July 8, 2005

MEMORANDUM TO: The Board of Directors

FROM: William F. Kroener, III
General Counsel

Michael J. Zamorski
Director
Division of Supervision and
Consumer Protection

SUBJECT: New Proposed Rule on Insurance Coverage of Funds Underlying Stored Value Cards and Other Nontraditional Access Mechanisms

RECOMMENDATION:

We recommend that the Board of Directors ("Board") seek comments on a new proposed rule that would clarify the insurance coverage of funds subject to transfer or withdrawal through the use of stored value cards and other nontraditional access mechanisms. This rule would replace the proposed rule published in April of 2004. *See* 69 FR 20558 (April 16, 2004). The new rule would provide: (1) that the funds underlying stored value cards (or other nontraditional access mechanisms) are "deposits" provided that the funds have been placed at an insured depository institution; and (2) that the insured owner of the "deposit" may or may not be the cardholder (depending upon the satisfaction of "pass-through" requirements). Also, through publication of the new rule, the FDIC would seek public comments on whether cardholders should receive mandatory disclosures about the insured status of the funds underlying their cards.

DISCUSSION:

For the FDIC, stored value cards (and other nontraditional access mechanisms) raise three primary issues. These issues are:

Is there a "deposit"?

If so, who is the insured owner?

Should cardholders receive disclosures about the insured status of the funds?

These issues are important to the FDIC for obvious reasons. If a “deposit” exists, then the insured depository institution must report the deposit in its Call Reports. The deposit will be subject to assessments. The deposit will be insured (up to the $100,000 limit). In the event of the failure of the depository institution, an identification of the owner of the deposit will be necessary in order for the FDIC to satisfy its obligation to pay insurance. Even in the absence of a bank failure, many cardholders will want to know whether they are protected by the FDIC.

Of course, the issues above are important to the FDIC only in those cases in which the stored value cards involve an insured depository institution. In the case of some stored value cards, no role is played by any insured depository institution. For example, in a “closed system,” a cardholder will purchase his/her card directly from a merchant. The card will enable the cardholder -- at a later point in time -- to collect goods or services from the same merchant. In such a system, the merchant is not paid through a bank. Rather, the merchant is prepaid through the sale of the card. In the absence of the placement of funds at any insured depository institution, no insured “deposit” can exist. Such a system (not involving any insured depository institution) would not be governed by the FDIC’s proposed regulation.

Below, the three primary issues are addressed with respect to systems involving insured depository institutions.

Is there a “deposit”?

“Deposit” is defined in the Federal Deposit Insurance Act (“FDI Act”) at 12 U.S.C. § 1813(l). The information below is relevant in determining whether the term “deposit” applies to funds underlying stored value cards (or other nontraditional access mechanisms).

<u>Funds underlying traditional access mechanisms.</u> In the case of funds subject to transfer or withdrawal through traditional access mechanisms or payment instruments (such as checks, official checks, traveler’s checks and money orders), the FDI Act sets forth a very simple rule: the funds are “deposits” provided that the funds have been placed at an insured depository institution. The only exceptions are certain narrow exceptions expressly created by Congress (such as an

exception for bank obligations payable solely outside the United States). *See* 12 U.S.C. §§ 1813(l)(1), 1813(l)(4), 1813(l)(5).

General Counsel's Opinion No. 8. Though the definition of "deposit" in the FDI Act refers to traditional access mechanisms (such as checks), the definition does not mention "stored value cards" or other modern access mechanisms (such as computers). As a result, uncertainty has existed as to whether the term "deposit" applies to funds underlying these nontraditional access mechanisms. In 1996, the FDIC addressed the issue through General Counsel's Opinion No. 8 ("GC8"). *See* 61 FR 40490 (August 2, 1996). With respect to funds underlying stored value cards, the FDIC took the position -- through GC8 -— that the funds held by an insured depository institution are "deposits" if the institution maintains individual accounts for the various cardholders. At the same time, the FDIC took the position that the funds are not "deposits" if the institution maintains a pooled "reserve account" for all cardholders.

