



FEDERAL RESERVE BANK OF PHILADELPHIA



A newsletter published by the Payment Cards Center, providing meaningful insights into developments in the payment card industry

From the Director *Peter Burns, Vice President & Director*

Fall 2004

Welcome to this edition of *Update*, a publication of the Payment Cards Center that highlights recent Center activities. Also available on our web site, *Update* complements the more complete set of content at www.phil.frb.org/pcc.

The Payment Cards Center was established at the Federal Reserve Bank of Philadelphia to develop insights and to communicate about issues relevant to the rapidly expanding arena of consumer payments. Its goal is to inform debate on current issues facing the industry and policymakers.

One way in which the Center pursues this goal is through its forums and conferences. A key to the success of these events has been the particular attention paid to bringing together the right group of experts to focus on current issues. Featured in this issue are two such conferences held earlier this year.

The first, a forum titled “Identity Theft: Where Do We Go from Here?,” focused on the dramatic growth in this new type of payment fraud. The discussion benefited from the perspectives offered by experts from the credit card industry, technology firms, credit reporting agencies, and the law enforcement, legal, and regulatory communities. As described more fully in this newsletter, discussion of the question where do we go from here revealed the need

for cooperation among all affected parties.

The second conference dealt with another development in payment cards: prepaid cards. As discussed in the sessions of “Prepaid Cards: How Do They Function? How Are They Regulated?” the market for prepaid cards is growing rapidly and expanding well beyond the original gift-card application. At the same time — and as with most financial-product innovations — there are growing uncertainties about applying existing laws and regulations to the governance of these new product categories. The quality of the dialogue on these and other critical issues was enhanced by contributions not only from lawyers and regulators but also from retailers, bankers, processors, and others who deal with specific prepaid business applications.

In addition to sponsoring conferences and forums, the Payment Cards Center actively supports original research and analysis. A list of recent papers written by the Center’s staff, colleagues from the Bank’s Research Department, and academic visitors is included in this newsletter. We have highlighted one particular effort, a Discussion Paper on “The Debate Over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards.” This timely analysis provides details about the act itself and

Mission Statement

The mission of the Payment Cards Center is to provide meaningful insights into developments in the payment card industry that are of interest not only to the Federal Reserve but also to the industry, other businesses, academia, policymakers, and the public at large. The Center will carry out its mission through an agenda of research and analysis as well as forums and conferences that will encourage a dialogue that includes industry, academic, and public-sector perspectives.

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outlines the evolution of related judicial opinions over the subsequent 140 years. The paper makes a particular contribution in its analysis of how the law and subsequent interpretations have shaped the credit card industry.

In support of the Center's own research agenda, staff analysts have been developing data sets and categorizing information relevant to the study of consumer credit and payments. Earlier this year, we upgraded two of these research tools — the Data Dictionary and a search-

able Consumer Payments Online Bibliography — and made them available on the Center's web site. We've provided a brief description of both in this issue of *Update*.

I hope you will enjoy reading this issue, and I thank you for your interest and support. As always, I welcome your thoughts as to how the Center can better serve the needs of market participants and other parties interested in this important and dynamic sector of the financial services industry. U

“Recent Developments in Consumer Credit and Payments”

**A Conference Sponsored by the
Research Department and Payment Cards Center of the
Federal Reserve Bank of Philadelphia
September 29-30, 2005
Call for Papers**

This conference will bring together researchers and industry professionals working on issues related to consumer credit and payments. Both theoretical and empirical papers are welcome. We also encourage researchers to submit papers on consumer credit or payments outside the U.S.

The deadline for submitting papers is June 1, 2005.
Visit www.phil.frb.org/econ/conf/conferences.html for more information.

“Identity Theft: Where Do We Go From Here?”

