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Stored-Value Cards: Challenges and Opportunities for Reaching Emerging Markets*

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ABSTRACT

In recent years, the financial services industry has become very inventive around new uses of technology to improve the structure and delivery of retail products. One relatively new type of payment product, stored-value cards (SVCs), serves as a cash or check alternative. At this point in the industry's development, many of these cards do not provide a platform for saving, building assets, or establishing (or repairing) credit. However, SVCs could pave the way for individuals to have both transactional services and links to broader financial opportunities. This paper discusses the implications of this emerging product for unbanked and underbanked consumers, explores the hypothesis that SVCs can offer consumers the potential to build assets and improve their credit records, and presents policy issues that may affect how the SVC market evolves. Questions for further research to facilitate the development of SVCs that better serve unbanked and underbanked consumers are also discussed.

Introduction

In recent years, the financial services industry has become very inventive around new uses of technology to improve the structure and delivery of retail products. One relatively new type of payment product, stored-value cards (SVCs), serves as a cash or check alternative. The purpose of this paper is to discern the implications of this emerging product. The study will discuss whether SVCs could offer consumers the potential to build assets and improve their credit records and will highlight policy issues related to SVCs. At this point in the industry's development, many of these cards do not provide a platform for saving, asset-building, or building or repairing credit. However, SVCs could pave the way for individuals to have both transactional services and links to broader financial opportunities, thus more closely mimicking traditional bank accounts.

As many as 20 million American households—disproportionately poor, minority, lower income, and young—are unbanked.[1] Additional households, estimated in the millions, conduct most of their financial transactions outside of banks, even though they may have a savings or checking account. Yet having a relationship with the financial services system can minimize the cost of financial transactions and help turn income into savings, assets, and wealth. SVCs are being heavily marketed to unbanked populations. Moreover, some SVC providers are focusing their marketing efforts on immigrant populations, youth, and individuals with tarnished credit. SVCs could be a valuable financial tool for these consumers for several reasons:

- SVCs generally lack the identification and credit requirements that effectively bar millions of individuals from opening traditional bank accounts.
- SVCs can be purchased and reloaded at a growing number of locations other than bank branches, such as check cashers, convenience stores, and other retailers.
- SVCs can provide immediate availability of funds at a cost that is, in some cases, lower than some other alternatives for unbanked consumers.
- SVCs are prepaid and difficult to overdraft, reducing the likelihood of unexpected fees.

This paper will explore the hypothesis that SVCs, which are currently structured as products with little additional functionality, can be married with asset-building opportunities and consumer protections that aid underserved consumers.

Overview of the Literature

There is a paucity of literature on SVCs, which is largely attributable to the fact that the prevalence of SVCs is a relatively recent phenomenon. Closed-loop SVCs were first introduced in the early 1990s, and open-loop cards became available by the middle of that decade. The difference between these two types of SVCs is important, as open-loop cards, which offer consumers the ability to use their cards for multiple purposes in multiple locations, are more functional for consumers than closed-loop cards, which can

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[1] Calculations by authors based on Survey of Income and Program Participation, United States Census Bureau, 2000.

only be used for limited purposes in limited locations. Much of the growth in SVC usage has occurred within the last several years, and innovation has moved more quickly with the open-loop products. Thus, few studies have been conducted on the products that are in greatest use today.

Reflecting the nature of the industry at the time, early studies of stored-value products focused on those using chip-based rather than magnetic-stripe-based technology. Lacker (1996) modeled the welfare economics of these chip-based cards, otherwise known as smart cards, as a replacement for currency and coin. The U.S. Congressional Budget Office (1996) conducted a market analysis of smart cards in the U.S., in which they concluded that the market for such cards would be small in the near term, perhaps only reaching the size of the market for traveler's checks in the longer term. Osterberg and Thomson (1998) considered the implications of greater smart card use on the elasticity and uniformity of the money supply, calling for further analysis of the attendant issues. Chakravorti (2000) examined the question of why general-purpose smart cards had not developed a substantial market in the United States, concluding that smart card issuers had not met the conditions necessary for a payment product to be successful. These conditions were that consumers and merchants needed to be simultaneously convinced of the product's advantages over other products as well as of the product's safety and security.

However, the cards that would come to dominate the industry were not smart cards, which keep information stored in microchips on the cards, but magnetic-stripe cards, which link to networks when consumers conduct transactions.[2] A few recent papers have examined the role of these kinds of SVCs in serving unbanked and underbanked markets in particular. Frumkin, Reeves, and Wides of the Office of the Comptroller of the Currency (2003) identified payroll cards (SVCs that can be used for the direct deposit of paychecks, without a necessary link to a bank account) as an innovative product for reaching unbanked and underbanked markets and conducted a survey of financial institutions in the payroll card market. They found that although banks were seeing demand from their commercial customers for payroll card products, banks would not take a more active role in the market until they determined that payroll cards were sufficiently profitable and that the unbanked market provided sufficient cross-selling opportunities for other bank products.

The possibility of using SVCs for asset- and credit-building purposes was first raised by Seidman and Tescher (2003) in a paper discussing the convergence of the interests of the financial services sector and low-income consumers. Seidman and Tescher pointed out the growing prevalence of SVCs in low-income markets and the need for greater consumer protections and functionality for these cards in order for them to truly mimic bank accounts.

These issues were further discussed by Jacob (2004) in a scan of the SVC market that described the primary characteristics of payroll and general spending cards and

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[2] For more information on smart card and other types of payment technology, see Allen and Barr 1997 and Bradford et al. 2003.

highlighted important product innovations and trends. Jacob found (1) wide variation in levels of consumer protections among different card products, (2) few products with explicit savings features, and (3) several products touting credit-building features whose true credit-building potential was uncertain.

The present paper seeks to build on this body of work by further examining the policy implications of the use of SVCs by unbanked and underbanked consumers and the potential of SVCs to serve as asset- and credit-building tools.

Methodology

The stored-value card market is extremely new in the United States. There are few empirical research studies that could serve to inform this work, and data on stored-value cards are not publicly available. Therefore, the authors employed a variety of research methods, in addition to analyzing market research data where available, to provide a detailed look into this cutting-edge industry.

In order to discern trends in the SVC arena, the Center for Financial Services Innovation (CFSI) carried out a broad overview of the industry by studying web sites, marketing materials, and market research on SVCs and the companies that process, issue, and distribute them. CFSI focused most heavily on trends in the industry that have the potential to turn SVCs into the true equivalent of a bank account. CFSI partnered with the Federal Reserve Bank of New York's Office of Regional and Community Affairs (FRBNY) to conduct a series of extensive interviews with SVC industry leaders. During the third quarter of 2004, CFSI and FRBNY interviewed 21 leaders in the stored-value card industry, including processors that provide the back-end systems for managing cards and transactions, SVC distributors, and financial institutions that act as card issuers. In November 2004, CFSI and FRBNY hosted a subset of these interviewees at a meeting in New York City to discuss possibilities for bringing credit- and asset-building opportunities into the SVC market. Lessons from this meeting have helped to inform this study.

Overview of the SVC Market

Product Description

Like traditional debit cards, stored-value cards (SVCs) use magnetic-stripe technology to store information and track funds. However, because they are prepaid, SVCs differ from traditional account-based debit cards in that they have limited risk of overdrafts while providing nearly immediate liquidity for consumers.

As was discussed earlier, SVC systems operate in two ways. One is the "closed-loop" system, which can only be used for the issuers' products or for limited purposes, such as prepaid gift cards at retailers like Borders or Old Navy. "Open-loop" systems offer consumers the ability to use their cards for multiple purposes, such as making purchases at a variety of stores or paying bills. "Non-branded cards" use PIN-based technology through one or more point-of-sale (POS) or ATM networks. "Branded" cards have a MasterCard, Visa, American Express, or Discover logo and use signature-based technology to allow consumers to make purchases virtually anywhere that the brand is accepted, in addition to allowing PIN-based purchases.[3]

Examples of open-loop cards in the marketplace today include payroll cards, general spending cards, government benefit program cards, child support cards, insurance claim cards, flexible savings account cards, and other employee compensation cards. Our research focused on the following types of open-loop SVCs because their functionality most closely resembled traditional bank accounts:

1) payroll-only cards, which can only be used for direct deposit of paychecks and other automated clearinghouse (ACH) deposits, such as Social Security or disability payments;
2) reloadable payroll cards, which serve primarily as direct deposit cards but also offer the option of loading other deposits onto the SVCs; and
3) reloadable general spending cards, which can be reloaded in a variety of ways at a range of locations.

