

FEDERAL RESERVE BANK OF CHICAGO 2008 PAYMENTS CONFERENCE

PAYMENTS FRAUD: PERCEPTION VS. REALITY

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OVERVIEW

- Electronic Payments Default Fraud Liability Architecture
 - Public Law
 - Private Rules
- Use of Contracts to Shift Fraud Liability
- Optimizing Fraud Liability Allocation

ELECTRONIC PAYMENT SYSTEM DEFAULT FRAUD LIABILITY ARCHITECTURE – PUBLIC LAW

- Credit Card Payments – Truth in Lending Act (TILA)/Regulation Z
 - Limits cardholder liability for unauthorized use to maximum of \$50
- Debit/Payroll Cards and Certain ACH Payments – Electronic Fund Transfer Act (EFTA)/Regulation E
 - Card Transaction (Access Device) – liability limited to:
 - Maximum of \$50 of unauthorized transactions if issuer notified within 2 business days after learning of loss/theft
 - Maximum of \$500 of unauthorized transactions if issuer notified after 2 business days but within 60 days of first fraudulent transaction appearing on statement
 - All EFTs (Card/ACH)– unlimited liability for unauthorized transactions beginning 61st day after fraud first appears on statement until fraud is reported to issuer

ELECTRONIC PAYMENT SYSTEM DEFAULT FRAUD LIABILITY ARCHITECTURE – PRIVATE RULES

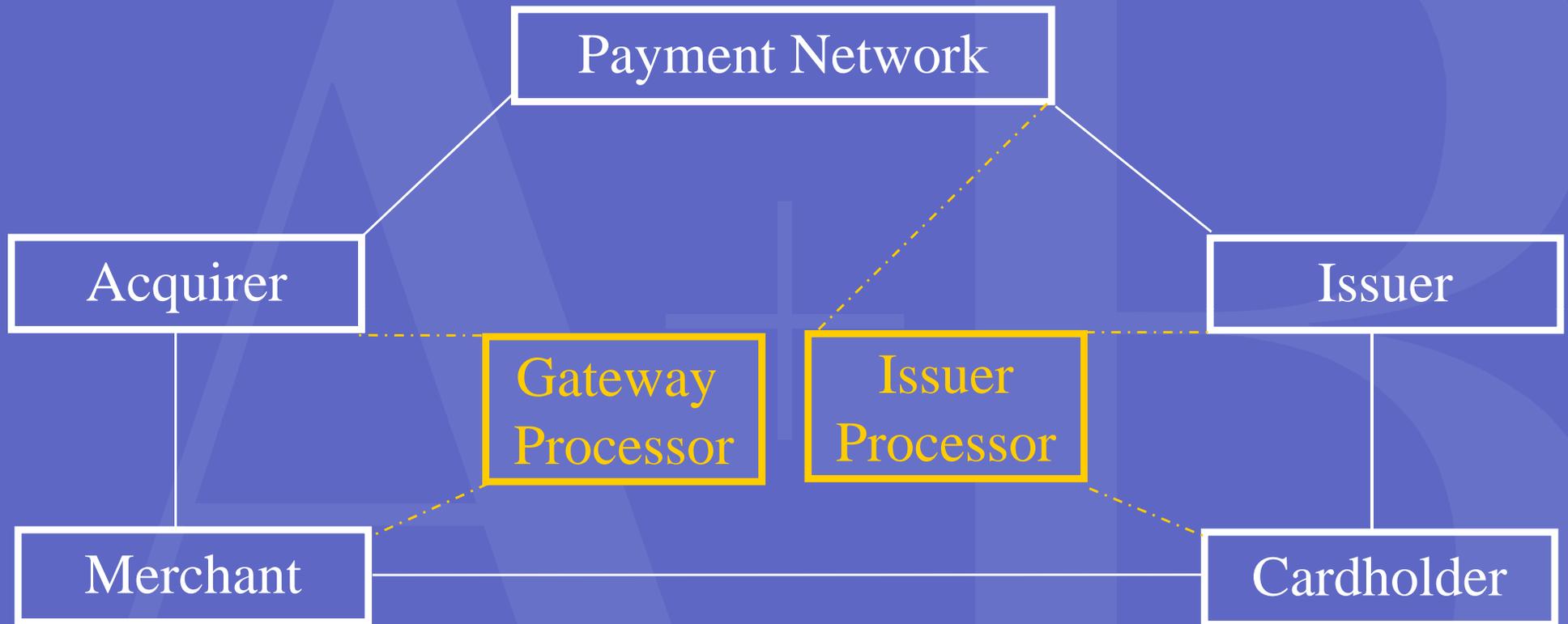
- Zero Liability for Cardholders
- Establish rules/requirements intended to mitigate system-wide fraud risk
 - Holograms, signature requirements
 - CID, Address Verification
 - PCI DSS
- Allocate fraud liability to payment stream participant that fails to comply with fraud-prevention rules

USE OF CONTRACTS TO FURTHER SHIFT FRAUD LIABILITY – TEXTBOOK MODEL



Model payment system framework contemplates 4 (or 2) parties for fraud liability allocation

USE OF CONTRACTS TO FURTHER ALLOCATE FRAUD LIABILITY – REALITY MODEL (ALMOST)



Default liability holders in payment systems use contracts to shift liability:

- Issuer shifts fraud monitoring responsibility and liability to processor
- Acquirer shifts PCI compliance responsibilities to Gateway service provider

WHAT IS THE OPTIMAL ALLOCATION OF FRAUD LIABILITY?

- Protectionism/paternalism v. confidence in payment system
 - Electronic payment systems depend on consumer confidence – may fall if increased fraud liability exposure
 - Insurance dilemma – low or no liability encourages risky behavior (but is fraud ever really free?)
- Impact on development of new payment technologies