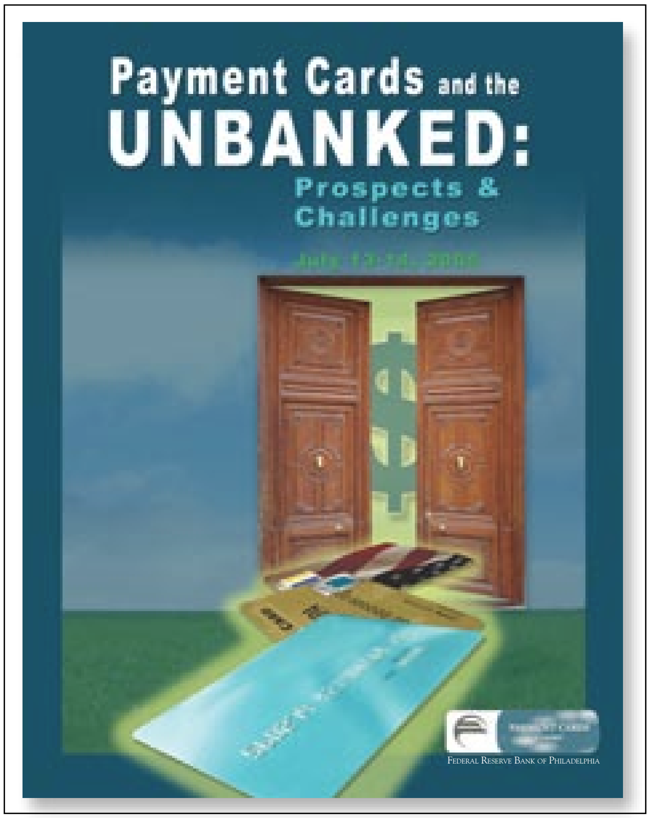
CONFERENCE SUMMARY



Payment Cards and the Unbanked:

Prospects and Challenges

July 13-14, 2005

PAYMENT CARDS Center

FEDERAL RESERVE BANK OF PHILADELPHIA

Payment Cards and the Unbanked:

Prospects and Challenges

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Summary

On July 13 and 14, 2005, the Payment Cards Center hosted a two-day conference, "Payment Cards and the Unbanked: Prospects and Challenges," that brought together experts from the financial services industry and from the policymaking, community development, and academic communities to examine the products, services, and providers that are emerging to meet underserved consumers' financial needs. This summary highlights key insights from the panel discussions and concludes by presenting three areas for further study as this consumer financial services sector continues to evolve: the roles played by banks and nonbanks, the requirements for consumer education, and the regulations governing these financial products and services.

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[1] The synopsis of the keynote address was written by Payment Cards Center Industry Specialist James C. McGrath.

I. Introduction

On July 13 and 14, 2005, the Payment Cards Center[2] hosted a two-day conference, "Payment Cards and the Unbanked: Prospects and Challenges,"[3] that brought together experts from the financial services industry and from the policymaking, community development, and academic communities. The wide range of experiences represented by the participants provided a unique framework for a discussion focused on the unbanked[4] and underserved[5] consumer segments and the products, services, and providers that are emerging to meet these consumers' financial needs.

As part of its mission, the Payment Cards Center studies new payment applications and emerging trends in the payments industry that are influencing the development of consumer financial services. In his welcoming remarks, Dr. Anthony M. Santomero, president of the Federal Reserve Bank of Philadelphia, emphasized that several recent advances in these areas have resulted in new opportunities to connect mainstream financial services with traditionally underserved consumer segments. While the electronification of payments and its related cost savings are partly responsible, he noted that other aspects of the current payments environment are also contributing to a changing landscape in this financial services sector. He encouraged the assembled stakeholders to examine these developments in financial services and the potential they present to better serve these consumer segments.

A relatively new payment application that is focusing attention on underserved consumers is the prepaid card. These cards are based on a different model than traditional card-based products: Prepaid cards require card holders to "pay early" for future purchases of goods and services as opposed to debit card holders, who pay at the time the purchase is made, or credit card holders, who pay after the purchase has been made. By requiring card holders to pay early, the prepaid model essentially eliminates nonpayment risk for the card-issuing bank. Therefore, banks have more flexibility to broadly distribute these cards and have less concern about the credit risk posed by consumers who may not have formal banking relationships or strong payment histories.[6] At the same time, prepaid card functionality is much the same as that offered by traditional credit and debit cards. Prepaid cards can be used to withdraw funds from ATMs as well as to make retail purchases or pay bills, in person, online, or over the phone. In essence, prepaid cards can provide underserved consumers with access to the payment system in ways that many have not had before and that typically have been reserved for credit and debit card holders. In the session "Payroll Cards: A Method of Payment and Account Management for Underserved Consumers," Jennifer Tescher, of the Center for Financial Services Innovation, led panelists in an examination of one type of prepaid card, the payroll card, and its potential to simplify financial services for the underserved while, at the same time, returning value to market participants providing these programs.[7]

More broadly, several aspects influencing the current financial services market are also leading to new financial alternatives for underserved consumers. As competition for new customers among the traditional banked population increases, greater attention is being focused on underserved consumer segments as potential sources for new relationships. Moreover, banks are realizing cost savings and greater efficiencies as a result of expanding electronic payment infrastructures (e.g., ATM, branch, and card-acceptance networks). Banks are also beginning to establish partnerships with third-party entities that are especially well positioned to market services directly to underserved consumers. Together, these market dynamics are contributing to the development of new products designed specifically for underserved consumers. Jeanne M.

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[2] For a listing of other recent publications by the Payment Cards Center, see Exhibit 1.

[3] For the conference agenda, see Exhibit 2.

[4] The term unbanked refers to individuals who do not have checking or savings accounts.

[5] In this paper, the term underserved will include both unbanked consumers and those who may have a bank account but also rely on alternative financial service providers for some of their financial needs.

[6] In this paper, prepaid cards will always refer to branded or open-system prepaid cards, i.e., those cards branded with a payment network such as Visa, MasterCard, American Express, or Discover. The discussion excludes closed-system prepaid cards. For more detail on the distinction between closed system and open system, see PCC Discussion Paper "Prepaid Card Models: A Study in Diversity," pp. 3-4.

[7] The provider of a payroll card program may not be a bank. Instead, it could be a third-party intermediary, such as an employer or payroll processor. The issuer of an open-system, branded payroll card will always be a bank. A bank may be both an issuer and a provider.

Hogarth, of the Board of Governors of the Federal Reserve System, moderated a second panel, "Remittance Cards, General Purpose Prepaid Cards, and Modified Financial Accounts: A Range of Financial Tools Adapted for Underserved Consumers," which considered several new and emerging products.

The migration to electronic-based consumer payments and the developing roles played by nonbank providers, especially in the financial services market for underserved consumers, have also contributed to new opportunities to better serve these consumers. T. Jack Williams, of Tier Technology, asserted that nonbank providers have been quicker than traditional banks in recognizing this potential and developing innovative solutions aimed at underserved consumers. Williams moderated the next panel, "Innovation and Emerging Market Structures: A Changing Landscape for Financial Services Providers," which brought together several nonbank innovators to discuss the ways in which their companies are providing financial products and services to the underserved.

As participants considered the market's increasing focus on underserved consumer segments, many emphasized that there will always be what keynote speaker Michael S. Barr, in his address entitled "Toward Efficient and Inclusive Payment Systems," termed an "alternative financial sector" (AFS), which includes money services businesses such as check cashers, payday lenders, and money transmitters.[8] These AFS businesses generally charge high relative fees for specific services, such as cashing checks or sending money to friends and family in a home country. A subsegment of underserved consumers will continue to use these financial outlets for a variety of reasons, such as being more comfortable conducting business with these providers. At the same time, Barr argued that in the current payments environment, which is increasingly moving to electronic modes of payment, the broader base of underserved consumers will have new, alternative, and, in many cases, cheaper options with which to meet their basic financial needs.[9]

[8] For analysis of this sector, see Michael S. Barr, "Banking the Poor," 21 *Yale Journal on Regulation* 121 (2004).

[9] The alternative financial sector is made up of money services businesses that provide check cashing, money transmitting, and payday lending services, among others. Nontraditional providers that fall outside the AFS characterization include new types of entrants, such as retail merchants and technology providers, that help facilitate transactions on behalf of these consumer segments.

