Office of Regional and Community Affairs
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Stored Value Cards as a Method of Electronic Payment for Unbanked Consumers

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STORED VALUE CARDS
AS A METHOD OF ELECTRONIC PAYMENT
FOR UNBANKED CONSUMERS †

By

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† The views expressed here are the authors and do not necessarily represent the views of the Federal Reserve Bank of New York or the Board of Governors of the Federal Reserve System.

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Executive Summary

In December 2004, the Federal Reserve System announced that electronic transactions had surpassed checks as the consumer's preferred noncash method of payment. Fifty-five percent of these noncash transactions were completed using a debit or credit card, through an automated clearing house (ACH) transaction, or an electronic benefit transfer (EBT). The remaining forty-five percent of these transactions were made by check.[1] *These findings make it clear that the trend toward electronic payments is well underway.*[2]

The stored value card market is one of the most dynamic and fastest growing segments of the financial services industry. It includes a variety of products, ranging from gift cards that are used to make small dollar transactions tied to specific retailers (closed-loop) to reloadable general spending or payroll cards (open-loop) that have greater complexity in usage and hold a substantial amount of the consumer's income. The purpose of this paper is to describe the stored value card market and to explain how unbanked consumers (that is, those without either a checking or a savings account) use reloadable general spending and payroll cards to meet their financial transactions needs. These prefunded financial services products are used to withdraw monies through ATMs, make point-of-sale debit transactions, pay bills, and transmit funds through account-to-account electronic transfer. These cards, therefore, function in much the same

[1] Federal Reserve System sponsored research, "The 2004 Federal Reserve Payments Study," Appendix A, December 2004, http://www.frbservices.org/.
[2] The study, "The Economics of a Cashless Society: An Analysis of the Costs and Benefits of Payment Instruments," by Daniel D. Garcia Swartz, Robert W. Hahn and Anne Layne-Farrar, AEI-Brookings Joint Center for Regulatory Studies, September 2004, finds evidence to suggest that the shift away from cash and checks to toward electronic payments results in net benefits to society.

way as conventional deposit accounts and are heavily marketed to unbanked individuals or consumers with blemished credit histories that preclude them from opening a deposit account.[3]

According to industry sources, roughly 20 million consumers use at least one of the 2,000 stored value card programs in the marketplace. By 2004, over 7 million cards were branded by a bank association such as Visa or MasterCard. This feature gives cards greater versatility because they can be used wherever these brands are accepted.[4] *Greater consumer adoption and marketplace acceptance of stored value cards have been facilitated by a mature credit/debit electronic infrastructure that accommodates transference of electronic payments between card accounts. Industry experts place this market in the early growth stage of the product life cycle, suggesting that substantial expansion is likely in the years ahead.*

The financial services industry offers consumers a wide array of product choices. Understanding the costs of each of these alternatives is needed for consumers to make sound financial decisions. This paper reports simulations undertaken by the authors that compare the costs of using four major financial services products: reloadable general spending cards, payroll cards, checking accounts, and check cashiers. Based on three consumer profiles making the same volume of transactions per month, the results show that a consumer's lowest-cost choice depends on the intensity of his or her financial services needs. While informative, these cost comparisons do not measure other potential costs associated with these choices. For example, a decision to use financial services products outside the financial mainstream based solely on transactions costs may have an unexpected or unintended impact on the individual's ability to accumulate interest-bearing assets or to establish credit worthiness. These simulations also cannot capture how consumer laws and regulations may influence the costs and benefits associated with these financial services product choices.

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[3] For example, Visa describes general spending cards as serving the unbanked consumer demographic segment (Todd Brockman, "Visa Prepaid 'Dual Advantages'," Stored Value: Challenging the Credit Card Paradigm Conference Proceedings, Pelorus Group, March 2004). Some of the major general spending card providers, such as Next Estate, NetSpend, and Rush Communications, explicitly identify the unbanked and/or credit-challenged as their target markets (Steve Streit, "Next Estate," Stored Value: Challenging the Credit Card Paradigm Conference Proceedings, Pelorus Group, March 2004; NetSpend Corporation, "Corporate Information: Overview," www.netspend.com/corp.shtml; Riva D. Atlas, "A Rap Impresario Tries His Hand at Banking," *The New York Times*, March 30, 2003).

[4] See Ted Dargan, "A Stored Value Update" and Karen Larsen, "Closed Systems: Strategies for Capitalizing on Gift/Convenience/Loyalty Cards," Stored Value: Challenging the Credit Card Paradigm Conference Proceedings, Pelorus Group, March 2004.

With few exceptions, funds placed in payroll card or reloadable general spending card accounts are not held in deposit accounts insured by the Federal Deposit Insurance Corporation (FDIC). Unlike banked consumers, these cardholders face additional financial uncertainties with respect to the safety and on-demand liquidity of these funds. In addition, choosing a particular stored value card because it is the lowest-cost financial services product available may result in future higher credit costs due to uncertainty about the cardholder's creditworthiness. A consumer's financial security hinges on building wealth through savings and other asset accumulation. However, only a few reloadable general spending card providers have introduced interest-bearing savings features to their stored value products.[5] Hence, the opportunity to save, earn interest, and accumulate assets is limited for many stored value cardholders.

The growth in the stored value card market, both in terms of cards in circulation and dollars transacted, has gained the attention of federal regulators. Both the Federal Reserve Board and the FDIC have pending proposed changes that seek to address the terms and conditions for coverage of specific stored value cards. One of the principal questions raised about stored value cards is whether regulations should distinguish among the different types of cards or not. Some argue that stored value cards such as gift cards are merely cash substitutes and therefore should not be subject to federal regulations that apply to deposit accounts, whereas others believe that cards that carry larger amounts of consumer assets and are used to make many kinds of electronic payments should be treated as electronic deposit accounts. A third prevailing argument is that it is too soon to set regulatory standards, that a slower approach is needed to ensure that regulation does not stifle product development in this emerging industry.

Fundamentally, the question becomes whether or not there is a need to advance consumer protections through regulatory change to general spending and payroll cardholders. On September 17, 2004, the Federal Reserve Board published for public comment proposed amendments to Regulation E that would extend the act's coverage to asset accounts related to electronic payment of wage and salary income. On August 8, 2005, the Federal Deposit Insurance Corporation (FDIC) published for notice and comment a

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[5] Some years ago, a few stored value card providers launched savings products that were discontinued due to a lack of customer interest; however, according to these providers, this lack of interest may have been the result of insufficient marketing. More recently, NetSpend and IndiGOCARD, both general spending card providers have launched a savings deposit account programs for their cardholders. Section V provides further details about this program.

proposed rule that aims to clarify the insurability of funds underlying stored value cards and other nontraditional access devices. Final rules from these regulators are pending.

From a policy perspective, research is needed to further clarify what type of regulatory framework can best protect consumers' assets, regardless of whether these funds are held in a conventional deposit or a stored value card account, while not inhibiting market innovation and growth. For example, identifying alternative, lower-cost ways to deliver account statement information could help guide policy. Additional research is also needed to learn what motivates consumers to choose a stored value cards in lieu of holding conventional deposit accounts and to identify the card features most preferred by cardholders. If the stored value card market is to move toward asset- and credit-building enhancements, more analysis is needed to determine the savings behavior of cardholders and how their stored value transactions relate, if at all, to credit worthiness. Because unbanked stored value cardholders have a wide range of characteristics, needs, and motivations for using these financial services products, a clearer understanding of consumer segmentation is needed to determine whether business models can support these features. Many consumers, especially those outside the financial mainstream, may have difficulty weighing the benefits against the costs of choosing the financial services products that best meet their needs. Financial education materials that describe stored value cards, their fee structures as well as the consumer protections afforded to these cards could help consumers with these decisions. As substantial changes continue in the financial services industry, studies should be undertaken to identify financial education programs most likely to help consumers make sound financial decisions for themselves and their families.

