DISCUSSION PAPER
PAYMENT CARDS CENTER

Prepaid Cards: An Important Innovation in Financial Services*

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Summary: *This paper describes the characteristics of closed-system and open-system prepaid cards. Of particular interest is a class of open-system programs that offer a set of features similar to conventional deposit accounts using card-based payment applications. The benefits that open-system prepaid cards offer for consumers, providers, and issuing banks contribute to the increased adoption of these payment applications. Using these cards, consumers can pay bills, make purchases, and get cash from ATM networks. At the same time, consumers who hold prepaid cards need not secure a traditional banking relationship nor gain approval for a deposit account or revolving credit. By offering prepaid cards, issuing banks may meet the financial needs of consumers who may not otherwise qualify for more traditional banking products and these banks may do so with a card-based electronic payment application that essentially eliminates credit risk for the bank.*

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I. Introduction

The prepaid card market is one of the most dynamic and fastest growing segments of the retail financial services industry. Based on a different business model than traditional credit and debit cards, prepaid cards require cardholders to “pay early” for future purchases of goods and services as opposed to debit-card holders, who pay at the time the purchase is made, or credit-card holders, who pay after the purchase has been made. By requiring cardholders to pay early, the prepaid model essentially eliminates nonpayment risk for the card-issuing bank. Therefore, banks have more flexibility to broadly distribute these cards and less concern about the credit risk posed by consumers who may not have formal banking relationships or strong payment histories.

The range of customization possible in product functionality and program servicing has led to the development of numerous and varied prepaid card programs. As explained by Cheney (2005), prepaid card programs can be classified as either closed system or open system, but these terms are not always absolute and programs can be structured to fall somewhere in the middle of these two types. For the purposes of this discussion, the characteristics of typical closed-system and open-system programs are described in more detail.

II. Prepaid Card Program Characteristics

The first nonphone-card prepaid programs were launched in the mid-1990s by national retailers such as Blockbuster Video and Kmart.[1] Their motivation was to replace paper-based gift certificates with lower cost, electronic payment cards that also provided

[1] Tom Locke, “Billions in Gift Cards: First Data Plans to Add Loyalty Feature in ’05,” *Denver Business Journal*, December 10, 2004 print edition

improved tracking of balances and redemption. The processing systems required to authorize and settle the transaction did not run on debit- and credit-card national payment networks but, instead, leveraged third-party processors to support the unique operational requirements of these prepaid retailer gift card programs. As so-called closed-loop systems, retailer gift card programs limit the redemption of the card's value to retail outlets of just one or maybe a few merchants. Retailer gift cards have become very successful and widely adopted by consumers. In fact, in 2003, retailer gift cards accounted for $42 billion,[2] or more than half of the $69.5 billion[3] in total value loaded on prepaid cards that year.

Because they are processed using the same systems as the network brand – MasterCard, Visa, American Express, or Discover – open-system prepaid card functionality more closely resembles that offered by traditional credit and debit cards. Open-system prepaid cards can be used to withdraw funds from ATMs as well as to make retail purchases or pay bills, either in person, online, or over the phone— effectively anywhere the network brand is accepted. In essence, open-system prepaid cards, based on the "pay early" business model, can provide cardholders with access to the payment system in much the same ways as do traditional credit and debit cards but without the need for a more formal banking relationship. Two examples of *open-system* prepaid card programs described in more detail in the next subsections are payroll cards and general spending reloadable cards. We chose to focus on these prepaid card programs because they offer a card-based payment application that provides functions similar to those

[2] Based on a report by TowerGroup. "Market Share Gains Ahead for Bank-Issued Gift Cards?" TransAct, published by America's Community Bankers, Spring 2004 Vol. 2, No. 2. (www.americascommunitybankers.com/publications/transact/ta04spring.pdf)
[3] *The Nilson Report*, Number 823, December 2004, p. 6.

