Demystifying Prepaid Cards:

An Opportunity for the Community Development Banking Institution Sector

A Report by the National Community Investment Fund

NCIF[SM] National Community Investment Fund

Leveraging Capital for Change[SM]

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NCIF Mission Statement

The National Community Investment Fund (NCIF) invests private capital in, and facilitates knowledge transfer to, depository institutions that increase access to financial services in underserved communities.

NCIF Lines of Business

"Equities with Exits" Investments

NCIF purchases common stock in individual Community Development Banking Institutions (CDBIs) as a patient investor. These institutions need to demonstrate sustainable, sound financial performance, a strong development impact in the communities they serve, and they must provide shareholder liquidity within a reasonable time frame. Additionally, NCIF makes seed fund loans, extends debt to banks and provides secondary capital to low-income credit unions.

CDBI Exchange Network

This informal peer-to-peer network of CEOs, CFOs and other participants in the CDBI industry provides best practices in risk management, valuation, corporate governance and development impact analysis. NCIF's Annual Development Banking Conference is the centerpiece of its knowledge transfer initiatives.

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NCIF encourages socially responsible investors to place deposits in community development banking institutions that are highly active in low income areas. By facilitating these new deposit investments, NCIF is stimulating additional lending capital to banks that will be provided to borrowers within low- and moderate- income communities.

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NCIF created a methodology for identifying and promoting depository institutions whose mission is to serve the financial needs of residents, entrepreneurs, and businesses in low- and moderate- income communities. For more information about the metrics and to utilize our searchable database that includes summary financial and social performance data on all domestic banks, please visit our website at www.ncif.org.

Fund Advisor

NCIF is advised by ShoreBank Corporation (www.shorebankcorp.com), the nation's first and leading community development financial institution.

For further information about NCIF please visit our website:

www.ncif.org

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In completing this experiment over the last 3 years and finalizing the report over the last 6 months several folks have generously contributed time and energy to help make the document user friendly and actionable.

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We reached out to industry experts to do a reality check on the information that we are publishing from different perspectives – John Badovinac, Senior Manager Marketing and Financial Institutions, and Harit Talwar, Executive Vice President-Card Programs and Chief Marketing Officer, from Discover Network, John Carey, Chief Administrative Officer, from Citi Cards, Katherine Yee, Prepaid Business Manager, and Kevin Rhein, Executive Vice President-Card Services and Consumer Lending, from Wells Fargo generously contributed their time in reviewing the final product. Neil Dugan, Senior Business Leader, from MasterCard Worldwide, took time to review the document and provide insight on the payments industry as a whole and where prepaid cards fit into the overall picture.

Similarly, Brud Baker, President and Chief Executive Officer, and Tania Warnock, Marketing Director, from Central National Bank & Trust of Enid and Mick Conlin, Senior Vice President-Agent Products, from Meta Payment Systems, gave their time and knowledge about the prepaid card industry. They also took the time to review the document and add provide helpful suggestions. Jennifer Kirby, Assistant V.P. Of Business Development and Marketing and Jim Tingey, Executive Vice President, from Palm Desert National Bank, provided information about the role of third-party issuing banks and issues associated with outsourcing prepaid card programs.

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NCIF would like to thank Ben Jackson, who worked as consultant to NCIF tirelessly to do this analysis and create a knowledge base for the CDFI Banking industry. Without Ben's effort and knowledge of the prepaid card industry, this document would not have been possible.

"In our quest to serve the "underserved", the pre-paid market holds great promise as a financial alternative to cash intensive, costly products. We are optimistic about the future of our prepaid programs and hope our learning can help others navigate the new frontier of the payment system, banking and electronic money. Thanks to NCIF and the Ford Foundation for their vision to support our efforts to benefit a broader stakeholder base."

David Reiling
Chief Executive Officer
Sunrise Community Banks

"As a small community development bank, we understand the tremendous need and opportunity that the prepaid card product line offered. Not only was there a great value proposition for the consumer, we saw it as a business line that we could develop and hopefully prosper for the good of our stakeholders. Even though our experience was not what we originally envisioned, we remain committed to determining the best methodology to deliver this product. We are hopeful through our experience, the industry in general will benefit from the issues discovered as outlined in the report. We have learned a great deal and we look forward to the future as we are much more knowledgeable regarding sales and delivery channels. Thank you to NCIF and their great work in helping provide our nation's financial institutions a framework for product delivery to the underserved market places around the country."

William M. Dana Jr.
President and CEO
Central Bank of Kansas City

"NCIF has a mission of investing in insured depositories that are operating in low-and moderate-income communities and catalyzing the flow of capital to underserved communities. These communities continue to be served by the informal financial services channels that are generally much more expensive. Among other things, NCIF has focused on research and identification of new channels and technology that can bring mainstream financial services to the poor. The prepaid card product is one such channel which is still in a relatively nascent phase of its development. The support of the Ford Foundation and the active participation of the University National Bank and Central Bank of Kansas City will help in demystifying prepaid cards so that many more CDFI banks may use it to bring retail financial services to the poor."

David J. McGrady — *Chairman*
Saurabh Narain — *Chief Fund Advisor*
National Community Investment Fund

The United States has 18.5 million households that have no banking relationship.[1] The members of these households, who may total more than 40 million individuals, rely on check cashers, convenience stores, and other fringe financial providers to cash paychecks, pay bills, and meet their other financial needs.

These services come with a high cost. By some estimates, consumers who pay to cash a check and then pay for money orders for each of their bills could end up spending almost $100 a month just to pay their monthly bills.[2]

Many of these consumers have given up their bank accounts because of past problems with banks. After paying multiple overdraft fees or receiving bad customer service, they may have decided that having a bank account was not worth the trouble. Others may have been forced out of the system because they overdrew their accounts too many times, and they now have files in ChexSystems, the national database most banks use to avoid giving accounts to high risk customers.

CDFI banks have sought ways to help these people meet their financial needs at a reasonable cost and to begin building assets. One product that holds promise for bringing these consumers into the financial mainstream is the prepaid card.

Prepaid cards provide a way to tap into the financial mainstream because they are a product that is less likely than a checking account to be overdrawn. They also offer a way to re-introduce the benefits of the banking system to consumers who have left.

As financial services regulations evolve, there may be incentives and opportunities for banks to explore prepaid cards. However, banks will need to keep up with the changes on a regular basis, and regulators must be sure they do not stifle innovation with unnecessary rules.

For those consumers who cannot have accounts because of their risk profile and those who choose not to have accounts, prepaid cards can, with the right features, serve as a substitute for an account.

This report will provide three things. First, it offers an overview of the prepaid card industry. Next, it shows lessons learned from the experiences of two CDFIs that tested using prepaid cards to reach unbanked consumers. Third, it gives banks who want to use prepaid cards a toolkit for starting their own programs.

We hope that taken as a whole, the report should demystify how prepaid cards work and show how they can fit into a CDFI bank's line of products for bringing consumers into the mainstream financial system.

[1] Sarah Gordon, Jennifer Romich, Eric Waithaka, "A Tool for Getting by or Getting Ahead? Consumers' Views on Prepaid Cards" April 2009.

[2] Rachel Schneider. "One Size Does Not Fit All: A Comparison of Monthly Financial Services Spending." June,2009.

Executive Summary

In 2005, the National Community Investment Fund (NCIF) made pass-through grants under a Ford Foundation Innovations Fund Grant program to two Community Development Financial Institution (CDFI) Banks, Central Bank of Kansas City (Kansas City, Missouri) and University National Bank (St. Paul, Minnesota) to experiment on whether prepaid cards can be used to serve people without bank accounts. NCIF has prepared this report to document their experiences and to help move the field forward in showing how banks might use prepaid cards to earn new business, meet client needs and bring the underserved into the financial mainstream. This report is divided into three sections:

1. A review of published information to understand the prepaid card landscape.
2. Documentation of experiences and lessons learned by the two grant recipients to show prepaid card opportunities, explain the product, and describe the infrastructure.
3. A "tool kit" for banks that wish to use prepaid cards to serve their clients.

The goal of this study is to draw lessons from the two CDFIs' experiences and use those lessons to help CDFI banks use prepaid cards to serve consumers without bank accounts.

Hypotheses

This work is based on three hypotheses that are used to test our understanding:

1. **Product Profitability Hypothesis:** Banks can use prepaid cards as a product line to generate sufficient fees on a standalone basis to create positive net income.
2. **Deepening Relationships Hypothesis:** Banks can use prepaid cards to earn new business, deepen customer relationships, and/or earn fees from commercial customers who want to pay wages, rebates, or benefits without checks.
3. **Unbanked Consumer Hypothesis:** Banks can use prepaid cards to turn people who do not have bank accounts into accountholders.

In the literature review, we explore how prepaid cards take the place of cash, checks, and other payment cards where consumers or businesses want to use an electronic means of payment that is not tied to a credit or debit account. We also look at how banks, retailers, and other companies are both working together and competing to get their shares of this over $50 billion market. Along the way, regulatory, operational, and infrastructure issues are explored.

In the case studies, we see what happened when two banks tried to launch prepaid card products. By examining the opportunities these banks saw in prepaid cards, the products they offered, and the infrastructure behind the products, we draw several lessons that can be used to create prepaid card programs. Both banks say that they see a future for prepaid cards in their overall suites of products.

In the third section, we offer a "toolkit" for banks that want to create prepaid card programs. The goal is to give bank officers an outline and the questions to ask themselves as they prepare a prepaid card business plan. Here we pull together the lessons learned and the information from the first two sections in a practical way to help banks launch successful products.

In the course of the study we have found that even though the prepaid market is quite large, the business is still young and the business model, technology, and regulations are still evolving. Even so, prepaid cards offer CDFI banks and other depository institutions a promising way to help people without bank accounts and those who are underserved by the current financial system access responsible financial service providers. Prepaid cards can also become a profitable product line for banks as they substitute for checking accounts for those who are ineligible and help business customers who want to pay employees without issuing checks.

While prepaid cards have been considered as a way to bring people into the banking system either for the first time or after a bad experience, we have found that this will not happen overnight. It will take long term planning and investment by banks to convert cardholders to accountholders.

Some cardholders may never become accountholders, so CDFI banks should focus on fee-based profitability. In order to do that, card transactions need to be priced correctly and banks need to have a sufficient volume of them to offset costs.

Because banks need to work with vendors such as transaction processors to offer card programs, they must take into account that these vendors help determine product design and pricing, and thus profitability. Banks must work with responsive, well-established vendors to be successful, since an inflexible, inexperienced processor can result in a mediocre product offering.

Demystifying Prepaid Cards Part One: The Prepaid Card Opportunity

What are Prepaid Cards?

Prepaid cards take the place of cash, checks, and other payment cards where consumers or businesses want to use an electronic means of payment, but do not want to tie the payment to a credit or debit account. Some carry major card brands (American Express, Discover, MasterCard, and Visa), and are referred to as "network branded" prepaid cards.

Stored Value Cards Versus Prepaid Cards

Stored value cards are a form of prepaid card where the value is stored on the card itself, and the card does not connect to any account. An example of this would be fare cards that are purchased at a kiosk and used to buy rides on a subway system.

Prepaid cards connect to an account and/or database to authorize payments. What kind of account the cards are attached to depends on the type of card. For example, store gift cards may be tied to a store account, and general purpose prepaid cards that function like debit cards may be tied to a pooled account held at a bank.[1]

Prepaid cards are grouped by where they can be used and whether cardholders can add more money to them. Cards to which consumers can add funds are reloadable cards, as opposed to one time-use, nonreloadable cards.

Closed-loop prepaid cards can be used only at one merchant. Most retail gift cards are closed-loop cards. Other examples of closed-loop cards are transit cards and cards sold to players for Internet games. Semi-closed loop cards refer to cards that can be used at a select group of merchants, such as a gift card that could be used at any store in a mall.

Open-loop prepaid cards connect to a network and can be used wherever the network is accepted. Branded open-loop cards carry one of the major card brands (American Express, Discover, MasterCard, or Visa). The cards draw on funds held in a pooled account at a bank. Cards that require cardholders to enter a personal identification number (PIN) to make purchases using the NYCE, Pulse, and Star debit networks are also open-loop. The table below shows the payment networks and what companies own them.

ATM and Debit Network Ownership

PULSE	ATM & POS	Discover Financial Services
Star	ATM & POS	First Data Corporation
NYCE	ATM & POS	Metavante Corporation
Plus	ATM	Visa Inc.
Allpoint	ATM	ATM National LLC
Cirrus	ATM	MasterCard Inc.
Visa Debit Processing/Interlink	POS	Visa Inc.
Debit MasterCard/Maestro	POS	MasterCard Inc.

Open-loop cards are the ones used most often to provide financial services to people without bank accounts. The ability to use the cards for almost all kinds of payments means that they can substitute for cash, credit cards, and checks.

Open-loop prepaid cards can take a wide range of forms. The cards are used as general purpose, reloadable cards where consumers can load money onto the cards and use them for general payments. They can be used as payroll cards, which employers give to employees and load wages onto the cards instead of printing paychecks. Retailers give open-loop cards as incentive cards or rebate cards instead of checks or other merchandise. Parents give reloadable open-loop cards to children and college students as a way of providing them with an allowance and to monitor spending. Consumers use open-loop cards to pay for medical expenses using money from a Health Savings or Flexible Spending Account. Also the federal government uses prepaid cards to distribute social security benefits and state governments use them for unemployment insurance and child support benefits. With the addition of features like bill payment to prepaid cards, consumers may use prepaid cards as substitutes for checking accounts.

