly into existing regulatory structures. Some states have categorised cryptocurrencies differently from others, and in the US money transmission is regulated at state level, whilst the impact of the new developments will have an impact both nationally and internationally. The regulators are facing a situation where the two parties to a trade or transaction will be in possession of potentially large amounts of information, whilst the regulators themselves will have access to very little. They are also

24 Lopes CJ in *Re Kingston Cotton Mills (No 2)* (1896) 1 Ch 331.

25 Interview between Austin Hill, Don Tapscott and Alex Tapscott, 22 July 2015 (recorded in Tapscott & Tapscott) (n 10) 76.

26 Finck (n 4) 97.

27 A joint development between Israeli and US cryptographers. See in this regard De Filippi & Wright (n 3) 67.

operating against a background of very rapidly changing circumstances, to which, historically, they have not always adapted well.

Across all these potential activities, and the others that will be created, the new distributed systems will be more resilient that the current centralised systems.[28] This is because having separate copies of data accessible to multiple participants greatly reduces the potential risk of data loss. As the blockchain is developed with an ever-increasing number of participants, this becomes more and more the case. A web attacker would need to take control of multiple participants to attack the system, and the longer a distributed ledger has been in use the greater this number is likely to be. It could be vast. Thus, the system is capable of continuing to perform even if part of it successfully comes under attack as almost all the participants will still be able to get direct access to their own data, which will be identical.[29] That said, the Bank of England's testing of a multi-node Etherium protocol-based project warranted further investigation of scalability, security, privacy, interoperability and sustainability.[30] Even so, most observers see distributed-ledger technology-based systems as stronger in these regards than the systems they are starting to replace.

However, now decentralised organisations with illegal intent have been created. Daemon, for example, will enable its anonymous shareholders to manage a market on the dark web. Its aims, amongst other things, are to evade government interference.[31]

There is a further problem in that behaviour that any objective observer would regard as criminal may, technically, not be so because the wording of the law lags behind the technological developments. For example, the DAO hack arose when US$ 150 million was invested in Ether by around 11 000 people. The idea was to create a start-up fund which would be operated on a democratic basis by the votes of the contributors. Due to a bug in the code a hacker was able to remove a third of the fund without breaching the criminal law.[32] There was then a democratic vote of the contributors and 87% of the relatively small number that voted agreed to create a hard fork reversing the effect of the hack.[33] Perhaps surprisingly some opposed this on what seem to be philosophical grounds – that, as a matter of principle, the blockchain should not be reversed.

6 Inherent problems

What then are the problems? Energy consumption needs to be considered. The process of running transactions through the secure algorithm[34] consumes a significant amount of energy. That said, there seems to be a huge variation in the estimates

28 HM Treasury (n 14) 22.
29 ibid.
30 ibid.
31 De Filippi & Wright (n 3) 145; Butnix "Daemon wants to become a decentralized Etherium-based smart darknet market" *The Merkle* 4 April 2016 http://themerkle.com.
32 Finck (n 4) 187; Raskin "The law and legality of smart contracts" 2017 *Georgetown Law and Technology Review* 305 335; Werbach & Cornell "Contracts *ex machina*" 2017 *Duke Law Journal* 313 365.
33 Technically there were two votes, the first on the procedure to be adopted and the second to reverse the blockchain.
34 Algorithm 256 (SHA-256).

that "experts" calculate are utilised.[35] This energy consumption needs to be offset though against the quantity of electricity that would otherwise be consumed by whatever alternative method had been adopted to carry out the transaction.

The greater the resilience built into a system the more limited the capacity will tend to be and some of the systems will be designed to cater for huge numbers of users. To maintain privacy, encryptions are used but there are suggestions that this can reduce performance. That said, in many situations the use of encryption is a necessary factor to maintain sufficient security; so, from the vantage point of the user, this is not going to be a negotiable element. Finally, the resilience of a system can be strengthened by limiting the distribution of data. Unfortunately, this is often not an option as the common distributed ledger will be a key element of making the system attractive to potential users.[36]

There may prove to be overheads related to co-ordination once the systems are in widespread use, though this should probably prove considerably less than current systems where parties other than those dealing directly with each other are concerned.[37] As years go by the complexity of some of the programs may increase in order to handle all the data, and security will become a greater concern, especially once computers that can handle mega data become operative.

In addition, there is as yet no standard-form platform for participants to use although IOSCO are looking into this.[38] It will be simpler to operate a system where there is an international standard, but there is no guarantee that one will emerge. Indeed, some participants may seek a competitive advantage through developing newer systems which have advantages over pre-existing ones.

7 The current situation

At the time of writing the US leads distributed-ledger technology start-ups with the UK in second place,[39] with London having the second highest number of such projects listed, closely behind San Francisco. However, the scale of the internet capacity and that of the computers most people use on the system is not capable of carrying a multiplicity of large-scale blockchain transactions; the transactional capacity is not there. It is suggested, however, that it will not be many years before it is and until then distributed-ledger technology is likely to develop progressively. Some aspects relevant to its development, such as law and regulation, can be developed fairly quickly. Some areas such as money laundering, market manipulation and theft will always be with us but the security distributed-ledger technology provides should render them safer than other methods of financial transfer.

35 Schneider "After the bitcoin gold rush" *The New Republic* 24 February 2015; Kaminska "Bitcoin's wasted power" *Financial Times* 5 September 2014.

36 Haynes & Yeoh *Cryptocurrencies and Cryptoassets: Regulatory and Legal Issues* (2020) 243.

37 Drescher (n 6) 13; Stead *What is Cryptocurrency: Your Complete Guide to Blockchain, Bitcoin and Beyond* (2018); Ganne *Can Blockchain Revolutionize International Trade?* (2018) 90–110.

38 International Standards Organisation (ISO) "ISO/TC 307 Blockchain and distributed ledger technologies" (2016) https://www.iso.org/committee/6266604.html.

39 Coindesk "Coindesk releases Q2 2018 State of Blockchain Report" https://www.coindesk.com/state-of-blockchain-q2-2018.

Strictly speaking, the World Trade Organisation (WTO) maintains that blockchain represents only one type of distributed-ledger technology, but the term now is commonly employed to refer to them in general.[40] Many would agree that blockchain goes beyond the cryptocurrency hype. Its potential trade-related applications are numerous and could probably transform international trade significantly. Some possible deployments of cryptocurrency could include trade finance, customs and certification processes, transportation and logistics, insurance, distribution, intellectual property and government procurement.[41] Even as the technology unfolds interesting opportunities to enhance efficiencies of numerous processes trimming costs in these areas, the technology is not a solution to everything. As such, this requires carefully weighing the costs and benefits involved. Interestingly, blockchain could help implement the WTO Trade Facilitation Agreement, as well as facilitating business-to-government and government-to-government processes at the national level.[42]

The World Economic Forum has predicted that by 2025 10% of global GDP could be stored on blockchain systems.[43] It sees it as akin to the invention of the internet, a system that functions as a general-purpose technology. Unfortunately, it remains held back by the limitations of the size of the distributed computer system.

There remain issues to be fully resolved if blockchain is to fulfil its potential; the issues of privacy, security, scalability, costs, hidden centrality, lack of flexibility and critical mass.[44] Privacy concerns arise because the nature of the blockchain is open so that users can verify ownership and transactions. However, it is possible to limit this as has been seen with the obfuscated ledger technology used in Monero and the cryptography-based system used for zcash.

Security is a potential concern with any software system. In the case of blockchain systems the accounts are cryptographic keys that are accessed through the system. It is safe as long as only the relevant person has access to the cryptographic key. If third parties can access its details then they can access the system as though they were the other person. The security in the system is so strong that a third party is only likely to access it if he or she is given the cryptographic key or accesses records the owner has kept outside the blockchain system. A related issue is the possibility that governments may require computer codes to have trapdoors built into them facilitating analysis, suspension or disabling.[45] That said, the users cannot be stopped from running the system without such an arrangement, though doing so would presumably be illegal. Such an approach by governments would

40 Cram-Martos "What is blockchain and DLT? Slide 1" in WTO Global Trade and Blockchain Forum (Geneva 2 December 2019) https://www.wto.org/english/res_e/reser_e/01_a_virginia_cram-martos_final_wto_2019-1202.pdf.

41 Ganne *Can Blockchain Revolutionize International Trade?* (2018) passim.

42 Ganne (n 41) viii to xii.

43 World Economic Forum "Deep shift – technology tipping points and societal impact" 7 www3.weforum.org/docs/WEF_GAC15_Technological_Tipping_Points_report_2015.pdf.

44 Drescher (n 6) 206.

45 De Filippi & Wright (n 3) 181. It could be argued that this would merely be an extension of the current arrangements whereby some governments impose obligations on those creating codes, eg, the Digital Millennium Copyright Act in the US.

almost certainly lead to a kind of regulatory arbitrage where systems were based in jurisdictions that did not do so.

The scalability element[46] arises as a result of the security that is built into the system. To stop later users altering earlier records the system is constructed from the history of the transactions so far with each having a hash puzzle added each time a block is added into the system. To change this retrospectively at the current level of software development would be prohibitively time-consuming and expensive. The consequence of this is that processing speed and the maximum scale on which the systems can currently operate are limiting factors. This overlaps with the issue of cost, though that needs to be offset against the cost of any alternative system that would have been used by the parties instead. As that would often currently involve the use of third parties, those costs could be considerably higher.

The weak link may be the 51% rule discussed earlier. In a smaller system it may be possible for someone with considerable software power to achieve 51% control of relevant nodes. The larger a blockchain system becomes, the safer it is from such attacks.

The current state of legal and regulatory clarity is extremely low. Where there is any, that in one part of the world often contradicts that in another. It is an area where it is reasonable to expect rapid development. It would appear that the blockchain ecosystem is positive towards effective regulation that would deter nefarious deployment of the technology.

Despite present limitations, blockchain enthusiasts have to be mindful of the potential liability. This raises questions concerning how distributed-ledger technology should be structured, owned and ultimately regulated. In this respect, consideration should be given as to whether the system is permissioned or permissionless, whether the legal structure is specified in the pertinent agreements, the system's express or implied purpose, the system's consensus mechanism and the matter of pre-existing relationships between the parties.[47] These features could be treated in law to be one of several legal entities, from a joint venture, a multi-party contract to a partnership. For instance, the group that designs the code that governs the ledger could be deemed a joint venture, and this could extend to nodes or even simple users of the ledger depending on the extent of their participation. Conversely, the distributed-ledger system could be treated as a multi-party contract where the group that sets up the code design and nodes is under a contractual obligation to maintain the system's security and operations. These potential legal structures could also differ across disparate jurisdictions.

The challenge hinges on the ability of law makers to strike a balance between the need for governance and the avoidance of strong state intervention that could terminate the innovation.[48] There is therefore the need to analyse carefully the

[46] The fact that as an ever-increasing number of blocks are added onto the hard fork it becomes progressively more difficult for a third party to interfere with a transaction.

[47] Zetzsche, Buckley & Arner "Blockchain distributed ledgers and liability" 2018 (2(4)) *Journal of Digital Banking* 298–310.

[48] Borg & Schembri "The regulation of blockchain technology" in Dewey (ed) *Blockchain & Cryptocurrency Regulation* (2019) 187; Yeoh "Regulatory issues in blockchain technology" 2017 (25(2)) *Journal of Financial Regulation and Compliance* 196–208.

functional features of various concepts under evaluation and their implications and risks to enable the delivery of appropriate and sufficient response to regulatory concerns without over regulation. This is not easy as blockchain is at an early stage of development and it is not clear into what forms it will evolve. Technologically, blockchains are also rather limited in that every full node must process each transaction and keep a full copy. This inevitably slows down utilisation, a problem that will increase as the size of a blockchain grows. Security for users will potentially be at the price of growing inefficiency. That said, there are developments such as off-chain payment channels, arranging for different nodes to store and process only part of the process, carrying out calculations outside the chain and directed acyclic graphs which do not use a linear blockchain approach.[49] Other approaches will also no doubt emerge.

Accordingly, regulatory intervention should be functional, technology-neutral and premised against regulatory goals and principles.[50] Indeed, like the Internet before it, distributed-ledger technology should be subject to regulation from governments around the world.[51]

Finally, while blockchain provides potential benefits in terms of improved transparency and reduced transaction costs by the more effective managing of data and streamlining of processes, improving supply chains, enabling tracking and management of intellectual property, improving the reliability and traceability of records, reducing the speed and cost of settlement, facilitating copyright and patent protection, as well as improving efficiency through automated reporting and smart contracts, its broader applications are facing various significant challenges. These include, amongst others, the following:[52]

i. Transaction capacity and scalability issues relative to conventional banking payments system.

ii. Rising concerns over privacy and security matters. In particular, blockchain-design choices frequently lead to inevitable trade-offs needed between performance, privacy and the degree of decentralisation. Future technical progress may potentially resolve these concerns.

iii. Interoperability challenges between different blockchains, between applications built on the same blockchain, and between blockchain and legacy systems.

iv. Rising fears over the theft or loss of private keys. This is best exemplified by the bitcoin theft of almost US$500 million from Mt. Gox in 2014.[53]

v. Trade-offs in relation to the governance of blockchains.

49 Finck (n 4) 31.

50 Borg & Schembri (n 48) passim.

51 Rodrigues "Law and the blockchain" 2019 (104(2)) *Iowa Law Review* 679–730.

52 Madir "Introduction: What is FinTech" in Madir (ed) *Fintech Law and Regulation* (2019) 1.

53 Editor's footnote: See in this regard Takahashi "Cryptocurrencies entrusted to an exchange provider: Shielded from the provider's bankruptcy?" in Hugo (ed) *Annual Banking Law Update* (2018) 1 et seq.

vi. To achieve wider deployment, the technology needs to be fully accommodated within public policy and legal frameworks, and this suggests the need for clear rules.

vii. Competition issues may need attention. This is because as permissioned blockchain networks advance to become essential infrastructure, say in clearing and settlement, competition issues may surface around access.

Although these are still early days, France has installed rules allowing the holding and transfer of non-listed securities via blockchain (already in 2016) and Japan has enacted rules requiring the registration of virtual currency exchange business operators. In 2018 the 27 member states in the EU signed a declaration to create the European Blockchain Partnership, and co-operated in the setting up of a European Blockchain Services Infrastructure to support the delivery of cross-border digital public services marked by the highest standards of security and privacy.[54]

The advent of blockchain is viewed by some as a revolutionary event moving through the five stages of denial, anger, negotiation, depression, and eventually acceptance.[55] At its commencement, bitcoin was largely ignored as an internet-based money without mainstream interest or a future. Then concerns arose as a result of it being used for criminal purposes by money launderers, terrorists and drug dealers. However, the range and use of blockchain-based products has become increasingly apparent and the extent of the usage of such arrangements has grown rapidly. Along with other exponential technologies[56] such as the Internet of Things (IoT), 3D, edge computing, robotics and artificial intelligence (AI) it has become one of the symbols of the Fourth Industrial Revolution,[57] as business and public processes may prove to be many times faster, better, and cheaper.

[54] Digibyte "European countries join blockchain partnership" (10 April 2018) https://ec.europa.eu/digital-single-market/en/news/european-countries-join-blockchain-partnership.

[55] Mignon "Blockchain: Perspectives and challenges" in Kraus, Obrist & Hari (eds) *Blockchains, Smart Contracts, Decentralized Autonomous Organizations and the Law* (2019).

[56] Ismail, Malone, & Van Geest *Exponential Organizations* (2019) passim.

[57] World Economic Forum (WEF) "Globalization 4.0: Shaping a global architecture in the Age of the Fourth Industrial Revolution" WEF Annual Meeting 22–25 January 2019 Overview, http://www3.weforum.org/docs/WEF_AM19_Meeting_Overview.pdf.

To CBDC or not to CBDC? Exploring central bank digital currency

MONICA LAURA VESSIO*

Abstract

This contribution deals with the technological potential of a central bank digital currency (CBDC). This is a form of digital money that could potentially be issued by the South African Reserve Bank. The SARB announced in 2019 that it was considering the possible introduction of a native cryptocurrency. The contribution examines what CBDCs are or have the potential to be and does so by examining what the functions of money are and how a CBDC fits within the types of money in circulation today, and differentiates between retail and wholesale CBDCs. The potential risks and benefits of having a sovereign digital rand are examined. Finally, the issues surrounding the regulatory remit of having a CBDC in circulation are identified. A CBDC payment system would require rules and guidelines on broader themes of interoperability, resilience, security, identity (including privacy and anonymity), fraud, failed transactions and cyber-risks, including on the countering of money laundering and the financing of terrorism. Innovation with caution must lie ahead, to fashion this development.

* * * * *

1 Introduction

Generally, the objectives of central banks across the world are to maintain monetary and financial stability.[1] To support these objectives, central banks try to provide the safest possible form of money to households, businesses and the financial system. Methods of payment are changing, however, with the use of banknotes and coins declining and the use of privately issued money and alternative payment methods

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[1] This function becomes especially prevalent in times of economic crisis. Most recently all central banks have had to weather the Covid-19 storm and the different authorities have had different key economic responses to limit the economic impacts. These ranged from suspending administrative penalties, deferment of loan instalments without penalties, the lowering of repo rates to adoption of quantitative easing measures. The South African Reserve Bank (SARB), in particular, reduced the policy rate by 200 bps and took measures to ease liquidity conditions: it issued guidelines on modalities to provide debt relief to bank customers; provided temporary relief on bank capital requirements and reduced the liquidity coverage ratio from 100 to 80 percent to provide additional liquidity and counter financial-system risks; it issued guidance on the distribution of dividend and cash-bonuses to ensure bank capital preservation; it returned the incidence of repo auctions to once a day and announced a series of prudential priority measures for co-operative financial institutions on prudential matters, supervisory activities, as well as governance and operational issues (IMF "Policy Tracker" https://www.imf.org/en/Topics/imf-and-covid19/Policy-Responses-to-COVID-19#S (16-5-2020)).

rising. In this context, central banks the world over are exploring the concept of central bank issued digital money, now commonly referred to as central bank digital currency or "CBDC". The Bank of Canada, the Bank of England, the Bank of Japan, the European Central Bank, the Sveriges Riksbank (Sweden's central bank) and the Swiss National Bank, together with the Bank of International Settlements (BIS), have created a discussion group to share experiences as they assess the potential cases for CBDCs in their domestic jurisdictions. The discussion group intends to assess CBDC use cases as well as economic, functional and technical design choices, including cross-border interoperability and the sharing of knowledge on emerging technologies.[2]

According to a 2019 survey by the BIS, at least 40 central banks worldwide were (or would soon be) researching and experimenting with CBDCs.[3]

South Africa is considered to be "crypto-friendly", with the Global Digital Report 2019 having ranked it as the top country for ownership of cryptocurrency. The survey found that 10.7 percent of internet users in the country own cryptocurrency.[4] South Africa has recently[5] issued recommendations for regulating virtual currencies, or as referred to by the Crypto Asset Regulation Working Group (CARWG) – "crypto assets",[6] and the South Africa Reserve Bank (SARB) commissioned a project on the viabilities of the underlying digital ledger technologies relative to interbank payments settlement.[7] These steps were indicators of South Africa's pursuit of globally moving trends,[8] and in 2019 South Africa joined the list of countries looking to create a government-backed digital currency, after it was announced that the SARB had been discussing the possible introduction of

[2] It will co-ordinate with the relevant institutions and forums – in particular, the Financial Stability Board and the Committee on Payments and Market Infrastructures (CPMI). The group will be co-chaired by Benoît Coeuré, Head of the BIS Innovation Hub, and Jon Cunliffe, Deputy Governor of the Bank of England and Chair of the CPMI. It will include senior representatives of the participating institutions (Bank of England Press Office News Release *Central Bank Group to Assess Potential Cases for Central Bank Digital Currencies*, https://www.bis.org/press/p200121.htm (21-1-2020)).

[3] Barontini and Holden "Proceeding with caution – a survey on central bank digital currency" *BIS [Bank for International Settlements] Papers* No 101 Monetary and Economic Department (January 2019) 7.

[4] The Global Treasurer "South Africa Reserve Bank wants to test CBDC based on native currency" https://www.theglobaltreasurer.com/SARB-wants-to-test-CBDC-based-on-native-currency (21-5-2020).

[5] April 2020.

[6] CARWG was formed in 2018 under the auspices of the Intergovernmental Fintech Working Group, which in turn was formed in 2016. CARWG's function was to review the position on virtual currencies and its objective to formulate a coherent and comprehensive policy stance on virtual currencies. For a discussion on these recommendations see Vessio in Moorcroft *Banking Law and Practice* (2019 et seq) ch 40.4.

[7] The South African Reserve Bank (SARB) "Exploring the use of digital ledger technologies for interbank payments settlement in South Africa" *Project Khokha* (2018), https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/8491/SARB_ProjectKhokha%2020180605.pdf.

[8] Europe and America are not necessarily in the lead; in 2015 Tunisia became the first country in the world to issue a blockchain-based national currency, the eDinar. Senegal followed suit when it issued its blockchain-based eCFA in 2016 (Coin Telegraph "State-issued digital currencies: the countries which adopted, rejected or researched the concept" https://cointelegraph.com/news/state-issued-digital-currencies-the-countries-which-adopted-rejected-or-researched-the-concept (21-5-2020)).

a native cryptocurrency. The SARB invited bids to develop the infrastructure necessary for a CBDC.[9]

This contribution looks at what CBDCs are or – perhaps more accurately – would possibly be, and critically examines their potential risks and benefits, with peripheral comments on regulatory aspects. Worldwide the concept of sovereign digitised money is sprouting and experimental. The discussion presented here therefore does not claim to be exhaustive to the topic – not only because governments are rapidly investigating the plausibility of such studies but also because the technical architecture behind such "money" has myriad potentiality.

2 What is a central bank digital currency?

A central bank digital currency can take several forms, depending on the coding architecture. The BIS stated that the concept is so obscure that presently it is probably easier to define what a CBDC is not.[10] It goes on to state:[11]

> "CBDC is not a well-defined term. It is used to refer to a number of concepts. However, it is envisioned by most to be a new form of central bank money. That is, a central bank liability, denominated in an existing unit of account, which serves both as a medium of exchange and a store of value. This would be an innovation for general purpose users but not for wholesale entities. Central banks already provide digital money in the form of reserves or settlement account balances held by commercial banks and certain other financial institutions at the central bank. This mix of new and already existing forms of central bank money makes it challenging to precisely define what a CBDC is."

Writers on CBDCs have attempted to provide definitions and understandings of what CBDCs are. Each of these jurists or economists has approached the definition from different definitional angles. In 2017 the BIS, in an attempt to answer this "deceptively simple question", started by looking at the taxonomy of money based on four key properties: issuer (central bank or other); form (electronic or physical); accessibility (universal or limited); and transfer mechanism (centralised or decentralised).[12] From there, it developed the definition of CBDCs: "an electronic form of central bank money that can be exchanged in a decentralised manner known as *peer-to-peer*, meaning that transactions occur directly between the payer and the payee without the need for a central intermediary".[13] This definitional concept is derived

[9] A tender notice was published by the SARB in April 2019 requesting expressions of interest from solution providers to investigate practically the feasibility, desirability and appropriateness of SARB-issued digital currency to be used as electronic legal tender, complementary to cash.

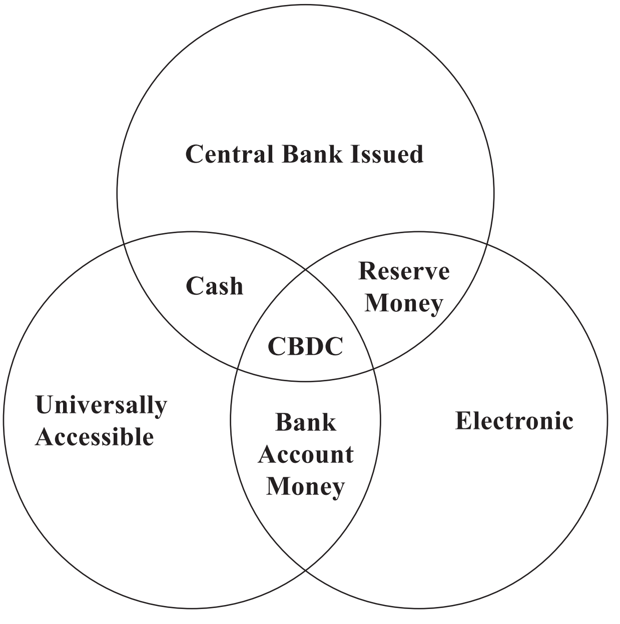
[10] One of the main issues is in fact a generally accepted terminology or taxonomy of digital currencies. As aptly observed by Didenko & Buckley "[a]bsence of agreed terminology … inhibits in-depth dialogue and analysis" ("The evolution of currency: Cash to cryptos to sovereign digital currencies" 2019 *Fordham International Law Journal* 2019 1041 1045).

[11] Bank for International Settlements "Central Bank Digital Currencies" Joint Report by the Committee on Payments and Market Infrastructure and Markets Committee (March 2018) 3, https://www.bis.org/cpmi/publ/d174.pdf.

[12] Bech & Garratt "Central bank cryptocurrencies" Bank for International Settlements *Quarterly Review* (September 2017) 55.

[13] A cash transaction is the traditional form of a peer-to-peer exchange; whereas, on a computer network, the peer-to-peer concept means that transactions can be processed without the need for a central server (Bech & Garratt (n 12) 56).

from the acceptance of the concept that there are three types of money in existence today: central bank issued reserves, bank account money (bank deposits) and cash. Each of these forms lacks one characteristic held by the other two. Bank account money is universally accessible and electronic, but not issued by the central bank. Cash is issued by the central bank and universally accessible, but it is not electronic, and central bank money is not universally accessible, but electronic and obviously central bank issued. We can see how a CBDC would have all the three qualities described. The following Venn diagram, incorporating CBDC, probably provides the clearest (visual) understanding of where a CBDC falls in relation to other types of money:[14]



The World Economic Forum has described CBDCs as a potential application of blockchain and distributed ledger technology (DLT)[15] where the central bank issues new money equivalent to – and redeemable for – its domestic currency.[16] It can

14 From Bjerg "Designing new money – the policy trilemma of central bank digital currency" CBS Working paper 1 June 2017 16, https://core.ac.uk/download/pdf/83593087.pdf.

15 For a discussion on blockchain and DLT see Vessio (n 6) ch 40.2.2. The trade-off for security provided by blockchain technology is the proof-of-work consensus mechanism which limits the velocity at which transactions can be processed, as well as implications for energy usage. However, in so-called permissioned or private blockchain environments, the implicit trust that the members of the network have in each other means that simpler consensus mechanisms can be used and this is where distributed ledgers become relevant – the DLT forms the basis of the systems that financial institutions globally are experimenting with (SARB (n 7) 12).

16 World Economic Forum "Central banks and distributed ledger technology: how are central banks exploring blockchain today?" White Paper March 2019 8 (hereinafter "WEF White Paper 2019"), http://www3.weforum.org/docs/WEF_Central_Bank_Activity_in_Blockchain_DLT.pdf

also, alternatively, operate on traditional centralised technologies,[17] and, ideally, simultaneously remove the equivalent amount of currency from the money supply.[18]

The CBDC may be issued for general use ("retail" CBDC) for peer-to-peer payments and payments from consumers to merchants. The CBDC may also be used by commercial banks and clearing houses ("wholesale" CBDC), for interbank payments that occur outside traditional correspondent banking and other payment systems.[19]

2.1 *Retail CBDC*

A retail CBDC[20] is one that would be issued for the general public; that is, a widely available, consumer-facing payment instrument targeted at retail transactions.[21] A retail CBDC based on DLT would have the features of anonymity, traceability, 24-hour as well as year-round accessibility and the potentiality of an interest rate application. In other words, this would be a central-bank-issued digital currency that is operated and settled in a peer-to-peer and decentralised manner (no intermediary), widely available for consumer use. It would serve as a complement or substitute for physical cash and an alternative to traditional bank deposits.[22]

2.2 *Wholesale CBDC*

A wholesale CBDC would be a central-bank-issued digital currency that would be operated and settled in a peer-to-peer and decentralised manner (no intermediary), available only for commercial banks and clearing houses for use in the wholesale interbank market.[23] A potential use could be to improve payments and securities settlement efficiency, as well as to reduce counterparty credit and liquidity risks.[24] In this form, a CBDC would be fundamentally different from the current system in which the central bank debits and credits accounts without transferring values.

The rationale for creating retail and wholesale CBDCs as two different types of instrument is unclear to the writer – or at least has not been sufficiently explained. Once the wholesale CBDC has been created, it would seem, at least prima facie, that it would not need to be based on a different technology than retail CBDC. Practical differences would be the technological design, functionality and store of value. If the intention is to differentiate the value between retail and wholesale CBDCs, then this appears to be a needless complication of the monetary and payments system. Again, because the concept is still in its infancy, the plausibility of a two-tiered system may later become patent.

