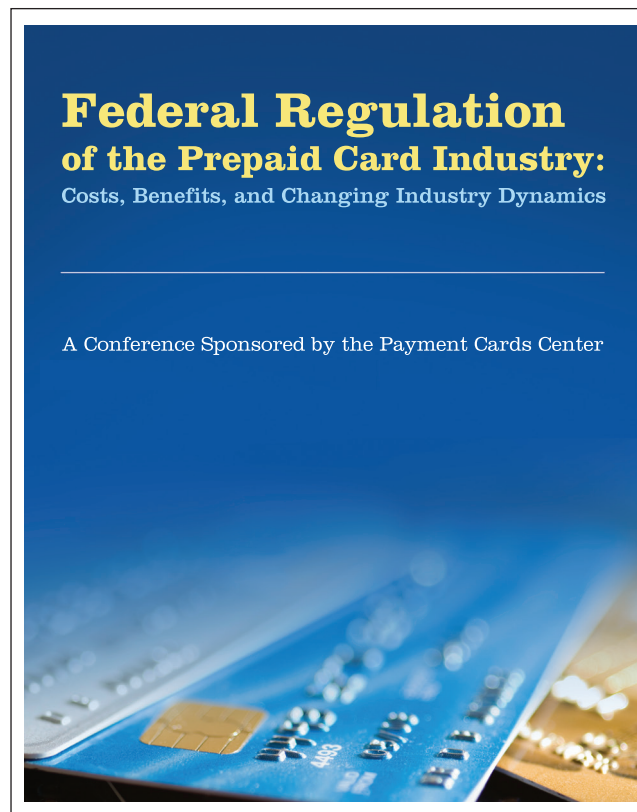


CONFERENCE SUMMARY



Federal Regulation of the Prepaid Card Industry:

Costs, Benefits, and Changing Industry Dynamics

April 8 - 9, 2010



FEDERAL RESERVE BANK OF PHILADELPHIA

CONFERENCE SUMMARY

Federal Regulation of the Prepaid Card Industry: Costs, Benefits, and Changing Industry Dynamics

Philip Keitel

Summary

On April 8-9, 2010, the Payment Cards Center of the Federal Reserve Bank of Philadelphia hosted a conference that brought together leaders in the prepaid card industry, regulators, consumer groups, law enforcement agents, and industry researchers to discuss the economics of prepaid cards and the benefits and costs of their regulation from the standpoint of several different product categories. In particular, the conference examined ways in which prepaid card products can differ, how the industry has developed over time, ongoing industry dynamics, ways in which the usefulness of prepaid products to criminals might be limited, whether consumers who use prepaid cards are adequately protected, and the challenges facing regulators. This paper summarizes the highlights from the presentations given at the conference and the discussions that ensued.

Keywords: Prepaid cards, Gift card rule, General-purpose-reloadable, Benefit disbursement, Stored value cards, FinCEN

JEL Codes: G28

The views expressed here do not necessarily represent the views of the Federal Reserve Bank of Philadelphia or the Federal Reserve System.

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I. Introduction

On April 8 and 9, 2010, the Payment Cards Center (PCC) of the Federal Reserve Bank of Philadelphia held a conference titled “Federal Regulation of the Prepaid Card Industry: Costs, Benefits, and Changing Industry Dynamics.” The conference brought together leaders in the prepaid industry, regulators, consumer groups, law enforcement agents, and industry researchers. Overall, the conference was designed to foster a better understanding of changes that are occurring in the industry, to establish an appreciation of variation among prepaid products, and to begin a discussion of how the federal regulatory environment affects the development of prepaid products.¹

From the discussions during the day-and-a-half conference, the following key themes emerged:

- **Prepaid cards encompass a tremendous variety of products and applications. With few exceptions, the prepaid market is a market of niches. Some prepaid products are mature, some are growing, and some are emerging. The heterogeneity of the market and the varied maturity of its niches pose challenges for regulators.** Prepaid cards can be obtained and funded by consumers, government, or businesses; can be intended for short- or long-term use; and can be designed for use by the purchaser or a subsequent cardholder. Some cards are reloadable and others are not. Literally, dozens of applications use prepaid cards, each possessing varying features and business models. One consequence of this variety of business models is that establishing a scope for a particular regulation can be difficult and time consuming. In addition, the effects of different federal regulations on various prepaid products may vary widely.
- **Although some significant differences of opinion remain, leaders in the prepaid industry and representatives from consumer groups agree on a number of protections that are important to — and should be made available to — consumers who use prepaid cards.** Areas of agreement include protection from unauthorized use, from loss, and from errors; the ability to obtain balance and transaction information electronically or over the phone,

¹ A list of previous PCC research on the topic of prepaid cards is included in Appendix B.

at little or no cost; deposit insurance from the Federal Deposit Insurance Corporation; and prominent and clear disclosures. While some differences of opinion remain, there appears to be a consensus on the basic consumer protections that should be made available to users of many types of prepaid cards, especially to those who use general-purpose-reloadable (GPR) prepaid cards.

- **The pricing of prepaid products within a segment is influenced by scale and competition within that segment, as well as the maturity of the segment. For some market segments, increased competition and scale have contributed to downward trends for certain costs and fees.** For example, even before new regulations were promulgated, dormancy and inactivity fees charged on gift cards were falling. Several prepaid industry executives at the conference predicted that as the GPR segment grows, providers of these products should enjoy greater scale economies. Given the amount of competition within this segment, much of these cost savings may be passed on to consumers.
- **Regulatory changes pose two additional challenges for the prepaid card business: coordination and inventory replacement. Either of these challenges can result in significant compliance costs.** The prepaid card value chain typically involves a number of independent parties working together to provide solutions for consumers. When a new regulation requires a product to be marketed differently, implementing those changes can be a challenge in terms of coordinating the affected parties and allocating the resulting costs. Second, prepaid cards typically use the plastic card form factor familiar to nearly all consumers. This necessitates an inventory of cards that are coded to function and that contain the necessary on-card disclosures, as well as printed terms and conditions. Thus, significant changes in regulatory requirements can result in firms having to replace existing card stock with new inventory. If the implementation period is short and the number of available suppliers is limited, the result can be substantial delay and higher costs. Both of these factors explain why it is important to have an open dialogue between the prepaid card industry and regulators in order to maximize the benefits and minimize the costs of new regulations.

II. Background

Welcome and Introductory Remarks & Keynote Address

Welcome and Introductory Remarks:

Bob Hunt, Vice President and Director, Payment Cards Center, Federal Reserve Bank of Philadelphia

Keynote Address:

Sandra Braunstein, Director, Division of Consumer and Community Affairs, Board of Governors of the Federal Reserve

On Thursday afternoon, Bob Hunt opened the conference by observing that the prepaid market is diverse, that there are financial innovations that have enhanced the well-being of consumers, and that financial innovations and consumer protection need not be inimical to one another. Hunt then introduced the keynote speaker, Sandra Braunstein, director of the Division of Consumer and Community Affairs at the Federal Reserve Board of Governors.

Braunstein began by noting the significant growth that has occurred within the prepaid industry over the past decade. As she observed, prepaid cards are entering a major period of development, refinement, and consumer adoption, and many believe the prepaid industry will benefit from new restrictions placed on overdrafts and on credit cards, and from consumers becoming more cautious of using credit cards for everyday purchases.

Braunstein stressed that many of the different prepaid products that exist in today's marketplace are designed for and targeted at certain specific, well-defined groups. For example, some products are designed and marketed as transaction account substitutes, some as spending tools for college and university students, some as teen-spending instruments, some as special purpose payment instruments — such as for health-care expenses or mass transit fares, and some as gifts. And in many instances, these products come with different features. For example, some might be reloadable and some might be nonreloadable, or some might be able to be used at a number of merchants, while others may be usable at only a single merchant.

Braunstein explained that this variety can be challenging for regulators. She gave examples of

how a regulator might consider different products in different ways. For example, she noted that if a prepaid card is a substitute for an unregulated cash transaction (such as the purchase of a transit card), it might be thought of differently than if it is a substitute for a traditional checking account or a debit card, which are subject to regulation. Braunstein explained that there is much that the Board of Governors of the Federal Reserve does to stay current and to understand what is going on in the marketplace. She observed that the Board conducts outreach initiatives with card issuers, card vendors, and consumer groups; uses an internal working group that looks at emerging payment issues and topics; participates in numerous external conferences; and sponsors its own conferences.

Looking at how prepaid products are currently regulated, Braunstein noted that the application of regulations to prepaid products is uneven. She observed that some prepaid cards, such as payroll cards and electronic benefit transfer (EBT) cards, are subject to consumer protections under Regulation E. In addition, as required by the Credit Card Accountability Responsibility and Disclosure Act (Credit CARD Act), the Board has recently issued rules under Regulation E that protect consumers who use gift cards. But she stressed that other prepaid products, notably GPR products (which can serve as account substitutes for many individuals) are not regulated under Regulation E. Braunstein argued that this variation in protection can be confusing to consumers because products that appear to be similar are governed by different rules.

Looking at the industry as a whole, Braunstein briefly discussed both the positive and negative aspects of prepaid cards. She noted that prepaid cards can be fast, efficient, and cost-effective payment instruments; can be used as budgeting tools; and can provide a means of access to mainstream payment products to unbanked and underbanked populations. On the other hand, some prepaid card products come with high fees, a lack of transparency about fees, and/or features similar to payday loans. Moreover, for some cards, the law does not require protections for lost or stolen cards or unauthorized or erroneous transactions (although many firms offer these protections voluntarily).

Looking to the future, Braunstein argued that federal regulators will have to carefully consider a number of factors. She noted that consumers must be protected from harmful threats in the marketplace, but that the effects of regulation on innovation and on products and services that are valuable to particular groups, such as the unbanked and underbanked, must

also be considered. Braunstein also observed that a number of government actors use prepaid cards, resulting in the need to analyze the potential effects of any future prepaid-related regulation on such programs.

Braunstein reasoned that due to the need to balance many factors, finding the “optimal point of intervention” will be important to regulators who are responsible for crafting protections for users of prepaid products. Braunstein also suggested that regulators should ask consumers about the kinds of protections that are important to them. She observed that when the Board extended protections to users of payroll products, certain specific aspects of the regulations were directly influenced by consumers. Braunstein explained that, during the rulemaking process, the Board conducted a number of interviews with consumers and that from these interviews the Board’s staff learned that consumers who use payroll products want the ability to know their balances at any time of day or night — but they do not necessarily want periodic paper statements sent to them in the mail. Reflecting this feedback, the final rule requires that balances must be made available by telephone or online and that statements must be made available upon request.

Braunstein concluded by offering three questions to help frame discussions about the federal regulation of the prepaid card industry and the protections that should be available to consumers who use prepaid cards. First, should the regulatory approaches for payroll cards and EBT products, or gift cards, be extended to other prepaid products, or should individual prepaid products be regulated differently? Second, should a gap analysis be used to identify which prepaid products are not subject to Regulation E protections, and should this analysis then be used to determine those products that should be regulated under Regulation E? And third, are there any ongoing unfair or abusive practices that should be addressed through substantive regulation?

III. Recent Federal Legislation and Regulation Related to Prepaid Cards

Moderator:

Philip Keitel, Industry Specialist, Payment Cards Center (PCC), Federal Reserve Bank of Philadelphia

Panelists:

Cindy Baltierra, Regulatory Policy Project Officer, Financial Crimes Enforcement Network, U.S. Department of the Treasury
Alysa Bernstein, Attorney, Federal Trade Commission

Christopher Hencke, Attorney, Federal Deposit Insurance Corporation

Ky Tran-Trong, Counsel, Board of Governors of the Federal Reserve

Following Sandy Braunstein’s opening remarks, Bob Hunt introduced Philip Keitel, an industry specialist in the PCC, to moderate the first panel, “Recent Prepaid-Related Legislation and Regulation.” This panel was structured to provide background information on federal regulation of the prepaid card industry, to provide context for the next day’s panels, and to raise general issues related to the current state of federal regulation of the prepaid card industry. This section of the summary recaps those federal agency actions discussed at the conference. These include (1) the rules under which Federal Deposit Insurance Corporation (FDIC) deposit insurance extends to the cardholder; (2) unfair and deceptive acts and practices involving gift cards; (3) protections now available to consumers who use gift cards (including gift certificates, store gift cards, and general-use prepaid cards); and (4) proposals for limiting the usefulness of prepaid products to criminals. In addition, this section reviews important legislative and regulatory actions that have occurred since the conference (see subsection E).

