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Banking the unbanked
Prepaid cards, mobile payments, and global opportunities in retail banking

A large untapped banking market?

Financial institutions around the world compete against one another trying to attract and retain the same middle- to upper-income retail customers year after year. Yet there is an enormous market that most banks are ignoring — and that nonbank competitors have begun to cultivate effectively: the world's 2.5 billion adults who are either unbanked or underbanked.[1]

By definition, unbanked customers have no checking, savings, credit, or insurance account with a traditional, regulated depository institution. Meanwhile, underbanked customers have one or more of these accounts, but conduct many of their financial transactions with alternative service providers, such as check-cashing services, payday lenders, and even pawn shops — and still use cash for many transactions.

In the United States, the Federal Deposit Insurance Corporation estimates that approximately 60 million people — one-quarter of all U.S. households — are either unbanked or underbanked.[2] In less-developed countries, which lack a robust financial services infrastructure, the percentage is likely substantially higher.

By any measure, global or domestic, the unbanked and underbanked represent a large, and potentially profitable, untapped market.

Prepaid cards and mobile payments: Recent innovations gaining rapid acceptance

The developing world is serving as a crucible of innovation for a new payments infrastructure for financial services — one that relies less on the physical presence of branch offices and more on wireless telecommunications and the Internet.

In countries like India and Kenya, for example, unbanked and underbanked consumers are typically able to meet many of their financial services needs through the use of two relatively new payments channels — prepaid cards and mobile phones.

Prepaid cards. Like the holiday gift cards that have become so popular in the United States, general purpose reloadable (GPR) prepaid cards are a medium of stored value. However, gift cards are typically "closed loop" products accepted by a single merchant, while GPR prepaid cards are "open loop" and accepted almost everywhere.

Prepaid cards can offer unbanked and underbanked consumers access to online shopping and bill payment, as well as a host of other traditional banking functionalities. Moreover, many governments around the world are increasingly adopting prepaid cards as a preferred mechanism for making benefits payments to consumers because it can be cheaper, faster, and more secure to transfer funds to cards than it is to mail checks or provide cash to all recipients. Plus, in regions where graft is a concern, some governments have found that consumers receive more of the funds they are due when payments are made through a direct secure paperless channel rather than by cash through often indirect channels.

[1] Financial Access Initiative, "Half the world is unbanked," October 2009

[2] "FDIC National Survey of Unbanked and Underbanked Households," December 2009, page 11, http://www.fdic.gov/householdsurvey/full_report.pdf

[3] "The World in 2011: ICT Facts and Figures," the International Telecommunication Union, http://www.itu.int/ITU-D/ict/facts/2011/material/ICTFactsFigures2011.pdf

[4] Ibid

Mobile payments. At the same time that prepaid cards are taking off, payments made through mobile phones are also becoming more common. According to the International Telecommunication Union, the United Nations agency for information and communication technologies, there were 5.9 billion mobile-cellular subscriptions in the world at the end of 2011.[3] With a global reach of 87 percent — and a developing-world adoption rate of 79 percent — mobile phones are in use almost everywhere and by virtually every consumer segment.[4] With such widespread access to mobile technology, consumers in Africa, Asia, and other emerging markets can pay bills, get cash from local merchants, and send money back home to their families — without having to step into a banking office.

What is happening globally?

While banks traditionally have been the providers of retail payment services, they are now facing a real threat of disruption as new technologies and new types of financial and nonfinancial intermediaries are combining to provide alternative and less-expensive solutions.

Governments are often torn between the desire to protect their banking system and their desire for more financial inclusion. In a fast-changing retail financial services arena, innovations like prepaid cards and mobile payments are typically causing banks, nonbanking financial institutions, financial services technology players, and investors to ask several questions:

- Will the traditional model of retail bank accounts be the primary vehicle for providing financial services to most people?
- Are banks really in danger of being disintermediated by new financial services firms or instruments?
- Can incumbent players retake leadership and, if so, what are some of the keys to success?
- For some of the answers, it is instructive to examine what is happening with payments in several countries.

