



June 2005

Insights

Community Affairs
Department

Payroll Cards:

An Innovative Product for Reaching the Unbanked and Underbanked

Abstract: This edition of Insights examines 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. Some employers offer this prepaid debit card to employees in place of a check to distribute wages. Employers can lower internal costs by using the card since it enables them to avoid the costs of producing and distributing checks, as well as dealing with lost and stolen checks. Payroll cards can serve as an introductory financial product for consumers who do not want to manage a checking account, but want the combined benefits of direct deposit and a nationally branded debit card.¹ The information presented here was obtained primarily from financial services institutions.

I. What Are Payroll Cards?

Payroll cards, a less costly alternative to paper payroll checks, allow employees to access their pay through various means, depending on the particular product. 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. One of the distinguishing characteristics about bank-issued payroll cards is that they generally are not marketed directly to consumers. Instead, banks market the cards to employers, who, in turn, encourage their employees who do not use direct deposit to use a payroll card to receive their wages.

The payroll card is a particular type of stored value (or prepaid) card, a product that streamlines the payment process for purchases or cash withdrawals. 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.² In the closed loop system, an issuer provides a card that can be used only 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 typically 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., STAR) or signature-based (e.g., Visa, MasterCard) transactions. Payroll cards use an open loop system.

¹ This edition of *Insights* updates an October 2003 Community Developments Analysis. It incorporates some of the regulatory responses to payroll cards – notably the OCC’s Advisory Letter on Payroll Card Systems (AL 2004-6), the Federal Reserve Board’s proposed changes to Regulation E, and the FDIC’s proposed rule addressing the applicability of deposit insurance to funds underlying stored value cards.

² 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.

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. 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. 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 like a traditional debit card. 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.

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.³ These programs have targeted countries – such as Mexico, the Philippines, and India – that have a large workforce in the United States. The programs provide 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.

Research and consulting firms that focus on payments systems and technology in the financial services industry have conducted analyses of payroll cards. A 2002 study reported that 10 percent of unbanked households, representing one million families, were using payroll cards at the end of 2002, up from almost zero in 1998.⁴ More recent research reported that 1.8 million prepaid payroll cards were used in 2004.⁵

II. Why Are Payroll Cards of Interest to Banks?

Our research drew out four main reasons that banks offer the payroll card product. One goal is to **provide a cash management service to commercial customers** that will increase their 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. The fourth goal is to **accomplish the other goals profitably**.

From our discussions with banks offering payroll cards, it was evident that the overriding goal 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.

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

³ See "Remittances: A Gateway to Unbanked Immigrants," Community Developments Insights, Office of the Comptroller of the Currency, September 2004.

⁴ "Payroll Cards: A Direct Deposit Solution for the Unbanked," Celent Communications, December 2002, p. 29.

⁵ "Payroll Card Markets and Strategies: The Market Demands More than Just a Card," Mercator Advisory Group, October 2004.

charged an interchange fee by the processing network, most of which is eventually paid to the bank that issued the card.

Generally, none of these fees are passed on to the cardholder; rather, they are absorbed by retailers as a cost of doing business. The difference in PIN interchange fees and signature interchange fees has narrowed in recent years as the regional POS networks have raised their PIN interchange fees, and signature fees were lowered by Visa and MasterCard as a result of the 2003 settlement in the Wal-Mart Debit Card Suit.

2. **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 eliminate 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.
3. **Other fees** may be levied for overdrafts, POS transactions, replacement cards, excess ATM transactions, dormant accounts, balance inquiries, card issuance, etc.

In addition to the revenue streams listed above, banks receive the traditional earnings from float before funds in the accounts are withdrawn.

Benefits to Commercial Customers

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, the cost of a paper check is estimated at \$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 hotels, department stores, home improvement stores, trucking companies, beverage producers, fast food restaurants, and package delivery services.

Table 1: 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 (e.g., 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. The issuance of payroll cards, like direct deposit, allows firms to avoid 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 2: Some Costs of Paper Checks

<ul style="list-style-type: none">• Americans without bank accounts spend roughly \$8 billion annually in check cashing and other financial services.
<ul style="list-style-type: none">• Four million payroll checks are lost or stolen every year.
<ul style="list-style-type: none">• Generating replacement checks and checks for exception pay costs employers an average of \$8 to \$10 per check, or \$48 million annually.
<ul style="list-style-type: none">• Tracking and escheating⁶ 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 (because they limit cardholder liability for lost or stolen cards), 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.”

