

All along the watchtower: seeking the future of Canada's payments system

*Comments addressed to the
Task Force for the
Payments System Review*



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“There must be some way out of here,” said the joker to the thief
“There’s too much confusion, I can’t get no relief”

Bob Dylan, *All along the watchtower*

Executive Summary

Confusion is impairing the evolution of Canada's payments system. The Task Force for the Payments System Review's decision to initiate broad consultations is therefore welcome. Part of its challenge will be to listen to the voices of consumers, in all their complexity: their responsiveness and vulnerability to changes in the payments environment are conditioned by many factors, including their economic and literacy status, and they cannot all be held to the classic canon of "rationality".

We suggest that the analysis leading a new framework for our payments environment should include a risk management approach and be principle-based. We suggest eight principles that should be taken into account, including (insofar as possible) technological neutrality.

Innovation in the Canadian payments environment is necessary and desirable, yet Canada lags behind even African countries in some respects. One of the major hurdles slowing down innovation is our competitive structure.

As they hold significant influence on the four major payment networks in the country and control access to most liquid assets, the largest deposit-taking financial institutions are in position to thwart competitors. There is a risk that either a marginal, unregulated payments market will develop at the fringe, or that the largest institutions will simply gobble up competitors. A third, more balanced scenario is unlikely to occur without outside support. An analysis of competitive issues in the payments environment should take into account its peculiar characteristics. The relative failure of the Competition Tribunal order in the Interac case to achieve a properly functioning market should be kept in mind.

Privacy also raises issues for consumers using payment mechanisms. Anonymity is a major concern. The fact that payment data crosses borders on a routine basis should also be of some concern.

The Canadian payments system is not always as efficient as it is said to be, and is certainly not as innovative as it could be. We believe part of the blame should go to an antiquated and inefficient regulatory framework which is too convoluted, sometimes unfair and fairly opaque.

Other jurisdictions, including the United States, the European Union (including the United Kingdom) and Australia have acted in recent years to modernize their regulatory framework and facilitate stakeholder involvement. Their example should inspire Canada.

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All along the watchtower: seeking the future of Canada's payments system

I- Introduction

A- Confusion

We can't go on like this.

There is too much confusion, indecision, head-knocking and agitation.

Contrast the current Canadian payments landscape with, say, the United Kingdom's. By 2018, cheques should disappear from England. So has recommended their Payments Council¹. There were broad consultations before the decision, no fuss when it was announced, and a clear implementation process has been laid out, including an ongoing impact assessment and mechanisms to push back the deadline if such is found to be necessary. A quite orderly process, really.

Can there be any clearer illustration of the profound alterations coming to the payments environment in advanced economies and of the part regulatory forces play in those changes? Such mutations are often both constructive and chaotic; in many countries, the emphasis is currently rather on the "chaotic" side of the process. Unfortunately, Canada is a prime example of the latter; indeed, in many ways, it is lagging behind many jurisdictions, both in terms of embracing new technologies and of controlling the risks associated therewith.

The establishment of a Task Force dedicated to a review of the Canadian payments system therefore comes at an auspicious time. Its task, however, is monumental: it must

¹ Payments Council. *The Future of Cheques in the UK*. London, Payments Council, December 2009. 35 p. Consulted at http://www.paymentscouncil.org.uk/files/the_future_of_cheques_-_dec_2009.pdf.

understand new payment technologies, diagnose the current regulatory framework, weigh diverse competitive interests and assess what would best serve economic efficiency as a whole while considering how² Canadians can adapt to the coming changes.

From the ship's bridge, it is often more alluring to spot the whales or the great white sharks than to account for the smaller fry. Similarly, debates around interchange fees or about the merits of having Visa and MasterCard entering the debit card market may leave in the shadow the ordinariness of the billions of payment operations consumers perform annually³, even though they are vital to the Canadian economy. In fact, consumer spending accounted in 2009 for 59% of the country's expenditure-based gross domestic product⁴. Of course, there is no consumer spending without consumer payments.

Ah! yes: consumers. Every stakeholder claims to hold their interest dearest to its heart.

"Consumers". As if more than thirty million individuals could fit under one label, one simple set of characteristics that would turn them all into one single, manageable concept.

Consumers. For the most part, they are also citizens: the strongest force in a democracy when organised. But also, alas, they are most often the weakest force in the market when divided, and barely amount to a whisper in the corridors of power.

Part of the Task Force's challenge will be to listen to the voices of consumers, accepting their complexity. Consumers, as diverse as they are, will make or break many a payment initiative; they will be on the frontline if and when providers fail and cost them hundreds or thousands of hard-earned dollars. They will likely bear the brunt of the fees, and of the mistakes. Hopefully, they will also garner a fair share of the harvest we are promised.

Innovation will – and should – come to the Canadian payments system. With it will come a flurry of new actors. The "good old days" are over. But with innovation and new players comes risk. The real challenge in this changing environment will be to identify

² or, in some instances, "whether".

³ To give only one example, over three billion point-of-service debit transactions cleared through the Canadian Payments Association ("CPA") in 2009.

⁴ 58.85%, to be accurate. Statistics Canada. *Gross domestic product, expenditure-based*. Consulted at <http://www40.statcan.gc.ca/101/cst01/econ04-eng.htm>. The proportion of consumer spending over the gross domestic product has been steadily increasing for the past five years at least.

and manage risk in a way that is beneficial to consumers and to the Canadian economy as a whole.

Such is the momentous task facing the Task Force. We hope in the following pages to point out some of our concerns, and consumers', as it begins to reach out to the community

B- Our contribution

1- The Public Interest Advocacy Centre

The Public Interest Advocacy Centre ("PIAC") is a non-profit organization based in Ottawa that provides legal and research services on behalf of consumer interests and, in particular, vulnerable consumers' interests, concerning the provision of important public services. PIAC has been interested in payment and other financial services issues for many years. It has been involved in recent years in various aspects of the payments system, such as the review of the *Canadian Code of Practice for Consumer Debit Card Services* and, more recently, has commented upon the draft *Code of conduct for the credit and debit card industry in Canada*.

PIAC has been a member of the Canadian Consumer Initiative, or "CCI", since its inception in 2001. CCI is a coalition of most of the largest consumer groups in Canada.

2- Our comments

Our comments are intended as a high-level presentation of our concerns surrounding the present and future of Canada's payments system. As we understand the process engaged by the Task Force, more detailed comments will be sought in the future, under one guise or another, and the Task Force currently seeks to map the landscape. In that context, we have opted here to eschew detailed arguments or expositions regarding a number of issues.

Our comments are generally organized around the themes put forward in the Task Force's consultation paper. We have, however, not followed the same order and have added some concerns of our own, which relate in particular to "who" Canadian consumers are and to governance issues. We hereby consent to the posting of our comments online by the Task Force, provided of course that the source is identified.

While we are cognizant of the indirect impact they may have on consumer interests, we will generally not address issues involving large value payments, business-to-business transactions or the clearing and settlement of transactions involving securities and other similar financial instruments.

While most current discussions around the payments environment, including the larger part of our comments herein, turn around electronic payments, older payment mechanisms should not be ignored. An increasingly problematic issue is the practice by retailers and others, including the Canadian government⁵, of declining payment in legal currency. The status of legal tender and the acceptability of cash are also issues that should be kept in mind, especially as more vulnerable Canadians may not have a credit card, or even an account with a deposit-taking financial institution⁶.

Of course, the fact that we have not commented at this point on any issue raised in the consultation paper should not be construed as meaning either agreement or disagreement with any position on such issue.

II- The background

A- Confusing consumers

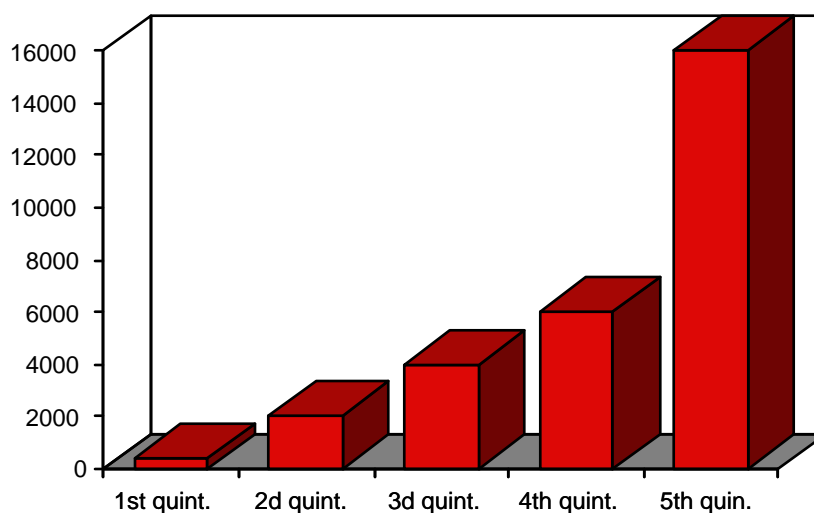
As we noted above, consumers are not a monolithic block. They range from well-heeled early adopters of new technology to unemployed single parents with low literacy. It is tempting to focus on the former, if only because they tend to be the highest-margin customers for diverse providers. Low income and low net worth families, however, are more numerous than Blackberry bearers.

