

PUTTING MONEY INTO PREPAID CARDS

Just like any other industry, financial services has its fashions. Lately, one of those fashions has been prepaid cards.

So here's the question: if you don't have a prepaid in your product line, should you be thinking of issuing one?

The prepaid market is growing fast. Many card issuers and other providers have already launched their own products, while others have yet to test the waters. This note aims to provide some background, particularly to businesses which are still weighing their decision.

To start with, some definitions:

Prepaid cards are preloaded with a monetary value. The table sets out some of the ways in which they can be used.

	Usage	Typical product	Typical user	Typical provider	Reloadable?
Closed loop	Only at nominated merchants	<ul style="list-style-type: none"> ▪ Gift card ▪ Transportation card 	<ul style="list-style-type: none"> ▪ Giver ▪ Commuter 	<ul style="list-style-type: none"> ▪ Retailers ▪ Transportation companies 	Gift cards are often one-time, but not necessarily
Open loop	At any merchant or provider accepting the card scheme brand	<ul style="list-style-type: none"> ▪ Debit card ▪ Student card ▪ Social security payments ▪ Travel money ▪ Payroll cards 	<ul style="list-style-type: none"> ▪ Unbanked ▪ Parents ▪ Government bodies ▪ Travellers ▪ Employers 	<ul style="list-style-type: none"> ▪ Banks and other card issuers 	Yes

Variations on this basic theme include:

Restricted loop cards Typically issued by mall operators for use only within their precincts, often offering merchant-funded discounts and special offers

Private label cards Usually operated by retailers and service providers wanting to reduce their set-up costs by using payment scheme functionality, but without payment scheme acceptability

Virtual cards Any of the above, but without plastic. Essentially an e-wallet, aimed at building customers' confidence in Internet purchasing by limiting their financial exposure

How big is the market?

Estimates of prepaid sector size and particularly its potential for growth are more than usually bedevilled by disagreement between sources – one forecast for the US market proved to be four times higher than was actually achieved¹. Part of the difficulty is that there is such a wide range of uses for prepaid. But there's no doubt that it's a large market and, precisely because of that versatility, growing fast.

¹ - <http://www.vrl-financial-news.com/cards--payments/cards-international/issues/ci-2010/ci-449/prepaid-the-trouble-with-stat.aspx>

For what it's worth, here are some numbers for the US from the Mercator Advisory Group²:

- By 2015, the total dollar load on open-loop prepaid cards is expected to hit \$389 billion, roughly a 28% increase from 2011.
- Prime candidates for the use of prepaid cards are the unbanked and underbanked, who represent more than 25 million households in the United States.
- About 87% of prepaid cards in the last year were gifts; 14% were used for household expense budgeting, 12% and 16% of those households, respectively, use a general purpose prepaid card.
- More than 32% of consumers have used a prepaid card.
- The average value of a prepaid card transaction, according to a 2010 Fed study, is \$33.
- More than two-thirds of general prepaid transactions were less than \$25.

What is the business case for prepaid?

Again, we need to take into account the product's versatility, encompassing a wide variety of providers and customers. Let's start with what we might call the stand-alone providers: bank card issuers.

Prepaid bank cards

Provider	Product	Target market	Customer benefit	Provider benefit
Bank card issuers	Prepaid debit (open loop)	Under- and unbanked segment	Provides access to (usually limited) range of banking services. <i>It has been suggested that prepaid helps customers build or rebuild a credit record: this is controversial</i>	<ul style="list-style-type: none"> ▪ Cuts cost of providing conventional banking services to infrequent users ▪ Provides entry point for currently unbanked customers ▪ Builds deposit balances ▪ Generates range of fees (start-up, annual, load, dormancy...)
	Student card (open loop)	Parents	<ul style="list-style-type: none"> ▪ Controlled access to funds ▪ Convenient ▪ Secure ▪ Widely accepted 	<ul style="list-style-type: none"> ▪ Generates range of fees (start-up, annual, load, dormancy...) ▪ Builds deposit balances
	Travel money card (open loop)	Holidaymakers	<ul style="list-style-type: none"> ▪ Convenient ▪ Secure ▪ Widely accepted 	<ul style="list-style-type: none"> ▪ Generates range of fees (start-up, annual, load, dormancy...) ▪ Builds deposit balances

² <http://www.atmmarketplace.com/article/203069/Want-to-add-prepaid-cards-Consider-6-things>

As well as those above, other emerging uses are to manage employee travel expenses and, especially in the Middle East, to fund staff responsible for buying on behalf of households. In both cases, controls can be set on transaction levels and merchant categories at which the cards can be used.

