DISCUSSION PAPER
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General-Use Prepaid Cards: The Path to Gaining Mainstream Acceptance

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Summary: *Following the rapid proliferation of merchant-issued prepaid gift cards, some people assumed that the added functionality available in network-branded prepaid cards would lead to similar early success for these payment vehicles. While a number of emerging applications are gaining traction, others are struggling to reach viable scale. This paper argues that the rich functionality made possible in what we define as general-use prepaid cards creates a significant "cost hurdle" that must be overcome with economically viable solutions. Observing market developments, the paper identifies two emerging strategies that hold particular promise: 1) developing applications that efficiently displace high-cost legacy structures, and 2) creating financial services solutions for consumers outside the traditional banking framework. Both of these strategies rely on defining large markets to target and creating longer term relationships with cardholders.*

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Introduction

Prepaid cards are among the newest payment card innovations. They are distinguished by a pay early model whereby cardholders set aside funds in advance for future purchases of goods and services. This differs from debit cardholders, who pay at the time the purchase is made, and credit cardholders, who pay after the purchase has been made. Such a structure allows prepaid cards to be more widely distributed with substantially less concern about credit or nonpayment risk than other types of payment cards.

These features have contributed to making prepaid cards one of the fastest growing payment card products. Prepaid cards accounted for $181.7 billion of transaction volume in 2006,[1] according to the market research firm Mercator Advisory Group.[2] However, the segment is actually rather complex, with a number of different categories and different types of prepaid cards contributing to this total.

The most well known and successful version of this product is retailer gift cards. Largely supplanting paper-based gift certificates at major retailers over the past few years, gift cards have been a boon to retailers and their customers, providing a safe, secure, and more efficient way to make purchases at participating merchants.[3] At the same time, bank issuers and nonbank "sponsors" are developing a range of other prepaid applications with significantly broader

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[1] H. Michael Jalili, "Review 2006: New Rules (and Opportunities) in Prepaid," *American Banker*, December 28, 2006.

[2] Industry leaders acknowledge that precise quantification of the size of the prepaid market has been difficult. The products' newness, the participation of a broad spectrum of institutions (banks and nonbanks), and a difficulty agreeing on a common terminology or taxonomy to describe the different categories of cards have compounded the challenge. This paper cites data from Mercator Advisory Group, as do many other industry publications. But other sources exist, and estimates vary. Using data from a single source does make it more likely that the numbers are internally consistent, however. For the purposes of this analysis — in particular, for comparing the relative magnitudes of different types of prepaid cards — this is a useful characteristic.

[3] Retailers have reason to be optimistic about gift cards. According to the National Retail Federation, gift card sales during the 2006 holiday season will total $24.81 billion, a substantial increase over the $18.48 billion loaded in 2005. At the same time, consumers will spend more on gift cards than they did before — an average of $116.51 in 2006 versus $88.03 the year before. See the press release "Holiday Gift Card Sales Reach All-Time High, According to NRF," November 17, 2006.

functionality than traditional gift cards. Such products are commonly referred to as network-branded prepaid cards, or as we will more specifically define, "general-use prepaid cards."

Following the success of retailer-specific prepaid gift cards, network-branded prepaid cards are thought to be an extremely powerful innovation that will generate significant transaction and ultimately outpace the success of the more limited retail gift-card applications. Some argue that the products' flexibility, favorable risk profile, and extended distribution capability will lead to many new, attractive bank-like payment applications outside traditional banking relationships. To date, this aggressive forecast has not been fully realized.

While a number of emerging applications appear to be gaining traction, a number of business models have fallen by the wayside, and others are struggling to reach viable scale. This paper argues that the increased flexibility and more complete functionality carry with them substantial new costs, resulting in a "cost hurdle" that must be overcome in order to create economically viable business models.

Examining several of the more promising applications emerging in the marketplace reveals certain conditions for success. This paper identifies two such strategies that appear to be viable means for overcoming the cost hurdle and encouraging consumer adoption: 1) developing applications for specific payment functions that replace significantly higher cost products with more efficient and consumer-friendly alternatives; and 2) developing financial services solutions for generally underserved consumers that integrate or "bundle" specific payment and banking functionality in a product offered outside traditional bank relationships. This paper further argues that the successful strategies will target markets with significant scale and create the basis for a type of longer-term financial services relationship that helps to both surmount the cost hurdle and increase utility for consumers.

The paper also considers policy refinements and business strategies that may be helpful to encourage increased adoption and build stronger business cases. Some of these may be seen as responses to particular challenges, such as contending with prepaid cards' perceived vulnerability to money laundering and finding ways to make certain applications more useful to populations outside the financial mainstream. The paper concludes that while gaps exist, they are not insurmountable. General-use prepaid card applications are moving beyond “proof of concept”: They constitute bona fide, attractive business opportunities while, at the same time, offering genuine utility to the unbanked and underserved segments of society.

What Are Prepaid Cards?

Simply put, prepaid cards are a payment card product built around a pay early, spend later model, rather than the pay-at-purchase model of debit cards and the pay later model used by credit cards. In other words, they allow users to set aside funds in advance in a prepaid “account” and to draw on those funds for subsequent transactions. Prepaid cards have other distinguishing characteristics as well: They are either single load or reloadable, are limited in acceptance to single or a small set of merchants - or very broadly accepted like traditional branded debit and credit cards and lastly, have either very focused functionality or broader applications.

Single load gift cards represent the earliest, simplest, and, thus far, most popular prepaid category. Of these, retailer gift cards are the most common example. These “closed loop” electronic payment alternatives act much like a conventional paper gift certificate, with limited acceptance and limited flexibility. Generally purchased at a retail store, they are redeemed using standard POS terminals linked to a specialized processor.[4]

Consumers have embraced these products because of their enhanced safety and flexibility compared with cash or paper gift certificates. Retailers have also favored them because they stand to benefit from these products in a number of different ways. First, these cards replace more

[4] Some retailer gift cards are reloadable. Indeed, some retailers, such as Starbucks, offer an auto-reload feature whereby funds on the card are replenished whenever the balance falls below a predetermined minimum. For the purposes of this paper, we do not consider these as general-use prepaid cards because their use is limited to franchises of a single retailer, as opposed to the much broader acceptance that is the hallmark of a fully functional general-use prepaid card.

costly and less efficient paper alternatives. Gift card programs allow for audit trails, may be integrated into loyalty programs, and allow merchants to more easily track purchasing behavior.