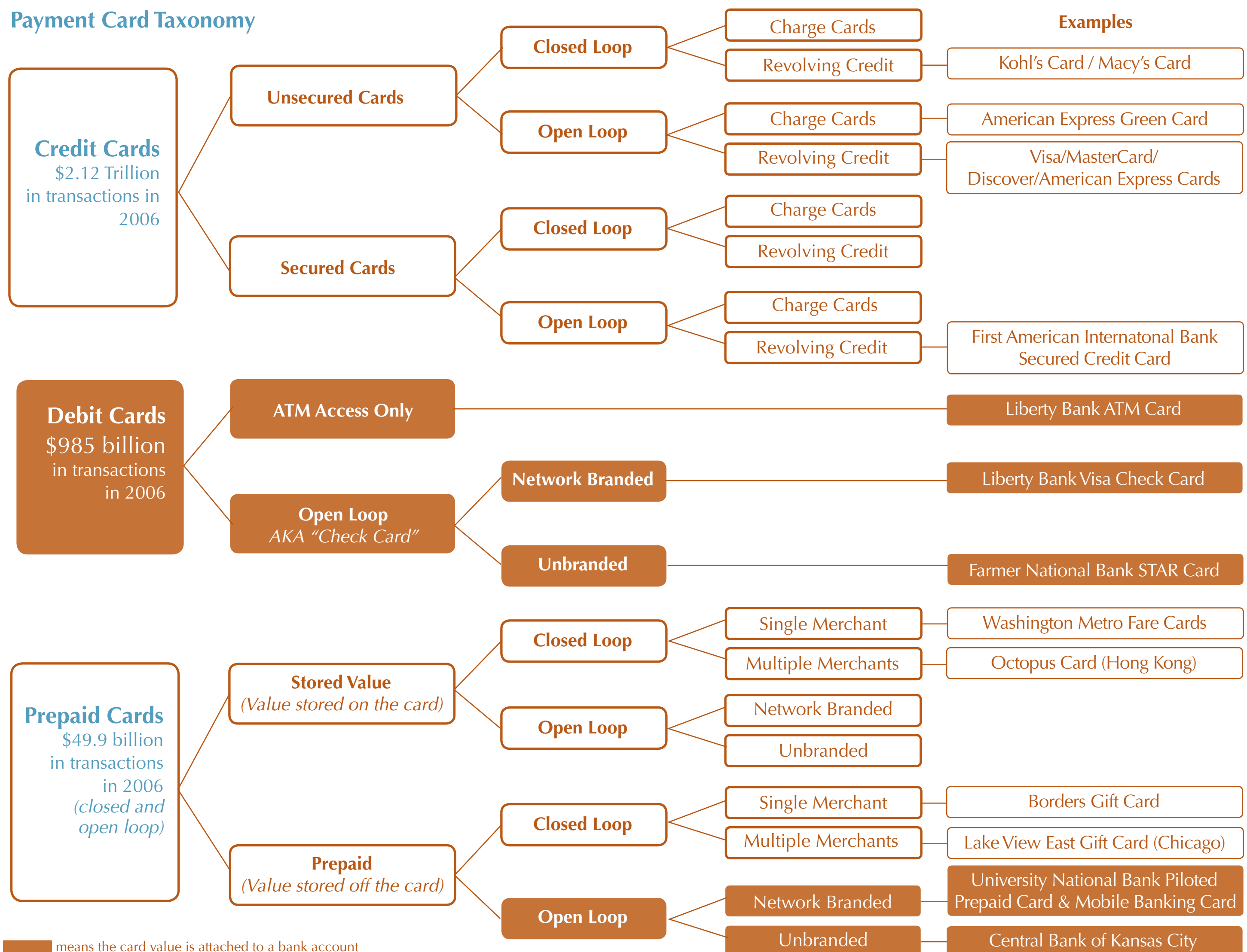
The Prepaid Landscape

The size of the prepaid market is open to debate. The Federal Reserve 2007 Electronic Payments Study estimated that open-loop prepaid transactions totaled $13.3 billion in 2006, and prepaid transactions as a whole totaled $49.9 billion, compared with $1.9 trillion in general purpose credit card payments and $986 billion in debit card transactions.[2] The same report pointed out that Aite Group LLC said the market had $95.4 billion in transactions for all prepaid cards, open and closed loop, and Mercator[4] Advisory said $197.9 million were loaded onto all prepaid cards, including closed-loop gift cards and open-loop prepaid cards. Network branded cards had a total of $26.75 billion loaded on them in 2006,[3] and that number grew to $38.66 billion in 2007, according to Mercator. The range of numbers shows that pinning down the size of the prepaid card market is not easy. Companies do not want to reveal what they have accomplished (or not accomplished) in card sales, and some companies count prepaid cards as debit cards.

Banks have found a place for prepaid cards in their product lines. Banks have served as issuers that hold the funds, settle transactions, and provide bank identification numbers for transaction routing for prepaid cards. They also have sold cards such as payroll cards, travel cards (to replace traveler's checks), gift cards, and other types of cards both to consumers and companies.

In a survey conducted in the first part of 2007 by the Independent Community Bankers of America, 43% of community banks said

The illustration below of shows where prepaid cards fit in the world of payment cards:



(Volume numbers come from The Electronic Payments Study, A Survey of Electronic Payments for the 2007 Federal Reserve Payments Study. Debit numbers do not include ATM-only cards.)

they sell network-branded gift cards. Only 3% said they offered payroll cards.[5] In the first survey in 2005, 2% said they provided payroll cards but nearly "one-fifth of community banks plan to offer payroll cards within two years" the ICBA said in a press release.[6] (The association sent surveys to all but the top 125 banks in the country, and received 1,107 responses in 2007 and 400 in 2005.)

Banks are not alone – other companies, including retailers, sell prepaid cards. Wal-Mart Stores Inc. has offered Visa-branded, reloadable prepaid cards since June 2007. The cards are issued by GE Money Bank. The Wall Street Journal reported that Wal-Mart "is on track to register $2 billion in deposits on two million cards in 2009."[7] The American Banker reported that "Wal-Mart, which gained more than 1 million customers with over $1 billion worth of transactions from the MoneyCard, is now 'in the range' of doubling both figures…."[8] while other reports say Wal-Mart has sold 2 million cards.[9]

Since companies like Wal-Mart must work with banks to offer open-loop cards, banks can get into the prepaid card business by acting as issuers that hold funds, authorize payments, and settle payments. The table below shows several nonbank prepaid card providers and their issuing banks:

Provider	# of Cards Sold	Issuing Banks
NetSpend Corp.	16 million gift and reloadable, MasterCard and Visa[10]	Inter National Bank, MetaBank
UniRush LLC	1.5 million + Visa cards [11]	Manufacturers and Traders Trust Co.
H&R Block	7 million prepaid MasterCard accounts since 2007[12]	H&R Block Bank
Wal-Mart	1 to 2 million Visa cards[13]	GE Money Bank
Green Dot	Over 2 million Visa and MasterCards as of 2006[14]	Columbus Bank & Trust Co.

(Source: These numbers come from company press releases and media reports cited in the end notes.)

The companies in the previous table have built businesses by selling cards to customers and charging fees for their use. Companies such as NetSpend Corp., Green Dot Corp., and UniRush LLC, provide cards as independent sales organizations. For example, Green Dot Corp. told the *New York Times* that there was more than $4 billion in transaction volume on its cards in 2008.[15] These companies sell their cards in check cashing outlets, payday lending outlets, in drug stores, grocery stores, and over the Internet.

The companies mentioned above show that prepaid cards can become a line of business for banks. Banks have offered payroll cards to companies that want to get rid of checks. These companies often want to use direct deposit for payroll but cannot because their employees do not have bank accounts. Prepaid cards give banks a way to provide a service by replacing checks with an electronic payment. Comerica and U.S. Bank have built large prepaid businesses by offering prepaid cards for government programs such as Social Security and state child support programs.

By offering prepaid cards, banks can boost their fee and interchange income. Beyond payroll and government benefits cards, banks have sold gift cards, travel cards, and payroll cards to consumers and businesses. The 2007 Federal Reserve Payments Study estimated that almost 322 million transactions were made with open-loop prepaid cards in 2006, and this shows that a large market for prepaid cards exists.[16]

The United States has approximately 18.5 million households that do not have a bank account.[17] These consumers are an opportunity for banks because they need to cash checks, pay bills, and buy goods and services. Prepaid cards can help them avoid check cashing fees when consumers use direct deposit, and they can help them make purchases over the Internet, rent cars, and make bill payments without using money orders or cashier's checks.

Although prepaid cards can be an opportunity for banks, before building a prepaid program, banks need to understand how prepaid cards work and what the challenges are.

Turning Cardholders into Accountholders

People don't have bank accounts for a number of reasons. They may have had accounts in the past which were closed due to consistent (planned or unplanned) overdrafts or they may have bad experiences in the past (either in the US or in the case of immigrants who saw nationalization in their home counties). As a result they have had to work with check cashers, payday lenders and other informal channels that may charge excessive fees for simple transactional services, but provide some convenience in financial services. Hence there seems to be an opportunity to create a path for bringing these customers back to open accounts via responsible products. Several CDFI banks have experimented with Second Chance Accounts (Legacy Bank, WI) to help re-induct these folks into banking relationships coupled with financial counseling.

Prepaid cards seem to be a reasonable product to slowly transition underserved and unbanked customers back into the banking system. However it is not clear how long it takes for this transition to occur. Limited success has been reported in turning prepaid cardholders into accountholders in the short term – this could be due to faulty card design or due to the need for a longer time horizon for changing the attitudes and needs of customers.

For customers who have a high risk profile or who do not want to have an account, prepaid cards can serve as a substitute for a bank account. In this case, banks could use the cards to provide a fee for service product as described in Hypothesis One of this paper.

A study by the Aite Group LLC says that banks should not assume unbanked consumers do not have bank accounts because of cultural and attitudinal reasons. From interviews of 400 customers at check cashing stores, Aite found that consumers do not have bank accounts because of bad credit, high account costs, low cash flow, and problems with bank customer service.[18] This is supported by interviews of prepaid cardholders done by the Center for Financial Services Innovation that shows cardholders gave up bank accounts for prepaid cards because of treatment they had received at banks.[19]

One possibility is that customers without bank accounts will eventually move from prepaid cards to accounts, but the time period may be longer than banks expect. Banks should consider this longer time period when creating their strategy; they need to ensure that the product line design generates reasonable profitability through fees only till such time as depository customer relationships are created.

Some industry franchise models (like Meta Financial) support the idea that the originating bank should get all the information on the prepaid cardholders so that they can market to them to convert the customers into accountholders. Another sign that cardholders might become accountholders is that NetSpend Corp. offers its cardholders the opportunity to open savings accounts with one of its issuers, Inter National Bank. Since the savings accounts began in 2005, cardholders have opened over 104,000 accounts and deposited more than $100 million.[20] How many active accounts remain is not clear, but the numbers indicate interest on the part of prepaid cardholders in opening accounts and saving. It should be remembered that NetSpend and other third-party prepaid card providers, such as AccountNow Inc. and Directo Inc., are not banks and hence turning cardholders into accountholders is not an immediate strategic priority.

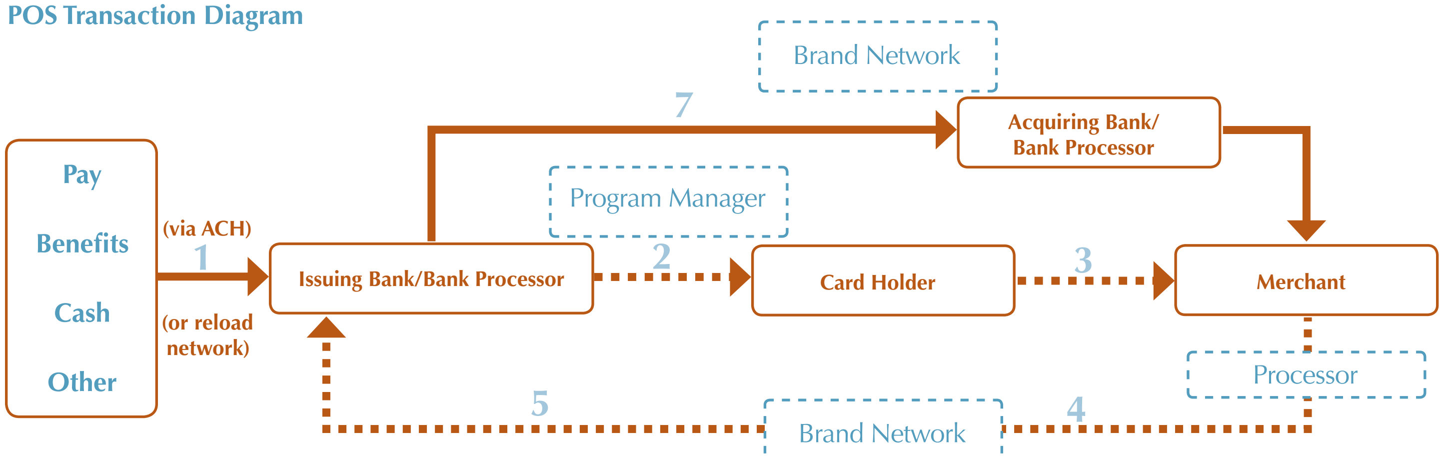
Infrastructure: How the Prepaid Business Model Works

Putting prepaid cards in consumers' hands requires the cooperation of several companies to handle the flow of transactions from the time a consumer uses a card until the transaction is settled. For a prepaid card program, typically there are issuers, processors, and the card networks involved. In addition, card programs may include program managers and reload networks, depending on how they are set up. The kinds of companies in the prepaid transaction chain are:[21]

Company Type	Role	Examples
Issuers	Financial institutions issue cards and offer settlement and risk management.	JP Morgan, US Bank, Bank of America, University National Bank, Central Bank of Kansas City, Wells Fargo
Processors	These companies authorize payments, clear transactions, and provide services such as call centers, arranging for card production and Web site design.	First Data Corp., TSYS Inc.
Brand Networks	These provide connections between the merchant's bank and the issuing bank.	Visa Inc., MasterCard Inc., Discover Financial Services, American Express Co.
Debit Networks	These allow for PIN Debit transactions at the point of sale.	Visa Debit, Debit MasterCard, PULSE, NYCE, Star
ATM Networks	The companies allow ATM transactions to take place.	All Point, MasterCard's Cirrus, Visa's Plus, PULSE, Star, and NYCE
Reload Networks	These networks allow cardholders to add money to cards at retail locations.	Green Dot Corp., MasterCard rePower, MoneyGram, Visa ReadyLink, Western Union
Program Managers	The companies handle program design, marketing, day-to-day operations, back office support, and card account maintenance. They also may arrange for Web site production and card design.	NetSpend Corp., Green Dot, Parago Inc.

