Achieving the Public Policy Objectives: 
The Governance of the Payments System in Canada

Background Paper for Discussion by the Payments System Advisory Committee
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Foreword

This paper is the last in a series of four background papers prepared by staff of the Bank of Canada and the Department of Finance for discussion by the Payments System Advisory Committee. The Advisory Committee is assisting the Department of Finance in its review of the payments system in Canada.

Building on the background and policy discussions of previous papers in this series, this fourth paper examines some basic questions about the governance of the payments system in Canada. For the purposes of the discussion, “governance” is broadly defined to include both the legal framework and the regulatory and decision-making structure under which payments system activity is carried out and evolves. Dealing with these two elements of governance separately, the paper reviews the current legislative and decision-making structure for the Canadian payments system and examines some of the key issues related to that structure in terms of the public policy objectives of efficiency, safety and the consideration of consumer interests. The roles of government and the private sector are explored, and some of the considerations involved in finding an appropriate balance between private sector activity and public sector involvement are discussed. In light of the issues raised, some alternative legislative and regulatory arrangements for the various elements of the payments system are presented, and some of the trade-offs involved in choosing among them are examined.

Accompanying this paper is a summary of the Advisory Committee’s discussions regarding the governance of the payments system in Canada. When read in conjunction with the paper, these comments provide the reader with a full appreciation of the range of issues and viewpoints discussed by the Committee.
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1. Introduction

Over the past decade, the Canadian financial system has undergone a major transformation, marked by innovation and competition among a variety of institutions in a broad range of markets for financial instruments and services. Financial sector regulatory reform over this period has generally supported, and even promoted, this restructuring. However, with the exception of the introduction of the Payment Clearing and Settlement Act in 1996, the legislative and decision-making structure for the Canadian payments system has remained substantially unchanged over this period. Given the importance of the payments system to both the financial system and the broader economy, there may be a need to re-examine its governance structure in light of these recent developments.

For the purposes of this paper, ‘governance’ of the payments system is broadly defined to include both the legal framework that guides the activities of the system and provides the statutory authority to its institutions, and the regulatory and decision-making arrangements that guide its operations and development. The specific objectives of this paper are:

(i) to review the current governance structure for the various parts of the payments system in Canada;

(ii) to examine issues related to the governance structure in terms of the public policy objectives; and

(iii) to consider alternative arrangements for achieving those objectives.

The remainder of the paper is organized as follows: Section 2 discusses the legislative framework for the payments system. Some basic principles of framework legislation are introduced, the current legislative and institutional framework is described, and some selected issues relating to this structure are examined along with some possible options for resolving them. Section 3 considers the regulatory and decision-making structure for the payments system. Again, some principles of government intervention are outlined, the current system examined and some issues and options presented for discussion. Section 4 provides some concluding observations.
2. Legislative Framework for the Payments System

2.1. Establishing a Legislative Framework

Market economies require institutions to organize the operation of the market system. Government contributes to the economy’s fundamental institutional arrangements through the development of economic ‘framework legislation’. Such legislation helps to specify property rights and the rules of conduct in commercial activities associated with the transfer of property. The various payment service networks that comprise the payments system in a market economy are typically governed by much of the same general framework legislation as other types of market activities, as well as by specialized legislation reflecting the unique function of the payments system in the economy.

A central decision that government must make in setting out such legislation is to determine exactly how extensive in scope and comprehensive in detail the framework should be. At a minimum, the framework should embody the notion of property rights, and include general competition laws to deal with cases in which the market alone does not function effectively. Further, the framework should facilitate the establishment by private contract of the rights and obligations of the various parties involved in payments activity, and contain enforcement mechanisms to ensure the robustness of those agreements.

Beyond this minimal framework, the general organization of payments activity, the rights and obligations of market participants, and the allocation of risks and liability could be determined according to voluntary agreements between and among the parties involved. Government may choose, however, to incorporate some of these aspects into its framework legislation. For example, the general bankruptcy and insolvency legislation in Canada sets out the procedures to be followed in the event of insolvency, including provisions ensuring the orderly winding-up of activities, and sets out the basic rights and obligations of affected parties. Specific to the payments system, the Bills of Exchange Act establishes the rights and responsibilities of the various parties involved in most types of paper-based payments activity. In the absence of such framework legislation, the negotiation of individual rights and general procedures would be left to market participants, and would need to be specified in the contractual agreements underpinning the relationships between the parties involved.
A main objective of economic framework legislation is to set out basic rules for the operation of the market consistent with the public policy objectives. As discussed in the second paper in this series, in the context of payments, the public interest is best served when the payments system is efficient, safe and takes consumer interests into consideration. To be effective, framework legislation for the payments system should be transparent, flexible and competitively neutral. Transparency of legislation implies that participants in the system can be reasonably certain about the legality of their specific activities. Flexibility in framework legislation means that, while comprehensive in principle, the legislation both permits market activity to evolve and can accommodate market activity in its new forms. Transparency and flexibility in legislation are among the key prerequisites for productive innovation and progress in the payments system. Finally, competitive neutrality implies that the legislation does not unduly discriminate against individual activities or participants, unless there is an overriding public interest.

2.2. Overview of the Existing Legislative and Institutional Framework

Underpinning the day-to-day operation of the payments system is a complex and interrelated web of laws, rules, standards and procedures that establish the legal and institutional basis for the operation of the various elements of the system. As the first paper in this series highlighted, the general legal framework is comprised of both public and private laws. The former are statutes and government regulations, designed to promote the public interest and having compulsory application; the latter are embodied in voluntary agreements between the various parties involved in payments activity, and in the body of precedents established by the courts in interpreting these agreements.

From an institutional perspective, the payments system is also characterized by a mix of public and private participation. Among the public sector agents that are involved in the operation and development of the system are federal and provincial governments, the Bank of Canada, the Office of the Superintendent of Financial Institutions (OSFI), the Canada Deposit

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1 A more detailed description of the current legislative and institutional framework for the Canadian payments system is contained in the Appendix.
Insurance Corporation (CDIC) and the Competition Bureau. On the list of private participants are the financial institutions involved in payments activity, the range of privately established and operated payment networks and joint-venture arrangements, and the users of payments services themselves. The Canadian Payments Association (CPA) is an example of a body that is characterized by elements of both public and private participation.²

The primary piece of payments legislation in Canada is the Canadian Payments Association Act (CPA Act). Adopted by Parliament in 1980, this Act established the Canadian Payments Association and gave it a statutory mandate to “establish and operate a national clearings and settlements system and to plan the evolution of the national payments system”. The CPA Act, together with the Association’s by-laws and rules, set out the rules, procedures and standards that govern the daily operation of participants in the national clearing and settlement system.

The Bank of Canada plays a crucial role in the Canadian payments system, carrying out an operational function as well as supervisory responsibilities with respect to certain clearing and settlement systems. Under the Bank of Canada Act, the Bank may accept from banks, and other members of the CPA, deposits which are used to effect the final settlement of payment liabilities in the national system. The Bank may also provide lender of last resort facilities to these institutions.³ The regulatory and oversight responsibilities of the Bank of Canada in respect of the payments system are outlined in the Payment Clearing and Settlement Act, which came into force in July 1996. This Act establishes a legislative basis for the Bank to oversee certain clearing and settlement systems in order to control systemic risk.

The federal financial institutions statutes (the Bank Act, Trust and Loan Companies Act, Cooperative Credit Associations Act and Insurance Companies Act), coupled with legislation governing provincially incorporated financial institutions, provide the statutory underpinnings of

² As will be discussed later, the CPA, established under federal statute, is essentially an independent industry association with a range of delegated regulatory powers, which receives some public policy input from government.

³ The Canada Deposit Insurance Corporation – a federal Crown corporation – also serves as a potential source of liquidity for some payments system participants. Under its Act, the deposit insurer may make loans or advances to its member institutions, and may also make deposits with its members.
the Canadian financial system. In doing so, these statutes also help to specify some of the participants in the markets for acquisition, clearing and settlement services. The general rights and obligations of these participants are spelled out in various statutes and private agreements. These include the federal Bills of Exchange Act, which sets out the statutory framework governing most paper-based payments activity, the agreements between financial institutions and their customers, and the rules and contracts governing the operation of proprietary payment networks.4

All of this payments system activity is established under the broader legislative framework for the economy. For example, the Competition Act, which contains provisions to deal with a broad range of anti-competitive activities, has general application to all firms in all sectors of the economy, except where an explicit exemption exists in other legislation.5 General bankruptcy and insolvency laws set out procedures for dealing with cases of insolvency, provide for the orderly winding-up of activities, and define the general rights and responsibilities of affected parties. Finally, provincial consumer protection legislation has application to acquisition services.