⁵ For instance and since August 18, 2010, Passports Canada specifies on bold type on its website that "Cash is not an acceptable method of payment" even when one is physically present to pick up his passport and pay the required fee: see www.ppt.gc.ca/cdn/section6.aspx?lang=eng®ion=Canada, consulted on August 31, 2010.

⁶ While the proportion of "unbanked" consumers is lower in Canada than in the United States, it varies along with factors such as socio-economic status. We are not aware of any recent national survey ascertaining the size of the unbanked population; an Environics survey in 1995 indicated that 3% of Canadians did not have a bank account at the time, a statistic that climbed to 6% in the Atlantic provinces and 8% for households with annual income below \$25 000: St Amant, Jacques. *Les hauts et les bas de l'accès aux services bancaires au Canada*. Montréal, ACEF-Centre, June 1996. 93 p. Pp. 17-22. Hopefully, regulatory changes since enacted and requiring banks to facilitate access to basic banking have somewhat improved the situation.

Twenty-two percent of Canadian family units have a net worth below \$15 000; together, they hold less than zero net worth⁷. Within the lowest net worth quintile, which includes over two million family units, the median amount of deposits in financial institutions in 2005 was four hundred dollars (\$400), but more than twenty-seven percent of families in that quintile declared no deposits⁸. From the lowest to the highest quintile, median amount of deposits in financial institutions grows from four hundred to sixteen thousand dollars:

Table 1
Deposits in financial institutions held by Canadian family units,
by quintile (2005)



Needless to say, families with barely four hundred dollars in the bank are sorely impacted by any payment processing mistake and may suffer bounced cheques, damaged credit rating, insurance cancellation or eviction simply because a pre-authorized debit was mistakenly presented twice, because their debit card was cloned or their pay was not

⁷ Statistics Canada. *Family units and net worth, by net worth group (2005)*. Consulted at <http://www40.statcan.gc.ca/l01/cst01/famil116a-eng.htm>. Since 6.5% of households have negative net worth of over 12 billion dollars, the global net worth of this lowest quintile of family units is negative. At the other end of the spectrum, the 8.2% of family households with net worth over a million dollars collectively hold 46.5% of Canadian family units' net worth.

⁸ Statistics Canada. *Assets and debts held by family units, median amounts, by net worth quintile (Lowest net worth quintile)*. Consulted at <http://www40.statcan.gc.ca/l01/cst01/famil116b-eng.htm>. Each quintile included over 2.6 million families in 2005. Seven hundred thirty-seven thousand family units in the lowest quintile declared holding no assets in the shape of deposits in financial accounts.

automatically deposited in their account in time⁹, and their financial institution spends a week investigating the incident before refunding the account. To higher net worth households, such incidents are highly annoying, to be sure but for lower net worth consumers, they can catastrophic.

Economic poverty, however, is not the only issue differentiating Canadian consumers.

While it may still seem incredible to some, close to one half of the Canadian population is functionally illiterate – that is, those Canadians can read words, but will quickly be overwhelmed by their meaning¹⁰. They will therefore often tend to avoid more complex technologies, and will generally be unable to assess adequately the risks associated with technologies that seem simple to operate but may conceal a high level of liability on their part if something goes wrong¹¹.

Functionally illiterate Canadians include some of our elders, but also recently arrived Canadians¹², and even younger people who dropped out prematurely and have not maintained high reading skills. It is therefore perfectly possible to envision a thirty-year old mother of two who quit after high school and now uses a contactless payment card at her favorite Tim Horton's on a daily basis without a second thought, but is thoroughly unable to understand liability allocation clauses in her issuer's terms and conditions.

More broadly, the notion of human rationality we have inherited from eighteenth-century philosophers, and which still stands at the core both of liberal economic theory and of contract law, is increasingly questioned by science. Behavioral economics, for

⁹ Of course, mistakes may also happen on the credit side, as for instance if her pay's automatic deposit in a consumer's account is delayed. Fifty-nine percent of salaried Canadians would be seriously inconvenienced in such a case, as they literally live from paycheque to paycheque and have no significant liquid savings enabling them to pay current accounts if their salary is delayed, according to a recent survey commissioned by the Canadian Payroll Association: <http://www.payroll.ca/Content/NavigationMenu/AbouttheCPA/NewsReleases/paycheque1.htm>

¹⁰ Human Resources and Skills Development Canada; Statistics Canada. *Building our Competencies: Canadian Results of the International Adult Literacy and Skills Survey*. Ottawa, Statistics Canada, 2005. Catalogue No. 89-617-XIE. Consulted at www.statcan.gc.ca/pub/89-617-x/89-617-x2005001-eng.pdf. Forty-eight percent (48%) of the Canadian population over 16 performed below "desired" levels of literacy competence and 19.9% performed at the lowest level of prose literacy: pp. 9, 16, 27, 28.

¹¹ Liability disclosure in Terms and conditions is clearly not an effective way to help these consumers make anything close to an enlightened decision regarding the level of risk they may be taking on.

¹² who may hold engineering and Farsi literature doctorates, but master neither official language and be unfamiliar with our institutions.

instance, explores the heuristics, that is the shortcuts taken by the human mind when we must make decisions, that impact the way consumers and other economic actors weigh their choices they face¹³. Consumers do not always act in the classically rational (and often theoretically expected) way not because they are inept, but because most people, in most situations, simply do not act in that way.

Easily a fifth of Canadians are economically highly vulnerable. Roughly one half of Canadians cannot be expected to read and understand written material. In most cases, the failings are not theirs; they are systemic, because our society tolerates poverty and illiteracy and because it is the way we humans are wired.

A sound payment policy for Canada must take those realities into account. It must be inclusive – that is, it must consider those dimensions in the policymaking process and it must strive to include all Canadians in the economic mainstream, rather than to tolerate the exclusion of a fifth, a third or a half of our population simply because it is a little more vulnerable, or a little less performing under some (debatable) standards.

B- Risk management

1- Risk everlasting

Users are not the most threatening risk around payment mechanisms. They might in fact be one the lesser...

Risk has always been associated with payments. Currency can be counterfeited, signatures can be forged, debtors may elope. Risk management measures have therefore been put in place by stakeholders ever since payment tokens have been exchanged.

As the payments universe evolves, risk changes, and countermeasures must be adjusted. Adequate ongoing risk management will be a large part of the challenge awaiting all stakeholders in the new payment universe to which we are migrating.

¹³ For a good summary of behavioral economics, see e.g. Kahneman, Daniel. *Maps of bounded rationality: a perspective on intuitive judgment and choice*. In The Nobel Prizes 2002. Stockholm, Tore Frängsmyr, 2003. Pp. 449-489, available at http://nobelprize.org/nobel_prizes/economics/laureates/2002/kahnemann-lecture.pdf. Professor Kahneman received the 2002 Nobel Memorial Prize in economic sciences for his pioneering work on behavioral economics, along with a co-laureate. For an example in the payments environment, see Levitin, Adam. *Priceless? The social costs of credit card merchant restraints*. [2008] 45 Harv. J. on Legis. 1, 18-20 and sources quoted therein

It may be useful to underline at this point that we do not envision risk strictly from the individual consumer's perspective, although it is of course one of our most immediate concerns. Rather, we see proper risk management as fostering economic efficiency and therefore benefitting all economic stakeholders.

For the purposes of this consultation, we shall focus on four (4) types of risk: operational risk, credit and liquidity risk, legal risk and reputational risk, and allude to systemic risk. Obviously, they are all intertwined.

We suggest that risk management be at the forefront of the Task Force's concerns and that it serve as an analytical tool in order to assess the options facing the Canadian payments environment. While change and innovation are welcome, some risks are not: they must be eliminated, or at least contained. In order to do so, they must first be well understood.

