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THE EVOLUTION OF GIFT CARDS IN SECONDARY MARKETS AND MONEY SERVICES

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ABSTRACT

This paper reviews gift cards and the regulations associated with these instruments in financial transactions. One important consideration of gift cards involves secondary markets and money services business. While the accounting of gift cards by retailers is easy when they are redeemed, gift cards become problematic when breakage (non-redemption) occurs. In addition to large organized exchanges for gift cards, many prospective sellers and buyers have turned to non-mainstream dealers to handle situations relating to the non-redemption of the gift card. This has caused gift cards to become an increasingly important player in the secondary market. Another important observation with these instruments involves the true cost to buyers. Most consumers fail to consider opportunity costs and alternatives. Since gift cards are perceived differently than cash, opportunity cost consideration should be viewed differently to determine the effective price value.

Keywords: Gift Card, Store Value Instrument, *Secondary Markets, Money Services, Money Transmitters*

1. INTRODUCTION

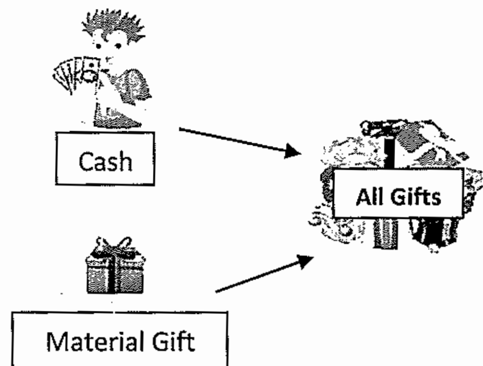

Figure 1 – Traditional Gift Pool

On special occasions, such as birthdays, weddings, and baby showers, it is customary to present a gift to the celebrator(s). In some cases, a financial (i.e. money or store-value card) gift is substituted for a material gift. A store-value card, commonly called a gift card, is more socially acceptable than a cash gift as cash may be viewed as cold or thoughtless. Gift cards may also be preferred when compared to the extensive investment in time to find an appropriate gift or in situations where the person receiving the gift is "hard to shop for." Researchers have found that general differences in cognitive valuations of gift cards and cash exist (Tuten & Kiecker, 2009; White, 2008). Differences in these instrument valuations trigger various consumer behaviors and are subject to financial regulations.

This paper presents an overview of the U.S. financial regulations associated with gift cards. Gift cards are subject to regulation as instruments of *stored valued* as the issuer and merchant for products and services may redeem cards. According to Eveleth (2013), gift cards were first issued by Blockbuster Video in 1994 as a countermeasure to increased counterfeiting of gift certificates. As counterfeiting can significantly erode profits and consumer confidence, merchants must protect their assets including company issued scrip (i.e. gift card) from fraudsters (McKinney et al., 2015). Blockbuster, like many other

retailers, used printed gift certificates without security features and legal protections of *legal tender* making counterfeiting certificates easy and enticing (Eveleth, 2013; McKinney et al., 2015).

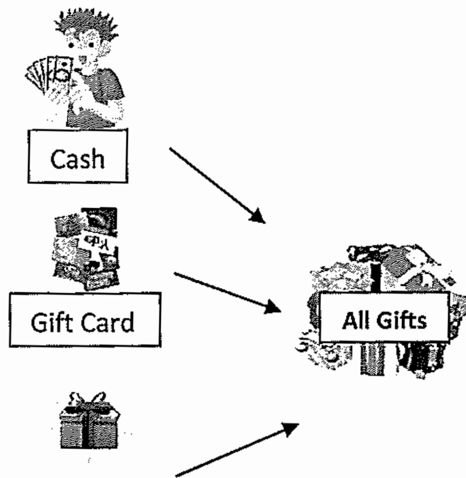

Figure 2 – Evolving Gift Pool

Since the initial introduction of the gift card as a countermeasure to counterfeiting, most large retailers have established gift card programs (Eveleth, 2013; McKinney et al., 2015). Moreover, Starbucks introduced reloadable gift cards in 2001 to help stimulate sales (Eveleth, 2013). Today, the preference for giving and receiving gift cards extends beyond the financial transactions to include the strengthening of social connections (Tuten & Kiecker, 2009). In fact, a general perception of gift cards is that the recipient can indulge in consumer purchazses, as cash requires greater consideration about consumption from the user. Tuten and Kiecker (2013) note that gift cards purchased during the Christmas and Hanukkah holiday season actually delay consumption resulting in the redemption of gift cards over subsequent months resulting in consistent product demand throughout the year. Another benefit resulting from this redemption delay is, during the time the gift cards are not redeemed, the company issuing the gift card is receiving interest from the cash that remains on the gift card while the person holding card makes their purchasing decision.