Typically, SVC providers market payroll cards directly to employers, who then distribute the cards to their employees, while general spending cards are marketed directly to consumers. Unfortunately, for the most part, these products are offered in a "silo" style. In other words, most SVCs do not currently work in a way that allows a single card to contain all levels of functionality—payroll, general spending, etc. Consumers who have payroll cards, for example, may not be able to or may not be aware that they are able to load other deposits besides payroll deposits onto their cards. One issue is that many cards are only set up to accept streams of direct deposits; manual reloads might not be available.

Industry leaders contend that SVC products have not reached their full potential in combining different types of functionality and features. However, these leaders believed that product convergence is coming to the market. Integrating different types of SVCs and adding functionality, such as reloadability, payroll direct deposit, bill payment, and others, are important innovations for the future of SVCs that would provide more benefits to consumers.

Size of the Market

The SVC market has exploded in the last few years. While the overall number of cards in circulation remains relatively small, every week, new cards are introduced into the market. SVCs are joining credit cards and debit cards in the race to turn cash into plastic.[4] An

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[3]MasterCard- and Visa-branded SVCs currently dominate the market, but in the future, Discover and American Express branded-SVCs might become widely available as well, in light of recent antitrust lawsuits levied against Visa and MasterCard. Discover recently purchased Pulse EFT Association, an electronic funds transfer (EFT) network with over 4,000 financial institution members. This could have further implications for future branding for SVCs (All, November 23, 2004).

[4] Recent research shows cash and checks accounting for 47 percent of customers' in-store purchases, compared with 57 percent in 1999. In contrast, 31 percent of purchases today are made with debit cards, compared to 21 percent four years ago (TeleComWeb.com 2004).

increasing number of companies are attempting to compete in this market, which currently includes hundreds of marketers, distributors, processors, and issuers. The number of cards and providers in the market has grown rapidly. MasterCard claims to have more than 200 SVC programs of different types with 100 issuers, and the company has seen double-digit increases in relationships with third parties and SVC processors in the last few years (Martin, 2004). While a few SVC providers are vertically integrated, handling nearly all of the functions internally, the majority of SVC providers outsource the transaction processing to one of the many firms that have developed special software platforms for running SVCs. It is possible that those prominent today may be displaced by new entrants because of competitive pressures. Moreover, other relative unknowns are likely to emerge as the market sorts itself into better defined mass-market and niche product markets.

It is difficult to ascertain the current size of the SVC market in a way that segregates closed-loop and open-loop processes. Closed-loop gift cards are by far the largest market segment. An accurate analysis of the size of the SVC market should include both the number of active cards and transaction dollar volumes for different categories of SVCs. In addition, data on penetration levels into various customer segments is needed. However, no publicly available data sources on SVCs exist. We present some commonly cited estimates below, which show that the SVC market is significant and growing. Each firm uses different units of measurement as well as different definitions and categorizations of store-value products.

- Mercator Advisory Group measures the dollar volume loaded onto “prepaid instruments,” which includes SVCs of all kinds, as well as all prepaid non-card products, such as prepaid wireless telephone services. Under this rubric, Mercator estimates that $157 billion was loaded onto prepaid instruments in 2003. Of that, the largest segments were the gift card and government program card segments, with each accounting for 25 percent of the total. According to Mercator, payroll and other employee benefits cards accounted for 17 percent of the total, while general spending products accounted for 15 percent (Sloane, 2004).

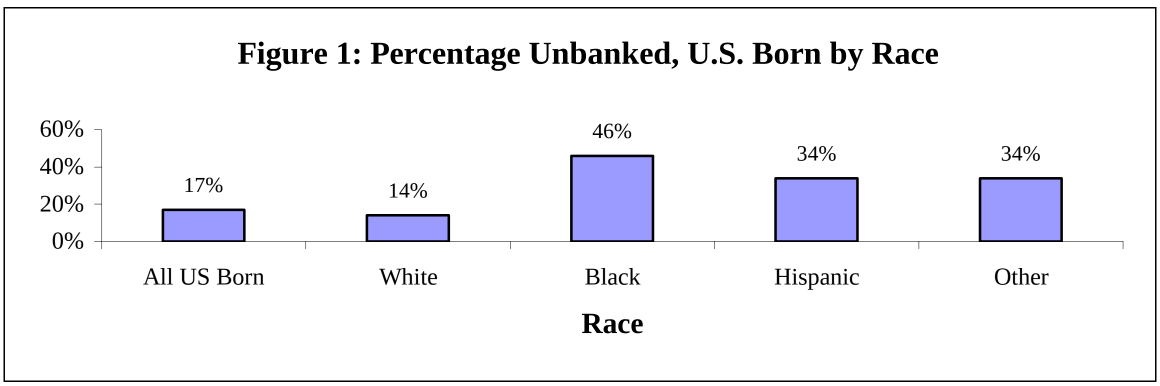
- The Pelorus Group measures market size based on numbers of cards issued, rather than dollar volume loaded. In addition, it counts card products only and uses product categorizations that differ somewhat from those of Mercator. In 2003, Pelorus estimated that 15 million “prepaid debit cards,” defined as all open-loop SVCs except for open-loop gift cards, were issued. Pelorus projects that this figure will rise to 34 million in 2005, with general spending cards accounting for the largest share at 35 percent, followed by government benefit and child support cards at 29 percent, payroll cards at 25 percent, and other cards such as flexible spending account cards at 11 percent (Miezejeski, 2004).

- Of particular interest for this paper is the prevalence of SVC usage in the unbanked population, but few estimates of penetration into that market exist. The market research firm Financial Insights found that general payroll card circulation in 2004 had doubled from a year earlier to over 2.2 million cards (All, April 4, 2004). Moreover, Visa estimates that paychecks cut to unbanked workers are worth $500 billion (Kuykendall, 2002). This may indicate that there is a large untapped market for employers seeking to simplify payroll through direct deposit and usage of payroll cards.

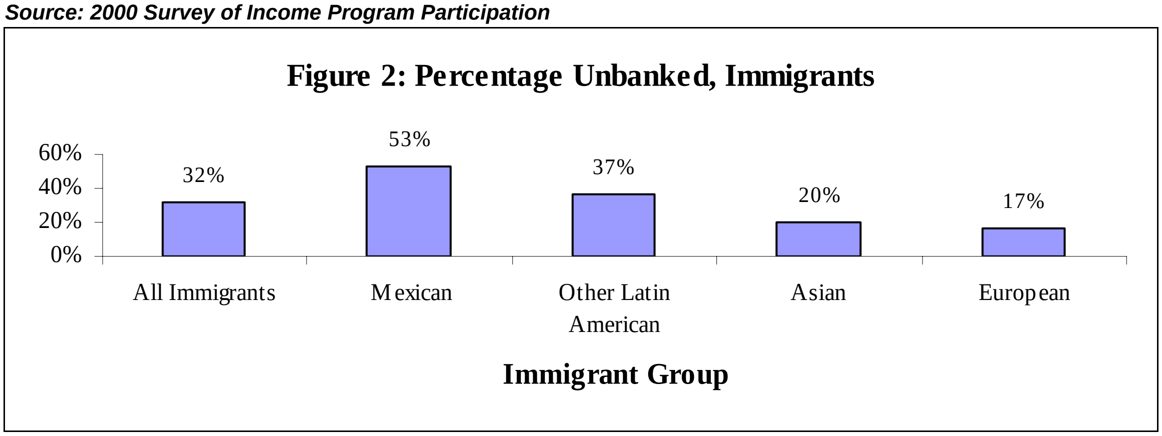
In addition, while payroll cards may have experienced significant growth thus far, there is some evidence that payroll card providers may be increasingly moving into the general spending product space. In several interviews, providers currently offering payroll cards mentioned existing or planned initiatives to either introduce general spending cards or increase distribution of them.

