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Analysis

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Payroll Cards:

An Innovative Product for Reaching the Unbanked and Underbanked

Executive Summary

The purpose of this paper is to provide background information on the growth of payroll cards and their potential for use by national banks to attract the nearly 10 million unbanked households into the financial mainstream.

Individual banks have developed a range of low-cost “basic bank accounts” designed for unbanked individuals, many of which encourage electronic transactions, such as direct deposit and ATM withdrawals in order to limit the cost of these products. In addition, the Electronic Transfer Account, introduced by the Treasury Department, seeks to reduce costs to the federal government through similar means. For a variety of reasons, most of these products do not appear to have made a significant dent in the unbanked population.

Over the past few years, a different product has emerged that addresses at least some of the basic financial transaction needs of the unbanked. Payroll cards, a less costly alternative to paper payroll checks, allow employees to access their pay through various means, depending on the particular product. The card is offered by an employer to employees in place of a check to distribute wages. Wages are deposited to the payroll card account via direct deposit, and the employee uses the card to withdraw cash at an ATM or purchase goods and services.

An earlier generation of payroll cards typically provided employees with the ability to withdraw funds only at an ATM or at a limited number of PIN-based point-of-sale locations. While these cards are still present in the marketplace, many payroll cards now also carry a Visa or MasterCard brand, enabling employees not only to withdraw funds at an ATM, but also to make purchases and receive cash back from numerous retailers just like a traditional debit card. Payroll cards can serve as a product for a consumer who does not want to manage a checking account, but wants the combined benefits of direct deposit and a nationally branded debit card.

In order for more banks to take an active role in providing payroll cards, it is likely that they will evaluate three factors – whether payroll cards are a product that their commercial customers want, whether they view the unbanked as a potential market for cross-selling other bank products, and whether the product is profitable for the bank to offer. Banks have found that commercial customers want this product, but their evaluation of the other two factors is not complete.

I. Product Basics

Stored Value Product Platform

The payroll card is a particular type of stored value (or prepaid) card, a product that streamlines the payment process for the recurring use of goods and services. A variety of stored value cards exist, including prepaid phone cards, mass transit cards, and prepaid debit cards. Stored value cards operate in either "closed loop" or "open loop" systems.[1] In the closed loop system, an issuer provides a card that can only be used for its products or at a finite number of merchant locations. Mass transit fare cards and college-issued cards that can be used at cafeterias, bookstores, and other campus venues have closed-loop systems. In an "open loop" system, cards are accepted beyond the issuer's locations through a more universal network for PIN-based (e.g., Interlink) or signature-based (e.g., Visa, MasterCard) transactions. Payroll cards use an open loop system.

National Branding

While a few banks had offered proprietary payroll cards for a number of years, the announcements by Visa and MasterCard in 2001 that they would put significant resources behind the product helped lead to the product's rapid growth over the past two years. With a proprietary card, a payroll card user usually only had the option of withdrawing funds at an ATM, although some also allowed cardholders to make purchases at POS terminals where a PIN could be entered. When the card has a Visa or MasterCard brand attached to it, however, it can be used to make purchases at any POS terminal regardless of whether a PIN could be entered, just like other debit cards offered by banks. The national branding (Visa or MasterCard) has added both prestige and utility to the card, making it significantly more attractive to consumers. Consequently, banks have seen an increase in the number of payroll cardholders from their levels when only non-branded, proprietary cards were available.

Celent Communications, a consulting and research firm that focuses on technology in the financial services industry, reports that 10 percent of unbanked households, representing one million families, were using payroll cards at the end of 2002, up from almost zero in 1998. In addition Celent projects that more than 25 percent of unbanked households will use payroll cards in 2006.

Funds Flow, Storage, and Access

From an employee's perspective, instead of receiving a paycheck, the employee's pay is loaded into an account tied to the payroll card. How the employee accesses the funds depends on the program's setup: In some programs, the employee takes the payroll card to an affiliated ATM and withdraws funds. In others, the employee can also use the card as a debit card to make purchases and receive cash back at retail locations. Funds can typically be accessed until the balance reaches zero, and drawing down an account to the last dollar — once a problem when ATMs would dispense cash only in twenty-dollar increment —is easier because retailers disburse cash back in a variety of increments. The ability to receive cash back at retail locations also means that customers have access to their funds nationwide; they are not restricted to ATMs.

