

# The Canadian Payments Association and Its Mandate: Is Canada Lagging Behind

Ani M. Abdalyan

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Article abstract

Nous remercions Mme Abdalyan, juriste spécialisée en droit bancaire, pour son aimable autorisation de publier son étude portant sur l'étendue du mandat confié, en 1983, à l'Association canadienne des paiements en vertu de la *Loi sur l'Association canadienne des paiements*. Après avoir rappelé les lignes directrices du mandat confié à l'Association, à savoir sa mission d'établir et de mettre en oeuvre un système national de compensation et de règlement mais encore de planifier le développement du système national de paiement, l'auteure examine comment l'Association s'est acquittée de son double mandat, depuis quinze ans, dans un contexte économique en constante évolution.

# The Canadian Payments Association and its Mandate: Is Canada Lagging Behind

by

Ani M. Abdalyan\*

*Nous remercions Mme Abdalyan, juriste spécialisée en droit bancaire, pour son aimable autorisation de publier son étude portant sur l'étendue du mandat confié, en 1983, à l'Association canadienne des paiements en vertu de la Loi sur l'Association canadienne des paiements. Après avoir rappelé les lignes directrices du mandat confié à l'Association, à savoir sa mission d'établir et de mettre en oeuvre un système national de compensation et de règlement mais encore de planifier le développement du système national de paiement, l'auteure examine comment l'Association s'est acquittée de son double mandat, depuis quinze ans, dans un contexte économique en constante évolution.*

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## Introduction

The purpose of this paper is to study how the Canadian Payments Association ("CPA") has met its mandate since assuming the operation of the payments system on February 1, 1983. The CPA was established on December 1, 1980, with a two-fold mandate, by the Canadian Payments Association Act ("CPA Act"):<sup>1</sup> "to establish and operate a national clearings and settlements system and to plan the evolution of the national

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\* Ms. Ani M. Abdalyan is a consultant at Cassels Brock & Blackwell. She wishes to express thanks to Claude Gingras, Department of Finance for his helpful commentary.

<sup>1</sup> The Canadian Payments Association Act ("CPA Act") was part IV (sections 54 to 89) of the Banks and Banking Law Revision Act, 1980, S.C. 1980-81, c.4.

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payments system".<sup>2</sup> These have come to be known as the "first mandate" and "second mandate" of the CPA. For the purpose of carrying out its objects, the CPA has natural person powers.<sup>3</sup>

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Canada, as a member of the Group of Ten ("G-10") Countries, has the reputation of having one of the finest payments systems in the world. There may be ways, however, to further improve Canada's payments system. Issues which are fundamental in the current debate regarding the payments system relate to (i) risk containment and risk allocation and (ii) access and control. These issues tie in with broader policy questions of systemic risk,<sup>4</sup> i.e. ensuring that the failure of a financial institution does not cause the failure of another financial institution, as well as competitiveness and the future of Canada's financial services industry. It appears that the focus of the CPA has been on the minimization of risk in clearing and settlement systems so as to preserve the soundness and integrity of the payments system. Such initiatives led to the neglect of the second mandate i.e. planning the evolution of the national payments system. The CPA, since its inception, appears to have exercised limited power to plan or appears to have planned only part of the evolution of the payments system. The thesis of this paper is that the supervision of the development of the payments system in Canada should be implemented in a different fashion so as to provide equitable access to the system.

Canada's financial institutions legislation was overhauled in 1992 so as to dismantle the traditional four pillars. The driving force behind the federal government's reform package was the hope that the ensuing competition among financial institutions would lead to broader choice, improved service and lower prices for consumers. It has been stated, however, that the oligopolistic structure of the payments system, in fact, prevents Canada's

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<sup>2</sup> CPA Act, R.S.C. 1985, c.21, s.5.

<sup>3</sup> *Ibid.*, s.6(2).

<sup>4</sup> M. Andrews & J. McGinn, *Current Issues in Payment, Clearing and Settlement Systems*, Conference Board of Canada, January 3, 1993, 5-6, (hereinafter "Current Issues"). The essence of systemic risk is the "domino effect".

financial institutions from competing on a level playing field.<sup>5</sup> Such allegations have been made by both members and non-members of the CPA. While the federal government's financial sector reform of 1992 attempted to "remove barriers to competition in the financial services marketplace, new barriers to competition are being erected by private interests through their growing control of the nation's payment and settlement systems".<sup>6</sup> Payments systems are the lifeblood of an economy and efficient, low cost payments systems contribute to the efficiency of the Canadian economy.<sup>7</sup> It is my view that as a result of the lack of competition in the payment transactions business, economic efficiency may be threatened.

