

New Changes and Challenges: Non-banks in the Payments System

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As Federal Reserve Board Governor Randall Kroszner highlighted in a speech earlier this year, electronic payments (credit and debit cards combined) have surpassed the use of checks as the preferred means of making non-cash payments.² Remote deposit capture is gaining popularity (and acceptance) with banks and their customers, while mobile bill payment and banking options continue to revolutionize the way in which customers conduct transactions. With these and other changes, non-banks have become increasingly prevalent throughout all aspects of the payments system, from front-end functions such as user authentication, to back-end processing, and even in developing new and innovative contributions to the payments system arena.

While their involvement has provided several important new products and methodologies, it has also brought with it increased risks and regulatory concerns. For example, a recent paper by the Federal Reserve Bank of Kansas City shows that in 2006, non-banks accounted for over 50 percent of all ATM transaction volume.³ Allowing non-banks this amount of access to U.S. payments systems, while not requiring them to be subject to federal regulatory supervision similar to that required of banks, raises the case for a reevaluation of how risks are managed and participants regulated in today's payments system environment. This is especially true in the areas of data security and prudential supervision.

The Shifting Payments System Landscape

As previously pointed out, the architecture comprising the U.S. payments system has changed dramatically in the past decade. Electronic payments have gained primacy over traditional paper-based payments, thereby demanding new and safer methods of controlling risk and ensuring the safety and soundness of U.S. payments systems. The advent of the Check Clearing for the 21st Century Act (Check 21) has increased the variety of ways, as well as the ease, with which electronic payments are processed. Allowing electronic check conversion, whereby a merchant uses specific information from a paper check to initiate an ACH electronic transaction, changes the payment system utilized for a specific transaction, thereby also impacting the way in which that transaction is regulated. Furthermore, while consumers remain protected under both ACH and check transactions, there are differences in the way each transaction is processed, as well as other nuances, such as reduced float times, customer liability for unauthorized transfers, and the ability of a customer to stop the transaction. Remote deposit capture has also changed the way in which the payments system is utilized,

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² Remarks by Governor Randall S. Kroszner before the 2007 Payments Conference, The Future of Payments: Challenges and Opportunities (May 10, 2007).

³ RICHARD J. SULLIVAN, RISK MANAGEMENT AND NONBANK PARTICIPATION IN THE U.S. RETAIL PAYMENTS SYSTEM 8 (2Q 2007).

requiring enhanced diligence in regard to the infrastructure through which the transaction is processed.

With the number and relative ease of electronic payments eclipsing the use of checks to make payments, financial institutions and their regulators are faced with an increasing need to provide secure and convenient methods of payments to their customers. Recognizing the trend towards electronic payments, the Federal Reserve System recently amended Appendix A of Regulation CC dealing with processing of checks and funds availability.⁴ This change amended the location for processing paper checks to more accurately reflect decreasing volume, eliminating paper check processing at the Nashville, TN, Helena, MT, and San Francisco, CA offices.

Current Regulation and Supervision of Non-Banks

Presently, non-banks are subject to supervision under the terms of the Bank Service Company Act of 1963 (BSCA).⁵ Under this law, financial institutions are required to notify their primary federal regulator in writing of any relationships or contracts they enter into with third parties for provision of certain services to the financial institution. These services include check and deposit sorting and posting, as well as other “similar functions performed for a depository institution.”⁶ Bank service companies are subject to examination and regulation to the same extent as their principal investor, which would be the financial institution.⁷ Additionally, whenever a federally regulated depository institution, or its functionally regulated subsidiary or affiliate, “causes to be performed for itself . . . any [permissible bank service company] services,”⁸ this performance will be subject to regulation and examination “to the same extent as if such services were being performed by the bank itself”⁹ Therefore, any company that provides services to a bank, such as check and deposit sorting and posting, preparation and mailing of checks, statements, or similar items,¹⁰ will be subject to regulation and examination by the bank’s federal regulator.

In spite of these measures, many non-bank payments system providers avoid full federal regulatory supervision due to the fact that the terms of the BSCA specify that there must be an outsourcing relationship present before the BSCA applies. Thus, companies who originate payments and subsequently send the information to the banks for processing avoid federal regulation under the BSCA.

To demonstrate, as a state-licensed money transmitter in 31 states, as well as the District of Columbia and Puerto Rico, PayPal remains subject to regulations from FinCEN, but is

⁴ See Availability of Funds and Collection of Checks, 72 Fed. Reg. 27951 (May 18, 2007).

⁵ 12 U.S.C. § 1867.

⁶ 12 U.S.C. § 1867, Section 3.

⁷ See 12 U.S.C. § 1867(a).

⁸ 12 U.S.C. § 1867(c).

⁹ Id.