While the conference discussions highlighted many of these positive developments and new opportunities, the dialogue also underscored that much about this financial services sector—its consumers, its providers, and its products—remains unsettled. Much is yet to be learned about the roles played by banks and nonbanks, the requirements for consumer education, and the regulations governing these financial products and services. These issues, touched on in each of the three earlier sessions, were highlighted in the final session, "Conclusions and Insights: What Have We Learned?," moderated by Peter Burns, director of the Payment Cards Center.

II. Keynote Address

Michael S. Barr, of the University of Michigan Law School, opened the conference with an overview of the unbanked consumer market segment. He first explored the means by which the unbanked—who lack access to checking or savings accounts—and low-income consumers have traditionally conducted financial transactions and the costs they incur to do so. Setting the stage for subsequent discussion throughout the conference, Barr then discussed why policymakers, industry leaders, and educators should be especially interested in the challenges faced by underserved segments and how they might get involved. Ultimately, Barr suggested that new products and appropriate incentives could lead to a more efficient and inclusive payment system, improving utility and efficiency for all participants.

The Unbanked and Underserved: Who Are They?

Barr noted that, according to Federal Reserve statistics, 22 percent of low-income U.S. families (10 million households, or 22 million people) are unbanked. In addition, he indicated that there are a number of households—the underserved—that do have some sort of bank account but that, lacking reliable or cost-effective vehicles to accumulate savings, acquire insurance, or access credit, still rely on nonbank sources for many types of financial services.[10] Barr suggested

[10] As previously noted, the term underserved is used broadly in this paper to capture both unbanked consumers as well as underserved consumers who may have some sort of bank account but still rely on the alternative financial sector.

a number of reasons why the underserved do not or cannot use traditional banking accounts, roughly dividing them into demand-based factors, such as the preferences and needs of low-income households, and supply-based reasons, which are largely cost or marketing considerations that affect how banks assess the attractiveness of this market.

Speaking first to demand-based reasons, Barr noted that conventional checking or demand deposit accounts (DDAs) may not be well suited to the poor or unbanked. Among factors that might discourage such consumers are perceived high overdraft fees, high monthly maintenance fees, prohibitive minimum balances, lack of physical access (due to a low density of neighborhood banks), and excessive delays associated with having deposited checks credited. With modest needs to write checks and insufficient income to generate meaningful savings, many potential customers have not seen a product that provides much usefulness or the right features.

Further, documentation requirements may be an obstacle for some immigrants, despite the increased flexibility now offered by many banks. As Barr has written elsewhere,[11] while matricula consular cards are widely accepted by banks as a suitable form of identification for opening a noninterest-bearing checking account or equivalent, an IRS-issued individual taxpayer ID number or Social Security number[12] is required to open an interest-bearing account.[13] Other underserved consumers may be effectively barred from the conventional banking sector altogether because of an unfavorable credit history or a history of failings with deposit accounts.[14] Finally, Barr emphasized that lack of financial education remains an impediment to building demand among the underserved, especially in immigrant communities. Such customers may require training simply to become comfortable using an ATM for basic cash withdrawals. They may struggle even more with sophisticated applications such as electronic bill payment.

Barr emphasized that, for consumers, the need for and benefits from savings and credit are related: both can be a form of self-insurance, smoothing consumption and dampening the impact of disruptions in income or unforeseen expenditures.[15] The fact that the underserved are largely excluded from viable savings vehicles means that they cannot work to build their own financial cushion, Barr contended, which tends to cement their reliance on government programs or drive them toward bankruptcy in the event of a disruption. Further, high-cost alternative financial products blunt the effectiveness of federal initiatives such as the earned income tax credit (EITC). By siphoning off a substantial portion of earmarked funds, transaction costs for check cashing, refund anticipation loans, and other functions blunt the program's intended benefits to low-income recipients. Ultimately, the underserved's lack of credible long-term savings options and the long-term budgeting advantages of responsible credit can limit their ability to undertake further education, purchase a home, or accumulate other long-term assets, limiting their social mobility over the long term.

Barr next addressed the supply side of the problem, acknowledging that the situation has changed for the better in recent years. With the increased flexibility afforded by technology and the transition from check- and teller-based services to

[11] Michael S. Barr, "Banking the Poor: Policies to Bring Low-Income Americans into the Financial Mainstream," The Brookings Institution, September 2004.

[12] The fears of poorly documented immigrants regarding the banking system are well known. However, with broad accommodations, such as acceptance of the matricula consular identification, some of the causes of these concerns are being addressed. However, Barr has noted (Michael S. Barr, 2004) that since the IRS no longer pledges that taxpayer information will not be shared with immigration officials, some immigrants could continue to limit their participation in the financial system to only the most rudimentary banking products.

[13] The National Taxpayer Advocate, in its fiscal year 2006 annual report to Congress, has called for improvements in the individual taxpayer identification number (ITIN) program so that immigrants can much more easily gain access to a valid ITIN, which will allow them to obtain a bank account.

[14] Barr has noted that 7 million such consumers have records in ChexSystems. ChexSystems, now a division of eFunds, was started in 1971as a means to control bad check writing. Today, it serves as an account screening tool used by 8,800 banks in 100,000 locations. This electronic database, analyzed using techniques similar to those applied to credit reports, has up to 400 payments-related fields for a given consumer. But in this case, the metrics are used to generate a "debit" score to allow banks to assess the potential riskiness of any prospective checking account based on the applicant's banking history.

[15] For further exploration, see Michael S. Barr and Michael Sherraden, "Institutions and Inclusion in Savings Policy," in Nicholas Restinas, Eric Belsky, eds., *Building Assets, Building Credit: Creating Wealth in Low-Income Communities,* 2005.

electronic transactions, he believes that cost and risk factors have improved appreciably for many banks and that the economics now do permit them to offer meaningful banking products at a viable price for customers and banks alike. Banks also enjoy exogenous incentives to become more involved. As an example, Barr cited the ETA,[16] spearheaded by the U.S. Treasury as part of its electronic funds transfer program of 1999 and the "First Accounts" pilot program. While this program has not had widespread impact, Barr believes that it is the sort of public-sector incentive that can spur more private-sector involvement in this market.[17]

The Underserved's Reliance on the Alternative Financial Sector (AFS)

The many underserved customers who choose not to participate in mainstream financial services, who aren't offered the right sort of product, or who cannot gain access have traditionally turned instead to nonbank service providers, categorized as the alternative financial sector, or AFS. For example, the underserved often rely on check cashing outlets to effect certain types of transactions. In addition to cashing checks, for which they may charge from 1.5 percent to 3.5 percent of face value, these services also give underserved consumers a way to transmit funds and pay bills. Research has estimated that, in the aggregate, such outlets processed 180 million checks with a face value of $55 billion, earning $1.5 billion in fees.[18] As is the case with most AFS offerings, the fees associated with check cashing services are high both in absolute terms and relative to the customer's income.[19]

To access a form of credit and to manage liquidity needs, the underserved often rely on payday lenders and may take out refund anticipation loans (RAL) at tax time. Numbering 12,000 nationwide, payday lenders have been making 65 million loans annually to 8 to 10 million households in recent years.[20] These loans, unlike those typically available at a bank, are made for relatively small amounts for short periods—often for only a week or two—with fees that may amount to $35 per loan.[21] If annualized, these fees would translate into an effective APR of over 470 percent. While there are some regulatory constraints, these businesses are not subject to the same degree of uniform federal regulation as banks.

With an RAL, the underserved can get a refund one month faster, a head start that can be indispensable for a family with no other credit alternatives. Barr noted that almost half of the $32 billion in EITC refunds earmarked for 18 million families are distributed through RALs.[22] But the seepage associated with the process of accessing these funds by the underserved is significant. Interest charges, tax preparation and filing fees, and check cashing fees may consume more than 8 percent of the total refund amount, including the EITC and other credits, significantly reducing the actual benefits received by low-income consumers.

Conclusion

Having outlined the current state of affairs, Barr looked to the future, proposing mechanisms for public- and private-sector entities to do more to accelerate the adoption of lower cost financial alternatives. First, he called generally for greater encouragement of card-based disbursement products such as the Trea-

[16] Electronic transfer accounts, or ETAs, are offered by banks to consumers receiving federal benefit checks. More than 60 financial institutions offer these accounts at more than 17,000 locations across the U.S., giving underserved consumers an inexpensive vehicle to receive their money electronically. They offer cash withdrawals, POS access, monthly statements, and all the benefits available to other account holders at that bank. There are attractive benefits to participating financial institutions as well: they receive a one-time setup fee of $12.60 for each new ETA opened and may provide add-on services. Banks can allow other sorts of deposits into an ETA, including direct deposits, and can issue interest-bearing and noninterest-bearing versions. While participating banks may face some product development costs the first time they become involved in this business, the Treasury's analysis showed that, given the subsidies to help cover the costs associated with opening an account, a $3.00 monthly fee would be sufficient to cover banks' monthly expenses and leave a $0.93 pre-tax monthly incremental profit. See Michael Barr, 2004. More information is available at www.fms.treas.gov/eta/.

