

Prepaid cards: a hybrid phenomenon

The rapid evolution taking place in the prepaid industry has been overwhelmingly positive for all market players, but such rapid growth has also led to greater confusion, not least when it comes to regulation. Hugo Godschalk, director of PaySys Consultancy, examines some of the more pertinent aspects

The emerging market of prepaid cards has given regulators and banking supervisors in Europe something of a headache. A prepaid card is like a chameleon, often changing its colour. It acts like a traditional payment card, but at the same time it is similar to former stored-value products, such as an e-purse. It is also a kind of e-voucher, replacing paper vouchers.

Last but not least, in the back office, it represents an account loaded with funds. So, how to regulate this hybrid product? Like deposits, or like e-money or like payment card issuance? Or no regulation at all, as in the case of paper vouchers?

Europe's banking supervisors opted for the e-money option by widening the e-money definition of the EUE-Money Directive (EMD). They introduced the expression 'account-based' (or 'server-based') e-money for products where the prepaid monetary value is not stored on an electronic device (like a chip), in possession of the user, but 'stored' on an account in the back office of the issuer. From a supervisory perspective, it was the easiest way to establish immediately a 'regulation-light' regime for open-loop prepaid cards without starting a new tedious legislative process at the EU level.

E-money regulation

What are the consequences of this Europe-wide regulatory regime for prepaid cards? The prepaid funds are basically e-money and subject to e-money regulation based on the EMD of 2000, which is implemented in all EU countries. The card is only an access instrument to the prepaid funds.

Prepaid funds within closed loops (acceptance of the payment only by the issuer) are not subject to e-money regulation. Prepaid funds within open-loop schemes, but also within (semi) open-loop prepaid card schemes, are e-money from a regulator's point of view.

To issue prepaid cards a full banking licence, or at least a licence as an electronic money institute (ELMI), is necessary. The licence governs capital requirements, limitations on investment of the prepaid funds and on business activities for ELMI, prudential

regime of banking supervisory authority, and other related aspects.

Most of the member states have implemented the waiver option of the EMD for small systems (outstanding e-money below €5 million/\$7 million) or with limited acceptance, which could be relevant for semi-open-loop prepaid cards. The maximum amount loaded for waived prepaid card portfolios is €150 per account.

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Prepaid funds (e-money) should be redeemable to the cardholder at par value and free of charges, other than those strictly necessary to carry out that operation.

It is important to realise that the prudential permit to issue payment cards (charge cards, debit cards or credit cards) within a (semi) open-loop system does not automatically imply a licence to issue prepaid cards.

The classification of prepaid card issuing as e-money business is relevant for the applicable anti-money laundering (AML) rules. For prepaid cards the usual enhanced customer due diligence (know-your-customer or KYC) is required: identification of the customer established by documents and so on. In the third AML Directive, which must be implemented by member states before the end of this year, special conditions are listed for a simplified customer due diligence (waiver of KYC) of e-money products with a low risk of money laundering and terrorist financing: non reloadable cards with a maximum amount stored of €150, and a limit of €2,500 as total amount transacted within one year for reloadable cards.

Although the European regulation of prepaid card issuing as e-money seems to

be clear and straightforward, there are still nebulous and tricky issues.

The regulatory line of demarcation between deposits (such as current accounts) and prepaid (card) accounts is still not harmonised within the EU and is individually drawn by the local banking supervisory authority. Every current account with a positive balance is in the end also prepaid (somebody has paid in). Therefore, to prevent the classification of prepaid cards as a deposit-taking business and therefore necessitating a full banking licence, the account of the prepaid cards (issued by non-banks) should not have the usual characteristics of a current bank account (such as overdraft facility, connectivity to the banking clearing system, interest payments, etc). Issuers with a full banking licence, however, could connect prepaid cards to accounts that are classified as deposits to add product features, which are not allowed in case of accounts classified as e-money.

Paper-based payment instruments

Prepaid gift cards should replace inefficient paper vouchers, but there are regulatory hurdles. Paper-based vouchers in open-loop systems are not on the radar screen of the regulators, although they are fulfilling all the legal criteria of e-money – except for the storage of funds on an electronic device.

Within the Payment Services Directive (PSD), paper-based payment instruments such as prepaid vouchers and cheques are also explicitly excluded. Other paper-based instruments, however, such as (prepaid) traveller's cheques, are mostly regulated and usually subject to prudential regimes even though they are paper-based. The substitution of an inefficient paper-based voucher by a prepaid card is blocked for many issuers by regulatory barriers (eg, ELMI licence, necessity of redeemability), although the financial risk would be the same. A harmonisation of regulation to restore the principle of technological neutrality should be part of discussion within the running evaluation process of the EMD.

Another peripheral area is (mostly card-based) prepaid accounts within multi-merchant loyalty schemes. These systems (for ▶

▶ example, the widespread chip card-based CityCards in Germany) are fulfilling all the criteria of e-money listed in the EMD. But the regulators don't see a need for regulation now. They argue that the merchant – rather than the cardholder or account holder – is prepaying the monetary value units before giving it away as gifts to customers. But e-money is not changing its intrinsic characteristics if the original prepayer gives it to another person in exchange for goods or as a gift. Otherwise prepaid gift cards would lose their legal e-money characteristics after being given away as presents.

