

# Improving the Foundation of Canada's Payments System

---

*Lana Embree and Paul Miller, Financial Stability Department*

- The Canadian payments environment has evolved with enhancements in technology and changes in user expectations. However, the existing regulatory framework and core payments infrastructure have not fully responded to these changes.
- Following a review of the payments system, the Government of Canada, in collaboration with the Bank of Canada, has begun to implement improvements to the governance and regulation of the payments system to better reflect the changes in the environment.
- In addition, the Canadian Payments Association is beginning a multi-year project to re-examine and redesign its payments system infrastructure.

Every day, individuals, businesses and governments in Canada make payments to buy goods and services, distribute social benefits, and give money to friends and family. These transactions, which are critical for economic activity and the daily lives of Canadians, are made using many different payment instruments, such as cash, cheques, debit cards, credit cards or electronic transfers. Underlying these transactions are payment networks and infrastructures that facilitate the actual movement of funds—the exchange, clearing and settlement of payments. In fact, most transactions are ultimately cleared and settled through two systems, the Automated Clearing Settlement System (ACSS)<sup>1</sup> and the Large Value Transfer System (LVTS),<sup>2</sup> which are operated by the Canadian Payments Association (CPA).<sup>3</sup> These systems are at the core of the Canadian financial system.

---

1 The ACSS is Canada's main retail payment clearing system. It clears cheques and other paper-based transfers, debit card transactions, and electronic transfers of funds (debits and credits).

2 The Large Value Transfer System (LVTS) is an electronic funds transfer system that allows financial institutions and their customers to send large payments securely in real time, with certainty that the payment will settle.

3 In 2011, 99 per cent of the value and 76 per cent of the volume of all payments in Canada were settled through ACSS and LVTS. (These are internal Bank of Canada calculations based on data from the CPA, the Canadian Bankers Association, Interac and the Bank for International Settlements.)

The payments environment has changed significantly since the CPA was established in 1980, with advances in technology, the introduction of new payment service providers, the establishment of new risk-management standards and changes in end-user expectations. Given these developments and the importance of the payments system to the financial system and economy, in 2010, Canada's Minister of Finance established the Task Force for the Payments System Review to conduct a comprehensive review of the Canadian payments sector. The Task Force identified concerns with the regulatory framework, governance and the functionality of the payments system in Canada. In response to these concerns, in 2012, the Minister began a review of payments system governance issues, including the governance of the CPA, to ensure the continued safety and soundness of the payments system, spur innovation, and promote the consideration of user interests. The Department of Finance, in collaboration with the Bank of Canada, has been conducting the review, which has included consideration of related developments in other countries and consultations with key stakeholders.<sup>4</sup> Important changes to the payments system have commenced as a result of this review.

This article describes the two key outcomes of the Payments System Governance Review: (i) changes to CPA governance and (ii) an enhanced regulatory framework. It also describes a CPA project to renew its core infrastructure(s) to incorporate the new technologies, standards and other developments needed for the next generation of payment systems. As well, it discusses the Bank's role in each of these three areas. With these updates, the Canadian payments system will have a strong foundation and thereby be able to support a modern and vibrant economy more effectively by serving the payments needs of Canadians safely and efficiently, as the payments industry continues to evolve.

◀ *With these updates, the Canadian payments system will have a strong foundation and thereby be able to support a modern and vibrant economy more effectively by serving the payments needs of Canadians safely and efficiently*

## Background

In recognition of the importance of a safe and efficient payments system, the Government of Canada established, in 2010, a Task Force for the Payments System Review with the mandate to identify public policy objectives; assess the regulatory and institutional structures best suited to achieve them; and assess the safety and soundness, competitiveness and other aspects of the Canadian payments system.<sup>5</sup> The Task Force highlighted in its December 2011 final report gaps in governance, the regulatory framework and functionality:

