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Public Interest Comment¹ on

The Consumer Financial Protection Bureau's Proposed Rule

Prepaid Accounts Under the Electronic Fund Transfer Act (Regulation E) and the Truth in Lending Act (Regulation Z)

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The George Washington University Regulatory Studies Center

The George Washington University Regulatory Studies Center works to improve regulatory policy through research, education, and outreach. As part of its mission, the Center conducts careful and independent analyses to assess rulemaking proposals from the perspective of the public interest. This comment on the Consumer Financial Protection Bureau's proposed rule extending protections and establishing disclosure requirements for prepaid accounts does not represent the views of any particular affected party or special interest, but is designed to evaluate the effect of CFPB's proposal on overall consumer welfare.

1. Introduction

This Consumer Financial Protection Bureau (CFPB or "Bureau") proposed rule would extend various consumer protections to prepaid account products. Protections for traditional bank account and credit products now exist through Regulation E, which governs electronic funds transfers,³ and Regulation Z, which governs the use of consumer credit.⁴ However, prepaid

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³ Regulation E implements the Electronic Fund Transfer Act (EFTA).

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accounts such as debit cards that can be pre-loaded with funds are currently unregulated. CFPB proposes to amend Regulation E and Regulation Z to apply existing and new protections to these relatively new financial products by imposing various information disclosure, limited liability, error resolution, and consumer credit requirements.

The proposal consists of five major provisions:⁵

1. Financial institutions must disclose fees and terms information “prior to the consumer’s acquisition of a prepaid account” with both long-form and short-form disclosures;⁶
2. The Bureau will apply “Regulation E’s periodic statement requirement to prepaid accounts” and financial institutions must provide “certain types of account information at no cost to the consumer”;
3. The Bureau will extend Regulation E’s “limited liability and error resolution regime” to prepaid accounts;
4. Issuers of prepaid accounts must “post their prepaid account agreements on their Web site” and “submit copies of their agreements to the Bureau on a quarterly basis”; and
5. The Bureau will modify and apply “particular provisions of Regulation E and Regulation Z to prepaid accounts that offer overdraft services or other credit features in connection with the account.”

Although this comment provides an overview of the proposed rule’s requirements, its statutory authority for doing so, and an analysis of its consideration of regulatory principles, the main focus is an analysis of CFPB’s information disclosure requirements. CFPB argues that confusing and shrouded pricing information for these products constitutes a market failure and consumer protection issue. However, their proposed remedy of information disclosure requirements may in reality do little to rectify this stated problem. This is at least partly because the increased competition resulting from market growth and maturation has served to diminish the information problem compared to when the Bureau decided to propose rules two years ago.

2. Overview and Rational for the proposal

2.1 Statutory authority

The Dodd-Frank Wall Street Reform and Consumer Protection Act (“Dodd Frank” or “the Dodd-Frank Act”) amended the Electronic Fund Transfer Act to authorize CFPB to “prescribe

⁴ Regulation Z implements the Truth in Lending Act (TILA).

⁵ 79 FR 77256

⁶ Ibid

regulations necessary to carry out the purposes of the EFTA.”⁷ As amended, the purpose of the EFTA is to establish “rights, liabilities, and responsibilities of participants” in electronic fund transfers,⁸ which include any transfer through electronic means authorizing a financial institution to debit or credit a consumer’s account. These include point-of-sale transfers, automated teller machine (ATM) transfers, direct deposit or direct withdrawals of funds, telephone-initiated transfers, and other debit card transactions.⁹

2.2 *Timing*

CFPB issued an advanced notice of proposed rulemaking (ANPR) on May 24, 2012¹⁰ and a proposed rule on December 23, 2014. It is unclear at what point the Bureau began to study the market for prepaid cards, conducted tests and surveys, and decided to collect data. It is important to bear in mind this timeframe when analyzing the proposal considering the rapidly evolving market described in section 2.3 of this comment.

2.3 *What does the proposal cover?*

This CFPB proposal covers “prepaid accounts,” which CFPB defines as “prepaid products that are cards, codes, or other devices capable of being loaded with funds.”¹¹ Often these products are in the form of prepaid debit cards that “use the existing payment card infrastructure to offer payment functionality” but are characteristically different from traditional debit and credit cards because funds are pre-loaded and not linked to a traditional bank account.