A. FDIC Deposit Insurance

To begin the panel’s discussion of federal regulation of the prepaid card industry, Christopher Hencke of the FDIC explained the circumstances in which consumers who use prepaid cards are protected by deposit insurance from the FDIC.² Under FDIC rules, holders of prepaid cards will be treated as owners of the deposits associated with those cards (the underlying funds associated with each card) as long as the FDIC’s standard “pass-through” requirements are met. These requirements are (1) that the agency or

² The rules that determine when deposit insurance extends to cardholders are contained in New General Counsel’s Opinion No. 8. This new opinion, which was issued on November 8, 2008, replaces the previous General Counsel’s Opinion No. 8 (released in 2006) and is available at www.fdic.gov/news/news/financial/2008/fil08129.html (accessed September 15, 2010).

custodial relationship must be disclosed in the account records of the insured depository institution; (2) that the identities and interests of the actual owners must be disclosed in the records of the depository institution or records maintained by the custodian or other party; and (3) that the deposits must be owned (under the contract) by the named owners and not by the custodian. (If these requirements are not met, the card distributor, program manager, or other named account holder will be recognized as the owner.) As Hencke explained, “the goal was to treat underlying prepaid deposits like other deposits that are eligible for pass-through coverage.”

B. Unfair and Deceptive Acts and Practices

Next, Alysa Bernstein of the Federal Trade Commission (FTC) discussed circumstances in which prepaid card issuers’ disclosure of terms and conditions is inadequate. Bernstein detailed two cases in which the FTC concluded that retailers had acted unfairly and/or deceptively with regard to their gift card programs.³ In the first case, the FTC alleged that beginning in 2003 Kmart made misleading statements about whether its gift cards expire, that it used confusing legal language in on-card disclosures, and that it did not disclose it was imposing a dormancy fee on its cards or that the dormancy fee charges could be applied retroactively to reduce a card’s underlying balance to zero after the 24th month of nonuse.⁴ For example, the FTC concluded that a statement made on cards — that “[a]fter 24 months of nonuse, a \$2.10 per month service fee will be deducted from your balance in arrears until the card is used or depleted (except in CA, NH, CT, MA, or where otherwise prohibited by law)” — was potentially misleading and confusing to customers, particularly since Kmart has stated elsewhere that cards “never expire.”

³ “Closed-loop” refers to gift cards that are sold by individual retailers, that are serviced by those retailers (or their agents), and that can ordinarily be used only at stores owned or operated by the issuing retailer. For more information on the types of gift cards and how consumers who use gift cards are protected, see Philip Keitel, “The Laws, Regulations, Guidelines, and Industry Practices That Protect Consumers Who Use Gift Cards,” Federal Reserve Bank of Philadelphia Payment Cards Center Discussion Paper (July 2008).

⁴ See Federal Trade Commission Press Release, “Kmart Settles with FTC Over Gift Card Sales Practices,” (March 12, 2007, available at: www.ftc.gov/opa/2007/03/kmart.shtml) (accessed January 10, 2011).

In March 2007, the FTC and Kmart settled.⁵ Under the settlement agreement, Kmart agreed to cease collecting fees on gift cards activated before the agreement, to more clearly and prominently disclose fees on cards sold after the agreement, to implement a refund program for eligible cardholders, and to publicize the refund program. In addition, Kmart consented to maintaining and making available to the FTC, upon request, highly detailed account records related to the retailer’s gift card programs for five years.

The second case Bernstein highlighted was a case against Darden Restaurants Inc., owner of Olive Garden, Red Lobster, Smokey Bones, and Bahama Breeze.⁶ In the Darden case, the FTC alleged that in various advertisements, Darden represented to consumers that cards could be redeemed for their entire monetary value, but the company failed to adequately disclose that there was a dormancy fee. The FTC also alleged that important disclosures were obscured by graphics on the cards.⁷

To provide some clarity about the circumstances under which the FTC might find a particular disclosure or advertisement to be deceptive, Bernstein pointed to a 1983 FTC policy statement.⁸ Under this statement, an ad is deceptive if it contains a material representation or omission of information that would likely mislead consumers acting reasonably under the circumstances. Bernstein suggested that when businesses design their disclosures they should consider four criteria: (1) whether the statement is big enough for consumers to notice and read; (2) whether the wording and format are easy for consumers to understand; (3) whether the statement is in a place where consumers will look at it; and (4) whether the wording is placed in proximity to related statements

⁵ See *In the Matter of Kmart Corp., Kmart Servs. Corp., and Kmart Promotions, LLC, Corps.*, Decision and Order, Docket No. C-4197 (August 2007), available at: www.ftc.gov/os/caselist/0623088/0623088do.pdf (accessed January 10, 2011).

⁶ See *In re Darden Restaurants, Inc., et al.*, Decision and Order of the FTC, Docket No. C-4189 (May 7, 2007). See also Federal Trade Commission Press Release, “National Restaurant Company Settles FTC Charges for Deceptive Gift Card Sales,” April 3, 2007, available at: www.ftc.gov/opa/2007/04/darden.shtml (accessed September 16, 2010).

⁷ For example, important disclosures on the back of a Red Lobster gift card were found to be too difficult to read because the cardstock featured an image of a lobster that obscured the disclosures.

⁸ Federal Trade Commission Policy Statement, “FTC Policy Statement on Deception,” (appended to *Cliffdale Associates, Inc.*, 103 F.T.C. 110, 174 [1984]) (October 14, 1983).

The Four Ps of Clear and Conspicuous Disclosure of Terms and Conditions:

1. Prominence – Is it big enough for consumers to notice and read?
2. Presentation – Are wording and format easy for consumers to understand?
3. Placement – Is it where consumers will look?
4. Proximity – Is it close to the claim it qualifies?

- Alysa Bernstein,
Federal Trade Commission

(for example, whether a modifying term or condition is placed near a claim to which it relates). Bernstein characterized these considerations as “the four Ps: prominence, presentation, placement, and proximity.”

C. Protections for Consumers Who Use Gift Cards

Following Bernstein’s presentation, Ky Tran-Trong, counsel in the division of Consumer and Community Affairs at the Board of Governors of the Federal Reserve, provided an overview of the Federal Reserve’s gift card rule — a regulation that provides substantive protections to consumers who use gift cards, including gift certificates, store gift cards, and general-use prepaid cards. The gift card rule implements Title IV of the Credit CARD Act of 2009.⁹ It was released in its final form in March 2010¹⁰ and came into effect on August 22, 2010.¹¹ The rule

⁹ Credit Card Accountability Responsibility and Disclosure Act of 2009 (Pub. L. No. 111-124, tit. IV) (2009). The full text of the statute is available at www.creditcardreform.org/pdf/credit-card-bill-2009.pdf (accessed September 20, 2010). Title IV of the Credit CARD Act is based on the Fair Gift Card Act of 2009 sponsored by Senators Schumer and Udall (S. 414, 111th Cong.) (2009).

¹⁰ Electronic Fund Transfers, 75 Fed. Reg. 16,580 (April 1, 2010). Additional information is available at www.federalreserve.gov/newsevents/press/bcreg/20100323a.htm (accessed September 20, 2010).

¹¹ However, subsequent legislation delayed the effective date of some disclosure-related provisions until January 31, 2011 (this is discussed in greater detail in subsection E below).

Types of prepaid cards covered by Regulation E:

- Payroll cards and payroll card accounts
- Gift cards (includes gift certificates, store gift cards, and general-use prepaid cards)

Types of prepaid cards not covered by Regulation E:

- Cards that are part of a loyalty, promotion, or reward program (although consumers must be informed of any expiration dates or fees for these cards)
- GPR prepaid cards that are not marketed as gift cards

applies to “any person” and, consequently, may apply to any of the parties involved in distributing a covered certificate or card, including card issuers, program managers, or retailers that sell cards.

Under the rule, dormancy, inactivity, and service fees charged in connection with gift certificates, store gift cards, and certain general-use prepaid cards (as defined under the Credit CARD Act) are prohibited unless: (1) there has been no activity for the previous year; (2) no more than one such fee is assessed per month; and (3) certain disclosures are provided. These include disclosures on the card or certificate itself (such as the date on which the funds expire, a toll-free number or website — if one is maintained — for consumers to obtain information or replacement cards, and information about any dormancy, inactivity, or service fees), and disclosures that must be made prior to purchase (including fee and expiration date disclosures). In addition, funds loaded onto a card that falls under this regulation may not expire for at least five years from the date of the last funds load.

Tran-Trong finished his presentation by noting that the gift card rule provides consumer protections under Regulation E to a new segment of the prepaid card market and builds upon the Board’s extension of Regulation E–based protections for users of payroll

cards in 2006.¹² Looking to the future, Tran-Trong suggested that it is possible that either the Board or the new Consumer Financial Protection Bureau will review segments of the prepaid market in order to determine whether additional Regulation E–based protections are warranted. He observed that one segment where such an evaluation may make sense is the GPR segment, particularly to the extent that GPR products are used by consumers as substitutes for traditional accounts or payment instruments.

D. Proposals to Limit the Usefulness of Prepaid Products to Criminals

The final panelist was Cindy Baltierra, a regulatory project policy officer in the Financial Crimes Enforcement Network (FinCEN) of the U.S. Department of the Treasury. At the time, FinCEN’s regulatory scheme for prepaid cards was being revised in light of changes introduced by the Credit CARD Act.¹³ Baltierra explained that FinCEN’s prepaid-related regulatory approach was likely to change from a scheme based on “stored value” terminology to a scheme based on “prepaid access” — a change that reflects how the industry, consumer groups, and analysts refer to these products and services today. Baltierra noted that under the new scheme, “issuers,” “sellers,” and “redeemers” of “stored value” are likely to be treated differently than they are presently.

Since the conference, FinCEN has released a notice of proposed rulemaking for prepaid cards.¹⁴ Under the proposed rule, *providers* of prepaid access must register with FinCEN, file suspicious activity reports similar to money services businesses, and have policies and procedures in place to verify the identity of persons who obtain prepaid access through a prepaid program. In addition, *providers* of prepaid access must retain and maintain customer information for five years, and put in place transactional recordkeeping systems. Moreover, *sellers* of prepaid access must put in place policies and procedures to verify the identity of customers who obtain prepaid access through a prepaid

¹² Electronic Fund Transfers, 71 Fed. Reg. 51,437 (August 30, 2006). Additional information is available at: www.federalreserve.gov/newsevents/press/bcreg/20060824a.htm (accessed September 21, 2010).

¹³ See Title V, section 503 of the Credit CARD Act.

¹⁴ See Financial Crimes Enforcement Network, Amendment to the Bank Secrecy Act Regulations — Definitions and Other Regulations Relating to Prepaid Access, 75 Fed. Reg. 36,589 (June 28, 2010). Additional information is available at www.fincen.gov/statutes_regs/fm/pending.html (accessed September 21, 2010).

program, and must file suspicious activity reports similar to money services businesses.

E. Legislative and Regulatory Developments That Have Occurred Since the Conference

Since the conference, a number of legislative and regulatory developments have occurred that will affect the prepaid card industry. These include (1) legislation that delays some of the disclosure requirements of the gift card rule for certain prepaid products; (2) two recent rulemakings by the Treasury Department that relate to prepaid cards; (3) the recent launch of two pilot programs by the Treasury Department that seek to encourage individuals without bank accounts to direct their federal tax refunds to accounts tied to a prepaid card; (4) a decision by the Internal Revenue Service to delay a revenue ruling affecting how prepaid cards can be used for public transit rides; and (5) enactment of the “Durbin Amendment” to the Dodd-Frank Wall Street Reform and Consumer Protection Act.