During the past number of years, we have seen the development of various private sector satellites of the national payments system. As has been pointed out by the Trust Companies Association of Canada ("TCAC"), "the design of these satellites will have, at the very least, an impact on the core activities of the CPA, yet they are being developed without CPA involvement or input".<sup>8</sup>

The current debate over development projects in the context of payments, clearing and settlement in Canada has focused on (i) Large Value Transfer System ("LVTS"), (ii) the Canadian Depository for Securities ("CDS") and (iii) Interac Association ("Interac"). This paper will deal with the regulatory issues of these development projects.

The delineation of which type of financial institution, i.e. banks and other deposit-taking institutions, sometimes referred

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<sup>5</sup> "Pushing for Reform of the Canadian Payments System" [CLHIA] Impact (1994), 3, (hereinafter "Pushing for Reform"). Banks, trust and loan companies, insurance companies and securities dealers are the traditional four pillars.

<sup>6</sup> Trust Companies Association of Canada Position Paper on Access to the Canadian Payments System, November 1, 1991, (hereinafter "TCAC Position Paper on Access").

<sup>7</sup> N. Le Pan, "Technology and Teamwork in Canada's Payments System: A View from Ottawa" (Paper presented to the Canadian Payments Association Conference, April 27, 1993) 2.

<sup>8</sup> Letter of D.E. Burt, R.G. Gassien and R.C. Hodges to S. Vachon (November 1, 1991), (hereinafter "Letter of Burt to Vachon").

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to as near-banks, may participate in the clearing and settlement system inherently characterizes the nature of competition in the financial services sector.<sup>9</sup> While the CPA was established to accept near-bank DTIs as participants in the payments system, Schedule I banks remain the key players in the Association and the satellite networks.

530 Yet, equitable access to the payments system, for the trust and loan industry, is said to be “the critical key to survival in the provision of retail or commercial banking services”.<sup>10</sup> If a financial institution is “precluded from having access to the payments system on the same terms and with the same costs as (its) competitors, then (the) chances of being successful in the most basic of banking services are remote”.<sup>11</sup>

Under the Insurance Companies Act which became effective July 1, 1992, insurance companies were given new corporate powers. Insurance companies are now allowed to provide “payment, credit and charge cards”, to provide money and portfolio management services and to issue travellers cheques. Life insurance companies may also provide consumer loans but they do not have the right accept deposits, not to mention chequable deposits. Without direct access to the payments system, however, insurance companies must depend on CPA members for clearing and settlement purposes. As a result, from the perspective of the life and health insurance industry, the new corporate powers of insurance companies are illusory. Not only are the intentions of the Insurance Companies Act frustrated but also the consumer is denied potential benefits from the provision of competitive services.<sup>12</sup>

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<sup>9</sup> “Current Issues”, *supra* note 4 at 5.

<sup>10</sup> R.W. Fleming, “The Issues Surrounding Equitable Access to the Payment System” (Address to the Canadian Payments Association Conference, April 27, 1993) 1, (hereinafter “Issues Surrounding Equitable Access”).

<sup>11</sup> *Ibid.* at 2.

<sup>12</sup> “Pushing for Reform”, *supra* note 9 at 6.

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## **The establishment of the Canadian Payments Association — Background**

The Report of the Royal Commission on Banking and Finance (“The Porter Commission”), released in 1964, contained the following recommendation regarding Canada’s payments system:

the clauses of the Canadian Bankers’ Association Act which gave the Association the right of operating the cheque-clearing system be repealed and an association of all clearing institutions be formed to manage the system and allocate costs equitably among all members in relation to the work done by each.<sup>13</sup>

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In 1975, the federal government released the Blue Book entitled “Towards an Electronic Payments System: An Elaboration of Government Policy”. The “common user communication network” contemplated consisted in payments network with the following characteristics:

- (i) nationwide in extent,
- (ii) publicly accessible, with no artificial barriers placed on its use by qualified users,
- (iii) a shared facility, the user paying only for his actual use of the facility,
- (iv) easy to plug into, regardless of the brand of computer equipment owned by the financial institution and the specifications of how to build compatible computer equipment should be public and easily available to hardware companies,
- (v) the common network would not preclude the development of private networks, but the private networks would not be permitted to carry payment messages.<sup>14</sup>

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<sup>13</sup> The Order in Council, P.C. 1962-1484, Royal Commission on Banking and Finance (1964) Report (Ottawa: Queen’s Printer), 382.

<sup>14</sup> Le Pan, *supra* note 7 at 6.