Second, they may provide "sales lift" — that is, customers often spend more than the value loaded on the card when they go to redeem it. This means that the sale of a $100 gift card may ultimately lead to more than $100 in sales when a customer redeems the card. And in any case, the merchant enjoys a profit margin on the goods purchased.

American Express, Visa, and other branded networks have developed their own gift card products. These cards differ from retailer-based gift cards in that they can be used to make purchases at all merchants who accept that network brand. Also known as "open-loop" or "network-branded" gift cards, they offer the same sort of functionality as traditional credit and debit cards and are authorized and settled using the existing payment networks.

Like retailer gift cards, these products are essentially a substitute for more expensive paper payment alternatives. But they are operationally more complex than the limited use retailer closed-loop gift cards and carry an added cost of card network provided consumer protections, processing, and distribution. Obviously, banks issuing network-branded gift cards do not benefit from sales lift or other merchant-related revenues and generally rely on fees to cover their costs. Purchase and activation fees, generally absent in retail gift card programs, can amount to $5 to $15.

While the branded gift card segment has also grown, it has trailed retailer-specific cards. Mercator Advisory Group estimates that open-loop, branded gift cards grew by 50 percent to reach $2 billion in loaded value in 2006 — rapid growth, but still something less than the 4 percent of the total value of the retailer gift cards sold last year.[5]

In summary, retailer-sponsored gift cards have proven to be very successful, providing even greater convenience and value to consumers and merchants than traditional paper gift

[5] H. Michael Jalili, "Review 2006: New Rules (and Opportunities) in Prepaid," *American Banker*, December 28, 2006.

certificates and at lower costs. Open-loop gift cards have proven less successful. While they offer far wider merchant acceptance than retailer-specific cards, consumers have, to date, not found them as attractive a value proposition. In part, the problem may be that when positioned as simply a “gift card” the network-branded alternative may not provide a significantly compelling value proposition. As we will see later, and as this example suggests, programs that offer only limited advantages over other payment alternatives will be challenged to succeed— especially if the cost to consumers is higher. The question is whether the added flexibility and applicability available via some of the newer prepaid card applications are enough to create payment alternatives that will truly transform the way payments are made. The paper next discusses these so-called network-branded reloadable prepaid programs and offers a specific definition for a “general-use prepaid card” in order to examine how the functionalities associated with this definition can be combined to create potentially viable business models.

Network-Branded Prepaid Card Programs

Network-branded or general-purpose prepaid cards are common industry terms that can refer to a number of product configurations. However, for the purposes of this discussion, we use the term “general-use prepaid cards” to describe prepaid products that are: 1) branded with a network logo, such as MasterCard, Visa, American Express, or Discover; 2) reloadable, so that users can direct recurring revenues such as salaries or government benefits to the card or make nonrecurring cash or check “deposits” to replenish the funds as they are depleted; and 3) functionally interchangeable with traditional debit cards for all types of online and offline usage, often including ATM access.

These attributes mean that general-use cards can provide a number of critical bank-like services outside traditional banking account relationships. This, in turn, also enables wider, nonbank distribution, including via retail establishments, employers, or government agencies. However, with this added potential for flexibility and advanced functionality come higher costs.

In addition to network-related costs, general-use prepaid cards have uniquely complex processing and customer servicing requirements and face additional expenses associated with wider distribution and the ability to be reloaded.

As we have noted, the branded gift card and a number of other general-use prepaid applications have yet to gain significant market acceptance. In part, this is undoubtedly due to their relative newness and their lack of familiarity among consumers. However, this paper makes the further argument that these more complex applications are relatively more costly and, therefore, must add substantial additional value in order to be economically viable. In short, the critical challenge is to design applications that solve real problems and be paid for doing so.

There is reason to suggest that this challenge can be met. In the next section of this paper, we describe several emerging solutions that appear to have the potential to create sufficient value to overcome the expense hurdles and also provide other attributes that can encourage consumer adoption. While future innovations are likely to lead to other successful models, the examples cited cluster around two general paradigms: In the first set of examples, several applications are described that replace relatively high-cost legacy alternatives with more efficient and customer-friendly solutions. In the second set of examples, the focus is not on general product solutions but rather on the development of entirely new products to serve the financial needs of unbanked or underserved consumers. One could also argue that the unbanked applications simply replace more costly financial services alternatives. While that is certainly true, the more compelling value proposition may well be that the broad set of emerging prepaid applications have the potential to redefine the nature of financial services outside traditional banking relationships in such a way as to be truly transformational .

Solutions to Replace High-Cost Alternatives

General-use prepaid products can be adapted to accommodate many types of transactions, payments, and processes formerly delivered through costly and inefficient paper-based methods.

Among the current applications, this paper focuses on four examples: government benefits, disaster relief, health care, and payroll disbursement.

Government benefits. Payment of government benefits is one of the more mature general-use prepaid card applications — one likely to become even more prominent in the future. According to Mercator Advisory Group, food stamp and Temporary Assistance for Needy Families (TANF) government benefits programs account for more than $55 billion of total prepaid spending.[6] When we consider that the entire annual prepaid volume (both open- and closed-loop cards of all types) amounted to $181.7 billion, it is clear that that these programs have already had a sizable impact. Due to their use limitations, these prepaid benefit applications do not strictly meet our definition of general-use prepaid cards. At the same time, these early prepaid applications have many similar functional characteristics.[7]

The next generation of government benefit applications, however, is moving to general-use prepaid card applications. More than 40 states are currently using Visa- or MasterCard-branded prepaid cards to distribute some sort of benefits, including child support and unemployment insurance.[8] Next year, New York state intends to start providing unemployment benefits via general-use prepaid cards. [9] Given that New York has the country's third largest population, this move signifies an additional, important vote of confidence in this type of delivery mechanism for state benefits.

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[6] "Report: Open-Loop Prepaid Cards Show Dramatic Year-Over-Year Growth," *ATM & Debit News*, October 19, 2006.