The First Proposed Rule. Following the publication of GC8, the industry developed new kinds of stored value card systems. These new systems prompted the FDIC, in April of 2004, to publish a proposed rule (the "First Proposed Rule"). *See* 69 FR 20558 (April 16, 2004). Through the First Proposed Rule, the FDIC sought to resolve questions that GC8 did not address. First, the FDIC recognized that many stored value cards do not involve a simple relationship between a depository institution and the cardholders. Rather, many stored value cards are issued by or through a third party or "sponsoring company." With respect to cards issued by a sponsoring company against an account at an insured depository institution, the FDIC proposed that the funds in such an account would be "deposits." Second, the FDIC recognized that some insured depository institutions have developed a system in which the institution maintains a pooled "reserve account" for all cardholders but simultaneously maintains individual accounts or subaccounts for the individual cardholders. The FDIC proposed that the funds in these subaccounts would be "deposits." Thus, under the First Proposed Rule, the only funds held by a bank that would not be "deposits" would be funds recorded in a pooled "reserve account" with no individual subaccounts.

The Second Proposed Rule. We are now recommending that the Board replace the First Proposed Rule with a new or "Second Proposed Rule." Under the new rule, all funds underlying stored value cards or other nontraditional access mechanisms would be "deposits" provided that the funds have been placed at an insured depository institution. The only possible exceptions would be the funds underlying cards with small balances (*e.g.,* up to $100) or funds placed directly at an insured depository institution by anonymous cardholders. Although the Second Proposed Rule does not expressly include such exceptions, the FDIC would request comments as to whether such exceptions should be recognized. Otherwise, under the Second Proposed Rule, the FDIC's treatment of the funds underlying stored value cards and other nontraditional access mechanisms would be exactly the same as the FDIC's treatment of funds underlying traditional access mechanisms (such as checks or traveler's checks or money orders).

Unlike the First Proposed Rule, the new rule also would address a separate question: Assuming the existence of a "deposit," who is the insured owner? This question is discussed below.

Who is the insured owner?

Cardholders generally do not obtain stored value cards directly from an insured depository institution. Rather, they obtain the cards from a third party. For example, in the case of "payroll cards," employees will obtain their cards from the employer (or agent company on behalf of the employer). Similarly, in the case of "gift cards," the cardholders will purchase their cards from a retail store. The payroll card or the gift card will enable the holder to effect transfers of funds to merchants (through the merchant's point of sale terminal). Some cards will enable the holder to make withdrawals at automated teller machines ("ATMs"). Prior to the cardholders' use of the cards, the employer (in the case of payroll cards) or the retail store (in the case of gift cards) will place the necessary funds at an insured depository institution. Thus, the funds are placed at the bank by one party (the employer or retail store) for transfer or withdrawal by another party (the cardholder). This arrangement raises the following question: Who should be recognized as the insured owner of the deposit? The information below may be useful in resolving this question.

<u>Checking accounts.</u> In the case of a traditional checking account (including an employer's payroll checking account), the insured owner of the funds in the account is the accountholder. The FDIC does not provide insurance to the holders of outstanding checks.

Official checks. In the case of an official check issued by an insured depository institution, the insured owner is the payee because the check represents the institution's direct obligation to the payee.

Traveler's checks, money orders. In the case of a traveler's check or money order issued by an insured depository institution in exchange for cash, the insured owner is the payee. In the case of an instrument issued by a third party (such as an express company or money transmitter) against that party's account at an insured depository institution, the insured owner of the funds in the account is the third party and not the third party's payees.

Brokered deposits. In the case of funds placed at an insured depository institution by an agent or custodian, the FDIC provides "pass-through" insurance coverage. This means that the coverage "passes through" the agent or custodian to each of the actual owners. *See* 12 C.F.R. § 330.7(a). "Pass-through" coverage is not available, however, unless certain requirements are satisfied. First, the account records of the insured depository institution must indicate that the nominal accountholder is not the actual owner. *See* 12 C.F.R. § 330.5(b)(1). This requirement can be satisfied with an account title such as the following: "ABC Company as Custodian." Second, the identities and interests of the actual owners must be disclosed in records maintained by the depository institution or the agent or custodian or other party. *See* 12 C.F.R. § 330.5(b)(2). Third, the deposit actually must be owned by the alleged actual owner(s). *See* 12 C.F.R. § 330.3(h); 12 C.F.R. § 330.5(a)(1). For example, in the case of brokered deposits, the broker must relinquish ownership of the deposit to the broker's customers (*e.g.,* by entering into an agency agreement with the customer). The broker cannot simply use the names of customers in order to obtain expanded insurance coverage for a corporate account.

The First Proposed Rule. The First Proposed Rule did not expressly discuss the FDIC's "pass-through" rules in connection with determining the owners of deposits underlying stored value cards or other nontraditional access mechanisms. Rather, the First Proposed Rule merely stated that the insurance coverage of any such deposits would be subject to the same rules that apply to any other deposits.

