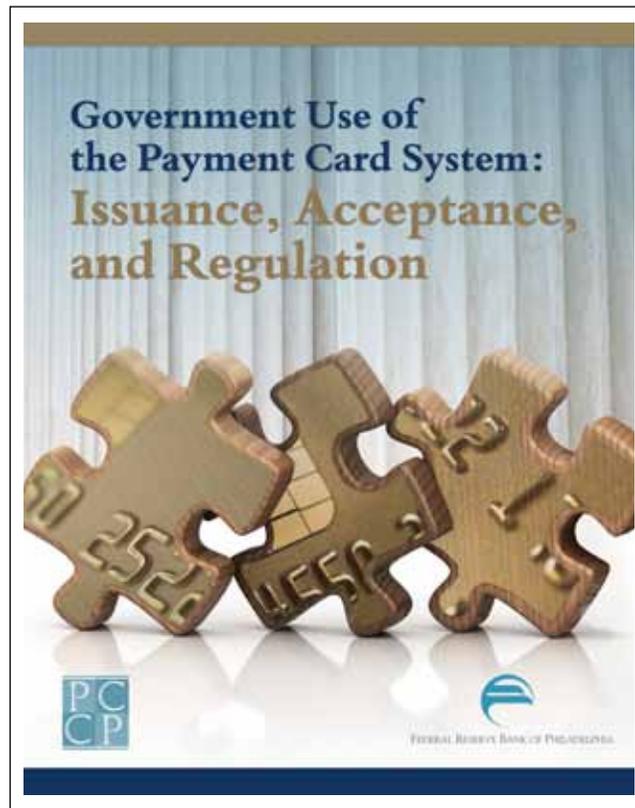


## CONFERENCE SUMMARY



# Government Use of the Payment Card System:

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Issuance, Acceptance, and Regulation

July 11 - 12, 2011



FEDERAL RESERVE BANK OF PHILADELPHIA

# CONFERENCE SUMMARY

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## Government Use of the Payment Card System: Issuance, Acceptance, and Regulation

Susan Herbst-Murphy

### Summary

The U.S. General Services Administration's SmartPay program is the world's largest commercial card portfolio. Nearly every state uses payment cards to electronically distribute unemployment insurance, child support, Temporary Assistance to Needy Families, or other funds. Federal, state, and local governments, as well as universities and other public-sector organizations, accept payments made with debit, credit, and prepaid cards. Recognizing the significant use of the payment card system by state and federal agencies, the Payment Cards Center hosted a conference on July 11 and 12, 2011 to explore the reasons why the public sector has adopted payment card options, the benefits that have resulted, and the challenges that must be managed.

Keywords: Public-sector payments, SmartPay, Direct Express, electronic benefits transfer, Debt Collection Improvement Act, Durbin Amendment, unbanked

JEL Codes: E42, G28, L38, L51

*\* The views expressed here do not necessarily represent those of the Federal Reserve Bank of Philadelphia or the Federal Reserve System. This paper is available free of charge at [www.philadelphiafed.org/consumer-credit-and-payments/payment-cards-center/publications/](http://www.philadelphiafed.org/consumer-credit-and-payments/payment-cards-center/publications/).*



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## I. Introduction

“Government is wasteful and inefficient.”  
“Government is doctrinaire and does not innovate.”

Attendees at a July 2011 Payment Cards Center (PCC) conference learned that, where payments and payment processing are concerned, neither of these stereotypes is accurate. On the contrary, presenters at the event described how billions of dollars in costs have been saved through the public sector’s effective use of the payment card system to conduct transactions and to distribute public funds. One federal government travel program has reduced direct costs for airline tickets by over \$5 billion annually. One state reduced annual costs by \$2.5 million by replacing the practice of printing and mailing checks for unemployment compensation and other benefits with electronic remittances disbursed via a prepaid card program.

Government has been an early adopter of new card products and technologies. Partnering with banks, processors, and payment networks, the public sector has collaborated on innovations in the card system that have later been implemented in the private sector. These advances leverage the card system’s electronic infrastructure and displace more expensive and time-consuming paper practices, enabling the government to make and receive payments and distribute funds in ways that are more efficient, more secure, and more reliable.

In spite of the benefits, there are still concerns about public-sector card programs. Some people question whether cards create opportunities for misuse by civil servants. There is apprehension that the costs of distributing benefits are being shifted to the beneficiaries through card fees. The government itself, in its regulatory capacity, can threaten the viability of some of these card programs when regulations are poorly designed.

### A. Background

Recognizing that payment cards were becoming an increasingly significant payment method in the public sector and that such use generates both advantages and challenges, the Payment

Cards Center of the Federal Reserve Bank of Philadelphia hosted a conference on July 11 and 12, 2011, “Government Use of the Payment Card System: Issuance, Acceptance, and Regulation.”

The purpose of the event was to bring together representatives of government card programs at the federal and state level, along with representatives of card networks, banks, and processors; academia; consumer advocacy groups; and regulatory agencies for a candid discussion of the benefits, concerns, opportunities, challenges, strengths, and limitations of these programs.

The conference consisted of five panels, each composed of distinguished panelists representing the various constituencies listed above. The conference agenda was organized around the three primary ways that the public sector uses the general-purpose payment cards system: paying for goods and services consumed in the conduct of doing the government’s work (commercial card applications); accepting payments from citizens, businesses, organizations, and other government offices (merchant acceptance); and distributing funds, particularly to individuals without other means to receive electronic disbursements (primarily using prepaid cards).

Through legislative and judicial auspices, government also has a role in regulating, securing, and, more recently, in setting pricing between trading partners in the payment card market.

To view the ways that the public sector is using the payment card system through a legal and regulatory prism, the conference concluded with a capstone panel of payments scholars who considered the concepts and activities discussed at the conference within the context of legislative and judicial initiatives in the payments arena.

In her opening remarks on the second day of the conference, Loretta Mester, executive vice president and director of research at the Philadelphia Fed, conceded that the conference would not yield all the answers. Mester suggested instead that events such as this could help to develop the

expertise and body of knowledge for improving public policy. “Incentives loom large, and conflicting incentives need to be understood,” she said. There is a need to understand domestic and global trends and new and emerging payment technologies. To that end, the presenters and conferees were important voices, and the event provided a forum for discussing the conflicting incentives and for anticipating possible unintended effects of policy initiatives.

## B. Recurring Themes

Participants on multiple panels raised several recurring themes over the course of the conference. The following were the most persistent themes that emerged:

- **Card programs are cost-effective.** Replacing a paper check with an electronic transfer can save up to \$1 in direct costs per transaction.
- **Fraud and abuse decrease.** Card programs capture purchase-related information in digital format. This enables the use of controls and reporting tools and allows for greater transparency, all of which are effective in identifying and reducing possible fraud and misuse.
- **Cards have some advantages over checks because funds are more likely to reach the intended payee, and the payee will have immediate use of the proceeds.** Electronic distributions to a prepaid card do not get lost or stolen in the mail; their delivery is not disrupted by natural disasters or catastrophic events; and monies can be used without the need for any intermediary action (such as cashing a check).
- **Learning and innovation from these programs beget substantial ancillary benefits.** Efficiencies and positive spillover effects occur well beyond those realized in the core payment transaction.

These themes were also reflected in the opening remarks made by the PCC’s director, Bob Hunt. From his perspective as a payments economist, Hunt observed that the payment card system exhibits characteristics of a general-purpose technology, a broadly adopted innovation with

the potential to transform consumer and business activity.<sup>1</sup> In ways similar to the country’s earlier experience with electricity and telecommunications, the basic consumer credit card platform and its network infrastructure, Hunt observed, have been leveraged and expanded to produce additional benefits that few would have predicted in the 1950s and 1960s. The ways in which the public sector is using the payment card system exemplify the three traits of a general-purpose technology — *pervasiveness*, *improvement over time*, and *innovational complementarity* — thus supporting Hunt’s premise.

This synopsis will be organized around the three ways that federal, state, and local government agencies use the payment card system and how public policy interrelates with those practices. The conference’s key themes and noteworthy insights will be summarized. For more detailed information, some of the speakers’ presentations are available on the center’s web pages.<sup>2</sup>

## II. Government as Commercial Card Client

The commercial card category consists of corporate travel and entertainment cards, procurement cards,<sup>3</sup> fleet cards, and other products designed to meet the needs of business, government, and other nonconsumer entities. The federal government’s commercial card program is the largest in the world, and the public sector has, in the words of Rick Malcolm, of Visa Inc., “driven all the innovation” in the commercial card segment. David Shea, of the GSA’s Office of Charge

<sup>1</sup> Timothy F. Bresnahan and Manuel Trajtenberg, “General Purpose Technologies: Engines of Growth?,” *Journal of Econometrics*, 65:1 (January 1995), pp. 83-108.

<sup>2</sup> Not all speakers used presentation decks. Nearly all who did have allowed the PCC to make them available on the center’s web pages at: <http://www.philadelphiafed.org/consumer-credit-and-payments/payment-cards-center/events/>.

<sup>3</sup> Procurement cards are also called purchasing cards or P-cards. For a taxonomy of commercial card products, see Susan Herbst-Murphy, “Getting Down to Business: Commercial Cards in Business-to-Business Payments,” Payment Cards Center Discussion Paper (March 2011).

Card Management, likened the infrastructure to Lego bricks, with all the components available to be assembled and configured for a variety of purposes. The commercial card category may best exemplify the type of collaborative innovation in electronic payment and purchasing processes that has resulted from the partnership between the public and private sectors.

Malcolm traced public-sector collaboration in developing card-based solutions to the first state program (in California) introduced in 1984. The federal government first used cards for procurement purposes in 1989, before a true purchasing card product had been commercialized. Since the original SmartPay program in 1998, through its relaunch 10 years later as SmartPay 2, the federal government has pushed for more data, for e-access systems, for greater control, and for robust management reporting tools.

The networks and banks have invested heavily in the technology to support these programs. Part of the role played by Visa and other networks is to research the market, understand customers' needs, build a core platform, and establish the rules so that all of the participants in these multi-party endeavors operate in ways that uphold the integrity of the payment system.

Federal programs are currently doing about \$30 billion in annual transaction volume; 47 states have purchasing card programs; 42 have travel card programs. Growth of state and local programs is moving an additional \$7 billion annually to electronic card payments, Malcolm reported, and programs at institutions of higher education, many of them public universities, are growing even more rapidly than are the state programs.

Malcolm observed that growth potential remains for government applications of commercial cards. As budget pressures continue, he believes that the government will adopt more card solutions because of their cost savings. Malcolm told the assembly that the fully allocated cost of an electronic transaction is \$19 versus \$50 to \$60 for a check payment, which includes the cost of check preparation, disbursement, and account reconciliation.<sup>4</sup> In addition, electronic payment and purchasing data have additional

value in data mining and reporting.

Malcolm noted that some observers have worried that these cards might be abused or misused. But he pointed to the enhanced visibility provided by electronic payment data, which has been useful in identifying and curbing this kind of activity. This visibility makes it easier to uncover practices that were happening previously but are now being brought to the surface with the fraud detection tools that the payment card system provides. Malcolm asserted that there are documented cases that provide evidence that these card-based tools are uncovering fraud that may have otherwise gone undetected or may have taken longer to uncover.

