



## Cheque Imaging: Surveying the Landscape

Late 2006 is the target date for implementing the CPA's industry-wide initiative to modernize the cheque clearing process by adopting cheque images and electronic data for that purpose. Although much work remains to be done in the three years ahead, some key elements of the new landscape are already emerging.

While the CPA's initiative relates specifically to the clearing of cheques and other paper payment items between financial institutions (FIs), it will also mean some changes to services for financial institutions' customers that have traditionally received their cancelled cheques with their statements. But the shift to image-based clearing is not a prerequisite for the introduction of these new services; in fact, several FIs are already capturing cheque images after the clearing process and printing them on customers' statements or providing on-line access to the images, at least for some customers. Most notably, credit unions in the four western provinces are now delivering image-based services to about 1.5 million customers or "members".

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Customers are generally enthusiastic about the convenience and efficiency of the new services, although some would like more information about how the transition to give images legal status will occur. The current clearing process, in which millions of paper cheques are physically exchanged between financial institutions each day, is based largely on provisions of the *Bills of Exchange Act*, a statute that has remained substantially unchanged for over 100 years. To facilitate the shift to the use of images for clearing purposes in 2006, the CPA is seeking legislative amendments to reflect the modern environment.

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Some other legislation already recognizes and accepts electronic records as replacements for original paper documents. Notably, the *Canada Evidence Act* and parallel legislation in a number of provinces provide for the admissibility of electronic documents in court, as long as the integrity of the systems used to record and store the documents can be established.

Currently, several CPA sub-committees are working on standards to ensure cheque images created under this initiative will satisfy this requirement. Draft standards on image quality and security of image exchange processes are expected to be completed by early 2004. It is anticipated that these standards will mirror internationally established standards in most respects. Looking down the road, this approach will create efficiencies for Canadian organizations that do business outside our borders.

A fundamental goal of the project is to ensure cheque images transmitted through the clearing system can serve all purposes for which cancelled cheques are currently used. Over the coming year, the CPA will be liaising with organizations that have legislative or regulatory requirements relating to cheques to

explain the changes in the works and seek their cooperation in putting in place a consistent regulatory framework regarding the use of cheque images.

To optimize image quality, it is important to ensure that cheque formats do not impede capturing a clearly legible electronic version of the document. In this regard, a CPA Working Group is reviewing the current specifications in Standard 006 relating to cheques and other MICR-encoded items and preparing recommendations. This work should be complete by early 2004, and the recommended amendments to cheque standards will then be distributed to industry stakeholders for comment.

Questions have also been raised about the potential impact of imaging on security features used in today's cheques to combat fraud. Results of preliminary testing on sample cheques show minimal impact on the vast majority of security features. Moreover, the move to cheque imaging and electronic clearing creates opportunities for new security features. For example, key data such as

the name of the payee and the amount of the cheque can be embedded in a bar code or seal on the cheque and used when the image file is received to verify that the cheque has not been altered.

The CPA's investigation of security features in an imaging environment is ongoing, most notably through its participation in an initiative led by the Financial Services Technology Consortium (FSTC). Under that project, a comprehensive testing program of all security features known to be in use currently, as well as sample cheque stocks, is under way. Results are anticipated in mid 2004.

## MOREOVER, THE MOVE TO CHEQUE IMAGING AND ELECTRONIC CLEARING CREATES OPPORTUNITIES FOR NEW SECURITY FEATURES.

"Cheque imaging is already being done by several organizations, and while it means a significant investment for CPA members, particularly the clearing agents, the core process is relatively straight-forward," comments CPA's President and CEO Guy Legault. "One of the biggest challenges is thinking through how various parties will use those images beyond the clearing process and ensuring those contexts are considered."

Recognizing that consultation is an important part of that process, the CPA has already met with and provided information to stakeholder representatives in several sectors. Additional consultations are planned on specific aspects of the initiative in 2004. Interested parties are invited to contact the Communications and Education Division at 613-238-4173 or by e-mail at [info@cdnpay.ca](mailto:info@cdnpay.ca).