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I. INTRODUCTION

In December 2004, the Federal Reserve System announced that electronic transactions had surpassed checks as the consumer's preferred noncash method of payment. Fifty-five percent of these noncash transactions were completed using a debit or credit card, through an automated clearing house (ACH) transaction, or an electronic benefit transfer (EBT). The remaining 45 percent of these transactions were made by check.[6] These findings suggest that the trend toward electronic payments is well underway.[7]

The stored value card market is one of the most dynamic and fastest growing segments of the financial services industry. It includes a variety of products, ranging from gift cards that are used to make small dollar transactions tied to specific retailers (closed-loop) to reloadable general spending or payroll cards (open-loop) that have greater complexity in usage and may hold a substantial amount of the consumer's income. The purpose of this paper is to describe the stored value card market and to explain how unbanked consumers (that is, those without either a checking or a savings account) use reloadable general spending and payroll cards to meet their financial transactions needs. These prefunded financial services products are used to withdraw monies through ATMs, make point-of-sale debit transactions, pay bills, and transmit funds through account-to-account electronic transfers. These cards, therefore, function in

[6] Federal Reserve System sponsored research, "The 2004 Federal Reserve Payments Study," Appendix A, December 2004, www.frbservices.org.
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much the same way as conventional deposit accounts and are heavily marketed to unbanked individuals or consumers with blemished credit histories that preclude them from opening a deposit account.[8]

The next section describes the stored value card market and explains the ways consumers obtain and use reloadable general spending and payroll cards. Section 3.0 discusses consumer behavior and decision making toward electronic transactions and highlights card features that are especially useful for unbanked consumers. In section 4.0, usage costs are compared among financial services products, including an average checking account, reloadable general spending cards, payroll cards, and check cashing businesses; while the additional costs and foregone opportunities from choosing general spending or payroll cards over a conventional checking account are discussed in Section 5.0. Federal regulatory issues pertaining to stored value cards are outlined in Section 6.0. The final section makes several recommendations for future research needed to better inform policy about this growing sector of the financial services industry.

II. THE STORED VALUE CARD MARKET

Numerous functions such as card issuance, transactions processing, funds management, customer service, and marketing/distribution are involved in bringing stored value cards to the marketplace. Different market players take varying roles, adding to the complex nature of this dynamic market. These financial services products are brought to the market by either banks or non-banks.[9] Several financial institutions have their own stored value program and product lines and may only use third-parties for transaction processing. Non-bank marketers/distributors that are vertically integrated still rely on financial institutions to provide back-office operations such as holding the funds in a non-depository trust or fiduciary account.

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[8] For example, Visa describes general spending cards as serving the unbanked consumer demographic segment (Todd Brockman, "Visa Prepaid 'Dual Advantages'," Stored Value: Challenging the Credit Card Paradigm Conference Proceedings, Pelorus Group, March 2004). Some of the major general spending card providers, such as Next Estate, NetSpend, and Rush Communications, explicitly identify the unbanked and/or credit-challenged as their target markets (Steve Streit, "Next Estate," Stored Value: Challenging the Credit Card Paradigm Conference Proceedings, Pelorus Group, March 2004; NetSpend Corporation, "Corporate Information: Overview," www.netspend.com/corp.shtml; Riva D. Atlas, "A Rap Impresario Tries His Hand at Banking," *The New York Times*, March 30, 2003).

[9] A description of how product functionality and program servicing differs between the prepaid (stored value) card market and bank-issued debit and credit cards are provided in "Prepaid Card Models: A Study in Diversity," by Julia S. Cheney, Federal Reserve Bank of Philadelphia, Payment Cards Center Discussion Paper, March 2005,http:// www.philadelphiafed.org/pcc/PrepaidCardModels_Palmer_FINAL.pdf.

The bulk of stored value card providers outsource the transaction processing to one of the numerous firms that have become specialized in creating and maintaining software platforms used in this market.[10]

According to industry sources, roughly 20 million consumers use at least one of the 2,000 stored value card programs in the marketplace. By 2004, over 7 million cards are branded by a bank association such as Visa or MasterCard. This feature gives cards greater versatility because they can be used wherever these brands are accepted.[11] Greater consumer adoption and marketplace acceptance of stored value cards has been facilitated by a mature credit/debit electronic infrastructure that accommodates transference of electronic payments between card accounts. Industry experts place this market in the early growth stage of the product life cycle, suggesting that substantial expansion is likely in the years ahead.

Stored value cards fall along a wide spectrum defined according to market acceptance and flexibility of use. For ease of discussion, we categorize stored value cards into two basic groups that fall at the extremes of this spectrum—single-purpose (closed-loop) cards and general-purpose (open-loop) cards. Consumers purchase closed-loop cards to make purchases from specific retailers or clusters of merchants such as those located in malls.[12] Merchant gift cards and telephone cards are examples of closed-loop cards.[13]

Open-loop cards, on the other hand, can be used to make a wide array of financial transactions among a substantial number of retailers or billers. These cards provide cardholders with the greatest flexibility in making financial transactions. Examples include reloadable general spending cards; payroll

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[10] For an in-depth discussion about the stored value card industry, see Katy Jacob, "Stored Value Cards: A Scan of Current Trends and Future Opportunities," The Center for Financial Services Innovation, Research Series White Paper #1, July 2004, www.winwinpartner.com/_downloads/0904_CFSI_SVCreport.pdf
and Mark Furletti, "Prepaid Card Markets & Regulation," Federal Reserve Bank of Philadelphia Payment Cards Center Discussion Paper, February 2004,
www.philadelphiafed.org/pcc/D2005MarchUnbankedCover.pdf.

[11] See Ted Dargan, "A Stored Value Update" and Karen Larsen, "Closed Systems: Strategies for Capitalizing on Gift/Convenience/Loyalty Cards," Stored Value: Challenging the Credit Card Paradigm Conference Proceedings, Pelorus Group, March 2004.

[12] A debate is underway to determine whether gift cards distributed by mall retailers fall under state or federal regulations. Simon Property Group, Inc., which operates 159 malls throughout the country, contends it is exempt from state gift card laws, whereas the Office of the Comptroller of the Currency and Attorneys General of Massachusetts, Connecticut and New Hampshire disagree. A description of this debate is given in "Gift Card Case Has OCC Siding with States," *American Banker*, November 17, 2004.

[13] A growing number of gift cards offered by bank associations or other payment card networks, including Visa, MasterCard, American Express and Discover Card, are proliferating in the marketplace. These gift cards are accepted at a variety of retailers, although they are not always accepted by retailers who accept the brand name. As an example, the American Express "gift card" may or may not be accepted at a department store that accepts the American Express card.

cards; bonus, commission, healthcare and other employee compensation-related cards; most government benefit program cards; child support cards; and insurance claim cards.

