

Prepaid Cards: Promise and Pitfalls for Consumers

Advertisers market general purpose reloadable (GPR) prepaid cards as providing low-income consumers with a convenient and cost-effective alternative to using basic checking accounts. However, consumer advocates note that these cards can be expensive for consumers to use and lack key consumer protections typically associated with mainstream financial products. This paper explores the potential benefits and drawbacks of using GPR cards and offers key design principles to protect consumers who use these types of cards.

Introduction

Prepaid cards are credit card-sized pieces of plastic that provide access to a preloaded amount of money. Unlike traditional credit or debit cards that derive their value from a line of credit or an existing bank account, the value of a prepaid card comes from money given to the card's issuer prior to its use.¹

The use of prepaid cards, also known as general purpose reloadable (GPR) cards, has steadily increased in the past decade. A 2010 Federal Reserve study found that 17 percent of consumers surveyed reported using a prepaid card to make payments.² According to industry sources, there were five billion prepaid card transactions in the United States in 2008, up from 2.5 billion transactions in 2003.³ In 2008, \$60.42 billion was loaded on GPR cards, up 54.3 percent from \$39.16 billion in 2007.⁴

GPR cards mimic many features of a traditional checking account. As such, these cards appeal to low-income unbanked people who use the cards in lieu of a bank account. GPR cards have the following key features:

- **Open loop:** GPR cards are widely accepted and cardholders can use their cards in the same manner as traditional credit and debit card products.⁵ This includes being able to purchase goods and services at retail stores, make online purchases, and use automated teller machines (ATMs) to withdraw cash.
- **Network branded:** Cards are branded with a network logo (American Express, Visa, MasterCard, or Discover Card) and can be used anywhere that accepts these brands.
- **Reloadable:** The GPR card value can be increased by depositing additional funds to the card at retail stores and banks, or through direct deposit of payroll funds or government benefit transfer payments.
- **Accesses an aggregate account:** While traditional credit and debit cards link directly to a line of credit or bank account held in the cardholder's name, GPR cards instead provide access to funds stored in an aggregate account.

Even though banks issue the actual GPR cards, third party nonfinancial entities generally distribute and market them.⁶ Because GPR card users typically can only draw on funds they have previously deposited, there is little risk of financial loss to the issuer or bank sponsoring the card.⁷

Who Uses GPR Cards?

GPR cards often appeal to the unbanked—those who are unable or unwilling to use more traditional banking products and low-income banked consumers.⁸ An AARP analysis of unbanked and underbanked individuals estimates that 25.3 million Americans age 18 and older are unbanked, with approximately 5.4 million of these individuals being age 45 and older.⁹ Other sources suggest that up to 45 million individuals rely on check-cashing services, money-wire services, and payday loan providers for their banking needs.¹⁰

In most cases, GPR card providers market their cards as offering the convenience of a debit or credit card without having to open a bank account or line of credit. Companies often market these cards as being cheaper than a bank account, as well as being cheaper for the unbanked than using check cashers and money orders.¹¹ GPR cards are widely available for purchase at many tax preparers,¹² retailers, check cashiers, money transmitters, and payday lenders.¹³

The increasing number of fees on bank accounts—and the amounts charged—are likely to add to the number of consumers using GPR cards as consumers seek to save money.¹⁴ Industry experts anticipate that banks will eliminate many of the basic free checking account products that appeal to low-income consumers.¹⁵ Instead, banks will likely start adding new fees to basic

checking accounts, such as monthly maintenance fees or minimum balance fees, potentially driving more low-income consumers out of mainstream banking services.¹⁶

Employers looking for ways to cut operating costs are moving away from the use of paper paychecks and requiring employees to use direct deposit. For this reason, many employers now issue GPR cards to employees without bank accounts, directly depositing the paycheck onto the GPR card.¹⁷

**Typical GPR
Prepaid Card Users**

- Unbanked individuals
- Lower-income banked individuals
- Employers (to distribute payroll)
- Government agencies (to distribute benefits)
- Banked individuals as a money-management tool

