Will Regulators Burst the Prepaid Bubble?

I. INTRODUCTION

People are trading cash for plastic and banks are taking in billions, at least for now.1 Hoping to build on the success of debit cards2 and recompense floundering credit card growth,3 banks now offer stored-value cards, commonly referred to in the industry as prepaid cards.4 Prepaid cards function like debit cards except that the funds underlying such cards are not held in a consumer demand account.5 Banks profit from fees associated with the cards and offer consumers a versatility and security not available in merchant-issued prepaid cards (merchant cards)6 or cash.7 However, many banks offering prepaid cards are concerned that a proposed regulation by the Federal Deposit Insurance Corporation (FDIC) may drive them out of the prepaid


2. See Paper or Plastic: New Card Options Promise to Further Displace Checks, ITEM PROCESSING REPORT, July 29, 2004, available at 2004 WL 61716548 (noting that debit card use has increased from 21% of in-store transactions in 2000 to 31% in 2004); see also Bank of America Reports That Its Customers Have Charged $100 Billion To Their Debit Cards, CARDLINE, Dec. 24, 2004, at 1, available at 2004 WL 8353981 (noting Bank of America customers spent $100 billion on their debit cards in 2004 and that Ken Kavanagh, a Bank of America executive in prepaid and debit cards, stated that a greater percentage of new customers are getting debit cards when opening bank accounts).


4. See Electronic Fund Transfers, 61 Fed. Reg. 19,696, 19,698 (proposed May 2, 1996) (to be codified at 12 C.F.R. pt. 205); see also, Letter from H. Kurt Helwig, Member, Electronic Funds Transfer Association, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation (July 27, 2004), available at http://www.fdic.gov/regulations/laws/federal/04chELWIGdepositDEF810pm.html (arguing that the FDIC should consider replacing the term "stored-value card" with "prepaid card" because the term is more commonly used and will lead to less confusion among consumers and industries).


6. While banks offer a variety of prepaid cards, merchants market their prepaid cards only as gift cards. See infra notes 16-27 and accompanying text.

The FDIC's proposal will treat the funds underlying many prepaid cards as "deposits" for purposes of the Federal Deposit Insurance Act (FDIA).\(^8\) Consumer advocacy groups laud the proposal because defining these funds as "deposits" insures them in the event of a bank failure.\(^9\) Banks, on the other hand, are not as enthusiastic, as they may be required to pay FDIC insurance premiums on these additional "deposits"\(^11\) and may be exposed to other more costly regulations, such as Regulation E of the Electronic Funds Transfer Act.\(^12\) This note will show that the FDIC's proposal to treat such funds as "deposits" creates the risk that banks may have to pay FDIC insurance premiums in the future, but it is unlikely to put banks out of the prepaid card business by exposing them to the costly requirements of Regulation E, and that a better solution might be to bypass regulation altogether.

Part II of this Note gives an overview of prepaid cards, the importance of prepaid cards to the banking industry, and the characteristics of bank-issued prepaid cards (bank cards) that could help them become the prepaid gift card market leader.\(^13\) Part III reviews the

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9. Definition of "Deposit": Stored Value Cards, 69 Fed. Reg. 20,558, 20,561-62 (proposed April 16, 2004) (to be codified at 12 C.F.R. pt. 303). The FDIC proposes to treat the funds underlying three systems as deposits. Id. The first system, which is not discussed in this note, is where a company maintains an account at a bank for purposes of making payments on prepaid cards that the company issues. Id. The second system, referred to as a hybrid system, will be discussed and involves funds that are maintained in "subaccounts" by a bank for purposes of making payments on prepaid cards issued by that bank. Id. Finally, a payroll card system is where an employer maintains an account at a bank for purposes of making payments on the prepaid cards issued by the employer to its employees. Id. Payroll card systems will be discussed briefly in this note by contrasting their treatment by the Federal Reserve Board with the treatment of hybrid system cards. See infra notes 159-75 and accompanying text.


11. See Furletti, supra note 7, at 15.


13. See infra notes 16-87 and accompanying text.
FDIC's existing definition of "deposit" as it relates to prepaid cards that are issued by FDIC insured banks and the proposed regulation which would alter that definition.\(^\text{14}\) Part IV examines whether this proposed regulation will increase the costs and regulatory burden on banks.\(^\text{15}\)

II. AN OVERVIEW OF PREPAID CARDS

A. Card Origins and Mechanics

1. Merchant Cards

Banks did not start the prepaid trend.\(^\text{16}\) In 1994, the department store Neiman Marcus offered the first prepaid gift card, replacing the traditional paper gift certificate.\(^\text{17}\) Merchant cards, as they are now called, are typically issued by a merchant for use at a merchant's own stores.\(^\text{18}\) Originally, merchants used such cards to better track gift credit and to avoid returning cash to consumers who spent less than a gift certificate's full value.\(^\text{19}\) Today, merchants also use such cards to increase customer loyalty,\(^\text{20}\) speed checkout, sell more full-price merchandise, study purchase behavior of customers, and enhance sales forecasts.\(^\text{21}\) Merchants do not intend to profit from the sale of the cards themselves, so merchant cards are typically sold without activation fees or other monthly fees.\(^\text{22}\) However, merchants certainly profit from the sale of goods or services whenever the cards are used\(^\text{23}\) and from interest

\(^{14}\) See infra notes 88-118 and accompanying text.

\(^{15}\) See infra notes 119-97 and accompanying text.


\(^{17}\) Id.

