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The Canadian card services market and payments in general is on the verge of dramatic change, driven by the migration to chip technology and the launch of domestic debit services by Visa and Master Card. In light of this upcoming evolution (if not revolution) in our payments and settlement system, we decided to include in the Policy and Advocacy Report a new series of articles dedicated to the subject. The first article in the series, Payments 101 by Sabrina Kellenberger examines the principles and rules governing the payments system. Future articles will cover other important aspects of the upcoming transformation of the payment system.

New to this edition of the Policy and Advocacy Report is an issue of a new report, The Legislative Bulletin which identifies federal legislative developments of interest to Centrals and their credit unions. We hope you will enjoy this Bulletin and encourage you to contact us if you have any questions or comments.

Happy reading and I hope to see you all at Canadian Central's Annual Conference (May 2 – 6) in Halifax!

Brigitte Goulard, Vice President, Policy, CUCC

On The Policy Front

Payments 101

Sabrina Kellenberger, Senior Manager, Clearing and Settlements, CUCC

Though economists and politicians may lament Canadians recent lack of enthusiasm for one of their favourite sports, shopping, the infrastructure that supports payment for goods and services is alive and well, and poised for rapid evolution.

“Cash,” in the form of coin and bank notes, is of course the most elementary “payment instrument,” or way in which value may be exchanged. But the very features that have characterized the enduring versatility of cash—its immediacy, bearer form, and anonymity—have also made it impractical for large value transactions due to portability and security concerns. The result has been the development of a wide variety of paper and electronic non-cash forms of payment, such as cheques, bank drafts, debit and credit cards transactions, preauthorized debits (PADs), and on-line payments.

What is a “Payments System”?

Canadians have wholeheartedly embraced these non-cash forms of payment, especially the electronic ones, and today, according to the Bank of International Settlement, Canadians make more card-based payments per capita than any other country in the world. But behind the expediency of using a cheque, or the “magic” of swiping a plastic card to make a purchase, is a claim on a financial institution (FI) that must ultimately be satisfied through a transfer of funds. The instruments, rules and procedures used to effect transfer of these funds collectively constitute a “payments system.”

Two steps are involved in processing payments instruments in a payments system. The first, “clearing,” is the process of exchanging and reconciling the payment items that result in a transfer of funds from one financial institution (FI) to another. Clearing is accomplished in the case of a debit payment item such as a cheque by sending the transactions to the financial institution holding the account on which the funds are drawn, or, in the case of a credit item such as a direct deposit, to the financial institution holding the account in which they are to be deposited. The

second step, “settlement,” is the process of adjusting the financial positions of individual FIs at the Bank of Canada to reflect the net amounts due to and from them (including interest compensation) because of the exchange of payment items.

The Canadian Payments Association

In Canada, the Canadian Payments Association (CPA), a not-for-profit association created in 1980 by an Act of Parliament, is charged with establishing and operating national systems for the clearing and settlement of payments. To this end, the CPA owns and operates:

1. The **Automated Clearing Settlement System (ACSS)**, which is used for processing both paper-based payment items, such as cheques, and, electronic items, including Automated Funds Transfer (AFT) debits (e.g. pre-authorized debits) and credits (e.g. direct deposits); and
2. The **Large Value Transfer System (LVTS)**, an electronic wire transfer system.

The total volume of transactions flowing through the Canadian payments system has increased by 162 percent between 1990 and 2008, and in 2008, the ACSS and LVTS combined cleared and settled a total of more than \$51 trillion, averaging more than \$202 billion worth of transactions every business day of the year.

The ACSS accounts for 99 percent of volume cleared through the CPA’s systems, but only 12 percent of the value. It is a batch based system that has the capability to track the volume and value of payment items exchanged between CPA members and determine the balances due to and from participants based on the various “streams,” or categories, of payment items cleared through it.

The LVTS, on the other hand, a collateralized, real-time system based on SWIFT messaging formats. The payments made through it are immediately final and irrevocable. Though there are no minimum payment

volume or value restrictions for its use, the LVTS only accounts for 1 percent of the volume flowing through the CPA’s systems. The LVTS, however, accounts for about 88 percent of the total value flowing through the Canadian payments system. The peak value for LVTS transactions in a single day is currently \$268.6 billion, which was set on September 4, 2007.

