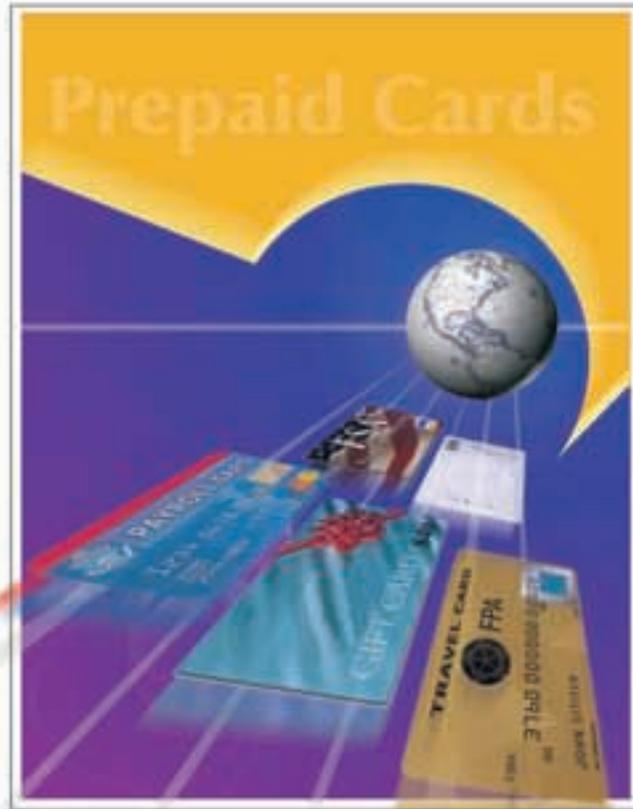


CONFERENCE SUMMARY



Prepaid Cards:

How Do They Function?
How Are They Regulated?

June 2-3, 2004



FEDERAL RESERVE BANK OF PHILADELPHIA

Prepaid Cards:

How Do They Function? How Are They Regulated?

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Summary

On June 3, 2004, the Payment Cards Center of the Federal Reserve Bank of Philadelphia hosted a conference on prepaid cards. The conference brought together representatives from eight major banks, seven national retailers, three state governments, three federal regulators, a score of providers of prepaid card services, and a number of legal professionals to discuss the development of the prepaid card market and its regulation. This summary of the conference is structured around the two key questions the conference was designed to answer: How do prepaid cards function? How are prepaid cards regulated?

** The views expressed here are not necessarily those of this Reserve Bank or of the Federal Reserve System. Thanks to the referenced conference participants for their helpful comments and suggestions and to colleagues in the Payment Cards Center for their contributions to this document.*

TABLE OF CONTENTS

Introduction	5
President’s Remarks	5
Dr. Anthony M. Santomero, president of the Federal Reserve Bank of Philadelphia, opened the conference by welcoming participants and describing the goals for the event.	
Synopsis of Keynote Address	5
The evening before the formal conference proceedings, Ronald Congemi, president of Debit Services and Star Systems for First Data Corporation, delivered the conference keynote address entitled “Electronic Payments: Back to the Future.” He highlighted several broad trends in the U.S. payments environment that are both challenging market participants and stimulating innovation.	
How Do Prepaid Cards Function?	7
Gift Cards	7
Payroll Cards	10
Flexible Spending Account Cards.....	11
Conference participants discussed the economics of various business models for prepaid cards, how different prepaid card transactions authorize and settle, the variety of companies involved in the prepaid card market, and the future of different prepaid card systems.	
How Are Prepaid Cards Regulated?	14
The Federal Deposit Insurance Act & Regulation E.....	14
States’ Abandoned Property & Money Transmitter Laws	17
Policy Concerns of Participants in the Prepaid Card Market	19
Legal experts and representatives of federal and state agencies discussed with conference participants their views on the extent to which various regulations affect prepaid cards.	
Conclusion	20
The conference concluded with a review of some of the day’s key findings as viewed by the director of the Payment Cards Center, Peter Burns, and the moderators of the various panels.	
Appendix A — Institutions Represented at the Conference	22
Appendix B — Conference Agenda	23
Appendix C — Summary of FDIC’s 1996 General Counsel’s Opinion #8	24

Introduction

On June 3, 2004, the Payment Cards Center of the Federal Reserve Bank of Philadelphia hosted a conference entitled “Prepaid Cards: How Do They Function? How Are They Regulated?” The conference brought together nearly 100 interested professionals to discuss the technological, operational, legal, and regulatory challenges facing the prepaid card industry. What follows is a summary of the conference, beginning with the opening comments of Federal Reserve Bank of Philadelphia President Anthony M. Santomero. Dr. Santomero’s comments are followed by a synopsis of the conference keynote on broad trends in the consumer payments industry. This keynote was delivered the evening before the formal conference proceedings by Ronald Congemi, president of Debit Services and Star Systems for First Data Corporation. The rest of the summary is structured around the two key questions the event was designed to answer: How do prepaid cards function? How are prepaid cards regulated? This paper builds on the basic concepts explained in a PCC Discussion Paper entitled “Prepaid Card Markets & Regulation.” That paper, which can be found on the Center’s web site at www.phil.frb.org/pcc/papers, is based on a workshop led by Judith Rinearson, former counsel to American Express’s prepaid card business.

President’s Remarks

Anthony M. Santomero, president of the Federal Reserve Bank of Philadelphia, welcomed participants and discussed the purpose of hosting a conference on prepaid cards. As he explained, the Bank’s Payment Cards Center was established to examine and develop insights into critical issues affecting the changing consumer payments landscape, an increasingly important sector of financial services. An important element of this mission is to facilitate constructive dialogue by bringing together market participants, policymakers, and other interested parties to share perspectives on issues of current importance. As he summarized, the conference set out to “bring together the right people, to discuss the right issues, at the right time.”

Prepaid cards clearly fall into the category of the “right issue” for two reasons. First, while prepaid cards currently represent only a small portion of U.S.

card payments, consumer demand for prepaid products is on the rise and spurring a spate of innovation. Second, in conversations with Dr. Santomero, industry executives have indicated that they are focused on the challenges facing the emerging market for prepaid cards, including those related to apparent uncertainties in the legal and regulatory environment.

To address these issues, the Center invited a diverse group of professionals representing a wide range of relevant perspectives—in a real sense, the “right people.” In addition to representatives from banks and payment networks, participants included retail merchants, state government officials, federal regulators, processors, providers of prepaid card services, economists, and legal experts.

The fact that so many of the “right people” participated in the event is evidence that these discussions were being held at the “right time.” As prepaid cards have become more popular with consumers, and the prepaid card market has produced a variety of new products and services, policymakers have taken notice. This past fall, regulation of prepaid cards was a major topic of discussion within the Federal Reserve Board’s Consumer Advisory Council. In the spring, the FDIC published proposed rules to clarify when prepaid cards should be subject to deposit insurance. More recently, and in response to inquiries relating to prepaid cards, the Office of the Comptroller of the Currency issued an Advisory Letter to banks on the subject. Last, many states are in the process of proposing or enacting legislation governing various aspects of prepaid cards.

In concluding his remarks, Dr. Santomero urged conference participants to use the day’s discussions to develop a broader understanding of the complex issues and stakeholder perspectives underlying various prepaid card debates. He challenged them to use this learning to develop insights into what is needed to support the growth of safe and healthy prepaid card markets and to stimulate continued innovation.

Synopsis of Keynote Address

Ron Congemi, president of Debit Services and Star Systems for First Data Corporation, opened the conference with his keynote address, “Electronic Payments: Back to the Future.” In his remarks, Congemi highlighted several broad trends in the U.S. payments environment that are challenging market participants and stimulating innovation in such areas as new uses

for prepaid cards. He described a payments environment faced with revenue compression in key payment categories, market stresses separating the retail and banking industries, and continued migration of payments methods to electronic formats, including prepaid card systems.

Compression in payments revenue, Congemi noted, is challenging an industry accustomed to high growth to adapt its business models to reflect a new environment characterized by more moderate expectations. He emphasized that while revenue compression is occurring across the payments industry, it is most evident in the ATM, signature-debit card, and check markets where pressures on both margins and volumes are presenting significant challenges. Congemi argued that revenue compression in these markets is forcing financial institutions to re-calibrate their business assumptions and to develop new growth opportunities.

After decades of rapid growth in both deployment of ATMs and consumer adoption rates, Congemi believes that the ATM market has reached maturity. Looking forward, he estimated annual transaction growth rates in the range of 3 to 4 percent. Congemi noted that surcharge fees, introduced in the 1990s, provided substantial profits and led banks to large-scale deployment of off-premise ATMs intended to capture traffic, and fees, from other banks' customers. However, Congemi believes that surcharge revenues have peaked as customers have learned to avoid machines that impose these fees.