Here is a diagram that shows the flow of funds in a prepaid purchase at a point of sale and an ATM transaction.

POS Transaction Diagram



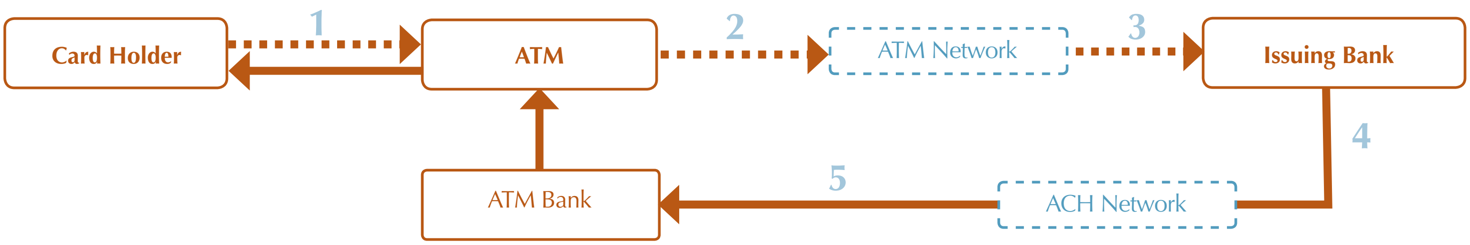
Steps in the Transaction

1. A cardholder receives funds by having pay or benefits directly deposited with the issuing bank via ACH.
2. The cardholder receives a card and/or a load notification from the program manager, if there is one.
3. The cardholder uses the card at a merchant.
4. The merchant's processor sends a transaction request to the bank.
5. The networks route the transaction using the Bank Indentification Number for the card.
6. If approved, the bank allows the transaction.
7. The issuing bank settles with the merchant's acquiring bank via a brand network (i.e. Visa, MasterCard).

Flow of Funds

Flow of Data

ATM Transaction Diagram



Note: The issuing bank and the ATM Bank could be the same. If so, then the issuing bank would just provide the funds for the ATM.

Flow of Funds

Flow of Data

Steps in the Transaction

1. The cardholder inserts the card and makes a withdrawal request.
2. The ATM contacts the ATM network (e.g. Cirrus, Plus, Star).
3. The ATM network contacts the issuing bank/the bank's processor.
4. If approved, the funds and any charge is taken from the cardholder's account.
5. The transaction is processed through the Federal Reserve's ACH system.
6. The surcharges and funds are deposited in the bank that owns the ATM.
7. The issuing bank debits the cardholder's account for any charges it imposes.

Banks that offer reloadable prepaid cards to consumers make money from fees that they charge cardholders to get new cards, monthly maintenance fees, reload fees, net interest income on card balances, and interchange fees paid by merchants who accept cards. However, they must share those fees with some or all of the companies as mentioned above. Simplistically put, profitability of a prepaid card program may look like this:

Profitability of a Card Program for an Issuing Bank

[(No. of Cards * New Card Fees)
+ (Number of POS transactions x Interchange from POS)
+ (Number of ATM transactions x ATM transaction fees)
+ (Number of Reloads x Reload fee)
+ (Net interest income on card balances)]

Less

[Card production costs
+ Marketing costs
+ Processor set up fee
+ (Number of POS transactions x Processor POS fee)
+ (Number of ATM transactions x Processor ATM fee)
+ Customer service cost
+ Credit and operational losses]

Running a profitable program depends on having large volumes of cards that generate fees because banks earn pennies per transaction, according to bankers and executives from the industry. Some suggest that banks find partners to offer prepaid cards with rather than trying to build programs. There are three basic business models for banks that want to offer prepaid cards to their customers.

Three Business Models Pros and Cons

Business Model	Pros	Cons
Build Program In-House	• Customize to needs • Control of customer information • Earn deposits and fees	• Expensive • Time consuming • Must assume all risks
Outsource Some Functions (e.g. Processing, Program Management)	• Quicker to market • Contract expertise • Lower resource commitment than building in-house	• Can be expensive • Vendor risks – unresponsive, can't do what bank needs • Less control over features • Customer information could be vendor's, causing reputational risk
Outsource Entire Program (White Label Card)	• Can focus on selling only • Reduced compliance risk because there is another issuing bank • Low resource commitment	• Do not own customer relationship • Less customization because of outsourcing • Less control over features

Banks can hire companies to give them a prepaid card that they can sell, they can build a prepaid card program in-house, or they can outsource some parts while building others. Finally, as the number of card accounts and the deposit balances increase, the banks can benefit from increased net interest income generated from the deposits.

Banks that choose to use a white label card do not have the legal relationship with the customer. However, depending on their vendor, they can still brand the card with their name and work to up-sell the cardholders into accounts at their banks, if they think the cardholders are potential clients for other bank services. This option requires a vendor that will share cardholder information with the bank that sells the cards.

Regulatory Issues

The regulatory space is still evolving with some open questions, issues that have been resolved and others that continue to be difficult to fix.

Here is a nonexclusive list of regulatory issues that affect prepaid cards:

- Bank Secrecy Act
- USA PATRIOT Act
- Regulation E of the Electronic Funds Transfer Act
- Federal Deposit Insurance Corp. Insurance
- State Laws about payroll and escheatment
- Credit CARD Act of 2009

With open-loop prepaid cards, banks face questions about requirements under the Bank Secrecy Act, The USA Patriot Act, Regulation E of the Electronic Funds Transfer Act, and state laws, such as abandoned property and wage payment laws.

The FDIC clarified one issue in November 2008 when it issued an opinion in the Federal Register that its insurance covers cardholders' funds as long as certain conditions are met.

In the opinion issued on Nov. 13, 2008, the FDIC said that it will insure prepaid card funds to each cardholder as long as the pooled account is identified as a custodial account and the cardholders' identities and card balances are available from the bank or the program manager. The addition of deposit insurance to prepaid card funds makes the cards more like checking accounts and leads some observers to ask whether prepaid programs will face scrutiny for compliance with other laws and regulations that govern traditional checking accounts.[22]

To address Bank Secrecy Act issues, banks have limited the maximum amount that can be loaded onto prepaid cards, and they have implemented systems to monitor how money goes out of the bank through cards as well as how it comes into the bank. For example, Central National Bank of Enid, Okla., which issues a large number of prepaid cards, many with remittance capabilities, monitors foreign transactions to be alert to patterns that indicate money laundering. If the bank sees that a large number of cards are all sending money to the same recipient, for example, the bank can put a block on future transactions from those cards to prevent money laundering.

Banks need to have a program in place for Know Your Customer rules. For example, a bank that has a third party selling prepaid cards for it would need to make sure that the vendor gathered the information required by the regulations so that the bank could make sure its files were complete. As an example, Green Dot Corp., which sells prepaid cards issued by Columbus Bank & Trust Co., tells consumers applying for a card on its Web site that Green Dot will ask them for their names, addresses, dates of birth, and other information, including social security numbers to comply with the USA Patriot Act. It also says Green Dot may "ask for copies of your driver's license or other identifying documents."[23]

When it comes to Regulation E of the Electronic Funds Transfer Act, prepaid card issuers have clear guidance with regard to payroll cards. Issuers do not need to provide a paper statement to cardholders unless the cardholder requests it in writing. The bank must provide account information by telephone and electronically at the customer's request. How this regulation applies to other forms of reloadable, open-loop prepaid cards is not entirely clear, according to banking executives.

With state laws there is no consistency when it comes to prepaid cards. Abandoned property laws are one area that banks will need to pay attention to going forward, because some states exempt prepaid cards and others require the money to be escheated back to the state after a certain time if the card is not used. Gift cards may be treated differently than other kinds of prepaid cards because retailers issue them and some states treat them in the same way as they did paper gift certificates, while other states may carve out an exemption for cards. Banks that plan to issue prepaid cards of any kind should review state laws to make sure their programs comply with any relevant statutes and regulations. A useful resource is a report produced by the Network Branded Prepaid Card Association. A link to this report can be found on page 31, along with another report from the American Payroll Association that provides information on state laws pertaining to payroll cards.

Another legal concern that affects prepaid cards is state payroll laws. Many states have restrictions on how employers can disburse wages. The underlying principle behind these laws is that employers cannot compel workers to receive their wages in a way that costs the workers money. Still product design can help a bank or program manager deal with this issue. For example, when University National Bank wanted to offer payroll cards, it ran into this problem. So instead of selling cards to employers as payroll cards, it worked with an independent sales organization to sell cards directly to consumers who then opted to have their wages directly deposited to the cards. Because the employees chose to have their wages deposited to the card, the employer was not forcing them to take their pay in a way that cost them money, and the bank could still assess fees on the cards.

The Credit CARD Act of 2009 was signed into law on May 22. It amended the Electronic Funds Transfer Act and put limits on fees and expiration dates for prepaid cards. While the act excludes a large number of prepaid cards, banks that are considering offering gift cards need to examine the provisions of this law to make sure they are in compliance.

Banks need to stay abreast of changes in regulations, and regulators should make sure that new rules do not unnecessarily stifle growth or innovation in the prepaid industry.

Compliance officers need to review programs and vet vendors to ensure regulatory compliance. More suggestions on this subject can be found in Section 3.

Operational and Credit Risk Issues

The big value proposition associated with prepaid cards is that they generally cannot be overdrawn, therefore reducing the credit risk associated with folks who have been running consistent overdrafts. It should be noted, however, that it is actually possible for a cardholder to exceed the limit of the value on the cards if, for example, transactions are not processed in real time; in this situation, the cardholder and the issuing bank do not know that the cardholder has exceeded his or her balance. Direct deposits help to manage this risk because banks can always recover the amount of the overdraft at the next deposit. Banks also can put holds on the cards for transactions to try to avoid purchases exceeding the amounts loaded onto the card. Measures like low balance alert messages may also help banks manage this risk.

Another risk is fraud. Banks need to monitor card transactions for suspicious activity. They can also set up systems such as contacting cardholders, with a phone call or text message for example, to get approval for certain types of transactions. Some card programs will send a text message to a cardholder's cell phone requesting approval for transactions over a certain amount.

Customer Perception Issues

Banks need to educate customers on the immense possibilities with prepaid cards – customers often think of finite uses of these cards but are not aware that they can be used to help them make purchases, pay bills, and avoid exorbitant check cashing fees. In a recent survey of prepaid industry executives, one-third said a lack of consumer awareness about prepaid cards is the biggest challenge to the industry's growth.[24]

Even if they are aware of prepaid cards, consumers may not think prepaid cards are reasonably priced or are better than their other options. For example, a survey of 2,000 people by Mintel Group Limited found that 77% of respondents did not want to receive their wages on prepaid cards. Thirty-one percent said they prefer cash or checks, and 28% said they were afraid of losing the card.[25] The American Banker noted that a Synergistics Research Corp. survey of 1,003 households conducted in September and October of 2008 that asked about Wal-Mart's prepaid cards found that only 1% of the respondents had purchased the cards, despite 20% being aware of them and that 83% called the up-front fee unreasonable.[26] Since that survey was completed, Wal-Mart has lowered its card fees, but consumers may feel that other prepaid cards cost too much.

Some Initial Observations from the Literature Review

1. Prepaid cards are still in a relatively nascent state of their product lifecycle and the business model, technology and regulations are still evolving. However the product offers significant promise to CDFI banks and other depository institutions in bringing underserved people into responsible financial service providers.
2. Prepaid cards have the potential to become a profitable product line for CDFI Banks for serving the needs of both unbanked consumers and commercial clients.
3. Transition of prepaid card customers into bank account customers will happen over a long period of time; banks need to invest for the longer term to achieve this transition while seeking fee-based profitability in the shorter term.
4. Banks need to achieve scale in terms of the number of active cards to get significant profitability.
5. Banks may need to offer a range of cards for deepening customer relationships; these include payroll cards, incentive cards, and rebate cards.
6. Network branded cards – those carrying a Visa, MasterCard, Discover, or American Express mark – which can be reloaded, have recognizable value to cardholders.