[17] See also Michael S. Barr, "Credit Where It Counts," 80 *New York University Law Review* 513 (2005).

[18] Michael S. Barr, 2004.

[19] Barr noted that, contrary to popular perception, check cashers do not predominantly deal with personal checks. Instead, 80 percent of the checks they process consist of payroll checks. Accordingly, the high fees charged by the industry are harder to justify as compensation for the risk of nonpayment. See Michael S. Barr, 2004.

[20] Michael S. Barr, 2004

[21] Michael A. Stegman and Robert Faris, "Payday Lending: A Business Model That Encourages Chronic Borrowing," *Economic Development Quarterly*, 17, 2003.

[22] Adapted from Alan Berube, et al., "The Price of Paying Taxes: How Tax Preparation and Refund Loan Fees Erode the Benefits of the EITC," The Brookings Institution, May 2002.

sury's ETA initiative. Second, he suggested reforms to the EITC program and tax preparation services, to place a greater emphasis on providing direct deposit. Third, states could move EBT payments to payment cards with single-account arrangements and allow former recipients to retain accounts opened through EBT programs.[23] Finally, in a more provocative proposal, he called upon the Federal Reserve System to make a change to the relative pricing of check clearing versus the ACH system. By increasing the costs of the check clearing process and decreasing the price of ACH services, the Federal Reserve, he believes, could hasten the more rapid adoption of cheaper, faster, and safer electronic alternatives to checks.

He also mentioned avenues for private entities to contribute. He called on employers to heavily promote these products and offer education in their use and available protections and safeguards. By encouraging more employees to use direct deposit, facilitated through payroll cards, employers reduce payroll costs and the costs and risks associated with check fraud, and they can increase the effective take-home pay of their employees by obviating employees' need to turn to pricey alternatives. He believes that banks can also drive further innovation: Barr cited Citibank's Access program as an example of an approach that works well.[24] He also called on EFT networks to develop ATM alliances for surcharge-free or low-cost access for the poor. Finally, he again emphasized that card-based products, which have seen substantial innovation over the past several years, generally have untapped potential to bring relevant and less costly financial services to the underserved.

[23] Electronic benefits transfer programs (EBTs) include welfare payments, state food-stamp programs, and so forth. The current EBT system generally is implemented through pooled products, depriving benefit recipients from access to a dedicated account held in their name. Allowing for portability could be especially beneficial because many state benefits recipients move on and off welfare frequently, needlessly disrupting their financial capabilities if they cannot retain a payment mechanism throughout these transitions.

[24] This is a low-cost banking product offered without paper checks or without a minimum balance requirement. It costs $3 per month, which is waived if the account holder receives a direct deposit during that period. The customer is entitled to pay bills online, bank online, and receive statements online. Citibank ATM access is free, with a $1.50 fee for use of a non-Citibank ATM. These accounts can be opened in person with a matricula consular card; a Social Security number is not required. Further details are available at: https://web.da-us.citibank.com/cgi-bin/citifi/scripts/prod_and_service/prod_serv_detail.jsp?BS_Id=AccessAccount&BV_UseBVCookie=yes

As others would note later in the conference, Barr stressed that education is of critical importance in improving the financial services opportunities for the underserved. Many recent immigrants are unfamiliar with the nuances of the American banking system, having had little exposure to banks in their home countries. Providing even rudimentary financial education to these consumers would be very valuable. However, individual banks are unlikely to shoulder the costs, since the benefits of shaping a more financially literate consumer need not accrue to the financial institution that made the effort. A solution to this public good problem may lie in more public-sector involvement, through industry-wide efforts, or public/private partnerships.

Before concluding, Barr acknowledged that many questions remain to be answered about the underserved. To fill in the gaps in our knowledge, Barr said that he is spearheading an empirical, household-focused study of low- and moderate-income consumers in the Detroit metropolitan area, conducted under the auspices of the University of Michigan's Institute for Social Research, Survey Research Center. Its aims are two-fold: (1) to better understand how and why these consumers use an array of financial services, as well as the costs and benefits of doing so, and (2) to gauge how these consumers would respond to new types of financial services or products tailored to their specific needs. Results from Barr's Detroit Area Household Financial Services Study will be available in early 2006.[25]

In summary, Barr emphasized that for the payments system, efficiency and inclusion are mutually reinforcing objectives. By moving toward electronic payments, system participants may benefit from network externalities, since the payments system becomes more valuable for all stakeholders as volume and usage increase. Greater demand can result in better and more widespread services, making the network more useful for everyone involved. In the process, the underserved will gain better access to savings, credit, and insurance products, providing appreciable social welfare enhancements at comparatively low cost.

[25] For further background, see Michael S. Barr, "Detroit Area Study on Financial Services: What? Why? How?" *Law Quad Notes* 48(1): 72-7, 2005.

III. Conference Sessions

1. Payroll Cards: A Method of Payment and Account Management for Underserved Consumers

Jennifer Tescher,[26] of the Center for Financial Services Innovation, moderated this session, which began with formal remarks made by each panelist: Armen Khachadourian of JPMorganChase (Chase), Peter Davidson of Genpass Card Solutions (Genpass), and Doris Damm of ACCU Staffing Services (ACCU). Khachadourian noted that Chase launched one of the earliest payroll card programs in 1988, and he described Chase's experience developing the next iteration of this product: the Chase E-funds payroll card. Genpass,[27] as both a provider and processor of payroll cards, has multiple clients. Therefore, Davidson's view stretched across the market rather than focusing on a single market participant. Based on this experience, he listed a series of requisite payroll card features for underserved consumers and discussed the potential for payroll cards to displace traditional account relationships. Damm's company, ACCU Staffing, is a large employer of temporary workers in southern New Jersey. Damm described her company's experience as an employer-provider of a payroll card program. As each panelist examined payroll cards and their applicability to underserved consumers, several key themes were identified: the role of employers in payroll card distribution, the potential of payroll cards to replace traditional bank accounts, the importance of consumer education, and the implications of an unsettled regulatory environment. These topics, among others, were also addressed in the discussion following their formal remarks.

To introduce this session, Tescher shared data, recently published by Mercator Advisory Group, estimating the size and growth of the payroll card market. This research showed that total payroll card spending grew from $15 billion in 2003 to $29 billion in 2004, an increase of $13 billion, or an 88 percent growth rate. Moreover, the number of payroll cards in circulation doubled over the same period, to 2.2 million cards.[28] Focusing on the unbanked segment, Tescher noted that 22 million individuals, or 10 million households, are without a bank account.[29] Of these households, 10 percent, or 1 million households, held a payroll card account in 2002. This percentage was predicted to increase to 25 percent, or 2.5 million households, by 2006.[30] These data describe the payroll card market as one with growing opportunity and increasing participation by underserved consumers.

Chase's Khachadourian stressed that this market opportunity – payroll cards as a means to improve financial services for the underserved – came about largely as the result of a 2001 decision by Visa and MasterCard to support network-branded payroll cards.[31] Compared to existing models in which card acceptance was limited to locations processing personal identification number (PIN) transactions,[32] network-branded payroll cards could be used by card holders anywhere the network brand was accepted, significantly expanding its utility for bill payment and retail purchasing activity. Network branding also changed the economics for issuers and card holders. Khachadourian estimated annual costs for ATM/PIN-only payroll card ownership to be $107 per card. The annual cost of card ownership declines to $79 per card for network-branded payroll cards.[33] For underserved consumers, branded payroll cards facilitated access to card acceptance networks and payment functionality without the need to have, or qualify for, a traditional

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[26] Tescher has written several papers on topics related to the financial services market for underserved consumers. Her recent papers include "Stored-Value Cards: Challenges and Opportunities for Reaching Emerging Markets" and "Breaking the Savings Barrier: How the Federal Government Can Build an Inclusive Financial System." To view a more complete listing of Tescher's work, see www.cfsinnovation.com/about_team.php#1.