India: Sending money home faster

India is a country where many of the unbanked are migrant agricultural workers who live away from home for months at a time and support their families by sending "remittances" to their families regularly.

Mobile payment systems can allow these workers to do just that — quickly, securely, and efficiently. With more than 900 million mobile subscribers[5] throughout the world's second-most populous country, mobile has emerged as an important medium of providing electronic payment solutions and providing the proverbial "last mile" connection. Banks, mobile network operators, payments networks, and niche payments players are focusing on developing an effective model for mobile payments and remittances.

Prepaid cards are also becoming an important tool for efficiently disbursing federal program subsidies. The Indian government plans to deploy prepaid cards to manage an annual payroll in excess of approximately $2 billion through the Mahatma Gandhi National Rural Employment Guarantee Scheme, which executes labor-intensive construction projects in rural India.[6]

In addition, the Indian government is taking several other initiatives to address financial inclusion:

- Allowing nonfinancial institutions to offer prepaid cards. Prepaid cards typically do not require consumers to produce the same detailed documentation that is required to open bank accounts.
- Authorizing banking correspondents to conduct bank operations. The Reserve Bank of India allows local shopkeepers to act as banking correspondents and offer basic banking services, which has increased rural banking penetration.
- Issuing a mandate on rural bank branches. To promote the growth of bank branches in rural areas, the Reserve Bank of India now requires banks to open two rural branches for each urban branch they want to establish. This is expected to increase banking penetration in rural areas.

[5] Source: http://www.trai.gov.in/WriteReadData/PressRealease/Document/PR-TSD-Ja.pdf

[6] Source: http://164.100.12.7/netnrega/writereaddata/state_out/wrk_mat_analysistemp_1112.html

[7] Source: http://www.safaricom.co.ke/fileadmin/M-PESA/Documents/statistics/M-PESA_Statistics_-_2.pdf

Kenya: Banking on mobile phones

M-PESA is a mobile-based branchless banking service designed to enable users to perform basic financial transactions without the need to visit a bank branch.

The continuing effectiveness of M-PESA in Kenya has been due to the creation of an affordable payment service with only limited involvement of a bank. The system now covers about 14 million people in Kenya[7] and has disrupted the core banking model there.

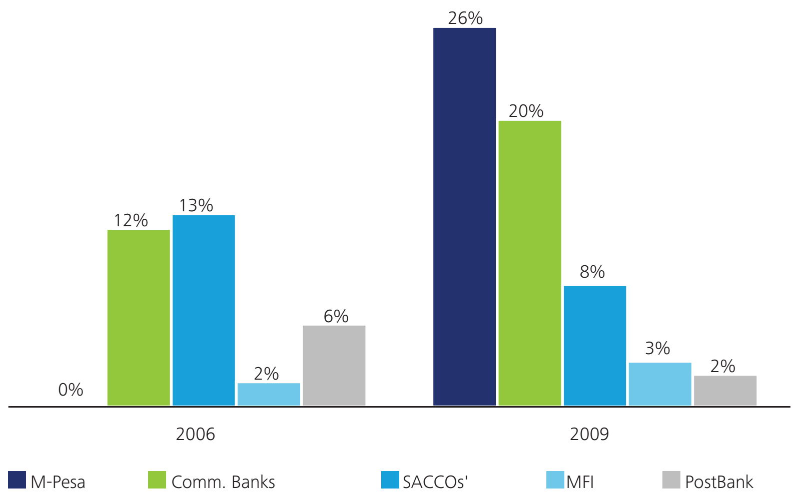
Over a three-year period, M-PESA has become among the most popular mechanism of providing financial services in Kenya and has grown at the expense of nonbank organizations providing no-frills basic banking services — savings and credit cooperative societies (SACCOs) and microfinance institutions (MFIs). Launched in 2007, M-PESA had more market share (26 percent) than either commercial banks (20 percent), SACCOs (6 percent), or MFIs (3 percent) in 2009.[8] Branchless banking is here to stay!