As long as card usage is priced along the lines of the products offered at the banks we surveyed (see Table 5 on page 11), 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 3: 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 pseudo-bank account—funds do not need to be withdrawn entirely as with using a check casher

Source: Celent Communications

III. How Do Payroll Cards Work?

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

⁶ “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.

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 increments — 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.

Some banks provide a second card, for use by 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.

There are two basic ways in which funds can be held; the method chosen determines who has legal rights to the money. Under 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. Under the first method, the funds are transferred to individual accounts for each employee, with each account qualifying for 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.

Under 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 may not 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 program operator holds the money in its own name. (With this method, the program operator is usually a third-party vendor.) 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 depends, in part, 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 EFT (electronic funds transfer) networks, such as those belonging to STAR Systems or NYCE. 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, signature-based cards bear the logo of the platform they use, such as Visa or MasterCard.

Table 4: PIN-based versus Signature-based Debit Cards

Features	PIN-based	Signature-based
Can be used at PIN-based POS terminals	Yes	Yes
Can be used at POS terminals where signatures are required	No	Yes
Costs to retailer to process at POS ⁷	\$0.34 for a \$40 retail purchase	\$0.57 for a \$40 retail purchase
Potential for overdrawn accounts	Unlikely	Possible in limited amounts

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.

Roles of Different Players

Three parties are always involved with a traditional payroll card product – the employer, the employee, and a bank. In addition, nonbank 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 record keeping (processor), and where the funds will be stored (value repository).

IV. What Are the Key Risks and Regulatory Considerations Presented by Payroll Cards?

When offering payroll cards, banks may incur operational and compliance risks posed by this product. In May 2004, the OCC issued guidance to national banks concerning a number of important compliance and consumer issues that banks should address before offering payroll card products.⁸

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 merely deduct the overdraft amount from the next payroll load, while others will

⁷ Interchange fees shown here are for a September 2004 retail purchase of \$40 (the average debit purchase amount) reported in “Report to the Congress on the Disclosure of Point-of-Sale Debit Fees,” Board of Governors of the Federal Reserve System, November 2004, p. 12. Fees charged to retailers vary depending upon volume-based and other discounts..

⁸ Advisory Letter 2004-6, Payroll Card Systems, Office of the Comptroller of the Currency, May 6, 2004.

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 Chexsystems also reports on certain aspects of a consumer's banking history, the banks surveyed would generally deny a payroll card only to individuals who have committed fraud, not to those who have bounced checks.

OCC supervisory guidance notes that there are a number of unsettled regulatory issues involving payroll cards, including whether the Customer Identification Program (CIP) regulation implementing section 326 of the USA PATRIOT Act applies to such cards. The guidance suggests that banks comply with this regulation while waiting for further guidance to protect against reputation and future compliance risk.⁹

The CIP regulation requires each bank to establish a customer identification program that specifies (a) the identifying information that the bank will obtain from someone seeking to open an account and (b) procedures for verifying the information obtained.¹⁰ The CIP rule provides that prior to opening an account, at a minimum, the bank must obtain the name, address, date of birth, and a U.S. taxpayer identification number from an individual opening an account. If the individual is not a U.S. citizen, the bank may obtain the number and country of issuance of any other government-issued document evidencing nationality or residence and bearing a photograph or similar safeguard.

The CIP rule neither endorses nor prohibits bank acceptance of information from particular types of identification documents issued by foreign governments, such as the matricula consular. Instead, a bank must decide for itself, based upon appropriate risk factors, whether the information presented by a customer is reliable.

Within a reasonable time after the account is opened, the CIP rule requires the bank to verify the customer's identity through documentary methods (e.g., documents provided by the customer) or non-documentary methods (e.g., checking information provided by the customer against information available from consumer reporting agencies, public databases, or other trusted sources). Regardless of the form of document relied on, a bank must conduct an appropriate level of due diligence to ensure to the extent possible that it knows the customer's true identity.

Use of Third Party Vendors

Many banks are looking to third-party relationships because they can offer banks legitimate and safe opportunities to improve financial performance. Through effective use of third-party relationships, banks can enhance product offerings, access superior expertise and industry best practices, devote resources to core businesses, and reduce costs.

Nevertheless, reliance on third-party relationships can increase a bank's risk profile – sometimes significantly. Increased risk most often arises from a lack of adequate planning, oversight, and control by the bank and inferior performance or service by the third party.

