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Stored value cards as 21st century currency

Emerging payment solution offers great opportunities for providers

by: Thomas Mizejeski

Stored value cards are changing the way people do business in the United States. Besides bringing added convenience to a larger proportion of consumers, stored value cards will allow consumers, retailers and even employers to save money. The prepaid industry, which for the last 15 years has focused primarily on telecom services, is about to explode into every sector of the economy. Stored value cards will change the way we use cash, checks and, most importantly, traditional credit cards. Stored value cards present significant revenue opportunities for new players, but they could also significantly reduce the revenues of banks and bank associations, such as Visa and MasterCard.

Stored value cards can be classified as either prepaid debit cards or gift/convenience cards. Prepaid debit cards also can be described as open system cards that can be used at a large number of different retail locations, ATMs and the internet. Gift/convenience cards are closed system cards that only can be used at one company's retail outlets. However, the primary reason people use either card is to make a purchase simpler and faster.

The opportunity

To understand the significance of the opportunity for stored value cards, we should take a look at the current state of banking and credit card markets. Electronic transactions made over financial networks play a part in almost every payment made today. Any person who does not have a bank ATM card or a credit card can experience more difficulty and possibly more expense than a person who has one or both of these cards.

Approximately 50 million adults in the U.S. do not have credit cards, and approximately 10 million households do not have bank accounts. Without these financial facilities, people must use cash, check-cashing services, money transfer services or money orders.

Furthermore, the opportunity for stored value extends well beyond the credit-challenged people who, for whatever reason, do not have a credit card or a bank account. Among people in the U.S. who have a credit card, 42 percent - or 54 million people - have a credit card that is within 5 percent of its credit limit.

In other words, the credit provided to the user to cover transactions in any given month has been used. These cards are, in effect, working like

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debit cards, since users have to pay down the credit balance on the card, which is about the same as loading money on a debit card, if they wish to use the card for additional purchases. The user could be paying interest of as much as 24 percent per year on the credit balance. Therefore, a debit card may prove a beneficial substitute.

Market projections ([click here for chart #1](#))

The applications for prepaid debit cards are so numerous that it is likely that almost everyone will use a prepaid debit card in the next few years. Prepaid debit cards are being used to pay transient workers, for product rebate programs, to pay insurance claims and much more.

Exhibit 1 provides a projection of the number of prepaid debit cards, mostly Visa and MasterCard, that will be issued to people who pay an initial fee to get the card and possibly a monthly maintenance fee while they hold the card. The Pelorus Group projects that prepaid debit cards issued will grow from 5.2 million cards in 2002 to 31.2 million cards in 2007. The two major groups of people who will be acquiring these cards will be people who could not otherwise get a credit card and the portion of the people who have a credit card but become aware that a prepaid debit card is much less costly when all fees are considered.

V is for value ([click here for chart #2](#))

The costs associated with postpaid accounts and traditional credit cards are much higher than prepaid debit cards. With a credit account, charges must be accumulated during the month, a statement created and mailed to the cardholder and a payment subsequently processed. Postpaid accounts also involve bad debt and fraud.

With prepaid accounts, the standard procedure is to provide online accounting or transaction information that can be accessed via an interactive voice response system. If a customer wants a hard copy statement, he pays an extra charge. Since users put money on the card before they spend it, the collection and payment steps are eliminated. Administrative costs for prepaid accounts can be as much as 75 percent less than the costs for postpaid accounts.

Transaction-processing fees paid by the merchant also are lower. Stored value cards are PIN-based debit cards whose transaction fees can be as low as 30 percent of signature-based credit card transactions.

Recently, Visa and MasterCard agreed that they would no longer force merchants to accept their debit card fees or risk losing the ability to accept Visa and MasterCard credit cards. Before the agreement, merchants were required to allow their customers to sign for their debit card purchases. This required that the transaction be processed through the card associations' own processing networks, which are much more costly than networks such as NYCE that process PIN-based debit card transactions.

Finally, people who have problems managing a credit account are exposed to the risk of paying additional fees such as over-line charges and late charges. These charges range from \$25 to \$35 for each month a payment is late or the balance due is over line. Since people are using their own money with debit cards, there are no penalties.