A Payment Cards Center conference held February 10, 2004



Many observers have described identity theft as the “fastest growing crime in America.” According to the Federal Trade Commission (FTC), consumer complaints have nearly doubled almost every year since the agency began tracking the crime. Further, the FTC reported that in the one-year period ending June 2003, crime associated with identity theft had affected nearly 10 million consumers and cost businesses and victims upwards of \$50 billion and \$5 billion, respectively.

Obviously, the direct financial costs of this crime are damaging. Even more insidious, though, are the indirect costs to victims of identity theft, who are faced with a lengthy and complex process to restore their credit standing. Moreover, as Philadelphia Fed President Anthony Santomero emphasized during the conference’s opening talk, it is critical that payment systems command the trust and confidence of consumers. Left unchecked, an increased incidence of identity theft and the onerous consequences for victims could threaten the growth of electronic payments and restrict progress toward a more efficient payments system.

To address these issues, the Payment Cards Center, in conjunction with Gartner Inc. and the Gartner Fellows Program, sponsored the discussion forum, “Identity Theft: Where Do We Go From Here?” In part, the forum was motivated by an earlier Payment Cards Center workshop on the same topic led by Avivah Litan, vice president and research director of Financial Services at Gartner. The February conference brought together participants from banks, retail merchants, Internet service and technology providers, and regulatory and law enforcement agencies. The intent was to allow this diverse group of stakeholders to share their perspectives and to develop new insights into the effort to coordinate solutions to the problem of identity theft.

Over the course of the four-session program, three general themes emerged: the definition and scope of identity theft and its impact on solutions, the efforts to track identity theft and to share data with law enforcement agencies, and the role of government in protecting the victim of identity theft.

Early in the program, it became clear that the way participants defined identity theft depended on the role they played in fighting this crime. In enacting the Identity Theft and Assumption Deterrence Act of 1998, lawmakers, for example, aimed to provide broad consumer protections against the fraudulent use of personal information in any form. Alternatively, credit card issuers have developed very segmented approaches to managing fraud, and they use a much narrower definition of identity theft. Legally, there is no distinction between fraud committed with a lost or stolen credit card and the more complex frauds that occur when



Richard Goldberg, Chief of Financial Institution Fraud and Identity Theft Section, U.S. Attorney’s Office, Eastern District of Pennsylvania, and Lois Greisman, Associate Director for the Division of Planning and Information, Federal Trade Commission

the perpetrator uses someone else's identity to establish new accounts, often with multiple lenders. The banking industry, on the other hand, uses very different detection and prevention tools in dealing with these two types of fraud and applies the term identity theft only to the latter, more-difficult-to-detect form of identity fraud.

Danny Buttafogo, of Juniper Bank, and Michael Cunningham, of JP Morgan Chase, emphasized that the industry's success in managing and controlling payment fraud is, in large part, the result of such a nuanced approach. Once the rationale behind the different definitions of identity theft was recognized, participants accepted a statement by Lois Greisman, of the Federal Trade Commission (FTC), that such definitional distinctions were not necessarily roadblocks to solutions but, instead, could be assimilated into the search for solutions.

Assistant U.S. Attorney Richard Goldberg emphasized that prosecuting crimes related to identity theft alone is not a sufficient response. The extent to which personal information is accessible in our society — and the numerous potential “points of compromise” — presents particular investigative challenges. Instead, he argued that solutions must include a combination of establishing robust protocols for protecting data, tracking incidents, and giving law enforcement agencies access to case data. Several participants outlined initiatives to achieve these goals, including the FTC's Data Clearinghouse and BITS Identity Theft Assistance Center.

As the discussion turned to consumer protection, Oliver Ireland, of Morrison and

Foerster, LLP, noted that the Fair and Accurate Credit Transactions Act of 2003 (FACT Act) includes important provisions that should go a long way toward providing consumers with tools to assist them with protecting personal data, monitoring their credit data, and recovering their credit standing. Other participants observed that the FACT Act's success will also depend on consumer education programs.

