

You are the compliance officer for a mid-size financial institution; your chief marketing officer comes to you with an idea to roll out a reloadable prepaid card product, saying, “Our customers have been asking for a reloadable product and we want to launch something in the next 90 days.”

Your institution does not even offer credit cards—how can you get into the prepaid card business? What are the regulations? What are the different types of products? How does the proposed product work? What are the key aspects of managing the risks? As their banks test the waters on entering the prepaid card market, many bankers encounter this very scenario and must quickly find the right fit for their customer bases and risk profiles.

Let's Discuss

This question and answer session, which will provide some clarity on these tough questions, is derived from discussions with Chris Daniel, chair of the payment systems group of the international law firm of Paul, Hastings, Janofsky and Walker, and Stan Sienkiewicz, senior manager of the Federal Reserve Bank of Philadelphia's Payment Cards Center. Tramond French, a vice president at Bank of America and a member of the ABA Prepaid Card Working Group, moderated the discussion.

Due Diligence: Should We Enter This Business?

Q. What are the different types of prepaid products?

The terms “prepaid card” and “stored value card” are used interchangeably within the payment industry and by regulators. These terms generally describe products that are funded by cardholders prior to use. These products fall into two general categories: closed systems and open systems, and there is a continuum of card products between the two. Closed-system cards can be used in specific locations or stores. The best example of this would be a store-specific card, such as a Best Buy or Borders Books card. By contrast, open systems operate on one of the four payment networks: Visa, MasterCard, American Express, or Discover. Open-loop cards may be used at any retailer that accepts the payment cards of the network whose brand is on the card.

Prepaid cards may have a number of differentiating features. For example, you can offer a product that can be used to withdraw cash from the global ATM network, that is reloadable, or that allows cross-border transfers, to name a few of the differentiating functions. Suffice it to say, there are many different types of prepaid cards available to a financial institution entering the prepaid market and each is important to understand.

Every prepaid product needs to be assessed for how well it fits with your financial institution's strategic plan. Do you have business clients that would find a need for a payroll card product? Payroll cards

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Cards

A hand holding a gold coin over a keyboard with 'PREPAID' text in the background. The background is a blue grid pattern with the word 'PREPAID' repeated in large, semi-transparent letters.

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have become an option for employers who want to reduce their check printing and distribution costs. Or do you have customers who need to remit funds back to family members in another country? Then you might be interested in remittance cards that allow one card to be issued to the U.S. cardholder and another card to be issued in the relative's country.

Some additional information on the different products can be found through the Network Branded Prepaid Card Association, www.nbpca.com.

For a number of reasons, it is very important that your institution understand all of the functionality of the prepaid card it decides to offer. There is a sliding scale of risk in offering prepaid products. Generally speaking, low-value, nonreloadable, closed-loop cards have generally lower risk profiles while reloadable, cross-border, open-loop cards with cash access are seen to require greater risk controls for an issuer.

Q. Do you understand the flow of funds?

To better understand the risks associated with the various prepaid card products, it may be useful for you to draw a diagram of the flow of funds. An issuer often understands only the presentment side of the particular prepaid product (i.e., it is a Visa card and we will settle with VisaNet for all transactions on our prepaid cards in accordance with the Visa rules). However, the other half of the prepaid card transaction (i.e., the purchase and load or reload) is equally, if not more, important to understand. As discussed below, there are a number of nonbank entities that participate in the sale/load side of a prepaid card transaction that will likely be unfamiliar to a number of financial institutions. It is only when you fully understand the prepaid card product, as discussed above, and the flow of funds that your institution can begin to assess the risks posed by issuing a prepaid or stored value card.

Some additional thoughts that may be helpful as your institution diagrams the funds flow associated with a particular prepaid or stored value card:

- Who touches the money? It is not unusual to have four different entities holding the funds associated with a prepaid card account at different times: the merchant, distributor, processor, and issuing bank.
- Is there a third-party vendor involved? Is that entity subject to, and abiding by, the various applicable federal and state statutes and regulations?
- May the cardholder load the prepaid card via other payment channels or a bank account?
- Who is activating the funds?
- What entity will be processing the loading of the cards?
- What entity will be processing purchases of the cards?