\(^{18}\) Furletti, supra note 7, at 7. A few retailers that offer such cards are Wal-Mart, Home Depot, Starbucks and Kohl's. Danforth, supra note 5. Cards that can only be used at the issuing merchant's store are also commonly referred to as closed-system cards. See Judith Rinearson & Chris Woods, Beware Strangers Bearing Gift Cards, BUS. L. TODAY, Nov./Dec. 2004, at 58. Bank cards can be used wherever the payment network is accepted and are commonly referred to as open-system cards. See Furletti, supra note 7, at 8.

\(^{19}\) Furletti, supra note 7, at 7.

\(^{20}\) Starbucks has seen more than 100 million redemptions on its reloadable gift cards. Rinearson, supra note 18, at 57.

\(^{21}\) Furletti, supra note 7, at 7.

\(^{22}\) See id. at 8.

\(^{23}\) Id. at 9.
earned on gift card proceeds.\textsuperscript{24} And while activation fees are rare, some cards have dormancy fees\textsuperscript{25} and maintenance fees,\textsuperscript{26} as well as expiration dates, after which the remaining value of the card may become the property of the merchant.\textsuperscript{27}

2. Bank Cards

After witnessing the success of merchant cards, banks began offering their own prepaid cards in 1996.\textsuperscript{28} Today, about a dozen large banks dominate the bank prepaid card market, with smaller banks rarely issuing cards.\textsuperscript{29} Banks make cards available for consumers to purchase at branch offices,\textsuperscript{30} kiosks in shopping centers,\textsuperscript{31} and on the Internet.\textsuperscript{32} Currently, banks market their cards as gift cards, travel cards,\textsuperscript{33} and as "training" debit cards for teenagers (teen cards).\textsuperscript{34} The logo of the payment card network (e.g., Visa, Mastercard, or American Express) on


\textsuperscript{26} Maintenance fees are typically debited from a card on a monthly basis and do not require any period of non-use. Rinearson, \textit{supra} note 18, at 61.

\textsuperscript{27} \textit{See id.} at 58, 61. Whether the remaining value on an expired card becomes the property of the merchant depends on the particular states’ escheat laws. \textit{Id.} For example, North Carolina exempts gift cards from the states’ escheat laws provided that the gift card does not have an expiration date. \textit{See N.C. Gen. Stat. § 116B-54(b) (2004).}

\textsuperscript{28} Linder, \textit{supra} note 1.


\textsuperscript{32} Lee, \textit{supra} note 30 (noting that U.S. Bank also makes its Visa Buxx card available for purchase on the internet). Currently, Bank of America’s Visa Gift Card is available exclusively for purchase over the phone or the Internet. \textit{See http://www. bankofamerica.com/giftcard} (last visited Jan. 10, 2005). After purchase, cards can be mailed either to the card purchaser or card recipient. \textit{See id.}


\textsuperscript{34} Visa Buxx is one example of these prepaid cards which are marketed to teenagers. \textit{See Kathy Chu, Prepaid Cash Cards Win Fans But Struggle to Make Impact}, \textit{WALL ST. J.}, Sept. 10, 2003, at B4G, \textit{available at} 2003 WL-WSJ 3979181.
these cards distinguishes them from their merchant counterparts.\textsuperscript{35} Gift cards are the most popular of the bank cards and the direct competitors of merchant cards.\textsuperscript{36} Some bank gift cards can be loaded with as much as $1,500,\textsuperscript{37} while around $42 is the average amount carried on a card.\textsuperscript{38} Although cards are limited in the funds they can hold, most are "reloadable."\textsuperscript{39} All bank cards, however, expire after a certain amount of time pursuant to an accompanying purchase agreement.\textsuperscript{40}

Unlike their merchant counterparts, banks seek to profit from a variety of fees related to the cards.\textsuperscript{41} Fees are commonly charged for activation, interchange,\textsuperscript{42} dormancy, maintenance, replacing lost or stolen cards,\textsuperscript{43} issuing new cards after expiration,\textsuperscript{44} and reloading money onto an existing card.\textsuperscript{45} Activation fees can be substantial, with some as high as $11.95.\textsuperscript{46} Dormancy fees, which allow banks to drain the remaining value of an inactive card, have proved both profitable and

\begin{itemize}
\item 35. Furletti, supra note 7, at 8.
\item 36. Id. at 7-10.
\item 37. The maximum amount that can be carried on a U.S. Bank Visa Buxx Card is $1,500. http://www.usbank.com (last visited Jan. 10, 2005). The maximum amount that can be carried on Bank of America’s Visa Buxx Card is $1,000 and Bank of America’s Visa Gift Card is $750. http://www.bankofamerica.com/giftcard (last visited Jan. 10, 2005).
\item 41. Danforth, supra note 5. Banks do not earn interest on any of the money underlying gift cards. Mohl, supra note 24.
\item 42. Lee, supra note 30 (noting that interchange fees, which are fees paid from the merchant’s bank to card-issuer’s bank, are the main source of revenue for bank cards).
\item 44. After a gift card expires, for a fee, Bank of America either will issue a new card or issue a check for the card’s remaining balance. http://www.bankofamerica.com/giftcard (last visited Jan. 10, 2005).
\item 45. Bank of America currently charges $3 for adding funds to a Visa Buxx card. http://www.bankofamerica.com (last visited Jan. 10, 2005). However, the fee is waived if the card is funded from a Bank of America credit or check card. Id. Bank of America’s Visa Gift Card is not currently reloadable. Id.
\end{itemize}
controversial for banks.\textsuperscript{47} Recently, several state legislatures have enacted laws that prohibit dormancy fees on prepaid cards because of increasing consumer complaints.\textsuperscript{48} Other states have similar legislation pending.\textsuperscript{49} Some national banks, however, have argued that such fee-restrictive state laws are preempted by federal law, and therefore, do not apply to their cards.\textsuperscript{50}