The policy paper further commented as follows:

The movement away from a paper-based system of payments will result in the eventual linking of a variety of institutions, financial, retail and government, and ultimately affect the day-to-day transactions of the individual customer. It is important that this evolution be such as to protect the rights of individual Canadians to enhance the competitive environment for deposit-taking institutions and the computer/communications service industry, and to ensure the development of an efficient and equitable payments system.<sup>15</sup>

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A federal government policy paper, released in 1976, provided as follows:

In the evolution of the payments system of today into the payments system of tomorrow, the economic interests of Canada will be served best by a national clearing system in which all the institutions directly involved may participate and share the requisite rights and obligations in an equitable manner.<sup>16</sup>

It is my view that the payments system has not developed in the manner envisaged by these policy papers of the federal government.

It is beyond the scope of this paper to give a detailed account of the historical developments leading to the creation of the CPA in 1980. In 1983, the CPA took over from the Canadian Bankers Association ("CBA") the administration and operation of the Canadian clearing and settlement system.<sup>17</sup> With the decennial review of the Bank Act in 1980, the establishment of

<sup>15</sup> Fleming, *supra* note 10 at 5.

<sup>16</sup> Government of Canada, Minister of Finance, White Paper on the Revision of Canadian Banking Legislation, (August, 1976), 18.

<sup>17</sup> An Act to Incorporate the Canadian Bankers Association Act, S.C. 1900, 63-64 Vict., c. 93 gave the Canadian Bankers Association the permissive power to "establish in any place in Canada a clearing house for banks, and make rules and regulations for the operations thereof" subject to the approval of the Treasury Board. The objects and general powers of the CBA is to "promote generally the interests and efficiency of banks". (See section 5 of the CBA Act).

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the CPA enabled near-bank DTIs to participate in the clearing system.<sup>18</sup> With the growing role of near-banks in the financial services marketplace, it was felt by policymakers that it was desirable that such institutions be given direct access to the payments system.

The CPA was established "to give the non-banks an equal voice in the planning, control and development of the national payments system, and to ensure that the public interest was represented and protected".<sup>19</sup> The CPA now has four classes of member institutions consisting of banks, credit unions, centrals and federations, trust and loan companies and other deposit-taking institutions. The lack of membership in the CPA by insurance companies is a major concern from the perspective of the insurance industry, especially in view of the new payment powers that such institutions were given in 1992.

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### **The CPA Act and the "Second Mandate"**

An analysis of the phrase which has come to be known as the "second mandate" of the CPA, ("... to plan the evolution of the national payments system"), reveals ambiguity in language. In fact, it has been suggested that it is an oxymoron.<sup>20</sup> In the context of financial policy, "evolution" appears to imply leaving everything to the market. "Planning the evolution" appears to imply guiding "market forces so that competition among competing suppliers results in the widest array of payments services at the best price, subject of course to necessary measures to protect the integrity of the system".<sup>21</sup>

The debate, over the years, has revolved around (i) the scope of authority conferred by the mandate "to plan", (ii) the extent of the CPA's responsibility to ensure "equitable access" to the payments system, and (iii) the exclusivity of jurisdiction of

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<sup>18</sup> C. Gingras, "Collection of Cheques - Issues in the Processing and Clearing Systems" (1986) *Current Issues in Canadian Business Law*, 472, Carswell, 1986.

<sup>19</sup> TCAC Position Paper on Access, *supra* note 6 at 2.

<sup>20</sup> Le Pan, *supra* note 7 at 9.

<sup>21</sup> *Ibid.* at 10.

the CPA as a result of the use of the term "the national payments system".<sup>22</sup>

While it has been suggested that the ambiguity in the statutory language of section 5 of the CPA Act "may have been a deliberate and reasoned attempt to avoid any premature constraints on the Association",<sup>23</sup> the Legal Department of the CPA has recommended that the CPA Act be amended to set out in a much more concise fashion the policy objectives and powers entailed in the mandate of the CPA.<sup>24</sup>

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### The Activities of the CPA

The payments system is in a constant state of modification and refinement. In recent years, the concern over the level of risk in Canada's payments and settlement system has heightened as a result of deregulation, securitization, internationalization and advances in computing and communication technologies. The payments system in Canada is in the process of gradually evolving from almost exclusive reliance upon cash and paper-based transactions toward the use of electronic forms of payments and data exchanges.

