

# Policy Issues in Retail Payments

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**T**he retail payments system is critical to commercial activity in Canada. Broadly defined, it has many components, including payment instruments, information technologies, and funds-transfer processes that involve a range of institutions. Each institution specializes in particular services required to initiate or settle a retail payment obligation. Retail payments are obligations arising from retail commercial and financial transactions between individuals and businesses and from transfers between them and governments.

Everyone is familiar with the various retail payment instruments, such as cash, cheques, and credit cards. The infrastructure arrangements for processing these instruments and for transferring the associated funds are less well known, but their efficient and reliable operation drives the retail payments system.

This note highlights some of the policy issues and initiatives that are emerging in retail payments systems, especially those affecting the infrastructure arrangements.<sup>1</sup> Some of these issues are being addressed by private and public sector organizations, while others are just beginning to emerge. To provide some context for discussing these issues, a brief overview of the organization of the retail payments system in Canada and of key developments that have given rise to these issues is necessary.

## Retail Payment Infrastructure

The principal system for clearing and settling retail payments in Canada is the Automated Clearing Settlement System (ACSS) operated by the Canadian Payments Association (CPA). CPA members are the financial institutions that provide payment accounts, instruments, and services to individuals and businesses. The CPA

### Infrastructure Systems

The infrastructure systems for payments provide transaction, clearing, and settlement services to their participating members.

Transaction systems use information and communication technology to deliver payment instructions between the parties to a transaction and their financial institutions. Their services include

- verifying the identity of the parties and their ability to pay;
- validating the payment instructions; and
- communicating information between the parties and their financial institutions.

Clearing systems exchange payment information between the financial institutions that settle their customers' payment obligations. They also calculate each institution's (clearing member's) settlement claim or obligation. Clearing services include

- sorting and matching transactions between member institutions;
- calculating members' settlement positions; and,
- transmitting the data to the individual member institutions and to the settlement bank.

Settlement systems transfer funds between deposit accounts that the clearing members hold at the central bank or at another depository. Settlement services include

- verifying interbank funds-transfer positions and the funds available in the paying institution's settlement account;
- settling obligations by posting the funds transfers to the institutions' settlement accounts; and
- confirming the completed settlement with the account holders.

1. For a more detailed description, see O'Connor (2003).

clears a variety of retail payment instruments through the ACSS daily. It nets the value of all these payment instruments, multilaterally across all direct participants, into a single settlement payable or receivable for each participant. These settlement positions are discharged through transfers across the settlement accounts held at the Bank of Canada by the direct participants in the ACSS.

There are also other clearing and settlement systems for retail payments in Canada. The major credit card organizations and some Internet payment schemes operate their own clearing systems and settle their payment obligations through accounts held at commercial banks. Most are associated with a shared or common-use transaction system. Some are operated by non-bank Internet payment providers.

The most established transaction systems are ATM, debit-card, Internet, and tele-banking systems owned and operated by the major Canadian financial institutions. The proprietary ATM and debit-card systems are typically linked nationwide through Interac into the largest of the common network arrangements. Payments made through Interac are cleared and settled through the ACSS.

## Developments in Retail Payments

Two principal factors underlie the changes in retail payments in recent years:

- Innovations in information technology that involve new payment applications, and
- Changes in financial sector policy aimed at improving competition and efficiency in financial services, including payment services.

The most noteworthy effects of these developments on retail payments have been:

- A shift towards electronic payments and away from cheques. This has been most pronounced with respect to card payments and reflects the relatively low costs and risks associated with these instruments, as well as the immediacy of payment.
- A trend towards outsourcing of payment processing and transaction services. This allows financial institutions to tap into common, shared networks and systems to reduce

costs for payment service and improve the quality of service.

- The separation of clearing and settlement systems for wholesale (large-value) and retail payments. This has permitted the CPA to initiate changes that will make the ACSS more cost-efficient for its participants.
- A relaxation of regulatory constraints on access to infrastructure systems and the provision of service in retail payment markets.

These developments present challenges to existing public and private sector policies regarding the operations and services of infrastructure systems for retail payments.<sup>2</sup>

## Issues and Initiatives

The key issues that have begun to emerge in retail payments systems as a result of these changes can be grouped into

- infrastructure arrangements and services,
- payment technologies and applications, and
- market access and competition.<sup>3</sup>

### Infrastructure arrangements

#### *Direct participation in the ACSS*

Two issues have emerged with respect to the structure of the ACSS. The first deals with the conditions for direct participation in the system. The Canadian Payments Act of 2001 extended access to include life insurance companies, securities dealers, and money market mutual funds. Direct participation is, however, subject to conditions regarding the minimum volume of payments cleared through the system, the type of institutional class to which a member belongs, and access to ACSS settlement facilities at the Bank of Canada. CPA members are concerned that these conditions may no longer be the most appropriate for direct participation in the ACSS, although some members are concerned that eliminating all conditions could impose significant costs and risks on the system.

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2. For a more comprehensive description of retail payments systems, see Committee on Payment and Settlement Systems (1999 and 2000).
  3. Some issues are shared by other countries. See Committee on Payment and Settlement Systems (2003).