In addition to the potential for internal misuse, these programs also need to be protected from fraud committed by external criminals. Malcolm reported that the card system's fraud mitigation and prevention efforts involve many layers and that the network's role is to align those strategies so that all the right pieces are there. Fraud and misuse rates, he reported, are at a historic low: 0.009 percent of total dollar volume in the private sector and even lower, 0.007 percent, in government programs. About \$60 per \$1 million of volume is fraudulent, he maintained, an indication that fraud mitigation tools are working well.

#### **A. Public-Private Collaboration in Innovation**

Pam Joseph, of U.S. Bank, reported that the relationships between banks and their government clients are "truly collaborative and frequently long term," conditions that are conducive to developing and testing customized solutions. She provided an example from U.S. Bank's work with the Department of Defense, a commercial card client, for whom they built a real-time freight payment solution that allows audit of a bill in which all pricing elements are included. The time and manual processes eliminated at the DOD because of this solution have reduced the number

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<sup>4</sup> For further information on how commercial cards reduce the costs of paper and manual processes, see Neil McHugh, "What Is Driving Commercial Purchasing Card Growth?," *Journal of Corporate Treasury Management*, 4:3 (2011), pp. 259-71.

of people involved from 350 to 125 and reduced costs by about \$200 million per year.

U.S. Bank also worked with the United States Postal Service, a fleet card client, to develop a tool that helps the USPS find the cheapest gas and avoid payment of taxes (as a tax-exempt entity). The tool also provides customized reporting and analytical capability. These solutions can lower the cost of processing an invoice from \$29 to \$10, Joseph stated.

These are just a few of the examples of ancillary benefits associated with the adoption of payment cards described by Joseph and other speakers during the conference. These additional benefits have been brought about because the information related to the purchase is captured and transmitted in an electronic format. This allows transaction-related information to be imported into purchase order systems, general ledgers, etc., without additional manual entry.

Automating government certification and accounting processes provides a huge benefit for the federal government, whose 128-character accounting codes allow many opportunities for error in a manual environment. Information in electronic format also becomes mineable data that can be used for management reports and enhanced fraud control. Joseph reported that controls employed in the GSA SmartPay program have prevented over \$100 million in fraudulent spending.

Gonca Latif-Schmitt, of Citi, provided two additional examples of the fruits of collaboration between the government and the payment card industry. She characterized the first, done in conjunction with the Department of Defense, as “reinventing what a commercial card program can be.” The DOD has very complex travel needs, involving over 60,000 program coordinators. For the majority of these uniformed service members, travel coordination is a collateral duty they carry out in addition to their other responsibilities. The military determined that these human resources could be better used elsewhere.

So the DOD sought assistance from Citi to find a way to integrate the management and payment of travel expenses that necessarily follow

from individual travel orders. The ultimate objective was to develop the ability to set a monetary limit, available through the service member’s credit card, with specific travel orders. If the card spending limit could be triggered from the DOD’s orders management system, administrators did not have to be directly involved in resetting card system credit limits at the account level as spending requirements varied.

What seemed to be a simple idea was very complex to implement. In addition to integration with the military’s system for issuing travel orders, there was a need for all involved to rethink the spending capacity of a card, not in terms of a constant credit limit but as a purse intended for use for a particular travel event. The Air Force volunteered to be the first to test such a system.

The initial test was a “pilot” in more than one sense of the word. The test was carried out at the commander level; Air Force pilots at bases throughout the world were willing to risk their own travel coordination to test whether the program could be expanded to the rest of the service. Latif-Schmitt reported that the test was “an incredible success,” and she said that she expects the program to be adopted by other branches of the military. However, it took one year of conceptual planning and nine months of testing before the program could be fully implemented.

Another innovation involved the Navy. During the SmartPay1 program, the Navy was struggling with an “abundance of riches” from all the data it was receiving through SmartPay. Specifically, the Navy wanted a system that could indicate when a transaction may be suspect. Using the rules developed by the Navy, Citi built a parameter-based system that enabled the Navy to reduce auditor manpower from over 30 sailors to just over three, with the skills of the other 27 sailors redeployed elsewhere. The innovation, developed by the bank but driven and tested by the client, was later embedded within the larger GSA program. Citi is also making it available to other commercial card clients, creating efficiencies in the broader economy.

Responding to an audience question about the amount spent to build these systems, Latif-

Schmitt said that the “rule of thumb” at Citi is to reinvest about 10 percent of its revenue in systems development.

## B. Capitalizing on Innovation

Innovation occurs not only in inventing something new but also in recognizing its value by applying it to solve specific problems or to improve an existing process.

About a decade ago, consultants Richard Palmer and Mahendra Gupta began the process of measuring cost savings that purveyors of commercial cards asserted their products would deliver. What Palmer and Gupta’s work has revealed is that a savings of about \$70 per transaction results when a traditional purchase order process is replaced by a purchasing card.<sup>5</sup>

Paul Kurtz, of Georgia’s Department of Administrative Services, reminded conferees that while this intelligence is now time-tested, it was not always the case. In the beginning, many were skeptical about the promise of P-cards. Due to the leap of faith on the part of early adopters, many of them in the public sector, there has been real-world validation that the P-card is “faster, less expensive, and safer than any other payment form we can use,” according to Kurtz. Kurtz believes that many new innovations could evolve from refinements of the earlier programs.

Perhaps more leaps of faith in innovation and early adoption might have occurred were it not for what Kurtz characterized as negative discourse pertaining to payment cards. He would prefer to see a more balanced discussion of the advantages and the disadvantages of government adoption of payment cards. Specifically, he point-

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<sup>5</sup> Throughout the conference there were numerous references to the work of Palmer and Gupta and their consulting firm, RPMG Research. Their first purchasing card benchmark survey was published in 1998, and it has been updated several times since. In addition to the cost savings noted by conference presenters, Palmer and Gupta’s work has also found that cards reduce the procurement cycle by approximately 12 days and reduce the number of suppliers managed in accounts payable databases by an average of 16 percent. Palmer and Gupta have written extensively on improvements in the procurement process and the use of commercial cards by government, the military, and businesses of varying size. A partial list of their publications can be viewed on RPMG’s website: <http://www.rpmgresearch.net/>.

ed to reports about abuse associated with government P-cards, which can and should be viewed from two perspectives.

Kurtz referred to an instance of abuse by a single employee at a large university. This employee was able to exploit vulnerabilities in the university’s internal system and embezzle \$350,000 over a five-year period. Weaknesses in the payroll system, a lack of oversight, and other factors all contributed to this fraud event, and its discovery was partially enabled by the increased visibility provided by the P-card data. Yet a number of press accounts placed blame solely on the card itself.

Echoing Rick Malcolm’s point, Kurtz noted that P-cards make it much easier to discover and investigate anomalies. But he noted that often when a transaction is flagged as possibly suspicious, further inquiry will reveal that it was legitimate. As an example, he cited a card purchase made at a lingerie shop that the card system reporting tool placed on a list for investigation. This was a purchase by a university drama department, which needed a bathrobe for one of its productions.

In many other instances, payment cards are clearly superior to other systems, such as vouchers or petty cash. Kurtz mentioned the example of a loss of \$10,000 in cash that had been obtained via a travel advance for a college band trip abroad.

Georgia’s P-card program has surpassed \$330 million in volume, but Kurtz maintains that it could easily be a \$1 billion program if other departments, cities, and counties eligible to participate would do so. The state does not mandate participation by its departments, so each department, county, and municipality must be individually convinced of the program’s value. Kurtz suggested that negative stereotypes associated with cards influence the perceptions of many agency and department heads. When the parties involved suspend judgment long enough to understand the benefits and to learn about the controls on fraud and abuse, Kurtz finds that these decision-makers often become adopters.

Like many commercial card clients, Georgia receives a rebate on purchase volume from its

card issuer. By law, the Department of Administrative Services does not share the rebate with other state agencies. This practice allows the department to be self-funded. The rebates, along with fees from statewide contracts, enable the department to be financially self-sufficient. The law does not prevent rebates from being shared with non-state-level participants, such as counties and municipalities, and many currently do share in the rebates. Kurtz is apprehensive that these rebates may potentially be subject to threat from the Durbin amendment, but until that occurs, he is amenable to sharing the rebate as an incentive for others to participate in the card program and benefit from its efficiencies.<sup>6</sup>

Kurtz concluded that the data capture, the rebate, and the convenience afforded by cards can take Georgia's commercial card program to where it should be, if the misperceptions can be overcome.

### C. Early Adoption by the Federal Government

David Shea agreed with Kurtz that not everyone recognized commercial cards' potential when they were first introduced. He recalled that some people saw cards as the antithesis of strategic sourcing.<sup>7</sup> He was among those who, early on, saw that cards could enable strategic sourcing. That vision is now coming to fruition.

The first step, according to Shea, was to get purchase orders out of the system and get cards issued. The second step was to implement controls on misuse, to integrate the electronic payment data into automated processes, and to

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<sup>6</sup> Kurtz was referring to a section of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 that tasked the Board of Governors with defining "reasonable and proportional" interchange fees on certain debit card transactions. For additional details, see Appendix A.

<sup>7</sup> The Office of Management and Budget defines strategic sourcing as "the process of continually analyzing the way agencies spend funds through contracts, delivery orders, and through the government purchase card program in order to ensure that agencies are: Leveraging their sourcing power by seeking opportunities to achieve discounts on commonly purchased goods and services; and Applying discounts to all charge card transactions, as appropriate." See OMB Circular A-123 Appendix B (revised) January 15, 2009.

begin mining the data. Today, the SmartPay program is in the third stage, where the data and automation are being used for strategic business solutions far beyond the simple payment function for which cards were originally designed.

An example of this, Shea reported, is in the purchase of office supplies. Regardless of the agency making the purchase or whether that purchase is made at a store or over the Internet, the intelligence built into the card system allows the vendor to recognize the card number as belonging to SmartPay, and the negotiated price automatically applies. Sales tax is automatically waived. As a result, most agencies are seeing an 8 to 10 percent savings on office supplies, or around \$10 million on the \$109 million in office supplies purchased in the first five months of 2011.

In addition to this type of direct cost savings, Shea said that the GSA's card programs also permit cost avoidance for the time spent on purchase order processing and on manual activities that have now been automated. Under the old methods, Shea reported, the administrative cost related to a purchase was sometimes greater than the cost of the item purchased.

In addition, the GSA receives refunds from the card issuer that, over the contract term for SmartPay 2, will contribute \$3.25 billion to the federal government's coffers.<sup>8</sup> A small sliver of that rebate, which has remained unchanged for 12 years, funds the management of the card office, which receives no congressional appropriations. The remainder of the rebate goes back to the agencies to support their missions, be it firefighting or law enforcement or any of the many activities federal government agencies are involved in.

Shea acknowledged that rebates are not without controversy, since they are related to the interchange that is part of the discount rate paid by the vendors. He noted, however, that the vendors receive payment within 24 to 48 hours, so they have their revenues working for them much

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<sup>8</sup> The GSA SmartPay2 master contract has a three-year base period that began on November 30, 2008, and allows for one four-year renewal option and one three-year option.

more rapidly.<sup>9</sup> When a vendor does not accept cards, federal agencies forgo the benefits of streamlined processes and rebates. To compensate for this, the GSA hopes to pilot test a cardless payment program with vendors that do not accept cards and that wish to be paid in less than 30 days. In exchange for these faster payments, the vendor would pay a small fee to help fund the cost of operating this payment process, as well as a modest agency refund. The fee would be less than the vendor's cost to borrow funds to address the typical invoice payment terms of 30 days from receipt used by the federal government.