The industry projects that 34 million open-loop cards will be in use by the end of 2005. The largest share will be reloadable general spending cards at 35 percent. Government income-support cards are expected to account for almost 30 percent, while 25 percent will be payroll cards. The remaining 10 percent will be other open-loop cards.[14] The industry predicts that over $107 billion will flow from transactions made using these open-loop cards by the end of 2005.[15] This paper highlights two types of open-loop cards—reloadable general spending cards and payroll cards. Unbanked consumers use these cards to meet the majority of their financial services needs.

Reloadable General Spending Cards

Consumers obtain reloadable general spending cards directly from a marketer/distributor through applications made over the telephone, the Internet, or increasingly, with retailers who act as the marketer/distributor's agent. Convenience stores and check cashing businesses are examples of retailers that have a business relationship with the marketer/distributor.[16]

Figure 1 provides a simple depiction of the reloadable general spending cardholders' relationship to the marketer/distributor card providers.[17] Typically, the card provider establishes a pooled account and/or cardholder sub-accounts, drawn on the pooled account, with its financial institution. The financial institution issues the card and has fiduciary and/or trustee responsibilities for the marketer/distributor's accounts. Transactions processing, customer services, or program administration are performed by third-party service providers (processors), the financial institution, or by the marketer/distributor if it is vertically integrated.

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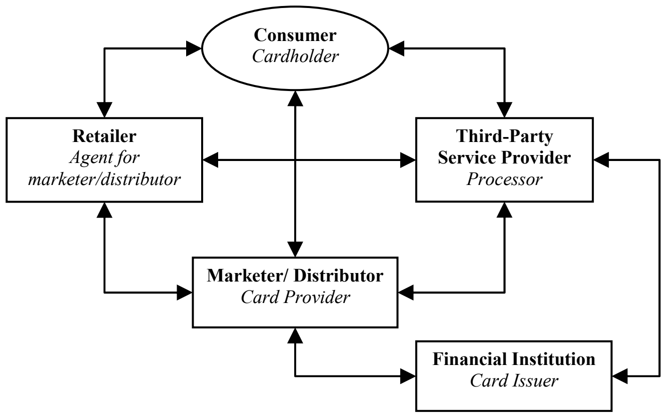
[14] Thomas Miezejeski,, "Stored Value: The Perfect Storm," Stored Value: The Shape of Things to Come Conference Proceedings, Pelorus Group, October 2004.
[15] Figures derived from conversations with Thomas Miezejeski, Vice President of Research, The Pelorus Group, November 2004.
[16] An example is the business arrangement between Secure Cash Network, Inc., a stored value card provider, and Circle K, a convenience store chain with roughly 1,900 company-operated locations in 16 states primarily located in the southern, western and Midwestern parts of the country.
[17] For a detailed technical discussion about the role of nonbanks in the payments system, see *Nonbanks in the Payments System*, by Terri Bradford, Matt Davies, and Stuart E. Weiner, Federal Reserve Bank of Kansas City, 2003, http://12.154.48.181/FRFS/NonBankPaper.pdf.

Figure 1. Reloadable General Spending Cards: Cardholder Perspective



The functions or features available to cardholders depend on the program offered by card providers. Typically, ATMs are used to draw cash from the account. Funds are loaded into the card account in a variety of ways including electronic transfer of wage and salary income, account-to-account transfers, and paper checks sent by mail or through retailers who accept these funds as agents of the card providers.[18] A greater number of card providers are offering other features such as bill payment and remittance services. Reloadable general spending cards are usually branded with a bank association logo, making it easier for the cardholder to obtain cash, make purchases, or pay bills from retailers at the point-of-sale, on the telephone or over the Internet.[19] According to the Pelorus Group, by the end of 2005 there will be more reloadable general spending cards (roughly 12 million) in circulation than payroll cards (8.4 million).[20]

Payroll Cards

Payroll cards are provided primarily to unbanked workers by employers who are seeking to lower payroll costs by using electronic payments rather than paper paycheck disbursements.[21] For example, an employer's cost to cut a payroll check is roughly between $1 and $2, while the per-unit cost for making electronic payments (transmittal of funds to a stored value account, a checking deposit account, or a savings

[18] An example of an account-to-account transfer is when a family member deposits the reloadable general spending cardholder's paycheck into his or her own checking account. The paycheck funds are then transferred via an ACH account-to-account transfer to the reloadable general spending card account.
[19] Receiving cash after making purchases is usually possible only when the debit transaction requires a PIN.
[20] Thomas Miezejeski, "Stored Value: The Perfect Storm," Stored Value: The Shape of Things to Come Conference Proceedings, Pelorus Group, October 2004.
[21] Consumers Union provides a list of questions for employees to ask concerning payroll cards, (http://www.consumersunion.org/pub/core_financial_services/000920.html) and offers employers guidance about how to choose a payroll provider to best meet their needs (http://www.consumersunion.org/pub/core_financial_services/000922.html).

deposit account) is about $0.20.[22] On an annual basis, these savings translate into $20 to $50 for each employee.[23]

Figure 2 is an abbreviated outline of the flow of transactions for the typical payroll card arrangement.[24] Financial institutions market payroll card services to business clients. These services may be provided directly by the financial institution or from a third-party payroll card program service provider (processor) on behalf of the financial institution. The third-party service provider usually handles card issuance and transactions processing, customer service, and program administration. Once the employer enrolls in the financial institution's payroll card program, cards are sent to employees either by the financial institution or the processor. Each pay period, employers electronically transmit employee wage and salary funds into pooled accounts held at the financial institution. These pooled accounts may be divided into sub-accounts for each employee. In a few instances, payroll card accounts are set up as electronic deposit accounts but this arrangement remains the exception to the rule.[25]

A common feature to all payroll cards is the use of ATMs to withdraw cash. Other card features, however, tend to vary because employers negotiate the terms and conditions with card issuers. Cards branded with a bank association logo give cardholders greater flexibility for making point-of-sale, telephone or Internet purchases from retailers and merchants. Increasingly, payroll cards offer electronic bill payment or remittance capabilities.

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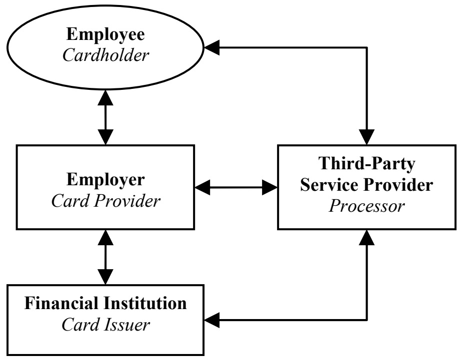
[22] Thomas Miezejeski, "Stored Value: The Perfect Storm," Stored Value: The Shape of Things to Come Conference Proceedings, Pelorus Group, October 2004.

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

[24] For a detailed technical discussion about payroll card transactions, see *NonBanks in the Payments System*, by Terri Bradford, Matt Davies, and Stuart E. Weiner, Federal Reserve Bank of Kansas, Payments System Research, 2003, http://12.154.48.181/FRFS/NonBankPaper.pdf.

[25] As of this writing, we have identified three payroll card providers or processors that set up payroll card accounts as electronic demand deposits. They are IndiGoCard , West Suburban Bank, and Directo.