First, under what is commonly referred to as the ECO-Gift Card Act and its implementing regulation, certain disclosure requirements of the Federal Reserve’s gift card rule were delayed until January 31, 2011.¹⁵ Under the implementing regulation, as long as certain prerequisites are met, disclosures about dormancy, inactivity, and service fees, as well as certain on-card disclosures (such as disclosure of expiration dates, toll-free telephone numbers, and websites, as well as policies surrounding replacement card availability) were delayed for gift certificates, store gift cards, and general-use prepaid cards produced prior to April 1, 2010. In addition, the card’s or certificate’s issuer was required to comply with other applicable gift card regulations; not impose an expiration date on underlying funds; replace a certificate or card at no cost to the consumer (if replacement is requested by the consumer); and make known that underlying funds do not expire, that cardholders have a right to a free replacement card or certificate, and that only dormancy, inactivity, or service fees that comply with the gift card rule will be charged.

Second, the Treasury Department’s

¹⁵ The official title of the legislation is the Act to Amend the Effective Date of the Gift Card Provisions of the Credit Card Accountability Responsibility and Disclosure Act of 2009 (Pub. L. 111-209) (2010). The act’s implementing regulations were published in the *Federal Register* at 75 Fed. Reg. 66,644 (October 29, 2010).

Financial Management Service (FMS) published two rulemakings that will facilitate the federal government's increasing usage of prepaid cards as a means of payment. Under the first rulemaking, as of May 1, 2011, individuals who receive federal, non-tax-related payments must receive these via an electronic funds transfer (EFT).¹⁶ The transition away from paper-based disbursements to EFTs marked by this rulemaking is expected to save the government more than \$400 million in the first five years alone.¹⁷ In recent years, the vast majority of recipients (about 80 percent) have designated an existing account at a financial institution to receive their federal benefit payment by direct deposit.¹⁸ But this leaves a significant number of recipients who either do not have an account with a financial institution or who choose not to share this information with the federal government.

Beginning on May 1, 2011, new benefit recipients who do not provide account information to the government will be enrolled in the Direct Express Debit MasterCard program. This is an existing prepaid card-based disbursement program run by FMS and its business partners.¹⁹ Existing benefit recipients who currently receive checks may continue to do so until March 1, 2013.²⁰ FMS has also waived the EFT requirement for recipients born before May 1, 1921, who currently receive their benefit payments by check. There are also exceptions for recipients whose Direct Express card has been suspended or canceled and for individuals for whom receiving their payment by EFT results in a hardship related to a mental impairment or a remote geographic location.

The Treasury Department's second rulemaking deals with the eligibility of prepaid card programs

¹⁶ Management of Federal Agency Disbursements, 75 Fed. Reg. 80,315, pp. 80,315-80,318 (December 22, 2010). The rule applies to benefit disbursements from Social Security, Supplemental Security Income, Veterans, Railroad Retirement, and Office of Personnel Management programs.

¹⁷ Treasury Department Press Release, "Treasury Goes Green, Saves, Green. Broad New Initiative Will Increase Electronic Transactions, Save More Than \$400 Million, 12 Million Pounds of Paper in First Five Years Alone," April 19, 2010.

¹⁸ See p. 80,318 of the *Federal Register*.

¹⁹ For more information on Direct Express, see www.usdirectexpress.com/edcfdtclient/index.html (accessed September 27, 2010).

²⁰ This exception also applies to individuals who file claims for federal benefits before May 1, 2011, and request to receive their benefit payments by check.

to receive federal benefit payments.²¹ Previously, Treasury regulations had required that EFT payments be made to an account at a financial institution held in the name of the recipient. This rule had the effect of prohibiting EFT payments to programs that used a pooled account structure because the name on the account was usually that of the program manager and not the cardholder. Under Treasury's revised rules, a prepaid program is eligible to receive federal benefit payments if it meets certain requirements. To qualify, prepaid products must provide pass-through deposit insurance to the cardholder and comply with the consumer protection requirements that apply to payroll cards under Regulation E. In addition, the prepaid card must not have "an attached line of credit or loan feature that triggers automatic repayment from the card account."²²

Third, the Treasury Department has launched two pilot programs designed to study and facilitate making tax refund payments to prepaid cards. Under the first program, the Treasury Department will offer a group of randomly selected low- and moderate-income individuals the ability to enroll in the MyAccountCard Visa Prepaid Debit Card program.²³ Participants will be able to have their tax refunds loaded on their MyAccountCard. In addition, participants will be able to deposit other funds on the card and may use the card to make purchases at retail locations as well as get cash at ATMs. The Treasury Department believes that the free services offered under the program,²⁴ as well as Regulation E-like protections and FDIC insurance passed-through, will make the MyAccountCard a safe, attractive, and low-cost product for many low- and moderate-income (or unbanked and underbanked) individuals. Representatives from consumer groups support the goals of the program. Lauren Saunders of the National Consumer Law Center notes that the pilot program "has low fees, free access to customer service, and can be used year round for routine financial transactions" while allowing taxpayers who

²¹ Federal Government Participation in the Automated Clearing House, 75 Fed. Reg. 80,335 (December 22, 2010).

²² 75 Fed. Reg. 80,335.

²³ See Department of the Treasury Press Release, "Treasury Launches Pilot Program of Prepaid Debit and Payroll Cards for Fast, Safe and Convenient Tax Refunds," January 13, 2011, p. 1.

²⁴ These include "free point-of-sale transactions, free online bill pay, free ATM cash withdrawals at more than 15,000 ATM machines nationwide, and free cash back at participating retail stores." See "Treasury Department Press Release (January 13, 2011), p. 1.

do not currently possess bank accounts to avoid costly refund anticipation loans.²⁵ Under the second pilot program, the Treasury Department is encouraging consumers who are already receiving their wage and salary payments on prepaid cards (e.g., payroll cards) to use those same cards to receive their 2010 federal tax refund through direct deposit.²⁶ The Treasury Department has partnered with ADP to encourage current payroll cardholders to have their tax refunds directed to their cards.

In combination, these Treasury Department rulemakings and pilot programs are likely to expand the public's exposure to prepaid cards and to influence the fee structures and consumer protections that cardholders will come to expect from prepaid card programs. Moreover, while the Treasury Department does not, by these actions, set new consumer protection standards, but rather relies on those established by the Federal Reserve Board and the FDIC, its new regulations have the effect of extending coverage of the other agencies' rules to additional card programs. As a result, the Treasury's actions will likely fuel additional debate about whether the existing consumer protection rules should be expanded and, if so, to what types of cards.

Fourth, the Internal Revenue Service (IRS) recently delayed, until January 1, 2012, a revenue ruling related to prepaid cards that can be used for public transit rides.²⁷ Under IRS Ruling 2006-57, employer-provided transportation fringe benefit systems that involve prepaid cards must be structured such that these prepaid cards function only as fare media for transit systems and cannot be used to purchase other goods or services.²⁸ In delaying Ruling 2006-57, the IRS notes that "transit systems need additional time to complete the process of adapting their technology" to be compatible with the rule.²⁹ This is the latest in a sequence of postponements issued since the rule was originally published. It is

²⁵ Consumer Federation of America Press Release, "Advocates Applaud Treasury Pilot to Speed Tax Refunds to Consumers with No Bank Account," January 13, 2011 (quoting Lauren Saunders).

²⁶ Department of the Treasury Press Release, "Pilot Delivers Targeted Offers for Individuals to Sign-up for New Accounts to Receive Their Tax Refunds Through Direct Deposit," September 2, 2010, p. 1.

²⁷ Internal Revenue Service, I.R.S. Internal Revenue Notice 2010-94 (December 2010).

²⁸ Internal Revenue Service, I.R.S. Revenue Ruling 2006-57 (contained in Internal Revenue Bulletin No. 2006-47, p. 911 [November 20, 2006]).

²⁹ I.R.S. Internal Revenue Notice 2010-94 (December 2010).

also an example of inconsistencies that sometimes exist between requirements specified in a regulation and the ways in which the electronic payment system functions.

Finally, under the Durbin Amendment, the fees that banks charge merchants for accepting debit cards must be "reasonable and proportional to the cost incurred by the issuer with respect to the transaction."³⁰ The legislation includes an exemption for certain prepaid products³¹ and provides the Board with some flexibility in determining the scope of the final rule. Nevertheless, some prepaid segments, such as nonreloadable loyalty and reward cards, may be affected.³² On December 16, 2010, the Federal Reserve released a proposed rule to implement the Durbin Amendment. Under the proposed rule, certain general-use prepaid cards (defined as a card, code, or device that is issued on a prepaid basis and is redeemable upon presentation at multiple unaffiliated merchants for goods or services or is usable at automated teller machines) and prepaid cards that are part of a government-administered payment program are exempt from coverage.³³

IV. Prepaid Products Intended for Short-Term Use

Moderator:

Jennifer Tramontana, Fletcher Group

Panelists:

Stefan Happ, American Express

Talbott Roche, Blackhawk Network

Julie Wade, Starbucks

Kathy Yee, Wells Fargo

³⁰ Dodd-Frank Wall Street Reform and Consumer Protection Act (Pub. L. 111-203, Title IX, section 1075) (2010).

³¹ For example, section 1075(a)(2)(a)(7) of the Dodd-Frank Act provides express exemptions for "government-administered payment programs" and "reloadable prepaid programs."

³² See "Prepaid Largely Spared in Final Durbin Amendment," *The Green Sheet* (July, 2010), addressing the potential impact of future Durbin Amendment-related regulation on the prepaid industry and certain prepaid products in particular, available at www.greensheet.com/emagazine.php?story_id=2005 (accessed September 24, 2010).

³³ See Debit Card Interchange Fees and Routing, 75 Fed. Reg. 81,722, pp. 81,755-81,756 (December 28, 2010).

This session examined how federal legislation and regulation affect prepaid products, gift cards in particular, intended for short-term use by consumers. Participating on this panel were Stefan Happ of American Express, Talbott Roche of Blackhawk Network, Julie Wade of Starbucks, and Kathy Yee of Wells Fargo. Each of the panelists discussed how their companies are involved in the prepaid market; aspects of issuing, marketing, and selling prepaid cards in a regulated environment; and costs associated with regulatory compliance. In particular, these panelists highlighted key differences in the products that they issue or manage by addressing how business models within the gift card market segment can differ substantially (three different gift card models were presented by this panel, each with a different design and economics).

To introduce this session, Jennifer Tramontana of the Fletcher Group noted that consumer use of prepaid cards has grown rapidly over the past decade³⁴ and that use of gift cards has grown in particular³⁵ — with some market research suggesting that more than 60 percent of all Americans have purchased or used a gift card.³⁶ Tramontana explained that the panel would focus on single-load gift and rewards cards, and reloadable cards that operate within a specific loyalty program or time period. She stressed that these products are those that are primarily affected by the Federal Reserve’s gift card rule. She distinguished these products from other prepaid products, such as reloadable products intended as general-purpose spending tools, government and corporate products, and products linked to special accounts such as health-care-related spending accounts.

³⁴ In February 2010, Blackhawk Network reported that, based on its research, 99 percent of adults in the U.S. have purchased or received a gift card in their lifetime. In comparison, the Federal Reserve Bank of Boston, as part of the Survey of Consumer Payment Choice, reports that 44.8 percent of consumers surveyed said that they have used a prepaid card. See Federal Reserve Bank of Boston, *Survey of Consumer Payment Choice* (April 2010), p. 17, Table 6.