- **Governance:** The Task Force raised concerns regarding the governance of the payments system and the CPA, noting that the ability of all relevant stakeholders, including users and traditional or emerging payment service providers, to collaborate is limited (Task Force for the Payments System Review 2011c).
- **Regulatory framework:** The report noted that the regulatory framework is fragmented and can result in different levels of oversight for payments depending on the provider (Task Force for the Payments System Review 2011a). For example, with advances in technology, non-bank service

<sup>4</sup> Consultations included the Finance Canada Payments Consultative Committee (FinPay), the CPA and the Canadian Bankers Association. FinPay is a forum of public and private sector representatives that advises the government on payments-related issues, including policy and emerging and ongoing challenges and/or opportunities in the payments system. More information on FinPay and its membership can be found at <http://www.fin.gc.ca/activity/pcc-ccsp-eng.asp>.

<sup>5</sup> More information on the Task Force is available at [http://www.fin.gc.ca/n12/data/12-030\\_1-eng.asp](http://www.fin.gc.ca/n12/data/12-030_1-eng.asp).

providers are increasingly involved in the provision of payments; however, they may be subject to less oversight than traditional payment service providers because they are not subject to the same regulations as banks.

- **Functionality:** Canadians increasingly expect to be able to make payments anywhere at any time to anyone, safely and efficiently (Task Force for the Payments System Review 2011b). For example, businesses and consumers would benefit from a digital alternative to cheques that would be faster and allow the recipient to access the funds sooner. In addition, a widely available alternative to cheques would improve efficiency by linking invoicing and reconciliation processes.

In light of these recommendations, fundamental changes were needed to the foundation of the Canadian payments system for it to continue to be safe, efficient and meet end-user interests in this new and evolving payments environment. As a result, following the release of the Task Force's final report, the Minister of Finance committed to undertake the Payments System Governance Review, in which the government would "review the governance framework for the payments sector, including the Canadian Payments Association, to ensure the continued safety and soundness of the payments system, spur innovation and promote the consideration of user interests" (Department of Finance Canada 2012).<sup>6</sup>

## Changes to the Governance of the Canadian Payments Association

The CPA owns and operates Canada's core national payments infrastructure: the LVTS and the ACSS. The CPA's mandate, as outlined in the Canadian Payments Act (CP Act), is to (i) establish and operate national systems for the clearing and settlement of payments, (ii) facilitate interaction of its systems with other systems, and (iii) facilitate the development of new payment methods and technologies. The existing governance structure of the CPA needed to be enhanced to improve the CPA's ability to respond to changes in the payments environment and upgrade the core infrastructure (Task Force for the Payments System Review 2011d). For example, while the LVTS and ACSS are well maintained and have been very reliable, these systems should be modernized to better achieve the government's public policy objectives (of safety, efficiency and meeting the needs of Canadians) as the payments environment continues to evolve.

The Payments System Governance Review identified a number of measures to better position the CPA to operate and strengthen the national clearing and settlement infrastructure to ensure that it remains responsive to the evolving needs of Canadians, while also supporting public policy objectives. These changes have recently been introduced through amendments to the CP Act (Department of Justice 2015) and can be divided into two broad categories—Board composition and accountability framework.

◀ *The Canadian Payments Association will be better positioned to ensure that it remains responsive to the evolving needs of Canadians while also supporting public policy*

<sup>6</sup> The commitment had two other components: (i) establish a senior-level advisory committee, FinPay; and (ii) review, in close consultation with stakeholders, the application of the Code of Conduct for the Credit and Debit Card Industry in Canada to emerging mobile payment products. See Department of Finance Canada (2012).

## Board composition

The CPA Board currently has 16 directors (12 CPA members,<sup>7</sup> 3 independent directors appointed by the Minister of Finance and a Bank of Canada representative as Chair). Voting on major recommendations, including annual operating and capital budgets, is weighted by members' payment volumes (i.e., the number of transactions), thereby concentrating decision-making power with the largest members, which may not be representative of the broader payments stakeholder community.

