



DISCUSSION PAPER

PAYMENT CARDS CENTER

Payment System Regulation and How It Causes Consumer Confusion*

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November 2004

***Summary:** On October 14, 2004, the Payment Cards Center hosted a workshop led by Professor Mark Budnitz of Georgia State University School of Law. Budnitz, the author of four books and many Law Review articles on consumer payments, described how the current regime of consumer payment regulation and various new payment products have led to much confusion among consumers. He also discussed a remedy for this situation: the adoption of uniform federal consumer protection standards. This paper summarizes the workshop and is organized around two of Budnitz's key assertions: (1) the current regulatory environment is confusing for consumers and (2) there is a need for more uniform consumer protection standards.*

* The views expressed here are not necessarily those of this Reserve Bank or of the Federal Reserve System.

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Introduction

On October 14, 2004, the Payment Cards Center hosted a workshop led by Professor Mark Budnitz of Georgia State University School of Law. Budnitz, the author of four books and many Law Review articles on consumer payments, described how the current regime of consumer payment regulation and various new payment products have led to much confusion among consumers. He also discussed a remedy for this situation: the adoption of uniform federal consumer protection standards. Budnitz's comments were based on preliminary research for an upcoming article on the need for more uniformity in the regulation of consumer payment systems.¹ This paper summarizes the workshop and is organized around two of Budnitz's key assertions.

Budnitz began the workshop by offering an explanation of his perspective on consumer payment issues. As a law professor and consumer-focused attorney, he is primarily informed by situations in which consumers are not well served by the payment system. "I only see the train wrecks," he explained, "not how the trains run most of the time." Budnitz learns of these "train wrecks" through e-mails and phone calls from distressed consumers or their attorneys and his work with various organizations that represent consumer interests, such as the National Consumer Law Center and the Atlanta Legal Aid Society. Because of this particular perspective, Budnitz acknowledged that he approaches regulatory issues differently than might an economist or a representative of the payments industry. "While I respect those that represent the interests of banks or look at problems in a different way," he explained, "I advocate a regulatory framework that is consumer-focused."

"The Current Environment Is Confusing for Consumers"

Budnitz's first key assertion was that the current consumer payments environment, with its complicated products and disparate laws, is confusing and overly complex. As evidence of

¹ The Center's web site will be updated to include a link to this article when it is made available.

this, he pointed to four developments that, in his view, have made it more difficult for consumers to understand their rights: (1) the increased use of new electronic check technology and the passage of the Check Clearing for the 21st Century Act; (2) the evolution of laws that govern consumer checking account transactions; (3) the names the industry uses to describe various payment products; and (4) the introduction of new card products and their inability to fit neatly into the existing regulatory framework. Each of these developments is described in more detail below.

New Check Processing Technology & Check 21

Budnitz argued that the increasing popularity of new electronic check products and the passage of the Check Clearing for the 21st Century Act (Check 21)² make payment by check “a complicated and bewildering exercise for consumers.”

Prior to the advent of new check processing technologies, all checks cleared and settled in their paper form and were governed by two sets of rules: a state-based set of rules found in the Uniform Commercial Code (UCC)³ and a federal set of rules embodied in Regulation CC (Reg CC).⁴ In this traditional paper-based system, if an error, such as a posting error, occurs, the state UCC determines the extent of the check writer’s rights.

Today, in the wake of Check 21 and new check processing technologies, how checks clear and settle and the legal landscape of check transactions are much more complex. Checks may clear and settle in their paper form (as noted above) or may be processed using a variety of electronic technologies. One of these new non-paper processing methods leverages the Automated Clearing House and involves the recipient of the check “converting” it into an

² The Check Clearing for the 21st Century Act (Check 21) is a federal law that went into effect on October 28, 2004. It aims to reduce the time, risks, and costs associated with paper check processing by facilitating the movement of electronic check images.

³ The UCC is a set of model state laws that have been adopted in substantially the same form by most states. These laws cover a wide variety of commercial transactions, including check and wire payments.

⁴ Regulation CC, promulgated by the Board of Governors, implements the Expedited Funds Availability Act and sets forth guidelines for when banks must make deposited funds available to consumers.

electronic funds transfer.⁵ Check transactions that have been “converted” in this way are referred to as electronic check conversion (ECC) transactions.⁶ Regulation E, which governs electronic funds transfers, and the rules of a private organization, the National Automated Clearing House Association (NACHA), govern ECC transactions. If an error, such as a posting error, were to occur in the processing of an ECC payment, a consumer would have the same federal rights she would have if she had used a debit card for the transaction.