[7] Delivering government benefits via magnetic stripe cards got its start with a trial program in Pennsylvania in 1984. There, a collaboration between the USDA and the state used cards to deliver food stamps benefits in the nation's first EBT (electronic benefits transfer) effort. The program was not cost-effective at that time because of the expenses associated with building card acceptance at the POS. However, it did demonstrate that the concept could bring many benefits to states, the federal government, merchants, and recipients of benefits. Successive efforts have become even more efficient and much more cost-effective. For a more extensive discussion of the history of prepaid cards in benefits disbursement, see the Payment Cards Center's Conference Summary, "Assessing the Impact of Electronic Benefits Transfer On America's Communities and the U.S. Payment System," 2005, available at www.philadelphiafed.org/pcc/papers/index.html#05.

[8] Nadia Oehlsen, "A Banking Play for the Underbanked," *Cards & Payments*, August 1, 2006.

[9] H. Michael Jalili, "Review 2006: New Rules (and Opportunities) in Prepaid," *American Banker*, December 28, 2006.

Among the disbursements that can be distributed in this way are child support payments, unemployment insurance, tax refunds, school lunch, and Social Security benefits. Aid recipients receive a card that can be used to make purchases at merchants who accept Visa or MasterCard, and depending on the program, get cash back and withdraw funds from ATMs. To date, the funds from the various programs have generally been loaded on separate cards, suggesting opportunities for additional efficiency gains if these programs are eventually consolidated onto a single card.[10]

Increased use of general-use prepaid cards for state benefits may be encouraged by recent legislation. For example, to eliminate the costs associated with printing, processing, and distributing paper checks that may amount to several dollars per payment, a new Michigan law requires child support payments to be distributed via direct deposit or prepaid card. Other state laws and the requirements of federal agencies are likely to encourage broader use of prepaid cards.

This area holds substantial promise for card issuers for a number of reasons. A single state program can include hundreds of thousands of recipients. Most programs feature repeat transactions, some over an extended period. Servicing this business would typically be parceled out in its entirety, providing a successful bidder a large jump in volume and a portfolio with longevity and relatively low risk.[11]

General-use card-based approaches to government benefits are seen to be a win-win proposition for each of the major stakeholders, providing appreciable benefits beyond the first-generation EBT programs. The states and federal government can save time and money. At the same time, they benefit from increased accountability and audit trails while delivering better

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[10] For a discussion of the prospects for this transition, see Richard Mitchell, "Company Puts 'Official' Stamp On State Prepaid Card Programs," *Cards & Payments*, May 1, 2006.

[11] These efforts do present some special challenges to issuers, however. States and individual agencies will often have different rules for program administration, including proscribing what kind of fees can be charged and where. See Richard Mitchell, "Company Puts 'Official' Stamp On State Prepaid Programs," *Cards & Payments*, May 2006.

service to recipients. Retailers benefit from faster payments, greatly reduced processing costs, and integration of benefits payments into their overall tendering and payments processing operations.

Finally, recipients benefit from greater security, reduced stigma, flexibility, and an easier way to plan. Budgeting and funds management are made easier through a monthly transaction statement available by mail or online. Additionally, the "account" underlying this dedicated card provides a sort of funds segmentation, which can further enhance budgeting or facilitate saving. Lastly, card-based programs may also offer international funds availability, which can be useful for custodial parents who live in other countries to receive child support payments.[12]

In sum, prepaid government benefits applications have proved successful in large part because they replace cumbersome and costly legacy payment systems with far more efficient alternatives and provide additional value to retailers and consumers that help further encourage adoption.

Disaster relief. An application closely related to state-based benefits programs is disaster relief. The ability of general-use prepaid cards to deliver value in this area was made especially clear over the past two years.

The devastation wrought by Hurricane Katrina in the fall of 2005 provided a case study in both the robustness of the financial system generally and how extraordinary circumstances pose unanticipated challenges for consumers and payments providers.[13] With widespread damage to physical infrastructure, access to bank branches or alternative financial services outlets was nearly impossible. The physical dislocation of much of the affected population made access to financial services providers and relief disbursements a significant challenge. For the unbanked, not having traditional banking relationships made their plight worse. Those with traditional bank

[12] A more extensive discussion of these benefits to recipients, as well as the costs and concerns about implementation for program sponsors can be found in the "Electronic Disbursement Options White Paper," from the U.S. Department of Health and Human Services, available at http://www.hhs.gov/emergency/rfi/comments/whitepaper.html.

[13] A thorough analysis of these events can be found in Julia S. Cheney and Sherrie L.W. Rhine, "How Effective Were the Financial Safety Nets in the Aftermath of Katrina?" Payment Cards Center Discussion Paper, January 2006.

relationships and electronic access to accounts via direct deposit and credit or debit cards fared better than those who were unbanked or who otherwise depended on a cash economy. For one thing, many peoples' homes were completely destroyed or inaccessible, so that they were unable to retrieve relief funds mailed to them. Living in shelters or with friends and family, these people effectively became refugees.

A study of the refugees staying in the Houston Astrodome in the wake of the disaster makes the extent of the challenge apparent. This study, conducted by the *Washington Pos*t, Kaiser Family Foundation, and Harvard University showed that almost two-thirds of the evacuees were unbanked and only 28 percent had a usable credit card. Clearly, their financial options were limited.[14] Acknowledging these difficulties, state and federal agencies and private charities were able to leverage prepaid cards to get funds where they were critically needed.

Several affected states used the EBT network (a specialized government benefits application that is functionally similar but more constrained than our defined general-use prepaid cards) to distribute both food aid and cash assistance to people already within that system.[15] Other disaster relief payments funds were distributed through general-use prepaid cards issued (with restricted reloading capability) by the Federal Emergency Management Agency (FEMA) and the Red Cross. The especially positive results of the Red Cross's program suggest that prepaid cards can indeed be a viable and effective means of getting funds where they are needed quickly.[16]

The Red Cross distributed 600,000 prepaid cards with $1.6 billion of assistance in response to damage caused by the 2005 gulf coast hurricanes. The cards were distributed in 47

[14] See Mollyann Brody, et al., "Experiences of Hurricane Katrina Evacuees in Houston Shelters: Implications for Future Planning," *American Journal of Public Health*, March 2006; available at: http://www.kff.org/newsmedia/7401.cfm

[15] Julia S. Cheney and Sherrie L.W. Rhine, "How Effective Were the Financial Safety Nets in the Aftermath of Katrina?" Payment Cards Center Discussion Paper, January 2006, p. 12.

