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OPEN-LOOP PREPAID CARD MANAGEMENT: STRATEGIES TO TAKE ADVANTAGE OF THE INDUSTRY'S INFLECTION POINT

As the industry matures, prepaid card issuers need to be certain their business is properly positioned.

The open-loop prepaid industry in the U.S. has hit an inflection point in 2017. In this ForeSight report, Mercator Advisory Group presents strategies for prepaid providers to find new opportunities and make their current programs competitive.

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Introduction

The prepaid card industry is at an inflection point where the traditional markets have matured, the industry is consolidating, and new markets will need to be found for future growth.

Prepaid card providers have found that the traditional model of prepaid cards as a transaction tool with the guarantee of good funds is changing. And as momentum builds around industry consolidation and change, the fundamentals of the prepaid industry must be reviewed by providers large and small. Here are some facts to consider:

- Green Dot Corporation's acquisition of UniRush LLC absorbed the last independent prepaid program manager of significant size into a larger financial services organization. This was the culmination of a larger trend of prepaid being placed within the context of suites of financial services.
- Closed-loop prepaid cards are not immune from this trend. Gift cards have evolved from being the plastic replacement of paper gift certificates into branded currencies that play a role in marketing and loyalty programs, mobile payments, and cost management programs.
- Financial services providers are looking to prepaid as a way to add instant payments capabilities with good funds to other financial products such as expense management tools. New opportunities will be developing in companion cards, commercial cards, and the internet of things.
- Technology will continue to be an important driver of success in prepaid programs in terms of both customer-facing technology and back-office tools that allow providers to gain insights and protect customer information.

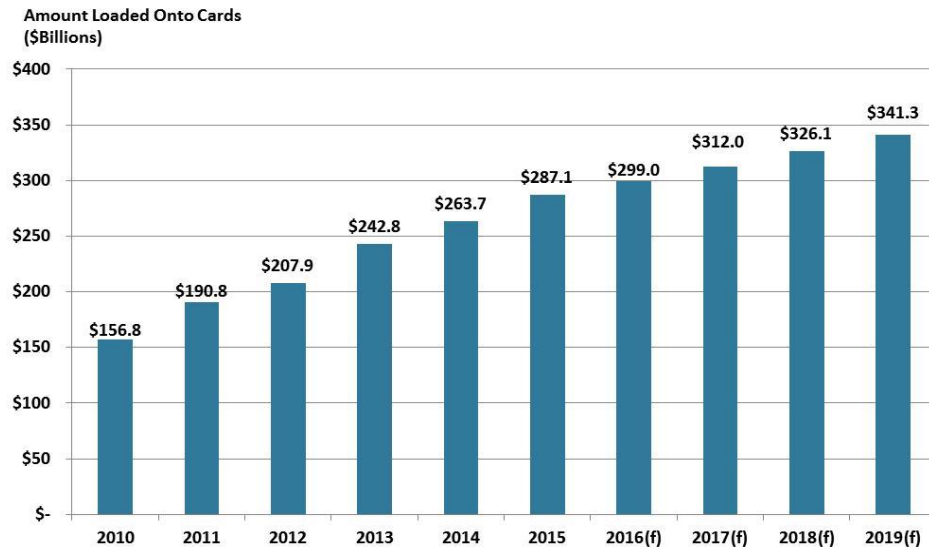
As it stands today, the U.S. prepaid card business is in relatively good health when measured by growth and total loads, but be advised that complacency is not in order. Mercator Advisory Group believes that the industry must focus on the fundamental value proposition of prepaid cards, with an emphasis on providing service to existing customer groups, identifying ways to use new technology to enhance prepaid cards, and focusing on applying that value proposition to new business cases. This ForeSight report outlines Mercator's view of the prepaid card industry continuum, discusses the value chain, and suggests a set of action items for prepaid providers.

The Prepaid Business Today

Growth Remains Healthy, but the Industry Is Maturing

U.S. open-loop prepaid card loads will surpass \$300 billion in 2017. Despite regulatory and public relations headwinds, the prepaid market continues to provide valuable transactions tools to individuals, businesses, and government agencies. The continued growth of the network-branded prepaid market as a whole reflects its diversity and staying power in the larger payments context. Figure 1 shows Mercator Advisory Group's projections of total loads in the U.S. open-loop prepaid market through 2019.