attainable through conventional deposit accounts. Increasingly, persons without a deposit account or individuals who have a preference for “pay early’ financial services products are turning to payroll and general spending reloadable cards as a way to meet their financial transactions needs.[4]

Payroll Cards

In 2001, Visa and MasterCard agreed to support payroll cards branded with their networks, introducing open-system payroll cards to the market. As a result, payroll cards could be used at locations that process personal identification number (PIN) transactions as well as at locations where the network brand is accepted. The increased utility made open-system payroll cards an attractive option for workers without traditional bank accounts because they can use the card to withdraw cash at ATMs, pay bills, and initiate transactions at both PIN and non-PIN merchant locations. In many cases, they can also initiate transactions online or over the phone.

In addition, payroll cards provide a more convenient, safer, and, in many cases, less expensive way for employees to access their wages compared with cashing paychecks at money services businesses and, subsequently, carrying large amounts of cash. Although open-system and ATM-access-only payroll cards are still available, the introduction of open-system payroll cards spurred several large card-issuing banks to develop programs of their own.[5] According to Mercator Advisory Group, spending on payroll cards grew from $15 billion in 2003 to $29 billion in 2004. Additionally, the

[4] Consumers without a deposit account, the unbanked, may choose for personal reasons not to hold a checking account or may be precluded from opening an account either because of a bad credit history or previous banking experiences that resulted in their being placed on ChexSystems, a consumer-reporting agency established for its member financial institutions. For more information about ChexSystems, go to www.consumerdebit.com.

[5] http://usa.visa.com/about_visa/newsroom/press_releases/nr33.html

estimated number of payroll cards in circulation doubled to 2.2 million cards during this same period.[6] Clearly, employers and their workers are increasingly adopting payroll cards.

Employers recognize the cost advantage of paying their employees through electronic payments using payroll cards in lieu of paper checks.[7] For the typical employer, the cost to cut a payroll check is roughly between $1 and $2,[8] while the per unit cost for making electronic payments (transmittal of funds to a prepaid card account, a checking deposit account, or a savings deposit account) is about $0.20.[9] Annually, employers save between $20 to $50 for each employee paid electronically.[10]

While open-system payroll cards are issued by financial institutions, the programs are typically marketed by financial institutions or payroll processing firms to employers, rather than directly to workers. Once an employer enrolls in a payroll card program, cards are distributed to employees directly from the financial institution, a third-party service provider that acts as an agent on behalf of the financial institution, or the employer. Third-party service providers may be responsible for handling card issuance (i.e., delivering payroll cards to the employer or directly to the employee), processing transactions made on the payroll card account, providing a range of program administration services for financial institutions or employers, and offering customer

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

[7] Consumers Union provides a list of questions for employees to ask concerning payroll cards and offers employers guidance about how to choose a payroll provider to best meet their needs. This document is available at www.consumersunion.org/pub/core_financial_services/000920.html .

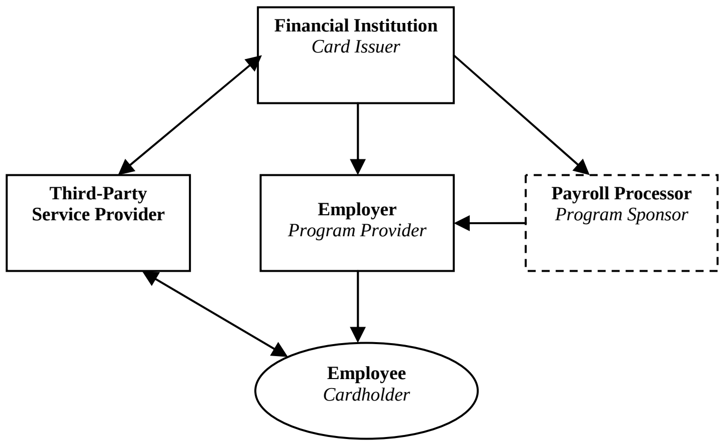
[8] By reducing paper payroll processing, employers also process fewer stop payments, replacements of lost or stolen checks, and check re-issuances.

