



DISCUSSION PAPER

PAYMENT CARDS CENTER

The Laws, Regulations, and Industry Practices That Protect Consumers Who Use Electronic Payment Systems: ACH E-Checks & Prepaid Cards

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Summary: This is the second in a series of three papers that examines the protections available to users of various electronic payment vehicles who fall victim to fraud, discover an error on their statement, or have a dispute with a merchant after making a purchase. Specifically, it examines the federal and state laws that protect consumers in the three situations described above as well as the relevant association, network, and bank policies that may apply. The protection information included in this paper is derived from a wide range of public and non-public sources, including federal and state statutes, issuer-consumer contracts, and interviews with scores of payments industry experts. This second paper focuses on two increasingly popular electronic payment methods: ACH electronic check applications (e-checks) and branded prepaid cards. The first paper in the series examined the two most widely used electronic payment vehicles: credit and debit cards. The third paper will discuss broader industry and policy implications of the authors' findings.

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I. Introduction

This is the second in a series of three papers that examine the protections available to users of electronic payment vehicles who fall victim to fraud, discover an error on their statement, or experience a dispute with a merchant. The first paper in this series, “The Laws, Regulations, and Industry Practices That Protect Consumers Who Use Electronic Payment Systems: Credit and Debit Cards,”¹ focused on the protections associated with credit and debit cards, the two most popular methods of electronic payment. This paper analyzes how consumers are protected from the problems associated with fraud, error, and a merchant dispute when they use ACH electronic check applications (e-checks) and prepaid cards, two newer and fast-growing forms of electronic payment.² The third paper in this series will discuss some of the implications of the findings of the first two papers. Ultimately, the goal of this series is to provide a better understanding of the interrelated body of laws and policies that protect consumers when they encounter the most common electronic payment problems. As the means of consumer payment shifts from paper to electronics,³ such an understanding becomes increasingly important for all those with a stake in the payment system, including consumers, regulators, networks, processors, and financial institutions.

For the purpose of this analysis, fraud occurs when an unauthorized person accesses the value associated with a payment vehicle. Error refers to a nonmalicious or innocent mistake by a merchant, such as when a merchant accidentally charges someone twice for a purchase or “mis-keys” a transaction (e.g., charging a person \$179 instead of \$17.90). A merchant dispute is a disagreement that arises between a merchant and a consumer after payment has been made for

¹ This paper is available on the Center’s web site at <http://www.philadelphiafed.org/pcc/papers>.

² While the focus of this paper is on ACH electronic check applications (e-checks), the rules and practices discussed in the ACH section of the paper apply equally to other kinds of ACH debits, such as the recurring debits consumers use to pay their utility and mortgage bills (i.e., PPDs).

³ The recently released *Federal Reserve Payment Study* notes that, in 2003, the number of electronic payments exceeded paper checks paid in the United States. The study (of consumer *and* business payments) reports that there were 43.7 billion electronic payments and 36.7 billion checks paid. Electronic payments accounted for 55 percent of non-cash payments in 2003, up from a 42 percent share in 2000. A copy of the entire study can be found at <http://www.frbservices.org/Retail/pdf/2004PaymentResearchReport.pdf>.

goods or services. Such disagreements may arise when a merchant does not deliver goods to a customer as promised or when the goods a merchant delivers differ (e.g., in quality, quantity, size, or color) from those the consumer had expected to receive.

The authors gathered consumer protection information about the two payment systems analyzed in the paper from a variety of public and nonpublic sources. Details about any relevant federal and state protections are based on a review of statutes, regulations, case law, and agency interpretations. Some of the information regarding protections provided by payment networks and banks comes from public sources, such as web sites, account agreements or contracts, press releases, and trade publications. Most of the detailed information about the internal rules and policies of banks and payment networks, however, is based on a series of interviews with scores of industry compliance officers, product managers, and attorneys who support the various payment products discussed. The information gathered through the interviewing process was verified and reviewed by industry experts before inclusion in the paper.

The analysis that follows is organized by payment vehicle type. It discusses the applicable federal laws, state laws, payment network rules, and bank policies that aid consumers in the three situations described above when they use ACH e-checks and bank-issued prepaid cards. Two appendices at the end of the paper summarize the protections according to the type of payment vehicle.

II. How Consumers Are Protected From Fraud, Error, and Merchant Disputes

As described above, there is a complex web of protections that consumers may be able to rely on when they fall victim to payment fraud, discover an error, or experience a post-purchase dispute with a merchant. Consumers should realize, however, that the source of a particular protection (e.g., a federal or state statute, a contract, or an internal company policy) can greatly determine the protection's usefulness. The protections described in this paper that derive from federal and state law are essentially undeniable. While statutory protections may be open to

interpretation by the courts, they generally cannot be waived by the consumer or modified without legislative action. Protections explicitly described in the contracts between consumers and issuers of payment instruments also have the force of law. Contractual protections, however, can usually be modified unilaterally by an institution and may be unclear or ambiguous as to their scope or application. Payment network rules and internal bank policies that provide additional protections do not have the force of law. Institutions can change these rules and policies without notice to consumers and interpret them largely as they see fit. In general, the value of these protections may depend on a particular organization's business model, regard for its reputation, and attitude toward customer service.

In addition to describing the federal and state laws that protect consumers, the following analyzes the voluntary protections afforded consumers by the policies of private networks and banks. Specifically, it attempts to characterize the *general industry practice* with regard to helping consumers resolve errors, fraud, and disputes with merchants. Obviously, each bank and network has its own set of rules and policies, and the reader should not rely on this paper's characterization of these for the purpose of resolving any actual payment problem. In addition, the reader should note that this characterization of industry practice is *not* based on a survey of the more than 7500 insured commercial banks in the U.S. or the scores of payment networks in existence. Instead, it relies on conversations with a number of experienced bank and network professionals who have a good understanding of how the industry functions.