Figure 1: U.S. Open-Loop Prepaid Loads, 2010–2019(F)



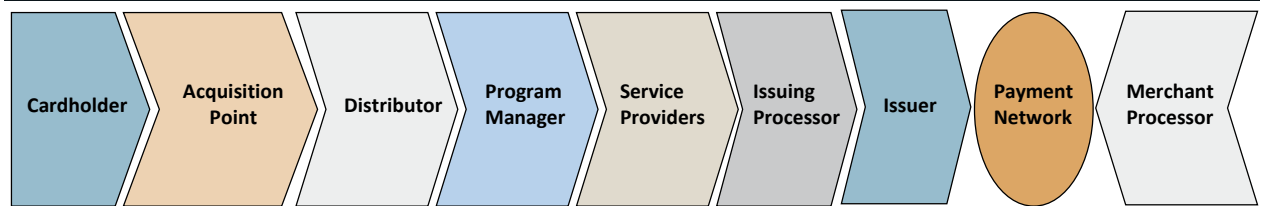
Source: Mercator Advisory Group

The growth of the market has been affected by a variety of factors. Federal and state government agencies have found prepaid cards to be a useful tool for eliminating paper checks, a goal that was codified into federal law in 1996. The federal government launched the Direct Express prepaid program in 2008 for Social Security payments, and electronic benefits transfer for the Supplemental Nutrition Assistance Program has been in all 50 states since 2004, with other programs such as Women, Infants, and Children (WIC) nutritional assistance and Temporary Assistance for Needy Families (TANF) rolling out across the country. On the corporate side, companies have used prepaid cards for payroll and incentives and recently have been paying more attention to prepaid cards for purposes like expense management. Consumers have also seen new products come to market from banks like Chase, PNC, and Regions. However, as the industry has grown and matured, it has also changed.

Industry Maturity Affects the Value Chain

Continued growth of prepaid business has led to consolidation and maturity. Prepaid card programs have had complex value chains that have put pressure on the margins of programs because a variety of companies need to share the revenue in order to make a prepaid card program function. Figure 2 shows the prepaid value chain.

Figure 2: The Prepaid Card Value Chain Can Put Pressure on Margins



Source: Mercator Advisory Group

Prepaid card companies have sought to create more vertically integrated value chains, but few have achieved complete integration. American Express was able to create a vertically integrated prepaid value chain with its Serve platform that provided most of the functions identified in Figure 1. Green Dot Corporation worked to create a vertically integrated value chain through its purchase of a bank, and many larger banks have become the issuers and program managers of their own card programs to reach new customer markets. But integration efforts have been tough to achieve for many players. The alternative has become integrating prepaid cards into a broader suites of products, and even some of the companies that have been successful with integrating their value chains have taken this approach as the next stage of their evolution.

The Focus Is Context

Open-Loop Prepaid Takes Its Place in Financial Product Suites

Banks and other financial services providers' products are taking their place in financial product suites. Rather than using prepaid as a stand-alone transactional tool, banks, credit unions, and other financial services companies are using prepaid as an anchor for other kinds of products or product suites. In addition, traditional prepaid companies have expanded their focus to include other types of products and services with their prepaid offerings.

One example of a company taking this approach is Green Dot Corporation, which bought a bank and has become a bank holding company that offers debit accounts and prepaid cards under its own brand and others. Green Dot has consistently expanded its product offering and its capabilities, moving from program manager to full bank holding company. It likely will add new banking products as time goes on using the full capacities of its bank charters.

Other companies have taken similar approaches. Tax preparation company H&R Block launched a prepaid card to help its customers receive tax refunds and loan proceeds. The Emerald card is an important part of its product suite and had more than \$7.7 billion in loads in fiscal year 2016.

Related Concerns

If you find this piece of interest and would like to explore this issue further, possible proprietary project work could be done to examine questions like these:

Which new segments and markets can provide your program with a new competitive niche?

How can you evaluate your current business to identify your next strategic move?

What are the most profitable strategies for you to capitalize on the current environment?

How can you best invest in infrastructure and technology to make your program competitive?

Let Mercator Advisory Group help your company become better positioned in the market.