With the developments, testing and innovation in information processing and telecommunications technologies, we have witnessed the emergence of third party suppliers of non-financial services with expertise in technology. These third parties carry messages to financial institutions but "the actual exchange of payments and final settlement are performed entirely within the core of the financial system".<sup>25</sup>

As has been pointed out in the CPA Legal Department submission to the Department of Finance, the CPA, between

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<sup>22</sup> CPA Legal Department, "CPA Payments System Development Planning: A Review of Legislative Impediments and Issues" (Consultative Committee Meeting with Department of Finance, May 13, 1993), 5-6.

<sup>23</sup> Ibid at 6.

<sup>24</sup> Ibid.

<sup>25</sup> Department of Finance, "Third Party Processing in the Production of Financial Services", November, 1993, (i).

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1983 and 1985 fulfilled many of the responsibilities entailed in its first mandate. It carried out projects pertaining to the transfer, integration and automation of the clearings and settlement system, the revision of rules governing this system and address matters pertaining to the administration and organization of the CPA. In 1983, the CPA established and continues to administer the Automated Clearing and Settlement System ("ACSS") for processing cheques. The CPA developed and maintains the rules, standards and guidelines for the exchange of payment instruments. It established standards for new electronic payments systems including automatic banking machines ("ABM") transactions, Consumer Pre-Authorized Debit Plans and Electronic Funds Transfer at the Point of Sale ("EFT POS").<sup>26</sup>

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The distinctive feature of the ACSS rests in the fact that virtually all items in Canada's paper-based payments system, i.e. cheques, are cleared on the day they are presented. Settlement occurs the following day on a back-dated basis on the books of the Bank of Canada.<sup>27</sup>

The inherent drawback of overnight settlement is that there is a short period of exposure between clearing and settlement. The postponement of settlement until the following day creates the concern that a financial institution may possibly be creating additional payment obligations with an institution whose payments from the previous day will not be settled. If a financial institution fails in the interim period, transactions with the failed institution are subject to being reworded".<sup>28</sup> Such lack of finality of payment of a cheque remains an unresolved issue in Canada. It is well recognized that if cheques are to be commercially acceptable in lieu of money, the principle of finality of payment is as important as the very negotiability of the cheque.

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<sup>26</sup> "Current Issues", *supra* note 4 at 2.

<sup>27</sup> *Ibid.* at 7.

<sup>28</sup> *Ibid.*

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## Large Value Transfer System

In Canada, as in the United States and Italy, cash and cheques predominate as methods of payments. In contrast, Germany and Switzerland have electronic methods of payment while Japan and the Netherlands are somewhere in the middle.<sup>29</sup> Smart cards, as a means of payment, are commonplace in Europe and Japan while merely in infancy stage in Canada. Only recently, debit cards came into general usage in Canada. Canada is the last of the G-10 countries to develop an LVTS.<sup>30</sup>

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In 1992, large-value transfers in Canada, i.e. all payments of \$50,000 and above, averaged \$68.1 billion per day, representing 93.4% of the value of transactions flowing through the ACSS.<sup>31</sup> It is possible to characterize large-value payments in three broad categories: (i) international payments, (ii) payments representing transactions in the Canadian securities markets and (iii) commercial and governmental payments.<sup>32</sup>

International payments are processed, on a net basis, through the International Interbank Payments System ("IIPS") which was begun in October 1976. IIPS is "a system for sending Canadian dollar credit transfer messages", and the operating procedures, management of IIPS and access criteria are determined by a committee of the CBA.<sup>33</sup> The IIPS also facilitates correspondent banking transactions, third party domestic payments of large-value and the settlement of transactions in the domestic interbank deposit market.<sup>34</sup> Paper-based transactions as well as electronic transactions flow through

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<sup>29</sup> *Supra* note 7 at 4.

<sup>30</sup> *Ibid.* at 5.

<sup>31</sup> Bank for International Settlements, "Payment Systems in the Group of Ten Countries", Basle, December, 1993, 62, (*hereinafter* "BIS").

<sup>32</sup> *Ibid.*

<sup>33</sup> TCAC Position Paper on Access, *supra* note 6 at 7. In 1991, there were 23 direct participants in IIPS consisting of the Bank of Canada, 20 banks, Royal Trust and the Caisse Centrale Desjardins du Quebec. 47 other financial institutions consisting mainly of foreign banks and including two trust companies were indirect participants using direct participants as agents.

<sup>34</sup> "BIS", *supra* note 31 at 62.

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the IIPS. The Society for Worldwide Interbank Financial Telecommunications ("SWIFT") is used as a service provider, to carry payment messages in the form of credit transfers.