A. ACH E-Checks

The Automated Clearing House (ACH) system is a nationwide consumer and commercial payment network that is primarily used to transfer funds among U.S. financial institutions. It is similar in function to the networks operated by the credit card associations (e.g., Visa and MasterCard) and the regional electronic fund transfer networks (e.g., Star, NYCE, Pulse). ACH relies on two communication systems: one operated by the Federal Reserve System and the other

operated by the Electronic Payments Network (EPN). Regardless of which network is used to facilitate an ACH payment, the rules of a private body, the National Automated Clearing House Association (NACHA),⁴ govern the transaction.

ACH-based products are becoming increasingly popular vehicles for consumer-to-merchant payments. Once primarily used for directly depositing employees' salaries into their bank accounts and paying recurring bills (e.g., utility and mortgage bills), the system is now used to reduce the costs to merchants associated with paper checks (through electronic check conversion) and to make payments to merchants over the phone or via the Internet. These new products, called electronic check applications, or e-checks,⁵ allow a merchant to withdraw money from a consumer's bank account via an ACH debit entry.⁶ In 2003, there were 1.3 billion consumer ACH e-check debit entries that moved \$344 billion.⁷ While ACH e-checks only represent approximately 6 percent of all consumer payment transactions and 1 percent of all consumer payment volume,⁸ they are among the fastest growing consumer payment mechanisms.

ACH transactions, like transactions involving debit cards, are covered by the Electronic Fund Transfer Act (EFTA) and Regulation E.⁹ As such, consumers who are party to an ACH payment have access to essentially the same federally mandated fraud and error resolution protections that apply to debit cards. They can also rely on any state-law protections that govern electronic funds transfers. Beyond federal and state law, consumers may be assisted by protections derived from two other sources: the private body of law that governs the relationships between financial institutions in the ACH network and the internal policies of banks. All of these

⁴ For more information about the National Automated Clearing House Association, see the organization's web site at www.nacha.org.

⁵ E-check transactions include web-initiated payments (WEB), telephone initiated payments (TEL), electronic check remittance conversions (ARC), and point-of-purchase check conversions (POP).

⁶ A credit entry, by contrast, is used to deposit money into a consumer's bank account.

⁷ NACHA Press Release, "Ten Billion ACH Payments in 2003, NACHA Announces," March 22, 2004 available at www.nacha.org/news/news/pressreleases/2004/Pr032204/pr032204.htm.

⁸ These statistics were obtained by dividing 2003 NACHA statistics by 2002 transaction and volume statistics (the latest available) from *The Nilson Report*, No. 799 (November 2003), p.6.

⁹ 12 C.F.R. § 205 (2004).

protections, as they relate to transactions in which a consumer's account is debited by a merchant or other party, are discussed in detail in the following subsections.

1. Electronic Fund Transfer Act & Regulation E

The consumer protections found in the Electronic Fund Transfer Act and in Regulation E, which are discussed in more detail in the first paper in this series, apply to *any* electronic fund transfer that authorizes a financial institution to debit or credit a consumer's account. That is, to be subject to the protective measures contained in Regulation E, an electronic transfer of funds need not be initiated by means of a debit card or other "access device" used by the consumer. Instead, a covered electronic fund transfer may be authorized by a consumer orally at the point-of-sale,¹⁰ by telephone, or over the Internet and, thus, effected entirely without the use of an access device. Regulation E also covers preauthorized electronic fund transfers, which are transfers of funds that are authorized by a consumer in advance to recur at substantially regular intervals of time (such as, e.g., the monthly payment of a mortgage or utility bill); most, if not all, of these transfers are made via ACH and do not involve an access device.

Where an electronic fund transfer has been made other than by the use of an access device—this includes transfers made via ACH e-check—a consumer has no liability under Regulation E for an unauthorized transfer, including one that has been preauthorized, that is initiated at the point-of sale, or that is effected over the Internet, unless the consumer fails to report the unauthorized transfer within 60 days after his receipt of a periodic statement evidencing the transfer.¹¹ Should the consumer fail within the prescribed time to provide such notice to his financial institution, the consumer may be liable for all unauthorized transfers made after the expiration of the 60-day period and prior to the giving of notice, provided the financial institution can establish that any such subsequent unauthorized transfers would not have occurred had the consumer notified it of the initial unauthorized transfer in a timely manner. Accordingly, it is

¹⁰ Note, however, that ACH rules do not permit the oral authorization of a point-of-sale ACH transaction.

¹¹ 12 C.F.R. § 205.6(b)(3) (2004).

possible that, under Regulation E, a consumer's potential liability in connection with unauthorized ACH payments may be unlimited, but only if he fails to comply with the regulation's notice requirement.¹²

If, upon perusal of her periodic statement, a consumer detects what she believes to be an error in connection with an ACH e-check that she did not authorize, she should notify her financial institution of the erroneous transfer—in person, by telephone, or in writing—as soon as possible but, in any event, not more than 60 days after the transmittal of the periodic statement. In her notice, she should provide the institution with sufficient pertinent information to identify the account and the allegedly erroneous transaction. Once she has done so, the financial institution must comply with the error-resolution procedures contained in Regulation E and, accordingly, investigate in a timely manner any error a consumer reports and promptly correct any transfer error that its investigation determines did in fact occur.

Regulation E's error-resolution procedures, however, are of no assistance to a consumer who has purchased allegedly defective goods or services using an ACH e-check and who attempts unsuccessfully to resolve any resulting dispute directly with the merchant. This contrasts sharply with the provisions of Regulation Z, which permit a consumer who uses a credit card to purchase allegedly defective goods or services to maintain against the card issuer the same claims and defenses that he would have against the merchant (subject to certain limitations).