[27] On May 10, 2005, U.S. Bank announced that it had acquired Genpass, Inc. To see the related press release, visit http://phx.corporate-ir.net/phoenix.zhtml?c=117565&p=irol-newsArticle&ID=708198&highlight=.

[28] Ann All, "The Channel Shuffle," ATMmarketplace.com, April 4, 2004, from www.atmmarketplace.com/futurearticles.htm?article_id=18820& (accessed February 1, 2005).

[29] Office of the Comptroller of the Currency, "Payroll Cards: An Innovative Product for Reaching the Unbanked and Underbanked," June 2005, p. 1 (www.occ.treas.gov/cdd/payrollcards.pdf)

[30] Ariana-Michele Moore, "Payroll Cards: A Direct Deposit Solution for the Unbanked," Celent Communications, December 2002. (www.celent.com/PressReleases/20021219/PayrollCards.htm)

[31] Payroll cards branded by a payment network such as Visa, MasterCard, Discover, or American Express are processed using the same systems as these networks' credit and debit cards.

[32] In many cases, these early payroll cards could be used only to withdraw funds at ATMs.

[33] These cost estimates assume weekly payroll, four ATM withdrawals/month, and four PIN purchases/month.

bank account.[34] The Visa and MasterCard decision spurred development of payroll card programs by several major banks, including Chase.

Khachadourian described Chase's payroll card product development process in more detail. It began with a broad customer segmentation strategy that asked questions such as: Who are underserved consumers? How do we reach them? And is a payroll card the right product? Their research estimated that 60 million Americans received their pay via paper check, of which 35 million were banked and 25 million were unbanked. As a result, the Chase E-funds Card Program[35] (i.e., a payroll card program) was designed to replace the paper payroll check with a product that mimicked a signature-debit card but without the need for the card holder to open an associated checking account. These cards were positioned as a convenient, safe, less costly way for underserved consumers to convert their payroll into cash, manage their budget, pay bills, and otherwise meet monthly financial needs.

Chase's research also revealed that 72 percent of the U.S. workforce is employed by small and mid-size companies, not Fortune 500 firms. Therefore, rather than focusing on large employers, Chase leveraged small business and middle market workplaces as the primary distribution channel. For the employer, the Chase E-funds payroll card program was positioned as a cost savings, described by Khachadourian as a way to "digitize the payroll process." Chase's program helped employers gain increased operational and cost efficiencies as a result of reducing paper payroll processing and disbursements.[36]

Tescher emphasized that employers are uniquely positioned to offer payroll cards to potential customers at a critical decision point – when employees are initially deciding how to receive their pay and making selections related to employment benefits.[37] Therefore, employers play a key intermediary role in the distribution of payroll cards, particularly for those employees who do not have other access to bank-provided products and services.

Returning to the consumer value proposition, Genpass's Davidson expanded on the payroll card features that—in his experience with Genpass's PayCard program and its clients—are critical to the success of any payroll card program for underserved consumers. Payroll cards must be low cost, with fees less than those charged in the alternative financial sector, and have a simple process in place for card holder application and enrollment. Applications should be universally approved.[38] Successful programs will also provide surcharge-free ATM access and facilitate bill payment. Finally, he emphasized the importance of customer service. In general, payroll card holders require a high level of account servicing—initially, to educate consumers about the product and its functionality and, later, to assist with questions about servicing.

Furthermore, Davidson stressed that the payroll card platform is flexible: Ultimately, it can support a range of financial activities for card holders, much more than ATM access, retail purchasing, and bill payment. In his view, several immediate areas of opportunity to expand payroll card functionality include the ability to send remittances, make card-to-card transfers, and allocate funds for specific budgetary purposes (e.g., shopping, savings, or food purchases). Given the potential to add functionality, Tescher questioned whether payroll cards are truly a unique prepaid model or rather are they distinguished solely by their distribution channel: the employer. Davidson agreed that payroll cards could be transformed into a more universal product, one not strictly tied to payroll deposits or the employer distribution channel. Rather, payroll cards can allow for loading funds beyond payroll to the cards—in a variety of ways and at a number of locations—while, at the same time, replicating many of the services available to any bank customer. For these reasons, Davidson asserted that payroll cards have the potential to be attractive substitutes for traditional bank products such as demand deposit and savings accounts.

In contrast to these perspectives, Damm, of

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34 For example, unbanked customers with a payroll card are able to use the card to pay bills over the phone or online, rather than relying solely on money orders or cash to pay their bills.

35 Payroll dollars are directly deposited to a payroll card account. Card holders have access to account activity (online, 800 number) and 24-hour access to funds and customer service. The Chase E-funds program also provides access to the Allpoint surcharge-free ATM network.

36 By reducing paper payroll processing, employers also process fewer stop payments, replacements of lost or stolen checks, and check re-issuances.

37 See Jennifer Tescher, "Payroll Cards Can Pay Off in Customers," *American Banker*, July 29, 2005.

38 Applicants are generally approved, with declinations limited to those with a record of default.

ACCU Staffing, described the payroll card market in the light of an employer providing a card program to employees. In her experience, payroll cards offered significant benefits for both employers and employees but barriers remained, limiting adoption by both groups. The economics clearly favored migrating ACCU employees to payroll cards from paper checks: $0.75 compared to $2.50 in unit processing costs.[39] While processing cost savings were significant, Damm pointed to state labor law as a potential challenge. For example, in New Jersey, employees cannot be forced to use direct deposit but rather must retain the option to receive their payroll dollars as a paper check. Therefore, New Jersey employers, such as ACCU, will never be able to fully "digitize the payroll process," as Khachadourian termed it. Further, in some states, employers may not charge payroll-related fees that reduce an employee's paycheck below the total of their hourly rate times the number of hours worked.[40] In other states, this area of law is unsettled, and in some cases, state law explicitly disallows the use of payroll cards.[41] Damm noted that in response to minimum wage law in New Jersey, her company pays ATM and other fees associated with ACCU Staffing Services' payroll card program to ensure that their employees' effective hourly wage is not less than the state's minimum wage requirement.

For employees, payroll cards provide many benefits: a cheaper alternative for converting a paycheck to cash, a card-based option for making retail purchases and paying bills, and a safer mechanism for storing and transporting payroll dollars. To illustrate the potential cost savings, Damm estimated that ACCU employees cashing their paychecks at local check cashers paid up to 20 percent of the face value of their payroll check. For example, an employee who pays a 20 percent fee to convert a $200 paycheck into cash will retain only $160. Damm stressed that payroll cards save much of this expense and increase employees' take-home pay.[42]

In Damm's experience, ACCU employees' general discomfort with banks and the services they provide are primary barriers to their adoption of payroll cards. She cited several reasons employees gave for opting out of ACCU's payroll card program, including anxiety associated with entering a bank or using ATMs; fear associated with safety/security of the funds held by the bank; and distrust of a bank's customer service and, specifically, its response to problems experienced by card holders. Notably, these concerns, combined with a basic affinity for paper checks, made the payroll card's value proposition (e.g., saving $40 in check conversion costs per paycheck) insufficient for motivating these employees to adopt payroll cards.

Despite these obstacles, payroll cards are a better option for ACCU employees, Damm stated, and her company would continue to support them. Finally, she emphasized that employees who had used a payroll card and gained a comfort level with the way these cards work liked the product. This insight implies that, with consumer education, payroll cards have real potential.

With the conclusion of the panelists' formal remarks, participants engaged in a broader discussion that examined in more detail several aspects of this topic: payroll cards' potential to serve as a method of payment and account management for underserved consumers. These areas included an examination of payroll card "portability" and its implications for the business model as well as further study of issues related to consumer education and payroll card regulation.

Payroll card portability means that card holders can take the card with them from one employer to another as they change jobs, i.e., new employers are able to deposit payroll dollars to an existing

[39] Damm noted that unit processing costs were an all-in cost to process paper payroll disbursements, including costs for check replacement, cancellation, re-issuance, and so forth.

[40] See N.J.S.A. §§ 34:11-4.1 to 34:11-4.2a (2005). Available at www.state.nj.us/labor/lsse/select.html.

[41] Kathleen Johnson Jarboe, "Maryland Considering Program to Implement Plastic, Debit-Like Payroll Cards," *The Daily Record*, April 1, 2005. *The Daily Record* is published in Baltimore, Maryland.