There are two basic ways in which funds can be held; the method chosen determines who has legal rights to the money. In either method, funds are usually sent by ACH or interbank transfer from an employer's payroll account to an omnibus holding account at the bank issuing the payroll card. The notable difference is in how the funds are held for employees. In one method, the funds are transferred to individual accounts for each employee, with each account qualifying for

[1] This description of stored value cards appears in "Payroll Cards: A Direct Deposit Solution for the Unbanked," Celent Communications, December 2002. Information from this report by Celent appears throughout this paper.

FDIC insurance – meaning that if the employer, the bank, or the vendor fails, the employee has clear rights to any funds remaining in the payroll card account. In this case, the program operator (which could be a bank or third-party vendor) is acting as an agent of the cardholder, meaning that the operator does not have any rights to the funds deposited in the account. Some issuers allow the employer to deposit funds directly into individual, FDIC-insured accounts.

In the second method, all of the funds are comingled in one company account, and notational accounts (sub-accounts) identify how much money "belongs" to each employee. With this method, since the owner of the account is the program operator, FDIC insurance does not automatically apply to each individual notational account. Pass through insurance may cover the notational accounts if the vendor or bank keeps sufficient records so that the FDIC can determine the amounts to which individual cardholders are entitled. In this method, the program operator often acts as a non-agent of the cardholder, meaning that once the funds are sent to the account by the employer, the operator holds the money in its own name. Similarly, a traveler's check company holds funds in its own name after a consumer purchases traveler's checks. Under this method, cardholders are exposed to the insolvency risk of the operator, unless some other party, such as the issuer, has been assigned responsibility for the insolvency risk of the operator.

Functionality

The functionality of a payroll card somewhat depends on whether the card provides only PIN-based access or also provides signature-based access. ***ATM and PIN-based debit*** programs allow the cards to be used at ATMs, PIN-based POS terminals, or both. Cards with these capabilities use platforms such as those belonging to Interlink, Star Systems, NYCE, PLUS, or Cirrus. ***Signature-based debit*** programs allow cards to be used at POS terminals with signature-based capability**,** in addition to ATMs and PIN-based POS terminals. Often known as "branded" cards, they bear the logo of the platform they use, such as Visa or MasterCard.

Table 1: PIN-based versus Signature-based Debit Cards

	PIN-based	**Signature-based**
Features		
Can be used at PIN-based POS terminals	Yes	Yes
Can be used at POS terminals where signatures are required	No	Yes
Revenue potential for banks	Low up to $0.10 per transaction	High [i] up to 1.5% of transaction
Costs to retailer to process at POS [ii]	Low $0.09 to $0.50 per transaction	High [i] 1.5 to 2.0 % of transaction
Potential for overdrawn accounts	Unlikely	Possible in limited amounts

Notes:

i. The fees and revenue from signature-based cards declined from this amount in August 2003, due to the settlement in the Wal-Mart Debit Card Suit.

ii. Fees charged to retailers vary depending upon volume-based and other discounts.

For both PIN-based and signature-based cards, non-payroll deposits are generally not permitted, although one bank reported that its product allows other electronic deposits to be made to the account.

Separate from payroll cards, a number of banks have begun to offer low-cost remittances enabling individuals working in the United States to send money to families in their home countries. These programs have targeted countries, such as Mexico and the Philippines, that have a large workforce in the United States. The programs afford ATM access in these countries to funds that have been transferred to the card here in the United States. At least one bank is in the process of integrating payroll cards with low-cost money transfers to Mexico.

Some banks provide a second card to payroll cardholders for a spouse or other family member. In some cases, the second card can be used abroad, but only allows ATM access. A second card can either provide complete access to the account, or the product can be structured so that the primary cardholder must transfer funds to the secondary account, before the second cardholder can access the funds.

Roles of Different Players

Three parties are always involved with a traditional payroll card product – the employer, the employee, and a bank. In addition, non-bank vendors may be involved to operate the payroll card program if the bank does not have the operational capability or for other strategic reasons. These vendors can be credit card merchant processors, human resources firms, payroll firms, or some combination of these vendors. Banks can serve as program operators, but only the largest with large-scale credit card operations and previous experience issuing their own proprietary payroll cards are likely to do so. If vendors are involved, the employer, bank, and vendors must establish at the outset who will be responsible for customer service (interface), who will have fiduciary responsibility for the funds once they have been disbursed from the employer's payroll account (issuer), who will take care of settlement of transactions and recordkeeping (processor), and where the funds will be stored (value repository).