Despite the numerous fees, when compared to merchant cards, bank cards are considerably less profitable, because banks do not profit from an underlying sale of goods or services when cards are used.\textsuperscript{51} Also, bank cards have higher costs, because they offer greater consumer protection.\textsuperscript{52} Increased costs may force banks to increase fees or see their profits dwindle.\textsuperscript{53} Increased fees may drive away consumers. However, losing profits may cause banks to dump their prepaid programs, because banks do not use prepaid cards for the same reasons merchants do.\textsuperscript{54} Therefore, banks have an incentive to control costs associated with the cards.

\textbf{B. Value of Prepaid Cards to the Banking Industry}

Prepaid cards are a $72 billion business that shows no signs of


\textsuperscript{48} Katie Kuehner-Hebert, Preview 2005: Predator, Payday, Imposter Bills Take Spotlight, AM. BANKER, Jan. 3, 2005, at 5, available at 2005 WL 66498302 (noting that ten states have either abolished or limited fees on prepaid gift cards); Rinearson, supra note 18, at 57.

\textsuperscript{49} Rinearson, supra note 18, at 61.

\textsuperscript{50} Id. at 63. Recently, the U.S. Office of the Comptroller of the Currency (OCC) gave their opinion on the issue of federal preemption and it differs from that of the national banks. Letter from Daniel P. Stipano, Acting Chief Counsel, OCC, to Thomas F. Reilly, Attorney General, Office of the Massachusetts Attorney General (Jan. 5, 2005) (on file with author). In a letter to be included in a Massachusetts Attorney General’s Office’s brief to the U.S. District Court of Massachusetts, the OCC’s acting chief counsel, Daniel P. Stipano, argued that the National Bank Act did not preempt state laws that abolished dormancy fees and expiration dates. Id.

\textsuperscript{51} Furletti, supra note 7, at 9 (noting that bank cards generate $1 in pre-tax net income on each $50 bank card sale, whereas merchants earn $7 in pre-tax net income on each $50 card).

\textsuperscript{52} Id.

\textsuperscript{53} See id. at 9-10.

\textsuperscript{54} Id. at 8-10.
In fact, prepaid gift card sales increased 50% from 2002 to 2003 and are expected to double by 2007.\textsuperscript{56} Last holiday season, a record $17 billion was spent on gift cards.\textsuperscript{57} Thus, banks have much to gain by taking a larger slice of the prepaid pie. In 2003, bank gift cards accounted for a modest 6% of the total prepaid gift card sales.\textsuperscript{58} However, many experts believe that given the greater versatility and security of bank cards, they will soon overtake their merchant counterparts,\textsuperscript{59} with expected sales in excess of $31 billion by 2007.\textsuperscript{60}

Along with the promise of new profits, prepaid cards also offer banks access to untapped demographics.\textsuperscript{61} Most recently, banks have started marketing prepaid cards to teenagers, touting the cards as a tool to teach teenagers responsible spending and to help parents better monitor this spending.\textsuperscript{62} Although skeptics question whether these are the banks' only motivations,\textsuperscript{63} Americans ages twelve to nineteen are an enticing demographic for banks.\textsuperscript{64} In 2001, American teenagers spent

\begin{thebibliography}{99}
\bibitem{55} Valerie S. Keating, \textit{Branding, Customization, and Other Keys to Success in Prepaid Cards}, AM. BANKER, July 9, 2004, at 10, available at 2004 WL 55827643 (noting that there will be an estimated $347 billion in sales from all prepaid cards in 2007).
\bibitem{57} Paul Grimaldi, \textit{As Popularity of Gift Cards Grow, So Do Calls For More Regulation}, PROVIDENCE J., Dec. 26, 2004, available at 2004 WL 59430739. A National Retail Federation survey predicted that 74.3\% of all shoppers would purchase at least one gift card during the 2004 holiday season, spending about $80 on average. \textit{Id.}
\bibitem{58} See Linder, \textit{ supra} note 1 (noting that banks sold $3 billion worth of gift cards in 2003); see also, \textit{US Gift Card Sales to Reach $90bn by 2007}, \textit{ supra} note 56 (noting that total gift card sales were $45 billion).
\bibitem{59} \textit{US Gift Card Sales to Reach $90bn by 2007}, \textit{ supra} note 56.
\bibitem{60} Linder, \textit{ supra} note 1.
\bibitem{62} See Chu, \textit{ supra} note 34, at B4G (noting that Visa Buxx is “going strong” three years after its introduction, but notes that Citigroup, Inc.’s Citi Cash Card, a similar card aimed at teens, was pulled because of soft demand); see also Caroline E. Meyer, \textit{Girls Go From Hello Kitty to Hello Debit Card; Brand’s Power Tapped to Reach Youth}, WASH. POST, Oct. 3, 2004, at A01 (noting that there are an estimated 100,000 Visa Buxx cardholders and sales were increasing 4\% to 8\% per month).
\bibitem{63} See Mireille Silcoff, \textit{Luring Kids into the Cult of Credit Lures the Young: Hillary Duff is a Goldmine for Online Retailers}, NAT’L POST, July 24, 2004, at RB1, available at 2004 WL 85154120 (arguing that teen cards are a way to indoctrinate "skippies," school kids with purchasing power, into the "cult of credit"); see also David Wichner, ‘\textit{Credit Cards’ Targeting Teens, Cards Compared}, ARIZ. DAILY STAR, Jan. 6, 2003, at A1, available at 2003 WL 11219369 (noting that John Morton, vice-president of the National Council on Economic Education, argues that encouraging teenagers to use plastic may make them lose sight of the fact they are actually spending cash).
\bibitem{64} See Wichner, \textit{ supra} note 63.
\end{thebibliography}
an estimated $172 billion. Obviously, with prepaid cards, banks hope to tap into this spending and to establish a banking relationship that will carry over to adulthood. Prepaid cards also allow banks access to the "underbanked," the estimated fifty million individuals without credit cards and the "unbanked," the estimated ten-million households without a bank account. Estimates place prepaid cards in the hands of 25% of "unbanked" households by 2006. The prepaid relationship allows banks the opportunity to interest the "unbanked" in other bank services. Finally, prepaid cards have become popular with businesses that use the cards in connection with incentive programs for employees. Cultivating such prepaid relationships with small businesses allows large banks the opportunity to interest them in other services, such as accounts or loans. This opportunity might not otherwise exist given that small businesses more traditionally deal with community banks.