Prepaid wireless paves the way

When prepaid wireless service was introduced, it required a unique payment-processing system. A prepaid wireless program must allow users to conveniently put money into a specific account. However, since these people may not have credit cards or bank accounts, a system outside of the traditional banking system was required. The solution was to use a credit card terminal or custom-designed terminal and

custom software to enable clerks in retail stores to accept cash that could be credited to a specific wireless account. Once these systems were established for wireless companies, only a little more work was required to extend the system to issue and reload prepaid debit cards.

Since a large percentage of prepaid wireless customers do not have access to traditional credit and banking, it was a natural progression to provide this segment with prepaid debit cards. In fact, some of the first prepaid debit cards, such as those from Next Estate, are distributed through Q Comm terminals, which are specifically designed to sell prepaid wireless.

More than prepaid debit cards

Paper money, a form of stored value, was created to facilitate trade. Before the days of inexpensive and ubiquitous information technology, using cash was the cheapest and fastest way to execute a transaction between buyer and seller. Today, stored value cards, especially closed system cards such as the Starbucks Card, enable the fastest and cheapest transactions. Companies issuing the cards get the added benefit of more control over and information about transactions.

Merchants also get two very important benefits from stored value cards. Stored value cards increase customer satisfaction because they make the transaction faster and easier. More importantly, stored value cards increase customer loyalty. Even without an incentive or premium, customers make a commitment to multiple purchases when they buy a stored value card. For example, at Starbucks in the second quarter of 2003, the average value of a card activation was about four times the value of an average transaction using a Starbucks Card. In other words, a customer buys a Starbucks Card and then uses it for that visit and three more visits to a Starbucks shop.

Most convenience cards are not reloadable, but the Starbucks Card is, and some companies now are starting to add the reload option. However, since convenience cards do not require a PIN, they are about the same as cash when lost or stolen.

Starbucks releases quite a bit of information about its stored value card program; see Exhibit 2. It shows activity for activations and redemption for the Starbucks Card for the first six quarters that the program has been in place. The figures indicate that while activations will spike with promotions, redemptions provide a more even cash flow. The chart illustrates one of the benefits of stored value cards - there may be some time between card activation and redemption. The issuing company enjoys the benefit of the float during this period. Stored value cards have been a big success for Starbucks. In the second fiscal quarter of 2003, the value of card redemptions was equal to 9.4 percent of sales.

Distribution

The infrastructure set up to reload prepaid wireless accounts is unique, especially for cash transactions. Thus, companies that are currently serving prepaid wireless are uniquely positioned for stored value card distribution. Also, since these companies have experience marketing to ethnic groups, which may also be credit-challenged, they can design point-of-purchase materials and promotion programs that give them an edge over companies that appeal to mass markets. The market for stored value is so large that almost every other distribution channel, such as the internet and direct mail, is already being used to distribute cards; however, prepaid channels should remain important.

Prepaid long distance vendors should be aware that some companies offer stored value cards that can also be used to make long distance telephone calls. It appears that the concept that AT&T introduced with

its Universal card may see renewed interest. While no major telephone company has yet issued a combined calling card, the concept explored a few years ago of using a wireless phone to make micro payments, such as vending machine purchases, may still become a reality. MasterCard is currently conducting a trial among merchants in Dallas of its PayPass program, where customers authorize a credit card payment for a purchase by waving a Nokia phone at a point-of-sale terminal. In the test, the charge goes to a standard credit card, but other programs could use a prepaid debit card instead.

Growth ahead

For most people in the U.S., payment by credit card has become almost as American as apple pie. However, the combined impact of lower cost for debit card transactions and the need of everyone to have some form of transaction card will move total debit transactions ahead of credit transactions by 2005. Prepaid wireless vendors were instrumental in the move to stored value cards because they created the infrastructure required to load prepaid cards with cash. People who are better served by prepaid wireless also are people who could use a stored value card. The Pelorus Group believes that stored value cards present a huge opportunity for vendors of prepaid products.

The author is vice president of research for The Pelorus Group, a Raritan, N.J.- based market research and consulting firm. Information in this article is based on the company's recent study, "Stored Value 21st Century Currency." For more information, visit The Pelorus Group online at <http://www.pelorus-group.com/>.



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