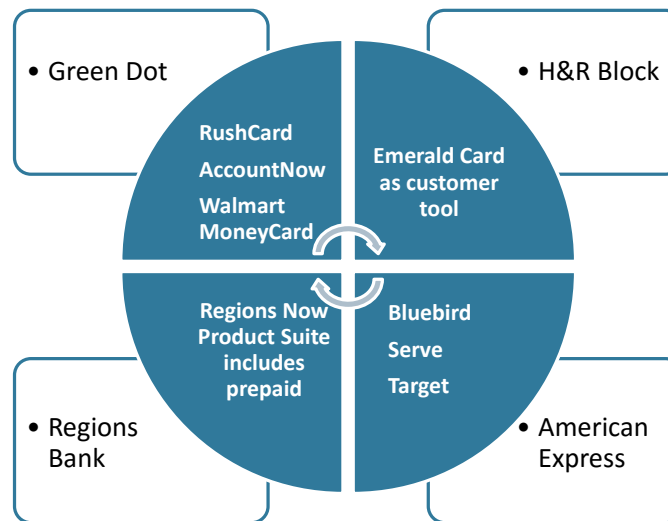
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Figure 3 shows other examples of how open-loop prepaid cards have been integrated into larger product suites.

Figure 3: Open-Loop Prepaid Cards Are Part of Financial Product Portfolio Management



Source: Mercator Advisory Group

On the closed-loop side, issuers have been working to integrate their prepaid cards into larger marketing plans and mobile payments in order to better engage customers and control payments costs. Perhaps the strongest example is Starbucks Coffee Company, which made its prepaid card the centerpiece of its Starbuck Rewards Program and mobile payments app. The company had \$6 billion of revenue come in through prepaid cards in fiscal year 2016, which was 38% of its total revenue, the company said in an investor presentation.ⁱ

Other companies are looking for ways to duplicate Starbucks' success, but for those companies with larger average tickets and fewer visits per customer, prepaid cards are not an obvious replacement for other payment types. They are still working through how to make prepaid cards more than just a digital version of the paper gift certificate. Incentives programs will be an important part of this, but issuers will need to think about how to reposition prepaid cards in the context of other sales and marketing tools like discounting and brand awareness. Opportunities may exist for retailers to offer other benefits for prepaid card holders such as connections to special deals, shopping events, or even content relevant to customers' interests.

Taking Action

To take advantage of the inflection point where the prepaid industry finds itself now, prepaid providers need to remind themselves of the distinguishing characteristics of prepaid cards and understand the value proposition.

The Distinguishing Characteristics of Prepaid

1. A card, password, or other device or authorization process provides access to a pooled account holding funds.
2. The device or password or authorization process is the only means of routine access to the account holding said funds.
3. The account balance is decremented based on the value of a payment or based on metered usage of a finite resource.

Prepaid accounts provide access to a dedicated pool of funds that does not require a line of credit or account ownership by individuals. These funds are guaranteed to be good and can provide access for general payments or for very specific purposes in the case of closed-loop cards. This means that prepaid cards can provide a tool that can fit into a variety of contexts from account replacement to incentives to expense control, all while reducing risk. The key for prepaid providers is to figure out where their programs can fit into the payments landscape. Following are some observations on possibilities.

Reaching the Unbanked/Underbanked Market

Although the traditional prepaid target market of unbanked, underserved people using open-loop prepaid cards has matured, opportunities still exist in this market. The Federal Deposit Insurance Corporation's 2015 National Survey of Unbanked and Underbanked Households finds that a large number of households still are not using prepaid cards. Table 1 shows there are more than 5 million unbanked households who might be able to use prepaid cards.

Table 1: The Continuing Unbanked Opportunity for Prepaid Cards

Statistic	FDIC Estimate, 2015
Total number of households in the United States	127,538,000
Percentage of households that are unbanked	7%
Number of unbanked households in the U.S.	8,969,000
Percentage of unbanked households using GPR prepaid cards	27.1%
Number of unbanked households using GPR	2,430,599
Percentage of unbanked NOT using prepaid	64.3%
Number of unbanked households not using prepaid —the near-term market opportunity for prepaid programs	5,767,067

Note: It was unknown whether or not 8.6% of unbanked household used prepaid cards.

Source: 2015 FDIC National Survey of Unbanked and Underbanked Households

These unbanked households have no doubt heard about prepaid cards and may even have used a prepaid card at some point. While the opportunity exists to sell prepaid cards to these people, the value proposition will have to be calibrated to meet their needs. The households need cards that provide features and functions beyond just the ability to take deposits and make transactions. Identifying additional features and functions, such as remote deposit capture, personal financial management tools, or access to large enough networks of surcharge-free ATMs will be critical to the successful execution of a program that targets the traditional unbanked/underbanked market.

