



The Federal Reserve Bank of Richmond

New Prepaid Cards Help Build Credit History

By Sarah Eckstein

The recent economic downturn has compelled many consumers to reconsider both their spending habits and credit options. As a result, some consumers are moving away from traditional, high interest rate credit cards in favor of prepaid cards. Various forms of prepaid products have been around for several decades in the form of public transit cards, stored-value cards, prepaid phone cards, government disbursements and college campus cards. Over the years, prepaid cards have evolved in function and in technology, driven by advances in companion technologies, such as mobile phones and SMS messaging, and consumer demands.¹

Earlier this year, a Las Vegas-based technology company, Paragon Dynamix LLC, launched one of the first general-purpose prepaid cards to feature a credit score tracking component.² The new feature could help those consumers who do not use traditional banking or payment systems to build a credit history. This article explores the potential opportunities and challenges associated with prepaid cards in general and the credit tracking feature innovation in particular.

The Growth of Prepaid Cards

Consumers typically purchase prepaid cards through a bank, retailer or credit card company and add money on the card at the retail store where the card was purchased or through the direct deposit of a paycheck, disbursements

or other payments. Prepaid cards work similarly to credit and debit cards. A prepaid card that is part of a card network system (e.g., Visa) can be used wherever that type of card is accepted, including purchases online and over the phone. Many prepaid card issuers are offering comparable security protections for stolen, lost or unauthorized purchases including being able to track transactions and freeze funds at any time.³

The primary distinction of the prepaid card is that the consumer's purchases generally cannot exceed the available funds deposited on the card.⁴ Also, unlike debit cards prepaid cards are not linked to a banking account. This distinction is attractive to consumers who have difficulty controlling their spending habits or that of the card user (e.g., children). Prepaid cards help consumers manage their money, monitor spending habits and avoid financing fees and overdraft charges. Prepaid cards have also become popular among consumers who lack established credit histories or who have a poor credit record because they are often unable to obtain a debit or credit card. Such consumers include college students, immigrants and those who amassed significant debt from using traditional credit cards.⁵ Prepaid cards can also provide a foundation for underbanked consumers to move toward traditional bank accounts.

Prepaid cards clearly appeal to a large cross-



section of the population. Some estimate that over 80 percent of the population uses some type of prepaid card. While prepaid cards still represent a relatively small fraction of consumer transactions, industry leaders are taking notice of their impressive growth rates.⁶ According to Mercator Advisory Group, a research firm that tracks the payment industry, customers loaded approximately \$8.7 billion on prepaid cards carrying Visa, MasterCard, American Express or Discover logos in 2008.⁷ The research firm found that 14 percent of purchasers

used prepaid cards as a way to budget their personal household expenses; 11 percent used them as an alternative to a checking account or debit card; 10 percent used the cards for making secure online purchases; and 7 percent used them for paying bills.⁸ Boston Consulting Group predicts that the total value of funds loaded onto branded prepaid cards will increase significantly over the next decade. The total value of funds loaded annually onto network-branded prepaid debit card accounts is expected to reach \$440 billion by 2017.⁹ In spite of all these advantages, prepaid activity could not generally help users build a credit history until Paragon's release of their new prepaid card.

The Appeal of a New Credit-tracking Innovation

One of the most valuable features of a prepaid card tied to credit scoring is the ability for consumers to establish or rebuild their credit history. The National Credit Reporting Association estimates that 70 million consumers have either no credit score or a lower score than their financial history and payment potential warrants.¹⁰ Poor credit

scores can severely limit a consumer's access to credit, housing and even certain jobs.

Another benefit of the Paragon card is that it allows consumers to prove their "creditworthiness" by tracking their payments of basic living expenses such as utility bills,

rent and car payments.