17 ibid.
18 ibid.
19 ibid.
20 Retail in a payment context refers to payments that involve households and/or small to medium-sized business (Bech & Garratt (n 12) 56).
21 WEF White Paper 2019 (n 16) 8.
22 WEF White Paper 2019 (n 16) 7.
23 ibid.
24 De Meijer "Central bank digital currencies: towards a global approach" https://www.finextra.com/blogposting/18450/central-bank-digital-currencies-towards-a-global-approach (30-6-2020).

3 Benefits and risks

If governments did not see benefits in the issuance of CBDCs, they would not fund the studies and testing. It is the potential for positive implications such as contribution to financial inclusion, economic growth, technological innovation and increased transaction efficiencies that motivate. However, the technology is new,[25] and, accordingly, the effects on the financial environment as well as monetary policy need to be considered carefully so as to avoid a sovereign digital coin causing any macroeconomic imbalances. Prior to examining the pros and cons, however, and because of the yet unestablished coding architecture and functionality of a future CBDC, there are certain parameters that need to be identified within which a constructive discussion can ensue. The parameters that have been treated in the following discussion may be related to a CBDC with the following characteristics: it is currency that will be in electronic form and will feature peer-to-peer exchange. Additionally, it will be denominated in fiat currency and, like cash and central bank deposits, will be a liability on the balance sheet of the central bank.[26] Furthermore, there are some parameters that must be assumed to be variable.[27] Where this is so, these are mentioned within this discussion. The reason is that, were other features to be designed into a CBDC, they would have diverse effects on each advantage or disadvantage discussed.

3.1 *Benefits*

Part of any central bank's (and SARB's) responsibilities is to issue banknotes and coins to its citizens as well as international visitors.[28] There are some basic parameters for circulating notes: the currency has to be distinctive and with visual themes that are clear, accessible, able to withstand regular handling, resistant to being counterfeited and with a professional design that reflects its purpose as legal tender and which will likely appeal to a wide range of the public.[29] Banknotes and coins must then be securely distributed around the country and inspected for quality when they recirculate back to the Reserve Bank.[30] These processes incur various costs. Whether the SARB develops its own infrastructure or outsources it, further study would be required to understand whether the costs of developing and maintaining a secure digital currency network (including its integration with the existing electronic point of sale technologies) would be lower than the costs

[25] In fact, a South African CBDC is not yet in existence; however, it is likely that governments will adopt one of the systems already used for virtual currencies with bespoke country-specific features.

[26] These characteristics have been elected as they correspond to the scope in the request for expression of interest for the issuance of sovereign digital currency by the SARB.

[27] The reason is that we are not dealing with set parameters as the digital-currency design has not yet been established.

[28] Wadsworth "The pros and cons of issuing a central bank digital currency" 2018 (81 No 7) *Reserve Bank of New Zealand Bulletin* 5.

[29] Wight "The imagery and themes of the Series 7 'Brighter Money' banknotes" 2016 (79 No 15) *Reserve Bank of New Zealand Bulletin* 3.

[30] Wadsworth (n 28) 5.

of distribution of cash.[31] In any event, it can be assumed that digital currency is easier to distribute than cash, which has to be physically transported to and from the Reserve Bank.[32]

In terms of physical safety, a CBDC would provide a safer form of distribution compared to cash.[33] When cash is distributed from merchants to bank branches and the SARB, the personnel of cash-in-transit-vehicles face the risk of armed robbery. A CBDC would lower concerns for personal safety, but would not be completely immune to theft or fraud. The design architecture of the CBDC would play a role in terms of vulnerability to cybercrime. A CBDC based on a centralised system could be prone to having a potential single point of failure,[34] whereas the nodes on a decentralised system would act as multiple (infinite) backup sites.[35]

A potential benefit of a CBDC would be an improvement in the efficiency of payment systems.[36] On the retail side, a CBDC could improve the efficiency of making payments, for example at the point of sale, online or peer-to-peer.[37] On the wholesale side a CBDC may be used to facilitate faster settlement and extended settlement hours for wholesale and interbank payments.[38]

CBDCs may have the potential to improve credit risk for cross-border interbank payments and settlements.[39] The current cross-border payment system relies on central banks operating the real-time gross settlement infrastructure which has various time limitations. These limitations include, for example, time-lags in cross-jurisdictional payments during which time parties are exposed to credit and settlement risk.[40]

There are potential advantages the introduction of a CBDC could have on monetary policy. Again, these impacts would be dependent upon the coding design features of the CBDC. For example, a CBDC based on DLT could unlock a central bank's ability to capture real-time economic surveillance, which would greatly inform monetary policy formulation.[41] If the CBDC were to be designed to function

31 ibid.
32 ibid.
33 Wadsworth (n 28) 6.
34 ibid.
35 The use of tamperproof safeguards in the blockchain technology, such as the various cryptographic methods of encryption, provide further security mechanisms. Similar reasoning was indicated by Project Khokha, where it was found that a DLT system brings a higher degree of resilience, in that the reliance on a single point of failure is removed and each node additionally acts as a backup of the ledger. The effects of the redistribution of some of the costs among the participants could remove the costs to the SARB of running a backup system for SAMOS (SARB (n 7) 56).
36 Ward & Rochemont "Understanding central bank digital currencies (CBDC)" addendum to Institute and Faculty of Actuaries *A Cashless Society – Benefits, Risks and Issues (Interim Paper)* (2019) 9, https://www.actuaries.org.uk/system/files/field/document/Understanding%20CBDCs%20Final%20-%20disc.pdf.
37 ibid.
38 ibid. Project Khokha concluded that a DLT system can sustain process speeds that enable it to cope with the current daily volumes of SAMOS within a two-hour period (SARB (n 7) 56).
39 Ward & Rochemont (n 36) 10.
40 ibid.
41 Ahmat & Sabrina "Central bank digital currency: a monetary policy perspective" in Bank Negara Malaysia 2017 (11) *Staff Insights* 4, https://www.bnm.gov.my/index.php?ch=en_publication&pg=en_staffinsight&ac=45&bb=file.

like physical cash and receive no interest payments, it is likely that in normal times people would prefer to keep their money in bank deposits as opposed to a CBDC, in that bank deposits accrue interest. During times of economic instability or a system-wide run on the banks, however, a CBDC would provide an alternative option to cash, as it would be fully guaranteed by the central bank, with no risk of losing its face value, and easily stored in large amounts.[42] If CBDCs were to be designed to receive interest payments for the purpose of transmitting monetary policy action directly to citizens, this would have the effect of increasing the efficiency of monetary policy. A CBDC issued with no interest would drop the lower bound to zero percent limiting the effectiveness of monetary policy. The reason is that, in such a scenario, depositors would have no tolerance for negative interest rates as there would be no cost of converting their deposits into the zero interest CBDC.[43]

Due to the fact that deposits in commercial banks may be at risk because they are not fully backed by reserves and because commercial banks take on greater risk through their lending and market operations (risk of commercial bank insolvency would result in loss of deposits), a CBDC would present a lower risk, providing a safer currency for transactions and deposits.[44]

A CBDC would make it more viable for a central bank to keep track of the exact location of every unit of the currency (again if the design assumes a centralised, database form). Being able to track currency in this manner could provide some advantages in terms of tax collection as it would make it almost impossible to use methods such as off-shore banking and unreported employment to hide financial activity from the government. It would facilitate the combating of cybercrime by making it easier to identify criminal activity and money laundering.

The issuance of a government-backed public digital currency would avoid a reduction of seigniorage income for governments, in the event of a disappearance of physical cash. The concern over significant seigniorage decline would be that a

42 On the other hand, a facile switch to a CBDC could trigger a run on banks, with the consequent impairment to financial intermediation, which would directly weaken the efficacy of monetary policy.

43 Wadsworth (n 28) 13. A secure CBDC would also alleviate the need for guarantee deposit schemes (argument adapted from Mayer "A digital euro to save EMU", https://voxeu.org/article/digital-euro-save-emu (29-6-2020)). A further advantage of a CBDC would be the ease with which in times of crisis the Reserve Bank could make use of "helicopter money". This is a monetary policy tactic that is slowly gaining support. Briefly, helicopter money is where a central bank creates new money and distributes an equal amount, as a non-repayable grant, to every citizen, in order to increase their ability to spend (or repay debt). Helicopter money is seen to have advantages over quantitative easing and the policy of relying on more bank lending to stimulate the economy because it gets money to members of the public, increasing their ability to spend without simultaneously increasing their debt. To implement helicopter money, central banks need a distribution channel that could guarantee that new money would find its way into the accounts of the intended recipients. A digital cash system linking the central bank's mechanisms for creating money with the digital cash accounts of citizens would provide this distribution channel (Dyson & Hodgson "Digital cash: why central banks should start issuing electronic money" 2016 *Positive Money* 8, https://positivemoney.org/wp-content/uploads/2016/01/Digital_Cash_WebPrintReady_20160113.pdf).

44 Wadsworth (n 28) 15. This, however, would have knock-on effects to the efficacy of the stability of the current financial system. See risks for the counter argument below.

central bank might need to rely on government funding, and this could ultimately undermine its autonomy.[45] The "digital manufacturing" costs of a CBDC would have to be calculated in a transparent yet different manner from the conventional costs found in minting.

3.2 *Risks*

CBDCs are not risk-free and some of the more obvious risks could present serious barriers to entry or at least exclusivity. A potential negative aspect of a CBDC is that it is vulnerable to outages in electricity and internet connections and could not be relied upon in a state of emergency – especially as the issuance of a CBDC has the potential to reduce the demand and supply of cash, which is an important back-up payment method when there are electricity or internet outages. A shortage of cash could worsen the impacts of emergencies and natural disasters. Therefore, if the SARB were to issue a CBDC, it might need to mitigate this risk by requiring formal management plans for back-up cash. These formalised back-up arrangements would ensure that cash is available for emergencies regardless of the demand and supply of cash in normal periods.[46]

Issuance of a CBDC would require additional monitoring and compliance under Anti-Money Laundering and Countering Financing of Terrorism (AML/CFT) laws.[47] The Reserve Bank may be required to monitor the users of its digital currency to comply with AML/CFT legislation. The SARB would also have to monitor payments with its CBDC to prevent issues such as fraud.[48] Again, these risks or additional costs would have to be analysed against the design and implementation features of the CBDC. For example, it would be theoretically easier to monitor a CBDC from an AML/CFT perspective if one adopted a centralised design, while a CBDC with high levels of anonymity and decentralisation embedded in the distributed ledger would complicate matters.[49] It has been suggested that one way to alleviate central banks from the administrative burden of issuing money to the public would be for private banks to administer a CBDC via designated bank accounts, with the funds in these accounts being held by the central bank.[50]

There is also the possibility of the effects of a CBDC being eclipsed by already existing virtual currencies such as Bitcoin and Ethereum, or even by privately owned e-money. The commercial motives of privately owned e-money or even the fluctuations of virtual currencies may not align with fiat currency. Thus, in situations where e-money or virtual currencies were dwarfing fiat currency,

[45] Engert & Fung "Central bank digital currency: motivations and implications" (2017–16) *Bank of Canada Staff Discussion Paper*, https://www.bankofcanada.ca/wp-content/uploads/2017/11/sdp2017-16.pdf.

[46] An example is the 2011 earthquake in Canterbury, where emergency ATM machines were set up in temporary containers powered by generators to provide access to cash (Wadsworth (n 28) 6).

[47] Wadsworth (n 28) 8.

[48] ibid.

[49] ibid.

[50] ibid.

those receiving welfare benefits via a fiat currency backed CBDC would be at a disadvantage relative to the wider public.[51]

There are, of course, implications arising from the introduction of a CBDC, in terms of financial stability. The first would be increased reliance on wholesale funding markets, because the core business of commercial banks is to receive financial deposits, facilitate payments and provide lending – and a sovereign digital currency would compete with transaction accounts, especially if the CBDC were to be interest-bearing.[52] Some households and businesses may elect to deposit money into the central bank, having a negative impact on commercial banks, which might find that they lose deposits as households put money into the central bank digital currency.[53] This would possibly cause instability in balance sheets of the commercial banks, with the potential consequence of a reduction in lending activity.[54] However, it has been suggested that risks of disintermediation can be addressed through decisions on the implementation of interest payments on the CBDC and account and transaction size limits.[55] There is also concern that a CBDC would have the potential to reduce the resilience of commercial banks to economic downturns due to increased competition and lower profitability.[56] If large sums of deposits were to move from commercial bank accounts to the CBDC, the commercial banks would have to compete for deposits by offering higher interest rates.[57] Furthermore, commercial banks earn significant revenues generated by their fees for effecting payments, which could be diminished if a CBDC offers cheaper domestic and cross-border transaction fees.[58] Wadsworth contends that while competition with banking activities resulting in a reduction in bank profitability might result in bank activities being conducted more efficiently, nevertheless there may be adverse consequences for financial stability because less profitable banks may become less resilient to shocks, or if they attempted to replace lost profitability by searching for higher yielding and, therefore, probably riskier, assets.[59]

51 Ideas taken from Ward & Rochemont (n 36) 10.

52 Wadsworth (n 28) 15.

53 ibid. In a study of the macroeconomic consequences, Barrdear & Kumhoff argue that CBDC issuance of 30% of GDP against government bonds could permanently raise GDP by as much as 3%, due to reductions in real interest rates, distortionary taxes and monetary transaction costs. They base these assumptions on mathematical models and on the basis that the CBDC would be universally accessible and interest-bearing, implemented via distributed ledgers and one that would compete with bank deposits as medium of exchange ("The macroeconomics of central bank issued digital currencies" *Bank of England Staff Working Paper No 605* (July 2016), https://www.bankofengland.co.uk/-/media/boe/files/working-paper/2016/the-macroeconomics-of-central-bank-issued-digital-currencies.pdf). I have grossly simplified their assumptions.

54 WEF White Paper 2019 (n 16) 9.

55 ibid.

56 Wadsworth (n 28) 15.

57 The net effect of this would need to be carefully analysed. A higher interest rate could benefit profitability and boost investment.

58 Wadsworth (n 28) 15. Once again this may not necessarily be a con; rather increased competition could be viewed as beneficial to the consumer as well as providing a further form of market control to the central bank through manipulation of its own fees in such instances.

59 Wadsworth (n 28) 15.

While financial inclusion is listed as a potential benefit of the introduction of a CBDC, South Africa must consider all the risks and downsides to implementation within its own specific domestic context. For instance, the introduction of centrally backed digital money has the potential to create financial exclusion rather than inclusion.[60] This would have the consequence that policymakers would have the task of encouraging the unbanked to participate in a new digital currency regime.[61] Hurdles to the adoption of a CBDC, such as usability challenges, access or insufficient government identity documentation, would need to be considered.[62]

4 Regulatory considerations

Discussing CBDCs from a regulatory perspective is by no means an easy task, especially at this nascent stage. Some of the broader principles have been contemplated here.[63] Financial stability is more likely to be prioritised over any kind of legal formalities, at least initially. If the CBDC design is not centralised and there are payment intermediaries involved, these will have to meet criteria that will have to be prescribed in legislation. The intermediaries would have to have relevant authorisations or licences and would need to be monitored, perhaps by relevant regulators. An understanding on how CBDC-related regulation will fit within the existing systems of regulation and mechanisms of oversight – or, alternatively, alongside such a regulatory framework – must be reached. The CBDC ecosystem would have to be risk assessed and stakeholder activities would have to be regulated accordingly. At the same time measures would have to be adopted that would ensure the maintenance of relevant standards of operational and financial resilience so that the risks which their operational or financial failure could pose to the chain of payments, especially with systemically important institutions, would be mitigated. Role players involved in the provision of the CBDC would also need to comply with the standards of conduct and other aspects determined by the Financial Sector Conduct Authority – and any other relevant regulators.

Fluidity in the payment ecosystem in which the CBDC would operate will have to be worked out and standards will have to be considered such as interoperability, resilience, security and identity. These, in turn, would ensure appropriate consumer protection. Rules and guidelines regarding issues of risk will have to be developed – especially concerning issues of fraud, failed transactions, cyber-risks and privacy.

A CBDC payment system would need to be compliant with AML and CFT regulations. Accordingly, the identity of CBDC users would need to be known to a responsible institution who could then validate the transaction. This would be self-fulfilling if a Bitcoin-type blockchain DLT platform were used, but there may

60 WEF White Paper 2019 (n 16) 9.

61 ibid.

62 ibid.

63 Ideas for the regulatory discussion have been drawn from a discussion paper issued by the Bank of England ("Central bank digital currency: opportunities, challenges and design" March 2020, https://www.bankofengland.co.uk/paper/2020/central-bank-digital-currency-opportunities-challenges-and-design-discussion-paper).

be dangers of central bank marginalisation in adopting a too-independent model. Accountable institutions would be responsible for applying AML checks to users, and for reporting suspicious transactions to the authorities.

How privacy will be respected, and data protected, will be essential considerations for the legislature in a CBDC era. If CBDC were to eclipse the banknote, then issues of legitimate anonymity, for example to avoid profiling, would have to be considered and respected. At a wholesale level, exploratory work has already been carried out by the SARB. It has investigated whether confidentiality could be achieved, when scale is increased, and whether multiple node types, each configured by a participating bank, could be accommodated.[64]

Many of these legislation-related requirements can only be implemented or begin to be implemented once the social and political discussions have been surmounted.

5 Concluding remarks

It is evident that a world where virtual impulses will override the era of notes and coins is on the horizon. The introduction of CBDCs will, however, be accompanied by myriad fiscal, regulatory, and practical implications in an already complex financial system. Each of these permeations will need to be considered profoundly. The introduction of a CBDC will impact on the role of the Reserve Bank. It will also have knock-on effects on financial intermediation. Furthermore, the choices in the design of the CBDC will greatly impact upon a variety of issues, ranging from anonymity to repercussions relating to the bearing (or non-bearing) of interest. These developments will create major new opportunities but simultaneously present risks and introduce new and discerning questions. There is still much pioneering work to be done, with no historical experience to draw from. Forging the way forward will have to be carried on with great, but innovative, caution. Above all, at the forefront of deliberation on the matter will be the fact that a CBDC would have an impact on almost every aspect of banking activity.

64 SARB (n 7) 6.

The legal significance of the Euro crisis for the Southern African Monetary Union

DUNIA ZONGWE*

Abstract

This contribution explores the significance and implications of the Euro crisis for the monetary union in the Common Monetary Area (CMA) in Southern Africa and the laws regulating it. The CMA formally pegs the national currencies of Namibia, Lesotho, and Swaziland (eSwatini) to the South African Rand on a one-to-one basis, thereby linking the monetary policies of those countries to those set by the South African Reserve Bank (SARB). However, the crisis in the European Monetary Union (EMU) raises the weighty question as to its relevance for Africa or Southern Africa in particular. This question arises because, just like the EMU, arrangements at the level of the African continent and almost all the region's economic communities envisage an economic and monetary union, but most of the policies and philosophies that informed Africa's legal instruments have not yet taken stock of the developments in the Eurozone. This contribution starts by presenting monetary unions and the crises that emerge within these legal and economic arrangements. It then explains the Euro crisis before pointing out what this crisis implies for monetary unions in Africa, especially Southern Africa. The CMA is a large body that experts regard as an unusually longstanding and successful monetary co-ordination project. Nonetheless, ignoring the lessons of the Eurozone crisis may spell doom for the CMA as some members might exit it should a similar crisis strike. Very few studies have dealt with the CMA. In fact, hardly any study has examined the CMA after the 2007–2008 global economic recession. Until very recently, legal scholars have shown an even greater lack of interest in monetary unions, finding it sufficient simply to describe the rules on monetary unions, considering them extremely technical (and political) issues. They confine themselves to reading the norms rather than writing them. While issues of monetary unions dramatically impact the welfare of CMA residents, so far, they have been left to experts and technocrats to decide. Ordinary people have not meaningfully participated in these issues despite their impact. Legal scholars must engage these issues to stimulate discussion within a wider educated audience.

* * * * *

1 Introduction

This chapter considers the significance of the Euro crisis of 2010 for the monetary union in Southern Africa and the laws regulating that monetary union. The monetary union in Southern Africa, known as the Common Monetary Area (CMA), pegs the national currencies of Namibia, Lesotho, and Swaziland (eSwatini) to the South African Rand. The peg is on a one-to-one basis, such that in practice

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this monetary arrangement actually constitutes a currency union, not unlike the European Monetary Union (EMU).

However, following the global financial crisis in 2007–2008, the EMU held problems for some economies in the Eurozone, such as Greece and Italy. The consequences include rises in unemployment and income inequality. In his book *The Euro,* Stiglitz discusses most of the major economic consequences of the EMU and its regional currency, the Euro.[1]

The negative consequences of the Euro crisis for certain EMU member states may tempt banking experts to ask: what about the monetary unions in Africa or in Southern Africa in particular? This question arises because, just like the EMU, arrangements at the level of the African continent envisage an economic and monetary union. The African Union (AU) provides for a continent-wide monetary union. The African Economic Community (AEC) Treaty, also known as the Abuja Treaty, tasks the AU with establishing an African Central Bank and a single African currency by 2028 after creating the AEC.[2] Indeed, virtually all regional economic communities on the continent dream of forming a monetary union.[3] However, most of the policies and philosophies that informed Africa's legal instruments have not yet taken stock of the developments in the Eurozone.

Thus, this contribution explores the importance and implications of the Euro crisis for the CMA. It begins by presenting monetary unions and the crises that emerge within those legal and economic arrangements. It then explains the Euro crisis before pointing out what that crisis implies for monetary unions and their laws in Africa, especially Southern Africa.

The CMA is a large regional body. Experts regard the CMA as an "unusually longstanding and successful monetary coordination project".[4] In 2018, with a gross domestic product (GDP) of 389 billion US dollars, the CMA economy represented about one-fourth of the Sub-Saharan economy.[5] However, ignoring the lessons of the Eurozone crisis may undermine the very existence of the CMA as some members might exit it if a similar crisis were to occur. This holds true because, unlike monetary unions, the CMA does not oblige its members to keep a given parity if their exchange-rate peg comes under pressure.[6]

1 Stiglitz *The Euro: How a Common Currency Threatens the Future of Europe* (2016).

2 Treaty Establishing the African Economic Community of 1991, art 6(2)(f)(iii) – hereinafter referred to as the "Abuja Treaty".

3 Patroba & Nene "Is SACU ready for a monetary union?" South African Institute of International Affairs (SAIIA) Occasional Paper No 143 (2013) 5.

4 Metzger "The Common Monetary Area in Southern Africa: a typical South-South coordination project?" in Fritz & Metzger (eds) *New Issues in Regional Monetary Coordination – Understanding North-South and South-South Arrangements* (2006) 147.

5 World Bank, data available at https://data.worldbank.org/indicator/NY.GDP.MKTP.CD?locations=NA-ZA-LS-SZ-ZG (24-07-2019).

6 Wang "The Common Monetary Area in Southern Africa: shocks, adjustment, and policy challenges" IMF Working Paper WP/07/158 (2007) 12, https://www.imf.org/external/pubs/ft/wp/2007/wp07158.pdf.

Very few studies have dealt with the CMA as a whole. Wang counts among the very few experts who researched the CMA as a group,[7] but even Wang could not ponder what the Euro crisis of 2010 means for the CMA (as he published his study before 2010). In fact, hardly any study has examined the CMA after the 2007–2008 global economic recession.

Until very recently, legal scholars have shown an even greater lack of interest in monetary unions. In an effort to explain this, Munari contends that, perhaps, lawyers see their job as describing or, better still, narrating rules on monetary unions, since these rules aim at regulating predominantly economic processes and, more precisely, macroeconomic processes.[8] Lawyers seem to view rules on monetary unions as connected to "extremely technical (and political) issues".[9] As a result, they confine themselves to reading the norms rather than writing them.[10]

Lawyers must thoroughly understand how monetary unions, including the CMA, work and affect society and the economy if they do not simply want to read monetary-union norms without knowing how to (re)write them. Furthermore, lawyers cannot read properly written norms if they do not fully understand the field regulated by the written text they read. While issues of monetary unions dramatically impact the welfare of CMA residents, these issues have, so far, been left to experts and technocrats to decide. Ordinary people have not meaningfully participated in these issues despite their impact on them. Legal scholars should engage in these issues in a sufficiently clear manner so that a wider educated audience may join this conversation. This contribution thus hopes to stimulate and popularise this conversation.

2 The CMA, monetary unions and their crises

2.1 *Why the Euro crisis matters*

Though the Euro crisis directly affected countries and economies in Europe, it has also dragged the global economy along with it and threatened fragile economies around the world.[11] In addition, the Euro crisis imperilled the stability of the international monetary and financial systems.[12]

More to the point, the crisis has lessons for other economic communities, such as the AU, that are contemplating the formation of monetary unions. The process of creating a continental monetary union entails integrating the existing monetary

7 Wang (n 6).

8 Munari "The European Monetary Union: a hard test for the rule of law within the EU legal system" 2017 *American University International Law Review* 345 349, 386–387. See also Judge Richard Posner in *Praxair, Inc v Hinshaw & Culbertson* 235 F 3d 1028, 1031 (7th Cir 2000) (commenting that few lawyers can make sophisticated economic arguments).

9 Munari (n 8) 349–350.

10 See Munari (n 8) 349.

11 Feibelman "Europe and the future of international monetary law" 2013 *Transnational Law and Contemporary Problems* 115 116.

12 ibid.

unions, such as the CFA[13] zones.[14] Currently, groups of AU states plan to create a monetary union in West Africa and East Africa, among others.[15]

The Euro crisis should also inform debates in the smaller economies, such as the one that occasionally arises in Namibia, regarding the delinking of the national currency from the South African Rand. Experts debate whether it is time for Namibia to delink its currency.[16] The proponents of delinking argue that the monetary arrangements result in South Africa exporting inflation to the smaller member states. They also argue that the value of the Rand does not reflect the competitiveness of the smaller states and thus undermines their exports.

The opponents of delinking counter that the monetary arrangements facilitate trade and stabilise the economy by providing it with a currency that has proved to be stable and that allows savers to invest their money without fearing that hyperinflation will wipe out their cherished and hard-earned savings.

2.2 *Monetary unions*

Although money is mostly regulated at the level of the national economy within a sovereign state, groups of countries have, in recent decades, moved towards closer economic integration and formed monetary unions. These unions represent one way to integrate economies.[17] They can also serve as bridges for less advanced countries in a regional economic community to reach the more advanced stages that other countries have achieved in that community.[18]

Monetary unions or currency unions?

On final analysis, the CMA does not fully qualify as a monetary union. The CMA does not have a regional central bank, though the South African Reserve Bank (SARB) considerably influences the monetary policies of Lesotho, Namibia and Swaziland (the LNS countries),[19] nor does the CMA have a common pool of reserves and a regional surveillance of domestic (fiscal and structural) policies.[20]

Moreover, the CMA does not have a single currency. National currencies freely circulate inside the LNS countries that issued them, but only the South African Rand serves as legal tender throughout the CMA. And, since the LNS countries

13 “CFA” stands for “Communauté Financière Africaine” (African Financial Community).

14 Asongu, Nwachukwu & Tchamyou “A literature survey on proposed African monetary unions” 2016 *Journal of Economic Surveys* 878 880.

15 See Asongu, Nwachukwu & Tchamyou (n 14) 880.

16 See Bank of Namibia “Namibia is not considering de-linking from South African rand”, https://www.bon.com.na/CMSTemplates/Bon/Files/bon.com.na/c3/c372369e-254b-4c0e-95bc-88566f36d0d9.pdf (30-8-2020); “Delinking from rand easier said than done” *The Namibian* (21-1-2016) 19 (quoting a Namibian economist claiming that, given Namibia’s limited foreign reserves, a free float Namibian dollar will likely become more volatile than the South African rand).

17 See also Olesti-Rayo “The monetary union and the creation of different rhythms in the European integration process” 1999 *Whittier Law Review* 625 627.

18 Olesti-Rayo (n 17) 627.

19 Wang (n 6) 12–13.

20 ibid.

have pegged their national currencies to the Rand one-to-one, those currencies perfectly substitute one another while members incur zero-charge for converting those currencies.[21] For that reason, the CMA is perhaps best described as a *de facto* currency union.

