Chapter 3

Competitive and Regulatory Environment of Electronic Funds Transfer

Chapter 3

Competitive and Regulatory Environment of Electronic Funds Transfer

Chapter Summary

Traditionally, financial institutions have been the providers of payment services. However, market and regulatory forces have encouraged others to enter the market; as a result, the mix of participants in the market is in a state of flux. In response to forces operating in the financial markets, the regulatory environment is also dynamic.

In general, American depository institutions (e.g., commercial banks, savings and loan associations) are no longer merely staid acceptors of deposits and makers of loans. They offer, and sell aggressively, diverse services including electronic funds transfer (EFT) in order to attract new customers, increase the volume of accounts held, and make a profit. In the process, old distinctions between the services offered by banks, thrift institutions, and other financial institutions are breaking down. Moreover, competing services are being marketed by nondepository institutions (e.g., securities brokers, and credit card companies) whose activities are not limited by the regulations that affect depository institutions. Money market funds, for example, allow customers to withdraw funds using "checks" and debit cards.

The key actors in the development of EFT, then, are financial institutions of all kinds; other organizations that offer EFT services; developers and manufacturers of EFT equipment and supporting technologies; telecommunication common carriers; merchants, especially large department store chains, discount chains, and supermarkets; Congress and Federal regulatory agencies; State regulatory agencies and State legislatures; and the public, as consumers and as taxpayers.

The Payments System

There are four ways of making payments–through barter, with cash, with checks, and by EFT. The use of a credit card does not result in a draft on the transaction balance of a consumer. It creates a record of the obligation to pay in the future–almost always by check. However, the use of a credit card *does* effect a transfer of funds to the acceptor from the credit card institution almost immediately upon receipt of a sales draft, Because credit cards are included in much of the debate about EFT, they are included here as an EFT service.

Cash is used in 87 percent of all transactions, but these account for only 3 percent by value (1). The amounts of hard currency exchanged tend to be small—under $10 in 95 percent of cash transactions. This is because cash is still the most convenient method of storing and transferring small amounts of value, and is almost universally accepted. On the other hand, very large cash transactions involving hundreds or even thousands of dollars sometimes indicate illegal activity and/or attempted tax evasion. Because there is likely to be no audit trail, cash offers a unique degree of anonymity that is not available to users of payment services.

Most "money" in fact exists only as information in the records of financial institutions. To shift funds from one account to another, Americans write about 32 billion checks a year, a number that has been increasing by about 5 percent annually (2). An estimated 81 percent of adults have checking accounts (3). Professionals and managers are most likely to have them, with housewives ranking second at 92 percent. Those who are less affluent and less educated are the least likely to have checking accounts. Nevertheless, over 50 percent of persons in the lower income brackets do maintain checking accounts (4).

Checks are handled an average of three times before they are returned to the writer as a receipt. There are no firm figures on the cost of processing a check. One estimate is $0.15 to $0.20 per check, with $0.50 to $0.75 for "exception processing" of the 2.7 percent of checks that have to be returned to the payee because they are rejected or bounce (5). The total cost of processing checks may be as high as $7 billion annually, excluding the costs to merchants trying to collect for bad checks and the cost of float (6). The desire to reduce the growing burden of check handling and processing is a major incentive in the move to EFT.

Approximately 62 percent of American adults have at least one credit card (7). The average household has 4.5 cards, and there are 475 million cards in use. Department store cards are the most popular, with 66 percent of all households having a card from one of the three large chains—Sears, Ward's, or Penney 's. Bank credit cards (such as Mastercard or Visa) are held by 64 percent of households, and gasoline credit cards by 49 percent (8).

Credit cards provide revenue for the service provider in three ways:

1. the merchant takes a discount that goes to the card provider,
2. the cardholder may be charged an annual fee, and
3. the holder pays interest on the debt, usually after a 25-day grace period.

However, financial institutions are prohibited from charging user fees in some jurisdictions, and there are legal limits on the interest that may be charged. Credit cards are not as profitable as they once were; thus, many institutions that provide credit card services would like to switch customers to the use of debit cards, which authorize an immediate transfer of funds from the user's account.

In spite of rising interest rates, as long as the inflation rate remains high, credit cards allow customers to manage their money to their own profit and to extend their financial flexibility. However, since financial institutions now market accounts with overdraft privileges, checks, as well as credit and debit cards, can be used as a tool for money management.