[42] Research by Sherrie L.W. Rhine of the Federal Reserve Bank of New York and her colleague Sabrina Su support the notion that generally payroll card holders pay less than those using services provided in the alternative financial sector. More specifically, Rhine and Su examined the costs associated with various payment options for consumers who conducted a low, moderate, or high number of monthly transactions. They found that payroll cards were consistently one of the least expensive options and check cashers were one of the most expensive options across each of these usage models. To see the full report, see "Stored-Value Cards as a Method of Electronic Payment for Unbanked Consumers" at www.newyorkfed.org/regional/Stored_Value_Card_Paper_August_2005.pdf.

payroll card account. Several participants suggested payroll card portability has the potential to increase card holder adoption and facilitate asset building for underserved consumers. Others viewed portability as positioning payroll cards to be substitutes for traditional bank accounts. In the course of this discussion, participants also raised several challenges to providing portability.

Portable payroll cards—existing cards able to receive payroll deposits from new employers—offer the potential to establish long-term relationships between the card holder and the issuing bank. From a bank's perspective, portability provides a view of the card holder's payment performance over time, data on underserved consumers that are typically unavailable (i.e., through credit reporting agencies). Using these data, banks can identify prospects for more mainstream financial products, such as saving accounts, secured cards, or mortgage loans.[43] As a result, Khachadourian noted that portable payroll cards can become an important stepping stone to traditional bank relationships and asset-building activity.

Some participants considered portability to be only one possible enhancement to payroll card functionality; they believed that payroll cards can serve many purposes, and therefore, the payroll card may evolve as a substitute for traditional bank accounts. In response, Khachadourian stressed that adding extensive functionality to payroll cards raises several issues for banks, including the potential to cause consumer confusion, create operational complexities, and change the way the product is viewed by regulators. Focusing again on portability, he gave several examples that its inclusion raised for issuers. For example, banks must consider how to account for and track deposits made by new, and perhaps multiple, employers to a single payroll card account. In addition, portability may influence regulators' perception of these cards and lead to their being viewed as more closely resembling traditional bank accounts. Barr raised another consideration in regard to portability: It may dilute the perceived benefit employees attribute to their relationship with a particular employer. As a result, Barr asked whether portability may undermine issuers' use of the employer distribution channel in favor of more direct-to-consumer models. In light of these considerations, Khachadourian stressed that banks must fully investigate the implications that adding functionality to payroll cards would have for their business models.

Damm raised the topic of consumer education and its role in encouraging payroll card adoption by underserved consumers. Along with formal education programs, Damm emphasized the importance of word-of-mouth recommendations in educating and generating interest among underserved consumers. In her experience, underserved consumers place considerable value on informal recommendations from family and friends. Unfortunately, this "informal" education process takes time to develop, and, in her view, it is not yet a force in this sector. Therefore, payroll cards may be suffering, in part, from an "early-adopter" syndrome. Additionally, Davidson observed that underserved consumers are generally unaware of the cards' features and benefits and their costs vis-à-vis alternative service providers.

In summary, conference participants identified three challenging areas in consumer education efforts: a general lack of awareness, an early-adopter stage, and limited information with which to compare the costs associated with payroll cards and similar services available in the alternative financial sector.

The current regulatory environment was another area of the payroll card market examined in this discussion. In particular, participants noted that the regulatory agencies are paying increased attention to payroll cards and there is growing uncertainty about the form regulation may take. Regulators were encouraged to consider the unique characteristics of payroll cards in comparison to other prepaid models, credit and debit card products, and demand deposit and savings accounts. As important, several participants stressed the risk of overly burdensome regulatory requirements weakening payroll card economics to an extent that effectively prices these products out of the market for underserved consumers. Participants generally agreed that payroll card regulation must achieve a balance between addressing consumer protection concerns and continuing to encourage development and use of electronic payments among underserved consumers.

[43] Khachadourian noted that for banks to be able to use payroll card account data to qualify card holders for other products offered by a financial institution, payroll card holders must have opted to allow these data to be shared not only with other lines of business within the bank but also with need-to-know affiliates.

Conference participants emphasized that payroll card regulation is generally unsettled at both the federal and state levels. On the federal level, regulators are considering whether payroll cards should be insured by the FDIC[44] and covered by the Electronic Fund Transfer Act's implementing regulation, Regulation E.[45] Several participants pointed to Regulation E's requirement to "send a periodic statement" to holders of an "account," as a potential barrier to underserved consumers' adoption of payroll cards. Although it appears that issuers are evenly divided among those that mail paper statements to payroll-card holders and those that do not, several participants suggested that considering payroll cards as an "account" per the definition in the act[46] and interpreting Regulation E's language as requiring statements to be physically mailed to card holders will result in a support cost that, for many programs, would have to be passed to the card holder. At the same time, several participants noted that Regulation E's requirement that a statement be sent presents regulators and payroll card providers with an opportunity for compromise, one that can achieve a balance between protecting consumers and encouraging payroll card use. Specifically, payroll card providers can better manage their program costs if given the flexibility to deliver statement information to card holders in ways that are less expensive, for example, via online or a toll-free number, rather than monthly mailings.[47] Such a compromise would meet two objectives: (1) it would ensure that card holders have regular access to statement information and (2) it would limit costs to underserved consumers using this electronic payment product. In addition, Hogarth, of the Board of Governors of the Federal Reserve System, suggested that underserved consumers may find it useful to receive real-time notifications of certain types of account activity, providing a more immediate picture of current use. For example, card holders—who are more likely to operate at the margin—can benefit from receipt of alerts related to certain types of account activity, such as low-balance or payment-due flags, which can help them to better manage their financial accounts.

At the state level, several participants agreed with Damm's earlier comments and identified minimum wage laws as a real barrier to developing payroll card programs for the underserved. Davidson argued that payroll cards should be considered to be similar to demand deposit accounts, where account fees are not viewed as reducing effective pay rates. However, until state regulation is more settled, Davidson emphasized that employers should continue to give employees a choice as to how they receive their pay and the fee information for each option. He suggested that by implementing a system of disclosure combined with employee choice, employers are better positioned to meet state regulatory requirements.

Participants generally agreed that payroll cards offer many opportunities to provide underserved consumers with real benefits. Most important, payroll cards give users the ability to conduct a range of financial activities more cheaply than in the alternative financial services sector. Successful payroll card programs will need to consider both distribution and consumer education in new lights that reflect the unique characteristics of underserved consumers and the ways they use financial services. Further, payroll card activity provides financial institutions with payment performance data that can be used to qualify underserved consumers for financial products and services that have the potential to facilitate asset building and savings for these groups.

2. Remittance Cards, General Purpose Prepaid Cards, and Modified Financial Accounts: A Range of Financial Tools Adapted for Underserved Consumers

The next session, moderated by Jeanne M. Hogarth, of the Board of Governors of the Federal

[44] On April 26, 2005, the FDIC put out for comment a "Proposed Rule on Determining When Funds Underlying Stored Value Cards Qualify as 'Deposits.'" The proposed rule summary states that "under the proposed regulation, funds placed at an insured depository institution (and not issued by a sponsoring company) also would qualify as "deposits if the depository institution maintains accounts or subaccounts for the individual cardholders." A final ruling on this proposal has not been made. For more information on the proposed rule, see www.fdic.gov/news/news/financial/2004/fil4404.html.

[45] On September 13, 2004, the Federal Reserve Board of Governors announced a proposed rule, 12 CFR Part 205, that would "provide that payroll card accounts established directly or indirectly by an employer on behalf of a consumer for the purpose of providing salary, wage, or other employee compensation on a recurring basis are accounts covered by Regulation E." A final ruling on this proposal has not been made. For more information on the proposed rule, see www.federalreserve.gov/boarddocs/press/bcreg/2004/20040913/attachment.pdf.

[46] This requirement would apply to payroll cards if they are included under the definition of "account" in Regulation E.

[47] For more detail on the regulatory environment for payroll cards, see the PCC Discussion Paper "Prepaid Cards: How Do They Function? How Are They Regulated?," pp. 14-20.

Reserve System, examined the broader set of financial alternatives, including remittance products, general purpose prepaid cards, and modified financial accounts, being designed for underserved consumers. As introduction, Hogarth described several relevant findings from her research that have the potential to influence underserved consumers' use of these financial alternatives. Notably, she found that underserved consumers are generally not opposed to using banks, but there is an "intimidation factor" that must be overcome. Further, customer service, the timing of the transaction, the cost of the service, and the reputation of the provider are all important factors that will affect the success of these products in generating adoption by underserved consumers.[48] Following Hogarth's remarks, Miguel Cintron, of Bank of America (BofA), described the rationale behind his company's product strategy, combining a starter checking account with a payment remittance service, for underserved consumers. Gary Palmer, of WildCard Systems,[49] focused his remarks on payments innovation in the prepaid card market and the potential for mainstream financial institutions to better serve these consumer segments. Finally, Emery Kobor, of the United States Department of the Treasury, reviewed the regulatory landscape. He highlighted concerns related to customer identification and product controls governing the use of remittance and general purpose prepaid cards.