Figure 2. Payroll Cards: Cardholder Perspective



Because payroll cards are a method of dispersing wage and salary income, state labor laws may influence the contractual arrangement made between the employer and the financial institution (payroll card issuer).[26] For example, some states disallow paying employees with a payroll card,[27] while other states require that a worker be given his or her wage or salary income at no cost, suggesting that at least one ATM withdrawal must be free of charge to the worker.[28]

According to Mercator Advisory Group, in 2003, $11 billion in wage and salary income was stored on these cards.[29] The Pelorus Group estimates that, by 2004, roughly 2.8 million payroll cards were in the marketplace and that 8.4 million cards will be issued to cardholders in 2005.[30] In 2002, roughly 8.5 percent of unbanked workers used payroll cards, according to Celent Communications. This figure is expected to increase by more than 25 percent by 2006.[31]

Employers with labor pools that have relatively higher turnover rates, or greater proportions of entry-level or geographically dispersed employees, or employees with money transfer needs may be most receptive to this employee payment method. Some examples of employers using payroll cards include: Fed

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[26] Samuel Frumkin, William Reeves and Barry Wides, "Payroll Cards: An Innovative Product for Reaching the Unbanked and Underbanked," *Community Developments Analysis*, Community Affairs Department, Comptroller of the Currency, June 2005, http://www.occ.treas.gov/cdd/payrollcards.pdf.

[27] Six states do not allow payroll cards: Maryland, Alaska, Hawaii, Minnesota, Montana, and Vermont. See "Maryland Considering Program to Implement Plastic, Debit-Like Payroll Cards," by Kathleen Johnston Jarboe, The Daily Record, April 1, 2005.

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

[29] Tim Sloane, "Prepaid Market Dynamics," Mercator Advisory Group, March 2004. In addition to payroll cards, employers are increasingly using stored value cards to provide employee benefits. In 2003, $4 billion in employee benefits were loaded onto stored value cards, with industry projections suggesting that this figure will rise sharply in coming years.

[30] Thomas Miezejeski,, "Stored Value: The Perfect Storm," Stored Value: The Shape of Things to Come Conference Proceedings, Pelorus Group, October 2004.

[31] Ariana-Michele Moore, "Payroll Cards: A Direct Deposit Solution for the Unbanked," December 2002, Celent Communications.

Ex, UPS, U-Haul, Manpower Inc. and other temporary employment agencies, members of the National Restaurant Association, McDonalds, Denny's, Coco-Cola, Blockbuster Videos, Office Depot, and Sears.

III. CONSUMER BEHAVIOR AND DECISION MAKING

Characteristics that contribute to a consumer's decision to conduct electronic financial transactions are expected to influence the demand for reloadable general spending or payroll cards.[32] Anguelov and others (2003) show that consumer adoption of electronic financial services products is more likely when the following features exist: lower cost, added convenience, improved time saving, user friendly technology, greater accessibility to technology, and increased versatility or usefulness. Conversely, adoption of electronic financial products tends to be slower for consumers who have an unclear understanding or misperception about how these products work or whether the benefits outweigh the costs of using these products.[33]

Unbanked and Underserved Individuals

Studies have documented that the unbanked are more likely to be younger, less educated, lower-income, or members of minority and immigrant groups. These consumers also tend to be among the working poor with less accumulated net worth.[34] Drawing on the 2001 Survey of Consumer Finances (SCF), Aizcorbe and others (2003) show that 5.1 percent of white families were unbanked, whereas 21.8 percent of non-white families were without a deposit account.[35] Findings from the 2000 Survey of Income Program Participation (SIPP) are useful for comparing the proportion of unbanked among U.S. born and immigrant groups. According to Rhine and Greene (2005), 14 percent of U.S. born white householders were unbanked. By comparison, 46 percent of U.S. born black householders and 34 percent of U.S. born Hispanic householders were unbanked. Among immigrant groups, 53 percent of Mexican, 37 percent of

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[32] For a review of this literature, see Christoslav E. Anguelov, Marianne A. Hilgert, and Jeanne M. Hogarth, "U.S. Consumers and Electronic Banking, 1995-2003," *Federal Reserve Bulletin*, Winter 2004.
[33] Similar findings are presented in the report by the Federal Reserve Bank of St. Louis, "Understanding the Dependence on Paper Checks: A Study of Federal Benefit Check Recipients and the Barriers to Boosting Direct Deposit," sponsored by the U.S. Treasury's Financial Management Service, July 2004.
[34] See Sherrie L.W. Rhine and William H. Greene, "The Determinants of Being Unbanked for Immigrants," forthcoming, *Journal of Consumer Affairs*, 2005-2006, and Jeanne M. Hogarth and Kevin H. O'Donnell, "Being Accountable: A Descriptive Study of Unbanked Households in the U.S.," *Proceedings of the Association for Financial Counseling and Planning Education*, Phoenix, Arizona, 1997.
[35] Ana M. Aizcorbe, Arthur B. Kennickell and Brian B. Moore, "Recent Changes in U.S. Family Finances: Evidence from the 1998 and 2001 Survey of Consumer Finances," *Federal Reserve Bulletin*, 89, January, 2003.

other Latin American householders, 20 percent of Asian householders, and 17 percent of European households were unbanked.[36]

Reasons why the unbanked choose not to hold either a checking or a savings account are reported by Aizcorbe and others (2003). According to their analysis using the 2001 SCF, almost 29 percent of families without a checking account said it was because not enough checks are written to make holding an account ‘worthwhile.” Another 34.3 percent said that either they do not have enough money (14.3 percent); that service charges (10.2 percent) or minimum balances (6.5 percent) are too high; or that they have credit problems (3.6 percent). Close to 23 percent of those without a checking account said they did not hold an account because they do not like dealing with banks, this is up from 18.5 percent reported in the 1998 SCF survey. Among unbanked families who *once* had a checking account, 12.8 percent said services charges were too high, while another 6.3 percent said they no longer hold a checking account because of credit problems.

General spending and payroll card providers heavily market to unbanked consumers or their employers. Similarly, underserved individuals, those who hold a deposit account but are fairly illiquid or who are heavily leveraged with credit card debt, are another consumer group targeted by reloadable general spending or payroll card providers. For example, some card providers pay financial institutions a fee for each person drawn from the financial institution’s credit card rejection list who signs up for a stored value product.[37] As a consequence, some unbanked consumers have likely moved away from the financial mainstream because a deposit account simply does not pass their cost/benefit test. Moreover, barriers may exist in re-opening a deposit account if a person is listed on ChexSystems or has a bad credit history.[38] To better meet their financial services needs, some unbanked or underserved consumers are turning to alternatives such as stored value cards.

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[36] Sherrie L.W. Rhine and William H. Greene, “The Determinants of Being Unbanked for Immigrants,” forthcoming, *Journal of Consumer Affairs*, 2005-2006.
[37] Lavonne Kuykendall, “Banks Taking Baby Steps in Prepaid Debit Space,” *The American Banker*, October 28, 2004.
[38] More information about ChexSystems can be found at www.chexhelp.com:447/ChexHelp/chex/english/publik/index.htm.

IV. COSTS OF ALTERNATIVE FINANCIAL SERVICES PRODUCTS

The financial services industry offers consumers a wide array of product choices. To better understand the costs for each of these alternatives, simulations were undertaken to compare the costs of using four major financial services products: reloadable general spending cards, payroll cards, checking accounts, and check cashiers. Each is described below.