[9] See Miezejeski (2004).

[10] Eric Miller, "Payroll Debit Cards," Stored Value: The Shape of Things to Come Conference Proceedings, Pelorus Group, October 2004. In addition to saving the costs of check printing, employers also save by reducing or eliminating costs related to distribution, escheat compliance, replacement of lost or stolen checks, check fraud, error correction, and reconciliation for termination pay.

services and support to cardholders. Figure 1 illustrates a simple open-system payroll card program.[11]

Figure 1. Payroll Card Program



Each pay period, employers electronically transmit employees' wages and salaries through the automated clearinghouse system (ACH) into pooled accounts and/or sub-accounts established for each employee at the financial institutions. Once the accounts have been funded, employees can access cash from ATMs or make debit transactions with their payroll cards. In a few instances, payroll card accounts are set up as electronic deposit accounts, but this arrangement remains the exception to the rule.[12] Because payroll cards are a method of disbursing wages and salaries, state labor laws generally influence the contractual arrangement made between the employer and the financial institution.[13] For example, some states do not allow paying employees with a payroll

[11] For a detailed technical discussion about payroll card transactions, see Bradford, Davies, and Weiner (2003).
[12] As of this writing, we have identified three payroll card providers or processors that set up payroll card accounts as electronic demand deposits. They are IndiGoCard, West Suburban Bank, and Directo.
[13] For more details, see Frumkin, Reeves, and Wides (2005).

card,[14] while other states require that a worker be given his or her wage or salary at no cost. To meet this requirement, some programs provide payroll cardholders with at least one ATM withdrawal free of charge.[15] As a result, state labor laws also influence the program costs for the employer and, ultimately, how these costs are shared between the employer and the employee. Program costs and the sharing of these costs also help determine the functionality provided as part of a particular employer's payroll card program. In research comparing payroll card programs to alternatives such as deposit accounts and general spending reloadable prepaid card programs, Rhine and Su (2005) found that for workers without a traditional deposit account, branded payroll cards can be a cost-effective way to meet their financial transactions needs.[16] Some reported examples of employers offering payroll cards programs are Fed Ex, UPS, U-Haul, Manpower Inc. and other temporary employment agencies, members of the National Restaurant Association, McDonald's, Denny's, Coca-Cola, Blockbuster Video, Office Depot, and Sears.

<u>General Spending Reloadable Cards: Nonbank Program Providers</u>

Typically, general spending reloadable cards are marketed directly to consumers in a growing range of programs often targeted to particular consumer segments. *Nonbank program providers or sponsors* usually sell this type of prepaid card and may have business arrangements with money service businesses or retailers, who act as agents on behalf of nonbank program providers. Check-cashing businesses and convenience stores

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[14] As of April 2005, six states do not allow payroll cards: Maryland, Alaska, Hawaii, Minnesota, Montana, and Vermont (Johnston Jarboe, 2005).

[15] In addition, the EFTA provides that no person may require a consumer to establish an account for receipt of EFTs with a particular institution as a condition of employment (EFTA § 913, 15 U.S.C. § 1693(k)).

[16] Rhine and Su (2005) run simulations showing how costs can vary for consumers making financial transactions with different types of financial service products, including payroll cards, general spending reloadable cards, checking accounts, and check cashier services.

are examples of agents used by program providers.[17] All network branded prepaid cards must be issued by a partnering financial institution that is a member of the Visa or MasterCard Association or by American Express or Discover.