As part of its ACSS settlement facility, the Bank of Canada provides overnight credit to direct participants. The Bank is concerned that it may be difficult to cover its credit exposures with a valid, first-priority, security interest for some of the classes of institutions newly eligible to participate in the ACSS. Some institutions are governed by pledging restrictions and bankruptcy regimes that could expose the Bank's security interest to stays on execution. Consequently, the Bank has been examining workable options for providing access to settlement facilities to all classes of institutions in the CPA. The fact that the net obligations of the ACSS are now settled through the Large Value Transfer System (LVTS) could help resolve this issue. With this method of settlement, the Bank will no longer need to extend overnight credit to settle positions in the ACSS. A legally valid security interest in collateral pledged to the Bank for these LVTS payments will be protected from stays on execution under the Payment Clearing and Settlement Act.<sup>4</sup>

The second issue is related to tiered participation in the ACSS. Only a few direct participants in the ACSS act as clearing agents for the indirect participants in the system. In doing so, they effectively operate their own clearing and settlement systems (called quasi-systems) within the ACSS. There is some concentration of settlement risk within these quasi-systems, but their risk-management controls are not transparent. The untimely failure of one of the principal clearing agents, or of a major indirect clearer, could disrupt settlement in the ACSS and cause repercussions for participants and their clients.

The CPA, the Bank of Canada, and the Department of Finance have established a joint study group to examine these issues and report their findings by next year.

#### *Retail payments and the LVTS*

Although the LVTS handles the majority of large-value payments cleared through the CPA, some large-value retail payments are still cleared and settled through the ACSS. Even though these payments are extremely unlikely to create systemic risk in the ACSS, the individual payments themselves are still open to settlement risks that are not present in the LVTS. Recently, the CPA established a maximum limit of \$25 million for individual cheques eligible

for clearing and settlement through the ACSS. This initiative is expected to reduce financial risk for ACSS participants and their clients.

There has been a proposal to impose the same limit on electronic payments that clear and settle through the ACSS. At issue is whether the risk reduction would be cost-effective for the participants in the ACSS and their clients.

#### *Cross-border retail payments systems*

With projections that the volume and value of cross-border retail payments will continue to grow, the development of centralized clearing systems that specialize in cross-border retail payments is again under review in some countries. Earlier proposals and programs for multilateral cross-border systems failed because of a weak business case related to relatively low values and volumes and the investments already made in well-established, decentralized bilateral correspondent banking arrangements. Some small multilateral systems do still exist, however. There has also been a recent initiative to develop a new multilateral system for clearing cross-border retail payments in the euro system. A proposal to link it with non-euro systems for clearing cross-currency payments, might encourage Canadian financial institutions to re-examine their business case for participation.

#### **New payment technologies**

The development of low-cost Internet communications has increased the commercial incentives for remote transactions and for making payments over multiple-user, open-network systems, such as the World Wide Web. Two key issues here are the security of payment information in these systems and authentication of the identity of the transacting parties. Private and public entities, such as the major credit card companies, the Canadian Payments Association, and Industry Canada, are spearheading the development of secure electronic information and storage technologies to resolve these issues. Legislation to protect privacy and to validate electronic documents and signatures has also recently been enacted.

As these technological and legal initiatives continue to build, related commercial issues still need to be resolved. Among these are the questions of interoperability of equipment, software, and operating standards for the

4. See Tuer (2003) for details on the settlement process.

infrastructure arrangements of rival Internet payment schemes. Also at issue is their compatibility with complementary services such as payment, clearing, and settlement.

There are also issues regarding the legal foundation for new forms of electronic payment applications. Principal among these is cheque truncation. Paper cheques would become digitized at the receiving institution so that the physical cheque would no longer need to be transferred back to the paying institution. Hence, the cost of clearing and settlement would decline. The technologies are now well developed and available; the CPA is working on drafting procedures and standards for digitized cheques; and the Department of Finance has begun a review of legislative requirements.

### Market access and competition

Many recent legislative changes and regulatory efforts have been aimed at enhancing competition and efficiency in retail payments. The pressure for increasingly open access to infrastructure organizations raises questions about differential regulation among similar infrastructure systems and remote access to them.

While the operators and systems of some infrastructure arrangements, such as the CPA and Interac, are regulated in various ways, many emerging Internet payment schemes and credit card systems are not regulated in Canada. Consequently, there is a question concerning the ability of regulated and unregulated entities to compete evenly in the same service markets. There is also the issue of what objectives and criteria are appropriate for regulation of retail payments systems.

Because of legal and regulatory concerns about conflicts of law and regulatory authority across sovereign jurisdictions, remote participation—access to domestic infrastructure systems for institutions located outside Canada—is prohibited. However, financial institutions in Canada already acquire some transaction and clearing services for card payments from organizations located elsewhere. Also, the emergence of Internet banking provides a platform by which institutions located elsewhere could provide retail payment accounts, instruments, and services to Canadian residents. With the resolution of the legal and regulatory concerns, remote participation in the

infrastructure systems for retail payments could become more likely.

### Conclusions

To lower costs and avoid costly disruptions in retail commercial and financial transactions, retail payments systems are required to operate efficiently and reliably. Innovations and policy changes aimed at achieving this goal are underway, but they raise a number of policy issues for both the public and private sectors. Initiatives to resolve some of the significant issues described above are already underway, and some consideration of others by both private and public sector organizations is beginning. All organizations involved in retail payments share the same objective: to find the right balance between the need for efficiency, necessary risk controls, and consumer interests that best serves the evolving retail payments system.

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