In addition to providing offsetting revenues, the program frees up more time for government employees to devote to their core mission rather than to the administrative paperwork related to the purchasing process. Thus, one of the benefits of SmartPay, according to Shea, is that agencies are able to provide more public services with the same level of resources. "This is about mission support more than anything else," he said.

Shea offered a specific example of how these three benefits of SmartPay — direct savings, cost avoidance, and rebates — have combined to yield savings of billions of taxpayer dollars in one of the government's travel programs. As airline tickets are booked, the card number identifies the buyer as a federal agency entitled to negotiated discounts. This generates direct savings of \$5 billion to \$6 billion annually compared with commercial rates. An additional \$1.5 billion to \$1.75 billion in cost avoidance is also realized because of the streamlined business processes the card system facilitates. Additionally, rebates on spending volume are returned to the travel office's operating budget.

Shea agreed with Kurtz that the additional transparency produced by the adoption of cards

<sup>9</sup> Merchants accepting payment cards also benefit from cost avoidance in accounts receivable management, including invoicing, collections, and the occasional credit loss. See Herbst-Murphy (March 2011).

can lead to misconceptions among the public. Shea noted that because the federal government does so much, it sometimes buys "some very weird things" for purposes that, on the surface, could appear suspect. "Transparency without context is confusion," Shea said.

**An Army Audit Agency study found savings of \$92.60 per transaction when a purchasing card is used, instead of the \$155/transaction when a purchase order is used.**

The \$30 billion in annual spending done with cards is only 6 percent of total annual spending, so there is significant opportunity for the expansion of SmartPay. In addition, Shea said that the GSA will continue to push for more data, particularly "green attribute data" to advance the GSA's goal of a zero environmental footprint. The GSA is also looking to improve its information about purchasing from small business vendors so that it can assess progress toward satisfying a congressional mandate to use small business suppliers wherever possible. Shea hopes that such data can be garnered through the purchasing card system.

The drive to constantly innovate in payments sometimes conflicts with behavior that Shea contends is reflexive and subject to habit. He described his experience with an early card program he managed before joining the General Services Administration. About half of the program's spending was being done with convenience checks connected to the card account. Upon investigating this pattern, he learned that it was simply because the employees were used to writing checks. They continued the practice even when using the card was more beneficial.

Shea spends a lot of time educating current and prospective card program managers in ways to effectively use cards. There is an annual conference that attracts 5,000 to 6,000 attendees. Monthly conference calls and quarterly workshops are conducted to provide education and information. Shea noted that there are a lot of miscon-

ceptions about card programs, but among agency personnel, he has also observed “phenomenal dedication” to doing payments well and efficiently.

### III. Government as Payment Card Accepting Merchant

Approximately 580 federal agency lines of business accept payment cards at nearly 5,000 worldwide locations, including the Bureau of Engraving and Printing, national parks, veterans’ canteens, and U.S courts. State agencies, public colleges and universities, and counties and municipalities will also accept cards from citizens paying for driver’s licenses, fishing licenses, taxes, fines, and fees. As cards became more significant in the mix of payments used by consumers, public-sector payees recognized a need to accommodate these changes in the payment landscape.

The U.S. Treasury’s Financial Management Service (FMS) coordinates card acceptance for all federal entities except the Internal Revenue Service. In 2010, total card receipts for all FMS-supported lines of business were \$9 billion, with about half of that coming from military commissaries. Another 25 percent were payments from corporate cardholders, and 5 percent were intra-governmental payments made with government-issued commercial cards. FMS’s card receipts are growing: Over the last three years, the number of transactions has increased by 20 percent, while the dollar value of those transactions has increased by 10 percent.

Bill Brushwood, of FMS, stated that the agency’s goal is to offer payment options to citizens, taxpayers, and military families that allow them to exercise their preferences for payment methods and also for payment channel, whether face-to-face, by mail, via the Internet, or over the phone. These preferences continue to evolve. And as is the case with other merchants and participants in the card system, regulatory changes driven by new laws require process modification. These and other forces result in continual changes and upgrades that can be costly and time-consuming.

Kevin Phalen, of Bank of America, agreed that the challenges have increased over time. He

said that there is more fragmentation and diversity in the payment card system than ever before. In the industry’s first few decades, the players were limited to a cardholder, a storefront merchant, and a bank that both issued cards to consumers and acquired payments for merchants. Since then, fewer banks remain in the acquiring business and nonbanks and processors are playing a greater role. There are many more niche applications and many new channels, including the fast-growing Internet channel. Phalen believes that cardholders and merchants will continue to make additional demands that will add even more complexity. Whether and how the industry will respond to these challenges depends on achieving alignment around:

- Who will pay?
- Will fees apply?
- Who will pay for infrastructure investment?
- How will services be provided to payers/cardholders?

#### A. Current Outlook

Phalen reported that, over the next few years, the card payment system will be attempting to regain its equilibrium in the wake of the Durbin amendment. He also noted that newer requests for proposals are calling for zero costs to the state and no fees to cardholders. The duration of contracts is shrinking from 10 to seven to five and even three years. This allows less and less time to recoup the investment costs that must be incurred at the beginning of the contract. Today’s operating environment, according to Phalen, is one of a “heightened level of political acrimony that does not allow us to move forward quickly.” There continue to be issues associated with a recovering economy and the potential for additional legislation or litigation.

Within this challenging milieu, merchants and cardholders alike continue to look to the card system for more solutions that allow them to do more with the same or fewer resources. According to Phalen, current expectations do not reflect the balance that existed a dozen years ago, when many of the programs described at this conference were

initially conceived. To re-establish such a balance will require a “collective long-term outlook,” Phalen said, and recognition of the “measurable values to all players in the ecosystem.”

Tim Spence, of Oliver Wyman, described some conclusions drawn from the results of surveys that suggest that consumers value the ability to defer payment of some purchases (with credit cards) and appreciate the convenience that cards afford them, particularly in situations like shopping online. Consumers value protections, including chargeback rights and fraud security, which are provided by cards. These attributes are apparently valued even when using a card results in a direct cost to the cardholder, as is the case with some categories of card payments to government. Spence explained why the cardholder may incur a transaction cost when the payee is in the public sector.

Since certain laws prevent some government agencies from paying a discount rate in order to accept card payments,<sup>10</sup> the card networks have allowed some limited exceptions to their rules that protect cardholders from merchant surcharges. These “convenience fees,” said Spence, can cost the cardholder 1.5 percent to 2.5 percent of the amount of the card transaction with a government entity.

Spence explained that preference for cards is not equal in all demographic segments. For example, younger people are more likely to use cards and other electronic financial services, such as online banking, to a greater degree than older consumers. And there is a segment of the population that worries about how the government may use the individual’s card number and personal information.

## **B. The Value of Payment-Related Information**

Echoing a theme from the opening panel, Spence observed, “The residual value beyond

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<sup>10</sup> Payment acceptance costs to merchants engaged in selling products and services are sometimes calculated as a discount rate, a percentage of the transaction amount that is retained by the merchant’s bank/payments processor in consideration for its role in obtaining funds from the buyer’s account and facilitating their deposit to the merchant’s account.

getting the payment is the actionable intelligence from it.” He said this could be used to create merchandising opportunities in the public sector similar to what is done in the private sector. For example, visitors to a national park or museum might opt in to receive information on other locations they might be interested in visiting.

Ronald Mann, of Columbia Law School, remarked that for at least two decades, there has been a serious problem that still exists today: obtaining and transmitting a variety of information associated with a payment. He remarked that the conference presented a number of examples of advances in solving this problem that were developed in government commercial card programs. He also observed that the recognition at the point of sale capability that enables the GSA’s customers to obtain the best prices could potentially be adapted to provide similar benefits to consumers and business customers. These are two examples of government initiatives serving as an incubator for new payment ideas developed by banks and card networks that can ultimately be expanded to the rest of the payment system.

Greg Gentile, of Govolution, explained that electronic data capture can also decrease the cost of payment acceptance. While Gentile was with the Department of Commerce, the department made a comparison of its payment acceptance costs. From that experience, Gentile learned that it costs about \$2.53 to accept a paper payment. This can drop to about \$1.58 for an electronic transaction, mainly because of the addition of data that enable greater efficiencies in business processes.

Gentile leads a technology company specializing in payment acceptance solutions for the public sector. He began working with the federal government in the late 1990s with an application for the purchase of U.S. savings bonds. The application was later extended to 600 other programs. Today, his firm is the sole-source provider of Internet payment acceptance solutions to the federal government.

Gentile described the progress of the U.S. Treasury in the area of payments technology as “trailblazing”; the FMS has received the Hamil-

ton Award for excellence in cash management.<sup>11</sup> He also noted that rapid adoption of payments technology is being seen across state and local governments. He noted that adoption is occurring at places with high consumer interaction, e.g., national parks and driver's license bureaus. Enterprise adoption, such as building permit purchases, tends to lag, suggesting that consumers, to a greater degree than commercial entities, are creating the momentum in card payments.

**The Gartner Group estimates that invoicing and processing cost vendors \$12 to \$17 per check they accept for payment.**

Card payment is just one component of a fully self-service conduit between the government and its citizens. The payer also has the ability to look up a bill online, at his or her convenience. The payment account can be immediately validated through the card system's real-time authorization networks, avoiding back-end cleanup. The electronic data capture in this environment ties the payment to the payee, avoiding the misapplication of payment that can occur in a manual environment. The data from the payment can automatically make an accounts receivable entry with the corresponding offset to the general ledger system. Both the citizen/payer and the government/payee benefit from convenience, cost savings, and reductions in errors.

Where improvement is still needed, according to Gentile, is in achieving a consistent customer experience across the government enterprise. With consistency across all agencies and departments, the customer can assume the ability to pay with a card (among other methods), to pay online, and to perform other self-service functions.

<sup>11</sup> The award, named in honor of Alexander Hamilton, the nation's first Secretary of the Treasury, is bestowed annually at the Treasury & Risk Best Practices Summit. The award is for "excellence and innovation in treasury management and finance at top companies and multinationals world-wide." (Source: AlexanderHamiltonAwards.com)

## IV. Using Cards to Distribute Public Funds

Two different variations of prepaid cards are used by the public sector: closed loop and open loop. The latter, also known as general-purpose prepaid cards, carry a network brand. Visa and MasterCard are the brands currently being used to distribute public funds, but American Express and Discover also provide access to a broad network of merchants and ATMs for their prepaid products and are included in the general-purpose category.

Dan Rose, of MasterCard, explained that closed-loop programs are appropriate for programs such as Women, Infants, and Children (WIC) and the former food stamp program, now called SNAP. In these programs, the government earmarks these funds for certain types of purchases, specifically nutritional food. So, access to the broader merchant network that accepts general-purpose cards is neither necessary nor desirable for these programs.