³⁵ As much as \$330 billion is estimated to have been loaded onto gift cards in 2009. See Mercator Advisory Group, “Seventh Annual Prepaid Card Forecast Press Release” (Maynard: Mercator Advisory Group, August 2010), available at www.mercatoradvisorygroup.com/index.php?doc=Prepaid&action=view_item&id=519&catid=16 (accessed September 30, 2010).

³⁶ See, for example, Network Branded Prepaid Card Association, *NBPCA Prepaid and the Economy, Consumer-Opinion Survey* (Montvale: NBPCA, November 18, 2008), noting that 67 percent of consumers surveyed reported having used a prepaid gift card.

A. Closed-Loop Gift Cards

The first prepaid product discussed by the panel was the closed-loop gift card. Julie Wade explained that Starbucks issues its own closed-loop, reloadable gift card.³⁷ According to Wade, the Starbucks gift card program, launched in 2001, has proven to be extremely successful for the company. Gift card sales represent about 15 percent of tender at Starbucks stores. In 2004, the cumulative value loaded onto Starbucks cards exceeded \$1 billion. In 2007 alone, more than \$1 billion of new funds were loaded onto Starbucks cards.

Wade explained that Starbucks distributes its cards through its stores, through partnerships with distributors such as InComm and Blackhawk (these companies place Starbucks cards in thousands of retail stores), and through a business-to-business program — whereby businesses can obtain Starbucks gift cards as rewards or as a means of offering an incentive to employees.

Unlike some gift cards, Starbucks cards, Wade noted, have no fees and do not expire.³⁸ She explained that in the closed-loop-gift-card-issuing environment it is possible to have a program without explicit fees because the card-issuing merchant can recover costs through the mark-up over the cost of goods sold. In addition, she argued that a retailer can benefit from having a closed-loop gift card program in several distinct ways: (1) the gift card program drives incremental sales at stores;³⁹ (2) the gift card program provides a platform for communicating with customers;⁴⁰ (3) the gift card program offers the ability to gather information on ongoing trends related to consumer spending; and (4) accepting gift card

³⁷ The term “closed-loop” refers to gift cards that are sold by individual retailers, are serviced by those retailers (or their agents), and function only at a selling retailer’s locations, whereas “open-loop” typically refers to cards that are issued by a financial institution, that operate over a debit or credit card network, and that can be used at a wide array of retail locations.

³⁸ Wade noted that an early version of the Starbucks card contained language about a dormancy fee, but she explained that, to her knowledge, no cardholder was ever charged such a fee.

³⁹ Starbucks’ internal research suggests that new people come into stores because they’ve received a gift card, and loyal customers tend to spend more using these cards.

⁴⁰ Starbucks accomplishes this by encouraging cardholders to register their cards. Consumers who register their cards receive special discounts — in the way of special promotions and rewards. They are also able to obtain replacement cards if a card is lost or stolen and are given the opportunity to reload their cards using their credit or debit cards.

programs results in cost-savings, since accepting a closed-loop gift card is typically cheaper than a credit card.

B. Open-Loop (Network-Branded) Gift Cards

In contrast to the closed-loop, retailer-issued gift card model presented by Wade, Stefan Happ of American Express discussed the open-loop or network-branded gift card model.⁴¹ These products, sometimes referred to as network-branded prepaid cards (since they bear the logo of a payment network and can be used at any merchant that accepts that payment network's cards), are younger than closed-loop products. American Express, the first payment network issuer to sell open-loop gift card products at retailers, sells gift cards at more than 75,000 locations.

Happ explained that the economics of the open-loop, bank-issued-card model are different from those of the closed-loop model. He noted that while charging a fee to consumers may not be necessary in the closed-loop environment, it generally is necessary on the open-loop side because issuers have numerous costs that they must recover in order to remain profitable. These costs include, for example, costs related to making cards (e.g., the costs of purchasing the plastic, the coding of the magnetic stripes, and the embossing), maintaining data, and distributing cards. In addition, open-loop issuers generally have a different relationship with consumers than closed-loop issuers. For example, retailers that issue closed-loop cards are often capable of recovering costs associated with their prepaid programs by marking up the goods or services they sell. Or, as Wade pointed out, retailers might benefit in other ways from having a gift card program, whereas open-loop issuers don't enjoy those same benefits.

Although consumer fees are an important part of the open-loop gift card model, Happ pointed out that ongoing industry dynamics have, as the open-loop industry has matured, resulted in many large issuers reducing or eliminating those fees. For example, Happ explained that over the past decade American Express has achieved scale, saved on costs,

⁴¹ The term "open-loop" generally signifies cards that are issued by a financial institution, that operate over a debit or credit card network, and that can be used at a wide array of retail locations. The term "network branded" refers to the branding of cards with the logo of one of the major payment networks (for example, Visa, MasterCard, American Express, or Discover). For the most part, network branded cards are issued by banks.

gained experience, and developed a better sense for its margins — all while competition in the industry has increased. According to Happ, these factors influenced the company's decision to eliminate all but one fee, a purchase fee.⁴² The Board, in its section-by-section analysis of the gift card rule, made a similar observation with regard to the closed-loop segment, noting that there has generally been a downward trend, over time, in the amount of dormancy and activity fees charged in connection with closed-loop retail gift cards.⁴³

Wells Fargo's Kathy Yee made similar observations about the variety of products that make up the gift card segment. Wells Fargo issues a network-branded gift card product that can be used at any merchant that accepts the network's brand (in this case, the cards are Visa-branded), and, as is the case for American Express, numerous costs must be recovered from consumers for the business model to remain viable, according to Yee. She pointed out that Wells Fargo's distribution model for gift cards is quite different from the one used by American Express. The Wells Fargo product is available for purchase only by current Wells Fargo and Wachovia customers, as well as by the bank's business clients. About 50 percent of the gift cards the bank sells are sold in one of its 6,000 stores. The rest are sold in bulk to businesses or to units within the bank (for things such as internal rewards programs). According to Yee, at Wells there was a demand for gift cards among consumers and businesses; therefore, the company made the decision to give customers what they wanted, but it did not want to sell the product in a more general fashion.

C. Another Variation of the Gift Card Business Model

As Talbott Roche explained, Blackhawk Network employs a different business model than the other businesses represented on the panel, adding even greater variety to the types of businesses operating in the market. Blackhawk, which is neither a merchant nor a bank, is engaged in activities related to both open-loop and closed-loop gift cards: Blackhawk distributes prepaid products (including many merchant-issued, closed-loop cards) to a network of

⁴² Happ noted that originally American Express charged two fees — an up-front purchase fee (of between \$3.95 and \$5.95) and a service fee (of \$2.00, applied per month, from month 13 on) — but that as the segment matured, the fee structure changed. The company now charges only a purchase fee for its products. This fee ranges from \$2.95 to \$6.95.

⁴³ See Electronic Fund Transfers, 75 Fed. Reg. 16,610 .

more than 80,000 retail locations; manages prepaid programs for a number of organizations; manages, together with an issuing bank sponsor, open-loop, Visa-branded gift card programs; and issues certain other gift cards. According to Roche, Blackhawk reaches more than 165 million customers per week. Frequent interaction with consumers gives Blackhawk the ability to gather detailed information about what consumers want and how consumers who buy and use prepaid cards behave. As Roche explained, analysis of these data suggests that consumers rank convenience and the ability to choose a card with features that fit their subjective goals as the most important factors when it comes to purchasing cards. Consumer demand for cards with particular features (such as a prepaid card redeemable for admission to a particular event, or a card that can be used on public transportation systems, or a product that can be used to make purchases at only one type of retailer) may explain the impressive diversity of products in the marketplace.

D. The Effects of Regulations on Gift Cards

The panelists also discussed how gift card business models are affected by regulation. Wade of Starbucks noted that the decade since Starbucks first launched its gift card has been one of significant legislative and regulatory activity. Many state laws that have been enacted in the past 10 or 15 years — including ones that govern the terms and conditions, disclosures of those terms, the transmission of money, cash refunds that must be made to consumers at points-of-sale, and escheat — affect prepaid card issuers, especially issuers of closed-loop products. According to Wade, the rules can be quite complex, depending, for example, on whether the cards are personalized or the cardholders' information is known by the issuer.

Wade pointed out that the new federal regulations can interact in peculiar ways with some state laws. For example, a provision of the gift card rule requires that cards covered by the rule remain usable for at least five years before any expiration policies are applied, but some state laws may require that the funds on those cards be turned over to the state or returned to the consumer within a time period that is less than five years.

Roche of Blackhawk argued that while her company supports protections for consumers who use prepaid cards, including the Fed's gift card rule, there is some uncertainty about whether the substantive protections that are part of federal legislation

accurately reflect consumers' sentiments about prepaid cards. For example, Roche and Happ of American Express remarked that the same requirement that Wade highlighted — the requirement that cards' underlying funds be able to be accessed for at least five years (contained in the Credit CARD Act and the gift card rule) — does not reflect behavior observable in the industry. They noted that only the tiniest fraction of spending occurs after year three (estimated at less than 1 percent for some products) and that, as a result of the rule, costs are generated for issuers that are likely disproportionate in comparison to consumers' apparent desire to access remaining funds beyond year three. In addition, Happ explained how regulation of foreign-currency-conversion fees (which are considered "service fees" under the gift card rule) may influence whether issuers permit gift cards to be used abroad (in spite of consumer demand for such functionality), since these fees are charged in order to recoup charges assessed by third parties. Looking briefly at consumer sentiment about gift cards, Roche observed that market research done by her company indicates that consumers are generally happy with products covered by the gift card rule and that consumers are satisfied with most gift card products (satisfied enough to purchase them repeatedly). Blackhawk's research finds that 84 percent of purchases in stores are "planned purchases"; 94 percent of consumers have purchased a prepaid card in the recent past; 97 percent of consumers have received some kind of prepaid card; and 97 percent of those who have purchased a card will again purchase a card.

Roche also highlighted the need to educate consumers about distinctions drawn in legislation and regulation that can be different from those that consumers would draw based on their own experiences with prepaid cards. She remarked that the regulatory distinctions need to be communicated to consumers in ways that consumers will understand. For example, a prepaid card that can only be used in the gift shop of an amusement park may not have the same protections as another gift card that looks similar but is not structured in a way that qualifies for an exclusion in the gift card rule.⁴⁴ Roche explained that Blackhawk, which sells hundreds of different prepaid cards via in-store displays, must design

⁴⁴ Section 205.20(b)(6) of Regulation E specifies an exception for cards redeemable solely for admission to events or venues, and cards that can be used to obtain goods or services in connection with admission to an event or venue.

displays that are both consistent with regulations and comprehensible to consumers. She noted that some displays and packaging will state “Not a Gift Card” to help consumers appreciate distinctions that are part of the gift card rule and understand that cards that look similar may come with very different protections. As a final area of concern, the panelists discussed the timeframe established for compliance with the gift card rule under Title IV of the Credit CARD Act, and the final rule itself. Happ observed that, under the gift card rule, his company alone would be required to destroy tens of millions of cards produced in the fourth quarter of 2009 (this was prior to the enactment of the ECO-Gift Card Bill described in section III E). He explained that the company would have to contend with supply constraints, since card printers did not have enough cardstock made from recycled material in inventory to meet the demands of all issuers needing to retool. The panelists stressed that everyone in the industry was preparing to fight over the vendors — from the businesses that provide the plastic cardstock down through embossers — because of limited capacity. And since the gift card rule’s disclosure requirements would necessitate the redesign of most gift cards, additional staff would likely be required. Roche of Blackhawk noted that her company would need to destroy around 40 million cards and tens of millions of packages and that nearly 100 million cards would need to be destroyed industry-wide — the equivalent of eight football fields, covered entirely in plastic cards, 12-feet deep. She also observed that due to varying merchandising cycles of Blackhawk’s retailer-partners, it would be a challenge to get cards on shelves in time for the 2010 holiday season. Since the conference, many of these concerns were ameliorated via the changes implemented in the ECO-Gift Card Act.

