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Integration of the Non-Bank Financial Institutions

The NBFIs in the Cheque-Based Payments System

In the 1970s, the principal non-bank deposit-taking financial institutions (NBFIs) in Canada were trust companies, mortgage loan companies, credit unions, and *caisses populaires*. Their ability to offer payments services—the equivalent of chequing accounts—to their clients depended on three elements: (i) the degree to which persons being offered an NBFI "cheque" in payment for goods and services found the offered item acceptable; (ii) the degree to which financial institutions taking an NBFI "cheque" over the counter on deposit from their client found that item acceptable (perhaps in immediate exchange for bank notes); and (iii) the degree to which an NBFI wishing to offer chequing accounts would be viewed by a bank offering clearing services as a suitable client at a reasonable fee. To grasp the ways in which the creation of the Canadian Payments Association significantly improved acceptability in all three of these aspects, one must examine the pre- and post-1980 situations in some detail.

Acceptability of NBFI Items to the General Public

For several decades prior to the CPA era, many non-bank deposit-taking institutions attempted to provide payments services to their clients. Nothing of a legal nature prevented an NBFI from opening deposit accounts and providing each depositor with a set of cheque-like printed documents for the purpose of making payments. Such items would be written instructions to the institution where funds were held on deposit to transfer value to the payee in the transaction. The documents were entirely legal negotiable instruments. But the payee might well refuse to accept an NBFI item for a number of reasons. Perhaps the financial institution identified would be unfamiliar; its name would not include the reassuring word "bank." The long-standing Bills of Exchange Act made no reference to such payment items (although including considerable detail concerning bank cheques and the procedures by which they were to be used) which might also create

uncertainty for a payee being offered an NBFI item. These legal niceties led to conventions (for example, in tendering for government contracts) that only a certified (bank) cheque or bank draft would be acceptable.

The legal aspects of the situation changed significantly in 1980 with the revision of banking legislation, together with the passage of the Canadian Payments Association Act and a number of consequential amendments to other laws. For example, the Bills of Exchange Act was revised so that payment items drawn on any member of the CPA would have the same legal status as cheques. The definition of payment item in the CPA Act was "a bill of exchange drawn on or payable through a member and includes any other class of items approved by means of a by-law;" the NBFIs were eligible to become members and, in most cases, did so. In the years following the creation of the CPA, these changes worked to extend the acceptability of NBFI items in various contexts, including financial-market transactions and payments to governments at all levels.

Acceptability of NBFI Items Presented on Deposit

When a payee receives a paper payment item such as a cheque, he or she will generally wish to deposit it (or cash it for bank notes) in a financial institution. The willingness and promptness with which that institution accepts the item can vary depending on the particular circumstances. For some items, the institution will be able to debit the payor's account or, more likely, deliver the items through the national clearing arrangements and gain the corresponding value in its settlement account, located either at a major banking institution or at the central bank. It therefore follows that the legal and other provisions that determine precisely which items may be delivered through the clearings are important for the acceptability of payment items being deposited at a teller's counter.

The CPA Act, the by-laws, and the associated technical rules—as a package—established the two ways in which payment items drawn on a particular NBFI (or bank) could be delivered to it in the clearings process. First, the NBFI could be a "direct clearer," with the right and obligation to participate in the daily clearings in at least one region of the country. In this way, the NBFI would receive the items drawn on it and would subsequently settle the obligation created (whenever the value of such items exceeded that of any deliveries it had made of other clearers' items) via a debit in a settlement account maintained by it at the Bank of Canada. Second, the NBFI could be an "indirect clearer," using a direct clearer—often a bank—as its agent for clearing purposes. Whenever that clearing agent received an item drawn on its NBFI client via the daily clearings, it would initiate a debit if necessary (as a component of an amount reflecting all the clearing flows

for that client that day) in a settlement account of the NBFI maintained with it for this purpose.