Governing Framework

The Canadian Payments Act (CP Act) and the CPA’s By-law No. 3 jointly govern financial institutions’ participation in the CPA, defining amongst other things, the eligibility criteria for membership in the CPA, as well as the criteria for participation in the ACSS¹ as a Direct Clearer (DC), Group Clearer (GC), or Indirect Clearer (IC). Clearing and settlement of payment items under each form of CPA membership is facilitated through the assignment of a unique Financial Institution Number (FIN)—an important feature for “clearing status” within the CPA framework.

With respect to banks, this framework stipulates that all banks must be members of the CPA, which may make application to participate as a “Direct Clearer” and make entries into the ACSS—providing criteria such as having a payment volume of no less than 0.5% of the total industry-wide volume of ACSS items, can be met. If unable to meet this criterion, their status in the CPA is that of “Indirect Clearer” and these FIs are required to retain the services of a “Clearing Agent,” (i.e. an eligible DC or GC), to make entries into the ACSS and effect clearing and settlement on their behalf.

With respect to credit unions, the framework sets out the entities eligible for membership in the CPA (Centrals, Cooperative Credit Associations, and locals (i.e. credit unions) that are not members of a Central), and allows for the concepts of a “clearing group,” “group clearer” and a “group clearer guarantee.” As a result, the credit union system participates in the CPA

¹ The legal foundation for LVTS is provided in the CPA’s *LVTS By-law* and in the *Payments Clearing and Settlement Act*.

today through the “CUCC Clearing Group”²—for the most part, the “group” equivalent of a Direct Clearer—with each Group Central a member of the CPA in its own right with a unique FIN, and the members of the Group collectively meeting the 0.5% of total industry volumes criterion.

At an operational level, individual CUCC Clearing Group Centrals³ exchange paper items at various regional exchange points (REPs) under their own FINs, making the appropriate volume and value entries into the ACSS for these items. Electronic items, on the other hand, are exchanged under Canadian Central's FIN in the “National Exchange Region” with certain Group Centrals functioning as “Designated Settlement Centrals” and making ACSS entries on CUCC's behalf.

At the end of each day, the values of all payment items entered by the Group Centrals into the ACSS are “rolled up” under CUCC's FIN and a netted total is calculated for settlement with other financial institutions through the account and credit facilities CUCC maintains for this purpose at the Bank of Canada. In turn, Canadian Central's proprietary National Inter-group Settlement System, or NISS, application is used by CUCC to reconcile and allocate this netted amount amongst the Group Centrals, based on the value of their credit unions' and Indirect Clearers' items exchanged during that cycle.

The Coming Evolution

While traditionally thought of as the “back office” of banking, the clearing and settlement aspects of our payment systems have for some time now remained unchanged. But as with much else today, change is definitely in the air in the payments ecosystem. Shifting market participation as well as technological advances, such as faster communications infrastructures and cheaper computing capacity, has driven a significant proliferation in the types of card-

based payments instruments available to consumers. Continually seeking new sources of revenue and ways to gain market share, financial institutions have generally been quick to embrace these new instruments. But in an attempt to focus on core competencies and hold down costs, institutions have often outsourced issuance and transaction processing to third-party “Payment Service Providers,” or PSPs.

The current CPA framework does not contemplate this type of situation, giving rise to ambiguity regarding compliance responsibility and allocation of liability between CPA members. So, in an effort to ensure that its by-laws and rules framework keeps pace with market developments, the CPA has undertaken an all-encompassing review of its framework. The first set of policy and rule amendments in this regard will be going forward to the CPA Board for approval shortly.

Similarly, Interac Association, which is responsible for the development and operations of the Inter-Member Network (IMN), the network that allows Canadians to access their money through Automated Banking Machines and Point-of-Sale terminals across the country, is also looking to transform itself in this changing business environment. Interac is proposing to change from a not-for-profit association to a widely-held, for-profit corporation in order to more effectively compete with new market entrants and fund future development. While this change is not expected to directly affect clearing or settlement of Interac transactions through the CPA's system, it is conceivable that there will be a future impact on the types of payment instruments and their volumes flowing through the new Interac's networks. The CPA clearing and settlement framework will have to be amended to accommodate these changes, too.

Government is not a passive by-stander in this scenario either. Stakeholders are gearing up to develop submissions to the 2012 review of financial institutions legislation, and in light of the key role the financial services sector has played in the current economic downturn, greater regulation could well be

² The CUCC Clearing Group consists of Credit Union Central of Canada (the “Group Clearer”), Central 1 Credit Union (formerly as CUCBC and CUCO), CUCA, CUCS and CUCM.

