Registry

CT - 95 / 02

THE COMPETITION TRIBUNAL

IN THE MATTER OF an Application by the Director of Investigation and Research under Sections 79 and 105 of the *Competition Act*, R.S.C. 1985, c. C-34;

AND IN THE MATTER OF an abuse of dominant position in the supply of shared electronic network services for consumer-initiated shared electronic financial services.

BETWEEN:

The Director Investigation and Research

Applicant

- and -

Bank of Montreal
The Bank of Nova Scotia
Canada Trustco Mortgage Company
Canadian Imperial Bank of Commerce
La Confédération des caisses populaires et d'économie Desjardins du Québec
Credit Union Central of Canada
National Bank of Canada
Royal Bank of Canada
The Toronto-Dominion Bank of Canada
Interac Inc.

Respondents

- and -

TelPay, a division of CTI-Comtel Inc.
Retail Council of Canada
Canadian Life and Health Insurance Association Inc.
Midland Walwyn Capital Inc.,
Richardson Greenshields of Canada Limited
Mackenzie Financial Corporation
Trimark Investment Management Inc.

Intervenors

AFFIDAVIT OF NEIL C. QUIGLEY SWORN
March 1, 1996.

I, Neil C. Quigley, of the City of Wellington, New Zealand

MAKE OATH AND SAY:

1. I have been retained by the Intervenors to provide expert economic evidence in respect of the Draft Consent Order filed by the Director of Investigation and Research, and have knowledge of the matters hereinafter stated.

Experience and Qualifications

2. I am Professor of Monetary Economics and Financial Institutions at Victoria University of Wellington, New Zealand, in which capacity I am Chair of the Money and Finance Department and President of the VUW Money and Finance Association. I am also a Research Associate at the Institute for Policy Analysis at the University of Toronto, an Adjunct Scholar of the C.D. Howe Institute in Toronto, and a regular Visiting Professor of Economics at the University of Western Ontario. My curriculum vitae is attached as Exhibit 1 to this affidavit.

3. I have studied Canadian banking and the Canadian financial system for the last fourteen years, beginning with the research for a PhD thesis completed at the University of Toronto in 1986. My subsequent research has included work on contemporary and historical aspects of bank management, financial sector regulation and the payments system. I have acted as a consultant to banks and investment managers in Canada and New Zealand, as well as undertaking sponsored research for the central banks of both countries. My research has been published by academic journals as well as the C D Howe Institute. Based on this and the other activities and experience set out in my curriculum vitae, I have developed knowledge and expertise in the economics of the Canadian financial system, particularly the operation and regulation of the banking and payments system.

4. My most recent paper, "Public Policy and the Canadian Payments System: Risk, Regulation and Competition", was delivered on January 5, 1996 at the Conference on Issues in the Reform of the Canadian Financial Services Industry in Toronto, Ontario. This paper is to be published by the C D Howe Institute. At the time that this paper was written and delivered, I had not had an opportunity to study a copy of the full text of the Draft Consent Order (DCO), and I had not been consulted or retained by any of the Intervenors in respect of the Application relating to Interac that is before the Competition Tribunal. This paper is appended to this Affidavit as Exhibit 2.

Scope of this Affidavit

5. Subsequent to delivering the above paper on January 5 of this year, the Intervenors retained me to express my expert views in relation to the Application by the Director of Investigation and Research. In particular, the Intervenors requested that I state my views on the efficacy of sweep, pass-through and zero balance accounts in allowing them to participate effectively in Interac and the economic issues arising from the use of such accounts, as well as the economics of participating in Interac as an acquirer only. In expressing my opinion, I draw upon the research I have done over the past fourteen years in respect of the Canadian financial system. I also rely upon my review of the Draft Consent Order, Notice of Application and the Consent Order Impact Statement.

Overview of the Payments System

6. The payments system provides for the transfer of monetary value from one party to another. Instructions for the transfer of value, such as cheques and Interac Direct Payment, are means of providing consumers with the ability to obtain access to funds or to make payments without actually transmitting cash.

7. Payments transactions are initially received and processed in clearing systems. Canada has a diversity of these clearing systems because different products and methods of initiating transfers of value require clearing facilities with distinct

communication protocols and technologies. Settlement is defined as the transfer of some form of ultimate value in satisfaction of the claims made through the payment system, and for practical purposes this is taken to occur only on the basis of the movement of funds between the settlement accounts that the individual "direct clearing" institutions maintain at the Bank of Canada. The transmission of aggregate instructions for the transfer of value to provide for this form of settlement occurs primarily through the Automated Cheque Settlement System(ACSS) operated by the Canadian Payments Association (CPA).

8. The payments system plays a crucial role in the any modern monetary economy because only small value transactions are settled in cash at the point of sale, leaving most transactions to be settled through the payments system. The recent economic literature on payment system issues focuses on:

(i) the search for innovations that increase the efficiency (speed and certainty) with which payments instructions are transmitted and settlement actually occurs,

(ii) changing patterns of participation in the payments system resulting from

(a) the creation of new financial instruments and new services in response to consumer demand, and

(b) changes in the services provided existing institutions and the emergence of new institutions which require access to the payments system.

