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# Credit Card Institutions and Canada's Payment System

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*"Clearing and settlement systems are essential to the smooth functioning of an economy. They provide the mechanisms by which customers of one financial institution can effect the transfer of funds to customers of another financial institution."*

*— Canadian Payments Association (CPA)*

*"Visa Inc., commonly referred to as VISA (**V**isa **I**nternational **S**ervice **A**ssociation), is a multinational corporation based in San Francisco, California, USA. The company operates the world's largest retail electronic payment network, managing payments among financial institutions, merchants, consumers, businesses and government entities. Before Visa Inc's IPO in early 2008, it was operated as a cooperative of some 21,000 financial institutions that issued and marketed Visa products."*

*— Wikipedia, March 29, 2010*

The major factor that makes banks special and highly regulated is that they operate the nation's payment system. That system is an essential part of everyday business and personal transactions. And it is carefully regulated for both large-value transactions (the LVTS system) as well as for personal and business cheques and other payments (the ACSS system). In Canada, the Canadian Payments Association (CPA) is a not-for-profit organization, operating under an Act of Parliament and charged with the public policy function of providing the payment clearing and settlement system.

But in the past decade or longer, Canada's payment system has been changing with the relative importance of cheques declining and credit card payments greatly expanding. Cheques and other small payment items handled by the CPA have fallen by half from a peak of 1.8-billion items in 1990 to only 0.9-billion in 2009. Cheques have been replaced by electronic payments, but, more importantly, by payment by credit card. The case is overwhelming that credit card payments are now far more common for individual transactions with merchants and other businesses. Some businesses, such as restaurants, seldom see any other form of payment. It is clearly time to look at the structure of this new prominent payment system from both a systemic risk point of view and from a consumer protection question.

### *Merchant Issues and Code of Conduct for Credit and Debit Card Industry*

On March 29 of this year, the Finance Department and its Minister finally recognized the importance of this new payment system and introduced in Parliament a "Payment Card Networks Act." When the Act is passed and comes into effect, it will allow the federal government to regulate both credit and debit card networks and their participants.

On April 16, the Minister of Finance released a "Code of Conduct for the Credit and Debit Card Industry in Canada" which was especially directed to the issue of merchants' fees. There are three distinct public policy issues revolving around the credit and debit card networks and the issuers and customers. These are issues of consumer protection, issues of merchants' fees and contracts, and the issues of stability of this new payments system now largely run by two unregulated U.S. companies.

The recent government release on a "Code of Conduct" addresses the question of merchants' fees and their contracts with credit and debit card companies and "acquirers" (those who provide merchants with the devices to transmit payments to the networks). The Finance Department release noted the following:

> "Under the Code, merchants will be:
>
> • provided with clear information regarding fees and rates;
>
> • given advance notice of any new fees and fee increases;
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> • able to cancel contracts without penalty should fees rise or new fees be introduced; and
>
> • given new tools to promote competition, and in particular, will have the freedom to accept credit payments from a particular network without the obligation to accept debit payments, and vice versa."

The Code further states that those who choose to adopt it must "agree to provide any requested information…to the Financial Consumer Agency of Canada for the purpose of monitoring compliance with the Code."

The Code is a step forward, but it is voluntary, and we will have to wait and see if the major companies adopt the Code. It would be much better if the Code were eventually to be made mandatory, but that might have to wait until the legislation is passed by Parliament and brought into effect. There are no penalties spelled out for not complying with the Code. To make the Code fully effective, it would need to be both mandatory and have penalties spelled out.

### *Some History of Credit Cards in Canada*

The bank credit card business in Canada began in the late 1960s, with three Canadian banks introducing their credit cards under the logo Chargex. The authorization and clearing of those items were through an agreement between those banks issuing the Chargex cards. Chargex eventually became a partner with a number of international banks, including BankAmeriCard and BarclayCard, to form the cooperative known as Visa. Two years ago, the cooperative, composed of several thousand international banks, took the step to become a separate U.S. company Visa Inc.

With the advent of the bank credit card, what has changed dramatically in Canada's payment system is that the cheque clearings declined as credit card usage increased. Until 2008, both the cheque clearing and credit card clearing systems were owned and operated by the banks and thus were fully regulated.

In 2008, however, both Visa and Mastercard became independent U.S. companies rather than the cooperatives owned and operated by the banks that issued their cards.

Banks and financial institutions still operate the credit side of the credit card business. They issue the cards and look after the various perks, the credit lines, and the interest rates and service charges. What Visa and Mastercard do is operate the authorization and clearing system and set the rules for both national and international transactions.