2- Operational risk

Operational risk is concerned with the effectiveness of technologies and processes and human performance, or the failure thereof. Payment activities obviously raise significant operational risk, as payors and payees expect their transactions to be processed swiftly and safely. Even large, experienced processors are not immune to operational breakdown¹⁴; smaller providers may be quickly overwhelmed by systems failure.

In such cases, operational risk rests squarely with providers. In some cases, however, it may appear to rest on users who make mistakes while using a payment mechanism. Obviously, user errors, and occasionally negligence, occur. One should consider, however, whether those mistakes are in fact induced by badly designed systems that are therefore laborious to use. System design quality is the provider's responsibility and should be closely investigated when one ponders why so many consumers seem to be so clumsy.

Operational risk also includes fraud control, a crucial dimension when it comes to electronic payments. Everyone agrees that payment mechanisms should be as safe as

¹⁴ The almost week-long systemwide breakdown experienced in June 2004 by Royal Bank provides the most obvious example in recent history, although other financial institutions have also had their share of problems.

possible. The real issue is the division of responsibilities between providers and users: when funds are lost or diverted, who should bear the cost?

We share the position adopted by Australian authorities, which is that, in many cases, an "economically efficient loss allocation rule" assigns liability on "[...] the account institution to encourage it to improve the security of the" system over time¹⁵. We agree with the Australian Securities and Investments Commission that the least cost avoider principle suggests that payment system providers are best placed to reduce costs and risks by improving their products at a systemic level, instead of burdening consumers with compliance with unrealistic requirements. Liability should also be allocated taking fully into account the informational asymmetry¹⁶ between providers and consumers.

Providers may argue that such a policy would create a moral hazard and reward negligent customers; they would rather transfer liability on consumers through contract than implement more secure payment mechanisms. In fact, the consequences of the latter moral hazard are far more significant for the Canadian economy. Providers are in a position to put in place globally safe *systems*; consumers can do nothing but to try and secure *individual transactions*. The onus on providers should therefore be obvious. They are the ones that should be held to account first.

Unfortunately, providers often seek to morph their self-inflicted operational risk into customers' legal risk, through unbalanced terms and conditions in contractual agreements which cannot be discussed. Providers therefore lack incentives to make needed improvements that would have a positive impact on market conduct and market efficiency¹⁷. Strong security and other concerns should be designed into systems in such a way that consumers need not be treated as the defective link and burdened with undue liability. The regulatory framework should ensure that proper incentives are in place so that providers will face their fair share of the social costs associated with fraud.

¹⁵ Express reliance of Australian authorities on the least cost avoider principle, elaborated first by Nobel Prize laureate Ronald Coase, goes back at least to 1999 and is reiterated in a recent consultation paper: Australian Securities and Investments Commission. *Consultation Paper 78 - Reviewing the EFT Code*. ASIC, January 2007. 129 p. P. 62. The Paper can be found at [http://www.fido.gov.au/asic/pdflib.nsf/LookupByFileName/eft_review_2007.pdf/\\$file/eft_review_2007.pdf](http://www.fido.gov.au/asic/pdflib.nsf/LookupByFileName/eft_review_2007.pdf/$file/eft_review_2007.pdf).

¹⁶ The negative impact of informational asymmetry on markets has been theorized *inter alia* by Joseph Stiglitz through work for which he also received the Nobel Memorial Prize in economy.

¹⁷ Obviously, we assume that deploying a less than optimal technology and having the cost of this inefficiency borne by parties that are powerless over that decision (i.e. consumers) is not an efficient allocation of resources.

3- Credit and liquidity risk

Credit and liquidity risks are obviously different. For our purposes, however, they can be considered together. Credit risk is the risk associated with a debtor's inability or refusal to fulfill its obligations: the creditor will therefore not receive money it expected. Liquidity risk is the risk that funds will not be available in a sufficiently liquid form when required for business purposes. In both cases, someone is short – quite often the end-user.

Within the payments context, credit risk arises under two guises. The first is obvious: credit cards are a significant part of the payments landscape and obviously generate credit risk for their issuers.

The second form of credit and liquidity risk may be slightly less obvious: deposits in deposit-taking financial institutions ("DTFIs") are customer loans to the institution¹⁸. The risk that a DTFI will not be able to reimburse is therefore a credit risk for the institution's customers, which is mitigated however by deposit insurance and regulatory supervision. More ominously, new payment schemes may raise credit risk that is mitigated neither by deposit insurance nor regulatory supervision. Prepaid cards and other schemes whereby consumers entrust money to a provider, to be accessed later through the provider's scheme, are very weakly regulated, if at all, for credit risk. In some jurisdictions, the credit risk associated with providers such as PayPal has even driven regulators to prohibit its operations on their territory or to require PayPal to take appropriate measures in order to mitigate credit risk¹⁹.

Non-regulated providers, and especially the smaller ones, also face the possibility that they will at some point have insufficient liquidity to deal with a sudden afflux of customer withdrawals. A liquidity crisis can quickly turn into a run and become a solvency issue, thereby raising credit risk for scheme users, as well as reputational risk to the industry.

¹⁸ *Foley v. Hill*, (1848) 2 H.L. Cas. 28, 9 E.R. 1002 (H.L.), which has been followed in Canada, including under Québec law.

¹⁹ In a PayPal transaction, the payor transfers the funds to PayPal, which then makes them available to the payee. Until the provider abides by payee's instructions to transfer the funds, PayPal holds the funds and, should it go bankrupt, it would be unable either to pay the payee or refund the payor. Authorities have therefore required PayPal at least to obtain a money transmitter license : see e.g. the June 3 2002 Interpretation Letter by the State of New York Banking Department to PayPal at <http://www.banking.state.ny.us/legal/lo020603.htm>.

As new providers emerge in the Canadian market as it currently stands, credit and liquidity risk are likely to rise unchecked. Canadian authorities may therefore wish to consider the framework which has been implemented by European authorities in order to regulate risks associated with payment institutions, to which we will briefly return in section III D-2 c).

4- Legal risk

Legal risk is the risk associated with inadequate compliance to laws, regulations or ethical standards. It takes two major forms in the current payments environment.

First, electronic payments are fraught with legal uncertainty in Canada. There are few clear rules in place. What rules we have are often inconsistent: whether a consumer pays through a preauthorized debit on her bank account, through a preauthorized debit on her credit union's credit card, through PIN-based point-of-sale debit, through PIN-less point-of-sale debit, Interac's Online service, PayPal, a prepaid card in Québec or a prepaid card in Manitoba, to name only a few possibilities, her rights and liabilities, and other stakeholders', will be quite different. Such an environment is unlikely to foster confidence and investments, especially as many of those rules can be changed privately, with scant consultation if any, by providers or their networks.

In addition, providers often attempt to minimize their legal risk by switching it to other parties, and especially consumers, through contractual terms and conditions. Consumers' legal risk may thereby become excessive, although they will likely be unaware of that fact: unfortunately, they tend to trust that if payment mechanisms are deployed in Canada, they should be reasonably safe and their users should be reasonably protected. Even for providers, however, that strategy remains risky: courts may well conclude that the provisions they have sought to impose on consumers are unfair and unconscionable, and therefore invalid.

As we will note in section III-D, Canada's legal framework for payments, and especially electronic payments, is hopelessly antiquated. Jurisdictions such as the United States, Australia and the European Union are easily a decade ahead of us. By not providing them with a clear and apposite regulatory framework, we do a disservice not only to consumers, but also to providers and to the whole economy.

5- Reputational risk

Reputational risk is the risk that action (or omission) will alter negatively a party's image in its community or lower others' confidence in that party. Operational failure and non-compliance are two major sources of reputational risk: needless to say, our current payments environment is a fruitful ground for reputational risk.

A damaged reputation may lose a provider current or prospective customers and, in the financial area, lead very quickly to liquidity risk. Especially in emerging industries, it can impact not only the provider who made a mistake, but all its competitors. From a policymaking standpoint, it is therefore important that reputational risk be minimized by providing a clear framework for all market participants and by being able to cull (or at least straighten out) less competent or less trustworthy participants before they can give the whole sector a black eye. We do not believe competitors should simply be left to straighten out each other without supervision.

6- Systemic risk

Systemic risk entails that one failure will propagate through a system and precipitate other participants' failures in a cascade that could eventually bring down the whole system. While the potential for large value payments to contribute significantly to systemic risk has been generally acknowledged and controlled over the last quarter century or so²⁰, smaller payments have usually not been perceived as holding a significant systemic risk potential.