Demystifying Prepaid Cards Part Two: Testing Prepaid Products

Introduction

In 2005, Central Bank of Kansas City, Mo., a $168 million-asset Community Development Financial Institution, saw an opportunity to reach out to consumers who did not have bank accounts by offering them prepaid cards. Its goal was to move these consumers away from high-cost financial service providers such as check cashers towards opening regular bank accounts.

At about the same time, University National Bank of St. Paul, Minn., a $120 million-asset Community Development Financial Institution, wanted to develop a prepaid card program to serve individuals without bank accounts.

To help them with that goal, the National Community Investment Fund and the Ford Foundation gave each bank a $150,000 grant as part of the Ford Foundation Innovations Fund in December 2005. The grant period closed at the end of 2008, and NCIF prepared this report to document the lessons learned.

The analysis considers the opportunities, products, and infrastructure of prepaid cards and is based on three hypotheses discussed in Section 1.

1. **Product Profitability Hypothesis:** Banks can use prepaid cards as a product line to generate sufficient fees on a standalone basis to create positive net income.
2. **Deepening Relationships Hypothesis:** Banks can use prepaid cards to win business, deepen customer relationships, and/or earn fees from commercial customers who want to pay wages, rebates, or benefits without checks.
3. **Unbanked Consumer Hypothesis:** Banks can use prepaid cards to turn people who do not have bank accounts into accountholders.

Case Study: Central Bank of Kansas City

Central Bank's management planned to sell prepaid cards to Hispanics in its market who did not have bank accounts and eventually turn them into accountholders. In 2006, it began offering La Tarjeta Segura (The Secure Card), a card specifically designed for Hispanics. When card growth was slow, management examined the reasons and started exploring alternatives.

In 2007, Central Bank began offering payroll cards for one of its clients that wanted to stop giving paychecks to employees who did not have bank accounts. This resulted in a significant increase in the number of people using this card, as shown by the table below.

Cards Outstanding

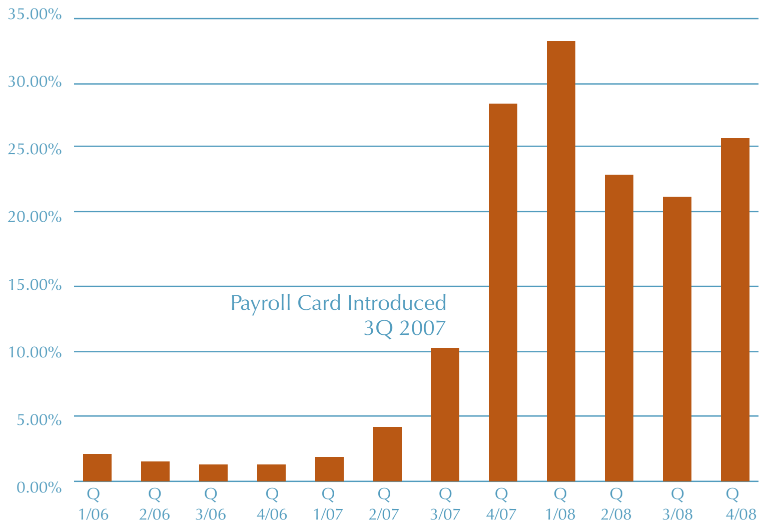
Before Payroll							After Payroll				
1Q06	2Q06	3Q06	4Q06	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08
24	27	30	55	71	74	51	584	1,052	1,244	1,397	1,535

Central Bank offered both cards at the same time, but stopped marketing La Tarjeta Segura after the introduction of its payroll card. As of the end of 2008, only 52 of the cards outstanding were La Tarjeta Segura cards.

Offering prepaid cards was expensive for Central Bank. Neither card made a profit for the bank. The costs of starting up the Tarjeta program were very high in the beginning. Then costs fell once the payroll card was introduced, and the bank moved closer to profitability. A graph on the next page plots revenue as a percentage of expenses showing the dramatic difference from start up towards profitability.

Despite the performance of its test cases, Central Bank's management says it wants to continue selling prepaid cards and considers the initial costs as "research and development and set up" costs to understand the product and the markets. It is important for new issuers to budget a significant 'initial set up investment.' A closer look at each program individually will explain the performance of the cards.

Revenue as a Percentage of Costs
(100% is Break Even)



The dip in 2008 is caused by higher fixed asset depreciation costs

La Tarjeta Segura

Central Bank began offering La Tarjeta Segura as an alternative to cash in 2006 to the Hispanic community in its area. The original objective was to offer a product that could convert customers from cardholders into accountholders.

The card was sold in two forms. One was an instant issue card, which consumers could pay for and receive immediately. To support this card, Central Bank purchased a card embosser that it could take to festivals and community centers. The other was a Visa-branded card that consumers would get five to seven days after they purchased it.

The table below lays out the features of the card.

Feature/Function	La Tarjeta Segura
Card Focus	General Spend
Transaction Types	Point of Sale and ATM
Major Card Brand	No on instant issues/Visa-branded card available with seven-day wait
Bill Payment	No
Remittances	Yes, to Mexico
FDIC Insurance	No
Reload Options	Direct Deposit/Cash at the Bank for $2.50
Savings Features	No
Credit Features	No

Potential cardholders needed to show one form of government-issued photo ID to get the card. They could use the Matricula Consular ID card issued by Mexican Consulates in the United States to obtain the card. They had to pay a $5.00 purchase fee and could load up to $2,500 onto the card.

Much of the struggle with La Tarjeta Segura came from marketing issues as well as customer perception issues. We have tried to use the five principles of marketing, or 5 Ps, to provide a framework for this analysis.

Product

The product had limited appeal to Central Bank's target audience. Many did not want to wait a week to receive a Visa-branded card and saw less use for an unbranded card. The bank's management said that the Hispanic population was more interested in receiving a mainstream card rather than one that designated the cardholder as Hispanic.

Price

Price, however, did not seem to be a factor keeping consumers from adopting the cards. Cardholders paid a $5.00 new card fee and a $2.50 reload fee.

People

The bank had two employees who focused on meeting with community leaders and attending events to sell the cards.

Promotion

The bank used billboards and brochures as its primary marketing. This was supplemented by staff members attending events and meeting with community leaders. While these leaders welcomed the cards in theory, when the cards actually became available, they were not active in helping to market them. These methods were not as successful as anticipated, in bringing new customers into the bank.

Place

Customers had to come into the branch to purchase and reload cards. This may have put some of them off from using the cards because they were unfamiliar with banks.

Infrastructure Issues

Central Bank functioned as the issuer and program manager for the cards. It outsourced processing to the lowest cost provider, and outsourcing just the processing meant that Central Bank could keep the deposits to earn interest income and possibly turn the cardholders into accountholders.

The card launch was delayed because the vendor could not combine features of its various stored-value cards into one. Central Bank needed to go through the set up process three times, which is one reason card numbers were low in 2006.

Because the Tarjeta Segura instant issue card only allowed for PIN debit transactions, Central Bank lost the potential for fee income because cardholders did not make purchases where they had to sign a receipt. These purchases would have given Central Bank more income than PIN purchases. By way of comparison, when Central Bank started its payroll card, it earned 29 cents for every signature transaction made, and 18 cents for every PIN transaction. Branded Tarjeta cards were not an easy sell because consumers had to part with their money and then wait for up to a week to have the card delivered.

Central Bank stopped selling the Tarjeta Segura in the fourth quarter of 2007 as the payroll card began to gain traction.

Payroll Card

Central Bank began offering payroll cards at the end of 2007 for an employer who is also a major depositor at the bank. The bank now has payroll cards in Illinois, Kansas, Louisiana, Missouri, and Texas. Cardholder numbers grew and expenses fell with the payroll card, but it did not make a profit for the bank.

The table below shows the features of the Central Bank Payroll Card as compared to La Tarjeta Segura.

Feature/Function	Central Bank Payroll	La Tarjeta Segura
Card Focus	Payroll Card	General Spend
Transaction Types	Point of Sale and ATM	Point of Sale and ATM
Major Card Brand	Visa	No on instant issues/Visa on others
Bill Payment	No	No
Remittances	No	Yes to Mexico
FDIC Insurance	No	No*
Reload Options	Direct Deposit/Cash at the Bank for $2.50	Direct Deposit/Cash at the Bank for $2.50
Savings Features	No	No
Credit Features	No	No

*(*Note: this program was launched before the FDIC ruling on insurance for prepaid cards in 2008)*

One benefit to payroll cards is that employers offer a defined audience with specific needs, according to bank management. The employer solves the marketing questions of people, promotion, and place by bringing the bank's products to employees.

However, because the employer is a large depositor with the bank, Central Bank did not charge any program fees. In addition, due to payroll laws in various states and resistance from the employer, Central Bank did not charge cardholders for using ATMs.

The lack of ATM charges meant the bank could not make money on the payroll cards because the cardholders would withdraw their wages from the ATM rather than using the card to make purchases or pay bills. This resulted in low transaction income.

The table below shows the income and cost for Central Bank of five transactions.

Transaction Type	Income Per Transaction	Cost Per Transaction
ATM Balance Inquiry	0¢	38¢
ATM Withdrawal	0¢	61¢
Signature Transactions	29¢	10¢
PIN Payment	18¢	8¢
Pinless Bill Payment	40¢	8¢

Central Bank had decided to keep the costs to the customer low to increase the transaction volume and also since the profitability came from customer deposits. Going forward, it will need to decide if the benefits gained from the employer's deposits outweigh the costs of offering the cards and whether they need to recover more costs from the cardholders. One method of doing this would be to determine what it would charge an employer with no deposits and see if the income from the deposits makes up for that cost.

Analysis

In looking at Central Bank's experiences in light of the three hypotheses, several conclusions can be drawn:

Hypothesis One

The set up costs and pricing were subsidized by the grant from NCIF and hence did not generate fee income for the bank. However, the grant allowed them to understand the different fee sources as explained below and prepare the institution for a stronger and more free standing prepaid program.

The bank must be paid for services it provides. For example, the bank offers risk management services and eliminates the cost of printing checks for the employer using its payroll card. The cardholders are freed from check casher fees. While there are state laws that affect charging for ATM use on payroll cards, the bank may be able to structure its program in such a way that it can meet the requirements and still charge for ATM use. For example, it may be able to comply with some state laws by allowing one free withdrawal a month.

Customer education might reduce fee structure problems. If cardholders can be taught to use ATMs less and to make purchases with the cards instead, costs would go down while income would go up.

Hypothesis Two

The bank has used its payroll cards to deepen its relationship with an important customer. The bank must value the costs and benefits associated with a profitable and sustainable program.

Hypothesis Three

Because the adoption of La Tarjeta Segura was so low, and the payroll cardholders were largely outside of Central Bank's market area, customers did not turn from cardholders to accountholders. However bank management speculates that over a longer period of time they will be able to get more customers converted into bank accountholders.

The Future

Central Bank plans to continue offering its payroll cards going forward. It also plans to move checking account customers who overdraft often to a payroll card while they pay down their overdraft debts and prove they can be responsible money managers. The bank plans to give financial education to these cardholders. The goal is to offer customers a chance to pay down their fees rather than closing their accounts.

Case Study: University National Bank

University National Bank also experimented with the prepaid card program but during the grant period did not generate significant volume. They also changed course during the 3-year period by offering two separate card programs. Now that the bank's management has become convinced that prepaid cards could become a profitable business, it not only intends to continue offering them but also plans to make it a significant scalable business.

University's first prepaid card program, launched in 2006, was a non-reloadable prepaid card designed to give low-income consumers an alternative to check cashers and other non-bank financial services providers. That program was shut down the same year.

University began testing its second card program, the University Mobile Bank Prepaid Card, in 2007 and launched it in 2008. It was designed to reach consumers with no bank accounts. The bank contracted with three independent sales organizations (ISOs) to sell the card in other states. At the end of 2008, it had a total of 1,247 cards outstanding. The cards from 2006 had already been cancelled.

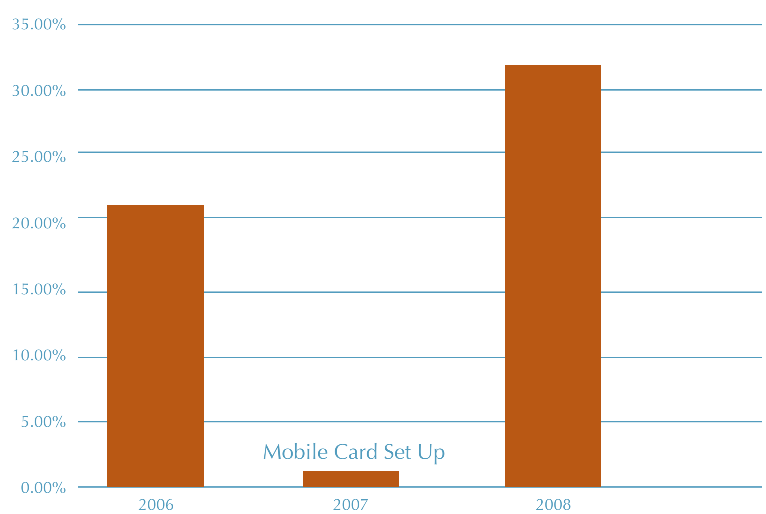
The Mobile Bank Prepaid Card program ended in 2009 after University Bank decided to hire a new processor.

Cards Outstanding

2006	1Q07	2Q07	3Q07	4Q07	1Q08	2Q08	3Q08	4Q08
274	0	0	10	20	34	47	295	1247

No accounts were opened for pilot prepaid cardholders, and its mobile banking cards were cards used in other states, so those cardholders did not become accountholders. The cards did not make a profit for University Bank as the chart below demonstrates. University Bank considers the grants as investment dollars as it built up its program.

