



August 24, 2016

From:
Sonya Gulati
Director, Policy
Payments Canada
Constitution Square
Tower II, 350 Albert, Suite 800
Ottawa, ON K1R 1A4

To:
Alexander Jokic
Senior Competition Law Officer
Competition and Promotion Branch
Competition Bureau
50 rue Victoria
Gatineau, QC
K1A 0C9

RE: Payments Canada's submission to Competition Bureau's market study in the financial services

We welcome the opportunity to provide input to the Competition Bureau's study on *Technology-led Innovation and Emerging Services in the Canadian Financial Services Sector*.¹ Our legislated mandate, as detailed in the *Canadian Payments Act*, states that it is our objective to:

1. Establish and operate national systems for the clearing and settlement of payments and other arrangements for the making or exchange of payments;
2. Facilitate the interaction of its clearing and settlement systems and related arrangements with other systems or arrangements involved in the exchange, clearing or settlement of payments; and,
3. Facilitate the development of new payment methods and technologies.

Being so vested in the well-functioning of the payments ecosystem, we are well-suited to work with the Competition Bureau as it undertakes this market study. Our submission, upon which we would be happy to elaborate in an interview at a later date, provides a summary of the work we are doing on access and market-competitiveness, as well as the context within which we are doing it. More specifically:

- The necessary first steps have been taken to enable Payments Canada to modernize its systems in the broader public interest;

¹ For specific reference to market study, see <http://www.competitionbureau.gc.ca/eic/site/cb-bc.nsf/eng/04087.html>



- The ecosystem is evolving, with innovation bringing the potential to realize new benefits and new risks for customers and businesses;
- Canada is in the process of reviewing its oversight frameworks and modernizing its payment systems, future-proofing them insofar as it is possible; and,
- As we modernize, it is important to us that we facilitate innovation and competition in this burgeoning space as we promote the safety and soundness of our systems.

Changes in Payments Canada oversight and governance

The necessary first steps have been taken to enable Payments Canada to modernize its systems in the broader public interest.

In December 2014, changes were made to the *Canadian Payments Act* (CP Act) and the *Payment Clearing and Settlement Act* (PCSA). These amendments were, in part, intended to support Payments Canada as it works to modernize core Canadian payments infrastructure.² As a result of these amendments, Payments Canada now has a majority independent board and is subject to strengthened oversight from Finance Canada and the Bank of Canada.³

The amendments to oversight include an expansion of the Bank of Canada's authority through a change to the PCSA that broadens the application of its power. Our LVTS (Large Value Transfer System) was designated under the PCSA as posing "systemic risk" in the 1990s, and our ACSS (Automated Clearing and Settlement System) was recently designated as a Prominent Payment System (PPS), subjecting us to criteria that our systems have to meet.⁴

In addition to making our Board independent,⁵ the legislative changes to governance modified the approval of Payments Canada's operating and capital budget. Before our entire membership was able to vote in order to approve our budget, where each member's volume of clearing items weighted their vote, but now we have only a duty to consult with our membership before establishing the budget.

These changes, among others, should help Payments Canada modernize the core payments infrastructure to meet the needs of a broader user-base. Though the recent changes have not expanded our membership, Payments Canada is currently working to align interests across a broad

² For more details on modernization, see <https://payments.ca/about-us/modernization/>

³ For more see *Balancing Oversight and Innovation in the Ways We Pay: A Consultation Paper* (2015) at <http://www.fin.gc.ca/activity/consult/onps-ssnp-eng.asp>

⁴ More about our payments systems can be found at <https://payments.ca/about-us/our-systems/> and more about the recent ACSS designation implications can be found at <http://www.bankofcanada.ca/wp-content/uploads/2016/02/criteria-risk-management-standards.pdf>

⁵ The Board now consists of: Payments Canada's president and CEO, seven independent directors elected by members, three directors representing direct clearers and two directors representing indirect clearers.



range of stakeholders through the development of a “shared vision” for the future of Canadian payments to meet the needs of not only members, but all Canadians.⁶

Payments and financial services are changing

The ecosystem is evolving, with innovation bringing the potential to realize new benefits and new risks for customers and businesses.