We suggest that the latter conclusion be reviewed. The immediate cause for the 2008 worldwide financial crisis was linked to delinquent consumer mortgage payments, which few have predicted could ever cause such turmoil. Obviously, we are aware that the subprime mortgage crisis was magnified and made global by the unexpected impacts of securitization and somewhat carefree use of various derivative products, but this only goes to show that it has become very hard indeed to predict whether a ripple in the consumer pond might turn into a tsunami everywhere else.

²⁰ In Canada, CPA's Large Value Transfer System was created in order to minimize systemic risk and CPA's more recent policy of not clearing payments exceeding twenty-five million dollars through ACSS was implemented with the same purpose.

One can imagine, within the next decade, say, a major non-DTFI United States-based payment provider emerging who would both replace PayPal on a worldwide basis and dominate North American (including Canadian) contactless stored-value point-of-sale payments through mobile payments, essentially replacing PIN-and-chip and even many credit card transactions; that provider could well process on average more than fifty billion dollars in payments every day, and therefore hold significantly more in stored value. Now let it fail on the evening of December 22, 2021²¹. Or, rather, don't.

We therefore suggest that it would be less than prudent to overlook the systemic risk potential that even small-value payments may hold, especially when they are processed by unregulated providers, and that care should be taken to assess and if necessary to minimize that potential.

C- A principles-based approach

1- Seeking a balance

Keeping a dynamic balance between leaving room for innovation on the one hand, and ensuring a modicum of certainty to stakeholders on the other, is a perennial challenge for policymakers. The Canadian payments environment is likely to provide an excellent example of this conundrum in the coming years.

Another danger which policymakers face is that they may become overly reactive and develop initiatives on an *ad hoc* basis. The recent adoption of Canada's *Code of conduct for the credit and debit card industry in Canada* provides an interesting case in point. As retailers forcefully protested interchange fees and other card issuer practices to the Federal minister of Finance²², a set of proposals was quickly drafted, submitted to a fairly

²¹ There would be an immediate impact on consumers who could not access the value they had stored and could therefore not spend it, and who very likely would reduce other money outlays out of uncertainty. There would be an impact on retailers who would see their customers stop spending and might also not get value from that provider for products and services already purchased by customers whom they cannot trace. Financial institutions may also be impacted, depending on arrangements between all parties. In addition, these impacts would be felt across borders. When the United States government decided to bail out AIG, value at risk was estimated at around eighty billion dollars and while the risks in that case were clearly more likely to ripple out, the failure of a provider holding perhaps as much in stored value would probably be seen as a significant cause for concern.

²² In itself an interesting issue, since card networks are not federally regulated *per se*, card issuers are not all federally regulated institutions and agreements between acquirers and retailers should come under provincial jurisdiction. Insofar as competition law issues might

short consultation process which did not allow for effective discussion between stakeholders, modified and implemented. That initiative, however, leaves aside a number of important issues, is not well coordinated with other aspects of Canadian consumer law and is likely to act as a brake to innovation. While the issues raised by retailers over the last eighteen months certainly deserved consideration, the way they were addressed obviously cannot serve as an example of how payment system issues should be considered in the future.

How, then, to navigate between confusion, rigidity and improvisation?

2- Some high-level principles

Since 2005, the Canadian Consumer Initiative, of which PIAC is a member, has advocated the implementation of a principles-based policy aimed at regulating electronic payments and, more broadly, the whole payments environment. While sufficiently flexible to be adaptable to innovations, principles provide a predictable, consistent set of directions to all stakeholders. CCI has proposed eight (8) principles that should form the basis of a Canadian policy for payments:

- **universality:** the broadest range of payment technologies should be regulated;
- **neutrality:** all technologies should be regulated by similar rules, insofar as possible;
- **security:** payment technologies and processes should be secure and sound;
- **accountability:** risk should be supported by the party which creates it;
- **transparency:** rules, responsibilities, risk, and prices should be clear for all parties;
- **liberty:** payors should be allowed to choose the payment method they prefer;
- **enforceability:** the framework should be effectively enforced;
- **legitimacy:** the framework should be fair, persuasive, authoritative, and it should compare favorably with best-in-class comparable instruments worldwide.

have been raised (many of which come under federal jurisdiction), they were not addressed by the Department of Finance's initiative.

We are of the view that the Task Force should recommend a principles-based policy framework for the development of the Canadian payment system and that it should take inspiration from these principles.

III- The proposed themes

A- Innovation

One needs only take a quick look at a website such as Paymentsnews.com to become convinced that new payment methods are blossoming on what seems to be a daily basis. We will not even attempt here to summarize the technological evolution we are witnessing. There is too much happening, the Task Force will already be aware of most of it and it remains hard to separate the wheat from the chaff and predict which new mechanisms or schemes will "stick" in the Canadian market.

Before we go further, one precision: it hopefully goes without saying that we are not Luddites. Convenient, inexpensive, efficient, safe payment technologies are good for consumers and for the economy as a whole. The challenge is to develop and implement precisely those technologies, and to keep away the others. For, unfortunately, there are others.

If innovation is a good thing and is happening all around the world, why is it that Africa (not to mention Japan) is so well ahead of Canada when it comes to mobile banking? Why is it that a Singapore bank can offer a dual debit/credit card²³? Why is it that it is a British provider which proposes even to Canadian consumers prepaid PIN codes which can be used to purchase goods and services on the web?²⁴

Of course, new providers are emerging in Canada, some as well-known as our large telecommunications providers²⁵ and others small, privately-held essentially unregulated undertakings with what they hope is a good idea and scant capital. Up to now, all this agitation has not led to significant change in the marketplace.

Perhaps part of the explanation for that inertia is that deposit-taking financial institutions are comparatively moving at a glacial pace. After all, the most dramatic

²³ See *POSB Launches First Card in Singapore Featuring Both Debit and Credit Functions*, August 24 2010, consulted at <http://www.businesswire.com/news/home/20100824005769/en>.

²⁴ See the Ukash website at www.ukash.com.

²⁵ See for instance their concerted initiative at www.zoompass.com.

change they outwardly seem to be considering at this point is a review of how they will apportion their payment activity portfolios between Interac, MasterCard and Visa, providers that have been around for decades: that does not feel like the bleeding edge of payment technology.

The technology is out there, and very slowly trickling in the Canadian market. But who decides what comes in, and how? Are they asking the right questions, from a policymaking perspective? We suspect the answer is negative, which raises two very significant issues: competition in the Canadian payments market and regulation (or lack thereof).

B- Competition

1- Sizing competition

We agree with the policy Parliament has set in the preamble to the *Competition Act*:

1.1 The purpose of this Act is to maintain and encourage competition in Canada in order to promote the efficiency and adaptability of the Canadian economy, in order to expand opportunities for Canadian participation in world markets while at the same time recognizing the role of foreign competition in Canada, in order to ensure that small and medium-sized enterprises have an equitable opportunity to participate in the Canadian economy and in order to provide consumers with competitive prices and product choices.²⁶

Competition is not an end in itself, as the preamble attests: it is a means to an end – or rather to four ends in this case, and since perfect markets cannot exist, competition will of necessity always be imperfect. Hence the need to regulate it and to compensate for its unavoidable failings. Competition is not a magic spell which will in and of itself cure all the ills in the market.

Unchecked, competition can actually lead to higher prices and worse services. Unfortunately, the Canadian payments environment provides a good example of the

²⁶ *Competition Act*, R.S.C., c. C-34. Under the *Act*, the notion of "product" mentioned at the end of s. 1.1 includes services.

negative impact competition may have. In 1996, the Competition Tribunal approved an order opening the automatic banking machine ("ABM") market to broader competition, *inter alia* by requiring the Interac Association to accept members other than DTFIs²⁷. As a result, the number of ABMs in Canada has exploded, going from eighteen thousand in 1996 to fifty-eight thousand in 2009. However, two thirds of those ABMs are now operated by providers other than DTFIs²⁸: those machines provide less services²⁹ but transaction fees paid by consumers are higher. Rational consumers would probably rather not pay more to obtain less services: the number of withdrawals from ABMs other than those of the consumer's own financial institution is therefore, logically, steadily declining³⁰. It is hard to see how increased competition in the Canadian ABM market has improved consumer or general economic welfare in the long run³¹. More competitors should not be confused with more efficient competition.