Howard Schmidt, of eBay, stressed that another component of finding a solution to the problem of identity theft resides in developing ubiquitous authentication technology. He

An ability to coordinate efforts to fight identity theft will assist all market participants in limiting its effects, both financial and otherwise.

believes that such a system is technologically within reach but that it must be marketed in a way that encourages widespread adoption.

Participants generally agreed that in developing solutions, it is important to leverage the experience of each stakeholder group and to recognize that each plays a particular role in fighting this crime. At the end of the day, an ability to coordinate efforts to fight identity theft will assist all market participants in limiting its effects, both financial and otherwise.

For more details on the day's discussions, including additional insights gleaned from these sessions, please see the conference summary entitled, “Identity Theft: Where Do We Go From Here?” on the Center's web site. 

“Prepaid Cards: How Do They Function? How Are They Regulated?”

A Payment Cards Center conference held June 2-3, 2004

In the last half century, payment cards – first credit cards and later debit cards – became established methods by which consumers paid electronically for goods and services. Since then, consumers have progressively migrated to electronic payments. Indeed, according to a recent Dove Consulting and American Bankers Association study, in 2003, for the first time, electronic payments surpassed traditional paper (cash and check) as a percentage of total consumer in-store payments.

A small portion of these electronic payments were attributed to a relative newcomer to the payments system: the prepaid card. A prepaid card is essentially a payment card with an amount of pre-loaded value. It offers a “pay early” value proposition, rather than the debit card’s “pay now” or the credit card’s “pay later” model. One of the first prepaid card applications, and also one of the most popular, is the merchant-issued gift card. Forty-five percent of U.S. adults have purchased at least one of these cards. Consumers’ adoption of the notion of “prepaid” has led to a range of new types of prepaid cards, all leveraging the idea of preloaded value.

This growing popularity and proliferation suggest that prepaid cards are gaining traction as a convenient payment alternative for many consumers. Prepaid card applications are also attracting policymakers’ attention.

To promote dialogue on this subject, the Payment Cards Center hosted the conference “Prepaid Cards: How Do They Function? How Are They Regulated?” at the Federal Reserve Bank of Philadelphia. The Center invited partici-

pants representing a wide range of perspectives in order to better understand specific prepaid business models, including gift, payroll, and flexible spending account (FSA) cards. More generally, the conference probed critical policy issues associated with prepaid cards: the market challenges faced by prepaid card issuers, the laws in place and under consideration to regulate this payment product, and the protections afforded to consumers who use these cards.



Peter Burns, Director, Payment Cards Center, with Jack Williams, National Processing Corporation

Ron Congemi, president of Debit Services and Star Systems for First Data Corporation, provided the event’s keynote address, during which he characterized the prepaid market as one of significant opportunity in terms of purchase volume growth, consumer adoption, and diversity of offerings. At the same time, Congemi emphasized that the ultimate success of prepaid applications lies in market partici-



pants' ability to address these challenges: dealing with an increasing number of new industry participants, some of which will prove to be "rogue" players; making the right technology and marketing investments; resolving legal and regulatory uncertainties; and managing new fraud vulnerabilities.

The Federal Reserve Bank of Philadelphia's president, Anthony M. Santomero, welcomed the conference participants and opened the day's discussions. He emphasized that the people in the room represented a broad set of perspectives and a diversity of experience invaluable to collective efforts to ensure continued and healthy growth in this payment channel. Santomero challenged the assembled group to engage in open dialogue aimed at achieving a shared goal: protecting consumer assets while at the same time encouraging growth in this important new segment of consumer payments.



Ronald Congemi, President,
Debit Services and Star Systems,
First Data Corporation

Beginning the formal sessions, Jack Williams, of National Processing Corporation, characterized prepaid applications as a market of extraordinary opportunity but also one of growing regulatory uncertainty. He highlighted the potential for prepaid cards to provide real value to under- and unbanked consumers. In this sense, he argued that prepaid cards could act as a bridge to building more traditional banking relationships with this relatively underserved segment of the population.