II. Fee Structure/Revenue/Costs

The cost structure of payroll card programs, and the fees charged to employees and employers, differ widely from program to program. However, it appears that payroll laws in some states require employers to provide employees with a means of accessing their pay at no cost. Many programs meet this requirement by allowing employees to make at least one withdrawal per pay period without incurring any fees. According to the bankers we surveyed, their banks encourage employers to offer the payroll card as an option, but not require its use if an employee does not use direct deposit.

Revenue Streams

Banks earn money from payroll cards from the following fees (listed in declining order of importance):

1. **Interchange fees** are paid by merchants to Visa, MasterCard, or one of the regional networks. When a consumer makes a purchase at a POS terminal, the merchant is charged an interchange fee by the processing network, most of which is eventually paid to the bank that issued the card. Retailers are generally charged from $0.09 to $0.50 per transaction for PIN-based debit transactions, and a percentage charge of approximately 1.5 to 2 percent for signature-based debit transactions. Generally, none of these fees are passed on to the cardholder; rather, they are absorbed by retailers as a cost of doing business.

It should be noted that the settlement in the Wal-Mart Debit Card Suit is expected to reduce the revenue that banks will receive from interchange fees related to signature-based debit cards. According to the preliminary settlement, on August 1, 2003, the interchange fees paid by retailers were cut by about one-third. After January 1, 2004, Visa and MasterCard will negotiate with merchants or merchant groups for a new interchange fee for debit cards.

2. **Foreign ATM** fees are incurred by payroll cardholders when they use an ATM that is not owned by the issuing bank. However, some banks will cover one foreign ATM fee per week, one per month, or some other frequency. In addition, cardholders under some programs incur no fee when obtaining cash back as part of a purchase from a retailer at a PIN-based POS terminal.

3. **Monthly or service fees** are charged by the bank to employees and employers. The banks we surveyed levied monthly fees of $1.50 to $5.00 on employees, with some waiving the fee entirely. One bank indicated that the amount of the fee would depend on the extent of the employer's relationship with the bank, and another bank indicated that it would be eliminating the employee fee in the near future. Banks may also charge employers a transaction fee each time the employer loads pay onto the card, but they often waive this fee.

4. **Other fees** may be levied for overdrafts, POS transactions, replacement cards, excess ATM transactions, dormant accounts, balance inquiries, etc.

Banks derive a number of additional benefits from providing payroll cards. The product creates an opportunity for banks to solidify or establish a relationship with their cash management and commercial clients by helping these clients reduce their payroll administration costs. The product also enables banks to efficiently target an employed portion of a market that is usually ignored by traditional financial institutions and who may also respond to cross selling. Finally, in addition to the revenue streams listed above, banks receive the traditional earnings from float before funds in the accounts are withdrawn.

Costs

The relative importance of costs that a bank faces depends on how their programs are structured. It is hard to make generalizations about which costs are highest in providing this product because features provided free to employees vary considerably from product to product. For example, some banks allow a specified number of free ATM transactions per month at any ATM, not just those owned by the issuing bank.[2] When a cardholder uses an ATM other than one owned by the bank that issued the card (a "foreign" ATM), the issuing bank incurs a fee of approximately $0.75 to $1.40 for use of the network.

If a bank provides free access to foreign ATMs, the cost to the bank of foreign ATM access is highest in the first few weeks that employees have a payroll card, when they are likely to withdraw all available funds from an ATM. Some issuers have found that after cardholders gain comfort with the card, they begin to use it to make purchases at POS terminals. If this happens, the cost of ATM interchange fees to the bank declines, and the bank begins to earn revenue from the POS transactions.

[2] ATM owners and networks each charge fees when a cardholder uses an ATM not operated by his or her bank. These fees are usually charged to the cardholder's bank, which in turn may pass them on to the cardholder. The ATM network assesses the cardholder's bank a *switching fee* to pay for processing network transactions and to defray other network operating costs such as advertising and network security. An ATM owner charges the cardholder's bank an *interchange fee* for handling a transaction. The cardholder's bank may charge the cardholder a *foreign fee*. This fee is set by the cardholder's bank presumably to cover the switching fee and interchange fee which the card-issuing institution must pay. Finally, ATM owners may impose a *surcharge* on ATM users who do not have accounts with them.