The IIPS lacks finality of payment because paper inter-member debit vouchers are used for settlement which depends on clearing the debit voucher.<sup>35</sup> As a result, there is the risk that if the participating institution fails, the transactions with these inter-member debit vouchers will be rewound.<sup>36</sup> Currently, "a default situation might force the unwinding of transactions that had taken place ... possibly leaving the receiving institution, and the recipient of the funds, in financial difficulty".<sup>37</sup>

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The CPA has carried out extensive activity with regard to the LVTS. It is intended that the LVTS will replace IIPS in 1996. The objectives of the proposed LVTS consist of the mitigation of risk associated with payments, providing finality of payments and ensuring certainty of settlement on the same day.<sup>38</sup> The reduction of risk and the ability to offer certainty of payment will enhance Canada's payment system in the international marketplace.

In order to qualify as a settling participant in the LVTS, a financial institution must be "a CPA member, have a reasonable level of participation in the system as measured by modest daily value and volume criteria, be a user of SWIFT in Canada and demonstrate technical competence".<sup>39</sup> Financial institutions that do not meet the foregoing criteria will be able to participate in

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<sup>35</sup> "Current Issues", *supra* note 4 at 16.

<sup>36</sup> *Ibid.*

<sup>37</sup> "CPA Twelfth Plenary Meeting Generates Lively Discussion" [CPA] Forum (December, 1994) 1, (*hereinafter* "CPA Meeting").

<sup>38</sup> *Ibid.*

<sup>39</sup> "Chairman Focuses on Progress in the Development of a Canadian LVTS" [CPA] Forum (June, 1993) 1, (*hereinafter* "Canadian LVTS"). Apparently, as a result of ongoing discussions, there is no longer to be value and volume criteria to be imposed on settling participants in the LVTS.

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the LVTS through agency arrangements with settling participants.<sup>40</sup>

Although the LVTS has been under discussion since 1985, "its development has not been addressed in conjunction with the development of other satellites".<sup>41</sup> The lack of involvement by the CPA in coordinating the development of the various parts of the payments system is perhaps a result of the uncertainty as to where the mandate of the CPA begins and ends.

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The insurance industry would likely benefit from implementation of the LVTS. Life and health insurance companies conduct a significant number of large securities and foreign exchange transactions and would likely use the LVTS to a great extent.

### **Reduction of Systemic Risk In Clearing and Settlement Systems**

In a policy paper, released by the Department of Finance in February 1995, entitled "Enhancing the Safety and Soundness of the Canadian Financial System" ("White Paper"), the federal government proposed that "federal legislation be developed to give Bank of Canada a more explicit role in the oversight of clearing settlement systems from a point of view of controlling systemic risk".<sup>42</sup>

The White Paper also provided as follows:

With respect to the LVTS, for which financial institutions themselves will be posting sufficient collateral to cover the single largest possible default, the Bank of Canada would have the power to guarantee settlement of transactions on the system in the extremely unlikely event that the collateral posted by the institutions is insufficient to cover

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<sup>40</sup> S. Vachon, "Opening Remarks" (Canadian Payments Association Conference, April 27, 1993), 3.

<sup>41</sup> "Letter of Burt to Vachon", supra note 8 at 2.

<sup>42</sup> *Ibid.* at 19.

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the losses arising from multiple participant failure at the same time.<sup>43</sup>

As a result of the implementation of the proposals in the White Paper, participants in the clearing and settlement systems will be able to offer intra-day finality of payment to customers. It is believed that this will substantially reduce the level of risk in the Canadian clearing and settlement system.

The White Paper also suggested that Canada's payments system be harmonized with current internationally agreed-upon standards for risk containment.<sup>44</sup>

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### **Canadian Depository for Securities**

CDS, a private company created in 1970, is owned by the members of the Toronto Stock Exchange, the Montreal Stock Exchange, the Investment Dealers Association, six banks and five trust and loan companies. It provides processing services, i.e. trading and lending of securities transactions for clients. To do so, it operates a book-entry clearing and settlement system for securities. Specifically, the key role of CDS is "to immobilize or dematerialize security transactions by substituting electronic book entries and electronic funds transfer payments to security certificates and cheque payments".<sup>45</sup>

The activities of CDS have been described as follows:

CDS receives and processes information on debt and equity transactions using a batch-based computer system and sends reports to participants on their delivery and payment organizations, as calculated by CDS. Each participant makes a net payment to, or receives a net payment from, CDS in each of the two daily settlement cycles.

Participants can make book-entry deliveries without the physical movement of certificates, which reduces the need

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<sup>43</sup> Ibid.

<sup>44</sup> Ibid.

<sup>45</sup> "Current Issues", *supra* note 4 at 13.