Revenue as a Percentage of Costs
(100% is Break Even)



The information here is presented on an annual basis because the bank had quarters where it invested in setting up a new program and so did not have any revenue in those quarters.

The bank said it has changed its approach from trying to sell cards to people without bank accounts directly to serving as the issuing bank for processors and ISOs that serve a variety of consumers – including consumers without bank accounts or who use non-bank financial service providers – who want prepaid cards.

Piloted Prepaid Card

Card Features

Feature/Function	Piloted Prepaid Card
Card Focus	General Spend
Transaction Types	Point of Sale and ATM
Major Card Brand	MasterCard
Bill Payment	No
Remittances	No
FDIC Insurance	No
Reload Options	None
Savings Features	None
Credit Features	None

By mid-year 2006, University cancelled its pilot because of the following issues:

- Vendor Issues – University's first vendor did not have a flexible system that would allow one card to have multiple capabilities, even though the vendor had initially sold its product features as such. As an example, the piloted card could not also serve as a payroll card, which management believed was a key product feature to reach the unbanked market. Subsequently this vendor was acquired by a major card provider which caused delays as they became absorbed in their own integration issues.
- Regulatory Issues – During the pilot, the state legislature in Minnesota sought to ban fees for stored-value gift cards. While University's stored value card was not the target of this scrutiny, it did nonetheless become embroiled in the debate. University's CEO, David Reiling, testified before the state legislature to distinguish between high fees on certain gift cards in Minnesota and responsible pricing for general purpose prepaid cards.
- Scale/Efficiency Issues – University management believes it overreached by attempting to pilot the product at all three of its affiliate banks to quickly gain scale, rather than starting at one bank and focusing on creating an efficient process before extending it to other distribution points.
- Competition – Non-banks such as local check-cashing outlets sold prepaid cards that were priced similarly to University's card with the same basic functionality.
- Profitability Issues – The piloted card was expensive to administer, placed all of the fraud risk at the bank (as opposed to risk being kept by the vendor) and yielded a minimal revenue stream. Management also concluded that a card that only targeted one segment of the market (i.e., low-income consumers) would not produce the volumes necessary to sustain a profitable business model.

During the pilot, University sold 274 cards and generated fee income of $1,630.30. These pre-paid cards did not produce float balances, so there was no net interest income. Processing expenses were $7,811.18. This resulted in a net loss of $6,180.88.

University's management said the company's approach to prepaid cards has shifted from using cards to serve consumers without bank accounts to viewing cards as a line of business.

Mobile Banking Prepaid Card

Product

Late in 2006, University signed a contract with a second vendor for a prepaid card that connected to cardholders' cell phones. Features relative to the original prepaid cards are given below:

Feature/Function	Mobile Banking Card	Piloted Prepaid Card
Card Focus	General Spend	General Spend
Transaction Types	Point of Sale and ATM	Point of Sale and ATM
Major Card Brand	Visa	MasterCard
Bill Payment	No	No
Remittances	No	No
FDIC Insurance	Yes	No
Reload Options	Direct Deposit	None
Savings Features	No	None
Credit Features	No	None

It had the following additional features:

- Visa zero-liability protection.
- Cardholders have free phone and on-line account information access.
- Account to account transfers via cell phone.
- Free ACH deposits.
- Reloading using cash via MoneyGram, via mail, on-line, and via cell phone.
- Free POS purchases and cash back at POS.

University's research showed that a large percentage of low-income consumers in its markets own cell phones. Linking the card to a cell phone allowed the card to be turned on/off by the consumer as a way to prevent fraud. Cardholders could receive text messages requesting transaction authorization, and make transactions via cell phone.

Infrastructure Issues

In 2008, University launched this new card program. The bank hired a staff member to deal with prepaid card issues specifically.

During the third quarter of 2007, a pilot program with 10 active cards (issued to bank employees) was launched and the bank tested the infrastructure. University had trouble making the product work with the software used by the three independent sales organizations signed up by the processor to sell the cards nationally. These problems led University to postpone its planned launch until the third quarter of 2008.

But as the cardholder table above shows, working with independent sales organizations selling cards outside of University's market area was successful in adding cardholders.

University did not make a profit from these cards because it did not receive a large enough portion of the transaction fees. It shared the fees with the processor and the independent sales organizations. The fee division for transactions is laid out below.

Transaction Type	Cardholder Fee	ISO Share	Processor Share	UNB Share*
Account Deposit	$1.00	$0.68	$0.25	$0.07
ATM Withdrawal	$1.50	$0.60	$0.70	$0.20
Bill Payment	$2.00	$0.60	$1.00	$0.40
POS Signature	—	—	—	—
POS PINs	—	—	—	—
Monthly Fee	$2.95	$1.45	$1.00	$0.50

*UNB stands for University National Bank.

University management believes that in retrospect, it should have kept about a third of the income to compensate for card administration work and for the risks associated with owning the account as the issuer (fraud risk, overdraft risk, etc.). However, the bank was unable to negotiate higher revenues since it was new in this space. Institutions should carefully negotiate contracts with ISOs and Processors.

Because the laws regarding wage payments vary from state to state, instead of offering a payroll card to companies, University Bank offered a card with direct deposit capabilities to consumers. They could choose to have their pay directly deposited onto the card, and the bank did not need to design its products around state laws.

University said that the grant made offering prepaid cards possible and let the bank do the tests that led to its strategy of offering many kinds of cards with partners going forward. University CEO David Reiling said vendors need their own compliance officers who understand banking law so that the bank does not need to teach processors what must be done to make a program compliant. He added that high card volumes are needed for success.

Analysis

In looking at University Bank's experiences in light of the three hypotheses, several conclusions can be drawn:

Hypothesis One

University Bank's prepaid cards did not turn a profit for the bank due to the initial set up costs. This mostly came as a result of problems with vendors, including contractual revenue sharing.

University Bank's management said that to make a profit from prepaid cards, a bank needs to build its own program. Offering cards from another bank in the form of a turn-key product is a defensive move for banks that want to round out their product lines with prepaid cards without creating a new line of business, according to University.

Hypothesis Two

University Bank saw its prepaid cards as a way to reach out to consumers without bank accounts as opposed to working with businesses or other institutional customers. However, as the business grows, University expects that the cards will help in deepening existing customer relationships.

Hypothesis Three

University did not test turning prepaid cardholders into accountholders due to the short time its first product was out and because its Mobile Banking Card was offered outside of its market area.

The Future

Looking ahead, University's management said that it plans to continue offering prepaid cards primarily as an issuer for processors and independent sales organizations. It expects to issue many kinds of reloadable prepaid cards for programs that target the general population as well as those that target consumers without bank accounts. University Bank's management expects prepaid card issuing to become a profitable line of business and expects to issue up to 500,000 cards over the next few years. It expects that the program in the current incarnation will generate card volume running into several hundred thousands and will result in significant customer deposits.

Specific Lessons Learned from the Banks' Experiences

Central Bank of Kansas City's Experiences:

1. Prepaid card product and program design must fit the banking needs and demographics of customers and the evolving regulatory landscape.
2. Cardholders must be educated on how to use the cards in a way that is most cost effective for both them and the bank. Unintended card usage that has not been priced appropriately can cause unplanned increase in costs.
3. Banks need to charge cardholders and stakeholders based on services provided, e.g. employers using payroll cards need to reimburse the bank for services either through fees or through compensating deposit balances.

University National Bank's Experiences:

1. Transaction processors and vendors can help determine product design, pricing, and thus profitability. It is critical to contract with a responsive, well-established processor that understands banking regulations for a successful product offering, since an inflexible, inexperienced processor can result in a mediocre product offering.
2. Partners such as employers and independent sales organizations can boost the adoption of prepaid cards.

Demystifying Prepaid Cards Part Three: A Prepaid Card Infrastructure Tool Kit

The objective of this section is to help banks who are interested in setting up a prepaid program ask themselves the questions that will help them be successful.

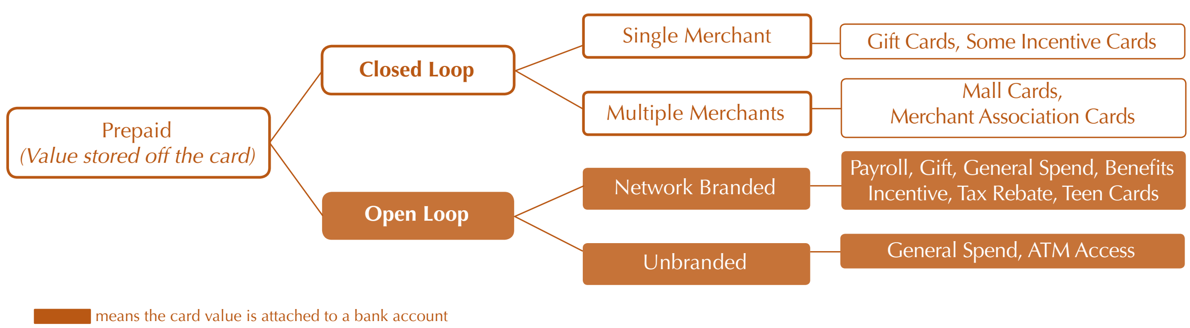
Bankers and industry insiders say that banks considering prepaid cards need to answer two primary questions before they can set up a successful prepaid line of business.

1. What role can prepaid cards play in the overall strategic goals of the bank?
2. Who will buy and use these cards? What audience is the bank trying to satisfy?

A bank should identify where prepaid cards would fit into its overall line of products:

- Prepaid cards can be an alternative for consumers not yet ready for checking accounts, debit cards, credit cards or other products.
- Prepaid cards can be a tool for deepening relationships with commercial customers who want to control employee spending, stop issuing paychecks, and stop issuing rebate and incentive checks, or other paper payments.
- Prepaid cards could be a product for customers who want to give a gift, send money to others, or have a way to provide a recurring source of money for teens or other family members.
- Prepaid cards can be a product offered to nonprofits or government agencies as a way to win new kinds of businesses and enter nontraditional market segments.

This sub-section from the payment card taxonomy, while not all-encompassing, gives an idea of the range and categories of payment cards a bank might want to issue. It should be noted that for many purposes, branded cards carry the most obvious value to cardholders when compared with other kinds of cards, but they are not the only kind of card that can be useful.



Later we include the lessons learned about prepaid cards in the course of the literature review and case studies. These lessons can provide guide posts for where prepaid cards might fit into a bank's strategic plans and how a bank might set up a program. The lessons will inform the rest of the discussion in this section. The tool kit will approach the process of setting up a prepaid card business in terms of opportunity, product design, and infrastructure.

Opportunity

Identifying the market opportunity will shape the prepaid card program and determine what business model the bank uses based on its business objectives for the program.

1. Business objective questions:

- Is the objective to increase fee income?
- Do you want to find new customers who will eventually migrate to checking accounts, savings accounts, and loans?
- Will prepaid cards be a value added service for commercial clients?

Some objectives are relationship oriented and some are profit oriented, though these are not necessarily exclusive. For relationship-oriented cards, a bank might consider pricing the cards at cost and a small profit over cost from other business generated from the client – however, strong management information systems or transfer pricing mechanisms need to be set up to ensure relationship profitability. For profit-oriented programs, the bank needs to make sure that card fees can cover costs and provide a profit margin.

Banks also must conduct a market assessment before launching prepaid cards. Banks need to identify the potential customer base. It could be that the bank has seen a large number of unbanked consumers who could benefit from using a prepaid card to make purchases, pay bills, and avoid check cashing fees. It might be that businesses want to stop issuing paychecks but have employees who do not have bank accounts and so cannot receive direct deposit. It may also be that the banks want to focus on special ethnic groups, new immigrants or demographic groups (teens, students). Finally, they may need to think whether this product can be offered to existing account holders, new unbanked customers, or both.

2. Market assessment questions:

- How big is the customer segment? How much market share will we seek in terms of customers and transaction volume?
- Where can the bank find customers and how will it reach them?
- Who is the competition for these customers – check cashers, retailers, etc.?
- What market factors could affect the prepaid card business, including regulation, the economy, and business trends?
- Why would customers use a prepaid card over other financial services options?
- Who do you plan to offer the cards to?
- What are their characteristics: low-income, immigrants, employers of day laborers, contract workers, government agencies?
- What needs do they have that prepaid cards fill?
- Can the needs be filled by an existing bank product or a modified version of an existing product?

Product

After identifying customer needs, a bank can design a product with features to meet those needs. This section will provide some of the questions to ask about what kind of product you want to create.

A bank's focus also affects what kinds of cards it might offer.

Retail Bank	Commercial Bank
Gift Cards for General Customers	Payroll Cards
Travel Cards	Incentive or Rebate Cards
Reloadable Prepaid for Unbanked or as an Alternative to Credit Cards	Healthcare Cards
	Business Expense Cards

While product design will be driven by customer needs, certain features contribute to successful prepaid cards. For customers to keep using the cards, they need a way to add money to their cards. Cards that combine functionality with ease of loading will always be most successful, according to industry members.

For example, the easiest reloading method is direct deposit of recurring checks. This is why payroll cards tend to be more successful in terms of long-term use than other cards.