2.3. Selected Issues and Options Related to the Legislative Framework

A clear and transparent legal and institutional framework can, by providing systematic definitions of the rights and obligations of the various parties to a transaction, help to bring certainty to the payments process and allow participants to identify and manage risks. Further, by providing a flexible and open structure within which to orchestrate technical innovation and the adoption of new processes and instruments, the framework can contribute to the future evolution and development of the payments system.

4 The voluntary Canadian Code of Practice for Consumer Debit Card Services, while not legally binding, also helps to define the rights and obligations of financial institutions and their customers with respect to the issuance and use of certain debit card products.

5 Activity which is conducted pursuant to a valid scheme of regulation may also be exempted from certain provisions of the Act under what is known as the ‘regulated conduct defence’.
The purpose of this section is to examine some important issues surrounding the existing legislative framework. The central concerns relate to innovation with regard to electronic payments, competition among service providers, and privacy and the security of information.

2.3.1. Innovation and Electronic Payments

The Possible Need for Legislation Governing Electronic Funds Transfers

In recent years, the Canadian payments system has been characterized by increased use of electronic payment technologies. As the first discussion paper in this series pointed out, although cheques and other paper-based instruments still account for roughly 98 per cent of non-cash payments activity when measured by value (most large-value payments are still executed using paper instruments), electronic payments (credit card and debit card transactions, and direct credit and debit transfers) now account for more than half of the volume of non-cash payments processed in Canada. While the use of electronic payment methods has become increasingly prevalent, the legal and regulatory framework for these arrangements remains relatively undeveloped.

In the case of paper-based payment items such as cheques, the definition of the rights and obligations of the various participants in the payment process is reasonably well established and understood. These basic legal principles are embodied in the Bills of Exchange Act and in the body of case law that, over many years, has been established by the courts in interpreting both the Act and the contractual agreements negotiated between private institutions and individuals.

In the case of electronic funds transfers (EFTs), however, there exists no public statute underpinning the legal framework, and the relative newness of the technology has not allowed time for the courts to establish a strong body of legal precedent, although many of the principles applying to paper instruments might also provide guidance in the electronic context. In the absence of a strong and transparent legal framework, however, there may exist significant uncertainty regarding such issues as the legal finality of payments and the assignment of liability in the event of institutional failure or system breakdown. While, in the long run, the instruments and agents of private law would likely develop a comprehensive legal structure for the evolving
electronic payments environment, questions have been raised as to whether the Canadian payments system needs a formal legislative framework to govern electronic funds transfers, as the Bills of Exchange Act has governed paper-based payments for more than a century.

In the context of electronic payments, a legislative response might be motivated by a desire to protect consumer interests or to provide certainty to market participants regarding their rights, responsibilities and liabilities in dealing with electronic funds transfers. In the absence of government oversight and intervention, privately negotiated agreements may tend to favour financial institutions over their customers, because of information asymmetries and unequal bargaining power. As a result, liability resulting from loss, fraud or malfunction, could be borne disproportionately by consumers. While it is reasonable to expect consumers to face a share of the risks associated with electronic payment instruments, in order to provide economic incentives to take reasonable security precautions – for example, in protecting their payment card and the integrity of the personal identification number (PIN) – it is also important that financial institutions face incentives to ensure a high level of integrity of their systems and equipment, in order to lessen the possibility of electronic breaches of security.

A second potential benefit of EFT legislation might be the removal of legal uncertainty among participants regarding their rights and obligations in dealing with electronic payments. Even if the legislation were to do nothing but codify market outcomes (setting aside the consumer interest objective discussed above), the removal of this uncertainty could lead to a more efficient outcome, as participants would be better able to identify and manage the risks they face.

It is possible, however, that both of the above objectives could be accomplished through alternative, and less direct, forms of public sector involvement. These approaches may offer the potential to contribute to a more equitable and efficient market outcome, without imposing the rigidities of formal legislation. For example, the existing voluntary Code of Practice for

6 The relatively small amounts of money involved in most retail payment transactions may serve as an impediment to this process, given the possible cost to consumers of using the courts to resolve problems that may arise.
Consumer Debit Card Services was developed in consultation with government and consumer groups, and has gained widespread acceptance within the deposit-taking industry. Other options for government include the issuance of standards for EFT activity, and consumer education programs to help offset the information advantages held by institutions, thus improving consumers’ bargaining positions vis-à-vis their service providers.

The Bills of Exchange Act and Cheque Truncation

Recent advances in information processing and communications technology have facilitated the use of increasingly automated techniques for processing and clearing paper-based payment items. One such example is the process of “cheque truncation”, by which the vital information from a cheque is captured and transmitted electronically – rather than the cheque itself being physically transported – to the institution on which it is drawn for verification and authorization of payment. Once this process has been completed electronically, the original cheque may be either retained in a central storage facility or destroyed, depending on the design of the system and any rules that may be established. The process of cheque truncation may present opportunities to significantly reduce the burden associated with the processing and clearing of paper payment items.

The Bills of Exchange Act, however, currently prevents the practice of cheque truncation, requiring that cheques be physically presented at the place of payment identified on the cheque (typically the branch of account of the payor). Further, the manner in which the Act defines the rights of certain parties to a cheque is tied to the notion of “possession” of the instrument. These definitions could prove to be problematic in instances where a cheque has been truncated and subsequently destroyed. There also exists uncertainty as to whether a truncated and destroyed cheque would be considered “lost” or whether the act of destruction would be construed as “intentional cancellation” under the Act.

Other legal impediments may also exist. For example, there appears to be significant uncertainty under the Canada Evidence Act as to the admissibility into evidence of computer-generated cheque images, and other electronically stored information in respect of a cheque.
It has been argued that these legislative impediments may be unnecessarily inhibiting the transition to more efficient payments processes, and a fuller exploitation of current technical capabilities. These efficiency goals, however, must be examined in the context of the broader public policy framework to ensure that the trade-offs among objectives are adequately managed. For example, with the advent of cheque truncation, customers would not generally receive their cancelled cheques for verification, and instead would have to rely on electronically generated images or mere descriptions of the items. With respect to safety, precautions would need to be taken to ensure that the electronic transmission and verification of information would not pose increased potential for fraud or error.

2.3.2. Competition Issues

Under its Act, the Canadian Payments Association is effectively given the exclusive right to organize the provision of certain payments services in Canada. Although the CPA is established under federal statute as a public interest corporation, the government has only a limited voice in its operation, and the day-to-day task of decision-making is left primarily to the CPA’s Board of Directors and its membership. These individuals and institutions, as active participants in the markets for payments services, may make decisions affecting the operation and development of the payments system that could have the potential to benefit existing members at the expense of other stakeholders in the system.

In spite of this potential outcome, under the interpretation of the Competition Act, activity that is carried out pursuant to a valid scheme of regulation is deemed to be in the public interest and therefore does not violate the criminal provisions of the Act. As a result of this ‘regulated conduct defence’, much of the activity conducted under the auspices of the CPA may be shielded from scrutiny and sanction under the Competition Act. To the extent that competition within a particular system or network may be constrained by such an outcome, efficiency in the provision of payment instruments and services to institutions outside the cooperative group and to consumers could be reduced. This may suggest a need for changes to the CPA Act, the Competition Act, or both, to eliminate any unintended insulation and to allow the principles

7 The CPA’s consultation and decision-making process will be discussed in detail in Section 3.
embodied in the *Competition Act* to be applied more directly to the markets for payments services and related financial products.

On the other hand, an argument can be made that any decisions approved by the government (or by a government-sanctioned body) should be above competition law on the basis that those decisions should reflect the full range of public policy considerations (including the objectives of competition law). Thus, the relative merits of applying competition law, versus allowing certain rules to be beyond its reach, will depend upon the degree to which the decision-making body for the payments system can be relied upon to set rules that reflect an appropriate balance among the public policy objectives.