III. Product Marketing

Goals of Bank

Whether the bank views the employer or the employee as the primary customer of a payroll card program may well determine how successful it is in attracting consumers into the banking mainstream. From our survey, we drew out four main goals that the payroll card product has for banks. One goal is to ***provide a cash management service to commercial customers*** that will increase these customers' direct deposit adoption rate and thus reduce their payroll processing costs. A second goal is to provide a ***product for employees of the commercial client who do not want to manage a checking account,*** but who want all the benefits and functionality of a debit card. A third goal, stated by some banks, is to ***transition payroll card customers into traditional bank account holders*** and users of other bank products. However, none of the banks surveyed has taken steps to achieve this third goal. ***The fourth goal is to accomplish the other goals profitably.***

While all of the banks surveyed touched on these four goals, it was evident that the overriding one is to provide improved cash management services by dramatically reducing the number of paper checks issued and thus employers' payroll processing costs. All of the bankers surveyed described the payroll card as one product offered to commercial customers within a suite of cash management products. Profitability appears to be measured within the context of the bank's overall relationship with the commercial customer, rather than on a stand-alone, product specific basis.[3]

Benefits to Employers

The main benefit to employers of offering payroll cards is lower internal costs. Not only does the employer avoid the costs of producing, handling, and distributing the checks, but it also avoids the costs associated with lost and stolen checks. The typical cost to an employer of a direct deposit transaction is 20 cents, estimates of the cost of a paper check range from $1 to $2, and the cost of posting money to a payroll card is somewhere in between. It costs businesses an estimated $8 to $10 to replace a lost or stolen check. The dollar amount of savings to employers is based on volume, with larger employers having the most to gain. These employers are likely to have a larger internal payroll infrastructure that could be pared down. Firms that have begun to use payroll cards include examples from the hotel, department store, home improvement store, trucking, beverage production, fast food, and package delivery industries.

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[3] One of the distinguishing characteristics about bank-issued payroll cards is that they are generally not marketed directly to consumers, but instead to firms who in turn take steps to encourage their employees who do not use direct deposit to use them. A product that takes a different approach is an instant-issue pre-paid debit card offered by some check cashers or other third parties. One check casher allows the funds on the pre-paid debit card to be transferred to a pre-paid MasterCard. This check casher allows the pre-paid debit card and pre-paid MasterCard to be reloaded (for a fee) at any of that company's check cashing stores. This product has an account number and ABA routing number, so that a consumer could set up direct deposit of a paycheck.

Another related product is the state-issued electronic benefit transfer (EBT) card. EBT is an electronic system that replaces paper food coupons or checks with electronic debit cards issued to qualified benefits recipients. Funds are authorized by state agencies to be eligible for purchase or cash withdrawal, then transferred from Federal or state program accounts to retailers' or acquirers' bank accounts for authorized purchases or withdrawals. A plastic card similar to a bank card is issued, and a PIN is assigned or chosen by the recipient to give access to the account. All but two states use magnetic strip cards, and from the consumer's perspective, the cards function like a PIN-based bank debit card. The Welfare Reform Act of 1996 mandated that all states must switch to EBT issuance for the Food Stamp Program.

Table 2: Benefits to Employers

Reduced bank processing fees and check handling fees	Reduced check printing costs
Reduced likelihood of check fraud	Reduced check reconciliation costs
Increased employee productivity (not needing time off during work to cash or deposit paycheck)	Reduced lost/stolen check replacement costs

Source: Celent Communications

In addition to cost savings, employers benefit from this product by being able to transmit payroll electronically to employees who are stationed at remote locations. The banks and vendors surveyed stated that employers encountered difficulties in getting payroll checks to employees when the Nation's air transportation system was grounded after 9/11. Payroll cards, like direct deposit, avoids the problems associated with paper check distribution.

When marketing payroll cards to their commercial customers, banks can provide promotional and bilingual educational materials that these customers can use to encourage employees to use payroll cards. Depending on the employer's size, bank staff may also make presentations on payroll cards to groups of employees.

Table 3: Some Costs of Paper Checks

• Americans without bank accounts spend roughly $8 billion annually in check cashing and other financial services.
• Four million payroll checks are lost or stolen every year.
• Generating replacement checks and checks for exception pay costs employers an average of $8 to $10 per check, or $48 million annually.
• Tracking and escheating[4] unclaimed paychecks is a difficult, costly, and inefficient process for employers.