C. Battle for Market Share – Are Banks Poised to be the Prepaid Leaders?

Banks are battling merchants for the heart of the American consumer who seems hooked on buying with plastic. Currently,

65. Id. (citing a study performed by Teenage Research Unlimited, a market research firm based in Northbrook, Ill.).
66. See id. (noting that Melinda Burke, director of the University of Arizona’s Southwest Retail Center for Education and Research, feels teen cards are a "very creative way to develop [credit card] name recognition at an early age").
68. Swann, supra note 61.
69. Id.; see also Punch, supra note 67 (quoting a MasterCard International vice-president as saying, “[p]repaid cards ... provide financial institutions the opportunity to build ‘sticky’ relationships with the unbanked” and that “[the unbanked] may one day require other more traditional banking and financial services, including checking and savings accounts, credit and debit cards, mortgages and other consumer and business loans”).
71. Id.
73. See Gould, supra note 40 (noting that 2003 was a breakout year for prepaid gift cards and that the market will continue to grow, with bank cards eventually overtaking their
Merchants lead the prepaid gift card market largely because of the merchant locations where these cards can be purchased. When shopping for a gift, consumers probably do not begin their search at a bank or on a bank’s Internet site where bank cards are available. Also, since banks charge fees, they are in the rather unenviable position of selling something others are giving away. Undoubtedly, this dependence on fees puts banks at a further competitive disadvantage. Further, since banks are more regulated than merchants, they risk new regulations increasing costs which may lead to higher fees and a less attractive product.

Notwithstanding these barriers, many experts believe banks are poised to become the leader of the booming prepaid gift card market because their cards offer greater security and versatility. Unlike cash, traditional paper gift certificates, or many merchant cards, lost or stolen bank cards can be replaced with minimal loss to the consumer. Unlike merchant cards, bank cards do not confine the card’s use to a particular merchant. In fact, bank cards are accepted by over thirty million merchants in over 150 countries, as well as over the Internet, and some cards can even be used at ATMs. In addition to security and versatility, bank cards have other advantages over merchant cards and cash. Some see bank gift cards, which are available in several designs and often have the recipient’s name embossed upon them, as a gift more

74. See Danforth, supra note 5 (noting that the most popular and successful prepaid cards are those gift cards offered by retailers in lieu of gift certificates).
75. Furletti, supra note 7, at 8; see also Bank-Issued Gift Cards Will Overtake Retailer Gift Cards, Report Predicts, CARDLINE, Apr. 9, 2004, at 1, available at 2004 WL 69960067 (noting that if banks instantly offered their product at the point of sale, as merchants do, bank cards would be significantly more competitive with merchant cards).
76. See supra note 77 and accompanying text.
77. See Furletti, supra note 7, at 8.
78. See supra note 79 and accompanying text.
79. See Bergman, supra note 8.
80. See Furletti, supra note 7, at 10; see also, Gould, supra note 40; US Gift Card Sales to Reach $90bn by 2007, supra note 56.
81. Furletti, supra note 7, at 9 (noting that retailers often do not offer the same protection for lost or stolen cards that banks offer).
82. See Gould, supra note 40.
83. Visa Gift Cards have a card number similar to those on debit and credit cards, and therefore can be used anywhere Visa cards are accepted. http://www.bankofamerica.com/giftcard (last visited Jan. 10, 2005).
84. Gould, supra note 40.
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personalized than cash or a generic merchant card. Also, teen cards allow parents to monitor their child's spending from the Internet, as well as add funds over the phone or Internet during an emergency. Finally, for the "unbanked," bank cards open the door to e-commerce, allowing cardholders to purchase goods over the Internet, and offer the security of not having to carry cash.

III. EXISTING AND PROPOSED DEFINITION OF "DEPOSIT"

Enacted in 1933 to instill confidence in our country's banking system, the Federal Deposit Insurance Act (FDIA) broadly defines "deposit." Paragraph (i)(1) of the FDIA defines, in relevant part, a "deposit" as "the unpaid balance of money or its equivalent received or held by a bank or savings association in the usual course of business and for which it has given or is obligated to give credit, either conditionally or unconditionally, to a commercial, checking, savings, time, or thrift account." Paragraph (i)(3) additionally defines a "deposit" as "money received or held by a bank or savings association ... in the usual course of business for a special or specific purpose." The FDIA authorizes the FDIC, while consulting with other financial regulatory agencies, to further define "deposit" through regulation.