Changes to the CP Act have been made, with input from the CPA, to improve representation and better align with best practices in governance. In particular, the Board will be smaller; more independent, especially from the interests of the direct participants;<sup>8</sup> and more reflective of the current payments environment. The new Board will be composed of 13 directors: 7 independent directors, 3 CPA members that are direct participants in the system,<sup>9</sup> 2 CPA members that are not direct participants and the President of the CPA. One of the independent directors will act as Chair. The Bank will no longer have a role on the CPA Board. Voting will be based on the principle of one member, one vote.

To complement the existing Stakeholder Advisory Council, a new Member Advisory Council is being established to provide technical knowledge and operational expertise to CPA Management and the Board.<sup>10</sup> Such advice will be a particularly useful input for independent Board directors not familiar with the details of payment operations.

## Accountability framework

A new accountability framework will ensure that the activities of the CPA are consistent with its mandate, as well as public policy objectives, and will provide further assurance that the views of both stakeholders and members are being considered.

The CPA will have greater accountability to the Minister of Finance and the public (including broader stakeholders). Each year the CPA will publish an annual report that includes audited financial statements, the auditor's report, a review of performance against corporate plan objectives, a statement of forward-looking priorities for the year and a report from the Stakeholder Advisory Council.

The CPA will also be required to submit, for ministerial approval, an annual five-year corporate plan. This plan will provide a means by which the Minister can consider, for example, whether stakeholder and member views are being taken into consideration, whether sufficient forward planning is taking place, and whether the CPA is supporting achievement of public policy objectives. To help ensure that appropriate outcomes are achieved,

◀ *Changes to the Canadian Payments Act have been made, with input from the Canadian Payments Association, to improve representation and better align with best practices in governance*

◀ *A new accountability framework will ensure that the activities of the Canadian Payments Association are consistent with its mandate, as well as public policy objectives*

<sup>7</sup> The Bank of Canada and all banks operating in Canada are required to be CPA members. Also eligible for CPA membership are credit union centrals, federations of caisses populaires, trust companies, loan companies and other deposit-taking institutions, life insurance companies, securities dealers that are members of the Investment Industry Regulatory Organization of Canada or the Bourse de Montréal, and money market mutual funds that meet certain requirements.

<sup>8</sup> Direct participants are those CPA members that participate directly in the ACSS or LVTS. Other CPA members may participate in these systems indirectly by relying on services provided by direct participants.

<sup>9</sup> Two of the three must be domestic systemically important banks.

<sup>10</sup> The Member Advisory Council will include representatives from CPA's membership, while the Stakeholder Advisory Council draws from the CPA's broader stakeholder base, including consumers, businesses, retailers and governments, as well as related service providers.

the Minister will also have expanded power to issue a directive in any situation if it is in the public interest to do so.<sup>11</sup>

These governance changes will affect the Bank of Canada's role with respect to the CPA. When the CPA was established, a Bank official was named as Board chair (i) to act as a neutral agent to arbitrate competing industry objectives and (ii) to exert government or public policy influence over the CPA. These objectives will now be achieved, first, through the improved representation on the CPA Board of a broader set of stakeholder views; and, second, through the new accountability measures and the Bank's oversight role under the Payment Clearing and Settlement Act (PCSA).<sup>12</sup>

It is anticipated that these changes will better position the CPA to adopt a forward-looking strategy and respond to changing technological capabilities and stakeholder needs. The changes to the governance of the CPA are expected to commence in mid-2015.

## Regulatory Framework

### Background

In its findings, the Task Force identified several areas of concern, including the fact that the regulatory framework, while relatively complete, was fragmented and that the payments system lacked comprehensive oversight.<sup>13</sup> For example, certain players in the payments industry, such as non-bank payment service providers, were not subject to the same oversight as others, such as banks.

Under this regulatory framework, the PCSA gave the Bank its oversight mandate for designated payment systems, which are those that have the potential to pose systemic risk.<sup>14</sup> Such systems are referred to as "systemically important." The Bank has designated five systems as systemically important, including the LVTS, Canada's main interbank payment system owned and operated by the CPA.<sup>15</sup> In addition, the Department of Finance had oversight responsibility for the CPA, and the Minister of Finance had the power to designate other systems if it was considered in the public interest to do so.