### 2.3.3. Privacy and the Security of Information

While recent advances in information processing technology have permitted the adoption of more efficient methods of processing payment instruments, as described above, they have also facilitated easier access to, and analysis of, personal financial information. Financial institutions collect and process extensive amounts of information about their customers, which may subsequently be used in the marketing of their services. As described above, because of information asymmetries and unequal bargaining power, there may be a need for government intervention to ensure that the rights of consumers are adequately reflected in contractual outcomes.

Existing provincial consumer protection legislation provides some assistance in this regard, as the area of consumer affairs is essentially one of provincial jurisdiction. In addition, at the federal level, Bill C-82, *An Act to amend certain laws relating to financial institutions*, which was recently passed into law, included amendments to the *Bank Act*, *Trust and Loan Companies Act* and *Insurance Companies Act* to strengthen the protection of consumer privacy. These amendments provide the Governor in Council with the authority to make regulations requiring the institutions governed by these statutes to establish procedures regarding the collection, retention, use and disclosure of customer information, and for dealing with related customer complaints.
Even with these measures, however, there may still exist substantial uncertainty concerning the rights and obligations of telecommunications carriers and other non-financial institution service providers with respect to privacy and the security of personal information. Certain elements of the framework legislation provide some guidance, such as the *Criminal Code*, which covers issues of computer fraud, and the *Canadian Human Rights Act*, which gives individuals access rights to records containing personal information. However, there may be a need to reassess the adequacy of the current legislative framework in dealing with issues of consumer privacy and the security of information.

### 3. Regulatory and Decision-Making Structure for the Payments System

#### 3.1. Principles of Government Intervention

A fundamental issue for the achievement of the public policy objectives is the degree to which the payments system should be shaped by competitive market forces, coordination and cooperation among participants, and direct forms of government intervention. The second paper in this series described a market-based approach to policy that encompasses both competition among individual providers of payment instruments and services, and the possibility that participants may cooperate in the establishment of standards, rules and procedures, and in the coordination of certain operations.

The general purpose of government intervention in the payments system is to shape the behaviour of market participants to achieve a desirable balance among the objectives of efficiency, safety and the consideration of consumer interests. For example, government intervention may be warranted if cooperation among market participants leads to excessive restriction of competition and to the exploitation of market power. As noted earlier, one policy instrument that can be used to deal with this situation is competition law; regulatory oversight of the cooperative activities is another. Where spillover effects are felt beyond individuals or cooperative groups, such as in the case of systemic risk, government intervention may be needed to ensure that these broader effects are taken into consideration.
Further, there may be situations where it is appropriate for governmental authorities to provide certain services directly in the market. For example, several arguments favour the use of the central bank as the provider of settlement services in a national payments system. First, there are competitive concerns with regard to private provision. A private settlement bank may be able to increase its market share in certain financial markets as a result of its central position as the provider of settlement services. Second, the provision of settlement services by the central bank limits systemic risk in the payments system, since the central bank cannot become insolvent and is able to readily provide liquidity support to payments system participants within the payment clearing cycle.

Although government may employ a number of intervention procedures to alter the behaviour of market participants, regulation has been the predominant intervention approach in markets for payments and other financial services. In a market-based approach to policy, regulation is preferred to direct provision of services when private firms are willing and able to provide services efficiently.

There is no single regulatory template, and government may construct the regulatory framework along a number of dimensions. For example, regulation in general may be defined in accordance with institutional arrangements, such that all institutions of the same type are required to satisfy the same set of rules and operating standards regardless of their mix of actual market activity. Alternatively, regulation may be defined on a functional basis, such that all institutions active in a particular market must meet common standards regardless of their type of incorporation. Regulation may be preventive in nature, designed to forestall or minimize the occurrence of some adverse market outcome, or remedial, setting out procedures to deal with adverse outcomes once they have occurred.

Finally, governments may choose to regulate directly or to delegate regulation. Direct government regulation involves rules set down by a legislative authority, with some public agency empowered to oversee compliance. In this case, the public regulatory authority must acquire the specialized technical and market expertise required to ensure effective rule-making and oversight. Delegated regulation involves the government in the determination of the general
parameters of the regulations (and, in some cases, specific rules and standards of particular importance), but leaves most of the responsibility for rule-making, oversight and enforcement with some non-government body directly involved in the market. Hybrid models are also possible, for example, where the functions of rule-making and oversight may be separated, with government retaining responsibility for one or the other.

Regardless of the template chosen, among the objectives of regulation are to ensure: prudential behaviour in market activities to minimize risks; adequate public disclosure of information about institutions, products, and counterparties in market transactions; sufficient competition in terms of pricing and provision; and minimum standards of product and service quality. Regulation should be transparent in terms of objectives, rules and procedures; flexible to permit rapid response to innovation; and competitively neutral to encourage the widest possible participation in the market, subject to prudential or other overriding considerations. The design of the regulatory mechanism should be cost-effective, both in terms of administration and enforcement, and of broad economic benefits and costs. Finally, the regulator should be accountable with regard to the achievement of the public policy objectives.

3.2. Overview of the Existing Regulatory and Decision-Making Structure

Settlement Services

Settlement services are provided by the Bank of Canada to institutions designated as Direct Clearers in the CPA through settlement accounts held at the Bank. In turn, these Direct Clearers provide clearing services and indirect access to settlement facilities for other CPA members designated as Indirect Clearers. When the CPA’s Large Value Transfer System (LVTS) begins operation in mid-1998, the Bank of Canada will provide settlement services to those CPA members that participate directly in LVTS.

The operations of the Bank of Canada, including its provision of settlement services, are defined under the Bank of Canada Act. A link to the Canadian Payments Association is provided by the Chairman of its Board of Directors, who is a senior Bank of Canada official. Views on specific issues related to the Bank’s role in the payments system are also received from a variety
of interested parties, including the Department of Finance, in both formal and informal meetings with Bank of Canada officials.

**Clearing Services**

The CPA provides facilities for its membership to clear payments for settlement on the books of the Bank of Canada. It sets rules, standards and guidelines for entry of payments into its Automated Clearing Settlement System (ACSS) from a complex system of regional and national clearing networks for both paper-based and electronic payment instruments. It will provide similar facilities and perform similar functions for LVTS.

The CPA operates under the authority of the *CPA Act* with its by-laws approved by the Governor in Council. OSFI is required to report annually to the Minister of Finance on the Association’s compliance with the Act. OSFI does not, however, have either rule-making or cease and desist powers with respect to CPA operations. The Bank of Canada – under the authority of the *Payment Clearing and Settlement Act* – has oversight responsibility and enforcement powers with respect to certain clearing and settlement networks that have the potential to create systemic risk.

With the exception of the by-laws, rule-making powers are delegated under the *CPA Act* to a Board of Directors, all of whom are representatives of member institutions and have considerable expertise in the operations of the payments system. The Board has 11 members – five elected by the chartered bank members of the Association, five elected by the non-bank deposit-taking institution members, and the Chairman, whom the Act specifies to be a senior official of the Bank of Canada. The CPA relies largely on institutional regulation at the federal and provincial levels – through the oversight of OSFI, CDIC, and other federal and provincial regulatory authorities – for standards of prudential management for its members.

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8 Of the non-bank directors, two are appointed by the trust and loan company members, two by the credit union centrals, and one by the class of other deposit-taking institutions.
Although the public sector has ultimate control over the decision-making process through the government’s specification of the *CPA Act*, its approval of the Association’s by-laws through the Governor in Council, and the Bank of Canada's powers granted under the *Payment Clearing and Settlement Act*, the bulk of the decision-making responsibility rests with the CPA Board.\(^9\) Within the Board itself, some special powers are invested in the Chairman by the *CPA Act*. In the event of a tie vote on any matter before the Board, the Chairman is given a second vote. The Chairman also has final decision powers on whether a proposed rule conforms to the by-laws of the Association approved by the Governor in Council.