## CPA By-laws Take Effect

Two CPA By-laws have received Governor-in-Council approval and came into effect on October 23, 2003. The *Payment Items* and *ACSS By-law* replaces the former *Clearing By-law*, while the *Compliance By-law* has been updated. The latter now incorporates matters previously addressed in the former By-law No. 4 – *Penalties for Failure to Appear*, which has consequently been repealed.

A key focus of the *Payment Items* and *ACSS By-law* is defining the rights, obligations and responsibilities that CPA members assume in each of the roles they may play in exchanging payment items generally and in the context of the Automated Clearing Settlement System (ACSS).

Further, the By-law clarifies the liability assumed by each party in various default scenarios. In the case of a Direct Clearer's default, the By-law requires the surviving Direct Clearers to contribute

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funds proportionately to the items they have exchanged with the defaulter to permit settlement of the defaulter's outstanding balance.

In the event of an Indirect Clearer's default, the defaulter's Clearing Agent is responsible for covering any shortfall. Other members are to return all items drawn on or payable by the defaulting Indirect Clearer, with the exception of items that are not subject to dishonour.

A CPA Working Group is continuing to study such issues as when a Clearing Agent can declare an Indirect Clearer in default and the finality of items entered into the clearing by an Indirect Clearer prior to its default. Once the study has been completed, procedures relating to the default of an Indirect Clearer will be incorporated in CPA Rules.

The *Payment Items and ACSS By-law* includes a provision implementing current government policy that insurance companies and money market mutual funds may not act as Direct Clearers. In light of the recent extension of eligibility for CPA membership to new categories, the CPA is now working with the Bank of Canada and the Department of Finance to examine what criteria for Direct Clearer status are appropriate in the new environment. Pending the outcome of this review, this provision may be revised in the future.

The By-law also puts in place a new CPA membership policy, under which any financial services provider that is eligible for CPA membership and holds client accounts on which it issues or receives payments through the clearing system must hold membership in the CPA. At present a small number of eligible financial institutions offer payment products to their clients and make use of the CPA's systems to clear them, although they are not CPA members.

The By-law establishes December 31, 2006 as the implementation date for the membership policy to allow adequate time for these organizations to become CPA members or change their current arrangements.

As a consequence, this policy requires that only CPA members may make the "pay/no pay" decision; that is, CPA members are responsible for the decision to honour or dishonour any payment item presented to them through the clearing. This will effectively prohibit "payable-through" arrangements, whereby some organizations that are not eligible for CPA membership create payment items drawn on funds they hold on behalf of clients make the "pay/no pay" decision on these items, and make use of the clearing system to process these items.

The By-law provides that exceptions to this policy can be set out in CPA Rules. In this regard, the revised rules will permit certain exceptions, including Receiver General warrants, Canada Customs and Revenue Agency remittances, Canadian postal money orders, traveller's cheques bearing a CPA institution number, and claims drafts and reimbursement drafts as described in Rule H2.

In essence, payable-through arrangements allow non-CPA member organizations to gain "back door" access to the payments system. They increase the risk exposure of CPA members because non-member organizations are not explicitly bound by the same framework of rules, including provisions defining liability. The new policy reflects the CPA's mandate to promote safety and soundness in the clearing and settlement system by ensuring that all organizations that hold client funds on which payments are drawn and cleared through CPA systems are subject to a common regulatory framework.

Turning to the *Compliance By-law*, most amendments could be described as "house-keeping", in that provisions formerly included in a separate Compliance Rule have now been incorporated in the By-law so that all matters relevant to CPA member compliance are dealt with in one place. As well, some additional amendments have been made to reflect recent revisions to the CPA's governing legislation as well as changes to other by-laws and to ensure consistency.

Copies of both By-laws are available in the Publications section of the CPA's web site, at [www.cdnpay.ca](http://www.cdnpay.ca).

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## Tele-cheque Prohibition Comes Into Effect

As reported in the Fall 2003 issue of FORUM, tele-cheques will be prohibited in Canada's clearing system in January 2004. Sometimes referred to as "cheques by phone", tele-cheques look like regular cheques but they are not signed by the account holder. Instead, they are created by a third party, purportedly with the consent of the account holder obtained over the telephone or sometimes over the Internet.