Prepaid cards have become commonplace as a payment method only within the last decade. Generally, payments may be either cash or noncash; noncash payment methods include cards, automated clearinghouse, or checks.¹² The Federal Reserve System mentioned “debit, prepaid, and credit” as the types of card payments in its triennial study on noncash payments.¹³ Similar language in the Federal Reserve 2010 report mentioned prepaid cards, but the 2007 report has no mention of prepaid cards or accounts.

Correspondingly, demand for these products has expanded rapidly and sizably in recent years, and in 2012 the Federal Reserve described the products as “among the fastest growing types of

⁷ 79 FR 77124

⁸ EFTA § 902(b)

⁹ EFTA § 1005.3(b)(1)

¹⁰ 77 FR 30923

¹¹ 79 FR 77102

¹² The 2013 Federal Reserve Payments Study (2013).

https://www.frbservices.org/files/communications/pdf/research/2013_payments_study_summary.pdf

¹³ Ibid

payment instruments in the United States.”¹⁴ In 2009 consumers made 5.9 billion prepaid card payments, and in 2012, this number had increased by over fifty percent to 9.2 billion payments.

One study using survey and demographic data from 2012 finds that prepaid cards are a popular form of payment among those with no or limited access to traditional financial services like checking accounts.¹⁵ However, 88 percent of prepaid card users in 2012 have used a bank account (29 percent no longer do) and 66 percent of users have used a credit card (22 percent no longer do).¹⁶ In 2012, prepaid cards clearly appealed to users of conventional financial services.

2.4 Why is CFPB proposing to regulate prepaid cards?

CFPB seeks to “reduce consumer uncertainty” and “lessen consumer risk associated with the use of prepaid accounts that do not currently comply with the proposed protections, or that would not comply in the future, absent the adoption of the proposed rule.”¹⁷ Specifically, the Bureau identifies two problems that the proposal seeks to address. First, consumers may “incorrectly believe” that these unregulated prepaid accounts are indeed regulated under Regulation E and Regulation Z.¹⁸ Second, the sellers may under-provide “information about prepaid accounts to consumer holders of these accounts.”¹⁹

The Bureau believes sellers of prepaid cards may under-provide information about prepaid accounts, which would lead to these sellers’ “exercise of market power.”²⁰ The Bureau argues such a scenario is an example of the market failure of information asymmetry.²¹ The question is thus whether data and experience suggest that such under-provision of information is indeed currently a problem in the market. This section offers relevant information on diagnosing market failure that the Bureau should take into consideration when determining the need for a final rule.

The CFPB claims sellers may “have less incentive to identify and highlight unattractive product features, such as high fees that may be associated with certain types of activities.”²² If relevant information is not available through other sources, such a scenario might present a classic market failure case of information asymmetry. The CFPB states, “In principle, third parties could try to generate (or approximate) this information independently. However, simply collecting

¹⁴ 79 FR 77103

¹⁵ Pew Charitable Trusts (2014), Why consumers use prepaid cards: A survey of cardholders motivations and views. Consumer Reports. “Prepaid cards: how they rate.”

¹⁶ Pew “Why consumers use” p. 7

¹⁷ 79 FR 77258

¹⁸ Ibid

¹⁹ Ibid

²⁰ 79 FR 77258

²¹ Information asymmetry citations

²² 79 FR 77258

synthesizing, and providing product information for a fee likely would not be profitable since the information generally would be non-excludable; that is, it could not be withheld from consumers who did not pay for it.”²³

In reality, however, third parties are already providing such information, and consumers today can access information about prepaid cards at no cost. Consumer Reports has published numerous evaluations of prepaid card fees and terms,²⁴ and the website Nerdwallet offers free information and a simple tool to help consumers decide which card is right for them:

Prepaid debit cards come loaded with charges, from monthly fees to ATM fees to fees for using the card. Answer a few questions to the left, and we’ll figure out which one will cost you the least money.²⁵

This calls into question the basic premise of the CFPB’s proposal, as discussed further in section 4, below.

