

The Race is On in Prepaid

Key issues for prepaid cards becoming clearer

By Mark Beresford and Steve Karp
Edgar, Dunn, & Company

Mark Beresford,
Engagement Manager
Edgar, Dunn, & Company

Mark has over 18 years consulting experience in the financial services industry and over 10 years in the payments sector. Based in the London office, he is a Client Engagement Manager where he applies his consulting and program management skills to a variety of clients based across Europe. Mark has considerable experience of leading large and complex change programs involving extensive dealings with global financial institutions. He has a track record in business strategy, process and back office improvement and deep expertise in the application of new technologies to introduce new payment products and services.

Steve Karp,
Engagement Manager
Edgar, Dunn, & Company

Steve has 15 years of management consulting and investment banking experience, including more than 10 years of consulting and operating experience in the electronic funds transfer, transaction processing, credit card issuing, and retail banking delivery industries. His areas of expertise include strategic planning, new product development and market analysis, financial modeling and analysis, operational benchmarking and re-engineering, and strategic partnership formation and execution. Steve serves clients across all sectors of the consumer payments industry, including credit and stored value card issuers, transaction processing companies, full-service retail financial institutions, and ATM deployers.

The prepaid card market feels like the early stages of a marathon, with many entrants testing their strength and jockeying for position. With a field of proven stars and aggressive upstarts, it's much too early to predict which competitors can pull away from the pack to earn dominant market share and consistent profitability. However, with each passing month, it becomes a bit clearer what's necessary to be a contender.

Prepaid cards are far from new. The Mondex stored value card, with its lofty goal of creating a cashless society, launched in the early 1990s. Fifteen years later, the prepaid industry is still looking up the steep end of the learning curve. However, the lessons are coming more rapidly as of late, shedding new light on what works and what's possible. While no prepaid product has reached any significant level of dominance, important incremental victories are being won. Likewise, enough prepaid products have misfired at this point that we can see some lessons in the experiences of the non-starters.

Here's a quick look at what we know so far, and what it means for the future.

Customer segmentation trumps general purpose cards. We have yet to see general purpose prepaid cards reach any broad, global level of success (although this market has grown significantly in the United States over the past 2-3 years, with Green Dot and NetSpend among the early market leaders). Without targeting a specific audience, the issuer must rely on unfocused, least common denominator benefits – marketing the card as a replacement for cash, credit, debit, or cheques.

On the other hand, with products targeted at specific customer segments, issuers can build a prepaid product that speaks to the needs and interests of an identified population, such as teenagers, travellers, the unbanked, or loyal patrons of a major retailer. For instance, an online merchant offering music or ring-tone downloads could accept MasterCard and Visa prepaid cards from teenagers not old enough to have their own bank accounts or credit cards. Such solutions, targeted to specific market segments, are easier to market, and more likely to take root.

Market segmentation can stimulate adoption levels and open the door to profitability. But it's important to note that simply targeting a specific market is not enough – the offer must either fill an unmet need or out-

Issuers can build a prepaid product that speaks to the needs and interests of an identified population, such as teenagers, travellers, the unbanked, or loyal patrons of a major retailer.

Broadening the consumer relationship is essential, given the challenging economics of operating a prepaid program.

perform existing options. Proving this point, American Express recently announced it was discontinuing its prepaid card version of travelers cheques. Travelers, it turned out, saw limited compelling benefit for the card over the company's century-old paper cheque format and over other alternatives available in the marketplace. American Express had previously discontinued its prepaid healthcare card, another targeted product that failed to gain traction.

A unique, desirable value proposition is critical. Regardless of segment, a prepaid card product must provide real value to attract consumer interest. It must solve a problem in the user's financial life that cannot be solved more easily or cheaply through existing alternatives. A compelling and straightforward value proposition is a must.