9. Under the *Canadian Payments Association Act*, the Canadian Payments Association (CPA) is provided with a mandate to assume the responsibilities for clearing and settlement which had been vested in the Canadian Bankers Association (CBA) since 1900. Specifically, the objects of the CPA are to "establish and operate a national clearings and settlements system and to plan the evolution of the national payments system" (1980 s 5). It has two classes of members, direct clearing institutions (each of which have to account for at least 0.5 percent of the national

clearing volume) and indirect clearers who clear through arrangements with a direct clearer.

10. Eligibility for CPA membership is defined by three general provisions:

(i) Chartered banks and the Bank of Canada must be members of the CPA,

(ii) other financial institutions may be admitted if they are

(a) a credit union, central, trust company, loan company or other institution which accepts deposits transferable by order to a third party, and if

(b) they are a member of the CDIC, or (for credit unions, centrals and other institutions) have deposits insured or guaranteed under provincial statutes.

Interac

11. Interac is an electronic network through which institutions allow customers to have access to their deposit and credit card accounts. Access is obtained through Automated Banking Machines (ABM) and Interac Direct Payment (IDP) terminals by using a card, on which is encoded the customer account identification, matched with a personal identification number.

12. Participation by issuing cards in this network has been in the past, and is under the Draft Consent Order (DCO), confined to Financial Institutions (as defined in the DCO) with customers who hold Demand Accounts (which has meant in practice deposits with and lines of credit from the Financial Institutions).

13. The Statement of Grounds and Material Facts (SGMF) notes that limiting eligibility for membership is an anti-competitive practice. In particular, limiting eligibility for sponsored membership is an anti-competitive act (SGMF c61), and has substantially lessened competition (SGMF c65 b). The exclusion of non-Financial

Institutions is an anticompetitive act (SGMF c61 ii). I am in agreement with these statements.

14. The DCO (c 3t) states that The requirement of the By-laws which stipulates that "an account shall not be an Eligible Account if it permits, by way of so-called "pass-through", "sweep" or "zero balance" accounts or otherwise, access to accounts held by, or credit from, persons not members in the Association", shall be revoked. Interac shall not impose any restriction or condition on access to the Services based on Member Financial Institution's arrangements with its customers regarding the operation of demand accounts." The Consent Order Impact Statement claims that "While 3(a) permits the Interac By-laws to continue to prohibit commercial entities that are not Financial Institutions from being Issuers, relief measure 3(t) offers these entities indirect access to Interac by eliminating restrictions on a Cardholder's ability to access "pass-through", "sweep", or "zero-balance" accounts. The Director recognizes that, while certain commercial entities will not satisfy the criteria to be an Issuer, the elimination of restrictions on accounts eligible to be accessed through the Shared Services will facilitate indirect access to the system by non-Members." The Intervenors have, however, questioned the commercial viability of such indirect access.

Demand Access and Deposits: An Evaluation of the Concepts Used to Justify the Use of Sweep, Zero Balance and Pass-Through Accounts

15. The definition of Financial Institution in the DCO appears in practical terms to be synonymous with the criteria for membership in the CPA. This approach to defining eligibility for membership reflects the fact that historically consumers have used the deposit instruments provided by banks, trust companies and credit unions to store funds that they do not wish to keep in cash but for which they require demand access or the right to transfer funds by order to a third party. The convention linking demand access and transferability by order to a third party to deposit instruments has defined thinking about the operation of the financial system and been embodied in the current

law as a monopoly privilege for banks and near-banks. But in the last decade consumers have increasingly used mutual funds, investment dealers and life insurers as repositories for liquid assets, and these institutions have responded by developing innovative new products to meet the needs of their customers.

16. A deposit contract is a promise by a financial institution to repay an equal amount (plus interest if applicable) on demand or after notice. The funds deposited with a bank are not held in trust; the relationship between a bank and its customer is one of debtor and creditor.

17. Since some deposits are issued for fixed terms, deposits are not always available for withdrawal or transfer to a third party on demand. Historically, deposits only earned interest when they were not payable on demand; that is, they could only be withdrawn at some fixed point in time or after some period of notice. The terms deposit and demand are therefore not synonymous.

18. The tradition linking transferable status to banks arose from the historical convention that banks redeemed deposits in cash (specie) on demand. Banks offered their customers chequing privileges as a means of economizing on the use of cash in the economy, and internalizing the transfer process within the banking system by making arrangements for these transfers to be cleared through a payments mechanism. The statutory power to take deposits transferable on demand to a third party originated as a means of providing legislative recognition of services that banks provided to meet the demands of their customers. It therefore seems reasonable to assume that institutional change in the financial system might result in different types of institutions deciding to offer their customers the convenience of demand access and transferability to a third party on demand. Financial institutions should therefore not be regarded as having exclusive domain over these services, even though they have certain statutory rights to accept demand and transferable by order deposits.

