

Regulating Internet Payment Intermediaries

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ეს სტატია მიმოიხილავს სამართლებრივ და პოლიტიკურ საკითხებს, რომელიც დაისვა გადახდის მეთოდების ცვლილებების საფუძველზე ინტერნეტის წარმოშობასთან დაკავშირებით. გადახდის მეთოდების ცვლილება გულისხმობს შემდეგს: P2P სისტემებისა, როგორცაა PayPal - ი და ინტერნეტ ანგარიშსწორების (რომელიც ცვლის საანგარიშსწორებო დოკუმენტებსა და ჩეკებს) სისტემების განვითარება და ზრდა. ორივე მათგანი წარმოადგენს იმ ახალ შუამავლებს, რომლებიც ხელს უწყობს გადახდების განხორციელებას საყოველთაოდ ცნობილი გადახდის სისტემების საშუალებით. სტატიაში გადმოცემულია აღნიშნული სისტემების მუშაობის პრინციპი. ასევე განხილულია ის პრობლემები, რომელიც არეგულირებს ამ სისტემების მუშაობას ამერიკის შეერთებულ შტატებში.

საბოლოოდ სტატიაში განხილულია პრობლემები, რომლებიც დაკავშირებულია გადახდის სერვისების შესაძლო ცვლილებებთან მკაცრად რეგულირებადი საბანკო ინდუსტრიიდან ახალ და არარეგულირებად ინტერნეტ კავშირზე. განხილულია სხვადასხვა სტრატეგიები ბანკებსა და ახალ პირებს შორის კონკურენციის სფეროს უზრუნველსაყოფად და ამ-ვდროულად უზრუნველყოფს ადეკვატურ დაცვას მომხმარებლებისთვის, რომლებიც სარგებლობენ ამ სისტემებით.

Summary

This article examines legal and policy issues raised by changes in payment methods related to the rise of the Internet. The two major changes – the rise of P2P systems like PayPal, and the rise of Internet billing systems to replace the use of paper bills and checks – both involve new intermediaries that facilitate payments made by conventional payment systems. The article first discusses how those systems work. It then discusses problems in the framework currently used to regulate those systems in the United States, which has not been updated to protect consumers from the special problems those systems raise. Finally, the article considers problems with the potential shift of payments services from the heavily regulated banking industry to new and unregulated Internet-related startups. The article considers a variety of strategies for producing a level field of competition between banks and the new entities and at the same time providing adequate protection for the consumers that use the systems in question.

INTRODUCTION

The Internet has produced significant changes in many aspects of commercial interaction. The rise of Internet retailers is one of the most obvious changes. Oddly enough, however, the

overwhelming majority of commercial transactions arranged over the Internet use a conventional payment system (typically a credit card). To many observers, this has come as a surprise. The early days of the Internet heralded a variety of proposals for entirely new payment systems – generically described as electronic money – that would use wholly electronic tokens that consumers could issue, transfer, and redeem.

Years later, however, no electronic money system has gained a significant role in commerce. The continuing maturation of the Internet, however, has brought significant changes to the methods by which individuals make payments. Person-to-person (P2P) systems like PayPal now make billions of payments a year between individuals. The most common purpose is to facilitate the purchase of items at Internet auctions, but increasingly P2P transfers are used to transfer funds overseas. Less far along, but gaining transactions rapidly, are a variety of systems for electronic bill presentment and payment (EBPP).

Interestingly, both of those developments follow a path less ambitious than the still-hypothetical electronic-money systems: they involve the use of intermediaries to “piggyback” on existing systems to provide payment. Thus, in essence, they use the technology of the Web site to facili-

tate the use of conventional payment networks. However disparate those developments might seem at first glance, they present a common challenge to the regulatory system.

Unlike banks, which control the execution of payment transactions in conventional payment transactions, the intermediaries that populate these new sectors generally are not subject to regulatory supervision. At most, P2P providers are subject to state regulation as money transmitters (akin to the regulation of Western Union). That circumstance presents a serious gap in the regulatory scheme. The pervasive regulatory supervision of banks ensures that they honor their obligations under a variety of consumer protection and data-privacy regulations that govern their activities. A shift of a significant share of volume to the new and unregulated entities raises a corresponding risk of loss from the irresponsibility of those entities. Thus, although the risk of fraud and privacy violations is doubtless higher in these new forms of transactions than it is in conventional transactions, the regulatory framework is much weaker.

Any regulatory intervention must accommodate both the benefits of increased competition from those new entities and the risks that their lack of responsibility will harm the consumers whose accounts are involved in the transactions.