Source: Visa USA, Inc.

Benefits to Consumers

All of the banks surveyed see payroll cards as a product for consumers who do not want to manage or do not qualify for a checking account. Payroll cards eliminate the need to stand in line at a bank or check casher to receive cash, offer immediate access to pay, and provide greater safety since the consumer only needs to withdraw as much cash as necessary. Branded debit cards not only increase that safety but also may provide a sense of personal empowerment since purchases can be made directly with the card. Branded cards allow cardholders to shop online, via catalogue or telephone, and pay bills on line – many conveniences associated with Visa and MasterCard products that most consumers take for granted. Some issuers have referred to payroll cards as "a checking account without the check."

[4] "Escheating" refers to state laws that provide that the state is entitled to certain types of abandoned property left in the hands of third parties after a specified period. Such property is said to "escheat" to the state. Deposit accounts are subject to escheat; banks, including national banks, are required in most states to file reports on escheated accounts.

As long as card usage is priced along the lines of the products offered at the banks we surveyed (see Table 5), consumers would pay less in financial transaction fees than they would at a check casher. Most banks also provide cardholders with a monthly statement to keep track of spending, which many of the unbanked currently have no easy way to do. In addition, one bank stated that it offers Internet banking/bill payment capabilities with its payroll card.

Table 4: Benefits to Employees

Reduces or eliminates check cashing fees	Offers ability to make purchases using credit card networks
Offers 24-hour access to funds via ATMs; no need to wait in lines	Reduces the need to carry a lot of cash
Makes money transfers more easily available to families	Provides a psuedo-bank account—funds do not need to be withdrawn entirely as with using a check casher

Source: Celent Communications

As shown in the table below, the annual cost of using a payroll card is significantly less than using a check casher.

Table 5: Product Cost Comparison[5]

Costs	**Payroll Card**	**Check Casher**	**Basic Bank Account**
Min. monthly balance required	N/A	N/A	$0
Min. deposit to establish acct.	N/A	N/A	$100
Check cashing fee	N/A	$8.77	0
Monthly fee (1)	$3.00	N/A	$5.95
ATM usage fee (2)	0	N/A	0
Money order fee (3)	$1.00	$1.00	N/A
Total monthly fees (4)	$6.00	$20.54	$5.95
Checks (box of 150)	N/A	N/A	$8.00
Total annual fees	$72.00	$246.48	$79.40

[5] Assumes two paychecks of $400 each month and three payments needing money orders or checks each month. The bank account and check casher costs in this table were obtained from a large bank and a large check cashing outlet in Los Angeles. These costs fell in the middle of the range from five cities surveyed. Notes: (1) Uses an average monthly fee for payroll cards issued by large banks. Assumes checking account customer does not use direct deposit. These fees may be waived or reduced. (2) Assumes customer does not use foreign ATMs to withdraw cash. (3) Assumes checking account customer will write personal checks to pay bills. Assumes payroll card holders and check cashing customers purchase

Employer Size

According to all of the product suppliers surveyed, firms need to be of at least a certain size before it would make sense for a bank to market this product to a firm. Anecdotal evidence points to a minimum threshold of 100 employees. Some banks indicated that they would provide the product to firms of any size, but would not actively market it to firms below a certain size. Other banks allow consumers to contact the bank directly to have their pay deposited on a payroll card, if the employer does not offer one. The only requirement is that the employer be able to process direct deposit transactions.

Adoption Rates

Demand for and interest in payroll cards has increased significantly since the entrance of Visa and MasterCard; however, this increase is relative. According to Celent Communications, less than 10 percent of the market potential for payroll cards has been realized. There are two main reasons for this small capture rate. First, firms need to be made more aware both of the existence of payroll cards as well as the cost savings that they provide. One product vendor commented that bankers do not understand how important it is to many firms to reduce their internal costs, and thus do not present the potential cost savings in an effective manner.

Second, the majority of consumers who fit the target profile of a payroll card program are likely to be unfamiliar with card-based products, and are likely to derive more reassurance and comfort from receiving a paper paycheck. Many of these consumers have also become comfortable using check cashers to cash their checks and take care of a variety of financial transactions, such as paying bills and purchasing money orders.