19. Mutual funds, independent investment dealers and insurance companies already transfer value from their customers' accounts on demand, but they are unable as a practical matter to provide payment on demand. This is because these institutions are unable to provide a mechanism through which the customer receives value directly. They must either provide a cheque drawn on a bank, or transfer the funds into a bank account on which a cheque can be drawn or from which cash can be demanded. Issuer access to Interac would provide that ability to provide their customers with payment on demand.

20. For any alternative institution to provide customers with demand access and to undertake to transfer value to a third party on demand, they must put in place a mechanism to facilitate it, such as Issuing membership in Interac. They must also manage the portfolio of assets in such a way as to ensure that they have sufficient liquidity to meet demands for the transfer of value. Hence, funds that are available on demand usually yield lower returns to compensate for the fact that institutions must keep larger amounts of funds securing demand accounts in low interest short term securities and in cash.

21. Historically, banks have been distinguished by both (i) demand liabilities and (ii) portfolios concentrated in short-term loans and liquid assets to accommodate this demand facility. This does not, however, mean that Financial Institutions as defined in the DCO are the sole possessors of the technology required to manage asset portfolios against which demand accounts are drawn. For example, the money market funds offered by mutual fund managers are in fact classic examples of highly liquid portfolios of short term securities against which demand access could reasonably be provided. Insurance companies and investment dealers may also invest in cash and near cash instruments to the extent that the their liability structures require this.

22. These considerations suggest that there is no reason for Interac's rules to distinguish between the demand and transferable by order products of non-deposit taking institutions and the deposit products of Financial Institutions. I regard attempts to exclude the Intervenors from direct access to Interac, or their inclusion in Interac only on terms which are commercially inferior to those applying to Financial Institutions, as being impossible to justify on the basis of the distinction between deposit and other types of instruments. The Financial Institutions' statutory monopoly over the supply of demand and transferable by order deposit products does not justify restrictions on the development of alternative demand and transferable by order financial products within Interac.

23. The respondents have stated that "Even if the new Interac Association were to grant the applicants [for Leave to Intervene] the ability to issue cards, existing regulatory requirements would bar them from participation in the deposit-taking retail financial services market, including the market for shared electronic financial services."[1]

24. Underpinning this statement of the Respondents are two implicit assumptions that I consider to be incorrect:

• *the assumption that to be an Interac Issuer the Intervenors must participate in deposit-taking services in a manner other than they are already statutorily authorized to do.* The services offered by the Intervenors may be close substitutes for those offered by deposit-taking institutions without being deposits, as the Pre-Hearing Conference Memorandum of the Respondents acknowledges: "Funds held by enterprises that are not deposit-taking financial institutions do not become the equivalent of deposits merely because they may be transferable by order to third parties. By means of the provisions of the federal law governing negotiable instruments, any person may draw a bill of exchange upon any creditor for the whole or any part of the debt owing, and transfer

[1] Prehearing Conference Memorandum of the Respondents c 51 pg 11 - 12.

the right to collect it and enforce payment to any other person."(page 14, c 54) The Intervenors do not infringe the statutory mandate of deposit-taking institutions by undertaking to transfer by order to a third party funds held for their clients, and federal law accommodates such activity by non-deposit taking institutions. Further, non-deposit-taking institutions may reasonably require effective access to Interac or other payments mechanisms without having the statutory authority to accept all or any types of deposits. So long as the Intervenors do not exceed their existing statutory powers to offer deposits, then I do not see why their demand products would be barred by regulatory requirements from inclusion within the market for shared electronic financial services.

• *the assumption that Interac is exclusively part of the deposit-taking retail financial services market.*

Interac is a system for the communication and clearing of financial messages in which a variety of services are currently provided and through which a broader range of services could be provided. Presently, Interac provides an ability to draw on the line of credit associated with a credit card. As the Canadian Bankers Association has stated: "At law, a credit card transaction is a loan from the bank to the cardholder, whereas a debit transaction drawn on a deposit account constitutes the - usually partial - repayment of a loan (ie the deposit) made by the consumer to the bank."[2] If the Interac system provides for drawings on lines of credit, I fail to see how it can be claimed to be exclusively the preserve of deposit-taking institutions. Other institutions with the right to issue credit cards (such as life and health insurers) might reasonably use Interac facilities.

25. Even if the Respondents had thus far chosen to restrict the operation of Interac to providing access to pure demand deposit accounts, I do not find convincing the

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[2] Canadian Bankers Association *Banking Industry Views on Access to the National Payments System: Balancing Rights and Responsibilities* (October 1995) pg 16. (Exhibit 3).

argument that direct participation as a card issuer in Interac should be limited to Financial Institutions because of their statutory monopoly over the taking of deposits.