Decisions taken by the Board are influenced to some degree by various committees of CPA members, and by external advisors and organizations representing a broad range of groups interested in the payments system. The CPA engages in a variety of organized forums to consult with stakeholders. For example the CPA sponsors conferences on the Canadian payments system to consider issues and proposals for system development. It holds biannual plenary meetings to which a broad range of private organizations and public sector agencies are invited to make presentations on topics of particular concern. In addition to these more comprehensive meetings, the CPA Board frequently invites third-party stakeholders to present their views to CPA technical working groups. The Association also participates in other liaison mechanisms with federal and provincial government bodies, including working groups and standing committees focused on particular activities and operations. The CPA also publishes newsletters, policy statements, activity reports and educational brochures for broad distribution to interested parties.

The CPA has taken steps recently to formalize further its consultative process through the creation of the CPA Stakeholder Advisory Council and the CPA Consultative Committee. The Stakeholder Advisory Council, established in 1996, is an 18-member group which advises the CPA Board on payments system issues from the perspectives of a variety of interest groups. All

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\(^9\) An exception is the approval process for the CPA’s operating budget. While the Board is responsible for preparing the budget, it must be approved by members using a weighted voting scheme, whereby the number of votes allocated to each member is equal to the dollar amount of its annual dues payable to the Association. These dues, in turn, are based on the member’s clearing volume during the previous year.
but three members of the Council – the General Manager of the CPA and two Board members – are drawn from outside stakeholders in the payments system. The Chairman of the Council is a representative of non-CPA member stakeholders and is chosen by the Council. The Consultative Committee is composed of some members of the CPA Board and representatives from the Department of Finance, and meets twice a year to discuss public policy issues related to the Association's activities.

**Acquisition Services**

There is no specific regulation directly governing the provision of acquisition services in Canada. However, the principal providers of these services are deposit-taking institutions, which are subject to prudential regulation at either the federal or provincial level. This prudential regulation serves as a primary mechanism for contributing to stability in markets for financial services, including payments services. Specific institutional legislation, such as the financial institutions statutes described earlier, and provincial consumer protection legislation, also set parameters for operational arrangements and contractual agreements that would contribute to the protection of consumer interests.

Payment card associations such as Interac for debit cards, Visa Canada and MasterCard for credit cards, and Mondex for e-money cards are not currently subject to direct financial regulatory oversight in Canada.\(^{10}\) Since these payment card organizations are cooperative associations of regulated financial institutions, however, institutional regulators such as OSFI provide some prudential oversight that may influence their behaviour in the provision of payment card services.

\(^{10}\) International credit card associations, such as Visa and MasterCard, are regulated in the United States – most notably under the *Truth in Lending Act* (1970), the *Fair Credit Billing Act* (1975) and the *Fair Credit and Charge Card Disclosure Act* (1988). In addition to this federal regulation, they are also subject to state regulation, some of which limits interest rates and restricts fees and charges. Some states have also adopted information privacy and disclosure laws, and fraudulent use liability laws, which supplement federal laws in this area. As a cost-saving procedure, these associations typically adopt U.S. standards as their ‘North American’ standards.
3.3. General Approaches for the Decision-Making Process

Possible approaches to the governance of various parts of the payments system may range from a predominantly market-based approach to those that rely to a greater degree on public policy input in various forms. The purpose of this section is to describe the key elements of the various approaches along the spectrum, and to identify some of the considerations involved in choosing among them.

**Market-Based Approach**

The market-based approach embodies a very minimal role for government, limited to the establishment of competition laws and a general legal framework supporting the specification of individual rights and obligations through private contracts. While highly flexible, this approach may provide inadequate means of dealing with a range of potential adverse outcomes. For example, while competition law could be relied upon to address the potential abuse of market power resulting from cooperation among market participants, it may not adequately consider safety, the possibility of spillover effects (both positive and negative), and potential consumer impacts.

**Industry Association with Government Oversight**

While this approach generally relies on private incentives in cases where the outcome produced is reasonably consistent with the public policy objectives, it provides public policy input to overcome the shortcomings of the market-based approach. Decision-making power is vested in private associations of market participants, which may face formal input from government into their day-to-day operations. In the payments system, such an association might have operational as well as rule-making functions. With respect to its operations, it would have many characteristics of a joint-venture business, while its rule-making powers would give it characteristics similar to those of a self-regulatory organization (SRO). The current arrangement for the organization of clearing services under the CPA fits this general description.

Like an SRO, such an association might be sanctioned by government and subject to some form of public sector oversight. For example, some or all of the rules of the association might be subject to government approval. The government may dictate criteria for participating in the
market by setting criteria for membership in the association, or these may be set by the
association itself. To a large extent, the rules of such an association could serve as a proxy for
direct regulation by government. Government approval of the rules may be used as a check to
help ensure this outcome. Another form of discipline on the association may be an implicit
understanding that, if it fails to serve the public interest, a more direct form of government
intervention may be imposed.

A benefit of creating an industry association with self-regulatory responsibilities is that it
may harness the self-interest of market participants (as a group), and their knowledge, to produce
more efficient regulation. In this regard, the association may also be well positioned to respond
to changes affecting the sector and to promote rules that permit or promote innovation. One
limitation may be that some regulation could be self-serving, or might not take adequate account
of the interests of others. For example, if an innovation happens to favour players outside the
association (or perhaps only a small portion of its members), the association might operate in a
manner that tends to maintain the status quo. Even if public oversight includes the approval of
the association’s rules by the government or a government agency, there is a risk that the
association’s information advantage could result in the approval of decisions that unduly favour
its members over other stakeholders.

**Public Sector Regulatory Agency**

This approach is distinguished from the industry association model in that rule-making is
taken away from market participants and centralized within a public sector regulatory body. The
regulatory body may have the power to control entry and exit from the industry, the general
market structure, product or service offerings, prices, and standards of various kinds.

This approach places a significant monitoring burden on the public sector body. For the
regulatory body to be effective, detailed knowledge of the workings of the payments system
would have to be obtained on an ongoing basis, drawn in part from the industry and its
stakeholders. If adequate knowledge can be successfully maintained within the regulatory body,
this approach can potentially lead to informed decision-making that serves the public policy
objectives well. However, because of the potential information advantage held by market
participants, they may have both the capacity and the incentive to act strategically in communicating information to the regulator.

**Direct Provision of Payment Services by Government**

This model involves the government in establishing and providing services covering all or some aspects of the national payments system. It might do so either as a sole provider or as a competitor in the market. In industries that exhibit natural monopoly characteristics, direct provision provides one way of capturing economies of scale without suffering the disadvantages of monopoly pricing. It may also provide an effective solution to the monitoring and information costs associated with the regulatory approach.

Further, if government has a strong comparative advantage as a provider of a particular service, then public sector provision may yield benefits that could not be duplicated in any other way. For example, as discussed earlier, central bank provision of at least some aspects of settlement services may be justified on the grounds that the central bank is able to provide risk-free instruments for settlement purposes, along with liquidity support that can be delivered within the payment settlement cycle, and set access terms to these services in a way that is consistent with the public policy objectives.

Such a comparative advantage is much less likely to exist in the markets for acquisition and clearing services. Even if segments of these markets were characterized by adverse market structures and the presence of market failure, these problems could be adequately addressed through government supervision and regulation, rather than direct provision.

### 3.4. Issues and Options Related to the Regulatory and Decision-Making Structure

The purpose of this section is to consider some of the key issues surrounding the current decision-making structure for the Canadian payments system. These issues tend to be focused on the appropriate roles of the public and private sectors. In this context, three basic questions are readily apparent:
(i) Who has input into the decisions regarding the operations and development of the payments system in Canada? Specifically, do all stakeholders in the system have some effective mechanism – either market-based or regulatory – to voice their concerns and preferences, and is the system responsive to them?

(ii) Who makes the final decisions regarding the operations and development of the system and how are these decisions reached? For example, are decisions made through public or private sector arrangements, or are they shared?

(iii) Are the existing arrangements the best ones for implementing these decisions and monitoring their effects? Most notably, is the current form of public sector intervention in the payments system the best mechanism for achieving the public policy objectives, and are the arrangements associated with that intervention mechanism as effective as they should be?

Most of the issues currently under discussion relate to markets for clearing and acquisition services. For the reasons discussed above, the benefits and appropriateness of direct provision of settlement services by the Bank of Canada – rather than by the private sector – do not appear to be in question.