How a monetary union benefits its members

Monetary unions carry several advantages. In these unions, countries share a common currency, which facilitates trade and economic exchanges, including tourism. In addition, a monetary union improves efficiency by promoting price transparency between members.[22]

In the CMA, the currency union implies that the LNS countries have tied their domestic inflation to the actual and targeted inflation rate in South Africa. In other words, monetary unions establish an anchor for monetary policy and import credibility.[23]

Members lose control over their interest and exchange rates

Despite the benefits members reap from uniting their currencies, the greatest lesson from the Euro crisis lies in realising that *currency unions entail ceding control over interest rates and exchange rates*. This cession carries significant risks: most notably it drastically affects the ability of monetary-union members to determine the money supply (to control inflation), manage economic cycles and borrow money.[24] When a recession hits, this puts pressure on member states to expand the money supply by monetary or fiscal means.[25]

Monetary and fiscal policies

Monetary and fiscal policies form the core of monetary-union policies. The EU appears to have relegated social integration and non-economic objectives to secondary priority, preferring monetary and fiscal policies over social and labour policies.[26]

The European Central Bank (ECB) manages monetary policy by determining a single interest rate and the money supply to control inflation. The ECB's inflation target hovers around 2%.[27]

[21] ibid.

[22] Hunt "A fresh look at the merits of a currency union" 2005 *The Reserve Bank of New Zealand Bulletin*, https://www.questia.com/read/1G1-140998524/a-fresh-look-at-the-merits-of-a-currency-union. See also Patroba & Nene (n 3) 9.

[23] Hunt (n 22) 4. See also Patroba & Nene (n 3) 9.

[24] See Nellis "Deficiencies in European Monetary Union's credible commitment against monetary expansion" 2000 *Cornell International Law Journal* 263 263–264; Brock "Beyond Maastricht: the long-term macroeconomic impact of European monetary union" 1998 *Transnational Lawyer* 107 124.

[25] Nellis (n 24) 264.

[26] Dahan "A path-dependent deadlock: institutional causes of the Euro crisis" 2016 *Cornell International Law Journal* 309 313, 357.

[27] Dahan (n 26) 309.

Dahan describes this ECB interest-rate policy as "one-size-fits-all".[28] The policy contributes to the asymmetrical design of the EMU. Members facing a recession have an incentive to increase the money supply to help alleviate the recession and score political goals.[29]

With regard to fiscal policies, the ECB shares responsibility for them with the Stability and Growth Pact (SGP). Nonetheless, EU member states retain the power to decide how to satisfy those criteria.[30] Research shows that countries in potential monetary unions in Africa find it difficult to meet the applicable criteria for fiscal convergence.[31] This should worry policy makers because some experts believe that the Euro crisis arose because it failed to co-ordinate fiscal policies.[32]

Other challenges

Regional economic communities generally and monetary unions specifically choose their members carefully. As a result, they tend to leave out certain countries, as researchers have observed in the case of African monetary unions.[33] Particularly, within the Southern African Development Community (SADC) region, the economies of Lesotho, Namibia, South Africa, Swaziland, Botswana, Mozambique, Mauritius, and Tanzania are converging.[34] In contrast, those of Angola, the Democratic Republic of the Congo (DRC), Malawi, Zimbabwe, and Zambia are not.[35] This has the consequence that a monetary union at the level of the SADC could possibly leave out the latter group of countries.

2.3 *The common monetary area in Southern Africa*

The legal framework for the CMA

In Africa's conception of regional economic integration, countries will go through four steps.[36] From a free trade area, countries will move to a customs union, then a monetary union before culminating in an economic union. In that conception, monetary unions represent the final step before the economies of the member states unite.

More specifically, the legal framework for the Common Monetary Area (CMA) in Southern Africa rests on one multilateral treaty and several bilateral treaties between South Africa and each of the other CMA members. The multilateral treaty and the bilateral treaties have provided a platform for monetary and exchange-rate policies.[37]

28 Dahan (n 26) 312.
29 Nellis (n 24) 264, 295.
30 See Dahan (n 26) 312.
31 Asongu, Nwachukwu & Tchamyou (n 14) 898.
32 Dahan (n 26) 312.
33 Asongu, Nwachukwu & Tchamyou (n 14) 898.
34 ibid.
35 ibid.
36 Hartzenberg "Regional economic integration in Africa" World Trade Organization (WTO) Staff Working Paper ERSD-2011-14 (2011) 2, https://www.wto.org/english/res_e/reser_e/ersd201114_e.pdf.
37 Asongu, Nwachukwu & Tchamyou (n 14) 890.

While the literature has gone through the terms of the multilateral agreement, the so-called (Multilateral) Common Monetary Area Agreement, CMA members have apparently not disclosed the terms of their bilateral agreements with South Africa. This means that, while scholars have an idea of what the Multilateral CMA Agreement provides for, they have much less clarity on the SA–LNS bilateral treaties.

At the international level, currency unions such as the CMA must ensure that they do not contravene the Articles of Agreement of the International Monetary Fund (IMF). Section 1 of Article IV lays the following down in this respect:

> "Each member undertakes to collaborate with the Fund and other members to assure orderly exchange arrangements and to promote a stable system of exchange rates. In particular, each member shall: …
>
> (ii) seek to promote stability by fostering orderly underlying economic and financial conditions and a monetary system that does not tend to produce erratic disruptions;
>
> (iii) avoid manipulating exchange rates or the international monetary system in order to prevent effective balance of payments adjustment or to gain an unfair competitive advantage over other members; and
>
> (iv) follow exchange policies compatible with the undertakings under this Section."

Furthermore, the articles empower the IMF to monitor how its members comply with their obligations.[38] Additionally they oblige members to provide the IMF with information necessary for it to execute its responsibilities.[39]

Historical background

The CMA finds its roots in British colonisation of Southern Africa. That colonisation integrated the economies of Southern African countries mainly through two major structures: a customs union and a *de facto* currency union. To this day, these structures have kept the economies of South Africa, Botswana, Namibia, Lesotho, and Swaziland closely integrated.

The British Empire created the Southern African Customs Union (SACU) in 1910 and the *de facto* currency union ten years later. After the South African government had established the South African Reserve Bank (SARB) in 1921, the British Pound became the sole legal tender in South Africa, Bechuanaland (present-day Botswana), Lesotho, Namibia and Swaziland. Funds moved freely within those countries, while South African banks channelled almost all external transactions, subject only to South Africa's exchange controls.

This *de facto* currency union continued even after Botswana, Lesotho and Swaziland gained political independence in the 1960s. In 1961, the Rand replaced the Pound as sole legal tender in South Africa (including Namibia, also known then as South West Africa), Botswana, Lesotho, and Swaziland. It was not until 1974 that South Africa, Botswana, Lesotho and Swaziland turned this *de facto* currency union into a formal agreement. Specifically, on 5 December 1974, these four countries signed the Rand Monetary Area (RMA) Agreement. However, Swaziland

[38] art IV s 3.
[39] art VIII s 5.

set up its own monetary authority and issued its own national currency that same year, while Botswana exited the currency union one year later, although it remained a member of SACU.

On 1 April 1986, the Trilateral Monetary Agreement replaced the RMA and established the Common Monetary Area of Lesotho, Swaziland, and South Africa. The Trilateral Agreement empowered Lesotho and Swaziland to issue their own national currencies. It also contained some provisions dealing with capital account, intra-CMA fund transfers, and seigniorage compensation. Ironically, still in 1986, the year it entered into the Trilateral Monetary Agreement, Swaziland stopped using the Rand as legal tender.[40] (Swaziland re-introduced the Rand as legal tender in 2003.) In January 1980, by virtue of the Trilateral Monetary Agreement, Lesotho set up its own central bank and proceeded to issue its national currency, the Loti.

Namibia gained political independence from South Africa on 21 March 1990. It joined the CMA in 1992. In that same year, CMA members replaced the Trilateral Monetary Agreement of 1986 with the Multilateral Agreement to include Namibia in the CMA. Namibia issued its own national currency, the Namibian Dollar, in 1993.

Currency arrangements

When the LNS countries issued their own currencies, they became responsible for their monetary policies and began to control their own financial institutions, but only to a very limited extent.[41] Since the LNS countries have introduced their own currencies, they have pegged them one-to-one to the South African Rand.[42] Moreover, bilateral agreements between the LNS countries and South Africa regulate how the LNS countries access South Africa's foreign exchange market.[43] The CMA Multilateral Agreement requires the exchange-control rules of LNS countries to follow those applying in South Africa closely.[44]

The CMA spells out the overall objective of the monetary area as providing for "equitable benefits" and "sustained economic development of the Common Monetary Area as a whole" and as advancing the less developed members of the CMA.[45]

Together with the CMA Multilateral Agreement of 1992, the bilateral agreements that South Africa entered into with each of the LNS countries regulate exchange rate and monetary policies in those countries. In particular, the bilateral agreements define the areas where the national currencies of member states circulate as legal tender.[46] In short, currencies issued by the BLNS serve as legal tender in their respective countries whereas the Rand serves as legal tender throughout the CMA.[47]

40 As a matter of fact, however, people continued to use the Rand widely in Swaziland even after the Swazi government discontinued its use in 1986. See Wang (n 6) 8 n 6.

41 Wang (n 6) 8.

42 Wang (n 6) 8–9.

43 ibid.

44 CMA (Multilateral) Agreement of 1992 preamble and art 5.

45 CMA (Multilateral) Agreement of 1992 preamble and art 2.

46 Wang (n 6) 8.

47 ibid. However, the South African towns bordering Lesotho accept the loti as medium of exchange (see Wang (n 6) 8 where he quotes Foulo).

Bilateral agreements also enable members to authorise certain dealers within their territories to convert, at par, notes issued by their central bank or SARB without restriction, apart from normal handling fees.[48]

The SA–Lesotho and the SA–Namibia bilateral agreements require the central banks of Lesotho and Namibia to maintain foreign reserves at least equivalent to the total amount of the currency they issue.[49] These foreign reserves comprise the Rand currency that Namibian and Lesotho central banks hold in their own accounts, the Rand currency that they hold in a special account with SARB, or South African government stock.[50] Nonetheless, unlike a typical currency board, the CMA does not legally restrict its members from acquiring domestic assets.[51]

Subject to certain limits, the CMA Multilateral Agreement allows LNS countries to access South Africa's capital and money markets. It further entitles LNS countries, in special circumstances, to enter into bilateral negotiations with South Africa, so as to obtain temporary credit.[52]

The CMA Multilateral Agreement prohibits member states from restricting the transfer of funds, whether for current or capital transactions, to or from any member country.[53] Investment and liquidity requirements that member states prescribe for their financial institutions constitute the only exception to this general prohibition. This flexibility speaks to the concerns of LNS countries that funds generated in their territories and deposited with local financial institutions tended to flow to the more developed capital markets of South Africa.[54]

Since the Rand circulates throughout the CMA as legal tender, South Africa compensates LNS states for the seigniorage they forgo. The compensation formula equals the product of

(1) two-thirds of the annual yield on the most recently issued long-term South African government stock; and
(2) the volume of Rand estimated to circulate in a given member country.

To implement the CMA Multilateral Agreement, member countries have set up a commission that meets at least once a year and in which each appoints one representative along with advisors. The commission aims to reconcile the interests and positions of member states on common issues pertaining to monetary and exchange policies.[55] The CMA Multilateral Agreement also provides for a tribunal to settle disagreements that might arise between member countries regarding the interpretation and application of the Agreement.[56]

48 Wang (n 6) 10.
49 ibid.
50 ibid.
51 Wang (n 6) 12.
52 Wang (n 6) 11.
53 CMA (Multilateral) Agreement of 1992 art 3.
54 Wang (n 6) 10.
55 Wang (n 6) 11.
56 CMA (Multilateral) Agreement of 1992 art 9.

2.4 *Crises in monetary unions*

Arguably, the most serious crisis of a monetary union in modern history has been the one that hit the Eurozone in the wake of the 2007–2008 global economic recession. The lesson that emerges from that time, and a major theme of this contribution, discloses to government strategists that, because of their core design, monetary unions magnify the fallout of economic downturns, although they may not always cause them.

Crucially, because monetary unions entail surrendering authority over interest rates and exchange rates to a regional central bank, monetary unions can exacerbate or bring about three types of major crises, namely high inflation, recessions, and asset bubbles as a result of excessive credit. Whatever caused the Euro crisis, it bears rich if painful lessons as to how other regions of the planet can design and implement their monetary unions, be they future or existing ones.

3 The Euro crisis

3.1 *The Euro as a currency*

Genesis

The 1992 Treaty on the European Union (TEU), also known as the Maastricht Treaty, mandates the Euro. Plausibly the most important feature of the European Union (EU),[57] the Euro replaced on 1 January 1999 the national currencies of 11 EU countries.[58] At the time of writing, the Eurozone encompasses 19 countries.[59]

Today, the Eurozone represents a single European currency for the first time since the Roman Empire.[60] An ambitious project, this relatively young regional currency was long planned, and people generally regard it as a significantly progressive move towards economic integration. The Euro covered all the biggest economies of Europe, making that continental currency arguably the most powerful currency after the US dollar.

The lack of critical analysis on the Euro has led to myriad illusions. First, it led to the illusion that the Euro totally immunised member countries against risks and that Eurozone membership constituted the gateway to advantages for all, spreading from the member states to their citizens.[61] Eurozone members further believed that membership would reduce interest rate charges, allow them to acquire goods and services at better prices, and abolish price instability.[62]

57 Olesti-Rayo (n 17) 627.

58 Horton "An introduction to the Euro" 1999 *North Carolina Banking Institute* 435.

59 See European Commission "What is the Euro area?", https://ec.europa.eu/info/business-economy-euro/euro-area/what-euro-area_en (25-7-2019). The Eurozone comprises Austria, Belgium, Cyprus, Estonia, Finland, France, Germany, Greece, Ireland, Italy, Latvia, Lithuania, Luxembourg, Malta, the Netherlands, Portugal, Slovakia, Slovenia, and Spain.

60 Horton (n 58) 435.

61 Munari (n 8) 350.

62 ibid.

Convergence criteria

The idea that a monetary union calls for a degree of economic homogeneity buttressed the European Monetary Union's (EMU's) "convergence criteria".[63] Still today, that idea underpins the theory of monetary unions. Ironically, the fact that the CMA lacks those convergence criteria greatly weakens it.

Article 109 of the Maastricht Treaty spells out the formal criteria for macroeconomic convergence in the EU:[64]

1. Member states must achieve an inflation rate of less than 1.5% higher than that of the three countries with the lowest inflation.
2. Interest rates must not be 2% higher than the three countries with the lowest inflation.
3. Government debt must not be more than 60% of the gross domestic product (GDP) and the current budget deficit must not exceed 3% of the GDP.

Approved in 1996, on the initiative of German finance minister, Theo Waigel, the Stability and Growth Pact (SGP) reinforces the third criterion (above) by making it compulsory, with EMU states being punished for missing the debt and deficit thresholds.[65]

Many scholars have criticised the EMU's convergence criteria. Many have claimed that they do not warrant real convergence, and that they are not necessary to establish an optimal monetary area.[66] Stiglitz claims that no persuasive evidence exists that explains how these high thresholds (3% and 60% of GDP) ensure convergence[67] while the President of the European Commission, Romano Prodi, famously described those rules as "stupid".[68]

Pereira observes that the convergence criteria result from a political balancing of different and sometimes conflicting interests, and not from an exhaustive analysis of what makes monetary unions succeed.[69] In fact, the EU allowed a number of countries to integrate the EMU fully even though they did not meet all the convergence criteria.[70]

63 Pereira "Economic restructuring and the European Monetary Union" 2001 *University of Miami International and Comparative Law Review* 45 58.
64 Treaty on the European Union of 1992, Article 109(j). See also Brock (n 24) 120–123 (explaining that a fourth criterion, the exchange rate mechanism, collapsed).
65 See also Brock (n 24) 124.
66 Pereira (n 63) 58-59.
67 Stiglitz (n 1) 87.
68 As quoted by Munari (n 8) 351.
69 Pereira (n 63) 58–59.
70 Pereira (n 63) 59.

3.2 *The Euro crisis*

The root causes

The global economic recession that started in 2007 in the United States (US) contaminated Europe, which suffered a severe financial and economic slowdown. The European recession culminated in a major sovereign debt crisis. The dominant narrative holds that inadequate deregulation of financial services, the cross-border mobility of financial capital, and labour-market flexibilisation caused both growing inequality and the exponential financialisation of the US economy.[71] With this account, the massive bailouts by EU countries to contain the global financial crisis led to massive debt overhangs.

However, Dahan disputes the widespread narrative that the Euro crisis constituted a sovereign debt crisis. For Dahan, the sovereign debt crisis only ended a process that started with legal and institutional flaws.[72] These flaws turned the financial crisis of 2007–2008 into a public debt crisis.[73] In other words, the Euro crisis is more than economic: it originates in historical institutional preferences.[74] Dahan traces the origins of that crisis back to the 1992 Treaty on the European Union (TEU),[75] also known as the Maastricht Treaty, which he regards as a "self-contradictory" "neoliberal" model.[76] In his opinion, the asymmetric design of the Maastricht Treaty lies at the root of the Euro crisis.[77]

Dahan argues that the economies of the core countries (notably, France and Germany) and the periphery (especially Greece, Italy, Ireland, Portugal, and Spain) did not really converge.[78] In short, he sees the Euro crisis as having unfolded because the Eurozone failed to harmonise monetary, fiscal, and labour policies. He claims that, as a result of "one-size-fits-all" monetary policy, distorted fiscal policy, and the absence of a common approach to wage determination, the economies of Germany and those at the periphery diverged, creating surpluses in the core economies and deficits in the periphery.[79]

On the one hand, the periphery depended more and more on expanding private credit (as opposed to public debt) and increasing asset prices in the market for commercial and housing investments.[80] On the other, the core supported training, upgraded its labour force, moderated wages, and grew its exports by relying on

71 Dahan (n 26) 311–312. See Lapavitsas et al *Crisis in the Eurozone* (2012) 1–2 (affirming that the "immediate causes" of the Eurozone crisis lie with the financial crisis of 2007–2008).

72 Dahan (n 26) 311–312.

73 ibid.

74 Dahan (n 26) 311.

75 ibid.

76 Dahan (n 26) 354. See also Pereira (n 63) 59–60 (describing the stages, conditions, and requirements of the EMU as "neoliberal", and concluding that the EMU is a mechanism to promote trade and, above all, to restructure European economies in order to set them up in service of globalisation).

77 Dahan (n 26) 356.

78 Dahan (n 26).

79 Dahan (n 26) 312.

80 Dahan (n 26) 313, 356.

targeted investments in capital goods.[81] This divergence eventually translated into "destabilizing macroeconomic imbalances".[82]

The distortions

During the crisis, it turned out that the single interest rates set by the ECB proved too high in low-inflation states while accommodating too much in high-inflation states.[83] This distortion led to finance-led growth and rapid wage inflation, while competition deteriorated.[84]

In addition, the bias in the fiscal and debt thresholds prevented the EMU from foreseeing or addressing the widening gulf between the core and the periphery.[85] The SGP brought about asset-price bubbles, excessive private debts and current-account imbalances.[86] It obsessed over nominal figures and did not differentiate between deficits in periods of growth and periods of recession.[87]

Because the EU did not co-ordinate the way its member countries determined wages, the competitiveness of EMU members diverged as well. Export-orientated states co-ordinated wages effectively and managed to constrain wage inflation.[88] By contrast, finance-led states poorly co-ordinated wages and could not mitigate wage inflation.[89] For that reason, the competitiveness of those states suffered, and they accumulated current-account deficits as the export-orientated states accumulated current-account surpluses.[90]

The value of the Euro, which represents the competitiveness of leading economies (like that of Germany) in trade, overestimated the trading competitiveness of countries on the periphery, such as Greece. In other words, the value of the Euro proved too strong for Greek producers. So, instead of boosting trading activities in Greece, it actually undermined Greek producers and brought about a major economic crisis.

The effects

The Euro arguably helped fuel the financial and economic crisis in Europe by increasing imbalances in the Eurozone and by accelerating a private and public credit bubble, mainly in the periphery.[91] More importantly, it complicated efforts to contain and resolve the worsening financial and economic situation in Europe.[92]

81 ibid.
82 Dahan (n 26) 309, 312–313.
83 Dahan (n 26) 356; Brock (n 24) 127–128.
84 Dahan (n 26) 356.
85 ibid.
86 Dahan (n 26) 356–357.
87 Dahan (n 26) 357.
88 ibid.
89 ibid.
90 ibid.
91 Feibelman (n 11) 115.
92 ibid.

The underlying problem remains that countries on the periphery record very little growth, which affects the EU economy as a whole because it relies so heavily on intra-EU trade.[93]

Talks emerged and some participants suggested that Greece must leave the Eurozone. It was said that Greece could not escape from its malaise if it retained the Euro as currency. Eventually, Greece remained within the Eurozone but, for detractors, that decision has stopped Greece from recovering from its recession.

But Greece was not the only country that suffered because of the relatively high value of the Euro. Italy finds itself in a similar position. In fact, this year, Italy attempted to introduce what experts regarded as a digital currency, in clear violation of the rules regulating the Euro and the Eurozone.

4 Implications for monetary unions and their laws

The Euro crisis has lessons for other monetary unions, including those in Africa, as well as for the laws and policies governing those unions. Feibelman observes that the EU did not design the framework of the Euro to respond effectively to the crises that erupted at the level of the European Monetary Union (EMU).[94]

4.1 *For monetary unions in general*

For monetary unions in general, the Euro crisis shows that, if poorly conceived and designed, monetary unions are doomed to fail. European countries designed the EMU as an asymmetrical community. Specifically, (1) the uniform ECB interest-rate policy, (2) the distorted SGP, and (3) the uncoordinated wage policy, have worsened imbalances in the Eurozone.[95]

It also shows that states should rather plan the monetary union carefully than rush into forming one, and thereafter to regret it or see it disintegrate. European policy makers[96] and scholars[97] have not hidden their concerns about the future of the Euro.

Crises in monetary or currency unions may carry in their wake violations of the rules of the IMF's Articles of Agreement.[98] Through monetary unions, states surrender to a regional central bank some of their policy-making functions central to their obligations under the IMF's Articles of Agreement.[99] The regional central bank, however, has no obligations vis-à-vis the IMF.[100] For that reason, the IMF has developed a system of surveilling and advising multilateral organisations such as

93 Dahan (n 26) 357–358.
94 Feibelman (n 11) 116.
95 Dahan (n 26) 356.
96 Feibelman (n 11) 116.
97 Munari (n 8) 346.
98 Feibelman (n 11) 116–117.
99 See Feibelman (n 11) 117.
100 ibid.

the ECB.[101] In the case of the CMA, a similar system would entail monitoring the SARB, which functions as the *de facto* central bank of the CMA.

4.2 *For African monetary unions*

In Africa, the Euro crisis presents several significant policy implications. The SADC has previously committed to establishing a monetary union by 2016 and a common currency by 2018[102] – targets that it has missed.

In addition to questions of design, conception, and implementation, the Euro crisis teaches policy makers in Africa that their current legal provisions on monetary unions will likely not suffice to ward off Euro-like crises and that they risk repeating the mistakes made with regard to the Euro. These lessons apply as much to the CFA Franc zone as to the common monetary area in Southern Africa.

4.3 *For monetary-union laws in Africa*

The laws of the AU provide for an African Monetary Area on scientific and legal knowledge as these existed before the Euro crisis. Policy makers in Africa should therefore carefully rethink their laws and policies on monetary unions so that they do not let history repeat itself.

5 The monetary union in Southern Africa and its laws

5.1 *Parallels between the Eurozone and the common monetary area*

To determine whether the Euro crisis may have any lessons for the CMA, analysts must gauge the extent to which the two zones resemble one another. In several respects, the Eurozone behaves like the CMA, which is much older than its European counterpart. In both zones, a free trade area or a customs union predated the monetary union. Indeed, the CMA emerged within a pre-existing customs union, SACU. Similarly, in both zones, capital moves very fluidly.[103] Thirdly, while the West African Economic and Monetary Union (WAEMU) and the Central African Economic and Monetary Community (CAEMC) have pegged their regional currency to the Euro, neither the Eurozone nor the CMA have pegged their currencies to an outside exchange-rate anchor.[104]

Several important aspects of the CMA, however, set it apart from the Eurozone. The core difference is that, while the Euro represents a monetary union, the CMA works rather like a currency union. As described above,[105] the CMA, unlike the EMU, does not provide for fiscal transfers to members affected by asymmetrical

101 Feibelman (n 11) 117.
102 Southern African Development Community *Regional Indicative Strategic Development Plan* (2001) 67, https://www.sadc.int/files/5713/5292/8372/Regional_Indicative_Strategic_Development_Plan.pdf.
103 Wang (n 6) 12–13.
104 Wang (n 6) 12–13.
105 See par 2.2.

economic shocks to cushion the impact of those shocks.[106] Overall, the similarities are relevant and significant enough to make the experience in Europe, especially the Euro crisis, speak to the currency union in Southern Africa.

5.2 *Implications for the CMA*

The size of an optimal currency area

Robert Mundell, the economist who won the Nobel Prize in economics for answering the question about the "optimal currency area", stated that such area needs to have the appropriate size.[107] An optimal currency area should be big enough that its currency would be viewed as a *serious* currency, but not so big that the differences among countries would hinder macroeconomic stability and impose excessive costs.[108]

The Euro crisis may have little to teach the CMA as the two differ in size. The Eurozone comprises 19 countries whereas the CMA only consists of four countries, though characterised by huge economic disparities. Nevertheless, the disparities and risks that a 19-member monetary union faces differ markedly from those that a four-member union confronts. Presumably, the four-member monetary union runs fewer risks, despite the internal dissimilarities, than a 19-member group.

Disparities among currency union members

For the common monetary area in Southern Africa, the Euro crisis should inform policy makers to reduce disparities between the economy of the regional hegemon South Africa and the smaller economies. Social and economic development have remained uneven among CMA members.[109] At present, South Africa represents about 90% of the CMA's GDP, trade, and population.[110] Only Namibia and South Africa rank as upper-middle-income countries, unlike Swaziland and Lesotho. As a matter of fact, the per-capita GDP differences among CMA members is nearly twice higher than those among countries in the Eurozone.[111]

This observation does not require that the economies of Namibia, Swaziland and Lesotho need be as large as that of South Africa. Rather, it demands that policy makers must see to it that macroeconomic variables converge. Already, the CMA members seem to converge on variables such as inflation (obviously), debt as a percentage of the GDP, and imports reserve holdings.[112]

Ceding control over interest and exchange rates can impose enormous costs on a country. The magnitude of the costs that a country will incur depends on

[106] See Wang (n 6) 12.
[107] Mundell "A theory of optimum currency areas" 1961 *American Economic Review* 657.
[108] Stiglitz (n 1) 86 n 4.
[109] Wang (n 6) 5–6.
[110] See Wang (n 6) 12.
[111] Wang (n 6) 13 (explaining that the ratio of per-capita GDP of richest to poorest country stands at 4.2 in the Eurozone while that ratio stands at 7.7 in the CMA).
[112] See Patroba & Nene (n 3) 15.

a number of factors, the most significant of which is the disparities among currency-union members.[113]

Mundell found that Euro countries were too diverse to share a common currency easily. In other words, the Euro as currency was not an unqualified success.[114] Because of those differences among Euro countries, the Maastricht Treaty required Euro members to satisfy convergence criteria.

Olesti-Rayo expressed the opinion that the Euro showed a way of further integrating economies without all its members advancing at the same speed.[115] Actually, the fact that member countries advanced at different speeds explains why the Euro has not worked as well as its proponents had hoped.

Ability to respond to economic shocks

In ceding their powers over interest rates and exchange rates to their region's central bank, members of currency unions run great risks. Indeed, they cannot readily dispense with interest rates and exchange rates in fighting certain shocks, such as current-account deficits or a general economic downturn. In the CMA, the absence of any formal mechanism to transfer money to members hit by shocks of this kind aggravates this risk.

In realising the EMU, states transferred to the EU (the European Central Bank in particular) the most important tools they had in protecting themselves against economic shocks.[116] These economic shocks may impact upon EMU countries because they have tied their hands when it comes to controlling inflation, managing business cycles, or reversing trade imbalances. Ceding their power to adjust interest rates and exchange rates to their region's central bank may have the consequence that EMU member states will likely fail to fight economic shocks such as high inflation and recessions. This leaves members with a considerably limited ability to respond to asymmetrical economic downturns by using fiscal policies.[117]

This limitation induces states on the periphery to flout convergence criteria by expanding the money supply, whether by monetary or fiscal means. If the monetary union lacks any mechanism for those countries to access credit or to enforce their fiscal commitments, this situation makes those countries' commitments to fiscal discipline much less credible.[118]

The Euro also created incentives for countries on the periphery of that monetary union to borrow money excessively because they would not bear costs of their excessive credit alone but share them with all their fellow EMU members.[119]

A potential monetary union becomes feasible when member states design it to adjust robustly to macroeconomic shocks. Asongu and others have recommended

113 See Stiglitz (n 1) 86.
114 See Stiglitz (n 1) 87.
115 Olesti-Rayo (n 17) 627–628, 645.
116 Olesti-Rayo (n 17) 645; Dahan (n 26) 312; Brock (n 24) 126.
117 Brock (n 24) 128.
118 Nellis (n 24) 295–296.
119 Brock (n 24) 129–130.

that monetary unions in Africa must channel fiscal transfers to equip themselves with the tools to adjust and respond to asymmetric shocks.[120] Without such channels, they found, asymmetric shocks will put member states under tremendous pressure.[121]

It will be interesting to see how and indeed whether the CMA tribunal will handle disputes between members. This role may enable LNS countries to adjust to external shocks. The experience in Europe shows that courts can play a large role in implementing mechanisms to protect members from economic shocks.[122]

The Euro crisis also teaches that the LNS countries will have less ability to use their interest rates to make their exports cheaper and more attractive.[123] This restriction on the manipulation of interest rates puts pressure on LNS countries to devalue their national currencies, which effectively has the consequence of revising the peg to the South African Rand or exiting the currency union altogether. Stated differently, poorly designing a monetary union may threaten its very viability.