26. The continued restriction of Interac Issuer status to CPA members would be of more general concern because of its likely effect on competition and innovation. Legitimate concerns about prudential standards and the stability of the payments system can easily be extended to the point where they become primarily a cloak for the protection of a dominant market position. It has two implications for innovation: first, it will force innovation within Interac to conform to the institutional structure provided by Financial Institution control of the core issuer function. Second, the institutions controlling the system will have no incentive to promote innovation which will facilitate greater competition from commercial entities who are not Financial Institutions.

27. The Respondents have stated that it is important in considering access to Interac that balances held with commercial entities are not insured to the same extent as deposits insured by the CDIC.[3] Similarly, the CBA has taken the position that government guarantee of the funds held by participants in the payments systems and extensive public sector prudential regulation should continue to be required for payments system participation.[4] I disagree with these views for two reasons:

(1) CDIC membership, and the associated guarantee of deposit balances, are not fundamental to the stability of the payments system. There have been no system-wide runs on Canadian financial institutions in the past one hundred years and publicly guaranteed and managed deposit insurance has served to reduce rather than enhance the stability of the financial system.[5] Consequently, the CBA have made "repeated calls for

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[3] Pre Hearing Conference Memorandum of the Respondents, c53.

[4] Canadian Bankers Association *Banking Industry Views on Access to the National Payments System: Balancing Rights and Responsibilities* (October 1995) pg 25.

[5] My views are set out in detail in J L Carr, G F Mathewson and N C Quigley, *Ensuring Failure: Financial System Stability and Deposit Insurance In Canada* C D Howe Institute, Observation 36 (1994) (Exhibit 4); and J L Carr, G F Mathewson and N C Quigley "Stability without Deposit Insurance: Canada 1890 - 1966" *Journal of Money Credit and Banking* 27 (4) 1995 pp 1137 - 1158 (Exhibit 5).

market-based reform (co-insurance)" that would reduce the guaranteed payment to depositors of failed institutions, and in addition "On several occasions, the banks have requested the option of providing deposit insurance through a private system.".[6]

(ii) The regulatory regime is endogenous to both the existence of government-guaranteed deposit insurance schemes (since government risk-bearing makes it efficient for the government to undertake monitoring) and the types of contracts that each institution writes. Because mutual funds are trusts that do not require repayment of a fixed nominal value, it is efficient for them to be subject to less stringent regulation than banks offering deposit contracts.

Deposit insurance and prudential regulation therefore do not provide a rationale for the restriction of the participation of insurers and investment firms in Interac to sweep, zero balance and pass-through accounts.

There is No Necessary Link Between Interac Membership and CPA Membership Which Will Require the Use of Sweep, Zero Balance and Pass-Through Accounts.

28. The Interac Association has, from its inception in 1985, required issuers of cards accessing accounts in the two shared services to be members in good standing of the Canadian Payments Association. The DCO appears to effectively require that card-issuing members of Interac be eligible to be members of the CPA through the definition of Financial Institution that it adopts. On this issue the Director has apparently accepted views such as those expressed by the Canadian Bankers Association:

"It has been, and remains, the position of the banking industry that allowing non-deposit-taking financial institutions, retailers or others to participate in the flow of funds within the inter-member network [Interac] is not a viable option, since doing so would entail allowing such parties to participate in the settlement process, an area which, for

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[6] Canadian Bankers Association (1995) *Financial Services Policy Regulation: The Paramountcy of Consumer Choice* (A Submission to the Standing Senate Committee on Banking, Trade and Commerce on its Review of the 1992 Federal Financial Services Reform Package) April 6 pg 43. (Exhibit 6).

reasons set out elsewhere in this paper, must remain limited to participation by deposit-taking financial institutions."[7]

This view appears to me to lie at the heart of the DCO's restriction of access to Interac for commercial entities such as the Intervenors to the use of sweep, zero balance and pass-through accounts.

29. So long as the current *CPA Act* remains in force, the CPA has the authority to restrict participation in the process of settlement, and the ability to use its ACSS settlement facilities, to CPA members. Interac is, however distinct from the CPA, and participation in Interac is not synonymous with participation in the settlement process. Interac is a communication and transaction clearing system. The Canadian Bankers Association has noted that clearing and settlement are separable functions. "Provided that deposit-taking financial institutions remain in control of both access to their transferable deposit accounts, and the provision of settlement and finality of payment ... there would be no reason to oppose the entry and expansion of third party activities in the processing and network fields."[8]

30. This allows the feasibility of Issuer participation in Interac by insurers, investment managers and investment dealers, as an alternative to the use of sweep, zero balance and pass-through accounts, since this function is not synonymous with participation in the settlement process or direct access to the settlement protocols managed by the CPA..