V. Prepaid Products Intended for Long-Term Use

Moderator:

Marilyn Bochicchio, Paybefore

Panelists:

Brad Hanson, Meta Payment Systems

Lauren Saunders, National Consumer Law Center

Steve Streit, Green Dot Corporation

Brian Triplett, Visa Inc.

Moderated by Marilyn Bochicchio of Paybefore, this session examined prepaid products, GPR cards in particular, intended for long-term use by consumers.⁴⁵ Participating on this panel were Brad Hanson of Meta Payment Systems, Lauren Saunders of the National Consumer Law Center (NCLC), Steve Streit of Green Dot Corporation, and Brian Triplett of Visa Inc. As the panelists discussed the industry, the future of the industry, and the protections that should be available to consumers who use prepaid cards, several key themes were identified: (1) the prepaid market is a market of niches, and “prepaid” might perhaps be better thought of as a platform than as a product; (2) prepaid cards — and GPR cards in particular — provide a number of distinct value propositions to consumers; (3) the GPR market is maturing and changing; and (4) there is some agreement between prepaid industry executives and consumer group representatives about protections that are important and should be made available to consumers who use prepaid cards.

To provide context for the discussion, Brian Triplett of Visa reviewed the market as a whole and highlighted different ways to think about the prepaid market. He argued that many view prepaid cards as a homogeneous product, like a credit or debit card, but that such a characterization fails to capture the variations in the dozens of prepaid products in the marketplace today.⁴⁶ Triplett suggested that given all the niches that make up the market, prepaid might be best thought of as a platform rather than a type of card. To provide examples of different ways prepaid

⁴⁵ Although “long term” is difficult to define in this context, one large provider of GPR prepaid cards (NetSpend) recently noted that its consumers use GPR prepaid cards not tied to direct deposit for about 11 months on average, whereas consumers use similar cards with direct deposit for about 20 months (Andrew Johnson, “Prepaid Card Providers Add Rewards to Fight Churn,” *Cardline*, October 1, 2010). By comparison, another leading provider of GPR prepaid cards notes that the “average card lifetime” is “nine months for our GPR cards and six months for our gift cards” (Green Dot Corporation, *Form 10-Q Quarterly Report to the Securities Exchange Commission* (November 3, 2010), p. 5 (“Notes to Consolidation Financial Statements”)).

⁴⁶ Although estimates vary, at least one firm that analyzes the prepaid industry estimates that there are between 30 and 40 distinct market segments (moreover, products within these segments can differ). See “The Latest Forecast Is Especially Sunny for Prepaid Cards,” *Digital Transactions* (December 2009), available at: www.digitaltransactions.net/newsstory.cfm?newsid=2390 (accessed October 15, 2010), noting that 2009 research by the Mercator Advisory Group identified 33 distinct segments in the prepaid market.

products can be divided up and analyzed, he noted that products can be distinguished by who funded the card (whether it was a consumer, corporation, or government), by whether products are branded with a payment network logo, by who has the right to use the card(s) or access the funds, by the application of or purpose for the card, by the functionality of cards in a program, by whether the card is personalized or registered, and possibly many other distinguishing characteristics.

A. The Value Chain for Open-Loop Prepaid Products

Next, Triplett described the supply side of the network-branded prepaid card market (those prepaid cards that bear the mark of a payment network and can be used anywhere cards associated with that network can be used). He noted that, relative to credit and debit cards, getting network-branded prepaid cards into consumers' hands typically involves more participants. In other words, the value chain for network-branded prepaid cards involves more parties than those commonly present in credit- or debit-issuing arrangements — the merchant acquirer, processors, a payment network, and a card issuer. These additional participants may include a program manager, a distributor, and a retailer. Triplett observed that, again in comparison to credit and debit cards, there are also more distribution channels for prepaid cards. These include retail stores, bank branches, malls, employers, and websites. In some cases, multiple parties can be responsible for managing these channels, even when a single product is involved. Finally, Triplett explained that even the functions performed by a single party, such as a prepaid processor, may differ from functions performed by a similar entity operating in the debit or credit arena.

Several implications of the relatively long value chain for network-branded prepaid cards are worth noting. First, each party in the chain can be exposed to risks tied to other parties. For example, in the event that a business in the value chain becomes insolvent, other parties in the chain may be liable for obligations incurred by the insolvent party. Banks in particular must carefully evaluate risks posed by other parties in the value chain. Second, but related, is the need for regulators to take into account principal-agent relationships all along the prepaid value chain. The significant presence of banks' agents (often many program sponsors and distributors operate as a bank's agent, for example) raises questions about

the applicability of state versus federal regulation to the different participants and, in some instances, to products themselves. Third, a new regulation that applies across the entire chain of participants can require significant communication between parties and can, in some instances, result in the need for coordinated action. For example, in the gift card rule, the Board notes that “[g]iven the various entities that may be involved in distributing or selling certificates or cards subject to the rule, the Board understands that several parties may be subject to the rule with respect to the same prepaid card program, including the issuer, the program manager, and the retailer.”⁴⁷ To help ensure compliance in situations in which multiple parties may each be liable for jointly undertaken endeavors, the Board permits parties to “contract among themselves” and provides that “[c]ompliance by one party [will] satisfy the compliance obligations for any other person with respect to [a particular] certificate or card.”⁴⁸

Another example of this is found in the Board's interpretation of the scope of one of the gift card rule's exclusions — the exclusion for cards that are reloadable and not marketed as a gift card. With regard to this exclusion, the Board has reasoned that “a card, code, or other device is deemed to be marketed or labeled as a gift card or gift certificate if anyone (other than the consumer-purchaser of the card), including the issuer, the retailer, the program manager that may distribute the card, or the payment network on which a card is used, promotes the use of the card as a gift card or gift certificate.”⁴⁹ Consequently, whether a product qualifies for the exclusion depends on the actions of multiple parties in the value chain. However, recognizing that “the broad scope of the rule to also cover the actions of any party that may be involved in the distribution or promotion of a certificate or card may pose substantial compliance risks for issuers,” the Board allows products to retain their exclusionary status in instances in which a product is labeled properly and “persons subject to the rule maintain policies and procedures reasonably designed to avoid such marketing.”⁵⁰ This type of regulatory interpretation can help reduce communication and coordination issues.

⁴⁷ 75 Fed. Reg. 16,595.

⁴⁸ 75 Fed. Reg. 16,595.

⁴⁹ 75 Fed. Reg. 16,593.

⁵⁰ 75 Fed. Reg. 16,593.

B. Reasons Why Consumers Choose Prepaid Cards

To address the demand-side of the market, Bochicchio engaged Green Dot's Steve Streit and MetaBank's Brad Hanson in a three-way discussion. Streit and Hanson highlighted a number of distinct value propositions that prepaid cards offer to consumers. First, they noted that prepaid cards are generally convenient and easy for consumers to use. Second, for many consumers, carrying prepaid cards is safer than carrying cash. Third, there are protections available to users of prepaid cards that are not available to those who use cash and checks. For example, users of prepaid cards may qualify for a program offered by payment networks, known as Zero Liability,⁵¹ that protects cardholders from fraudulent transactions and unauthorized use of their accounts. In addition, some cardholders are protected from default of the financial institution that holds the funds because the program they participate in extends FDIC deposit insurance directly to the cardholder by following the FDIC's pass-through rule.⁵² Fourth, practically all programs make detailed transaction and balance information available to cardholders.

The panelists also observed that consumer satisfaction with their prepaid cards is partly influenced by their experience with alternative payment instruments, financial products, and financial services. Hanson noted that many people who use prepaid cards report having had a bad experience with a financial institution in the past. Some consumers report that they do not have enough money to have a traditional account or that they simply prefer having a prepaid card to a traditional demand deposit account.

Hanson also argued that prepaid cards can be a vehicle for making credit available to consumers who might not ordinarily qualify for extensions of credit tied to, for example, credit cards. Hanson noted that many people who buy and use prepaid cards want small-dollar loans. He argued that individuals can and should receive these loans as long as the risk of extending such credit is acceptable to the lending institution and

⁵¹ See Mark Furlletti and Stephen Smith, "The Laws, Regulations, and Industry Practices That Protect Consumers Who Use Electronic Payment Systems: ACH E-Checks & Prepaid Cards," Federal Reserve Bank of Philadelphia Payment Cards Center Discussion Paper (March 2005), pp. 11-12 & 15-16, discussing Zero Liability.

⁵² This rule is addressed earlier in this summary, on pages 7-8.

appropriate underwriting has occurred.⁵³

As part of their dialogue, Streit and Hanson also discussed how the prepaid market is evolving. Hanson argued that much has happened in the past five years. He noted that some issuers of prepaid cards have achieved scale and that large issuers and program managers have begun competing with one another on price. Streit and Hanson both agreed that as issuers and program managers are able to further reduce their average costs, and as competition increases, consumers are likely to benefit. They observed that cost-savings and competition have thus far contributed to significant reductions in fees for many of their products and their competitors' products. Specifically, Hanson observed that "costs [passed on] to the consumer have gone down sharply in the previous 18–24 months," and costs are likely to continue to decline in the near future, largely due to scale. Still, Hanson stressed that fees are necessary in open-loop prepaid-related business models because there are costs that must be recovered, such as customer service costs, system-support costs, fraud and loss costs, regulatory and compliance costs, statement issuance costs, and inventory replacement costs.

Streit noted that the original pricing model for GreenDot's products included a number of fees. Over time, as Green Dot's systems have supported more volume, the company has been able to reduce its fees. Currently, Green Dot charges between four and five fees — a purchase fee, a monthly account fee, an out-of-network-ATM-use fee, a reload fee (if cardholders reload with cash at a reload outlet), and a card replacement fee — and Streit believes that his company might soon be able to eliminate the card-replacement fee. Streit stressed that the evolution of the fee model and the decline in fees are directly attributable to increased volume. He noted that sales have increased, while unit margins have fallen, and that both have contributed to higher profits.

Streit and Hanson concluded their portion of the panel by arguing that as prepaid businesses achieve greater scale, and as incremental cost savings are realized, there will be more opportunities to

⁵³ As Meta subsequently experienced with its iAdvance product, which was suspended under a directive issued by the Office of Thrift Supervision in October 2010, linking prepaid cards to small-dollar loans can trigger regulatory concerns (the OTS alleged that Meta's practices surrounding the iAdvance product were unfair and/or deceptive). For more information, see "OTS Clamps Down on MetaBank's iAdvance Activities," *Paybeforelegal* (October 2010), pp. 1 & 3.

further reduce fees. Nevertheless, similar to most bank accounts, fees will likely remain for some services. In particular, fees are likely to continue in cases where a bank or program manager has costs that are set by third parties and that relate to particular action(s) taken by cardholders (such as use of an out-of-network ATM).

C. What Protections Are Important to Consumers Who Use Prepaid Cards?

Next, Lauren Saunders of the National Consumer Law Center addressed the types of protections that are important to consumers who use prepaid cards. She agreed that prepaid cards, and GPR cards in particular, provide tremendous opportunities for consumers. But she argued that all consumers who use prepaid cards should have (1) the ability to choose whether or not to use a prepaid card; (2) the protection afforded by FDIC deposit insurance (passed-through to the cardholder); (3) access to conspicuous, understandable disclosures (Saunders stressed that consumers should be able to easily make well-informed choices and that disclosures should be clear and conspicuous); (4) no unreasonable fees; (5) protection from unauthorized use, loss, and error via regulation (as opposed to by contract); (6) readily available and up-to-date transaction information; (7) statements that are available upon demand and can be obtained for a nominal fee; and (8) no dangerous credit features. Pointing to a product that provides most, if not all, of these protections, Saunders highlighted the Treasury's Direct Express card (see the next section). She suggested that the Direct Express product might serve as a model for other programs to emulate.