Implications of Market Growth

This substantial growth in the SVC market is important for a number of reasons. Unbanked and underbanked consumers are using SVCs as alternatives to traditional bank accounts. Based on the 2000 Survey of Income Program Participation (SIPP), the proportion of unbanked households in the U.S. that year was 17 percent, or 20.9 million families. Moreover, by racial/ethnic group, the proportion of unbanked families varies substantially. The SIPP found that 14 percent of all white, non-Hispanic families were unbanked, compared to 46 percent of black households and 34 percent of Hispanic families. Among immigrants, 32 percent are unbanked, including 53 percent of the immigrant Mexican population. These consumers need a safe, efficient, and affordable way to get cash, access pay checks, pay bills, and buy goods.



Source: 2000 Survey of Income Program Participation



Source: 2000 Survey of Income Program Participation

Stored-value cards can provide an alternative to bank accounts for unbanked consumers to access retail financial services. For instance, consumers who lack credit histories or certain forms of identification might be able to access funds without burdensome credit or identification requirements. Some SVCs can be loaded at retail stores or other locations that have extensive hours of operation, adding to customer convenience. SVCs might be attractive to consumers who are not familiar with banks, or who come from countries where banking systems are limited, unreliable, or untenable; for these consumers, SVCs can be a safe alternative to traditional banking.

Also, branded SVCs give consumers access to their brands' platforms. SVCs can provide immediate availability of funds at a cost that can be lower than some other alternatives for unbanked consumers. Currently, many unbanked consumers rely on check cashers for their basic financial services, expending approximately $8 billion a year on these services (Lewis, 2004). On the other hand, while SVCs contain features that mimic bank accounts, they lack important consumer protections. Thus, the challenge for SVC providers and for policymakers is to figure out how to economically marry the multiple functionalities of the SVC model with a full range of consumer benefits and protections. According to our interviews, some industry leaders contend that as SVCs begin to look more like bank accounts in terms of consumer protections, they could become significantly more expensive to provide, leading to profitability problems akin to those of low-balance checking accounts.

Profitability and Pricing: The Business Case

One of the most interesting interview findings to emerge from this study was the lack of consensus among SVC leaders about what makes products profitable. The SVC industry seems unanimous in its notion that large scale is needed to earn profit, but a keener understanding of the key cost drivers is needed to better ascertain the business case. There are a variety of potential profit drivers that interact with each other depending on the structure of the product. In order to develop a card structure that will be profitable, card providers need to take into account how many cards are active in their system, how much money is loaded onto each card, how frequently the cards are used, the number of transactions occurring each month, and how much unspent money is left on unused cards. Industry leaders maintain that it is quite expensive to continue to service cards that are rarely or never used; it is important for providers to consider ways to ensure that customers continue to reload funds onto the cards.

In addition, most of our interview respondents cited customer service as a major expense, particularly given the need for significant up-front education of new users. Some claimed that fraud-related expenses were high, while others disagreed. Income is generated through fees paid by cardholders for activation, maintenance, and debit transactions, as well as through interchange fees from merchants and earnings from float on the funds held. How an SVC provider views these various revenue sources is likely reflected in whether it focuses primarily on increasing the number of cards issued, the number of cardholders retained, the amount loaded onto its cards, or the number and frequency of transactions made.

The lack of consensus around the key profitability drivers might help to explain the wide variety of pricing structures and fees levied by SVC providers. Based on the factors listed above, one SVC provider might decide to offer multiple cards, each with a different set of features and pricing. For instance, some payroll card providers may negotiate different pricing structures and card features with employers and offer another pricing structure to customers who sign up for the product through the Internet. Providers might offer a flat monthly fee product that includes a set number of free transactions, a product that includes only monthly fees with unlimited transactions, or a card that is entirely transaction-based in its fee structure. It is important to note that, with increasing competition in the marketplace, prices for SVCs seem to be coming down, albeit slowly. Some of the fees that consumers might pay to sign up for and use SVCs include:

- Entrance and/or shipping fees
- Annual fees
- Monthly fees
- ATM fees
- Point-of-sale (POS) fees
- Reload fees
- Remittance fees
- Inactivity fees
- Overdraft fees[5]

Because of the wide variety of fee structures, it is hard to quantify the exact costs of SVCs for consumers. Even within a specific card system, there might be a variety of fee structures based on geography, community partners, or other factors.[6]

It is difficult to ascertain if SVCs are more or less expensive for consumers than using basic bank accounts or check cashing services. Bankrate.com conducted a survey of checking accounts in spring 2003 and discovered that the average monthly fee for a non-interest bearing checking account in the country’s 25 largest markets was about $6 (Bruce, 2003). Though checking accounts advertised as “free” and lacking in monthly fees proliferate on the marketplace today, non-sufficient funds and bounced check fees can average $25 in these accounts; ATM surcharges might apply as well. Moreover, the Office of the Comptroller of the Currency (OCC) estimates that a typical consumer making basic transactions would incur costs of $270 per year at a check casher, assuming that consumer cashed two $400 checks per month and required five money orders to pay bills (Frumkin et al., 2003).

Depending on the card pricing structure and the consumer’s usage pattern, an SVC could be a highly expensive option, perhaps even more costly than using a check casher for basic transactions. In other cases, however, an SVC with a lower pricing structure or a

[5] Though SVCs should technically not include overdraft charges since they are prepaid, it is possible to overdraft. If a consumer makes a signature-based purchase that clears before an automatic monthly fee is deducted, or if there is a lag time for direct deposit of a paycheck, an overdraft might occur. Overdraft charges for the SVCs surveyed in this scan are about $25.

[6] For more information on SVC pricing structures and scenarios, see Jacob, 2004.

structure that is consistent with the holder's usage pattern could be cheaper for certain consumers than using a check casher (or a bank account, if overdraft charges or other fees are levied).

The Role of Insured Depositories

In the introduction to this paper, we discussed how SVCs can meet customer needs and wants. But SVCs also offer interesting opportunities for banks that see low-balance savings accounts as cost-prohibitive products. If the SVC industry can figure out a way to offer savings and other benefits to previously unbanked consumers, it would be a win-win proposition for customers and companies alike.

At present, the largest banks in the country, including Bank of America, Citigroup, and JP Morgan Chase, are becoming increasingly involved in the issuance, marketing, and distribution of SVCs. Smaller institutions, including community banks and credit unions, are also working to structure SVC programs that can meet their current or potential customers' needs. Some financial institutions distribute their own SVC products, while others, such as BANKFIRST, primarily serve as the issuers behind the SVCs distributed by third parties.

As issuers, banks hold the funds underlying stored-value cards. According to our interviews, this is done in a variety of ways: some banks hold the funds off balance sheet, in fiduciary accounts; others hold the funds on the balance sheet in pooled accounts, perhaps in the name of the card's distributor, or, in the case of payroll cards, in the employer's name; while still others provide individual deposit accounts in the name of each cardholder.

The distinction between SVC products that are distributed by financial institutions and those distributed by non-bank firms is an important one. Initial market scans and interviews uncovered the fact that products directly distributed by banks and credit unions might be more likely to have additional consumer protections. For example, among the SVCs that we researched, those distributed by insured depositories rather than third parties are more likely to offer FDIC insurance on a pass-through basis to consumers. Moreover, FDIC-insured products are more likely to include enhancements like free statements and balance inquiry options.

For large banks, this may be partly due to their greater involvement in the payroll card market than in the general spending market – according to our interviews, a selling point for employers is that the cards will offer consumer protections similar to those enjoyed by traditional bank accountholders. But our hypothesis that banks distributing SVCs would use them as opportunities for cross-selling other bank products was not necessarily reflected in our interview findings. Although some large banks expressed interest in cross-selling in the future, none of the interviewed parties were actively engaged in it at the time, and some even expressed a lack of interest in it. On the other hand, certain small regional banks, such as Central Bank of Kansas City and University Bank in St. Paul, have created new SVC programs that are intended to serve as entry-level products for consumers who might access additional bank services in the future. In another recent development, New

York Community Bank, the fourth largest thrift in the country, has begun to offer SVCs in its branches. The bank is marketing the cards as entry-level products and is also marketing to customers who are denied checking accounts or who prefer prepaid instruments.