In 2008, \$17.22 billion was loaded onto payroll cards, up 26 percent from \$13.64 billion in 2007.¹⁸ Industry sources estimate that the number of payroll cards in circulation will reach 17.5 million in 2010, compared with the 2.2 million in circulation in 2004.¹⁹ It is likely that payroll card usage will continue to increase, owing to their cost-saving advantages for businesses.²⁰

GPR cards are also becoming increasingly popular as a way for government agencies at all levels to distribute a variety of benefits to those who do not have bank accounts.²¹ For example, the U.S. Department of the Treasury is proposing that individuals receiving Social Security, Supplemental Security Income, Veterans, Railroad Retirement, and Office of Personnel Management benefits will be required to

use direct deposit.²² If the benefit recipient does not have a bank account, the Treasury will issue the recipient a GPR card to provide access to funds transferred by direct deposit.

As was the case with payroll cards, switching to the use of direct deposit instead of issuing paper checks can save government agencies substantial amounts of money. For example, the state of Florida expects to save about \$317,000 a year by switching to a prepaid card system to deliver unemployment benefits.²³ The U.S. Department of the Treasury similarly expects to save \$400 million dollars in the first five years of requiring direct deposit.²⁴

Consumers who purchase GPR cards at retail locations have a choice about which card they purchase, but those who receive a GPR card from their employer or a government agency do not have this choice. It is, therefore, up to the employer or government agency distributing GPR cards to negotiate the terms and conditions on behalf of the recipient.

Finally, GPR cards are starting to gain acceptance as a money management tool for some moderate-income banked individuals.²⁵ Prepaid cards are an alternative to high-interest-rate credit cards and bank fees paid for overdrafts on traditional checking accounts. Since spending is capped by the amount of money previously loaded onto the GPR card, consumers can avoid overspending their checking account or running up high-interest credit card debt.

What Are the Potential Benefits for Cardholders?

GPR cards may provide a number of benefits to cardholders.

GPR Cards Can Be Cost-Effective for Unbanked and Low-Income Consumers

GPR cards may be cost-effective for unbanked consumers. For example, unbanked consumers can save money compared with the cost of using check-cashing services, which typically assess a fee of 3 percent of the check value.²⁶ Unbanked consumers can also save money by not having to purchase money orders or cashier's checks to pay bills.

GPR cards can also be cost-effective for some low-income banked consumers who hold basic checking accounts. If banks begin to add monthly maintenance fees or require a minimum balance to maintain basic checking accounts, low-income consumers may be able to save money by switching to a GPR card.²⁷

A study by the Federal Deposit Insurance Corporation (FDIC) found that recurrent account overdrafts were more common among banked low-income consumers than among higher income banked consumers.²⁸ According to the FDIC study, most consumers with overdrafts had five or more overdrafts in the 12-month period preceding the study.²⁹ The study also noted that the median overdraft fee was \$27, resulting in a consumer with five overdrafts a year paying \$135 or more in overdraft fees annually.³⁰

GPR cards could save consumers from paying fees associated with routinely using check-cashing services or having frequent account overdrafts. However, the cost effectiveness of any product will depend on the specific fees associated with the card, as well as the usage characteristics³¹ of the cardholder.

GPR Cards Are Convenient

Because cardholders can use network-branded cards anywhere that traditional credit or debit cards are used, GPR cards are versatile and convenient for consumers to use. Consumers can use

GPR cards to book hotel rooms, rent cars, and make online purchases. GPR cards are also convenient for making cash withdrawals at ATMs, or to obtain cash back during retail transactions. Finally, these cards are useful for paying bills, either online or over the phone, thereby avoiding the need to go to multiple locations to pay bills in person.

GPR Cards Can Be Safer to Use Than Cash

GPR prepaid cards can provide greater protection to consumers than carrying and using cash. While cash can be lost or stolen, many GPR cards provide protections against fraud or loss. For example, GPR cards used to distribute payroll are required under Regulation E,³² which implements the Electronic Funds Transfer Act (EFTA),³³ to provide cardholders with important rights and protections (see box on Regulation E protections). However, Regulation E does not cover most other GPR cards.