[16] See Julia S. Cheney, "The Role of Electronic Payments in Disaster Recovery: Providing More Than Convenience," PCC Conference Summary, 2006.

states to evacuees who lost their homes. A Red Cross spokesperson estimated that the agency saved $2 million by using prepaid cards in this disaster relief effort as opposed to paper checks.[17]

As this example illustrates, while cost savings were relevant, the other advantages inherent in the flexibility associated with the application of general-use prepaid cards were arguably more important features in their adoption. It is often said that cost and convenience are driving factors in adopting new payment forms. However, as this disaster relief scenario demonstrated, general-use prepaid cards provided more than simple convenience to those in need of emergency funding.

Health care. Another potentially attractive application of general-use prepaid cards is for health-care payments and specifically with the greater adoption of health savings accounts (HSAs) that has arisen from the Medicare Prescription Drug Improvement and Modernization Act of 2003. Motivated by a desire to reduce costs and increase the efficiency of health care spending, employers and other entities offer HSAs as a means for consumers to pay for health-care purchases through tax-deferred savings plans that they, not their employers, control.

Prepaid cards' prospects for use in health-care payments were further bolstered by the passage of the Health Opportunity Patient Empowerment Act of 2006, which raises personal contribution limits, making these programs more attractive to consumers and payment providers. Accordingly, this sector is expected to balloon over the next few years. Forrester Research predicts the number of HSAs will grow from about 391,000 in 2006 to nearly 6.3 million by 2008.[18] If flexible spending accounts[19] are included in the mix, TowerGroup expects an increase to 29.1 million in 2010 from 17.3 million in 2005.[20]

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[17] "No Turning Back For Red Cross Relief Cards," *ATM & Debit News*, February 23, 2006.
[18] Nadia Oehlsen, "Mixing It," *Cards & Payments*, October 3, 2005.
[19] Prepaid card programs supporting these various medical payment systems have a number of similar characteristics, including the ability to restrict access to certain merchant category codes and ATM's. Nevertheless, HAS's may prove a more attractive product for a broader base of bank issuers. HAS cards can be marketed directly to a bank's customer base while FSA cards are typically distributed at the employer program level.
[20] "US Health Care Reform Boosts Cards," *Electronic Payments International* January 31, 2006.

For providers, insurers, and others in the industry, the underlying paper-based payment system has long been seen as a costly and cumbersome process. The burgeoning interest in these types of health savings accounts, coupled with the opportunity to dramatically improve efficiencies, is seen as a real opportunity for general-use prepaid cards. Simply as a payment alternative, prepaid cards offer substantial cost savings due to reduced administrative expense for processing paper-based claims and reimbursement.

Moreover, some industry participants expect that the flexibility and efficiency of prepaid cards can have an even greater impact in this area. Some prepaid card issuers and processors are developing systems that will allow multiple "purses" to be associated with HSA cards, allowing, for instance, a reloadable general-use prepaid account on the card to be used for incidental pharmacy purchases, while the HSA account proper may be debited for prescription purchases.[21]

Payroll disbursement. Payroll disbursement is another example of an area where general-use prepaid cards deliver increased utility to employees, especially those who lack bank accounts, while dramatically reducing the payroll processing costs of the companies that use them. By successfully addressing the cost issues and providing added consumer benefits, payroll cards are among the most successful of the general-use prepaid applications. According to Mercator Advisory Group, payroll card volume reached $10 billion in 2006, a 60 percent increase over 2005.[22] The research firm estimates that payroll cards in use will grow to 14.2 million by 2008 from just 812,500 in 2004.[23] While estimates for payroll card volumes vary, all sources note rapid growth that affirms the attractiveness of this product to consumers and employers.

Much of the payroll cards' success can be attributed to their strong value propositions to both sides of the market — employers and employees. Payroll cards offer substantial cost savings to employers. Many employers and payroll processors suggest that electronic delivery of payroll

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[21] "Dual Function May Take On New Meaning," *ATM & Debit News*, August 17, 2006.
[22] H. Michael Jalili, "Review 2006: New Rules (and Opportunities) in Prepaid," *American Banker*, December 28, 2006.
[23] Nadia Oehlsen, "A Banking Play for the Underbanked," *Cards & Payments*, August 1, 2006.

funds can save between $1 to $2 per employer per pay period when compared with the processing costs of paper checks.[24]

Added to these basic costs are other expenses generally associated with check-based payroll systems, including the expense of investigating the inevitable lost or stolen checks, complying with escheat regulation, correcting errors, and issuing replacement checks. Each of these costs could amount to an additional several dollars per incident. In contrast, after the initial administrative investment and the distribution of the card itself, the marginal cost of subsequent loads on a payroll card is around 20 cents.[25]

This presents a sizable opportunity for sponsors and issuers. MasterCard estimates that $200 billion[26] is paid to unbanked workers annually, through paper checks, which are then typically cashed for a fee, ranging from 1.5 to 3.0 percent at check cashing outlets, keeping these funds and consumers largely outside the financial services industry. Payroll cards offer an efficient means for bridging this gap.

Payroll cards offer a worthwhile value proposition to consumers. For the unbanked, the ability to receive payroll seamlessly on a product linked with the global payments system confers an obvious benefit. The cost savings are considerable, especially when we take into account that many payroll card users may work multiple jobs and thus would potentially incur multiple check cashing fees every week. For instance, according to the Office of the Comptroller of the Currency, an employee earning $12,000 annually would incur $72 of fees if he received his wages on a payroll card. In contrast, he would pay $246 annually if he used a check casher instead.[27]

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[24] Office of the Comptroller of the Currency, "Payroll Cards: An Innovative Product for Reaching the Unbanked and Underbanked," June 2005.
[25] Yvette Presberry, "Fed Adds Payroll Cards to Reg E," *Cards & Payments*, October 1, 2006.
[26] Peter Lucas, "Payroll Cards: The Key to the Unbanked," Digital Transactions, November 2006.
[27] Office of the Comptroller of the Currency, "Payroll Cards: An Innovative Product for Reaching the Unbanked and Underbanked," June 2005.

Some anecdotal evidence suggests that the unbanked are not the only segment that finds payroll cards to be a valuable tool. Ecount, Inc., a prepaid card marketer and processor, reports that 54 percent of 2,000 randomly surveyed payroll card users actually had regular deposit accounts.[28] The company surmises that earners are using the prepaid product for budgeting or savings purposes, a secondary benefit of prepaid products that could inspire other new applications in the future.