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86. Randy Kraft, To Buy ... or Not To Buy ** Keeping Tabs on Teens, ALLENTOWN MORNING CALL, May 20, 2003, at El, available at 2003 WL 19971752.

87. Davis, supra note 67. The "unbanked" also will benefit greatly from another type of stored-value card, the "payroll" card, which serves as a substitute to the traditional paycheck. See Diane E. Lewis, It's All in the Card: For Some Employees, Paper Is Giving Way to Plastic on Payday, BOSTON GLOBE, Feb. 15, 2004, at El, available at 2004 WL 55853686. Employers will also benefit by saving on the costs associated with a traditional paper check. Id. Typically, it costs between $1 and $2 to process a single paper check, whereas a single electronic payment through a payroll card program costs only 20¢. Id.


A. FDIC's Existing Definition of "Deposit"

In 1996, the FDIC first dealt with prepaid cards in General Counsel's Opinion No. 8 (GC8), but deferred regulation rather than risk stifling development in this growing area. In GC8, the FDIC identified four types of prepaid card systems. The two systems relevant to bank cards were the "bank primary-reserve system" (reserve system) and the "bank primary-customer account system" (account system).

1. Bank Primary-Reserve System

In a reserve system, cardholders give cash to a bank in exchange for a prepaid card. Rather than maintaining an individual account for each cardholder's funds, the bank maintains a pooled "reserve account" for the funds underlying the prepaid cards of all cardholders. Whenever a cardholder uses the card to purchase goods or services, the bank debits the "reserve account."

The FDIC determined that such funds held in "reserve accounts" were not "deposits" for purposes of the FDIA. First, the FDIC found that when banks issued a prepaid card they did not credit, nor did the card purchasers intend to have credited, a conventional "commercial, checking, savings, time, or thrift account." The banks merely credited the "reserve account," and therefore such funds held by banks are not "deposits" as defined by paragraph (l)(1) of the FDIA. Second, the FDIC found that since the funds could be disbursed to any number of merchants for miscellaneous and unrelated transactions, they were not sufficiently "special or specific" as required by paragraph

95. See id.
96. See id. at 40,492.
97. See id.
98. Id.
99. Id. at 40,494.
101. Id.
2. Bank Primary-Customer Account System

Account systems are similar to reserve systems in that cardholders receive a prepaid card from a bank in exchange for cash. However, when a purchase is made under an account system, rather than debiting a pooled "reserve account," the bank debits an individual account maintained for each cardholder.

The FDIC determined that such funds held in these individual accounts would be considered "deposits" for purposes of the FDIA. The FDIC reasoned that paragraph (l)(1) was satisfied since an individual account is kept for each cardholder. However, the FDIC assumed that such accounts would be conventional "commercial, checking, savings, time, or thrift accounts." As expected, banks avoided account systems for prepaid cards rather than submitting to FDIC regulation.

B. Broadening the Definition of "Deposit"

In its April 16, 2004 proposal, the FDIC cited several recent developments in prepaid card systems that have rendered GC8 "at a minimum incomplete, and . . . obsolete." The relevant recently

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102. Id. at 40,493.
104. See General Counsel's Opinion No. 8; Stored Value Cards, 61 Fed. Reg. at 40,490 (noting that the funds underlying prepaid cards are maintained in a customer's account until the value is transferred to a third party, who then collects from the customer's bank).
105. Id. at 40,492.
108. See Furletti, supra note 7, at 8-9.
109. Definition of "Deposit": Stored Value Cards, 69 Fed. Reg. at 20,560. While the FDIC's proposal discusses prepaid cards issued by sponsoring companies who place the cash into an account at a bank and payroll cards, this note addresses only the portion of the regulation affecting bank-issued prepaid gift, teen, and travel cards. The FDIC's treatment of payroll cards, offered by employers to their employees in lieu of a traditional paycheck, and sponsoring company cards has not stirred as much controversy. Charles Davis, Gift Cards to be Treated as Deposits?, CARDS INT'L, June 29, 2004, at 5, available at 2004 WL 69103030.
developed prepaid card system used by banks is a hybrid of the account system and the reserve system. As in the reserve system, banks employing such hybrid systems maintain a pooled "reserve account" for all cardholders. However, similar to an account system, such banks also maintain supplemental records, "subaccounts," which allow them to calculate the balance on the card for each individual cardholder.

The FDIC proposes to treat the funds in a hybrid system within the statutory definition of "deposits" given in paragraph (l)(1) and (l)(3). The FDIC acknowledges that such "subaccounts" are arguably not a conventional "commercial, checking, savings, time, or thrift account," nor is the purpose of the funds underlying these systems any more "special or specific" than those mentioned in GC8. However, the FDIC notes that in GC8, paragraph (l)(3) was applied to "reserve accounts" but never applied to individual accounts. Applying paragraph (l)(3) to "subaccounts" in a hybrid system, the FDIC argues that the funds are held by the bank for the "special or specific" purpose of satisfying the debits of the cardholder, regardless of whether these "subaccounts" are conventional "commercial, checking, savings, time, or thrift account[s]." Further, the FDIC argues that such "subaccounts" are in fact conventional "commercial, checking, savings, time, or thrift account[s]." Therefore, the FDIC proposes that funds underlying such hybrid systems should be treated as "deposits" in accordance with paragraph (l)(1) and (l)(3).