Another non-paper-based method of processing checks is a direct result of Check 21. As of October 28, 2004, in lieu of submitting checks in their paper form for clearing and settlement, banks are permitted to “truncate”⁷ paper checks and electronically transmit images of them. This reduces the overall costs of clearing and settlement by eliminating transportation costs. If a bank chooses to truncate *and* the consumer who wrote the check elects to have it returned to him or her, three laws apply: the UCC, Reg. CC, and Check 21. If a posting error were to occur in this situation, the consumer would have a federal right to a series of error resolution procedures.

Budnitz criticized a framework that can result in three different kinds of processing (i.e., traditional paper clearing, ECC, and electronic clearing) with different sets of rules. He said that most consumers believe that the same set of rules apply to all check-based transactions. “That might be logical,” he said, “but it is not correct.” Instead, check transactions are governed by three sets of rules contained in two federal laws, one non-uniform body of state law (the UCC),⁸ and the rules of a private body (NACHA). “This irrational patchwork creates an information asymmetry between banks and customers,” he argued, “leading consumers to make ill-informed decisions about which payment product to use for a given transaction.”

⁵ ACH transactions are electronic fund transfers that are processed over a secure network that connects U.S. financial institutions.

⁶ Consumers must have notice that their check transactions are being converted into ECC transactions.

⁷ Truncation involves stopping the movement of a check in its paper form through the clearing and settlement process and moving it into an electronic clearing and settlement system.

⁸ Budnitz criticizes the Uniform Commercial Code as non-uniform because, although states adopt the model law in substantially the same form, variations in adoption render it non-uniform.

Laws That Govern Checking Account Transactions

Budnitz further believes that the laws that govern consumer checking account transactions create “a tangled legal web” leading to consumer confusion. He explained that, from a consumer’s perspective, there are two basic kinds of checking account transactions: deposits and withdrawals. The law, however, creates a complicated framework into which subsets of these two transactions must fit. For example, as mentioned above, if a consumer accesses his or her account via check, the state UCC governs how problems are resolved. If a consumer uses a debit card or an ATM to access an account, the Electronic Fund Transfer Act regulates the consumer’s rights. If the consumer’s account is accessed with a substitute check, right under Check 21 apply. If the ACH system is used to access a consumer’s account (e.g., at the point-of-sale, by telephone, or over the Internet), NACHA rules can be of assistance. Further complicating this framework, Budnitz explained, is a separate body of law that addresses how banks deal with “non sufficient funds” (NSF) transfers. Overall, this framework confuses consumers and leads to situations in which they do not know which laws apply to any given checking account transaction.

Names of Payment Products

Looking beyond the industry’s regulatory framework to its own marketing practices, Budnitz finds the names given to various payment products confusing. He contended that the vast majority of consumers understand how cash and checks look and function. The names of new electronic payment products that include words like “cash” and “check,” however, are misleading and confusing. For example, Budnitz explained that a “check card” neither looks nor functions exactly like a check. Similarly, a “cash card” neither looks nor functions like cash. A “convenience check,” he explained, looks like a check, but functions more like a credit card. A “money card” looks like a debit card but may function like a prepaid or stored-value card. “A product name that suggests that a product functions in a way that it does not,” he explained, “simply adds to consumer confusion.”

New Card-Based Technologies and How They Fit into the Existing Framework

Another source of confusion, Budnitz believes, is the result of two developments: federal regulators trying to shoehorn new card products into a 20- to 30-year-old regulatory framework and state regulators trying to tailor new regulations for new card products. “In the good old days,” Budnitz explained, “Regulation Z covered credit cards, Regulation E covered debit cards, and no laws really covered prepaid cards.” Today, however, the line between prepaid and debit is blurring. The FDIC and the Federal Reserve have proposed rules that would effectively treat some prepaid cards more like debit cards. States, he explained, have also become more interested in prepaid card regulation, passing statutes that address dormancy fees, redemption periods, and expiration dates. “Today you have some rather complex regulation of a product that, up until recently,” Budnitz explained, “was hardly regulated at all.” Such regulation provides consumers with some non-uniform protections at the expense of making the overall regulatory scheme more complicated.⁹

Budnitz concluded his discussion of consumer confusion by criticizing the current regulatory structure as inadequate, overly complicated, and misleading. “By targeting regulation at the sector or product level,” he asserted, “we have created a system that is non-uniform and treats seemingly similar transactions very differently. Such a system does not promote transparency or consumer understanding of rights.”