The discussion continued with a focus on specific types of prepaid cards and the ways in

which they function. The conference summary provides an analysis of the most popular prepaid card program — the gift card — as well as two emerging prepaid applications: the payroll card and the flexible-spending-account (FSA) card. Gift cards can be issued by merchants typically as a "private" program or by financial institutions using the more recently introduced "open" program. Private programs are restricted in that the recipient can use the card only in limited locations. Open programs, however, allow the recipient to use the card anywhere the cards of the sponsoring network (i.e., Visa or MasterCard) are accepted. Generally, payroll cards allow employers to credit paycheck dollars to a prepaid card product while FSA cards act similarly for qualified pre-tax dollars in company health plans.

Addressing the "unsettled" regulatory environment, Judith Rinearson, former counsel to American Express' prepaid card business, aptly described prepaid cards as standing at the intersection of multiple kinds of laws. Federal lawmakers and state legislators are considering new statutes and applying existing statutes to prepaid card applications. Primary areas being addressed include protecting the preloaded value before it is spent by the consumer, establishing consumer liability limits in the case of fraud, determining ownership for unused portions of preloaded value, and clarifying the role and regulation of nonbanks operating in the prepaid card industry. The general discussion of these issues focused on how differently many of these legal and regulatory issues affect the wide variety of applications.

At the end of the day, participants shared a general feeling of optimism about the opportunities presented by prepaid applications,



including their use as a mechanism to encourage participation in the payments system by the traditionally under- or unbanked segment of the population. They also generally accepted that prepaid applications — leveraging the concept of preloaded value — can apply to a wide range of business models. As such, regulation of this payments category presents a challenge because any regulations formulated need to consider this diversity. At the same time, participants agreed that a degree of regulation can aid stakeholders in structuring a prepaid market that provides

greater accountability for issuers, harmonizing state law applied to these products, and continuing to provide all consumers with a breadth of prepaid products in a cost-effective and safe manner.

For a more detailed summary of the day’s discussion, please see the conference summary entitled, “Prepaid Cards: How Do They Function? How Are They Regulated?” on the Center’s web site. 

The National Bank Act and the Credit Card Industry

A Payment Cards Center Discussion Paper

Prior to the Civil War, our nation’s bank-related activities, including issuing currency and chartering and regulating banks, took place at the state level. As our economy grew and became more national in scope, Congress recognized that this system was inadequate. In response, it passed the National Bank Act of 1864 (NBA). The NBA established a national banking system that could create a uniform national currency and support an increasingly national economy. The act was passed during the Civil War, a time of great conflict between many states and the federal government. As such, the act was also intended to protect the new national banking system from potential state interference. The NBA established the Office of the Comptroller of the Currency (OCC), under the Department of the Treasury as its implementing agency, and gave it the responsibility for examining, supervising, and regulating nationally chartered banks.

One of the ways in which the NBA protects national banks is by “preempting,” or rendering inapplicable, any state laws that conflict with either the NBA or the regulations promulgated by the OCC pursuant to the NBA. In effect, the NBA provided national banks with an exemption from certain types of legislation enacted by individual states. As a result, the NBA has played a particularly significant role in the development of retail financial services. Specifically, by making federal law supreme, the governance structure has eliminated a national bank’s need — and a significant cost — to meet a patchwork of state regulation and, at the same time, has facilitated its ability to reach a national customer base.

The NBA’s history of preemption has sparked much debate over the last half century about the OCC’s powers versus states’ rights to

regulate the increasingly national credit card industry. National banks account for more than three-fourths of all outstanding credit card loans in the United States today.

In “The Debate Over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards,” Mark Furletti reviews these and other developments, including the regulatory and judicial history of OCC preemption rulings. He also discusses how these preemption rulings have shaped the development of the national credit card industry and consumers’ access to credit. Last, he analyzes the current debate over preemption and suggests policy implications for the future of the payment card industry.