Providers and Regulators of Payment Services

The diverse financial and nonfinancial institutions providing EFT services are subject to different laws and regulatory systems on both Federal and State levels. Depository *institutions* include commercial banks, mutual savings banks, savings and loan organizations, and credit unions. No other institutions can accept deposits. These organizations are chartered either by a State or by the Federal Government, but to operate within a State a federally chartered bank must also have a State license and abide by State laws. EFT services are also offered by *nondepository institutions* including mortgage brokers, securities brokers, credit card companies, retail credit organizations, and other loan companies. A variety of specialized services are offered by companies that set up and operate under their own logo, networks of automated teller machines (ATMs) for banks.

Retail finance companies are subject to only limited regulation; brokerage firms are regulated by the Securities and Exchange Commission, but their payment services are almost completely unregulated. Depository institutions are regulated by a number of Federal and State agencies such as the following:

- *The Federal Reserve System (FRS).* All national banks are members. State chartered banks may join. FRS examines and supervises State member banks and bank holding companies. It establishes reserve requirements for members and nonmembers, distributes currency and coin, assists in the processing and clearing of checks for both member and nonmember institutions, and acts as the fiscal agent for the Federal Government. FRS services are paid for by the users.
- *The U.S. Comptroller of the Currency* charters, supervises, and examines national banks.
- *The Federal Credit Union Administration* charters and regulates federally chartered credit unions.
- *The Federal Deposit Insurance Corporation* oversees insured State banks that are not members of FRS, and insures all national banks and State banks that are members of FRS.
- *The Federal Home Loan Bank Board* regulates and insures federally chartered savings and loan organizations and federally chartered mutual savings banks.

In addition, State regulatory agencies oversee the operation of all financial institutions chartered by the State. The so-called "tangled web" of bank regulation is illustrated in figure 1.

Existing and Proposed Laws

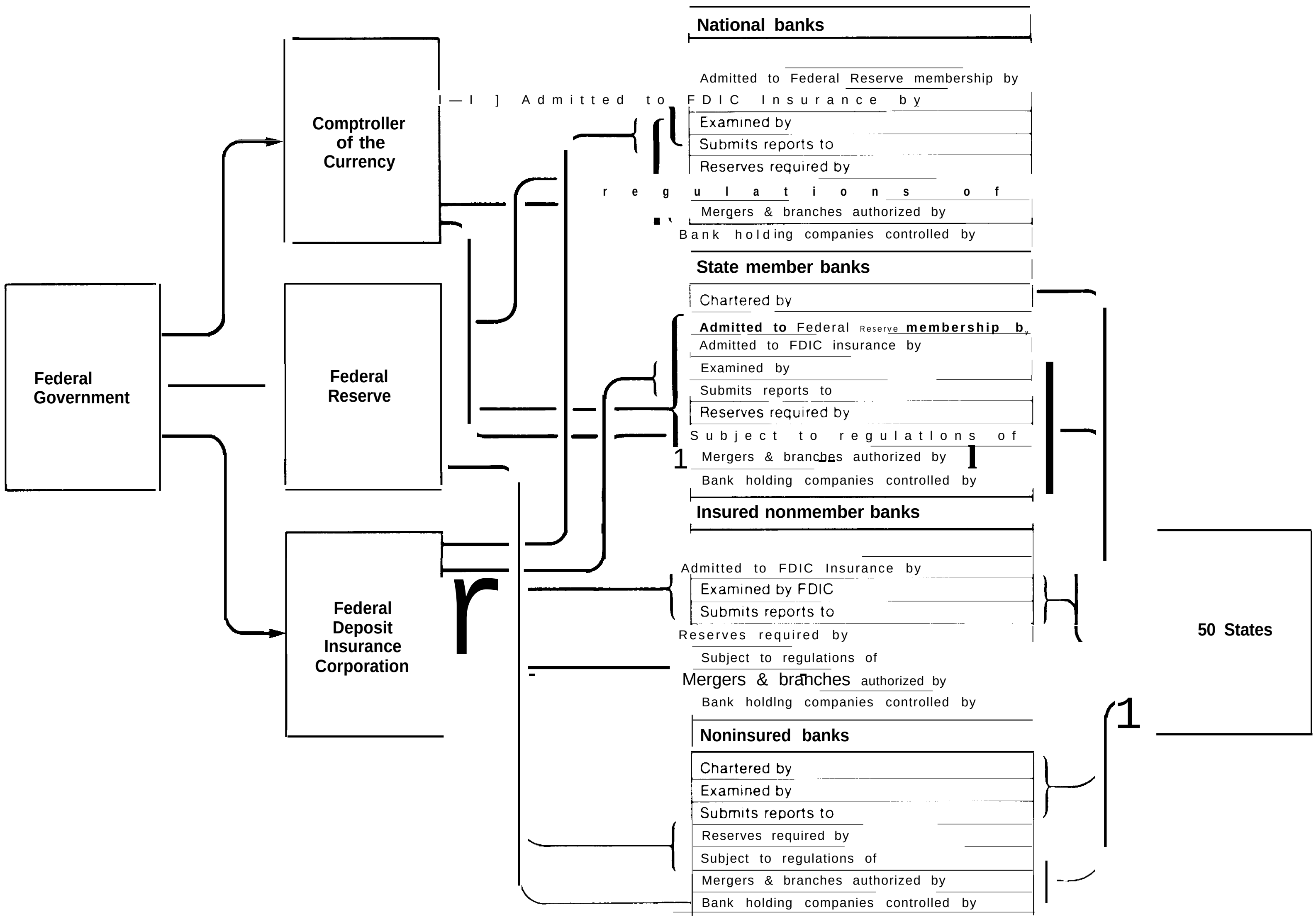
The Electronic Funds Transfer Act is title XX of the Financial Institutions Regulatory and Interest Rate Control Act of 1978 (9). This act defines the rights and responsibilities of EFT consumers and providers. For example, the act:

- sets limits on the liability of consumers if there are errors in an EFT transaction or if an improperly authorized transaction is executed;
- establishes the responsibility of consumers for ensuring the security of their EFT accounts and for reviewing statements provided by the financial institutions;
- establishes requirements for the documentation of an EFT transaction that must be provided to the consumer, including definition of the contents of a receipt provided at the time of a transaction and the timing and content of periodic statements that are issued by the service operator;
- establishes rules governing the issuance of EFT access devices.

The Right to Financial Privacy Act of 1978 (10) limits the right of the Federal Government to access financial records of individuals and small partnerships, as well as the right of financial institutions to disclose such records to the Government. It applies only to the Federal Government and not to other organizations and institutions that might seek information.

Legislation that was proposed in the 96th Congress, but not enacted, includes the Privacy of EFT Act (11) and the Fair Financial Information Practices Act (12). The first would protect privacy in EFT systems in

Figure 1.—The Tangled Web of Bank Regulation



SOURCE *Savings and Time Deposit Banking* American Institute of Banking 1968 American Bankers Association much the same way as letters and telephones are protected; it would provide criminal penalties and would allow victims to sue for damages in civil court when there is disclosure of information to anyone other than participants in the exchange or to Federal agencies with a court order. The Fair Financial Practices Act would establish more specific obligations and rights, such as the necessity to inform consumers of information-gathering practices and policies, and "enforceable expectations of confidentiality. " (See ch. 4 for further discussion.)

The 1927 McFadden Act (13) requires that national banks operating within a State abide by the State laws regarding branch banking; it effectively bars interstate branching since State laws generally prohibit such branching. However, foreign-owned banks operating within the United States are permitted to establish branches wherever they can obtain permission from the appropriate regulatory authorities. The McFadden Act prohibits banks from offering some EFT services across State lines, such as accepting deposits through their own ATMs. However, services such as telephone bill payment and the dispensing of cash are offered in some areas without regard to State boundaries. Some smaller banks have expressed the fear that larger institutions will use interstate EFT services as a wedge to penetrate their markets and eventually drive them out of business. As described below, interstate EFT services are now spreading rapidly.

Rules governing EFT services are not uniform among the States. Some prohibit the deployment of terminals because they are considered to be branches, and branching within some States is prohibited. In others, EFT services of all kinds may be offered statewide. Some States require that EFT terminals and facilities be shared among all institutions applying for access; others permit sharing at the discretion of the owner of the facility; some expressly prohibit the sharing of E FT facilities among financial institutions.

The Depository Institutions Deregulation and Monetary Control Act of 1980 (14) has a direct bearing on the legal environment in which EFT will be offered in the future. Specifically, it permits: 1) thrift institutions to offer checking services in conjunction with passbook and share draft accounts, and 2) commercial banks to pay interest on transaction balances.

Thus, some of the distinctions between thrift institutions and commercial banks have been eliminated. Thrift institutions can now offer the full range of EFT services to consumers. At the same time, because they no longer have to use devices such as TBP to get around limitations on the offering of checking services, some of the impetus behind the growth of EFT may have been reduced.