Consumers obtain general spending reloadable cards by applying over the telephone, on the Internet, or at an agent location. Typically, the program provider establishes pooled accounts or cardholder sub-accounts drawn on the pooled account with a financial institution. The functions or features available to holders of general spending reloadable cards depend on the program, most of which are open-system programs. These functions may include cash withdrawals at ATMs and any combination of remaining features offered through network branded prepaid cards, as described in earlier sections. Funds can be loaded onto the card account in a variety of ways, including electronic transfer of wages and salaries, account-to-account transfers, cash loads at a program provider's or its agents' locations, and paper checks sent by mail or accepted by agents of the program providers.[18] Program fees may be assessed for a range of cardholder activity. Fee structures will vary across general spending card programs; for example, depending on the program, cardholders may pay fees — typically set by the program provider — related to account setup, monthly maintenance, fund loads, cash withdrawals, purchase transactions, and balance inquiries, among other types of account-based activities.[19]

To support general spending reloadable card programs, third-party service providers, the financial institution, or the program provider if it is vertically integrated

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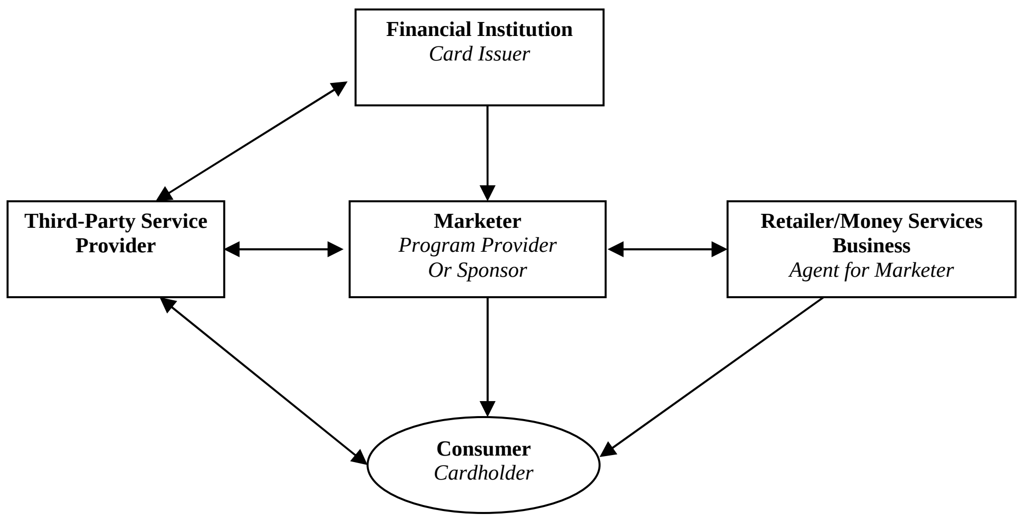
[17] An example is the business arrangement between Secure Cash Network, Inc., a prepaid card provider, and Circle K, a convenience store chain with roughly 1,900 company-operated locations in 16 states primarily located in the southern, western, and midwestern parts of the country.

[18] An example of an account-to-account transfer is when a family member deposits the reloadable general spending cardholder's paycheck into his or her own checking account. The paycheck funds are then moved via an ACH account-to-account transfer to the reloadable general spending card account.

[19] See Rhine and Su (2005) for a broader discussion of cardholder fees associated with general spending reloadable cards.

perform transaction processing, program administration, and customer services. Figure 2 depicts a simple general spending reloadable card program offered by nonbank providers.[20]

Figure 2. General Spending Reloadable Cards: Nonbank Program Providers



The numerous market participants associated with providing these programs, combined with the range of potential functionality and the many possible ways to load funds to these cards, result in much product variation, particularly in pricing structures, across general spending reloadable card programs. Examples of general spend reloadable card programs offered by nonbanks include NetSpend All-Access, GreenDot, and the Rush card.