³ This work is done for Saskatchewan credit unions by CUPS in Calgary. There is no REP in Regina.

the outcome. Concerns over fees, disclosure, fraud and recourse, are reaching a crescendo too, and governments are taking note. Consumer protection is, in fact, a growing priority for governments, and both existing and new payments instruments will undoubtedly be heavily scrutinized in this regard and care will have to be exercised that any actions taken do not end up stifling innovation in payments.

Despite the challenges and uncertainty these changes may bring, there is also opportunity. With clear goals and solid planning, the credit union system may well emerge from these times, stronger and more agile in the payments arena.

Ontario Provincial Budget – Harmonization of Sales Taxes will Cost Credit Unions

Gary Rogers, Vice President, Financial Policy, CUCC

The recent Ontario provincial budget announced that Ontario's Retail Sales Tax (RST) will be harmonized with the federal GST, effective July 1, 2010. As a result, Ontario will be joining New Brunswick, Nova Scotia and Newfoundland & Labrador in imposing a Harmonized Sales Tax (HST), collected and administered by Canada Revenue Agency (CRA).

Blending the two taxes at current rates (13%) will result in increased costs for entities that supply GST-exempt services, such as Ontario credit unions, Canadian Central, CUSOURCE and Central 1. This is because sales taxes on most services will increase from 5% to 13%, but are not recoverable as input tax credits.

When GST was introduced in 1991 with a new 7% tax on most goods and services, credit unions estimated that their increased operating costs were 1.5% or less. Adding 8% RST to the GST base will increase the cost for such services as rent, telephone and internet, repairs, audit fees, legal costs, etc. The impact is expected to be less than GST was, probably less than 1%. But the impact will be unique for each credit union

depending on spending patterns e.g. rent or own their offices, purchase or self-supply certain services.

The impact should be positive for most business members of credit unions as they will start to receive input tax credit refunds for all of the RST they currently pay. That is why business associations and chambers of commerce are solidly behind the concept.

There are two existing models for financial services when sales taxes are blended. In NS, NB, and NL the GST rules were followed when sales tax harmonization occurred. As a result, the sales tax costs for FIs increased first with GST and then again when the RST base was broadened when HST was introduced.

In Quebec, a modified harmonization exists which is a different model. There was concern that by increasing the sales tax burden on financial institutions (FI), certain financial activity would migrate to Ontario. Therefore, caisses populaires and banks advocated for zero-rating of financial services with a new compensatory tax to avoid a windfall to FIs. This means that FIs are entitled to full input tax credits for QST harmonized tax. To offset the advantage, banks pay an additional payroll tax and capital tax. And caisses pay an extra payroll tax only.

Consultations will occur regarding implementation issues during the next few months. FIs are expected to explore the possibility of adopting the Quebec QST model in Ontario. However, federal resistance is expected. The Quebec government administers the QST and is inclined to make this exception. On the other hand, CRA will administer the Ontario HST and the federal government has not made exceptions to GST rules for FIs in the other harmonized provinces.

New Identity Theft Legislation

Robert Martin, Director, Research, CUCC

On March 31, 2009 the Federal Government introduced into the Senate, Bill S-4, - *An Act to amend the Criminal Code (identity theft and related misconduct)*. Bill S-4 is substantially similar to Bill C-27, the proposed identity theft legislation the Conservative government introduced in late 2007 only to see it delayed in Parliament and then die when the election was called.

The proposed legislation (Bill S-4) will create several new Criminal Code offences specifically targeting aspects of identity theft that are not yet covered by the existing provisions of the Criminal Code. More specifically, the proposed legislation will establish three new offences targeting the early stages of identity-related crime. The proposed offences include:

- Obtaining and possessing identity information with the intent to use the information deceptively, dishonestly or fraudulently in the commission of a crime;
- Trafficking in identity information, an offence that targets those who transfer or sell information to another person with knowledge of or recklessness toward the possible criminal use of the information; and
- Unlawfully possessing or trafficking in government-issued identity documents that contain the information of another person.

Additional *Criminal Code* amendments would create new offences of fraudulently redirecting or causing redirection of a person's mail, possessing a counterfeit Canada Post mail key, and possessing instruments for extracting and copying debit and credit card information. It would also add new offences and certain existing offences to the list of offences for which a wiretap order may be obtained. This legislation would also give courts the power to order an offender to pay restitution to a victim of identity theft or fraud

where the victim has incurred expenses related to rehabilitating their identity.