While growth in debit card transactions is expected to remain strong, Congemi believes it will moderate from the 25 percent to 30 percent range experienced in recent years, with PIN-debit growth outpacing signature-debit growth rates. He expects PIN-debit to benefit from a convergence in pricing for the two debit models and from merchants' increased acceptance of PIN-debit. As such, Congemi believes that with pricing and incentives relatively equal, growth of signature-debit transactions will more closely track the growth in demand deposit accounts while PIN-debit will benefit as merchant acceptance increases.

Turning to checks and the profitability of demand deposit accounts, Congemi noted that while the DDA revenue stream is under some pressure from the decline in signature-debit-interchange revenue, declining check volume and related fee revenues will become increasingly more important factors. As a result, Congemi estimated that profits per DDA account could be

reduced by up to 15 percent over the next five years.

Congemi warned that the revenue compression as described in these three payment markets has, in part, contributed to an environment of increasing sensitivity around pricing on both the revenue side for payments providers and on the cost side for retailers. Reflecting his sense of these growing tensions, he characterized this continuing price-based conflict as the "interchange wars." At the end of the day, Congemi warned that left unaddressed, the "interchange wars" will continue to drive payment card providers and retailers apart at the expense of cooperative strategies leading to mutual benefits. One example of where cooperative efforts are critical is in the battle against payment fraud. Congemi emphasized that the ultimate success of any payment instrument depends on the successful management of fraud, which, in turn, requires data sharing and other cooperative efforts to reduce losses from fraud and maintain consumer confidence.

On the other hand, Congemi noted that a positive outcome of the "interchange wars" and other price-based pressures has been the spurt of innovation in payments as both providers and retailers have worked to develop more efficient payment instruments. Not surprisingly, these products tend to be electronic, displacing more costly paper and, in some cases, other electronic-payment alternatives. In fact, based on Star-commissioned studies, Congemi estimated that check volume will decline about one-third over the next five years, with checks being replaced by electronic substitutes, such as prepaid cards.

Congemi noted that prepaid cards are an especially significant example of an innovation in payments. While still a small part of the overall retail payments flow, prepaid cards, he noted, are gaining traction, accounting for \$54.6 billion and 1,990 million transactions in 2002 and growing at double-digit rates.

In closing, Congemi outlined opportunities for the prepaid card market: strong growth prospects; diverse segment and product types; strong market positioning for banks; and ability to penetrate untapped markets. He also identified challenges: an increasing number of new industry participants, some of which will prove to be "rogue" players; making the right technology and marketing investments; resolving legal and regulatory uncertainties; and managing new vulnerabilities to fraud. These and other aspects of prepaid products were addressed over the course of the next day, as discussed in the following pages.

How Do Prepaid Cards Function?

Prepaid cards include a wide variety of products, including gift cards, payroll cards, teen cards, flexible spending account cards, employee incentive cards, government stored-value cards, and disaster relief cards. Each of these prepaid products has its own unique set of economic, technological, and operational complexities. The Payment Cards Center's conference focused primarily on the single most popular prepaid card, the gift card, and two emerging types, the payroll card and flexible spending account (FSA) card. The discussions involving the functionality of these three types of prepaid cards are summarized by product type in the sections that follow.

Gift Cards

As its name implies, a gift card is a payment card with a preloaded value that one consumer gives to another as a gift—the modern-day version of the gift certificate. Like a gift certificate, a gift card can be used to purchase goods or services from one or more merchants. Gift cards are among the most popular of prepaid cards. *Electronic Payments International*, a payments industry newsletter, reported in May 2004 that sales of these cards in the U.S. reached \$45 billion in 2003. While the gift card may seem like a common and uncontroversial type of prepaid card, conference speakers alluded to a competitive struggle between two different kinds of gift cards: those issued by merchants for use at particular stores and those issued by financial institutions for use at any location that accepts Visa, MasterCard, or American Express.

Merchant-Issued Gift Cards

As Jack Williams of the National Processing Corporation (NPC) explained in the conference's opening presentation, "private" gift cards (i.e., those usually issued by a merchant for use at that merchant's own locations) are among the most popular of prepaid cards.¹ Forty-five percent of U.S. adults, he indicated, have purchased at least one. The cards were originally marketed as replacements for paper gift certificates, enabling merchants to enhance the tracking and control of gift credit and avoid returning cash to consumers who spent less than the certificate's face value. Today, Williams explained, the private gift card is no longer exclusively used for such "defensive" purposes. Rather, it is "an offensive weapon that merchants can use to

attack competitors." The cards allow merchants to increase customer loyalty, speed checkout, sell more full-price merchandise, gain insights into customers' purchase behavior, and improve sales forecasts.

David Doyle of Brinker International (the parent company of restaurants such as Chili's, Macaroni Grill, and Maggiano's) addressed the strategic reasons that led his company to replace gift certificates with private gift cards. "The sheer increase in the ability of Brinker to control the disbursement and redemption of gift cards," he said, "was a compelling enough reason to issue them." He was surprised, however, by how popular they were with consumers. After introducing the cards for the 2000 holiday season, sales of them were up almost one-third over the previous year's sales of paper gift certificates. In January 2004, gift cards were tendered for approximately 7 percent of Brinker's sales. Finally, Doyle explained that the cards allowed Brinker to increase the reach of its brand. The company entered into agreements with noncompeting merchants, such as Walgreens, CVS, and Safeway, to have Brinker gift cards sold in their checkout lanes.

Private gift card programs, however, are not without their challenges. Williams explained that if merchant systems malfunction and gift cards cannot be issued or used to make a purchase, customers will likely get angry and blame the merchant, instead of a third-party card network, for the failure. (If such a system failure were to occur at Brinker, Doyle noted, an off-line back-up system could be used to capture information and process the company's cards.) Williams also described how challenging it is for merchants to train their employees to accept and sell gift cards. Often, gift card transactions involve unique keystrokes and transaction codes that complicate a sales clerk's or cashier's job.

Unlike most other point-of-sale transactions, Williams explained, those exclusively involving private gift cards do not require settlement because the merchant issuing the gift card is the same entity accepting the gift card. In these cases, the merchant has already received payment for the card's value at the time of its purchase. Merchants, however, must authorize every gift card transaction. Doyle noted that every Brinker restaurant has a direct connection to its gift card trans-

¹ A copy of Williams' presentation is available on the Center's web site at http://www.phil.frb.org/pcc/conferences/jack_williams.pdf.

action processor. That processor keeps track of how much value is contained on each card and ensures that no card is used for more than its prepaid amount. The processor also immediately activates each card Brinker sells. Williams, whose company processes private gift card transactions, explained that NPC does more than just activate cards and authorize transactions. It also advises merchants on how to package their gift cards, provides data support for the call centers that tell consumers how much is left on their cards, reports to merchants on the success of their card programs, and coordinates the shipment of new cards.

At the conclusion of his presentation, Doyle discussed the costs of his company's private gift card program. Major expenses include the cost of the plastic card itself, the discount Brinker offers to its merchant partners that sell the cards, the processing fees the company pays when a gift card is purchased and subsequently redeemed, and the costs of shipping the cards. He indicated that the plastic and transaction costs, as a percentage of total gift card sales, are in the range of 2 percent to 3 percent. The merchant-partner discounts are between 3 percent and 4 percent of total sales.

Walter Paulsen of grocery-giant Safeway concluded the discussion of merchant-issued gift cards with an overview of his company's efforts to leverage its checkout aisle real estate to create a new stream of gift-card-based revenues. His company has signed almost 30 deals with other noncompeting retailers (e.g., Bed, Bath, & Beyond, Barnes & Noble, and Home Depot) to have gift cards from their stores prominently displayed for purchase at Safeway. Sales of these gift cards totaled "over \$100 million" last year, and he expects them to reach over \$1 billion by 2007. Safeway sells its partners' gift cards in predetermined denominations (e.g., \$25, \$50) and can immediately activate them at the point of sale.

Paulsen, like many other speakers at the conference, contrasted private gift cards with open-system gift card products that are issued by financial institutions, redeemable at many merchant locations, and branded with a payment system brand (such as Visa, MasterCard, or American Express). In Paulsen's opinion, the private gift cards he sells are better for gift-giving than branded "open-system" cards. He pointed to the fact that private gift cards are usually sold at face value and, unlike most branded cards, come without any activation or monthly fees. Private gift cards, he

says, also leave more of a "memory trace" than branded cards. "If someone gives you a Home Depot gift card," Paulsen explained, "you will remember what you purchased with it and associate that gift with the one who gave you the card. The same is not true when you have a card that can be used anywhere for anything." Paulsen also argued that private gift cards have an advantage because of the retail locations through which they can be sold. "MasterCard and Visa do not have any retail locations," he said, "and this puts them at a distinct disadvantage when it comes to the gift card market."

Looking ahead, Williams, Paulsen, and Doyle were optimistic about the future of private gift cards. Williams and Doyle talked about the possibility of issuing private gift cards that could be redeemed at a small number of merchants that sell complementary products. For example, Doyle thinks a dinner-and-a-movie gift card redeemable at a Brinker restaurant and a video rental chain could be popular. Paulsen indicated that his company is approaching other grocery store chains about leveraging Safeway's legal, information technology, and operational expertise in selling gift cards. He wants to help these stores set up similar merchant-partnering arrangements. Overall, all three expect to see private gift card sales increase significantly over the next few years.

