Prepaid Cards:
How Do They Function?
How Are They Regulated?
June 2-3, 2004

Federal Reserve Bank of Philadelphia
Credit and debit cards are not the only plastic payment mechanisms contributing to the decline of paper at the point of sale. Prepaid cards, which include products such as gift cards, travel cards, and payroll cards, are quickly replacing their paper counterparts. Almost weekly, merchants, banks, and employers are announcing new prepaid card initiatives. At least some of these initiatives are meeting with success. The National Retail Federation reported that consumer spending on gift cards totaled more than $17 billion during the 2003 holiday season, representing 8 percent of retail sales volume.

MasterCard and Visa both estimate that, over time, the prepaid market could grow to over $2 trillion and include business-to-consumer, business-to-business, consumer-to-consumer, and government-to-consumer transactions. As with many new payment innovations, prepaid card operating infrastructures and business models are constantly changing, making the legal environment for card issuers somewhat unpredictable. It is unclear, for example, which federal and state statutes that cover traditional payment products can or should be extended to prepaid cards.

The Payment Cards Center of the Federal Reserve Bank of Philadelphia is sponsoring this conference on prepaid cards to provide an opportunity for dialog between leaders in the prepaid card industry and policymakers. The conference’s four sessions aim to improve participants’ understanding of various prepaid-card-system infrastructures, value propositions, and risks. The sessions also aim to improve participants’ understanding of the legal and regulatory issues surrounding prepaid cards, including those relating to homeland security issues and consumer-protection laws. Ultimately, the conference aspires to increase awareness of how various prepaid-card systems work and the ways in which different state and federal laws can affect them. Such awareness, the Center hopes, can inform the debate over how best to regulate this increasingly popular payment method.
Wednesday, June 2, 2004  Boehne Auditorium & Eastburn Court

5:30 pm  Registration

6:00 pm  Keynote Address: Electronic Payments: Back to the Future
Ronald Congemi, President, Debit Services, First Data Corporation, President of Star Systems®

6:30 pm  Reception & Tours of Bank’s “Money in Motion” Exhibit

8:00 pm  Reception Concludes

Thursday, June 3, 2004  Public Affairs Conference Center (3rd Floor)

7:45 am  Registration & Continental Breakfast

8:15 am  Welcome
Dr. Anthony M. Santomero, President, Federal Reserve Bank of Philadelphia
Peter Burns, Director, Payment Cards Center

8:30 am  Setting the Stage: Prepaid-Card Markets and Infrastructure
Speaker: T. Jack Williams, National Processing Company

Although consumers may believe that prepaid cards operate just like credit cards, the infrastructures that support the two products are very different. In the prepaid-card world, for example, merchant processors often do more than just clear and settle card transactions. They may store account-balance information, authorize transactions in real-time, and work with other entities to create new prepaid-card products. Williams will discuss the roles of third-party processors and others involved in providing prepaid-card services and focus on the following topics:

• the authorization, clearing, and settling of prepaid-card transactions;
• the merchant processors’ role in effecting transactions in closed and open systems;
• the merchant processors’ role in creating new prepaid-card products; and
• the role of third parties in providing prepaid-card reloading services.

9:15 am  The Economics and Risks of Prepaid Cards: Gift Cards
Moderator: Paul Tomaszofsky, Two Sparrows Consulting
Panelists: Eduardo Vergara, Bank of America
Walter Paulsen, Safeway
David Doyle, Brinker International

Closed-system prepaid cards are those issued by and redeemable at a single merchant (or merchant chain). They are currently among the most popular prepaid-card applications. Open-system gift cards are issued by a third party, such as a bank or money transmitter, and carry the brand of a card association or other payment network. They can be used at any merchant that accepts the brand on the card. While these products are relatively newer than closed-system gift cards, they are becoming increasingly popular as a gift idea or a tool to help manage spending. This session will examine open- and closed-system gift cards and focus on the following issues:

• how open- and closed-system gift cards function;
• the fraud and settlement risks associated with gift-card transactions;
• the value of gift cards for merchants, consumers, and issuers; and
• the regulatory or market-related issues that may affect the growth of gift-card products.

10:30 am  Break
Prepaid-card-based payment systems have moved well beyond the facilitation of gift-giving. For example, an increasing number of employers are using the cards to process payroll for a portion of the estimated 14.2 million “unbanked” households. Funded by an account into which an employer has deposited an individual’s earnings, payroll cards aim to displace traditional payroll checks. Another emerging application is the flexible spending account (FSA) prepaid card. Recent rulings by the Internal Revenue Service have been interpreted as allowing employees access to monies they have saved in their FSAs and health-related reimbursement accounts by prepaid card. This session will examine the following issues involving these emerging applications:

- how the payroll and FSA prepaid cards function;
- the fraud and settlement risks associated with these products;
- the value of these products for merchants, consumers, and issuers; and
- the regulatory or market-related issues that may affect the growth of these products.

The legal environment in which prepaid-card issuers operate is unsettled. It is unclear how and whether prepaid cards should fit into the federal legal infrastructure that supports other, more traditional payment methods (e.g., debit cards and Regulation E, credit cards and Regulation Z, checks and Regulation CC). It is also unclear how new laws, such as those designed to thwart terrorists’ efforts to use the U.S. payments system to finance their activities, should apply to prepaid products. Compounding these uncertainties is a layer of various state laws devised to protect consumers and state financial interests. This session will explore the legal issues facing prepaid-card issuers, including the extent to which various federal and state laws apply to their products. The session will be divided into three sections, addressing each of the following legal issues separately:

- federal homeland-security-type laws and regulations (e.g., Patriot Act, Bank Secrecy Act, money-servicing business regulations);
- federal consumer-protection-type laws and regulations (e.g., EFTA, FDIC Act); and
- state consumer protection and escheat laws (e.g., money transmitter laws, dormancy fee laws, expiration date laws).