For other programs, such as unemployment insurance, Social Security, or child support, where there are no constraints on how the funds are used, the open-loop system is appropriate. The open-loop segment is projected to quintuple by 2017, according to MasterCard-commissioned research conducted by the Boston Consulting Group in 2009. Citing that study, Rose reported current load volume of \$32 billion in open-loop government prepaid cards, a figure that Boston Consulting projects will grow to \$162 billion in 2017.<sup>12</sup>

Rose stated that the federal government's Direct Express program is on track to be the largest government-sponsored prepaid program in operation, followed by state unemployment insurance

<sup>12</sup> Mercator Advisory Group, in its "8th Annual Open-Loop Prepaid Market Assessment and Prepaid Industry Overview," published in September 2011, estimated that \$5.9 billion in load value was credited to Direct Express prepaid cards. An additional \$16 million in TANF benefits, \$17.5 billion in court-ordered payments, and \$24.8 billion in state unemployment insurance was also credited to prepaid cards that year, according to Mercator's estimates.

(UI) and child support programs. Between 2008 and 2010, UI programs more than doubled because of rising unemployment rates and because the eligible benefit period nearly quadrupled. Dollar volume channeled through UI programs is declining as benefits are exhausted and people return to work, but other programs are growing. Direct Express cardholders will double from 2 million to about 4 million because of the FMS mandates issued in 2011.

### A. Impetus for Prepaid Distribution

There are two benefits to distributing public funds via prepaid cards rather than checks:

- Sponsors realize cost savings both in direct savings of disbursing via ACH rather than cutting and mailing checks, and in indirect savings of avoiding lost and stolen checks, incurring losses from fraudulent checks, and reducing time spent in check reconciliation.
- Recipients receive funds safely and reliably in a form permitting immediate use to make purchases or obtain cash.

Dan Rose noted that cards provide the additional benefit of lessening the stigma associated with some other forms of benefits distribution that require users to go to special checkout lines or tear coupons out of a book.

At the federal government level, the migration to electronic payments has come about through legislative mandate. Under the Debt Collection Improvement Act of 1996, a regulation was issued that required all federal government payments to be made electronically. The rationale for this mandate was to reduce the government's administrative costs. Dick Gregg, of the U.S. Treasury, reported that an electronic payment costs the federal government nearly \$1 less than a manual (paper check) payment. With the Department of the Treasury making over 1 billion payments annually, the immediate and direct savings obtained by converting from checks to electronic fund transfers (EFT) is substantial.

Over the years, considerable gains were made with wire transfers and direct deposit to

deposit accounts, but the Treasury soon recognized a major impediment to the "100 percent electronic payments" goal. Available EFT methods could send funds only to traditional deposit accounts. At the end of the 20<sup>th</sup> century, about 15 percent of U.S. households did not have such accounts.<sup>13</sup>

In an attempt to clear this hurdle, the Treasury's Financial Management Service designed and endorsed the electronic transfer account (ETA) as a way of getting unbanked Americans onto the electronic payments grid. Despite a "bounty" of \$12.60 paid to a financial institution for every ETA it opened, the concept failed to achieve sufficient adoption to create new inroads.<sup>14</sup>

Tragic events provided further motivation for advancing electronic payments. After the terrorist attacks of September 11, 2001, physical transport of paper checks was curtailed, precluding their delivery, clearing, and settlement, and the availability of funds to payees. Four years later, the massive dislocation of Hurricane Katrina victims focused attention on the problem of check delivery to a residence that has been destroyed or when the whereabouts of the occupant are unknown for an extended period of time.<sup>15</sup>

### B. Virginia's Path to Prepaid

The Commonwealth of Virginia had faced a similar situation two years before in the aftermath of Hurricane Isabel, which, in addition to causing death and injury, disrupted normal activity for some time afterwards. As Bob Schmitt, manager of banking services for Virginia's Department of Treasury, recalled, "People had difficulty getting funds at a time when they really needed

<sup>13</sup> Edward S. Prescott and Daniel D. Tatar, "Means of Payment, the Unbanked, and EFT '99," *Federal Reserve Bank of Richmond Economic Quarterly*, 85:4 (Fall 1999). More recently, the Federal Deposit Insurance Corporation's National Survey of Unbanked and Underbanked Households (January 2009) found that 7.7 percent of U.S. households had neither a checking nor a savings account.

<sup>14</sup> For an account of why the ETA failed, see Hanns Kuttner, "The Move to Digital Payments: When the Check Is No Longer in the Mail," *The Hudson Institute* (February 2011).

<sup>15</sup> Julia S. Cheney and Sherrie L.W. Rhine, "How Effective Were the Financial Safety Nets in the Aftermath of Katrina?," *Payment Cards Center Discussion Paper* (January 2006).

their money.” At the time Isabel struck Virginia, the commonwealth’s general warrant contract was about to expire. Informed by the federal experience, Virginia was considering doing more electronic disbursement. Hurricane Isabel provided the “seminal event,” said Schmidt, to impel the commonwealth along that path. A paragraph included in the request for proposal (RFP) for the general warrant contract asked for “creative solutions” for enabling more electronic payments.

The creative solution that was adopted by Virginia was the general-purpose prepaid card. This product, introduced into the marketplace in the early 2000s, combines the electronic funding capabilities of the automated clearinghouse (ACH) with the cash access and point-of-sale spending outlets of the card networks. Prepaid cards could be provided by government agencies, through issuing banks, to individuals who did not want or could not qualify for checking accounts. The government then had the means to direct electronic funds to those individuals via the prepaid cards. The cards, in turn, could be used within the global network of merchants, banks, and ATMs honoring the card brand. (Virginia’s programs are MasterCard branded; Visa-branded cards are also in use for similar public-sector programs.)

Schmitt added that in piloting Virginia’s first prepaid program, a payroll card initiative, agency decision-makers were urged to participate in the testing. Many of them opted to get part of their salary directed to a payroll card. This provided them with the same experience their citizens would confront when using prepaid cards.

Once comfortable with how the product worked, Virginia began distributing unemployment insurance via prepaid card, followed by child support and then Temporary Aid to Needy Families (TANF) in August 2008. While Virginia’s per-payment savings (65 cents) is less than what the federal government is realizing, the commonwealth has nonetheless reduced annual costs by \$2.5 million as a result of its prepaid card program.

### **C. Prepaid Adoption at the Federal Level**

By this point, the FMS had also recognized the general-purpose prepaid card’s ability

to bridge the gap that ETA was unable to fill. In collaboration with bank partner Comerica and its processor, the FMS developed the Direct Express prepaid product, introducing it in 2008 as a means to distribute Supplemental Security Income (SSI) benefits. In addition to contracting for very low end-user fees, the FMS also stipulated that funds associated with a Direct Express card could not be garnished. These factors, Gregg said, were critical to obtaining support to launch Direct Express.

In addition to saving the costs of printing and mailing checks, electronic funds transfer (EFT) also obviates the problem of lost and stolen checks. Gregg said that the FMS handles about 600,000 claims for stolen checks each year. In addition to the administrative costs incurred, stolen checks create delays in receiving funds by people who, Gregg observed, can ill afford the wait.

Another end-user benefit is that EFT proceeds are immediately fungible; the recipient no longer needs to cash or deposit a check before the underlying funds can be used. Michelle Jun noted that the Direct Express cardholder fees are preferable to the check-cashing charges frequently paid by the unbanked.

With a product in place to reach the unbanked, the Treasury introduced new rules in December 2010 that were not practicable a decade earlier. Effective May 1, 2011, all new applicants for Social Security, Veterans Affairs, or other federal benefits are required to receive benefits electronically. Existing recipients receiving paper checks will have until March 1, 2013, to convert to EFT. Dick Gregg outlined the three exceptions to the EFT mandate. Those age 90 years or older can continue to receive paper checks. Those living in very remote areas not well served by ATMs and electronic payment terminals (as determined by the Treasury Department) may continue to receive checks. The third exemption is for individuals who are mentally impaired. Gregg noted, however, that most recipients with cognitive handicaps have a representative payee for their finances.

The FMS allows fund transfers to prepaid cards other than Direct Express, but those cards must meet certain standards in order to have

government distributions directed to them. Funds must be FDIC insured; the cards must provide the same Regulation E protections as required for payroll cards (including clear and concise fee disclosure); and there may not be a loan or line of credit feature connected with the card.<sup>16</sup>

These protections and enhancements have been critical to the FMS's being allowed to move forward in its goal of achieving near-100 percent electronic disbursement. The Treasury's Matt Helfrich said that gains have been substantial, with most recipients getting direct deposit. But two obstacles impeded electronic disbursement to the other recipients. One was a lack of bank accounts able to receive electronic deposits, a problem mitigated by prepaid cards. The other was the ability of individuals to opt out of direct deposit through self-certifying waivers, which essentially allowed anyone to continue to receive a paper check merely by asking.

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<sup>16</sup> Philip Keitel, "Federal Regulation of the Prepaid Card Industry: Costs, Benefits, and Changing Industry Dynamics," Payment Cards Center Conference Summary (2010).

As David Shea learned in his early experience with convenience checks associated with commercial card accounts, entrenched habits can inhibit progress. With the issuance of a check costing nearly \$1 more than an electronic transfer and with the number of outgoing remittances expected to rise significantly as baby boomers become eligible for Social Security, the FMS was motivated to offset such force-of-habit behavior. (See *What Can Cost Savings Mean?*) Waiver requests must now be made to the Department of the Treasury, must be notarized, and must fall into one of the three exception categories Dick Gregg identified in his remarks.

#### **D. Rhode Island's Experience**

Ray Filippone, of Rhode Island's Department of Labor and Training, reinforced Helfrich's point about the challenges in getting people to adopt electronic remittance. Rhode Island had been unable to get more than 8 percent of UI payees to accept direct deposit, despite the fact that many were paying \$25 per paper check to a check cashier in order to have use of the money. He also

### **What Can Cost Savings Mean?**

Over 3 million monthly Social Security payments can be made from savings realized through the electronic disbursement of benefits to the baby boom generation's first wave of retirees.

As the oldest boomers began turning 65 in 2011, U.S. Treasurer Rosie Rios announced, "More than 18 million baby boomers are expected to reach retirement age during the next five years, with 10,000 people a day becoming eligible for Social Security benefits." The estimated savings over the benefit lifetime of a Social Security recipient receiving monthly disbursements electronically instead of by check is \$205. Applying this figure to the group that Rios mentions, electronic

distribution can save nearly \$3.7 billion compared with printing and mailing checks. Based on the July 2011 average monthly Social Security benefit of \$1177, \$3.7 billion would fund 3.144 million monthly benefit payments. The average duration of benefits for an individual filing at age 65 is 222 months, during which time he will receive an average lifetime benefit of \$261,294. Based on these calculations, the lifetime benefits for more than 14,000 retirees could be funded from the cost difference between paper checks and EFT just for the 18 million boomers who will retire over the next five years. And this group accounts for less than one-fourth of the entire baby boom population.

Sources: SSA.gov; U.S. census; Kuttner (February 2011); FMS press release April 26, 2011; Seniorliving.about.com

relayed the events of December 2005, when 1,500 UI checks went missing in the mail.<sup>17</sup> The call center was besieged with calls from hundreds of individuals without money for food or gifts as the holidays approached. It was necessary to void all 1,500 items, reissue, and re-mail replacements for the original checks. After this event, Filippone decided that the state had to aggressively exit the check-writing business.

