VIEWPOINT

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2018 Outlook: Prepaid

Regulation will be one of many concerns in the coming year.

The results of the 2016 U.S. elections may have led many in the prepaid payments industry to think that their regulatory concerns were at an end, but a more likely consequence is that companies will need to deal with shifting regulations for at least the next two years. Technological change and economic factors will also influence the outlook.

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What to Expect in 2018

As 2017 comes to a close and 2018 approaches, it is time to look at factors that are likely to affect the open- and closed-loop prepaid debit card markets in the United States.

Prepaid debit cards are a financial tool used to move money in a number of segments within the U.S. economy. Most consumers recognize prepaid debit cards as “gift cards” or as a “reloadable” form of payment, formally known as general purpose reloadable (GPR) prepaid cards.

Factors that will affect prepaid debit cards in 2018 are as follows:

- Regulations and law changes
- Technology advancements
- Economic conditions
- Political forces in play

The Bane of the Prepaid Industry’s Existence: Never-Ending Legal and Regulatory Uncertainty

As we turn the page from 2017 to 2018, the regulations that were to be implemented in 2017 have once again been delayed, prolonging uncertainty as to the requirements for which the industry will need to prepare and when they will be taken effect. The proposed regulations are broader than the current prepaid debit card definition, which means that additional products may fall under the regulations of the Consumer Financial Protection Bureau (CFPB), namely mobile wallets and person-to-person (P2P) payments like Venmo and Zelle. The CFPB postponed the prepaid regulation’s start date from October 1, 2017 to April 1, 2018. At the same time the Bureau sought additional comment on a few topics, so it is highly likely that the start date will be delayed even further. Add to this the political turmoil afflicting the CFPB (more below), and It may well be October 1, 2018 or even April 1, 2019 before everything is resolved.

Also, the Office of the Comptroller of the Currency (OCC) is weighing whether nonbanks should be allowed to obtain a special purpose national bank charter.[i] The stated intention is to bring nonbanks, in particular financial technology providers, or fintechs, under the same sort of regulatory supervision that is imposed on federally-chartered national banks while preserving their ability to innovate. This has raised fears and opposition among state regulators, who are worried about losing their ability to protect consumers, and among national banks, who fear increased competition. The fight has echoes of the controversy over industrial banks.

An industrial bank is a state-chartered bank whose deposits are insured by the Federal Deposit Insurance Corporation (FDIC) but are exempt from the Bank Holding Company Act, which means that industrial charter banks are not subject to many of the laws and requirements governing community banks. We saw an attempt by a nonbank to obtain an industrial charter many years ago when Walmart attempted to become a bank. Today we are seeing companies like SoFi and Square endeavor to achieve that status, and others like Amazon and PayPal may follow suit. If some of these entities are allowed into the financial services industry without the same rules as the current prepaid bank issuers, there will no longer be a level playing field and 2018 could prove to be a difficult year for the both chartered and industrial chartered bank institutions.

And it doesn't stop there. This environment is further complicated by "The Financial Choice Act," which would repeal most of the Dodd-Frank Act and strip the majority of the CFPB's power to impose fees as well as bring its structure in line with most government agencies with regard to budgeting and appointments. This places the prepaid players in a difficult situation. They have to determine how to start to implement the proposed changes knowing they might still change. This entails spending countless hours in programming or preparing and preprinting disclosures or even having new card stock and packaging that will adhere to the law. Think of all the cards on J-hooks in retail stores that will need to be replaced depending on the final law and its implementation date. This would include creating, printing, and procuring new cards for display and sale to the end consumer. Having to destroy and replace the current inventory would cost the issuer a substantial amount—hence the desire to make only changes that will be permanent.

Another area in the regulation that is up for change is overdraft protection rules on general purpose reloadable, or GPR, cards. The CFPB is reconsidering its initial position, and this could change the prepaid card industry's product offerings and its revenue-generating ability.

Last, there are concerns that if the industry makes changes and then additional changes are made to the proposed regulation the industry could be in violation of UDAAP, the Unfair, Deceptive, or Abusive Acts or Practices regulation. Many players in the industry have already been fined for UDAAP violations and certainly would not want to place themselves in that position purposely.

Mercator Advisory Group's suggestions: Create and be prepared for the required disclosures to be fully implemented (this will most likely happen); know your plan for programming changes that will be required (e.g., calculation of the top five fees charged each year, calculation of month-to-date and year-to-date fees on statements). If you offer overdraft protection or want to offer overdraft protection as a new function, wait. This portion of the law is highly controversial.

