Emerging Payment Systems A Prepaid Card Primer

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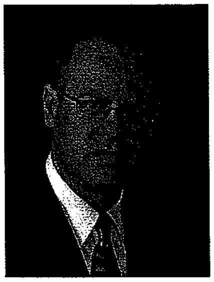

Increasingly, we are becoming an "instantaneous" society. The average consuming public has become intolerant of delays in conducting everyday transactions, including financial transactions. Emerging payment methods reflect this trend. The way we pay for our purchases has evolved from a "pay later" system (i.e. traditional credit cards); to a "pay now" system (debit cards); to, increasingly, a "pay in advance" system (prepaid/gift cards). While traditional credit and debit cards are still prevalent, the financial services industry continues to find new and innovative ways for consumers to part with their money. This column provides a primer to the emerging prepaid card landscape.

Prepaid cards may generally be either "reloadable" or "nonreloadable/single-use." Reloadable cards allow the cardholder to replenish the value on the card at any time prior to the expiration of the card, subject to certain card limits imposed by the issuer. Nonreloadable cards may only be loaded for value once, at the time of issuance. Once the funds have been expended, the card is of no further use.

A further distinction among prepaid cards lies in the functionality of the cards, including: "closed universe," "semi-closed universe," "semi-open universe," and "open universe."

Closed Universe Cards. In a closed universe environment, the cards may only be purchased and redeemed at a single vendor (e.g. Home Depot gift card). These cards effectively function as electronic gift certificates. They are generally issued directly by the merchant for fixed dollar amounts, are not embossed with the cardholders' names, and may not be reloaded.

Semi-Closed Universe Cards. In a semi-closed universe environment, the cards are typically issued by a third-party financial institution or money transmitter and are redeemable at a variety of merchants (e.g. shopping mall gift cards). These cards are typically tied to one of the major payment networks, are issued for a fixed dollar amount, and are not reloadable or embossed with the cardholders' names.

Semi-Open Universe Cards. The primary difference between a semi-closed and a semi-open universe card is that the semi-open universe card is not limited to specific merchants. These cards may be used anywhere that the associated payment network is accepted (e.g. Visa Gift Card) and are often reloadable and embossed with the cardholders' names.

Open Universe Cards. The most versatile of the prepaid cards is the open universe card, which functions the same as a semi-open universe card but with the added functionality of allowing the cardholder to withdraw cash from an ATM.

There are a number of bank regulatory implications associated with the issuance by financial institutions of prepaid cards, a few of which are discussed below:

Anti-Money Laundering. In many respects, prepaid cards function like traditional bank accounts. However, because these cards make it easy to transport relatively large sums of money and allow for anonymous accessibility, they have become a common mechanism for the movement of illicit funds. While banks are required to perform normal Customer Identification Procedures on the variety of prepaid cards that function effectively as accounts (i.e. payroll cards and most open-universe cards), many prepaid cards are sold today by independent third-party retailers and, in such instances, the issuing financial institution has no way of knowing in whose hands their cards end up.

Accordingly, it would be prudent for an issuing financial institution to only allow the sale of their prepaid cards in their own branch offices, or to perform rigorous due diligence on the merchants through which their cards are marketed. It also will be important for the bank to understand the source of the funds loaded on the cards and to be vigilant for suspicious activity (e.g. purchases of bulk cards).

Regulation E. Final rules of the Federal Reserve Board amending Regulation E became effective on July 1 and had the effect of bringing one form of prepaid cards, payroll cards, under the auspices of Regulation E. What this generally means is that payroll cards are now subject to the "periodic statement" requirements of Regulation E, with limited exception. In order to avoid having to issue periodic statements to its payroll card customers, a bank must: (1) make balance information available to the consumer over the telephone; (2) make an electronic history available to the consumer; and (3) provide consumers with a written history of their transactions upon their oral or written request.

Consumers have up to 60 days from the date they access their electronic history to report an error to the bank. If the bank is unable to track when the consumer accesses the account history, the final rule provided a safe-harbor for institutions that treat the notice of error as timely if it is received within 120 days of when the transaction was posted to the consumer's account.

Given the recent changes to Regulation E, it would be prudent for banks that issue payroll cards to review their card terms and conditions, as well as their internal error resolution procedures, to make sure they remain in compliance with the new rules.

Consumers are demanding that their financial institutions keep up with the current trends in payment systems. If your institution is considering entering into the prepaid card fray, it is important to thoroughly understand the landscape, and its attendant regulatory implications.