Regulation E also provides that the Board of Governors may determine that a state statute relating to electronic fund transfers that is inconsistent with the consumer protection provisions of that regulation is preempted, at least to the extent of the inconsistency. State laws relating to electronic fund transfers that are more protective of consumers than federal law are not preempted. It does not appear to be the case, however, that any state has enacted a law that is

¹² The first two tiers of liability discussed in the first paper in this series are inapplicable to transfers effected without the use of an "access device." Official Commentary to 12 C.F.R. § 205.6 (Paragraph 6(b)(3), paragraph 2).

more protective of consumers with respect to instances of fraud, error, or merchant dispute than is Regulation E.¹³

2. ACH Network Rules

As mentioned above, there is an entire body of private law that governs how financial institutions in the ACH network interact. This body of law, known as the ACH rules, allocates liability and describes the processes by which errors and conflicts between banks are to be resolved. While consumers are not a party to these network agreements, consumers benefit from rights the agreements give to banks.

To understand how the ACH rules can be of assistance to consumers, we must first understand how an ACH e-check is processed. First, a merchant or provider of services (referred to as an “originator” in the ACH system) receives authorization from a consumer to withdraw money from his account. Next, the originator gathers the information necessary to execute a debit against the account, including the consumer’s bank account number and bank routing number. The originator then contacts its bank and requests that the bank execute an e-check debit entry against the consumer’s account on a specific date for a specific amount. At the appointed time, the originator’s bank transmits an electronic message to an ACH operator (either the Federal Reserve or EPN) who passes the message along to the consumer’s bank. After receiving the electronic message requesting the debit, the consumer’s bank debits the consumer’s account and sends the requested amount of money back through the ACH operator to the originator’s bank.¹⁴ This process is illustrated in Figure 1.¹⁵

¹³ Most states have enacted a version of Article 4A of the Uniform Commercial Code. However, that article does not apply to consumer transactions governed by federal law; accordingly, it does not apply to electronic funds transfers governed by Regulation E.

¹⁴ In ACH lingo, the originator’s bank is referred to as the originating depository financial institution (ODFI), the consumer’s bank is referred to as the receiving depository financial institutions (RDFI), and the consumer is referred to as the receiver.

¹⁵ For more information about how ACH transactions are processed, see Thomas P. Vartanian et al., *21st Century Money, Banking & Commerce* (Fried, Frank, Harris, Shriver & Jacobson 1998), p.52-3; Ronald J. Mann, *Payment Systems and Other Financial Transactions* (Aspen Law & Business 2003), p.157-65.

The cornerstone of the ACH system (and the source of most of the procedures that can be of assistance to consumers) is a guarantee by the originator's bank to the consumer's bank that any debit the originator's bank sends through the ACH system is legal and authorized.¹⁶ This guarantee is necessary because the consumer's bank has no information, such as a PIN or a card's magnetic stripe security data, with which to authenticate the validity of an ACH debit entry. In effect, the consumer's bank in the ACH process is only passively posting debit entries. Because of this passive role, ACH rules permit a consumer's bank to return any debit entry to the originator's bank that is not "authorized."¹⁷

ACH rules make it fairly easy for a consumer to declare that a transaction is "unauthorized" and trigger the process that leads to the consumer's bank returning (i.e., reversing) the ACH e-check. In general, a consumer must do two things to initiate the return: First, she must complete and sign an affidavit or "Written Statement Under Penalty of Perjury" that declares the transaction to have been unauthorized.¹⁸ Second, she must send or deliver that affidavit to her bank within 15 calendar days of receiving the periodic statement on which the unauthorized transaction is listed.¹⁹ As soon as the consumer's bank receives the consumer's statement, it "must promptly credit the amount of the debit entry" to the consumer's account.²⁰

Although ACH rules are clear about the process by which a consumer can get an unauthorized entry returned, they are less clear about what the term "unauthorized" means. The rules address unauthorized debit entries in two different contexts. The first is in the operating rules that govern the interactions of the merchant's bank (i.e., ODFI) and the consumer's bank (i.e., RDFI) on the network. The operating rules explain that an entry is unauthorized if it is

¹⁶ "Each [originator's bank] sending an entry warrants the following to each [consumer bank]:...each entry...is in accordance with the proper authorization provided by Originator and the [consumer]...each debit entry is for an amount which on the Settlement Date will be due and owing to the Originator from the [consumer]...neither the [originator's bank] nor the Originator has actual knowledge of the revocation of the [consumer's] authorization..." 2004 NACHA Operating Rules, Art. 2, Section 2.2.

¹⁷ 2004 NACHA Operating Rules, Art. 5.

¹⁸ 2004 NACHA Operating Rules 7.6.

¹⁹ *Id.*

²⁰ The rules do not specifically define what "promptly" means.

erroneous (e.g., it was executed early or for the wrong amount)²¹ or the originator did not get authorization for the entry.²² The operating rules also state that an entry is *not* unauthorized if the consumer's only ACH-related claim involves the quality or nature of the goods or services that underlie the ACH transaction. The second context in which unauthorized entries are addressed is in the model affidavit that NACHA suggests banks send to consumers who report an unauthorized debit. This model affidavit, which serves as a guide to consumers who are alleging that an entry is unauthorized, explains the following: "An unauthorized debit...means an electronic fund transfer from a consumer's account initiated by a person who was not authorized by the consumer..."²³

Applying the somewhat circular definitions above to the problems of fraud, error, and dispute seems to result in the following: A fraudulent or erroneous e-check transaction falls within the definition of "unauthorized" and can easily be returned by signing the "Written Statement Under Penalty of Perjury." An otherwise legitimate and error-free e-check transaction associated with a disputed purchase may or may not fall within the meaning of "unauthorized." If the consumer disputes the transaction because the goods or services he received did not meet his expectations, he should not be able to claim that the e-check transaction was unauthorized. If the consumer disputes the transaction because the goods or services he ordered were never delivered, it is unclear whether the e-check transaction falls within the definition of "unauthorized." Because of the ambiguity of the definitions and the different ways banks handle unauthorized payment claims (discussed in the next section), the technical distinction between authorized and unauthorized in the context of a dispute is blurred and potentially irrelevant.