<u>General Spending Reloadable Cards: Financial Institutions as Program Providers</u>

Among the myriad of general spending reloadable card programs in the marketplace are those directly offered by financial institutions. Two types of prepaid

[20] For a technical discussion about the role of nonbanks in the payments system, see Bradford, Davies, and Weiner (2003).

programs provided by banks are highlighted here: branded remittance cards and teen cards. An increasing number of bank-issued prepaid cards are being used to make remittances (global money transfers).[21] According to a recent report issued by Aite Group (2005), the number of U.S.-issued Visa and MasterCard branded prepaid money transfer cards is likely to reach over 1 million in 2006, a substantial increase from the 400,000 cards issued in 2005. In terms of dollar volume, almost 2 percent of the $269 billion world volume is expected to flow through these prepaid cards.

To explain how these programs might work, two *basic* types of prepaid card programs that offer a remittance feature are highlighted. In each example, the sender of the remittance lives in the U.S, while the recipient resides outside the country.

In the first example, the recipient is either unbanked (without a checking or a savings account) or has a desire for a general spending reloadable card. The sender uses a bank (or agent financial institution) to electronically transfer money to a pre-established, branded prepaid card account using cash, an existing bank account, or a payment card. Then a bank in the sender's or recipient's country issues a prepaid card to the recipient. The recipient uses the card to obtain cash at an ATM machine or at merchant locations that participate in the brand's payment network.

In the second example, the sender has a branded prepaid card and access to the Internet. In this case, the sender uses banks or private service providers to gain access to online portals to send funds to the recipient. The recipient receives the funds either in cash or in credits made to a pre-existing prepaid card account or a bank account.

[21] As reported by Aite Group (2005), the top three issuers of remittance cards in the U.S. market are Bank of America, U.S. Bank, and Citigroup.

These two examples demonstrate the growing number of innovative ways in which branded prepaid cards are being used to make person-to-person transfers of funds.

Teen cards are marketed by banks as a way to help parents instill in their children a sense of financial independence and responsibility while monitoring and supervising their children's spending.[22] To establish a prepaid teen card account, the parent applies for a card with the issuing bank and puts funds into the account either by withdrawing funds from their deposit account or by using a credit card. Additional funds can be put into the prepaid card account in the same way. While the terms and conditions vary among issuing banks, most banks charge fees for setting up and loading funds onto the prepaid card and for making ATM withdrawals or purchases at the point of sale, on the Internet, or over the phone.

III. Unique Conditions Present in the Prepaid Market

The prepaid card market is growing rapidly, but it is still relatively small in comparison to purchase volume processed using traditional credit and debit cards. For example, Mercator Advisory Group estimated about $160 billion[23] in volume was loaded to prepaid cards in 2004. In comparison, in 2004, $1.5 trillion in purchase volume was processed on Visa and MasterCard debit and credit cards;[24] these estimates show prepaid card volume to be about one-tenth the size of traditional Visa and MasterCard card programs. Over this same period, prepaid card volume grew by 24 percent, and traditional card purchase volume on Visa and MasterCard networks grew by 13 percent. Although there is strong growth in the prepaid cards category, there is also significant

[22] An example of a teen card is the Visa Buxx card.
[23] Mercator Advisory Group, *Prepaid Benchmark 2004*.
[24] *The Nilson Report*, Number 828, February 2005, p. 7 and Number 805, February 2004, p. 7.

variation among the many types of prepaid card programs being developed. Some programs, such as payroll cards, are more established than others, such as remittance cards, which remain in earlier stages of development. Both the growth in the prepaid market and the number of prepaid card programs that are being developed at different rates make this market a confusing one for consumers.

The substantial variation in prepaid card programs is illustrated by differences in card functionality, pricing, and consumer protections. Moreover, nonbanks' role in marketing and distributing prepaid cards – program providers and distributors – may make it unclear as to whether the nonbank or the issuing bank is the primary point of contact for cardholders.

In summary, consumer education to build awareness of the terms, conditions, and consumer protections associated with the various types of prepaid cards can aid consumers when deciding whether this payment application is the best suited to meet their financial needs.