2- Adapting competition

At a time when new competitors are striving to enter the Canadian payments market, the Interac debacle should therefore be kept in mind: increasing the number of competitors does not always entail better economic welfare. That results in part from some peculiar characteristics of payment systems.

²⁷ *Director of Investigation and Research v. Bank of Montreal et al.*, ci-après la «Décision», dont on trouvera le texte au <http://www.ct-tc.gc.ca/CMFiles/0092a38PEW-3102004-3532.pdf>. The Order has been varied from time to time since 1996.

²⁸ The number of ABMs operated by banks has gone from 17 174 in 2000 to 15 950 in 2005 and back to 17 255 in 2009: Canadian Bankers Association. *Number of Cash Dispensing ABMs*. May 31 2010. Consulted at www.cba.ca/contents/files/statistics/stat_abmnum_db427_en.pdf. During the same period, the number of shared ABMs using Interac protocols went steadily from 31 900 to 58 200: Interac Association. *Interac 2009 Statistics*. Consulted at www.interac.ca/media/stats.php. Bank-operated ABMs therefore went from 54% to less than 30% of the total. The impact of DTFIs other than banks would not alter significantly the trend.

²⁹ The typical non-DTFI ABM is strictly a cash withdrawal machine, whereas DTFI ABMs also provide other functions, such as deposit and bill payment.

³⁰ The volume of shared ABM network transactions cleared through CPA systems has declined from 389.7 million transactions in 2001 to 250.2 million in 2009, a drop of 36% in eight years: Canadian Payments Association. *Annual flow of payment items through the Automated Clearing Settlement System (ACSS)*. Consulted at http://www.cdnpay.ca/imis15/pdf/pdfs_publications/acss_ann.pdf. Offer, through the number of ABMs on the market, keeps climbing, but demand is declining: this market's current behavior is therefore most likely unsustainable.

³¹ What remains debatable is the potentially positive impact the Competition Tribunal's order may have had on the acquiring industry for point-of-sale transactions, whose number keeps growing, albeit more slowly now than in the nineties, the market now being presumably close to saturation.

First and generally speaking, payment systems are highly influenced by networks effects³²: customers prefer a larger, more accessible network and providers prefer to participate in a network that attracts more customers. Switching costs may also play a part in customer choices and mobility on the market³³. A sound competition policy in the payments area must take into account the unavoidable cooperation between network participants, market friction and other economic considerations.

Second, payment schemes require a fairly high level of standardization and a high degree of cooperation in the implementation of security, safety and soundness policies. Again, competition policy must account for those aspects.

Finally and as the Canadian financial industry is currently organized, the larger DTFIs are able to act as strangleholds. They control or heavily influence the Canadian Payments Association, Interac, Visa Canada and MasterCard Canada, currently the four largest payment networks. They also control access to hundreds of billions of dollars in deposits which are used to perform payments, and to the accounts where such payments are credited. Important providers such as Moneris are controlled by DTFIs. There is no effective counterweight to their ability to steer a large part of the Canadian payments industry in a given direction. Granted, they may be competing against each other, but they alone select both the game and the field where the game will be played, and they set the game's rules: in such a context, those who would prefer football to hockey are simply shoved aside. There may be (limited) competition within the game, but there can hardly be competition between the games that are offered to the customers' choice.

3- Some scenarios

What, then, is the game being played? At the risk of grossly oversimplifying the analysis, we suspect the payment service provider ("PSP") industry can be roughly divided in two camps: deposit-taking financial institutions, and others.

³² See for instance Matutes, Carmen; Padilla, A. Jorge. *Shared ATM networks and banking competition*. European Economic Review 38 (1994) 1113.

³³ In economic terms, switching costs are the obstacles that tend to prevent customers from switching from a provider to another in a given market. For more, see *inter alia* Farrell, Joseph; Klemperer, Paul. *Coordination and Lock-Up: Competition with Switching Costs and Network Effects*. in *Handbook of Industrial Organization*. Vol. 3. M. Armstrong et R. Porter, editors. Elsevier, North Holland, 2007. Pp. 1977-8. The text of that chapter is also available at www.nuff.ox.ac.uk/users/klemperer/Farrell_KlempererWP.pdf.

Banks hold well over six hundred billion dollars in consumer deposits and over five hundred billions in deposits from businesses and public bodies³⁴, to which must be added deposits held by other DTFIs. By and large, these are the funds that Canadians use to make payments. DTFIs are entrusted with that money and legitimately control access to our funds so that they are not diverted without their legal holders' consent.

The largest DTFIs also exert a large measure of control over the CPA Interac, Visa and MasterCard, all four of which are obviously major players in our payments industry. Control goes beyond holding a majority of shares or naming directors: it can take many shapes. It may emerge as a major player's decision not to participate in a project, which derails that initiative for the whole industry. It may be come as a savvy representative on a network's working group who will ensure that this feature is to be included in a new payment mechanism and not that one, thus securing his own employer's advantage over smaller competitors who are not represented around the table. Since they can throw significant resources at payment issues, the largest DTFIs are simply in a position to exert massive influence on the important payment networks. Experience shows that, at least occasionally, their relative weight (and inertia) results in evolution at the pace of the slowest³⁵.

Deposit-taking financial institutions therefore constitute the core of the payments system. They are the custodians of the more liquid assets which consumers (and others) can use to proffer payments and they have almost unchecked influence on the evolution of the four largest payment networks. While they cordially compete for market share, they also cooperate in order to maintain safety, soundness and security of the system – as they collectively conceive them.

While competition within the core remains subdued³⁶, it is getting frenzied at the periphery. Players as different as large telecommunication providers and much smaller,

³⁴ Bank of Canada. *Weekly financial statistics*. Ottawa, Bank of Canada, September 3 2010, table C2. In July 2010, personal deposits in Canadian dollars held by Canadian banks amounted to 660 742 million dollars and non-personal deposits amounted to 545 561 million dollars (excluding Government of Canada deposits).

³⁵ The author has been a member of various CPA working groups over the years and has been able to observe the success of the largest DTFIs in steering the development (or lack thereof) of payment mechanisms.

³⁶ We acknowledge that DTFIs would argue that they are in fact fiercely competing; they are, within a very tight set of unwritten rules and converging objectives.

still untested providers are knocking at the door. They propose new technologies, new networks, and sometimes even new currency³⁷.

Three broad scenarios can therefore be envisioned.

In the first scenario, at least some peripheral providers establish significant market share³⁸. They remain, however, shut out by core providers and for the most part cannot access DTFI-held accounts. A dual payments market would then develop, the core market being highly regulated and less innovative while the peripheral market would be highly innovative, and potentially weakly regulated (if at all). As the peripheral market grows (as it likely would, being more innovative), risk would gradually increase and might result in a serious crisis³⁹. Whatever regulatory framework is in place would probably not be universal, technologically neutral or fair.

In the second scenario, core providers simply gobble up the most promising peripheral competitors and may, or may not, implement their technologies, at a pace of their own choosing. Market stability is ensured and the regulatory framework is not as clearly threatened, but innovation may well be thwarted. Innovative solutions may become proprietary to one financial group or one network.

In the third scenario, core and peripheral providers become complementary. Trustworthy peripheral providers are given access to DTFI-held accounts and are not tied down to one financial group or network: open standards are the norm. Peripheral providers are adequately regulated, thereby reducing risk to a manageable level without unduly hindering innovation. The regulatory framework encompasses all providers and tends to offer a level playing field to all.

³⁷ Some virtual worlds have created their own currency, which may be convertible to real-world currency; in the bricks-and-mortar world, communities are also creating their own currency in order to foster local purchases and local economic development: see for instance McCillum, Sandy. *Portland to get it's [sic] own currency*. Portland Home & Living Examiner, August 11, 2010, consulted at <http://www.examiner.com/home-living-in-portland/portland-to-get-it-s-own-currency>. The local currency movement is also quite active in the United Kingdom.

³⁸ The case of PayPal illustrates how quickly a provider may become mainstream: it now has 87 million active accounts in 190 national markets and had a payment volume of 21 billion dollars in the second quarter of 2010 : PayPal. *Corporate Fast Facts. Q2 2010 fast facts*. Consulted at <https://www.paypal-media.com/documentdisplay.cfm?DocumentID=2260>.

³⁹ Small, unregulated providers with short experience and scant capital would face significant operational, liquidity, legal and reputational risk. Should one well-known provider fail, the whole industry might well be tainted.