The United States: An emerging market for prepaid cards

In the United States, a number of prepaid program managers are increasingly positioning their GPR prepaid products as a checking/debit alternative and targeting them to both the unbanked and underbanked population as well as presently banked consumers. Prepaid cards can appeal not only to younger consumers looking for a cheaper, more convenient alternative to traditional banks, but also parents eager to control, compartmentalize, and track their children's spend or their own.

Emerging online banking players are offering a broader product array, including savings and credit accounts to complement their prepaid offerings. Adding to the pressure, several established nonbank players and several large retailers have introduced everyday payment prepaid cards with fewer fees aimed at younger consumers and the cost-conscious segment of the market.

Exhibit 1. Kenya financial services market penetration – percentage of adult population[9]



[8] Source: http://www.fsdkenya.org/finaccess/documents/11-06-27_finaccess_09_results_analysis.pdf

[9] Source: http://www.fsdkenya.org/finaccess/documents/11-06-27_finaccess_09_results_analysis.pdf

The threat to traditional financial institutions

Some major banks are reacting to increased regulatory rules and compliance costs as well as to other pressures on their business models by further increasing fees and by steering unprofitable customers to other institutions.

While some of these customers are expected to migrate to community banks, credit unions, and online banks, others may discover that prepaid products can be viable alternatives to a basic checking account and, from there, migrate their other financial services needs to these or other new providers as well.

Just as Southwest and JetBlue disrupted the airline industry 15–20 years ago with their low-cost business models, so, too, might prepaid nonbanks disrupt the banking industry with their alternative products.

According to disruption theory, four conditions must be met for a new product or service to disrupt an existing industry:

1. The existence of a large, nonconsuming market segment whose needs are met by the substitute product.
2. The availability of a product construct that is structurally advantage from a cost standpoint.
3. The neglect from entrenched competitors that view that segment as unattractive.
4. Technology supportive of "an upward march" that allows the nontraditional competitor to invade the previously unassailable home turf of the traditional competitors by expanding the features and benefits of the disruptive product beyond their initial foothold.

Consider how the following conditions for disruption are affecting the traditional banking industry today:

Nonconsuming market segment. Some 60 million Americans[10] are presently unbanked or underbanked and have to resort to cash and high-cost alternatives, such as check-cashing services. This is a very large and growing segment of the U.S. population and one that typically suffers from the neglect of the traditional banking providers. Consumer needs related to transactions and payments can be well-met by the features offered by prepaid cards.

Consumer preference	Common prepaid features
Low barrier to entry	No credit/paperwork requirement
Convenience, comfort	Broad distribution channels, locations, and hours
Liquidity	Immediate funds availability
Fee transparency	Difficult to overdraft

Prepaid card features are also increasing over time. Some prepaid cards now include features like remittances, bill payment, rewards, expanded reload networks, credit building, and spending controls.

[10] Source: FDIC National survey of Unbanked/Underbanked households

Cost. Some prepaid card companies offer to provide low-cost GPR products through a variety of distribution channels to the unbanked and underbanked. Prepaid processing platforms are new, built on efficient technology platforms, and can be readily scaled. While maintaining strong profitability, these products can be sold at less than half the price of a traditional bank account. Various cost-of-ownership studies have clearly shown that consumers can save money by using GPR prepaid cards rather than a checking account or traditional cash vehicles and providers. This is especially the case for prepaid cards with direct deposit, as this feature is associated with greater spend, engagement, and retention behaviors, which can allow program managers to reduce fees (Exhibit 3).

The same cost advantage exists in developing economies where numerous branchless banking studies have shown the cost advantage of "mobile money" over traditional retail branches.