3.4.1. Planning the Evolution of the Payments System

As indicated earlier, one possible risk associated with a centralized decision-making body, such as an industry association like the CPA, is that decisions may be partly motivated by the internal interests of those institutions directly involved in the decision-making process. In the context of decisions concerning future directions, the result may be that such development planning becomes biased toward ‘status quo’ outcomes or that innovation tends to conform to existing institutional structures. A further question concerns the ability of such a centralized body to successfully ‘pick winners’ – for example, to make decisions concerning (and possibly choices among) emerging technologies at their early stages of development.

These points speak to the more fundamental question of whether the evolution of something as complex as the payments system can be ‘planned’ in an orderly fashion, or whether that evolution should be left to the market, to be determined as the collective outcome of individual,
and often independent, decisions taken by its participants. The key issue is whether the benefits associated with cooperation and centralization (e.g., interoperability and common technical standards) are strong enough to compensate for potential losses in dynamic efficiency that might result from a diminished role for the market in the development of particular elements of the system.

As described in Section 2, the legislative structure underpinning the Canadian payments system attempts to centralize, to a certain extent, the function of planning the future development of the system. This principle is embodied in the CPA’s ‘second mandate’, which gives the Association the role of planning the evolution of the national payments system. Many observers, however, have questioned whether the CPA has effectively fulfilled this aspect of its mandate. The arguments have tended to focus on the specification of the mandate in the CPA Act, criticizing it for being vague in setting out the role of the CPA in this area and for not providing sufficient statutory direction as to its objects and powers.

If, in fact, the current legislative framework provides insufficient guidance as to the role of the CPA in planning the evolution of the payments system, two options are available for resolving this dilemma. First, the CPA Act could be amended to clarify the Association’s objects, specifically with regard to the meaning of the statement “to plan the evolution of the national payments system”, and to elaborate on the powers available to it in fulfilling this mandate. Such legislative change may need to be accompanied by changes in the CPA consultation and decision-making process, in order to elevate and formalize the strategic planning exercise. Second, the role of planning the evolution of the Canadian payments system could be removed entirely from the CPA’s mandate, and left to market forces.

3.4.2. Scope of the Oversight Function

Related to the question of the role of a central oversight body in the planning of the payments system is the question of how the scope of an oversight body should evolve with the development of new forms of payment and new payment networks. Some observers have suggested, for example, that a weakness in the existing governance structure is that much of the development and operation of electronic forms of payment is currently outside the scope of any
formal oversight body. Closing this perceived gap could be done either by having the government assume an oversight role with respect to payment networks other than those operated by the CPA, or perhaps by adapting the CPA itself to allow it to serve such a function.

Extending public policy input and oversight to additional networks may be justified primarily where market forces have led to the emergence of dominant players in particular types of payment services, such as those provided by Interac, the Canadian Depository for Securities, and possibly Mondex. If the government’s role in the payments system were to extend beyond the CPA (and beyond the current authority of the Bank of Canada under the *Payment Clearing and Settlement Act*), it may be more efficient to create a regulatory or oversight board covering all relevant payments system networks than to duplicate the forms of public sector input for each one.

Potential benefits of broadening the scope of the CPA to cover these networks may arise from increased coordination on standards and from providing public policy input into these networks through the CPA. For example, a CPA with an expanded mandate could play an enhanced role in encouraging the compatibility of different payments services and promoting standards related to safety and integrity. In addition, the elements of public policy influence over the CPA would extend to these other networks. An important caveat to this approach, however, is that, by increasing the CPA’s authority, the importance of ensuring that the governance structure of the CPA serves the public policy objectives may be even more critical.

### 3.4.3. Stakeholder and Public Policy Input

A wide range of mechanisms could be adopted to counter the potential for the decisions of an industry association to diverge from the public interest. Most would work by providing for greater input from outside the association and greater consideration of broader interests. In general, these options involve choices about how, and at what stage, this input is to be provided in the decision-making process. For example, should outside stakeholders play an advisory role, or should they have a ‘vote’ in decisions of the association? Should a public sector agent represent outside interests, or should outside stakeholders have direct input themselves? Also, can private sector decision-making be made sufficiently responsive to broader interests, or
should decision-making be shifted to the public sector? These broad questions suggest a number of options for possible changes to the existing decision-making structure.

**CPA Approach with Strengthened Input from Outside the CPA**

The CPA’s consultative process, while extensive and still evolving, is not required by legislation. A system of consultations with non-member stakeholders has been established at the CPA’s own initiative. If the consultation process were to be required in legislation, such legislation could set out both the precise form and role of these consultations. A legislated requirement to consult with government and non-member stakeholders would help to ensure that public sector representatives and non-member stakeholders are involved at an appropriate stage in discussions. The legislation could include, for example, certain rights of a consultative body to obtain information from the CPA. Articulation of the consultative process in legislation could also increase accountability and provide a benchmark against which to measure actual performance. A consultative body could be required, for example, to report on a regular basis on its activities. On the other hand, a disadvantage of a detailed description of the process in legislation is that it might be more difficult to adapt the process if needed over time.

Even without a ‘vote’ in decisions (i.e., direct representation on the Board of Directors), non-member stakeholders may be able to provide effective input by their careful consideration of the information available to them and communication of their views to the CPA. If this does not work, non-member stakeholders can express their views to the government, which can attempt to influence the CPA’s decisions either through moral suasion or a formal approval process. As will be discussed later, the effectiveness of this type of influence may depend on the extent of the government’s powers to approve or reject decisions taken by the CPA.

Going a step further to provide some form of representation and voting rights for non-CPA members on the CPA board would give non-members a window on the activities of the board and may bring broader interests to bear on its decisions. The key considerations of this option include whether the broader interests should be represented by government, stakeholder or independent directors, and what should be the mandate of any such directors.
The degree of public sector representation on the CPA board should strike a balance that appropriately weights benefits from private sector knowledge of the activity, and public sector input, to ensure consideration of the public interest. The effectiveness of the current level of public sector representation provided for in the *CPA Act* may be hampered both by its limited extent (i.e., one member out of 11, with the ability to cast an additional vote in the event of a tie) and by the lack of an explicit mandate in legislation. In fact, the legislation does not explicitly give the position of Chairman any mandate or duty to carry out the responsibilities of the position in a way that serves the public interest.

Business corporations statutes require directors to act with a view to the best interests of the corporation. The appointment of a public official to the Board of Directors of the CPA could possibly be interpreted as implying that the official is expected to act in the public interest, but this is neither spelled out in the *CPA Act* nor clear in law. It may be appropriate, then, to ensure that any appointment of public sector directors to the CPA is accompanied by an amendment to the Act to provide an explicit mandate to promote the public interest.

Typically, when private sector stakeholders are appointed to boards of directors of private corporations, they too have a responsibility to act in the best interest of the corporation and not in the interest of the particular group they represent. Thus, although they bring their own perspective to the decision-making process, they are expected to vote according to what is best for the corporation. Although CPA directors, including any that might be appointed from among non-members, could be given the mandate in legislation to act in the best interests of their constituency group, this could result in tensions within the board that could make it unworkable. Thus, adding non-CPA members to the board may be useful, but the constraint on these directors’ ability to represent the interests of non-members should be borne in mind.

In addition to providing broader representation on the CPA board, the entire board could be instructed in the *CPA Act* to consider the impact of its decisions on consumers and corporate users, on access to the payments system by non-members, and on the overall competitive environment. Conferring such a broad mandate on a mostly private sector organization would raise questions about the compatibility of private incentives and public objectives. It would be
important under these circumstances to make the board accountable for its mandate, perhaps through regular reporting to the Minister of Finance.

**CPA Approach with Strengthened Review or Oversight**

A number of observers have commented that the provision of the *CPA Act* which makes CPA by-laws subject to Governor-in-Council approval, but not the Association’s rules, leaves open the potential for decisions with significant public policy implications to be made in rules and, therefore, outside the government’s formal review. The restrictions placed on the use of pre-authorized debits by Rule H4 in its original form are seen by some observers as evidence that there should be greater oversight of the rule-making process.

A possible approach would be to broaden the requirement for Governor-in-Council approval to cover CPA rules and thereby extend public sector oversight to a wider range of the CPA’s activities. Such a change, however, would imply a significant increase in the demands on the approval process. Not only would the volume of work increase, but the detailed and technical nature of rules related to the payments system would not be easily accommodated by the Governor-in-Council review process. The ability of the payments system to develop and adopt new rules and respond to emerging trends and technologies could be seriously hampered. Further, the ability of the approval process to serve the public interest by approving or rejecting particular by-laws and rules would be limited by the resources available.