### New framework

The government has begun to develop and implement a new regulatory framework that will expand the scope of the current oversight regime in order to cover the entire spectrum of payment systems. This proposal, outlined in the Department of Finance's public consultation document on the

◀ *A new regulatory framework will expand the scope of the current oversight regime in order to cover the entire spectrum of payment systems*

<sup>11</sup> The Minister's directive power is currently limited to situations when making, amending or repealing bylaws, rules or standards. The Minister's directive power is distinct from the power of the Governor of the Bank of Canada to issue directives to systems that have been designated under the Payment Clearing and Settlement Act.

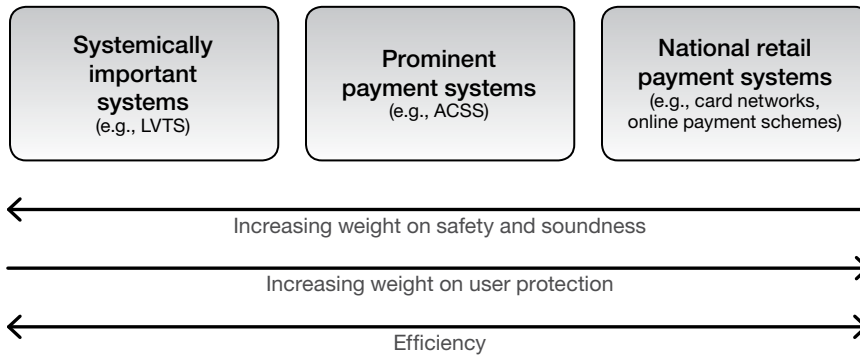
<sup>12</sup> The PCSA is available at <http://laws.justice.gc.ca/PDF/P-4.4.pdf>.

<sup>13</sup> As described by the Task Force (2011c), certain systems are subject to Bank oversight as systemically important, while the existing oversight of other systems includes broad laws such as competition and privacy laws, as well as payments-specific legislation (Canadian Payments Act and Payment Card Network Act); codes of conduct (e.g., the Code of Conduct for the Credit and Debit Card Industry in Canada); and private sector rules, policies and standards.

<sup>14</sup> Systemic risk is defined in the PCSA as the risk that a disruption or failure could transmit financial problems throughout the system, causing other institutions to be unable to meet their obligations ("knock-on defaults") or adverse economic effects on the stability or integrity of the Canadian financial system.

<sup>15</sup> The other systemically important systems are the CLS Bank, CDSX, Canadian Derivatives Clearing Service and LCH.Clearnet Limited's SwapClear Service. For more information on the Bank's oversight role, see <http://www.bankofcanada.ca/core-functions/financial-system/oversight-designated-clearing-settlement-systems>.

**Figure 1: Conceptual framework for oversight of the Canadian Payments System**



oversight of national payment systems (Department of Finance Canada, 2015), complements the category of systemically important systems with two new categories of payment systems:

- (i) **Prominent payment systems:** systems where a disruption or failure has the potential to adversely affect Canadian economic activity and general confidence in the payments system.
- (ii) **National retail payment systems:** systems of national scope that process lower-value transactions. Because users have alternatives, a shock or disruption in a single system would have a limited impact on individuals and businesses and would be unlikely to affect the Canadian financial system and economy.

Under the new framework, payment systems will be classified as systemically important, prominent or national retail payment systems and would be subject to oversight and regulation proportional to the risks they pose. This classification recognizes that the issues that are most relevant for each type of system differ. For example, as shown in **Figure 1**, safety and soundness are crucial for systemically important systems, while they are relatively less so for national retail payment systems, for which user-protection issues are of greater importance.

◀ *Payment systems will be classified as systemically important, prominent or national retail payment systems and would be subject to oversight and regulation proportional to the risks they pose*

## Prominent payment systems and an enhanced role for the Bank of Canada

To begin implementing this framework, the government has amended the PCSA to give the Bank responsibility to designate and oversee systems that have the potential to pose “payments system risk.”<sup>16</sup> Such systems will be categorized as “prominent payment systems.” The Bank has been given this responsibility because it has a comparative advantage in the oversight of risk management of financial market infrastructures, including payment systems.

