

Gift Cards – Facts and Cautions Regarding a Widely Used Financial Product

By Helen Mirza

Introduction

Gift cards have grown in popularity for many reasons. They are a convenient option for any occasion requiring a gift, and a step up from giving cash. Some receivers (or observers) may consider a gift card an impersonal gesture, but the cards are practical in that the receiver obtains something he/she will likely use.

The above considerations aside, the gift card business is booming. The National Retail Federation estimated that \$25 billion was spent on gift cards during the 2006 holiday season alone.¹ In 2004, according to writer Bruce Mohl of the Boston Globe, total gift card sales for the entire year were forecast at \$55 billion. Thus an estimate of gift card sales for the entire year of 2006 would exceed \$100 billion.

TowerGroup, a research and advisory service for the financial services industry, collects and projects estimates of gift card sales, and has estimated a total of \$67 billion in 2005, \$82 billion in 2006, and projected sales of \$97 billion in 2007.²

History of Gift Cards

For many decades, people have been able to obtain gift certificates from individual retailers. The certificate is valid only at a particular store, and if the recipient did not use up the entire certificate on his first purchase, he would either be issued a new certificate for the balance or a store credit to be used later. While such certificates always had a certain popularity, they were most appropriate for individual recipients who lived near and would likely frequent the issuing store. The issuing store also knew that a certain number of the certificates issued would never be redeemed. Many certificates had an expiration date. Some were issued for a small fee to the giver and some had a redemption fee to the user. Most stores were glad to issue them, however, because a certain percent of them represented pure profit if never redeemed.

Later, gift certificates for most retailers were replaced by gift cards. These cards are machine readable and can be loaded with a particular amount of credit to be designated either at the time the card is created or at the time the card is purchased. By using sequential numbering, card issuers can keep track of the inventory of such cards, as well as the balance outstanding. It is not necessary to reissue these stored value cards if the gift amount is not used in full; the value declines by the amount used each time the card is presented for payment.

A more recent development is the issuance of stored value cards by large credit card companies or banks. These cards can be used virtually anywhere credit cards are accepted, but carry fees to generate a profit to the issuer, who is not the retailer.

Fees and Expiration Periods

There are often the following fees: (1) an initial handling or issuing fee; (2) a dormancy fee levied on a monthly basis, which results in a gradual decrease in the value of the card; or (3) less frequently, a fee upon redemption. Further, these cards usually have an expiration date upon which the entire balance is forfeited to the issuer. Some individual retailers that issue gift cards also often invoke fees and expiration dates.

Sometimes the expiration date is not indicated to the customer nor noted on the card. As a result, the customer may try to use the card and discover that it has expired. Another common restriction is that some cards do not allow cash refunds for any remaining portion of the value, regardless of how small. Thus the customer has to either forfeit the balance or buy an additional item or items to realize the full value of the card.

Receivers of gift cards have an additional option if they are unable or unwilling to use a card. There is a primarily Internet-based resale market for gift cards.

Theft of Gift Cards and/or Their Contents

Unfortunately, thieves have learned how to defraud the card holders and issuers. A typical gift card scam works this way: a retailer places a number and variety of gift cards out on a rack in the store; a thief writes down the card numbers for several cards and then calls the store to see if they have been sold, pretending to be the customer asking how much the card still has on it. Sometimes the answer is that that particular card has not yet been issued. But if the answer is that there is a balance, the thief then uses the number to buy something over the Internet using the card's number and stating the value of the card. The Internet retailer can then get the same information about the card that was issued (the date and amount issued) and allows redemption of the card's value for purchase of his products. Thieves also use fraudulent credit card numbers (that they have obtained from legitimate holders in various ways) to buy the cards over the Internet.

Since gift cards and stored value cards are not usually registered to an individual purchaser, they can also be easily stolen. Since there is usually no record of who purchased the card, whoever has possession of it can use it without detection. Some stores do urge customers to access their Web site and register cards in their name, offering at least some protection against theft. However, checking the cards against a registry is not yet common. Victims of gift card theft generally lose the entire value of the card and have no recourse against the issuer or retailers where they are used fraudulently.