Alternatively, an oversight board could be created to carry out the approval of rules made by the CPA. It would have the advantage of having access to greater resources and specialized knowledge of the activity it oversees than could be expected from the process of Governor-in-Council approval. In this way, an oversight board might succeed in overcoming, to a considerable extent, the inherent information disadvantage of the public sector relative to the CPA.

The composition of an oversight board could be designed to bring a broad range of interests and expertise to the process of approving rules and decisions taken by the CPA. Expertise can be enlisted to deal with the specific challenges identified earlier in this paper. For example, the
board might include experts on competition policy and law, a Bank of Canada representative with knowledge of systemic risk issues, and a government official with responsibility for assessing spillover effects on the financial sector and the economy as a whole. At the same time, a public sector oversight board adds administrative overhead and complexity to the governance structure. If an oversight board is composed of stakeholder representatives in place of, or in addition to, government representatives, it may be difficult to devise a means for the board to reach decisions consistent with the public interest rather than specific stakeholder interests.

An effective oversight board could be established either as a substitute for, or a complement to, direct involvement by the public sector or non-member stakeholders in the decision-making process of the CPA. In the case of the former, a model incorporating an oversight board might see the CPA run only by member institutions with no outside involvement on the Board of Directors. Bank of Canada representation, however, might be maintained in light of the Bank’s role as a provider of settlement services.

**A Public Sector Regulatory Board**

This approach would remove from the CPA its rule-making responsibilities, and would give them to a public sector regulatory board as discussed earlier under the regulatory agency model. The provision of services, however, would continue to be coordinated by the CPA.

This approach has the potential advantage of providing a greater degree of government control over market outcomes. In addition to greater control over the achievement of the public policy objectives, many of the advantages of an oversight board would be shared by this approach. In particular, a broad range of interests and expertise could be represented on a regulatory board as a means of providing decisions that are well informed and consistent with the public interest. On the other hand, the approach may go too far in diminishing the active involvement of market participants in decisions about activities that they understand well. This would be the case particularly with the development of more detailed rules that had little public policy relevance. Also, moving the development of standards and rules regarding the clearing process to such a public sector body may be problematic in that this is essentially a cooperative activity requiring a high level of input from market participants. This suggests that such an
approach would likely prove relatively costly in terms of the administration of the decision-making process.

4. Concluding Remarks

While the legislative framework for the payments system has experienced only limited change since the creation of the CPA in 1980, there have been significant changes in both the legislative framework and organizational structure of other aspects of the financial system in Canada. Dramatic changes have also been seen in the operation of the payments system itself, with a marked shift toward increased automation and the use of electronic forms of payment. These developments suggest that a review of the existing regulatory and governance structure for the payments system may be in order.

With regard to the framework legislation for the payments system, the most prominent issues that must be addressed relate to innovation and electronic payments, effective competition within payment system networks, and the protection of privacy and the security of information. The options for resolving these concerns generally rely on amending existing framework legislation – the Bills of Exchange Act, for example – and better integrating various components of the framework – for example, the CPA Act and the Competition Act – in a manner to more effectively achieve the public policy objectives for the payments system. In some cases, new legislation may be contemplated – for example, to address issues related to electronic funds transfers.

However, such changes may be more easily contemplated than accomplished, since amendments to framework legislation, which generally has broad applicability, might have implications beyond those envisioned for the payments system alone. Further, federal-provincial jurisdictional issues may arise – most notably with respect to consumer protection – that require a high degree of coordination among various authorities. Achieving such coordination is often very difficult, a factor which may further slow progress.
In moving from the broad framework legislation to the regulatory and decision-making structure for the payments system, it is evident that the degree of government involvement varies substantially with regard to the type of payment service offered. The public sector, through the Bank of Canada, provides settlement services directly to Direct Clearers in the CPA; the CPA, which operates clearing and settlement networks, is governed by the CPA Act with limited oversight by government; and acquisition services, while not formally regulated, are influenced by general financial sector and competition regulation, and by provincial laws with respect to consumer protection.

The existing structure of regulation and decision-making results in a particular balance in the achievement of the public policy objectives for the payments system, and changes in this structure may alter that balance in some way. Indeed, the actual rebalancing will depend on a number of empirical questions regarding the effects of any change on competition, risk and dynamism within the new system.
Appendix: Detailed Overview of the Legislative and Institutional Framework for the Payments System in Canada

Canadian Payments Association Act, By-laws and Rules

The primary piece of payments legislation in Canada is the *Canadian Payments Association Act* (*CPA Act*). Adopted by Parliament in 1980, this Act established the Canadian Payments Association (CPA) and gave it a statutory mandate to “establish and operate a national clearings and settlements system and to plan the evolution of the national payments system”. Prior to the creation of the CPA, the Canadian Bankers Association had administrative responsibility for the Canadian payments system.

The Act provides that the CPA may “arrange the exchange of payment items at such places in Canada as the Association considers appropriate” and gives its Board of Directors the power to make by-laws establishing, subject to the Act, requirements for membership in the Association, and dealing with, among other things, clearing arrangements, settlements and related matters. The latter may also be addressed in rules established by the board. In order to become effective, the by-laws require approval by the Governor in Council, and those that establish penalties also require approval by the CPA’s membership. Under the *CPA Act*, members of the Association “may present payment items and shall accept and arrange for settlement of payment items in accordance with the by-laws and the rules”.

To date, the Association has promulgated five by-laws, the most important of which to the day-to-day operation of the payments system is the Clearing By-law (Association By-law

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11 It should be noted that the CPA does not maintain authority over all aspects of what might broadly be considered to be part of “the national payments system”. Some systems and networks (e.g., IIPS, Interac, VISA and MasterCard networks) operate either partially or fully outside the auspices of the CPA.

12 Under the *Canadian Bankers Association Act* (*CBA Act*), the Canadian Bankers Association (CBA) had the power to “establish in any place in Canada a clearing house for banks” and to “make rules and regulations for the operation thereof” subject to Treasury Board approval. The transfer of responsibilities from the CBA to the CPA did not actually occur until June 1983, with the repeal of the relevant provisions of the *CBA Act*. To facilitate a smooth transition, the CPA assumed from the CBA the fundamental components of the existing clearing system.
No. 3). This by-law, together with the rules of the Association, sets out the procedures and standards that govern the daily operation of participants in the national clearing and settlement system. Among the items covered are the organizational structure of the clearing system; the general procedures for the introduction and exchange of payment items in the clearings and their subsequent settlement on the books of the Bank of Canada; the description of which classes of items are eligible for clearing in the national system; and the definition of the rights and responsibilities of member institutions (e.g., criteria for direct participation in the clearings, the relationship between Direct and Indirect Clearers, and provisions for default). These rules can be considered to form the operational backbone of the national clearing and settlement system.

**Bank of Canada Act**

The Bank of Canada plays a crucial role in the Canadian payments system, carrying out both an operational role as well as supervisory responsibilities with respect to certain clearing and settlement systems. The former is provided for primarily in the *Bank of Canada Act*.

Under the Act, the Bank may accept deposits from banks and other members of the CPA, and these deposits are used to effect the final settlement of payment liabilities in the national system. The Bank also serves as an ultimate source of liquidity for the payments system, through its role as a lender of last resort. Under the Act, the Bank of Canada is authorized to make loans or advances, on a secured basis, to banks and other members of the CPA that maintain deposits with the Bank.

**Payment Clearing and Settlement Act**

The regulatory and oversight responsibilities of the Bank of Canada in respect of clearing and settlement systems are outlined in the *Payment Clearing and Settlement Act*. The Act, which came into force in July 1996, establishes a legislative basis for the Bank to oversee certain

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13 The others, in numerical order are By-law No. 1 - General By-law, By-law No. 2 - Financial By-law, By-law No. 4 - Penalties for Failure to Appear and By-law No. 5 - Penalties for Failure to Pay Dues or Fees on Time. Two further by-laws are currently under development: the Compliance By-law and the LVTS By-law.
clearing and settlement arrangements in order to control systemic risk, and provides legislative protection for netting arrangements between financial institutions.