Technology Will Bring Change, Uncertainty, and Risk

Technology has been changing and will continue to do so at a rapid pace. In the last five years we have seen continued integration between companies and their technology providers via application programming interfaces (APIs), which make it easier for banks and other financial institutions to integrate financial technology provided by with fintech firms. Information passed between firms is documented and passed electronically in real time rather than via spreadsheets or batch upload or SQL strings. APIs have made it easier for companies to move from a one-size-fits-all program to programs that can be customized for specific clients without recreating the entire program.

In other words, customization and personalization are much easier in an API environment than in a legacy financial system.

Consider the influence of smartphone advancements on financial services and other industries. Smartphones have been in existence for a little more than 10 years and have become progressively smarter and more entwined in our lives. The advent of apps, fingerprint identification, the ability to upload photos and document scans with a phone, the ability to send money, and now biometric user authentication bring new concerns and risks. For example, Apple's new Face ID facial recognition system has already raised questions as to whether this new technology is reliable enough for authentication of the user for financial services.

And these are just a few technology changes. Providers in the prepaid world have to ask what new opportunities are opened up by these change, and what new risks need to be considered. Clearly, there are new opportunities to reach the consumer and improve customer service. At the same time, there are new opportunities for fraudsters to abuse the financial system.

Economic Conditions: A Mixed Bag

As stated earlier in this document, economic conditions affect prepaid cards directly because prepaid usage is closely tied to the rise and fall of the economy. For example the unemployment rate for the nation is the lowest in 2017 that it has been in many years and is poised to stay that way for the next several years, reaching what the Federal Reserve terms "full employment."[1] When employment is high, fewer persons apply for unemployment benefits, nutritional assistance, or health care assistance, meaning the volume and number of prepaid cards in these segments will change. With a renewed focus on government efficiency and cost cutting, we can expect fewer prepaid cards in the government. And with the possibility of a tax cut, we can be optimistic regarding additional consumer spend, which translates into potentially higher balances on general purpose reloadable, or GPR, prepaid cards and additional discretionary income for items like gift cards.

Political Forces

Political ferment in the U.S. is at a peak, consuming most of the news cycle with near-daily conflict at all levels of government. The Financial Choice Act, which was to unwind much of the Dodd-Frank Act is stalled in the U.S. Senate. Richard Cordray has retired as director of the CFPB, leaving its ultimate direction uncertain. The president designated budget director Mick Mulvaney as interim director, but his right to appoint the director is disputed and may have to be decided by the court system as appeals take place. Once a new director is confirmed by the Senate, there will certainly be changes in the way the CFPB operates. Under the current president, deregulation

[1] "The Federal Reserve considers a base unemployment rate (the U-3 rate) of 5.0 to 5.2 percent as 'full employment' in the economy. The recovery has now achieved that level, known technically as the Non-Accelerating Inflation Rate of Unemployment, or NAIRU," according to Marketplace.org, Sep. 4, 2015.

has been a priority. So, we are looking at a revamped CFPB with new leadership and probably further delays and major changes to the new prepaid rules.

Predictions

Looking back at our 2017 Outlook predictions, Mercator Advisory Group was correct regarding the uncertainty surrounding the regulatory process, in particular those regulations proposed for implementation. Here we are a year later pretty much in the same position—hurry up and wait! Prepaid issuers will be closely following the drama at the CFPB as well as the fate of the Financial Choice Act. Traditional firms will need to develop a strategy for cooperating with and/or competing with fintechs, possibly involving the construction of open APIs and developer portals. Prepaid issuers will also have to contend with new fraud threats opened up by new technology.

However, there are some bright spots related to prepaid debit card performance in 2018 for both open and closed-loop. There are a few new breakout segments as the players in the market continue to use their creativity and advances in technology to further additional uses, as represented by the 10% predicted compound annual growth rate (CAGR) increase in the Tolls segment of Prepaid and a 12% predicted CAGR increase in Prepaid Mobile Minutes and Data. The open-loop FSA/HSA Tax Deferred Programs segment is also predicted to have continued growth as it has benefited from the trend toward high-deductible health care plans paired with Health Savings Accounts. Finally, expect prepaid card volume to decrease but total dollar loads on prepaid cards to increase due to consolidation of major players.

Endnotes

[i] https://www.occ.gov/topics/responsible-innovation/comments/special-purpose-national-bank-charters-for-fintech.pdf

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