Under normal circumstances, if a country has an excess of imports, the exchange rate falls, making imports more expensive and exports cheaper.[124] On the other hand, with a fixed exchange rate, this does not happen. A country with a trade deficit must finance excess imports; and, if it cannot borrow the money to finance it, it will run into severe difficulties.[125]

Ability to create employment

The Euro crisis points to the fact that, with the CMA, LNS countries have reduced their ability to create employment. The challenge consists in finding ways for a single currency to ensure that a diverse region can maintain full employment in all its parts.[126] As Stiglitz notes, since adjustments in interest rates and exchange rates count among the most important ways that countries adjust to maintain full employment, the Euro took away two of the most important tools to ensure employment.[127]

In this regard, Asongu and others believe that labour mobility and infrastructural development can assist member states in responding to asymmetric shocks.[128] Dahan concurs insofar as the Euro crisis emerged as a failure to co-ordinate labour policies.[129]

120 Asongu, Nwachukwu & Tchamyou (n 14) 898.
121 ibid.
122 Nellis (n 24) 265 (suggesting that legal rulings by courts and agencies in the European Community can interpret broadly defined legal duties so as to fill gaps in the Maastricht Treaty); Koedooder "The *Pringle* judgment: Economic and/or monetary union" 2013 *Fordham International Law Journal* 111.
123 See Stiglitz (n 1) 86.
124 Stiglitz (n 1) 86.
125 See Stiglitz (n 1) 86.
126 Stiglitz (n 1) 86 n 4.
127 Stiglitz (n 1) 86.
128 Asongu, Nwachukwu & Tchamyou (n 14) 898.
129 Dahan (n 26) 312.

5.3 *Implications for the law regulating the common monetary area*

Correcting asymmetrical design

The Euro crisis shows that asymmetrical policies within the design of its monetary union primarily caused and worsened the impact of the 2007–2008 global financial crisis in Europe.[130] This European experience first demonstrates that CMA policy makers must distinguish the interests of the states at the core from those of the states at the periphery. As Olesti-Rayo noted in the case of the European monetary union, political and legal problems in differentiating between the core states and the states on the periphery could arise.[131] The implications of the Euro crisis for appropriate measures regulating the common monetary area in Southern Africa suggest that CMA members amend the existing law so that the region can avoid the pitfalls and negative experience of the Eurozone members. It also means that CMA members must rethink their monetary arrangements to ensure that they can better conceive and design their currency union.

Agreeing on sound convergence criteria

It follows from the foregoing that member states must lay out common criteria for their economies to converge. So far, CMA members have not co-ordinated their fiscal policies[132] – a major weakness of that currency arrangement. The feasibility of monetary unions depends on such criteria, but – as discussed earlier – the greatest challenge consists in identifying precisely what criteria would ensure the desired convergence. Scholars have not succeeded in establishing, with remotely sufficient consensus, which criteria can best guarantee that members of monetary unions may successfully converge their policy frameworks for the good of the monetary union.[133] In this respect, this contribution has demonstrated that the SGP thresholds do not adequately track the convergence required for a monetary union to succeed.

Setting up a mechanism to stabilise the CMA

The sovereign debt crisis that led to or aggravated the Eurozone crisis has given rise to a broad political consensus in Europe on the necessity for mechanisms to ensure permanent stability, on a wide range of fronts.[134] Likewise, policy makers in Southern Africa must establish a mechanism to transfer money to members in distress, especially the LNS countries. Without such a safety valve, the CMA will not prevent Euro-like crises either from happening or worsening.

[130] See Dahan (n 26) 312.
[131] Olesti-Rayo (n 17) 645.
[132] See Patroba & Nene (n 3) 5.
[133] Asongu, Nwachukwu & Tchamyou (n 14) 898.
[134] Koedooder (n 122) 146.

Conforming to international monetary law

Another challenge relates to the status of monetary unions under international monetary law. Feibelman argues that monetary unions impair the legal framework for an international monetary system and limit the ability of the IMF to promote stable exchange rates and global stability.[135] When and if the CMA decides to reform itself and strengthen its architecture for tackling economic shocks, it must strive to conform to international monetary law.

6 Conclusion

Monetary unions serve as an important link in the economic chain that progressively brings African economies together. Africa's model of economic integration envisions monetary unions as one of the last stages of economic integration. Consequently, monetary unions are a core goal of the continent's development.

However, the experience in the Eurozone rings alarm bells, and policy makers on the continent must learn from that experience so that they can avoid the woes that countries like Greece and Italy suffered. Moreover, Southern Africa may not necessarily have the same sort of economic resilience as Greece and Italy, or the same access to continental bailouts as they do in Europe, should a major crisis hit the CMA. The COVID-19 pandemic has showed that even South Africa had to call on a non-CMA, outside player (the IMF) for relief as the respiratory disease deepens the country's economic recession.

Probably, the most significant lesson of the Euro crisis does not simply come down to the necessity for states to design monetary unions better. Rather, the most salutary lesson is that states should prefer to design a monetary union carefully, even though this may take time. Ill-considered haste in design may come at a cost that they can ill-afford and that, ultimately, they will regret.

135 Feibelman (n 11) 118.

Prudential banking regulation in France and South Africa

CAMILLE GRIZET*

Abstract

Prudential banking regulation has become a significant part of overall banking regulation. It can be defined as an ensemble of rules that govern banking institutions with the principal aim of ensuring financial stability and protecting bank clientele. This paper compares the South African and the French prudential banking regulations. These two countries have different legal traditions, which have also led to different sources of prudential banking regulation. France, as a member of the European Union, has two legal sources of regulations. In addition, the countries have adopted different approaches. In France, the prudential banking framework is uniform and applies to all credit institutions, whereas in South Africa, the prudential banking framework differs dependent upon the type of institution being regulated. However, although the scope and the sources are different for the two countries, the content of the regulation is very similar. This is due to the influence of the Basel Accord elaborated by the Basel Committee on Banking Supervision at an international level. Most of the requirements of both countries' prudential regulation stem from implementation of these international standards, and the differences between them are therefore relatively minor. There is one main exception: they deal differently with mutual and co-operative banks. The study presented in this contribution shows that despite their economic and legal differences, South Africa and France have very similar frameworks as a result of international standards being incorporated within the national law of both countries.

* * * * *

1 Introduction

The concept of "prudential regulation" can be defined as an ensemble of management standards[1] that banking institutions have to follow with the aim of guaranteeing the soundness of each banking institution as well as the banking and financial system as a whole. In substance, prudential regulation consists of macro-economic and micro-economic tools including "minimum capital requirements, liquidity or loan portfolio diversification standards, limitations on a bank's investment portfolio or lines of business, and other restrictions intended to limit the type of risks which a banking firm may undertake".[2]

This contribution is a comparative study of the French and South African prudential banking regulations. Before analysing the content of the prudential regulations of each in order to identify similarities and differences, a presentation

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1 Bonneau "La norme prudentielle" 2015 3 *Revue de Droit bancaire et financier* 36.

2 Flannery "Prudential regulation for banks" in Sawamoto, Nakajima & Taguchi (eds) *Financial Stability in a Changing Environment* (1995) 281.

of the legal sources and scope of implementation is provided. The contribution will conclude by identifying some implications emanating from this study.

2 Sources and scope of the prudential banking framework

2.1 *Sources of the prudential banking framework: South Africa and France*

South Africa and France do not share exactly the same legal tradition. Consequently, the sources of the legal requirements relating to banking actors are different. In South Africa, the legal framework for banking is contained within various statutes and their associated regulations, in accordance with the common-law tradition that forms part of South African law. The most important of these statutes is the Banks Act 94 of 1990, the intention of which was "to provide for the regulation and supervision of the business of public companies taking deposits from the public".[3] This Act is complemented by a number of regulations, including "Regulations relating to Banks", that stipulate the prudential requirements applicable to the institutions covered by the scope of the Act. In addition to this statute, other banking institutions have been regulated by statutes specifically applicable to them. This is the case for mutual banks, co-operative banks and certain other institutions (for example the Land and Agricultural Development Bank of South Africa, the Development Bank of Southern Africa and the Postbank of South Africa) that are regulated respectively by the Mutual Banks Act 124 of 1993, the Co-operative Banks Act 40 of 2007 and other Acts concerning specific individual institutions. These statutes are also supplemented by their own regulations that incorporate the prudential framework applicable to each of them. The most recent important statute affecting the South African prudential framework is the Financial Sector Regulation Act 9 of 2017 that intends "to establish a system of financial regulation by establishing the Prudential Authority and the Financial Sector Conduct Authority, and conferring powers on these entities".[4] This statute provides an important framework for bank supervision and regulation within South Africa.

In France, a country within the civil-law tradition, the rules governing all banking institutions are contained within legislation known as the Monetary and Financial Code (*Code Monétaire et Financier*). However, owing to France being a member of the European Union, sources of the legal framework for banking are no longer solely national. Part of the French legislation comes directly (or indirectly) from the European Union and applies to all Member States. This is the case for the prudential legal framework that, in France today, is essentially European. In 2013, the European Union adopted two legislative instruments in order to establish the current prudential framework: Regulation (EU) No 575/2013[5] and Directive

[3] In accordance with the long title of the Act.

[4] In accordance with the long title of the Act.

[5] Regulation (EU) No 575/2013 of the European Parliament and of the Council of 26 June 2013 on prudential requirements for credit institutions and investment firms – amending Regulation (EU) No 648/2012.

2013/36/EU,[6] that form what is referred to as the "CRD IV" package. This is supplemented by different delegated regulations that set out additional details. Regulations are directly applicable within all Member States,[7] which means that the requirements defined by the Regulation 575/2013 are applicable to France without being incorporated into the Monetary and Financial Code or other legal mechanisms. Directive 2013/36/EU, which also contains some prudential requirements for banking institutions, needs to be adopted into national law in order to be effective.[8] France has incorporated the European directive by way of a combination of decrees and orders that have been included into the Monetary and Financial Code,[9] which means that the legal source of these prudential requirements remains national even though its "foundations" are European. The French prudential framework is therefore a mix between the provisions contained in European Regulation No 575/2013 and in the French Monetary and Financial Code (with some provisions resulting from European Union initiatives and others not).

2.2 *Scope of prudential banking framework: Uniform as opposed to differentiated approach*

Inasmuch as the legal mechanisms containing prudential regulations are different, so too is the scope of prudential frameworks in South Africa and France. Whereas in France the prudential framework is a uniform one applying to all "banks", South Africa has adopted a differentiated approach, with there being, in certain respects, correspondingly different requirements for different banking institutions.

With the exception of the specific institutions cited above (which are excluded from the common legislation), three different frameworks exist in South Africa. The first is a prudential legal framework, which applies to all banks that are subject to the Banks Act and its regulations. The Banks Act does not expressly refer to the type of banks it regulates and does not provide a clear definition of a "bank". It is simply defined as "a public company registered as a bank in terms of this Act".[10] The statute focuses rather on the definition of the activities of the institutions it regulates, namely "the business of a bank", which is defined in section 1 of the Act. All institutions that conduct "the business of a bank" fall within the scope of this statute, except those institutions detailed in section 2 that are expressly excluded.

[6] Directive 2013/36/EU of the European Parliament and of the Council of 26 June 2013 on access to the activity of credit institutions and the prudential supervision of credit institutions and investment firms – amending Directive 2002/87/EC and repealing Directives 2006/48/EC and 2006/49/EC.

[7] In accordance with Art 288 of the Treaty on the Functioning of the European Union (TFEU): "A regulation shall have general application. It shall be binding in its entirety and directly applicable in all Member States."

[8] Art 288 of the TFEU: "A directive shall be binding, as to the result to be achieved, upon each Member State to which it is addressed, but shall leave to the national authorities the choice of form and methods."

[9] All orders and decrees in French legislation that incorporate European Directives can be found on the *Légifrance* website: https://www.legifrance.gouv.fr/affichTexte.do?cidTexte=JORFTEXT000028133250&categorieLien=id (22-07-2020).

[10] s 1 of the Banks Act 94 of 1990.

According to these provisions, the Banks Act applies to all banks in South Africa with the exception of the Reserve Bank, the Postbank of South Africa, the Land and Agricultural Development Bank, the Development Bank of Southern Africa, the Corporation for Public Deposits, the Public Investment Corporation Limited, any other institution or body designated by the Minister, as well as any co-operative bank or mutual bank.

A second prudential framework applies to mutual banks. This framework, defined in the Mutual Banks Act and associated regulations, is less stringent than that which applies to the institutions falling within the scope of the Banks Act. Finally, a third prudential framework is applicable to co-operative banks through the Co-operative Banks Act and associated regulations. This is also less stringent than the Banks Act.[11]

This differentiated approach can be explained by the nature and role of mutual and co-operative banks in the South African banking system. These two categories of banks were created "to cater for the lower-income segment of the market"[12] and "to promote access to financial services, particularly to those groups of people characterized by low incomes and lack of access to conventional banking".[13] In other words, as part of the quest for financial inclusion in South Africa, this was a way to provide access to the banking system to those who traditionally had no access to ordinary commercial banks. In order for these institutions to achieve this goal, the prudential requirements needed to be less stringent and complicated than those applicable to commercial banks. In South Africa, mutual and co-operative banks are small institutions that generally operate at a local level. Consequently, they are not structured in the same way, do not take the same risks, and do not conduct the same type of business as commercial banks. Therefore, the prudential framework has been adapted to their business activities and objectives.

In contrast to South Africa, the French legal prudential framework for banking institutions is, with a few exceptions, a unified one. The framework was unified during the 1980s due to the influence of European legislation around the concept of "credit institutions".[14] The ordinary regime of law in the Monetary and Financial Code, combined with European Legislation, applies to all credit institutions. "Credit institutions" is a generic European concept transposed into French law and refers to "legal entities having as their customary activity the carrying out of banking transactions within the meaning of Article L. 311-1. They may also carry out transactions related to their activities within the meaning of Article L. 311-2."[15] According to Article L511-9 of the Monetary and Financial Code, a credit institution can be defined as a bank, a mutual or co-operative bank (*banque*

[11] Schulze "Banks and banking law" in Sharrock (ed) *The Law of Banking and Payment in South Africa* (2016) 4.

[12] Schulze (n 11) 6.

[13] Schulze (n 11) 8.

[14] Bonneau *Droit Bancaire* (2019) 127.

[15] art L511-1 of the Monetary and Financial Code: "Credit institutions are legal entities having as their customary activity the carrying out of banking transactions within the meaning of Article L. 311-1. They may also carry out transactions related to their activities within the meaning of Article L. 311-2" – English Translation of the French Monetary and Financial Code (legislative part) is available

mutualiste ou coopérative), a municipal credit bank (*Caisse de Crédit Municipal*), a finance company (*société financière*) or a specialised financial institution (*institution financière spécialisée*). These institutions, which are referred to as banks in general terms, are all subject to the same prudential requirements. This means that in France, unlike in South Africa, the prudential regime does not differ for mutual and co-operative banks.[16] The reason for this can be found in the fact that French mutual banks and co-operative banks are not fully comparable to their South African counterparts today. In France, as in South Africa, mutual and co-operative banks have their own specific structure when compared to commercial and universal ones. However, in France, owing to the fact that their size, activities and way of conducting business are all very similar to conventional banks, they are regarded as requiring the same prudential regulations.[17]

In parallel to the general legal system, some institutions that are involved in banking operations have their own framework and are subject to specific prudential requirements. In France, as in South Africa, certain institutions are not subject to the ordinary rules of law applicable to banks, yet may nevertheless perform banking operations. These institutions are considered in Article L. 518-1.[18] In addition, other institutions that participate in the banking system by providing certain banking services are covered by the national prudential body (*Autorité de Contrôle Prudentiel et de Résolution* – ACPR) and have their own specific legal framework. This is the case for payment institutions (*Etablissements de paiement*)[19] and electronic money institutions (*Etablissement de monnaie électronique*).[20] However, legally, they are not considered as banking institutions, and therefore will not be discussed in this study.[21]

As is evident from what has been said above, the sources and scope of banking regulations are different in the two countries. However, the same cannot be

on the *Légifrance* website: https://www.legifrance.gouv.fr/Traductions/en-English/Legifrance-translations.

16 This was the case in the past, but the last specific regulation for mutual and co-operative French banks was withdrawn in 2009. See Coelho, Svoronos, Mazzillo & Taohua "Regulation and supervision of financial cooperatives" Financial Stability Institute (FSI) *Insights on Policy Implementation No 15* (2019) 45 https://www.bis.org/list/fsi_publ/sds_1/index.htm.

17 It should be noted that three of the five financial groups, representing an 87% share of the banking market, are mutual and co-operatives banks or are composed of mutual and co-operative banks, which means that mutual and co-operative banks have the same importance as commercial banks in the French banking sector – see International Monetary Fund (IMF) *France: 2019 Article IV Consultation – Press Release; Staff Report; Statement by the Executive Director for France* 32 https://www.imf.org/en/Publications/CR/Issues/2019/07/24/France-2019-Article-IV-Consultation-Press-Release-Staff-Report-and-Statement-by-the-48523.

18 The following institutions are identified in the article: "The Trésor Public, the Banque de France, La Poste, under the terms set out in Article L. 518-25, the Issuing Institution of the Overseas *Départements* (Institut d'Émission des Départements d'OutreMer), the Overseas Issuing Institution (Institut d'Émission d'Outre-Mer) and the Caisse des Dépôts et Consignations shall not be subject to the provisions of Chapters I to VII of this Title".

19 art L522-14 to L522-18 of the Monetary and Financial Code.

20 art L526-27 to L526-34 of the Monetary and Financial Code.

21 The Monetary and Financial Code does not classify them in the category of "banking sector institutions" but in the category of "payment service providers and money changers".

said as regards their content. Prudential requirements in both South Africa and France actually share many similarities that can be explained by the influence of international standards implemented in both countries.

3 Contents of the legal framework

3.1 *The Basel Accord: source of similarities in national law*

In the past, banking regulation was primarily a national concern. Each country established its own rules and its own mechanisms, designed to accommodate its national institutions and the issues faced by its banking institutions and national system. However, in the 1970s, the banking and financial systems began to change. With the end of a fixed-rate system, followed by liberalisation (then globalisation), global financial interaction emerged strongly, transcending national borders. This brought about new problems, at an international level, in the banking system. To deal with these issues, the Basel Committee on Banking Supervision was set up in 1974. The Committee "was established to enhance financial stability by improving the quality of banking supervision worldwide, and to serve as a forum for regular co-operation between its member countries on banking supervisory matters".[22]

Although the initial role of the Basel Committee was to prevent banking institutions from evading supervision, its activities have evolved to focus on the development of international prudential standards (mostly relating to capital adequacy),[23] and it has become "the primary global standard setter for the prudential regulation of banks".[24] The most well-known standards developed by the Committee are referred to as the Basel Accord. Today, the Accord is considered as a reference and contributes to the harmonisation of national legislation in the area of prudential banking.

The first Basel Accord entitled *International Convergence of Capital Measurement and Capital Standards* was published in 1988. It was also known as "Basel I" and was the first international standard on capital adequacy requirements. Essentially, it defined a minimum risk-weighted capital ratio of 8% that all the international banks of Basel Committee Members had to adhere to. This standard was basic and soon showed itself to be lacking. Therefore, to address this issue, "Basel II"[25] was published in 2004. This new Accord revised the ratio of Basel I (this constituted Pillar 1 of the new Accord) and supplemented this ratio by the introduction of a prudential supervisory process, market discipline and disclosure requirements (Pillars 2 and 3). Following the Global Financial Crisis, Basel II

[22] Basel Committee on Banking Supervision (BCBS) "History" https://www.bis.org/bcbs/history.htm (22-07-2020).

[23] ibid.

[24] s 1 Basel Committee Charter https://www.bis.org/bcbs/charter.htm.

[25] BCBS *International Convergence of Capital Measurement and Capital Standards – A Revised Framework* (2004).

needed to be updated, and, therefore, Basel 2.5[26] followed by Basel III[27] were adopted. Basel III, and its amendments, provide the current version of the Basel Accord. It is more sophisticated, complex and detailed than the previous Accords, and enhances the Basel framework by revising the three pillars of Basel II and introducing new prudential mechanisms.

To summarise, Basel III comprises three pillars and frameworks relating to systemic institutions, liquidity standards and large exposure. Pillar 1 concerns capital requirements. It has updated the minimum risk-weighted capital ratio supplemented by a capital conservation buffer, a countercyclical buffer and a leverage ratio. Pillar 2 provides recommendations relating to risk management and supervision and "ensures that banks have adequate capital and liquidity to support all the risks in their business, especially with respect to risks not fully captured by the Pillar 1 process, and encourages good risk management".[28] Pillar 3 also supplements Pillar 1 by providing guidance and a template for disclosure requirements. In addition to these three pillars, Basel III introduces two global liquidity standards: the Liquidity Coverage Ratio "intended to promote resilience to potential liquidity disruptions over a thirty-day horizon"[29] and the Net Stable Funding Ratio that "requires a minimum amount of stable sources of funding at a bank relative to the liquidity profiles of the assets, as well as the potential for contingent liquidity needs arising from off-balance sheet commitments, over a one-year horizon".[30] It also establishes a framework to deal with systemic risk by adding additional requirements for global and domestic systemically important banks and a framework for large exposure.[31]

According to the Basel Committee Charter, the Committee does not possess "any formal supranational authority" and "its decisions do not have legal force".[32] Consequently, the Basel Accord, from Basel I to Basel III, and its updates, are not binding mechanisms and do not have any legal authority. However, the Basel Committee relies on its members to incorporate these standards into national legislation to make them effective.[33] With Basel I, the success went beyond the Basel Committee Members as more than 120 countries, including France and South Africa, implemented the Accord.[34] At that time, the Committee only had 11 members. The implementation of Basel II was not as successful as Basel I. It was more complex than its predecessor, and necessitated additional technical means,

26 BCBS *Enhancements to the Basel II Framework* (2009).
27 BCBS *Basel III: A Global Regulatory Framework for More Resilient Banks and Banking Systems* (2010 rev 2011).
28 BCBS *Basel Framework* (2019) 1047.
29 BCBS (n 27) 9.
30 ibid.
31 It should be noted that all current requirements relating to the Basel Accord (Basel III and its latest amendments) were consolidated at the end of 2019 into a single document called *Basel Framework*.
32 s 3 read with s 5 of the Basel Committee Charter (n 24).
33 ibid.
34 Stephanou & Mendoza "Credit risk measurement under Basel II: an overview and implementation issues for developing countries" 2005 *World Bank Policy Research Working Paper* 3556 3.

knowledge and infrastructure from the State implementing it. The same applies to Basel III, which is the current version of the Accord.[35]

Basel II and III were implemented successfully in both France and South Africa: Basel II was incorporated into the South African regulatory framework[36] in 2008, and it was implemented in France, in 2007, by a decree[37] with European legislation[38] being transposed into national law.

Basel III has been implemented in both countries since 2013 and the latest updates of Basel III are still in the implementation process. In South Africa, Basel III was incorporated into national law primarily through amendments to banking regulations.[39] In France, the implementation of Basel III comprises the aforementioned Regulation (EU) No 575/2013, that is directly applicable, as well as Directive 2013/36/EU, which has been transposed into national law through a combination of orders and decrees.[40]

3.2 *Similarities between the prudential frameworks in South Africa and in France: Implementation of the Basel Accord*

Owing to the implementation of the Basel Accord, French and South African prudential requirements are very similar, through the Banks Act in the case of South Africa (banks, bank-controlling companies and branches of foreign institutions registered under the Act),[41] and, in France, the ordinary law regime for all French credit institutions.

In both countries, banks are subject to capital requirements that take the form of a minimum risk-weighted capital ratio. In South Africa, "the minimum amount of allocated qualifying common equity Tier 1 capital and reserve funds, additional Tier 1 capital and reserve funds and Tier 2 capital and reserve funds that the bank is required to maintain … shall be a minimum of 8 per cent, or such a higher percentage as may be determined in accordance with the relevant requirements

[35] Although Basel III was initially implemented by only a few countries (only 6 non-members of the 2014 Basel Committee have adopted the capital standard), by 2018, more than 60 countries had implemented part of its requirements – see Coen "Global adoption of the Basel framework: enhancing financial stability across countries" *9th Islamic Financial Services Board Public Lecture* (5-04-2017), and, for further information on the implementation, Hohl, Sison, Stastny & Zamil "The Basel framework in 100 jurisdictions: implementation status and proportionality practices" *FSI Insights on Policy Implementation No 11* (2018) https://www.bis.org/list/fsi_publ/sds_1/index.htm.

[36] Regulations relating to Banks GN R1029 in *GG* 35950 of 12 December 2012.

[37] Decree of 20 February 2007 on capital requirements applicable to credit institutions and investment firms.

[38] Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the taking up and pursuit of the business of credit institutions and Directive 2006/49/EC of the European Parliament and of the Council of 14 June 2006 on the capital adequacy of investment firms and credit institutions constitute the implementation of Basel II at EU level.

[39] Further details concerning the timeline and new capital requirements can be found in Directive 5/2013 issued in terms of the provisions of section 6(6) of the Banks Act 94 of 1990.

[40] For the list, see n 9 above.

[41] BCBS "Assessment of Basel III risk-based capital regulations – South Africa" *Regulatory Consistency Assessment Programme (RCAP)* (2015) 34 https://www.bis.org/bcbs/publ/d322.pdf.

specified in this subregulation"[42] with a common equity Tier 1 capital and reserve of no less than 4.5% and a Tier 1 capital and reserve of no less than 6%.[43] In France, the total capital ratio is also 8% with a common equity Tier 1 capital ratio of 4.5% and a Tier 1 capital ratio of 6%.[44] Consequently, the requirements for the capital ratio are similar in both countries, but certain details (for example terminology, component of capital Tier 1 or 2) are slightly different.[45] The same assessment may be made concerning risks and methodologies used for calculation purposes. In France, as in South Africa, credit risk, counterparty credit risk, market risk and operational risk are taken into consideration, and all approaches put forward by Basel III (standardised, internal, etc) are authorised in both countries,[46] but some differences can be identified in the implementation of these approaches.[47]

In accordance with Basel III, banks in both countries are also subject to a capital conservation buffer and a countercyclical capital buffer. In South Africa, and in France, the capital conservation buffer is composed of common equity Tier 1 capital, and, in South Africa,[48] it is from 0 to 2.5% depending on the bank risk exposure, whereas in France, it is 2.5% conforming with European legislation.[49] As concerns the countercyclical capital buffer, it is also composed of common equity Tier 1 capital and varies from 0 to 2.5% in both countries.[50] Due to the COVID-19 pandemic, this countercyclical capital buffer is currently 0% in both France[51] and South Africa.[52]

In addition to capital requirements, in both countries, banks are subject to liquidity ratio standards (the Liquidity Coverage Ratio[53] and the Net Stable Funding Ratio[54]), to a leverage ratio of 3%[55] and similar requirements concerning

42 Regulations relating to Banks (n 36) reg 38(8)*(b)*.

43 Regulations relating to Banks (n 36) reg 38(8)*(e)*(i)(A) and (B).

44 art 92 of Regulation (EU) No 575/2013.

45 The terminology used is not identical and neither is the definition of the elements that compose the different tiers of capital – for more detail see Regulation relating to Banks (n 36) reg 38 and Regulation (EU) No 575/2013.

46 For South Africa, see Regulations relating to Banks (n 36) reg 38(2), and for France, refer to Part 3 Title II to IV of Regulation (EU) No 575/2013.

47 For further information see BCBS (n 41) and BCBS "Assessment of Basel III regulations – European Union" *Regulatory Consistency Assessment Programme (RACP)* (2014) https://www.bis.org/bcbs/publ/d300.pdf.

48 Regulations relating to Banks (n 36) reg 38(8)*(e)*(iv).

49 art L511-41-1-A of the Monetary and Financial Code.