Recent product developments in the United States point toward a range of unique value propositions. For some consumers, prepaid affinity cards (e.g., NetSpend's Vince Young All-Access Visa Prepaid Card or RushCard's Baby Phat Visa Prepaid Card) create a desirable connection to icons of sports, entertainment or fashion. Others seek the financial and perceived benefits of programs like Green Dot's "Premier" card, which has reduced fees, higher balance limits, priority customer service, and other differentiating features. Innovative issuers are crafting entirely new card functionality, such as: savings accounts (e.g., NetSpend offers a card with an interest-bearing savings account); overdraft protection and short-term lending (e.g., Revel Prepaid MasterCard); and the ability for the cardholder to build a positive credit history (e.g., Account Now's Vantage Prepaid MasterCard).

Value propositions vary around the world. In the Asia Pacific region, for example, many prepaid offers target ease of use. Transit cards, such as Octopus in Hong Kong and a MasterCard *PayPass* program on Taiwan's Kaohsiung bus system, reduce cash handling and increase the speed of transactions. Other programs in the region target the unique needs of the unbanked, the youth market, and overseas workers wishing to send money home. As with the United Kingdom around three years ago and the United States five years ago, Australia is very much in the initial stages of the prepaid evolution, with merchant gift cards the most popular prepaid programs.

These focused programs not only benefit consumers; they also have the potential to lengthen and strengthen the relationship between the issuer, the third party distribution network or merchant, and the cardholder, all while generating recurring revenue. Broadening the consumer relationship is essential, given the challenging economics of operating a prepaid program.

Economies of scale demand vast distribution channels. Prepaid card programs involve considerable costs – both fixed and variable – to build and operate. Consumers ultimately bear these costs. So, to create an affordable prepaid offering, high adoption is critical; 300,000-500,000 active cardholders seems to be the threshold where economies of scale begin to facilitate pricing structures that are both affordable for cardholders and profitable for issuers. Lacking this critical mass, issuers and program managers must charge cardholder fees that are, at some level, suppressing adoption and usage rates.

Furthermore, given the relative lack of financial sophistication of the average prepaid card customer, participants in all components of the industry value chain (card issuers, program managers, card networks, etc.) recognize the need for safe, secure, and comfortable environments where customers can purchase, reload, and use their prepaid cards.

These two distribution channel requirements – size and trust – are among the reasons that several promising prepaid offerings in Europe have come from postal services. Whereas the largest banks in the United Kingdom have approximately 2,500 to 3,500 branches, the United Kingdom postal service boasts 16,000 potential distribution points. Indeed, European post offices have a history of playing an important role in the provision of banking services. In France, La Poste is the main provider of basic bank accounts to people on low incomes. In Germany, Deutsche Postbank is one of the most important players in the underserved and unbanked market. And in Italy, Poste Italiane originally targeted the youth market with a prepaid card, but has quickly learned that the opportunity is greater for the underserved and unbanked customer segments. Likewise, tax preparer H&R Block, with 12,500 locations in the United States, has a foot in the door with millions of potential prepaid users, and an advantageous bricks and mortar distribution network for its Emerald Prepaid MasterCard (which can be loaded via a federal tax refund).

SERVING THE UNDERSERVED

When combined, all of the factors described above point to the same apparent conclusion: the prepaid card is most valuable and viable for the unbanked and others underserved by the products and services offered by traditional financial services organizations.

A prepaid card typically offers greater value – that is, solves more problems – for the unbanked than for consumers with wallets stuffed with credit cards, debit cards, cheques, and cash. As such, this population is more likely to accept the fees in order to have a card with the worldwide acceptance mark (e.g., MasterCard or Visa) for use in a vast array of financial transactions, from downloading music over the Internet or buying a sandwich to renting a car or transferring money to a family member in another country.