ACH rules, although they limit to 15 days the amount of time during which a consumer can report an unauthorized transaction, nevertheless give a consumer's bank 60 days after

²¹ 2004 NACHA Operating Rules 7.6.6.

²² 2004 NACHA Operating Rules 2.1.2.

²³ 2004 NACHA Operating Guidelines pp. 60-61.

settlement during which to return an ACH e-check debit entry.²⁴ In most cases, as long as the consumer's bank sends the "unauthorized" return through the system within 60 days, the originator's bank will accept the return and pass the loss along to the originator.²⁵ This leaves the originator (i.e., the merchant) in the position of having to directly pursue its customer for any claim it may still have.

In addition to allowing consumers to get an immediate credit for unauthorized debits, ACH rules allow consumers to "stop payment" on a transaction. In general, as long as the consumer gives his bank "a reasonable opportunity to act upon the stop payment order," she can keep the entry from debiting her account.²⁶ Because of the speed with which most debit entries are processed, however, it may be difficult for a consumer to place such an order in time.²⁷

3. General Industry Practice with Regard to ACH E-Checks

In their written agreements with their customers, banks typically limit the discussion of consumer protections available on ACH e-checks to a disclosure mandated by Regulation E. This disclosure describes the consumer's rights under the EFTA, including the right to the resolution of billing errors and limited liability for fraudulent transactions. In practice, however, banks can provide a host of nonfederally required protections to consumers that experience problems with an ACH e-check transaction. Most of these protections find their source in how banks interpret the ACH rules discussed above.

One way that a bank may provide protections that exceed those required by Regulation E involves the bank's use of the ACH debit return process. As stated above, if a consumer submits an affidavit to his bank asserting that a particular ACH e-check is "unauthorized," the consumer's bank will immediately credit the consumer's account for the transaction and return the entry to

²⁴ 2004 NACHA Operating Rules 7.7.

²⁵ The originator's bank has a right to "dishonor" the return entry under two circumstances: i) when the RDFI did not meet the return time frames established by the rules or ii) when the return entry contains incorrect information. 2004 NACHA Operating Rules 5.2.

²⁶ 2004 NACHA Operating Rules 7.4.

²⁷ On average, ACH debit transactions settle within 2 days.

the originator's bank.²⁸ Often to the consumer's benefit, ACH rules define "unauthorized" in a way that has allowed room for interpretation. The ACH experts interviewed by the authors explained that "unauthorized" covers transactions that result from outright fraud and those that are erroneous. In practice, however, most banks do not have the resources to ask consumers why they think a particular transaction is not authorized.²⁹ In most cases, as soon as a bank's customer submits the affidavit (or notifies the bank in writing), the bank credits the customer's account and returns the transaction to the originator's bank.³⁰ Given the passive role of the consumer's bank in processing the return, it is essentially up to the customer to decide whether to have the transaction reversed by swearing that it was not authorized. Ultimately, this system allows consumers to assert that a wide range of transactions are "unauthorized," including those in which a merchant does not deliver the goods it promised or delivers goods different from those the consumer expected.

Some in the industry believe that this system, which allows consumers to easily get transactions returned, leads to abuse. One bank estimated that, nationwide, a significant portion of e-check returns (initiated by consumers who swore that a particular transaction was "unauthorized") are technically "authorized." Some consumers, banks contend, sign the affidavit because they do not have the money to cover the transaction or because they do not recognize the originator's name on their statement. As the ACH system handles an increasing number of consumer transactions, some in the industry believe that the ACH rules will have to be modified to disallow such returns and hold consumers more accountable for abuses.

²⁸ Bank practices with respect to the affidavit vary. Some banks call the affidavit a "Written Statement Under Penalty of Perjury" and require that it be notarized. Other banks make it seem less legalistic (and, therefore, less legally binding), take out the "under penalty of perjury language," and do not ask that it be notarized.

²⁹ Even though banks do not screen consumer claims, most report that they believe "unauthorized" can be defined broadly and should include situations in which consumers do not receive goods they ordered from a merchant.

³⁰ Some banks report that they do not use the "Written Statement Under Penalty of Perjury" model form set out in the ACH rules. Instead, they use a form without the "penalty of perjury" language or just ask for some kind of signed writing from the consumer.

Another way banks expand on the protections afforded by Regulation E and ACH rules is by lengthening the time during which they will initiate a return on behalf of a customer for an “unauthorized” entry. As stated above, the ACH rules give consumers 15 days (from the time a periodic statement is sent) to notify the bank that a transaction is not authorized. In practice, most banks will act upon a consumer’s notification for at least 60 days from settlement date. For transactions that occur outside of the ACH rules’ 60-day window, a consumer’s bank will usually try to work with the originator’s bank to get the return processed. This is especially true for transactions that occur outside of the 60-day window set by the ACH rules (as measured from transaction settlement date), but within the 60-day window set forth in Regulation E (as measured from statement mailing date). Returns requested after the 60-day Regulation E window (but before the running of any state statute of limitations) will typically be processed only if the originator (i.e., the merchant) consents to the return.³¹

A final (although less substantive) way that banks provide protections above what Regulation E requires is by having a deep understanding of the ACH rules. In the opinion of one industry expert, the extent to which a bank can help a consumer with an ACH e-check problem largely depends on the bank’s experience with ACH transactions in general. Banks that process very few ACH transactions have less knowledge of how the rules can be interpreted and the various options that might be available to a consumer in a particular situation.