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for participants to maintain a physical stock of securities certificates, and therefore cuts the costs of safe-keeping and record-keeping, and eliminates the messenger and banking costs of certificated deliveries.<sup>46</sup>

540 The current CDS system, however, is unable to realize intra-day settlement of money market transactions. As a result, CDS has been active in the development of the new Debt Clearing Service ("DCS"). DCS, when implemented, will "replace paper handling and delivery of money-market and longer-term debt securities with an automated book-entry system".<sup>47</sup>

Collateralization will be used as a risk-containment mechanism.<sup>48</sup> At the outset, Government of Canada bonds will be the only securities eligible for DCS, with the intention that the service will be extended to other money market instruments including treasury bills, bankers' acceptances, bearer deposit notes, commercial paper, provincial and municipal bonds and notes, corporate bonds, term deposits and guaranteed investment certificates.<sup>49</sup>

Ultimately, CDS is intended to be a satellite of the LVTS. Accordingly, uncertainties about the LVTS have resulted in difficulties in "finalizing the risk proofing mechanism for DCS".<sup>50</sup>

The membership of the CPA has not been invited nor was involved in the design of the DCS for CDS. It has been suggested that the design of the CDS system is properly within the CPA's mandate of planning the evolution of the national payments system.<sup>51</sup> As a result, this provides an example of where the CPA failed to meet its second mandate.

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<sup>46</sup> "BIS", *supra* note 31 at 69.

<sup>47</sup> "Current Issues", *supra* note 4 at 13.

<sup>48</sup> "BIS", *supra* note 31 at 69.

<sup>49</sup> *Ibid.*

<sup>50</sup> "Letter of Burt to Vachon", *supra* note 8 at 3.

<sup>51</sup> "TCAC Position Paper on Access", *supra* note 6 at 11.

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### Interac Association

Similarly, Interac, a major electronic payment and credit distribution system, set up in the spring of 1985, developed with only marginal involvement by the CPA.<sup>52</sup> Specifically, the role of Interac is to be a facilitator in the development of shared networks and services in support of banking and payment services to its members.<sup>53</sup>

Since the creation of Interac in 1985, a privately-owned shared cash dispensing service, i.e. a "service to exchange transactions originating from shared automated banking systems",<sup>54</sup> has been implemented. The network includes over 16,000 ABMs in Canada. Through Interac, a shared electronic funds transfer at point of sale (EFT POS) for members' debit cardholders and retail customers has also been developed.<sup>55</sup>

Since 1989, coincidentally when American Express was awarded a banking licence in Canada, the terms and conditions of access and control of Interac have been the subject of public debate. In fact, since 1991, the Bureau of Competition Policy has been investigating Interac for anti-competitive behavior. Deposit-taking institutions which are members of CPA i.e., banks, trust and loan companies and co-operative credit institutions, can become members of Interac. As of the end of 1992, Interac's membership consisted of nine charter members<sup>56</sup> and nineteen sponsored member financial institutions.<sup>57</sup>

It is possible to obtain access to Interac services only through sponsorship by one of the nine charter members. Sponsored members are able to receive service and have a passive role in the operation of the system.

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<sup>52</sup> "Current Issues", supra note 4 at 16. CPA is involved in standard setting matters of Interac, i.e. cards, messages.

<sup>53</sup> "BIS", supra note 31 at 49.

<sup>54</sup> Ibid.

<sup>55</sup> "Current Issues", supra note 4 at 19.

<sup>56</sup> Interac's charter members are the six major banks, Canada Trust, Canadian Co-operative Credit Society and Confederation Desjardins.

<sup>57</sup> "BIS", supra note 31 at 49. Amex Bank of Canada is also a member.

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Charter members of Interac have borne the costs and risks of establishing the shared networks. They therefore assert that "they have the right to control the activities of Interac and that in pricing access by non-members, they are entitled to a reasonable return on their investment".<sup>58</sup> However, institutions interested in joining the network do not want to pay more than reasonable entrance and user fees.

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The TCAC which, in 1991, represented approximately 60 trust companies in Canada, stated that the development of a payment satellite such as Interac outside the CPA leads to concerns that "equitable access to the national payments system is in jeopardy and the maintenance of competition in the transactions business is critically threatened".<sup>59</sup>

Until 1989, to become a sponsored member of Interac, a reasonable fee was required. A number of non-bank deposit-taking institutions became sponsored members and hoped that "they would be able to convert to charter membership at a later date, upon payment of an equity share".<sup>60</sup>

However, the class of charter membership in CPA was closed to its existing members at the end of 1988 and the entrance fee for sponsored members was increased to the greater of \$100,000 or \$7.00 per card.<sup>61</sup>

With the introduction of EFT POS, access to the new structure was given a separate price. Sponsored members must now pay a new fee for the EFT POS network which is "the greater of \$100,000 or \$5.74 per card based on the estimated number of cards the sponsored member will have issued three years after joining the service."<sup>62</sup>

It has been suggested that the price of access to EFT POS is inappropriate primarily because of the valuation method which is

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<sup>58</sup> "Current Issues" *supra* note 4 at 19.