Reloadable General Spending and Payroll Card Costs

Table 1 reports the primary categories and ranges of fees charged by reloadable general spending and payroll card providers.[39] Generally, cards that have relatively high fees in one category often have relatively low fees in another category; for example, higher monthly fees are often associated with lower or no transaction fees.

Table 1. Basic Fee Categories

Fee Type	**Fee Range**
Entrance/Activation	\$0.00 to \$39.95
Maintenance	
Annual	\$0.00 to \$99.95
Monthly	\$0.00 to \$ 9.95
Point of Sale[†]	\$0.00 to \$ 2.00
Domestic ATM Transaction (within network)	\$0.00 to \$ 2.50

[†] Pin-based transactions tend to have higher fees than signature-based transactions.

Other potential costs that may be incurred by the cardholder include:

Automated balance inquiry fee
Bill payment fee
Credit-reporting fee
Dispute fee
Domestic ATM transaction fee
International ATM transaction fee
Inactivity fee
Live customer service inquiry fee
Money transfer fee
Overdraft fee
Overdraft protection fee
Payday advance fee
Phone or online transaction fee
Reload fee
Transaction limit fee

Payroll cardholders are unlikely to pay entrance/activation or maintenance fees because of the business arrangement between the employer and the card provider. Whether they pay a fee for the initial card issued (or card replacement if lost or stolen) also depends on the terms and conditions between the employer and

[39] Fee ranges are taken from "Stored Value Cards: A Scan of Current Trends and Future Opportunities," Katy Jacob, Center for Financial Services Innovation, 2004, http://www.cfsinnovation.com/managed_documents/storedvaluecard_report.pdf.

the card provider. Accessing ATM or point-of-sale networks, however, likely generates fees paid by the cardholder. Dual ATM fees also may be triggered. For instance, card providers may not charge a fee to consumers for using an ATM to obtain cash but fees may be charged by third-parties if the ATMs are not included in the card providers' networks.

Whether reloadable general spending or payroll cards make financial sense for a consumer likely depends on how the consumer expects to use the card. As an example, consumers who make a relatively large number of transactions may find that a card with a monthly fee but no per-transaction fees is a better value than a card that only charges per-transaction fees.

Checking Account Costs

Comparing the costs of using a reloadable general spending or payroll card in lieu of holding a checking account is a complex question because the types of checking accounts can vary along with their fee structures. Table 2 shows average fees nationwide for various types of non-interest-bearing checking accounts.[40]

Table 2. Minimum Balances and Fees for Non-Interest-Bearing Checking Accounts

Type of Account	**Minimum Balance to Open ($)**	**Average Minimum Balance ($)**	**Average Monthly Fee ($)**	**Average Per-Check Fee ($)**
Single-Balance, Single-Fee†	159.21	591.46	7.35	0.00
Fee-Only††	78.41	0.00	5.27	0.22
Free	73.82	0.00	0.00	0.00

† The monthly fee is not charged if accountholder maintains the minimum balance.
††The monthly fee is charged regardless of balance; per-check fees are not always charged.

In addition, checking accounts may incur fees for ATM transactions (particularly if the ATM is owned by another institution), PIN-based debit transactions, overdrafts, balance inquiries, electronic bill payment, and other financial services. Table 3 displays the average transaction fees for checking accounts.

[40] Board of Governors of the Federal Reserve System, "Annual Report to the Congress on Retail Fees and Services of Depository Institutions," June 2003.

Table 3. Average Transaction Fees for Checking Accounts†

Fee Type	Average Fee ($)
ATM Transaction – Other Institution	1.14
ATM Transaction – Operator Surcharge	1.36
PIN Debit Fee	0.75
Signature Debit Fee	0.00
Overdraft Fee	21.80

† Debit fees taken from Board of Governors of the Federal Reserve System, "Report to the Congress on the Disclosure of Point-of-Sale Debit Fees", November 2004. All other fees taken from Board of Governors of the Federal Reserve System, "Annual Report to the Congress on Retail Fees and Services of Depository Institutions, June 2003.

Check Casher Fees

Fees at check-cashing businesses vary widely because the fees are determined at the state regulatory level. Check-cashing costs can be relatively inexpensive in New York State, where fees are capped at 1.5 percent of the value of the check. In some states, however, fee limits are much higher and in eighteen states no fee limits are imposed.[41] In addition to check-cashing fees, customers will pay fees for bill payment services, money orders, and money transfer services. The per transaction fees often are based on the dollar value of the financial service obtained.

Modeling Cost Alternatives

Consumer theory teaches that well-informed individuals will choose the lowest-cost financial services products that meet their needs. For the simulations described below, three profiles were created to represent a consumer's behavior or preference toward electronic-based transactions. A low financial services transactor seldom uses electronic transactions, whereas a high financial services transactor uses electronic-based transactions whenever possible. By comparison, a moderate financial services transactor tends to make a combination of cash-based and electronic transactions. For each of the consumer profiles described below, we assumed monthly earnings of $1,200 and payments of six bills per month, one of which is over $500.[42]

- The "Low Transactor" is a consumer who prefers cash-based transactions. She uses electronic transactions in limited ways, such as using an ATM to withdraw her entire paycheck following each electronic transfer to her account. She makes no debit transactions and does not use electronic bill payment of any kind, even if electronic bill payment options are available to her. If she has a checking account, she writes checks to pay her bills; if she does not have a checking account, she purchases money orders.

[41] Financial Service Centers of America, "Check Casher Fee Schedule: Regulated States," 2003, www.fisca.org/FeeSchedulenew.pdf.
[42] Consumer profiles were created based on information obtained from stored value card providers in interviews conducted for this study in November 2004.

- The "Moderate Transactor" is a consumer who makes a combination of cash-based and electronic transactions. He does not withdraw his entire paycheck once it has been deposited and makes approximately one debit purchase each week. However, he still relies on checks or money orders to pay bills, even if electronic bill payment options are available to him.

- The "High Transactor" is a consumer who is quite comfortable using electronic payment systems. She makes frequent ATM and debit transactions and uses electronic bill payment mechanisms to the extent that they are available to her.[43]

Eight distinctive financial products and services are compared: two different payroll cards, three types of reloadable general spending cards, an average checking account, and a relatively higher-cost and a relatively lower-cost check casher. Each is described below:

Payroll Card A: No Monthly Fee & Some Transaction Fees
This card charges no monthly fee and all debit transactions are free. Cardholders pay a fee to the payroll card provider only for ATM transactions exceeding a monthly limit; however, for all ATM transactions, the cardholder may pay fees to the ATM operator. Electronic bill payment is only available for those billers accepting Visa and MasterCard.

Payroll Card B: Monthly Fee & Transaction Limit Fees
This card charges a low monthly fee to the cardholder and provides a limited number of transactions free to the cardholder; a per-transaction fee is imposed for any transactions exceeding the monthly limit. Electronic bill payment is only available for those billers accepting Visa and MasterCard.

Reloadable General Spending Card A: Monthly Fee Only
This card charges a monthly fee and provides all transactions free of charge. However, for ATM transactions, the cardholder may pay fees to the ATM operator. Electronic bill payment to any biller is available free of charge.

Reloadable General Spending Card B: Annual Fee & Selected Transaction Fees
This card charges an annual fee as well as fees for ATM transactions. Debit transactions are provided free of charge. Electronic bill payment is only available for those billers accepting Visa and MasterCard.