4. Comparison of Protections

While Regulation E provides consumers with a series of strong protections, the ACH rules promulgated by NACHA and the internal policies of banks may be of considerable benefit to consumers in particular circumstances. For a consumer who reports a problem with an ACH debit within 60 days of receiving her statement, Regulation E provides an error-resolution mechanism, the right to a provisional credit for a fraudulent or erroneous transaction within 10

³¹ State law, however, may extend beyond 60 days the originator bank’s obligation to accept a returned transaction from the consumer’s bank.

days of its being reported, and zero liability for fraudulent and erroneous transactions. ACH rules go beyond Regulation E when consumers report problems within 15 days after their statement date, providing for faster error-resolution procedures and faster crediting of unauthorized and erroneous transaction amounts. ACH rules also allow consumers to place a “stop payment” on a transaction, something Regulation E does not require. The internal policies of banks build on the ACH rules by extending the reporting period (during which the more beneficial ACH rules apply) from 15 days after the statement date to 60 days after the transaction settlement date. Bank policies may also protect consumers from liability for problem transactions not contemplated by Regulation E, including those involving nonreceipt of goods and other types of situations involving merchant disputes. Please see Appendix A for a chart comparing these various ACH e-check protections.

B. Prepaid Cards

A prepaid card, also commonly referred to as a stored-value card, is typically a credit card-sized piece of plastic that contains or represents an amount of pre-loaded value. Unlike credit cards, which draw their value from a line of credit, or debit cards, which draw their value from a checking account, the value on a prepaid card typically comes from money given to the card’s issuer (or a designee) prior to its use. Prepaid cards take many forms, including gift cards that can be used at a specific merchant or mall, travel cards that can be used in the same way as travelers’ checks, payroll cards that can be used to access one’s wages, and “teen cards” that are marketed to those under 18 years to access funds their parents load onto the card.³²

³² For a more detailed analysis of the various kinds of prepaid card products, see Mark Furletti, “Prepaid Card Markets & Regulation,” Federal Reserve Bank of Philadelphia Payment Cards Center Discussion Paper, February 2004, available at http://www.phil.frb.org/pcc/discussion/feb_04_prepaid.pdf.

This section focuses on Visa- and MasterCard-branded (or association-branded)³³ prepaid cards that can be used anywhere the associations' products are accepted.³⁴ In 2003, Visa and MasterCard member banks issued 7.6 million such cards loaded with almost \$2 billion of value.³⁵ While most of these cards were gift cards, the majority of value loaded onto them was for nongift purposes (e.g., payroll cards, flexible spending cards). At present, merchant-issued or "closed-loop" gift cards are much more popular than branded gift cards. Merchant-issued cards, however, fall outside the scope of this paper because they are not intended for general purpose use and, as such, generally have no standard fraud, error, or dispute protections.

Unlike the other payment vehicles discussed in this series of papers, prepaid cards are not currently the subject of any federal consumer protection laws or regulations. Regulation Z, which protects credit card consumers, does not apply to prepaid cards because prepaid card users are not being extended credit.³⁶ Regulation E, which protects users of debit cards and ACH transfers, does not extend to prepaid cards because the account associated with such cards falls outside of the definition of "consumer asset account"—the type of account the statute was designed to protect.³⁷ Although the Board of Governors recently proposed amending Regulation E to cover a subset of prepaid cards (i.e., "payroll" cards), the proposed amendment would leave the large majority of prepaid card users without any federal protection against fraud, error, or merchant

³³ This paper uses the term "associations" to reference Visa and MasterCard. This term, however, no longer accurately describes MasterCard. In June 2002, MasterCard converted from a membership association to a private share corporation. As such, MasterCard now refers to itself as a global payments or bankcard "company."

³⁴ Transactions effected using association-branded prepaid cards are authorized, cleared, and settled in the same way as credit and debit card transactions. Figure 2 contains a simple illustration of this.

³⁵ Mark Furletti, "Prepaid Cards: How Do They Function? How Are They Regulated?," Federal Reserve Bank of Philadelphia Payment Cards Center Conference Summary, August 2004, p.9, available at http://www.phil.frb.org/pcc/papers/Prepaid_Cards.pdf

³⁶ See Regulation Z, 12 C.F.R. § 226.1(c)(1) (2004), which states, "This regulation applies to each...business that offers or extends credit..."

³⁷ See Regulation E, 12 C.F.R. § 205.2 (2004), which defines the kind of account covered by the regulation as "a demand deposit (checking), savings, or other consumer asset account...held...by a financial institution...for personal, family, or household purposes."

dispute.³⁸ Similarly, state laws do not explicitly provide much protection for consumers using prepaid cards who experience these problems.

Given the lack of federal or state protections that address the problems of fraud, error, or dispute, the associations and most of the banks that issue branded prepaid cards have voluntarily extended safeguards to prepaid card users who experience these problems. The following subsections detail these protections.

1. Visa and MasterCard Rules

As with Visa- and MasterCard-branded credit and debit cards, essentially two association policies can help prepaid-card consumers who experience fraud, error, or a merchant dispute. The first is each association's widely publicized "zero liability" fraud protection. For prepaid-card consumers who are essentially unprotected by federal law when their card is used fraudulently, the associations' policies of zero liability can provide significant value. These policies, which are described in detail in the first paper in this series (on pages 11 and 12), essentially require that issuers of association-branded products shield consumers from any liability for certain unauthorized charges. The policies also require that issuers re-credit consumers within five business days for any losses they suffer as a result of fraud.