Key Regulation E Protections

- Limit fraud losses to \$50 for lost or stolen cards
- Establish dispute resolution process
- Provide clear disclosure of all terms, conditions, and fees

Many network-branded GPR cards voluntarily offer cardholders the same protections against losses from fraud as are available on similarly branded traditional credit and debit card products.³⁴ However, nonpayroll cards are not required to provide these fraud protections, or to establish dispute resolution processes and provide clear disclosure of terms of services as is the case under Regulation E.

What Are the Potential Concerns About GPR Cards?

There are several concerns about the use of GPR cards.

GPR Cards Can Be Costly for Cardholders

GPR cards can carry an expansive array of fees (see box). Depending on what fees apply and the cost of each fee, GPR cards may actually be an expensive alternative to traditional banking services. An analysis of several GPR cards sold at retail locations concluded that while monthly usage costs varied widely depending on the product, the cards were generally expensive to use.³⁵

Of particular concern is that some GPR cards charge overdraft or shortage fees if a consumer inadvertently spends more than the amount preloaded on the card. Most GPR cards do not allow the consumer to spend more than is held on

Many Activities Can Result in Fees

- Account activation
- Monthly account maintenance
- Point of sale transaction
- Bill payment
- Cash withdrawal
- Balance inquiry
- Adding funds to the card
- Receiving a printed statement
- Customer service requests
- Card replacement
- Inactivity
- Declined transaction
- Refund of remaining card balance
- Shortage/overdraft
- Account advances

the card, but on some cards overdrafts can result when a card is processed using a signature instead of a personal identification number (PIN) to complete the transaction. Because the signature transaction takes longer to post than a PIN-based transaction, a transaction may be processed even though insufficient funds remain on the card.

Lack of Regulation

A lack of regulation of GPR products raises concerns that cardholders using these products will not have the same consumer protections available on mainstream financial products. Currently, regulators do not apply Regulation E and EFTA protections to nonpayroll cards GPR cards.³⁶ As a result, nonpayroll GPR cards are not currently required to have protections against fraudulent use, a dispute resolution process, or full disclosure of terms of service. At the time of the writing of this report, it is not clear whether the implementation of the Dodd-Frank Wall Street Reform and Consumer Protection Act will address these issues for GPR cards.

Further, in some circumstances, FDIC protections are not available on cardholder funds deposited on GPR cards even though the institution holding the funds is FDIC insured. Because these funds are stored in an aggregate account, the FDIC deposit insurance cap can apply to the aggregate account as a whole instead of to the individual cardholder's funds. The FDIC announced that funds stored on prepaid cards are covered up to \$250,000 per cardholder as long as the aggregate account is held at an insured depository institution and set up to meet the FDIC "pass-through" requirements.³⁷ Unfortunately, it is difficult for consumers to determine whether their particular account is set up this way.

Direct Deposit Account Advances

Some GPR cards allow cardholders who receive regular direct deposits of wages or government transfer funds to take a short-term advance on an upcoming deposit. Repayment of the amount of the advance plus associated fees is automatic as soon as the next direct deposit occurs, regardless of whether the cardholder needs the funds for food or other essential needs.

These advances are subject to substantial fees that, according to one study, can exceed those charged on payday loans.³⁸ Consumer advocates fear that this practice will take the place of increasingly regulated payday loans to make high-cost short-term loans to cardholders while avoiding state laws limiting fees on payday loans.³⁹

Lack of Standardized Disclosure of Fees and Terms of Service

The lack of clear and concise disclosure of all fees associated with a GPR card can result in consumers incurring fees that will rapidly drain their account balance. For example, if the consumer is not aware that they will be charged for each cash withdrawal at an ATM, they might make multiple small withdrawals instead of one large one and be assessed a fee each time. Often advertising claims herald the absence of one type of fee on a GPR card, but do not disclose other fees that make the card expensive to use.⁴⁰

In addition, the lack of an established standard format to disclose fees and terms of service makes it very difficult for consumers to compare competing GPR card products and select the least expensive product given their usage characteristics. Further, without clear disclosure of terms of service, it is hard for consumers to know what protections exist in cases of fraud or disputed purchases.

