

# inside the vault

AN ECONOMIC EDUCATION NEWSLETTER FROM THE FEDERAL RESERVE BANK OF ST. LOUIS



## Cards, Cards and More Cards: The Evolution to Prepaid Cards

It's almost impossible to get by today without some kind of plastic card—just try to make a hotel reservation or rent a car without one. How did we become so dependent on plastic cards and cashless payments? A look back in time reveals the answer.

**What's Your Question?**  
Cards, Cards and More Cards

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The evolution to credit cards came naturally. Recall the American West, when pioneers charged items at the country store then paid their bills as they had the money. Now consider the sharecroppers of the past century, whose livelihood depended on the credit provided by landowners. Landowners supplied a “furnish”—supplies and food—for sharecroppers to plant crops and subsist. Sharecroppers then repaid their debt with a percentage of the crops harvested—an ongoing cycle.

Stores later defined credit limits and some introduced 90-day credit accounts. Customers could charge purchases, take the merchandise, then pay the bill over a three-month period without interest. Although initially store-based, such credit accounts evolved to become today's credit cards. Credit cards represent borrowed money and the agreement that the cardholder may buy on credit now and pay later. If payment isn't made by a given date, the credit card holder pays interest on the loan. The first widely accepted credit card debuted in 1950—The Diners' Club. Cardholders of this then-paper card could charge meals with payment due in full monthly. By the mid-1950s, several companies entered the credit card market.

And, MasterCard and Visa emerged successfully. In 1959, Bank of America introduced the first “revolving” charge card called the BankAmericard. Cardholders did not have to pay the bill in full monthly, but could make monthly payments toward the total, with interest applied to remaining balances.<sup>1</sup>

As the credit card system grew, computer technology advanced and revolutionized banking. In the mid-1980s, automated teller machines (ATMs) enabled 24-hour access to cash and account information. As consumers began to have their paychecks deposited electronically into their bank account and pay their bills electronically, banking business could be conducted without physically going to a bank at all!<sup>2</sup>

In 1984, banks began issuing a new tool—debit cards. Debit cards are linked to a bank account. When the card is used to make a purchase, payment is withdrawn from the cardholder's bank account. Because of the convenience of debit cards, they soon became a popular replacement for cash and checks. By 1998, consumers used debit cards more often than checks.<sup>3</sup>

Today, a new trend is emerging: the prepaid card. According to the 2010 Federal

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## **Cards, Cards and More Cards**

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Reserve Payments Study, consumers conducted 6 billion transactions with prepaid cards for a total of \$140 billion during 2009. From 2006 to 2009, the use of such cards increased 20 percent and the value of these transactions increased by 22.9 percent per year. Transactions using prepaid cards comprise a relatively small portion of total noncash payments but are the fastest growing option within the category.<sup>4</sup> This trend began in the late 1980s when prepaid phone cards appeared. These were followed in the mid-1990s by the closed-system (merchant specific) gift cards. Open-system prepaid cards began in the early 1990s, when the government replaced paper-based food stamps with Electronic Benefits Transfer (EBT) cards. Open-system gift cards were introduced in the mid-1990s.<sup>5</sup>

### **What Is a Prepaid Card?**

A prepaid card looks like a debit or credit card but is not linked to a bank account and is “pay as you go.” The card has a zero value until it is purchased and “loaded” with an amount of money. When a purchase is made, the amount of the purchase is subtracted from the card’s balance. When the balance reaches zero, the card is empty. Some cards are “reloadable”—money may be added to the card at certain stores, online, or by direct deposit. Other cards must be discarded when the balance reaches zero. As prepaid cards gained popularity, cards emerged for a wide variety of products and services.

According to estimates from the Federal Reserve Bank of Boston’s 2009 Survey of Consumer Payment Choice, about one-third of consumers have a prepaid card of some type.<sup>6</sup> Some cards are targeted to specific customer needs. For example, general purpose reloadable (GPR) cards may substitute for bank accounts for unbanked or underbanked individuals. Gift cards, employee incentive cards, payroll cards, and government benefit cards provide a simplified system of budgeting and money distribution. In lieu of checks and direct deposit payments, some employers and government agencies issue prepaid cards to employees and beneficiaries.