Generally, there was much agreement about protections that are important to, and should be made available to, consumers who use GPR prepaid cards. In particular, there was a sense that a Regulation E-based protection scheme similar to that which has been applied to payroll cards could, if properly structured, provide strong and appropriate protections for consumers who use such cards. These protections would include a requirement for clear and conspicuous disclosure of terms and conditions, protection from fraudulent and unauthorized use, protection from errors, and the right to obtain important information (such as balance and transaction information) upon request.

Green Dot's Streit observed that, at Green Dot, GPR accounts are referred to as "transactional accounts" and argued that, in his view, there really

is not a lot of difference between these accounts and demand deposit accounts. Streit stressed that Green Dot welcomes formal regulatory protections for consumers who use GPR prepaid cards because such protections will help develop consumer confidence, build consumers' faith, and ultimately result in increased adoption.

Hanson of MetaBank remarked that, in general, MetaBank treats cards as bank account substitutes. He noted that MetaBank makes funds immediately available (although having immediate access to funds is of great convenience to cardholders, it can result in the bank taking on some credit risk on behalf of the consumer) and provides robust protections from loss, theft, or fraudulent use (including offering the Zero Liability program). He also noted that MetaBank typically provides FDIC deposit insurance protections to cardholders.

There were, however, some issues on which the panelists did not agree. For example, there was some disagreement about whether consumers should receive periodic statements in paper form or have the opportunity to obtain paper statements upon request, and whether there should be any charges for making paper statements available. Saunders of the National Consumer Law Center argued that consumers should always be able to obtain paper statements for free or a nominal fee and that the time to dispute unauthorized charges or billing errors should not begin until the consumer receives some form of transaction information reflecting the charge. Hanson of MetaBank remarked that while consumers should always have access to transaction and balance information, sending periodic paper statements to all cardholders through the mail entails additional costs that should be taken into account in any rulemaking that contemplates making them mandatory. Second, Hanson observed that today there are significant concerns related to the safety and security of consumers' personally identifiable information sent through the mail. Hanson also noted that, based on his company's interactions with its customers, most consumers prefer not to have statements containing information about them sent through the mail. Consumers indicated a similar preference during testing performed by the Board of Governors in relation to the extension of Regulation E-based protections to payroll card users. In the final rulemaking, the Board noted that "[w]hile a few participants [in consumer testing] wanted to receive paper statements, most indicated a clear preference

for using alternative means of monitoring account activity, in particular by phone and online.”⁵⁴ In that rulemaking, the Board also noted that consumers reported “rarely use[ing] [paper statements] to track transactions or look for errors.”⁵⁵

Another source of potential disagreement concerned whether protection from fraudulent use, unauthorized use, and error is sufficient when made part of the contract between the cardholder and the issuer, or whether such protection ought to be embodied in regulation. Saunders argued that there are situations in which consumers are left unprotected — because programs like Zero Liability include exceptions that allow banks to withhold protection in some instances — and that this would not be the case if protections were extended under regulation. She also argued that, in general, consumer protections stemming from contracts can be less permanent than protections based on regulations. One conference participant, a representative from a large prepaid-card-issuing bank, remarked that banks, as a practical matter, do not want to suffer the reputational harm that would result from rescinding Zero Liability protection.

This panel concluded with multiple panelists stressing that numerous factors are likely to contribute to robust growth of the market for prepaid cards. These factors include the effects of the recession, financial regulatory reform, changing credit and debit card strategies among large banks, ongoing changes in consumer credit, increased use of prepaid products by the government, and the improved capitalization of prepaid card firms. Additionally, panelists argued that prepaid cards will provide greater accessibility to financial services for unbanked and underbanked individuals. Triplett of Visa observed that the prepaid industry presently reaches only 4 percent of unbanked and underbanked individuals but that the industry is actively marketing to this group because it is quite large. Approximately 26 percent of U.S. households are believed to be unbanked or underbanked. About half of these households had a bank account at one point, but currently they either do not want one or cannot get one.⁵⁶ He estimated that the size of the market

⁵⁴ Electronic Fund Transfers, 71 Fed. Reg. 51,437, p. 51,443 (August 30, 2006)

⁵⁵ 71 Fed. Reg. 51,443.

⁵⁶ In presenting these statistics, Triplett cited the *FDIC National Survey of Unbanked and Underbanked Households* (December 2009), available at: www.fdic.gov/householdsurvey/full_report.pdf

opportunity just for what the industry calls general-purpose prepaid cards and payroll cards is \$962 billion (in dollars loaded). Triplett concluded the session by noting that, overall, the prepaid industry must develop a better, safer alternative to cash — an alternative that appeals to consumers and has relatively low fees.

VI. Prepaid Products Distributed by Businesses and Government

Moderator:

Stephen Middlebrook, U.S. Department of the Treasury

Panelists:

Nora Arpin, Comerica

Pete Isberg, ADP

Drew Kese, Citi

Chris Paton, J.P. Morgan

Moderated by Stephen Middlebrook from the U.S. Department of the Treasury, Financial Management Service (FMS), this panel explored government-related prepaid products and prepaid products frequently used by businesses — such as incentive, loyalty, reward, award, and payroll products. Participating on this panel were Nora Arpin of Comerica Bank, Pete Isberg of ADP, Drew Kese of Citi, and Chris Paton of J.P. Morgan. From these discussions, the three main themes that emerged were (1) prepaid programs appeal to businesses and the government because they offer significant cost savings over other payment instruments, in addition to the safety, speed, and reliability that electronic payment systems offer in general; (2) these programs differ significantly from the prepaid products and programs discussed earlier in the conference, as well as from each other; and (3) many of the products in these segments offer good opportunities to reach traditionally underserved populations.

A. Cost Savings from Switching to Electronic Payments

First, the panelists examined how prepaid programs can help the government and businesses

(accessed October 15, 2010), and research conducted by Mercator Advisory Group, specifically Mercator Advisory Group, *Prepaid Market Forecast 2009-2012* (November 2009).

reduce payment expenses. To begin, Arpin of Comerica described the cost savings that result from the government's use of the Direct Express Debit MasterCard (the Direct Express card of the Direct Express program). The Direct Express card is a prepaid product issued by Comerica on behalf of the Treasury Department's FMS. The program enables about 1.5 million cardholders to access Social Security and Supplemental Security Income (SSI) disbursements.⁵⁷ Arpin explained that for each check that is displaced by an electronic fund transfer the government saves about \$0.93 (issuing a check costs about \$1.03 as compared with \$0.10 for an electronic funds transfer to a Direct Express cardholder). These savings can be substantial. The federal government continues to print millions of checks that are issued to consumers. Just over 7 million monthly Social Security payments are made by check; nearly 2.72 million monthly SSI payments are made by check; and an estimated 45 million paper checks are currently issued by the government for tax refunds.⁵⁸ The Treasury Department's initiatives to displace paper checks, which are highlighted at the end of Section III, are expected to save upward of \$300 million in the first five years.⁵⁹

Although the cost savings of individual programs are likely to differ depending on program-specific aspects, such as the cost to print paper checks, the cost of mailing checks, the cost of replacing checks that are lost or stolen, fraud-related costs, and the cost of electronic-payment alternatives, Arpin's savings estimate was similar to the other panelists'. For example, Christopher Paton of J.P. Morgan estimated that when states disburse benefits using prepaid card programs they can save as much as \$2.25 per payment. For businesses, the savings are similar. ADP's Isberg observed that businesses spend around \$1 to \$2 per check issued compared with only about \$0.22 per

⁵⁷ For more information on the Direct Express Program, see MasterCard Worldwide, "Case Study: Direct Express Card" (Purchase, N.Y.: MasterCard Card Study, 2010). See also U.S. Treasury Department, Treasury Statistics, "Fast Facts" (Washington, D.C.: Treasury Department Statistical Press Release), available online at www.godirect.org/media/about/research/ (accessed January 19, 2011).

⁵⁸ See U.S. Treasury Department Statistical Press Release, p. 1 (providing statistics on Social Security and SSI payments); and Sundeep Reddy, "U.S. Treasury to Deliver Tax Refunds on Prepaid Debit Cards," *Wall Street Journal*, January 13, 2011 (providing information on federal tax-refund checks).

⁵⁹ See Treasury Department Press Release (April 19, 2010), p. 1.

electronic payment. Isberg further remarked that employees who receive payroll cards also save money. He noted that the fee for cashing a check can be as high as 5 percent of the face value of the check, whereas an employee with a payroll card can obtain access to cash for much less.

The panelists also highlighted the safety, speed, and reliability of the electronic payments systems. Kese of Citi observed that, generally, electronic payments provide greater control, convenience, and security than alternative systems, such as checks. He argued that corporations or agencies that use electronic payments not only have better visibility over funds (and can therefore manage funds better) but they can also use information gathered in near real time to make important business or policy decisions. In the case of the Direct Express program, Arpin noted that electronic fund transfers are able to deliver funds to cardholders almost instantaneously, whereas checks depend on the mail system. She also noted that use of the prepaid system has decreased FMS's exposure to lost and fraudulent checks.⁶⁰ Moreover, Arpin observed that card-based programs can provide protections not available in other systems, such as personal identification number (PIN) requirements for certain types of transactions.

Adding features such as PIN requirements is not the only way for businesses and the government to work with card issuers to tailor programs in ways that limit abuse. According to Paton of J.P. Morgan, subtracting some functionality, such as the ability to use certain prepaid cards to pay at gas pumps, can also reduce the risk of fraud. In other instances, programs can be tailored so that cards work only at one type of merchant (based on merchant category codes [MCC]) or have other restrictions in place, such as the inability to access cash at automated teller machines. These may be important features in the design of certain benefit programs.

B. Regulation and the Diversity of Government- and Employer-Sponsored Programs

The second theme from this panel was that government- and business-sponsored prepaid programs employ a wide array of business models and that these models can differ substantially due to the

⁶⁰ In fiscal year 2010, more than 540,000 Social Security and SSI checks were reported lost or stolen; nearly 50,000 checks issued by the Treasury Department were altered or fraudulently endorsed; and nearly 1.3 million people reported a paper-check-related problem to the Treasury Department. See "Fast Facts," p. 1.

highly specialized or detailed applications. Kese of Citi provided a sense for the breadth of applications for prepaid cards that fall under compensation- or promotion-related categories. He observed that businesses use prepaid cards to compensate employees as part of payroll, channel sales incentives, health-care incentives, employee rewards, and direct selling programs, and that businesses' promotional programs include customer incentives, consumer rebates, and loyalty, retention, and referral programs. He also provided examples of types of disbursement programs, noting that these can include unemployment benefits, claims settlements, class action settlements, relocation payments, higher education payments, and pension payments. Kese argued that, for each of these applications, cost and revenue models can differ and that the effects of regulations can differ.

Paton of J.P. Morgan noted that increased compliance costs associated with a patchwork of state or federal regulations (that were not necessarily drafted with government-sponsored prepaid cards in mind) can complicate matters where margins are thin, which is not uncommon for government-related prepaid issuing models. Paton observed that because increased regulation often imposes added costs to card issuers, it is important for issuers to have mechanisms for allocating costs among participants in an issuing arrangement, especially when underlying regulatory changes could not have been anticipated when the business arrangement arose. He remarked that discussions about sharing increased regulatory compliance costs can often be contentious. Paton also observed that most contracts fix pricing for the duration of the term and any changes require agreement from the government sponsor. He noted that with thin margins and no ready mechanism for allocating unanticipated costs, a significant increase in costs induced by a regulatory change could jeopardize the viability of some programs. In that case, a government sponsor could be forced to revert to a more expensive, less efficient means of making payments or disbursing funds, such as checks. Isberg of ADP noted that payroll cards, in particular, are subject to a patchwork of diverse state wage and hour laws, some of which discourage employers from offering payroll debit cards as an alternative. He noted that federal laws can help establish clarity (and thereby reduce compliance costs) and develop consumer confidence. Isberg explained that payroll products are subject to the Regulation E-based protection scheme (although periodic paper statements are not required if

this information is accessible by other means) and that the resulting protections have helped foster consumer confidence in that product.