In each of the examples cited above, the successful application of general-use prepaid cards depends on value propositions that result in significant cost savings for business sponsors and real benefits for consumers and merchants that help spur adoption. Several other common features of these programs come into focus: They are used to establish or benefit from a sustained customer relationship, they layer more sophisticated business logic on top of the core payment functionality, and they solve particular problems in elegant ways. These same factors will arise again, as the paper considers the other major area for general-use prepaid cards that will exert significant influence in the future.

Creating Financial Services Alternatives for Underserved Consumers

By virtue of their broad acceptance and flexibility, general-use prepaid products can offer a means to provide meaningful, low-cost financial services to the large numbers of consumers without regular banking relationships. This population is sizable and diverse, and, in the aggregate, it has considerable spending power. A recent collaborative study conducted by BearingPoint, a consulting firm, and Visa found that there are 84 million people in the U.S. who don't have banking accounts or don't have access to credit because of low scores or thin or nonexistent credit files.[29] The study estimates that these 84 million people collectively earn a sizable $1.1 trillion in annual income.[30]

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[28] Jim Daly, "Payday for Payroll Cards?," *Digital Transactions*, May 2006.

[29] Estimates of the actual number of unbanked individuals vary widely. Part of the difficulty arises from inconsistent definitions: Do the unbanked include those who are self-excluded from banking relationships, those with bad credit, or those who have no credit cards whatsoever? Another problem is that the

Whatever the reason that this cohort of people has remained in the cash economy, it is clear they would benefit from the types of services that can be delivered by means of general-use prepaid programs. In addition to debit-based purchases at the POS, ATM transactions, and direct deposit of payroll funds, prepaid programs offer other benefits that may make them a compelling option for this population.

Integrated bill payments are one initiative especially well suited to the unbanked market. Several retailers have installed full-service financial kiosks in their retail locations that both dispense general-use prepaid cards and allow bill payment. The national convenience store chain 7-Eleven is among those taking the lead in this effort, with plans to install up to 5,000 of the proprietary Vcom kiosks in its stores.[31] Other merchants following similar strategies include gas vendors Exxon Mobil and Circle K. The latter has concentrated its deployments in border states with larger immigrant populations, who may be less likely to have formal banking relationships.

International remittances offer a similar selling point to the unbanked market. Remittances — essentially fund transfers from one person to another who is typically located abroad — are another opportunity to both increase cardholders and generate fee-based revenues. Many recent immigrants remit a portion of their take-home pay to family members in their country of origin. Traditionally, carrying out these transfers has been very costly, with transfer agents charging up to 10 percent of the transfer amount to facilitate the transaction. Some innovative banks saw this as an opportunity for prepaid cards to fill a role. In a typical scenario, a U.S. resident will acquire two prepaid cards accessing a common underlying "account." One would be sent by post to the recipient, who would then use the card at local ATMs to withdraw

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calculations involve estimates for individuals of whom banks do not have records — a much more difficult proposition than detailed analysis of those already in the financial mainstream. The Visa/BearingPoint estimate is among the largest. A more parsimonious study from Celent Communications puts the total at a much smaller 14 million. See the news release "MasterCard Launches the MasterCard rePower Prepaid Load Network," December 19, 2006.

[30] "Sizing the Market," *US Banker*, August 1, 2006.

[31] "Kiosks the New Frontier for Payment Cards," *Cards International*, June 14, 2006.

cash. This strategy offers several benefits. It is relatively low cost compared with many traditional alternatives, and by easily segmenting funds for remittances, the sending party is able to protect the remainder of his or her money while monitoring withdrawals.

The market opportunity this practice presents for prepaid cards appears to be considerable. The worldwide value of remittances is estimated at $110 billion, with remittances to Mexico at $20 billion and to Latin America and the Caribbean at $48 million.[32] Of this, cash-to-cash transfers continue to dominate, accounting for an estimated 85 percent of the market, with much of that facilitated by Western Union. Banks have yet to devise a winning card-based formula to service this market, and some have remained on the sidelines while early movers refine the business model. Notably, many of the banks active in this area do not necessarily expect to make sizable profits from the remittances themselves but see the program as a means to create interest in their other banking products and potentially create cross-selling opportunities.[33]

These examples represent not so much a single application as a set of applications that have the potential to define a new form of financial services relationship that has the potential to add real value to unbanked customers. Taken together, they hold the promise of delivering a financial services capability that goes beyond simply providing an electronic alternative to paper-based payments. However, at this early stage, single-purpose functions are more prevalent. For example, payroll cards may not have remittance functionality; bill payment may be a feature of cards from one sponsor and not others. Despite the fact that the technology appears ready, the market is still waiting for an application that better integrates a range of functionalities. The paper next addresses this issue and other “gaps” that must be dealt with before these products can more fully realize their potential.

[32] David Gosnell, “U.S. Bank Stands by Remittance Card Program,” *Prepaid Trends*, June 21, 2006.
[33] Participating banks have experimented with a number of different pricing and distribution schemes. But most do charge for reloading. U.S. Bank, for instance, charges $8 for its customers to reload, but it does not charge an initial set-up fee. See the article cited in footnote 36.

"Gaps" and Challenges

Clearly, general-use prepaid cards show promise, both to reduce costs and inefficiencies in existing applications and to provide cost-effective and flexible financial service alternatives to a large market of underserved consumers. At the same time, they face some unique challenges that must be addressed as the product matures. Some of these challenges stem from the newness of the product: Consumer protections and regulatory oversight remain in the early stages. Other gaps pertain more to the business model. For example, while prepaid cards may provide attractive options to many paper-based applications, many programs are themselves quite complex and costly and require operational and technological sophistication. Last, some functional limitations need to be addressed in order to improve usability and spur adoption.

The paper will address these challenges in turn. First, it will note the perceived vulnerability of prepaid cards to money laundering and will discuss other relevant regulatory issues. It then examines the profit function within the business model, looking at factors affecting costs and revenues. Finally, it addresses two issues that may accelerate consumer adoption: payroll card portability and improved and extended reloadability options. Generally, the paper finds that initiatives are already underway or that others likely to be implemented will address many of these challenges. Doing so should strengthen the value propositions underlying a number of the product applications discussed and lay the groundwork for future prepaid innovations.