Reloadable General Spending Card C: Monthly Fee & Transaction Fees
This card charges a monthly fee as well as fees for each transaction. Electronic bill payment is only available for those billers accepting Visa and MasterCard.

Checking Account: Average Fees
This account is a "Fee-Only" account (see Table 2 above), in which the accountholder is charged a monthly fee regardless of balance, as well as a per-check fee.[44] Electronic bill payment is only available for those billers accepting electronic payments.

Check Casher in State A: 5% Fee
For payroll checks, this state imposes a fee limit of 5 percent of the value of the check.

[43] For example, in the case of General Spending Card C, only certain types of electronic bill payment are possible.
[44] This type of account was selected for the model because, among the three types of non-interest checking accounts described in Table 2, it was the most prevalent (offered by 40% of surveyed institutions). (See Board of Governors of the Federal Reserve System, "Annual Report to the Congress on Retail Fees and Services of Depository Institutions," June 2003.)

Check Casher in State B: 1.5% Fee
For payroll checks, this state imposes a fee limit of 1.5 percent of the value of the check.

For each consumer profile, the transactions costs for each of the eight financial products or services are modeled and compared. While these comparisons are useful, it should be kept in mind that further research on consumer preferences is needed to determine consumers' price sensitivity toward the types of options presented in the simulation models. Consumers with certain profiles will likely sort themselves according to those products that are most cost-effective for them. For example, a High Transactor is unlikely to use a per-transaction-fee-based product in lieu of a monthly-fee based product.

For ease of discussion, the models exclude the whole array of additional fees that consumers may incur when making their financial transactions. The most significant omissions may be the following:

- Balance inquiries and live customer service inquiries often pose additional costs for both stored value card users and checking accountholders. These costs were not included in the models for the sake of simplicity, as the fee structures for such services vary widely and are not always transparent. However, these costs may be significant for those low- and moderate-income consumers who have greater financial education and customer service needs.

- Overdraft and insufficient funds (NSF) fees are often cited as the main factors that make checking accounts an expensive financial product for low- and moderate-income consumers. The consumer profiles created do not include any overdraft activity due to our lack of data on the frequency of such activity. It is important to note that, although overdrafts are less likely to occur with stored value cards, they can occur with signature-based debit transactions. As such, fees may be charged for these overdrafts.

- All of the reloadable general spending stored value card models assume that employers make electronic payments for wage and salary income. Otherwise, the costs of holding a reloadable general spending card would be higher because the cardholder would have to pay a reloading fee each time he or she loads cash onto the card.

Tables 4a – 4c summarize the model results for each type of transactor (see Appendix A for details about the models):

Table 4. Transactor Profiles

Low Transactor

Receives payment of wages twice per month
Conducts two ATM withdrawals per month, following transmittal of payroll
Makes no debit transactions
Pays one monthly rent bill of over $500
Pays five other monthly bills of less than $500 each
Does not use electronic bill payment of any kind

	Start-Up Costs*	Yearly Costs	
Payroll Card A	$0.00	$101.64	least expensive option
Payroll Card B	$0.00	$119.64	
General Spending Card A	$49.95	$259.59	
General Spending Card B	$19.95	$239.54	
General Spending Card C	$18.95	$209.04	
Check Casher A	$0.00	$789.00	most expensive option
Check Casher B	$0.00	$285.00	
Checking Account	$0.00	$115.54	

*Start-up costs include activation/entrance and shipping/handling fees. It is worth noting that although checking accounts do not have such fees, they often have opening balance requirements (see Table 2 above), which may also pose a barrier to entry for low- and moderate-income individuals.

Moderate Transactor

Receives payment of wages twice per month
Conducts five ATM transactions per month
Makes four debit transactions per month (two PIN-based and two signature-based)
Pays one monthly rent bill of over $500
Pays five other monthly bills of less than $500 each
Does not use electronic bill payment of any kind

	Start-Up Costs*	Yearly Costs	
Payroll Card A	$0.00	$168.60	
Payroll Card B	$0.00	$186.60	
General Spending Card A	$49.95	$258.60	
General Spending Card B	$19.95	$340.55	
General Spending Card C	$18.95	$354.00	
Check Casher A	$0.00	$789.00	most expensive option
Check Casher B	$0.00	$285.00	
Checking Account	$0.00	$159.22	least expensive option

* Start-up costs include activation/entrance and shipping/handling fees. It is worth noting that although checking accounts do not have such fees, they often have opening balance requirements (see Table 2 above), which may also pose a barrier to entry for low- and moderate-income individuals.

High Transactor
Receives payment of wages twice per month
Conducts eight ATM transactions per month
Makes ten debit transactions per month (five PIN-based, five signature-based)
Pays one monthly rent bill of over $500
Pays five other monthly bills of less than $500 each
Uses electronic bill payment when possible

	Start-Up Costs*	Yearly Costs	
Payroll Card A	$0.00	$249.96	
Payroll Card B	$0.00	$270.96	
General Spending Card A	$49.95	$238.56	
General Spending Card B	$19.95	$439.91	
General Spending Card C	$18.95	$477.36	
Check Casher A	$0.00	$789.00	most expensive option
Check Casher B	$0.00	$285.00	
Checking Account	$0.00	$193.07	least expensive option

* Start-up costs include activation/entrance and shipping/handling fees. It is worth noting that although checking accounts do not have such fees, they often have opening balance requirements (see Table 2 above), which may also pose a barrier to entry for low- and moderate-income individuals.

Table 5 displays a ranking of costs for each type of transactor based on the model findings in Tables 4.

Table 5. Ranking of Options for Each Transactor Type

Cost Ranking	**Low Transactor**	**Moderate Transactor**	**High Transactor**
1 (Lowest)	Payroll Card A	Checking Account	Checking Account
2	Checking Account	Payroll Card A	General Spending Card A
3	Payroll Card B	Payroll Card B	Payroll Card A
4	General Spending Card C	General Spending Card A	Payroll Card B
5	General Spending Card B	Check Casher B	Check Casher B
6	General Spending Card A	General Spending Card B	General Spending Card B
7	Check Casher B	General Spending Card C	General Spending Card C
8 (Highest)	Check Casher A	Check Casher A	Check Casher A

For all three types of consumers, Check Casher A was the most expensive alternative. For the Moderate and High Transactor profiles, the least expensive alternative was Checking Account, while for the Low Transactor, Payroll Card A was the least expensive alternative. It must be noted that payroll cards are not selected by employees but by their employers. With this in mind, a Low Transactor may not have the option of using Payroll Card A. Under these circumstances, her next lowest cost option is a checking account. Conversely, an employee may be offered Payroll Card A by her employer, but if she is a Moderate or High Transactor, this will be a more expensive option than a checking account.

For consumers comparing reloadable general spending cards, the frequency and type of usage are very important. Among reloadable general spending cards, Card C was the least expensive option for the

Low Transactor and the most expensive option for the Moderate and High Transactors. Conversely, Card A was the most expensive reloadable general spending option for the Low Transactor but the least expensive for the Moderate and High Transactors. The models also show that, in a state with check-cashing fee limits as low as 1.5 percent, reloadable general spending cards may be a more expensive option than using check cashers.