Furletti’s paper presents significant court cases that challenged the NBA’s legislative intent to use preemption to “protect national banks” and, at times, tested the OCC’s authority to

included not only interest but also certain account fees, such as late, overlimit, and annual fees. Importantly, with respect to this challenge, in a 1996 unanimous decision, the Supreme Court of the United States supported the OCC’s authority to preempt state law that attempted to regulate such fees.

The second dimension of preemption, based on section 24(seventh), corresponds to preemption of state laws that regulate nonprice-related credit card terms, such as those that mandate consumer-related disclosures. These issues have been the focal point of recent debate on preemption powers related to the credit card industry.

A particular contribution of the paper is the discussion of how the National Bank Act and subsequent court decisions have shaped the credit card industry. Among the areas covered are the evolution of national markets for credit cards and the broadening of consumers’ access to unsecured credit.

The NBA has played a significant role in...retail financial services.

preempt state law. The paper segments these court cases into two distinct strands: those that address price-related terms for credit cards under authority granted in Section 85 of the NBA, and those that address nonprice-related terms under authority granted in Section 24(seventh) of the NBA.

In 1978, the Supreme Court, in *Marquette National Bank of Minneapolis v. First Omaha Service Corporation*, found that section 85 of the NBA provided for the preemption of state laws that regulated price-related lending terms. Additionally, in response to later challenges, various courts ruled that credit card pricing terms in-

In closing, Furletti outlines the current debate on whether the OCC has overstepped its NBA mandate when acting to preempt state consumer protection law. Of particular concern to consumer groups and state regulators is the potential risk to consumers from predatory lending in the mortgage industry. While Furletti concludes that in the current debate there is little overlap with credit card lending, the larger issue of preemption and its impact on national credit card businesses will require continued attention.

The full paper is available on the Payment Cards Center’s web site and will be published in the *Temple Law Review* this winter. 

Recent Publications

The Payment Cards Center's commitment to industry analysis and research is fulfilled through its support of consumer payments- and payment cards-related papers written by Center staff, visiting scholars, researchers affiliated with the Center, and economists in the Bank's Research Department. These papers can take several forms: Discussion Papers, Conference Summaries, Working Papers, and Business Review articles. Discussion papers and conference summaries are written by Center staff for a wide audience, including industry professionals, regulators, consumers, and academics and can be based on PCC-sponsored conferences or workshops or on original staff research. Working Papers are intended for the professional researcher and are written by Center visiting scholars, economists in the Bank's Research Department, and other economists affiliated with the Center. The Business Review includes less technical articles written by economists in the Bank's Research Department.

Recently published papers are available in pdf format on the Center's web site. A chronological listing of papers posted to the site in 2003 and 2004 follows.

2003

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| 03-01 Mandatory Arbitration Clauses in the Credit Card Industry | 03-13 Consumer Credit Counseling: Credit Card Issuers' Perspectives |
| 03-02 Credit Card Pricing Developments and Their Disclosure | 03-14 Cost Savings from Electronic Payments and ATMs in Europe |
| 03-03 An Overview of Consumer Data and Credit Reporting | 03-15 Measuring Credit Card Industry Charge-offs: A Review of Sources and Methods |
| 03-04 What Is the Value of Recourse to Asset-Backed Securities? A Clinical Study of Credit Card Banks | 03-16 Consumer Bankruptcy: How Unsecured Lenders Fare |
| 03-05 Credit Card Securitization and Regulatory Arbitrage | 03-17 Identity Theft: A Pernicious and Costly Fraud |
| 03-06 Voting with Your Feet: Consumers' Problems with Credit Cards and Exit Behaviors | |
| 03-07 Financial Privacy: Perspectives from the Payment Cards Industry | |
| 03-08 An Introduction to the Economics of Payment Card Networks | |
| 03-09 Theory of Credit Card Networks: A Survey of the Literature | |
| 03-10 Innovations at the Point of Sale | |
| 03-11 Antitrust Issues in Payment Card Networks: Can They Do That? Should We Let Them? | |
| 03-12 After the Hype: e-Commerce Payments Grow Up | |