The Second Proposed Rule. The Second Proposed Rule would explicitly extend the FDIC's "pass-through" requirements to funds underlying stored value cards and other nontraditional access mechanisms. The rule could be summarized as follows:

- In the case of funds received by an insured depository institution from one party for transfer or withdrawal by the same party (*e.g.,* funds placed into transaction accounts accessible solely by computer and not by checks), the funds would be insured to that party.

- In the case of funds received by an insured depository institution from one party for transfer or withdrawal by other parties (*e.g.,* funds underlying payroll cards or gift cards), the funds would be insured to the first party unless (A) the bank's account records reflect the fact that the first party is not the actual owner; and (B) either the bank or the first party maintains records reflecting the identities of the persons holding the access mechanisms and the amount payable to each such person. If both of these requirements are satisfied, the funds would be insured to the persons holding the access mechanisms.

With respect to funds underlying payroll cards (but not gift cards), the FDIC would request comments on whether satisfaction of "pass-through" requirements should be mandated so that the funds held by an insured depository institution always would be insured to the employees (and not the employer). For example, a rule could be adopted under which insured depository institutions would be forbidden from accepting funds underlying payroll cards unless (1) the employer (or agent) maintains records reflecting the amount payable to each employee; and (2) the employer relinquishes ownership of the funds to the employees so that the employer cannot recover the funds in the bank under any circumstances (*e.g.,* upon the expiration of a card).

Examples

The operation of the Second Proposed Rule can be illustrated through examples.

Example 1. A merchant sells gift cards directly to the public. The card may be used to collect goods or services from the same merchant. In this system (sometimes referred to as a “closed system”), the merchant does not receive payment through a depository institution but instead is prepaid through the sale of the card. No “deposit” exists in this system because no funds are placed at an insured depository institution.

Example 2. Same as above except that the merchant, following the sales of cards, places some or all of the collected money into an insured depository institution. The funds placed at the depository institution are “deposits.” The insured owner of the deposits is the merchant and not the cardholders.

Example 3. An employer issues payroll cards in the total amount of $250,000. In order to make payments on these cards, the employer places funds at an insured depository institution. The amount of funds placed at the bank, however, is only $200,000. Moreover, the employer does not relinquish ownership and control of the funds. Rather, the employer retains the right to recover the funds if a card is not used within 30 days. In this scenario, a “deposit” exists at the insured depository institution in the amount of $200,000. The insured owner of the deposit is the employer and not the employees.

Example 4. An employer issues payroll cards in the total amount of $250,000. In order to make payments on these cards, the employer places $250,000 at an insured depository institution. The funds are placed into individual accounts for the various cardholders; the employer does not retain the right to recover the funds. In this scenario, “deposits” exist in the total amount of $250,000. The insured owners of the deposits are the employees.

Example 5. A retail store sells gift cards to the public in the total amount of $500,000. These cards may be used to buy goods or services from any merchant that accepts major credit cards. In order to make payments on these cards, the retail store places $500,000 into an account at an insured depository institution. The account is titled as follows: “Retail Store as Custodian for Cardholders.” However, the retail store collects and maintains no information about the identities of the cardholders. In addition, the retail store retains the right to recover the funds underlying any expired cards. In this scenario, a “deposit” exists at the insured depository institution in the amount of $500,000. The insured owner is the retail store and not the cardholders. Thus, the deposit is insured in the amount of $100,000 (in aggregation with any other deposit accounts maintained by the retail store at the same insured depository institution) and uninsured in the amount of $400,000.

Should cardholders receive disclosures?

The examples above reflect the fact that the insurability of funds underlying stored value cards and other nontraditional access mechanisms depends upon the circumstances. In some cases, no “deposit” will exist at an insured depository institution. In other cases, “deposits” may exist but the insured owners may not be the cardholders. In light of these various possibilities, cardholders may need to receive disclosures about the insured status of the underlying funds. We recommend that the Board seek comments on this issue.

CONCLUSION:

In response to the First Proposed Rule, the FDIC received comments from consumers as well as banks. Generally, consumers favored the proposed rule but banks opposed the rule. Banks feared that classification of funds as “deposits” would trigger various laws and regulations (such as the USA Patriot Act and Regulation E dealing with electronic fund transfers), with the result that costs would be increased and the development of stored value products would be stifled. We do not believe that the proposed rule would cause this effect because these other laws and regulations do not incorporate the definition of “deposit” in the FDI Act. We recommend that the Board authorize publication of the revised proposed rule (attached).

Staff member knowledgeable about this case:

Christopher Hencke
Legal Division (X88839)

Attachment

Concur:

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Jodey C. Arrington
Chief of Staff to the Chairman