The results of these simulations suggest that consumers need to recognize the type of transactors they are so that they can shop around for the financial services products that best meet their needs. While informative, these cost comparisons do not measure other potential costs or benefits associated with these choices. For example, a decision to use financial services products outside the financial mainstream based solely on transactions costs may have an unexpected or unintended impact on the individual's ability to accumulate interest-bearing assets or to establish credit worthiness. These simulations also cannot capture how the consumer laws and regulations may influence the costs and benefits associated with these financial services product choices.

V. ADDITIONAL COSTS AND FOREGONE OPPORTUNTIES

Individuals who choose non-deposit accounts to meet their financial transactions needs may face additional costs and foregone opportunities. With few exceptions, funds placed in payroll card or reloadable general spending card accounts are not held in deposit accounts insured by the Federal Deposit Insurance Corporation (FDIC). Unlike banked consumers, these cardholders face additional financial uncertainties with respect to the safety and on-demand liquidity of these funds. In addition, choosing a particular stored value card because it is the lowest-cost financial services product available may result in future higher credit costs due to uncertainty about the cardholder's creditworthiness. A consumer's financial security hinges on building wealth through savings and other asset accumulation. Only a few reloadable general spending card providers have introduced savings features to their stored value products.[45] Hence, the opportunity to save, earn interest, and accumulate assets has been limited for stored value cardholders.

[45] Several years ago, a few stored value card providers launched savings products that were discontinued due to a lack of customer interest; however, according to these providers, this lack of interest may have been the result of insufficient marketing. More recently, NetSpend and IndiGoCard, general spending card providers, launched savings

Credit Building Opportunities for Stored Value Cardholders

The pay-as-you-go nature of these nontraditional financial products also makes it difficult, if not impossible, for the cardholder to establish creditworthiness. By comparison, banked consumers who maintain a conventional deposit account in good standing have developed relationships with financial institutions that facilitate cross-selling opportunities such as credit cards and other loan products. Stored value cardholders have little, if any, transaction information that can be used in the credit scoring models to reveal their creditworthiness. As such, these cardholders may be making choices that lower their financial transactions costs at the expense of higher credit costs. From a community development perspective, an important question arises as to how stored value cardholders can reveal their credit worthiness and thereby obtain accurately calibrated, risk-based credit which is needed for purchasing a home, vehicle, or other higher-priced consumer product.

A few stored value card providers have attempted to report "accounts in good standing" or payments of monthly fees to credit reporting agencies; however, credit reporting systems are not set up to easily accept these type of data. Some card providers also offer small extensions of credit or overdraft protection features with reloadable general spending card accounts, while a few card providers give small lines of credit with a separate credit card account.[46]

Other possibilities for using stored value cards to establish creditworthiness may be found in what has been learned in the mortgage lending market. Some financial institutions have expanded or are seeking to expand their underwriting criteria to include consistent and timely rental, utility and other major monthly payments to reach the lower-income and expanding immigrant markets.[47] An expanded underwriting criterion is being viewed by the industry as a beneficial way to gain information about the potential

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deposit account programs for their cardholders. These are described in more detail in the next sub-section, Asset Building Opportunities for Stored Value Cardholders.

[46] For more discussion of these products, see Katy Jacob, Sabrina Su, Sherrie L.W. Rhine, and Jennifer Tescher, "Stored Value Cards: Challenges and Opportunities for Reaching Emerging Markets," *Promises and Pitfalls: As Consumer Finance Options Multiply, Who is Being Served and at What Cost? Conference Proceedings,* Federal Reserve System Community Affairs Research Conference, August 2005, http://www.newyorkfed.org/regional/svc_em.pdf.

[47] FreddieMac and FannieMae have encouraged and supported more flexible underwriting of home mortgages for lower-income families and underserved communities. A discussion about this is given by Paul Peterson, Former Chief Operating Officer, Freddie Mac, "10th Anniversary of Automated Underwriting: A Look Back, A Look Ahead," February 27, 2004, Park City, Utah and "Mortgage Solutions to America's Toughest Housing Problems, FannieMae, December 2000, http://www.fanniemae.com/global/pdf/housingcommdev/affordable/solutionstoughestproblems.pdf.

creditworthiness of families who have limited or no credit history. In response to the needs of the mortgage market, Fair Isaac, a major credit scoring company, created a new credit score product, the FICO Expansion Score, which includes some nontraditional payments in its credit score calculations.[48] More recently, Fair Isaac extended the FICO expansion score product to merchants and retailers for making credit decisions in the automotive and installment finance, retail, and bankcard markets.

Employing a methodology similar to that being applied in the mortgage and other credit markets, the Information Policy Institute (2005) has undertaken a study to explore whether recurring bill payment data can be used to help determine the credit worthiness of consumers with little or no credit history.[49] The Information Policy Institute's study finds that specific non-traditional information such as utility and telecom data have "credit-like" attributes that may be potentially useful for better establishing the credit worthiness of consumers with little or no credit history. The Information Policy Institute has a research project underway to empirically assess the predictive power of various types of non-traditional data on a consumer's credit worthiness.

In addition, there is some evidence that demand deposit account data, such as the number and amounts of direct deposits, the amounts of aggregate outflows, and the number and amounts of overdrafts, can predict overdraft protection decisions.[50] Whether equivalent data from reloadable general spending and payroll cardholders has predictive value for credit worthiness requires further study.

Asset Building Opportunities for Stored Value Cardholders

Research has shown that, when given the opportunity and incentive, lower-income families do save and accumulate assets.[51] According to the SCF, 60 percent of families at or below the poverty level possessed positive assets primarily in cash or cash equivalents (for example, checking, savings, money market or call accounts). Eighty-six percent of families between 101 percent and 150 percent of the poverty threshold held these types of liquid assets, while 95 percent of families between 151 percent and 200

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[48] More information about the FICO Expansion Score can be gleaned from http://www.fairisaac.com.
[49] The Information Policy Institute's study is available at http://www.infopolicy.org.
[50] In the United Kingdom, banks analyze demand deposit account data on their customers for determining creditworthiness; however, these data are used internally only and not reported to any external entities.
[51] Michael Sherraden, "Saving in IDA Programs," *Invited Testimony to the President's Commission on Social Security*, October 28, 2001, Washington, DC and Michael Schreiner, M. Clancy and M. Sherraden, "*Final Report: Saving Performance in the American Dream Demonstration*", Center for Social Development, St. Louis, October 2002, MO.

percent of the poverty level possessed these types of assets.[52] Similarly, Hogarth and others (2005) show that savings deposit account ownership went up substantially for lower-income families between 1995 and 2001.[53] Over this period, the proportion of families in the lowest income quartile increased their savings account holdings by 129 percent, while the proportion of families in the second lowest quartile increased their savings holdings by 56 percent. These findings offer further support to the proposition that lower-income families have an interest in saving.