IV. INCREASING REGULATION AND INCREASING COSTS

Expectantly, many banking industry leaders are not enthused by the prospect of increased regulation. Banks fear that regulatory oversight of prepaid cards will increase costs in an already cost-

111. Id. at 20,562.
112. Id. at 20,562.
113. Id. at 20,562.
114. Id. at 20,562
116. Id.
117. Id.
118. Id.
119. Bergman, supra note 8.
sensitive undertaking. Increased costs would either drive fees beyond what consumers are willing to pay or decrease profits to a level unattractive to banks. The comment letters responding to the FDIC's proposal discussed a myriad of regulations that may soon burden prepaid cards because of the actions of the FDIC. However, Regulation E seems forefront on the minds of the banking industry. This section examines whether FDIC regulation itself will pose any considerable cost to banks, specifically the cost of FDIC premiums, the significance of the risk posed by Regulation E, and whether increased regulation will actually benefit consumers.

A. FDIC Coverage Costs

In the event of a bank failure, FDIC insurance protects a consumer for up to $100,000 in funds held at an insured bank as deposits. In order that funds are available in the event of a bank failure, FDIC insured banks pay a premium to the FDIC assessed according to the amount of the bank's deposits. Notwithstanding these premiums, having funds insured by the FDIC does not necessarily mean an increase in cost for banks. Prior to 1993, all banks paid a fixed-rate deposit insurance premium according to their deposit levels. However, the FDIC has since moved to risk-based assessments, with those banks engaged in riskier activity subject to

120. See Furletti, supra note 7, at 19
121. See id.
122. See, e.g., Letter from Daniel G. Weiss, Associate General Counsel, Bank of America, NA, to Robert E. Feldman, Executive Secretary, Federal Deposit Insurance Corporation (July 12, 2004), available at http://www.fdic.gov/regulations/laws/federal/04cWEISSdepositDef715.html (last modified July 15, 2004) (noting that FDIC regulation may lead to significant uncertainty with regards to prepaid cards and Customer Identification Rules under the Patriot Act, Reserve Requirements for Depository Institutions under Regulation D, and Electronic Fund Transfer Disclosures Requirements under Regulation E).
123. See Furletti, supra note 7, at 19.
124. See infra notes 125-97 and accompanying text.
126. Furletti, supra note 7, at 15.
127. See id. (explaining that since 1996, financially sound, well-capitalized federally insured depository institutions have not had to contribute to the deposit insurance funds).
higher premiums than their more conservative counterparts. The Deposit Insurance Funds Act, enacted in 1996, prohibits the FDIC from collecting premiums altogether from banks in the lowest risk category, thereby exempting approximately 95% of all banks from paying FDIC insurance premiums. Thus, the vast majority of banks offering prepaid cards will not immediately realize an additional cost in the form of insurance premiums on any funds newly deemed deposits by the FDIC.

However, banks finding comfort in their current premium-exempt status should be wary of the calls for FDIC insurance reform and a declining designated reserve ratio (DRR). Before studying this further, a short overview of the current FDIC system is helpful. Currently, all FDIC insurance premiums are maintained in the Bank Insurance Fund (BIF). The BIF must maintain a DRR of reserves to insured deposits of 1.25%. As long as the DRR is met, banks deemed well-capitalized pay no premiums. If the DRR dips below 1.25% and remains there for one year, all insured banks will be assessed a minimum of 23 basis points or $0.23 per $100 of assessable deposits.

Several factors have led the ratio of reserves to estimated insured deposits to decline close to 1.25% for the first time in years. Several recent, costly bank failures have led to a depletion of the BIF. Also, the FDIC has substantially increased the reserves kept in the event of future failures. Finally, there has been an increase in insured deposits due to the conversion of Cash Management Accounts into deposit accounts by several securities firms. Assuming funds

129. Id.
131. Wilmarth, supra note 128, at 246.
132. See Furletti, supra note 7, at 15.
133. See infra notes 138-48 and accompanying text.
136. Martin, supra note 134.
138. Martin, supra note 134.
139. Id.
140. Id.
141. Id.
underlying prepaid cards are deemed "deposits," the amount of insured deposits would further increase. In fact, if current predictions are correct, an additional $31 billion would be included as insured deposits in 2007 by virtue of bank gift card sales alone. Additionally, many banking industry leaders have warned that the BIF's current reserves are possibly insufficient to handle the failure of two major U.S. banks. This has caused some to suggest that reforms should be implemented requiring that all banks once again pay premiums according to the risks they pose to the system. Recent reform proposals have also called for replacing the DRR with a target ratio range between 1.15% and 1.4% with premiums gradually increasing as the ratio neared the bottom of the range. Thus, premiums would be assessed at a level higher than the current DRR level, a level the BIF is currently nearing. Even if reforms are not instituted, if the DRR continues a decline, all banks may face insurance premiums. The premiums could easily reach as high as $71 million industry-wide. This cost may seem insignificant given that estimated future sales of gift cards are around $31 billion. However, since banks only make $1 for every $50 of gift card sales, $31 billion in sales would equal $620 million in profits. Thus, the $71 million in insurance premiums are a significant cost.