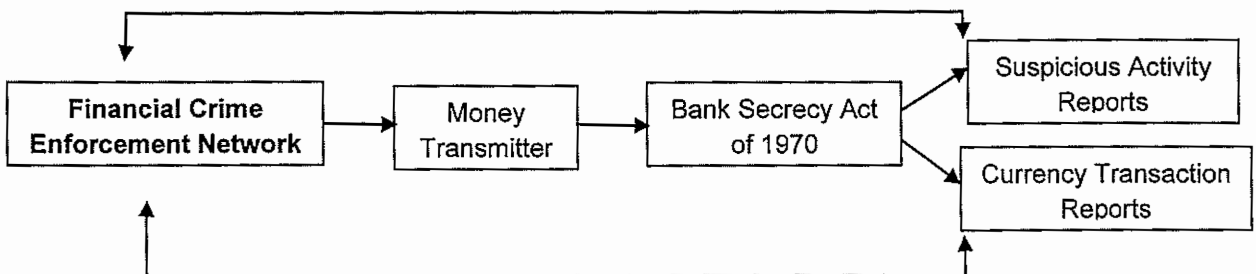

***Figure 3 –Money Transmitter Accountability**

*Gift Cards are not considered Money Transmitters at this point.

Gift cards sales in 1999 was $19 billion, in 2014 sales were $124 billion, and 2016 sales are estimated to be $140 billion (Arnold, 2016). With significant sales of gift cards and the inability to exchange unwanted gift cards with merchants for cash, some gift cards, estimated at about 19%, go unredeemed (Kile, 2007). This has created secondary markets for gift cards whereby unwanted cards could be sold and desired cards purchased. With secondary market operators, the original terms of the cards must be followed (FinCEN, 2013). Another important consideration of gift cards involves secondary markets and money services business.

2. MONEY SERVICES BUSINESS

Regulators determine whether a secondary marketer is a money transmitter or other form of money services business (MSB) is to determine whether the Bank Secrecy Act of 1970 (BSA) applies to transactions that would require Suspicious Activity Reports (SARs) and Currency Transaction Reports (CTRs) to be generated. MSBs are required to register the *financial instrument* through The Financial Crime Enforcement Network ("FinCEN") division of the U.S. Treasury Department as many MSBs operate as money transmitters (31 CFR 103.41). Money transmitters are conduits whereby money moves from one person at one location to another person and location. Although gift cards provide similar operations, they do not operate as money transmitters.

Gift cards operate in a closed loop program in which a store value card can be used at one or a limited number of locations and is not considered a money transmitter (FinCEN, 2013). Other prepaid cards, such as those issued by credit card companies, are open loop cards that may be used nearly anywhere. The term Money Transmitter was further clarified by FinCEN by removing prepaid access systems that have a maximum daily amount of $2,000. Gift cards are not considered to be money transmitters since they are considered low risk (FinCEN, 2013). Other prepaid access instruments issued at denominations exceeding $2,000 are deemed money transmission. The overall intent of MSB regulation is to prevent money laundering, funding terrorism and fraud. Being of such small denominations, FinCEN views closed loop gift cards as unlikely vehicles for achieving those types of illegal activities. In the next section, we consider the property status of gift cards.

3. ACCOUNTING OF GIFT CARDS AND SECONDARY MARKET OPERATIONS

The accounting of gift cards by retailers is easy when those gift cards are redeemed but very problematic when breakage (non-redemption) occurs in gift cards (Kile, 2007). Researchers notes that some retailers have made significant adjustments to earnings as a result of adjustments of breakages. Consequently, not all breakage can be reported as income due to the escheat laws (Feinson, 2008; Kile & Wall, 2008). Many states' escheat laws treat gift cards as personal property with breakage being escheated to the state as abandoned or unclaimed property (Feinson, 2008). However, gift cards are not treated as personal property when issued since sales tax is not collected and the card is a liability to the company until redemption. This treats the card as a medium of exchange with sales tax collected at redemption. To increase profits, some companies use a separate legal entity located in a state without escheat requirements to handle gift card programs. If gift cards are treated as personal property, they can be transferred in the secondary markets.