Vendors of payroll cards abound, because it is relatively easy for any payment processor to add payroll card capability to its product offering. 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

⁹ Id.

¹⁰ See 31 CFR 103.121. The federal financial regulatory agencies also jointly issued frequently asked questions regarding customer identification programs (CIP). They are available at <http://www.occ.treas.gov/ftp/release/2005-42a.pdf>.

¹¹ See OCC Bulletin 2001-47, Third Party Relationships, Office of the Comptroller of the Currency, Nov. 1, 2001.

abusive fees, or fails, the bank's reputation could be harmed. OCC supervisory guidance advises banks that choose to enter into such relationships to conduct proper due diligence in selecting a third-party provider and ongoing oversight of the third party and third-party activities.¹¹

Consumer Issues

There are a number of unresolved consumer issues involving payroll cards, including whether Regulation E applies to payroll card systems and when FDIC deposit insurance is available to cardholders. While waiting for further guidance on the application of these laws and regulation, the OCC has issued supervisory guidance advising that national banks may decide to comply with the substance of those laws and regulations to protect the bank against reputation risk and future compliance risk.¹²

Regulation E

The Federal Reserve Board has proposed revisions to Regulation E to provide that payroll card accounts that are established either directly or indirectly by an employer on behalf of a consumer to provide salary, wages, or other employee compensation on a recurring basis are covered by Regulation E. A payroll card account would be subject to the regulation whether the account is operated or managed by the employer, a third-party vendor, or a depository institution.¹³ The banks that we surveyed stated that they already provide the protections described in Regulation E to their payroll cardholders.

Deposit Insurance

Whether FDIC insurance covers cardholders' funds underlying their payroll cards varies from product to product, depending on the product's operating structure (see page 5). To address this issue, the FDIC has proposed a rule governing under what circumstances funds underlying stored value cards are "deposits" under the Federal Deposit Insurance Act, and thus, potentially eligible for deposit insurance.¹⁴

State Payroll Laws

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. OCC supervisory guidance advises national banks to conduct due diligence to confirm that employers are conforming with the laws applicable to them regarding their payroll card systems.¹⁵

Lost and Stolen Cards

Each bank develops its own terms and conditions on fees charged to replace lost or stolen 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 also limit cardholders' liability for lost or

¹² Advisory Letter 2004-6, Office of the Comptroller of the Currency, May 6, 2004.

¹³ In September 2004, the Federal Reserve Board published for comment proposed amendments to Regulation E. See <http://www.federalreserve.gov/BoardDocs/Press/bcreg/2004/20040913/attachment.pdf>.

¹⁴ See 69 Federal Register 20558 (April 16, 2004).

¹⁵ Advisory Letter 2004-6 advises national banks to check whether employers are compelling employee participation in a payroll card, because such compulsion can be relevant to whether employee cardholders can avoid potentially unfair terms or practices.

¹⁶ According to "Questions for Employees to Ask about Payroll Cards" and "Payroll Cards: Issues for Employers," published by Consumers Union, these zero liability policies have exceptions and are not the same as Regulation E protections. See http://www.consumersunion.org/pub/core_financial_services/000920.html and http://www.consumersunion.org/pub/core_financial_services/000922.html.

stolen cards. Both Visa and MasterCard provide a zero liability feature to all cardholders who are victims of fraud when transactions are processed through their networks.¹⁶ OCC supervisory guidance advises national banks to address disclosure of the treatment of lost or stolen cards, limits on consumer liability for unauthorized use, and error resolution procedures.¹⁷

Differences between Payroll Cards and Bank Accounts

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 deposit insurance, interest on deposits, and associated fees.

First, if a nonbank 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 nonbank vendor fails, the cardholder stands to lose whatever outstanding balance was on the payroll card. OCC supervisory guidance advises national banks to address the disclosure of risk exposures including the absence of deposit insurance and potential bankruptcy of any third parties holding funds.¹⁸

Second, the payroll card product is not a full-service bank account. Other deposits to payroll cards 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, payroll cardholders 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. OCC supervisory guidance advises national banks to disclose any costs to cardholders of accessing funds and where and how the payroll card will be accepted and the funds accessed.¹⁹

Ancillary Products

Some issuers offer direct deposit payroll advance programs that permit the payroll card customer to receive an advance on future deposits. OCC supervisory guidance advises national banks to appropriately address the potential use of a payroll card system to support or facilitate abusive overdraft or "payday lending" programs.²⁰ In addition, consumers must be careful to ensure that they do not become victims of abusive loan practices.