B. Federal Reserve Board and Regulation E

The Electronic Fund Transfer Act (EFTA) was enacted by Congress in 1978 to protect consumers using electronic fund transfer

142. See supra note 125 and accompanying text.
143. See Linder, supra note 1.
144. Wilmarth, supra note 128.
146. Martin, supra note 134.
147. Id.
148. See supra note 137 and accompanying text.
149. Based on 2007 gift card sales estimates and a minimum assessment of 23 basis points. See supra notes 1, 137 and accompanying text.
150. See supra note 1.
151. See supra note 51.
The EFTA authorized the Federal Reserve Board to implement provisions of the EFTA through regulation. Thus, the Federal Reserve Board issued Regulation E, specifically to deal with debit cards. Section 205.2(b)(1) of Regulation E defines an “account” as a “demand deposit (checking), savings, or other consumer asset account . . . held directly or indirectly by a financial institution and established primarily for personal, family, or household purposes.” Bringing prepaid cards within the ambit of Regulation E would require banks to send prepaid cardholders “monthly statements detailing transfer activity, implement procedures for handling consumers’ claims that a transfer reflects an error, provide consumers with written documentation of transfer activity, and limit consumer liability for unauthorized transfers.” Banks fear that if the FDIC considers funds underlying prepaid cards as “deposits” because they are held in “subaccounts,” then the Federal Reserve Board will consider these “subaccounts” to be within Regulation E’s definition of “account.” However, recent action taken by the Federal Reserve Board should assuage these fears.

Shortly after the FDIC issued its proposal, the Federal Reserve Board issued a proposal concerning prepaid cards and Regulation E. Despite banking industry fears, the Federal Reserve Board left the majority of bank cards alone. Rather than lumping together all prepaid cards, the Federal Reserve Board chose only to include payroll cards within the ambit of Regulation E. The Federal Reserve Board

156. Furletti, supra note 7, at 16.
159. See id.
160. See id.
161. Id. at 55,999. Payroll cards are used when “an employer (or a third party acting on behalf of the employer) establishes an account at a [bank] in which employees’ salaries are periodically deposited and held on their behalf.” Id. at 55,997 Employees are then issued a payroll card “that they can use to access their funds electronically to obtain cash at an ATM
recognized that payroll cards are

assigned to an identifiable consumer, represent a stream of payments to a consumer (which may be a primary source of the consumer's income or assets), are replenished on a recurring basis and can be used in multiple locations for multiple purposes, and utilize the kinds of access devices, electronic terminals, and networks as do other EFT services.\textsuperscript{162}

The Federal Reserve Board also noted that payroll cards are marketed in such a way as to serve as a substitute for traditional checking accounts and as a potential mechanism for holding the primary financial assets for an individual.\textsuperscript{163}

The characteristics of payroll cards identified by the Federal Reserve Board as essential to its conclusion that Regulation E should apply to payroll cards are somewhat different than those of other bank cards.\textsuperscript{164} While bank cards are often assigned to an identifiable consumer and are capable of being used for multiple purposes at multiple locations,\textsuperscript{165} the similarities with payroll cards end there. Bank cards do not represent a stream of payments to a consumer.\textsuperscript{166} Gift cards are by definition not payments, they are gifts, and therefore given sporadically when gifts are appropriate. Although, gift cards are sometimes used in connection with employee-incentive programs,\textsuperscript{167} it is doubtful that such "bonuses" would be viewed as a stream of payments. Travel cards certainly would not be considered a stream of payments because they are purchased by the user to serve as a modern-day traveler's check.\textsuperscript{168} Arguably, teen cards may represent a stream of payments if parents periodically credit the card with an allowance, but given that payroll cards are typically used in the employer/employee

\textit{or [to] make purchase[s].}'' \textit{Id.} at 55,997.
\textsuperscript{162} \textit{Id.} at 55,999.
\textsuperscript{163} \textit{Id.}
\textsuperscript{164} \textit{See infra} notes 165-75 and accompanying text.
\textsuperscript{165} \textit{See supra} notes 83-84 and accompanying text.
\textsuperscript{166} \textit{See infra} notes 167-69 and accompany text.
\textsuperscript{167} \textit{See supra} note 70 and accompanying text.
\textsuperscript{168} \textit{See Mohl}, \textit{supra} note 33.
context\textsuperscript{169} it is doubtful such periodic credits would be considered payments. Although, bank cards are reloadable, few bank cards are replenished on a recurring basis.\textsuperscript{170} Teen cards may be periodically replenished more often than gift cards, but they account for only a small percentage of bank card sales.\textsuperscript{171} Gift cards are unlikely to be replenished given that gifts typically are given all at once. In fact, the funds initially placed on gift cards are often not completely exhausted.\textsuperscript{172} Also, limitations placed on the amounts bank cards can hold,\textsuperscript{173} which are not placed on payroll cards,\textsuperscript{174} make it unlikely such cards would be considered a mechanism for holding the primary financial assets of an individual. Finally, the Federal Reserve Board specifically exempted merchant gift cards from Regulation E; although the silence on other bank cards (e.g. gift, travel, and teen cards) leaves open the possibility of future regulation of them.\textsuperscript{175}

The limited view taken by the Federal Reserve Board in its recent proposal is consistent with its prior attempt at regulating prepaid cards.\textsuperscript{176} In 1996, prior to GC8, the Federal Reserve Board proposed regulating all prepaid cards, but with some limitations.\textsuperscript{177} First, the proposal limited the requirements that would be enforced.\textsuperscript{178} Second, a \textit{de minimis} exception was made for cards incapable of carrying more than $100.\textsuperscript{179} Ultimately, the whole proposal was scrapped after an investigation revealed that full compliance with Regulation E would