31. Clause 3d of the DCO provides that "Any requirement in the By-laws that a Direct Connector ("DC") to the Interac Shared Services must be a Direct Clearer in the CPA shall be revoked, and replaced by a provision that any member may become a DC." This might be regarded as a barrier to insurers and investment managers and

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[7] Ibid pg 28.
[8] Ibid pg 38.

dealers from attaining DC status within Interac if this involved an necessary participation in the settlement system, where CPA rules would currently preclude participation by non-members of the CPA. However, there is no necessary link between DC or Indirect Connector status within Interac and membership of the CPA, since it is feasible for non-members of the CPA to contract with Financial Institutions to do their clearing for them. This means that there is no reason why Interac rules should be allowed to prohibit insurers and investment managers and dealers from becoming card-issuing, DC Members of Interac.

32. The key difference between participation as a DC or Indirect Connector, and that provided via sweep, zero balance and pass-through accounts, is that the ability to connect would provide to insurers and investment managers exactly the same terms of membership in Interac as Financial Institutions. In practical terms this should remove the existing discrimination against non-Financial Institutions within Interac: these Institutions would either become DCs or establish a contractual relationship with a DC, which would undertake the business on the basis of its assessment of the soundness of the Institutions. An Indirect Connector commercial entity would have its credit - worthiness monitored by the DC, but the latter would not monitor or be involved in decisions about payments from the individual customers of the sponsored member.

Operation of Sweep, Zero Balance and Pass-Through Accounts

33. The DCO does not provide a definition of sweep, pass through and zero balance accounts, or indicate precisely how the Director expects them to operate. I expect that in each case the customer of a commercial entity who requires access to their funds through Interac would also need to maintain an account at a Financial Institution.

34. A sweep account is one from which the balance, or a certain proportion of the balance, is periodically swept into another account. In the context of Interac, this could work to sweep funds from a commercial entity (such as an insurance company,

investment manager or investment dealer) into a deposit account at a Financial Institution each day. The value of the funds swept would be determined by the extent of the funds to which the customer required demand access. Alternatively, the sweep could occur at the end of each day, and be determined by the value of Interac transactions processed during the day. In this case, Interac access would be provided to the customer of the commercial entity via a daylight overdraft facility for the deposit account maintained at the Financial Institution

35. Pass-through accounts are distinguished from sweep arrangements by the fact that no funds are ever placed in the deposit account at the Financial Intermediary. The request for funds passes through the account maintained by the Financial Institution, via an on-line real time interface with the commercial entity. The request for funds through the Interac system would be met solely on the basis of information about the extent of available funds held that was provided by the commercial entity.

36. Sweep, zero balance and pass through accounts are inefficient because they increase transactions costs. Transactions costs are the costs of contracting in addition to the price actually paid for the product; that is, the costs of writing, monitoring and enforcing contracts. Where there are regulations in a market that allow the incumbents to impose on potential entrants higher transactions costs than the incumbents themselves would have to bear to undertake the same activity, then transactions costs may impose a barrier to entry.

37. The most notable examples of the extent to which transactions costs are increased by sweep, zero balance and pass-through accounts is in their impact on administration, monitoring and switching costs within Interac. These accounts require that any Financial Institution entering into such arrangements with a commercial entity would be required to establish accounts for all individuals who wished to access funds through Interac, so that signature cards and account records would need to be

maintained at both institutions. Individuals would face the inconvenience of dealing with accounts at two different financial sector firms when one account could technically provide all of their needs. Because there are such high administrative costs associated with the establishment of sweep, zero balance and pass-through accounts, the costs of switching between different suppliers of these services will be important in determining the commercial feasibility of commercial entities moving between different suppliers. In addition, these accounts may require the Financial Institution to assess the creditworthiness of each individual borrower separately from the decision that is made by the insurer or investment manager or dealer, effectively doubling the monitoring costs involved.

38. Sweep, pass-through and zero balance accounts will involve members of Interac in a web of additional transactions associated with the need to shift balances from the commercial entity to the Financial Institution. Such arrangements increase the risk of breakdown of the communication process within Interac, and in addition, increase the risk in the payments system as a whole. For example, if commercial entities are prohibited from issuing their own cards, all of their transactions must go through the shared Interac network even if those entities have their own terminals.

39. These costs will be built into the price of using these forms of access to Interac, with the result that it will be more expensive for participants than the direct access available to Financial Institutions. This will serve to undermine their commercial viability.

40. The net negative implications for the competitive viability of any institution forced to use these means of accessing the Interac network are clear. This is because I am unaware of any benefits for the individual institutions involved, or efficiency gains for Interac and the payments system more generally which would offset the costs that I have outlined above. The use of pass-through accounts is no more than a costly means

of establishing the fiction that demand access is being provided to deposit accounts. Since the funds to which access is being provided actually remain with the commercial entity in each case, there are no tangible benefits from this action, save for the preservation of the barrier to competition provided by the claim that only Financial Institution accounts can legitimately be accessed through Interac. With respect to sweep accounts, funds may actually be placed in a deposit account with a Financial Intermediary, but again this represents an increase in the transactions costs incurred by the agents involved without any offsetting gains such as reduced risk being evident.

41. Consequently, they do not provide a basis for effective competition between card-issuing Members of Interac and other commercial entities such as life insurers, investment dealers and investment managers.