Dealing with Money Laundering

Federal law enforcement agencies are concerned that money laundering may present a serious security risk to this product category. Several agencies have summarized their findings in the recent multi-agency report: "Money Laundering Threat Assessment."[34] This report notes examples where prepaid cards have been used by drug dealers to pay suppliers or where prepaid

[34] The entire report is available at
http://www.ustreas.gov/press/releases/reports/js3077_01112005_MLTA.pdf

cards were funded with cash from stolen credit cards. Simply put, reloadable prepaid cards are seen by many in the law enforcement community to be an attractive tool for money laundering.

Certain attributes of general-use prepaid cards are seen to increase their vulnerability to money laundering. While some programs record the purchaser's identity at the time of purchase, before card activitation, or before the card can be reloaded, other, more anonymous prepaid card programs are seen to be at risk, since the cards could easily be sold or transferred after purchase to an unidentifiable party. The problem is compounded because the common "know-your-customer" principle can be complicated when the issuing bank may not be the direct seller of the card. [35]

At the same time, some general-use prepaid cards can be acquired and used online, without the user ever interacting with another person. Once purchased, these cards provide access to the global payments system, but they can be used impersonally at the point of sale or, advantageously for money launderers, through electronic channels like the Internet, limiting the ability to identify illicit transactions.

Government agencies and industry participants are focusing on this problem and are taking steps to confront and control what they recognize as a real threat. Some of the strategies being implemented include enacting robust identification requirements, establishing value load limits, and placing other restrictions on card sales and usage. Technology solutions are also being developed to monitor transaction flows to identify suspicious usage. Criminal attraction to new payment innovations is an unfortunate reality. The battle is far from won and will require concerted effort from all payments stakeholders. At the same time, real progress is being made as

[35] The use of general-use prepaid cards to load and access money via international ATM networks is a particular concern of the U.S. Department of the Treasury. See Julia S. Cheney, "Payment Cards and the Unbanked: Prospects and Challenges," PCC conference summary, July 2005, pp. 16-17.

industry providers and law enforcement agencies continue to collaborate on identifying vulnerabilities and developing increasingly more effective mitigation strategies.[36]

Achieving Regulatory Clarity

The money laundering issue is just one area where disparate law enforcement and regulatory entities have intersected with the prepaid sector. The involvement of multiple agencies and multiple jurisdictions contending with rapidly evolving products has presented challenges for lawmakers and payments providers. Federal regulation has addressed some types of prepaid cards and programs, e.g., payroll cards; others types, such as branded gift cards, have attracted state attention.

Arguably, payroll cards gained the attention of federal regulators precisely because of their relative success and the perceived need to clarify consumer protections under the Federal Reserve's Regulation E. [37] At the same time it can also be argued that this development may buttress both supply and demand in this segment: for consumers the regulatory guidance may increase the comfort level with the product; and suppliers can commit to investment, confident that they understand and can plan for uniform requirements as specified by the Federal Reserve.

For other prepaid programs, negotiating the legal landscape has increased issuers' compliance costs and, in some case, has made structuring national prepaid card programs more difficult. However, recent guidance from other federal regulators, including the Office of Thrift Supervision, the Office of the Comptroller of the Currency, and the Federal Deposit Insurance Corporation, may do much to address some of the remaining legal and regulatory heterogeneity,

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[36] For a full discussion of prepaid card vulnerability to money laundering abuse, see Stan Sienkiewicz, "Prepaid Cards: Vulnerable to Money Laundering Abuse?" Payment Cards Center Discussion Paper, February 2007

[37] The final rule states that Reg E covers payroll card accounts that "are established directly or indirectly through an employer, and to which transfers of the consumer's salary, wages, or other employee compensation are made on a recurring basis." It also offers issuers an alternative to providing periodic statements for payroll card accounts if they make account information available to consumers by "specified means." See *Federal Register*, Volume 71, Number 168, August 30, 2006.

thereby reducing uncertainty and complexity. Moreover, the ongoing investment from the major card associations and the industry's ability to speak in one voice through new advocacy channels, such as the Network Branded Prepaid Card Association,[38] promises to foster solutions to many of the other systemic challenges that have complicated the prepaid business model.

Reduce Costs for Card Issuers, Processors, and Sponsors

Legal compliance is but one expense associated with running a general-use prepaid card program. In addition, many of these applications require sophisticated accounting, operational, and information technology expertise as well as a complete understanding of banking and payment card network rules. They also require capabilities similar but distinct from those needed to facilitate a conventional credit or debit program because of the additional business intelligence demanded by the account management process.

Increased scale, in conjunction with specialization and strategic outsourcing, will be important in dealing with the complexity of administering programs. Today, program sponsors can join with a number of specialized processors that have developed the infrastructure to capably and efficiently handle the behind-the-scenes details more cheaply than they could in-house.

Firms like First Data, TSYS Prepaid, eFunds, and others demonstrate how the scale economies enjoyed by specialized processing organizations may bring costs down across the industry. For instance, TSYS has just announced that it has increased its health-care business to more than 11 million active cards.[39] This 11 million is composed of programs from multiple sponsors, but by outsourcing processing to TSYS, the overhead costs incurred by these players are significantly reduced. Such arrangements make sense for even the largest prepaid sponsors:

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[38] http://www.nbpca.com/
[39] News Release, "TSYS Prepaid Surpasses Milestone of 11 Million Healthcare Accounts," December 20, 2006.

American Express has just announced that it is outsourcing its entire prepaid card processing operation to eFunds for the same reasons.[40]

Besides processing costs, the costs of acquiring customers, producing and distributing plastic, and above all, supporting customers are all significant sources of additional expense. While some of these expenses cannot be eliminated, they, too, can be spread over higher volumes, bringing down average costs.[41] At the same time, as sponsors invest in consumer education and users become more familiar with the product, the incidence of customer service calls should decrease, helping to bring these costs to more manageable levels as well.

Increased Revenues

The other part of the profitability equation is revenue. Controlling costs is important, but so is increasing revenues in the aggregate and on a per-cardholder basis. This can be achieved by identifying applications where the competing payment alternatives are substantially more expensive, allowing program sponsors pricing power to cover their costs and to still offer a compelling economic proposition. As noted earlier, government payments, disaster relief, health care, and payroll cards are situations that potentially fit this model.