2004

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| 04-01 Prepaid Card Markets & Regulation | |
| 04-02 The Debate Over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards, <i>Temple Law Review</i> (forthcoming 2004) | |
| 04-03 Identity Theft: Where Do We Go From Here? | |
| 04-04 Prepaid Cards: How Do They Function? How Are They Regulated? | |

Payment Cards Center Announces

New Resources Available on Its Web Site

Consumer Payments Online Bibliography

The Payment Cards Center's Consumer Payments Online Bibliography is the result of recent searches conducted by the Federal Reserve Bank of Philadelphia's Payment Cards Center, Research Department, and Research Library on consumer payments. Its purpose is to provide researchers and interested parties with a searchable bibliography of academic

articles, books, reports, and publications related to consumer payments. The bibliography can be searched by category, publication type, author's last name, or a combination of the three. The bibliography is accessible on the Payment Cards Center's web site at www.phil.frb.org/pcc/bibliography.cfm.

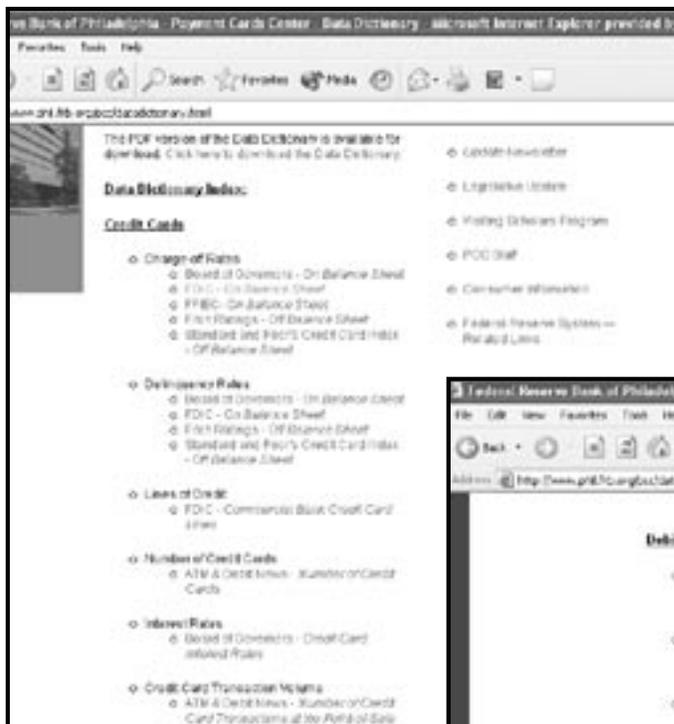


Data Dictionary

The Payment Cards Center's Data Dictionary provides information on relevant industry statistics to researchers and others interested in the payment card industry. Gathering payment card industry data can be difficult because there are often multiple sources for seemingly similar statistics. Definitions and calculations of statistics are also difficult to find and interpret. To address these problems, PCC staff developed this dictionary of industry statistics and, where

necessary, worked with analysts at source institutions to confirm definitions and calculations.

The dictionary is a work in progress, and additional statistical categories will be added over time. Terms in the following categories are described in the dictionary: credit cards, debit cards, ATMs, and consumer credit, and they are indexed as shown below. The Data Dictionary is available on the Payment Cards Center's web site at: www.phil.frb.org/pcc/datadictionary.html.





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Update

Payment Cards Center Newsletter

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The Payment Cards Center was established to serve as a source of knowledge and expertise on this important segment of the financial system, which includes credit cards, debit cards, smart cards, stored-value cards, and similar payment vehicles. Consumers' and businesses' evolving use of various types of payment cards to effect transactions in the economy has potential implications for the structure of the financial system, for the way that monetary policy affects the economy, and for the efficiency of the payments system.

"The Philadelphia Reserve Bank will be broadly recognized as an important center of central bank knowledge and capability."

*Anthony M. Santomero
President*