Interstate EFT Services

As already noted, the McFadden Act prohibits interstate banking. But even without direct legislative action, aggressive business decisions are being made and regulatory actions taken which are, in effect, establishing interstate financial services (15). Examples are:

- Rocky Mountain Visa bank cardholders may withdraw cash from their savings or checking (asset) accounts or draw upon a line of credit at ATMs established by participating banks in any of the seven or so States in the region. The interstate withdrawals are based on a legal opinion of counsel that they are the functional equivalent of cashing a check.
- Both Visa and MasterCard had planned to implement national ATM networks during 1981 for cash withdrawals from a

line of credit or asset account. However, this implementation did not take place.
- The cash management accounts offered by nonbanking entities such as Merrill Lynch, Shearson Loeb Rhoades, Dean Witter Reynolds, etc., look, sound, and act like checking accounts, and continue to grow. These nonbanking entities are not presently limited by Federal or State branch banking laws.
- A recent Federal Reserve Board decision concerning the definition of a commercial bank for the purpose of the Bank Holding Company Act will allow bank holding companies to hold chains of "noncommercial" banks across the Nation that may not offer checking accounts, but could provide check-like services such as ATMs or negotiable order of withdrawal (NOW) accounts.
- A ruling by the Comptroller of the Currency that EFT services provided by a bank service corporation do not constitute branch banking by the participating banks—coupled with the Comptroller's earlier ruling that a national bank sharing an ATM established by another entity does not represent interstate branching–provides legal authority for the aggressive development of ATM networks.
- The Federal Home Loan Bank Board has eliminated geographic restrictions on the remote service unit (RSU) operations of federally chartered savings and loan institutions.

This acceleration of the development of interstate services is likely to increase the pressure for revision of banking laws.

Key Actors in EFT Development

The key institutional actors are listed in table *4.* Banks and other depository institutions want rapid development of centralized EFT systems to relieve them of the heavy burden of check processing and to reduce their costs. They view decentralized EFT systems as necessary to attract new customers and to increase their volume of accounts in a market that is becoming more and more competitive. Nondepository institutions are seeking ways to compete for some portions of this market, and a variety of nonfinancial institutions strive to make a place for themselves; e.g., by providing and operating EFT devices and networks for the financial institutions.

These participants in EFT development place high priority on continued innovation and technical development to make EFT (especially decentralized systems) more cost effective and more attractive to commercial organizations. Some of the providers believe it is in their interest to respond to concerns about privacy, security, and equity, and to resolve these problems in a way that is fully satisfactory to a concerned public, if only to avoid or reduce the necessity for new legislation and regulations that might inadvertently stifle innovation and continuing improvement in the technology. Other providers believe that privacy, security, and equity are not major problems and therefore do not merit serious attention. At the same time, some financial and related institutions hope for changes in State and Federal laws that will remove barriers to branch banking, as well as other obstacles to interregional and national applications of EFT. Others, particularly the smaller institutions, do not necessarily agree with this view. They have concerns about possible encroachment on their markets by large institutions.

Providers of credit card services (which include retail chains and banks as well as some specialized companies) are finding credit services less profitable than in the past. EFT can help to reduce excessive costs (e.g., by prior authorization), but it also offers the potential for shifting customers from the use of credit cards to debit cards. Providers believe

Table 4.—Key Institutional Actors in EFT Development[a]

Financial *institutions*

Commercial banks (over 14,000)
: Banks are Involved as providers of EFT by offering ATMs and telephone bill I payer (TBP) services. Banks also participate in automated clearinghouse (ACH) and point-of-sale (POS) systems. and wire transfers.

Savings and loan associations (S&Ls) (over 4,000)
: S&Ls were in the forefront of EFT development as they tried to use EFT services to gain a competitive advantage on banks They Implemented consumer EFT like ATMs, POS, and TBP,

Mutual savings banks (MSBs) (almost 500)
: Many MSBs were less Involved with EFT at the outset since they were pioneering NOW accounts. Today they are Involved, like S&Ls. In consumer EFT services

Credit unions (CUs) (over 24,000)
: Some of the larger CUs were EFT Innovators. like S&Ls, and concentrated on EFT consumer services.

Government institutions

Federal Reserve
: The Federal Reserve was Instrumental in organizing the first ACH They have continued to provide leadership in developing standards for ACH and protocols for Interregional transfers They also have a regulatory role.