Not so long ago, some might have mischievously added a fourth scenario whereby Google purchased the banks and managed all payments. Beyond the obvious legal impediments to such a solution, the fact is that DTFIs will remain crucial players within the payments environment; the issue is whether they will remain able to control it as effectively as they have in the past, and whether they should⁴⁰. We believe the answer is negative, and that a future along the lines of our third scenario should be fostered. The first two scenarios are fraught with either risk or inertia; they are, however, those most likely to happen "naturally" in the short term, to every Canadian's detriment. In order to facilitate the advent of the third scenario, the Canadian regulatory framework will need some tweaking, an issue we shall revisit in section III-D.

That said, competition issues are but one piece of the puzzle. First, broader policy objectives must be set; only then can the competition policy best adapted at achieving those objectives be identified.

C- Privacy

PIAC and other Canadian consumer groups have long been greatly concerned with privacy matters in Canadian markets. In the financial area, and especially when it comes to payments, privacy raises three major issues.

The first is anonymity. People should not need to be identified (or identifiable) merely because they make a payment and it should not be necessary for them to disclose indirectly that they stood at a given place at a given time merely because they are paying. The concern goes beyond transactions that may be shady or somehow reproachable: it is a canon of privacy law that persons should not be required to disclose more personal information than what is necessary in order to perform a transaction. Such personal information, when generated, can be kept by provider and intermediaries, sold, lost, hacked or used for all sorts of tracking and marketing purposes. Personal information protection rules should be embedded in the design of payment mechanisms; the opposite seems to be more often the case, especially, when mechanisms are borrowed from our southerly neighbors, where excessive information gathering remains the norm.

⁴⁰ By "effectively", we obviously mean in this sentence that their influence has been dominant, not necessarily that it has resulted in a efficient market.

A second concern has to do with transborder data flows and transparency. Not every consumer realizes that whenever they use a Visa card to make a payment in Canada, data flows including personal information necessarily flow through Visanet to a processing center located outside Canada, and we understand the same is true with MasterCard transactions. Even less obviously, consumers may not be aware that when they make a purchase on a retailer's website, the pages dedicated to the payment operation itself may well be provided by an acquirer who will ensure those pages have the same "look and feel" as the retailer's own, and who may well be located in another country⁴¹.

The third problem with privacy, which largely exceeds payment issues, is enforcement. While Canada and most provinces have enacted fairly good privacy legislation, enforcement is sorely lacking. There is not enough energy devoted to prevention, so process designers are not sufficiently aware of privacy issues and do not embed personal information protection in their systems. There is not enough information, so consumers do not always recognize privacy breaches for what they are. Neither are there enough resources dedicated to ensuring compliance. The end result is that the legislative framework is much less effective than it could be.

As the payment environment increasingly opens to new providers, and occasionally to foreign providers, privacy issues may raise legal and reputational risk for providers. While the larger ones may be aware of those risks⁴², the smaller ones may not be. As the appetite for personal information for marketing purposes and often misguided security concerns grow, product design is often slanted to generating more personal information, rather than guaranteeing anonymity. Risks are therefore likely to increase.

Adequate product design is often the best way to address privacy issues in the marketplace. When unnecessary personal information is simply not generated, it cannot be abused. When strong security is designed in systems from the outset where it is necessary, it does not need to be added-on at great expense later.

⁴¹ Some years ago, the author worked on the design of a Canadian website whereby consumers would be driven, in order to purchase software offered by a provider, to web pages provided by a U.S.-based acquirer, without ever being informed that the payment pages were provided by another party located in another country. Neither was there any visual clue that could have alerted a consumer to the fact that she was no longer technically on the seller's website, but temporarily on another. That case is certainly not unique.

⁴² Some years ago, a representative of one of Canada's largest DTFIs acknowledged privately that consumer surveys commissioned by that institution indicated that a privacy breach was the factor most frequently identified by consumers as the factor which would make them switch to another provider.

D- Efficiency and governance

1- An efficiency shortfall

The current Canadian payments environment is not as efficient as it could be. Innovation is curbed. Costs are high. While payment mechanisms may seem quick and dependable, the fact is that consumer deposits are often held for days and that preauthorized debit users experience a quite high level of mistaken withdrawals⁴³.

In addition, the environment is opaque. We do not expect consumers to master the subtlest points of item revocability under ACSS rules, of course. But the largest retailers have been complaining that interchange fees have become impossible for them to understand. Most Interac rules are confidential. Major strategic initiatives are abandoned without notice⁴⁴.

It is also very hard to understand. Some payments are governed (insofar as they apply) by CPA rules, while other, similar operations are not. PIN-based payments with a debit card are governed by the *Canadian Code of Practice for Consumer Debit Card Services*, while PIN-less payments using the same card are not. Consumers, and most other stakeholders, should be forgiven for having no idea whatsoever about the rules that may or may not apply to a given transaction. Actually, it is a fair guess that most Canadian lawyers would be unable to provide an adequate description of the regulatory landscape. Legal risk and uncertainty seldom breed efficiency.

Stakeholders increasingly wish to be heard and have a say. For all practical purposes, CPA has offered them the only useful forums, which are limited however by their format and CPA's own mandate and alignments. As a result, retailers knocked at the Minister of Finance's door last year and obtained part of what they sought, which may or may not be congruent with economic welfare in the broadest sense. Department of Finance's belated attempts to upgrade the *Canadian Code of Practice for Consumer Debit Card Services*

⁴³ According to a Winter 2006 Environics survey on behalf of CCI, 66% of Canadian consumers were at the time using preauthorized debits, of which fully 12% had experienced a problem with a preauthorized debit over the two preceding years; the most frequent problems observed were a mistake over the amount, a mistake over the date or a double dip. For a summary or the full results, see http://www.option-consommateurs.org/salle_presse/communiques/69/ or <http://www.consommateur.qc.ca/union/DPAsurvey.pdf>.

⁴⁴ CPA's public key initiative in the nineties and more recent electronic cheque presentment initiative are cases in point: after millions of dollars had been invested, both were abandoned, without clear and convincing justification.

since 2007 have failed after achieving the exceptional feat of raising stakeholder unanimity against the proposed changes and the consultative process put in place at the time.

While there are obviously other sources of inefficiency in the Canadian payments system, we therefore strongly believe that regulatory and governance failure currently stands as a major impediment to progress.

2- High-level comparisons

a) the Canadian patchwork

When compared to those of jurisdictions such as the United States, the United Kingdom or Australia, the Canadian regulatory framework around payments might be said to appear quaint, which would be a nice way of saying it is inadequate and antiquated. Canada's framework is a hodgepodge of rules, standards and contracts supported by scant (and often archaic) legislation⁴⁵ which provides incoherent solutions and comes under the purview of no effective monitoring agency.

There is some federal legislation which addresses payment issues. Increasingly, there is also provincial legislation, governing for instance prepaid cards⁴⁶, and the validity of contractual terms and conditions comes primarily under provincial legislation. So do credit cards when used as payment tools, except for the fact that banks must also abide by the *Bank Act* and regulations enacted under its authority with regard to the credit cards they issue.

Some payment mechanisms have the benefit of rules adopted by the Canadian Payments Association: preauthorized payments debited to DTFI accounts provide the classic example. However, the Supreme Court of Canada has been adamant not only that CPA rules have no legal effect on parties which are not CPA members, but also that the rules cannot even be considered as being implicitly included in the contract between a member financial institution and its customers⁴⁷.

⁴⁵ such as the *Bills of Exchange Act*, R.S.C., c. B-4 and the *Currency Act*, R.S.C., c. C-52.

⁴⁶ See for instance recently enacted sections 187.1 to 187.5 of Québec's *Consumer Protection Act*, R.S.Q., c. P-40.1.

⁴⁷ *B.M.P. Global Distribution Inc. v. Bank of Nova Scotia*, [2009] 1 S.C.R. 504, §§ 54-60.

However, a consumer may also make arrangements for preauthorized payments to be debited from her credit card account. While the two types of transactions may appear identical to her, CPA rules would not apply to the latter. Generally speaking, rights and obligations related to various, often similar, payment mechanisms vary in ways that consumers are not aware of and for reasons they could at times scarcely understand.

Differences regarding the status of the various networks may seem just as bewildering. CPA is governed by legislation. Some aspects of Interac's activities are governed by a Competition Tribunal order. Networks such as Interac, Visa and MasterCard could be "designated" under Part II of the *Canadian Payments Act*⁴⁸ (but are not). Smaller providers may not be subject to such designation, as is the Act is currently drafted, and escape all regulation.