The cardholder's bill payment history is reported monthly to three major credit bureaus: Equifax, Experian, and TransUnion, where it is used to build a comprehensive credit report including an evaluation of the

cardholder's ability to repay a loan.¹¹

Some banks are rethinking the sole use of credit scores for underwriting, arguing that it does not encompass all aspects of a borrower's credit history and are searching for other data and additional intelligence.¹² Records of payment performance that are not traditionally reported to the credit reporting agencies are valuable in predicting how likely it will be for an individual to repay debt.¹³ By more accurately predicting risk associated with "thin-" and "no-file" borrowers, lenders could facilitate financing, in some cases at a lower cost, to lower risk borrowers who otherwise might be priced out of the market.¹⁴

Barriers to Adoption

While the new credit-tracking prepaid card might help some individuals, there are barriers to adoption of prepaid cards. The pricing and services of prepaid cards vary widely, which may cause confusion for some consumers, at least initially. Some fees are unique to prepaid cards and consumers will need to familiarize themselves with the new terms. If term

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disclosures are not straightforward, this may make it more challenging for consumers to compare rates across prepaid cards. Also, many prepaid cards still have monthly or transactional fees: as much as \$2.95 to \$9.95 per month and ATM transaction fees of \$1.50 to \$2.50 for each transaction.¹⁵ Some cards carry transaction fees that can quickly accumulate, including customer service charges and account inactivity fees.¹⁶ For low-income consumers, these fees may price prepaid cards out of their budget.

Consumers who have credit options need to carefully compare the terms of prepaid, debit and credit cards. In some cases, prepaid cards may carry higher fees than debit cards depending on usage patterns. According to a 2009 Bretton Woods report, bank consumers with common overdraft patterns (six per year) pay \$200 to \$350 annually for a basic checking account, while those who use prepaid cards pay \$108 to \$320.¹⁷ Prepaid cards may also have limits on how much can be withdrawn from an ATM in a day, which can be a drawback for those who use the card for emergencies.

To date, the prepaid card industry has gone relatively unregulated, lacking uniformity of consumer protection regulation.¹⁸ In 2009, Congress passed the Credit Card Act, which gave the Federal Reserve the authority to write rules on gift cards. The new rules, however, only apply to reloadable prepaid cards that are intended for gift-giving purposes.¹⁹ Prepaid cards are not covered by federal statutes that protect cardholders from stolen or fraudulent transactions, although card companies may offer these protections voluntarily and they may exceed the regulatory protections.²⁰ Prepaid card companies do not always issue monthly statements, although some card issuers provide balance, transaction and other statement information online or over the phone.

Definition

Prepaid Card (also called a stored value card or gift card) - A card that can be used for payment up to the amount of money stored (or loaded) on the card. Often these cards may have a Visa or MasterCard logo, but they are not credit or debit cards. Examples include: general purpose, specific purpose (retailers, telephone, public transportation, etc.), payroll card and electronic benefits transfer (EBT).

Current Adoption of Payment Instruments

Percentage of consumers

	Percent*
Paper Instruments	98.3
Cash	98.2
Check	91.3
Money Order*	18.3
Travelers Check*	4.7
Payment Cards	93.4
Debit	80.2
Credit	78.3
Prepaid	17.2
Other Payment Instruments	81.2
Online banking bill payment	52.5
Electronic bank account deduction*	73.4

* Adoption of these payment instruments is defined by incidence of use in a given year.

Source: Foster, Kevin; Meijer, Erik; Schuh, Scott; Zabek, Michael A. *The 2008 Survey of Consumer Payment Choice*. Federal Reserve Bank of Boston. No. 09-10. April 2010. p 21.



Conclusion

New payment innovations such as prepaid cards are providing greater banking options for underserved consumers. The new credit reporting feature offered on some prepaid cards can provide consumers with an alternative and convenient way to build credit history. The card can also help maintain control of their financial future. As prepaid cards continue to expand and more companies enter the prepaid card market, the expectation is that fees will decline and cards will become less costly for consumers to use. Despite the growth of the prepaid card industry, it is critical that consumers continue to educate themselves on the terms and features of prepaid cards to ensure they find a product that meets their unique financial situation.

For more information about the Paragon card, visit www.paragondynamix.com.