42. In setting out the requirement that the prohibition on sweep, zero balance and pass-through accounts be removed, the Director has provided implicit recognition that

(a) non-Financial Institutions have a legitimate need to provide their customers with access to funds through Interac, and

(b) there is no reason to stop commercial entities participating in Interac.

43. The CBA has recommended "that regulatory authorities address the risks associated with "payable through arrangements", which might include a prohibition in the Bills of Exchange Act against the issuance of instruments with all of the visual attributes of cheques, but drawn on a non-CPA member".[9] If this view were to be adopted by the CPA it might be possible for that body to pass By-laws that would increase the transactions costs associated with sweep, pass through and zero balance accounts, and thus further undermine the extent to which they can be used as an effective vehicle for competition.

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[9] Canadian Bankers Association *Banking Industry Views on Access to the National Payments System: Balancing Rights and Responsibilities* (October 1995) pg 12.

44. For example, in the case of a chequable money market mutual fund product that Trimark Investment Management attempted to offer in association with one of the direct clearing banks, the CPA required that only the deposit-taking institution could be allowed to accept the risk associated with the cheques that it was processing for Trimark. In effect, the CPA took the view that money market mutual funds in themselves were not sufficient security for the payments system - though the exact same assets in these funds would have been sufficient security if they had been managed by a bank. This meant that to establish a pass-through account for each customer, the bank would have been required to establish individual lines of credit for each customer, or the assets segregated for each unitholder would have had to be pledged to the bank. Neither of these solutions has proved to be practical or cost effective, and so the product has not been developed.

Contractual Issues Arising From the Use of Sweep, Pass Through and Zero Balance Accounts

45. The necessity for non-Financial Institutions to contract with Financial Institutions for the supply of services associated with the operation of sweep, zero-balance and pass-through accounts creates a principal-agent problem which will be costly to resolve. The use of sweep, pass through and zero balance accounts in the ways envisaged in the DCO requires that the Financial Institution act as the agent of the non-Financial Institution (the principal) in processing any transaction for a customer of the latter over the Interac network.

46. The fact that the Financial Institution and the non-Financial Institution are direct competitors for the supply to the customer of a wide range of financial services will make it difficult and costly for them to write a contract which will provide a satisfactory basis for this relationship. This is because the moral hazard (hidden action) and hidden

information problems normally associated with principal-agent relationships are compounded where the contractual parties are competitors.

47. For example,

(a) neither the customer of the commercial entity nor the commercial entity itself will posses as much knowledge as the Financial Institution about the speed and quality of service that could be provided within the constraints of the sweep, zero balance and pass-through arrangements. This will make it feasible for the Financial Institution to act undertake strategic action which will disadvantage the commercial entity. Such action might include giving priority to its own customers whenever the system is busy, or, in the extreme, providing the poorest possible service to the customers of the commercial entity in the hope that these customers will become frustrated at dealing with an entity that is unable to provide direct access to the Interac network, and switch their business to the Financial Intermediary.

(b) the Financial Institution has the ability to monitor the frequency and nature of card use by the individual customers of its competitors. This will give the Financial Institution information which may be of strategic advantage should it attempt to solicit the business of those customers of its competitor. It would, for example, provide a basis for more precisely targeted marketing of products suited to individuals with particular lifestyles and spending patterns.

48. The commercial entity may undertake monitoring of the actions of the Financial Institution. It may also attempt to write into the contract terms and conditions which will anticipate strategic action by the Financial Institution and provide incentives which discourage such action. In addition, the potential for strategic action may be reduced the more competitive is the market for the services provided by the Financial Institution.

49. Attempts to ameliorate the potential for strategic action by the Financial Institution will, however, be costly. Moreover, since substantial (sunk) transactions

cost expenditures will be associated with each contract for the supply of sweep, zero-balance and pass-through accounts that is negotiated, the potential for holdup will exist even if the market for the supply of these services is competitive. Sweep, zero balance and pass-through accounts therefore impose costs on the commercial entity which are different from, and in excess of, those faced by incumbent Financial Institutions operating in Interac. To this extent they cannot provide a viable basis for competition between financial institutions an commercial entities.

Establishing a Subsidiary Trust Company

50. It is commonly suggested that non-Members of Interac may participate in Interac by establishing a subsidiary trust company which would be eligible for Interac membership, and that this might provide a means of addressing some of the inefficiencies associated with sweep, zero balance and pass-through accounts. The establishment of a subsidiary trust company would provide a means of overcoming barriers to entry in Interac if the only problems were (i) fixed costs in establishing agreements with independent deposit-takers and the inability to write a binding long-term contract to ensure a return on the fixed investment ("hold-up") or (ii) the lack of competition among the existing Charter and Sponsored Members of Interac for the business of non-members.