The ecosystem is changing, and so have the needs and habits of its participants.⁷ We at Payments consult with members and stakeholders regularly throughout the year to stay “plugged-in” to the ecosystem, working to stay abreast of issues as we fulfil our legislated mandate.⁸ Recently Payments Canada undertook a more substantial work effort to consult with a broad range of stakeholders and users to better understand the change underway today and what it means for the ecosystem. The end product was a document that identified the “shared” vision of the needs of a modernized payments ecosystem.⁹

One of the key drivers of the change underway is technology-led innovation. Some of the world’s largest digital companies are introducing innovative payment services and products, as are hundreds of smaller companies. They are introducing digital wallets, in-app payments and app-based virtual banks, among other things. Some new entrants are using payment services to capture market share and consumer data, while others are using payments to strengthen the value proposition of their core products and services. Not all new entrants are taking on incumbents alone, as some innovators have opted to partner with incumbents instead.¹⁰

Other innovators are even changing the game. There are technologies emerging that are so novel they even offer alternatives to traditional payment infrastructure. One example is distributed ledger technology: it has the potential in particular applications to improve trust, which is key to managing

⁶ See *Vision for the Canadian Payments Ecosystem* at <https://payments.ca/wp-content/uploads/2016/06/vision-canadian-payments-ecosystem-1.pdf>

⁷ Payments Canada regularly surveys the landscape to identify emerging payment methods and trends. For more, see the Canadian Payments Methods and Trends series, the latest iteration of which is Tompkins (2015).

⁸ To stay plugged in to non-member perspectives and concerns, Payments Canada regularly engages the Stakeholder Advisory Council (SAC), which includes such fintechs as D+H Canada and nanoPay. For more details, see <https://payments.ca/about-us/how-we-collaborate/stakeholder-advisory-council/>. Payments Canada also engages fintechs in other ways that promote innovation (e.g., see <http://paymentspanorama.ca/fintech-cup-application/>)

⁹ For more detail with respect to our survey of the needs of the ecosystem, as reported by a broad range of stakeholders and users, see our report entitled *Vision for the Canadian Payments Ecosystem* (<https://payments.ca/wp-content/uploads/2016/06/vision-canadian-payments-ecosystem-1.pdf>)

¹⁰ Payments companies believe some parts of their businesses are at risk of being lost to fintechs, but they are disproportionately involved in engaging with fintechs, either by acquiring them or entering into joint partnerships. For more, see <http://www.pwc.com/qx/en/financial-services/fintech/assets/payments-in-the-wild-tech-world.pdf>.



counterparty risk in financial transactions. Financial institutions are currently experimenting with distributed ledger technology.¹¹

As technology changes, however, so does the challenge it brings. Old ways of paying, for example, have been adapted to work beyond the point-of-transaction. In e-commerce, transactions with credit and debit cards are conducted remotely, and within seconds, forcing financial institutions to make authorization and fraud-management decisions in near real-time. Furthermore, new customer authentication methods that use sensitive information, such as active and passive biometrics, are being deployed, which means the protection of payment-related information is critical.

Technology-led innovation is also changing customer expectations, as they have become accustomed to quick and seamless payments. Customers increasingly expect immediate access to funds, for example, which incentivizes new entrants to take on the risk of delivering the funds immediately, even though it takes a few days for the funds to be cleared and settled. These new entrants that are not financial institutions, and that operate outside the regulatory obligations of deposit-taking institutions, may be introducing unintended risks into the payments ecosystem.

It will be important for regulators going forward to understand the new opportunities for innovators and the benefits they will generate for consumers and businesses, as well as the barriers that may get in the way of innovation. But it is also important that we understand the new risks that are emerging.

Regulatory frameworks, payment systems need updating

Canada is reviewing its oversight frameworks and modernizing its payment systems, future-proofing them insofar as it is possible.

Some oversight frameworks have become outdated, as they do not take into account the diversity of entities in the payments ecosystem. In the national retail payments space, for example, existing rules and regulations have focused on the nature of the provider rather than the function or service the entity provides (i.e., a financial institution is regulated differently than a non-financial institution that offers one or more similar services). In addition to making uneven the competitive playing-field, the regulatory imbalance introduces new risks into the current ecosystem.

Finance Canada is currently working with stakeholders (including Payments Canada) as it addresses these issues and explores how to develop a sound oversight framework for the national retail payments space.¹² Payments Canada has brought forward the suggestion that any oversight

¹¹ See coverage in the *Financial Times* for more detail (<https://next.ft.com/content/1117c780-3397-11e6-bda0-04585c31b153>)

¹² For more details, see <https://www.fin.gc.ca/activty/consult/onps-ssnp-eng.asp>



framework be institutionally independent, based instead upon the function or service the entity provides.

Also outdated is our payment infrastructure itself. While our systems (the ACSS and the LVTS) have served the needs of the economy and payments ecosystem for decades, the systems pose operational challenges while struggling to evolve at the speed now required by the industry and end-users.