¹⁰ For a list of permissible bank service company activities, see 12 U.S.C. § 1863.

not subject to federal regulation as a depository institution.¹¹ PayPal does, however, state that it complies with the Electronic Funds Transfer Act, as enforced under the Federal Reserve's Regulation E. Other companies with similar models and services such as Obopay and Yodlee are likely to follow similar regulatory patterns. Likewise, non-banks or merchants that offer electronic check conversion, are also not subject to federal regulation as depository institutions. They are required under the terms of Regulation E to provide consumers with notice that their checks may be converted to electronic payments, and must obtain consumer consent before initiating such transactions.¹² The Federal Trade Commission has enforcement authority over non-banks for purposes of this provision.

Regulators need to be provided appropriate and effective enforcement tools to ensure that not only do non-banks in the payments system comply with required regulatory provisions, but also that they engage in appropriately safe and secure risk management. Given that the BSCA is over 40 years old, revisiting this legislation should be given serious consideration with an eye towards establishing uniform supervision for uniform activities. Additional regulatory provisions may be called for as well; if non-banks are engaging in the same or greater involvement in the payments system as depository institutions, the industry should be provided a level playing field with all parties subject to equivalent regulatory and supervisory standards.

Non-Banks and Unlawful Internet Gambling Regulation

To the extent that they are part of the payments system, non-banks will be affected by the newly proposed prohibition on funding of unlawful Internet gambling (Prohibition)¹³ as well. For instance PayPal, as a state-licensed money transmitting business, would be subject to the terms of the Prohibition, and would have to “establish policies and procedures reasonably designed to identify and block or otherwise prevent transactions in connection with unlawful Internet gambling.”¹⁴ While the proposed regulation's suggested policies and procedures for money transmitting businesses are similar to those for depository institutions and appear to be robust, including due diligence, customer agreements, and monitoring of payment patterns and web sites, how these requirements will be followed remains to be seen. Additionally, enforcement of the Prohibition for money transmitting businesses falls on the Federal Trade Commission, which may adopt a different methodology or level of enforcement and regulation than that reached by the Federal Reserve Board and other federal financial regulators who will enforce the regulation for insured depository institutions.

¹¹ In February 2007, eBay is reported to have approached officials in Washington about obtaining an ILC charter for PayPal.¹¹ If eBay successfully obtains an ILC charter for PayPal, then PayPal would be subject to FDIC regulation as a state-licensed depository institution once it applied for and received FDIC deposit insurance.

¹² 12 C.F.R. § 205.3(b)(2)(i).

¹³ Prohibition on Funding of Unlawful Internet Gambling, 72 Fed. Reg. 56680 (Oct. 4, 2007).

¹⁴ Id.

Non-Bank Partnerships

One popular method for non-banks to gain access to the payments system is for retailers to partner with a financial institution to offer services. Wal-Mart, perhaps the nation's largest retailer, has partnered with GE Money to offer check-cashing services and reloadable debit cards. This partnership seems aimed at offering services to the unbanked, but will also likely result in Wal-Mart's capturing of a significant portion of this market. The FDIC's Committee on Economic Inclusion (ComE-IN) recently held a meeting on money services businesses and their access to the banking and payments system, possibly indicating regulator concern over the extent to which individuals are using non-federally regulated business to access the payments system and conduct financial transactions. Likewise, Virgin Money's acquisition of CircleLending and entry into the expanding person-to-person (P2P) lending market signals their interest in entering banking. This conclusion is bolstered by Virgin's statement that they want to be a "disruptive force" in the mortgage market.¹⁵

Non-banks are also expanding into the mobile payments market. PayPal and Obopay currently offer their products through mobile phones, and have partnered with wireless carriers to provide their customers with bill payment services. While banks have also begun to engage themselves in this developing area, their efforts will benefit from working with federal banking regulators, but non-banks offering the same services will not have the same regulation and supervision. This dichotomy is especially salient given that this nascent technology continues to evolve, with important questions still largely undecided such as carrier access, system integrity, user verification, and even through what platform to deliver these services, such as downloadable applications, text messaging, or wireless application protocol (WAP).

Conclusion

The proliferation of non-banks in the payments system seems irreversible and is here to stay. Non-banks have gained a substantial marketshare in ATMs, peer-to-peer lending, and the online payments system. It is undeniable that they have been agents of innovation within the payments system, pushing the boundaries of current technologies and methodologies. While this has resulted in advances in how payments are conducted, it also poses the possibility that innovation will outstrip the ability of the payments system and regulators to adequately supervise and protect these same transactions. The specter of fraud or identity theft remains a serious question, especially for the online non-bank payment providers.¹⁶

The question of whether or not the existing supervisory and regulatory composition for non-banks in the payments system is adequate should receive new and careful attention, with an eye towards reinforcing, or replacing if necessary, this structure.

¹⁵ Harry Terris, "Virgin Money Evolution Path Sketched Out," [American Banker](#), Oct. 16, 2007.

¹⁶ Daniel Wolfe, "Yahoo to Help eBay, PayPal Thwart Phishers," [American Banker](#) (Oct. 5, 2007).