In reviewing online secondary market firms, we found that most firms follow similar policies. Secondary marketers pay between 75% to 90% of gift card face value contingent on the issuer and the broadness in product line (Cipriani, 2014). In selling gift cards, secondary marketers add at least 5% of a gift card's face value to their purchase price. For example a secondary marketer pays $85 for a gift card with $100 face value and subsequently sells it for $90. While this is a good deal for the purchaser, the original transaction of $100 for a card could be worth only $85 to the recipient if sold to a third party instead of redeemed.

In addition to large organized exchanges (e.g., CardCash, CardHub, GameStop, GiftCardGranny, and Plastic Jungle) for gift cards, many prospective sellers and buyers have turned to non-mainstream

dealers such as Craigslist and eBay (Cipriani, 2014). When trading with non-mainstream dealers, sellers risk that a good card is exchanged for a bad check or a credit card payment is disputed and reversed. Buyers have several risks including the card could be stolen or it could have little or no remaining balance. Also, there is no guaranty that the balance will be there immediately after purchase. Many card transfers are simply exchanges of access codes that allow sellers to use codes after the card is sold. It should be noted, there are limited regulations that deal with this situation, with prices being determined by market supply and demand. Some factors influencing pricing are issuer bankruptcy risk, card expiration date, card balance, and issuer terms and conditions.

4. OPPORTUNITY COSTS OF GIFT CARDS

Most consumers fail to consider opportunity costs and alternatives (Spiller, 2011). Since gift cards are perceived differently than cash, opportunity cost consideration would also be viewed differently (Tuten, & Kiecker, 2009). There are differences in purchases of gift cards from on-site locations and purchases online, since online purchases may include up to $7 in fees and shipping costs: the $100 gift card, in this case, would end up costing $107. Moreover, additional fees (see table below) may be associated with using or not using a gift card. Prior to the passage of the *Credit Card Accountability Responsibility and Disclosure Act of 2009*, a gift card could lose a large part of its value through fees and charges that a cardholder may have been unaware of at the time of purchase.

Table 1: Types of Fees Associated with Gift Cards

Types of Fees	Description
Dormancy Fees	Charge for inactive cards. Inactivity must be greater than twelve consecutive months prior to charging fees. In some cases, dormant gift cards must be escheated to states.
Loading Fees	Charge for adding value to the gift card
Inquiry Fees	Fees for accessing the balance of the gift card
Monthly Service Charge	Fees for the privilege of having access to the gift card
Transaction Fee	Fees associated with gift card use
Expiration	Gift cards cannot expire for at least five years (12 CFR 1005.20)

Before these increased disclosure requirements were in place, many purchasers failed to realize the total amount of fees that would rapidly deplete gift card balances. Spiller (2011) notes that consumers fail to fully consider opportunity costs associated with purchases. The Credit CARD Act dramatically changed the rules as to fees issuers could charge. While most fees remain, the disclosure of fees must be *"clear and conspicuous"* and made prior to purchase (12 CFR 1005.20). Furthermore, gift cards must be dormant for twelve consecutive months before dormancy fees can be charged, and those dormancy fees cannot effectively surrender gift cards prior to an expiration of less than five years.

5. CONCLUSIONS

This paper discussed the increasing and evolving use of gift cards in place of traditional gifts or cash. They have become a very popular form of gift to give and to receive. Non-redemption of card value can result in problems for issuers. In addition, there are risks associated with using non-mainstream dealers. Another consideration is that most consumers fail to consider opportunity costs, such as the loss of card value, and alternatives to giving and using gift cards in place of tradition gifts or cash. Research indicates a significant number of gift cards are not redeemed for their full value.

Given that recipients of gift cards can receive far less than the purchase price value, why are gift cards popular? According to Tuten and Kiecker (2009), gift cards are more socially acceptable than giving cash and are easier than buying personalized gifts. The result is it is unlikely a replacement for this increasing important form of gift giving will be replaced in the near future. It is also likely, this form of gift giving will continue to grow in its importance and should be watched as it continues to evolve.

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