At this time, the most widely-cited reason for banks to issue prepaid debit cards is to serve customers who are currently under-banked (which usually means having limited funds and prone to slip into unplanned overdrafts) or have no banking relationship. In fact, the two groups present different challenges: under-banked are typically expensive to serve by conventional means, while unbanked customers may present a profit opportunity either now, or as they become better-off, in the future. In both cases, there is significant pressure from consumer groups and regulators to offer affordable banking facilities to these consumers.

Historically, banks have generated profits from under-banked customers by charging significant fees for overdrafts and other current account services. Today, under pressure from regulators to slash these charges, migrating customers in this group to a prepaid debit card makes a lot of sense. In fact, under the new rules, JP Morgan Chase estimates that as many of 10% of its retail customers are now unprofitable. The case is well put by Todd Maclin, who heads Chase's consumer and business banking unit: "When we get out of the overdraft business, we also get out of the check business, which means we get out of the paper business, which means we also get out of a lot of processing, which means we save a lot of money."³

Whether or not the sums will add up in quite the way that Maclin envisages, it's clear that the move will free up resources which can then be put to work in attracting and retaining better-off customers who will buy more profitable banking services and products.

These benefits are valuable, but tangential and difficult to measure. All the more reason, therefore, to keep a careful eye on the direct costs and revenues generated by prepaid.

Prepaid gift cards

As well as operating their own prepaid products, stand-alone providers also provide prepaid capabilities to other businesses, typically retailers and e music stores. Leaving aside the special case of transit cards, in most markets retail gift cards are the biggest single prepaid product, offering customers and providers valuable benefits:

Provider	Product	Target market	Customer benefit	Provider benefit
<ul style="list-style-type: none"> ▪ Retailers ▪ E music stores 	Gift card (closed or restricted loop)	<ul style="list-style-type: none"> ▪ Retail customers ▪ Businesses (staff incentives, customer compensation) 	Convenient, flexible, attractively-packaged	<ul style="list-style-type: none"> ▪ Builds cash balances ▪ Breakage ▪ Spend uplift

³ http://articles.chicagotribune.com/2012-05-08/business/sns-rt-us-jpmorgan-cardbre8470z0-20120508_1_prepaid-debit-overdraft-fees-jpmorgan-chase

How big is the market?

Looking at the UK, one estimate⁴ is that the market for prepaid gift cards and vouchers was worth around £4.5 billion in 2011 – a growth of some 12% in a context where retail sales increased only by 2.2%.

This suggests that gift cards are capable of generating incremental business, a hypothesis supported by anecdotal evidence that customers redeeming gift cards spend up to 40% more than the card's face value. Essentially, a prepaid card can drive our old friends lift and shift: lift in overall basket size, shift from competing brands. Beyond this, important commercial benefits also stem from the balances held prior to redemption, and the fact that, again anecdotally, around 5% of card values are never redeemed at all.

Naturally, where customer deposits are potentially at risk, there are regulations. The regulations around prepaid products are complex and not always consistent. In the UK, for example, recent events have demonstrated that many closed loop products are not controlled by the e-money licensing regime of the Financial Services Authority. By contrast, if the card is to be open loop, the provider has also to comply with other rules, notably those imposed by the card schemes, but also including BIN sponsors, transaction processors and transaction acquirers, who will have their own operating standards – and charging structures. Fortunately perhaps, there are experienced programme management companies who will, for a fee, provide a full or partial outsourcing service for prepaid cards. How the fee is made up will inevitably be a matter for negotiation: for instance, there could well be debate about how start-up and transaction charges should be set, or how revenues from breakage and cash balances should be allocated. Put simply, for a retailer to attempt to negotiate without support the many hurdles associated with launching a prepaid card is probably not a great idea. Hiring professional help will be a great deal simpler – and correspondingly more expensive.