Branded, or Open-System, Gift Cards

Branded, or "open-system," gift cards are relative newcomers to the prepaid card market. Carrying the logo of a payment card network (e.g., Visa, MasterCard, or American Express), branded gift cards are sold by banks or their nonbank partners and can be used at any merchant that accepts the corresponding payment network's brand.² Owing to their near-universal acceptance, these open-system cards are often good for uses other than gift giving. As Williams noted in his opening comments, Visa marketed its first prepaid open-system card, the Visa Buxx card, as a teen card that parents can use as a tool to monitor and control their children's allowance spending.

Eduardo Vergara of Bank of America led the discussion of branded gift cards. As compared with their merchant-issued counterparts, branded cards have a different value proposition, method of authorization and settlement, and economic model. Vergara explained that while merchant cards can be used to create loyalty to a particular retailer, branded gift cards

are paper payment substitutes that can be used at millions of merchants around the world. Branded cards, he also pointed out, carry the same fraud and purchase protections as debit and credit cards. So if a consumer were to lose his branded gift card, he would not necessarily lose the value on the card. In general, retailer cards do not offer similar protections. Whereas retailer cards enable consumers to essentially prepay for merchandise, branded gift cards, asserted Vergara, are “an entirely new payment instrument.”

While they may be a new payment form, branded open-system cards (and the other branded prepaid products discussed at the conference) operate very much like debit cards that are tied to consumers’ checking accounts. Unlike a debit card, however, the branded open-system card is usually linked to a single pooled account at a bank, with the value associated with each card tracked separately by card number. If the card is used for a signature-based transaction, the merchant swipes the card and requests authorization for the purchase via the appropriate network (e.g., MasterCard, Visa, or American Express). The bank that holds the prepaid funds or its processor determines whether there is enough value on the card to cover the purchase. If there is, the issuer or its processor authorizes the transaction and, in most cases, soon thereafter reduces that particular card’s value to reflect the transaction. Later, the transaction is cleared and settled through the association’s network. The pooled account is debited, and the merchant receives the funds for the purchase less an interchange fee (calculated using the signature interchange rate schedule). If that particular card does not have sufficient funds, authorization for the transaction is denied. If the card is used for a PIN-based debit transaction (e.g., through STAR, Interlink, or NYCE), a very similar authorization and settlement process occurs through the PIN-debit network. In a PIN transaction, however, the funds are debited from the pooled account immediately, and the value associated with the card is reduced in “real time.” In addition, the merchant discount or interchange fee associ-

ated with PIN transactions is usually lower.

Using two examples, Vergara explained the differences in the economic models of branded and private gift cards. The private gift card, he explained, is far more profitable for merchant issuers than the branded card is for bank issuers. On the sale and subsequent use of a single \$50 private gift card, Vergara estimated that retailers earn more than \$7 in pre-tax net income.³ This is the result of the retailer’s earning about \$5 in profit when the card is used to purchase goods or services, \$1.50 by inducing consumers to spend more than the card’s face value, \$2.50 from a monthly service fee, and \$0.20 in float revenue. From this \$9.20 in revenue, he subtracted \$2.00 for plastic and processing expenses. Safeway’s Paulsen challenged Vergara’s \$2.50 monthly fee assumption. Paulsen said that few, if any, of his company’s partners actually charge a monthly fee. “Some merchants [who issue private gift cards] may have charged such a fee two to four years ago,” Paulsen said, “but, due to a consumer backlash, the vast majority of merchants’ cards no longer have such fees.”

Even if merchants do not charge a monthly service fee on their private gift cards, Vergara noted that branded cards are still significantly less profitable than private cards. He estimated that a \$50 branded card generates just \$1 in pre-tax net income for the financial institution that issues it. Branded cards are far more fee-dependent, he explained, with a purchase fee (\$3.95), a merchant interchange fee (\$0.70), monthly fees (\$2.50), and other fees (\$0.50) generating all but \$0.20 (from float) of the card’s revenue. The branded card program also has higher per card expenses (driven, in part, by the various cardholder-protection features that the associations require). In addition to \$3.00 in processing and plastic costs, banks face \$2.35 of customer service expense, \$1.00 in marketing expense, and \$0.50 in fraud expense.⁴ Vergara stressed that in light of high per card expenses, fee revenue is critical to the product’s success. “While some of these fees have generated controversy,” he said, “without

² According to conference attendee Gary Palmer of Wildcard Systems, Visa and MasterCard issued 7.6 million prepaid cards last year that were loaded with almost \$2 billion of value. Most of the 7.6 million cards issued were gift cards. Most of the \$2 billion in value, however, was loaded onto nongift-card products (e.g., payroll cards, flexible spending cards).

³ Vergara relied on the following assumptions for his merchant gift card illustration: 70 percent of consumers spend more than the value of the card; median incremental spending for those 70 percent of consumers is \$20; breakage (i.e., percentage of gift card value never spent by consumer) is 5 percent; the profit margin on the sale of the merchant’s product is 10 percent; and the average float period is 60 days.

them, the product would be under water and not economically viable.”

Williams noted that branded gift cards also face operational challenges. These challenges are partially due to branded gift card transactions authorizing and settling in the same way as debit card transactions. Assume, for example, that a consumer uses a \$25 branded gift card to make a \$28 purchase. If the consumer does not notify the merchant about the shortfall, the merchant will attempt to get an authorization for an amount that exceeds the value on the card by \$3. In this case, the issuing financial institution or its processor will refuse to authorize the purchase and, because of point-of-sale system constraints, will not be able to notify the merchant as to the reason. Even if the consumer tells the merchant about the shortfall, however, the consumer may not be able to use a second card-based payment vehicle to pay the difference. This is due to the limitations of some older point-of-sale terminals. These two problems, Williams explained, are commonly known in the industry as “split tender” problems.

Despite these economic and technological challenges, Vergara and other participants were confident that branded gift cards will do well in the future. They point out that financial institutions have not yet marketed branded gift cards nearly as aggressively as merchants have. In their view, as more financial institutions begin to offer the cards and consumer awareness of them increases, financial institutions will be better positioned to compete against merchants for the dollars consumers allocate to gift giving.

Payroll Cards

Payroll cards, which technically function very much like branded gift cards but with ATM access, are funded by one or more accounts into which an employer deposits employees’ wages. *ATM & Debit News* reports that there are 3.5 million such cards in the U.S., and it expects that number to double in the next three years. Two conference speakers discussed payroll cards: Campbell Langdon of Automatic Data Processing, Inc. (ADP) and Peter Davidson of Genpass Card Solutions

⁴ Vergara made the following assumptions for his branded card illustration: a 1.4 percent interchange rate; no ATM usage of gift card; a 5 percent rate of breakage; a 60-day average float period; and a 5 percent annual interest rate for float calculation.

(Genpass).⁵ Campbell’s company is the largest payroll processor in the world and offers a payroll card product to its customer base of employers. Davidson’s company is a card processor and EFT network that provides payroll card services to financial institutions, payroll companies, and employers.

Two years ago, when payroll cards began grabbing headlines, the companies most interested in offering them to employees were those that employed many workers without formal banking relationships in many different physical locations. Fast-food restaurants (e.g., Burger King and Domino’s Pizza), large food processors (e.g., Pilgrim’s Pride), and large retailers (e.g., Lowe’s and Office Depot) were some of the first employers to use the cards to pay employees who were unable or unwilling to be paid by direct deposit. As Langdon and Davidson explained, one of the primary reasons employers such as these adopted payroll cards was to reduce check printing and distribution costs. Davidson, citing an American Payroll Association estimate, indicated that an employer’s cost of printing and distributing a payroll check is between \$1.00 and \$2.50 per check. Electronically paying employees who have a card, however, costs just about as much as paying an employee with direct deposit—about \$0.10 per pay period.

While the early adopters of payroll cards were primarily employers anxious to cut payroll processing costs, many of those who now consider offering the cards see them as a meaningful employee benefit. For some employees, the cards enable them to avoid the high fees and security dangers of a trip to a check-cashing outlet. For others, the cards obviate the need for an extra trip to work when their payday falls on a scheduled day off. Many employers, Langdon explained, will actually allow their employees the option of receiving their pay by check, direct deposit, payroll card, or any combination of the three. Conference participants were interested to learn that many of the employees who direct ADP to place some portion of their pay onto a payroll card also receive wages via direct deposit or check. Apparently, these employees use the card as a budgeting or savings tool.

ADP’s and Genpass’s payroll cards are functionally equivalent, enabling employers to electronical-

⁵ A copy of Davidson’s presentation can be found on the Center’s web site at http://www.phil.frb.org/pcc/conferences/pete_davidson.pdf.

ly load wages onto an employee's card on payday. Both cards also allow employees to access their money at ATMs and at merchants that accept PIN- and signature-debit transactions. The business models that underlie the two products, however, are slightly different. For example, Genpass markets the cards directly to employers and payroll processing companies and indirectly through its financial institution customers. ADP, on the other hand, markets the cards exclusively to employers. Employees with ADP's card receive a paper statement from the company each month. Genpass, by contrast, makes statements available on the Internet without charge and allows an employee to check his or her card's balances at an ATM.