Cintron characterized Bank of America's product strategy as beginning with "a commitment to improve financial services for the underserved." He shared data from Visa USA that show that around 80 million consumers are without a traditional deposit account or have limited access to traditional bank credit. Annually, these consumers are receiving almost $1 trillion in payments and are paying over $1.5 billion in check-cashing fees. These payment flows served as impetus for Bank of America to develop new and better financial services alternatives that would be attractive to portions of this market segment. As a result, Bank of America modified its existing demand deposit account but retained check-writing capability for this consumer segment. By doing so, Bank of America has given underserved consumers an opportunity to become banked. Moreover, the bank's existing infrastructure, including bank branches, ATMs, and check processing systems, can be used to support these modified demand deposit accounts.

At the same time, the rapid growth of the Hispanic population[50] and its strong representation in Bank of America's geographic service area influenced the product development strategy. Cintron noted that 93 percent of Hispanics in the United States live in markets served by Bank of America, and he estimated that 10.4 million of these households are unbanked. Moreover, Bank of America's research showed that 65 percent of unbanked Hispanics send money to family members in their home country. For these reasons, Bank of America's end-product combined the starter checking account, "My Access," with remittance capability, "Safe Send." The Safe Send U.S.–Mexico remittance feature is being priced with no foreign exchange mark-up and no remittance fees[51] to encourage immigrants to use the product.

Cintron stressed the importance of developing an educational marketing strategy that effectively communicates the My Access/Safe Send product's value —safety, security, low cost, and easy to use—to the target audience: underserved and Hispanic consumers. To accomplish this, Bank of America produced product materials in both Spanish and English, employed Spanish-speaking associates in branches, and distributed product information in locations popular with immigrants outside of the branch network. In addition, the product is broadly accessible with virtually all applications approved except in situations where there was a

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48 See Jeanne M. Hogarth, Christoslav E. Anguelov, and Jinhook Lee, "Who Has a Bank Account? Exploring Changes Over Time, 1989-2001," *Journal of Family and Economic Issues*, 26(1), Spring 2005. Also see Jeanne M. Hogarth, et al., "Banking on Remittances: Increasing Market Efficiencies for Consumers and Financial Institutions," Federal Reserve System Community Affairs Research Conference, April 15, 2005. This paper is available at www.chicagofed.org/cedric/files/2005_conf_paper_session3_hogarth.pdf.

49 WildCard Systems, a large processor of prepaid card transactions, was recently acquired by eFunds Corporation. To see the related press release, visit www.corporate-ir.net/ireye/ir_site.zhtml?ticker=EFD&script=410&layout=-6&item_id=718962.

50 Cintron described a Hispanic population that is growing rapidly in the United States—at four times the rate of the non-Hispanic population—and this rate differential is even more pronounced in the under-30 age group. Cintron's data source was the U.S. Census.

51 Nationwide, no-fee remittance services from the United States to Mexico are scheduled to be in place by September 2005. Until then, U.S.-Mexico remittance services are free only in Chicago.

record of payment default. To date, the My Access/Safe Send product has resulted in over 1 million new account relationships, 50 percent of which were from previously unbanked consumers.

In summary, Cintron stressed the importance of developing the right product for this targeted consumer segment, making it easy for these consumers to become banked, and marketing the product in a way that easily conveys its value.

Whereas Bank of America's strategy was based on modifying existing demand deposit accounts, Palmer emphasized the continuing innovation in the prepaid card market as a significant area of opportunity for banks looking to adapt financial tools to better meet the needs of underserved consumers. He described the financial market for underserved consumers as suffering from a historic gap between the financial products and services offered by traditional banks and those offered in the alternative financial sector. The prepaid model bridges this gap because it can be easily customized to provide a range of traditional functionality, with low-cost and low-risk advantages for the issuing bank. Palmer stressed that in order to be successful using prepaid cards to serve this consumer segment, banks also need to develop distribution relationships with third-party providers that have direct relationships with these consumers. In his experience, banks that leverage such third-party distributors will obtain new customers from the pool of those disinclined to deal directly with banks.

As described, many opportunities exist to use prepaid cards and remittance services as tools to better serve these consumer segments. On the other hand, Emery Kobor, of the United States Department of the Treasury, focused his remarks on some of the potential risks posed by these products. He observed that prepaid cards are especially well-suited to facilitating money laundering activities because they can provide access to cash globally through international ATM networks. Moreover, he noted that regulators are increasingly challenged to develop rules and guidelines that limit the potential for such misuse that, at the same time, encourage payment innovation and consumer adoption.

Kobor described regulatory attention as centering on issues related to customer identification and to the rules governing the use of these products. With respect to prepaid cards, Kobor suggested that prepaid card issuers could either impose stringent card holder identification requirements or implement usage controls to limit the maximum dollar amount loadable to a card, the frequency of these reloads, the spending or cash-withdrawal amounts, and the number of cards per account. Such rules would set parameters to restrict unknown entities' access to the payment system and, thereby, the potential for using prepaid cards to commit crimes such as money laundering, financial fraud, and terrorist financing.[52]

In further discussion of the legal structure for prepaid cards and remittance services, Kobor highlighted the roles played by money services businesses (MSBs) and other nonbanks in the management and distribution of these products and services. He noted that prepaid cards use bank payment networks but are considered an MSB product under current regulations issued by the Financial Crimes Enforcement Network (FinCEN),[53] which administers the Bank Secrecy Act (BSA). He added that, unlike banks, which are required to have a customer identification program, MSBs have no such obligation, although the BSA does impose some relevant controls. For example, for money transfers greater than $3,000, MSBs must exercise additional due diligence in regard to identification. Further, money transmitters, a type of MSB, are required to be licensed with the U.S. Treasury and, many times, the state in which they are doing business. Money transmitters must also meet additional BSA requirements, such as filing suspicious activity reports (SARs) as warranted on transactions of $2,000 or more. Kobor observed that unlike money transfers and other MSB products and services, reloadable prepaid cards are not a discrete transaction but can represent an ongoing customer relationship akin to a bank relationship. As such, further controls may be warranted.

As a final area of concern, Kobor identified challenges posed by the globalization of payment networks. Global payment networks present opportunities for criminals to leverage weaker regulatory regimes to

[52] Kobor gave several examples where federal law enforcement has uncovered illicit use: Prepaid cards were used by drug dealers to send money to suppliers, by criminals to convert cash from stolen credit cards, and by overseas groups to withdraw proceeds from stolen personal and corporate checks brought into the U.S. for deposit.

[53] *Guidance to Money Services Businesses on Obtaining and Maintaining Banking Services*, Advisory from the Financial Crimes Enforcement Network, Department of the Treasury, April 26, 2005, pp. 1-2. See www.fincen.gov/fincenadv04262005.pdf.

facilitate financial crimes in countries with stronger controls. For example, prepaid cards can be issued overseas and then used at U.S.-based ATMs to withdraw cash. As a result, establishing sufficient customer identification requirements and product controls is increasingly becoming a global regulatory issue.

In the ensuing discussion, several participants examined the trade-off between ensuring strong customer identification and product controls and facilitating payment system access for underserved consumers. This is particularly relevant to immigrant populations and has real economic effects for these consumers. The purchasing power of Hispanics in the United States alone is expected to increase from $686 billion in 2004 to $992 billion in 2009.[54] At the same time, in many cases, immigrants lack documents, such as Social Security cards, passports, or driver's licenses, required to open traditional bank accounts. As a result, these consumers are more likely to turn to the alternative financial sector—generally paying the higher fees charged by check cashers and other MSBs—to meet their growing financial needs.

In summary, several participants emphasized that requiring immigrant customers to produce identification is a good example of how regulation in this area affects adoption of electronic payment options by underserved consumers who either cannot or do not want to provide such documentation. The problem, all agreed, calls for imaginative solutions.

