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STATEMENT BY

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BOARD OF GOVERNORS OF THE FEDERAL RESERVE SYSTEM

BEFORE THE

{SUBCOMMITTEE ON CONSUMER AFFAIRS}
COMMITTEE ON BANKING, HOUSING, AND URBAN AFFAIRS

UNITED STATES SENATE

OCTOBER 4, 1977

Mr. Chairman, the Board of Governors is pleased to participate in your Committee's hearings on consumer safeguards under the proposed "Electronic Funds Transfer Consumer Protection Act." As you may know, I recently testified on a similar bill before the Subcommittee on Consumer Affairs of the House Banking, Finance, and Urban Affairs Committee. It is clear that the need for such consumer safeguards in EFT has been widely recognized--by the Congress, the Board, the National Commission on Electronic Fund Transfers, and many representatives of the general public. The Board commends your Committee for undertaking this essential work.

I will begin today as I did in my House testimony by mentioning the public benefits that EFT can provide to our society. The electronic funds transfer systems open up opportunities to broaden consumer payment alternatives and to improve consumer convenience and service while reducing the costs of making payments. Direct deposit of government payroll and social security benefit payments through automated clearing houses has already helped people receiving funds by improving the security and convenience of such payments and has resulted in substantial cost savings to the government. Installation of teller machines by the financial institutions has offered consumers longer banking hours and more convenient banking facilities at costs much less than regular branches. The retailing industry has successfully installed electronic cash registers that have demonstrated the convenience and cost savings expected of EFT at the point of purchase.

But, EFT is developing at a more moderate and cautious pace than many predicted. The major reasons for this slow development are found in the many uncertainties that surround the substitution of electronic systems

for the traditional use of paper in bills, checks, receipts, and ledgers. Consumers, businessmen, and depository institutions are unsure of their rights and liabilities in EFT systems. There are antitrust questions that need to be clarified since cooperation among competing depository institutions may be necessary in many markets to successfully introduce the new technology. It is not surprising, then, that we are applying only a fraction of the technology we possess and that businesses are reluctant to make the substantial investment necessary to utilize present know-how.

Clearly, the work of this Committee can speed the process by which we can realize the cost savings and conveniences that our inventive technology can bring to the simple, normal daily tasks of life by helping establish a legal framework for the rights, liabilities, and responsibilities of participants in EFT. S. 2065 addresses consumer rights and interests and is directed at quieting many of the fears. The Board endorses the intent of the proposed EFT consumer legislation.

The Board believes that consumer protection legislation should start with the premise that keen competition is an aid to consumers when both suppliers and purchasers are numerous. Competition is most likely to develop when there are many participants in the marketplace. Therefore, legislation establishing a legal framework for EFT should make it possible for any and all depository institutions to set up EFT plans for their customers. The goal should be to afford individuals, small businesses, and other users of EFT at least the same breadth of choice among alternative suppliers of EFT services that they now have among alternative suppliers

of checking accounts. If every depository institution can provide EFT capabilities to its depositors, every depository institution can compete effectively, and competition will generate a broad choice of alternatives for the public. Limits on the ability of institutions to offer EFT plans, whether imposed by legislation or by the nature of EFT technology including economies of scale, could result in the same sort of highly concentrated market that characterizes the bank credit card industry. Such an outcome would probably not be in the public interest.

S. 2065's most important provisions would prescribe the information the institution supplies to the consumer as well as the substantive rights of the consumers. The Board particularly supports the advance disclosure of EFT terms. The Board believes that this disclosure should be in easily understood language and should include a list of all of the consumer's rights and remedies that concern his EFT account. The bill's requirement for semiannual disclosure of EFT terms, however, would increase EFT costs, and it is doubtful that repeated disclosures will heighten consumer awareness.

The Board is also concerned about the provision requiring semi-annual renewal of preauthorized transfers. This would add substantially to the costs of providing such transfers and burden consumers by requiring periodic attention to a variety of authorization dates at the peril of having an unplanned interruption of automatic payments such as for rent, utilities, insurance premiums, etc.

The Board also endorses the concept of descriptive periodic statements describing the activity that has taken place in the consumer's

account. The Board recommends that the statements include the transaction date, amount, location, means of transfer, type of transaction, other parties to the transaction, and transaction number. An appropriate descriptive statement is particularly important because it will serve many functions now being provided by cancelled checks.

S. 2065 would also require that EFT generate written documentation of virtually all transactions: sales, loans, debits, and credits. The cost of this broad requirement could nullify the benefits and conveniences EFT offers. A requirement of such records at the point of sale or loan appears reasonable. Simply handing a receipt to the consumer presents few logistical problems, entails no mailing costs, and permits the EFT institution to obtain the user's signature for potential comparison to the account holder's in the event of a disputed transaction. However, concurrent mailing of a record of a nonpoint-of-sale or loan transaction to the consumer involves significant costs. Since the transaction will generate no consumer signature, the degree of protection afforded the consumer by this procedure has limits. The Board, therefore, questions whether the nonpoint-of-sale or loan transaction, particularly a periodic deposit or preauthorized transfer, warrants the expense of concurrent documentation, when it may result in so little additional consumer protection and will add substantially to costs.

The Board commends S. 2065's negative notice provisions for regular credits to an EFT account as a partial solution to the documentation cost problem. The Committee may also wish to extend this approach to regular debits.