### **Kinds of Prepaid Cards**

A closed-system prepaid card is merchant specific: The card can be used only at a single merchant or merchant chain. (Sears cards can be used only for purchases at Sears; JC Penney cards can be used only for purchases at JC Penney.) Gift cards are typically both closed system and non-reloadable.<sup>7</sup> Most closed-system prepaid cards are stored-value cards. The monetary value of the card is stored on the card

itself via a small microchip. There is no external record of the card value on any payment network and stored-value cards are usually anonymous.

An open-system prepaid card is associated with a given electronic payment network (such as Visa or MasterCard): The card may be used at any business within the network, identifiable by a logo. The monetary value of open-system cards is maintained by the card issuer, not on the card itself. The value of the card is accessed via a unique card number embedded on a magnetic strip on the card.<sup>8</sup> These cards are usually issued in the name of an individual account holder.

### **Prepaid Card Fees**

Many prepaid cards have complicated fee structures that can be difficult to understand. Fees as well as terms and conditions vary by card. Fees may be assessed for initial activation, monthly maintenance, ATM withdrawals, reloading, replacement, monthly statements, and more. Competition among prepaid card issuers and increased volume have helped lower card fees and simplify card terms; however, prepaid cards are exempt from federal consumer protection laws that apply to bank debit cards.<sup>9</sup> It is wise to compare prepaid card fees and question unclear terms and conditions.

### **Who Uses Prepaid Cards**

While these cards have traditionally served the unbanked and underbanked, more and more mainstream consumers are choosing these cards to circumvent rapidly escalating bank fees. Prepaid cards have also become popular among parents of high school and college students as a means of distributing allowance. Most prepaid cards are purchased at stores, including check-cashing outlets, grocery stores, or big-box retailers such as Wal-Mart. The biggest U.S. issuer of prepaid cards is Green Dot, which sells cards through Wal-Mart and other large chains.<sup>10</sup>

### **Advantages and Disadvantages**

In addition to serving as a tool for an estimated 60 million unbanked Americans<sup>11</sup>, prepaid cards have other advantages. They require no approval process, no credit check, no bank account, and no interest payments. Those with no bank account or bad or non-existent credit histories, thus unable to acquire a credit card, can purchase prepaid cards. These cards offer similar services and convenience as a debit card or credit card and allow online payments. Some prepaid cards, generally name-brand cards, offer security when traveling because lost or stolen cards may be cancelled and replaced.

Because of the preset limit—the monetary value placed on the card—a prepaid card can help prevent debt accumulation, cultivate better spending habits, and promote budgeting. In addition, prepaid cards can serve as a tool for parents to teach children money management. Most general-purpose reloadable (GPR) cards allow users to track recent transactions online via a personal account; thus, parents can track children's spending as well. The pay-as-you-go method can also provide direction for financial decision making and goal setting—you can't spend money until you have it.

Prepaid cards can help guard against fraud. If a card is lost or stolen, it contains no personal or bank account information and no open line of credit linked to the card—your bank account can't be

drained and your credit can't be ruined. In addition, prepaid cards can be safer than carrying a large amount of cash, yet still provide quick access to cash in an emergency.

Prepaid cards do, however, have downsides. You do not build a credit history from using a prepaid card<sup>12</sup>, and a credit history can be helpful when applying for loans or credit cards. Fees vary from card to card and may be costly, especially because prepaid cards are less regulated than credit cards. Most prepaid cards charge a start-up fee, which can be minimal or substantial. Another downside is that some businesses that accept automatic payments from banks or credit card accounts will not accept them from prepaid cards.<sup>13</sup>

Presently, no law requires an issuer to provide refunds for lost or stolen cards, although some cards do provide this safety net.<sup>14</sup> Most

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## Glossary

**Automatic teller machine (ATM) card**—A form of debit card used to withdraw money from a cash machine when the user punches in a unique code called a personal identification number (PIN). Withdrawn money is electronically deducted from the cardholder's bank account.

**Closed-system card (closed-loop card)**—A merchant-specific card that can be used only at a particular merchant or chain of merchants (e.g., Sears or JC Penney).