Another push in that direction came from changes in how the states are compensated by the federal government for the administrative costs of their unemployment insurance programs. Formerly, the costs of postage were directly compensated with federal monies. States now receive a set allowance from the federal government, and anything not spent on postage can be applied to other administrative expenses. This provided the impetus for creating efficiencies in check printing and mailing, reallocating the savings to other department expenses.

As the economy went into recession and unemployment rose, Rhode Island experienced the third highest unemployment rate in the country. And payments, which had been capped at 26 weeks, reached an average duration of 60 weeks in the state. Had Rhode Island not implemented cost-saving disbursement methods, the already significant stress on the state's UI budget would have been even worse. Bob Schmitt had raised the same point in the opening session: the fiscally stressed states were fortunate to have electronic alternatives available to them when they were inundated with an unusually high number of unemployment claims.

In addition to "significant postage savings," Filippone also reported that moving to electronic disbursement had reduced by one full-time equivalent the time spent responding to questions from beneficiaries calling about the status of their checks. They now know that the payment has processed, which has reduced incoming calls asking where the check is, and the corresponding outgoing calls to the post office. Since the program was implemented in 2007, there has never been

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<sup>17</sup> Those checks were found a month later in a mail bag in another state.

a failure of funds reaching a recipient's account within 48 hours. Filippone also noted that the prepaid card program was one of the easiest programs he had implemented in 35 years of state service.

### **E. Consumer Attitudes About Prepaid Cards**

Rachel Schneider, of the Center for Financial Services Innovation (CFSI), reported on research the center conducted that sought to understand usage and perceptions of prepaid cards by financially underserved consumers. Financially underserved consumers include the 9 million U.S. households that are unbanked, as well as 21 million "underbanked" households that may have bank accounts but also use some type of alternative financial service. She pointed out that CFSI's research was not specifically focused on users of government-sponsored prepaid programs, but she suggested that there is likely a considerable overlap between the population receiving government-sponsored prepaid cards and the population included in CFSI's research. This research included: 1) CFSI's 2008 national survey of underbanked consumers; 2) a quantitative online survey conducted in partnership with the National Branded Prepaid Card Association in 2009; and 3) in-depth interviews conducted with underbanked users of prepaid cards, also in 2009.

In CFSI's quantitative research, 78 percent of respondents said that prepaid cards are "extremely" or "very" useful. Schneider noted that she was surprised at how strongly having access to a network-branded prepaid card resonated with the interviewees. There was a strong emotional appeal to having access to the mainstream payments network that these cards make possible – access that the fully banked population has through credit and debit cards.

As was the case with the stigma that Rose mentioned, CFSI's research found that being without a branded card can carry negative connotations for people. Interviewees said that having the card shielded their privacy because friends and acquaintances were less likely to be aware that the cardholder had a low credit score and was unable to get a general-purpose credit card.

In addition to inclusion, the characteristics

of prepaid cards valued by research respondents fell into five other categories:

- **Convenience.** Obtaining a card is easier than opening a checking account, and cards are universally accepted.
- **Immediacy.** Among people who are managing money “by the minute,” Schneider said that the lag time between receiving a check and having access to the underlying funds is untenable.
- **Simplicity and transparency.** Schneider noted, however, that this element has become a bit more complicated in the past couple of years, and CFSI would welcome even more transparency about fees.
- **Value.** For individuals who overdraw their checking accounts, they view the fees associated with prepaid cards as less than the cost of overdraft fees on a checking account.
- **Budgeting.** Forty-one percent of respondents said that they use prepaid cards to keep to a budget. Because nearly all transactions are authorized in real time, prepaid cardholders rely on the card authorization process to prevent them from overspending.

The capacity of a prepaid card to act as a budgetary tool is “an incredibly important value proposition” among one element of the population, Schneider said. CFSI’s research found that there is a segment that is uninterested in the feature set that includes access to a credit line through the card or the ability to exceed the value loaded on the card.

What this group likes about a prepaid card is that it stops them from spending more than they have. For these individuals, Schneider noted that some prepaid providers “have been doing an admirable job of offering information” that can help those who need assistance with budgeting. She specifically mentioned the use of text messages to advise when a transaction is made and to report the remaining balance as adding value to the user.

Michelle Jun presented a different perspective based on responses to a questionnaire that Consumers Union circulated to its contact list of

about 1 million people. CU attempted to gather opinions about the Treasury Department’s rules to substantially reduce the use of checks for paying federal benefits. CU received about a thousand comments, with many people saying they are “used to their ways” and still want the option of receiving a check. A number of respondents expressed privacy concerns related to “Big Brother” knowing about their transactions.

Matt Helfrich provided some additional “voice of the consumer” findings from a survey the FMS conducted with Direct Express cardholders in 2010. The FMS found high customer satisfaction rates: 94 percent reported that they like the card and 90 percent said they would recommend it to family or friends. But the survey also revealed that cardholders do not understand all of the features and benefits, so the FMS is working with its issuer, Comerica, on an education campaign. One goal is to inform cardholders about protections such as FDIC insurance and Regulation E rights. Another goal is to teach end-users how to use the cards wisely to reduce the fees incurred or avoid them altogether. Helfrich said that because the Direct Express card charges no monthly fees and provides most other services free, it is entirely possible for a cardholder to make point-of-sale (POS) purchases, ATM withdrawals, and obtain cash back at the POS without incurring any fees whatsoever.

## F. Education, Outreach, and Cost Control

There was general agreement among issuers, sponsoring agencies, and consumer advocates that there is more to be done in bringing end-users along the learning curve. Dan Rose said that he is happy to see that more RFPs are including financial inclusion and financial literacy provisions. Since these prepaid cards are often issued to individuals who have operated outside the banking mainstream, helping them understand how to fully optimize the card and recognize its benefits plays a role in whether the success thus far realized with these programs can be sustained.

Pam Joseph spoke to the challenges of reaching end-users with educational materials. She said that U.S. Bank has surveyed people to

learn their preferences for receiving information. The bank has used video, telephone, even YouTube, and still can't connect with everyone. In fact, she said that the bank's outreach has revealed that there are some people who say they are disinclined to review any educational materials. They prefer to use the card until they encounter a problem. This creates frustration, according to Joseph, because it is to no one's benefit if the product doesn't work well for people.

Jodi Golinsky, of American Express, concurred, noting that any negative consumer experience has the potential to be imputed to the entire industry, undercutting the efforts of the many players who are working diligently to provide a good value proposition to cardholders and sponsoring agencies. Michelle Jun acknowledged that there is no one solution, but she noted the importance of having well-informed and available customer service representatives to help cardholders when they encounter a problem.

Ray Filippone said that education and marketing need to be a collaborative effort between the card issuer and the agency. Materials need to be highly visual, colorful, broken down into simple terms, and designed to be readable at a fifth grade level. He observed that elderly people have the most difficulty learning how to make optimum use of the card. Rhode Island was one of the last states to pay beneficiaries in cash and

**The provider cost for a customer service interaction with a live agent can be 20 times the cost of an interaction using automated response technology, according to a report by CBS News.**

went through a challenging process when people's payments were converted from cash payouts to checks. Now the state is repeating that experience as it trains recipients on using the cards and avoiding fees and also coaching them on the need to set aside funds for food and other needs.

The goal of these outreach efforts is to minimize the fees that cardholders pay, but Filippone also defended having limits on the extent of

free activity to mitigate unnecessary cost-generating behaviors among cardholders. The actions of a small number of cardholders can measurably increase the total costs of a program. One example is cardholders' overuse of the call center, both in terms of making a large number of calls and by opting for a more costly live operator to obtain information, such as available balance, that can easily be obtained through the less expensive automated voice response system.<sup>18</sup>

There was common purpose among issuers, networks, agencies, and consumer advocates that consumers should be able to use these cards and enjoy access to customer service resources without experiencing untoward costs. Pam Joseph and others familiar with program costs made the case that imprudent end-user pricing can undermine the efficiencies and cost savings that make these programs sustainable. Failure to consider how uncontrolled free usage can drive up total program costs puts the continued viability of these programs at risk. Put another way, the convenience enjoyed by the majority of recipients and the taxpayer savings realized by program efficiencies could be compromised unless the expensive overuse by a minority of recipients can be contained.

Michael Barr, of the University of Michigan Law School, acknowledged the tricky problem of the minority of cardholders who drive

up total program costs in wasteful and unproductive ways, such as overuse of call centers. He asked whether there are methods besides fees that could induce a change in behavior among these cardhold-

<sup>18</sup> A CBS News report, "Call Centers: Putting Customer Service on Hold," which aired on July 3, 2011, reported that the average cost of a customer service interaction with a live U.S. agent is \$7.50, over 20 times more costly than the 35 cent average cost of a voice response unit interaction. A call to an offshore customer service agent costs an average \$2.35. About 3 million agents working in American call centers receive 43 billion calls a year, or 10.75 per hour based on a 40-hour workweek.

ers. He encouraged all parties involved to think about approaches that use incentives rather than fees to modify behavior.

Such an approach is being tested in a pilot launched in April 2011 by venture firm PayPerks in partnership with MasterCard. PayPerks has developed an educational program to coach the un- and underbanked in the wise use of prepaid cards. Employing game dynamics, the program awards points to cardholders for completing educational modules, for demonstrating fee-minimizing behavior, for using the cards at the point-of-sale, and, importantly, for using prepaid cards to accumulate savings. Participants are eligible for weekly cash prizes.<sup>19</sup>

Chris Paton delved more into the costs associated with prepaid card programs and how cardholder usage can affect those costs. His company, JPMorgan Chase, is the largest issuer of public-sector-sponsored cards. JP Morgan Chase supports 12 million active cardholders of this type and receives 42 million related customer service calls every month. The resulting average of 3.5 calls per customer per month is higher than the average for other types of card and checking account products. Paton reported that there are some cardholders in these programs who call 100 times a month, check their balance multiple times a day, and don't use the voice response unit.

Paton offered some explanations for the higher rate of customer calls his company experiences with these programs. Some individuals who were previously unbanked may have less experience in keeping a record of credits and debits and may need help in keeping track of balances. Some may have an urgent need to access money as soon as it is available, so they check frequently until they can confirm that funds have been credited to their card.

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<sup>19</sup> The Payment Cards Center hosted a workshop in May 2012 facilitated by the co-founders of PayPerks. At that event, it was announced that the Treasury's Direct Express program, along with its issuing and processing partners, is adopting the PayPerks curriculum for the program's cardholders. A summary of that workshop is forthcoming. More information about PayPerks is available on its website: <https://www.payperks.com/>.

Paton explained that JPM Chase's fees to cardholders are related to an associated expense the bank incurs. For example, when the cardholder uses an out-of-network ATM, the ATM owner charges JPM Chase a fee. So Chase's fee schedule represents "defensive pricing," which encourages the use of lower-cost services (electronic statements accessible through the bank's website) instead of higher-cost ones (paper statements delivered by mail). But JPM Chase must also price competitively against others in the market while also complying with the level of free activity required by the sponsoring agency's RFP. Maximizing cardholder value while managing costs and client expectations is an ongoing balancing act for issuers in this business.