On the side of opportunities, several of the market characteristics described earlier—an increasing competition among banks for new customers, an expanding payments infrastructure, and emerging partnerships between banks and nonbanks—are focusing mainstream financial institutions' new-found attention on underserved segments. As a result, banks are learning more about these consumers and their needs. As part of this process, Cintron noted that banks are debunking some long-held assumptions about these consumers and how they use financial services. For example, underserved consumers were thought to hold very low deposit amounts, but Cintron noted that Bank of America has found account deposits to be higher than expected. Higher balances may be the result of extended households putting money into one combined account or two breadwinners, rather then one, contributing to household expenses. In any case, Cintron stressed that the economics behind providing financial services to underserved consumers are changing. To a large degree, these changes are driven by the migration of payments to electronic platforms and the expanding payments infrastructure supporting electronic transactions. They are also happening because of changes in how underserved consumers are using and accessing financial services. In the end, conference participants largely agreed that the changing economics are inspiring alternative delivery channels, new product development, and additional opportunities for both providers and the underserved end-users.

3. Innovation and Emerging Market Structures: A Changing Landscape for Financial Services Providers

Moderated by T. Jack Williams, of Tier Technology, this session examined emerging players in the financial services market for underserved consumers and how these providers are changing the way banks and nonbanks view this payments environment. Participating on this panel were David Brillembourg of Emida Technologies (Emida), Jim Callahan of H.E. Butt Grocery Company (HEB), Steve Streit of Next-Estate (Green Dot Network), and Scott Walker of BillMatrix. Each of these panelists discussed how his company is using technology and new payments tools to build relationships with underserved consumers. This section discusses the experience these innovators have had as providers of financial and related services to underserved consumers.

Brillembourg described his company, Emida, as a network for payments distribution from the United States to and within many Latin American countries. To build this network, Emida is executing distribution agreements with retailer networks, prepaid card issuers, and other money transfer outlets in Latin America. Brillembourg noted that 80 percent of Latin Americans are unbanked and many receive funds from family in the United States. As a result, Emida is approaching this segment from the perspective not only of United States immigrants but also of those to whom money is sent in Latin American countries. Emida is providing both constituencies with greater access to the payments system and to card-based functionality.

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[54] Jeffrey M. Humphreys, "The Multicultural Economy – 2004: America's Minority Buying Power," *Georgia Business and Economic Conditions*, University of Georgia, 64 (3), Third Quarter 2004, p. 6.

H.E. Butt Grocery Company, with 60,000 employees, is the largest private employer in Texas. The company operates 280 stores in the state that process in-person transactions with over 1 million customers a day. The average transaction size is $40, with 43 percent of these transactions made using either a credit or debit card. At the low end, one HEB store has only 2 percent of transactions made with a credit or debit card. Callahan shared these data to give participants a sense of the generally low and varying use of electronic payment tools by customers across HEB's market. He also noted that many of the stores are located in markets with a high proportion of underserved consumers.

HEB introduced "business centers" into its stores to provide a variety of services for its customers, including check cashing, prepaid cards, money transfers, bill payment, and money orders, among others. Callahan said these centers are very successful. For HEB, the business centers were a way to increase customer loyalty to the grocery stores by providing additional benefits for their customers. These customers already felt comfortable in the retail store environment and were finding it convenient to conduct a variety of financial transactions in the same place and at the same time as they did their grocery shopping. Furthermore, Callahan suggested that the line is blurring, particularly for the underserved consumer, as to what is considered a "bank." As more merchants are providing payment services, it is becoming less important for these consumers to have a traditional banking relationship because they can meet their financial needs elsewhere, in places where they are comfortable and already doing business.

At the same time, Callahan noted that banks are beginning to recognize the underserved market as profitable. In the past, he suggested that banks had discounted these consumers for reasons such as not having credit histories or being unable to maintain minimum balances. Despite banks' renewed focus on these consumer segments, in Callahan's view, the fast pace of innovation in the prepaid card and remittance markets will lend itself to entities more flexible than banks, entities that can quickly adapt to changing market conditions and consumer needs.

In summary, Callahan stressed that a bank will always be involved in the financial services market, for any consumer segment, because ultimately, they will hold the funds. But, in this segment, Callahan believes nonbank providers will play an increasingly significant role in the distribution of financial products and services.

Another emerging provider of financial services targeting underserved consumer segments is the Green Dot Network operated by NextEstate. This network facilitates cash reloads to prepaid cards at retail merchants in the "Green Dot Network." Streit described the limited infrastructure supporting cash reloads to general purpose prepaid cards as a barrier to their adoption by underserved consumers. He stated that this constraint is analogous to the issue of portability, described earlier in reference to payroll cards, and it addresses a similar need: to facilitate use of the card and to build long-term financial relationships with underserved consumers. Echoing Callahan's comments, Streit argued that a merchant network that allows cash reloads offers great potential because underserved consumers tend to be more comfortable conducting financial transactions in retail locations, rather than in traditional bank branches.

Focusing on one type of payment activity, Walker, of BillMatrix, discussed his company's online bill payment program, the advantages to its use by underserved consumers, and the challenges to encouraging adoption by these consumers. Recurring bill payments typically fall into one of four categories: telecommunications, financial services, utilities, and insurance. Underserved consumers have expenses in each of these areas and can benefit from increased opportunities to pay these bills electronically rather than in-person using cash or a money order.

Walker noted that for many years, BillMatrix has provided functionality allowing consumers to initiate bill payments over the phone. But he stressed that in the Internet environment, these consumers make up an as yet untapped market for online bill payments. Several reasons contribute to slower adoption of online bill payment among the underserved. Obviously, the lack of a financial account or payment card limits bill payment options. As important, consumers must have access to the Internet to initiate online bill payments. Agreeing with several earlier speakers, Walker noted that underserved consumers also require high-touch customer service. Walker asserted that if these various hurdles were overcome and the process was convenient, underserved consumers would be motivated to use online bill-payment services such as those offered by BillMatrix, which offer a "last-minute payment feature" to customers who are most in need of real-time expense management.

Each of these providers is attacking, in different ways, constraints in the financial services market that make it more difficult and, many times, more costly for underserved consumers to manage their financial affairs. As Palmer stated earlier, these innovators are helping to bridge the gap between financial products and services provided by mainstream financial institutions and those available in the alternative financial sector. These providers believe that retail merchants will be a key distribution channel for financial services to these consumer segments because, in many cases, underserved consumers are more comfortable conducting their financial transactions in retail outlets than in banks.

In summary, Williams asserted that merchants are playing an increasingly important role in delivering financial services to underserved consumers and, notably, they are seeing better results than banks in terms of customer adoption and use of the services they provide. He believes that while banks will always play a role in providing financial services, in terms of this consumer segment, the merchants will do a better job, because they know these consumers and have built relationships with them over time.

4. Conclusions and Insights: What Have We Learned?

The last session brought together the panel moderators for a discussion of what was learned about this consumer market for financial services. This panel, moderated by Peter Burns, of the Payment Cards Center, highlighted several insights gained during the course of the day. These related to the roles played by banks and nonbanks, the need for consumer education, and the regulations governing these financial products and services.

The roles played by banks and nonbanks in providing financial products and services to underserved consumers were addressed in each conference session. These discussions showed that nonbanks are participating in a wide variety of programs, including the distribution of prepaid cards, remittance products, and various types of adapted financial accounts. They are also developing networks and technology solutions. These entities' direct relationships with underserved consumers are an underlying motivation for their growing involvement in this consumer financial services market. Notably, the distribution partnerships between banks and nonbanks are changing traditional market structures in consumer financial services because an intermediary is now situated between the bank and the end-consumer where one had not existed in the past.

Several participants commented that the introduction of nonbanks, particularly their role in the prepaid card market, has caused confusion about the meanings of the terms card issuer and card provider. Todd Brockman, of Visa U.S.A., asserted that banks will always issue payment cards (e.g., prepaid cards) and will continue to play a central role in providing these programs because (1) they hold the funds for these cards and (2) Visa and MasterCard rules obligate banks to meet due diligence requirements for each bank-issued card program. Some debate arose as to the degree to which banks are actually participating in these programs and, hence, their ability to manage appropriate usage. Brockman responded that Visa and MasterCard have explicit rules about the responsibilities of banks that are issuing any branded-card program, including oversight of third-party partners acting as intermediaries between the issuing bank and the end consumer. Therefore, while banks may not always be directly providing the product to the end-user, they will always play a prominent role in supporting these programs.