New players in prepaid

Finally, prepaid functionality is used by a growing group of providers who until fairly recently would have been seen as outside the mainstream.

Provider	Product	Target market	Customer benefit	Provider benefit
Government	Social security benefit cards (open loop)	Benefit recipients	<ul style="list-style-type: none">▪ Convenient▪ Secure▪ Widely accepted▪ Avoids actual or potential current account charges	<ul style="list-style-type: none">▪ Cheaper than cheques or equivalent▪ Reduces fraud
Employers	Payroll card (open loop)	Staff		<ul style="list-style-type: none">▪ Cheaper than cheques or cash▪ Reduces fraud
Insurers	Claims payments (open loop)	Policy claimants	<ul style="list-style-type: none">▪ Convenient▪ Secure▪ Widely accepted	<ul style="list-style-type: none">▪ Cheaper than paper▪ Reduces fraud

⁴ http://www.ukgcva.co.uk/downloads/factsheets/summary_2011.pdf

In virtually all these cases, the card will be managed by an issuing bank, which may gain from the funds generated and fees charged. Benefit and payroll cards have the added attraction of recurring direct deposits which greatly extend card life and usage levels.

How big is the market?

Subject to the usual provisos about predictions, in a November 2012 report⁵ Aite Group reckons that the gross dollar volume loaded on to payroll cards in the US will rise from an actual \$27 billion in 2011 to a forecast \$67 billion by 2015. For its part, the US Federal Reserve calculates⁶ that in 2011 \$99.8 billion was loaded on to Federal and State-issued open loop cards (mostly benefit payments); average transaction values ranged from \$30 to \$41 for POS, and \$143 for ATM withdrawals.

Managing prepaid for profitability

As well as any indirect benefits, prepaid cards generate costs and revenues on their own account. Depending on the product, outcomes will vary widely, but experience and best practice suggest the following basic rules:

Card life tends to be short, often less than six months. This means that set-up and issuance costs have to be recovered rapidly or not at all. What extends life is reload activity. This would suggest that reload fees should be kept at a reasonable level, so as not to inhibit continuing use. In the past, this has not always been the case.

Activity levels are skewed to infrequent use, with only a small minority of cards having intense usage. Profit per account is likely to be low. On the other hand, debit card users make relatively frequent balance enquiries. Accordingly, it makes sense to restrict account servicing to electronic channels.

The balance between fees and interchange revenues will vary from product to product, and will change according to usage. On balance, *experience suggests that interchange will be only a modest part of prepaid revenue.*

From a cost perspective, *inter-bank charges for off-us ATM withdrawals can be a significant element of operating overhead.* It may be appropriate to recognise this in the customer fee structure.

Recurring direct deposit, as with payroll and social security cards, is a strong driver of both usage and account life. Accordingly, employers and Government institutions are valuable prospects. In search of regular reload activity, prepaid marketers are also moving into the fleet card and expense management sectors.

As a final thought on prepaid management, issuers should *watch out for signs of potential money-laundering* on reloadable cards.

⁵ <http://www.aitegroup.com/Reports/ReportDetail.aspx?recordItemID=1008>

⁶ <http://www.federalreserve.gov/publications/other-reports/files/government-prepaid-report-201207.pdf>

The broad view

In summary, the upside of prepaid is its flexibility: organisations of all sorts are continually finding new uses for this functionality. Among providers, banks are under pressure to offer services to the under- and unbanked: prepaid is one way to respond. For retailers, it offers the ability to build incremental business. For many businesses, prepaid can be cheaper and more secure than existing payment methods. Providers who can access cash deposits and breakage revenues enjoy attractive benefits. In the past, fees have been a very substantial income stream. However, allegedly excessive charges have caught the attention of regulators in many markets, and we believe that in the future issuers should expect only readily-justifiable returns from this source.

The downsides are that prepaid products are as expensive to issue as other cards, but often have a much shorter life and lower usage. Accordingly, their financial dynamics are so finely balanced – a US study⁷ finds open loop account profitability between \$1 and \$3.95 – that even a couple of customer service calls can push a prepaid card into loss. Perhaps more than with any other card product, prepaid needs unremitting attention.

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⁷ *Achieving Profitability with Prepaid Cards, PSCU Financial Services*