To fulfill this new responsibility, the Bank will establish criteria that will be used to identify prominent payment systems. It will also establish risk-management standards that it considers appropriate for prominent payment systems and will publish these standards as part of its Guideline Related to Bank of Canada Oversight Activities under the Payment Clearing and

<sup>16</sup> Payments system risk is the risk that a disruption or failure in a system could cause a significant adverse effect on economic activity in Canada by (i) impairing the ability to make payments or (ii) producing a general loss of confidence in the overall Canadian payments system.

Settlement Act.<sup>17</sup> The standards will be based on those applied to systemically important systems—the Principles for Financial Market Infrastructures—but modified to reflect the different nature and magnitude of risks relevant to prominent payment systems (Schembri 2014). The Bank will consult publicly on both the criteria and standards.

Once the criteria and standards are established, the Bank will review existing payment systems and determine which should be designated as prominent payment systems.

### Framework for national retail payment systems

National retail payment systems will be subject to oversight that is proportional to the risks that are present in that type of system. As shown in **Figure 1**, user protection will be of relatively greater importance for these systems, and safety and soundness less so. The type of oversight that will be appropriate for these systems is therefore different than that for systemically important or prominent payment systems. The Department of Finance is currently working with stakeholders and consulting publicly to understand the nature of risks associated with these systems as well as the appropriate scope of and approaches for oversight.

Given that the focus of oversight for retail payment systems is expected to be weighted more heavily on user protection, other authorities may be better suited than the Bank to oversee them. However, because it is important that oversight of each category be complementary, the Bank expects to communicate and coordinate, when needed, with the authority or authorities that will be responsible for these systems.<sup>18</sup>

### Next Generation Payment System(s)

In addition to a need for change in the governance and regulatory frameworks, the infrastructure and functionality of payment systems need improvement. The ACSS and LVTS were first introduced in 1984 and 1999, respectively. While these systems have been upgraded periodically to allow them to continue to function soundly and accommodate new payment instruments, they have not taken full advantage of the possibilities made available by changes in technology or fully adapted to end-user expectations. Adapting to such changes would allow for greater safety and efficiency as well as an improved ability to meet end-user needs. For example, enhancements could facilitate safe, faster and more efficient domestic and cross-border payments.<sup>19</sup> Improvements to the core infrastructure could also offer efficiencies for direct users of the system by consolidating common activities and potentially reducing duplication of back-office processes at each participant.

---

<sup>17</sup> Under the PCSA, the Bank can issue guidelines and has traditionally used its Guideline to describe sound risk-management practices. The Guideline is available at <http://www.bankofcanada.ca/core-functions/financial-system/oversight-designated-clearing-settlement-systems/oversight-and-legislation/guideline-related-oversight-activities>.

<sup>18</sup> The Bank collaborates and coordinates, both domestically and internationally, with other overseers and regulators of important financial market infrastructures. For example, the Bank has arrangements with the Department of Finance and with provincial regulators (the Autorité des marchés financiers, the British Columbia Securities Commission and the Ontario Securities Commission) to facilitate co-operation and collaboration related to the oversight of systems with shared responsibility. Such co-operation allows for efficient and effective oversight.

<sup>19</sup> Schembri (2014) discusses these desirable characteristics in greater detail.

The CPA has identified the modernization of its systems as an important part of its strategic direction and has begun a multi-year project to renew the core infrastructure(s), which may include the redesign of ACSS, LVTS or both.<sup>20</sup> The objective of the Next Generation Clearing and Settlement System Program is to meet the needs of Canadians and achieve the public policy objectives for years to come. While this is a CPA initiative, it will require input, collaboration and support from industry and regulatory authorities to achieve this objective. Those involved will need to take a long-term view and ensure that the core system will be sufficiently flexible to accommodate further changes in the payments industry, including innovations such as new payment instruments.