50 art L511-41-1-A of the Monetary and Financial Code, and Regulation relating to Banks (n 36) reg 38(8)*(e)*(v) and *(g)*(vi).

51 High Council for Financial Stability (*Haut Conseil de Stabilité Financière*) Decision No D-HCSF-2020-2 relating to the countercyclical capital ratio (01-04-2020).

52 Directive 2/2020 issued in terms of section 6(6) of the Banks Act 94 of 1990 https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/9843/D2%20of%202020%20-%20Matters%20related%20to%20temporary%20capital%20relief%20in%20light%20of%20COVID%2019.pdf.

53 art 412 of Regulation (EU) No 575/2013 and Regulations relating to Banks (n 36) reg 26(12).

54 art 413 of Regulation (EU) No 575/2013 and Regulations relating to Banks (n 36) reg 26(14).

55 Regulation (EU) 2019/876 of the European Parliament and of the Council of 20 May 2019 amending Regulation (EU) No 575/2013 as regards the leverage ratio, the net stable funding ratio, requirements for own funds and eligible liabilities, counterparty credit risk, market risk, exposures to central counterparties, exposures to collective investment undertakings, high exposures, reporting

large exposure.[56] France and South Africa have also established, conforming to Basel Committee recommendations, a prudential framework relating to systemic institutions that impose additional requirements on them.[57]

Pillar 2 of Basel III, relating to the supervisory process, has also been transposed into the French and South African prudential legal frameworks. In both cases, it is considered compliant with Basel III requirements.[58] This pillar comprises four key principles, and supplementary requirements, relating to banks' internal control and supervisory evaluation. Concerning the overall responsibility of the banks, in South Africa requirements relating to internal control, board management, report monitoring and other mechanisms used in the control process have been incorporated into the regulation relating to the process of corporate governance,[59] and, in France, are based on Article 511-41-1-B of the Monetary and Financial Code and detailed in a decree of 3 November 2014.[60] In terms of the supervisory process, the Financial Sector Regulation Act[61] provides the framework for the Prudential Authority (that monitors deposit-taking institutions in South Africa), which includes the requirements set out in Pillar 2. In France, the supervisory provisions are contained within a decree that has transposed the requirements of Directive 2013/36/EU,[62] and additional recommendations may be found in the guidelines provided by the European Banking Authority on common procedures and methodologies for the supervisory review and evaluation process (SREP) of December 2014.[63]

In both France and South Africa,[64] the implementation of Pillar 3 of Basel III, relating to requirements as to disclosure, has been deemed compliant by the Basel Committee. Consequently, both countries have the same rules in this regard. In South Africa, these requirements are detailed in regulation 43, entitled "Public disclosure". In France, the content of Pillar 3 is contained in the European Regulation 575/2013.[65]

and disclosure requirements, and Regulation (EU) No 648/2012 (10); Regulation relating to Banks (n 36) reg 38(15).

56 art 387 et seq of Regulation (EU) No 575/2013.

57 art L511-41-1-A of the Monetary and Financial Code, and Regulations relating to Banks (n 36) reg 38(8)*(e)*(vi.)

58 BCBS (n 41) 18 and BCBS (n 47) 22.

59 Regulations relating to Banks (n 36) reg 39.

60 Decree of 3 November 2014 on the internal control of banking, payment services and investment services companies subject to the supervision of the *Autorité de Contrôle Prudentiel et de Résolution* (ACPR) who transposed the requirements from Directive 2013/36/EU.

61 Chapters 7, 9 and 10 of the Financial Sector Regulation Act 9 of 2017.

62 Decree of 3 November 2014 on the process of prudential supervision and risk assessment of banking service providers and investment firms other than portfolio management companies.

63 These requirements concern only the national supervisory body (ACPR in France) that does not monitor all credit institutions in the country. In 2013, the Single Supervisory Mechanism was created by the Members of the "Euro zone", who entrusted the direct supervision of the major credit institutions to the European Central Bank. Consequently, today the supervision of credit institutions in France is shared between the European Central Bank and the ACPR. For further information on the EU supervisory structure, see Partsch *Droit Bancaire et Financier Européen* (2016) 474–557.

64 BCBS (n 41) 18 and BCBS (n 47) 22.

65 art 431 et seq of Regulation (EU) No 575/2013.

The implementation of the content of the Basel standards today constitutes the majority of prudential requirements that apply in France and in South Africa. It contains a large number of macro- and micro-prudential mechanisms (capital adequacy, credit risk, operational risk, liquidity, systemic risk, supervisory process, disclosure, etc) that can be used to maintain soundness of banking institutions and banking systems. For this reason, there are today only a few other prudential requirements dealing with the stability of banking institutions, or the system itself, that do not issue from international standards. However, despite this implementation, there remain some differences between the South African and French legal frameworks.

3.3 *Differences that remain between national prudential requirements: beyond Basel III and national specificities*

There are three main types of differences that remain between the two national legal frameworks. The first type results from the implementation of Basel III, which is not strictly identical in the two countries. The second arises from some additional requirements that differ from one country to another. The last difference lies in the prudential requirements that apply to mutual and co-operative banks in both countries.

The differences resulting from the Basel III implementation may be explained by looking at three aspects.

First, Basel III is a minimum standard, which means that countries can go even further if they so wish. South Africa and France both opted to go even further with certain standards, and, as a consequence there are differences between their respective national requirements.[66] A good example of this is the level of capital ratio requirement. As mentioned above,[67] the Regulations relating to Banks in South Africa provide that the ratio should be no less than 8%, with a minimum of 4.5% of common equity Tier 1 capital and 6% of Tier 1 capital. However, in accordance with a directive of the South African Reserve Bank,[68] a higher level of prudential requirements than those defined by the Basel Committee (and consequently higher than the EU one) has become necessary. According to the new requirement in South Africa that has been applicable since January 2015, the minimum capital ratio cannot be less than 10% of Tier 1 capital and reserve funds, additional Tier 1 capital and reserve funds and Tier 2 capital and reserve funds to risk-weighted exposure, with a minimum of 6.5% of common equity Tier 1 capital and reserve funds and 8% of common equity Tier 1 capital and reserve funds and additional Tier 1 capital and reserve funds.[69] Consequently, in this respect, the level of requirements is higher in South Africa than in France.

66 For more information on the areas in which South Africa and France have gone beyond the Basel requirements, see BCBS (n 41) 34 and BCBS (n 47) 77.

67 See par 3.2 above at note 42 et seq.

68 Directive 5/2013 issued in terms of section 6(6) of the Banks Act, 1990 https://www.resbank.co.za/Lists/News%20and%20Publications/Attachments/5686/01%20D5%20of%202013.pdf.

69 Regulations relating to Banks (n 36) reg 38(9)*(a)*.

Secondly, differences remain because of the discretionary margin granted to Member States for the implementation of Basel Standards. For instance, the liquidity standards have been internationally harmonised, but "certain parameters [used to calibrate these standards] contain elements of national discretion to reflect jurisdiction-specific conditions".[70] Consequently, there are some differences between South Africa and France in the calibration of the liquidity standards.[71]

Finally, Basel III is a standard that has been developed without taking national specificities into consideration. One important difference between the banking system in France and in South Africa is the extent of their international presence. The French market is international, with major international activity, and four of the five major French banks (that represent 87% of market share)[72] have been defined as global systemically important institutions.[73] In South Africa, the banking system operates primarily in a domestic market, and has only domestic systemically important institutions, even though the share of foreign assets has risen since 2000 owing to an international recruitment of funds.[74] As mentioned earlier, both countries have a legal prudential framework that applies to systemic institutions. However, in practice, the frameworks cannot be identical due to their structural differences. Consequently, in France there are two different frameworks for systemically important institutions, one for "Other systemically important institutions", which are banking institutions presenting a systemic risk at national level, and one for the "Global Systemically Important Institutions" that present a risk for the international financial system. In South Africa, because there are no global systemically important institutions, the prudential requirements relating to systemic risk provide the only framework for all systemically important institutions.[75]

As mentioned earlier, there are only a few prudential requirements relating to banks in France and South Africa that lie outside the scope of Basel III (and consequently not derived from international standards). In both countries, some additional requirements in terms of capital or liquidity can be identified that are strictly national;[76] however, the list of these prudential requirements is short and the differences are minor.

As detailed above,[77] the scope for implementation of the Basel Accord in South Africa and in France is not the same. In France, it applies to all credit institutions, whereas in South Africa, it only applies to banks that are subject to the Banks Act. In South Africa, as mutual and co-operative banks lie outside this scope, they have

70 BCBS (n 27) 9.

71 See BCBS (n 41) 31–33 and BCBS "Assessment of Basel III LCR regulations – European Union" *Regulatory Consistency Programme (RCAP)* (2017) 40-42.

72 IMF (n 17) 32.

73 ACPR *Liste des Établissements d'importance systémique mondiale (EISM) au titre de l'exercice 2018 conformément aux dispositions de l'article L511-41-1 A VI du Code monétaire et financier.*

74 International Monetary Fund (IMF) *South Africa – Financial System Stability Assessment* (2014) 10 https://www.imf.org/external/pubs/ft/scr/2014/cr14340.pdf.

75 Regulations relating to Banks (n 36) reg 38(8)*(e)*(vi).

76 For example, in South Africa, banks are required to comply with the capital ratio and to have a minimum amount of funds – see s 70(2)*(a)* of the Banks Act 94 of 1990.

77 par 2.2.

a prudential framework that differs from the Banks Act. The position thus differs from that in France, even though some similarities in the structure can be found. This difference in framework is the main difference between the two countries and deserves to be explored further.

Like all other banks, mutual banks and co-operative banks in South Africa must comply with capital adequacy requirements, liquidity standards, large exposure, disclosure requirements and a supervisory process. However, as mentioned above, these requirements are less stringent than for the other banks.

The prudential framework for mutual banks is based on Chapter 5 of the Mutual Banks Act 124 of 1993 and detailed in the Regulations Relating to Mutual Banks.[78] The requirements to which they must adhere are closer to those defined for banks under the Banks Act than those applying to co-operative banks. According to these texts, they have to comply with a risk-weighted capital ratio, fixed at 10% of primary and secondary share capital and the primary and secondary unimpaired reserve funds risk weight.[79] Although the ratio appears similar to the one provided by Basel III that applies to the other banks, the methodology used is actually very similar to the one defined in Basel I, which consists of categorising the assets and off-balance sheet activities according to their risk profiles in order to weight the capital. Mutual banks are subject to this simplified approach with a weighting of 0, 5, 10, 20, 50 or 100% that are the six categories.[80] In addition to the prudential ratio, mutual banks are subject to liquidity requirements which do not take the form of two ratios but rather an amount of liquid assets that mutual banks must hold.[81] They also must comply with requirements relating to large exposure,[82] control[83] and a supervisory process[84] which are less stringent than those required by the Banks Act and the regulations issued under it.

The prudential framework for co-operative banks is also less stringent than the framework of the Banks Act. It is contained in Chapter 3 of the Co-operative Banks Act 40 of 2007 and the regulations[85] and rules[86] relating to it. According to these regulations, co-operative banks must adhere to the following requirements: they have to maintain a minimum capital adequacy ratio of 6% of the total of their assets, a minimum loan loss provision for delinquent loans, hold no deposit from any one member or related person that exceeds the lesser of either 10% of the total assets held or 25% of the capital of the co-operative bank, and comply with different liquidity requirements relating to the type of assets, maximum amount of cash

78 GN R 2508 in *GG* 15381 of 28 December 1993.
79 Minimum Capital and Reserve Funds to be Maintained by Mutual Banks GN R 1007 in *GG* 22738 of 5 October 2001.
80 Regulations relating to Mutual Banks (n 78) reg 23(6)*(p)*.
81 s 50 of the Mutual Banks Act 124 of 1993.
82 s 51 of the Mutual Banks Act 124 of 1993.
83 s 4, 5 & 53 of the Mutual Banks Act 124 of 1993.
84 They are supervised by the Prudential Authority.
85 Regulations in terms of section 86 GN R712 in *GG* 32357 of 1 July 2009.
86 Supervisors' rules GN 5 in *GG* 32860 of 12 January 2010; Co-operative Banks Act rules for representative bodies and support organisations GN 72 in *GG* 38441 of 6 February 2015.

donation and use of the deposits.[87] They are also subject to reporting requirements to the Minister on a two-monthly and quarterly basis.[88]

4 Conclusion and implications of the comparison of the legal frameworks in France and South Africa

Prudential banking regulations in France and South Africa share many similarities. Although the national (or regional in the case of France) sources of prudential requirements are bound to differ owing to the different legal and political traditions, their content, directly influenced by the Basel Committee's international standards, does not. Despite a differentiated approach in South Africa, where there is a different framework for certain banking institutions that form a minority share of the banking market,[89] the national prudential regulation that applies to banks comprises norms and mechanisms relating to the management of assets, capital and risks, in order to control and supervise the activities of banks so as to maintain their financial soundness. For the majority of banks, this framework is built on a risk-weighted capital adequacy ratio, liquidity ratios, additional capital buffers, leverage ratio, systemic risk framework, disclosure requirements and a supervisory process, mechanisms that are a direct result of the implementation of Basel III. Although the implementation does not produce an identical national prudential framework, it clearly leads to close similarity in relation to the substantive content of national prudential requirements.

Consequently, this comparative study, in addition to indicating that both prudential frameworks have more similarities than differences, notwithstanding the different make-up of their banking systems and their legal traditions, also reflects the influence of the standards developed by the Basel Committee and the phenomenon of harmonisation generated by their incorporation into national laws. Even in the absence of legal authority and despite its "soft law" character, the Basel Accord has had a direct effect on the conception of national prudential banking regulation and contributes to a process of worldwide harmonisation (even convergence) of the prudential requirements. The influence of Basel standards and the ensuing phenomenon of harmonisation have contributed to a number of discussions on the theory of international law regarding the "internationalisation" of banking law and the legal significance of "soft law" international standards,[90] fuelling the debate on the emergence of new theories on international law.[91]

[87] Regulations in terms of section 86 (n 85) part 4(4)(1).

[88] Regulations in terms of section 86 (n 85) part 7.

[89] In 2017, in South Africa, co-operative banks represented assets worth approximately 338 million ZAR and mutual banks represented assets worth 5380 million ZAR while the total assets of the entire banking system was estimated at 5157 billion ZAR. See FSI (n 16) 70 and South African Reserve Bank *Bank Supervision Department Annual Report 2017* (2018) 44.

[90] On international standards, legal significance and the use of "soft law", see Brummer *Soft Law and the Global Financial System* (2015).

[91] These new theories relate to transnational law, global administrative law and the globalisation of law. On the Basel Accord and these new theories, see Barr & Miller "Global administrative law: the view from Basel" 2006 *EJIL* 17 No 1.

On a practical level, there has also been much debate concerning the correlation of the Basel Accord and the issues faced by certain national banking systems.[92] Although the influence of international standards is a good thing, allowing the prudential framework to be adapted to new issues that arise from the globalisation of the banking system and the guaranteeing of fair competition between banks in different countries, questions emerge concerning that framework's compatibility with the specificities of each national banking system. The European Union has a tendency to implement international standards by the mechanism of total harmonisation within its legal order even if their intended purpose is not necessarily pertinent to the EU and even if they were not developed to take into account the specificities of the EU.[93] Basel III is a good illustration of this process. In South Africa, the implementation of Basel III has generated some concerns for the smaller banks especially. For example, they have more difficulty in evaluating their risks so as to conform with the standard set by Basel III – more particularly as they do not take the same risks for which the Basel Accord was developed. So even if the Basel Accord has proved to be an advancement for prudential regulation and for guaranteeing international financial stability, attention should be paid to its suitability for the institutions it regulates in order to avoid counterproductive results.

[92] For the challenges that it can represent, especially for developing countries, see Jones & Zeitz "The limits of globalizing Basel banking standards" 2017 *Journal of Financial Regulation* 3; Ferreira, Jenkinson & Wilson "From Basel I to Basel III: sequencing implementation in developing economies" 2019 *IMF Working Paper* WP/19/127.

[93] Partsch (n 63) 91.

The powers of the debt restructuring court under the National Credit Act: Tampering with interest and fees

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Abstract

The National Credit Act 34 of 2005 ("NCA") has been ground-breaking credit legislation that presents a comprehensive overhaul of the framework for credit regulation in South Africa. The NCA aims to open up access to credit by creating a sustainable, fair and accessible credit market in which consumers are adequately protected. Despite its strong consumer-protection tenor the purposes of the NCA are, *inter alia*, directed at "balancing" the rights of credit providers and consumers. The Act not only seeks to prevent over-indebtedness of natural persons but is particularly progressive in respect of the novel debt relief measures it extends to over-indebted consumers as captured in its provisions pertaining to debt review. As pointed out in this contribution, the debt review process seeks to enable over-indebted consumers to be afforded a breathing space through restructuring of their credit agreement debt, either by agreement or by the court, subject to the NCA's stated purpose of placing priority on the eventual satisfaction of all responsibly incurred credit agreements. The focus of this contribution is on the statutorily proscribed debt restructuring powers of the courts as captured in section 86(7)*(c)* read with section 87 of the NCA and the recent extension of these powers by the National Credit Amendment Act 7 of 2019 to provide the court with more intrusive powers to enable writing off of interest, fees and charges.

* * * * *

1 Introduction

The National Credit Act 34 of 2005 ("NCA") has been ground-breaking credit legislation that presents a comprehensive overhaul of the framework for credit regulation in South Africa. Its wide-ranging purposes are "to promote and advance the social and economic welfare of South Africans, promote a fair, transparent, competitive, sustainable, responsible, efficient, effective and accessible credit market and industry, and to protect consumers" and, *inter alia*, include the following:

> "…
>
> *(d)* promoting equity in the credit market by balancing the respective rights and responsibilities of credit providers and consumers;
>
> ….
>
> *(g)* addressing and preventing over-indebtedness of consumers, and providing mechanisms for resolving over-indebtedness based on the principle of satisfaction by the consumer of all responsible financial obligations;
>
> ….

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> *(i)* providing for a consistent and harmonised system of debt restructuring, enforcement and judgment, which places priority on the eventual satisfaction of all responsible consumer obligations under credit agreements."

The NCA thus aims at creating a sustainable credit market by balancing the rights of credit providers and consumers, albeit that it introduced an extensive range of measures to protect credit consumers given the lack of appropriate consumer protection in the previous credit regulation dispensation.[1] Amongst the many novel measures the NCA introduced for purposes of extending greater protection to credit consumers is the alleviation afforded to over-indebted[2] natural persons through the debt review process captured in section 86 of the NCA.[3] In brief, this process enables an over-indebted consumer to apply to a debt counsellor for debt review with the aim of eventually being declared formally over-indebted and having his credit agreement debt restructured by a debt restructuring court.[4]

Where a debt counsellor finds a consumer over-indebted, the debt counsellor will make a proposal for re-arrangement (restructuring)[5] of the consumer's credit agreement debt.[6] Where all the consumer's credit providers agree to the debt re-arrangement proposal, the NCA requires the terms of such re-arrangement to be captured in a consent order.[7] In such an instance, where all the credit providers are in agreement with the debt restructuring proposal by the debt counsellor, the court will generally not involve itself with the terms on which the debt is restructured and will merely make an order confirming such arrangement. This has the consequence that the parties can agree to various methods of debt restructuring and could arguably even agree to reduced or zero interest rates and/or reduction or write-off of fees.[8] More often than not, however, the position will be that not all credit providers agree to the proposed debt re-arrangement, in which event the proposal must be referred to court for a hearing. Such a referral is done by means of an application consisting of a notice of motion and founding affidavit and supporting documentation by means of which the relevant information is placed before the

[1] Regarding the lack of appropriate consumer protection in the previous credit dispensation comprising of the Usury Act 73 of 1968 and the Credit Agreements Act 75 of 1980, see the Department of Trade and Industry South Africa *Consumer Credit Law Reform: Policy Framework for Consumer Credit* Aug 2004 par 2.10–2.14 and 4.1–4.4 and Kelly-Louw (assisted by Stoop) *Consumer Credit Regulation in South Africa* (2012) 7–17.

[2] See s 79 of the NCA, where the test for over-indebtedness for purposes of the Act is set out.

[3] The debt relief measures in the Act do not apply to consumers who are legal persons, see s 78(1).

[4] For a detailed explanation of the debt review process, see Van Heerden in Scholtz (ed) *Guide to the National Credit Act* (2008) Ch 11 par 11.3; Van Heerden & Coetzee "Unintentionally trapped by debt review: Procedural inadequacies in the *National Credit Act 34 of 2005* relating to withdrawal from the debt review process" 2019 (22) *PER/PELJ* 1 par 2 (DOI http://dx.doi.org/10.17159/1727-3781/2019/v22i0a6966).

[5] The concepts "re-arrangement" and "restructuring" will be used interchangeably in this contribution.

[6] s 86(7)*(c)* of the NCA.

[7] s 86(8)*(a)* read with s 138 of the NCA.

[8] The provisions of s 86(7)*(c)*(i) and (ii) apply only in the context of a debt restructuring order made in terms of s 86(7)*(c)*.

court.[9] At this hearing, the court is then tasked to consider whether the consumer must be declared over-indebted, and, if so, how his debt should be restructured. The debt restructuring court does not have carte blanche to restructure the consumer's credit agreement debt and its restructuring powers are proscribed by statute.

Once the consumer's debt is restructured, he must then make payments in accordance with the court order to a payment distribution agent. The agent allocates the payments, generally on a monthly basis, to the consumer's credit providers who are parties to the debt restructuring order.[10] In *FirstRand Bank Ltd v Evans*[11] the court stated that the effect of a debt re-arrangement order is not to alter the debtor's contractual obligations to the creditor, but that it merely precludes the creditor from pursuing its contractual rights, for as long as the debtor is complying with the provisions of the debt re-arrangement order. As long as the consumer makes payments in terms of the debt restructuring order, his credit providers are barred by section 88(3)[12] of the NCA from enforcing the credit agreement. Should the consumer default, however, the moratorium against enforcement lapses and the credit provider is entitled to enforce the original terms of the credit agreement without the need to provide any pre-litigation notice under the NCA to the consumer.[13]

The purpose of this contribution is to consider the powers of the debt restructuring court as provided for in the NCA in those instances where not all credit providers have agreed to the debt counsellor's proposal for debt restructuring. This will be done with reference to applicable provisions of the NCA, relevant case law and recent developments introduced by the National Credit Amendment Act 7 of 2019.

9 The application must conform to Magistrates' Courts Rule 55. See *National Credit Regulator v Nedbank Ltd* 2009 (6) SA 295 (GNP) 46, confirmed on appeal in *Nedbank Ltd v National Credit Regulator* 2011 (3) SA 581 (SCA) par 26; *FirstRand Bank Ltd v Barnard* 2015 JDR 1614 (GP) par 15 and 17; and *Driskel v Maseko* [2017] ZAFSHC 150 (24 August 2017) par 42.

10 See the definition of payment distribution agent in s 1 of the NCA as introduced by s 1 of the National Credit Amendment Act 19 of 2014. See also s 44A and s 46 as introduced by ss 12 and 14 of the aforementioned Amendment Act respectively and reg 10A of the Regulations to the National Credit Act published in GNR489 in *GG* 28864 of 31 May 2006 as amended by GN R202 in *GG* 38557 of 13 March 2015 (which introduced the regulations regarding payment distribution agents).

11 2011 (4) SA 597 (KZD) par 35. See also *Nedbank Ltd v Norris* 2016 (3) SA 568 (ECP) par 44 and *FirstRand Bank Ltd v McLachlan* [2020] ZASCA 31 (1 April 2020) par 12.

12 s 88(3) provides as follows: "Subject to section 86(9) and (10), a credit provider who receives notice of court proceedings contemplated in section 83 or 85, or notice in terms of section 86(4)*(b)*(i), may not exercise or enforce by litigation or other judicial process any right or security under that credit agreement until – *(a)* the consumer is in default under the credit agreement; and *(b)* one of the following has occurred: (i) An event contemplated in subsection (1)*(a)* through *(c)*; or (ii) the consumer defaults on any obligation in terms of a re-arrangement agreed between the consumer and credit providers, or ordered by a court or the Tribunal." The events contemplated in s 88(1)*(a)* to *(c)* are as follows: "*(a)* The debt counsellor rejects the application and the prescribed time period for direct filing in terms of section 86(9) has expired without the consumer having so applied; *(b)* the court has determined that the consumer is not over-indebted, or has rejected a debt counsellor's proposal or the consumer's application; or *(c)* a court having made an order or the consumer and credit providers having made an agreement re-arranging the consumer's obligations, all the consumer's obligations under the credit agreements as re-arranged are fulfilled, unless the consumer fulfilled the obligations by way of a consolidation agreement."

13 See *Ferris v FirstRand Bank Ltd* 2014 (3) SA 39 (CC) par 14. The pre-litigation notices otherwise required by the Act are set out in s 129(1)*(a)* and s 86(10) respectively.

The focus will be on the debt restructuring court's power to tamper with interest and other fees and charges and to consider the impact of the Amendment Act on this power. Throughout, reference will be made to the magistrate's court's debt restructuring powers, but it should be borne in mind that, since 13 March 2015, the National Consumer Tribunal may also make debt restructuring orders when it declares a credit agreement reckless as contemplated in section 80(1)*(b)*(ii) of the NCA. This discussion is therefore also relevant to the debt restructuring powers of that Tribunal.[14]

2 The powers of the debt restructuring court as originally provided for in the NCA

2.1 *Section 87*

The powers of the debt restructuring court, which will generally always be a magistrate's court,[15] are set out in section 86(7)*(c)*(ii) read with section 87 of the NCA. Section 87 is titled "Magistrate's Court may re-arrange consumer's obligations" and deals with the hearing of an application for debt restructuring. It provides that where a debt counsellor makes a proposal to the magistrate's court for restructuring of a consumer's credit agreement debt, the magistrate's court is obliged to conduct a "hearing". At such hearing the court must have regard to the debt restructuring proposal and the information placed before the court as well as the consumer's "financial means, prospects and obligations".[16] The court may then either reject the application for debt restructuring, or it may make an order declaring any of the consumer's credit agreements as reckless credit and provide redress in that regard as contemplated in section 83(2) or (3) of the NCA; or it

[14] See the amendment to s 83 as per s 25 of the National Credit Amendment Act 19 of 2014. Where a credit agreement has been declared reckless as per s 80(1)*(b)*(ii) the NCA affords debt relief by means of an order that can be made in accordance with s 83(3) which includes suspension of the specific reckless credit agreement and restructuring of the consumer's other credit agreement debt.

[15] Without ousting the jurisdiction of the High Court to deal with debt review matters – see *Standard Bank of South Africa Ltd v Panayiotts* 2009 (3) SA 363 (W). It is to be noted though that in practice high courts do not engage in debt restructuring in terms of s 86(7)*(c)*(ii) despite the fact that their jurisdiction to do so has not been ousted.

[16] The concept "financial means, prospects and obligations" is defined in s 78(3) of the NCA and includes: "*(a)* income, or any right to receive income, regardless of the source, frequency or regularity of that income, other than income that the consumer or prospective consumer receives, has a right to receive, or holds in trust for another person; *(b)* the financial means, prospects and obligations of any other adult person within the consumer's immediate family or household, to the extent that the consumer, or prospective consumer, and that other person customarily – (i) share their respective financial means; and (ii) mutually bear their respective financial obligations; and *(c)* if the consumer has or had a commercial purpose for applying for or entering into a particular credit agreement, the reasonably estimated future revenue flow from that business purpose." See also the *Panayiotts* case (n 15) 366E–F, where the court held that "financial means" include not only income and expenses but also assets and liabilities. The court further held that "prospects" include prospects of improvements to the consumer's financial position, such as increases and even the liquidating of assets. At 366G the court held that in the case of credit agreements where goods are involved, financial means and prospects must include the prospect of selling the goods in order to reduce the consumer's over-indebtedness.

may re-arrange the consumer's obligations "in any manner contemplated in section 86(7)*(c)*(ii)". Alternatively it may make both the aforesaid orders.[17] Significantly, the debt restructuring court is not required merely to "rubber stamp" the debt counsellor's proposal but it has to consider such proposal and, if not suitable,[18] it may reject the proposal and substitute its terms with more suitable terms. If, at this stage, there are still some credit providers who are not in agreement with the debt restructuring terms contained in the proposal or modified by the court, they have the right to object to them, but eventually the magistrate's court can nevertheless "cram down" the debt restructuring terms it deems appropriate on these credit providers by means of a debt restructuring order. Should a credit provider be of the view that the magistrate erred in making the debt restructuring order or that the magistrate acted irregularly during the section 87 hearing, the matter may be taken on appeal or review to the High Court.