Regulatory confusion and discrepancies are not limited to products at the retail level. For instance, Interac transactions are cleared in Canada and through the CPA, while Visa or MasterCard transactions are cleared outside the country and through proprietary networks over which Canadian regulators have limited jurisdiction. CPA rose some of those issues in a July 2009 Discussion paper and while we did not agree with the solutions it then proposed, we believe the problems it pointed to, such as systemic risk as well as regulatory consistency and transparency, are real and serious.

Put shortly, there is significant – and growing – confusion around our regulatory framework. There is anything but a level playing field between competitors. There is globally inadequate protection for users, including both consumers and retailers. We face excessive legal, reputational and, eventually, systemic risk.

Similar challenges have been tackled more effectively in other jurisdictions. It may be useful to summarize those experiences.

b) the United States

Electronic payments have been legislatively regulated at the federal level in the United States since 1978⁴⁹. Specific aspects, such as fund availability and holds on deposits,

⁴⁸ R.S.C., c. C-21.

⁴⁹ *Electronic Fund Transfer Act*, now codified as 15 USC §§ 1693 ss.

have also been legislated decades ago⁵⁰. While that framework is starting to show its age, it is certainly clearer and more cohesive than Canada's, and there is no indication that it has significantly hindered innovation.

For instance, the notion of "electronic fund transfer" within the 1978 legislation encompasses "any transfer of funds" originated other than through a paper instrument, and initiated through a terminal, telephone or computer, including point-of-sale transactions and preauthorized debits. Provisions governing terms and conditions, documentation and information, error resolution and consumer liability cover all types of electronic fund transfers, with few exceptions made for specific types of transfers⁵¹.

The federal *Dodd-Frank Wall Street Reform and Consumer Protection Act*⁵² was signed into law on July 21 2010. It is a massive and complex piece of legislation and has been deemed the most significant review of the U.S. financial sector regulatory framework since 1933. Much of the legislation's impact remains difficult to ascertain, since it will depend in large part on the results of some 67 studies mandated by Congress and the way some 243 rulemaking powers will be exercised⁵³. It is clear, however, that the payments environment will be altered through at least two major innovations.

First, Title X of the Act creates a new, autonomous *Bureau of Consumer Financial Protection* within the Federal Reserve system. The Bureau will be assisted by a Consumer Advisory Board. It will ensure the compliance of financial institutions and their service providers with a number of regulatory requirements which we understand to include those covering electronic payments. It will also be enabled to deem a broad range of practices as unfair or abusive.

In addition, the Federal Reserve Board is required, by April 2011, to determine debit interchange fee parameters and it is also enabled to regulate other network fees to ensure

⁵⁰ *Expedited Fund Availability Act*, 12 USC §§ 4001-4009, enacted by Pub L. 100-86, Title VI, §602, August 10 1987. At the time, Ronald Reagan was President of the United States.

⁵¹ For instance, §1693e requires that a preauthorized fund transfer be authorized in writing, a requirement that would be irrelevant for most other types of electronic fund transfers.

⁵² Pub. L. 111-203. The legislation is well over 800 pages long.

⁵³ The estimate of the number of studies and rulemaking powers within the legislation was made last July by a large U.S. law firm: Davis Polk & Wardwell. *Summary of the Dodd-Frank Wall Street Reform and Consumer Protection Act, Enacted into Law on July 21, 2010*. July 21, 2010. 118 p. Consulted at http://www.davispolk.com/files/Publication/efb94428-9911-4472-b5dd-006e9c6185bb/Presentation/PublicationAttachment/efd835f6-2014-4a48-832d-00aa2a4e3fdd/070910_Financial_Reform_Summary.pdf.

that they are not used to compensate for any ceiling set on interchange fees. Other rules will forbid payment routing restrictions or allow consumers to benefit from discounts serving as incentives to the use of specific payment methods.

The 2010 reforms should allay somewhat some of the regulatory problems that do afflict the United States environment. In particular, a number of issues – interchange fees being the obvious example – have been taken to courts, making for a high level of legal uncertainty. New rulemaking powers, and the new Bureau's ability to oversee a broad range of consumer protection issues, should help reduce legal risk in time, although providers will most likely experience significant legal uncertainty for the next year or two.

c) the European experience

i) European Union directives and regulations

European authorities realized as early as 2000 that electronic money was entering payment markets, and that unregulated new providers might eventually threaten the economy. After a first regulatory iteration, they have significantly improved the Union's regulatory framework in 2007 and 2009.

Under the 2007 *Directive on payment services*⁵⁴, member States are required to establish a regulatory framework whereby undertakings offering listed payment services must *inter alia* be authorized⁵⁵, are required to hold adequate initial capital and own funds, are required to put in place safeguarding mechanisms for third party funds in their custody, must provide customers with adequate information and must cap consumer liability. The Directive applies *inter alia* to ABM transactions, preauthorized debits and transactions authorized through any telecommunications or digital device. The Directive therefore achieves a fairly high level of universality and technological neutrality. Member countries were required the Directive in national legislation by November 2009.

⁵⁴ *Directive 2007/64/EC of the European Parliament and of the Council of 11 November 2007 on payment services in the internal market amending Directives 97/7/EC, 2002/65/EC, 2005/60/EC and 2006/48/EC, and repealing Directive 97/5/EC.* OJ L. 319, 5.12.2007, p. 1.

⁵⁵ There are exceptions dealing *inter alia* with otherwise-regulated deposit-taking institutions, or with small providers.

In addition, the 2009 Directive on electronic money institutions⁵⁶ regulates institutions that issue electronic money, i.e. monetary value which is electronically stored and represented by a claim on the issuer and which is accepted for payment purposes by a party other than the issuer. Prudential supervision and capital requirements are set, as well as rules such as one requiring electronic money to be issued at par and to be redeemable under limited exceptions.

Also in 2009, a Regulation on cross-border payments⁵⁷ was adopted which is likely to have an impact both on those and on national transactions, as *inter alia* it requires that the communication of some information include the IBAN⁵⁸ and sets a default interchange fee for cross-border preauthorized debits.

Those reforms take place against the background of SEPA, the Single Euro Payments Area, an initiative launched by European authorities but effectively controlled by the European financial sector through the European Payments Council. Interestingly for our purposes, stakeholders represented on the Payment System End-users Committee (the "EUC") have been clamoring for more input in the SEPA rulemaking process⁵⁹.

When examined through the prism of the principles we propose in section I C-2 *supra*, the European framework appears to strive for a high level of universality, neutrality, security, accountability, transparency and legitimacy. It is likely to reduce legal risk and to constrain operational and credit/liquidity risk. While certainly not perfect, nor perfectly adaptable to the Canadian context, it certainly appears to have high potential as a model. Increasing efforts to facilitate stakeholder participation in the development of payment mechanisms also represent an interesting trend.

⁵⁶ Directive 2009/110/EC of the European Parliament and of the Council of 16 September 2009 on the taking up, pursuit and prudential supervision of the business of electronic money institutions amending Directives 2005/60/EC and 2006/48/EC and repealing Directive 2000/46/EC. OJ L 267, 10.10.2009, p. 7.

⁵⁷ Regulation (EC) No 924/2009 of the European Parliament and of the Council of 16 September 2009 on cross-border payments in the Community and repealing Regulation (EC) No 2560/2001. OJ L266, 9.10.2009, p. 11.

⁵⁸ The International Bank Account Number. Such a requirement may encourage financial institutions to adopt information processing protocols using the IBAN not only for cross-border purposes, but also across their entire system. The purpose of this requirement in the Regulation is expressly stated as "facilitating the automation of payments".

⁵⁹ See *inter alia* EUC. *EUC comments on SEPA Governance paper*. April 15 2010. 3 p. The document is co-signed by organisations representing consumers, insurers, retailers, small and medium enterprises, corporate treasurers and the periodical press. Consulted through <http://www.eurocommerce.be/content.aspx?PageId=41790&lang=EN>.

ii) the case of the United Kingdom

For over two decades relationships between the major British DTFIs and their customers were in large part governed by the *Banking Code*, a voluntary industry code whose latest iterations provided a reasonably interesting level of consumer protection⁶⁰. The *Code* has now been abolished⁶¹ and payment activities are governed since November 2009 by the *Payment Services Regulations 2009*⁶² (the "PSR"), which accomplish the transposition of the *Directive on payment services* in British law.