Some segments of the unbanked population may be more difficult to convert to payroll cards. For example, according to a trade publication,[6] while the comfort level of banked Hispanics with ATMs and PIN-based debit cards is well-documented, getting debit cards into the hands of unbanked Hispanic workers has proven to be difficult. In a survey by Houston-based Analytica Inc., about 800 unbanked individuals were asked if they "would really prefer" to get cash from an ATM. Only 11 percent of Hispanics expressed a preference for ATMs compared with 43 percent of Asian-Americans and 26 percent of African-Americans.

Table 6: Selected Payroll Card Participants

MasterCard	Visa
ABN Amro	AmSouth
BankFirst	Bank of America
Citibank	Bank One
Comerica	JP Morgan Chase
First Bank	First Tennessee
JP Morgan Chase	Fleet
Keybank	Texas Capital
	US Bank

Source: Celent Communications as of 12/02

money orders through the U.S. Postal Service. (4) Typical payroll card and bank account fees may be understated as they do not include negative balance and excessive phone inquiry fees for payroll cards and bounced check and below minimum balance fees for checking accounts.

[6] "Unbanked Hispanics are Proving to be a Tough Debit Sell", ATM & Debit News, February 21, 2002.

Some banks have found that it is easier to convince consumers who want something tangible in their hands on payday to accept a payroll card rather than a more traditional account with direct deposit. In addition, any fees associated with the card need to be at a level to make the product more attractive than using a check casher's products and services that a consumer already understands.

Some banks have found that, surprisingly, a number of those signing up for the card were older employees and already used direct deposit, but liked having their pay linked directly to a card. As a result, some banks market the payroll card as a mainstream product, designed for consumers who prefer not to manage a checking account or who for some reason do not want their pay deposited into an existing bank account.

Celent Communications predicts that card providers and distributors will significantly increase awareness and use of payroll cards. By 2006, Celent expects significant growth in the use of payroll cards by the unbanked. Banks overall reported low rates of attrition, finding that once people use a payroll card they do not revert to receiving a paper paycheck.

Transitioning Payroll Cardholders to Bank Accounts

To achieve a second-stage goal of transitioning payroll cardholders to traditional bank account holders, banks may have to develop a marketing plan specifically for this audience. Our survey did not reveal any reports of clear plans designed to transition payroll cardholders into traditional bank account holders. However, banks appear to view payroll cards as an entry-level product and have an opportunity to cross-sell other products in statement stuffers mailed to payroll cardholders.

At least one bank reported that a significant percentage of payroll card users had migrated to traditional bank accounts. However, the migration was not due to any coordinated marketing activity by the bank.

IV. Risks to Banks and How They Are Addressed

When offering payroll cards, banks incur risks of such problems as overdrafts, money laundering, and failing to comply with consumer regulations.

Overdrafts

While it might seem that overdrafts are not possible with a debit card since the cardholder is only authorized to spend or withdraw what is in the account, delays in processing transactions — especially signature-based debits — mean that accounts are not always debited immediately after a purchase is made. In these circumstances, unsophisticated payroll cardholders could overdraw their accounts. Overdrafts can also occur if the issuer has inadequate authorization system controls. Finally, they can occur because some payroll cards allow employees withdrawing funds at an ATM to round any amount on the card below $20 up to the next $20 increment.

Banks have different ways of handling these overdrafts. Some will allow overdrafts from purchases and simply deduct the overdraft amount from the next payroll load, while others will also charge an overdraft fee, although it may be less expensive than a standard checking account insufficient funds (NSF) fee.

Customer Identification

The banks surveyed verify identification of payroll card customers both through Chexsystems and by relying on employers. Chexsystems is generally used to ensure that the social security number is valid and matches the name of the employee. While it also reports credit history, the banks surveyed would generally deny a payroll card only to individuals who have committed fraud, not to those who have bounced checks.

Chargeback Requirements

Participation in any credit or debit card with a Visa or MasterCard brand requires the issuing financial institution to comply with the card associations' chargeback requirements and operating rules. As a result, payroll cards have risks similar to any other merchant processing arrangement. For example, if a purchase is fraudulently made on a card and the cardholder disputes the item, then the issuing bank must absorb the loss if the merchant does not cover the amount of the purchase.

Money Laundering

The products we surveyed appear to avoid money laundering concerns by allowing exclusively electronic deposits to the account and by prohibiting deposits to the account to be made abroad, even if withdrawals abroad are permitted.