Balances and tradeoffs exist throughout the spectrum of government-sponsored cards, Paton stated. In most closed-loop programs, for example, cardholder fees are minimal or non-existent, but their usefulness to the end-user is also more limited. Open-loop cards, by contrast, provide far more utility, but the costs to the issuer to support general-purpose prepaid card programs are four to five times greater than for unbranded, closed-loop programs. The reasons for the higher costs are directly related to the greater utility to the end-user. Because general-purpose cards do more, they have higher customer service costs, they result in more fraud losses to the bank, they have higher regulatory compliance costs, and they are subject to network fees, Paton stated.

Given that managing costs for these programs is already challenging, several panelists expressed concern about a trend they are seeing in the latest prepaid-card RFPs: requests for rebates and revenue sharing with the sponsoring agency. Dan Rose noted that rebates are common in procurement card and commercial travel card programs, but the dynamics of those programs are quite different from those of social benefit programs. Similar concerns were voiced by those bank issuers and consumer advocates in attendance.

During the capstone panel, moderator Bob Hunt asked whether the government, given the card-sponsoring role it is playing, has a responsibility to educate the beneficiaries on card use.

Michael Barr responded that, in the abstract, the answer is yes, but that there is a lack of analysis and evidence of what constitutes effective financial education. He noted that the FMS is involved in educational efforts and should do more, as should the new Consumer Financial Protection Bureau.

Many of the existing education efforts have emphasized disclosing information, but Barr observed that there is a gap between receiving information and understanding it. “Providing increasingly more disclosure,” he noted, “is not always productive.” Ronald Mann expressed similar reservations about overdependence on disclosures, noting that it is “damaging as a policy matter to put so much emphasis on them. With a complicated product, you can’t just give people something to read and expect it to be understood.”

Citing research done when he was with the U.S. Treasury, Barr described attempts to map core competencies needed in consumer financial education. The learning behaviors were broken down into how one receives income, how one saves from that income, how spending and borrowing are conducted, and how one obtains financial protection. Barr challenged conferees to think about how cards can help consumers develop understanding in each of these categories.

Barr acknowledged that heterogeneity in the low- to moderate-income population presents challenges in advancing their use of financial services technology and their participation in the financial mainstream. He encouraged multifaceted approaches that address three aspects of service delivery: education, access, and consumer protection.

## V. Policy and Payment Cards

Despite the many benefits and advantages to employing payment card solutions in the public sector, there are challenges, as well. Jodi Golinsky observed that, ironically, some of these challenges come from the government in the form of regulation. For example, she described the recently enacted Durbin amendment as extraordinary in its implications.

Because of the huge dollar volumes in play, Golinsky explained, the government can typically negotiate deals that yield very thin margins for their bank partners. She argued that if the price caps on debit interchange fees contained in the Durbin amendment applied to government prepaid programs such as Direct Express, those programs might not be financially viable.

Government-sponsored debit and prepaid cards were exempted from some of the provisions of the Durbin amendment.<sup>20</sup> But those exemptions are forfeited if a card goes into negative balance or if the card allows certain features, such as recurring payments or bill payment, which are valued by payers and payees. Also, the government exemption does not apply to the routing mandates of Durbin, and these mandates have the potential for increasing backroom expenses and processing costs for card issuers. According to Golinsky, banks supporting these government programs may encounter increased costs and reduced revenues within programs that already operate on thin margins.

Golinsky also pointed to potential “regulatory uncertainty” as the new Consumer Financial Protection Bureau (CFPB) works out how it will interact with states’ attorneys general, as provided for in the Dodd-Frank Act. This can affect state government prepaid programs, which are often customized in response to state law and the objectives of one or more state agencies. How the CFPB will evaluate the variations developed by different states is, Golinsky observed, a true unknown.

Golinsky said that the true value of the payment card system — in terms of cost savings and beneficial services — is more fully demonstrated through its use by the government than in any other sector. She posited that the vigilance the industry exercises in its efforts to provide innovative, inexpensive, and safe ways to help people in their daily lives will need to be even more heightened as the regulatory environment intensifies. “This is more true,” she concluded, “in the government space than in any other place where alternative payments are being offered.”

<sup>20</sup> See §235.5 Code of Federal Regulations, Title 12.

## A. Effecting a More Balanced Policy

Ronald Mann shared Golinsky's concerns about the Durbin amendment. He was more optimistic, however, that the government's use of payment systems might drive more balanced payment policies.

He explained that payments legislation is usually influenced by one or both of two politically powerful groups: the banks that facilitate payments and the merchants who accept them. Mann posited that government agencies operating card programs can provide a counterbalance to the political influence exerted on Congress by industry lobbies. The government takes in a lot of payments, makes a lot of payments, and disburses a great deal of money, so the government has a vested interest in having a sensible system for making and receiving payments, Mann observed. He further stated that the government itself wields political power, its agencies are "systemically sensitive to consumers," and the card programs it sponsors are designed not just to reduce costs but also to provide value to consumers. These elements, combined with having governmental agencies on both sides of the market, should contribute to better government policy, Mann concluded.

Mann suggested that the government apparently had sufficient influence in the debate on the Durbin amendment to obtain an exemption so that some of its provisions would not apply to government card programs. While the immunity makes it possible for government-sponsored payment card programs to continue to deliver value and cost savings, Mann suggested that "laws which do not work well for government entities likely do not work well for private-sector organizations and individuals, either."

In order for Durbin to pass, Mann noted, carve-outs needed to be created for small banks and government. If a regulatory idea is good for the payment system, Mann maintained, it should make sense for both public- and private-sector programs and participants.

## B. Innovation, Change, and Public Policy

Ronald Mann opined that the intense RFP and contract negotiation process and competition

among banks force bids to gravitate to marginal costs. The result should be systems and networks that operate in a very lean, highly scaled, and efficient manner approaching socially optimal cost.

Mann further discussed the power of large governments in advancing new ideas. Along with its ability to mandate, the government has the capacity to move large numbers in a way that can quickly achieve the critical mass needed in a two-sided market. A decision by the government to adopt or mandate a particular method would create an "instant market," Mann stated. The ability exists to wield this capacity in the pursuit of scale economies for payment methods with the potential to reduce social cost and advance social benefit. Both Michael Barr and David Evans, of the Global Economics Group, cautioned, however, that this would have to be done judiciously and with consideration of downstream effects. They noted, for example, that government subsidization of check clearing decades ago may have contributed to the overuse of checks for a protracted amount of time when other payment forms might have been preferable.<sup>21</sup>

Still, the implications of what Evans referred to as the government's "seeding the market with digital currency in the form of millions of prepaid cards" captured the imagination of Evans and his co-panelists. Mann noted that several aspects of the Direct Express program offer stronger protections than are currently required for most prepaid cards by Regulation E. He ventured that if we learn that more expansive Reg E benefits are

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<sup>21</sup> A number of researchers have written about the relative efficiency of the check payment system. McKinsey & Company reported that nations where checks are widely used have more costly banking systems. (See Matthias M. Bekier and Sam Nickless, "Banks Need Fewer Checks, Not Fewer Branches," *McKinsey Quarterly* (February 1998).) Litan and Baily contrast the development of giro payments in Europe, where check clearing was not insured and subsidized, with the evolution of the check payment system in the U.S., where the Federal Reserve assumed certain risks and costs so that checks could clear at par value. (See Robert E. Litan and Martin Neil Baily, eds., *Moving Money: The Future of Consumer Payments*, Brookings Institution Press, 2009.) Kirstin Wells challenged the persistent use of checks when "[they] cost society more to produce and process than do electronic instruments." (See "Are Checks Overused?," Federal Reserve Bank of Minneapolis *Quarterly Review*, 20:4 (Fall 1996).)

sustainable in a public-sector program, it may indicate that they could be more broadly introduced to the general public.

Evans envisioned government program sponsors operating in a role similar to co-branded sponsors, leveraging the strength of their membership to secure discounts and perks for cardholders. The same system logic that applies to negotiated travel discounts for SmartPay cardholders could be programmed to provide benefits, for example, to Direct Express cardholders. Aggregate spending data (which reveal nothing about any individual) can identify the retailers where these cardholders most commonly shop. The management teams for the programs could use their collective buying power to negotiate special deals at those merchants for cardholders, creating some added value that might offset the occasional fee and mollify any irritation created when the card is a mandate, not a freely chosen option.

Michael Barr spoke to the power of these prepaid cards to bring unbanked, low- and moderate-income (LMI) individuals into the electronic transaction mainstream. He recalled a time when the products and services did not exist to offer unbanked households meaningful access to the electronic payments grid. Providing branded prepaid cards to more than 2 million households through the Direct Express program is significant, he noted.

In addition to access, these cards also come with some protections that the general population may have come to take for granted but which resonate with the unbanked. Citing research conducted in Detroit several years ago, Barr reported the “surprising finding” that the lost card and fraudulent use protections afforded by branded payment cards were valued by the unbanked LMI population to a greater degree than by other households.

While monthly cost was the key determinant of adoption for most households, among the unbanked, having access to basic consumer protections, provided on branded cards through Regulation E and through network dispute rights, was *equally as important a factor* as monthly cost. The protections were valued by a factor of more

than two to one when comparing low-income black women with non-black moderate-income men of similar age. This research indicated that a card product with a set of features including lost card protections, even at a monthly fee of \$9.95, is attractive to nearly 45 percent of the LMI unbanked population.<sup>22</sup>

The value that consumers place on the safeguards and functionality of general-purpose payment cards and consumers’ apparent willingness to pay for that value suggest some caution when thinking about potential limitations on the functionality of prepaid cards or the fees charged for them. In this context, Paton noted that limiting the means of adding funds or certain ways of making bill payments in order to qualify for the exemption in the Durbin amendment may result in a product that is less attractive to LMI households. On the other hand, if these features are offered, the resulting limitations on interchange revenues might shift a higher proportion of costs to prepaid cardholders. And if those fees were disallowed, either by contract or through regulation, the product may not be viable. Few would support the idea of reducing safeguards or consumer protections on prepaid cards in the hopes of obtaining offsetting cost reductions.

### C. Future Payments, Future Policy

David Evans observed that the attributes of government payment programs have applications for advancing future generation payments. Importantly, contracts sometimes extend for 10 years, allowing sufficient time to conceive, develop, and commercialize “the next new thing.” He also noted the significance of endowing millions of

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<sup>22</sup> See slides 5-7 of Barr’s conference presentation, available at <http://www.philadelphiafed.org/consumer-credit-and-payments/payment-cards-center/events/>. In addition to lost card protections, the major payment card brands (Amex, Discover, MasterCard, and Visa) also give cardholders chargeback rights. See Mark Furletti and Stephen Smith, “The Laws, Regulations, and Industry Practices That Protect Consumers Who Use Electronic Payment Systems: Credit and Debit Cards,” Payment Cards Center Discussion Paper (January 2005), or Arnold S. Rosenberg, “Better than Cash? Global Proliferation of Debit and Prepaid Cards and Consumer Protection Policy,” The Berkeley Electronic Press, bepress Legal series, Paper 766 (2005).

people with digital currency in the form of pre-paid cards, many of whom are also equipped with mobile telephones. This is taking place within an environment where Internet access is increasingly expanding to mobile phones and other portable devices. Software platforms now exist in the cloud, and more people are writing software for open systems.