As the marketplace matures, it appears that non-bank firms are beginning to replace bank distributors as the most innovative actors in figuring out how to add enhanced features to SVCs that could provide increased service to lower-income consumers. Perhaps because of regulatory uncertainty, to be discussed later, or a more conservative approach to entering new markets, banks are lagging in innovation with regard to these products. For example, one bank expressed a desire to proceed cautiously in creating products for the unbanked, given the need for significant consumer education in order for new customers to use SVCs appropriately. It may be that the non-bank companies that enter this industry with a specific focus on reaching the unbanked and underbanked are more willing to experiment with new products.

Product Trends and Innovations

Our interviews with SVC providers found that the industry is most focused on improving the following:

Reloadability: The ability to load cards in multiple fashions at a variety of locations will drastically increase the business case for these products, according to industry leaders. SVC providers are pursuing partnerships with money-service businesses, convenience stores, and other retail distribution channels to increase SVC users' reloading options. Regulatory limitations on the development of these kinds of partnerships are discussed later in this paper.

Bill Payment: Many SVCs offer some sort of bill pay option, especially branded cards that enable signature-based transactions. Because many SVC users are unbanked, the functionality of paying bills without using checking accounts or money orders is important. Often, consumers can use an SVC to pay any bill that can be funded through direct debit. A few cards are offering free bill pay, while most charge a nominal fee, between $0.50 and $3. Further research and innovation could be valuable in this area, as most bill pay options for SVC users are online or in-person. Additional options, such as self-service bill pay at kiosks in retail locations, could provide additional functionality for unbanked consumers (Intelecard News Online, 2004).

Remittance Features: Several companies are beginning to tie their SVC products to remittance products that enable consumers to send money to friends and family in other countries. Like SVCs, the remittance market is growing and changing rapidly.[7] Most of these funds are sent through services such as MoneyGram and Western Union, though banks and credit unions are beginning to gain presence in the market.

[7] According to the Inter-American Development Bank, remittances are the largest source of foreign investment in Latin America. Latinos living outside of their home countries sent $38 billion home in 2003, including $13 billion to Mexico alone (Glaister, 2004).

A significant number of SVCs offer remittances. This feature allows U.S. cardholders to transfer funds to authorized family members in other countries. SVC-based remittance features are structured in at least two ways. Sometimes, dual cards are issued to customers, and one of the cards is sent to family in another country to access funds from the sender's "account" via ATMs. Other cards allow cardholders to designate "subaccount" holders in other countries for the purposes of transferring money. In these cases, the subaccount holder has access only to the money that the primary account holder designates to share.

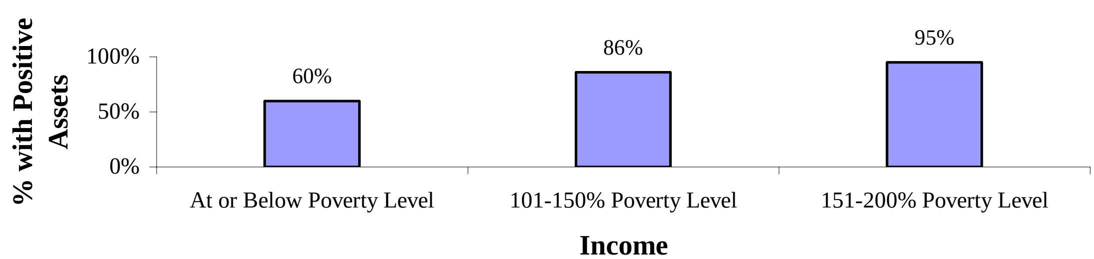
Rewards: Credit cards have long offered reward programs to consumers, with debit cards beginning to follow suit. Now, SVCs have begun to explore the possibility of providing loyal customers with rewards or "points" for using the cards. These rewards could take many forms, including points toward rebates on merchandise; a bonus or cash rebate directly loaded onto a card for maintaining a certain balance; and, perhaps in the future, tiered interest rates for SVCs that are connected to savings products.

Asset- and Credit-Building Enhancements for SVCs

Asset-Building Opportunities

One feature that is lacking in most SVCs is the ability for cardholders to save and build assets. There is ample evidence that the demand for savings features in SVC products is potentially powerful. According to the 1998 Survey of Consumer Finances, 60 percent of households at or below the poverty level had positive assets, compared to 86 percent of households with incomes between 101-150 percent of poverty and 95 percent of those families with incomes between 151-200 percent of the poverty level. In other words, families with relatively low incomes have assets that could be stored in a savings vehicle (Hogarth and Anguelov, 2003). But many of these families may not have access to traditional accounts at banks or credit unions.

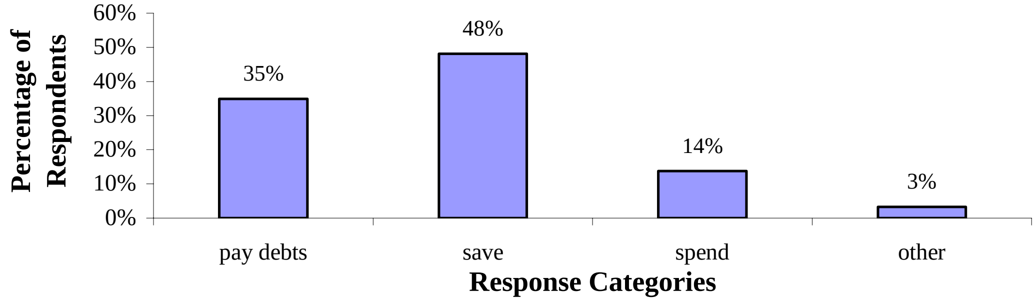
Figure 3: Potential for Lower-Income Savers



Source: Federal Reserve Board's 1998 Survey of Consumer Finances – 1998 Dollars

Moreover, research shows that lower-income consumers desire products that provide a safe, convenient and inexpensive way to pay bills, make purchases, save, and build credit. For example, a 2000 industry survey of check-cashing customers showed that 49 percent would use savings accounts if they were available from their regular check-cashing outlets (Eric Mower Associates, 2000). The following figure highlights findings from one market research firm specializing in lower-income urban markets on how families would spend $10,000.

Figure 4: What Would You Do With $10,000?
(LMI Households in Chicago, Los Angeles, and Washinton, DC, 2003)



Source: MetroEdge Financial Services Survey 2003.

The above chart shows that an overwhelming majority of low- and moderate-income consumers, given the opportunity to spend $10,000, would invest the money in some type of asset-building opportunity (MetroEdge, 2003). But in order to save, lower-income families need opportunity or the ability to access a savings vehicle; incentive or the ability to earn interest on funds; and motivation, such as direct deposit, which makes automatic saving much easier.

A few SVC companies have experimented with offering savings features with their cards. For instance, in the past, Directo included a savings component as part of the bundled services offered with its card program, but the company suspended it in part because few customers were using the feature. Particularly in a low interest-rate environment, consumers would pay more in fees to transfer funds to savings than they would earn in interest. NetSpend, one of the largest SVC providers in the country, has recently announced a strategy to link a savings vehicle with its SVC. This product will officially be launched in May 2005. In addition, indiGOCARD recently launched a program linking savings accounts to its SVCs but has marketed it as an overdraft protection program. Linkages with savings accounts, tax refunds (such as the SVC programs offered by Jackson Hewitt and H&R Block), individual development accounts (IDAs), or other savings vehicles through an issuing financial institution are possibilities that deserve further exploration.

Helping the Unbanked Save: A Case Study of NetSpend

NetSpend is an Austin, Texas-based marketer and processor of prepaid and stored-value cards that was launched in 1999 by brothers Roy and Bertrand Sosa. Today, the company is one of the largest SVC providers, with more than 700,000 cardholders, and in the past year, customers have loaded in excess of $1 billion in funds onto NetSpend cards, showing the potential scale of SVCs. NetSpend's SVCs are distributed through check cashing outlets and grocery stores; NetSpend often serves as the exclusive SVC provider for partner firms. NetSpend's cards can be either branded or unbranded. The company works with several regional banks that serve as issuers of the NetSpend card programs and hold the corresponding funds, including InterNational Bank and Town North Bank in Texas and BankFIRST in South Dakota. NetSpend cards issued by Inter National Bank are FDIC insured at the individual account level.