Consumers who rely on the associations' policies of zero liability, however, should note that they have limitations. For example, issuers are permitted to hold a consumer liable for fraudulent transactions if there is evidence that the fraud resulted from a consumer's "gross negligence" (Visa) or failure to "exercise reasonable care" (MasterCard). MasterCard's policy is also contingent on the consumer's account being in good standing and the consumer's not having reported two or more fraudulent claims during the 12-month period preceding the current event. The associations also give issuers some flexibility in implementing zero liability, permitting

³⁸ See Proposed Amendments to Regulation E, Sept. 13, 2004, available at <http://www.federalreserve.gov/BoardDocs/Press/bcreg/2004/20040913/attachment.pdf>. Essentially, the amendments proposed by the Board would provide payroll card users with fraud and error protections very similar to those provided to debit card users. These protections are described in detail in the first paper in this series on pages 20 through 24.

issuers to honor the zero liability commitment for as long or as short a period of time as they would like.

The second association policy that can be of use to consumers involves issuers' ability to "charge back" problematic purchases. As explained in detail in the first paper in this series (on pages 13 through 16), issuers of any association-branded product are permitted to reverse merchant charges that are erroneous or disputed by the consumer. Such reversals can generally be done up to 120 days after the date of a charge, but typically only after the consumer supplies oral or documentary evidence to her issuer demonstrating the charge's inappropriateness. The ability of an issuer to initiate a chargeback derives from a series of agreements among card issuers, merchants, and merchant banks and is done exclusively at the issuer's discretion. Issuers pay their associations a fee of around \$10 to \$25 to initiate a chargeback and may have to pay a fee of around \$400 to arbitrate disputes with merchants that the parties themselves cannot settle.

Given that prepaid-card consumers have no federal error-resolution rights, such as those provided by Regulations Z and E to credit and debit card consumers, and no federal merchant dispute protection, such as that detailed in Regulation Z for credit card consumers, the associations' chargeback policies can be of great benefit to prepaid-card consumers who discover an error or experience a merchant dispute. The extent to which issuers use the chargeback process to help prepaid card consumers, however, varies widely.

2. General Industry Practice with Regard to Prepaid Card Protections

Unlike the consumer protections that apply to credit and debit cards, the consumer protections that apply to prepaid cards vary substantially by card type (e.g., payroll card, teen card, gift card) and by issuer. There also seems to be a difference between the protections issuers explicitly describe in their written agreements with consumers and the protections that, in practice, they actually provide.

In their agreements with prepaid-card users, the authors observed prepaid-card issuers implementing the associations' zero liability policies in different ways. The most generous issuers

extended it to fraudulent prepaid card transactions reported within 60 days, as calculated from the date of the statement on which the transaction appeared. Less generous issuers stated they would honor the pledge for as few as two days and subsequently impose up to \$50 or \$500 of liability. Still other issuers stated they would honor the policy for up to two weeks, after which the consumer would assume full liability. Issuers also subjected their zero liability pledges to conditions above and beyond those disclosed by the associations. For example, one issuer stated in its agreement with consumers that it would not extend the zero liability policy to fraudulent charges that did not involve use of the prepaid card itself (presumably excluding, for example, fraudulent charges initiated over the Internet without the card). Another issuer indicated that the consumer would have to keep a record of the card's account number in order to benefit from the policy if his card was lost or stolen.

As explained in the previous subsection, one of the features of the associations' zero liability policy is an assurance that a victim of fraud will be provisionally credited in a timely fashion for reportedly fraudulent transactions. Visa's web site explains this as follows: "Visa's cardholder protection policy requires all financial institutions issuing Visa products to extend provisional credit for losses from unauthorized card use within *five business days* of notification of the loss."³⁹ The authors, however, found this stated policy of the associations to be in conflict with some issuers' own written and unwritten fraud policies. For example, one large prepaid-card issuer, in its written agreement with prepaid card users, promises to provide provisional credits within 10 days (assuming that it cannot complete its investigation of the claim sooner). Another prepaid card issuer interviewed by the authors indicated that it also waits 10 days to provide the credit. If issuers were to provide the provisional credit sooner, the issuer explained, it would be very difficult to recover the provisional credit in the event that investigation of the claim later proved the charge was not fraudulent. Despite some issuers' written limitations on the zero liability policy and conflicting information regarding provisional crediting, many issuers admitted

³⁹ See Visa's web site at http://usa.visa.com/personal/security/zero_liability.html.

that, in practice, most prepaid-card consumers who report fraud in a timely manner are not held liable for fraudulent use and are credited promptly.

The written policies of prepaid card issuers with respect to the resolution of consumer-merchant disputes also varied. Some issuers did not address disputes, and others expressly limited the circumstances under which a transaction giving rise to a consumer-merchant dispute might be charged back. For example, in some agreements, issuers included a sentence such as the following: “You are responsible for resolving all disputes with the merchant that accepted your card regarding the quality of the goods and services purchased or rented from such merchant...” Despite the language in their written agreements and the expense of initiating a chargeback (which includes the \$10 to \$25 fee levied by the association and the cost of the issuer’s personnel who handle the dispute), many issuers indicated that, in practice, they will initiate dispute-related chargebacks for prepaid-card consumers just as they would for credit and debit card consumers.