The answers to certain questions will inform the product design:

- Will the cards be open loop or closed loop?
- What brand will the card carry?
- Will it offer a savings account connected with the card?
- Will it offer credit? How will we ensure that credit risk or overdrafts are managed within limits?
- How will consumers check their balances?
- How will they load money onto the card? Cash load? Direct deposit?
- Can they send money to others in the United States and abroad?
- What other features would customers or potential customers like to see?
- Should the card be associated with some other partner such as a local business or organization, or a national partner such as a well-recognized distributor?
- How will consumers get their cards? For example, will they need an instant issue card, and will they get it at their place of employment, a retail store, or through the mail?

Prepaid cards need to let customers make transactions at a point of sale. Depending on their purpose (for example payroll cards, teen cards, travel cards), they may also need to allow for ATM withdrawals. A gift card or a rebate card might not let cardholders take cash from an ATM.

Cards that have one of the major card brands provide the most flexibility to card holders because of their acceptance. Personalization of cards helps with Know Your Customer concerns and protects balances. It is also necessary to connect a card with a particular cardholder in order to ensure FDIC insurance. This may also help consumers feel like they have a card that is like regular credit and debit cards and make them more likely to use it.

As mentioned above, direct deposit leads to cardholder loyalty and recurring use of the cards. Allowing cardholders to reload their cards at point of sale terminals, such as MoneyGram or Western Union locations, also encourages consumers to reload their cards as opposed to using them once and throwing them away.

Online balance information, text messaging, and customer service via telephone help consumers manage their accounts and give them up to date balance information. This information can mean that consumers have almost the same awareness of how much money they have as if they were carrying cash. Online customer service also can be paired with budgeting tools and financial education.

Remittances can be a profitable line of business as it is an attractive product for immigrant groups. To become profitable the bank must convince immigrants to switch from non-card based methods of sending money to using their cards.

A few other features, while not standard, may be worth considering:

Enabling customers to pay bills online means the cards offer a service that matches checking account features. This may help transition these consumers to financial services such as checking and savings accounts.

Credit reporting means that consumers can build credit ratings through card use.[28]

Savings accounts allow cardholders to keep money on the card over a longer time and generate increased use and loyalty.

Offering credit is an avenue that some issuers are beginning to explore. Offering small dollar loans using the prepaid card as a disbursement method and a repayment method may become a way for banks to compete against payday lenders and other nontraditional lenders.

Understanding Prepaid Cards Using the Five Principles of Marketing (5 Ps)

Product	Price	People	Promotion	Place
1. Where does the bank's prepaid card fit into its overall suite of products? 2. What needs is it designed to meet, and for whom? 3. What features does the product include? Should the bank offer a suite of prepaid cards? 4. What is the profile of the potential cardholder? 5. Do potential cardholders have experience with cards and understand their value?	1. Do card revenues cover all the costs of the program including fixed costs, marketing, card production, and others? Are we paying for the costs from revenues earned elsewhere? 2. Is the card pricing competitive with the competition, which may be check cashers, secured credit cards, or other services aimed at the same audience? 3. How will the bank budget for fixed costs?	1. Can the bank dedicate staff for issuing, processing, and marketing and outreach?	1. How will the bank reach potential cardholders? 2. Are there any partners that can bring potential cardholders to the bank? 3. Do the bank's promotions include educating cardholders on how best to use their cards? 4. How can the bank leverage existing advertizing for promoting prepaid cards?	1. Where will cardholders purchase and receive their cards? 2. Where will they reload them? 3. What alternatives exist in the market and whether they are 'more convenient' for the customers?

Infrastructure

When setting up a prepaid program, banks can choose from different models.

The Three Primary Business Models

Business Model	Roles the Bank Must Play
Build Program In-House	Issuing Bank Program Manager Processor Reload Network
Partial Outsourcing (e.g. processing, program management)	Issuer Program Manager (If one is not hired)
Total Outsourcing (White label Card)	Sales Agent

A bank can determine whether it should work alone or partner with another bank or program manager to offer prepaid cards by answering several questions about its strategy:

- How quickly do I want to get to market?
- Do we have the staff to commit to and support our prepaid efforts?
- How are we going to market our program?
- What kind of budget can we afford?
- Is upper management behind the decision?
- How will we measure success?

The size and capabilities of a financial institution will determine the answers to these questions. A small bank that doesn't want to spend much money to get a program up and running might want to buy a turn-key prepaid card program from another bank or program manager, but a larger bank might want to build a program in-house.

Pros and Cons of the Three Primary Business Models

Business Model	Pros	Cons
Build Program In-House	Customize to needs Control of customer information Earn deposits and fees	Expensive Time consuming Must assume all risks
Partial Outsourcing (e.g. processing, program management)	Quicker to market Contract expertise Lower resource commitment than building in-house	Can be expensive Vendor risks – unresponsive, can't do what bank needs Less control over features Customer information could be vendor's, causing reputational risk
Total Outsourcing (White Label Card)	Can focus on selling only Reduced compliance risk because the issuing bank shares this risk Low resource commitment	Do not own customer relationship Less customization because of out sourcing Less control over features

Four hypothetical profit and loss statements provided on the following pages show how a card program might look if a bank chose to be its own issuer or if it chose to sell another bank's cards. There are versions showing what would happen if high and low volumes of cards are sold. The table on the next page shows the assumptions for each case. This is meant to demonstrate sources of revenues and expenses that need to be monitored to maximize profitability.

Areas of Risk Management: Profit and Loss Statement Assumptions

Bank as Issuer Case	Bank as Franchisee Case
Bank is successful in selling cards to customers. The net increase in cards refers to increase in active cards. Customers use cards to make six signature purchases per month. Customers use cards to make two PIN purchases per month. Customers use cards to make four ATM withdrawals a month and use ATMs to check balances twice a month. Customers call to check balances four times a month. Customers receive two direct deposits a month. Bill pay and remittances are included as options, but not used in these cases. Case assumes 10% increase in marketing and 3% increase in staff costs each year. Average card balance of $20 per card and a net interest margin of 3.5% for Net Interest Income calculations.	Assume $1.50 per month per active card, with an average card life of 6 months.[1] Bank is successful in selling cards to customers. The net increase in cards refers to increase in active cards. [1]Other franchise methods exist where the issuing bank gives its client banks a share of the gross income from the cards.

In the model where banks build their own programs, they need to negotiate what they would pay for each service with their processors and decide what to charge for each service they provide.

Below is what a profit and loss table would look like for a program where the bank issues its own cards, hires a third-party processor, and has a low volume of card sales. This has been created to demonstrate the profitability of the card programs based on the above assumptions and that variances in customer behavior can impact revenues and expenses.

Alternative 1: CDFI Bank is Issuer of Cards - Low Volume of Card Sales

Possible Prepaid Profit and Loss Statement - Fees and Expenses to be Negotiated

	Income/Cost Per Transaction	Transactions Per Month	Total $ Per Month	Total $ Per Year 1	Total $ Per Year 2	Total $ Per Year 3	Total $ Per Year 4	Total $ Per Year 5
Number of Cards in Stable State					1,000	2,000	3,000	4,000
Net New Cards Issued				1,000	1,000	1,000	1,000	1,000
Active Cards				1,000	2,000	3,000	4,000	5,000
Assumes small bank issuer that has few ATMs								
Card balances per card	**$20.00**							
Net Interest margin on card balance	**3.50%**							
INCOME								
Card Issuance and Maintenance Fees				**$6,425**	**$9,375**	**$12,325**	**$15,275**	**$18,225**
New Card Issuance Fee	$4.95			$4,950	$4,950	$4,950	$4,950	$4,950
Monthly Maintenance Fee	$2.95			$1,475	$4,425	$7,375	$10,325	$13,275
POS Transactions				**$33,000**	**$82,200**	**$131,400**	**$180,600**	**$229,800**
Signature Purchases: Processor Income + Interchange	$0.45	6	$2.70	$16,200	$48,600	$81,000	$113,400	$145,800
PIN Purchases: Processor Income + Interchange	$0.70	2	$1.40	$16,800	$33,600	$50,400	$67,200	$84,000
ATM Transactions				**$39,000**	**$117,000**	**$195,000**	**$273,000**	**$351,000**
ATM Withdrawals - At Bank ATM Machines	$1.50	1	$1.50	$9,000	$27,000	$45,000	$63,000	$81,000
ATM Withdrawals - At Another Bank	$1.50	3	$4.50	$27,000	$81,000	$135,000	$189,000	$243,000
ATM Balance Inquiries	$0.25	2	$0.50	$3,000	$9,000	$15,000	$21,000	$27,000
Optional Services - Fees if Services Offered								
Bill Payment Fees	$1.00	0	$0.00	$0	$0	$0	$0	$0
Remittance Fees	$5.00	0	$0.00	$0	$0	$0	$0	$0
Administrative Fees				**$1,500**	**$4,500**	**$7,500**	**$10,500**	**$13,500**
Telephone Balance Inquiry Fee	$0.00	4	$0.00	$0	$0	$0	$0	$0
Text Message Balance Inquiry Fee	$0.00	2	$0.00	$0	$0	$0	$0	$0
Direct Deposit Fees	$0.00	2	$0.00	$0	$0	$0	$0	$0
Reload Fee	$0.25	1	$0.25	$1,500	$4,500	$7,500	$10,500	$13,500
Net Interest Income				**$350**	**$1,050**	**$1,750**	**$2,450**	**$3,150**
Card Balances x Net Interest Margin of 3.5%				$350	$1,050	$1,750	$2,450	$3,150
Total Revenues				**$80,275**	**$214,125**	**$347,975**	**$481,825**	**$615,675**
EXPENSE								
POS Transactions				**$7,800**	**$23,400**	**$39,000**	**$54,600**	**$70,200**
POS Signature Purchases - Costs	$0.15	6	$0.90	$5,400	$16,200	$27,000	$37,800	$48,600
POS PIN Purchases - Costs	$0.20	2	$0.40	$2,400	$7,200	$12,000	$16,800	$21,600
ATM Transactions				**$22,080**	**$66,240**	**$110,400**	**$154,560**	**$198,720**
ATM Withdrawal - At Home Bank ATM	$0.75	1	$0.75	$4,500	$13,500	$22,500	$31,500	$40,500
ATM Withdrawal - At Foreign Bank ATM	$0.75	3	$2.25	$13,500	$40,500	$67,500	$94,500	$121,500
ATM Balance Inquiries	$0.34	2	$0.68	$4,080	$12,240	$20,400	$28,560	$36,720
Optional Services - Fees if Services Offered								
Bill Payment Costs	$0.10	0	$0.00	$0	$0	$0	$0	$0
Remittance Costs	$0.50	0	$0.00	$0	$0	$0	$0	$0
Administrative Fees				**$156,100**	**$180,520**	**$205,501**	**$231,093**	**$257,353**
Account creation fee	$0.20		$0.00	$200	$200	$200	$200	$200
Telephone Balance Inquiry Fee	$0.25	4	$1.00	$6,000	$18,000	$30,000	$42,000	$54,000
Text Message Balance Inquiry Fee	$0.02	2	$0.04	$480	$960	$1,440	$1,920	$2,400
Direct Deposit Fees	$0.02	2	$0.04	$240	$720	$1,200	$1,680	$2,160
Reload Fee Expense	$0.12	1	$0.12	$720	$2,160	$3,600	$5,040	$6,480
Monthly Maintenance Fee	$0.12		$0.00	$60	$180	$300	$420	$540
Cardholder Web Site	$600.00	1	$600.00	$7,200	$7,200	$7,200	$7,200	$7,200
ACH Funding	$0.10	2	$0.20	$1,200	$3,600	$6,000	$8,400	$10,800
Card Production	$2.00		$0.00	$2,000	$2,000	$2,000	$2,000	$2,000
Marketing/Advertising	$4,000.00	1	$4,000.00	$48,000	$52,800	$58,080	$63,888	$70,277
Staff Costs	$7,500.00	1	$7,500.00	$90,000	$92,700	$95,481	$98,345	$101,296
Total Costs				**$185,980**	**$270,160**	**$354,901**	**$440,253**	**$526,273**
Total Revenues				**$80,275**	**$214,125**	**$347,975**	**$481,825**	**$615,675**
Total Costs				**$185,980**	**$270,160**	**$354,901**	**$440,253**	**$526,273**
Net Contribution Before Overheads				**-$105,705**	**-$56,035**	**-$6,926**	**$41,572**	**$89,402**

If, for example, the same number of cards were outstanding in year five but cardholders made only half as many POS transactions because they were withdrawing larger amounts of cash in the same number of ATM transactions and using cash instead of paying with their cards, the total net contribution, even with the associated reduction in expenses, would fall to $9,602.41.

Here are what the revenues, expenses and net contribution might look like in a high volume program. (This assumes that all of the categories are the same and the only difference is the volume of cards.)