Under the Act, those systems, which in the opinion of the Governor of the Bank of Canada have the potential to pose systemic risk, may, subject to approval by the Minister of Finance, be “designated” and made subject to scrutiny and regulation by the Bank. The Bank is given the power to collect information necessary to make a determination regarding the prospects for a particular system to generate systemic risk, and to issue directives to any designated system to remedy any action that is perceived to be contributing to systemic risk.

For clearing and settlement systems designated under the Act, the Bank is also given the power to provide a (secured or unsecured) guarantee of settlement by participants, to make liquidity loans to the clearing house or central counterparty, and to act as the central counterparty to participants. Some of these powers will be put to use in the context of the proposed Large Value Transfer System (LVTS), for which the Bank of Canada will serve as a guarantor of settlement, such that all payments processed through the LVTS will be irrevocable upon acceptance by the system.

With respect to netting arrangements, the Act contains provisions to ensure that such agreements, when negotiated between financial institutions, will be respected even in the event of insolvency or restructuring of one or more of the parties.

**Canada Deposit Insurance Corporation Act**

The Canada Deposit Insurance Corporation (CDIC) – a federal Crown corporation – plays a limited and somewhat indirect role in the payments system. Among the objectives of the Corporation are to provide insurance against the loss of part or all of deposits; to be instrumental in the promotion of standards of sound business and financial practices for its member institutions; and to generally promote the stability of the Canadian financial system. In the event of the failure of a CDIC member, the Corporation will reimburse depositors for the first $60,000 of eligible deposits held at the institution. The Corporation has also adopted a set of eight Standards of Sound Business and Financial Practices, to which its members are required to
adhere. These standards cover such areas as liquidity management, interest rate, foreign exchange and credit risk management and internal control. Under the provisions of the CPA Act dealing with financial stability, each member of the Association must also be a member of the CDIC, or of the Canadian Co-operative Credit Society Limited, or have its deposits insured or guaranteed under provincial legislation.14

The deposit insurer also serves as a potential source of liquidity for some payments system participants. Under the Canada Deposit Insurance Corporation Act, the Corporation may make loans or advances, with or without security, to its member institutions and may also make deposits with its members.

**Bills of Exchange Act**

The Bills of Exchange Act sets out the statutory framework governing cheques, promissory notes and other bills of exchange. The Act, which is modelled largely on nineteenth century British law (going so far as to explicitly incorporate the rules of the common law of England except where inconsistent with the express provisions of the Act) has remained substantially unchanged since its last major revision in 1906. The Act deals with such things as what constitutes a valid Bill of Exchange and the rights and obligations of various parties to a bill, including provisions establishing liability in the event of fraud or forgery, and responsibilities in the event of the loss of an instrument.

**Financial Institutions Statutes and Related Legislation**

The federal financial institutions statutes (Bank Act, Trust and Loan Companies Act, Cooperative Credit Associations Act and Insurance Companies Act), coupled with legislation governing provincially incorporated financial institutions, provide the statutory underpinnings of

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14 Under the provisions of Bill C-82, An Act to amend certain laws relating to financial institutions, passed by Parliament in April 1997, an exemption from these requirements is made for banks that serve primarily the wholesale market and elect to “opt out” of membership in the CDIC. These provisions, however, have not yet come into force.

For those companies that have their deposits insured or guaranteed provincially, the province must also ensure the inspection of the member to ensure that sound business and financial practices are being followed.
the Canadian financial system. These statutes regulate such things as corporate ownership and business powers, and define many aspects of the relationships between financial institutions and their customers, the government and some government agencies. Certain prudential concerns may also be dealt with directly in the statutes or in mandatory guidelines issued by either federal or provincial regulators – for example, by setting restrictions on permitted investments and establishing minimum capital and liquidity requirements.

By generally establishing the institutional structure of the Canadian financial system, these statutes also help to define many of the participants in the markets for acquisition, clearing and settlement services. The *CPA Act* adopts the notion of institutional type (as determined according to governing statute) in establishing the eligibility criteria for participation in the national clearing and settlement system.

**Competition Act**

The *Competition Act* contains both criminal and non-criminal provisions to deal with a broad range of anti-competitive activities. The Director of Investigation and Research has the responsibility to undertake investigations to determine whether a particular form of business conduct raises concern. The Director may also make representations to regulatory agencies, and serves as the advisor to the government on competition matters.

The *Competition Act* is of general application to all firms in all sectors of the economy, except where an explicit exemption exists in other legislation. Exemptions from the criminal provisions of the Act may also exist under what is known as the “regulated conduct defence”. Under this defence, activity which is conducted pursuant to a valid scheme of regulation (e.g., prices in an industry are set by a regulatory authority) is deemed to be in the public interest and therefore does not draw criminal sanction. The application of the regulated conduct defence to the civil provisions of the Act (the most significant of which deal with mergers and abuse of dominant position) has never been tested.
Canadian Code of Practice for Consumer Debit Card Services

The voluntary Code of Practice for Consumer Debit Card Services was developed through consultation among consumer groups, financial institutions, retailers and government with the intent of establishing minimum levels of consumer protection in debit card arrangements. The Code applies to services that use debit cards and personal identification numbers (PINs) to access automated banking machines, point-of-sale terminals and debit card terminals in the home. The Code outlines the responsibilities of card and PIN issuers; establishes content guidelines for cardholder agreements and standards for record keeping and the recording of transactions; contains provisions dealing with security and liability for loss in the event of unauthorized use; and defines procedures for the resolution of disputes. The Code does not, however, set out sanctions for those institutions that endorse the Code but fail to adhere to its principles.

Rules and Contracts Governing the Operation of Proprietary Networks

Governing the daily operation of proprietary payment networks, such as the Interac, Visa and MasterCard networks, is a basic set of by-laws, procedural rules and operating standards agreed to by their members. These agreements may incorporate certain safety and risk control features, such as minimum standards for participation and rules governing loss sharing and the allocation of liability in the event of institutional failure or technical malfunction. They may also include a number of operational characteristics, such as minimum technical and communication standards to ensure software and system compatibility, and a definition of the general terms and conditions upon which members may submit payment items into the network, and will accept those items submitted by other members.

Agreements between a Financial Institution and its Customer

Most financial institutions require their customers to sign a standard agreement upon opening a deposit account or establishing a line of credit. These agreements typically cover such things as the authority to debit accounts, service charges, lost or stolen instruments, liability in the event of fraud or error, the recording of transactions, record keeping and verification of account statements, the collection and use of personal information and the termination of the agreement.
These agreements serve to establish the general terms and conditions underlying the relationship between customers and their payment service providers.
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Summary of Discussion

Introduction

The Payments System Advisory Committee met twice to discuss issues related to the legal and regulatory framework for the payments system in Canada. The discussion paper, *Achieving the Public Policy Objectives: The Governance of the Payments System in Canada*, prepared by staff of the Department of Finance and the Bank of Canada served as background to the Committee’s discussion.

Legislative Framework for the Payments System

*Electronic Funds Transfers*

The Committee discussed the possible need for legislation governing electronic funds transfers (EFT). It was noted that legislation tends to be rigid and is typically time consuming to change. It was generally agreed that full consideration should be given to less formal means of regulating electronic payments activity. It was suggested that flexibility could be achieved by making the legislative framework general while leaving the details to regulations.

One member suggested the possibility of creating a single piece of legislation to deal with both paper-based and electronic payments – for example, by amending and expanding the existing *Bills of Exchange Act* to combine its general contents with new provisions covering EFT. A suggestion was made that elements of the model law developed by “UNCITRAL” on electronic commerce could serve as a model for Canada.

It was noted that the creation of a legislative framework for EFT, particularly elements aimed at consumer protection, might involve certain jurisdictional issues, with regard to the division between federal and provincial responsibilities.

*Cheque Truncation*

It was generally agreed that, although there are potentially significant efficiency gains to be achieved through the adoption of cheque truncation, certain other considerations such as the interests of consumers also warrant attention. Like other payments system issues, the merits of
cheque truncation must be assessed by looking at the trade-offs among the public policy objectives.