The desire to provide certain customers with better levels of service, one issuer suggested, drives the disparity between issuers’ written and unwritten fraud and dispute policies. Issuers, for example, are more likely to arbitrate a dispute (and potentially incur a \$400 fee) for consumers who may have other relationships with the issuer (e.g., checking or savings accounts or other prepaid cards) or for those who are or will likely be longer term prepaid card customers (e.g., payroll card users). With respect to differences among issuers, experts suggested that business models, regard for reputation, and competition are important factors.

The protections afforded prepaid-card consumers who discover an error, as compared to protections available to victims of fraud and consumers engaged in a merchant dispute, are much more uniform. Most issuers, in their written agreements, explicitly provide consumers with Regulation E-like rights for erroneous charges. As such, issuers agree to investigate unfamiliar or inaccurate charges in a timely fashion and provide consumers with a written summary of the investigation’s ultimate determination. The time frames issuers establish for the investigation

period (and any associated provisional crediting) mirrored those set forth in Regulation E.⁴⁰ (In general, issuers have 45 days to investigate errors under Regulation E). Overall, issuers provide consumers with very strong erroneous charge protection.

3. Comparison of Protections

At present, users of prepaid cards generally have no substantive fraud, error, or dispute protection that derives from federal or state law. Issuers of prepaid cards and the associations that support their use, however, provide consumers with some basic protections that are extended largely at the discretion of issuers. With respect to fraud, depending on the issuer and the consumer's ability to meet certain conditions, the zero liability policies of the associations can be of great use. Some issuers generously apply this policy, providing it for 60 days and crediting consumers for fraud losses in a prompt fashion. Others apply it less generously, providing it for a limited number of days under a limited set of circumstances. The associations also provide issuers with the ability to charge back disputed transactions. Depending on the prepaid card product and its issuer, consumers may or may not get assistance with a dispute. In the event of error, prepaid card issuers explicitly provide strong protections that mirror those afforded debit-card consumers under Regulation E. Please refer to Appendix B for a chart that compares the various prepaid card protections.

III. Conclusion

While ACH e-checks and prepaid cards have followed similar paths with respect to product development and consumer acceptance, the protections afforded consumers who use these products are very different. Users of the ACH e-check are covered by a 27-year-old federal regulatory scheme that features comprehensive fraud and error protection. In contrast, users of prepaid cards have no federal error or fraud protection. Users of the ACH e-check are also protected by a set of private laws (i.e., the ACH rules) that are publicly available and generally

⁴⁰ For a detailed description of these time frames, see pages 23 and 24 of the first paper in this series.

applied in a uniform manner by banks to help consumers who discover fraudulent and erroneous charges. In contrast, users of prepaid cards who discover fraud or error must rely on a private and less transparent system of protection that varies by product type and issuer and is based largely on the discretion of banks. The policy issues surrounding the lack of parity between prepaid card and ACH e-check protections and the effect of each product's current regulatory scheme will be considered in the third and final paper in this series.

Figure 1: Simplified Illustration of the Typical ACH Debit Transaction*

This is a highly simplified illustration of a typical ACH debit transaction. The dotted arrows represent the path of the payment instruction sent through the merchant's bank to the consumer's bank. The solid arrows represent the settlement process, by which the amount debited from the consumer's account is credited to the merchant's account.

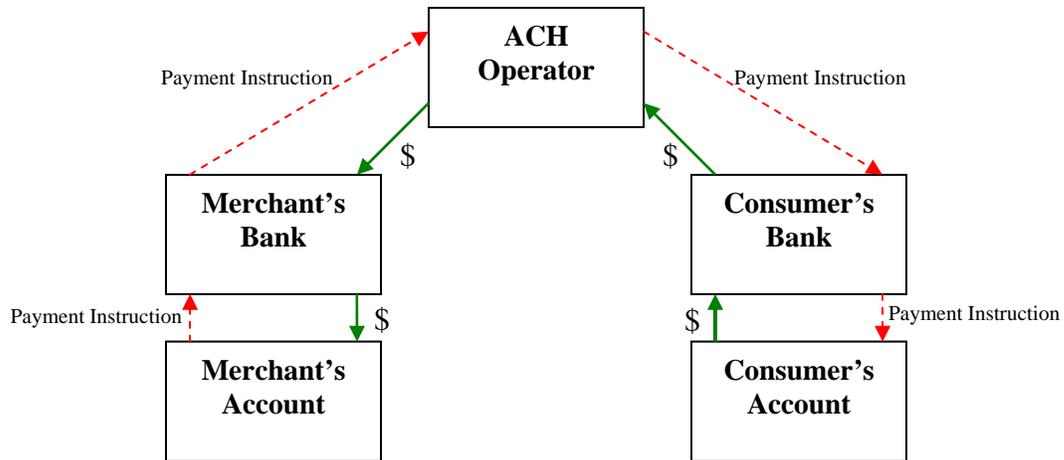
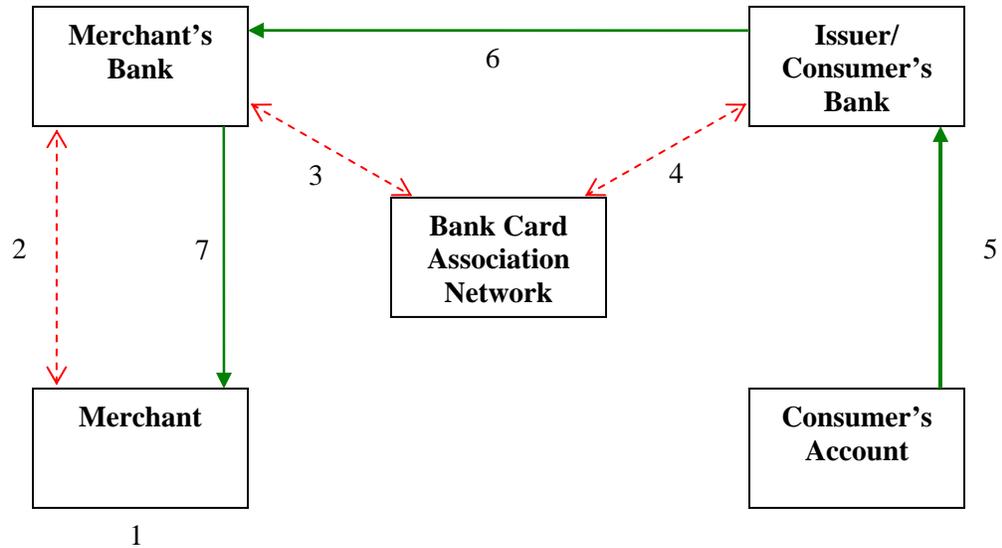