But the operation of a separate clearing system poses systemic risks to the Canadian payments system. It should therefore come under federal government supervision, both because of the risks it poses for the Canadian economy and for the consumer protection and privacy issues that arise from the operation of any payments system. At present, however, the credit card system operates outside the CPA.

### *Consumer Issues with Credit and Debit Cards*

As matters have evolved, many Canadians use credit cards for day-to-day spending—especially to pay for housekeeping, bills and travel expenses. Credit cards offer a payment function and a credit function, that is, by offering the card holder either a temporary loan or a revolving loan. Credit cards have occasionally received a bad name, given that many Canadians have gotten themselves deep into personal debt by not managing their credit effectively.

Credit card usage and terms have always been controversial with the public and with some elected officials. Credit card interest rates are regarded as steep, though this has probably not halted the usage of the cards for borrowing. Credit card payments are usually made on a monthly basis, unless the customer chooses to run a line of credit with the issuing institution. As well, the minimum monthly payment on a credit card often just covers the amount of interest being charged. This could effectively mean that it could take decades to pay off a loan if only the minimum were paid each month.

On the consumer protection front, credit problems have been perhaps more exaggerated in the U.S. than in Canada. Nonetheless, at the U.S. federal level, some serious first steps have been taken.

> "New (U.S.) federal credit card rules that took effect Monday promise to outlaw the most egregious practices of the credit card industry that have plunged customers into insurmountable debt. The Credit Card Accountability Responsibility and Disclosure, or CARD, Act includes new protections for customers under 21 and makes it illegal for credit card companies to retroactively increase rates and charge certain types of misleading fees." (Amy Goodman, *Democracy Now* website, Feb. 23, 2010)

In Canada, the government's recent move to increase the downpayment on residential mortgages was done as a step to prevent consumers from acquiring too much mortgage debt. We suggest that the government might also consider increasing the required minimum payment on credit card debt. That, too, would encourage consumers to repay credit card debt more quickly and to refrain from getting adicted to great amounts of credit card debt with its very high interest rates.

### *The Stability of the Credit Card Payments System*

Since so much of the recent financial crisis has been unprecedented in origin and scale, it is very important to think "outside of the box" about other possible areas that might endanger the financial system.

Although it is not widely recognized, credit card use and the credit card payment system is one such area of concern, since credit card payments now dominate the world's payments system for individual transactions. This is an area of systemic risk and possible instability in the financial and payments system.

Any failure of the credit card system would leave in question a significant part of the payments system that has become relied upon by both business and individuals. Both of the two dominant players, Visa and Mastercard, pose some regulatory questions as they form an important aspect of both the international and individual countries' economies. That is, the regulatory concerns are that two unregulated U.S. companies are in charge of a major and important part of Canada's payments system.

We have a whole host of questions and worries about these two unregulated corporations. What would happen to our payments system if one of these companies failed, for reasons that may have nothing to do with their Canadian operations? Would a failure of one of these corporations require a bailout by some authority, just as the risk to the system of an AIG failure in the U.S. was seen as too significant to contemplate? Would Canada's credit card system be at risk if such a failure occurred?

There is no question that the rules set out by these independent and unregulated U.S. companies should be subject to Canadian regulation, both for systemic risk reasons and for consumer protection, and the Canadian Code of Conduct is a step forward. Their international rules should also come under Canadian regulation insofar as they affect Canadians. The failure of either or both of these U.S. companies would put the Canadian payments system into a panic. That would threaten Canada's economic growth, and the ensuing uncertainty could well push the economy back into recession.

The simplest solution would be to require all operating companies' Canadian operations to be owned and operated by one or more Canadian banks or other federally-regulated financial institution, and also be part of the Canadian Payments Association and subject to their rules. The rules of the CPA are subject to the approval of the Minister of Finance, giving those rules a specific political and regulatory input. That would also bring the systemic risk of the credit card system under the supervision of the federal Office of the Superintendent of Financial Institutions (OSFI)—and that would bring consumer issues under federal regulation as well.

A more complicated solution would be to require the Canadian operations of both companies and any of the so-called "acquirers" to become some kind of federal financial institution and part of the Canadian Payments Association, since the operation of a payments system is clearly a banking business and thus under federal jurisdiction. Under the new "Payment Card Networks Act," perhaps these operations will come under federal review, but we will have to wait to see how the Act moves through Parliament and what regulations are forthcoming.

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