3. Regulatory Analysis

3.1 Anticipated benefits and costs

The Dodd-Frank Act requires that CFPB consider in its standards for rulemaking “the potential benefits and costs to consumers and covered persons, including the potential reduction of access by consumers to consumer financial products or services resulting from such rule.”²⁶ In the proposal, the Bureau initiates its discussion of benefits and costs by simply stating it has “considered the potential benefits, costs, and impacts.” It is unclear why the Bureau does not attempt to a greater extent to quantify and monetize benefits and costs in the proposal itself.

The only such quantified estimate is of the paperwork compliance burden, as required by the Paperwork Reduction Act. A supplementary document estimates quantified costs of applying Regulation E requirements to prepaid accounts in the form of increased burden hours. The Bureau estimates that account providers would make a one-time investment of approximately 29,000 hours to comply with the proposal and that the Bureau itself would spend approximately 17,000 hours. The Bureau estimates the following sources of increased burden hours:

- changes in “account opening disclosures, changes in term notices, and annual error resolution notices” to meet Regulation E requirements:

²³ 79 FR 77258

²⁴ Consumer Reports, “Prepaid cards: how they rate.”

²⁵ <http://www.nerdwallet.com/prepaid/>

²⁶ Dodd-Frank Act Section 1022(b)(2)(A)(1)

- “one-time and ongoing costs of implementing this change would be minimal.”²⁷
- provision of “transaction disclosures” for electronic fund transfer services:
 - “the burden on providers is minimal.”²⁸
- “a provider would be required to make available a short form and a long form disclosure required...before the consumer acquired the prepaid account”²⁹:
 - 92 hours per provider, one time, “to develop the short form disclosure and to update systems.”³⁰
 - 1104 minutes per provider, per year “to evaluate and if necessary update incidence-based fees on the short-form disclosure.”³¹
 - 8 hours per program “to develop the long form disclosure and update systems” because the “long form disclosure is substantially the same as disclosures already provided in prepaid account agreements.”³²
- requirement for providers to “provide periodic statements unless they use the alternative method of compliance proposed.”³³
 - 24 hours per prepaid account program
- requirement to “extend limited liability and error resolution provisions of Regulation E, as they apply to payroll card accounts” for those not already fully complying.³⁴
 - 8 hours per non-compliant program
 - variable ongoing costs from customer service calls, some of which may “be time consuming” and cause providers to “incur an ongoing burden.”
- requirement to “send to the Bureau copies of the account agreements”
 - 40 hours one time, 8 hours per quarter thereafter, per program
- location, shipment, and destruction of non-compliant prepaid account stock after the grace period following the proposal’s effective date.
 - one-time cost of “approximately \$17 million.”³⁵
- federal government’s costs of processing and reviewing “prepaid account agreements that providers would send in compliance with the proposal.”³⁶

²⁷ Supporting Statement - Electronic Fund Transfer Act (Regulation E), p. 16.
<http://www.regulations.gov/#!documentDetail;D=CFPB-2014-0031-0004>

²⁸ Ibid

²⁹ Ibid

³⁰ Ibid

³¹ Ibid

³² Ibid

³³ Ibid p. 17

³⁴ Ibid

³⁵ Ibid p. 17-18

³⁶ Ibid p. 18

Given the Bureau’s statutory mandate to consider the rule’s potential effect on consumers’ access to financial products, it is surprising that the analysis of regulatory costs does not include an estimate of how the proposal will affect prepaid account users and sellers beyond mere initial regulatory compliance. Such an estimate would first require an assessment of the current market situation, which is also absent. For example, how does the Bureau expect the extension of Regulation E and Regulation Z will affect demand for the accounts? Will the cost of providing the accounts change? Might providers enter or exit the market as a result of the new cost structures?

Also absent is a quantified benefit analysis. Rather, the Bureau lists as expected benefits greater information provision (as discussed previously) and implicitly assumes such provision will lead consumers to make more informed decisions. This problem is discussed in depth in section 4.