**Credit**—The granting of money or something else of value in exchange for a promise of future repayment.

**Credit card**—A card that represents an agreement between a lender—the institution issuing the card—and the cardholder: The cardholder may charge purchases (or borrow money), usually up to a specified limit. The lender pays merchants directly for the charged amounts. The cardholder, in turn promises to pay back the lender in full plus interest. Credit cards may be issued by banks, savings and loans, retail stores, and other businesses.

**Debit card**—A card issued by banks to bank-account holders. The card may be used for point-of-sale transactions in place of cash or checks. Transaction amounts are deducted electronically from a cardholder's bank account.

**Durbin Amendment**—An amendment to the Dodd-Frank Act that states that debit card fees must be reasonable and proportional to the actual cost of processing the transaction.

**Electronic benefit transfer (EBT)**—An electronic system that allows a recipient to receive financial benefits from the government via a debit card. The recipient uses the EBT card to make purchases from retailers.

**Fees**—Money charged to service an account.

**General-purpose reloadable (GPR) card**—Prepaid cards that are branded "general purpose" reloadable (GPR) cards. Prepaid GPR cards allow customers to reload the cards with additional funds and even set up direct deposits to the cards.

**Gift card**—A non-reloadable prepaid card often given as a gift. Transaction amounts are automatically deducted from the balance of the card. The card may be used until the balance on the card is zero.

**Interchange fee (swipe fee)**—The fee the issuer of a payment card charges a merchant each time the merchant accepts payment via one of these cards—that is, each time a customer "swipes" one of these cards to make a purchase.

**Network branded card (open-system card)**—A prepaid card issued by a specific payment network, such as Visa or MasterCard, branded with a logo and usable at any merchant within that network.

**Non-reloadable card**—Prepaid cards that can be used until the balance is zero and cannot be reloaded.

**Open-system card (network branded card or open-loop card)**—A prepaid card, associated with a major electronic payment network such as Visa or MasterCard that can be used any place these networks are accepted.

**Payroll card**—A payroll card is a type of prepaid card that allows direct deposit of earnings to a card, rather than a bank account.

**Prepaid card**—A card worth the value of the purchase amount (excluding fees) and possibly reloadable. Transaction amounts are automatically deducted from the balance of the card. It may be an open- or closed-system card.

**Reloadable card**—A prepaid card that allows the cardholder to add more funds (money) to the card.

**Unbanked**—Consumers who have no account at a bank or a financial institution.

**Underbanked**—Consumers or businesses that have limited or poor access to primary financial services provided by banks and rely on alternative financial services.

## Cards, Cards and More Cards

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closed-system cards cannot be redeemed for cash, creating a use-it-or-lose-it scenario. The unredeemed balance of any card is retained by the card issuer.

### Protection

GPR card issuers are not always required to provide the same consumer protection as debit card issuers. The market dynamics and industry competition among GPR cards, however, have resulted in GPR card issuers offering greater consumer protections than provided with closed-system prepaid cards, such as gift cards. Non-reloadable gift cards, whether closed-system or open-system, are generally not registered in the name of the account holder and, therefore, lack consumer protections—there is no recourse for lost or stolen cards. GPR card issuers, however, uphold the same voluntary zero liability protection policies applied to credit and debit cards within the same network:<sup>14</sup>

- American Express: As long as transactions are reported within 60 days of discovery, consumers are not liable for fraudulent transactions.
- Discover: Consumers are protected with a \$0 fraud liability guarantee.
- Visa: As long as cardholders have not been negligent or fraudulent in the handling of the card, they will not be liable for fraudulent transactions.
- MasterCard: Consumers are protected with zero liability only on signature transactions if the card is in good standing, and if the consumer has taken reasonable care to protect the card and has reported no more than two incidents of unauthorized uses in the previous year.

Some banks that issue GPR cards offer the same protection provided with debit cards: a \$50 maximum liability if the cardholder notifies the bank within two days of discovering the unauthorized use and a \$500 maximum liability if the cardholder notifies the bank within 60 days.<sup>14</sup> Consumers should read the cardholder agreements to better understand the terms, including each issuer's liability policy for unauthorized transactions.