Some air miles loyalty programmes are e-money schemes which are not regulated, although these loyalty schemes are very successful. For example, the monetary value units of the Miles & More loyalty programme of German airline Lufthansa can be directly used by card payments as a currency at other (open-loop) retailers. Usually, miles are earned as bonus points but the miles become definitely 'prepaid' if they are bought at Lufthansa or at other participants for cash. The different regulatory treatment of prepaid payment instruments within loyalty schemes is preventing new prepaid products combining gift cards with loyalty programme stored value. Thus, equal products are treated differently. This indicates the urgent need for an amendment of the e-money regulation.

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We see at the moment the same unequal prudential treatment regarding prepaid accounts of mobile network operators (MNOs) which can be used for payments at third parties (eg, ring tones, games, etc). In most of the EU member states, these prepaid products are not subject to e-money regulation. Due to successful lobbying activities, the prepaid products of the MNOs with limited usage will also be exempted from the regulation of payment institutions after implementation of the PSD in 2009 and onwards. It seems to be that this prepaid market segment will stay outside regulatory provisions even after the expected amendment of the EMD.

Other hurdles exist for non-banks that want to issue prepaid cards: legal status as an e-money institute is a prerequisite, as is having the issuing licence of an international card scheme if the ELMI intends to issue open-loop cards with an international brand. For the time being, only MasterCard is willing to licence ELMIs by getting an own bank identification number (BIN) for the issuance of prepaid cards with the MasterCard brand. The other option is looking for a licensed bank as a BIN sponsor.

The Payment Services Directive

The PSD, which was passed by the European Parliament in April 2007 after a long legislative process, is giving rise to the assumption that this directive will lighten the regulatory load for prepaid card issuers. The PSD should be implemented at the latest by November 2009 in the EU member states. Some observers – especially in the UK – believe that the coming prudential status as payment institutions (PI) will give non-bank-licensed payment service providers access to the issuance of open-loop prepaid cards.

The reason for this misunderstanding is the future access of PI for the issuing and acquiring of payment cards within the international card schemes, such as Visa and MasterCard, forced by the PSD (article 23). However, if these products are prepaid they will be classed as e-money. It is explicitly stated in the PSD that “payment institutions are not allowed to issue electronic money” (recital 7a). A PI could act only as a distributor, service provider and processor of prepaid cards.

Regarding the supervisory requirements for issuers of open-loop prepaid cards, the current PSD is also not relevant. A PI will need an additional ELMI licence (or a waiver) if it intends to issue prepaid cards.

In other aspects, the PSD is, of course, relevant. Issuers and acquirers of open-loop prepaid cards will be subject (as bank or as ELMI) to all other user protection requirements of the PSD mentioned in Title III (“transparency of conditions and information requirements for payment services”) and Title IV (“rights and obligations in relation to the provision and use of payment services”) of the PSD, except from some derogations for low-value payment instruments and e-money (article 40d).

There is another misunderstanding regarding the impact of the PSD on prepaid cards. Some observers are expecting that the EMD will be integrated into the PSD by lowering the prudential regime of ELMIs to the level of PIs. Within the ongoing EMD-evaluation process, the option of abandoning the EMD by integrating the e-money regulation within the context of the PSD is discussed and is a

■ PAYMENT SERVICES DIRECTIVE

What the PSD includes and excludes

Included in PSD

- Money remittances
- Issuing payment cards enabling fund transfers
- Providing a cash withdrawal or cash depositing facility
- Payment transactions: whether by card, direct debit or standing order
- Payments using mobile phones or other networks (unless the provider is involved in delivery of the goods and the goods are electronic)

Excluded from PSD

- Cash payments
- Cashbacks
- Currency exchange
- Paper-based instruments including cheques and vouchers
- IT service providers
- Non-redeemable products used within closed groups

Source: CardsInternational

very realistic scenario.

Another (less realistic) scenario is an amendment of the EMD. Within the scenario of integration within the PSD, the requirements for e-money-issuance could become less stringent. In this case, a possible outcome could be the harmonisation between the requirements of ELMI and PIs and the disappearance of the ELMI as a regulatory level for e-money-issuance.

Whichever path is chosen, none of these scenarios will happen before the current PSD becomes live in 2009. The integration of the e-money regulation could occur in a second (!) PSD. In this case we will see a first draft of the new PSD II, expert hearings, and parliamentary discussions (which can take several years). Once these stages are complete, the new PSD would be passed by the European Parliament and the Economic and Financial Affairs Council of the EU, and then a period of probably 18 months would follow for implementation into national law. So the PSD II could become relevant, at best, in around seven years from now.

Still, the PSD might have indirect effects. Supervisory authorities could harmonise and change the e-money regulation within Europe step-by-step, taking into account the controversial issues discussed above and the new light regulatory regime for PIs. That outcome would be a substantial step forward for the prepaid card market. ■