In closing, several participants questioned the role banks will play in this consumer financial services market 10 years from now and how it might change over time. Most participants stood by banks' issuer role, but they were less sure of the prominence banks will have in other aspects of these programs focused on underserved communities. Some believed banks will adapt to better serve these segments and, therefore, will continue to be very involved in all aspects of these programs. Alternatively, other participants suggested that banks' role will become less straightforward as nonbanks take more of the lead in dealing with the end-consumer, particularly in distribution functions. In general, participants agreed that as the market continues to evolve, attention will have to be paid to the ways in which these roles develop and the related implications for policymakers as they consider the effects on the financial services industry and related consumer protection issues.

For banks, panelists generally agreed that educating consumers and building product awareness among underserved consumers are critical components in overcoming inherent distrust of or discomfort with mainstream bank-providers of financial services. Several participants stressed that these educational efforts must be in person, rather than through direct mail, the Internet, or over the phone. Additionally, as Hogarth cautioned, "underserved consumers" is not a homogeneous segment, and educational needs vary depending on whether the customer is, for example, an immigrant, low income, underserved, or unbanked. She noted that, as a result, it requires both bank and nonbank providers in this market to "segment, segment, segment." Further, Hogarth stressed that not only banks and nonbanks but also financial educators and regulators must adapt their views to consider the unique characteristics of these individual segments.

Many participants underscored the uncertain regulatory environment as a potential impediment to innovation and development of financial products and services aimed at the underserved consumer market. In several sessions, discussion highlighted examples of where current regulation is unsettled, including (1) federal and state statutes governing payroll cards and (2) customer identification and product controls for general purpose and other prepaid cards and remittance services. At the same time, participants recognized that consumers need to be protected from unfair and deceptive practices that rogue elements within the industry might perpetrate. All agreed that some form of federal standards were preferable to varying state regulation. Further questions were raised about how effective existing federal consumer protections are in considering the role of nonbanks. As nonbank participation in financial services continues to expand, participants concluded that more thought needs to be given as to how best to monitor and police their relationships with consumers.

IV. Conclusion

The conference sessions explored a range of new financial products and services being offered to underserved consumers and examined the "prospects and challenges" for each to better meet these consumers' financial needs. The broad perspectives represented in the day's discussion led to important insights into how underserved consumer segments behave and their use of financial products and services. The dialogue highlighted that this market is dynamic and evolving and that much remains uncertain.

Finally, this paper identified several areas for further study as financial products and services in this consumer sector continue to evolve: the roles played by banks and nonbanks, the need for consumer education, and the regulations governing these financial products and services.

Exhibit 1:
Payment Cards Center - Recent Publications

The Payment Cards Center's commitment to industry analysis and research is fulfilled through its support of consumer payments- and payment cards-related papers written by Center staff, visiting scholars, researchers affiliated with the Center, and economists in the Bank's Research Department. These papers can take several forms: Discussion Papers, Conference Summaries, Working Papers, and *Business Review* articles. Discussion papers and conference summaries are written by Center staff for a wide audience, including industry professionals, regulators, consumers, and academics, and can be based on PCC-sponsored conferences or workshops or on original staff research. Working Papers are intended for the professional researcher and are written by Center visiting scholars, economists in the Bank's Research Department, and other economists affiliated with the Center. The *Business Review* includes less-technical articles written by economists in the Bank's Research Department.

Recently published papers are available in pdf format on the Center's web site. A chronological listing of papers posted to the site in 2004 and 2005 follows:

2005

05-14 The Laws, Regulations, and Industry Practices That Protect Consumers Who Use Electronic Payment Systems: Policy Considerations (third in a three-part series)

05-13 Special Purpose Vehicles and Securitization

05-12 A Quantitative Theory of Unsecured Consumer Credit with Risk of Default

05-11 Federal Consumer Protection Regulation: Disclosures and Beyond

05-10 Identity Theft: Do Definitions Still Matter?

05-09 Switching Costs and Adverse Selection in the Market for Credit Cards: New Evidence

05-08 Will Online Bill Payment Spell the Demise of Paper Checks?

05-07 A Century of Consumer Credit Reporting in America

05-06 The Cost Effectiveness of Stored-Value Products for Unbanked Consumers

05-05 Forum on Validation of Consumer Credit Risk Models

05-04 The Laws, Regulations, and Industry Practices That Protect Consumers Who Use Electronic Payment Systems: ACH E-Checks & Prepaid Cards (second in a three-part series)

05-03 Prepaid Card Models: A Study in Diversity

05-02 Assessing the Impact of Electronic Benefits Transfer

05-01 The Laws, Regulations, and Industry Practices That Protect Consumers Who Use Electronic Payment Systems: Credit and Debit Cards (first in a three-part series)

2004

04-05 Payment System Regulation and How It Causes Consumer Confusion

04-04 Prepaid Cards: How Do They Function? How Are They Regulated?

04-03 Identity Theft: Where Do We Go From Here?

04-02 The Debate Over the National Bank Act and the Preemption of State Efforts to Regulate Credit Cards, ©*Temple Law Review* (Summer 2004)

04-01 Prepaid Card Markets & Regulation

Exhibit 2:
Conference Agenda

Wednesday, July 13, 2005

"Toward Efficient and Inclusive Payment Systems"

Keynote Address: Michael S. Barr, *University of Michigan Law School*

Thursday, July 14, 2005

Welcome

Anthony M. Santomero, *President, Federal Reserve Bank of Philadelphia*

Peter P. Burns, *Director, Payment Cards Center*

Payroll Cards: A Method of Payment and Account Management for Underserved Consumers

Moderator:	Jennifer Tescher, *Center for Financial Services Innovation*
Panelists:	Doris M. Damm, *ACCU Staffing Services*
	Peter Davidson, *Genpass Card Solutions*
	Armen Khachadourian, *JPMorganChase*

Remittance Cards, General Purpose Prepaid Cards, and Modified Financial Accounts: A Range of Financial Tools Adapted for Underserved Consumers

Moderator:	Jeanne M. Hogarth, *Federal Reserve Board of Governors*
Panelists:	Miguel Cintron, *Bank of America*
	Emery Kobor, *United States Department of the Treasury*
	Gary Palmer, *WildCard Systems*

Innovation and Emerging Market Structures: A Changing Landscape for Financial Services Providers

Moderator:	T. Jack Williams, *Tier Technology*
Panelists:	David Brillembourg, *Emida Technologies*
	Jim Callahan, *H.E. Butt Grocery Company*
	Steve Streit, *NextEstate*
	Scott Walker, *BillMatrix*

Conclusion and Insights: What Have We Learned?

Moderator:	Peter P. Burns, *Federal Reserve Bank of Philadelphia*
Panelists:	Jeanne M. Hogarth, *Federal Reserve Board of Governors*
	Jennifer Tescher, *Center for Financial Services Innovation*
	T. Jack Williams, *Tier Technology*

Exhibit 3:
Institutions Represented at the Conference

ACCU Staffing Services
Alliance Data Systems
Automatic Data Processing, Inc.
Bank of America
BillMatrix Corporation
Biometric Access Company
Bryan Cave LLP
Campaign for Working Families
CCCS of Delaware Valley
Certegy Card Services
eCommLink
eFunds Corporation
Electronic Funds Transfer Association
Emida Technologies
Experian
Federal Reserve Bank of Boston
Federal Reserve Bank of Chicago
Federal Reserve Bank of Cleveland
Federal Reserve Bank of Kansas City
Federal Reserve Bank of Minneapolis
Federal Reserve Bank of New York
Federal Reserve Bank of Philadelphia
Federal Reserve Bank of St. Louis
Federal Reserve Board
First Annapolis Consulting
First Bank of Delaware
Genpass Card Solutions
Global Vision Group
Greater Philadelphia Urban Affairs Coalition
HEB Grocery Company
IPP of America, Inc
JPMorganChase
Katalyst
Marshall BankFirst
National City Bank
NextEstate Communications, Inc.
Office of the Comptroller of the Currency
OHCD
PaymentCard Marketing, LLC
Paymentech
PayQuik, Inc.
Pennsylvania Dept. of Banking
Sodexho
State of Delaware
Swarthmore College
The Center for Financial Services Innovation
Tier Technology
Tower Group
TSYS Prepaid
U.S. Department of the Treasury
University of Michigan Law School
Visa USA
Wachovia Corporation
Wells Fargo

"The Philadelphia Reserve Bank will be broadly recognized as an important center of central bank knowledge and capability."

Anthony M. Santomero
President

PAYMENT CARDS
Center

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Peter Burns
Vice President and Director

Stan Sienkiewicz
Manager

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.