Figure 2: Simplified Illustration of the Typical Prepaid Card Transaction

This is a highly simplified illustration of a typical prepaid card transaction. The dotted arrows represent the authorization process (steps 2 through 4), by which the merchant obtains clearance to debit the consumer's prepaid card account. The solid arrows represent the clearing and settlement process (steps 5 through 7), by which the merchant receives payment from the consumer's prepaid card issuer.



Cardholder presents card to merchant for payment.

Appendix A: Summary of ACH E-Check Protections Related to Fraud, Error, and Merchant Dispute

	Federal Law (Regulation E)	State Law (Various State Statutes)	Association/Network Rules[^] (NACHA Rules)	General Industry Practice^{+*}
P R O T E C T I O N S	FRAUD: Limits liability to \$0 if consumer reports unauthorized use within 60 days of being sent statement containing record of fraudulent transaction.	State statutes generally do not address this specific issue.	Limits liability to \$0 for unauthorized use as long as consumer reports within 15 days of being transmitted statement.	Limits liability to \$0 for unauthorized use as long as consumer reports within 60 days of transaction settlement date.
	ERROR: Allows consumers 60 days from statement date during which to notify bank about erroneous or fraudulent transactions.	State statutes generally do not address this specific issue.	Allows consumers 15 days from statement date during which to notify bank about erroneous or fraudulent transactions and have those transactions resolved under ACH rules.	Allows consumers 60 days from transaction settlement date during which to notify bank about erroneous or fraudulent transactions and have those transactions resolved under ACH rules.
	ERROR & FRAUD: Requires banks to investigate claims of error and fraud and provide consumer with response within 45 days.	State statutes generally do not address this specific issue.	Does not require bank to investigate, but rather relies on customer’s sworn statement.	Most banks do not investigate, but instead rely on customer’s sworn statement.
	ERROR & FRAUD: Requires banks to provisionally credit consumer if investigation exceeds 10 days.	State statutes generally do not address this specific issue.	Requires bank to “promptly” credit as soon as it receives customer’s sworn statement.	Banks will generally credit consumer’s account upon receipt of sworn statement.
	DISPUTE: Does not provide any protection for transactions involving a post-purchase dispute with merchant.	State statutes generally do not address this specific issue.	Does not explicitly provide any protection for transactions involving a post-purchase dispute with merchant.	Effectively extends protection for erroneous and fraudulent transactions to those involving post-purchase disputes with merchant.
	DISPUTE: Does not provide any stop-payment rights.	State statutes generally do not address this specific issue.	Provides stop-payment rights.	Provides stop-payment rights, but limited because of clearing speed.

⁺ Please note, these protections are provided by card issuers/networks on a voluntary basis and do not have the force of law. Issuers or networks can generally change them unilaterally or decide not to abide by them.

^{*} Information intended only to give the reader an idea of general industry practice. Consumers should consult their individual bank’s policies for further information.

Appendix B: Summary of Branded Prepaid Card Protections Related to Fraud, Error, and Merchant Dispute

	Federal Law	State Law	Association/Network Rules[^]	General Industry Practice^{+*}
P R O T E C T I O N S	FRAUD: Federal statutes generally do not address this specific issue.	State statutes generally do not address this specific issue.	Zero liability policies require issuers to shield consumers from any liability for fraudulent use. Policies, however, are subject to various association- and bank-imposed limitations (e.g., consumers must exercise “reasonable care” in handling card).	Varies by issuer. Some issuers explicitly limit period after loss or theft of card during which they will provide zero liability. These issuers will not provisionally credit for 10 days. Others provide zero liability for 60 days and provisionally credit promptly.
	ERROR: Federal statutes generally do not address this specific issue.	State statutes generally do not address this specific issue.	“Chargeback” policies permit issuers to assist consumers who discover erroneous transactions for up to 120 days after the date of the transaction.	Most issuers explicitly provide strong error-resolution protection for at least 60 days. Many will generally leverage the “chargeback” procedures of the associations and assist consumers who discover an error for as long as they are permitted (i.e., 120 days).
	DISPUTE: Federal statutes generally do not address this specific issue.	State statutes generally do not address this specific issue.	“Chargeback” policies permit issuers to return a transaction if a dispute arises up to 120 days after the date of transaction. Dispute-related chargebacks, however, are ultimately done at the issuer’s discretion.	Varies by issuer. Some leverage the associations’ chargeback procedures to assist a consumer who is in a dispute with a merchant as long as the consumer provides sufficient proof of her claim. Others require consumers to settle disputes themselves.

⁺ Please note, these protections are provided by card issuers/networks on a voluntary basis and do not have the force of law. Issuers or networks can generally change them unilaterally or decide not to abide by them.

^{*} Information intended only to give the reader an idea of general industry practice. Consumers should consult their individual bank’s policies for further information.