For some types of government-sponsored prepaid cards, analyses of the regulatory impact may be complicated by the fact that many programs that disburse government benefits are based on very specific enabling legislation that often defines beneficiaries' rights. These rights can differ substantially from government program to government program. For example, Paton noted that under some government programs, such as child support and unemployment programs, benefit recipients are considered the owners of the disbursed funds and recipients enjoy an unlimited right to access funds that have been paid out. In other programs, such as various states' Temporary Assistance to Needy Families (TANF) programs, underlying program funds are agency-owned and provide the beneficiary with only a temporary right to access funds. This limited right of access is generally based on the terms specified in the law — in which the beneficiary's rights may depend on certain eligibility criteria, such as a means test. Since these and other features may differ from those offered with a GPR prepaid card, it is important to understand how regulation may affect the economics of a program or programs.

C. Reaching Underserved Populations

The third theme from this panel was that many users of prepaid products distributed or funded by the government and businesses differ from mainstream consumers. Arpin of Comerica noted that many Social Security and SSI recipients are not customers of mainstream financial institutions. Isberg of ADP observed that there are nearly 80 million consumers in the U.S. without a traditional bank account or with limited access to credit, and that these individuals receive almost \$1 trillion annually from employers, governments, insurance companies, and other sources. Isberg argued that prepaid programs can offer the opportunity to encourage inclusion in mainstream financial services as long as they are less expensive than the financial products or services they are displacing (e.g., check cashers) and as long as they are quick, convenient, safe, and thoughtfully designed. He noted that designing products can at times be difficult, particularly since the preferences of underserved groups can be hard to predict. He observed, for example, that the often neglected factor of products' invasiveness (e.g., merchant requirements

for proof of identification, such as thumbprints, Social Security numbers, or calling employers to verify check amounts) is very important to some groups of consumers seeking to maintain their privacy and that this may influence consumers' adoption of payment instruments and technologies.

A related point is that for many of the prepaid cards distributed by a government or business to consumers, the consumer does not necessarily choose this payment method. This is different from the typical experience with prepaid cards discussed in previous panels, where the consumer usually seeks out the product. In those cases, a consumer who acquires a prepaid card for the first time has made a conscious decision to obtain one and learn how it works. However, for the kinds of prepaid cards discussed in this panel, this is not necessarily the case. As a result, many of these consumers may require additional education about prepaid cards. They will also need some time to acquire experience with the cards before they are fully comfortable with them.

Thus, it is important for these programs to take into account the required customer service in the design stage. For example, Arpin observed that in the Direct Express program, a small proportion of beneficiaries account for the majority of call center contacts for assistance or basic information on how the cards function. This customer support volume does create additional costs, which must be absorbed by the program. She explained that the Direct Express program provides around-the-clock customer support, as well as deposit notification, balance updates, and online account information.

This panel concluded with a discussion between panelists and audience members about the future of these segments of the industry. Paton of J.P. Morgan noted that the more states that adopt common commercial practices related to prepaid programs, the better and cheaper can issuers provide services, thus lowering the costs for everyone. Nonetheless, both he and Kese of Citi observed that issuers of products distributed by governments and businesses, such as issuers of gift cards or other types of cards, have costs that must be recovered. The two principal sources of cost recovery are (1) part of the cost savings enjoyed by a business or government and (2) fees charged to the consumer. It is important for the long-term success of these programs to strike an appropriate balance between these two. Otherwise, users will be unhappy with their prepaid cards, and issuers may find it impractical to continue the programs.

VII. Looking Ahead

Moderator:

Rachel Schneider, Center for Financial Services Innovation

Panelists:

Ralph Bianco, U.S. Bank

Jean Ann Fox, Consumer Federation of America

Dan Henry, NetSpend

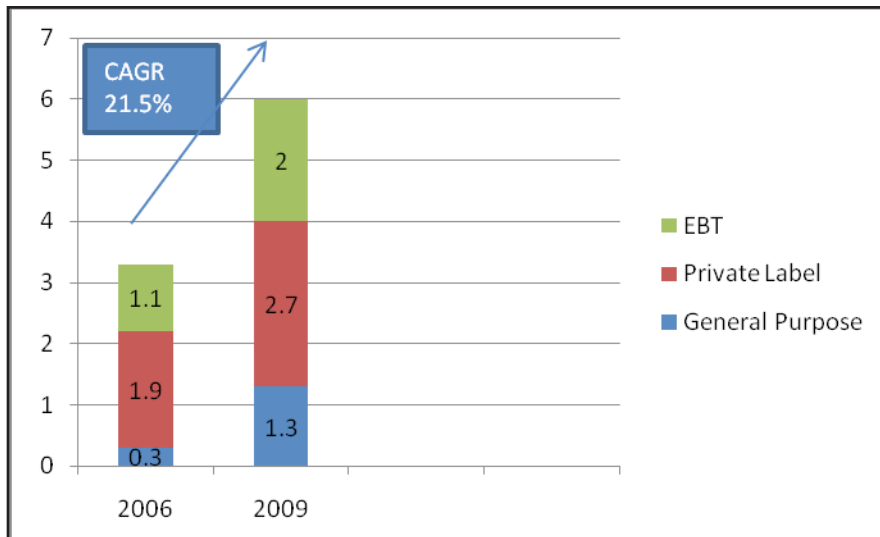
Laura Kelly, MasterCard

Moderated by Rachel Schneider of the Center for Financial Services Innovation (CFSI), this panel focused on synthesizing the discussions from the previous day-and-a-half and addressing the future of the prepaid industry. Participating on this panel were Ralph Bianco of U.S. Bank, Jean Ann Fox of the Consumer Federation of America (CFA), Dan Henry of NetSpend, and Laura Kelly of MasterCard. The panelists discussed their views of where the industry is headed, aspects of how the industry is or should be regulated at a federal level, and the costs and benefits of regulation of the industry.

From the panelists' discussions, three key themes emerged. First, the prepaid market is in a major period of growth, and while certain segments are expanding more rapidly than others, both the economic downturn and the new regulations affecting competing products (such as credit cards and deposit accounts) could further stimulate this growth and development. Second, the prepaid market is, and will continue to be, a market of niches. Because of this, legislators and regulators will be challenged with carefully considering the individual aspects of the many business models, taking into account the value propositions these models deliver and evaluating any potential risks for consumers. This variety of products also creates challenges for educating consumers about prepaid cards and protections available to them (since some regulations seem to treat similar products in different ways).⁶¹ Third, although some differences

⁶¹ For example, under the gift card rule, a gift card — that is in a consumer's hands and that is designed with celebratory motifs and images that would otherwise result in the card being considered a gift card (and would therefore subject that product to the substantive restrictions contained in the rule) — is exempt from the rule if it is provided pursuant to a loyalty, award, or promotional program. See 75 Fed. Reg. 16,588, 16,597. A consumer holding such a card would therefore not receive the

Consumer, Prepaid Payments by Type (number of transactions, in billions), 2006-2009:



underserved individuals; (4) convergence of new payment systems and traditional platforms (such as transit-fare-payment platforms); and (5) efficiencies available in electronic payments that appeal to government and corporations. Kelly noted that research commissioned by MasterCard predicts that demand for network-branded products will support \$385 billion in spending through network-branded prepaid cards in the U.S. and Canada in 2015 and that public-sector, corporate, and consumer demand are estimated to be \$174, \$120,

and \$50 billion, respectively, by 2015. However, Kelly stressed that some segments are likely to grow faster than others. In particular, she observed that government disbursements, court-ordered payments, corporate incentive programs, and health-care spending-related programs (such as health-care savings accounts [HSAs]) are all likely to grow rapidly in the near future.

A. A Period of Major Growth

of opinion remain, prepaid industry leaders and representatives from consumer groups broadly agree on many protections that are important to — and should be made available to — consumers who use prepaid cards.

To introduce this session, Schneider of CFSI noted that consumer and business use and adoption of prepaid products (and electronic payments in general) over the past decade have been significant, resulting in increased attention from consumer groups and regulators. Looking at overall demand for prepaid products in the U.S., Kelly of MasterCard argued that there are five underlying forces driving prepaid growth in the U.S. These factors include (1) a secular trend toward electronic payments; (2) the emergence of nontraditional players (such as merchants, telecom companies, and the government) that are positively influencing the adoption of electronic payments; (3) consumer demand for control and convenience related to payments, particularly among traditionally

The rapid growth in consumer use of prepaid cards is documented in the Federal Reserve’s most recent payments study.⁶² The 2010 payments study finds that although prepaid-card-based payments are still far fewer in number than payments made using credit or debit cards, “the use of prepaid card[s] is the fastest growing.”⁶³ The study reports that the number of prepaid transactions increased 21.5 percent per year from 2006 to 2009 and that the value of prepaid transactions increased 22.4 percent per year over the same period (see Chart above).

As further evidence of the strong demand for GPR cards in particular, Henry of NetSpend observed that several important measurements, such as the number of cards that are actively being used by cardholders and the total dollar volume of transactions made by cardholders, all show marked growth. For

same kinds of protections as they would for a card identical in appearance but that was obtained under different circumstances. To help consumers understand that cards obtained under certain circumstances are not covered by the rule, the Board has issued educational publications. See, for example, Board of Governors of the Federal Reserve System, “What You Need to Know: New Rules for Gift Cards” (Washington, D.C.: Board of Governors Press Release, April 30, 2010), available at www.federalreserve.gov/consumerinfo/wyntk_giftcards.htm (accessed January 19, 2011).

⁶² The Federal Reserve System, *The 2010 Federal Reserve Payments Study: Noncash Payments Trends in the United States: 2006-2009* (December 2010), pp. 17-18. The 2010 study is the Fed’s most recent analysis of noncash payment trends in the United States.

⁶³ *The 2010 Federal Reserve Payments Study: Noncash Payments Trends in the United States: 2006-2009* (December 2010), p. 17.

example, as of September 30, 2010, NetSpend had 2.1 million active⁶⁴ GPR cards, compared with 1.7 million active cards at the same point in 2009, an increase of about 24 percent.⁶⁵ Additionally, the total dollar volume of debit transactions and cash withdrawals made using NetSpend GPR cards (a measurement known as “gross dollar volume”) increased about 33 percent from 2009 to 2010.⁶⁶

Numerous panelists, including Kelly and Henry, as well as Jean Ann Fox of the Consumer Federation of America (CFA), observed that prepaid cards are becoming important tools for the unbanked, underbanked, and/or underserved.⁶⁷ Kelly highlighted research by CFSI that finds that as many as 40 million U.S. households or 106 million individuals are unbanked or underbanked and that this group spends around \$13 billion annually.⁶⁸ She also observed that, based on a joint study by CFSI and the Network Branded Prepaid Card Association,⁶⁹ 96 percent of underbanked consumers who used prepaid cards reported finding them useful, and 94 percent of underbanked consumers who used prepaid cards said they would recommend using the cards to others.⁷⁰

Despite the rapid growth in consumers’ use of prepaid cards and the potential of prepaid products

⁶⁴ Active is defined as having a PIN- or signature-based transaction, a load transaction at a retailer location, or an automated teller machine transaction within the previous 90 days.

⁶⁵ NetSpend Corporation, *Form 10-Q Quarterly Report to the Securities Exchange Commission* (November 10, 2010), p. 25.

⁶⁶ *Form 10-Q Quarterly Report to the Securities Exchange Commission* (for NetSpend corporation), p. 25 (derived from gross dollar volume amounts reported).

⁶⁷ For more information on unbanked and underbanked individuals, see Federal Deposit Insurance Corporation, *FDIC National Survey of Unbanked and Underbanked Households* (Washington, D.C.: FDIC, December 2009) (the survey distinguishes unbanked individuals from underbanked individuals on p. 46). The survey is available at www.fdic.gov/householdsurvey/full_report.pdf (accessed October 20, 2010).