Neglect. In the United States, many traditional bank competitors view the unbanked and underbanked segments as unattractive as their costs to serve are high and income generated low relative to more affluent segments. This is partially a reflection of a high-cost base and expensive and restrictive regulatory actions exacerbated by recent consumer legislation.

High-cost providers typically prefer cross-selling more products to their traditional, more affluent customers. Indeed, many of the major banks today are focusing on their affluent customers — as well as on their competitors' — while allowing or encouraging attrition among their less-affluent or higher cost-to-serve customers. This could, over time, reduce large banks' scale advantage and allow disruptive providers to move up and target former or dissatisfied banked consumers.

Exhibit 2. Total funds loaded on U.S. GPR products[11]

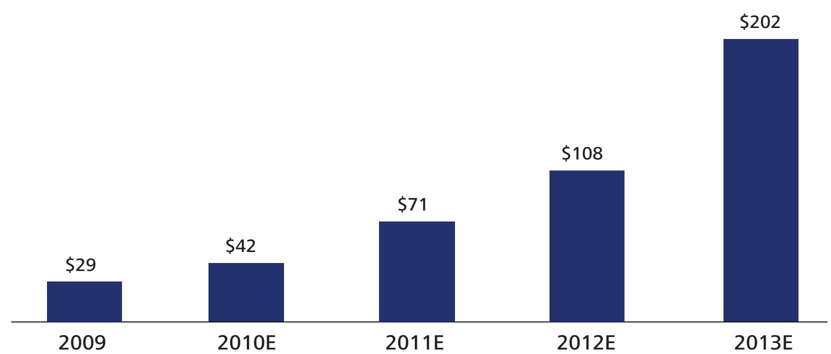
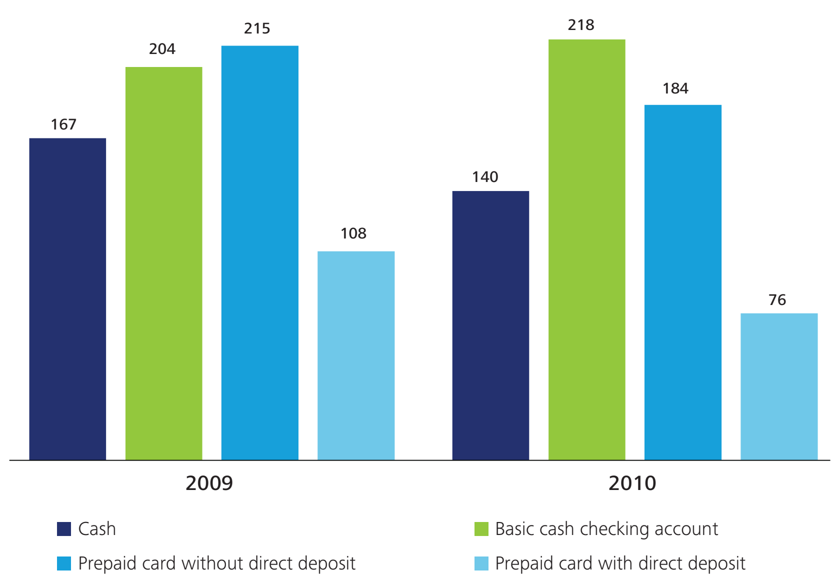


Exhibit 3. Average annual cost of ownership — consumers union transaction pattern[12]



[11] Source: NetSpend's Nov. 8, 2011 presentation at the Citi 2011 Financial Technology Conference. See slide 6. NetSpend cites Mercator Advisory Group and Boston Consulting Group as the source. See http://investor.netspend.com/common/download/download.cfm?companyid=ABEA-56BIQV&fileid=516738&filekey=4c51bbb2-5da2-4df9-82ec-f19432d92902&filename=NTSP_IR_Presentation_Nov-2011.pdf

[12] Bretton Woods Inc's comparative analysis of reloadable prepaid cards based on Consumers Union transaction pattern. March, 2011

Technology. Today's top GPR prepaid cards are full-featured products that are both high-quality and easy to use as traditional checking account/debit card products. The GPR product offers free direct deposit, person-to-person transfers, supports point of sale and online purchases, Bill Pay options, extensive ATM access, rewards and discounted merchant offers, online checks and money orders, mobile alerts, etc.