Differences between the products ultimately result in different expense and fee structures. ADP charges employers that offer payroll cards a fee for each card issued. Employers also pay a fee to load the cards each pay period. This fee, indicated Langdon, is the same as the fee an employer pays to have ADP cut a check or execute a direct deposit. ADP charges employees who use payroll cards a monthly fee of \$1.50. This fee covers the cost of the mailed monthly statement and some of the product's customer service expense. Langdon explained that his company is not yet breaking even on the product. "Customer service is very expensive for payroll cards, as lots of education is required when people start using the product."

Genpass does not charge employers who issue the cards a fee, and since it does not mail statements, it does not charge a monthly fee to the employee. Instead, Genpass relies primarily on fees generated by ATM usage (\$1.50 per domestic withdrawal),⁶ money transfers (\$0.50 per transfer to another payroll card account), and non-Internet balance inquiries (\$0.50 per ATM or call center inquiry) to cover the costs of the card. Davidson indicated that employees can use the card to make purchases at the point of sale (with the option of getting cash back) without charge.

A primary goal of both ADP and Genpass is keeping the price employees pay for the payroll card as low as possible. As discussed in the next section, both Langdon and Davidson expressed concern about the potential for regulation to significantly change the product's cost structure. Neither company's business

⁶Davidson noted that some employers elect to allow their employees one free ATM cash advance per pay period.

model is based on charging exorbitant fees or taking advantage of the unbanked. As such, if the regulatory costs associated with payroll cards become too high, the companies may not be able to offer a service that often benefits consumers who do not have formal banking relationships. Davidson hopes this does not happen. "The payroll card," he said, "is one of the few products that is a win for everyone except those in the business of gouging consumers."

From Davidson's perspective, the distinction between a "payroll card" and a "gift card" is somewhat fuzzy. He sees the prepaid platform going beyond payroll to helping consumers send money to relatives abroad and to students away at college. The cards could also be used in lieu of debit cards to reduce the chance of overdrawing one's checking account. For banks, Davidson sees a payroll-like card as a "bridge product" for those who do not yet qualify for a demand deposit account. The cards could also help banks move noncustomers who are seeking to cash paychecks out of teller lines and into ATM lines. Williams also thinks these cards have applications beyond payroll. Once the cards can be reloaded at the point of sale, he said, "they will become the standard of banking for the unbanked."⁷

Flexible Spending Account Cards

Victoria Nipple of MBI discussed flexible spending account (FSA) prepaid cards, including how they work, why employees and employers like them, and the technological challenges they face. Before discussing the details of FSA cards, however, it is necessary to first understand how the pre-tax accounts that underlie these cards work.

Flexible Spending Account Background

A flexible spending account (FSA) is an employer-maintained account into which an employee can deposit a portion of his or her pre-tax earnings. The employee can then use the untaxed funds in this account for a specific category of tax-favored expenditures. Many employers offer multiple spending account

⁷ The Center for Financial Services Innovation recently published a white paper on payroll cards. The paper discusses how the cards could be used to help "unbanked" consumers save money and build a credit history. A copy of the report can be found at the following web address: http://www.cfsinnovation.com/managed_documents/storedvaluecard_report.pdf

options, each of which corresponds to a specific type of expense that receives favorable treatment under the U.S. Internal Revenue Code. The most popular spending accounts are those that employees can use for health care, dependent care, and commuting expenses.⁸

The IRS has issued an array of rules and regulations that govern FSAs, including some that limit the amount of money an employee can set aside for any given expense category (e.g., one can contribute only \$5000 into a dependent care account and only if married and filing jointly). The IRS also mandates a “use-it-or-lose-it” rule for any funds in a health-care FSA. If, for example, an employee overestimates the amount of money he will spend on a qualified category of expenses during a given year, the excess funds that remain in his account revert to his employer. IRS rules also require that contributions to health-care and dependent care accounts be fully planned before the start of the calendar year. Once an employee decides on a per-pay-period contribution, he cannot modify or stop it until the next calendar year unless he experiences one or more of the specific events qualifying for a change in contribution. (Contributions to a transportation FSA can be changed monthly.) Employees with FSAs must also be able to prove that funds in the account are used only for “qualified” expenses. As such, in order to get access to FSA funds, employees (without FSA cards) must gather receipts and submit claim forms to either their employer or a company their employer uses to administer benefits.

With one exception, spending accounts are entirely funded via payroll contributions by the employee. The balance in the account increases whenever there is a payday contribution and decreases whenever the employee makes a qualified withdrawal. Consider, for example, an employee who participates in a transportation spending account to pay for her qualified commuting expenses. If she contributes \$25 into the account each week when she gets paid, at the end of any given month she will have an account balance of \$100. If during that month she pays \$5 per day to park, after four weeks she will be able to present her parking receipts and withdraw the \$100 balance in the account.

⁸ These spending accounts are regulated by Sections 125, 129, 132, and 223 of the Internal Revenue Code. A list of approved expenditures can be found in Section 213 of the Internal Revenue Code.

The one exception to the completely-employee-funded rule is the health-care FSA. Health-care FSAs are pre-funded by employers. Consider, for example, an employee who contributes \$25 each week into his health-care FSA. On January 1, at the beginning of the tax year, his employer will put \$1300 (i.e., \$25 multiplied by 52 weeks) into the account. The employee could then purchase \$1300 of qualified health-related goods and services on January 2, present his employer with the claim, and get fully reimbursed—all before he contributes a single dollar into the account. By law, even if the employee in this example quit his job on January 3, he would not have to pay back any of the \$1300 that his employer advanced for these expenses.

Despite the potential for employees to take advantage of the pre-funded nature of health-care FSAs, the accounts can be very attractive to employers. Employees’ FSA contributions are not taxed under the Federal Insurance Contribution Act (FICA). For employers, this means that they can avoid paying an almost 8 percent federal tax on any dollar they can get an employee to contribute to his or her FSA.⁹ Employers also benefit, as explained above, by recouping any funds that employees leave in their accounts.

The benefit of the FSA for employees is obvious. For every dollar they can put into an FSA, they can avoid between 10 and 35 cents in federal income tax (depending on their marginal tax rate). A married person making \$60,000 per year who contributes \$1200 to an FSA, for example, can avoid \$300 in taxes by taking advantage of the account.

FSA Prepaid Cards

An FSA prepaid card is a branded prepaid product used to access the funds an employee has in his or her FSA. Like the branded gift card and the payroll card, it functions very much like a signature-debit card. As mentioned above, Victoria Nipple of MBI gave conference participants an overview of FSA prepaid cards. Her company is one of the largest employee-benefit card companies in the U.S. It has distributed almost 1 million FSA cards, with most bearing

⁹ FICA tax is a combination of a Social Security tax and a Medicare tax. Employers and employees currently share the burden of both of these taxes, with each paying (as a percentage of total wages) 6.20 percent for the Social Security component and 1.45 percent for the Medicare component. (Note that the Social Security component is subject to a ceiling.)

the MasterCard logo. MBI's clients are third-party administrators (TPAs), the companies that set up and administer the various kinds of FSAs for employers. Nipple primarily addressed issues facing prepaid cards used to access health-care FSAs.

Nipple began her presentation by briefly describing the current health-care FSA market. She said that 90 percent of employers with more than 1000 employees offer health-care FSAs. Employee response to the offering, however, has not been overly enthusiastic. Approximately 12 percent to 15 percent of a given employer's employees will sign up for an account, earmarking, on average, \$80 of their monthly earnings to it. Nipple noted that the Labor Department estimates that a total of 20 million workers take advantage of health-care FSAs, annually contributing about \$20 billion.

Given the escalating costs of health care and the tax advantages described above, one would expect higher participation and contribution rates. Nipple, however, offered three reasons why she thought the noncard-based programs have not attracted more consumer interest. First, rules require that most employees essentially pay twice for approved goods or services. As described in the previous section, unless the majority of an employee's health-care expenses fall in the first few months of the year, he or she will have contributed to the health-care FSA before actually incurring any qualified expenses. When she does incur these expenses, she will have to pay for them out of pocket and wait for reimbursement from the FSA account. In this way, she was out twice the amount of the qualified expense from the time she incurred it to the time she was reimbursed.

Nipple explained that the program's administrative burdens are another likely deterrent to broader enrollment. As described above, employees who use FSAs are typically required to track their expenses, gather receipts, complete reimbursement forms, and deposit reimbursement checks. Finally, Nipple explained, employees may be somewhat intimidated by the "use-it-or-lose-it" rules of the FSA, which effectively penalize employees who cannot precisely forecast their qualified expenses.