### Government Usage

Federal, state, and local governments continue to expand their use of general-purpose

prepaid cards to reduce costs and provide convenience for recipients. Although estimates vary, the savings from using prepaid cards to provide government benefits instead of issuing and mailing checks are substantial. Some estimates are as high as a 75 percent savings on disbursements<sup>11</sup> while others estimate the prepaid card saves the government about \$0.93 on each electronic transfer.<sup>15</sup>

In December 2010, to further increase savings, the U.S. Department of the Treasury mandated that all government benefits be paid electronically. Effective May 1, 2011, all non-tax payments for new benefit recipients must be made via electronic deposit to a bank account; existing recipients have until March 1, 2013, to switch to the new system. Recipients (new or existing) who do not provide bank-account information for direct deposits will be issued a Direct Express card or a prepaid card of the recipient's choice as long as certain requirements are met.<sup>16</sup>

The Direct Express card, issued on behalf of the Treasury, is used to disburse federal benefit payments for several agencies. For example, the Social Security Administration, the largest user of the card, provides benefits including Supplemental Security Income (SSI) payments to about 1.5 million cardholders.<sup>15</sup> Other payments provided through the Direct Express card include veterans and military benefits, wages for federal employees, and unemployment benefits.

Additionally, the U.S. Treasury initiated pilot programs to leverage general-use prepaid cards for federal tax refunds in 2011. One program offered electronic delivery of 2010 federal tax refunds via a "MyAccount-Card" prepaid card. Taxpayers could have their tax refunds deposited directly onto the cards. The second pilot program was designed to encourage current and potential payroll card users to elect to have federal tax refunds deposited directly onto general-purpose payroll cards.<sup>17</sup> A payroll card is a type of prepaid card that allows direct deposit of earnings to a card, rather than a bank account.

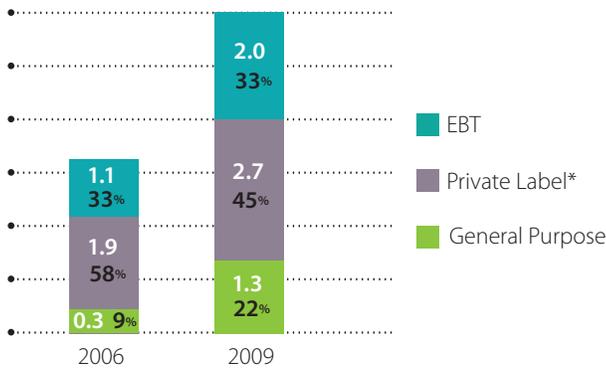
### Durbin Amendment and Reform

For each payment card transaction, the issuer of the card charges the merchant who

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## Prepaid Market is Small But Growing Rapidly

**Prepaid Debit Payments by Type (in billions)**



\*Private label transactions are prepaid cards which are limited in usage to one or several merchants—a closed-system card.

**1. What percent of all prepaid cards were general purpose cards in 2009? In 2006?**

In 2009, general purpose cards comprised 22 percent of prepaid debit payments compared to only 9 percent in 2006.

**2. How do general purpose cards differ from private label and EBT cards?**

Private label cards are merchant specific. They are generally not reloadable. EBT cards are government-issued prepaid cards that allow recipients to receive financial benefits. The recipients use these cards widely to purchase goods and services. EBT cards are reloadable; the government reloads the card when benefits are due. General purpose cards are also reloadable, but they are reloaded by the cardholder. They can be used widely for goods and services.

**3. Which type of prepaid debit card was used most in 2009? How many payment were made by this type of card?**

The most used prepaid card was the private label card. 2.7 billion transactions were made with this type of card.

**4. Which type of payment card has grown the most in use from 2006 to 2009?**

The general purpose card.