IV. Policy Considerations and Concluding Remarks

The quickly developing prepaid card market and its inherent product variation are also raising policy questions such as how to protect consumers while continuing to encourage product innovation. What regulatory or enforcement structure, if any, needs to be in place to limit the potential use of prepaid cards for terrorist or money-laundering activities? As the prepaid card market continues to evolve, policymakers are considering how to address these questions in the context of applying Regulation E protections[25] and

[25] The Federal Reserve Board's Regulation E (12 C.F.R. Part 205) implements the Electronic Fund Transfer Act (15 U.S.C. § 1693-1693r). The act establishes the basic rights, liabilities, and responsibilities of

FDIC insurance coverage to prepaid card products.[26] At the state level, the introduction and adoption of prepaid cards have implications, for example, related to their coverage under state labor and escheatment law. In each of these cases, policymakers are faced with developing regulations that "do no harm" and that, at the same time, protect consumers while supporting access to the global payment system in an environment consistent with safe and sound banking practices.

The benefits that open-system prepaid cards offer for consumers, providers, and issuing banks contribute to the increased adoption of these payment applications. Consumers use these cards to pay bills, make purchases, and access cash from ATM networks. Prepaid cards can also be used to secure car rentals and to make hotel and air travel reservations. At the same time, holders of prepaid cards need not secure a traditional banking relationship nor gain approval for a deposit account or revolving credit. Prepaid card providers may be nonbank third parties, such as employers and payroll processing companies, that can use prepaid cards as a means to convert paper disbursements, such as payroll checks, benefit claims forms, travel checks, gift certificates, and government checks, to less costly electronic payments. Finally, bank card issuers have an opportunity to serve a broader set of consumers. By offering prepaid cards, issuing banks may meet the financial needs of consumers who may not otherwise

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consumers who engage in electronic fund transfer services and of the financial institutions that offer these services (15 U.S.C. §§ 1693 at seq.). Regulation E provides guidelines about disclosure, liability, and dispute resolution and provision of periodic statements when electronic fund transfer services are involved (12 C.F.R. Part 205). A description of the interim final rule is available at www.federalreserve.gov/BoardDocs/Press/bcreg/2005/20051230/attachment2.pdf. This rule states that payroll card accounts established directly or indirectly by an employer on behalf of a consumer to which electronic fund transfers of the consumer's salary, wages, or other employee compensation are made on a recurring basis are accounts covered by Regulation E.

[26] On August 8, 2005, the FDIC released a proposed rule on the insurability of funds subject to transfer or withdrawal through the use of nontraditional access devices, including stored-value cards (12 C.F.R. Part 330). To date, no final rule has been published. A copy of the proposed rule is available at www.fdic.gov/regulations/laws/federal/2005/05cstoredval88.pdf.

qualify for more traditional banking products, and these banks may do so with a card-based electronic payment application that essentially eliminates credit risk for the bank.

From a policy perspective, research is needed to further clarify what motivates consumers to choose branded open-system prepaid cards in lieu of, or in addition to, holding conventional deposit accounts and to identify the card features most preferred by cardholders. If the prepaid market is to move toward asset- and/or credit-building enhancements, more analysis is needed to determine the savings behavior of cardholders and how their prepaid card transactions relate, if at all, to creditworthiness. Because unbanked prepaid cardholders have a wide range of characteristics, needs, and motivations for using these financial services products, a clearer understanding of consumer segmentation is needed to determine whether business models can support these features.

As evolutionary changes in the branded open-system prepaid card market continue, we, as a society, should continue to encourage and support consumer financial education and literacy. Financial education materials should be augmented to define and explain emerging financial services products, such as payroll cards and general spending reloadable cards, the fee structure for these cards, and the consumer protections afforded these cards relative to those afforded conventional deposit accounts. Studies of the effectiveness of specific financial education and literacy programs will help identify those programs most likely to help consumers determine which financial services products best meet their needs.

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