51. Even if these factors were unimportant, ownership of a trust company would not provide a remedy for the Intervenors. This is because a trust company owned by a commercial entity would still have to overcome the obstacles to the provision of commercially viable ATM access created by the differential status of Financial Institutions and commercial entities such as insurers, investment managers and investment dealers within Interac. By explicitly providing Interac which the authority to retain By-laws which relegate institutions such as the Intervenors to non-Issuer status, the DCO fails to provide for commercially viable Intervenor participation in Interac, even via a trust company subsidiary. Retention of this barrier to competition is the

more difficult to justify when it is understood that providing the Intervenors with direct Issuer access to Interac represents an efficient solution to the access problem without providing for greater risk or transactions costs within the Interac system.

52. Added to these problems are the high costs of establishing and maintaining a separate regulated subsidiary Trust company, and the restrictions on information transfers between a trust and its parent that are provided in provincial law. I agree with the views of the Canadian Bankers Association that "The mandatory use of subsidiaries limits the ability of financial institutions to arrange their business activities based on business considerations" and that "With increasing emphasis on the integration of financial services for the benefit of consumers, the requirements for separate subsidiaries will only interfere with, and add cost to, the ability of financial institutions to serve their customers."[10]

The Use of Sweep, Zero Balance and Pass-Through Accounts Maintains Barriers to Entry in Card Issuance

53. Financial sector regulations in Canada currently provide three exclusive privileges to so-called deposit-taking institutions (banks, trust and loan companies, credit unions): (i) the authority to take deposits transferable by order to a third party, (ii) membership in Canada Deposit Insurance Corporation (CDIC) or an alternative government guaranteed scheme, and (iii) the right or obligation to be a member of the Canadian Payments Association (CPA). The Respondents have the votes to appoint a majority of the Board of the Canadian Payments Association (SGMF c57).

54. Interac By-laws permitted by the DCO effectively provide that only members of the Canadian Payments Association are eligible to be Issuing members of Interac. By providing that Interac may continue to restrict to Financial Institutions the right to issue

[10] Canadian Bankers Association In the Consumer's Interest: Ensuring Stability, Competitiveness and Service in Canada's Financial Services Sector (A Submission to Finance Canada on Proposed Changes to Federal Financial Services Legislation) July 20, 1995, pg 22. (Exhibit 7).

cards which access the shared services network, the DCO allows Financial Institutions to extend their monopoly privileges into the market for consumer-initiated shared electronic financial services, despite the absence of any explicit statutory authority for this.

55. The Canadian Bankers Association has stated that "In order to achieve full competition for the benefit of consumers, our industry believes there should be no preferential treatment for one type of financial institution at the expense of others.[11] Most economists would agree with the CBA that barriers to competition usually result in lower output, higher prices and smaller consumer welfare than in competitive markets. The exclusion of insurance and investment firms from effective Issuer participation in Interac, except through costly and cumbersome sweep, zero balance or pass-through arrangements, is such a barrier.

The Number of Direct Connectors

56. The Consent Order Impact Statement (c12) states that " it is anticipated that the Order will lead to a significant increase in the number of Direct Connectors competing to supply access to the Shared Electronic Network Services, and an increase in the number of Indirect Connectors able to purchase access to the network through Direct Connectors." The efficacy of sweep, zero balance and pass-through accounts therefore depends in part on the assumption that the terms of the DCO will provide for more DCs, as well as for more competition between them.

57. There are two problems with the assumption that the number of DCs will rise: (i) If there are substantial fixed costs involved in becoming a Direct Connector (associated with owning and operating a switch, for example), and if the capacity of the current Direct Connectors to process transactions has not been reached, is not obvious

[11] Canadian Bankers Association *Financial Services Policy Regulation: The Paramountcy of Consumer Choice* (A Submission to the Standing Senate Committee on Banking, Trade and Commerce on its Review of the 1992 Federal Financial Services Reform Package) April 6 1995 pg 42.

to me that the equilibrium is for more firms to be Direct Connecting Members of Interac. For example, National Trust meets the minimum volume requirements to become a Direct Clearing member of the CPA, but has chosen not to exercise the option to become a direct clearer.

(ii) If the current DCs are operating efficiently in terms of their relationship with other Financial Institutions, then the number of direct clearers may not increase at all. There is still, however, the potential for barrier to entry to remains. This occurs because Financial Institutions are all members of the CPA, and may use this forum as a basis for co-operation which might involve invoking new Interac rules which will discriminate against insurers, investment dealers and investment managers. So long as DC status is restricted to members of the CPA, I consider that there will be a significant risk that the substantial lessening of competition within Interac will not be removed by the terms of the DCO.

Acquirer Status

58. The Consent Order Impact Statement c 13 states that DCO "3(c) opens Membership for acquiring transactions to all commercial entities and Financial Institutions that choose to participate only as an Acquirer or an Issuer, in contrast to the current situation in which Members have to participate as both". Whether this provision will reduce the substantial lessening of competition associated with the past management of Interac depends on whether the Acquirer and Issuer functions are separable on economic grounds.