Identity theft is considered a rapidly growing problem by law enforcement officials. The Canadian Council of Better Business Bureaus estimates that identity theft costs Canadian consumers, financial institutions, stores and other businesses more than \$2 billion annually. Canadian Central supported the legislative proposals found in the previous Bill C-27 and continues to support the Federal Government's initiatives to combat identity theft.

Canadian Central will monitor the progress of the Bill through Parliament.

Further information on the legislation can be obtained at: http://www.justice.gc.ca/eng/news-nouv/nr-cp/2009/doc_32348.html

Happening on the Hill

Brigitte Goulard, Vice President, Policy, CUCC

Canadian Central has been extremely busy since the last edition of the Policy and Advocacy Report.

The Senate Banking Committee is currently conducting a series of hearings on credit and debit card issues. On March 26th, Douglas Whalen, Director, Payments and Brigitte Goulard, Vice President, Policy appeared before the Senate Banking Committee and outlined for the members of the Committee the structure of the Canadian credit union system and the manner in which card services are provided to members.

Canadian Central who appeared along with Caisses Desjardins stressed to the members of the Committee the importance of a strong Interac organization.

Canadian Central also appeared on April 2nd before the House of Commons Standing Committee on Finance

as participants in the Committee's study on "Measures to Enhance Credit Availability and the Stability of the Canadian Financial System".

David Phillips, President and CEO of CUCC and Ralph Luimes, President and CEO of HALD-NOR Credit Union and Chairman of the Steering Committee responsible for the Canadian Business Owner Strategy appeared on behalf of Canadian Central and stated that credit unions are very much aware of the economic difficulties currently facing Canadians and are working closely with their members and their communities to temper the impact of the crisis.

Canadian Central could potentially be called to again appear before the Finance Committee as the Committee recently announced its intention to conduct a study of the credit and debit card transactions fees imposed on merchants and of the proposed changes to credit card interchange fees and the debit payment system.

The House of Commons Standing Committee on Industry, Science and Technology has still not announced its proposed plans for its study of the credit card interchange fees and the debit payment system in Canada or the proposed hearing dates for its study of how the current financial crisis is affecting small and medium-sized businesses.

Canadian Central's team in Ottawa continues to closely monitor Parliamentary activities.

Your Policy Team at Work

Financial Literacy Update

Jan Hopper, Senior Policy Advisor, Consumer Affairs, CUCC

Our thanks to readers of the *Policy and Advocacy Report* for responding to our request for information about credit union system financial literacy programs.

Responses, received from as far away as Madison, Wisconsin, were helpful in formulating a letter to the Minister of Finance, to request that a credit union system representative be included on the new Financial Literacy Task Force. As noted in the February 20th article, the 2009 federal budget document included the creation of a Financial Literacy Task Force with members to be appointed by the Minister of Finance, the Honourable Jim Flaherty.

Following input from the Centrals, Canadian Central has nominated the following individuals for consideration for inclusion on the task force as a result of input received from the system:

Colleen Edmunds, Credit Union Central of Manitoba;

Loretta Elford, SaskCentral; and

Bobbi MacEachern, Credit Union Central of Nova Scotia

Each of these individuals has been instrumental in the development, promotion and delivery of financial literacy programs in their local communities and would be a great asset to the Minister's task force if appointed. Although there is no guarantee that the nominees will be chosen, Canadian Central's letter to the Minister of Finance ensures that the government is aware of the extensive work that credit unions have accomplished in the area of financial literacy and the added value a credit union representative could bring to the Task Force.

It is not too late...Should Centrals or credit unions wish to put forth the names of other individuals who they believe would add value to the Financial Literacy Task Force Canadian Central would be pleased to forward to the Minister of Finance the names of additional nominees for consideration. Please send a note detailing your qualifications and relevant experience to Jan Hopper via e-mail at hopperj@cucentral.com. Task force members are to be selected in the spring so please advise as soon as possible of other potential nominees.



Your Statistical Report

National System Results – The Largest 100 Credit Unions/Caisses Populaires Outside Quebec

Sandra Brizland, Research Analyst, CUCC

At the end of 2008, the 516 credit unions and caisses populaires outside of Quebec reported combined assets of over \$124.1 billion, a six-month increase of 4.1 per cent over second quarter of 2008.

The largest 100 credit unions and caisses populaires continue to steer asset growth within the system, reporting a six-month growth rate of 4.8 per cent over mid-year results. At the end of 2008 the largest 100 credit unions reported assets of almost \$101 billion. Amalgamations throughout the credit union system continue to increase the proportion of system assets that the top 100 group controls. These credit unions now account for 81.4 percent of total system assets.