The health-care FSA prepaid card, Nipple explained, solves many of these problems. First, since the card directly accesses the funds in the FSA, there is no need for the employee to pay out-of-pocket for expenses and wait for reimbursement. Second, if the

card is used for a qualified expense at a retailer such as a pharmacy, there is no need for the employee to substantiate the purchase or fill out a claim form. Finally, the cards make it easier for an employee to spend the money in his or her account, reducing the chance of his or her forfeiting any of the account's balance to the employer.

The prepaid cards also benefit employers. When employers introduce the cards, Nipple explained, employee enrollment in and contributions to the health-care FSA increase. To the extent that this occurs, employers benefit from a reduction in their FICA tax liability. Employers can also promote the cards as an employee benefit. The cards can make it easier for employees to access their pre-tax savings and save money on purchases not covered by health insurance.

As with the other types of prepaid cards discussed at the conference, health-care FSA cards face a number of challenges. The first set of challenges, explained Nipple, relate to technology. At present, the MasterCard and Visa systems that allow the authorization and settlement of FSA card transactions do not include details about each item that a consumer purchases (referred to as "Level 3" or "UPC-level" detail). Instead, the systems track merchant-level data. This creates an array of problems for FSA administrators, some of which keep employees from enjoying completely receipt-free reimbursements. Consider, for example, a consumer who goes into a Safeway and uses her health FSA card to buy a \$10 prescription drug at the store's pharmacy. If the pharmacy department uses the grocery store's merchant code when it requests authorization for the purchase, it is impossible for MBI or its processor to know whether the \$10 authorization request is for a permitted drug purchase or for groceries. As such, depending on the agreement between the employer and its TPA, the transaction may be denied. If this occurs, the consumer will have to pay for the drug in some other way and later request reimbursement from her employer's TPA. If the transaction is not denied, the consumer may still be required to substantiate that she did not buy groceries by sending the TPA a receipt. Until transaction data include product-level information, consumers will not likely be completely free of administrative hassles.

As explained earlier, prepaid FSA cards are a branded product that function very much like signature-debit cards. As such, they are subject to the same

association rules and interchange fees as signature-debit cards. In Nipple's opinion, the recent dispute between Wal-Mart and MasterCard over the acceptance of the association's signature-debit products, which included branded prepaid cards, highlighted the potential need for broader acceptance of PIN-debit. To the extent to which merchants that sell prescription drugs decide to accept PIN and not signature cards, PIN functionality on the health-care FSA card could make it possible for employees to continue to use their cards for purchases. For this reason, she thought that broader merchant acceptance of PIN could be helpful for the proliferation of FSA prepaid cards.

Nipple is optimistic about the future of FSA cards. She estimates that her company will have over 3 million cards in employees' hands by 2007. In the near future, she expects that a credit component will be added to the cards her company offers. "A credit line," she explained, "could be used to pay for medical expenses that are not covered by the FSA or to pay for an unexpected deductible." Overall, Nipple sees FSA cards "as part of a broader movement in the health-care industry toward products that place more responsibility on consumers to manage their own health-care expense." She expects that health-care FSA cards and related products will be a critical component in the next generation of health-care delivery.

How Are Prepaid Cards Regulated?

As Dr. Santomero noted in his opening remarks, the Payment Cards Center's interest in hosting a conference on prepaid cards was driven in part by the unsettled nature of the laws and regulations that surround this new payment innovation. During the conference, merchants and banks pointed to the unsettled legal environment as one of the most challenging aspects of the prepaid business. While many conference participants were frustrated by the expense of complying with the laws of the federal government and 50 states, they were most concerned about not being able to get a basic sense of many laws' requirements. As Walter Paulsen of Safeway explained, "We want to follow the rules. It's just really hard to know what they are."

This part of the paper begins with an overview of the major prepaid card laws and regulations discussed during the conference. The overview is in two sections. The first focuses on the two federal laws that conference participants thought might have a signifi-

cant impact on the prepaid card industry: the Federal Deposit Insurance Act and Regulation E. The second section focuses on two state law issues that were discussed and that already affect how the market functions: abandoned property laws and money transmitter laws. This overview is followed by a third section that summarizes conference participants' thoughts on the impact of these and other laws and their suggestions for future government policies.

As Judith Rinearson explained while introducing the conference's final session on prepaid card regulation, "Prepaid cards are at an intersection of multiple kinds of laws." The sections that follow generally discuss the issues surrounding the two federal and two state laws mentioned above. Many prepaid card issuers, however, are subject to a host of other laws. For example, payroll card issuers must comply with various state labor laws. Gift card issuers must comply with an increasing number of state consumer protection laws that regulate items such as gift card expiration dates, fees, and disclosures. Health-care FSA card issuers must comply with a host of IRS regulations and various provisions of the Health Insurance Portability and Accountability Act. There are also privacy laws, anti-terrorism laws, anti-money-laundering laws, and banking laws that potentially apply to all or some of those in the prepaid card industry. Because of time constraints, these and other important prepaid card legal issues were not covered at the conference; as such, the following is not intended to be a comprehensive review of all of the legal issues affecting prepaid cards.

The Federal Deposit Insurance Act & Regulation E

The final session of the conference focused on the legal and regulatory issues confronting the prepaid card industry. Two of the five experts on the session's panel directed their comments toward federal laws and regulations. Richard Osterman, Jr. of the Federal Deposit Insurance Corporation (FDIC), and Daniel Lonergan of the Board of Governors of the Federal Reserve System (the Board) explained how the Federal Deposit Insurance Act and Regulation E affect prepaid cards.

The Federal Deposit Insurance Act

Rick Osterman discussed a proposed rule that the agency published for notice and comment on April 16, 2004.¹⁰ The rule addresses the extent to which

prepaid card system funds held at federally insured depository institutions are “deposits” for purposes of the Federal Deposit Insurance Act (FDIA).

The classification of the value on a prepaid card as a “deposit” under the FDIA is relevant for two reasons.¹¹ First, the value on the card becomes insured by the FDIC against the risk of loss through bank or thrift failure (as long as the depositor has no more than a total of \$100,000 on deposit at the bank that issues the card). Second, the value on the card is added to the total amount of deposits on which banks must pay assessments to the FDIC. The FDIC puts the assessments it collects from its institutions into an insurance fund that can be accessed in the event of a bank failure.¹²

After briefly explaining the consequences of prepaid card funds qualifying as “deposits” under the FDIA, Osterman indicated that not all prepaid card products are covered by the FDIC’s proposed rule. He explained that the agency is concerned only with prepaid cards funded through federally insured banks and thrifts. Products that meet this criterion include many branded open-system cards, such as certain payroll cards and gift cards issued by financial institutions. Merchant-issued gift cards and other closed-system, retailer-issued cards are generally outside the scope of the FDIC’s rule.

While it has always been clear that merchant-issued cards were not affected by the FDIC’s rules, recent developments in the industry have blurred the distinction between prepaid card funds that banks

treat as deposits and those they do not. “Although there have been a few staff opinions issued, the FDIC Board has not addressed the classification of prepaid card funds since August 1996,” explained Osterman, “when General Counsel’s Opinion Number 8 was released.” General Counsel’s Opinion Number 8 (GC8) evaluated four types of prepaid card systems prevalent at the time. The opinion concluded that the funds in two of the four systems were “deposits” (see Appendix C for an overview of GC8). Since GC8, however, new systems have emerged. “The market has changed significantly,” explained Osterman, “and the development of new systems has created a need for additional guidance.” As such, the agency issued proposed rules this past April that subsume GC8, addressing the same “deposit” classification question.

The FDIC’s proposal specifically addresses three systems that are popular today. As described by the FDIC, they are (1) accounts funded by sponsoring companies, (2) pooled “reserve accounts” with individual subaccounts, and (3) payroll cards. In the first system, accounts funded by sponsoring companies, a nonbank company (i.e., a sponsoring company) collects funds from consumers and provides them with a prepaid card. The nonbank company deposits these funds in an account at an FDIC-insured institution and debits this account when consumers make purchases with the card. The FDIC proposes that the funds in such a system should be considered “deposits” for FDIA purposes. In most cases, the FDIC anticipates these would be deposits of the sponsoring company, not the cardholders.

The pooled “reserve accounts” with individual subaccounts system involves a bank-issued card that draws from a pooled self-described “reserve” account maintained by the bank. The bank, or a processor, also maintains “subaccounts” associated with the reserve account for each individual prepaid card. When a consumer uses the card to make a purchase, both accounts are debited. The FDIC proposes that funds stored in this type of system also be considered deposits.

The FDIC broadly describes the payroll card system as one that enables employers to pay their employees using prepaid cards funded by an account at a depository institution. Such cards would be subject to the same rules as other prepaid cards. As the FDIC asserts in its notice, “The proposed rule would apply equally to all types of stored-value bank cards.” Osterman explained that, under the rule, all funds held by

¹⁰ Interested parties had the opportunity to submit comments on the rule up until July 15, 2004. Now that the deadline has passed, all of the comments the agency received on the matter can be viewed on its web site at <http://www.fdic.gov/regulations/laws/federal/04comDEPOSITDEF.html>.