1. P2P Systems

The success of eBay's auction business had the rare effect of creating a vast market for an entirely new payment product, one that would allow non-merchants (who cannot accept conventional credit-card payments) to receive rapid payments in remote transactions. Without such a system, purchasers in the early days of eBay had to use cashier's checks or money orders; typically sellers waited to ship products until receipt of the paper-based payment device through the mails. From a flood of startups offering competing products, PayPal (now owned by eBay) has emerged as the dominant player in the industry, now processing billions of payments each year. A separate (and much smaller) submarket, exemplified by City Bank's c2it service, uses similar systems for cross-border payments. To understand the policy ramifications of P2P payments, it is necessary to understand the relation between the P2P provider and the conventional accounts from which and to which P2P payments are made. That relation can be illustrated by a summary of the three steps that must be completed for a successful P2P transaction.

1.1 Providing Funds for Payment

The purchaser that wishes to use a P2P provider to make a payment has two general ways to provide funds for payment. First, it could fund an account with the provider, normally by drawing on a deposit or credit-card account. Because it ensures that funds are available for an immediate transfer, that process is common for those who make frequent purchases. P2P account balances also are common for frequent eBay sellers, who receive funds into their P2P accounts from those to whom they make sales. Alternatively,

the purchaser could wait until the moment that it wishes to make a purchase. Again, it could choose at the time of payment to provide the funds in question by drawing on either a deposit account or a credit-card account. As discussed below, the choice between a credit card and a deposit account as a funding source has significant legal consequences to the user. In either case, the fee structure is likely to discourage the use of credit cards, because the P2P provider incurs higher fees when it pays the interchange owed to the bank that has issued the credit card from which funds are drawn than when it pays the fees necessary to draw funds from a deposit account through a debit entry in the ACH system. Similarly, because the P2P provider can profit by investing funds that remain in transaction accounts, some providers (including PayPal) encourage users to leave funds in those accounts by paying interest on them.

1.2 Making Payments

The attraction of the P2P process, of course, is that it is quite simple to make payments. Normally, the only information that the purchaser needs to make a payment is the amount of money and the email address of the intended recipient. After entering that information into a form at the P2P provider's Web site, the purchaser clicks on a "send money" button to request execution of the transaction. If the funds are sent from a balance in an account with the P2P provider or if they are drawn from a credit card, they should arrive in a few hours. If they are drawn directly from a deposit account, arrival will be delayed by a few days (until settlement of the ACH transaction to obtain the funds from the user's bank).

1.3 Collecting Payments

The final step is for the recipient (the seller if the payment is for an auction) to collect the payment. In the typical process, the recipient receives an email notifying it that the payment has arrived. If the recipient has an account with the P2P provider and is willing to leave the funds in that account, then it need do nothing further. If it does not have an account, or if it wishes to withdraw the funds, it will need to go to the provider's Web site and provide the necessary details. Ordinarily, the recipient will pay some fee to the provider for making the payment available. Those fees vary considerably, but a typical charge at PayPal would be 25-50 cents plus 2-4% of the transaction amount.

2. EBPP Systems

EBPP systems are at a much less mature stage in their development than P2P systems. Accordingly, it is much harder to provide a clear picture of their operations. Generally, though, three different models compete, with the distinction turning on whether the Web site is operated by the biller, by the payor's bank, or by a third-party service provider. As with P2P systems, the fact that the different models compete to perform quite similar services for consumers should not obscure the significantly differing legal and policy implications of the different models. According-

ly, it is important to explain briefly how each of the three models works.

All-In-One statement processing. Picture 1.



3. P2P Intermediaries

Selecting a regulatory approach for the P2P intermediaries is difficult for a variety of reasons. First, because of the persistent allegations of misconduct by PayPal – none of which, to be sure, seem to have resulted in any proof of serious misconduct – it seems unacceptable to have PayPal completely unregulated. At the same time, the competitive landscape shows a tension between PayPal – now owned by eBay – and smaller competitors primarily controlled by banks. In that setting, it seems particularly inappropriate to use the gatekeeper strategy to subject PayPal’s operations to the control of the banking industry. For the same reason, it seems absurd to say that P2P services must be provided by a bank. That is simply to require eBay to sell PayPal to a bank. The evident synergy between PayPal’s operations and eBay’s suggests that any such outcome would unnecessarily destroy some significant opportunity for innovation in the provision of payment services. My views on that point are strongly influenced by the potential of PayPal to be a major competitive figure as Internet payment systems develop in the years to come. For example, it is a well known aspect of the Internet that the payment systems available for Internet retailers are wholly inadequate: they are both expensive and subject to high rates of fraud (the costs of which are born directly by the retailers). Yet, the major credit-card networks have retained a dominant near-monopoly position in that market. PayPal is already one of their strongest competitors, as it provides payment services to smaller merchants that find it uneconomical to join Visa or MasterCard directly. It may be that an unconstrained PayPal has the potential to be a risk for consumers. But at the same time an unconstrained PayPal that forces Visa, MasterCard, and the banking industry to look constantly