The Board also approves of the bill's provisions on liability, error resolution, and the prohibitions against compulsory use of EFT. The Board endorses the limit proposed in S. 2065 on a consumer's liability for unauthorized transfers by means of an EFT card. This provision roughly parallels an earlier Board recommendation. Unauthorized uses of EFT cards, beyond minimal amounts, represent avoidable or insurable risks which the Board believes institutions, not consumers, are better able to bear.

The Board similarly approves of the provision in S. 2065 which makes financial institutions solely liable for consequential damages suffered by the consumer as a result of a failure of the financial institution to carry out transactions as ordered by the consumer, except where the failure resulted from a technical malfunction caused by an act of God or other circumstances beyond the institution's control. This provision parallels a similar provision for checks in the Uniform Commercial Code.

The bill would provide that a financial institution shall reverse an electronic funds transfer upon request of the consumer within three business days after the transfer. The provision in the bill for reversing purchase transactions is quite similar to the customer's present right to stop payment on a check. The Board supports the intent of this provision. However, there may be other worthy alternatives to an arbitrary reversal period such as value dating, a system that permits the consumer and the merchant to agree on a future date on which a payment will become final.

Mechanical and human errors will occur under an EFT system as they do in the paper payments system. Consumers have a particular reason under EFT to expect prompt error correction. Errors may reduce or deplete

the funds in the consumer's account needed for day-to-day living expenses. The Board, therefore, favors rapid error resolution and S. 2065's requirement that statements contain sufficient identifying information to enable the consumer to detect mistakes. The bill would set different resolution deadlines depending on when the consumer brings the error to the institution's attention. The Board questions the need for this distinction.

The bill would provide that financial institutions have a fiduciary duty to protect and safeguard EFT deposit account information. "Fiduciary duty" is a legal term of art encompassing a good deal of unstated meaning. Applying this concept to EFT could change the existing relationship between depository institutions and depositors from that of debtor and creditor to one of trustee and beneficiary. Thus, for example, a trustee is not permitted to mingle the beneficiary's funds with his own, whereas a depository institution routinely does so. The Board believes that a better approach may be to prescribe with specificity the scope of any institutional duty to protect the consumer's privacy.

Another concern of the Board is that the bill could have anti-competitive consequences. Vigorous competition between financial institutions constitutes an important form of consumer protection. S. 2065's prohibition upon circulation of EFT cards which consumers have not requested can impose a substantial barrier to entry into the EFT market. The new EFT institution faces more difficult start-up problems than even those experienced by a credit card issuer. A large base of cardholders is essential to attract merchant participants. Without such a base of participating merchants, consumers will not find the system attractive.

We should not recreate the extreme concentration that presently exists in the credit card industry in "debit" or EFT cards.

EFT cards are inherently safer than credit cards. Depository institutions and consumers are not exposed to any liability from the unsolicited issuance of EFT cards, because the card cannot be used without an access code, i.e., the Personal Identification Number (PIN), or if the consumer does not have a deposit account with the issuer. Moreover, the bill properly provides that the depository institution is fully liable for unauthorized uses of an unaccepted card, that is, one which the consumer has not affirmatively requested. Thus, the consumer gains from enhanced competition would seem to outweigh any additional consumer protections that a ban on unsolicited issuance might provide. Further, there may be a worthy compromise in permitting the unsolicited distribution of EFT cards, while requiring that the access code necessary for the card's use be sent only if the customer accepts the plan.

Of equal importance is the resolution of questions that will be raised governing the use of shared point-of-sale systems. While it is not in S. 2065, surely Congress will want to give considerable attention to this issue. EFT should serve the consumer by presenting as few barriers as possible to the consumer's access to all advantages of the network. Consumers should be able to make a purchase from any merchant willing to accept their EFT card, regardless of which institution issued the card. The consumer can get little benefit from his EFT account if he cannot use his card in a store having a terminal because the switching network will not accept the transaction. This sharing issue was addressed by

the National Commission on Electronic Fund Transfers in its final recommendations, and the Commission appears to have taken a somewhat different view.

Finally, the Board notes that S. 2065 covers EFT accounts held by nondepository institutions. Thus, if the consumer uses EFT to access his balance at a securities brokerage house, mutual fund, or retail seller, he enjoys the same safeguards as for his EFT balance at a depository institution. The Board endorses the concept of uniform protection but hopes that this bill will avoid becoming accidentally embroiled in the controversy over what institutions may offer banking services. As this Committee knows, the definition of a deposit, the institutions holding deposits, and the means by which depositors obtain access to their funds have become increasingly flexible. The Board supports competition in deposit services, but believes that legislation should address this issue separately from EFT consumer protection; indeed, separately from EFT.

Many people feel that EFT proponents have focused attention upon EFT issues involving technology and marketing and have not paid sufficient heed to safeguarding consumers. S. 2065 is a most important step to balance these concerns. That is the reason I have offered the Board's strong support for the work of this Committee on many of the key provisions in the bill. Comments urging further study of the possible anticompetitive effects of the bill and the increased costs to the consumer are offered in the spirit of helping the Committee improve the legislation. The Board believes that many of these problems can be resolved after further careful study. With your approval, Mr. Chairman, I plan to submit a technical appendix for

the record offering appropriate suggestions for some of the points I have raised this morning.

I hope these comments have been helpful, and I will be pleased to try to answer whatever questions you may have.

Thank you.