Near-Term, New-Market Opportunities

Near-term, new-market opportunities for prepaid cards will come from all three major sectors (direct-to-consumer, commercial, and government programs) and from the development of new technologies that will require payments.

Direct-to-Consumer

In the direct-to-consumer space, prepaid cards will provide tools for consumers who want to manage their budgets and protect their privacy or isolate funds from other payment accounts. As online card-not-present fraud grows, hacks get larger, and identity theft continues, some shoppers will want to limit their exposure. Although consumers know that zero-liability policies limit their financial losses in the event of a hack, they still don't like the feeling that their accounts have been taken by a criminal. In addition, while they can avoid paying for a fraudulent transaction, they still must go through the process of closing one account and opening a new one, getting a new card, and making sure the attack was limited to one transaction. Prepaid cards—both physical and virtual—can provide ways to limit a shopper's exposure.

Prepaid also can provide a way to limit an issuers' exposure in the event of a hack, since only the funds on the card are at risk and not an entire credit line or deposit account. While there are still problems of merchant acceptance of prepaid online such as being able to do split tender transactions with more than one form of open-loop payment, prepaid may provide one way to manage risk in the new fraud environment while cross-selling a new companion card to existing account holders.

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Commercial

In the same way that prepaid can be used to limit risk on the consumer side, it can be used to limit risk on the commercial side. Companies that want to provide funds for employees or contractors without extending credit or granting access to company accounts can make use of prepaid cards to do so. They also can attach those cards to record-keeping systems, and in some cases even filter where those cards can be used.

Government

Government programs also will find uses for prepaid cards in the future. Many government benefits programs still issue checks, and converting them to electronic payments likely will involve prepaid cards because of the ease of issuing the cards and the ability to control spend while providing good funds. The use of prepaid cards will continue to grow in this category as cards are put to use for things like distributing benefits, and for government-sponsored programs like transit and tolls where guaranteed good funds are strongly desired.

New Technology

New technology will also open opportunities for prepaid programs. They led the way and continue to dominate mobile payments, especially on the open-loop side. Prepaid will find a place in the internet of things and a possible resurgence of wearables.

Currently, connected devices that make payments operate on a prepaid basis. Connected devices like toll transponders and smart utility meters can be connected to credit and debit account, but they rely on those accounts for continuous reloading. It is likely that smart vehicles and smart appliances will also use prepaid cards as a way to limit exposure for both the users and the merchants.

Wearable devices have also drawn renewed interest from the payments industry. The most successful wearable payments seem to operate in specific contexts. The Disney Magic Band, for instance, shows how wearable payments can provide a tool that enables access, payments, and other services all through one device. Mercator Advisory Group believes that wearables will succeed in specific contexts but general purpose wearable payments devices will probably be rather limited.

Evaluating New Opportunities

Evaluating new opportunities requires understanding prepaid in the large context of payment options available to potential customers. Possible opportunities can be sorted into four large categories.

1. Can my prepaid program provide new value to the traditional markets of the unbanked/underserved?
2. Can my prepaid program serve as the transactional tool of a product designed to solve a problem for consumers, businesses, or government (security, budgeting, record keeping, etc.)?
3. Can my prepaid program provide a low-risk way to implement payments as part of a new technology such as the internet of things or wearable technology?

4. Can my program provide an omnichannel user experience that offers mobile tools, virtual cards and payments, and distribution across all channels that the customer uses to spend or receive funds?

By understanding the fundamental value proposition of prepaid, working with the many partners along the value chain, and paying attention to the lessons of customers and the market, prepaid card providers can find new ways to deliver profitable programs.

Conclusions

The U.S. prepaid card business continues to move forward in a growth mode, but the future growth will come from new kinds of business that are complementary to what got the industry to where it is today. So, while the unbanked and underserved market will continue to be an important one for prepaid cards, so will new markets such as companion cards, mobile wallets, the internet of things, and other fintech developments. Prepaid providers must position their products within large suites of financial services to take advantage of revenue opportunities and react in a changing world. The strategies outlined in this Mercator Advisory Group ForeSight report are offered as a practical guide.

Endnote

ⁱ http://s21.q4cdn.com/369030626/files/doc_downloads/presentations/SID16_1206_MattR_GerriMF.pdf



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