Conclusion

The use of GPR cards continues to increase. These cards may provide low-income consumers a cost-effective and convenient alternative to holding a bank account or using other alternative financial services. However, some of these cards lack key protections that are available to holders of bank accounts and traditional credit and debit cards.

Further, it is often difficult for cardholders to determine how to best use their GPR cards to minimize potential fees. Without better disclosure of this information, it is challenging for consumers to make informed decisions about whether a product is suitable for their needs, or how to minimize fees when using their GPR card.

Recommended Policy Options

To provide necessary protections for consumers using GPR cards, the following design principles are important:

- Expand the Electronic Funds Transfer Act and Regulation E to include all GPR cards. This would provide consumers with important protections to limit fraud losses, provide a dispute resolution process, and create disclosure requirements. These protections are necessary for consumers who want to ensure the security of funds deposited on GPR cards.
- Issuing banks for GPR cards should be required to meet FDIC “pass-through” requirements when establishing the aggregate account to ensure that all cardholders receive the full protection of FDIC insurance on the funds they have deposited. This will guarantee the safety of cardholder funds in case of bank insolvency.

- Develop a standardized disclosure form to allow consumers to identify and understand all fees and key terms of service prior to purchasing or using a GPR card. This will also enable consumers to compare products and identify a suitable GPR card for their usage pattern.
- Prohibit overdraft or shortage fees. It should not be possible for consumers using a GPR card to overdraw prepaid accounts and accrue overdraft or shortage fees.
- Prohibit direct deposit account advances with high fees. GPR cards should not have the same disadvantages as high-cost payday loans.
- Employers and government agencies who distribute GPR cards should negotiate the best possible deal on behalf of the card recipients.

¹ M. Furletti, *Prepaid Card Markets & Regulation*, Federal Reserve Bank of Philadelphia Discussion Paper (February 2004).

² Federal Reserve, *The Survey of Consumer Payment Choice*, Federal Reserve Bank of Boston (January 2010).

³ CreditCards.com, accessed May 20, 2010. <http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php>

⁴ *Ibid.* This includes GPR cards as well as nonreloadable general-purpose cards.

⁵ P. Keitel, *The Laws, Regulations, Guidelines, and Industry Practices That Protect Consumers Who Use Gift Cards*, Federal Reserve Bank of Philadelphia Discussion Paper (July 2008).

⁶ J. McGrath, *The Cost Effectiveness of Stored-Value Products for Unbanked Consumers*, Federal Reserve Bank of Philadelphia Discussion Paper. May 2005.

⁷ A. Martin, “Prepaid, but Not Prepared for Debit Card Fees,” *The New York Times* (October 26, 2009).

⁸ *Ibid.*

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⁹ A. Jackson et al., *A Portrait of Older Unbanked and Underbanked Consumers: Highlights of a National Survey*, AARP Public Policy Institute (July 2010).

¹⁰ K. R. Roane, "One More Worry for Banks: Wal-Mart," *Fortune* (June 22, 2010).

¹¹ M. Jun, *Prepaid Cards: Second-Tier Bank Account Substitutes*, Consumers Union Report (August 2009).

¹² For example, in 2008 H&R Block was the top issuer of prepaid cards, with \$7.71 billion in purchase volume. Source, CreditCards.com, accessed May 20, 2010. <http://www.creditcards.com/credit-card-news/credit-card-industry-facts-personal-debt-statistics-1276.php>

¹³ M. Jun, op cit.

¹⁴ M. Scott, "With Bank Fees Rising, Prepaid Debit Cards Could Replace Checking Accounts," *Daily Finance* (December 4, 2009). <http://www.dailyfinance.com/story/with-bank-fees-rising-prepaid-debit-cards-could-replace-checkin/19262841/>

¹⁵ R. Sidel and D. Fitzpatrick, "End Is Seen to Free Checking," *The Wall Street Journal* (June 16, 2010).