¹¹ According to an article in the *American Banker*, some large banks assert that this classification could have broader implications. They argue that the deposit classification could potentially subject the cards to the reserve requirements of Regulation D or the disclosure requirements of Regulation E. Hannah Bergman, “Financial Giants Chide FDIC Over Stored-Value Card Plan,” *American Banker*, Aug. 3, 2004, p.4.

¹² Osterman explained that since 1996, financially sound, well-capitalized federally insured depository institutions have not had to contribute to the deposit insurance funds. The approximately 10 percent of U.S. banks and thrifts that do not meet the well-capitalized and financially sound criteria pay an assessment of between 3 and 27 basis points on their total “deposit” base each year.

banks that underlie payroll cards and other similar products would be considered deposits for FDIA purposes with one exception. The funds on a prepaid card issued by a bank (i.e., not a nonbank employer or sponsoring company) and maintained in a pooled reserve account without any individual subaccounts are not considered deposits.

Regardless of whether funds in a particular system are deposits, Osterman explained that the FDIC is considering requiring banks to improve the disclosures associated with prepaid cards. “Although we have not yet settled on anything specific,” he said, “we have requested comment on whether banks should be required to put some kind of disclosure on their cards that alerts consumers to the presence or absence of FDIC insurance on the card’s underlying value.” Overall, Osterman hopes that the proposed rules “bring clarity” to the banks the FDIC insures and results in more uniform practices.

Regulation E

Daniel Loneragan of the Board of Governors of the Federal Reserve System began his discussion of Regulation E and prepaid cards with a review of the regulation’s history. In 1978, he explained, Congress passed the Electronic Fund Transfer Act (EFTA) to provide various protections to consumers using electronic fund transfer (EFT) systems. Among other things, the act requires financial institutions to send consumers monthly statements detailing transfer activity, implement procedures for handling consumers’ claims that a transfer reflects an error, provide consumers with written documentation of transfer activity, and limit consumer liability for unauthorized transfers. The EFTA also directs the Board of Governors to develop regulations to implement the various provisions of the act. In response, the Board issued Regulation E. Today, Regulation E covers a host of consumer transactions, including debit card transactions, ACH transfers, and ATM withdrawals.

Loneragan noted that Congress did not intend the EFTA to apply to the transfer of funds involving any consumer “asset.” “The real concern of Congress,” he said, “was that a consumer could suffer a serious loss or have her account cleaned out by way of an EFT from her checking, savings, or other asset account. And, as a result, she would be unable to make her mortgage payment or cover her utility bills or other obligations.” Evidence of this intention can be found in

the act’s definition of an “account.” The EFTA defines an “account” as “a demand deposit, savings deposit, or other asset account...established primarily for personal, family, or household purposes” (emphasis added).

As several conference participants noted, the prepaid card industry is concerned about whether accounts connected to prepaid cards are deemed “consumer asset accounts” for purposes of Regulation E. To the extent that they are, consumers would need to be provided, among other things, the protections, rights, and records described above (e.g., liability limits, error resolution procedures, and statements). While many issuers have voluntarily provided such protections for certain prepaid card products, others assert that making their products comply with Regulation E is costly and may limit their ability to offer consumers lower cost products (e.g., ones with Internet- or phone-accessed statements instead of mailed statements). In addressing whether “asset account” covers prepaid card accounts, Loneragan began by explaining that the Board staff considered extending Regulation E to prepaid accounts in 1996. At the time, however, the proposal met with resistance. The industry argued against the proposal for fear that it would halt the development of prepaid products. He also noted that, one year later, the Treasury Department examined the same issue and came to the same conclusion. While consumers would benefit from clear disclosures as to the terms and costs of such products, the Treasury found it was too early to regulate.

Recently, however, Regulation E and some prepaid cards have once again found themselves on the Board’s agenda. In October 2003, the Consumer Advisory Council of the Board discussed the implications of extending Regulation E protections to a distinct segment of prepaid cards—those loaded with an employee’s wages. At the time, members of the council were divided. Some thought the Board should delay extending the protections; others thought the Board should have extended them a long time ago.¹³ More recently, Loneragan indicated that his office has seen an increase in the number of inquiries related to prepaid cards and Regulation E, particularly payroll cards. Although the Board has not yet taken any official action with regard

¹³ A transcript of the Consumer Advisory Council’s October meeting can be found at <http://www.federalreserve.gov/generalinfo/adviscoun/cac/transcripts/2003/200310/october03transcript.htm>.

to this issue, Loneragan recommends that issuers look to Regulation E as a model when developing new prepaid products.

Specifically, Loneragan recommends that issuers examine the intent of Congress when it passed the EFTA. Legislators intended to protect significant transaction assets used for personal, family, and household purposes. Loneragan said that issuers should ask the following questions about their programs: Is significant value being stored and reloaded onto the card? What is the purpose of the card? What is the source of the card's funding? Is the card issued to a named individual or is it anonymous? Based on these and other questions, Loneragan indicated that payroll cards, for example, seem a likely candidate for inclusion in the "consumer asset account" definition. He admitted, however, that current market developments concerning payroll cards do not make this as simple a determination as one might hope. "Although these products were designed to help employers avoid the costs of providing paper checks altogether," Loneragan explained, "I learned today that evidently some employees do not have their entire paycheck deposited onto the cards. Some load only a portion of their pay for budgeting reasons. So the payroll card issue is even more complicated, since not only do payroll products differ somewhat, but so does the manner in which consumers choose to load them."

States' Abandoned Property & Money Transmitter Laws

The final session included the perspectives of two experts on state law. Jeb (George B.) Spaulding is Vermont's state treasurer and vice president of the National Association of State Treasurers' Unclaimed Property Committee. Judith Rinearson, who served as moderator for the panel, is counsel at KMZ Rosenman, a commercial law firm. Spaulding addressed states' abandoned property laws, and Rinearson, whose work focuses on prepaid cards, spoke about states' money transmitter laws.¹⁴

Abandoned Property Laws

Abandoned or unclaimed property laws, also known as escheat laws, require those in possession of

the "unclaimed" property of others to surrender that property to the state after attempting to locate the owner. Property subject to escheat includes a wide range of forgotten items, including deposits with rental companies, monies in brokerage accounts, bank deposits, checks that were never cashed, and proceeds of life insurance policies. The period that must elapse before the property is subject to escheat varies, depending on the state and the property involved (e.g., 15 years for travelers' checks and three to five years for gift certificates). For general unclaimed funds, 34 states and the District of Columbia have a five-year period; seven states have a seven-year period; eight states have a three-year period; and New York has just a two-year period. In most instances, the property is surrendered to the state of the property owner's last known address (or for anonymous property, to the state of incorporation of the property's holder).¹⁵ Once the property is surrendered, state officials make an attempt to notify the owner, usually via a newspaper advertisement. The rightful owners of property can come forward at any time and recover their property. Until then, the state gets to keep the property and any interest income it generates.

With respect to prepaid cards, Spaulding explained that state escheat laws vary greatly. Some states have amended their laws to specifically include "gift cards" in the list of assets that must be surrendered; others have amended their laws to specifically exclude prepaid cards. Some states have asserted that their escheat laws, as written, apply to prepaid cards; still others have admitted that their laws, as written, do not cover them. Some states claim that inactivity fees that drain a prepaid card's balance before it is escheated are illegal; others say these fees are acceptable. For prepaid card issuers, understanding and complying with 51 different abandoned property laws (including the District of Columbia's), in the words of Jack Williams, "is a nightmare." Addressing the variation of escheat laws by state, Spaulding acknowledged that a uniform approach was needed. He understood the administrative burdens that merchants faced and hoped to work toward easing them.

Spaulding then turned to the rather challenging task of explaining to a room of prepaid card issuers

¹⁴ A copy of Rinearson's presentation can be found on the Center's web site at http://www.phil.frb.org/pcc/conferences/judith_rinearson.pdf.

¹⁵ Notable exceptions to the last-known-address rule are money orders and travelers' checks. These are escheated to the state in which the sale of the product occurred.

why unused prepaid card funds should be sent to state capitals. “Why does the state get to keep it?” he asked rhetorically. “Because by law it belongs to the citizens of the states.” Given this, he asserted, it makes more sense for the “citizens,” represented by their states, to keep the money until it is claimed than it does to let companies keep it. Beyond the public policy interest in having the unclaimed funds revert to state ownership, Spaulding explained that states’ residents significantly benefit from escheat laws. While they work aggressively to return funds to their rightful owner, state treasurers can use the interest that the unclaimed funds generate to pay for state services and possibly cover budget shortfalls.

Spaulding indicated that many states are shortening the time that elapses before companies must hand over funds. Shorter periods, Spaulding explained, make it more likely that the state will get abandoned property back to its rightful owners. States, in his view, can do a better job at returning the money than anyone else. He also noted that state treasurers, most of whom are elected, have an additional incentive to get the money back to the people: Many citizens have a high opinion of those who sign and mail them checks for money they forgot they owned.