State Law Response to Fees and Expiration

Many states have passed laws restricting the use of fees and expiration dates in relation to gift and stored value cards. Consumer groups have expressed misgivings about card issuers that do not inform users about fees and expirations.

"California and a handful of states prohibit retailers from letting the cards expire, and Tennessee is among several states that restrict gift card fees," says Martiga Lohn of Associated Press.³ Minnesota is also considering legislation, which would require expiration dates and other terms to be displayed prominently on the front of the cards, require retailers to honor gift cards indefinitely, and prohibit dormancy fees. The proposal would also allow consumers to get cash back for small balances under \$5.⁴ According to the National Conference of State Legislatures, 25 states or more have 'strengthened' their consumer laws regarding gift and stored value cards.⁵ Some states – notably Connecticut, Montana, and Rhode Island – prohibit all fees and expiration dates.⁶

As a result of the recent wave of state consumer protections and the accompanying publicity, some stores have honored expired cards upon customer request. Another incentive for honoring cards that have expired is the fact that patrons often spend more than the face value of the card. Acceptance of expired cards is not universal, however, and some retailers, absent explicit, new guidelines, do not honor them.

Federal Law Response

"The Federal Trade Commission (FTC) recently brought charges against Darden Restaurants, Inc., which owns several popular restaurant chains, alleging that it engaged in deceptive practices in advertising and selling its gift cards. Darden agreed to a settlement and will restore fees that have been deducted from consumers' gift cards and disclose fees or expiration dates in future gift card sales. This is the agency's second law enforcement action involving allegedly deceptive gift card practices. [The first action pertained to K-Mart stores.]

According to the FTC's complaint, Darden's advertisements represented that consumers could redeem the cards to buy goods or services at its restaurants equal to the card's monetary value. However, Darden did not disclose 'dormancy fees' that would be deducted after a certain period of time. Typically, the firm deducted \$1.50 per month in dormancy fees after a period of either 15 or 24 months had passed from the date of purchase.

In many instances, the Commission alleged, consumers did not learn of the fee until they attempted to use their gift cards and learned that they had little or no remaining value. Disclosures on the cards were in fine print or obscured by other information.

The settlement requires Darden to disclose any automatic fee or expiration date clearly and prominently in future advertising, at point of sale, and on the card. It also prohibits the company from collecting any fee on cards activated before the order is final. Darden has already restored all previous charges.

'The FTC works to make sure consumers have the facts they need to make smart decisions, no matter what they're buying,' said Lydia Parnes, director of the FTC's Bureau of Consumer Protection. 'When it comes to gift cards, issuers can't gloss over key information. They must clearly and prominently disclose fees and restrictions that affect the use of their gift cards.'⁷

The Federal Reserve System has also taken steps to understand and focus on current and emerging issues concerning stored-value cards and other prepaid products. On November 12, 2004, a roundtable discussion was held at the Federal Reserve Board of Governors in Washington, D.C. This discussion was part of an ongoing program to discuss payments system developments and barriers to innovation with a range of parties, and was hosted by the Federal Reserve System's Payments System Development Committee (PSDC).⁸ This initiative not only considered the consumer issues, but also the business and evolving technological aspects of these systems, as well as the ramifications for the payments systems infrastructure in the U.S.

More information on the PSDC and the Federal Reserve System's roundtable on stored value cards is available at www.federalreserve.gov/paymentsystems/storedvalue/default.htm.

Notes

- 1 Lohn, Martiga. 2006. Associated Press. November 22. As quoted on Minnesota Public Radio. <http://minnesota.publicradio.org>.
- 2 Riley, Brian. 2007. TowerGroup. January, p.2. www.towergroup.com.
- 3 Lohn, Martiga. 2006. Associated Press. November 22. As quoted on Minnesota Public Radio. <http://minnesota.publicradio.org>.
- 4 Ibid.
- 5 2006. National Conference of State Legislatures. As quoted by Phillip Ewing. October 17. www.stateline.org/live/details/story?contentId=149457.
- 6 Ibid.
- 7 2007. More Gift Card Issues. *Pratt's Letter*. April 9.
- 8 2004. A Summary of the Roundtable Discussion on Stored-Value Cards and Other Prepaid Products. www.federalreserve.gov/paymentsystems/storedvalue/default.htm.

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