The implication of all of this for payments is the merging of the physical environment with the virtual online world, so that all point-of-sale devices are connected to the Internet, while we, as consumers, are carrying around Internet-connected devices. Such is an environment of ubiquitous interactive capability. Just as data have become important in the online world for on-screen advertising, offering discounts à la Groupon, once payment transactions at physical points of sale are integrated with the virtual world, the information related to the transaction has value incremental to, and apart from, the core payment function of the transaction.

In the online world, Evans continued, Google is interested in payments because it is interested in selling advertising and in offering coupons. PayPal is attempting to enable its user base to make PayPal transactions at physical points of sale. These Internet giants, along with Apple and others, are working on interesting innovations that are likely to prove disruptive to the payment card system. Evans suspects that this will require reinvention of business models by the established players. It may also have implications for regulation. He also expects that information and interactivity will come together to provide new value to merchants, which may increase their willingness to pay for advanced payments technology.

All three panelists considered how the earnings models in this scenario would work across the various participants. Mann noted that the card system obtains profits by pricing payment services slightly above costs. Google can price below cost because it is making money on advertising. Apple can operate payments below cost because it is making money on hardware and applications. These varying models would create tension among competitors who are pricing above cost, at cost,

and below cost. Furthermore, Mann noted, the dominant traditional entities are subject to both regulation and prudential supervision, while others are not.

Barr added that banking regulations in the United States have historically included both consumer protections and prudential accountability. He noted that the approach is very different internationally. If we shift to a model that permits nonbanking payment systems that are not regulated in the same way as bank-based ones, Barr warned that “a race to the bottom” could result.

With all of the potential for disruptive innovation in payments, the examples presented at the conference of private-sector innovations spurred along by government adoption might provide a template for navigating the future in a way that considers payments efficiency, system stability, and consumer protection in a comprehensive way.

Paton expects that we will continue to see migration from paper to electronic payments. He also thinks that limited staff and budgets for state and federal agencies will motivate continued efforts to achieve efficiencies. Regulations are necessary and essential, and he agrees with the vast majority of regulations that are in place. He has observed some worrisome trends regarding state-specific regulations that could potentially introduce a patchwork compliance approach, thus increasing costs.

## VI. Conclusion

Use of the payment card system within the public sector provides a microcosm of the two-sided platform construct for cards, where tensions continually operate among the players involved. A two-sided network always involves at least three parties — a card company, a cardholder, and a card-accepting merchant — or four in the case of Visa and MasterCard bank cards. Other parties involved as the network expands include card sponsors, third-party processors, and value-added resellers.

Over time, the payment card system has grown more complex, which enables it to provide solutions to many complicated payments-related

problems. Indeed, one reason the system has become more complex is precisely *because* solutions have been built for problems far different from those considered in the original mid-20<sup>th</sup> century design. Over the decades, the payment card system has been expanded, adapted, and retrofitted to incorporate new technologies, to reach a broader base, and to function in new channels — in short, to be useful and relevant into the 21<sup>st</sup> century.

By this point in its evolution, the card system functions as a general-purpose technology, a concept introduced in Bob Hunt’s opening remarks. This impression was strengthened as presenters discussed the robust capabilities that have been built on the basic financial transaction to create additional efficiencies and added value to the government, and to society, through spillover effects.

Some of the efficiencies have resulted from the transformation of information into digital data that can be moved forward multiple times in a process without needing to be manually re-entered. This saves time and averts opportunities for data-entry errors at each stage of the process. Digital information also opens up opportunities for data mining. Value has already been gained from analyzing these data to inform decision-making, provide management reporting, and mitigate fraud. These advances in the use of payment-related data evoke the words of former Citibank chairman Walter Wriston, which are inscribed in the lobby of New York’s Library of Science, Industry, and Business: “Information about money has become almost as important as money itself.”

Many of the advances in the capture and transmission of purchase data have been brought about by the government operating as an incubator for innovation and as a change agent in achieving critical mass. The government has also created some specialized applications that have introduced efficiencies that reduce the costs of running the government, thereby benefiting taxpayers.

Innovation often comes into conflict with behavior that is reflexive and habitual. When this is the case, questions of fairness arise. Should

individuals have to change behavior because of a government mandate? Conversely, should a minority of individuals be able to obstruct cost-saving measures because they do not want to adapt to a new routine?

Another fairness question emerges in the use of prepaid cards to replace checks in distributing funds to citizens. Are the savings that agencies are realizing coming from efficiency, or are administrative costs merely being shifted to the cardholder?<sup>23</sup> The efficiencies of electronic payment have been demonstrated in many other environments, so there is reason to think they exist. But much of the case for prepaid has been based on the rationale that card fees paid by the consumer are cheaper than the fees they would otherwise pay to cash checks, rather than on the superiority of electronic versus paper payments for the payer.

Adoption of the payment card system by the government reflects the dominant culture and economy of the 21<sup>st</sup> century. Cards have become a leading method of consumer payment and are accepted by most merchants who provide consumer goods and services. While most Americans are accustomed to using debit, credit, and/or prepaid cards, some individuals are obtaining cards for the first time through a government-sponsored program. Challenges exist in how best to reach these cardholders with effective educational messages. Card issuers and government agencies have employed print, Internet, video, telephone, and even YouTube, and there are still some cardholders for whom these messages are not effective. Cardholder education is particularly important in creating understanding among cardholders about how to use the cards in ways that reduce the likelihood that they will incur a fee.

While much criticism has been directed at these fees, there is a legitimate need to balance the moral hazard of unchecked free ATM access, live operator, and other expense-generating activity with the need to keep fees minimal for end-users. Nonetheless, issuers are being challenged

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<sup>23</sup> See, for example, “Unemployment Compensation Prepaid Cards: States Can Deal Workers a Winning Hand by Discarding Junk Fees,” National Consumer Law Center (May 2011).

to find approaches that use “carrots” instead of “sticks” to modify the behavior of the outliers in the cardholder base whose overuse drives up total program costs and thus the costs borne by all cardholders in the program.

While the struggle to find best practices in cost mitigation and cardholder education continues, one best practice that received endorsement from a cross-section of panelists was including key decision-makers in piloting new card programs. From state unemployment insurance card programs to the military’s reengineered travel card program, people who could influence the final design and delivery were involved in beta tests. First-hand experience with what the larger end-user population will encounter in full rollout not only improves product design but also turns those in authority into program advocates.

Some of the most significant information resulting from the conference enhanced understanding of areas where government card programs have drawn criticism, such as in the area of fraud. Fraud accounts for only \$60 of every \$1 million of card spend, less than the rate of some nongovernment portfolios and programs. While the reporting of some of these fraud events would suggest that card use has a causal relationship to fraud, conference presenters knowledgeable and familiar with the topic reported that cards simply make fraud more transparent, sometimes revealing problems that already existed but had remained hidden.

Recalling panelist David Shea’s observation that “transparency without context is confusion,” the conference provided abundant context for better understanding the government’s use of the payment card system.

## APPENDIX A

### The Durbin Backdrop

Throughout the conference, references were made to the Durbin amendment, its effect on debit and prepaid card interchange fees, and exemptions contained within the amendment for small banks and government-sponsored prepaid cards. For those unfamiliar with the amendment and the circumstances that precipitated it, a brief synopsis is offered here to provide context for comments included in the body of this document.

The Durbin amendment to the Dodd-Frank Act, which was passed by Congress in 2010, limits the interchange fees that card-issuing banks with assets of \$10 billion or more can collect from card acquirers, the banks that enter merchants' debit card receipts into the clearing and settlement system. The amendment was a controversial one. Over 11,000 public comments were submitted in the two months after the Federal Reserve Board issued its initial draft rules in December 2010.

The controversy was not surprising given the fierce debates that have taken place within the industry, the legal system, and the court of public opinion over interchange and its growing cost to the merchant community. While the battle has largely been perceived as one between merchants and card-issuing banks, consumers who are customers of both merchants and banks also stand to be affected. A brief discussion of payment economics helps to elucidate this.

A payment is a transfer of denominated currency between the two parties to a transaction where an exchange of value has taken place. In a routine purchase transaction, the buyer obtains value in the form of the good or service received. The merchant obtains value from profits on the sale, achieved by adding a markup over his fixed and variable costs — inventory, operations, rents, distribution, payroll, etc. — to the price of the merchandise sold. The related payment costs will be borne by one or both of those two parties. This cost could be shared equally or in

proportion to the benefit derived by each party, with the side receiving greater benefit subsidizing the other side.

The division of who pays, how much, and in what form can vary by type of payment method, and practices vary from country to country. While banks facilitate payments and incur costs in doing so, they do not directly benefit from the corresponding value exchange between the buyer and seller involved in a transaction. For their role in mediating payments, banks are compensated through fees that, in the United States, come disproportionately from the seller's side of the transaction. This is the case whether the consumer's payment takes the form of cash, check, payment card, or food stamps. In many other countries, consumers directly support a larger share of their country's payment system costs through bank account and transaction fees. In the United States, however, through a confluence of convention, intervention, and competition, these fees have largely disappeared; free checking and no-annual-fee payment cards are the norm.

By the turn of the 21st century, consumers' displacement of paper payments with electronic card-based payments was evident. In 2000, debit cards accounted for less than 6 percent of the dollars transacted in the U.S. consumer payment system and 7.4 percent of purchase transactions. By 2010, debit share had grown to 20 percent of dollar volume and over 28 percent of consumer payment transactions. During this time, check use, which dominated in 2000 at 43 percent of dollar volume and 26 percent of transactions, slid to 18 percent of dollars and 11 percent of transactions. Cash share over that time declined from 44 percent to 33 percent of transactions, but cash dollar share remained stable at 19 percent because the average ticket of a cash transaction increased 50 percent, from \$21 to \$31.

Before the sharp uptick in the trend occurred, debit cards had been in the marketplace for over a

decade, experiencing steady but very slow growth. The reasons for the change in trajectory include growth in the number of people who have debit cards, growth in both the categories and the number of merchants that accept cards, and deployment of PIN pads at merchant locations. In 1995, there were only 0.5 million PIN devices at point-of-purchase; 10 years later, there were 5 million.

With these conditions in place, an explosion in debit card use by American consumers started at the end of the last century and continued through the first decade of this century. This change in consumer payment preferences created a corollary increase in the costs that merchants were paying to accept payment cards. While there were some offsetting savings – reduced cash-handling costs and decreased check fraud losses, for example – the observable payment processing line item on merchants’ budgets was increasing at an appreciable rate and was doing so over a succession of years.

Merchants and their trade associations coalesced around efforts to reduce these costs. Since PIN debit costs were less than those for signature debit, many merchants steered cardholders to use PINs as a way to control costs. A few offered discounts to customers who paid with cash. Some attempted to create alternative interchange-free payment products, such as decoupled debit, but consumer response was unenthusiastic.

Merchants also took up litigation and sought legislative relief. Senator Richard Durbin of Illinois was successful in adding an amendment to the 2010 Dodd-Frank Act. The culmination was a change to the Electronic Fund Transfer Act to state, “...the amount of any interchange transaction fee that an issuer receives or charges with respect to an electronic debit transaction must be reasonable and proportional to the cost incurred by the issuer ...” in facilitating that transaction.