3.2 Regulatory Alternatives

The Bureau considered an alternative pre-acquisition disclosure called “all-in disclosure,” which is a “disclosure of a single monthly cost for using a prepaid account.”³⁷ The all-in disclosure, in theory, would “provide a quick and understandable reference point and...could also allow for easier comparisons among prepaid products.”³⁸ However, the Bureau decided not to adopt all-in disclosure because “it may not be possible to develop a single formula to reflect accurately how most consumers typically use a prepaid account.”³⁹

The Bureau is probably correct to reject this alternative. However, its observation regarding the variation in how different consumers use prepaid accounts casts doubt on the effectiveness of its preferred alternative, as well. It should consider further alternatives after analyzing more recent prepaid card consumer spending and behavior data. The current proposal was based on data at least two to three years old. In that time the market for prepaid cards has become much more competitive and consumer demands have evolved.

4. The improbable efficacy of increased information disclosure

The Bureau asserts that its proposed disclosure requirements are necessary to remedy asymmetric information in the market for prepaid cards. However, the market for prepaid accounts has grown and become exceedingly competitive since the Bureau began to collect information and draft a proposal, and an analysis of current market conditions for prepaid accounts suggests that such a complicated web of information is not representative of reality. As

³⁷ 79 FR 77150

³⁸ Ibid

³⁹ Ibid

a result of this competition, fee structures are simpler, and fees themselves are much lower, than in previous years.

Even if the Bureau's concern about information asymmetry were valid, however, its analysis likely overstates the effect the proposed disclosure requirements would have on informing consumers. The remainder of this section provides the Bureau with an analysis of information asymmetry from the economic literature, discusses the possibly limited effectiveness mandatory disclosure may have on a complex fee regime the Bureau describes, and concludes by arguing that an increasingly competitive market and the emergence of new entrants and third party providers of information have diminished the problem of asymmetric information over time.

Today, most sellers disclose fee and service information, and—in many cases—charge very low fees. One seller offers a prepaid debit card with general services for a fee of one dollar per month, and there are no activation, replacement, or reloading fees.

4.1 A market of heterogeneous consumption

The proposal presents the theory of search costs and its relationship to market efficiency and market power.⁴⁰ However, the extent to which this economic theory applies to the reality of prepaid account devices is unclear. The market in question is much more complicated and warrants deeper consideration than the Bureau has thus given.

The presence of a search cost for buyers theoretically could enable monopolistic pricing by sellers. An increased ability for buyers to access price information reduces the marginal cost of obtaining information about additional options; it also reduces the ability for sellers to obfuscate their price information. Thus a reduction in these search costs should reduce sellers' market power, promote competition, and move markets closer to the ideal Walrasian scenario of fully-informed buyers.

The Bureau cites an academic paper, Stahl II (1989), as evidence. However, this highly theoretical paper models consumer search and equilibria in a market “for a homogeneous good with identical costs and no capacity restraints.”⁴¹ While lower search costs may lead to more competitive markets for heterogeneous goods, like prepaid cards, it is likely the process will be much more complex than the one following Stahl II's model.

Following these assumptions, the paper concludes more monopolistic pricing schemes make consumers with positive search costs worse off because a rational consumer will search until the

⁴⁰ 79 FR 77158

⁴¹ Stahl II, Dale O. (1989). Oligopolistic pricing with sequential consumer search. *The American Economic Review*, 79, pp. 700-712.

costs from that search exceed the benefits. Further, it concludes that entry of more sellers (or “stores”) lowers each seller’s expected gain from offering low prices because their ability to capture consumers with positive search costs decreases. The subsequent welfare effect is unclear, though, because a greater number of sellers benefits consumers by providing more shopping options. It is thus a reasonable argument in the context of Stahl II (1989) that lowering search costs would benefit consumers—as long as this lowering does not occur at the expense of decreasing consumers’ shopping options.

The traditional economic examples of homogeneous preferences in a unified marketplace are government bonds and agricultural and mineral products. In these markets, buyers need only consider price when making a decision. In all other markets, buyers have to consider not only price information, but also product information.