¹⁶ Ibid.

¹⁷ For example, Wal-Mart estimates that about half of its 1.4 million employees use GPR payroll cards. Source: L. Heet, "More Employees say 'Hello' to Payroll Cards," CreditCards.com (September 29, 2009), accessed April 27, 2010 <http://www.creditcards.com/credit-card-news/payroll-cards-pay-cards-walmart-1217.php>

¹⁸ Ibid.

¹⁹ J. Cheney, *Payment Cards and the Unbanked: Prospects and Challenges*, Federal Reserve Bank of Philadelphia, Conference Summary. July 2005.

²⁰ L. Heet, op cit.

²¹ For example, Visa reports that more than 40 state governments currently use Visa-branded prepaid cards to distribute benefits. See <http://corporate.visa.com/corporate-responsibility/financial-inclusion/prepaid.shtml>, accessed May 20, 2010.

²² U.S. Department of the Treasury, "Treasury Goes Green, Saves Green," press release (April 19, 2010). AARP submitted comments to the Treasury urging that this implementation be delayed until improvements are made to strengthen the accessibility of benefit payments,

including a reduction of fees and surcharges associated with the debit card, and that beneficiaries be given access to at least four free withdrawals per month, similar to an electronic transfer account. Further, AARP asks that the Treasury establish waivers for those who have disabilities that make it difficult to use a debit card or in instances where a paper check is the least expensive, most accessible form of payment. http://www.aarp.org/about-aarp/press-center/info-08-2010/treasury_comments_ss_payments.html

²³ M. Heroux Pounds, "Florida's Jobless Could Have Debit Card Option this Fall," *South Florida Sun-Sentinel* (April 6, 2010).

²⁴ U.S. Department of the Treasury, op cit.

²⁵ N. Trejos, "Prepaid Cards Are a Convenient Alternative to Debit or Credit, But They Can Come with Hefty Fees," *The Washington Post* (October 25, 2009).

²⁶ Federal Deposit Insurance Corporation, *Alternative Financial Services: A Primer*. April 27, 2009. Accessed May 21, 2010. http://www.fdic.gov/bank/analytical/quarterly/2009_vol3_1/AltFinServicesprimer.html.

²⁷ The Federal Deposit Insurance Corporation (FDIC) notes that there is a need for safe, affordable bank accounts to meet the needs of low- and moderate-income consumers. To address this issue, the FDIC has created a proposed template to provide banks with a roadmap for creating economically feasible low-cost bank accounts that can accomplish this goal. FDIC, "FDIC Seeks Public Comment on Templates for Safe, Low-cost Transactional and Basic Savings Accounts," press release, May 7, 2010.

²⁸ Federal Deposit Insurance Corporation, *FDIC Study of Bank Overdraft Programs*, November 2008.

²⁹ Ibid.

³⁰ Ibid.

³¹ Usage characteristics include factors such as how often the cardholder uses the card, how many times funds are withdrawn from an ATM in a given month, whether the cardholder uses the card for bill pay, and the number of transactions in a given month.

³² 12 CFR part 205.

³³ 15 U.S.C. 1693 *et seq.*

³⁴ Bretton Woods, Inc., *Payment Systems Evolution and Branded Prepaid Card Analysis*, October 2009.

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³⁵ M. Jun, op cit.

³⁶ The Federal Reserve Board has been responsible for interpreting Regulation E. As a result of the Dodd-Frank Wall Street Reform and Consumer Protection Act, the consumer protection functions of the EFTA will be moved into the Consumer Financial Protection Agency.

³⁷ FDIC, *Stored Value Cards and Other Nontraditional Access Mechanisms*, New General Counsel's Opinion No. 8 (November 13, 2008).

³⁸ L. Saunders and L. Plunkett, *Stopping the Payday Loan Trap: Alternatives that Work, Ones That Don't*, National Consumer Law Center (June 2010).

³⁹ Ibid.

⁴⁰ M. Jun, op cit.

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