Many prepaid providers can be very efficient. Their new technology platforms and distribution channels can afford them operating costs that are structurally lower than those of traditional retail banks. In addition, prepaid providers may have an increased capacity to innovate, can be more flexible and agile, and know their consumers well. They are also gaining scale quickly, which will likely further enable them to potentially reduce their prices or add to their margins. Consider the following two sources of growth:

- **Government payments.** Government payments are moving quickly to electronic channels as both the U.S. federal government and states mandate direct deposit of benefits and other disbursements. These are increasingly going on prepaid products.
- **Existing banked lower-middle-income households.** Direct deposit of government payments will likely increase the awareness of and comfort level with prepaid cards among large segments of the population. This will likely raise the awareness of GPR products within the banked population and, given the significant savings available, could drive adoption and use of prepaid products among banked consumers. There are more than 60 million[13] households in the $30,000–$50,000 household income segment, not to mention technology-savvy recent college graduates.

Prepaid cards in India offer services like mobile "top-ups," a way to recharge minutes on prepaid mobile phones; online payment capability; recurring payment setup; and, in some case, remittance functionality, which helps to address the need of India's domestic migrant population. In Africa, prepaid cards are designed to allow microcredit organizations to collect payments and allow remittances. The accompanying exhibits illustrate the potential "upward march" for product offerings catering to the unbanked and underbanked in the United States, India, and Africa, and more importantly, for a broader cross-section of the general population who may then not often bank with traditional banking institutions.

Foothold for upmarket march

Exhibit 4. India: Help consumers achieve financial inclusion

Incremental innovation

Product feature	Customer need
Use spend patterns to provide additional value-added offers	Need for customized value added services
Cobranding with merchants to reach out to additional consumers	Need of merchants to reach out to unbanked consumers
Provide fraud prevention for online usage and maintain privacy	Need for privacy and reduced risk of using a card online
Provide basic electronic payment and spend segmentation facilities	Need for remittance and electronic payroll
Offer payroll and remittance opportunities on the card	Need for making electronic payments

Consumer unmet needs

[13] U.S. Census bureau, current population survey, 2011, annual social and economic supplement

Exhibit 5. Kenya: Help consumers to obtain a mechanism to repay microloans

Incremental innovation → Consumer unmet needs

Product feature	Customer need
Use spend patterns to provide additional value-added offers	Need for customized services
Offer customized credit facility and other products like insurance based on spend history on M-PESA	Need for peripheral financial services
Offer remittance and bank account functionality	Need for remittances and actual bank accounts
Provide mechanism to make payment for all goods	Need for making electronic payments for other items
Provide mechanism for repayment of microloans	Need for making small payments

Exhibit 6. United States: Help consumer obtain a low fee alternative to checking accounts

Incremental innovation → Consumer unmet needs

Product feature	Customer need
Use spend patterns to provide rewards and other services to consumers	Need for customized services
Partner with tax/accounting service providers to provide value-added services	Need for peripheral financial services
Offer customized credit facility and other financial products based on spend history on prepaid cards	Need for credit facility and other sophisticated products
Offer specialized prepaid cards	Need for segmenting spend in other spend categories
Provide basic electronic payroll, payment, spend segmentation, and online payment facility	Need for low fee alternative to checking accounts

Other retail financial services products: Microloans to individuals and small businesses and microinsurance might well be the next set of financial services disrupted. In addition, peer-to-peer models are starting to gain share as well. In India and Africa, prepaid cards are considered good vehicles for providing additional benefits, like remittances and recurring payments for loans and insurance premiums. Everywhere, mobile phones can enable efficient distribution of new services, ranging from microloans to health credits

Responding to new competitors

A range of potential responses exists for traditional financial institutions to consider when responding to the threat presented by nonbank providers of payments services. From the perspective of banks in a mature market, three strategic options are available:

Stay the course and reduce operating costs. Some banks may elect to continue to grow their share of wallet among existing profitable customers while further reducing operating costs in-line with the new reality of regulatory constrained fee income.