Reputation Risk

If a bank partners with a third-party vendor to operate a payroll card program, and the vendor either does not run the program properly, charges abusive fees, or fails, the bank's reputation could be harmed.

Consumer Compliance Issues

The Federal Reserve Board has not ruled as to whether electronic deposit accounts are subject to disclosures under consumer protection regulations, including Regulation E (Electronic Fund Transfers). However, the banks that we surveyed stated that they provide the disclosures described in Regulation E to their payroll cardholders.

Whether cardholders can be confident that FDIC insurance covers their money varies from product to product. In addition, while the bankers we interviewed said that they encourage their commercial customers to offer payroll cards only on a voluntary basis in order to comply with state payroll laws that require employers to provide employees with a means of accessing their pay at no cost, it is unclear whether all employers follow this in practice.

Each bank develops its own terms and conditions on fees charged for lost cards. Banks can turn off access to payroll cards (just as they do to standard debit cards) once they have been reported lost or stolen. Some programs limit cardholders' liability for lost or stolen cards; however, programs that do not comply with Regulation E do not provide these protections. Both Visa and MasterCard provide a zero liability feature to all cardholders who are victims of fraud when transactions are processed through their networks.

V. Potential Market for Banks

Ties to Short-Term Advances

There may be a cost effective means of structuring short-term credit products that permit the payroll card customer to receive an advance on future deposits, as does a direct deposit advance product. There are products in the market, one offered by at least one bank and one marketed by a third-party vendor, that tie repayment of short-term advances to electronic payroll deposits. If banks tie these products together, they should be careful to avoid the abusive practices that have characterized payday loans.

Cautions for Smaller Banks

Anecdotal evidence leads us to believe that there are responsible providers of this product in the market, such as the large banks and large merchant processing vendors surveyed for this paper. These providers appear to charge reasonable fees for providing this product and have a history of reliable transaction processing. However, vendors of this product abound, as it is relatively easy for any payment processor to add payroll card capability to its product offering. There is a risk that third-party operators of this product would approach smaller banks that lack the capability to effectively oversee the program.

Product Projections

There has been a surge in the number of banks and third-party vendors offering payroll cards over the past two years. The ability of banks to add a Visa or MasterCard brand to the cards has given the cards a cachet that proprietary payroll cards lacked. And both Visa and MasterCard are engaged in an active campaign of marketing payroll cards both to banks and large corporations. Further, as the cost of technology drops, enabling banks to provide more services to this population at lower cost (such as with remittances to foreign countries), and as bankers better understand the profit potential of underserved communities (as witnessed by a proliferation of ethnic marketing campaigns), products such as payroll cards are likely to grow. Two of the banks we spoke with indicated that they see payroll cards as a means of establishing new banking relationships with previously unbanked customers.

In terms of profitability to banks, it appears that banks assess the success of the payroll card product as part of their overall relationship with their commercial customers. Banks are in the early stages of evaluating the profitability of the product, but intend to continue to offer it as part of a suite of products for their commercial customers. Some banks vary the monthly fee charged to employees based on the bank's relationship with the employer. In addition, the fact that the banks surveyed indicated that they measure revenue streams from the card leads us to believe that the card is designed to be a profitable product.

VI. Consumer Concerns

In evaluating a payroll card, consumers should be aware of how a payroll card account may differ from a traditional bank account. These potential differences include the applicability of deposit insurance, the ability to earn interest on deposits, and associated fees.

If a non-bank vendor operates the payroll card program and if the program is structured so that the owner of the account is the program operator, cardholders may be exposed to insolvency risk of the operator. If the program is structured so that deposit insurance does not protect the cardholders in the event that the non-bank vendor fails, then the cardholder stands to lose whatever outstanding balance was on the payroll card.

Second, the payroll card product is not a full-service bank account. Other deposits are usually not permitted, and no interest is paid on funds in the account. Therefore it does not appear to assist consumers with wealth building. Unless a bank institutes programs to transition payroll cardholders into traditional bank account customers, these people may not gain a means of accumulating capital and developing a credit history, and may remain outside the banking mainstream.

Third, payroll card programs could be structured with a myriad of fees that in effect would make the bank's product more expensive than a check casher.