59. I have not undertaken a detailed analysis of the economics of Acquisition and Issuing within the Interac network, because I do not have access to the data that would be necessary to do this. However, on theoretical grounds I question whether it will be commercially feasible for any commercial entity to participate in the Interac network as an Acquirer only. This is for three reasons:

(i) The fact that the dominant participants in Interac at present are both Issuers and Acquirers suggests that there may be symmetries or joint costs associated with these two activities which provide significant economies of scope in joint production. In particular, it seems likely that the fixed costs associated with the investment in technology that is required to establish as an Acquirer would also cover much of the technology required to act as an Issuer. It therefore may not be competitively viable to invest in the technology required to link to Interac as an Acquirer unless there also exists the possibility of using this technology to the generate revenue via the Issuer function. If this is true, then Acquiror-only entry to Interac will not be feasible.

(ii) Retailers using the IDP facilities provided by Interac require the full range of facilities associated with credit card and direct debit card purchases, and the speedy transfer of funds in to their bank account. An institution able to act as an Acquirer only would not be able to offer the full range of services, and this would put it at a competitive disadvantage with respect to Financial Institutions.

(iii) Incumbent members of Interac may find it feasible and profitable to inhibit entry by new independent Acquirors by pricing transaction fees for ABM use at below their marginal cost. This possibility will be reinforced if there continue to be barriers to entry of the type sanctioned in the DCO with respect to the Issuer function, since this will provide a basis for Issuers to earn rents which may be used to subsidize the Acquisition prices.

Summary

60. In requiring that Interac remove the prohibition on sweep, zero balance and pass-through accounts, the DCO recognizes that the Intervenors have a legitimate need to participate in Interac, and that such participation is necessary to reduce the substantial lessening of competition which has resulted from the Respondents' actions.

61. The DCO, however, provides that Interac may continue to prohibit non-Financial Institutions from becoming card-issuing Members. The sweep, zero balance

and pass-through accounts that the Intervenors will be forced to use to participate in Interac under the terms of the DCO are not an innovative and efficient solution to the provision of access: they are a costly means of establishing the fiction that all of the funds being accessed through Interac are traditional deposits. The use of these accounts for access to Interac will increase risk, transaction and monitoring costs within the payments system, without any offsetting efficiency gains being realized.

62. The requirement embodied within the DCO that Issuers be deposit-taking institutions insured by the CDIC and who are eligible for membership in the CPA has no justification in concerns about risk, the legal status of Interac transactions, or the technological capability of the Interac system. There is no necessary connection between the clearing functions performed within Interac and the settlement function for which membership in the CPA is required, and there is no necessary link between the provision of demand access or transferability requiring access to the payments system and deposit accounts at CPA member institutions. There is thus no plausible justification for confining the Intervenors' access to Interac to sweep, zero balance or pass-through accounts.

63. The problem with the current Interac system is that the incumbents (members of the CPA) do not have appropriate incentives for the assessment of the optimal level of risk in, and new entry to, the payments system. The Charter Members have found it convenient to closely tie Interac access criteria to CPA policies that place broad restrictions on payment system participation by institutions who are not CPA members, and have no incentives to search for commercially viable means of making Interac directly accessible to firms such as the Intervenors on a commercially viable basis. This is because their private interests lie in retaining a barrier to competition from non-Financial Institutions. The preferences of the incumbents in Interac are therefore weighted towards the status quo because this perpetuates the privileges provided by

their statutory monopoly over the acceptance of demand and transferable by order deposits.

64. Overall, it is my assessment that the DCO will not meet the first of the four objectives set out in the Consent Order Impact Statement (c 11): "(a) to ensure access to the Shared Electronic Network Services by new participants on a nondiscriminatory basis;" This is because:

(a) transactional and informational symmetries between the Acquirer and Issuer functions make it economically infeasible to compete solely as an acquirer, and

(b) sweep, zero balance and pass-through accounts will not operate as a commercially viable vehicle for the Intervenors to compete with card-issuing Members of Interac.

The measures provided in the DCO will therefore not cure the admitted substantial lessening of competition or reduce the potential for the Respondents to abuse their dominant position in the market for consumer-initiated shared electronic financial services.

65. Finally I note that the statutory monopoly for management of the Canadian payments system currently provided to the CPA, and the dominant role that the Respondents play in that body, represent an obstacle to the reduction of the substantial lessening of competition which has resulted from the actions of the Respondents within Interac. It is my view, however, that it is possible to provide for access to Interac by the Intervenors on terms that will reduce the substantial lessening of competition without infringing the legitimate mandate of the CPA. This will require that commercial entities such as the Intervenors are provided with the authority to participate in Interac as Issuers without the necessity of operating through sweep, zero balance or pass-through accounts, which may be subject to the control and regulation of the CPA.

SWORN BEFORE ME at the)
City of Wellington,)
New Zealand, this 1st)
day of March, 1996)

NEIL C QUIGLEY

A COMMISSIONER FOR TAKING OATHS, ETC.
BRIAN I.D. GOULD
Solicitor of the
High Court of New Zealand.