<sup>59</sup> "TCAC Position Paper on Access", *supra* note 6 at 1.

<sup>60</sup> *Ibid.* at 3.

<sup>61</sup> *Ibid.*

<sup>62</sup> *Ibid.* at 4.

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“an investment cost approach”.<sup>63</sup> The investment cost approach is used to value common stock rather than to a pay fee for service. The access fee to EFT POS, does not result in “an ownership share of the network , nor any of the benefits of ownership”.<sup>64</sup>

Just as financial institutions offered access to ABMs in order to remain competitive in the retail deposit business, the “major non-Interac financial institutions must be able to offer electronic point of sale payment to their clients if they are to retain their transactions business over the long run”.<sup>65</sup> While the entrance fees to the EFT POS system work as a major barrier to access, sponsored members also face uncertainty about additional costs which will be charged to admitted sponsored members.

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From the perspective of the life and health insurance industry, Interac is of special interest because of its role in the context of the debit card system as well as the ABM network. Specifically, in the context of insurance retailing, if the banks are allowed to sell insurance through ABMs, the inability of insurance companies to be members of Interac will create competitive disadvantages. In addition, without access to Interac, the new powers in respect of payment, credit and charge cards given to life insurance companies given in 1992 remain useless.

### **Why Access to the Payments System Is Important**

In November 1990, John Crow in a speech to a Treasury Management Association of Canada conference set out four desirable features of clearing and settlement projects:

- (i) the minimization of systemic risk,
- (ii) the appropriate distribution of risk,
- (iii) the maintenance of equitable access to these systems,

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<sup>63</sup> “Letter of Burt to Vachon”, supra note 8 at 3.

<sup>64</sup> Ibid.

<sup>65</sup> “TCAC Position Paper on Access” supra note 6 at 6.

(iv) effective supervisory oversight of the systems.<sup>66</sup>

As Michael Porter of the Harvard Business School has pointed out, "domestic rivalry is critical to innovation and development of competitive advantage. Vigorous domestic rivalry encourages international success".<sup>67</sup>

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With the 1992 reform package of financial institutions legislation, the Canadian landscape for the financial services industry changed fundamentally as the traditional four pillars crumbled. From the perspective of non-deposit-taking financial institutions, for the best interests of the consumer and sound public policy, the ability to compete with the banks and other deposit-taking institutions on a fair and equitable basis is vital to the continuing evolution of the financial services industry. Currently, life and health insurance companies cannot be members of CPA and as a result are barred from joining Interac.

Although life and health insurance companies are prohibited under the Insurance Companies Act from accepting deposits, many life insurance products in fact share the key attributes of deposits held by deposit-taking institutions. This is the case, for instance, in respect of annuity products during their accumulation period. It has been asserted that lack of access to the CPA by the life and health insurance industry has three key consequences:

- (i) it eliminates a powerful source of competition to the existing payments system providers,
- (ii) it denies the customers of life and health insurers the definite advantage of being able to access their funds on account with an insurance company whenever they need to, and
- (iii) it prevents life and health insurers from exercising all their corporate powers.<sup>68</sup>

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<sup>66</sup> "Issues Surrounding Equitable Access", supra note 9 at 9.

<sup>67</sup> Ibid. at 11.

<sup>68</sup> "Pushing for Reform", supra note 5 at 4.

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It has been stated by the Canadian Life and Health Insurance Association ("CLHIA") that the inability of life and health insurance companies to have direct access to the CPA has competitive implications and prevents life and health insurance companies from building on established relationships<sup>69</sup> with their present clients, an important strategy in the context of intense competition and shrinking profit margins.

As an example, when a life insurance policyholder dies, the beneficiary will be paid the proceed which will be deposited in an account at a bank, trust company or credit union. As a result, the existing relationship is abruptly halted and insurance companies lose customers to banks because they are unable to provide the full range of services required by the customer, including convenient access to funds for payment purposes.