2.2 *Judicial restructuring of credit agreement debt*

Debt restructuring powers in terms of section 86(7)(c)(ii) as originally enacted

In its original format prior to its recent amendment[19] section 86(7)*(c)*(ii) provided that the magistrate's court could re-arrange the consumer's credit agreement obligations by:

> "*(aa)* extending the period of the agreement and reducing the amount of each payment due accordingly;
>
> *(bb)* postponing during a specified period the dates on which payments are due under the agreement;
>
> *(cc)* extending the period of the agreement and postponing during a specified period the dates on which payments are due under the agreement; or
>
> *(dd)* recalculating the consumer's obligations because of contraventions of Part A or B of Chapter 5, or Part A of Chapter 6 [of the NCA]."

These are statutory powers contained in a *lex specialis*, which means that the magistrate's court, as a creature of statute possessing no inherent jurisdiction, would have to adhere to such powers and would not be able to deviate from the provisions of section 86(7)*(c)*(ii) in making the debt restructuring order.[20] Although the magistrate's court is given discretion as to whether to make the order or not, it does not have any discretion as to the restructuring methodology to be applied. The implication is further that the debt counsellor's proposal should also make provision for restructuring of the debt only in the terms permitted by section 86(7)*(c)*(ii) and that, in those instances where the debt counsellor's proposal deviates from the

17 s 87(1)*(a)* and *(b)*.

18 The NCA does not lay down any prescriptions regarding what requirements such a proposal should meet. It has been held that the agreement should be "economically rational" – see *FirstRand Bank Ltd v Seyffert* 2010 (6) SA 429 (GSJ), confirmed on appeal in *Seyffert and Another v FirstRand Bank Ltd* 2012 (6) SA 581 (SCA).

19 See the discussion of the amendment introduced by the National Credit Amendment Act 7 of 2019 in par 4 below.

20 See *National Credit Regulator v Nedbank* (n 9).

restructuring terms permitted by the aforesaid subsection, the court would not be able to give effect to those parts of the proposal. In essence, the debt restructuring court is limited to the powers given to it by section 86(7)*(c)*(ii). One accordingly needs to consider how these powers translate on a practical level.

The practical application of these debt restructuring powers can best be explained if one considers the example of a consumer who entered into a credit agreement with a credit provider in terms whereof he borrowed R24 000 to be repaid in 12 monthly instalments of R2 000 each together with interest at a rate of 10% per year together with other costs of credit as envisaged by section 101 of the NCA, namely an initiation fee, a service fee, cost of credit insurance, default administration charges and collection costs. Suppose the consumer becomes over-indebted after 6 months into the agreement and becomes unable to repay the debt on the terms as agreed (without reckless credit granting). He applies for debt review, his credit provider objects to the debt counsellor's debt restructuring proposal and the matter is referred to court for an order as contemplated in section 87. The court finds the consumer over-indebted, declares him as such and proceeds to restructure his debt (either in accordance with the debt counsellor's proposal or on other terms that the court deems more suitable based on the facts of the particular matter). The court is bound by the provisions of section 86(7)*(c)*, which means the court can restructure the debt only as follows:

(a) by extending the remaining 6 months of the contract (to, for example, 12 months) and reducing the amount of each payment due accordingly (thus providing that the consumer pays an instalment of R1 000 together with interest and other costs as applicable); or

(b) by postponing (note that the NCA does not use the term "suspending" here although it is used elsewhere in the Act)[21] during a specified period the dates on which payments are due (for example, if the payments were due on the first day of each month they can then be postponed to the last day of each month);

(c) by combining the aforementioned two restructuring approaches, thus extending the period of repayment, reducing the monthly instalment and also postponing the dates on which the monthly instalment has to be paid; or

[21] See s 84 of the Act, which specifically deals with a "suspension" in relation to reckless credit and sets out the effect of such suspension. It is submitted that had the legislature intended the word "postponing" in s 86(7)*(c)*(ii)*(bb)* to mean a "suspension" it would have said so – given that the latter term is indeed used in the Act. Consequently, the inference is that "postponing" cannot be equated to "suspending" for purposes of the NCA.

(d) by recalculating the consumer's obligations because of contraventions of the Act as stipulated in section 86(7)*(c)*(ii)*(dd)*[22] which would have the effect of reducing[23] the amount owed by the consumer.

It should be noted, however, that section 86(7)*(c)*(ii) contains no specific provision enabling the court to tamper with interest and the cost of credit as a means to restructure the consumer's credit agreement debt and afford him debt relief. As pointed out above the NCA provides in section 3(i) *inter alia* for "a consistent and harmonised system of debt restructuring … which places priority on the *eventual satisfaction* of all responsible consumer obligations under credit agreements".[24] As such the NCA makes no provision for the discharge of debt[25] at any stage during the process of debt review and subsequent debt restructuring. The consumer thus has to repay all his debt albeit in terms that afford him debt relief by providing him some "breathing space" and in some instances taking account of contraventions of the NCA that added to his debt burden. Once the consumer has repaid the debt in accordance with the terms of the debt restructuring order, only then is he entitled to a clearance certificate from the debt counsellor as contemplated in section 71 of the Act.[26] The important point here is that, apart from the exception made by section 71 in relation to long-term credit agreements, the consumer cannot exit the debt review process prior to making all the payments as required in terms of the debt restructuring order.[27]

22 Part A of chapter 5 the Act provides for unlawful credit agreements (s 89); unlawful provisions of credit agreements (s 90); prohibition of unlawful provisions in credit agreements and in supplementary agreements (s 91). Part B provides for pre-agreement disclosure (s 92); the form of credit agreements (s 93); liability for lost or stolen cards or other identification devices (s 94); changes, deferrals and waivers (s 95); address for notice (s 96); disclosure by the consumer of the location of goods (s 97); agreement attached to substituted goods (s 98); and obligations of pawn brokers (s 99).

23 If the contravention relates to an unlawful agreement the effect may even be that the court can in some instances declare that the consumer does not owe the credit provider any further money and that any money paid to the credit provider by the consumer should be repaid to the latter. The reason is that the particular court must declare the unlawful credit agreement void. See s 89(5)*(a)*. See also Otto & Renke in Scholtz (ed) (n 4) par 9.3.4.1.

24 Author's emphasis.

25 Parties are, however, free to provide a discharge to the other party to the credit agreement.

26 s 71 was amended by s 8 of the National Credit Amendment Act 19 of 2014. Pertinent for purposes of this contribution is s 71(1), which provides that a consumer whose debt has been re-arranged in terms of Part D of Chapter 4 "must be issued with a clearance certificate by a debt counsellor within seven days after the consumer has – *(a)* satisfied all the obligations under every credit agreement that was subject to that debt re-arrangement order or agreement, in accordance with that order or agreement; or (*b*) demonstrated – (i) financial ability to satisfy the future obligations in terms of the rearrangement order or agreement under – *(aa)* a mortgage agreement which secures a credit agreement for the purchase or improvement of immovable property; or *(bb)* any long term agreement as may be prescribed; (ii) that there are no arrears in the re-arranged agreements contemplated in subparagraph (i); and (iii) that all obligations under every credit agreement included in the re-arrangement order or agreement, other than those contemplated in subparagraph (i), have been settled in full."

27 See Van Heerden & Coetzee (n 4) 1.

Note should also be taken that, over the years, certain informal guidelines have been developed by so-called debt review "task teams" comprising of various industry players to lay down maximum terms over which the repayment of the debt in terms of a restructured credit agreement may be spread (as contemplated in section 86(7)*(c)*(ii)*(aa)*). For example: for mortgages, the extension limit is up to 240 months from the date of restructuring to a maximum repayment term of 360 months from the inception of the loan; and for vehicle asset finance in respect of private vehicles it is up to 1.5 times the contractual term from inception of the relevant credit agreement subject to an 84 months' limit.[28] Accordingly, debt counsellors will generally stay within the parameters of these informal guidelines when they draft debt restructuring proposals, and, as can be seen from the aforementioned examples, depending on the over-indebted consumer's financial position, the debt relief that is afforded to him may be for shorter or longer periods not exceeding the maximum limit in the task team agreements. Although these task team agreements are not binding on the courts, it can be expected that courts will generally not go beyond these industry-agreed extensions of the period of the agreement, the reason being that an extension which is too long may compromise the economic viability of the debt restructuring.

Case law

Over the years, the question whether the debt restructuring court could tamper with interest[29] has been dealt with in a number of cases that were mainly concerned with the power provided for in section 86(7)*(c)*(ii)*(aa)* where the period of the agreement is extended and the amount of each payment is reduced accordingly. The first reported case in this regard was *SA Taxi Securitisation (Pty) Ltd v Lennard*,[30] where the magistrate who restructured the consumer's debt did so by reducing the amount of each monthly payment and also ordered that the interest rate in terms of the credit agreement be reduced from 25% as originally agreed, to 15.5%. On appeal to the High Court, it was held that a magistrate's court does not have the

[28] See Debt Review Task Team Agreements, Circular 2 of 2015 (January 2015): Debt Review Task Team Agreements of 2010 Guidelines available at https://www/ncr.org.za (9-9-2020), where it is indicated that in October 2013 the NCR, through the Credit Industry Forum (CFI), initiated a review process of the Task Team Agreements of 2010 (TTA) to align them with the current debt review processes. It is further stated that the Task Team recommendations are largely directed at voluntary, non-statutory measures being put in place and are issued as guidelines by the NCR for implementation by all credit industry stakeholders. For the various extension limits see Annexure D: Industry agreed consensual debt restructuring rules to be deployed under section 48(1) industry code of conduct to combat over-indebtedness.

[29] "Interest" is not defined in the Act or in the Regulations. It is submitted that interest has a narrower meaning than "finance charges", which is also not defined in the Act but which, it is submitted, can be equated with the broader cumulative concept "cost of credit". Calculation of interest is dealt with in reg 40. Reg 42, Table A further stipulates the maximum prescribed interest rates for mortgage agreements, credit facilities, unsecured credit transactions, developmental credit agreements, short-term transactions, other credit agreements and incidental credit agreements.

[30] 2012 (2) SA 456 (ECG) par 6–10. See also *SA Taxi Securitisation (Pty) Ltd v Mongezi Moni* [2011] ZAECGHC 11 (28 April 2011) par 36.

power to make any order other than those listed in section 87(1)*(a)* and *(b)*, which includes the debt restructuring powers in section 86(7)*(c)*(ii). The court indicated that by tampering with the interest rate, the magistrate had acted outside his powers and that the wording of section 86(7)*(c)*(ii)*(aa)* is clear and unambiguous: it does not permit the magistrate's court to reduce the interest rate applicable to a credit agreement in order to provide debt relief to a consumer. In the result, the magistrate was held to have acted *ultra vires* by tampering with the interest and the debt restructuring order was set aside.

In *FirstRand Bank Ltd v Adams*[31] the court had to consider a summary judgment application. With reference to section 3(i) of the NCA the court remarked as follows:[32]

> "In short, the Act seeks to ensure that obligations which have been incurred by consumers, are discharged to the satisfaction of the credit provider, but, in circumstances where the interests of the consumer are considered; hence, instead of the consumer, such as in the present case losing their key asset, a restructuring mechanism is established and can be utilised to achieve a necessary balance between competing interests of [the] consumer [and the] credit provider."

The court held that there was no legislative basis on which an agreed interest rate could be reduced (unilaterally) pursuant to a debt restructuring proposal and stated:

> "A proposal can extend the time period for payment or the proposal can have a window in terms of which payments are not made, in order to give the consumer an opportunity to generate liquidity which will allow payments to resume. However, the proposal cannot be based on a reduction of the contracted interest rate."[33]

In *Du Plessis v Absa Bank Ltd*[34] the application before the court was one for rescission of judgment. The facts were, *inter alia*, that the magistrate who restructured the consumer's debt unilaterally reduced the interest rate from 6.5% to 0%. The court, however, indicated that the credit provider had to challenge the restructuring order on appeal or review if it was of the view that the alteration of the interest rate was done *ultra vires* the debt restructuring powers afforded by the NCA.

In *FirstRand Bank Ltd v Barnard*,[35] however, the debt counsellor also proposed a reduction of interest on a credit agreement from 15.7% to 10%. Again, the High Court held that the magistrate's court had no jurisdiction to reduce the interest rate.[36]

In *Nedbank Ltd v Norris*,[37] the debt restructuring magistrate re-arranged the consumer's credit agreement debt by providing for payment of a monthly amount of R289.15 over a 260-month period and by reducing the interest rate from 17.5% to 0% interest per month. When an application for rescission of the aforesaid order was brought by the consumer's credit providers, the magistrate hearing the rescission application refused to rescind the order and merely ordered that "the interest rates

31 2012 (4) SA 14 (WCC).
32 at 3.
33 at 15.
34 [2014] ZAGPPHC 951 (28 November 2014) par 15.
35 2015 JDR 1614 (GP) par 28.
36 par 29.
37 2016 (3) SA 568 (ECP).

on accounts relating to the Applicant are changed to the contractually agreed rates, effective from the date hereof".[38] On review, the High Court pointed out that section 86(7)*(c)*(ii) does not confer a power on a magistrate's court to reduce interest when it restructures a credit agreement debt. The court remarked that a debt re-arrangement order has, as its purpose, the rescheduling or re-arrangement of the obligations of the consumer in such a manner as to enable the consumer to meet his obligations to the credit provider. It therefore serves to mitigate the effect of over-indebtedness by making provision for payments within the existing means of the consumer and over an extended period. The court emphasised that a "re-arrangement order, does not, and cannot, extinguish the underlying contractual obligations". Accordingly, it held that the order reducing the consumer's contractual obligation to pay interest on the outstanding balance of the loan was *ultra vires* the NCA.[39] The court made an order *inter alia* declaring that a magistrate's court hearing a matter in terms of section 87(1) of the NCA does not enjoy jurisdiction to vary (by reduction or otherwise) a contractually agreed interest rate determined by a credit agreement.[40] A similar declaratory order regarding the lack of the debt restructuring court's powers to vary the contractually agreed upon interest rate was subsequently granted by the Western Cape High Court in *Nedbank Ltd v Jones*.[41]

Note should also be taken of *Sansom v Mars*,[42] where Allie J heard an appeal against the decision of the Worcester Magistrate's Court in which the magistrate (relying on *Nedbank Ltd v Jones* above) held that the magistrate's court does not have the authority under the NCA to grant an order in which a variation of interest rates from the initial credit agreement is sought, "even in circumstances where the variation of interest rates were mutually agreed by the consumer and credit provider".[43] The High Court, however, held that the debt review process is meant to mediate the competing interests of consumers and credit providers. Therefore, the court ordering a re-arrangement must consider the extent to which a proposal by a debt counsellor achieves a mediated settlement with due regard to the amount of the debt, the extent of the over-indebtedness, the financial means of the consumer and the period within which the debt will be amortised. The High Court stated that interest rates and ancillary costs form an integral part of indebtedness and ought to be taken into consideration when decisions are made on how payments can best be

38 par 7.

39 par 44. The court also emphasised that a magistrate's court is a creature of statute and cannot grant any orders other than those it is expressly authorised to grant – par 45.

40 It also ordered that a re-arrangement proposal in terms of s 86(7)*(c)* of the Act that contemplates a monthly instalment which is less than the monthly interest which accrues to the outstanding balance does not meet the purposes of the Act and a re-arrangement order incorporating such proposal is *ultra vires* the Act, and a magistrate's court has no jurisdiction to grant such an order. See par 51.

41 2017 (2) SA 473 (WCC). In the *Jones* case the magistrate did not reduce the interest rate to zero, but he "permanently" fixed it at a level that would render the debt incapable of ever being settled by the consumers. Following the *Norris* case, the court held that the debt restructuring order was *ultra vires* and of no force and effect. See also Van Niekerk & Seckel "Debt review: Points on orders" 2017 *De Rebus* 33.

42 [2017] ZAWCHC 112 (13 September 2017).

43 par 1.

re-arranged.[44] It observed further that, when a magistrate reduces the instalment due in terms of a credit agreement that is subject to debt review, "he or she consequentially also reduces the amount apportioned to the payment of interest without necessarily declaring a reduction in the interest rate".[45] The court indicated that "[t]he extended duration of the credit agreement would cause undue hardship to consumers and credit providers alike if it were not open to them to agree a reduced rate of interest for a specified time".[46] Allie J remarked that the NCA does not expressly impose an obligation on the magistrate's court to ensure that the reduced payment should cover the interest portion of the agreement, but stated that the purpose of the NCA as articulated in section 3, requires the court to decide the terms of a re-arrangement by embarking upon an exercise whereby the competing interests and needs of consumers and credit providers are mediated.[47] The court went on to note that, in the exercise of its power to extend the duration of the credit agreement and to vary the amount of instalments payable by the consumer, the magistrate's court "implicitly has the power to vary the rate of interest payable for the duration of the period of debt review".[48] Consequently, the court held as follows:

> "In my view the ratio in *Jones* is too broad and overarching and does not admit of exceptions. The order made in *Jones*' case fails to recognise that there are instances in which a magistrate, after duly applying his/her mind to all the relevant factors, will be required to vary the duration of the credit agreement, the instalments due and payable and interest that forms part of the indebtedness under the credit agreement to achieve an equitable and fair result for the parties."[49]

Subsequently, in *First National Bank A Division of FirstRand Bank Ltd v Da Silva*[50] the court, following the *Norris* judgment, also set aside a debt restructuring order where the magistrate reduced the interest rate.[51]

Although not a case in which the debt restructuring court tampered with the interest rate, note should be taken of the principled approach of the Supreme Court of Appeal in the recent case of *FirstRand Bank Ltd v McLachlan*.[52] This case concerned an appeal against a debt restructuring order where the magistrate had restructured the consumer's credit agreement debt but did not do so according to the debt counsellor's proposal. In respect of the particular loan agreement concerned, the monthly instalments were reduced to R8 185.50 per month and the period was extended to 261 months. The court apparently did not tamper with the interest rate. The effect of the debt review order, however, was that

44 par 9.

45 par 23. The court remarked at par 24: "Indeed, if interest rates could never be reduced in re-arrangement orders, consumers would find themselves unable to extinguish their indebtedness because they would be saddled with the same interest rate during the extended period as they would had the original credit agreement's instalments not been re-arranged."

46 par 25.

47 par 26.

48 par 29. Author's emphasis.

49 par 38.

50 [2019] ZAGPJHC 79 (7 February 2019).

51 See par 18–20.

52 [2020] ZASCA 31 (1 April 2020).

the monthly instalment would not even cover the monthly interest accruing on the outstanding balance. The consequence of this order was that the debt owing under the loan agreement had grown much larger since the granting of the debt review order. The Supreme Court of Appeal referred to the finding in *Nedbank Ltd v Jones*[53] (which, as indicated, was similar to the finding in *Nedbank Ltd v Norris*[54]) that "[a] re-arrangement proposal in terms of s 86(7)*(c)* of the National Credit Act that contemplates a monthly instalment which is less than the monthly interest which accrues on the outstanding balance does not meet the purposes of the National Credit Act. A re-arrangement order incorporating such a proposal is ultra vires the National Credit Act and the magistrate's court has no jurisdiction to grant such an order."[55] The Supreme Court of Appeal considered the merits of the aforesaid conclusion in *Jones*. It pointed out that the debt review court "is empowered to 're-arrange' (section 86(7)(*c*)(ii)) or 'restructure' (section 3(*i*)) the consumer's obligations under the credit agreement. *It is not empowered to alter or amend the obligation.*" It consequently also endorsed the finding in *Norris* that "a re-arrangement order does not, and cannot, extinguish the underlying contractual obligations".[56] The Supreme Court of Appeal stated further that, "in re-arranging the obligations, the debt review court is enjoined to do so with due deference to the legislative purpose articulated in section 3*(d)*, *(g)* and *(i)* of the NCA".[57] The court remarked that the point of departure in any re-arrangement must of necessity be the provisions of the NCA and, in particular, section 3. Where section 86(7)*(c)*(ii)*(aa)* "empowers a magistrate to re-arrange the debt repayment by extending the period and reducing the monthly instalments 'accordingly' it envisages a reduction in the monthly instalment, with a concomitant extension of the repayment period, which would have the effect that *all the obligations assumed under the credit agreement would be satisfied at the conclusion of the extended period*".[58] It indicated that the observation in *Seyffert and Another v FirstRand Bank Ltd*[59] about the debt review proposals being "devoid of economic rationality", and that it "would have left a substantial part of the debt unpaid" are equally apposite to the debt review order in this case.[60] Accordingly, a debt review order which does not result in the satisfaction of all responsible obligations assumed under the credit agreement during the repayment period does not meet the purposes of the NCA. The court held that a debt restructuring order where reduction of the monthly instalment was so substantial that it does not remotely cover the monthly interest due in terms of the order "does not serve to protect the interests of the consumer who would, at the end of the period, be left with a substantial debt which they would in all likelihood

[53] (n 41).
[54] (n 37).
[55] par 7.
[56] par 12 (author's emphasis).
[57] par 13. Regarding the contents of s 3*(d)*, *(g)* and *(i)* see par 1 above.
[58] par 15 (author's emphasis).
[59] 2012 (6) SA 581 (SCA).
[60] par 16–17.

be unable to pay". Following this line of reasoning the court held that the debt review order was *ultra vires* the provisions of the NCA and void *ab origine.*[61]

It accordingly appears that, in relation to the court's debt restructuring powers under section 86(7)*(c)*(ii)*(aa)*, there is general agreement in the case law that a debt restructuring court that unilaterally tampers with interest acts *ultra vires* the provisions of section 86(7)*(c)* of the NCA. It is submitted that the proposition by Allie J in *Sansom v Mars* that an order in terms of section 86(7)*(c)*(ii)*(aa)* necessarily implies that the magistrate can tamper with interest cannot be supported. This is because the effect of such an order is merely to spread out repayment of the amount owed by the consumer and although the effect would be that a smaller amount would then be payable every month (over a longer period), with the consequence that a lesser *amount* of interest is also paid each month, the position would still be that the interest *rate* would remain the same. Thus, instead of paying, for example 10% interest on an amount of R1 000 per month over a 10-month period, the consumer who has his debt restructured in terms of the NCA will still be paying 10% interest but on a smaller monthly amount over a longer period. Of important significance also is the endorsement by the Supreme Court of Appeal in the *McLachlan* case that any exercise of the debt restructuring court's powers has to occur with due deference to the purposes of the NCA as captured in section 3*(d)*, *(g)* and *(i)*.

2.3 *Changes introduced by the National Credit Amendment Act 7 of 2019*

It became clear, however, that the Department of Trade and Industry was eager to broaden the debt restructuring court's powers. This led to a draft amendment bill being published on 16 November 2012 that proposed the amendment of section 86(7)*(c)*(ii) by seeking to introduce a power for the debt restructuring court to suspend the accrual of interest for a period of up to five years.[62] Nothing, however, came of this bill and the powers of the debt restructuring court as provided for in section 86(7)*(c)*(ii), discussed above, have remained unaltered until the recent enactment of the National Credit Amendment Act 7 of 2019, which has yet to be put into effect.

In particular section 12*(b)* of the 2019 National Credit Amendment Act introduces a paragraph *(cc*A*)* to section 86(7)*(c)* allowing a magistrate's court to "[determine], *as prescribed,* the maximum rate of *interest, fees or other charges, excluding charges contemplated in section 101(1)(e)* [credit life insurance], under a credit agreement, for such a period as the magistrate's court deems fair and reasonable, but not exceeding the period contemplated in section 86A(6)(*d*)."[63] It appears that the aforementioned amendment is directed specifically at the court's

[61] par 18. Notably, the Supreme Court of Appeal further held (par 21–22) that where a debt restructuring order was rescinded on the basis that it was null and void, the rescission of such order is not appealable in terms of s 83*(b)* of the Magistrates' Courts Act because it was an interlocutory order which placed the parties back in the position that they were in prior to the granting of the re-arrangement order.

[62] National Credit Amendment Bill 2012 as published in *GG* 35876 on 16 November 2012.

[63] Author's emphasis. The reference to s 86A is to the new debt intervention procedure introduced by the 2019 National Credit Amendment Act.

powers to tamper with the interest rate when making a debt restructuring order and that it takes this tampering power even further by extending it also to fees or other charges. Notably the reference to section 86A(6)*(d)*, which deals with the new debt intervention process introduced by the 2019 Amendment Act, is to a five-year period.[64] In addition to the aforesaid amendment, the 2019 Amendment Act further introduces an accompanying amendment to section 171 of the NCA ("Regulations") to provide that the Minister must make regulations relating to orders that can be made by the magistrate's court and the Tribunal *inter alia* in respect of the new power contemplated in section 86(7)*(c)*(ii)*(cc*A*)*.[65]

As indicated above, currently the 2019 Amendment Act is not yet in operation and to date no regulations have been issued in relation to these new wide powers to tamper with interest, fees and other charges. Hence, courts cannot yet unilaterally apply the provisions of the new section 86(7)*(c)*(ii) to interest rates or fees or charges during debt restructuring. It should further be noted that the provisions of section 3*(i)* of the NCA that refer to the eventual satisfaction of his credit agreement debt by a consumer, have *not* been amended by the 2019 Amendment Act.

3 Discussion

It has been said on many occasions that credit is the lifeblood of an economy. Consequently, legislation affecting the provision of credit should aspire to enable as many consumers as possible to access credit. The main reason why a person would enter into the business of providing credit would, however, not only be to enable access to credit but, probably primarily, also to make profit from it. This profit is the *quid pro quo* for the deferral of the payment of the amount advanced and the risks that the credit provider takes in extending credit to consumers, and is, of course, derived mainly from the interest that the credit provider is allowed to levy and some fees it may charge. In alignment with the principle *pacta servanda sunt* parties must abide by the terms of the credit agreement concluded by them. Practically this means that the consumer must repay the credit provider the monies advanced to him on the terms as originally agreed in the credit agreement, including interest, fees and other charges.

The NCA, however, through the debt restructuring of credit agreement debt pursuant to a debt review where a consumer has been determined to be over-indebted, allows for some deviation from this principle – but only to the extent that the manner of repayment is changed. This restructuring, however, remains subject to the requirement contemplated in section 3*(i)* that payment indeed must lead to the eventual satisfaction of all the consumer's responsible debt obligations.

[64] s 86A(6)*(d)*, as introduced by s 13 of the 2019 National Credit Amendment Act, allows for the re-arrangement of the debt obligations of a debt intervention applicant over a period of five years or such longer period as may be prescribed. The debt intervention procedure will apply to consumers who earn R7 000 or less per month and who owe no more than R50 000 in unsecured debt. See further Coetzee "An opportunity for no income no asset (NINA) debtors to get out of check? – An evaluation of the proposed debt intervention measure" 2018 *THRHR* 593.

[65] See s 29*(a)* of the 2019 National Credit Amendment Act.

It may consequently be asked what exactly the new section 86(7)*(c)*(ii)*(cc*A*)* seeks to achieve. Clearly, it has in mind that the debt restructuring court will be able to tamper with the interest rate applicable to a credit agreement unilaterally and that it may determine the "maximum rate"[66] applicable to a restructured credit agreement. In fact, it goes much further than that as the debt restructuring court will now be able also to tamper with the maximum rate of fees and other charges (except credit life insurance). Having regard to the provisions of section 101 of the NCA pertaining to cost of credit, it thus appears that, in addition to tampering with the maximum rate of interest levied in respect of a credit agreement, the court will also be able to tamper with the maximum rate pertaining to the following fees and charges: the initiation fee,[67] the service fee,[68] default administration charges[69] and collection costs.[70] The maximum rates that a credit provider is allowed to charge on interest and on fees such as the initiation fee, services fee, default administration charges and collection costs are prescribed by the regulations to the NCA.[71] In addition, it must be borne in mind that certain fees and charges as allowed by section 102 can also be included in the principal debt. In this regard, section 102 provides that:

66 The NCA only caps maximum rates of interest and caps maximum amounts that may be charged in relation to other fees as indicated below. It does not set out minimum limits in this regard, hence the reference to "maximum rate" in s 86(7)*(c)*(ii)*(cc*A*)*.

67 "Initiation fee" as defined in s 1 of the NCA means "a fee in respect of costs of initiating a credit agreement, and (i) charged to the consumer by the credit provider; or (ii) paid to the credit provider by the consumer upon entering into the credit agreement." Reg 42, Table B sets out the maximum initiation fee that may be charged in respect of mortgage agreements, credit facilities, unsecured credit transactions, developmental credit agreements, short-term credit transactions, other credit agreements and incidental credit agreements.

68 "Service fee" means "a fee that may be charged periodically by a credit provider in connection with the routine administration cost of maintaining a credit agreement".