Q. What statutes/regulations apply to these products?

Myriad federal and state statutes and regulations may apply to prepaid or stored value products depending on the functionality of each particular prepaid card and the flow of funds:

- state money transmitter statutes
- state gift card statutes
- state unclaimed payments statutes
- BSA/AML
- GLBA/privacy
- deposit taking
- branching
- EFTA/Regulation E (currently applies only to payroll cards)

Q. Can our existing compliance program manage the risk?

After reviewing the functionalities of the particular card product, the funds flow, and the various statutes and regulations that may apply to the product, your institution can ask itself whether it can manage the risk: The answer, of course, will hinge in part on your institution's resources and the knowledge base of your compliance department.

There are a variety of publications and regulatory releases that may be helpful from a compliance perspective, including the *FFIEC BSA/AML Examination Manual* (recently re-released), a number of articles written by the Federal Reserve Bank of Philadelphia's Payment Cards Center, and a number of vendor due diligence releases by the Office of the Comptroller of the Currency (OCC), Federal Deposit Insurance Corporation (FDIC), Office of Thrift Supervision (OTS), and the Federal Reserve.

Q. AML controls needed to mitigate risk?

While there have been only a limited number of publicized financial crimes using prepaid cards, various government agencies have issued reports concerning the risks that various new payment products such as prepaid cards may pose to the payment industry.

For example, the Money Laundering Threat Assessment, a product of an interagency working group published first in 2005 and then updated in 2007, and the Financial Action Task Force (FATF) Report on New Payment Methods issued in 2006 outlined some risks, depending on the product offered:

- potentially anonymous cardholders
- ability to move funds cross-border
- programs that do not have customer identification programs
- high card value limit or no limit on the number of cards an individual can acquire
- access to cash through ATMs
- offshore issuers may not observe laws in all jurisdictions

To mitigate these perceived risks, there are a variety of controls and monitoring techniques that the prepaid card issuer can implement, such as:

- verifying cardholder identification
- limiting funding options and load value
- limiting the number of cards that an individual can acquire
- cross-border restrictions
- monitoring transactions and reporting suspicious activity
- restricting cash withdrawals at ATMs or monitoring frequency of load and cash withdrawals

Again, it is important to understand all the risks that apply. When you do, you can better assess the need for additional staffing, outsourcing, or a stay-the-course strategy. Understanding your bank's overall risk profile is the key to developing a compliant AML strategy.

Vendor Management: Evaluating and Managing Vendor Relationships

Q. Who (or what) should banks watch out for when it comes to identifying third-party vendors and service providers?

It is important to recognize that one of the major differences between issuing prepaid cards and issuing credit or debit cards is the role of third-party nonbank entities. Depending on the particular prepaid card product at issue, entities with whom the bank is not familiar may be involved in the funds flow or distribution of the prepaid card. Such entities are often referred to as distributors or program sponsors. Distributors are the entities that actually place the prepaid card in the merchant locations where such cards can be purchased by consumers. Program sponsors typically design the prepaid card program and often manage the same for the benefit of the issuing bank, the distributor, and to a lesser extent the cardholder.

As with any use of a third-party vendor, there are various steps a financial institution should take to ensure that the third-party vendor does not pose unreasonable harm to the safety and soundness of the financial institution. There have been several law enforcement actions taken against prepaid distributors and program sponsors in the last two years.

Q. What are the proper components of a successful vendor management program?

Given the number of third-party nonbank entities involved in prepaid card distribution, activation, and sponsorship, it may be useful for the issuing institution to review the regulatory releases that address third-party vendor management before contracting with such a party for the distribution of a prepaid card.

By way of summary, the three consistent themes arise from a review of the regulators' discussions on successful

vendor management programs are: (1) initial due diligence of vendors, (2) proper contractual drafting, and (3) ongoing monitoring of the financial institution/vendor relationship.

■ **Due diligence:** Investigate your vendors. Ask questions about their financial performance, prior experience, SAS 70 audits, etc.

■ **Documentation:** Ensure contract accuracy by describing exactly what you want the vendor to do for you, including service-level standards, and ensuring that your institution has the right to terminate the relationship in the appropriate circumstance.

■ **Performance monitoring:** Review MIS reporting, perform on-site visits, and evaluate how the portfolio is performing.

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Closing

In sum, there are three steps any financial institution should take when considering entering the prepaid card market: (1) understanding the functionalities of the prepaid card it will be issuing, (2) drawing a flow of funds diagram that will help determine the parties involved in the prepaid card offering as well as the applicable federal and state statutes and regulations, and (3) managing vendors.

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