This option is a traditional response of large incumbents when faced with disruptors. It also is a well-established playbook and might make the most sense for many banks. This option will likely require forcing out unprofitable consumers and will shrink the total consumer franchise. Typically, large national banks seem to have chosen this option, either due to a profitability imperative or to a strategic choice to focus on the affluent. Some regional banks have made a similar choice as well. The shallow profit pool of existing prepaid customers is also a common reason cited for this choice.

Staying the course and reducing operating costs can be a good option if it is based on a model that can maintain a unit-cost advantage even when the number of customers declines. However, it may not work for smaller financial institutions. The potential risks include negative publicity from "demarketing" less-profitable customers and the possibility of missing out on providing a path to bankability for a new set of consumers. In addition, there is potential risk that banks will likely need to continue to acquire or "trade" expensive affluent consumers in an increasingly crowded market.

Protect the franchise. Other banks may decide to offer prepaid products to unprofitable checking/debit consumers, migrate them to the cheaper prepaid platform, and offer prepaid options to less creditworthy customers.

This approach will likely preserve the size and scale of the franchise and preserve the future option of migrating prepaid customers to traditional banking products as their financial situation improves. Banks that are more comfortable with middle-income and subprime customers as well as regionals looking to grow aggressively are considering this option. The risks associated with this option are a dilution of efforts and the traditional risks associated with middle-of-the-road options.

Embrace the disruption. Still other banks may choose to create an enterprise-level focus on the unbanked and underbanked markets initially around prepaid offerings and actively prepare for the upward march of this new banking solution. Of course, this option can be especially attractive for banks in fast-developing markets where the non-consuming segment is 70 percent or more of the population.

Traditional banks could acquire one of the prepaid specialists or create their own program-management capability. The upward march would involve migrating the product functionalities and positioning to help meet the needs of selected banked segments, whether lower-middle class or younger affluent segments that do not want or need traditional banking relationships.

This can be a difficult option to execute and one that most existing banking institutions will likely see as fraught with risks to the core business and requiring too much resourcing. Nontraditional financial services providers such as e-commerce businesses facilitating online payments and large retailers might be in the most effective position against the incumbents to follow this option.

Too great an opportunity to ignore?

Traditional banks could be at risk of missing an opportunity to expand their addressable market and increase revenues at a time when other banking revenue streams are under pressure from the global slowdown, regulatory actions, and competition from alternative providers.

The global marketplace of approximately 2.5 billion[14] unbanked and underbanked adult consumers is evolving rapidly, and banks could face significant disintermediation threats from nontraditional providers facilitated by new technologies and operating models with inherently lower cost and richer functionalities.

Banks in emerging markets may wish to consider embracing prepaid products and mobile platforms to penetrate the mass market "bottom of the pyramid." This could be a particularly important strategy for international banks, as they have limited branch presence and mobile can offer them a low-cost channel to acquire new customers and scale-up efficiently

Prepaid products can act as an effective alternative to bank accounts, which are more expensive to manage and service and which require detailed paperwork that may not be available from low-income, semiliterate populations. Prepaid products can also provide banks with a foothold in a fast-growing customer segment, which can cross-sold such traditional financial products as farming loans and crop insurance as customers become more financially literate.

However, as financial institutions regard prepaid card and mobile payments today, the possibilities they can afford for future growth cannot be overlooked.

[14] Financial Access Initiative, "Half the world is unbanked," October 2009

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