\textsuperscript{169} See Furletti, \textit{supra} note 7, at 10.
\textsuperscript{171} See \textit{Bank-Issued Gift Cards Will Overtake Retailer Gift Cards, Report Predicts}, \textit{CARDLINE}, Apr. 9, 2004, at 1, \textit{available at} 2004 WL 69960067 (noting that banks issued 3 million gift cards in 2003); \textit{see also} Meyer, \textit{supra} note 62 (noting that there are an estimated 100,000 Visa Buxx cardholders).
\textsuperscript{172} Breitkopf, \textit{supra} note 47 (noting that consumers left an estimated $4 billion on gift cards in 2002).
\textsuperscript{173} See \textit{supra} note 37 and accompanying text.
\textsuperscript{175} Id.
\textsuperscript{176} See \textit{infra} notes 177-83 and accompanying text.
\textsuperscript{178} Id.
\textsuperscript{179} Id. at 19,703.
make the cards unprofitable.\textsuperscript{180} Thus, the proposal was revealing in two respects. First, while the proposal sought to regulate more prepaid cards than the current proposal,\textsuperscript{181} choosing not to subject the cards to the full requirements of Regulation E\textsuperscript{182} indicates a willingness to treat bank cards differently than a traditional debit card. Second, the cost/benefit analysis by the Federal Reserve Board was done on the truncated version of Regulation E requirements,\textsuperscript{183} making it more doubtful that the demands of full compliance with Regulation E would ever be imposed on prepaid card issuers.

Interestingly, after having seen the broad inclusion of prepaid cards in the recent FDIC proposal, the Federal Reserve Board proposal had a much narrower reach.\textsuperscript{184} The possibility exists that the Federal Reserve Board left bank cards alone only because it wants to see a final ruling from the FDIC before it regulates bank cards. However, the Federal Reserve Board’s recent proposal\textsuperscript{185} and its 1996 proposal\textsuperscript{186} on prepaid cards, taken together, suggest otherwise. Both of the Federal Reserve Board’s proposals were limited in some respects,\textsuperscript{187} indicating its understanding that all prepaid cards are different from debit cards. Additionally, the Federal Reserve Board’s new proposal follows the earlier, broader proposal which ended in a determination that the benefits to consumers did not surpass the costs of compliance for banks.\textsuperscript{188} The narrower reach of the current proposal signals that this remains the Federal Reserve Board’s belief. Therefore, banks should not fear that gift, teen, and travel cards will soon have to meet the costly requirements of Regulation E.\textsuperscript{189}

\textsuperscript{181} See supra notes 161, 177 and accompanying text.
\textsuperscript{182} See supra notes 178-79 and accompanying text.
\textsuperscript{183} See supra notes 178-80 and accompanying text.
\textsuperscript{184} See supra notes 160-63 and accompanying text.
\textsuperscript{185} Electronic Fund Transfers, 69 Fed. Reg. at 55,996.
\textsuperscript{187} See supra notes 161, 178-79 and accompanying text.
\textsuperscript{189} See supra notes 184-88 and accompanying text.
CONSUMER PROTECTION ISSUES

C. More Regulation Protecting Consumers May Lead to Less-Protected Consumers

Finally, the unfortunate result of any regulatory attempt to protect prepaid cardholders may actually be less consumer protection. Assuming, the FDIC’s action induces other regulators to act and costs increase, banks may very well leave the prepaid business. The economic model of the bank cards will not support increased costs. Thus, consumers seeking prepaid cards will be left in the hands of the less-regulated retailers. Neither the current proposals of the Federal Reserve Board nor the FDIC aim to regulate merchant cards. In fact, the FDIC does not have the power to regulate merchants. Additionally, many merchant cards do not protect consumers in the event a card is lost or stolen. Although the monetary loss is the same in either case, a lost or stolen card seems more probable than the failure of a large bank. Therefore, lost or stolen card protection would seem more important to consumers than insured funds and periodic statements. Finally, besides security, consumers will lose the other advantages offered by bank cards.

VI. CONCLUSION

For banks, the fast-growing prepaid card market opens many doors and promises rich returns. Banks, while not currently the prepaid card market leaders, are primed to surpass merchant cards in market share. Yet, bank cards face a tougher regulatory environment and a much different economic model than merchant cards. Although

190. See Bergman, supra note 8.
191. Id.
192. See supra note 52-55 and accompanying text.
196. Furlotti, supra note 7, at 9.
197. See supra notes 82-87 and accompanying text.
198. See supra notes 55-72 and accompanying text.
199. US Gift Card Sales to Reach $90bn by 2007, supra note 56.
200. See Furlotti, supra note 7, at 10.
the FDIC proposal alone would not spell the end for bank cards, the risk remains for increased cost if the FDIC reevaluates its assessment policy.201 Further, the FDIC proposal potentially opens the regulatory door for the Federal Reserve Board.202 However, given the Federal Reserve Board’s previous actions with respect to prepaid cards, it will in all probability not enter the door and include bank cards in Regulation E.203 Thus, as the banking industry awaits the final rule from the FDIC, they should rest easier knowing that despite the FDIC’s decision the Federal Reserve Board will most likely avoid burdening the much-liked bank cards with the costly requirements of Regulation E.204

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201. See supra notes 125-51 and accompanying text.
202. See supra note 157 and accompanying text.
203. See supra notes 159-89 and accompanying text.
204. See supra notes 159-89 and accompanying text.