It was noted that a wide range of possible cheque truncation systems is possible. On efficiency grounds, a system that stops the flow of paper completely, and at an early stage, is preferred to one that simply delays the transfer of the physical items. One member noted that cheque imaging is expensive technology and that its cost effectiveness as part of a cheque truncation system would need to be considered very carefully.

One member questioned the economic attractiveness of cheque truncation given the growing trend toward electronic payment technologies. The member suggested that it might be better to focus on these new payment methods rather than spending resources trying to improve the old systems. It was pointed out, however, that even if the shift to electronic payments continues as expected, cheques are likely to remain a significant component of the system for some time to come.

A number of members indicated that certain customers, particularly businesses, like to receive their cancelled cheques as proof of payment and for general record keeping. Whether these customers would willingly accept a substitute for the actual cheque would likely depend on the extent to which any cost savings from cheque truncation were passed on to them.

**Competition Issues**

The Committee discussed the issue of competition in the payments system, in terms of whether the current framework promotes adequate competition among payment service providers. It was noted that some rules that appear to be anti-competitive (e.g., restrictions on payments system access) may serve to promote efficiency or safety. One member suggested that access restrictions should not be considered as the only method of controlling risk in the payments system. Other measures, such as real-time electronic controls, could be incorporated as an alternative that would not overly restrict access and reduce competition.
It was also noted that questions concerning the role of competition law are linked to the nature of the public oversight function for the payments system, and how that oversight can be used to prevent anti-competitive behaviour.

**Privacy and the Security of Information**

It was suggested that the issues of privacy and the security of information might involve jurisdictional questions, surrounding the division between federal and provincial authority. Further, one member suggested that privacy concerns related to payments system activity should not be considered distinct from privacy concerns generally. If a strong general privacy framework exists, then additional rules regarding privacy in the payments system may not be required.

**Regulatory and Decision-Making Structure for the Payments System**

*Planning the Evolution of the Payments System*

It was generally agreed that it is not feasible to ask a central decision-making body – whether private or public – to “plan the evolution” of the payments system. Most members believe that market forces should be relied upon as the source of innovation. It was agreed, however, that a central body might have a role in “facilitating” this process. This could involve, for example, setting standards with respect to interoperability, risk mitigation and consumer protection. The key is to maintain flexibility in the system in order to be able to adapt to change, and avoid overly constraining the process of innovation.

The dilemma facing regulators regarding the appropriate timing of regulatory intervention in the market was also discussed. Intervention at too early a stage in the development process may hamper innovation. However, if regulatory decisions are made later in the development process, this may result in the loss of significant investments by payments system participants if the market outcome is found not to be satisfactory from a public policy perspective. One member noted that government authorities in some other countries appear to be moving away from intervention at an early stage in the development of new payment technologies and toward an approach where technologies and market practices are allowed more time to evolve.
Stakeholder and Public Policy Input

The Committee considered a spectrum of possible options for the decision-making process, from one based largely on market forces, through a range of cooperative approaches, to one in which the public sector not only makes decisions but also provides some services directly in the market. Committee members generally felt that the current overall balance between private sector activity and government involvement is pretty good, but that some improvements were possible.

Committee members generally agreed that outside stakeholders should be more directly involved in the decision-making process for the payments system, particularly with respect to the CPA. It was also generally felt that enhanced public sector oversight of payments system activity might help to ensure that the public policy objectives are achieved. Much of the Committee’s discussion focussed on the different forms that this expanded input and oversight might take.

Stakeholder Input

The current practice of selecting CPA directors from classes of members (i.e., banks, trust and loan companies, credit union centrals and other deposit-taking institutions) was discussed. One member suggested that this system needs to be maintained in order to maintain the perceived fairness of the process. Another member noted that it is becoming increasingly difficult to define members according to institutional class. For example, one could add members representing securities dealers, mutual funds and insurance companies and have all of these new directors still come from the major banks, given that banks are becoming increasingly involved in all of these activities.

The Committee suggested that the CPA’s Board of Directors should include a meaningful number of outside (or independent) members. Members expressed a range of views on the appropriate balance of representation between payments system participants and outside stakeholders. Some members felt that those participants (or groups) that bear a larger share of the cost and risk in the payments system should be given proportionately greater representation.
in the voting process. Others felt that all types of institutions should be afforded equal status. It was noted, however, that the duty of any director is to serve the best interests of the Association, and not to represent the interests of the group from which they were drawn.

Committee members agreed that, even if the CPA Board is expanded to include outside directors, additional consultative processes, such as the existing Stakeholder Advisory Council, are needed to ensure that all stakeholders have adequate access to the decision-making process. The possibility of requiring the pre-publication for public comment of CPA by-laws and rules was suggested as a means of soliciting broader input into the decision-making process. One member suggested that, at a minimum, there should be a requirement to make information available to the public regarding proposed rules prior to their implementation. It was also suggested that legislation could specify such things as the time allowed for public comment, the form of publication (e.g., in the Canada Gazette), and other particulars of the process.

Public Policy Input

The Committee discussed the possibility of creating a new level of public sector oversight to review decisions taken by the CPA, and possibly other systems or networks that have developed outside of the purview of the CPA (e.g., Interac, e-money, securities clearing and settlement). It was suggested that this oversight function could be performed by either the Governor of the Bank of Canada or the Minister of Finance. The Committee did not favour the creation of a wholly new, government-appointed body to undertake the oversight function.

There was some discussion of the relative merits of having the Governor or the Minister serve the role. It was noted that the central bank might have a tendency to place too much emphasis on risk considerations in determining the appropriate balance among the public policy objectives. Further, a possible conflict was pointed out because of the Bank of Canada’s operational presence in the payments system. One member suggested, however, that the Governor would be well suited for the role, given the Governor’s existing powers under the Payment Clearing and Settlement Act with respect to systemic risk. Any other alternative would divide oversight responsibilities related to the payments system and could result in a loss of overall perspective. The Bank of Canada’s expertise in payments matters was also noted.
The Committee discussed the types of decisions that might be subject to review. It was suggested that a review body should have the power of “non-disapproval” over all CPA by-laws and rules. Some members expressed concern, however, about the ability of an oversight body to deal with the significant volume of technical rules produced by the CPA on an ongoing basis. They felt that the CPA should have some discretion to determine which items have significant policy content, and to submit only those items for review. Other members commented on the difficulty of separating purely technical matters from those with broader policy implications. These members believe that the current distinction between by-laws and rules is inappropriate for determining whether approval by a public sector oversight body should be required. Accordingly, they would make all instruments subject to non-disapproval by the review body. A related issue that arose is whether the by-laws of the modified CPA should be statutory instruments, and what implications this might have for the approval process. Currently, CPA by-laws must be approved by the Governor in Council. A question was raised as to whether, from a public policy perspective, this would still be necessary if the by-laws were also subject to review by an oversight body.

In addition to the power of non-disapproval, it was suggested that the oversight body could be given some limited power to issue directives to the CPA. The directive power might be used, for example, to require the CPA to examine a particular issue or rule.

Members felt that the costs of a review process should be borne by the government – as opposed to requiring payments system participants or users to pay an additional fee – in recognition of the “public utility” nature of the payments system.

Finally, it was noted that it would be important for the review body to be open to public input as an additional means for stakeholders to voice their concerns and have their views considered.
Scope and Mandate of the Oversight Function

One member suggested that the CPA should have oversight over all aspects of the payments system, including certain activities over which it does not currently exercise any authority (e.g., debit card, credit card and e-money networks). An alternative approach, with which a number of Committee members concurred, was to keep the focus of the CPA somewhat narrower and to give the oversight body a mandate to consider a very broad range of payments system issues and activities.

This approach would not subject the rules of organisations and systems outside of the CPA to routine review by the oversight body, but would allow the oversight body to intervene if there were compelling public policy reasons to do so. Given some members’ concerns about providing such broad authority to the review body, it was suggested that its role with respect to activities outside the CPA could be limited to making recommendations to the organisations involved and to the government. The government would, of course, have the option of putting forward legislation or taking other action to deal with a given situation.

With respect to the criteria that might be adopted to guide the oversight body’s review, it was suggested that they should mirror the policy objectives of the revised CPA. In this way, the role of the oversight body would be to ensure that decisions taken by the CPA were, in fact, consistent with the policy objectives established for the CPA by Parliament.