Industry participants, including direct and indirect system participants, other payment service providers, and end-users (e.g., merchant and consumer groups), are expected to provide their views regarding the new core payments infrastructure.

The Department of Finance has reaffirmed in the CP Act the public policy objectives that the CPA's payment systems should meet and has updated the governance framework, which is expected to support the CPA in successfully completing the Next Generation project. The Department is expected to closely follow developments to ensure that the public policy objectives are achieved.

The Bank is contributing to the Next Generation project in several ways.

**Setting risk-management expectations.** Under the PCSA, the Bank can issue guidelines related to its oversight role. The Bank uses this power to issue guidelines that describe what it considers to be sound risk-management practices. As discussed above, the Bank is developing standards, to be included in its guideline, for prominent payment systems.

Because of the importance of the ACSS and LVTS, it is reasonable to expect that any new CPA system resulting from the Next Generation project would be a systemically important or prominent payment system and will therefore need to meet the Bank's risk-management standards. As a result, it is useful for the CPA to be aware of the Bank's risk-management expectations when considering options for the design of the new system(s).

**Contributing technical expertise.** The CPA is currently undertaking research and analysis to inform the design of the Next Generation system(s), and the Bank is contributing technical expertise to this effort. This research and consultation with stakeholders will help the CPA to develop a conceptual design that articulates the desired attributes and characteristics of the core infrastructure.

Once the CPA has determined the appropriate design of the new system(s), the building and implementation phase will begin. At that time, the Bank's operational departments will increase their involvement, since the Bank will be a participant, and, as the central bank, will continue to play unique roles in the system(s).<sup>21</sup>

◀ *The Canadian Payments Association has identified the modernization of its systems as an important part of its strategic direction and has begun a multi-year project to renew the core infrastructure(s)*

<sup>20</sup> See the *Canadian Payments Association Annual Report 2013* at <http://www.cdnpayannualreview.ca>.

<sup>21</sup> Currently, the Bank plays several unique roles in the LVTS and ACSS infrastructures. For example, the Bank is settlement agent for both systems and extends collateralized credit in the LVTS.



**Encouraging involvement from stakeholders.** The Bank will actively encourage and support collaboration from all stakeholders, since it is critical for the success of the Next Generation project. The more input the CPA receives from stakeholders, the better the system will be at meeting and balancing diverse stakeholders' needs.

## Conclusion

The payments system landscape has been undergoing change for some time. Through the Payments System Governance Review, the governance of the CPA is being modernized and the oversight framework is being enhanced. The CPA has also begun a project to redevelop core infrastructure where it is needed. These changes are expected to reposition the Canadian payments system to ensure that it continues to meet the public policy objectives of safety and soundness, efficiency, and meeting end-user needs as the payments industry continues to evolve.

---

## Literature Cited

- Department of Finance Canada. 2015. "Balancing Oversight and Innovation in the Ways We Pay: Consultation Paper." 13 April. Available at <http://www.fin.gc.ca/activty/consult/onps-ssnp-eng.asp>.
- . 2012. "Archived – Minister of Finance Welcomes Findings of the Task Force for the Payments System Review." 23 March. Available at <http://www.fin.gc.ca/n12/12-030-eng.asp>.
- Department of Justice Canada. 2015. "Canadian Payments Act." 22 April. Available at <http://laws.justice.gc.ca/PDF/C-21.pdf>.
- Schembri, L. 2014. "A Dual Vision for the Canadian Payments System." Speech to the Canadian Payments Association, Charlottetown, Prince Edward Island, 27 June.
- Task Force for the Payments System Review. 2011a. "Moving Canada into the Digital Age." (December).
- . 2011b. "Policy Paper A: Users and their Discontent." (December).
- . 2011c. "Policy Paper B: Governance: Stakeholders and their Disconnect." (December).
- . 2011d. "Policy Paper D: Infrastructure: A Reinvented Canadian Payments Association." (December).