Although being either a direct clearer or an indirect clearer meant that the payment items drawn on an NBFI would be acceptable for clearing and, hence, normally acceptable at tellers' counters across the country, there were distinctions between these two configurations, particularly with respect to the degree of risk. Any *direct* clearer had to be a relatively significant institution; pursuant to the Clearing By-law, it had to account for at least one-half per cent of the national payments volume—the number of cheques and other items passing through the clearings. In the early 1980s, only 8 banks and 6 NBFI private institutions qualified. Moreover, each direct clearer had a line of credit from the Bank of Canada that could be drawn upon in the event that the institution's settlement account was in deficit as a result of the day's clearing calculations. If a solvent NBFI direct clearer experienced financial difficulty and began to lose deposits, the corresponding clearing losses could—at least in the short run—be offset by liquidity support from the central bank. In contrast, an *indirectly* clearing NBFI would operate in a manner little changed from the pre-CPA arrangements. Such an institution would obtain a line of credit from its clearing agent to be used when its settlement account at that institution was in deficit. (Further information about how the smaller NBFIs functioned in the clearing system is given in the next section.)

Acceptability of the NBFIs to the Clearing Agents

The negotiation of a clearing-agency arrangement between an NBFI and a major clearing bank in the pre-CPA world was shaped by various factors. The bank would wish to know if the possible client was a regulated and supervised institution. This might lead to additional questions about the differences between the federal and provincial regulatory structures. If the institution suffered a rapid decline in deposits, was there an arrangement by which it could receive liquidity support, perhaps from a provincial government? What volume and value of payment items would flow to and from the NBFI on a typical day? What fee per item might prove mutually satisfactory? Would the fee revenue compensate not only for the processing work being done, but also for any risks entailed?

The legal structure governing the clearing-agency arrangements before 1980 involved certain sections of Article 24 of the By-laws of the Canadian Bankers Association (CBA), particularly those dealing with the liability of a bank functioning as the clearing agent for an NBFI and with the procedures

to be used in a default situation.[1] The clearing agent was required to accept through the clearings all items drawn on its NBFI client—including items so received in the daily clearing cycle, which concluded on the business day following the day on which the bank gave notice to a failing NBFI that it was terminating the agency relationship. The clearing agent was, however, permitted to subsequently return this last flow of items, also through the clearings, to the other participants that had originally delivered them. This provision would presumably be followed diligently, because a complete return flow would lead to an increase in the settlement account of the clearing agent at the Bank of Canada broadly equal to the debit the agent had experienced on the preceding day while still performing services for the failing NBFI. (A minority interpretation of the relevant CBA by-law sections, and one that concluded that the risks borne by the clearing agents were much greater, existed among knowledgeable bankers as the Canadian Payments Association came into being.)[2]

At the first meeting of the CPA Board in February 1981, a committee was established to prepare a draft of the new clearing by-law. This committee reflected the broadened membership of the new Association, with two directors from banks, two from the centrals, and a representative of the trust companies. It was chaired by the alternate director for the Bank of Canada. There was lengthy deliberation as to the correct interpretation of the former default provisions and the precise rights and obligations of clearing agents. In the end, the majority view concerning the integration of the smaller NBFIs in the clearing system as set out in the above paragraph was accepted, and it was subsequently confirmed when the CPA Board approved section 13.07 (on the liability of clearing agents serving indirect clearers) in the Clearing By-law.

Integration of the NBFIs—in Human Terms

There is no better description of the process by which the representatives of banks and non-bank deposit-taking institutions gradually came to work together as directors of the CPA than that of one of the senior bankers, Robert MacIntosh, who was on the CPA Board from its first meeting in 1981 until he retired in 1989.

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1. See the By-laws of the Canadian Bankers Association, as amended in 1976, Article 24, sections 11 and 17(c). (The full text of Article 24 is reproduced in Charbonneau and Lévesque, op. cit. 257–65.)
2. J. Crean, "Automation in Canadian Banking. Part 2, The Canadian Payments System," *The Canadian Banker and ICB Review* 85 (October 1979): 28.

"The evolution of the personal relationships on the board of directors was an interesting exercise in human dynamics. The bankers were wary of the directors who had arrived by virtue of their political clout and who had limited expertise in the technology of the payments system. The newcomers were suspicious of the bankers' willingness to share authority.... The near-banks soon learned that their long-held belief that the banks overcharged them for clearing services was mistaken. (Only two of the four trust companies which met the test of processing 0.5 percent of the clearings volume.... elected to become direct clearers like the banks.) The bankers found that the representatives from the *caisses populaires* and some other institutions brought mature technical skills to the table."[3]

3. R.M. MacIntosh, *Different Drummers: Banking and Politics in Canada* (Toronto: Macmillan Canada, 1991), 290.