Community Reinvestment Act

Payroll cards may offer some potential for credit under the service test of the Community Reinvestment Act (CRA). For example, a commercial customer of a bank may employ large numbers of people who do not have bank accounts. The firm can provide these employees' wages via payroll cards, which can be used to access funds from ATMs or for point-of-sale transactions. To the extent that such cards are free or low-cost and improve access to financial services for low- or moderate-income individuals, they would qualify as a community development service.²¹

¹⁷ Advisory Letter 2004-6.

¹⁸ Id..

¹⁹ Id..

²⁰ Id..

²¹ Karen Tucker. "Services and Technology: CRA Considerations," Community Developments, Office of the Comptroller of the Currency, Fall 2004.

V. Who Is in the Payroll Card Business Today?

There has been steady growth in the number of banks and third-party vendors offering payroll cards since 2001. The ability of banks to add a Visa or MasterCard brand to the cards has given the cards a broad utility 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, and as bankers better understand the profit potential of underserved communities, products such as payroll cards are likely to grow.

A 2002 study on payroll cards predicted that by 2006, the use of payroll cards by the unbanked should grow significantly.²² The study also envisioned card providers and distributors taking steps to increase significantly the awareness and use of payroll cards. In addition to banks, payroll processors, as well as a variety of other third-party providers, such as payments processors, offer payroll cards.

VI. How Does the Cost Structure Operate?

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.

The relative importance of costs that a bank faces depends on how its program is 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.²³ 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.

²² “Payroll Cards: A Direct Deposit Solution for the Unbanked,” Celent Communications, December 2002, p. 29.

²³ 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 that the card-issuing institution must pay. Finally, ATM owners may impose a *surcharge* on ATM users who do not have accounts with them.

As shown in the following table, the annual cost of using a payroll card may be significantly less than using a check casher.

Table 5: Product Cost Comparison²⁴

Monthly 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

VII. What Barriers Have Constrained the Growth of Bank Payroll Card Products?

Demand for and interest in payroll cards has increased significantly since the entrance of Visa and MasterCard; however, this increase is relative. According to a 2002 study on payroll cards, less than 10 percent of the market potential for payroll cards has been realized.²⁵ There are two main reasons for this small capture rate. First, firms must be made more aware of the existence of payroll cards and the cost savings 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, 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 one market research survey, about 800 unbanked

²⁴ 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 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.

²⁵ "Payroll Cards: A Direct Deposit Solution for the Unbanked," Celent Communications, December 2002, p. 27.

²⁶ "Unbanked Hispanics are Proving to be a Tough Debit Sell," ATM & Debit News, February 21, 2002, reporting on a survey by Houston-based Analytica.

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.²⁶

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 must 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 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.

According to all of the product suppliers surveyed, firms must be of a certain size before payroll card services make economic sense. 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 or other stored value card, if the employer does not offer one. The only requirement is that the employer be able to process direct deposit transactions.

VIII. Conclusion

This Insights report provides background on the growth of payroll cards and their potential use to attract unbanked consumers into the financial mainstream. The question of whether a payroll card can serve the major needs of unbanked individuals remains.

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 on a stand-alone basis.

The card brings consumers who use it into the electronic payments system, and provides them with a safe, convenient, and relatively inexpensive way of accessing cash and making purchases. Banks overall reported low rates of attrition, finding that once people use a payroll card they do not revert to receiving a paper paycheck. Our research did not, however, reveal that banks had any clear plans to convert payroll cardholders into traditional bank account holders. 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. 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 be used only 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 that 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 using 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 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 pre-paid debit 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.

This paper was co-authored by Samuel Frumkin, William Reeves, and Barry Wides. Also contributing were Anna Alvarez Boyd, Frank Dwyer, Karen Furst, Jeff Gillespie, Greg Isaacs, Deborah Katz, Kathryn Ray, and Julie Williams. Community Developments *Insights* papers differ from OCC advisory letters, bulletins, and regulations in that they do not reflect agency policy and should not be considered as definitive regulatory or supervisory guidance. Some of the information used in the preparation of this paper was obtained from publicly available sources that are considered reliable. However, the use of this information does not constitute an endorsement of its accuracy by the Office of the Comptroller of the Currency.

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