Such examples demonstrate how the revenue picture is improved as sponsors devise specific programs that increase the range and scope of “priceable” features and services delivered via prepaid cards. A closely related strategy to improve profitability is to extend the duration of the customer-issuer relationship. Raising the lifetime value of each customer is a critical economic driver, since many programs face substantial customer acquisition and account set-up costs that might not be recouped if the card is used for only a short time. From a consumer adoption standpoint, it seems logical that cards that have long-term utility will be valued more highly.

[40] “Amex, eFunds Enter Prepaid Deal,” *Cards International*, January 11, 2007.
[41] These ideas are explored in more detail in Julia S. Cheney, “Prepaid Card Models: A Study in Diversity,” PCC Discussion Paper, March 2005, pp. 14-15.

Payroll Card Portability

Payroll cards are an example of a general-use prepaid application that derives a great deal of its benefit from an extended customer relationship. Payroll deposits represent a recurring funding stream that not only enhances issuers' and sponsors' bottom lines but also provides a payment vehicle for consumers that arguably increases in value with use and familiarity. The question is: Are there ways in which these benefits can be augmented to further enhance the value proposition?

Generally, payroll cards have been limited to the scope of a single employment relationship, meaning that the card cannot be retained by the employee if he or she changes jobs. Job changes are especially frequent among unbanked consumers. In response, some issuers have discussed the idea of providing portability — marketing the card directly to the consumer to be used to receive wages from any employer.[42] Other examples, often referred to as "general purpose spending cards" are currently offered by program sponsors like Green Dot and NetSpend.[43] To date, such programs have been limited but given the needs of this market, this feature will likely become more common.

This strategy offers some clear advantages. It will extend the lifetime value of the card, providing revenue benefits to issuers. At the same time, the creation of a more long-standing financial services relationship is especially relevant to the unbanked market as it moves them closer to the financial mainstream. Finally, for consumers generally, it offers the opportunity to integrate multiple payments, including other load sources, on a single card.

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[42] Jackson Hewitt, a tax preparation firm, recently announced the iPower CashCard, a payroll card distributed directly to consumers that expressly accommodates multiple employers and is designed to be retained as users change jobs. However, this product is expensive and is marketed only to Jackson Hewitt customers, limiting its impact. See, "Tax Preparers Use Debit Experiences to Fine Tune Their Prepaid Initiatives," *ATM & Debit News*, October, 12 2006.

[43] http://www.greendotcorp.com/products.htm; https://www.netspend.com/corp.shtml

Making Reloadability Easier

A related and fundamental feature of the general-use prepaid category, reloadability, is seen as the key to turning prepaid cards into a genuinely useful financial product. With recent announcements from Visa, MasterCard, and Discover promising to potentially open up their respective merchant networks to reloading, prepaid cards may finally be close to fulfilling their promise.

Essentially, each of these approaches offers the holder of a branded reloadable card the ability to add monetary value by presenting the card and funds at the checkout counter. The participating merchant would then transmit the card load amount to its acquiring bank, which in turn routes it to the card-issuing bank for approval. The card issuer is able to approve the transaction in real time, and the cardholder gets the card back with immediate access to loaded funds.

This section will summarize several recently announced reloading options and conclude by summarizing the importance of this feature to the success of prepaid cards.

- Green Dot Corporation, a Monrovia, CA, payments company was a pioneer in facilitating reloading.[44] The company's Green Dot Financial Network features more than 50,000 merchant locations where cardholders can put new value on their MasterCard- or Visa-branded general-use cards. Its primary focus has been the unbanked and underserved market, providing it a heightened sensitivity to the particular needs and psychographics of that segment. More recently, Green Dot has teamed up with Discover to distribute the Discover-branded prepaid card product through its network. .[45]
- Visa completed its "ReadyLink" reloading system infrastructure in March 2006. It has entered into a partnership with Blackhawk Marketing Service, a prepaid card subsidiary

[44] See http://www.greendotcorp.com/
[45] "Discover Launches Reloadable Prepaid Cards," *Cardline*, January 5, 2007.

of Safeway Stores, Inc. This collaboration gives Visa access to the 1,550 Safeway stores, and potentially far more, as Blackhawk handles prepaid card marketing for 100 other merchants as well.[46]

- MasterCard has announced a similar arrangement. Teaming with Interactive Communications International (InComm), MasterCard has developed the "rePower Prepaid Load Network," which will allow users to add funds to any MasterCard- or Maestro-branded prepaid product at potentially any of 145,000 retail locations where InComm sells its prepaid cards.[47]
- Metavante Corporation, the technology and card processing concern, will be the first third-party processor to introduce a reload network. While it has limited acceptance so far, with slightly more than 1,500 merchant locations participating, Metavante's sophisticated technology allows it to let cardholders add funds to payroll and benefit cards, in addition to general-spend cards.[48] This additional capability may point to increased convergence between these separate prepaid applications, suggesting that future products may be even more flexible and have enhanced functionality.

The ability to include a reloading feature has evolved and matured markedly since Green Dot first started offering reloading capabilities on MasterCard- or Visa-branded prepaid products in 2001. Today, with Green Dot still servicing a network that has 50,000 locations, and with Visa, MasterCard, then Discover and Metavante, in rapid succession jumping into the fray over the past year, it is clear that major players consider this an important area of future growth.

Reloading offers benefits to each of the stakeholders in the prepaid marketplace. Merchants who join these systems need not make additional investment in technology beyond

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[46] H. Michael Jalili, "Block Switches Its Prepaid Cards to MC," *American Banker*, December 20, 2006.
[47] News Release, "MasterCard Launches the MasterCard rePower Prepaid Load Network," December 19, 2006.
[48] H. Michael Jalili, "Discover Enters Reloading Fray with Green Dot Deal," *American* Banker, January 4, 2007.

their existing POS terminals. But they may benefit from increased customer traffic and may share in reload fees. They may also gain from potential loyalty effects: Cardholders may be motivated to visit a particular store more frequently, and at the same time, a merchant can target specific customers with better-tailored promotions. Related benefits for merchants include sales lift and the increased traffic flow generated by customers seeking to purchase or reload a prepaid card.