An exhaustive analysis of the PSR goes well beyond the ambit of this paper. Of note is that most undertakings wishing to act as payment institutions must be authorized or registered and must comply with capital and "own funds" requirements⁶³. Institutions are generally required to provide information to consumers, even prior to the conclusion of a contract. Consumer liability is regulated and usually limited to fifty pounds (£50); the onus is explicitly on the institution to prove that a disputed transaction was in fact authorized by the customer. The PSR also strive to accomplish technological neutrality by applying to a broad variety of payment mechanisms and providing similar solutions in most cases.

The United Kingdom may also serve as a model in terms of governance. While there are numerous players within the British payment industry, there does appear to be a semblance of order.

In particular, there is slightly more competition on the clearing side of the market. Different payment streams are served by different clearers, and especially BACS and CHAPS, in addition to worldwide card networks. However, an attempt has been made in recent years to establish a body which could, in its own, words, set "strategy for UK payments" and ensure that "UK payment systems meet the needs of users, payment service providers and the wider economy"⁶⁴. The Payments Council lists as its objectives:

⁶⁰ at least insofar as it is compared for similar Canadian initiatives.

⁶¹ except for provisions regarding credit, which were turned into a new code.

⁶² S.I. 2009 No. 209.

⁶³ There are exceptions based *inter alia* on the size and payment volume of the undertaking.

⁶⁴ Payments Council. *About us*. Consulted at www.paymentscouncil.org.uk/about_us/. The Council was established in 2007.

- to have a strategic vision for payments and lead the future development of co-operative payment services in the UK;
- to ensure payment systems are open, accountable and transparent;
- and to ensure the operational efficiency, effectiveness and integrity of payment services in the UK.⁶⁵

To some, such language may evoke s. 5 of the *Canadian Payments Act* and CPA's mandate. One huge difference is that the Council is not an operator, and therefore cannot find itself in competition with other providers for which it would seek to establish a strategic vision. Another important difference is that while Council members are financial institutions⁶⁶, the minority of independent directors on the Council's board have to ability, if acting together, to veto any decision.

It is the Payments Council which, in December 2009, announced that the industry intended to stop clearing cheques after October 2018 and which coordinated the consultations and discussion leading to that landmark decision. The Council has also published *inter alia* a financial inclusion policy which binds its members and, in May 2010, a *Review of the contactless and prepaid card markets* which presents a high-level picture of the challenges facing the industry as it tries to implement these mechanisms. In short, the Council appears to play a meaningful leadership role within the industry.

The industry is also served by organisations such as UK Payments, which defines itself as "the service company providing people, facilities and expertise to the UK payments industry" and The UK Cards Association, which represents the credit card industry.

Finally, financial regulation in the United Kingdom is likely to undergo yet another deep transformation in coming years. Her Majesty's Treasury announced in July 2010 its intention to divide current Financial Services Authority's jurisdictions over *inter alia*

⁶⁵ *Ibid.*

⁶⁶ Clearing schemes are bound by contract to the Council, which can take decisions that are binding on the schemes.

payments and market conduct between a new Prudential Regulation Authority within the Bank of England and a new Consumer Protection and Markets Authority⁶⁷.

d) Australia

Australia's legislative framework regarding payments has some apparent similarities with Canada's. For instance, the *Payments Systems (Regulation) Act 1998* allows for the designation of payment systems, as does Part II of the *Canadian Payments Act*. In Australia however, the Visa Debit system and the EFTPOS debit card system have been designated in 2004, whereas the Canadian designation power has yet to be used. Designation has enabled authorities to set interchange fees and remove some rules that used to be imposed by designated systems. The Australian ATM system was also designated in 2008, again enabling authorities to set or alter rules governing a payment system.

Obviously, Australian authorities have been significantly more active in regulating payment systems. That may in fact stem from the fact that regulatory powers are for the most part concentrated within one entity, in this case the Reserve Bank of Australia. Not only does the Reserve Bank enjoy broad powers, but it acts in the payments area through the Payments System Board, which is created by legislation and is responsible for "determining the Reserve Bank's payments system policy", "controlling risk in the financial system, promoting the efficiency of the payments system and promoting competition in the market for payment systems, consistent with the overall stability of the financial system."⁶⁸

The Payments System Board's activities are quite wide-ranging, as evidenced for instance by its 2009 Annual Report. The document *inter alia* reports on the Board's monitoring of trends in the use of various payment mechanisms and on the impact of its own decisions (as for example on merchant service fees or merchant surcharging following the regulation of interchange fees). The report also summarizes the results of a broad-ranging review of recent reforms, which were published in 2008. Indeed, a review of the Board's activities over the past decade could not overlook the depth of the public

⁶⁷ HM Treasury. *A new approach to financial regulation: judgement, focus and stability*. London, July 2010. Cm 7874. See *inter alia* §§ 1.14 to 1.23, 5.4 and 5.12 to 5.18. Consulted at http://www.hm-treasury.gov.uk/d/consult_financial_regulation_condoc.pdf.

⁶⁸ Reserve Bank of Australia. *Payments System Board – Responsibilities and Powers*. Consulted at www.rba.gov.au/payments-system/policy-framework/psb-board.html.

consultations it has undertaken and the exceptional quality of the consultation papers it has put forward.

From a consumer perspective, another important aspect of the Australian payments framework is the *Electronic Funds Transfer Code of Conduct*, which in its current iteration was adopted in 2001 and modified in 2002 and 2008. Monitoring and review of the Code are conducted through the Australian Securities and Investments Commission. The Code appears to achieve a high level of universality and neutrality, as it covers a broad range of electronic transactions with requirements that are fairly consistent across that range. Consumer protection requirements are quite high, when compared to Canada's.

3- Lessons to learn

Beyond the obvious differences between the regulatory frameworks put in place in the United States, European Union and Australia, some commonalities emerge.

In all cases, the regulatory framework is stronger and more coherent than Canada's. Governments have rightly concluded that some State action is required in order to provide a modicum of certainty to all stakeholders. All those frameworks also strive for universality and neutrality: while those objectives are not perfectly achievable, they spell a simplification of the framework which would be most welcome in Canada.

Increasingly, leadership on payment issues is devolved to one or two bodies. Solutions differ, of course. Australia has opted for a specialized body within its Reserve Bank, while the United Kingdom maintains a clearer distinction between supervision on the one hand and policy leadership on the other, the latter function having been taken over by a private concern, the Payments Council.

In all cases, consumer protection is strong, or being strengthened.

And in all cases, efforts are increasingly made to improve stakeholder involvement and, incidentally, limit the ability of a few entrenched players to act as bottlenecks to change.

We respectfully suggest that Washington, Brussels, London and Canberra are unlikely to all be wrong at the same time on issues that have been in most cases considered at length. The trends we have outlined should provide useful guidelines for the Task Force.

Governance issues may appear of secondary importance. They are, in fact, fundamental. In 2009, retailers felt they had nowhere else to go but to the Minister of Finance's door, because there is no governing body overseeing the payments industry. When CPA decided to raise systemic risk issues surrounding the settlement of Visa and MasterCard transactions, also in 2009, it had nowhere to go but the same door. We suspect the Minister would rather not be required to improvise satisfactory solutions to convoluted payment problems on a regular basis.

As for consumers who are victims of inappropriate practices, they do not know whether to go to their provincial consumer protection regulator, to the Financial Consumer Agency of Canada or elsewhere, because no one apparently has clear jurisdiction or the extensive know-how required to understand our payments system and propose solutions.

Clarifying governance would not settle all problems: it would, however, provide a forum where problems can be debated and sorted out. Such a forum is sorely lacking in Canada.

IV- A provisional conclusion

The Canadian payments industry must be modernized and opened up, without jeopardizing its safety and soundness and without imposing an undue burden on consumers. In order to do so, changes are required to the regulatory framework and to the current structure of the industry. Choices will have to be made, which concern highly complex – and sometimes very contentious – issues.

We do not expect the Task Force to find solutions to all the problems that currently vex stakeholders in our payments environment: that is not its mandate, and it could not possibly achieve that result in the next year even if it was.

The Task Force can, however, do two very important things: it can identify and acknowledge the most important issues the industry must face, and it can point the way to a mechanism, or a series of mechanisms, that will be able to tackle those issues effectively in the future. We present these summary comments in that perspective.

A new dialogue is hopefully being opened, for which we have waited for years. We intend to participate actively in the debate which the Task Force's work will generate.