Alternative 1: CDFI Bank is Issuer of Cards - High Volume of Card Sales

Possible Prepaid Profit and Loss Statement - Fees and Expenses to be Negotiated

	Total $ Per Year 1	Total $ Per Year 2	Total $ Per Year 3	Total $ Per Year 4	Total $ Per Year 5
Number of Cards in Stable State		1,000	4,000	14,000	24,000
Net New Cards Issued	1,000	3,000	10,000	10,000	10,000
Active Cards	1,000	4,000	14,000	24,000	34,000
Assumes small bank issuer that has few ATMs					
Card balances per card	$20				
Net Interest margin on card balance	3.5%				
INCOME					
Card Issuance and Maintenance Fees	$6,425	$22,225	$76,050	$105,550	$135,050
POS Transactions	$33,000	$148,200	$526,800	$1,018,800	$1,510,800
ATM Transactions	$39,000	$195,000	$702,000	$1,482,000	$2,262,000
Optional Services - Fees if Services Offered					
Administrative Fees	$1,500	$7,500	$27,000	$57,000	$87,000
Net Interest Income	$350	$1,750	$6,300	$13,300	$20,300
Total Revenues	$80,275	$374,675	$1,338,150	$2,676,650	$4,015,150
EXPENSE					
POS Transactions	$7,800	$39,000	$140,400	$296,400	$452,400
ATM Transactions	$22,080	$110,400	$397,440	$839,040	$1,280,640
Optional Services - Fees if Services Offered					
Administrative Fees	$156,100	$202,320	$337,441	$515,313	$693,8523
Total Costs	$185,980	$351,720	$875,281	$1,650,753	$2,426,893
Total Revenues	$80,275	$374,675	$1,338,150	$2,676,650	$4,015,150
Total Costs	$185,980	$351,720	$875,281	$1,650,753	$2,426,893
Net Contribution Before Overheads	**-$105,705**	**$22,955**	**$462,869**	**$1,025,897**	**$1,588,257**

The actual behavior of cardholders and the life of the card may vary significantly from these examples, so revenues could fluctuate. As the case studies in section two reinforce, cardholder use pattern determines how well a prepaid card program performs and costs.

In the second alternative, the advantages of outsourcing the program are shown in that while the return is smaller, the bank only needs to sell the cards. It does not set the fees or features of the cards, but it also does not need to form vendor relationships or add staff. This option may be more appropriate for banks that do not plan to sell many cards but want to have prepaid cards in their suites of products.

Alternative 2: CDFI Bank Franchises Card Issuance with a Major Provider - Low Volume of Card Sales

Possible Prepaid Profit and Loss Statement - Fees and Expenses to be Negotiated

	Income/Cost Per Transaction	Total $ Per Year 1	Total $ Per Year 2	Total $ Per Year 3	Total $ Per Year 4	Total $ Per Year 5
Number of Cards in Stable State			1,000	2,000	3,000	4,000
Net New Cards Issued		1,000	1,000	1,000	1,000	1,000
Total Cards		1,000	2,000	3,000	4,000	5,000
Assumes small bank issuer that has few ATMs						
INCOME						
Franchise Income from Third Party (Per Active Card)	**$9.00**	**$9,000**	**$18,000**	**$27,000**	**$36,000**	**$45,000**
Card Issuance and Maintenance Fees						
New Card Issuance Fee	$0.00	$0	$0	$0	$0	$0
Monthly Maintenance Fee	$0.00	$0	$0	$0	$0	$0
POS Transactions						
Revenues						
Signature Purchases: Processor Income + Interchange	$0.00	$0	$0	$0	$0	$0
PIN Purchases: Processor Income + Interchange	$0.00	$0	$0	$0	$0	$0
ATM Transactions						
ATM Withdrawals - At Bank ATM Machines	$0.00	$0	$0	$0	$0	$0
ATM Withdrawals - At Another Bank	$0.00	$0	$0	$0	$0	$0
ATM Balance Inquiries	$0.00	$0	$0	$0	$0	$0
Optional Services - Fees if Services Offered						
Bill Payment Fees	$0.00	$0	$0	$0	$0	$0
Remittance Fees	$0.00	$0	$0	$0	$0	$0
Administrative Fees						
Telephone Balance Inquiry Fee	$0.00	$0	$0	$0	$0	$0
Text Message Balance Inquiry Fee	$0.00	$0	$0	$0	$0	$0
Direct Deposit Fees	$0.00	$0	$0	$0	$0	$0
Reload Fee	$0.00	$0	$0	$0	$0	$0
Net Interest Income						
Card Balances x Net Interest Margin of 3.5%	$0.00	$0	$0	$0	$0	$0
Total Revenues		**$9,000**	**$18,000**	**$27,000**	**$36,000**	**$45,000**
EXPENSE						
POS Transactions						
POS Signature Purchases - Costs	$0.00	$0	$0	$0	$0	$0
POS PIN Purchases - Costs	$0.00	$0	$0	$0	$0	$0
ATM Transactions						
ATM Withdrawal - At Home Bank ATM	$0.00	$0	$0	$0	$0	$0
ATM Withdrawal - At Foreign Bank ATM	$0.00	$0	$0	$0	$0	$0
ATM Balance Inquiries	$0.00	$0	$0	$0	$0	$0
Optional Services - Fees if Services Offered						
Bill Payment Costs	$0.00	$0	$0	$0	$0	$0
Remittance Costs	$0.00	$0	$0	$0	$0	$0
Administrative Fees						
Account Creation Fee	$0.00	$0	$0	$0	$0	$0
Telephone Balance Inquiry Fee	$0.00	$0	$0	$0	$0	$0
Text Message Balance Inquiry Fee	$0.00	$0	$0	$0	$0	$0
Direct Deposit Fees	$0.00	$0	$0	$0	$0	$0
Reload Fee Expense	$0.00	$0	$0	$0	$0	$0
Monthly Maintenance Fee	$0.00	$0	$0	$0	$0	$0
Cardholder Web Site	$0.00	$0	$0	$0	$0	$0
ACH Funding	$0.00	$0	$0	$0	$0	$0
Card Production	$0.00	$0	$0	$0	$0	$0
Marketing/Advertising	$100.00	$1,200	$1,200	$1,200	$1,200	$1,200
Staff Costs	$1,000.00	$12,000	$12,000	$12,000	$12,000	$12,000
Total Costs		**$13,200.00**	**$13,200**	**$13,200**	**$13,200**	**$13,200**
Total Revenues		**$9,000**	**$18,000**	**$27,000**	**$36,000**	**$45,000**
Total Costs		**$13,200**	**$13,200**	**$13,200**	**$13,200**	**$13,200**
Net Revenues		**-$4,200**	**$4,800**	**$13,800**	**$22,800**	**$31,800**

If the cards stay active for longer than six months, then the profits on this could be much greater. For example if the cards stay active for 12 months, then the income in year five more than doubles to $76,800. So even in the franchise case, much depends on cardholder use.

Here are what the revenues, expenses and net contribution might look like in a high volume franchise program. (This assumes that the only difference is the volume of cards.)

Alternative 2: CDFI Bank Franchises Card Issuance with a Major Provider - High Volume of Card Sales

Possible Prepaid Profit and Loss Statement - Fees and Expenses to be Negotiated

	Total $ Per Year 1	Total $ Per Year 2	Total $ Per Year 3	Total $ Per Year 4	Total $ Per Year 5
Number of Cards in Stable State		1,000	4,000	14,000	24,000
Net New Cards Issued	1,000	3,000	10,000	10,000	10,000
Active Cards	1,000	4,000	14,000	44,000	34,000
Assumes small bank issuer that has few ATMs					
Card balances per card					
Net Interest margin on card balance					
INCOME					
Franchise Income from Third Party (Per Active Card)	$9,000	$36,000	$126,000	$396,000	$306,000
Card Issuance and Maintenance Fees	$0	$0	$0	$0	$0
POS Transactions	$0	$0	$0	$0	$0
ATM Transactions	$0	$0	$0	$0	$0
Optional Services - Fees if Services Offered	$0	$0	$0	$0	$0
Administrative Fees	$0	$0	$0	$0	$0
Net Interest Income	$0	$0	$0	$0	$0
Total Revenues	$9,000	$36,000	$126,000	$396,000	$306,000
EXPENSE					
POS Transactions	$0	$0	$0	$0	$0
ATM Transactions	$0	$0	$0	$0	$0
Optional Services - Fees if Services Offered	$0	$0	$0	$0	$0
Administrative Fees	$13,200	$13,200	$13,200	$13,200	$13,200
Total Costs	$13,200	$13,200	$13,200	$13,200	$13,200
Total Revenues	$9,000	$36,000	$126,000	$396,000	$306,000
Total Costs	$13,200	$13,200	$13,200	$13,200	$13,200
Net Revenues	**-$4,200**	**$22,800**	**$112,800**	**$382,800**	**$292,800**

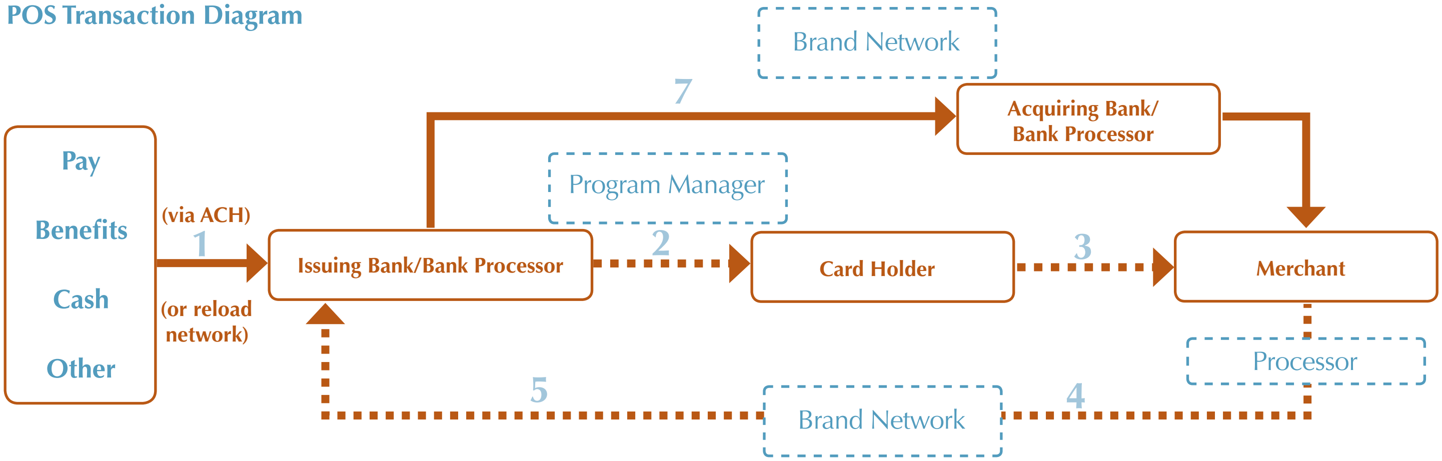
Banks should build a similar table for any program they are contemplating and test it to see how many cards and what fees are required to build a profitable program. Banks should also be sure that the assumptions on the level of card use – for example, six signature transactions per month, two PIN purchases per month, and four ATM withdrawals a month – can be validated.

Questions for Banks to Ask When Considering Each Alternative

Issue	Franchise
1. Will cardholders use the cards in the way we predict?	1. What resources will we need to devote to selling cards?
2. How can we encourage the card use we want?	2. How many cards will we need to sell to make it worthwhile?
3. Does our pricing ensure profitability if card use does match our model?	3. Is our vendor compliant with all regulations?
4. How will we monitor card use?	4. How will the vendor handle customer concerns and complaints?
5. What will we do if we see card use is not matching our projections?	5. Who owns the customer relationship? Will the vendor share information with us?
6. How many cards can we sell and how long can we expect them to be active?	6. What is the vendor's business plan – will it be around to support the product or be acquired within a year, leaving a hole in our product line?

Because a large number of companies can be involved handling prepaid accounts, the ABA Bank Compliance magazine suggests that institutions draw a diagram of the flow of funds associated with prepaid cards to better understand the costs and potential risks.[29] Below is an example of how funds and information might flow in a point of sale transaction.

POS Transaction Diagram



Flow of Funds

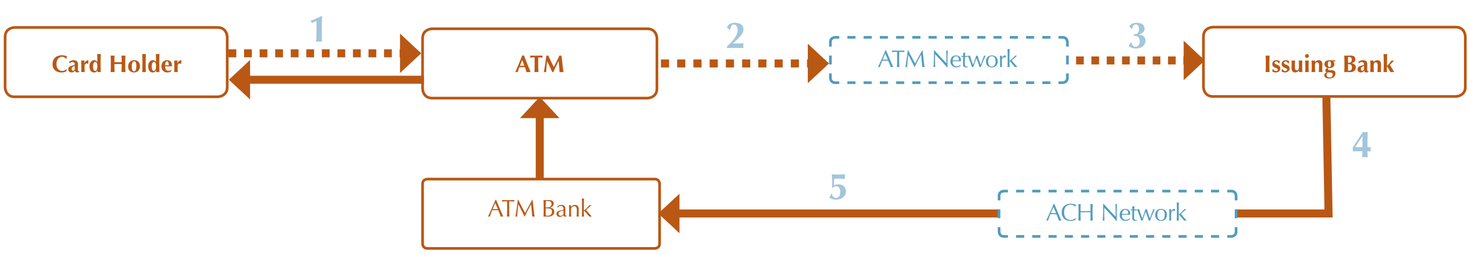
Flow of Data

Steps in the Transaction

1. A cardholder receives funds by having pay or benefits directly deposited with the issuing bank via ACH.
2. The cardholder receives a card and/or a load notification from the program manager, if there is one.
3. The cardholder uses the card at a merchant.
4. The merchant's processor sends a transaction request to the bank.
5. The networks route the transaction using the Bank Indentification Number for the card.
6. If approved, the bank allows the transaction.
7. The issuing bank settles with the merchant's acquiring bank via a brand network (i.e. Visa, MasterCard).

Below is a diagram showing how an ATM transaction might work:

ATM Transaction Diagram



Note: The issuing bank and the ATM Bank could be the same. If so, then the issuing bank would just provide the funds for the ATM.

