Proposed Prepaid Rule Unlikely To Stem Growth

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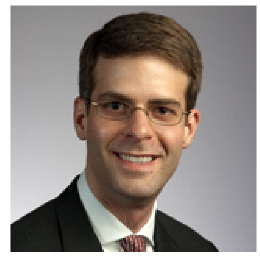

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The Consumer Financial Protection Bureau has proposed a sweeping new rule that would expand consumer protections in the fast-growing market for traditional plastic prepaid cards, including general purpose reloadable cards (GPR cards), and electronic prepaid accounts that can store funds.[1]

The proposed rule includes “Know Before You Owe” disclosures, liability limitations for lost or stolen or cards, error resolution requirements, and requirements for free, easy access to account information. And issuers who offer overdraft or other credit features with their prepaid accounts would be required to adhere to credit card protections.

With a proposal of this length and complexity, the first question on the minds of many prepaid issuers is: How will this affect my business? There is no question that an era of greater consumer protections and CFPB oversight is coming to the prepaid market, but the proposed rule is unlikely to significantly dampen the economics of prepaid offerings or stem the pace of growth.

The Prepaid Market

It is no secret that the prepaid market has been a growth spot in the retail banking industry as consumers look for simpler, more accessible ways to store funds and carry out transactions. According to one study cited by the CFPB, the total dollar value loaded on GPR cards has risen from less than $1 billion in 2003 to an expected total of over $98 billion in 2014. A separate report by the Federal Reserve Board of Governors found that the number of prepaid card payments increased at a faster rate than all other payment types in recent years.

There is great variation among “prepaid” offerings. Prepaid cards may be “reloadable” and allow the customer to replenish funds on the cards; they may also be “closed-loop,” meaning that the customer can use the card only at certain merchants or a group of affiliated merchants. Some employers even distribute wages to employees on prepaid payroll cards. Depending on the type of functions the prepaid card offers, different rules and regulations will apply.

Prepaid cards are often used in lieu of traditional deposit accounts by the unbanked and under-banked. One recent Federal Deposit Insurance Corp. study found that unbanked households use GPR cards at more than twice the rate of the general population. The proposed rule therefore reflects the CFPB’s twin priorities of increasing access to the traditional banking system and extending consumer protections to consumers who do not have bank accounts.

In his prepared remarks at the field hearing that coincided with the release of the proposed rule, Director Richard Cordray vocalized these priorities by stating that “[m]ore than one out of every five unbanked consumers has used a prepaid card, and this number is growing ... [b]ut with this expanded access to financial services, it is also crucial that consumers have strong protections under the law.”

Impact of the Proposed Rule on Prepaid Revenue

Prepaid issuers typically earn revenue in four ways: fees paid at the time the account is opened, account service and maintenance fees, so-called “swipe” or interchange fees, and interest yield on deposited funds. Some prepaid issuers also offer credit in the form of overdrafts. The proposed rule, if implemented, would have some impact on fee revenue, but little or no impact on interchange fee revenue and deposit float. The proposed lending restrictions could materially impact the minority of issuers who offer overdraft credit, however.

The proposal’s impact on fee revenue is limited by the authorities for the CFPB’s regulation of prepaid accounts. Neither the Truth in Lending Act nor the Electronic Funds Transfer Act empower the CFPB to cap fees on prepaid accounts, and Dodd-Frank specifically prohibits the CFPB from imposing a usury cap. That said, the proposed rule would require clear and uniform disclosure of key revenue generators like the monthly fees, fees per purchase, ATM withdrawal costs, and fees to reload cash onto the account. While the model disclosures are likely to reduce fees somewhat because of the competitive forces of easier comparison shopping, the proposed rule does not cap fee revenue for prepaid products, and fee revenue is likely to be a continuing motivator for issuers to enter this market.

Issuers have been aggressively expanding their prepaid offerings to meet consumer demand, but also to capitalize on an exemption to the Durbin Amendment in Dodd-Frank that is left unchanged by the CFPB’s proposal. The Durbin Amendment, implemented through Regulation II, established a maximum interchange fee that a covered financial institution may receive for an electronic debit transaction. Certain reloadable, general-use prepaid cards that are not marketed or labeled as gifts card are exempt from these fee caps, however, and can generate substantially higher interchange fee revenue for issuers than nonexempt products.

Nothing in the proposed rule modifies these interchange fee exemptions. In fact, the proposed rule could even widen opportunities for issuers to capture additional interchange revenue by broadening the market for GPR cards to more traditional mainstream consumers. Similar opportunities exist to earn additional revenue by float on growing prepaid card balances.

Finally, the proposed rule, if adopted, would extend a range of credit card protections to overdraft, limiting revenue from fees paid to issuers who offer this capability. Typically, a consumer cannot spend more than the funds loaded onto a prepaid card, and, as the preamble to the proposed rule observes, “financial institutions that issue prepaid accounts typically do not earn their revenue from ‘back-end’ overdraft fees or NSF fees.”

Larger issuers are disincentivized to offer overdraft because the charging of overdraft fees means the prepaid account loses its exemption from the Durbin Amendment interchange fee caps, negating any incremental fee revenue. Nevertheless, for issuers who do generate overdraft fee revenue — typically smaller issuers who qualify for a separate exemption to the interchange fee limits — the additional disclosure requirements, required “ability-to-repay” underwriting, and limits on fees and interest charges are likely to dent overdraft revenue.

Impact on Prepaid Costs

The proposed rule would also impose a number of costs on prepaid card issuers. While the proposal provides an alternative to expensive periodic statements, issuers will incur website development and maintenance expense needed to provide consumers online account information. In addition, the extension of Regulation E’s liability and error resolution provisions will increase issuer costs due to fraud and other consumer disputes.

While some in the prepaid industry have been concerned with the cost and potential for abuse by extending Regulation E’s liability limitations to prepaid and GPR cards, in particular the provisional credit provisions, many prepaid programs already limit consumer liability in accordance with Regulation E and provide provisional credit. As the CFPB recognizes, many of the Regulation E compliance costs that would result from the proposal are therefore part of the marketplace as it currently operates.

As with any rule of this length and complexity, issuers will require increased compliance resources to ensure they do not run afoul of the manifold requirements and restrictions. Compliance costs will arise on the front end as issuers must ensure new products are designed with the strictures of the CFPB’s rule in mind. Compliance monitoring and testing will also result in ongoing costs throughout the product lifecycle. And failure to dedicate adequate compliance resources could lead to the worst sort of costs — a regulatory enforcement action with its attendant reputational damage, penalties and customer restitution.

Conclusion

Although the proposed rule was broader than anticipated both in terms of products covered and consumer protections extended, it is unlikely to significantly change the revenue profile of prepaid card products. While the provision limiting credit features may decrease revenue for some issuers, the majority of prepaid products on the market do not have credit features associated with them. And as technological innovation makes prepaid products easier to use, more convenient, and more widely available, the market is likely to continue its upward growth.

While the proposed rule will increase compliance costs for the issuer and provide the CFPB another rule for enforcement, it is unlikely to stem the growth of the prepaid industry. Consumers are increasingly opting for prepaid products because of convenience, ease of use, and in some cases, lack of other options. The proposed rule does not change these motives, and in fact, increased oversight and disclosure may prompt additional customers to use a physical or virtual prepaid card.

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[1] The proposed rule would also cover payroll cards; certain federal, state, and local government benefit cards such as those used to distribute unemployment insurance, child support, and pension payments; student financial aid disbursement cards; tax refund cards; and peer-to-peer payment products.