THE PREPAID ACCOUNT INSTEAD OF CHECKING

by Steve Brown

A recent trend in banking is the move to migrate entry level checking accounts to a prepaid card structure in order to save costs and generate revenue. While prepaid/reloadable cards have been popular for a number of years, banks have mostly used them to serve the gift or reward program market. Now, banks are starting to use prepaid cards as a replacement for a checking account. Started last year, Chase, BB&T, US Bank, Regions and others now all offer a prepaid account that essentially acts like a checking account. According to CNNMoney, the prepaid card market is expected to hit a record $82B in balances, an increase of 44% over last year. The argument to switch from a traditional checking account to a prepaid account is compelling on several fronts. For the consumer, without free checking, most banks' entry level checking account costs between $8 and $12 per month. Comparatively, most prepaid accounts cost $4.40 per month (our current calculated national average) with almost the identical benefits to checking. Recently, with increase sensitivity to fees, about 46% of consumers have indicated a willingness to switch from a checking to a prepaid card. The amazing thing here is that 46% number is from a demographic cross section of America and includes all demographic types. In other words, the current attraction to prepaid cards, extends far beyond the underbanked. The most often reason cited for this trend include (in order): cost, better fee transparency and enhanced ability to control spending. For the bank, the argument is even more compelling. Given that the average checking account at a community bank costs about $325 per year to administer (as of 1Q 2012), banks are losing money on their average customer. The cost to administer a prepaid card, because of its all digital handling and cheaper production, on the other hand, is about $155 per annum, almost halving the average balance needed to break even. However, the main reason to move from a checking to a prepaid structure is that the prepaid card is exempt from the Durbin Amendment which has significantly limited merchant interchange revenue on debit card payments for large banks. Thus, the prepaid card not only is cheaper to administer, but for a large bank, a prepaid card can generate more revenue, at a lower cost than a checking/debit card combination. While it is too early to be able to verify profitability, anecdotal evidence suggest that the combination of costs and greater revenue, the reloadable prepaid account is 20% to 30% more profitable than the checking/debit account combination. If you are thinking about offering a prepaid card as a checking replacement, our research indicates a couple items to consider. Like all things banking, the devil is in the details and a bank can design a prepaid account with the same acceptance rate and cost as a traditional checking account, thereby resulting in zero net gain. The biggest examples of this are that most banks charge (an average of $2) for out-of-network ATM usage. This may work fine for US Bank, but may be problematic for community banks. A decision also has to be made on the following: if you charge for inactivity fees, balance reductions by check, card replacements and customer service, as only a small number of banks charge for this, but for your bank it may be important. The same goes for the small number of banks that offer companion overdraft protection on their prepaid cards that ends up helping profitability, but hurting the consumer perception of more control over spending and lower fees. Finally, we will point out that if you are going to offer a prepaid account, our research indicates that the optimal price for most community banks is $3.15 per month, a level that under cuts the large banks enough that the community bank gains volume that offsets the lower monthly fee. Because of the interchange cap and interest rate environment, we look for prepaid card accounts to increase in popularity through

2012 and into next year at the large banks. Whether the trend catches on at community banks remains to be seen, but it is a product that we believe should be on every retail-oriented bank's radar screen for consideration.

BANK NEWS

M&A

Equity Bancshares ($600mm, KS) will double its asset size and buy First Community Bank of Lee's Summit ($637mm, MO) for an undisclosed sum.

M&A

Peoples Bancorp ($1.8B, OH) will buy First Federal Savings Bank ($48mm, WV) for $9.8mm in cash.

Rates

Two dovish articles this week in the WSJ has most bankers speculating that the Fed will extend Operation Twist at the next FOMC meeting on the 20th.

Basel III

As the Fed meets next week to discuss the implementation of the Basel III capital requirements for large banks, the FDIC nicely chimed in yesterday to add that an "overwhelming majority" of community banks already meet the new minimum capital levels that will be proposed under the Basel III accord.

Clawback Test

The OCC is reportedly reviewing clawback policies to determine whether executives at JPMorgan will be forced to give back compensation after the bank's hedging strategy delivered at $2B+ in losses.

TAG Extension

American Banker is reporting more than 30 state bank trade associations have joined the ICBA in urging Congress to extend TAG (unlimited deposit insurance on transaction accounts) for 5 more years, saying $1.3T in deposits sitting at community and other banks would be at risk if the program ends on Dec 31.