Flow of Funds

Flow of Data

Steps in the Transaction

1. The cardholder inserts the card and makes a withdrawal request.
2. The ATM contacts the ATM network (e.g. Cirrus, Plus, Star).
3. The ATM network contacts the issuing bank/the bank's processor.
4. If approved, the funds and any charge is taken from the cardholder's account.
5. The transaction is processed through the Federal Reserve's ACH system.
6. The surcharges and funds are deposited in the bank that owns the ATM.
7. The issuing bank debits the cardholder's account for any charges it imposes.

Choosing a Vendor

The choice of a vendor affects all aspects of a prepaid card program. Those banks that choose to outsource part or all of their prepaid card programs should ask the following questions of potential vendors:

1. Does the vendor focus on the kind of card the bank wants to offer and what parts of the infrastructure?
2. Can the vendor provide all the services necessary?
3. Can they provide different product types without needing to create new silos?
4. Does the vendor have a compliance officer who understands bank regulations?
5. What does it charge for services, and what income does it share with the bank?
6. Does it comply with regulatory and legal requirements such as having anti-money laundering controls in place?
7. What kinds of support does the vendor offer – does it offer sales and marketing support, call centers, etc.?
8. What reporting does it supply to help a bank measure whether or not the program is successful?
9. Can the vendor handle growth in the number of cardholders and transactions as the program grows?
10. Can the vendor provide information about who would be a good credit risk, who could upgrade to a checking account, and the like, or will they see any attempt to move customers onto other banking products as competition? (The vendor's business goals must align with the bank's goals.)
11. How long will it take to get the program up and running?
12. Does the vendor's system work with the bank's system?
13. Does the vendor's system work with other processors and payment networks?
14. Does the vendor have disaster recovery plans?
15. Does the vendor have fraud monitoring systems?
16. What is the vendor's reputation in the industry? (Talk to former clients, the brand networks, etc.)
17. Is the vendor financially stable, what is its business plan?

Finally, banks must realize that everything is negotiable.

Regulatory Issues

As with any product, prepaid cards raise a number of regulatory issues. While this is not meant to be a comprehensive guide and should not substitute for legal advice, here is a non-exclusive list of regulatory issues that affect prepaid cards:

1 Deposit Insurance: The issue of deposit insurance was resolved in 2008, when the FDIC said that it would cover cardholder funds if certain conditions were met. Still, banks must make sure their programs meet these conditions. Because this moved prepaid cards closer to checking accounts in form and function, industry observers say that the regulators may view the cards as being subject to similar regulations.

2. Regulation E: This implements the Electronic Funds Transfer Act, which defines consumer protections in relation to electronic transactions. Payroll cards were determined to be covered under Regulation E by the Federal Reserve. Banks have some flexibility in complying. Under the rule, institutions are not required to provide paper periodic statements to cardholders if the institution makes account information available by telephone, electronically, and, upon the consumer's request, in writing.

3. Anti-Money Laundering: The Network Branded Prepaid Card Association released a best practices guide for issuers and sellers of prepaid cards to help prevent money laundering. Some of the recommendations include:[30]

   a. having an independent risk assessment for each product issued or sold,

   b. monitoring transactions for suspicious activity, and

   c. establishing record keeping requirements for large-dollar prepaid card sales.

4. Payroll Laws: Many states have laws that cover how employers may pay wages. One principle that guides many of these laws is that employees cannot be forced to accept wages in a way that would cost them money. Employers must make sure that an employee can get their entire net pay without incurring any fees. Laws on this vary from state to state, so a bank offering payroll cards will need to ensure that its program complies with applicable state laws. University Bank, one bank in the study, managed to avoid this problem by providing general purpose reloadable cards directly to consumers who then elected to have their paychecks directly deposited to their cards. Other banks have dealt with the issue of access to wages by allowing cardholders to

withdraw their entire balances at tellers, convenience checks, and cash back at the point of sale. Because it is often impossible to make a withdrawal from an ATM of an entire paycheck (which may dispense only $10 or $20 bills) banks in some states need to make other accommodations. A link to a report from the American Payroll Association that provides information on state laws pertaining to payroll cards can be found on page 31.

5. Abandoned Property Laws: Laws on abandoned property also change from state to state. Some states have exempted prepaid cards from abandoned property laws specifically while other states will claim unused prepaid card funds after a certain amount of time. Banks must review the laws and record keeping requirements in those states where they issue prepaid cards to make sure that the cards programs they have set up to keep track of unused funds and to comply with any laws in place about escheatment (the state claiming abandoned property). New laws regarding this have come up frequently in many states, so banks need to follow the latest developments.

   If a bank hires a vendor for part, or all, of its prepaid card program, then it must conduct due diligence to ensure it complies with necessary laws and regulations. While outsourcing may reduce the compliance burden, banks need reputable partners A useful resource is a report produced by the Network Branded Prepaid Card Association. A link to this report can be found on page 31.

6 Credit CARD Act: In May 2009, the Credit Card Accountability Responsibility and Disclosure Act was signed into law. It imposes restrictions on fees and expiration dates on gift cards. While many types of prepaid cards are not covered under the law, such as reloadable cards not marketed as gift cards, banks will need to compare their programs with the provisions of the Act to make sure that they are in full compliance.

Marketing and Distribution

Once the product is ready to go to market, banks need to find a way to tell potential customers that it is there and what it can do for them.

Methods of Marketing and Distribution

Method	Pros	Cons
Traditional Advertising – Newspapers, Radio, Television, Billboards	Can have broad reach and appeal	Hard to measure effectiveness
Ethnic Media – Newspapers, Radio, Television focused on a particular group	Targeted, can specify the audience	Language barriers
Direct Mail	Targeted to audience Provide response card to encourage action	May be discarded as junk mail
Direct Marketing at Events	Raises profile of product and bank	Need appropriate events where customers want to think about finances
Employer Partnerships – Payroll Cards	Defined audience with clear needs	Limited to employees
Nonprofit Partnerships	Can reach specific audience through trusted intermediary	Need to get them to agree to help and to specifics of program
Independent Sales Organizations	Expand markets	Need to ensure compliance and good practices Need to ensure technology compatibility

To determine the best way to sell cards, banks need to understand their target market. Banks need a marketing plan that tries to reach potential cardholders through every effective method. Business objectives will determine the way in which cards are marketed. For example, a bank that wants to use prepaid cards as a profitable line of business will need to find partners to sell its cards outside of its immediate market area. Those banks that want to offer cards as a way to deepen relationships with existing customers might not do any outside marketing and instead let a commercial client deliver its payroll cards to employees.

Banks also must consider what challenges they need to overcome to get cards into the hands of customers. For example, if customers change addresses frequently, then banks may have a hard time sending cards through the mail. So, the bank may distribute cards at the place of employment. For customers worried about immediate access to their money, banks may need to offer an instant-issue, temporary card, and then follow-up with a personalized card.

To determine effectiveness, banks must constantly monitor their efforts and the number of new customers. If something is not effective, then the approach should be changed.

For more information on all the topics covered here, please see our list of additional resources and bibliography.

Collected Lessons Learned about Prepaid Cards

1. Prepaid cards are still in a relatively nascent state of their product lifecycle and the business model, technology and regulations are still evolving. However, the product offers significant promise to CDFI banks and other depository institutions in bringing underserved people into responsible financial service providers.
2. Prepaid cards have the potential to become a profitable product line for CDFI Banks for serving the needs of both unbanked consumers and commercial clients.
3. Banks need to achieve scale in terms of number of active cards to get significant profitability.
4. Partners such as employers and independent sales organizations can boost the adoption of prepaid cards.
5. Prepaid card product and program design must fit the banking needs and demographics of customers and the evolving regulatory landscape.
6. Network branded cards – those carrying a Visa, MasterCard, Discover, or American Express mark – which can be reloaded, have recognizable value to cardholders.
7. Cardholders must be educated on how to use the cards in a way that is most cost effective for both them and the bank. Unintended card usage that has not been priced appropriately can cause unplanned increases in costs.
8. Transaction processors and vendors can help determine product design, pricing, and thus profitability. It is critical to contract with a responsive, well-established processor that understands banking regulations for a successful product offering, since an inflexible, inexperienced processor can result in a mediocre product offering.
9. Banks need to charge cardholders and stakeholders for services provided, e.g. employers using payroll cards need to reimburse the bank for services either through fees or through compensating deposit balances.
10. Transition of prepaid card customers into bank account customers will happen over a long period of time; banks need to invest for the longer term to achieve this transition while seeking fee based profitability in the shorter term.
11. Banks must track card use to know whether or not the cards are meeting the banks' objectives.
12. Banks may need to offer a range of cards for deepening customer relationships; these include payroll cards, incentive cards, and rebate cards.

Prepaid Card Business Plan Outline

I. Opportunity

A. Business Model

1. Fee income
2. Value-added service
3. Customer migration

B. Market Assessment

1. Target audience: consumers, businesses, nonprofits
2. Competition

C. Do you need to offer prepaid cards or do you already have a product to take advantage of this opportunity?

II. Product

A. Features

1. Open-loop/Closed-loop
2. How to reload?
3. Other services: bill pay, direct deposit, remittances, etc.

III. Infrastructure

A. Different Models

1. In-house program
2. Partial/Total Outsourcing

B. Hypothetical Profit and Loss Statements

C. Business Issues

1. Due diligence on vendors
2. Get what you want from vendors – Everything is negotiable

D. Regulatory Issues

1. Federal regulations
2. State laws

E. Marketing and Distribution

1. Selling and marketing directly to consumer
2. Partnerships with employers and nonprofits

End Notes

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[3] Tim Sloane. "4th Annual Network Branded Prepaid Market Assessment." September 2007.

[4] Tim Sloane. "5th Annual Network Branded Prepaid Market Assessment." August 2008.

[5] Independent Community Bankers of America. "2007 Community Banks Payments Survey Executive Summary" October 2007.

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[13] Aspan. 19 February 2009.

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[18] Gwenn Bèzard and Judy Fishman, "Debunking Myths About the Unbanked and Underbanked." Boston: Aite Group LLC, February 2009.

[19] Sarah Gordon, Jennifer Romich, Eric Waithaka, "A Tool for Getting by or Getting Ahead? Consumers' Views on Prepaid Cards" April 2009.

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[21] Based on information provided by the Network Branded Prepaid Card Association and from "A Summary of the Roundtable Discussion on Stored-Value Cards and Other Prepaid Products" from the Federal Reserve, accessed on March 2, 2009 at www.federalreserve.gov/paymentsystems/storedvalue/default.htm#conclusion, last updated on Jan. 12, 2005.

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Available at: http://www.cfsinnovation.com/research-paper-detail.php?article_id=330539

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Additional Resources by Topic

Inclusion of these reports and links does not constitute an endorsement of information by NCIF. Readers access the information and use it at their own risk.

Anti-Money Laundering
Network Branded Prepaid Card Association Best Practices on Money Laundering

http://www.nbpca.com/docs/AML-BP-Summary.pdf

Bank Efforts to Serve Underbanked Consumers
Edward Bachelder, Elizabeth Kronick Alexander, Lydia Yu, Charles Bellows, Joel Stanton, Jesse Rumble, and Michael S. Barr. "Banks' Efforts to Serve the Unbanked and Underbanked for the Federal Deposit Insurance Corp." December 2008.

http://www.fdic.gov/unbankedsurveys/

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Tramond French, Stanley Sienkiewicz, and Chris Daniel. "Let's Discuss Prepaid Cards." ABA Bank Compliance. November/ December 2007.

http://www.aba.com/NR/rdonlyres/CC139B64-7199-4568-BAD5-3EFFE9F7BDA3/49997/BCND2007CoverStory.pdf

Consumer Attitudes Towards Prepaid Cards
Center for Financial Services Innovation and Network Branded Prepaid Card Association Study

http://www.nbpca.com/docs/NBPCA-CFSI-Reloadable-Underbanked-Poll.pdf

Payment instrument choice: The case of prepaid cards

http://www.chicagofed.org/publications/economicperspectives/ep_2qtr2006_part3_chakravorti_Lubasi.pdf

FAQ's about Prepaid Cards

Network Branded Prepaid Card Association

http://www.nbpca.com/docs/NBPCA_Prepaid_FAQ.pdf

FAQ on Prepaid for consumers:
http://www.creditcards.com/credit-card-news/help/9-things-you-need-to-know-about-prepaid-cards-6000.php

Glossaries

FDIC Credit Card Glossary:

http://www.fdic.gov/regulations/examinations/credit_card/glossary.html#gloss73

Federal and State Regulation
FDIC Credit Card Activities Manual

http://www.fdic.gov/regulations/examinations/credit_card/index.html

Payroll Card Law Overview

http://legacy.americanpayroll.org/pdfs/paycard/APAPaycardGuide.pdf

Virginia Changes Payroll Card Laws

http://hr.cch.com/news/payroll/042709a.asp

White Paper on Abandoned Property Laws

http://www.nbpca.com/docs/AbandonedPropertyWhitePaper.pdf

Unemployment Cards
Unemployment Card Fees

http://www.cnn.com/2009/US/03/13/unemployment.fees/

Fees on Missouri Unemployment Cards

https://www.fsvsecurecard.com/fsv/websites/CentralBank2/home.asp

Tips On Using Prepaid Cards For the Unemployed

http://www.defendyourdollars.org/2009/03/tips_for_consumers_using_unemp.html

Vendors
What You Need To Know When Choosing a Prepaid Card Processor

http://www.digitaltransactions.net/files/0707end.doc

Choosing a Prepaid Processor in an Evolving Market:

http://www.visadps.com/downloads/prepaid-processing-javelin-11-5-08.pdf

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