over their shoulders could do more for the competitiveness of Internet payment providers than any pressure that the Antitrust Division of the Department of Justice has brought to bear. More broadly, the introduction of this paper notes the persistent failure of electronic-money products to take hold on the Internet. If there is a market for a new and innovative electronic-money product, the likelihood that such a product will be developed, implemented, and deployed successfully is maximized by a regulatory system that permits the continuing presence of a large player like PayPal not wedded to the existing payments networks. The foregoing comments seem to leave a choice between doing

Nothing and adopting the light federal regulatory regime discussed above. Doing nothing of course does not leave PayPal completely unregulated, because it already is under the supervision of money transmitter statutes in a number of states. For the reasons discussed above, however, that arrangement presents a high risk of duplicative or inappropriate regulation – which ultimately could be either excessive or too lenient. Accordingly, in a perfect world, a single federal arrangement would make more sense. Given the fact that PayPal’s parent eBay already must comply with the increasingly onerous requirements that come with its

listing on NASDAQ, it seems unlikely that those requirements would impose costs that would have competitive significance to PayPal. And at the same time they should go far to assuage the concerns summarized above about PayPal’s responsibility for its regulatory obligations.

4. EBPP Intermediaries

It is much harder to come to rest on a recommendation for the EBPP systems. The nature of their operations makes the privacy and fraud concerns much more substantial than in the P2P context – because their operations necessarily involve pervasive access to consumer deposit accounts. P2P providers by contrast, are likely for many consumers to conduct their operations without any mechanism for accessing the consumer’s deposit account. To be sure, there are few reports of problems with the EBPP systems to date. But the fluidity of the highly fractionated market gives little basis for confidence that all members of the industry will be responsible. Thus, it seems unacceptable to think that the current regulatory framework will be suitable in the end. At the same time, it seems excessive to say that only banks can provide those services. Among other things, a rule limiting those services to banks would significantly diminish the likelihood of a universal payment service. In the long run, there seems to be a strong case that such a site is at least part of the optimal response, because it would be easier for such a site to overcome the classic bandwagon-effects problems of attracting sufficient billers and consumer payors as customers.

Of course such a site still could develop in a “bank-only” approach – for example through contracts by individual

banks with a dominant provider like Check Free. But to the extent that a bank-only approach lessens the potential for such a service, it is a serious cost of the approach.

That leaves for consideration the intermediate approaches of industry-specific regulation and the use of banks as gatekeepers. There is much to be said for a gatekeeper approach. It would permit a tempered market experiment of competition between the more sophisticated universal model, on the one hand, and the simpler Internet banking and biller models, on the other hand. Thus, it would help reveal the strength of consumer preferences for the different models. At the same time, it would provide the strongest assurance that consumers in fact would be protected from losses from fraud and error. But the gatekeeper approach would do nothing to ensure the privacy of consumer information – it is feasible to require banks to hold deposit accounts unharmed from unauthorized transactions, but it is much more problematic to require them to ensure that intermediaries comply with their privacy obligations. A light scheme of federal regulation like the one discussed above could include monitoring of data-privacy compliance to assuage that concern. Moreover, for the reasons discussed above, the gatekeeper approach creates a substantial risk of anti-competitive conduct by banks tempted to exclude their nonbank competitors. A separate regulatory apparatus would avoid that problem.

Conclusion

This paper examines legal and policy issues raised by changes in payment methods related to the rise of the Internet. The two major changes – the rise of P2P systems like PayPal, and the rise of Internet billing systems to replace the use of paper bills and checks – both involve new intermediaries that facilitate payments made by conventional payment systems. The paper first discusses how those systems work. It then discusses problems in the framework currently used to regulate those systems in the United States, which has not been updated to protect consumers from the special problems those systems raise. Finally, the paper considers problems with the potential shift of payments services from the heavily regulated banking industry to new and unregulated Internet-related startups. The paper considers a variety of strategies for producing a level field of competition between banks and the new entities and at the same time providing adequate protection for the consumers that use the systems in question

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