Tying SVCs to Savings Products

In an attempt to meet the savings needs of its customers, in 2005, NetSpend developed the All-Access National Savings Program, which will debut in the marketplace in May 2005. The Financial Service Centers of America (FiSCA, the country's largest trade association for check cashers) has endorsed the program as its exclusive saving product. The partnership with FiSCA has potential to reach large scale, as it involves a significant player in the SVC market in addition to large FiSCA members such as ACE Cash Express, the nation's largest publicly traded check cashing chain, and Wal-Mart, which recently started offering check cashing services in its stores.

Through the All-Access National Savings Program, account holders can move funds into interest-bearing savings accounts by transferring money through their prepaid debit cards. The savings accounts, which will be held at InterNational Bank, pay interest similar to that paid to traditional savings accounts. Customers can enroll online or by calling a toll-free number. During enrollment, cardholders must accept the program's terms and conditions and provide additional cardholder information, including Social Security numbers. Cardholders then have the option of making one-time transfers to savings or setting up automatic, recurring transfers that move a fixed dollar amount from the card account to the savings account whenever a load is made to the card. In the case of automatic transfers, customers cannot transfer more than 25 percent of the balance of the card to savings. However, if a customer makes a manual reload, that customer could place 100 percent of that deposit in the savings account.

Importantly, enrollment in the program is free, and there are no fees for maintenance or transfers. Customers would still have to pay to withdraw money, however. According to NetSpend representatives, the program is compliant with federal regulations limiting transfers out of the savings account to six per month; transfers to the savings account, however, are unlimited. Electronic statements are provided online and balance updates are available via text messages to customers' mobile phones or e-mail addresses. Because the program was in formation at the time of this writing, an evaluation of its success is unavailable. Moreover, models and fees related to the product are subject to change in the future. In the second half of 2005, NetSpend plans to actively court partners to provide matching funds for the savings product. According to company representatives, matching funds are very important to the future of the savings product. NetSpend also plans to work with partner agencies to incorporate more financial education services into its marketing materials and website to promote long-term financial planning.

In conclusion, NetSpend offers one example of a model that attempts to marry the needs of the un- and underbanked with long-term profit. It will be important to follow NetSpend's experiences with the All Access National Savings program in order to tease out usage patterns, take-up rates, successful marketing strategies, and the impact of past deterrents to such programs, including low interest rates on savings products, ID requirements, and lack of synergy with the credit scoring system.

Credit-Building Opportunities

With few exceptions, credit-building features have not been prominent on the SVC industry's radar screen, although the characteristics of the product's target markets indicate that there may be untapped demand for such features. Because the cards are marketed primarily to unbanked customers that may have "thin-file" or sparse credit histories, credit-building features would add an additional benefit that could help consumers ultimately buy a house or car or rent an apartment. Moreover, SVCs have the potential to be an effective personal financial management tool for some people, and branded SVCs offer consumers who have been kept out of the credit card market with options to buy goods at places where Visa and MasterCard are accepted without incurring high-interest debt. At this point, purchases made with SVCs do not affect a consumer's credit record, whether or not the card is branded.

Today, a few companies are attempting to provide a payday advance or overdraft protection feature tied to an SVC. These include small extensions of credit, both formal (such as payday advances) and informal (such as paying overdrafts on a discretionary basis). These products do not currently help a consumer's credit score, as existing credit models do not allow for the reporting of credit relationships lasting fewer than 30 days.[8] But some SVC companies are looking to these types of products as those that could be incorporated into the credit scoring system in the future. As consumers, particularly lower-income households, need small extensions of credit in emergency situations, these

[8] Fair Isaac Corporation recently announced the development of a new credit score for those with little or no credit histories; this credit score may use data on payday loan repayment, although it is unclear how such data would be used.

features, if structured responsibly, could fill that void.[9]

In a scan of the SVC universe, CFSI found three products that at one point attempted to incorporate credit-building into their cards. These are the indiGOCARD, Eufora Credit Builder, and the NetSpend CredAbility program. These SVC issuers attempted to use the credit-building component as a marketing tool for the cards and prominently advertised this feature in their literature and web sites. In their experiments with credit-building features, these companies had a variety of strategies to try to link SVCs with the credit bureaus.

In the case of the indiGOCARD, which is described below, the company attempted to report accounts in good standing to a credit bureau but discontinued the program when it could not confirm that these data were being used by the credit bureau. In other cases, monthly fees paid by the customer, or monthly fees set up as an installment loan payment plan, were reported to the bureaus. However, because the credit bureaus are not currently set up to include debit and stored value information, it is unlikely that the reporting of these products ever made an impact on consumers' credit scores. In fact, one credit bureau representative stated that after reviewing proposals from a few SVC providers regarding this kind of reporting, the bureau determined that it would not allow SVC data to be reported. Ultimately, if the credit bureau system develops a way for SVC and debit transactions to impact consumers' credit scores, this could help move some consumers, particularly those with little to no credit history, closer to new credit opportunities.

The SVC as "Checkless Checking Account": A Case Study of indiGOCARD

IndiGOCARD, L.P., based in Fort Worth, Texas, is a boutique general spending card company that has issued fewer than 10,000 MasterCard-branded SVCs since its inception in April 2003. Cards are distributed both through employers, which range from national hotel chains to local construction companies, as well as directly to consumers via the Internet and other channels that will soon include money-service businesses and convenience stores.

Daniel Hines started indiGOCARD in response to what he saw as the mistakes made by the market's early entrants, such as a lack of consumer protections, inadequate customer education, a reliance on fees for every transaction, and a focus on issuing as many cards as possible rather than on retaining customers. Hines wanted to create a product that would appeal to consumers who choose not to use banks but that would essentially function as a "checkless checking account." In keeping with this concept, card funds are held in individually FDIC-insured deposit accounts at Southwest Bank in Fort Worth,

[9] The provision of overdraft protection or payday advances raises several related concerns. It is unclear whether these services should be considered extensions of credit from a regulatory perspective and therefore subject to corresponding disclosures and regulations. Member agencies of the Federal Financial Institutions Examination Council (FFIEC) have requested comments on this issue. These products can make it difficult to differentiate between available funds and those the financial institution will advance for a fee. Finally, the ultimate benefit to the consumer is disputed, particularly given the costs. Some argue that low-income consumers should be able to access small credit and that the costs are reasonable; others argue that the costs are prohibitive.

which also serves as the card processor. In addition, card accounts are fully compliant with Regulation E; unlike most other SVC companies, indiGOCARD provides mailed paper statements as mandated in that regulation. Unlike many stored value cards, indiGOCARD has a very simple fee structure: one monthly fee of $9.00 covers unlimited use of all services, including ATM and debit transactions, online bill payment, and live customer service calls. Hines believes that customer satisfaction as evidenced by responses to customer surveys show that cardholders are happy with this kind of fee structure, which may be more transparent to them than a transaction-based fee structure.

Hines reports that the average deposit amount into card accounts is approximately $400, with most deposits ranging from $300 to $500. About 85 percent of deposits occur via direct deposit, even though only 30 percent of cardholders receive their cards through their employers. The average balance in card accounts at the end of each month is approximately $500.

In keeping with Hines' stated desire of creating a high-quality product for the unbanked, the company has experimented with ways to incorporate asset-building and credit-building features into its card.

An Early Experiment: Reporting of "Accounts in Good Standing"

In early 2004, indiGOCARD began offering a credit-building feature, in which accounts in good standing were to be reported to Experian, one of the three major credit reporting agencies. Southwest Bank, indiGOCARD's issuer, uploaded data on the accounts to Experian in the same manner in which it would report credit information. However, a standard data reporting format has not yet been established for non-credit data, so Experian could not accept the data. Experian is currently working with indiGOCARD and other financial services companies to design a program that will allow the reporting of non-credit information.