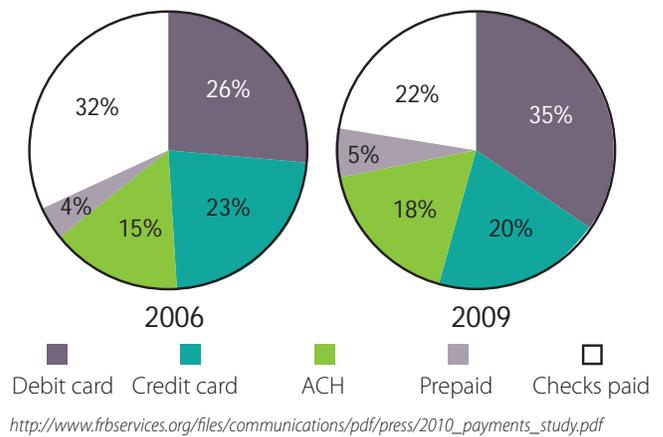
**Second Quarter 2011**

	Q3-'10	Q4-'10	Q1-'11	Q2-'11
<b>Growth Rate</b>				
Real Gross Domestic Product	2.5%	2.3%	0.4%	1.0%*
<b>Inflation Rate</b>				
Consumer Price Index	1.4%	2.6%	5.2%	4.1%
<b>Civilian Unemployment Rate</b>	9.6%	9.6%	8.9%	9.1%

\*second estimate

GDP – Bureau of Economic Analysis: [www.bea.gov](http://www.bea.gov)  
Unemployment and CPI – Bureau of Labor Statistics: [www.bls.gov](http://www.bls.gov)

**Distribution of the Number of Noncash Payments**



**1. Review the pie charts above. Create a table that uses the same data as the pie charts. Then write a description of how the distribution of noncash payments has changed from 2006 to 2009.**

Debit card payments have increased greatly. Credit card payments have decreased. ACH payments have increased. Prepaid card payments have increased. Check payments have decreased.

**2. The use of debit cards has increased while the use of checks and credit cards has declined. Between checks and credit cards, which is a close substitute for debit cards? Why?**

Checks are a close substitute for debit cards because debit card payments are taken directly from your checking account, the same as check payments.

**3. Why is the use of checks declining as the use of debit cards increases?**

Checks are inconvenient when compared to debit cards.

**4. Why are credit cards not considered a close substitute for debit cards?**

Payments made by credit cards are paid by the bank that issued the credit card. You pay the bank back at a later date. So, transactions you make by credit card are loans.

## Cards, Cards and More Cards

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### **Q. What is the Durbin Amendment?**

A. The Durbin Amendment is a provision in the final Dodd-Frank Wall Street Reform and Consumer Protection Act intended to limit the interchange transaction fee, or “swipe fee.” This is the fee the issuer of debit or prepaid cards charges a merchant each time the merchant accepts—swipes—one of these cards. The amendment directs the Federal Reserve to set a fee that is “reasonable and proportional to the cost incurred by the issuer with respect to the transaction.” The Federal Reserve set the fee at \$0.21 effective October 1, 2011. Banks and credit unions with less than \$10 billion in assets are exempt from the rule, as are reloadable prepaid cards.

### **Q. What is the difference between a credit card, prepaid card, and a debit card?**

A. A credit card offers a line of credit; the cardholder is lent the money for the transaction. Total purchases are limited to the card’s credit limit. A prepaid card pays for a transaction using the money loaded onto the card. The transaction amount is automatically withdrawn (paid for) from the value

(balance) of the card. Total purchases are limited to the value of the card. A debit card pays for a transaction by withdrawing the transaction amount (money) from the cardholder’s bank account. Total purchases are limited to the amount of money in that account.

### **Q. Are consumers protected if a non-reloadable prepaid card is lost or stolen?**

A. A non-reloadable card, whether closed system (retailer specific) or open system (branded and affiliated with a network, such as Visa or MasterCard), is generally not registered in the name of the account holder and therefore lacks consumer protections.

### **Q. Are consumers protected if a general-purpose reloadable (GPR) prepaid card is lost or stolen?**

A. If a GPR card is lost or stolen, the consumer is provided with the same voluntary zero liability protection policies that apply to credit and debit cards in the card’s payment networks (e.g., Visa and MasterCard). Policies vary by network.