The Durbin amendment included as recoverable costs the incremental costs of authorization, clearing, and settlement of the transaction. Certain fixed costs of operating a debit program, servicing costs, and a markup for profit could not be included in the interchange fee. Exclusions were made in

the amendment for two categories where lawmakers wanted to mitigate anticipated shocks: banks with assets under \$10 billion and government-sponsored card programs.\*

Dodd-Frank authorized the Federal Reserve Board to develop regulations consistent with the provisions of the Durbin amendment. The resulting Regulation II set an interchange price cap of 21 cents per transaction, allowed a fraud loss adjustment of 5 basis points ad valorem, and allowed for a potential additional 1 cent fraud prevention adjustment. The effect was a 45 percent reduction in revenue to the cardholder’s financial institution. The average interchange earned from a debit transaction is expected to fall from 44 cents to 24 cents.

Another provision of Regulation II restricts how card issuers may select networks on which they process transactions. For some issuers, this would require supporting the interface with at least one additional network. In addition to the upfront system conversion costs, there would be an ongoing loss of operating efficiencies, adding costs for financial institutions that offer debit cards. The exemptions for small issuers and government-sponsored programs do not apply to this provision; all debit card issuers would be affected.

The final rule set was released by the Federal Reserve Board on June 29, 2011, less than two weeks prior to the Payment Cards Center’s conference on Government Use of the Payment Card System.

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\*For specific information on recoverable costs allowed in the final rule and exemptions allowed under the amendment, see the memorandum from Federal Reserve Board Vice Chair Janet Yellen, “Final Rule on Debit Interchange Fees and Routing and Interim Final Rule on Fraud Prevention Adjustment” (June 22, 2011).

Other sources that will help the reader’s understanding of the issues can be found in David S. Evans and Richard Schmalensee, *Paying with Plastic*, The MIT Press, 2005; Robert E. Litan and Martin Neil Baily, *Moving Money - The Future of Consumer Payments*, Brookings Institution Press, 2009; Mats Bergman, Gabriela Guibourg, and Bjorn Segendorf, “Card and Cash Payments from a Social Perspective,” *Sveriges Riksbank Economic Review*, February 2008; Fumiko Hayashi, Richard J. Sullivan, and Stuart E. Weiner, “A Guide to the ATM and Debit Card Industry 2006 Update,” Federal Reserve Bank of Kansas City; “A Retailer’s Guide to Electronic Payment Systems Costs,” The Food Marketing Institute, 1998; and *The Nilson Report*, issues 753 (December 2001) and 935 (December 2011).

## APPENDIX B

### Conference Agenda

*Monday, July 11, 2011*

- 1:00 p.m.      **Opening Remarks**  
Bob Hunt, Vice President and Director, Payment Cards Center, Federal Reserve Bank of Philadelphia
- 1:30 p.m.      **Opening Panel: Finding a 360° Solution**  
Panelists representing different perspectives will undertake a high-level discussion of why public agencies are interested in using payment card alternatives for making payments, receiving payments, and distributing funds. The discourse will introduce participants to the strategic boundaries that are created when constituents are not in complete alignment and will open a dialogue on the need for negotiating these discordant areas to achieve acceptable solutions for all parties.
- Moderator:**  
Susan Herbst-Murphy, Industry Specialist, Federal Reserve Bank of Philadelphia
- Panelists:**  
Jodi Golinsky, Chief Prepaid Counsel, American Express Company  
Richard Gregg, Fiscal Assistant Secretary, U.S. Department of the Treasury  
Pamela Joseph, Vice Chairman, Payment Services, U.S. Bank  
Michelle Jun, Senior Attorney, Consumers Union  
Robert Schmitt, Manager of Banking Services, Department of Treasury, Commonwealth of Virginia
- 3:30 p.m.      **Panel on Government Acceptance of Cards for Payment**  
This panel will look at public-sector entities as card-accepting merchants and will examine the reasons considered in the decision to accept cards, the response of and adoption by payers, and special rules and payment intermediaries that operate in this segment.
- Moderator:**  
Dubravka Ritter, Industry Specialist, Federal Reserve Bank of Philadelphia
- Panelists:**  
Bill Brushwood, Director, Settlement Services Division, Department of Treasury, Financial Management Service  
Greg Gentile, President, Govolution LLC  
Kevin Phalen, Commercial Card and Comprehensive Payables Executive, Global Treasury Services, Bank of America  
Tim Spence, Partner, Oliver Wyman

*Tuesday, July 12, 2011*

- 8:30 a.m.      **Opening Remarks**  
Loretta Mester, Executive Vice President and Director of Research, Federal Reserve Bank of Philadelphia

8:45 a.m. **Panel on Government as Commercial Card Client**  
This panel will discuss the factors considered in the decision to implement a procurement or other commercial card program, along with various programs' experience in achieving cost savings, improving control and reporting, and attaining employee satisfaction.

**Moderator:**

Stephanie Wilshusen, Industry Specialist, Federal Reserve Bank of Philadelphia

**Panelists:**

Paul Kurtz, State Cards Program Manager, Georgia Department of Administrative Services

Rick Malcolm, Head of Prepaid and Commercial Partnerships, Visa Inc.

Gonca Latif-Schmitt, Managing Director, Global Transaction Services, Citi

David Shea, Director, Office of Charge Card Management, Federal Acquisition Service, U.S.

General Services Administration

10:45 a.m. **Panel on the Use of Payment Cards to Distribute Public Funds**  
Topics will include the rationale for cards as an alternative to checks; the RFP and vendor selection process; the government's role in protecting beneficiaries from excessive fees; customer service and satisfaction issues; cardholder education; and the successes and lessons learned in these programs.

**Moderator:**

Philip Keitel, Industry Specialist, Federal Reserve Bank of Philadelphia

**Panelists:**

Raymond Filippone, Assistant Director Income Support, Rhode Island Department of Labor & Training

Matt Helfrich, Senior Program Analyst, Department of Treasury, Financial Management Service

Chris Paton, Managing Director, Treasury Services, JPMorgan Chase

Daniel Rose, Vice President, Public Sector Department, MasterCard Worldwide

Rachel Schneider, Vice President, Innovation and Research, Center for Financial Services Innovation

1:15 p.m. **Capstone Panel**  
In this finale to the conference, the panelists will review the costs, benefits, interests, concerns, successes, and challenges articulated throughout the conference and consider these factors within the context of legislative and judicial initiatives that may affect the feasibility of current and future public-sector card programs.

**Moderator:**

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

**Panelists:**

Michael Barr, Professor of Law, University of Michigan Law School

David Evans, Chairman, Global Economics Group

Ronald Mann, Professor of Law, Columbia Law School

## APPENDIX C

### Conference Participants

Brett Adams	MasterCard Worldwide
Randi Adelstein	MasterCard Worldwide
Nora Arpin	Comerica
Elizabeth Baltierra	Financial Crime Enforcement Network
Michael Barr	University of Michigan Law School
Barbara Brumley	Federal Reserve Bank of St. Louis
Bill Brushwood	U.S. Department of the Treasury
Bob Bucceri	Electronic Funds Transfer Assoc.
Karen Burnham	Federal Reserve Bank of Philadelphia
Peter Burns	Heartland Payment Systems
Julia Cheney	Federal Reserve Bank of Philadelphia
Dena Corson	U.S. Department of the Treasury
Paul Crowe	U.S. Department of the Treasury
Tracy Dangott	JPMorgan Chase
Leonard DeProspero	Janney Montgomery Scott
JB Donaldson	CS Xerox
Ronel Elul	Federal Reserve Bank of Philadelphia
Steven Evans	Visa Inc.
David Evans	Global Economics Group
Raymond Filippone	R.I. Dept. of Labor & Training
Greg Gentile	Govolution LLC
Bruce Glazer	Wellington Management Co.
Jodi Golinsky	American Express Company
Brian Greehan	Bank of America
Ellen Greene	Wells Fargo
Richard Gregg	U.S. Department of the Treasury
Gayle Griffith	Federal Reserve Bank of Philadelphia
Eric Grover	Intrepid Ventures
John Hagy	Meta Payment Systems
Matt Helfrich	U.S. Department of the Treasury
Kurt Helwig	Electronic Funds Transfer Association
Susan Herbst-Murphy	Federal Reserve Bank of Philadelphia
Gail Hillebrand	Consumer Financial Protection Bureau
Robert Hunt	Federal Reserve Bank of Philadelphia
James Jeffries	U.S. Department of the Treasury
Pamela Joseph	US Bank
Michelle Jun	Consumers Union
Jerry Kane	SEPTA
Philip Keitel	Federal Reserve Bank of Philadelphia
Craig Kessler	Internal Revenue Service
Rachael Kling	Federal Reserve Bank of Philadelphia

Melissa Koide	Center for Financial Services Innovation
Paul Kurtz	State of GA Dept. of Admin. Services
Johannes Kuttner	The Hudson Institute
Gonca Latif-Schmitt	Citigroup
Rick Malcolm	Visa Inc.
Ronald Mann	Columbia Law School
Frank Martien	First Annapolis Consulting
Thomas McCrohan	Janney Capital Markets
John McGee	SEPTA
Tim Mead	Federal Reserve Bank of Richmond
Orson Morgan	Bank of America
Dede Myers	Federal Reserve Bank of Philadelphia
Harriett Newburger	Federal Reserve Bank of Philadelphia
Patricia O'Donnell	JPMorgan Chase
James van Opstal	Federal Reserve Bank of Philadelphia
Jonathan Palmer	Network Branded Prepaid Card Assoc.
Dee Dee Parrish	Bank of America
Christopher Paton	JPMorgan Chase
Avi Peled	Federal Reserve Bank of Philadelphia
Kevin Phalen	Bank of America
Richard Pileggi	US Bank
Stephen Pipito	Federal Reserve Bank of Philadelphia
Helen Reilly	US Department of the Treasury
Dubravka Ritter	Federal Reserve Bank of Philadelphia
Mamta Rodrigues	MasterCard Worldwide
Daniel Rose	MasterCard Worldwide
Lauren Saunders	National Consumer Law Center
Robert Schmitt	Commonwealth of Virginia
Rachel Schneider	Center for Financial Services Innovation
David Shea	U.S. General Services Administration
Oz Shy	Federal Reserve Bank of Boston
Alan Smith	Bank of America
Timothy Spence	Oliver Wyman
Cara Stepanczuk	Federal Reserve Bank of Philadelphia
Joe Stone	Systems Methods Inc.
Nicholas Strychacz	Federal Reserve Bank of San Francisco
Jeannine Szostek	Federal Reserve Board of Governors
Milissa Tadeo	Federal Reserve Bank of Philadelphia
Paul Tomasofofsky	Secure Remote Payment Council
Dave Turner	ACS Xerox
Heather Vogelsong	State of Oregon
Robert Williams	Federal Reserve Bank of Atlanta
Stephanie Wilshusen	Federal Reserve Bank of Philadelphia

## **APPENDIX D**

### **Bibliography of Related Publications**

EBT Industry Council. "Debit and Stored Value Cards for Government: A Growing Trend but States Could Do More," EBT Industry Council (November 2006).

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leader and innovator in  
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and service.”

Charles I. Plosser  
*President*



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**Bob Hunt**  
*Vice President and Director*

**Julia Cheney**  
*Manager, Research and Programming*

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.