A Savings Vehicle Marketed as Overdraft Protection

In December 2004, indiGOCARD began offering a feature called "overdraft savings protection." After receiving repeated requests from customers for some form of overdraft protection, the company realized the desire for overdraft protection could provide an incentive for customers to save. It decided to offer linked savings accounts that would be marketed as overdraft protection vehicles.

Under the program, cardholders designate periodic automatic transfers from their card accounts into linked savings accounts that, like their card accounts, are held at Southwest Bank. If a card account is overdrawn, the funds in the linked savings accounts will be used to cover the overdrawn amount. Enrollment, account maintenance, and transfers into the savings accounts are free of charge to cardholders. For each overdraft, cardholders pay a $5 fee. Outside of overdrafts cardholders may make 12 free withdrawals per year, with each additional withdrawal costing $1. Hines hopes that this pricing structure will create incentives to save without making withdrawals unaffordable.

The linked accounts are FDIC-insured savings accounts, and funds in the accounts earn a rate of interest determined by Southwest Bank. Customers enroll by phone, during which time the terms of the account are explained; they also receive a statement of terms by mail. Customers receive monthly statements of account balances and transactions by mail and can also access that information online.

As the program was launched only recently, it is too early to determine its level of appeal to customers. As of the date of this writing, it had been marketed by mail and e-mail to existing customers; within the following month it was to be marketed to all potential customers. Among those who have enrolled so far, automatic transfer amounts range from $5 per week to $50 per week. Hines projects a participation rate of 10 percent in the first six months of the program. As the program progresses, it will be worth following indiGOCARD's experiences with different customer segments and their usage of the product.

Barriers to Asset and Credit-Building Features

Although opportunities for adding saving and credit-building features to SVCs are promising, significant barriers must be overcome to allow these transactional products to link consumers to long-term wealth-building behavior. During its interviews with SVC leaders, CFSI and FRBNY learned that SVC industry representatives are unclear on what specifically attracts consumers to stored-value products. There is a lack of market research on who uses SVCs and for what purposes. Industry leaders maintain that better customer segmentation is needed before savings or credit-building features can be added to SVCs, as unbanked and underbanked SVC users have a wide range of characteristics, needs, and motivations for using SVCs.

For example, according to industry leaders, there are several perceived barriers to providing unbanked consumers with savings opportunities through SVCs:

- Some consumers may choose to use SVCs because of the relative anonymity offered. Savings or credit-building features would require more stringent identification verification that might be unappealing to some consumers.
- SVC users may not want transaction history data to be reported for credit-building purposes, as they may perceive that such data could negatively affect their credit scores.

- "Saving" has different meanings for different people, and it is important to determine what needs a savings product would meet. A "savings" product may be very different from traditional bank savings products.
  - A subset of consumers may not have enough money to save. For some, a rebate or a flexible spending account may act as a savings feature.
  - Some consumers may prefer alternative "savings" vehicles (putting money under the mattress, purchasing gold), depending on their needs for accessibility, tangibility, anonymity, or other concerns.
  - Other consumers may already view SVCs as savings vehicles in that SVCs provide storage for their funds or perhaps reduce the amount they would spend on financial services otherwise.
  - "Savings" products may actually serve other purposes for customers. For example, a savings account tied to an SVC may serve as overdraft protection.

In addition to the question of whether sufficient demand exists for SVCs that have asset- and credit-building features, the need for consumer education in appropriate use of such features may be a barrier. In interviews, SVC providers frequently mentioned consumer education and customer service expenses as among the most significant barriers present in the industry. They feel that consumers already face difficulties in understanding how SVCs work, how fees are structured, and how to manage their funds, and that employees at current SVC distribution points (places of employment, check cashers, retail locations) are poorly equipped to explain products to consumers. Adding enhancements such as savings and credit-building features may require a level of sophistication and education in consumers that does not currently exist. However, SVCs as a product category is a new phenomenon; over time, as consumers better understand how SVCs work, the education hurdle might lessen in importance.

The structure of the United States' credit reporting system also presents barriers. First, just as Visa and MasterCard-branded products require Social Security numbers, the experimental credit-building features of SVCs also required Social Security numbers. Currently, the credit bureaus do not accept individual tax identification numbers (ITINs)[10] as substitutes for Social Security numbers for credit reporting purposes. Second, credit bureaus currently can only collect credit data; debit and SVC data are not considered to be "credit," so in order to include such data, the bureaus would have to create new systems. Moreover, such data are not factored into credit scoring methods because at present it is unclear what impact such data have on consumers' creditworthiness.

As was stated earlier, some SVC companies have attempted to report monthly fees as "bill payments." A few lenders use bill payment data in underwriting decisions, but no research has been done showing the relationship of bill payment history to creditworthiness. In fact, laws in some states restrict the reporting of bill payment histories by utility companies, although the federal Gramm-Leach Bliley Act (GLBA) allows such reporting by financial institutions to credit reporting agencies. In general, interviews uncovered that the

[10] ITIN stands for Individual Taxpayer Identification Number. It is a number that the IRS provides to workers who do not have Social Security numbers in order to enable them to pay federal and state income taxes. Many financial institutions have begun accepting ITINs in order to open bank accounts. Though many immigrants do not have Social Security numbers, the USA PATRIOT Act allows for the acceptance of ITINs in their place.

industry has not discerned the impact of SVC transactions on creditworthiness. Current credit-scoring models in the United States do not use SVC-related data. According to industry leaders, the value of SVC usage information in predicting creditworthiness must be determined before suppliers and users of credit-scoring models will invest in new systems incorporating SVC-related information.

Some evidence exists that demand deposit account (DDA) data, such as the number and amounts of direct deposits, the amount of aggregate outflows, and the number and amounts of overdrafts, can predict a financial institution's decisions regarding the extension of overdraft protection to an accountholder. Equivalent data from SVC accounts may have similar predictive value.[11] According to attorneys at two bank regulatory agencies, under the Fair Credit Reporting Act (FCRA), financial institutions and other entities should also be able to report SVC transaction information (i.e., how much money went into an account, and how much came out) in addition to information on balances and length of card ownership to credit bureaus. Based on our conversations with regulatory attorneys, it is our understanding that as long as institutions follow FCRA guidelines, GLBA privacy issues should not stop banks and others from reporting SVC transaction data to the bureaus. However, this is not presently occurring in the marketplace.

Public Policy Implications

As new products with few comparables, SVCs raise several complex legal and regulatory concerns. In addition, given the various functions involved in offering SVCs—card issuance, transaction processing, funds management, customer service, recordkeeping—sorting out roles and responsibilities can be complicated. Some consumers are using stored-value cards as substitutes for or in addition to deposit accounts with banks or credit unions, while others are using SVCs as cash substitutes. Ideally, consumers would also be able to use SVCs in ways that will increase their financial stability (i.e., build a credit history and asset base) while being assured that their funds are protected. In their research and interviews, the authors uncovered several policy issues surrounding SVCs that warrant further discussion.

Protection Against Loss of Funds

One important feature of bank accounts that is often absent in SVCs is protection from loss of consumers' funds. As SVCs begin to more closely mirror bank accounts, this issue has taken on further importance. However, the fact that SVCs are not bank accounts is often an attractive feature for consumers who for various reasons do not desire to have bank accounts. These reasons might include lack of comfort with giving personal information, prohibitive identification requirements, the desire to keep money private and separate from family funds, and other factors. Moreover, companies that want to keep costs low and see their SVC programs as cash alternatives, not account alternatives, might also shy away from features that make SVCs look more like bank accounts. Loss protection includes several components, which are discussed in further detail below.

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[11] In the United Kingdom, the practice of collecting DDA data is widespread, but the data are usually limited to an internal system wherein a financial institution cannot view another institution's customer data.

(A) FDIC INSURANCE

The underlying funds in some SVCs are held in individual deposit accounts that are insured on the cardholder's behalf by the Federal Deposit Insurance Corporation (FDIC). However, for many SVC products, the underlying funds are held in pooled accounts that represent the funds of multiple cardholders. The FDIC is currently considering a proposal that would define the circumstances in which funds underlying stored value cards are "deposits" ("Definition of Deposits, 2004).