The appearance of the largest 10 credit unions remained unchanged as all ten credit unions retained their position from six months ago. This group reported growth higher than the entire top 100, with a 5.6 per cent increase since mid-year. As a result, the top 10 credit unions increased their control to 39.2 per cent of system assets, compared to 38.6 per cent six months ago. The largest 10 credit unions had combined assets of almost \$48.6 billion – an increase of almost \$2.6 billion from the \$46 billion recorded at second quarter.

Ranking 4Q08	Ranking 2008	Top 10 Credit Unions
1	1	Vancity
2	2	Coast Capital Savings
3	3	Servus Credit Union
4	4	Meridian Credit Union
5	5	Envision Credit Union
6	6	Community Credit Union
7	7	Conexus Credit Union
8	8	Steinbach Credit Union
9	9	Assiniboine Credit Union
10	10	First Calgary Savings

Further analysis shows the 5 largest credit unions with strong growth of 5.7 per cent over mid-year. This small group of credit unions account for 28.7 per cent of all system assets in the country (excluding Quebec), with combined assets of \$35.6 billion.

Credit unions ranked 11 to 100 recorded a six-month growth of 4 per cent in assets, while assets in the remaining part of the system experienced a marginal increase of 1.3 per cent.

With mergers occurring the first day of the first quarter of 2009, changes are expected in the mid-year 2009 Largest 100 listing. For instance, in Alberta, on November 1, 2008 (the first day of the new fiscal year), Servus Credit Union amalgamated with Common Wealth Credit Union and Community Credit Union. The new Servus Credit Union has assets of about \$9.5 billion. A jump in the top 10's share of the system asset base is anticipated in the next issue of the top 100.

Regional representation on the list is as follows: B.C., 26; Alberta, 12; Saskatchewan, 11; Manitoba, 17; Ontario, 30; New Brunswick, 2; Nova Scotia and Newfoundland at one each.

To see the complete top 100 listing:

http://www.cucentral.com/Top100_4thQ08_15april09

National Affiliated System Results – Q4

Sandra Brizland, Research Analyst, CUCC

National affiliated system final results for the 4th quarter of 2008 were recently released by Canadian Central. Despite the economic downturn that began in the last quarter of 2008, the Canadian credit union system ended the year on solid financial ground. System assets, savings/deposits and loans all recorded solid gains, maintaining the annual growth reported in the previous quarter, but down from the rates reported in 2007.

Some key findings in the Q4 system results are:

- System assets are currently \$113.89 billion, compared with \$110.64 billion at the end of Q3;
- Loan growth has slowed throughout 2008, however, the 7.3% gain reported in Q4 is consistent with the previous quarter's annualized growth rate of 7.6%; loan volume stands at \$94.41 billion;
- Deposits/savings annualized growth remains strong at 9.7%; total deposits are currently at \$100.7 billion;
- Combined earnings for the system reached an all-time high of \$543.27 million at the end of 2008, a 9.1 per cent increase over the \$497.73 million reported a year ago.
- At the end of Q4, the number of credit unions stood at 440 (down from 444 at the end of Q3), the number of locations was 1,734 (down from 1,740 in Q3), and the number of members was 5,052,972 (a decrease from 5,057,400 at the end of Q3 mainly due to a number of credit unions removing "closed accounts" from their banking system).

To see the full report:

http://www.cucentral.com/Top100_4thQ08_15april09

Your Fraud Report

Heather Mitchell, Policy Analyst, Fraud Loss Mitigation, CUCC

Ganaraska Financial Services Group, a credit union located in Ontario, has reported counterfeit copies of its bank draft being circulated across Canada and in the United States.

The counterfeit drafts are good quality and have sequential serial numbers starting in the 5200 range.

Members of the public received some of the counterfeit cheques, unsolicited, through the mail. Other cheques were received as part of a "secret shopper" e-mail scam. Both the direct mail and secret shopper scam

required that the cheque be cashed and a percentage be wired back to the sender.

The recipient of the cheque could keep a certain amount of the cheque as payment. When the cheque was returned through the clearing as counterfeit, the recipient would be liable for the whole amount of the cheque.

This incident is under investigation by police.

If you would like more information or if one of these questionable cheques is presented, please call the credit union at: 1-888-374-1717 or e-mail info@ganaraskacu.com or contact Heather Mitchell at Credit Union Central of Canada 416-232-3454 mitchellh@cucentral.com

The *Policy and Advocacy Report* is published by Credit Union Central of Canada. For editorial or general inquiries please contact:

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