Issuing banks benefit from an opportunity to increase and extend customer relationships. Customers, for whom the practical aspects of reloading cards has remained an impediment to sustained usage, will benefit, since they will one day be able to, in theory, reload their branded prepaid card any of the more than 6 million U.S. locations where branded cards are accepted. The increased convenience can make these cards more attractive to a range of potential new users and more attractive to each of the stakeholders.

At the same time, with multiple providers competing, consumers may ultimately begin to see increased savings as this service becomes genuinely competitive. With reload fees coming down and many thousands more reload locations coming online, easier reloadability could be instrumental in enabling prepaid cards to assume a more prominent role in consumer finance.

Building Savings, Borrowing, and Credit Building Features: The Unbanked Market

While enhancements to payroll cards and expanded reloadability can improve the economics and usability for both banked and unbanked users of general-use prepaid cards, other features and services could have even more direct applicability to the unbanked. Some issuers and sponsors have experimented with savings and credit building, two applications that when added to a general-use card may further improve the value proposition to unbanked populations. A card that is easily reloadable, is widely accepted at the point of sale and at ATMs, provides bill payment capabilities, includes a savings option, and may help the user gain access to credit begins to look more like an alternative to a conventional banking relationship.

NetSpend, one of the earlier general-spend reloadable sponsors, was among the first to offer a savings option. It has partnered with the Financial Service Centers of America to provide its “All-Access National Savings Program” offering 0.75 percent annual interest on savings funds. So far 35,000 such accounts are operational, with an average balance of $131 — not a large number, but significant in that it represents genuine savings by a population that has traditionally found it very difficult to do so.[49]

NetSpend’s is not the only initiative in this area. The Center for Community Change, a national nonprofit organization attending to the needs of low-income and migrant workers, in conjunction with the Center for Financial Services Innovation, is piloting a program to provide a savings option associated with a reloadable general-use prepaid card. If this initiative is successful, it is envisioned that other services, such as remittances, bill payment, and possibly even small loans and mortgages, could be introduced in this manner.[50]

Aside from their obvious benefits to cardholders, such programs also suggest potential benefits to card issuers or sponsors, which may further strengthen the business case. NetSpend reports that the savings program has increased the amount of time that funds are loaded and active by 50 percent. This “stickiness,” in conjunction with reloadability, is valuable in making prepaid cards a bona fide substitute banking product. Maintaining a relationship with a single prepaid provider allows consumers to build up a richer, more robust payment and transaction history, which, in turn, can make it easier for the provider to offer more value-added services.

Credit building is an application further away from implementation but with similarly important implications. For unbanked consumers, for whom credit may be unavailable or prohibitively expensive, general-use cards may serve as a stepping-stone to building a credit history — an indispensable step toward economical access to credit. Traditionally, credit bureaus have incorporated data, including revolving and installment credit balances and repayment track

[49] Nadia Oehlsen, “A Banking Play for the Underbanked,” *Cards & Payments*, August 1, 2006.
[50] Jennifer Tescher, “Viewpoint: Reaching Client Groups via Social Bonds,” *American Banker*, April 28, 2006.

records, as a way to formulate a credit score. Prepaid cards don't present that sort of information, but some issuers and credit reporting agencies believe they can also be used to this end. Agencies have been developing the ability to correlate certain types of purchases and behaviors, inferable from transactional records, with fiscal responsibility. While this is an emerging technique and data and reporting problems remain, growing interest in this area suggests that such analysis may become more viable.

Finally, leveraging the information they've accumulated about users' transaction behavior, some issuers and sponsors may one day be able to offer a line of credit, completing the transition to full participation in the financial mainstream. Some have already taken steps in this direction. For instance, according to NetSpend president Roy Sosa, the firm will use data analysis tools to analyze spending and load patterns. In instances when a consumer may attempt to pay a bill but be some degree short, the company may extend "float" to allow the bill to go through, if it expects a regular reloading transaction to occur shortly.[51]

Such creative solutions to the lingering gaps in the business model bode well for the continued success of general-use prepaid cards. Reloadability is a start, and when it is combined with savings and credit building capabilities, these products truly can be seen as a bridge to the financial mainstream or even as a legitimate stand-alone financial product.

Conclusion

Prepaid cards are an increasingly important consumer financial product. While still in their early days of development, a number of emerging general-use prepaid card products seem to hold special promise as a platform on which to build value-added financial services.

Over the past decade, the number of applications built around the general-use prepaid card model has grown steadily. The product's flexibility, unique risk profile, and broad reach allow for the provision of a number of bank-like payment features outside traditional banking

[51] Nadia Oehlsen, "A Banking Play for the Underbanked," *Cards & Payments*, August 1, 2006.

account relationships. But along with the increased flexibility and advanced functionality come higher costs. Program administration, complex processing requirements, card network fees, and the additional expenses associated with more complicated distribution and reloading channels combine to create a "cost hurdle" that must be overcome in creating an economically viable business model. In a sense, this challenge may be characterized as identifying problems where prepaid cards provide cost-effective or high-value solutions.

While cost is a challenge, this paper argues that this hurdle can be overcome. At this stage in the evolution of the general-use prepaid business, we observe two models where successful applications are emerging: (1) applications that serve to replace relatively high-cost alternatives with more efficient and consumer-friendly solutions. Examples discussed in this paper include payroll applications where the existing paper-based payment method is both especially costly for providers and cumbersome for consumers. And (2) emerging applications to provide integrated or "bundled" financial services solutions to replace piecemeal and costly alternatives for unbanked and underserved consumers. While the solutions for the unbanked also depend on achieving cost efficiencies like those observed in the purer product categories such as HSA/medical payments, their potential to create a new business model to deliver financial services offer more than cost displacement.

Still, gaps remain and there is more to be done by multiple stakeholders as this payment innovation evolves and matures. Initiatives are already underway to address the various challenges and bring general-use prepaid products closer to fulfilling their promise. Card providers are designing means to extend the length of the customer-issuer relationship while increasing the range and scope of priced features and services associated with the cards. Among these strategies are broader, more flexible reloading options, payroll card portability, and in general, strategies directed at better integrating the financial services functions needed by unbanked consumers onto a single card-based product. As industry participants develop these features and incorporate and refine other innovations, general-use prepaid cards move closer to achieving their potential as a transformational financial services product.