69 "Default administration charge" is defined to mean a "charge that may be imposed by a credit provider to cover administration costs incurred as a result of a consumer on an obligation under a credit agreement". In terms of s 101*(f)*(i) and (ii) the costs of default administration charges may not exceed the prescribed maximum for the category of credit agreement concerned. Also, default administration charges may be imposed only if the consumer has defaulted on a payment obligation under the credit agreement, and only to the extent permitted by Part C of Chapter 6. Reg 46 further stipulates: "The credit provider may require payment by the consumer of default administration charges in respect of each letter necessarily written in terms of Part C of Chapter 6 of the Act. Such payment may not exceed the amount payable in respect of a registered letter of demand in an undefended action in terms of the Magistrates' Courts Act, 1944 in addition to any reasonable and necessary expenses incurred to deliver such letter."

70 The Act defines "collection costs" to mean "an amount that may be charged by a credit provider in respect of enforcement of a consumer's monetary obligations under a credit agreement, but does not include a default administration charge". S 101*(g)* allows collection costs to be charged as "costs of credit" but stipulates that it may not exceed the prescribed maximum for the category of credit agreement concerned and may be imposed only to the extent permitted by Part C of Chapter 6.

71 Regarding the maximum prescribed interest rates see reg 42 Table A; for the maximum prescribed initiation fee see reg 42 Table B; and for the maximum service fee see reg 44. For limitations pertaining to the maximum amounts that can be levied in respect of default administration charges see reg 46 and for limitations applicable to the maximum amounts that can be levied for collection costs, see reg 47.

> "If a credit agreement is an instalment sale agreement, a mortgage agreement, a secured loan or a lease, the credit provider may include in the principal debt deferred under the agreement any of the following items to the extent that they are applicable in respect of any goods that are the subject of the agreement–
>
> *(a)* an initiation fee as contemplated in section 101(1)*(b)*, if the consumer has been offered and declined the option of paying that fee separately;
>
> *(b)* the cost of an extended warranty agreement;
>
> *(c)* delivery, installation and initial fuelling charges;
>
> *(d)* connection fees, levies or charges;
>
> *(e)* taxes, licence or registration fees; or
>
> *(f)* subject to section 106, the premiums of any credit insurance payable in respect of that credit agreement."

It may consequently be asked whether courts will now be able to engage in making "determinations" regarding aspects such as, for example, collection costs on a credit agreement – which are costs actually incurred by the credit provider to enforce payment and are paid to an attorney as third party and recovered from the consumer by agreement, and which are not in fact subject to a maximum *rate* but rather capped at a maximum *amount*? Also, given the provisions of section 102 as indicated above, does it mean that a court will be able to make "determinations" regarding those types of amounts also (with the exception of credit life insurance as mentioned in section 102(1)*(f)*) – which as appears from section 102*(b)* – *(e)*, are amounts actually incurred by the credit provider and paid to a third party on behalf of the consumer?

This brings us to the next question: what exactly does the concept "determining" in the new section 86(7)*(c)*(ii)*(cc*A*)* mean? When one looks at this new restructuring provision, it may appear at first glance that the debt restructuring court would be able to suspend interest, fees and charges for a period of up to five years (to some extent mirroring the ill-fated attempt at debt suspension in 2012 as referred to above). It may then be asked exactly how this provision will be applied and what will happen to such interest, fees and charges after the suspension period. On closer inspection, however, it appears that what this new provision seeks to enable is rather that the debt restructuring court would be able to determine that, for example, instead of the 15% annual interest rate that applies to a credit agreement before it, a new maximum rate of 10% or even 0% should apply for a period of up to a maximum of five years. Obviously, the court, in deciding on the period over which the maximum rate will be ordered to apply, as part of determining whether such a period is "fair and reasonable", will also be guided by the period over which the debt is proposed to be restructured. Thus, it appears not to be a suspension of interest, fees and charges that is contemplated by the new section 86(7)*(c)*(ii)*(cc*A*)* but in fact that the amounts of interest, charges and other fees are written off – in other words, a discharge. This may also explain why the word "suspension" is not used, although it is used elsewhere in the NCA,[72] and why the provision contains no indication of what is to happen to the affected interest, fees and charges after the suspension ends. It is therefore far more invasive than the power sought to

[72] See s 84.

be introduced in 2012. In any event, it is submitted that what exactly to provide in relation to such a suspension would have been quite a challenge – as it would have implied that at some stage those interest, fees and charges would have had to be added to the consumer's account again and the question would then be how exactly to do this, given that a consumer cannot exit debt review (except in the case of long-term credit agreements) before all his debt is repaid as per the debt restructuring order and he is eligible for a clearance certificate in terms of section 71, as pointed out above.[73] Moreover, what would then have been the position if the consumer defaulted on the debt restructuring order? Clearly, a suspension of interest, costs and charges would have meant that in such a case the debt that can be enforced due to failure to comply with the debt restructuring order would have grown and the consumer's financial predicament would be increased as a result thereof. It would therefore appear that, in the context of the amending legislation, "determine" is actually a sugar-coated term for describing the fact that the debt restructuring court will be able to write off certain parts of the consumer's debt. It is thus far more invasive than the power to suspend interest that was sought to be introduced in 2012 but never materialised.

As regards the methodology for the application of section 86(7)*(c)*(ii)*(cc*A*)*, it also needs to be pointed out that once a court has exercised its initial discretion to find a consumer over-indebted and that his debt requires to be restructured, application of this new power requires a combination of discretion and prescribed measures. From the wording of the provision it is unclear whether a court will at all be able to refrain from making a determination as prescribed by the regulations. Should it transpire that a court does not have such a discretion, then it seems that the discretion that the court will be able to exercise will be only in relation to the time period it regards as "fair and reasonable" for purposes of the "determination" it has to make with regard to interest, costs and charges. Accordingly, it would seem that when a matter serves before the court for debt restructuring, and the court has exercised its discretion and has decided that the consumer is indeed over-indebted and that his debt should be restructured, the court, in the restructuring, must in the first place apply whatever measure will be prescribed in the contemplated regulations to "determine" the maximum rate in relation to interest, fees and charges. In view of the fact that the new debt restructuring power contemplates that the court will have a discretion as to the time period for which its "determination" will apply, one may surmise that the regulations will not contain prescriptions regarding time periods but will rather affect reductions in interest, fees and charges.

73 If a suspension was envisaged, it would have required quite some mental gymnastics to come up with a suitable approach to facilitating the procedure pursuant to such suspension. If a mere suspension is intended, one can appreciate that end-loading the debt review process with all these suspended amounts is not a prudent step. The interaction between a suspension and s 71 in its current format would have been problematic and would most probably have required a further amendment to s 71 to address this issue. Such amendment would then *inter alia* require considering whether the consumer would be expected to pay these amounts in one go or whether he would have to enter into a further restructuring period just to settle these suspended amounts in order to eventually be able to obtain a clearance certificate and exit the debt review process.

For example, if the regulations prescribe a reduction of 20% in all interest, fees, costs or charges for instalment agreements in respect of vehicles that are being restructured, the court will be obliged to apply that reduction – it has no discretion on this aspect. Its discretion then only arises when it has to decide on the time period for which its "determination" will apply. It may be surmised further that the discretion regarding the period for which the determination will apply will have to be informed by the facts of the matter that serve before the debt restructuring court, such as the over-indebted consumer's financial situation, the extent of his over-indebtedness and the type and duration of the credit agreements concerned. In this respect it is necessary to remain mindful, as observed above, that the period ordered does not exceed the period of restructuring of the matter at hand. From the reference to section 86A(6)*(d)* it further appears that this period can be less than, but never more than, five years – meaning that, for example, in one instance, a court may decide it is "fair and reasonable" to write off interest, fees and charges for a period of two years whereas in another matter it may order that interest, fees and charges be written off for a period of five years. One can imagine that, where, for example, a person's debt is restructured over a three year period and he is afforded a discharge of 20% on fees for the first year, after which he must start paying the remaining fees again (less the discharged amount), this would most likely give rise to protestations that he is being treated unequally compared to, for example, a consumer whose debt is restructured over a two year period and who receives a discharge of 100% for the whole two years thus having to pay no interest, costs or fees at all. As pointed out above, it is unclear whether a court will be able to refrain from making a determination as prescribed by the regulations, but if not, it may be asked whether indeed a court will be able to decide in a given instance that it will make a determination that the maximum rate of interest, fees and other charges will apply for a period of zero months – thus, in effect, that no such reduction will apply. The can of worms pertaining to equal treatment of consumers that such an order by a court will open is quite ghastly to contemplate. This underlines the need for the envisaged regulations to provide some rational basis for the writing off of interest, fees and charges and the need for the court to exercise its discretion regarding applicable time periods on a rational judicial basis.

To return to the issue of what the effect of such a "determination" by the court will be: if what is contemplated is a reduction (write-off or discharge) of interest, fees or charges (on a sliding scale or otherwise) over a specific period of time (as deemed fair and reasonable by the court), it needs to be fathomed how this power will be exercised in practical terms. This will depend on whether the contemplated regulations will prescribe reductions that simultaneously apply to interest, fees and charges on a sliding scale depending on the type of agreement involved, or whether, for instance, the regulations will prescribe reductions that involve first reducing interest and only in certain situations prescribe reductions in charges and fees, or whether a zero rate will be prescribed (implying that during the period that is covered by the "determination" the consumer will not have to pay any interest, fees and charges). It has also been speculated that the regulations may follow the informal guidelines set out in the Debt Review Task Team Agreement Guidelines referred to above,[74] but these guidelines only deal with the period for extending a credit agreement that is sought to be restructured and not to the interest rates or other fees to be charged. Therefore, it is not clear what the approach would be if these guidelines are indeed used to inform the drafting of the regulations. Even if this will not be the case, when these regulations are issued their interplay with the guidelines in the Debt Review Task Team Agreement will in any event have to be considered. It is likely that if the regulations, for example, allow up to 20% reduction in interest rates, fees and charges in relation to a specific type of credit agreement, debt counsellors will merely from the start propose such a reduction in their debt restructuring proposal even if the consumer would otherwise have been able to service the spread out interest, fees and other charges over the course of the restructuring period.

If, indeed, the observation in this contribution is correct that what section 86(7)*(c)*(ii)*(cc*A*)* envisages is a writing off or discharge of interest, fees and other charges, it is particularly invasive on the rights of credit providers and moves the discussion into the realm of section 25 of the Constitution.[75] Section 25 provides: "[N]o one may be deprived of property except in terms of law of general application, and no law may permit arbitrary deprivation of property." In *First National Bank v Commissioner of SARS*[76] (the *FNB* case) it was held that deprivation is a wide concept that includes "any interference with the use, enjoyment or exploitation of private property"[77] and that the general purpose of constitutional property law is to achieve a balance between the protection of vested rights and the promotion of the public interest in regulating the use of property.[78] The concept "property" is not defined in the Constitution, but in section 25(4)*(b)* it is stated that "property is not limited to land". As pointed out by Brits, there is support in academic scholarship and case law for the prospect that a contractual right with a monetary value (such as the credit provider's personal right to claim interest, fees and charges in respect of a credit agreement) qualifies as "property" for purposes of section 25 of the Constitution.[79] Brits also points out that the Constitutional Court has on a number of occasions recognised personal rights as property for purposes of section 25(1).[80]

74 See par 2.

75 Constitution of the Republic of South Africa, 1996.

76 2002 (4) SA 768 (CC) par 50; Brits "The National Credit Act's remedies for reckless credit in the mortgage context" 2018 (21) *PER/PELJ* (https://doi.org/10.17159/1727-3781/2018/v21i0a2955). See also Brits "Arbitrary deprivation of an unregistered credit provider's right to claim restitution of performance rendered: *Opperman v Boonzaaier* (24887/2010) 2012 ZAWCHC 27 (17 April 2012) and *National Credit Regulator v Opperman* 2013 (2) SA 1 (CC)" 2013 (16) *PER/PELJ* (http://dx.doi.org/10.4314/pelj.v16i4.12).

77 *FNB* case (n 76) par 57.

78 *FNB* case (n 76) par 50.

79 Brits (n 76 (2018 *PER/PELJ*)) 4, 15 et seq. Regarding academic support for this view see Brits (2018) *PELJ* fn 90. Support for this view is also found in the following cases listed by Brits: *FirstRand Bank v Smith* (24205/08) WLD (31 October 2008) par 25; *Rossouw v FirstRand Bank Ltd* 2010 (6) SA 439 (SCA) par 17, 42; *African Banking Corporation v Kariba* 2013 (6) SA 471 (GNP) par 45; *Opperman v Boonzaaier* [2012] ZAWCHC 27 (17 April 2012) par 18; *Troskie v Von Holdt* [2013] ZAECGHC 31 (11 April 2013) par 37.

80 *National Credit Regulator v Opperman* 2013 (2) SA 1 (CC) par 61; *Chevron v Wilson* 2015 (10) BCLR 1158 (CC) as discussed by Brits (n 76 (2018 *PER/PELJ*)) 18.

The issue would therefore be whether the power of the debt restructuring court to write off or discharge interest, fees and charges as permitted in section 86(7)*(c)*(ii)*(cc*A*)* of the NCA, being a law of general application, could be regarded as permitting the arbitrary deprivation of the credit provider's property. According to the *FNB* case a deprivation is arbitrary if the law "does not provide sufficient reason for the particular deprivation in question or is procedurally unfair".[81] As pointed out by Brits, two forms of arbitrariness are implicated: substantive arbitrariness (insufficient reason) and procedural arbitrariness (procedural unfairness).

Because the draft regulations prescribing the methodology for "determining" the percentage or amounts of interest, charges and other fees that can be written off or discharged by the debt restructuring court have not yet been published and it is as yet unclear what format they would take, it would be premature to comment on the procedural fairness or otherwise of the new section 86(7)*(c)*(ii)*(cc*A*)*. Even at this stage, one may, however, point out that the notion that a consumer qualifies upfront for a discharge of debt is at odds with other debt alleviation measures available in South Africa, in particular the principles of insolvency law that allow such a discharge only once the debtor has been through the whole insolvency process and reached the rehabilitation stage.[82] It is also at odds with the new debt intervention process where the *particularly vulnerable* over-indebted consumer who earns less than R7 000 per month will only be afforded a discharge after jumping through a considerable number of procedural hoops, where his ability to afford to repay his debts is scrutinised and a discharge of his debt is afforded only in limited circumstances. Notably an applicant for debt intervention is also required, as part of the process, to undergo counselling and training in financial literacy – which is not required of an over-indebted consumer who enters the debt review process to obtain restructuring of his debt.[83]

As regards the substantive arbitrariness of this provision some questions may, however, now be raised. In the *FNB* case it was held that the question regarding substantive arbitrariness has to be answered with regard to the relevant facts of each particular case and requires an evaluation of "the relationship between the means employed, namely the deprivation in question and the ends sought to be achieved, namely the purpose of the law in question".[84] Consequently, Brits points out that several relationships require consideration in this context. These include the relationship between the purpose of the deprivation and the person whose property is affected; that between the purpose of the deprivation and the nature of the property; and that between the purpose and extent of the deprivation.[85] In particular, he observes that: "[I]n other words, not only must the deprivation be buttressed by a valid public purpose, but in each individual case there must also be a sufficient relationship between this purpose and the effect that the deprivation

81 *FNB* case (n 76) par 100.
82 s 25 of the Insolvency Act 24 of 1936.
83 See s 86A read with s 87A ("Other orders relating to debt intervention") as introduced by s 15 of the National Credit Amendment Act 7 of 2019.
84 *FNB* case (n 76) par 100(h).
85 Brits (n 76 (2018 *PER/PELJ*)) 20 with reference to the *FNB* case (n 76) par 100(a).

has on the person whose property is affected. Depending on the facts, the level of scrutiny will then be somewhere on a continuum between a mere rationality test and a proportionality test almost as strict as the one contemplated in section 36 of the Constitution."[86]

Bearing in mind what was said above and considering the purpose of debt review, which is to provide the consumer with some breathing space to repay his debt subject to the obligation regarding *eventual satisfaction* of his responsible credit agreement obligations, and the fact that, where the credit provider was the cause of the consumer's over-indebtedness, the NCA avails sufficient remedies for reckless credit granting to address the consumer's plight – can it be said that there is sufficient reason for writing off interest, fees and charges as contemplated in section 86(7)*(c)*(ii)*(cc*A*)*? Even if one could in principle argue that the concept of extending a discharge of interest, fees and other charges on the ground that the consumer is over-indebted constitutes sufficient reason for depriving the credit provider of his property, it is submitted that the disproportionality of this approach viewed holistically in the context of the NCA cannot be justified.

As observed above, the NCA contains various provisions aimed at protecting consumers, and specifically provides for debt alleviation to consumers where credit providers have either acted unlawfully or where they have engaged in prohibited reckless lending. The debt restructuring court may make declarations of reckless lending and dispense appropriate redress in this regard. It may also provide further relief in accordance with its powers to recalculate the consumer's obligations where the credit provider has contravened certain parts of the NCA, with the result that the consumer may have less, or, in some instances, even nothing, to repay towards a credit agreement. If the court exercises these powers where they apply, or where these provisions do not apply because no reckless credit was extended and the credit provider did not contravene the NCA in any other respect that would entitle the court to recalculate the consumer's obligations, it means that the credit provider had no part to play in the consumer's over-indebtedness. Because the NCA seeks to extend some debt alleviation to over-indebted consumers, regardless of the cause of their over-indebtedness, the credit provider has no choice but to observe the provisions of section 86 and patiently wait for repayment of the debt owing to him in a smaller monthly amount over a longer period regardless of whether it may impact negatively on his business. Should the credit provider, in such an instance, now also have to suffer deprivation of his property because the debt restructuring court may write off interest, fees and charges, it raises deeply serious questions regarding the sustainability of the credit market and whether credit providers will, in future, be as willing to lend to consumers whom they perceive as likely candidates for debt review somewhere along the course of servicing the credit

[86] Brits (n 76 (2018 *PER/PELJ*)) 20 with reference to the *FNB* case (n 76) par 100(g). Section 36 of the Constitution provides for limitation of the rights in the Bill of Rights only in terms of a law of general application to the extent that such limitation is "reasonable and justifiable in an open and democratic society based on human dignity, equality and freedom" and taking into account relevant factors that include: the nature of the right; the importance of the purpose of the limitation; the relation between the limitation and its purpose; and less restrictive means to achieve such purpose.

agreement. It may even incentivise credit providers to raise the cost of credit – at least to the maximum extent provided for in the NCA. Even consumers who are diligently repaying their credit agreement debt every month, without accessing the debt review process, may have to bear the brunt of increased cost of credit. The ability of the debt restructuring court to write off interest, fees and charges may foster antipathy towards the mechanism of debt review and lead to enforcement measures being instituted much more promptly by credit providers in order to limit the access of consumers to the debt review process.

4 Conclusion

The purpose of this contribution is not to underplay the need for debt alleviation for over-indebted consumers. Indeed, it is trite that over-indebtedness of consumers is a very valid cause for concern, and needs to be addressed by measures to alleviate such over-indebtedness. This is what the NCA, thus far, has sought to do. It has various built-in measures to protect a consumer against becoming over-indebted through adequate disclosure measures, limits on cost of credit and prohibitions against, and remedies in respect of, reckless credit extension as well as various other provisions on which consumers can rely to ensure that they are not charged amounts that are not due by them. The NCA, in particular, provided the mechanism of debt review for over-indebted consumers to achieve debt alleviation – even if none of the aforementioned protections and remedies were applicable to their situation because the credit provider was not at fault in any way whatsoever. However, as observed in this contribution, the introduction of a power for the debt restructuring court now, together with all its other restructuring powers, to write off interest, fees and charges, is in conflict with the purpose of debt review, namely the eventual satisfaction of the consumer's responsible debt obligations under credit agreements. This, it is submitted, goes against the aim of the Act to balance the rights of consumers and credit providers. It also raises red flags as to the likely arbitrariness of such deprivation of the credit provider's property. Moreover, there are large, long-term consequences that loom within the latest amendments to the NCA of 2019. These consequences are likely to impact directly on the sustainability of the South African credit market.

The development of withholding tax on interest in South Africa: 2012 – 2020

THABO LEGWAILA*

Abstract

South Africa introduced withholding tax on interest with effect from 1 April 2014, *inter alia* to assert its source-taxation jurisdiction and to unify the withholding-tax regimes, in line with the withholding taxes on dividends and royalties. The withholding tax on interest imposes a tax liability on a recipient of South African sourced interest that is not tax resident in South Africa, subject to certain exemptions and subject to relief provided by double-tax agreements. It also imposes the liability to withhold the tax and pay it over to the South African Revenue Service on the person paying the interest. Since introduction, the withholding tax on interest regime has undergone numerous amendments to ensure that it operates optimally. This contribution explores the technical mechanics of withholding tax on interest, analyses the challenges experienced since its introduction and explores the efficacy of the changes made to the regime.

* * * * *

1 Introduction

In 2012 the then South African Minister of Finance, Pravin Gordhan, announced the introduction of the Withholding Tax on Interest (hereinafter referred to as "the WHT") in the 2012 Budget Review. Originally, it was to come into effect on 1 April 2014. The date had been postponed to 1 January 2015 and then to 1 March 2015 due to the technical and administrative details and the requirements attached to the levying of the tax. The WHT finally came into effect on 1 March 2015 and applies to any interest paid on or after that date. It relates to any interest paid on or after 1 March 2015, regardless of the fact that the arrangement giving rise to the interest payment may have been entered into, came to force or was backdated to a date before 1 March 2015.

Interest is taxable under the normal rules of tax. Interest forms part of the gross income of a taxpayer as an amount in cash received by or accrued to a taxpayer that is not of a capital nature.[1] Such interest is taxable if it is received or accrues to a person that is a resident. If the recipient of the interest or the person to whom the interest accrued is not a resident as defined, such interest is exempt from tax in terms of section 10(1)*(h)* of the Income Tax Act 58 of 1962 (hereinafter referred to as "the Act").[2] At the outset it may be helpful to explore the nature or character of interest in order to contextualise the subject of this contribution.

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1 Interest is an amount received or accrued for the employment of capital and is generally accepted to be of a revenue nature. See Legwaila, Oguttu, Muller, Williams, Louw & Surtees *Tax Law: An Introduction* (2020) 84; Haupt *Notes on South African Income Tax* (2020) 456.

2 Unless otherwise stated, references to sections and parts in this paper are references to the sections or parts of the Act as the case may be.

2 Definition of interest

The definition of interest is of fundamental importance for payers and recipients of interest. Payers of interest, especially banks and other financial institutions, often make various payments of amounts that may be akin to interest, but that are not necessarily or technically interest. The WHT applies to interest that is paid by a resident to a non-resident. The Act does not define interest in the "general definitions" contained in section 1. This means that interest that is subject to the WHT is interest in the ordinary or common-law sense of the word. In general, interest is understood to be an amount charged by a lender for the use or detention of money.[3] The definition of interest is specific to section 24J of the Act, the purpose of which is to determine the incurral and accrual of interest.[4] The section 24J definition of interest is much broader than the literal meaning of interest. In terms of section 24J, "interest" includes the following:

> "*(a)* gross amount of any interest or related finance charges, discount or premium payable or receivable in terms of or in respect of a financial arrangement;
>
> *(b)* amount (or portion thereof) payable by a borrower to the lender in terms of any lending arrangement as represents compensation for any amount to which the lender would, but for such lending arrangement, have been entitled; and
>
> *(c)* absolute value of the difference between all amounts receivable and payable by a person in terms of a sale and leaseback arrangement as contemplated in section 23G throughout the full term of such arrangement, to which such person is a party,
>
> irrespective of whether such amount is—
>
> calculated with reference to a fixed rate of interest or a variable rate of interest; or
>
> payable or receivable as a lump sum or in unequal instalments during the term of the financial arrangement … ."

The differences between interest to which the withholding tax applies and interest to which section 24J applies can be attributed to the fact that section 24J determines the incurral and accrual of interest with the specific purpose of curbing the avoidance of tax by taxpayers *inter alia* expediting the incurral of interest for the lender and delaying the accrual of the interest by the borrower.

As will be seen below in this article, the WHT can be reduced by application of a double taxation agreement (DTA) between SA and the country of residence of the borrower. Even though South Africa is not a member of the Organisation for Economic Co-operation and Development (OECD), South Africa's DTAs follow the OECD Model Convention. The treaties generally exempt interest from the WHT. These treaties contain a definition of interest and they generally define interest as follows:

> "The term 'interest' as used in this Article means income from debt-claims of every kind, whether or not secured by mortgage and whether or not carrying a right to participate in the debtor's profits, and in particular, income from government securities and income from bonds or debentures, including premiums and prizes attaching to such securities, bonds or debentures. Penalty charges for late payment shall not be regarded as interest for the purpose of this Article."[5]

[3] See IBFD *International Tax Glossary* (2005), definition of "interest".
[4] See Stiglingh (ed) *Silke: South African Income Tax* (2020) 528.
[5] See art 11(3) of the OECD Model Tax Convention 2014.

While this Model Treaty definition may seem extensive in its application, its specific references neither extend nor deviate from the literal definition of interest, let alone limit the definition. In effect, if it were of a more limited application than the general or literal definition of interest as contemplated in section 50B, it would pose problems as some interest would not be covered by treaty relief. Conversely, if it were broader, it would apply to certain items that are not subject to the WHT, and perhaps extend to provide treaty relief to items that are not subject to tax in terms of the WHT regime.

3 Exemption of interest from normal income tax

In terms of section 10(1)*(h)*, interest is exempt from income tax if the interest is earned by a person that is not resident unless that person is a natural person who has been physically present in South Africa for a period of 183 days or more in that year of assessment, or if the interest is earned by a person other than a natural person and the interest is attributable to a permanent establishment that such person has in South Africa. As will be seen below, if the natural person has been physically present in South Africa for a period of 183 days or more, or it is attributable to a permanent establishment of a non-resident in South Africa, such interest will not be subject to the WHT in terms of Part IVB of the Act.

In effect therefore, section 10(1)*(h)* exempts from normal income tax interest that is subject to the WHT. It is not clear why the legislature opted for a long version of the exemption as opposed to a shorter and more direct wording that states "there shall be exempt from tax any interest paid to a non-resident if that interest is taxable in term[s] of Part IVB". Interestingly, this was the wording that the legislature employed in the repealed section 10(1)*(h*B*)* in exempting service fees that are taxable in terms of the withholding tax on services regime provided for in the repealed Part IVC of the Act.

Several observations may be made from this exemption. First, taxing interest that is earned from a South African source by a person that is not a resident presents challenges of enforcement. South Africa does not generally have jurisdiction to enforce South African laws on non-residents. Secondly, even if South Africa had such jurisdiction, for example in terms of an extradition treaty, the costs of such enforcement would be large in relation to the benefit that could be derived from such enforcement. Thirdly, the exemption of interest sourced in South Africa deprives the South African fiscus of South African sourced income to which South Africa should have a primary taxing right. Fourthly, the self-deprivation of the taxing right by South Africa appeals to investors at a minimal level only as the country of residence of the investor then assumes the full taxing right to the interest. It therefore neutralises the positive effects that South Africa may derive from exempting interest earned by a non-resident from tax. Fifthly, the unequal treatment of residents vis-à-vis non-residents created an uncomfortable political vulnerability of the South Africa tax system that could result in tax driven business and economic investment practices adverse to the SA economy. Finally, and most importantly, South Africa levies a withholding tax on royalties and dividends.[6] If interest payable to non-residents was not taxable at all, investors would be tempted to re-characterise royalty or dividend payments to non-residents as interest to benefit from the tax free treatment. This not only creates an undesirable situation in which the different tax treatment of different instruments unduly influences the business practices, but also imposes an increased and anomalous anti-avoidance administrative burden on the SARS.[7]

The Act also specifically exempts from normal tax any receipts and accruals of any bank, if that bank is not resident in South Africa and is entrusted by the government of a territory outside South Africa with the custody of the principal foreign exchange reserves of that territory.[8]

4 Levying of and liability for WHT

The WHT is levied on interest paid to a foreign person to the extent that the interest is regarded as having been received by or accrued to that person from a source within the Republic.[9] A foreign person is a person that is not resident in South Africa. Resident is defined in section 1 of the Act as a natural person that is ordinarily resident in South Africa[10] or that satisfies the physical presence test in South Africa.[11] In relation to persons other than natural persons a person is resident if it is established, formed or incorporated in South Africa or has its place of effective management in South Africa.[12] A person that does not fall under this definition is a non-resident and therefore liable to the withholding tax.

The charging provision for WHT is section 50B(1), which provides as follows:

> "There must be levied for the benefit of the National Revenue Fund a tax, to be known as the withholding tax on interest, calculated at the rate of 15 per cent of the amount of any interest that is paid by any person to or for the benefit of any foreign person to the extent that the amount is regarded as having been received or accrued from a source within the Republic in terms of section 9 (2) (*b*)."

The WHT is not a tax *per se*. It is an administrative mechanism to collect the tax from the person who receives interest, or to whom interest accrues if that interest is from a South African source. Thus, the liability for, and incidence of, the tax on interest rests upon the recipient or payee of the interest. In this regard,

6 The withholding tax on service fees was scheduled to come into effect on 1 January 2016. It was however, repealed before it came into effect.