⁶⁸ Center for Financial Services Innovation, *The CFSI Underbanked Consumer Study, Underbanked Consumer Overview & Market Segments Fact Sheet* (Chicago, IL: CFSI, June 8, 2008), available at www.cfsinnovation.com/publications/article/330525 (accessed January 11, 2011).

⁶⁹ The NBPCA is a prepaid industry trade group that represents businesses involved in issuing network branded prepaid cards.

⁷⁰ For more information, see Network Branded Prepaid Card Association and Center for Financial Services Innovation, *Underbanked Reloadable Prepaid Card Users, A Public Opinion Survey* (Montvale, NJ: NBPCA and CFSI, March 9, 2009), available at www.nbpc.com/en/Research-and-Publications/Research-Articles/CFSI-Prepaid-Card-Study.aspx (accessed January 19, 2011).

to serve unbanked, underbanked, or underserved groups, ensuring that consumers who use prepaid cards understand how they work will be paramount to building consumer confidence in these products. Perhaps equally important will be ensuring that consumers understand the terms and conditions that apply and making sure that they have important information available to them when they need it. Speaking to the extent of knowledge that consumers have about prepaid cards, Fox cautioned that these products can come with surprises, such as fees that are not disclosed before purchase, and stated that these products can sometimes be an expensive means of banking, particularly for low- or moderate-income consumers. The CFA and the National Consumer Law Center and Consumers Union, publisher of *Consumer Reports*, surveyed a number of GPR prepaid products and found very high or confusing fees in some cases.⁷¹ The various fees identified in their survey included purchase fees, activation fees, monthly fees, fees to get cash, balance inquiry fees, statement fees, customer service-contact fees, inactivity fees, and overdraft fees.

Fox argued that prepaid products and GPR products, in particular, need to provide clear, conspicuous, and full disclosures of fees and need to be fairly priced. She further argued that properly structured prepaid products probably can compete with other, higher-priced products and services in the marketplace. For example, she observed that prepaid programs might provide an inexpensive means for consumers without bank accounts, or for those who do not want to provide bank account information, to obtain a funds transfer of tax refunds or other government payments or disbursements. Fox noted that her organization has worked with prepaid card issuers in the past to help ensure that issuers make important information available to consumers who are making purchasing decisions.

B. A Market of Niches

The second theme that emerged from this

⁷¹ For the full Consumer Federation of America, National Consumer Law Center, and Consumers Union report, see Michelle Jun, *Prepaid Cards: Second-Tier Bank Account Substitutes* (Washington D.C.: Consumers Union, National Consumer Law Center, and Consumer Federation of America, September 2010), available at www.defendyourdollars.org/Prepaid%20WP.pdf (accessed October 21, 2010). This report surveys a myriad of prepaid programs and the terms and conditions applicable to them. It also reviews corporate statements, industry research, and laws and regulations applicable to prepaid cards, to make general recommendations for policymakers.

panel was that the prepaid market is a market of niches, with many different products employing different business models and different economics. Kelly of MasterCard observed that in three distinct sectors — the public sector, the corporate sector, and the consumer sector — there are dozens of products. Highlighting popular products in each of the sectors,⁷² Kelly stressed that prepaid, as a platform, provides businesses, government, and consumers with the ability to accomplish very specific objectives related to individual payments at relatively little cost. In addition, because there are many specialized needs and the costs of customization are relatively low, there is tremendous variety in the marketplace. This variety is likely to exist for as long as the cost of using prepaid technology as a platform remains low relative to other payment options.

The final group of panelists also discussed how the diversity of prepaid products in the marketplace (and of the business models that underlie these products) and the relative complexity of the value chain that brings network-branded prepaid cards to market (relative to credit or debit cards) pose a challenge to policymakers. Bianco of U.S. Bank argued that the future of the prepaid industry could be bright, in large part because of the flexibility of this payment platform to meet the highly specific needs of consumers and businesses and because of the regulations that affect competing products, such as credit and debit cards. On the other hand, he mentioned that new regulations applied to prepaid cards might decrease investment and innovation in this market as well. The deciding factor would be the costs imposed relative to available returns on investment in prepaid cards. He noted that regulations that limit the ability to charge fees might impair some prepaid products, and he argued instead for a marketplace in which well-informed consumers make educated decisions about what products they want to use.

Bianco further argued that while thorough and rigorous consumer protections are absolutely necessary and that core protections should be made available to consumers who use prepaid cards (these are discussed below), the regulatory scheme for the

⁷² Kelly noted that popular products in the public sector include benefit disbursement cards, emergency assistance cards, and payroll cards; that popular products in the corporate sector include payroll cards, as well as business incentive products and business-related travel products; and that in the consumer sector some of the most popular products are everyday prepaid products (such as GPR cards), gift products, and personal travel products.

prepaid industry should allow different products to have different underlying fee structures and business models. Fox of CFA responded by noting that such an approach may be confusing to consumers. She argued that if a regulatory scheme treats many products — products that look similar to consumers — differently, then consumers will need to be well educated about the differences in products in order to understand the protections available to them. Fox suggested some alternative approaches. First, consumer protections could be harmonized so that consumers do not need to learn different sets of rules for different types of cards. For example, regulations might limit the types of fees that all issuers can charge. If this occurs, consumers could have fewer fees to compare and contrast. Second, regulations could specify a common approach for disclosing fees. Fox stressed that for the market to have a chance to work, there has to be enough uniformity around disclosures for consumers to effectively compare products.

C. Protections for Consumers Who Use Prepaid Cards

The final theme discussed by this panel centered on the considerable agreement that exists over protections that should be available to consumers who use prepaid cards. Bianco of U.S. Bank suggested that FDIC deposit insurance should be extended to individual cardholders. He also stated that Regulation E-based protections make sense as long as there is an exception for periodic paper statements, as currently exists for payroll products.⁷³ He also expressed his support for effective consumer disclosures. However, Bianco disagreed with a regulatory approach that would limit when fees can be charged and the amount of fees. He argued that competition should determine the nature and level of fees, subject to the requirement that clear and conspicuous disclosures are provided to consumers. In the end, Bianco said that consumers should make up their minds about what products they want to purchase.

⁷³ Under the Board's regulations applicable to payroll products, a financial institution does not need to provide periodic paper statements if the institution (1) makes balance information "available to consumers through a readily available telephone line; (2) makes available to the consumer an electronic history, such as through an Internet website, of the consumer's account transactions covering a period of at least 60 days preceding the date the consumer electronically accesses the account; and (3) upon the consumer's oral or written request, promptly provides a written history of the consumer's account transactions covering a period of at least 60 days prior to the request." 71 Fed. Reg. 51,439 (2006).

Henry noted that many large providers of prepaid cards, whether program managers or issuers, voluntarily provide significant protections to consumers. He observed that NetSpend fully discloses its fees and that its products offer cardholders the protection of FDIC deposit insurance, as well as free services, such as free alerts, free direct deposits, and free person-to-person transfers. He argued that many of the protections that NetSpend might be required by regulation to offer are already offered.

Fox of CFA pointed out, however, that there are a number of outstanding concerns with regard to consumer protection. She noted that there are some prepaid companies that do not adequately disclose terms and conditions and that consumers are sometimes the victims of hidden fees. She argued that protections that are offered voluntarily by issuers could subsequently be revoked and that there are some restrictions on when and how consumers can avail themselves of industry-provided protections.

For example, Fox pointed out that Zero Liability–related protection can be denied to a consumer if that consumer had a complaint in the previous year. Bianco of U.S. Bank argued that it would be impractical for a bank or payment network to deny such a claim. Bianco explained that fees banks pay to payment networks help fund programs like this and that, while it is true that a consumer might be denied Zero Liability coverage at a particular moment in time, as a practical matter it is extremely unlikely that this would occur because the reputation of the bank and/or the payment network would suffer from the appearance of breaching a well-advertised promise to consumers.

Overall, there seemed to be a consensus in favor of robust disclosure requirements for prepaid products (and perhaps even for a uniform disclosure format). In addition, there also seemed to be a consensus in favor of FDIC deposit insurance protections that apply to cardholders. Furthermore, many industry representatives supported the idea of providing transaction and balance information free to consumers when they request it, in lieu of providing periodic paper statements. The representatives from consumer groups in attendance agreed as long as consumers have the ability to obtain paper copies upon request and at little or no cost. However, there were also areas of disagreement. For example, there was some disagreement on the question of whether Regulation E–type protections for unauthorized use should apply to all varieties of prepaid cards or what

would be a reasonable fee to charge for mailing a periodic paper statement. Even so, the conversation suggested much more agreement on the basic ingredients of consumer protections than was evident in the past.

VIII. Conclusion

Prepaid cards — the fastest growing electronic consumer payment instrument by usage — are likely to play an important role in the future of electronic consumer payments, especially for the underbanked. Recent market and regulatory developments affecting credit and debit cards could further stimulate demand for general-purpose prepaid cards over the next several years. But it is important to recognize that prepaid cards are not a minor variation on a debit card attached to a traditional bank or credit union account. There are significant differences in these two payment instruments and in the customers they attract.

As emphasized during the conference, there is no single business model for prepaid cards because the products are quite heterogeneous. There are literally dozens of applications based on a pay-before-use format. As one speaker suggested, prepaid is best viewed as a platform that supports a wide variety of products, each with a different business model. In addition, different prepaid products are at very different developmental stages. Some (such as gift cards and GPR prepaid cards) are beginning to achieve scale, while others remain in their formative stages. These characteristics suggest important implications for both research and policymaking.

For example, policymakers should consider the potential effects of a regulation on a dozen or more different applications. This may require more extensive analyses if the goal is to carefully balance the costs and benefits in each case. Alternatively, policymakers must accept that a more uniform rule will have differential effects on different niches, favoring some products over others, and possibly eliminating some altogether. But the countervailing concern is that of complexity for consumers. Is it reasonable to assume that most users of prepaid cards will comprehend that their rights may vary significantly depending on what seems to them to be small variations in features?

A third, but equally important, observation is that the network-branded prepaid card value chain

differs from other card products in that it typically involves more participants, and many of those are not regulated banks. This adds to sources of complexity, which includes the need for a collective understanding of risks that each participant in the transaction chain poses to its partners. This is a basic aspect of governance in the prepaid model that firms must manage effectively in order to be effective. Second, it means that more regulators may be involved in the prepaid arena than is the case for other payment products. For example, state regulation of money service business or money transmission is far more relevant to some prepaid products than to credit or debit cards. Thus, it is important that policymakers anticipate issues and effectively coordinate a response.

Overall, the prepaid industry is entering a major period of development, refinement, and consumer adoption, but some difficult choices remain about how regulation of the industry will proceed. Nonetheless, and despite some differences of opinion that remain, consensus is building among prepaid industry leaders and consumer groups about protections that are important to, and should be made available to, those who use prepaid cards.

APPENDIX A Participant List

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Independent Banking/Payments Consult
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Blackhawk Network
National Consumer Law Center
Center for Financial Services Innovation
Federal Reserve Bank of Philadelphia
Federal Reserve Bank of Boston
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Consumer Credit Counseling Service of Delaware Valley
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Federal Reserve Board of Governors
Green Dot Corporation
Pillsbury Winthrop LLP
Secure Remote Payment Council
Fletcher Group/NBPCA
Federal Reserve Board of Governors
Visa
Network Branded Prepaid Card Assoc.
Visa
Starbucks Coffee Company
Office of the Comptroller of the Currency
Value Pay Services Inc.
Paymentcard Services Inc.
Federal Reserve Board of Governors
Federal Reserve Bank of Philadelphia
Wells Fargo

APPENDIX B

Related Research Produced by the Payment Cards Center

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The Payment Cards Center was established to serve as a source of knowledge and expertise on this important segment of the financial system, which includes credit cards, debit cards, smart cards, stored-value cards, and similar payment vehicles. Consumers' and businesses' evolving use of various types of payment cards to effect transactions in the economy has potential implications for the structure of the financial system, for the way that monetary policy affects the economy, and for the efficiency of the payments system.