U S Treasury
: The Treasury has provided large transaction volumes to EFT by disbursing Government funds with EFT. Treasury uses direct deposit of Social Security. military retirement. and SSI checks

Regulators of financial Institutions
: Besides the Federal Reserve, there are four other major regulatory bodies the Comptroller of the Currency, the Federal Deposit Insurance Corporation (FDIC), the Federal Home Loan Bank Board (FHLBB). and the National Credit Union Administration (NCUA) These regulators define the legal environment of EFT for federally chartered institutions. State chartered institutions often come under some Federal control and are also regulated at the State level

Business institutions

Retail stores
: These stores are Involved either by having ATMs on the premises or by Installing POS terminals at check-out stands

Employers
: They participate in EFT by using direct deposit of payroll or by installing ATMs or POSs on premises as an employee benefit.

[a]Does not include the credit card associations or financial conglomerates formed through recent merger activity,

SOURCE Kent W Colton et al *Electronic Funds Transfer Systems and Crime* Public Systems Evaluation Inc February 1981 draft

that debit card services can be supplied more efficiently and profitably than credit card services.

In addition to reducing losses from bad checks and credit cards, merchants find that offering EFT services is necessary to safeguard their competitive position. The development of systems that would permit merchants to capture payment and operational data simultaneously, thus helping to control rapidly increasing labor costs, would be most important to them.

The Federal Government's role in EFT is fourfold:

1. provider (e.g., the Federal Reserve System's ACHS);
2. regulator;
3. major customer and user; and, most importantly,
4. ultimate custodian of the public interest.

It is concerned with encouraging innovation and improvement in the technology and associated networks, and with assuring reasonable levels of privacy, security, and equity in its use. State governments share these roles and objectives.

One survey indicates that most Americans are aware of decentralized consumer-oriented EFT services, even though they may not be available in their communities (see table 5). Only a small percentage of people actually use these services now. The most widely available and the most frequently used are preauthorized charges and automatic check approval, but these are often initiated by someone other than the consumer; for example, mortgageholders may encourage the use of preauthorized charges as a payment plan and merchants may refuse to honor checks without validation.

Table 5.— EFT Services: Public Awareness, Availability, Usage, and Interest

EFT Services—Awareness, Availability, **and Usage**

	Awareness	Availability	Usage	Usage index[a]
Automated teller machines ...	72.5%	31.5%	8.9%	0.283
Preauthorized charges . . .	66,6	427	166	0.389
Direct deposit of payroll	66.1	36.8	7,5	0.204
Pay-by-telephone bill paying	55.7	17,8	2.5	0140
Automatic check approval at POS	42.1	24.1	7.6	0.315
Bank{ng at POS	32,0	8.5	1.9	0.224

***EFT** Services—Interest*

	Interest index[b]
Automatic check approval at POS	'1,23
Automated teller machines . . .,	1.18
Banking at POS. .,	063
Pay-by-telephone bill paying .,	062
Direct deposit of payroll ., ., .,	0.60
Preauthorized charges.	
Fixed amount	0.49
Varying amounts	0.31

[a]Computed by dividing the usage rate by the availability rate
[b]The interest index is computed by dividing the combined favorable attitudinal responses "definitely" and "probably" by the combined unfavorable attitudinal responses "probably not" and "definitely not"

SOURCE. Off Ice of Technology Assessment and *Payments Perspectives* '78, Payments Systems, Inc and Darden Research Corp

Chapter 3 References

1. Payment Systems Inc. and Darden Research Corp., *Payment Systems Perspectives* '78 (Atlanta: 1978); and Federal Reserve, "The Payment System in the United States" (Jan. 25, 1979), pp. 4-7.
2. Federal Reserve Bank of Atlanta, *A Quantitative Description of the Check Collection System,* 1981.
3. Payment Systems, Inc. and Darden Research Corp., op. cit., p. 53.
4. Ibid., p. 51.
5. Working Paper A, Imperial Computer Services, *Electronic Funds Transfer: The Policy Issues* (May 1979), Part II, "A Typology of Information Relevant to the Study of Electronic Banking, " p. 16.
6. Ibid., p. 18.
7. Payment Systems, Inc. and Darden Research Corp., op. cit., pp. 89-90.
8. Ibid., see *also* data from A. J. Wood Research Corp., in *BankCard,* August 1978, p. 2.
9. Public Law 95-630 2002, 92 Stat. 3641, codified in the Consumer Credit Protection Act, 15 U.S.C. 1601 et. seq.
10. Title XI, Public Law 630, 12 U.S.C. sec. 3401 et. seq.
11. S.1929, 96th Cong.
12. S.1928, 96th Cong.
13. 12 U.S.C. 36.
14. Public Law 96-221.
15. Examples from Fred M. Greguras in letter to OTA, Sept. 9, 1981.