The proposed rule defines a "stored-value card" as "a device that enables the cardholder to transfer the underlying funds (i.e., the funds received by the issuer of the card in exchange for the issuance or reloading of the card) to a merchant at the merchant's point of sale terminal." Although this definition would ostensibly apply to closed-loop gift cards issued by retailers, the supplementary information accompanying the FDIC proposal explicitly excludes such cards from the proposed rule's coverage. The proposed rule distinguishes between two types of SVCs: those issued by insured depository institutions and those issued by what the proposal calls sponsoring companies.[12]

Under the proposed rule, the funds used to purchase SVCs issued by insured depository institutions would be considered deposits unless the depository institution keeps the funds in a pooled reserve account without subaccounts for individual cardholders or other records indicating the amounts owed to individual cardholders. Funds that qualify as deposits would be insured on a "pass-through basis" to the individual cardholder (i.e., the cardholder would be the beneficiary of the insurance in the event of a bank failure).

The treatment of funds underlying SVCs that are issued by sponsoring companies is more complicated. Whether such funds would be considered deposits, as well as whether those deposits are insurable to the cardholder on a pass-through basis or to the sponsoring company depends on a variety of factors.[13] The complexity of the circumstances under which funds will be insured on behalf of the individual cardholder highlights the importance

[12] A "sponsoring company" is an entity other than an insured depository institution that issues SVCs. Employers that issue SVCs therefore fall within the meaning of the term "sponsoring company."

[13] Under the proposed rule, any funds that a sponsoring company places at an insured depository institution for the purpose of making payments on SVCs issued by that company (i.e., funds in reserve accounts) would be considered deposits. In addition, funds collected by an insured depository institution from cardholders in exchange for SVCs issued by a sponsoring company would be classified as deposits only if and as long as the depository institution bears an obligation to forward the funds to the sponsoring company or to hold the funds for the sponsoring company. In other words, once the depository institution has forwarded the funds to the sponsoring company or once the sponsoring company has withdrawn the funds from its account at the depository institution, the funds would cease to be deposits at the depository institution. Assuming the funds underlying a sponsoring company–issued SVC are determined to be a deposit under the rules outlined above, the deposit is either insurable to the cardholder on a pass-through basis or to the sponsoring company, depending on whether the FDIC treats the sponsoring company as an agent or custodian acting on behalf of the cardholder. In making this determination, the FDIC looks at three factors: (1) whether the fiduciary relationship between the sponsoring company and the cardholder is expressly disclosed in the insured depository institution's account records; (2) whether the cardholder's interest in the funds is ascertainable either from the depository institution's account records or from records maintained by the sponsoring company or its agent; and (3) whether the deposit belongs to the cardholder (i.e., whether the agency or custodial relationship is genuine). If all three factors are answered affirmatively, the deposit is insurable to the cardholder. Otherwise, the deposit is insurable to the sponsoring company.

of disclosures to consumers. How disclosures can best inform consumers regarding whether their funds are insured on their behalf, rather than on behalf of the sponsoring company, warrants further consideration.

(B) NON-BANK SVC PROVIDER FAILURE

FDIC insurance protects consumers' funds in cases of bank failures. Another related point in the SVC universe involves the possible failure of a non-depository third party. In other words, how, if at all, are consumers' funds protected if the non-depository third-party provider fails prior to bank settlement of the consumer's transaction? Questions of third-party liability and whether SVC customers understand the associated risks to their funds warrant further exploration.[14]

(C) REGULATION E

Regulation E, which implements the Electronic Fund Transfer Act (EFTA), provides protections to consumers using electronic fund transfer (EFT) systems; these protections include disclosures of the terms and conditions of an EFT service, documentation of electronic transfers through receipts and monthly statements, limitations on consumer liability for unauthorized transfers, procedures for error resolution, and other provisions. Although some SVC companies may already provide some of these protections, SVCs are not currently covered by Regulation E.[15] However, the Board of Governors of the Federal Reserve System, which is responsible for implementing EFTA, is currently considering a proposal to revise Regulation E to cover payroll card accounts ("Electronic Fund Transfers", 2004).

In its proposal, the Board concluded that payroll cards were "designed, implemented, and marketed as substitutes for traditional checking accounts at a financial institution" (p. 55999), and that these cards shared some of the characteristics of Electronic Benefit Transfer (EBT) cards, which are covered by Regulation E. These characteristics include being assigned to an identifiable consumer, representing a stream of payments to a consumer, being accessible in multiple locations for multiple purposes, and using access devices and networks that are the same as those used by other EFT services.

Our interviews with SVC providers indicate that many general spending card products may be similar to payroll cards in bearing these characteristics. Whether some SVCs outside of payroll cards do in fact bear these characteristics and could be included in the Regulation E definition of an account is worth further investigation.

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[14] Though not an example of a third-party SVC provider failure, one interesting precedent has occurred in the Northeastern U.S. In 2004, New York State suspended the license of CashPoint, a bill-payment company that signed hundreds of retailers as agents to offer bill payment services and ultimately did not pay hundreds of billions of dollars in bills to utility companies. While the courts advised collectors against the practice, consumers who had handled their bill payment through CashPoint were ultimately responsible for the funds if collectors chose to seek repayment.

[15] Banks that issue SVCs may voluntarily provide disclosures that describe consumer protections (Frumkin et al., 2003). The Office of the Comptroller of the Currency (OCC) recently issued guidance to the banks it regulates on proper disclosures of consumer protections for SVCs (Office of the Comptroller of the Currency, 2004).

Some of the SVC providers we interviewed, including both payroll and general spending card providers, said that they were already providing at least some of the protections required by Regulation E, such as limitations on consumer liability for unauthorized transfers and procedures for error resolution. Very few, however, said that they were providing periodic mailed statements. Many stated that Regulation E's requirement that periodic paper statements be mailed to account holders may be a negative value proposition for SVC providers. These industry leaders maintained that permitting alternative ways to deliver statements would be much less expensive and perhaps more appropriate. These providers said that periodic paper statements may not be the most effective way of keeping underbanked cardholders informed of their balances and transactions. For example, many of the unbanked do not have stable addresses, so mailed statements do not reach them. Moreover, statements are delivered 10-15 days after a transaction has occurred, and the information might no longer be useful to the cardholder.

Several of the industry leaders interviewed suggested that any Regulation E coverage of SVCs should follow the model provided for electronic benefits transfer (EBT) transactions and permit the use of alternative mechanisms for providing transaction and balance information to cardholders. Many SVC providers offer transaction and balance information online and via telephone voice-response systems. Innovations that may become more prevalent in the near future include text messaging transaction and balance information via mobile phone and delivery of paper statements at ATMs. Whether these innovations are more effective than mailed paper statements in meeting SVC cardholders' needs is a question worth further exploration.

USA PATRIOT Act and Bank Secrecy Act Requirements

As concerns about terrorism and money laundering increased following September 11, 2001, financial institutions came under more pressure to keep and report accurate records verifying their customers' identities. Section 326 of the USA PATRIOT Act requires financial institutions to be diligent in documenting customer identification, which has had significant impact on enrollment processes and management of SVC programs. Most SVC providers do not currently require that customers provide Social Security numbers if their cards are PIN-based. Considering that some underbanked consumers cite privacy as a primary concern, the reduced identification requirements for PIN-based SVCs may help encourage customer acceptance. At the same time, Visa and MasterCard require Social Security numbers for signature-based SVCs, an important change in the industry following the PATRIOT Act. Another emerging issue around the PATRIOT Act is that some SVC products allow consumers to give second cards to family members in other countries as a way to transfer money, and it can be difficult to verify the identity of individuals living outside the U.S.

The Bank Secrecy Act (BSA), administered by the Financial Crimes Enforcement Network (FinCEN), requires financial institutions, including banks and money services businesses

(MSBs), to keep certain paper trails on their customers' transactions.[16] Currently, although they fall under the MSB definition, issuers, sellers, and redeemers of SVCs are not required to register with FinCEN or to maintain a list of their agents ("Registration of," 2004). However, issuers, sellers, and redeemers of SVCs are subject to certain BSA reporting requirements, including reporting of cash transactions exceeding $10,000 ("Reports Relating," 2004). The rationale for the exemption for SVC issuers, sellers, and redeemers was that the SVC industry was in its infancy and should not be inhibited by premature regulation ("Bank Activities," 2004). As the industry matures, SVC providers should be aware of money laundering concerns; those with well-developed back-office systems that enable them to keep track of transactions will be better prepared to handle BSA requirements, follow Office of Foreign Assets Control rules, create customer identification programs and provide suspicious activity reports.