The market for prepaid account devices, though, is different: like most markets, it is characterized by a variety of offerings to consumers with heterogeneous preferences. The variety of offerings includes different fee structures (e.g. initial purchase, monthly, purchase/swipe, ATM, etc.) and limitations (e.g. balance minimum/maximum, overdraft). Heterogeneous preferences arise from diverse buyers who favor one fee structure over another because of their individual spending behavior. The Bureau acknowledges this heterogeneity: “there no single use case for all prepaid accounts.”⁴²

This is not to say that lower search costs will not decrease market power and promote competition. Bakos (1997) argues that the rise of electronic marketplaces would have such a general effect.

When searching for a product, consumers decide “whether to purchase one of the products already identified or to keep searching.”⁴³ If a consumer chooses a suboptimal product early in the search process a “‘fit’ cost” representing “the loss of utility from obtaining a less than ideal product” is endured, but the consumer also foregoes any further search costs.⁴⁴ On the other hand, more extensive search may lead to purchase of a superior product but at a higher search cost.

Similarly to the discussion in 4.2, it is impossible to classify prepaid cards as either search or experience goods for the entire population. Some consumers will be more inclined to search compared to others for a number of reasons. Not a minor matter to consider is financial literacy

⁴² 79 FR 77150

⁴³ Bakos, J. Yannis (1997). Reducing buyer search costs: implications for electronic marketplaces. *Management Science*, 43, p. 1697

⁴⁴ Ibid.

and numeracy⁴⁵: financially illiterate or otherwise innumerate consumers may have infinitely high search costs, and these may be the people the Bureau is trying to protect. If so, the Bureau should consider ways to protect these consumers other than through increased information disclosure requirements. Other consumers may simply find the search process tedious, and thus their search behavior may not change at all with more information present.

4.2 The question of the long-form disclosure, particularly in retail stores

The proposed rule presents for itself an interesting challenge for accounts acquired in retail stores. As previously discussed, the Bureau seeks to lower search costs for consumers by providing additional information through short-form and long-form disclosures. In order for this information to have any effect on lowering search costs, the consumer must utilize and then act on this information before making a purchasing decision. Thus, it is strange that for sales occurring retail stores, where 54% of prepaid cards are obtained, the Bureau proposes to allow long-form disclosures to be available to consumers only after purchasing the account.

The Bureau recognizes that it is not feasible to provide long-form disclosures to consumers in retail stores before purchase because of size, packaging, and space constraints. Therefore, the Bureau proposes to allow sellers to provide the long-form disclosure after the consumer purchases the account as long as (1) the long form disclosure is available inside the packaging material, (2) the short form disclosure is visible on the packaging materials, and (3) the seller provides a telephone number and URL on the packaging that would direct the buyer to the long form disclosure.

Thus, even if purchasers of prepaid accounts had no other source of information (e.g., from third party sources mentioned above) it is unlikely that the Bureau's proposal will address the information asymmetry problem. The long-form disclosure cannot facilitate lower search costs for the buyer if it is unavailable while the buyer is searching.

5. Conclusions and recommendations

Several years ago, CFPB determined that consumers of prepaid debit cards were making purchases without accurate information about fees and terms. The Bureau believed this asymmetric information reflected a failure of private markets, which it proposed to address with increased information disclosure requirements.

The data on which the Bureau makes its case is outdated, however. New sellers have entered the market and, as a result, have introduced products with lower fees and clearer terms in order to

⁴⁵ Lusardi, Annamaria and Olivia S. Mitchell. The Economic importance of financial literacy: theory and evidence. *Journal of Economic Literature*, 52, pp. 5-44.

remain competitive. Further, as demand for the products has grown, for-profit and not-for-profit third-party information sources have begun to provide objective information to help match individual consumers with the card that best suits their needs. These substantial developments in the market for prepaid debit cards have occurred after the Bureau decided to propose regulations, and raise the question as to whether the proposed disclosure requirements are necessary at all. However, even if there were a need, it is unlikely the Bureau's proposed disclosure requirements will thoroughly address the problem of information asymmetry it identifies.

Before proceeding, CFPB should gather more updated information on the prepaid debit card market about sellers and buyers of prepaid cards, as required by statute. As this proposal stands, it is likely to increase costs and may reduce access with little or no discernible benefits for card users.