In the future, Spaulding hopes that escheat laws can be less confusing and easier to comply with. It is possible, in his opinion, for states to create abandoned property policies that are in the best interest of consumers and compatible with market realities. As an example, he thinks that a *de minimis* exception to escheat (exempting, for example, a gift card with up to \$10 or \$25 of value on it) could significantly reduce the burden of compliance. Overall, Spaulding hopes that states can better appreciate the position of companies that are trying to comply with their laws and make it easier to do so.

Money Transmitter Laws

Another way states regulate prepaid card issuers is through “money transmitter” laws. Rinearson explained that 45 states have some form of such laws that generally apply to nonbank businesses that perform payment services for consumers. Traditionally, these laws have applied to nonbanks that issue payment products, such as money orders or travelers’ checks, or that provide wire transfer services. At least 15 states and the District of Columbia, however, have explicitly amended their money transmitter laws to include pre-

paid card issuers.¹⁶ Other states, Rinearson noted, have asserted that prepaid card issuers are covered by their unamended money transmitter laws.

Generally, money transmitter laws aim to ensure the safety and soundness of nonbank businesses that transmit money. They generally do not apply to merchants that issue their own store gift cards or banks, credit unions, or other regulated depository institutions that issue prepaid cards. Most of the laws, Rinearson explained, have two key provisions. The first limits the ways in which consumer funds can be used from the time they are received by the licensed transmitter to the time they are spent. For example, some laws require that 100 percent of unused funds be kept in highly secure investments. The second key provision usually addresses the relationship between the licensed transmitter and any of its authorized distributors. For example, some state laws require that any funds given by a consumer to a distributor be remitted to the licensed transmitter within a certain period of time.

Those involved in any way with nonbank-issued gift cards should be sure they understand money transmitter laws. Even if a business simply sells prepaid cards issued by another, Rinearson recommends that the seller verify that the issuing entity is either a bank or a licensed transmitter. If it is not, the seller could be exposed to liability. In addition, licensees that distribute prepaid products through retail outlets must be careful to ensure that their sellers comply with certain provisions of the laws. Rinearson cited an example of a licensee that was held responsible for the training, supervision, and oversight of employees who worked for the retailers in its product’s distribution network.

It is very important that those who qualify as money transmitters adhere to these laws, asserted Rinearson, as they are backed up by a federal criminal statute (18 U.S.C. § 1960). That statute states that anyone who operates a money transmitting business without a license can be fined or imprisoned, or both. Additionally, the law’s penalties are not contingent on knowledge of a state’s licensing requirements. An operator can be liable “whether or not [the operator] knew that the operation was required to be licensed.” Rinearson noted that money transmitter laws increase the costs of doing business in this area for nonbanks

¹⁶ The states are Connecticut, Illinois, Iowa, Louisiana, Maryland, Minnesota, Mississippi, North Carolina, Oregon, Texas, Vermont, Virginia, Washington, West Virginia, and Wyoming.

and especially increase the regulatory and compliance burdens of transmitters that operate in multiple states. Overall, however, she thinks that money transmitter laws have value. She argues that they allow nonbanks, with some oversight, to participate in the payments industry. At the same time, they provide consumers with some protections that make it less likely that funds on nonbank-issued cards will “disappear” before being used.

Policy Concerns of Participants in the Prepaid Card Market

Throughout the day, conference participants openly discussed their concerns about the challenging regulatory environment in which they operate. They also offered suggestions as to how policymakers might address these challenges. Some of these comments and suggestions were broad, and others focused narrowly on specific lines of business. This section summarizes their concerns and is loosely organized by prepaid card constituency.

For merchants that issue their own gift cards, no policy issue seemed more important than escheat. As NPC’s Jack Williams explained, “It is the biggest single merchant concern.” Escheat laws force merchants that issue gift cards to surrender the unused value that remains on any of their gift cards after three to five years. Since the vast majority of retailer gift cards are issued anonymously, the value that reverts to the state can never really be claimed by any retailer’s customers. Ideally, merchants would like gift card credit balances to be exempted from escheat laws. Williams asked, “If expired airline tickets don’t escheat and postal service money orders don’t escheat, why should gift card balances?” If merchants cannot get an exemption, they would at least like to see more uniform laws. Understanding the abandoned property laws of all 50 states and the District of Columbia and filling out the paperwork necessary to send the unclaimed property back to state treasuries is a significant burden on retailers. Vermont Treasurer Jeb Spaulding’s suggestion regarding a de minimis exception would also seem to go a long way toward making the process easier for merchants.

Merchants were also concerned about new regulations that would significantly alter the market for gift cards. As Safeway’s Walter Paulsen explained, “Merchants have the most to lose if there is a regulatory misstep because our programs are the most es-

tablished.” They hope to see regulations that promote orderly growth.

While the banks that issue branded gift cards were also concerned about escheat, their attention was focused more on fee regulation and Regulation E. As Bank of America’s Eduardo Vergara explained, fee revenue is an important component of a branded gift card’s economics. If state legislatures or regulators limit or prohibit gift card fees in a way that affects both branded and store-issued products, branded gift card economics will change drastically, and banks will have less incentive to issue them. (Because store-issued cards have a different economic model, it is not likely that fee-related laws would similarly deter their issuance.) In lieu of regulation that targets fee-setting, Vergara proposes better disclosure of fees. “As long as the fees are disclosed up-front,” he asserted, “there should be nothing wrong with issuing a branded card with fees.” He indicated that Bank of America plans to print its prepaid product fees on the back of the card so that consumers are aware of its costs. Banks were also concerned about the extension of Regulation E to gift cards. In particular, they are worried about having to send statements to branded gift card customers. Printing and mailing statements is expensive and would further increase the costs of a product that already operates on thin margins. Vergara warned regulators not to treat all branded prepaid cards the same. “A one-size-fits-all approach to branded card regulation,” he said, could effectively “kill a product that consumers really value.”

Payroll card providers were similarly concerned about further regulation and its potential to affect the cost structure of the card. To the extent to which regulations make payroll card products more expensive, providers are faced with the choice of either increasing the fees they charge “unbanked” workers or exiting the business. Campbell Langdon of ADP showed a slide that illustrated the “spectrum of regulation” of payroll cards. On one end of the spectrum were regulations that presented “reasonable” costs to payroll card issuers. These costs included those associated with Regulation E, such as monthly statement costs, disclosure costs, and customer service costs. On the other end of the spectrum were “contemplated requirements” that imposed what Langdon considered “prohibitive” costs. These cost-prohibitive requirements included FDIC insurance, individual or trust account requirements, and significant investment or fee

restrictions. Overall, Langdon perceived the need for “clarity regarding the relationship between nonbank institutions and regulatory bodies.”

The fifth legal expert on the final panel of the day was Mark Budnitz, professor of law at Georgia State University.¹⁷ Budnitz has written books on consumer payment systems and, throughout his career, has worked to enhance the various consumer protection mechanisms in those systems. Budnitz agreed with conference participants who expressed a need for more uniformity in the law. “Right now,” he explained, “we have a patchwork of laws that directly and indirectly address prepaid card legal issues. We can continue to go in this direction, but such a course is very expensive.” Consistency and uniformity would be much more desirable for consumers, making it easier for them to understand their rights. For this reason, Budnitz advocated for a federal statute that would guarantee a basic level of protection on all prepaid cards. Certain cards could be exempted from certain provisions of the law, reflecting underlying differences in the products. In an effort to provide lawmakers with a starting point for such a law, Budnitz and colleague Margot Saunders crafted the Model Stored-Value Card Protection Act. The model law can be found in the second edition of the National Consumer Law Center’s Consumer Banking and Payments Law.¹⁸

While each constituency had its own unique concerns and policy priorities, conference participants clearly shared common concerns. The foremost of these was best articulated by Ron Congemi during his keynote speech the evening before the conference. Congemi was worried about the number of businesses entering the prepaid card market that are seemingly without proper oversight. He quipped, “We should be worried when Daryl, Daryl, and their other brother Daryl, start taking consumers’ money and issuing them prepaid cards.” Participants agreed that the industry could be vulnerable to unscrupulous operators who may not properly protect consumers’ funds. Peter Davidson of Genpass also believes that consumer

¹⁷ Budnitz prepared a brief for conference participants on the laws and regulations that affect consumers of prepaid card products. A copy of his brief can be found on the Center’s web site at http://www.phil.frb.org/pcc/conferences/mark_budnitz.pdf.

¹⁸ The model law is also available on the National Consumer Law Center’s web site at http://www.consumerlaw.org/initiatives/e_commerce/mstest_2.shtml.

information may not be adequately protected. “We should be concerned about policing the industry,” he explained, “as there are prepaid card issuers out there that are not adequately protecting their consumer data against attack.” Participants generally favored additional regulations that would ensure that rogue players would not harm the industry’s reputation.