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Resources:

Federal Reserve Bank of Philadelphia- Payment Cards Center
www.philadelphiafed.org/payment-cards-center/

Federal Reserve Bank of Boston- Consumer Payments Research Center
www.bos.frb.org/economic/cprc/index.htm

Bretton Woods, Inc.- 2009 Branded Prepaid Card Analysis
<http://bretton-woods.com/71501/index.html>

Endnotes:

¹ Flore, G. Michael. *Payment Systems Evolution and Branded Prepaid Card Analysis*. Bretton Woods Inc., October 2009. p. 10. SMS messaging stands for Short Messaging Service and is a data application used to send short text messages, generally between mobile phones.

² Hernandez, Will. "Credit-Score Feature For Prepaid Cards A Significant Step." *Cardline and SourceMedia, Inc.* March 26, 2010.

³ Ibid.

⁴ Many prepaid card issuers do not allow consumers to go over the limit, however, some companies offer "opt in" services. Depending on processing and authorization speeds, a transaction can be declined if it exceeds the amount available on the card.

⁵ Trejos, Nancy. "Loaded Propositions." *The Washington Post*. October 25, 2009.

www.washingtonpost.com/wp-dyn/content/article/2009/10/23/AR2009102304334.html

⁶ Herbst-Murphy, Susan. "Trends and Preferences in Consumer Payments: Lessons from the Visa Payment Study." *Federal Reserve Bank of Philadelphia*. May 2010. p. 11.

www.philadelphiafed.org/payment-cards-center/publications/discussion-papers/2010/D-2010-Visa-Payment-Panel-Study.pdf

⁷ Trejos, Nancy. "Loaded Propositions." *The Washington Post*. October 25, 2009.

www.washingtonpost.com/wp-dyn/content/article/2009/10/23/AR2009102304334.html

⁸ Herbst-Murphy, Susan. "Trends and Preferences in Consumer Payments."

Data from Mercator Advisory Group cited in "Prepaid Market Overview." A presentation by its director of prepaid services, Tim Sloane, Prepaid Expo, February 2010. p. 13.

www.philadelphiafed.org/payment-cards-center/publications/discussion-papers/2010/D-2010-Visa-Payment-Panel-Study.pdf

⁹ Hernandez, Will. "Report Predicts Network-Branded Prepaid Account Deposits to Reach \$440 Billion By 2017." *PaymentSource*. July 17, 2010.



¹⁰ The National Credit Reporting Association. Press Release. October 3, 2005.

www.ncrainc.org/documents/ncra%20prbc%20press%20release%203%2000.pdf

¹¹ Hernandez. "Credit-Score Feature For Prepaid Cards A Significant Step."

¹² Johnson, Andrew. "Post-Bubble, Alternatives to Credit Scores in Greater Demand." *American Banker*. July 13, 2010.

¹³ Hernandez. "Credit-Score Feature For Prepaid Cards A Significant Step."

¹⁴ Cheney, Julia S. "Alternative Data and its Use in Credit Scoring Thin- and No-File Customers." *Federal Reserve Bank of Philadelphia*. p. 11. Citation: Rachel Schneider and Arhan Schutte, "The Predictive Value of Alternative Credit Scores." The Federal Reserve Bank of Philadelphia, Center for Financial Services Innovation. February 2008. pp 7-9, 17.

www.philadelphiafed.org/payment-cards-center/publications/discussion-papers/2008/d2008febalternativedata.pdf

A "thin-file" borrower is a consumer with very few trade lines. These can include a credit card account, a mortgage or a car loan. A "no-file" borrower has no trade lines and no history of open accounts.

¹⁵ Trejos.

¹⁶ Martin, Andrew. "Prepaid, but Not Prepared for Debit Card Fees." *New York Times*. October 6, 2009.

www.nytimes.com/2009/10/06/your-money/06prepay.html

¹⁷ Flore.

¹⁸ Martin.

¹⁹ *What You Need to Know: New Rules on Gift Cards*. Federal Reserve Board. April 30, 2010.

www.federalreserve.gov/consumerinfo/wyntk_giftcards.htm

²⁰ Peterson, Kristina. "Should Prepaid Cards be Regulated?" *Wall Street Journal*. July 1, 2009.

<http://online.wsj.com/article/SB10001424052970203937504574248001346852532.html>