Fourth, while such products are not common in the U.S. marketplace today, the technology exists that would make it easy for program operators to offer payday loans in conjunction with payroll cards. If such a product does begin to appear in the United States, consumers will need to be careful to ensure that they do not become victims of loan products that are abusive and addictive.

VII. Conclusion

The question of whether a payroll card can serve the major needs of unbanked individuals remains. The purpose of this paper was to provide background information on the growth of payroll cards and their potential use to attract unbanked consumers into the financial mainstream.

The card brings consumers who use it into the electronic payments system, and provides them a safe, convenient, and relatively inexpensive way of accessing cash and making purchases. Our research did not, however, reveal that banks had any clear plans to convert payroll cardholders into traditional bank account holders. As the payroll card product matures in the marketplace, banks that offer payroll cards will likely determine whether they want to introduce programs aimed at bringing payroll cardholders more fully into the banking system.

Glossary

ABA routing number A numerical code originated by the American Bankers Association to facilitate the sorting and processing of checks. Each bank is assigned a unique number.

automated clearing house (ACH) A clearing facility operated for the convenience of the banks in a particular region, generally through the regional Federal Reserve Bank. Automated clearing houses electronically process interbank credits and debits and may also handle the electronic transfer of funds, such as the automatic deposit of wages, direct deposit of Social Security payments, and preauthorized payments of bills by banks.

automated teller machine (ATM) A machine activated by a magnetically encoded card and the transmission of a code that allows customers to perform routine banking transactions.

branded card A bank-issued card that has a national brand (Visa or MasterCard) on it.

closed loop system A type of stored value card system where the card can only be used to purchase products or services, or withdraw cash, at a finite number of locations.

demand deposit account (DDA) Funds that a customer may withdraw from a bank with no advance notice, usually by writing checks or using an automated teller machine. Checking accounts are the most common form of demand deposit accounts.

debit card A plastic card enabling the cardholder to purchase goods or services, or to withdraw cash, the cost of which is immediately charged to his or her bank account. Debit cards are used to activate point-of-sale terminals in supermarkets, gas stations, and other retail stores. Together with credit cards, they are commonly referred to as bank cards.

direct deposit Automatic deposit of wages or benefits (such as Social Security payments) into a consumer's bank account.

escheat The reversion of property to the state when there are no heirs. It is applicable to all kinds of property, including dormant accounts whose owners cannot be located.

foreign fee, or **foreign bank fee** Set by the cardholder's bank, presumably to cover the switching fee and interchange fee which the card-issuing institution must pay, when a cardholder uses an ATM not owned by the cardholder's bank. This fee may be charged to the cardholder.

interchange fee Charged by an ATM owner to a cardholder's bank for handling a transaction. Charged by a merchant bank to a cardholder's bank for handling a sales transaction.

interbank transfer An electronic transfer of funds through an account balance at the Federal Reserve or an account balance at a correspondent bank.

open loop system A type of stored value card system where goods and services can be purchased, or cash withdrawn, at a large number of locations by utilizing universal networks such as Interlink, MasterCard, or Visa.

PIN-based Transactions processed based on a string of characters selected by the cardholder or randomly assigned by the card issuer to provide personal security in accessing a financial service terminal and to prevent use of a bank card by unauthorized parties.

point of sale (POS) terminal A device placed in a merchant location that is connected to a financial institution or payment processor by telephone lines and is designed to authorize, record, and forward electronically payment for each sale as it occurs.

pre-paid debit card A debit card on which funds are loaded and then drawn down through purchases or cash withdrawals. Additional funds may or may not then be loaded onto the card. Prepaid and stored value cards are the same.

Regulation E Federal Reserve regulation that sets rules, liabilities, and procedures for electronic funds transfers (EFT), and establishes consumer protections using EFT systems. This regulation prescribes rules for solicitation and issuance of EFT debit cards, governs consumer liability for unauthorized transfers, and requires financial institutions to disclose annually the terms and conditions of EFT services.

signature-based Transactions processed based on a retailer using signature verification as a means of customer identification.

stored value card See prepaid card.

surcharge Fee that may be imposed by ATM owners on ATM users who do not have accounts with them. For surcharges, ATM owners often bill the cardholder's bank, which in turn charges the cardholder's account. See also foreign bank fee.

switching fee Assessed by an ATM network to the cardholder's bank to pay for processing network transactions and to defray other network operating costs such as advertising and network security.

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