There are an estimated 150 million underserved and unbanked adults in Europe, and 65 million more in the United States (not to mention millions of “pre-banked” teens worldwide). Some, distrustful of or uncomfortable dealing with banks, have opted out voluntarily. Others, such as those lacking a suitable credit history, are simply left out. Either way, the un/underbanked population comprises a market segment that is huge and has clear, unmet financial needs. If there is a killer app for prepaid cards, it is most likely bringing the unbanked into the world of mainstream financial services.

EXPANDING THE BANKING BUSINESS MODEL

What types of institutions will serve the unbanked consumer? As mentioned, postal systems and non-bank financial service providers can fill some of the void. But banks want to be in the picture too. The challenge: many major banks sorely lack experience in attracting underserved or unbanked consumers. In fact, many financial institutions have historically built products and marketing campaigns that intentionally discouraged this low-end, high-risk segment. This approach must change if banks wish to compete for the unbanked market, and it is changing.

One of the first big corporate moves in this arena is the purchase of NetSpend, a top marketer of prepaid programs in the United States, by Capital One. This is not a simple diversification move. It is a means for Capital One to redirect consumers it declines for credit cards to an alternative – the prepaid card. So instead of turning away these individuals, Capital One will be able to extend “pre-credit” to millions of applicants. The company thereby generates prepaid fee income in the short term, and builds relationships with consumers who may later qualify for debit cards, credit cards or other services. NetSpend, in return, benefits from the marketing, segmentation, and distribution abilities of Capital One.

The prepaid card is most valuable and viable for the unbanked and others underserved by traditional financial services organizations.

Many banks have historically built products and marketing campaigns that intentionally discouraged the low-end, high-risk unbanked segment.

Wal-Mart's effort is touted by some as "the rising tide that can lift all boats", the high profile boost that prepaid needs.

In prepaid, the next few years will be just as exciting and interesting as the last few, with many changes in the future.

WATCHING WAL-MART

Other consumer-oriented organizations, outside the conventional financial services industry, want a piece of the unbanked market as well. Most notably, Wal-Mart, leveraging its existing relationship with a significant portion of these unbanked consumers, is launching MoneyCard, a co-branded Visa prepaid card in many of its locations in the United States. Wal-Mart's effort is touted by some as "the rising tide that can lift all boats", the high profile boost that prepaid needs. Much of the optimism around the effort is based on the idea that Wal-Mart is a trusted merchant for a consumer sector with limited positive experience with banks, and is known for value pricing. Therefore, the logic goes, Wal-Mart (and other non-financial institutions offering banking-related products and services) can succeed where big banks may flounder.

But does this logic hold true? To gain an early read into the prospects for the Wal-Mart MoneyCard, Edgar, Dunn & Company recently conducted a survey of 1,100 consumers. Some of the key findings include:

- Wal-Mart is viewed by the respondents as more trustworthy for "money and financial matters" than some traditional providers of services to the unbanked/underbanked (e.g., Ace Cash Express, MoneyGram), but not others (e.g., Western Union). And, it is viewed as far less trustworthy than financial institutions such as Bank of America and Wells Fargo.
- Of those respondents indicating a need for a prepaid debit card, 56% said they would be "likely" or "extremely likely" to purchase and use the Wal-Mart MoneyCard.

These survey results neither lend credence to industry pundits who have already proclaimed the Wal-Mart program a success (before it even launched!) nor do they portend doom for the effort. To us, it's just too early to tell.

MORE CHANGES AHEAD

For industry participants and observers, the next few years will be just as exciting and interesting as the last few, with many changes ahead. Products will be launched to serve new customer segments and/or provide new value propositions; prepaid solutions will have matured and diversified, and a significant number of fragmented suppliers will be offering different services across the entire value chain.

In addition to continued strong growth in the general purpose consumer prepaid category, increased activity in the government, private healthcare, and business segments will also spur industry growth. Governments, especially in the United States and across Europe, are increasingly deploying prepaid cards as a means of inexpensive distribution of social benefits. Businesses will increase their use of prepaid for petty cash, relocation expenses, bonuses, commissions, etc., and private sector healthcare players in the United States will continue to promote prepaid cards related to HSA and FSA accounts.