Participants also agreed on the need for simpler laws and regulations. As Rinearson explained, prepaid cards are at “the intersection of many laws.” Not only does this array of regulation make it expensive for market participants to operate, but it may also deter those who want to enter the market. Walter Paulsen sees the complex legal situation as “a big barrier to entry that precludes small guys from getting into the prepaid business.” Overall, many participants agreed with Campbell Langdon’s assessment that “one set of rules would make everyone’s life much easier.”

Conclusion

The conference concluded with a wrap-up session featuring Jack Williams and the moderators of the three panels, Paul Tomasofsky of Two Sparrows Consulting, Jim Shanahan of E-Smart Services, and Judith Rinearson of KMZ Rosenman. Peter Burns, director of the Payment Cards Center, led the group in a discussion of the lessons learned during the conference.

Burns and Shanahan noted the relative success merchants had achieved in the prepaid card arena, having essentially bypassed the banking system. As Shanahan noted, “Banks are the traditional leaders of our payment systems and yet they are not really involved in many of these businesses.” Tomasofsky, however, argued that merchant domination, at least in the gift card area, will not last. “I don’t see retailers in the picture for the long term,” he argued. “Their focus is and should be selling products, not processing payments.” For Tomasofsky, the current environment reminds him of the 1960s “when you had lots of merchants with private label cards. For the most part, these cards were ultimately replaced over time by MasterCard and Visa and the co-branded credit card.” He sees a similar market shift in the prepaid card industry, with branded gift cards ultimately dominating retailer cards.

Conference attendee Dan Olstead of Best Buy challenged Tomasofsky’s assessment. “Merchants have always strived to make people’s shopping experiences more convenient and gift cards are part of this trend,”

he explained. “In addition, merchants have learned a lot about what happens when they lose control of their own cost structure. They won’t let that happen again.”

Rinearson’s and Williams’ comments focused on the regulatory environment. Williams suggested that participants and policymakers have overcomplicated the regulatory issues surrounding prepaid cards. “Don’t make this more complicated than it really is,” he admonished. “There are personalized cards and nonpersonalized cards, and the two should have their own sets of rules.” As for gift cards, Williams would like to see a federal law that eliminates expiration dates and inactivity fees and exempts gift card balances from states’ abandoned property laws. Rinearson suggested that the next regulatory hurdle that prepaid cards will have to clear is international in nature. “I become nervous,” she explained, “when prepaid cards are used overseas because the technology, fraud protection, and regulation of such transactions are not yet fully developed.”

Burns also echoed keynote speaker Ronald Congemi’s admonition about the risks associated with participants in this market who are financially weak or who are “rogue players.” Despite the fact that these bad operators may be one or two steps removed from the banks that ultimately settle their transactions, resolving any security breaches or other problems that

these operators cause could ultimately become the responsibility of the banks.

Last, Shanahan commented on the importance of communication between regulators and those they regulate. “It is important that regulators reach out to the various stakeholders,” he asserted, “to fully understand their perspectives, so as to not throw the baby out with the bathwater by implementing regulations that may not be necessary or that may miss potential issues.” At the same time, he urged participants in the prepaid card market to make their policy concerns known to policymakers. “Stakeholders,” Shanahan stated, “need to become more active in providing their input to the regulators either directly or through the channels that are in place.”

Overall, participants recognized that more cooperation, innovation, and dialog with policymakers are necessary. Operational challenges, such as those associated with split-tender or FSA transactions, need to be addressed by technology providers or card associations or both. The challenges presented by the unclear legal and regulatory environment must be resolved in a way that protects the interests of market participants and consumers. Hopefully, this conference, by bringing together a wide range of stakeholders to candidly discuss critical prepaid card issues, brings us closer to overcoming some of these challenges.

APPENDIX A Institutions Represented at the Conference

ADP	HQ Gift Cards LLC
American Express	ICBA Bancard Inc.
Atrana Solutions, Inc.	JP Morgan Chase
Bank of America	Juniper Bank
Best Buy Company	Katten Muchin Zavis Rosenman
Brinker International	Marriott International, Inc.
Certegy Card Services	MBI
Citibank National	Meta Payment Systems
City Corporation	National Association of State Treasurers
Citigroup Global Transaction Services	National Processing Company
Ecount	Office of the Comptroller of the Currency
eFunds Corporation	Pennsylvania State Treasury
ePay Capital Partners LLC	Piper Rudnick LLP
E-Smart Services PNC	PULSE EFT Association
EWI	Quadagno and Associates
Federal Deposit Insurance Corporation	Radio Shack Corporation
Federal Reserve Board	Safeway Marketing Services
First Data/Star Systems	State of Delaware – Dept. of Finance
Federal Reserve Bank of Chicago	Tower Group
Federal Reserve Bank of Kansas City	Two Sparrows Consulting
Federal Reserve Bank of Philadelphia	U.S. Treasury Department
Fried, Frank, Harris, Shriver & Jacobson LLP	Vermont State Treasury
General Growth Properties	Vesta Corporation
Genpass Card Solutions	Visa U.S.A.
Georgia State University College of Law	Westfield Corporation, Inc.
HEB Grocery Company	WildCard Systems

APPENDIX B Conference Agenda

Wednesday, June 2, 2004

Keynote Address

Ronald Congemi, President, Debit Services, First Data Corporation

Thursday, June 3, 2004

Welcome

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

Peter Burns, Director, Payment Cards Center

Setting the Stage: Prepaid Card Markets and Infrastructure

Speaker: T. Jack Williams, National Processing Company

The Economics and Risks of Prepaid Cards: Gift Cards

Moderator: Paul Tomasofsky, Two Sparrows Consulting

Panelists: Eduardo Vergara, Bank of America

Walter Paulsen, Safeway

David Doyle, Brinker International

The Economics and Risks of Prepaid Cards: Emerging Applications

Moderator: James Shanahan, E-Smart Services

Panelists: Campbell Langdon, ADP

Peter Davidson, Genpass Card Solutions

Victoria Nipple, MBI

Legal and Regulatory Issues Facing the Prepaid-Card Industry

Moderator: Judith Rinearson, KMZ Rosenman

Panelists: Mark Budnitz, Georgia State University College of Law

Daniel Lonergan, Federal Reserve Board

Richard Osterman, Jr., Federal Deposit Insurance Corporation

Jeb Spaulding, Vermont State Treasurer

Where Do We Go From Here?

Moderator: Peter Burns, FRB Philadelphia

Panelists: T. Jack Williams, National Processing Company

Paul Tomasofsky, Two Sparrows Consulting

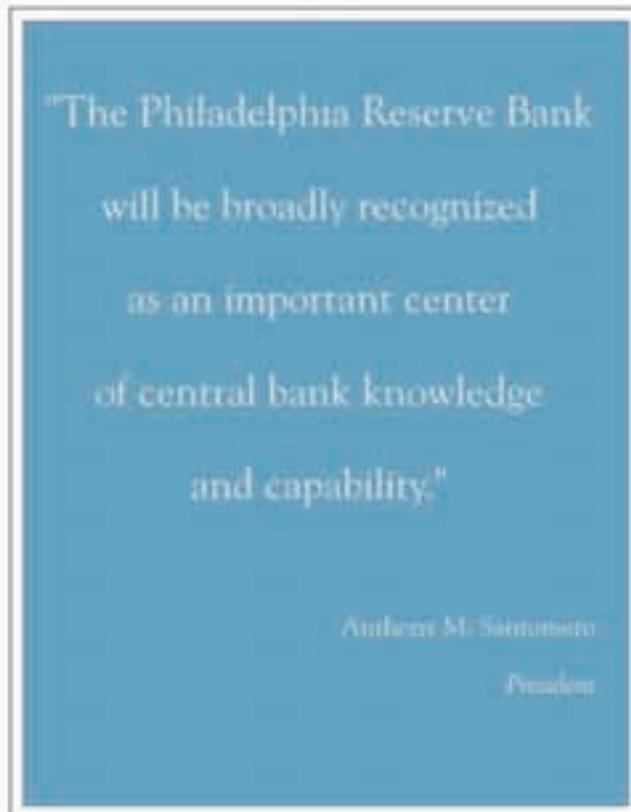
James Shanahan, E-Smart Services

Judith Rinearson, KMZ Rosenman

APPENDIX C
Summary of FDIC’s 1996 General Counsel’s Opinion #8

#	System Type	Brief Description	Deposit?
1	Bank Primary- Reserve System	Bank issues cards to cardholders. Bank maintains a pooled “reserve account” for all cardholders. Bank uses funds in this account to reimburse merchants.	No
2	Bank Primary- Customer Account System	Bank issues cards to cardholders. Bank maintains an individual account for each cardholder, reimbursing merchants from these accounts.	Yes
3	Bank Secondary- Advance System	Bank is an intermediary that collects funds from cardholders in exchange for cards issued by a third party. Funds are held by bank for a short time and then forwarded to third party. Third party pays merchants.	Yes
4	Bank Secondary- Pre-Acquisition System	Bank essentially buys cards from third party and sells them to cardholders. The third party, not the bank, is responsible for reimbursing merchants.	No

Note: “Bank” describes entities that the FDIC terms “insured depository institutions.”



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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.