“We Need Uniform Consumer Protection Standards”

Budnitz’s recent research has focused on finding ways to make the current regulatory scheme more consistent and easier to understand. Although he is still working on an article that will explain his proposals for legal reform in detail, he argued that there should be some level of

⁹ For a thorough discussion of the regulatory issues facing prepaid card products, see the following paper that summarizes a conference the Center hosted in June 2004: Mark Furletti, “Prepaid Cards: How Do They Function? How Are They Regulated?” Federal Reserve Bank of Philadelphia, Payment Cards Center Discussion Paper (August 2004), available at http://www.phil.frb.org/pcc/papers/Prepaid_Cards.pdf.

federally mandated protection available on all payment products. As a starting point, he argued that the following three protections be adopted: (1) mandatory disclosures; (2) caps on consumer liability for unauthorized use; and (3) error resolution procedures. These protections, Budnitz argued, should derive from federal legislation, be uniform in their application, and cover *all* types of consumer payment vehicles.

In Budnitz's view credit cards and debit cards already have sufficient federal disclosure requirements as mandated by Regulations Z and E, respectively. He proposed creating new disclosure requirements, however, for various check products and prepaid cards. For checks, consumers should be informed about how post-dated checks are processed and the requirements for using checks to discharge claims that creditors might have against consumers. Check writers should also be made aware of how their rights might be affected if their checks are truncated. For prepaid card customers, Budnitz called for the disclosure of a variety of card attributes, including any expiration date, potential fees, and redemption rights. Prepaid cards should also come with a toll-free number that consumers can use to obtain balance information, inquire about billing errors, and request reimbursement for card losses.

Budnitz also advocated limiting consumer liability for the unauthorized use of any payment vehicle. At present, users of credit cards, debit cards, and checks are already protected from liability for unauthorized charges. Budnitz would like to extend similar protection to prepaid cards. He suggested, for example, that a prepaid cardholder's liability for unauthorized charges should be limited to \$50 as long as a cardholder notifies her issuer of a loss in time for the issuer to block the card's further use (and where such a block is feasible). This liability limit is analogous to the limit established by Regulation E for debit cardholders who promptly notify their issuers about unauthorized use.

Finally, Budnitz asserted that all payment products should have some form of error resolution protection. Currently, prepaid cards and most checks do not have any federally required error resolution mechanisms. Citing Regulation E's error resolution procedures as a

model, Budnitz would like consumers to have 60 days to notify their bank about a possible error and banks to have a maximum of 45 days to investigate it. He also advocated that such investigations extend beyond errors made within consumers' banks to those made by merchants and other financial institutions that might have been involved in processing the payment.

Uniformity of consumer protections across payment vehicles, Budnitz asserted, would benefit all payment market participants. For consumers, such protections would reduce confusion and increase the likelihood that they would try new payment products. For the industry, uniform federal standards would make it easier to comply with federal law and improve consumers' overall confidence in the payments system. Finally, for regulators, uniform standards would simplify the process of crafting and enforcing regulations. Overall, Budnitz noted, such reforms would add integrity to the system and make it more rational.

While Budnitz would like to see a uniform system of protection based in federal law, he believes that states should play a role in shaping the protections. "State consumer protection laws that do not conflict with federal standards and that give consumers additional protection," he asserted, "should not be preempted." Budnitz recognized that states play an important role as "laboratories" for policy "experiments." While products are still in their infancy, however, he thought states should be discouraged from imposing overly burdensome regulation. His approach would balance the need for uniformity with the need to let states experiment with new and creative policy solutions.

Budnitz emphasized that, while the goal of his proposed reforms is uniformity, there would likely have to be exceptions, exemptions, and variations for certain products. "There are a number of factors, including operational issues," he said, "that require some variation of these protections by product." He also indicated that there would likely need to be some "de minimus" exceptions to the policies (e.g., for prepaid cards with very little value loaded onto them). A "transitional" period for newly introduced payment technologies would also be necessary. During

the transitional period, however, he indicated that the federal minimum protections should still apply.

Conclusion

Budnitz believes that, from a consumer's perspective, the payments landscape is overly complex. Regulation varies too much at the product level. In addition, a consumer's rights are determined by the processing choices of others instead of by laws based on decisions about what rights should be accorded as a matter of public policy. According to Budnitz, this creates a system that is confusing and leads to ill-informed decisions on the part of consumers. To remedy this problem, Budnitz is calling for the reformation of the system of federal laws that pertain to consumer payments. In his view, all products should have similar disclosure, error, and fraud protections. The federal government should set a protection "floor" for all products and allow states to provide additional protections. With such reforms in place, Budnitz believes that consumer confidence in the payment system will increase and the industry will find it easier to introduce innovative products.