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If a new class of membership, i.e. non-deposit-taking financial institutions were implemented within the CPA, then a life and health insurance company would be able to offer a much broader range of services to a beneficiary. As a result of membership in CPA, a life and health insurance company "could hold the funds for the beneficiary in a money market account ... at competitive interest rates and provide a chequebook and plastic payment card acceptable at ABMs and debit terminals".<sup>70</sup>

The exclusion of life and health insurance companies from CPA also brings about the awkward scenario that where a life and health insurance company develops an innovative new product that includes a new payment method, the company must provide full product details to its payments system sponsor, e.g., a bank for approval, before being able to market the new product. This is particularly troublesome because the sponsor is likely also a competitor of the life and health company, and the information being processed may in fact be more valuable than the processing itself.

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<sup>69</sup> Ibid.

<sup>70</sup> "Need for Payment System Reform in Canada: The Perspective of Life and Health Insurers", CLHIA, (submitted to the Department of Finance, Ottawa) 6.

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From the perspective of the life and health insurance industry, membership in the CPA would preserve the life and health insurance industry as a powerful source of competition to the deposit-taking institutions, ultimately leading to more innovation in the payments system. The life and health insurance industry wants "an open system, with full disclosure and full participation in setting and amending rules governing the payments system."<sup>71</sup>

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In Japan, the Nippon Life Insurance Company enhanced the features of the Nissay Card in 1990. Policyholders who have the Nissay Card can now take out loans and withdraw accumulated dividend receipts by using ABMs throughout Japan.<sup>72</sup> If a life and health insurance company in Canada wants to develop a card with equivalent features, it would likely face competitive disadvantages because of lack of membership in the CPA and restricted access to the Interac network.

### Conclusion

This paper has attempted to examine the extent to which the CPA has fulfilled, since its establishment in 1980, the original Parliamentary intent, i.e., that the "non-bank deposit-taking institutions be brought in as partners with the banks in the management, administration and development of the payments system".<sup>73</sup> It is questionable, however, the extent to which the partnership has been a reality. The paper has also discussed the need to open up membership in the CPA.

It has been suggested that because of lack of agreement on the interpretation of the CPA's second mandate, the banks by default have imposed their own, almost exclusive, interpretation of how the payments system in Canada must evolve.

As a result of technological and regulatory changes, CPA is now operating in a changing environment. It has been

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<sup>71</sup> "Pushing for Reform" *supra* note 5 at 4.

<sup>72</sup> Nippon Life Insurance Company, Annual Report, 1991, 13.

<sup>73</sup> Letter of J.L. Evans to S. Vachon, (August 16, 1991) at 2.

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recommended that CPA develop a Strategic Plan, focusing on the future rather than on the past.<sup>74</sup> The recommendation provides as follows:

(CPA) must clearly identify the factors and forces that are driving change in the sector and assess how these will likely shape the payments system of the future. The Association must outline what the fully electronic payments system should be by the year 2001, describe all its components, and strategically plan, in stages, how it will arrive at its objectives.<sup>75</sup>

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Strategic Planning Guidelines<sup>76</sup> have been drafted for the CPA and include the following items: mandate, mission, issues, objectives, strategies, actions, etc. The mission could address a number of issues including minimization of systemic risk, appropriate distribution of risk, equitable access for all CPA members, effective supervisory oversight of the systems, integrity and professionalism, protection of the rights of the consumers and other users of the clearing systems and promotion of the efficiency of clearing systems.<sup>77</sup>

The CPA is subject to statutory regulation or supervision. The Superintendent of Financial Institutions reports annually to the Minister of Finance whether or not the CPA is operating in conformity with the CPA Act and the by-laws.

It is my view that the activities of privately-owned groups discussed in this paper as well of those of the CPA must be examined and implemented bearing in mind the Parliamentary intent in the establishment of the CPA. Indicators of progress of a payments system include speed of settlement, cost-effectiveness, security and acceptability to all stakeholders. The CPA "must play the strong role it was intended to play in maintaining healthy competition among its many member

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<sup>74</sup> Ibid.

<sup>75</sup> Ibid.

<sup>76</sup> Ibid.

<sup>77</sup> Ibid. at 6.

institutions by keeping the payments highway open for all those who qualify to use it".<sup>78</sup>

Fifteen years after its enactment, the CPA Act is in dire need of in-depth review in my opinion if the legitimate goals set above are to be achieved. Without such a review, the financial institution legislative reform of 1992, which gave each of the classes of institutions the general right to provide all financial services, will remain incomplete to the disadvantage of Canadian consumers of financial services.

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<sup>78</sup> Trust Companies Association of Canada, "Position Paper on Equitable Access to the Canadian Payments Systems" submitted to the Board of Directors of the Canadian Payments Association, February 3, 1992, 9.