Recognizing that aging payment infrastructure makes the introduction of new payment products and services challenging, jurisdictions the world over have embarked upon their own modernization initiatives. At the time of writing *Vision for the Canadian Payments Ecosystem*, we had identified 17 that had modernized their systems. We had also identified 15 other jurisdictions that had entered the planning- or build-phase of modernization. Currently, Canada is in the former group, which well-positions us to take away lessons from those jurisdictions that have already modernized.

Access and market-competitiveness

As we modernize, it is important to us that we facilitate innovation and promote competition in this burgeoning space as we promote the safety and soundness of our systems.

One of the needs of a modernized ecosystem, as revealed in our “shared vision,” is that our systems be open, fair and subject to risk-based access-criteria. Having embarked upon our multi-year modernization initiative, we have been working to understand how our rules on access relate to market competitiveness in the payments ecosystem.¹³

Generally speaking, one may access our systems as a direct or indirect participant. Direct participants are direct clearers, group clearers and clearing agents, whereas indirect participants are indirect clearers who must go through either a clearing agent or group to access our systems.¹⁴ Most indirect clearers benefit from connecting with our systems indirectly; they save back-office operating costs, for example, by outsourcing their clearing and settlement requirements to clearing agents. The benefits, however, may come at a price: indirect clearers may incur some agency risks as they

¹³ More than a decade ago, Payments Canada, the Bank of Canada and Finance Canada worked together to produce a study, published in 2006, that outlined several policy recommendations and guiding principles with respect to direct access to the ACSS. In our more recent work, as well, [e.g., see Chapman et al. (2015) at <https://payments.ca/wp-content/uploads/2016/05/2015-ppo-next-generation.pdf>] we have been exploring how access, among other things, assists us in meeting our public policy objectives, one element of which is concerned with market competitiveness and innovation.

¹⁴ The rules to participation as a direct, group and indirect clearer, as well as a clearing agent, are outlined in our by-laws. See Section D at <https://payments.ca/about-us/our-systems/retail-system/rules/#D>



engage our systems through intermediaries, the realization of which risks would have implications for market-competitiveness.¹⁵

For example, since clearing agents incur some financial risk as part of their clearing and settling arrangements with indirect clearers, they limit their exposure by imposing risk controls on their indirect clearers. Some of these risk controls may impose a higher cost on indirect clearers, potentially putting these indirect clearers at a competitive disadvantage in end-user markets when competing with direct clearers and/or clearing agents. Though clearing agents may impose such costs upon indirect clearers inadvertently, in cases where both are competing with each other in end-user markets there exists a stronger incentive to do so strategically.

With such risks in mind, Payments Canada is exploring how to minimize the market-competitiveness issues that may arise as we modernize our systems. For example, we are exploring ways to make access more open and fair by assessing whether our objectives would be better met by replacing the volume-requirement that must be met to become a direct participant in the ACSS with some other risk-based measure.¹⁶ We may also explore whether and how we can allow non-financial institutions access to exchange systems while being sponsored by an entity with a settlement account.¹⁷ In any event, more work will have to be done to determine which points of access should be opened, as well as how to manage the new risks that new access may bring.¹⁸

Further discussion is required to further our thinking on these important issues. In the near future, Payments Canada will engage with our members and stakeholders to better understand the issues touched upon in this submission.

We hope our submission and ongoing discussions will be helpful to the Competition Bureau as it undertakes this work effort. We would be happy to set up an interview at which we can elaborate on

¹⁵ Agency risks are those that would be realized if a clearing agent took some action for its own benefit that would impose costs upon indirect clearers through their clearing and settlement arrangement. To see more about these types of risks, see Conditions for Participation in the ACSS by The Tripartite Study Group (2006).

¹⁶ Our volume requirement states that there must be provided "evidence that the applicant has a payment items volume of no less than 0.5% of the total national volume of Payment Items during the last completed fiscal year preceding the application." For more see, <https://payments.ca/wp-content/uploads/2016/05/Rule-D1.pdf>

¹⁷ One exception to system access that is often cited is Public Works and Government Services Canada (PWGSC). PWGSC has the ability to directly access exchange services for the government's direct deposit program. This exception is governed by procedures unique to the processing of government items, as set out in Rule G12. For more on the Rule, see <https://payments.ca/wp-content/uploads/2016/08/Rule-G12.pdf>.

¹⁸ For more detail on how we understand the trade-offs between payment system attributes, see Chapman et al (2015) at <https://payments.ca/wp-content/uploads/2016/05/2015-ppo-next-generation.pdf>



our submission and discuss the study in greater detail. We look forward to ongoing engagement with the Competition Bureau on this important issue, as well as with our members and other stakeholders.

Sincerely,

A handwritten signature in blue ink that reads "Sonya Gulati".

Sonya Gulati
Director, Policy
Payments Canada