One example of a savings feature for general spending or payroll cardholders is an interest bearing savings sub-account that is linked to the stored value card primary account. Recently, NetSpend, a general spending card provider, launched a savings program, All-Access National Savings Program (All Access) for its cardholders. Cardholders can transfer funds from their general spending account to their interest-bearing, savings deposit account through one of its customer service agents, the Internet, or an automated phone system. Having a savings sub-account tied to the primary spending account could also provide a form of overdraft protection. IndiGOCARD, another general spending card provider, offers overdraft protection to its cardholders through an interest-earning savings account that is attached to the IndiGOCARD account. Each month, an amount of pre-specified funds are transferred from the IndiGOCARD account to the savings deposit account. If an overdraft occurs in the IndiGOCARD account, funds are automatically transferred from the savings account to the IndiGOCARD account to cover the overdraft.[54]

VI. FEDERAL REGULATORY ISSUES

The growth in the stored value card market, both in terms of cards in circulation and dollars transacted, has gained the attention of federal regulators. Both the Federal Reserve Board and the FDIC

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[52] Jeanne M. Hogarth and Chris E. Anguelov, "How Much Can the Poor Save?" *Consumer Interests Annual*, Volume 49, 2003.
[53] Jeanne M. Hogarth, Chris E. Anguelov, and Jinkook Lee, "Who Has a Bank Account? Exploring Changes Over Time, 1989-2001, *Journal of Family and Economic Issues*, Vol. 26(1), Spring 2005.
[54] For more discussion of both of these products, see Katy Jacob, Sabrina Su, Sherrie L.W. Rhine, and Jennifer Tescher, "Stored Value Cards: Challenges and Opportunities for Reaching Emerging Markets," *Promises and Pitfalls: As Consumer Finance Options Multiply, Who is Being Served and at What Cost? Conference Proceedings,* Federal Reserve System Community Affairs Research Conference, August 2005, http://www.newyorkfed.org/regional/svc_em.pdf.

have pending proposed changes that seek to address the terms and conditions for coverage of specific stored value cards. One of the principal questions raised about stored value cards is whether or not regulations should distinguish among the different types of cards. This market includes a wide range of products, from gift cards that are used to make small dollar amount transactions tied to specific retailers (closed-loop) to reloadable general spending or payroll cards (open-loop) that have greater complexity in usage and hold a substantial amount of the consumer's income. Some argue that stored value cards such as gift cards are merely cash substitutes and therefore should not be subject to federal regulations that apply to deposit accounts, whereas others believe that cards that carry larger amounts of consumer assets and are used to make many kinds of electronic payments (that is, payroll cards and reloadable general spending cards) should be treated as electronic deposit accounts. A third prevailing argument is that it is too soon to set regulatory standards, that a slower approach is needed to ensure that regulation does not stifle product development in this emerging industry. Fundamentally, the question becomes whether or not there is a need to advance consumer protections to general spending and payroll cardholders through regulatory change.

Regulation E

The Federal Reserve Board's Regulation E (12 C.F.R. Part 205) implements the Electronic Fund Transfer Act (15 U.S.C. § 1693-1693r). The act establishes the basic rights, liabilities, and responsibilities of consumers who engage in electronic fund transfers (EFT) services and of the financial institutions that offer these services.[55] Regulation E provides guidelines about disclosure, liability and dispute resolution, and provision of periodic statements when electronic fund transfer services are involved.[56] On September 17, 2004, the Federal Reserve Board published for public comment proposed amendments to Regulation E. In essence, these proposed changes would extend the act's coverage to asset accounts related to electronic payment of wage and salary income onto *payroll cards*. The proposal covers payroll card accounts directly or indirectly established by an employer on behalf of an employee to which EFTs of the employee's wages, salary or other employee compensation are made on a recurring basis, whether the account is operated or

[55] 15 U.S.C. §§ 1693 at seq.
[56] 12 C.F.R. Part 205.

managed by the employer, a third-party payroll processor, or a depository institution (69 Fed. Reg. 56, 008 (2004)).

FDIC Insurance Coverage

On August 8, 2005, the FDIC released a new proposed rule on the insurability of funds subject to transfer or withdrawal through the use of nontraditional access devices, including stored value cards.[57] This proposed rule replaces the earlier proposal published in April 2004. The new proposed rule states that funds underlying devices such as stored value cards would be insurable "deposits" if the funds are placed at an insured depository institution. Funds would be insured on behalf of the party that places the funds in the depository institution, such as the employer in the case of payroll cards, unless the following conditions are met: (1) the depository institution's records indicate that the party placing the funds is not the owner of the funds, and (2) either the depository institution or the party placing the funds maintains records indicating the identities of the cardholders and the amount payable to each cardholder. If both of these conditions are satisfied, the funds would be insured on a "pass-through" basis to cardholders.

The Regulators' Dilemma

Regulators face difficult decisions about how to best encourage competition, innovation, growth, and stability in financial markets and to provide appropriate safeguards and protections to consumers. Knowing when the benefits of protection are outweighed by the regulatory compliance costs to suppliers is difficult to measure. The industry purports that changes to Regulation E and FDIC insurance coverage may result in overly burdensome costs. Concerns that additional costs may stymie innovation must be balanced with other factors such as the competitive nature of the marketplace and consumers' need for safe and sound financial service products. Regulations too narrowly defined may distort the market. If, for example, regulatory changes have unbalanced coverage, certain financial service products could become more costly. Under these conditions, the industry might shift away from supplying the more heavily regulated and costly financial services products toward unregulated, less costly product alternatives, potentially leaving even more consumers unprotected over time. Balanced regulations that offer consumers adequate protections while allowing for market competition and innovation are needed as consumers—banked and unbanked—

[57] 12 C.F.R. Part 330.

continue to shift toward electronic payments. The regulatory uncertainties for general spending and payroll cards leave open to question whether consumers who choose these cards in lieu of a checking account are provided with consumer protections, rights, and responsibilities comparable to those associated with mainstream deposit accounts.

VII. FUTURE RESEARCH

From a policy perspective, research is needed to further clarify what type of regulatory framework can best protect consumers' assets, regardless of whether their funds are held in a conventional deposit or a stored value card account, while not inhibiting market innovation and growth. Industry representatives have argued that applying Regulation E requirements to stored value cards more generally would make these products economically unviable, while others welcome at least some modification of Regulation E coverage as a way of providing greater legitimacy to this market. While some card providers say they already voluntarily give Regulation E-type protections by providing cost disclosures and protection against lost or stolen cards, they usually do not provide paper statements because of the high production and delivery costs. Periodic paper statements may not be the most effective way of keeping cardholders informed of their transactions and balances. Numerous card providers already offer transaction and balance information online and via telephone voice-response systems.[58] Innovations that may become more prevalent in the future include ATM-sourced statements or text messaging of transaction and balance information via mobile phone. Undertaking a study to identify alternative, lower-cost ways for providing cardholders with statement information would enlighten policymakers and be beneficial to cardholders and card providers.

Additional research is also needed to learn what motivates consumers to choose stored value cards in lieu of holding conventional deposit accounts and to identify the card features most preferred by cardholders. If the stored value card market is to move toward asset- and credit-building enhancements, more analysis is needed to determine the savings behavior of cardholders and how their stored value transactions relate, if at all, to credit worthiness. Because unbanked stored value cardholders have a wide

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[58] David Breitkopf, "ABA Opposes Paper Statements for Payroll Cards," *American Banker*, November 23, 2004.

range of characteristics, needs, and motivations for using these financial services products, a clearer understanding of customer segmentation is needed to determine whether business models can support these features.

As substantial changes in the financial services industry continue, advocacy should continue for financial education and literacy. Financial education materials should be augmented to define and explain emerging financial services products such as reloadable general spending and payroll cards, the fee structure for these cards, and any consumer protections afforded to these cards relative to conventional mainstream deposit accounts. Studies of the effectiveness of specific financial education and literacy programs will help identify which programs are most likely to help consumers determine which financial services products best meet their needs.