7 See National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2012* (10 December 2012) 119; and National Treasury *Explanatory Memorandum on the Taxation Laws Amendment Bill, 2013* (24 October 2013) 75. Both documents are accessible from https://www.sars.gov.za/Legal/Preparation-of-Legislation/Pages/Explanatory-Memoranda.aspx.

8 s 10(1)*(j)*. See also Legwaila *et al* (n 1) 528.

9 s 50C (1).

10 s 1(1)*(a)*(i) in the definition of "resident". See *Robinson v COT* 1917 TPD 542, 32 SATC 41; *Cohen v CIR* 1946 AD 174, 13 SATC 362; *Nathan's Estate v CIR* 1948 (3) SA 866 (N), 15 SATC 328; *H v COT* 1960 (2) SA 695 (SR), 23 SATC 292; *CIR v Kuttel* 1992 (3) SA 242 (A), 54 SATC 298.

11 s 1(1)*(a)*(ii) in the definition of "resident".

12 s 1(1)*(b)* in the definition of "resident".

section 50C(1) provides that "[a] foreign person to which an amount of interest is paid is liable for the withholding tax on interest to the extent that the interest is regarded as having been received by or accrued to that foreign person from a source within the Republic in terms of section 9(2)(*b*)".

As stated above, however, South Africa does not have jurisdiction over non-residents. It would therefore be administratively burdensome for South Africa to collect the tax on interest due by non-residents. The administrative solution to this problem has been found in the form of a withholding tax. While the liability for the tax is on the recipient of the interest, the Act placed the administrative burden, in terms of calculation and collection, on the resident paying the interest. This has been done primarily because the government has jurisdiction over the resident payer of the interest. This is achieved through section 50E(1), which provides that "[s]ubject to subsections (2) and (3), any person who makes payment of any amount of interest to or for the benefit of a foreign person must withhold an amount of withholding tax on interest calculated at the rate contemplated in section 50B(1) from that payment". In terms of section 50C(2), where any amount of withholding tax on interest is withheld[13] and paid[14] that amount of withholding tax on interest is regarded as an amount that is paid in respect of that foreign person's liability.

5 Rate of WHT

The WHT is leviable on any interest paid to a non-resident at the rate of 15%.[15] While the 15% rate may at first sight seem low and favourable as compared to the 28% corporate income tax rate, it should be noted that the 15% rate is applied to the gross amount of the interest paid, and not the net amount after exemptions and deductions attributable to normal income subject to the 28% corporate income tax. Interest is deemed to have been paid on the earlier of the date on which the interest is paid or becomes due and payable. The WHT is a final tax.[16]

In order to allow for changes in the rate without delays in the implementation that could result in strategic tax avoidance, in 2017 section 50B(1)*(a)*(ii) of the Act was added by the substitution of section 50B(1) to provide for an alternative rate, namely the rate that the Minister of Finance may announce in the national annual budget contemplated in section 27(1) of the Public Finance Management Act 1 of 1999, with effect from a date mentioned in that announcement.[17] Once the Minister of Finance makes the rate-change announcement that rate comes into effect as determined by the Minister, and continues to apply for a period of 12 months from that date, subject to Parliament passing legislation giving effect to that

[13] As contemplated in s 50E(1).

[14] As contemplated in s 50F(2).

[15] s 50B(1)*(a)*(i).

[16] s 50B(3). Final tax is "[c]ommonly used to describe income which is subject to withholding tax and which is not included in income for purposes of computing tax at progressive rates. The withholding tax therefore represents the taxpayer's final tax liability in respect of the income in question." IBFD *International Tax Glossary* (2005), definition of "final tax".

[17] s 50B(1) was substituted by s 58 of the Taxation Laws Amendment Act 17 of 2017.

announcement within that period.[18] Should such legislation not be passed, the 15% rate will apply from that period. Arguably, however, the Minister may reinstate, or extend the application of the different rate by making a new announcement.

6 Tax relief

The WHT operates as a direct tax on the recipient of the interest withheld by the payer of the interest. The practical consequence is that the payer will deduct the amount of the WHT from the amount of the interest before that interest is paid. It is not a tax on the net amount paid as interest, that is, it is not paid over and above the amount of the interest. For example, if the amount of the interest is R100 000, the payer will for accounting purposes expense the full R100 000 but pay the recipient R85 000 and pay the remaining R15 000 to the SARS on behalf of the recipient. The recipient would therefore receive the R85 000. The recipient would then account for tax in their jurisdiction on the R100 000. If the country of the recipient does not provide the foreign tax relief, and there is no DTA in place that provides for the relief from double taxation, the recipient would then account for tax on the R100 000. A variation of the amount could result from the imposition of tax only on the amounts actually received similar to the blocked funds exclusion in section 9A of the Act.[19]

The situation would be different if the foreign country provides for relief against double taxation. Such relief could be provided in one of three forms: exemption, credit or deduction.

- In terms of the tax exemption system a recipient would not be taxable on the amount of interest earned from South Africa. The effective tax payable by the recipient in this regard would be the 15% paid in South Africa. Thus, in the example above, the recipient would pay a total tax of R15 000.
- In terms of the tax credit system, the recipient is credited for the amount of tax paid in the other country, that is South Africa. Thus, in the aforementioned example the recipient would account for tax on the full R100 000 and once his tax liability on the R100 000 is determined in terms of the local laws of the foreign country the R15 000 would be credited, which in effect means that his tax liability would be reduced by the R15 000.
- In terms of the tax deduction system, the recipient is allowed a deduction of the amount of tax paid in the source country. The recipient then accounts for the tax on the net amount received. Thus, in the above example, the recipient would account for the tax on the R85 000.

18 s 50B(1)*(b)*.

19 s 9A(1) provides that "[w]here any amount, or any portion of any amount, received by or accrued to any person which is required to be included in the income of that person during any year of assessment may not be remitted to the Republic during that year as a result of currency or other restrictions or limitations imposed in terms of the laws of the country where the amount arose, that person shall be allowed to deduct from his or her income for that year an amount equal to so much of the amount or portion which may not be remitted as is required to be included in the income of that person for that year".

7 Grossing up

As has been seen, the WHT reduces the amount of interest received by the recipient. If no double taxation relief method is available for the recipient, the WHT could disastrously affect the recipient of the interest. In order to eliminate the adverse effects of the WHT, investors provide for a gross-up clause in their international contractual terms. The gross-up clause indemnifies the recipient from the withholding tax by contractually placing the liability of the tax on the payer of the interest. This ensures that the recipient receives the full amount of the interest. The gross-up clause increases the amount of the interest that the payer expenses.[20] Using the above example, the gross-up clause would result in the interest being calculated at about R118 000. This would result in the WHT of about R18 000 and net interest paid to the recipient of R100 000.

Gross-up clauses are applied both where there is no double taxation relief and where there is relief. Where there is double taxation relief, the payer is required to gross up the amount if the payer fails to assist the recipient with the formal requirements by the foreign country that should be provided by the source country, for example tax certificates proving that the WHT has been paid in the source country. Two observations may be made at this stage: firstly, that the WHT does not prohibit or regulate the use of gross-up clauses; secondly, the fact that the payer has grossed up the amount does not prohibit the recipient from claiming the foreign tax relief where it is provided. The latter instance could result in the recipient doubling up on the benefit of the tax gross-up clause by receiving the gross amount of the interest and claiming the foreign tax credit on the grossed-up amount.

8 The withholding liability

It is important to distinguish between the liability for the tax on the recipient and the administrative liability to withhold and pay the tax to the SARS that rests with the payer of the interest. The payer and the recipient are jointly and severally liable for the tax in that both can be practically compelled to pay the amount and that payment by either the payer or the recipient absolves the recipient or the payer, as the case may be, from the liability for the tax.

The liability to withhold on the part of the payer of the interest is provided for in section 50E, which states that "any person who makes payment of any amount of interest to or for the benefit of a foreign person must withhold an amount of withholding tax on interest". On the other hand, the liability for the tax on the recipient of the interest is provided for in section 50F, which states that "[i]f…a foreign person is liable for any amount of withholding tax on interest in respect of any amount of interest that is paid to or for the benefit of the foreign person, that foreign person must pay that amount of withholding tax by the last day of the month following the month during which the interest is paid, *unless the tax has*

[20] For accounting purposes "expense" is a term used to describe the costs associated with the day-to-day normal operations of a business. See Schutte *Who Owns Whom's Dictionary of Stock Market Terms* (2001), definition of "expense".

been paid by any other person".[21] The italicised words indicate that if the payer of the interest withheld and paid the WHT to the SARS, the recipient is absolved from the payment of the WHT. The Act does not expressly provide for a relief for the payer for instances where the recipient pays the withholding tax and the payer does not withhold. On the strict reading of the WHT provisions, the payer remains liable to withhold even if the tax had been paid. The WHT provisions do not stipulate to the effect that if the recipient of the interest pays the WHT, the payer is deemed to have paid and therefore the payer's liability to withhold is extinguished.

9 Exemptions

Section 50C provides for exemptions from the WHT. These exemptions are based on the person paying the interest as opposed to the recipient of the interest, the nature of the instrument giving rise to the interest or any other possible distinguishing factors. Section 50D exempts interest paid by (1) the government of the Republic in the national, provincial or local sphere;[22] (2) any bank, the South African Reserve Bank, the Development Bank of Southern Africa or the Industrial Development Corporation;[23] and (3) a headquarter company in respect of the granting of financial assistance.[24] Section 50D also exempts interest paid to specified international bodies and certain specific foreign persons, as will be explained below. Because the interest is paid by the entity giving rise to the exemption, no further requirements are to be met in order to qualify for the exemption. In this regard section 50E(2)*(a)* merely provides that "[a] person must not withhold any amount from any payment contemplated in subsection (1) to the extent that the interest is exempt from the withholding tax on interest in terms of section 50D (1)".

9.1 *The government of the Republic in the national, provincial or local sphere*

Interest paid by the government of the Republic in the national, provincial or local sphere is exempt from WHT. This would typically be interest paid on government bonds and similar instruments issued by the government. It is trite that the WHT is aimed at curbing the avoidance of tax by re-characterising income and to bridge the gap in the tax treatment of interest for residents and non-residents. With regard to interest on government bonds, the tax treatment of residents and non-residents remains different. While non-residents are exempt from the WHT, residents do not have any relief from tax on interest paid by the government of the Republic in the national, provincial or local sphere.

21 My italics.
22 s 50D(1)*(a)*(i)*(aa)*.
23 s 50D(1)*(a)*(i)*(bb)*.
24 The headquarter-company exemption is provided for in s 50D(1)*(a)*(i)*(cc)* for "a headquarter company in respect of the granting of financial assistance as defined in section 31(1) to which section 31 does not apply as a result of the exclusions contained in section 31(5)(*a*)".

9.2 *Banks and branches of banks*

With regard to the exemption on interest paid by a bank, the original definition of a bank in the Taxation Laws Amendment Act of 2013[25] provided that a "bank means any bank as defined in section 1 of the Banks Act".[26] The reference to "bank" as defined in the Banks Act presented technical challenges for branches of foreign banks. Branches of international banks (hereinafter referred to as "international banks") operating in South Africa are the following: AlBaraka Bank Ltd, Bank of China Johannesburg, Citibank NA, Deutsche Bank, Bank of Taiwan, China Construction Bank, HBSC Bank PLC, JP Morgan Chase Bank, Mercantile Bank, Societe Generale JHB Branch, State Bank of India and Bank of Athens. These international banks are all members of the International Bankers Association. Section 1 of the Banks Act defines "bank" as follows: "'bank' means a public company registered as a bank in terms of this Act". International banks are not public companies and are not registered as banks in terms of the Banks Act.

International banks generally operate under licence in terms of a "Certificate of Authorization for the Conducting of the Business of a Bank by a Foreign Institution by means of a Branch in South Africa" granted by the South African Reserve Bank in terms of section 18A of the Banks Act. This certificate authorises an institution, which lawfully conducts the business of a bank and which has been established in a foreign country, to conduct the business of a bank by means of a branch in South Africa. They are not banks as defined in section 50A, as introduced by the Taxation Laws Amendment Act of 2013. This implied that interest paid by an international bank would be subject to WHT while interest paid by a local bank would be exempt. It goes without saying that such a situation would create an uneven banking environment in terms of which investors would prefer to borrow from local banks than international banks operating in South Africa. This is regardless of the unilateral or multilateral foreign tax relief measures that could be offered for the interest paid to a unilateral tax relief country or the treaty partner. The exemption for local banks and the taxation of interest paid by international banks would also create undesirable discrimination against international banks that goes against the spirit of the South African Constitution[27] and the non-discrimination clause contained in the multitudes of double taxation treaties that South Africa signed with various countries.[28]

This anomaly was exposed and was rectified by section 64 of the Taxation Laws Amendment Act of 2014[29] by amending the definition of "bank" in section 50A. The amendment changed the definition of bank to read: "'bank' means any bank or branch as defined in section 1 of the Banks Act respectively". Section 1 of the

[25] s 98(1) of the Taxation Laws Amendment Act 31 of 2013.

[26] s 1 of the Act defines the Banks Act as the "Banks Act, 1990 (Act 94 of 1990)".

[27] See s 9 of the Constitution of the Republic of South Africa Act 108 of 1996.

[28] See the SARS list of treaties on http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Rest-of-the-World).aspx (6-5-2015) and http://www.sars.gov.za/Legal/International-Treaties-Agreements/DTA-Protocols/Pages/DTAs-and-Protocols-(Africa).aspx (6-8-2020).

[29] Taxation Laws Amendment Act 43 of 2014.

Banks Act defines a branch as "an institution that is not a public company or a state owned company as contemplated in section 11(1), but by means of which a foreign institution conducts the business of a bank in the Republic under an authorisation referred to in section 18A". This successfully places international banks and local banks on par as regards interest payments to non-residents.

Bank back-to-back anti-avoidance

Section 50D(2) provides an anti-avoidance measure for instances where a bank can be used as an intermediary or pass-through entity for interest paid by an entity that does not qualify for an exemption. This could be achieved where a non-resident entity extends a loan to a resident entity which is not a bank. Under section 50B such interest is subject to the WHT. There is no exemption for that interest in section 50D. The WHT could be avoided by the non-resident entity lending the capital to a local bank, and the local bank on-lending that amount to a local entity (commonly referred to as a back-to-back loan). On payment of interest, the WHT does not apply as interest is paid to a resident. When the bank pays the non-resident the interest, such interest would be exempt from WHT, as it is paid by a bank. For income tax purposes, the local entity paying the interest could claim a deduction for the full amount of interest (in terms of section 11*(a)*) and the bank would also deduct the full amount of interest on-paid to the non-resident (in terms of section 11*(a)*). The bank may be taxed on any commission (albeit minimal) earned in terms of the back-to-back loan. In order to curb this form of avoidance, section 50D(2) provides as follows:

> "Interest paid to a foreign person in respect of any amount advanced by the foreign person to a bank is not exempt from the withholding tax on interest if the amount is advanced in the course of any arrangement, transaction, operation or scheme to which the foreign person and any other person are parties and in terms of which the bank advances any amount to that other person on the strength of the amount advanced by the foreign person to the bank."

As Stiglingh *et al* state, "[l]ocal banks can therefore not be used as intermediaries for foreign funding to avoid the withholding tax on interest".[30]

Coupon stripping

While section 50D(2) could curb the back-to-back loans using banks, it may fall short when it comes to various other forms of transactions designed to avoid the WHT such as a coupon strip arrangement in terms of which a foreign lender receives funding upfront and the future interest payments on the inter-company loan are paid directly to a local bank.[31]

30 (n 4) 829.

31 "Coupon stripping is the act of detaching the interest payment coupons from a note or bond and treating the coupons and the body as separate securities," Federal Reserve Bank of New York "Zero Coupons and STRIPS", http://www.newyorkfed.org/aboutthefed/fedpoint/fed42.html (20-8-2020).

In terms of this form of coupon stripping a South African tax resident bank purchases the future interest payments from an offshore lender for the discounted present value of such future interest payments. In this manner the lender sells the future interest stream of the inter-company debt to the bank before the interest starts accruing. The offshore lender receives the funds "upfront" and guarantees future interest payments to the bank. In the result, the bank would have provided funding to the offshore lender equal to the purchase price paid for the future interest payments (being the present value of the interest payments). Future interest payments are made directly to the bank and are exempt from the WHT. Although these interest payments would be subject to income tax, the bank would have deducted the full present value at the time of the upfront payment to the offshore lender. This transaction achieves the same purpose as factoring a receivable.[32]

The tax implications of this transaction would be that the interest paid by the borrower to the bank is not subject to WHT because the borrower and the bank are both resident in South Africa. The payment by the bank of the purchase price of the future interest payments is not interest and therefore not subject to the WHT. The question is then whether the common-law doctrine of "substance over form" or the general anti-avoidance provisions contained in sections 80A–80L would prevent this form of avoidance. While it is submitted that the structure of the deal could result in the application of neither the doctrine, nor the general anti-avoidance provisions being applicable, the determination of whether these anti-avoidance measures would prevent this form of avoidance is beyond the scope of this contribution.

9.3 *Listed debts*

Interest paid in respect of any listed debt is exempt from the WHT.[33] A listed debt is defined as "any debt that is listed on a recognised exchange as defined in paragraph 1 of the Eighth Schedule".[34] Paragraph 1 of the Eighth Schedule defines listed debt as an exchange licensed under the Securities Services Act 36 of 2004, which is mainly the Johannesburg Stock Exchange ("JSE"). It also defines a recognised exchange as an exchange in a country other than the Republic of South Africa which is similar to the JSE which has been recognised by the Minister of Finance for purposes of the Eighth Schedule by notice in the *Government Gazette*.

The South African rationale behind this exemption is not stated in the Explanatory Memorandum.[35] The rationale seems to be international competitiveness as most major exchanges allow the interest on listed debt to be paid without source taxation. For example, in the European Union an exemption generally applies on interest derived from corporate and government bonds, and debt instruments, listed on a

32 "Accounts receivable factoring is a way for business owners to get working capital to run their business and the peace of mind to know they'll get paid": CIT "Factoring University" http://www.cit.com/factoring-university/accounts-receivable-factoring/index.htm (25-8-2020).

33 See s 50D(1)*(a)*(ii).

34 See the definition of "listed debt" in s 50A(1).

35 National Treasury (10 December 2012) (n 7).

regulated stock exchange in the EU/EEA. Also, countries such as Cameroon, China, Iceland, Ireland, Israel, Mexico, Mongolia, and US provide for an exemption of interest on listed debt.[36]

9.4 *183 days and permanent establishment exemption*

A further exemption is provided for interest that is taxable as normal income in terms of the Act. Section 50D(3) provides as follows:

> "(3) A foreign person is exempt from the withholding tax on interest if—
>
> *(a)* that foreign person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the interest is paid; or
>
> *(b)* the debt claim in respect of which that interest is paid is effectively connected with a permanent establishment of that foreign person in the Republic if that foreign person is registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act."

In order to obtain relief from WHT in terms of section 50D(3), section 50E(3)*(b)* provides that the payer must not withhold any amount of WHT from interest payment if the recipient has submitted to the payer a declaration that the recipient is exempt from the WHT. This additional administrative requirement arises from the fact that the payer does not necessarily have access to information relating to the whereabouts or business structures of the recipient in order to determine whether the recipient has spent time in South Africa or operates through a branch to which the interest is attributable or not, as the case may be.

A branch is an extension of its parent company. It does not have separate legal personality apart from its parent company. A South African branch of a foreign company is merely the foreign company carrying on business activities through a permanent establishment in South Africa. As a branch of a foreign company does not make the foreign company a resident in South Africa, in effect interest paid to the branch is technically paid to the non-resident parent company of that branch.[37] Such interest would, but for section 50C(3), be subject to the WHT. By reason, however, of the fact that the interest paid to the branch is taxable in terms of the normal corporate income tax rules, this interest is exempt from the WHT. Section 50C(4) provides that: "[a] foreign person is exempt from the withholding tax on interest if … (*b*) the debt claim in respect of which that interest is paid is effectively connected with a permanent establishment of that foreign person in the Republic if that foreign person is registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act."

[36] See Thomson Reuters Practical Law "Withholding tax requirement on interest on corporate debt, and key exemptions" 1 July 2020, https://uk.practicallaw.thomsonreuters.com/3-502-0416?transitionType=Default&contextData=(sc.Default)&firstPage=true&bhcp=1 (13-8-2020). PWC Summaries "Corporate – Withholding taxes" 10 July 2020, https://taxsummaries.pwc.com/united-kingdom/corporate/withholding-taxes (13-8-2020).

[37] Olivier & Honiball *International Tax: A South African Perspective* (2011) 89–91.

Similarly, interest that is earned by a foreign individual that is taxable in terms of the normal tax system is exempt from the WHT in terms of section 50D(3)*(a)*. This section provides that a foreign person is exempt from the withholding tax on interest if *(a)* that foreign person is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the interest is paid. Such interest falls outside the exemption from normal tax that is provided in section 10(1)*(h)*. Section 10(1)*(h)* exempts interest that is received by or accrues to a person who is not a resident unless the person was physically present in South Africa for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the interest is received by or accrues to that person. Therefore, the interest that is earned by the non-resident individual that has been in South Africa for more than 183 days is subject to normal tax and therefore exempt from WHT in order to avoid double taxation of the interest.

This exemption effectively eliminates the risk of double taxation of interest as normal income subject to corporate tax and also taxable in terms of the WHT.

9.5 *Foreign person to foreign person interest*

While section 50D(3) exempts a foreign person from WHT, section 50D(1)*(c)* exempts interest paid by a foreign person to another foreign person unless the recipient of the interest is a natural person who was physically present in the Republic for a period exceeding 183 days in aggregate during the twelve-month period preceding the date on which the interest is paid; or the debt claim in respect of which that interest is paid is effectively connected with a permanent establishment of that foreign person in the Republic if that foreign person is registered as a taxpayer in terms of Chapter 3 of the Tax Administration Act.

9.6 *Specified international bodies*

In 2018 a new provision[38] was added to exempt interest that is paid to – (i) the African Development Bank established on 10 September 1964; (ii) the World Bank established on 27 December 1945, including the International Bank for Reconstruction and Development and International Development Association; (iii) the International Monetary Fund established on 27 December 1945; (iv) the African Import and Export Bank established on 8 May 1993; (v) the European Investment Bank established on 1 January 1958 under the Treaty of Rome; or (vi) the New Development Bank established on 15 July 2014.[39]

[38] Section 50D(1)*(d)*.

[39] The provision on specified bodies was added by s 56(1)*(b)* of Taxation Laws Amendment Act 15 of 2016 and amended by s 59 of Taxation Laws Amendment Act 23 of 2018.

9.7 *Taxed donations, settlements and other dispositions*

Section 7(8)*(a)* of the Act provides for the inclusion in the income of a resident an amount attributable to a donation, settlement or other disposition if, by reason of or in consequence of any donation, settlement or other disposition made by any resident, any amount is received by or accrued to any person who is not a resident (other than a controlled foreign company in relation to such resident), which would have constituted income had that person been a resident.[40] Subjecting these payments to the WHT would amount to double taxation. In order to avoid the potential double taxation, in 2018 the Act was amended to exempt these payments from WHT.[41]

10 Tax treaty benefits

Relief from WHT can be provided by the application of a double taxation agreement between South Africa and a foreign country. Section 50E(3) provides for a reduction of the WHT. The payee can access treaty relief by providing the payer with a declaration that the interest is subject to a reduced rate as per a double taxation agreement between South Africa and the country of residence of the payee.[42]

In effect, the DTA may reduce the rate to as low as 0%. While the Act does not provide for an exemption provided by DTA, the practical effect is the same. Technically, however, the interest is taxable at the rate of 0%. For treaty purposes, this means that the payee country would treat the interest as subject to tax in South Africa, and not exempt from tax. This will affect the relief measures provided in the payee country. South Africa has a good treaty network with African countries and other countries worldwide. In total, South Africa has treaties with more than 70 countries. Its treaties cover all its main trading partners and the biggest economies in the world. South African treaties provide for a reduction of the WHT from 15% to 10%, 5% and 0%.

The original provision on treaty relief contained in section 50E(3) implicitly imposed the responsibility to apply treaty relief to the payer of the interest if the following three conditions are met:

(i) The recipient should claim tax treaty relief.

(ii) The tax relief must be claimed by the date determined by the payer or the date of payment if no date is determined by the payer. Logically, the date determined by the payer will be prior to the date on which the dividend is paid, or at the latest the date on which the interest is paid as the payer cannot withhold the WHT once the interest payment is made.

40 This excludes a donation, settlement or other disposition to an entity which does not qualify as a resident and which is similar to a public benefit organisation contemplated in s 30 of the Act.

41 s 50D(1)*(e)* was added by s 59 of the Taxation Laws Amendment Act 23 of 2018. See also Stiglingh (n 4) 830.

42 s 50E(3)*(a)*.

(iii) The recipient must undertake to notify the payer if the circumstances affecting the application of the DTA change. It is not clear what circumstances would change that could affect the application of the DTA once the interest has been paid. It is conceivable, however, that the DTA benefits could be affected between the date on which the declaration is made and the date when the interest is actually paid, for example by change of residence of the recipient of the interest. Clearly, those circumstances would be scarce. Furthermore, since the provision does not specify whether the recipient should make a declaration for each interest payment made, the circumstances may change between the different interest-payment periods.

While the original provision with regards to declarations made the declarations valid for an indefinite period, unless the payee's circumstances changed, with effect from 1 July 2020 the period of validity of the declaration has been limited to a period of five years from the date of the declaration. Accordingly, a new declaration is required every five years if the payee seeks to claim treaty benefits for a further five-year period.[43]

The Tax Administration Laws Amendment Act 33 of 2019 changed the provision in relation to the date on which tax relief must be claimed by removing the determination of such date by the payer as an alternative to the date of payment.[44] The new provision only refers to the date of payment as the date on which tax relief must be claimed.[45] This amendment provides more certainty, removes unnecessary ambiguity and eases the administrative burden on the payer of interest.

11 Currency of payments to SARS

Section 50H provides for instances where the interest payable in terms of a loan agreement is denominated in a currency other than the Rand as the South African currency. In that case, the amount of the WHT must be translated to the Rand at the spot rate on the date on which the amount is withheld. Notably, this is not the spot rate on the date on which the interest is paid. Although the Act does not specifically state the time at which the person paying the interest must withhold, section 50E provides that the person must withhold the WHT from the payment implying that such withholding would happen at the time of the payment.[46] This therefore implies that the translation to the Rand at spot rate will be done on the date of the payment of the interest.

[43] This provision was added by s 4(1)*(c)* of the Tax Administration Laws Amendment Act 33 of 2019. It is not applicable if the person making payment is subject to the provisions of *(a)* the Financial Intelligence Centre Act 38 of 2001; *(b)* the Agreement Between the Government of the Republic of South Africa and the Government of the United States of America to improve International Tax Compliance and to Implement the US Foreign Account Tax Compliance Act; or *(c)* the regulations for the purposes of paragraph *(a)* of the definition of "international tax standard" in s 1 of the Tax Administration Act, with regard to the foreign person to or for the benefit of which the payment is to be made and takes account of these provisions in monitoring the continued validity of the declaration.

[44] s 4(1)*(b)* of the Tax Administration Laws Amendment Act 33 of 2019.

[45] s 50E(3).

[46] s 50E(1) provides as follows: "Subject to subsections (2) and (3), any person who makes payment of any amount of interest to or for the benefit of a foreign person must withhold an amount of withholding tax on interest calculated at the rate contemplated in section 50B (1) from that payment."

12 Refunds

Section 50G contemplates situations where the recipient of the interest may either be exempt from WHT or subject to a lower rate in terms of a DTA but fails to submit a declaration to the payer on time. In that case, the payer would withhold the full tax and pay that over to the SARS. Section 50G provides that if such a declaration is submitted to the Commissioner for the SARS within a period of three years after the payment of the interest in respect of which the declaration is made, the amount of interest is refundable by the Commissioner. It follows that if the declaration is made before the payer pays the interest over to the SARS the payer should be able to pay the withheld amount or a portion thereof as the case may be to the recipient of the interest.

13 Conclusion

The WHT in South Africa is a welcome alignment of the South African tax system with international tax practices: it could earn South Africa some tax revenue and goes some way to promote the equal treatment of residents vis-à-vis non-residents. In its nascency, the WHT continues to have teething problems that should be cleared in the near future, even as some more are discovered. The main achievement of the WHT remains, however, the fact that it eliminates the need for re-characterisation of dividends, royalties and other income as interest, and therefore eases the tax administration, removing the challenge that previously existed with the opportunistic characterisation by some taxpayers of certain amounts as interest when, in fact, they were not.

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