In a policy statement issued in June 2003, the CPA Board of Directors indicated its intention to ban tele-cheques because

there is no practical method for the account holder's financial institution to verify that its customer has authorized the payment, and the lack of a signature or underlying written agreement raises significant concerns about the potential for fraud. Interested readers may access the policy statement on the CPA's web site at [www.cdnpay.ca](http://www.cdnpay.ca). The related amendments to Rules A1 and A4 have been approved by the CPA Board and will be posted on the web site once the standard ministerial review process has been completed.

## ACSS Value Reductions Produce Safety Gains

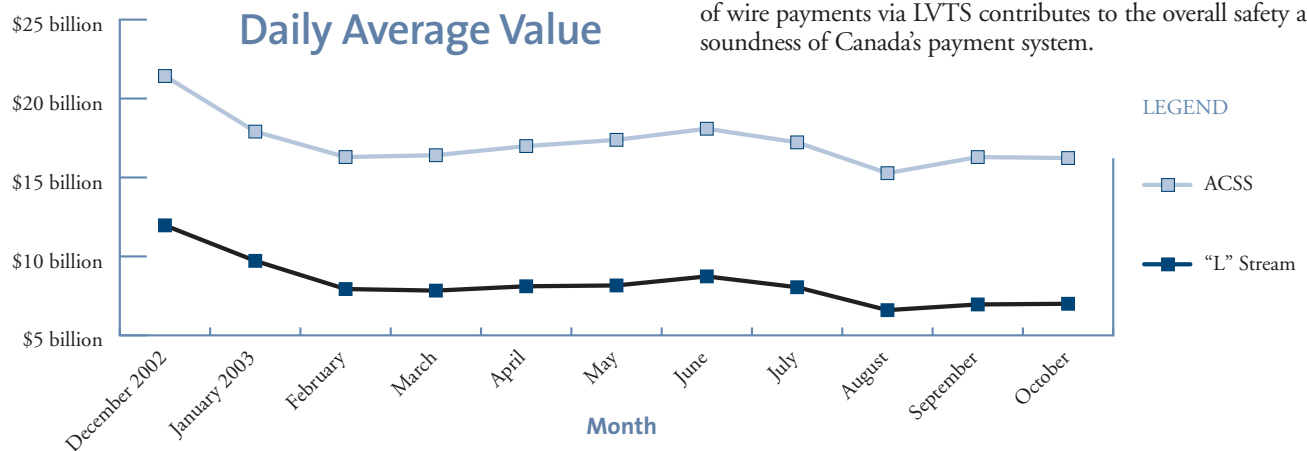
As anticipated, the \$25 million ceiling for clearing cheques and other paper-based payments through the Automated Clearing Settlement System (ACSS) has resulted in a shifting of value to the Large Value Transfer System (LVTS), and consequently a reduction in settlement risk in Canada's payment system.

For the three months following the full implementation of the ceiling at the beginning of August 2003, the average daily value in ACSS was \$15.9 billion, down approximately 20 per cent from the daily average of \$19.8 billion during 2002. Meanwhile,

the daily average value for LVTS during the same three-month period was \$118.2 billion, up from \$114.5 billion during 2002.

As shown in the chart, virtually all of the ACSS reduction has occurred in the "L" stream, which captures large-value cheques and other paper payment items.

Since LVTS was introduced in 1999, the total daily ACSS value has been cut almost in half, from \$32 billion in February 1999 to a little over \$16 billion in October 2003. Since all LVTS payments are final and their settlement is guaranteed, the growth of wire payments via LVTS contributes to the overall safety and soundness of Canada's payment system.



## Association Notes

- The Bank of Canada implemented next-day settlement of Direct Clearers' ACSS balances with interest compensation on November 3, 2003. As reported in the Fall 2003 issue of FORUM, the shift from retro-active settlement to next-day settlement is essentially a change of accounting practices and does not impact indirect clearers or users of the payment system.
- Effective May 16, 2003, UBS AG Canada Branch, institution number 339, became a member of the Association.
- On May 26, 2003, All Trans Credit Union Limited, institution number 810, changed its name to All Trans Financial Trust Incorporated.
- Effective September 12, 2003, ICICI Bank Canada, institution number 340, became a member of the Association.
- Effective September 24, 2003, Sun Life Financial Trust Incorporated, institution number 600, ceased membership in the Association.

The CPA wishes FORUM readers the best of the

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