As in any immature sector, many players have their eye on profitability goals that only a few will achieve.

BY THE NUMBERS

In 2007, Edgar, Dunn & Company estimates that the prepaid debit card market in the United States alone will account for more than 7 billion transactions and \$175 billion in volume (in aggregate, across all product types and applications), with a 15%+ annual growth rate through 2010. The large majority of transaction growth in the U.S. will be driven within the general purpose reloadable prepaid card market segment (i.e., MasterCard or Visa-branded prepaid cards sold at retail locations and supported by companies such as Account Now, Green Dot, and NetSpend). This segment has grown at nearly 40% annually over the past few years.

Perhaps more importantly, the broader consumer awareness and perceptions of this market segment are moving in the right direction too. According to a recent consumer survey conducted by the Network Branded Prepaid Card Association, nearly 90% of those surveyed that had used a reloadable prepaid card “had a positive experience and found the cards useful.” In addition, overall awareness of reloadable prepaid cards came in at nearly 75%.

ELUSIVE PROFITABILITY

As in any immature sector, many players have their eye on profitability goals that only a few will achieve. Winners will be those parties that offer the right value proposition to the right consumer segment, via the right distribution mechanism (i.e., one that can achieve necessary economies of scale). On the cost side, issuers should pursue the creation of a prepaid infrastructure that will support a suite of prepaid products across multiple customer segments in order to reduce the overall cost per customer. European issuers have not yet achieved this. Robert Courtneidge, one of the Directors of the recently launched Prepaid International Forum (PIF), said “There are almost 80 live scheme-branded reloadable prepaid programmes across Europe and probably only one or two have reached a breakeven point in their business models.” The infrastructure is stronger in the United States, though available products have yet to foster full and long-term relationships with consumers.

And while the enormous underbanked segment offers impressive immediate opportunity, it is important to remember that the “banked” population is even larger – far too large to ignore. Issuers will continue to test niche applications in the banked segment, with emphasis on value propositions and new features/ services that allow higher price points, drive significant card activity, and foster greater profit potential. For example, issuers may position the prepaid card as a more effective family budget management tool than credit or debit alternatives. While it is too early to say with certainty how and when prepaid cards will penetrate the banked segment in a big way, it is a key area to watch.

EDGAR, DUNN & COMPANY AND THE PREPAID MARKET

At Edgar, Dunn & Company, we see vast opportunity in the evolving prepaid market. We have been working in this market on a range of assignments at both the industry and individual participant level, including market research and assessment, new product development, strategy reviews and development, and market segmentation. We are also active in surveying industry participants, gathering the insights of key players into the future of prepaid offerings.

If you would like more information about how we could help assess the opportunities in prepaid for your business, please contact Mark Beresford at +44-20-7220-0406 or mark.beresford@edgardunn.com, or Steve Karp at +1-404-881-5704 or steve.karp@edgardunn.com.

Contact Information:

contact@edgardunn.com

OFFICES

Atlanta

+1-404-879-0710

Frankfurt

+49-172-683-0008

London

+44-20-7283-1114

San Francisco

+1-415-977-1870

Sydney

+61-2-9279-2442

About Edgar, Dunn & Company

Edgar, Dunn & Company (EDC) is a global strategy consulting firm specializing in financial services. Founded in 1978, the firm is widely regarded as trusted advisors in the payments industry providing a full range of strategy consulting services, expertise and market insight through in-depth industry and consumer benchmarking including its proprietary data intelligence platform, PaymentDynamicsSM. Additional areas of expertise include new financial services channels, technologies and retail financial services.

EDC's offices are located in San Francisco, Atlanta, London, Frankfurt and Sydney, and serve clients in over 30 countries on six continents. More information can be found at www.edgardunn.com.