State Money Services Business (MSB) Laws

Many of the industry representatives interviewed stated that SVC providers will not achieve real scale in reaching the unbanked unless they use appropriate distribution channels, such as convenience stores and check-cashing outlets. However, state laws regulating money services businesses (MSBs) vary widely and have different requirements regarding bonding and licensing, making it difficult for some SVC providers to use non-bank retail distribution channels at scale. Banks are generally exempt from state MSB laws.

MSB laws serve to ensure the viability of companies that engage in money transfer transactions and to protect consumers' funds in case of failure of the MSB. A scan of the various state laws covering MSBs shows that most do not explicitly cover SVCs,[17] and, according to one state regulator interviewed, these laws are subject to interpretation. New products that are distributed in a variety of ways raise questions around issues such as the definition of a "branch" and the definition of an "agent" of a financial institution. The following attempts to synthesize trends in MSB licensing.[18]

Most states have laws that specifically state bonding and fee requirements for businesses to become licensed MSBs. Forty-two states have explicit bonding requirements, although how these requirements are derived varies widely. Moreover, application, investigation, license, registration and location (fees for each additional location included under the license) might also be levied on MSBs.

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[16] Persons or entities (other than banks or persons regulated or examined by the Securities and Exchange Commission or the Commodity Futures Trading Commission) are required to register as Money Services Businesses if they conduct more than $1,000 in transactions with any one person on the same day in one or more of the following services: stored value; money orders; traveler's checks; check cashing; and currency dealing or exchange. All such businesses that provide money transfer services must register, regardless of the amount of transactions. The federal MSB registration requirement does not apply to a business that is an MSB solely because it serves as an agent of another MSB (Financial Crimes Enforcement Network, 2003).

[17] Sixteen states have expanded their MSB laws to include prepaid cards; many of these exclude single-use gift cards (Kountz and Gould 2004).

[18] In addition to these trends, one industry report states that some states may be considering whether to regulate the issuance of general spending and payroll cards as a branch-banking activity, thus requiring that issuing banks have branches in states in which their cards are distributed (Kountz and Gould, 2004).

Again, most state laws do not explicitly mention SVCs. Moreover, some SVC providers contend that because their business never touches money or directly handles transactions (rather, the issuing bank and the point-of-distribution merchant cover transactions), MSB laws do not apply to them. Some SVC companies have been granted exceptions to registering as MSBs under state laws, while others have been ordered to cease and desist until they are licensed by the state. According to the state regulator we interviewed, this disparity shows a general lack of consensus in how these laws should treat SVCs. The issue is not a trivial one. Under federal law, it is a crime to operate a money transmitting business without the proper state license.

In addition, the issue of whether distribution points (i.e., retail stores that sell SVCs) should register as MSBs under state laws is also unclear. Sometimes, large retail or other firms might register for MSB licenses in order to be able to provide a wide range of financial services from any of their locations. In this case, the question of whether the individual location is a "branch" or an "agent" of some sort is raised. In other cases, individual franchises might have exclusive or non-exclusive agency contracts with SVC providers, further complicating the question of who should register as an MSB.

MSB laws, which are evolving with the changing marketplace, provide important protections for consumers. If and when these various state MSB laws apply to companies that solely issue SVCs, the industry will need to sift through complexities and costs related to MSB compliance. State regulatory leaders involved with the Conference of State Bank Supervisors have begun to meet to discuss ways to simplify the MSB laws across states and ensure that they are keeping pace as products and technologies change.

Payroll Card Issues

Another important legal issue is specific to payroll cards and underscores the importance of consumer protections for these cards. Many states mandate that an employer cannot demand that workers receive their pay in a specific manner; payroll cards must be offered as an option rather than a requirement (Wiley, 2004). In most states, employment laws allow employers to offer direct deposit, but they do not allow employers to mandate that their workers participate in their direct deposit programs. Alternatively, employment laws in other states do permit employers to mandate worker participation in direct deposit programs as long as the worker can choose the financial institution to which the funds are electronically transmitted. Most states also stipulate that employees must be able to access their pay without incurring any additional costs.[19] Many payroll card products are structured to be offered nationwide and must therefore comply with varying state requirements.[20] Since most state employment regulations do not specifically address payroll cards, many employers may be relying on what each state says about direct deposit mandates, reasoning that the two payment methods are quite similar.

[19] For more information, see the American Payroll Association website (http://www.apa.org).

[20] Apart from the state employment law issue, the OCC has also issued guidance on how national banks should deal with payroll cards. The guidance warns national banks about unfair marketing practices and disclosures, unauthorized use and error resolution. The OCC is specifically concerned with payroll cards being designed to facilitate payday lending programs or other services that the Comptroller deems predatory (Office of the Comptroller of the Currency, 2004).

Federal Preemption of State Laws

The issue of federal preemption of state laws covering aspects of prepaid cards recently came to light when the state Attorneys General in Massachusetts, New Hampshire, and Connecticut filed suit against the Simon Property Group for selling Bank of America-issued gift cards in its malls. The attorneys general claimed that Simon violated state laws aimed at curbing unreasonable expiration dates and fees by subtracting $2.50 a month from gift cards that had unused balances after six months and charging a $7.50 fee to reactivate expired cards. Simon Property Group has claimed that those state laws are preempted by the National Bank Act and by OCC regulations.[21]

However, in a recent letter to both the states and Simon Property Group, the OCC opined that federal law did not preempt state law in this instance (Jewell, 2005). Therefore, it appears that in this case, states had the right to enforce restrictions on fees and expiration dates for retail gift cards issued through national banks.[22] The precedent set by this case could be significant, particularly because it involves a national bank regulator siding with states rather than claiming preemption.

Conclusion

This study highlights many promising developments in the SVC industry and the regulatory environment, as well as a need for further research. First of all, research is needed on the characteristics, needs, and motivations of SVC users. Although some SVC providers have shown interest in adding savings, asset-building, or credit-building features, they are hesitant to do so without a better understanding of what consumers want. While SVC users might have unique preferences, they are by no means a homogenous group. Further research should focus on why consumers use SVCs, whether they would want to use them for asset- or credit-building purposes, and, if so, what kinds of asset- or credit-building features they would prefer.

A second area in which further research is needed is in determining the value of SVC-related data in predicting credit-worthiness. Even if consumer demand for credit-building SVC products is demonstrated, credit rating agencies, credit scorers, and lenders must also be convinced of the predictive value of SVC-related data. Research is needed to determine exactly what kinds of SVC-related data, such as data on account inflows and outflows, overdrafts, or on balances, have such value.

Third, general market research data on SVC usage, take-up, profitability, and potential should be collected and publicly distributed. Currently, the only information available is proprietary data given to a small number of market research firms, and it is difficult to ascertain the validity or impact of these data.

[21] In early 2004 the OCC issued a rule identifying types of state laws that are and are not preempted by federal law. Stored value cards are not explicitly mentioned in the rule (“Bank Activities,” 2004).
[22] Since the date of these letters, the New York State Attorney General has also filed suit against Simon Property Group (Office of the Attorney General of the State of New York, 2005).

Finally, research on the impacts of various regulatory alternatives would be useful to understanding current and future trends in this industry. For example, it would be instructive to discern whether or not SVC customers would use and value periodic mailed statements. Likewise, it would be important to understand if customers who were to receive statements in alternative forms feel they have adequate access to balance and transaction history information.

The SVC industry is in its relative infancy in the United States, as providers work to figure out ways to achieve profitability and hone functionality. There are a myriad of pricing structures, card types, and target markets for this product set. As the market continues to evolve, with SVCs offering greater functionality and increasingly serving as a primary financial instrument for unbanked and underbanked individuals, steps should be taken to ensure appropriate consumer protections and to encourage the development of mechanisms for allowing these consumers to build assets and credit. Continued study of the questions raised above will facilitate the development of SVC products that unbanked and underbanked consumers demand and that serve them effectively.

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