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## Cards, Cards and More Cards

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fee, or “swipe fee.” These fees are set by Visa and MasterCard and are passed on to the banks that issue the cards. These fees vary widely by card and in some cases are considered excessive. In the past, debit card transaction swipe fees paid by merchants to card issuers averaged 44 cents. The Durbin Amendment, which is part of the Dodd-Frank Act, directs the Federal Reserve to address these fees as follows:

The amount of any interchange transaction fee that the issuer may receive or charge with respect to an electronic debit transaction shall be reasonable and proportional to the cost incurred by the issuer with respect to the transaction.<sup>18</sup>

The Federal Reserve capped the swipe fee at \$0.21 effective October 1, 2011.<sup>19</sup> This cap could cut card issuers’ annual revenue from swipe fees in half.<sup>20</sup> Cards issued by banks and credit unions with less

than \$10 billion in assets are exempt from the cap. Reloadable prepaid cards are exempt as long as card transactions are the only means to access the funds underlying the card, i.e. a prepaid card that offers check writing privileges is not exempt. Prepaid cards marketed or labeled as a gift card or gift certificate are not exempt either. Considering the popularity of prepaid cards, banks may look to the prepaid card market to replace lost revenue.

## Conclusion

As technology advances, payment systems and business opportunities will continue to evolve. The challenge for consumers is to stay informed, read the terms for any prepaid card carefully, and know the fee structure. Above all, read the fine print!

What’s next? It’s reasonable to assume that the prepaid card market will continue to grow and the electronic payment system will continue to replace traditional paper-based methods. ■

ALL LOCATIONS

For more information on any of the following events, go to [www.stlouisfed.org/education\\_resources/events/](http://www.stlouisfed.org/education_resources/events/) unless otherwise indicated.

ST. LOUIS

Contact: [barbara.flowers@stls.frb.org](mailto:barbara.flowers@stls.frb.org)

**Annual Professors Conference: Topics and Tools for the College Classroom**

Nov. 3, 2011, 1 – 8 p.m.

*(reception and dinner provided)*

Nov. 4, 2011, 8:30 a.m. – Noon

*(breakfast and lunch provided)*

LITTLE ROCK AND MEMPHIS

**Fitting the Pieces Together: Economics, Arkansas History, and the Common Core Curriculum**

Jan. 20, 2012, 8:30 a.m. – 3:30 p.m.

*(lunch provided)*

Little Rock contact: [kris.a.bertelsen@stls.frb.org](mailto:kris.a.bertelsen@stls.frb.org)

Memphis contact: [jeannette.n.bennett@stls.frb.org](mailto:jeannette.n.bennett@stls.frb.org)

LOUISVILLE

Contact: [caryn.rossiter@stls.frb.org](mailto:caryn.rossiter@stls.frb.org)

**Financial Literacy Workshop at Bellarmine University**

Oct. 20, 2011, 4:30 – 7:30 p.m.

*(lunch provided)*

Visit our website for detailed event information and to register:

[www.stlouisfed.org/education\\_resources/events/](http://www.stlouisfed.org/education_resources/events/)

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## FEATURED RESOURCES

# New Economic Education Resources

### FOR HIGH SCHOOL

#### Podcasts and Video Companions

Look for video companions to selected “Economic Lowdown” podcasts: “Supply” is available now; “Demand” and “Market Equilibrium” will be available by year end.

#### Online Courses

**“Comparative Advantage”**: Superhero Jack of All Trades can produce everything better and faster (he has absolute advantage). A thorough and humorous explanation of comparative advantage reveals that Jack and a business partner can each specialize and produce more together.

**“Personal Finance 101 – Chats”**: These chats feature topics presented as instant-messaging exchanges between customers and financial experts, parents and children, friends and family. New topics include payday loans, rent-to-own agreements, and prepaid cards.

### FOR MIDDLE SCHOOL AND HIGH SCHOOL

**“Soar to Savings”**: Teaches benefits of personal saving, the Rule of 72, tips for saving, the difference between bonds and stocks, the relationship between risk and return, and the impact of saving on the economy as a whole. Through true-to-life savings and lending scenarios, Fred the Frugal Eagle, the St. Louis Fed mascot, playfully tests students’ knowledge.

### FOR ELEMENTARY SCHOOL

Seven new economics and children’s literature lessons available now.

- Beatrice’s Goat
- Something Special for Me
- The Case of the Shrunken Allowance
- Glo Goes Shopping
- Little Nino’s Pizzeria
- One Hen: How One Small Loan Made a Big Difference
- Sheep in a Shop

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