

Gift Cards: The Battle Between FIs and Merchants

With the holiday season in full swing, many of us are thinking about gift ideas for friends and loved ones. When doing our shopping, we all look for gifts that will be well received—gifts that are meaningful and will be enjoyed by the receiver—but are also convenient to purchase. Gift cards meet both criteria: they are flexible and easy to purchase, and they ensure that the receiver will have a gift they will like. Due to their mass appeal, gift cards have become a holiday staple, and 2006 looks to be another banner year for gift card sales.

In the midst of this gift card boom, there is a battle brewing between merchants, who issue store-branded (closed loop) gift cards, and financial institutions, who issue network-branded (open loop) gift cards. Although both types of gift cards fulfill similar purposes, there are distinct differences between the two models, and these differences have a significant impact on the dynamics of the market and the outlook for future growth.

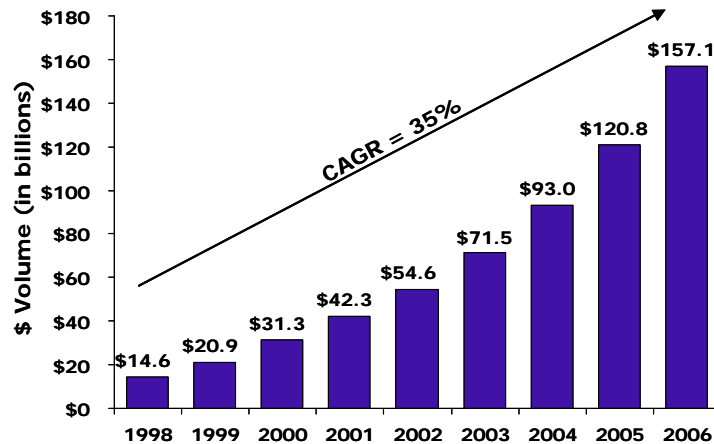
Some analysts are projecting that financial institutions' network-branded cards will eclipse the incumbent store-branded cards, given the greater utility (acceptance) of open-loop cards. It is our belief, however, that while there is room in the market for both gift card models, store-branded cards will remain the dominant gift card vehicle for the foreseeable future.

A Large and Growing Market

Gift cards are a subset of a broader prepaid card market that includes not only gift cards, but also travel cards, payroll cards, incentive cards, insurance cards, teen cards, money transfer cards and many others. Each of these products has its own niche in the market, with unique features and applications.

Although gift cards are the only application that has achieved mass market adoption to date, there is no denying that the prepaid category, as a whole, is taking off. The overall prepaid industry has grown to represent a significant—and expanding—market opportunity. Prepaid transaction volumes reached 5.5 billion in 2005, and consumer spending on prepaid cards has increased at an estimated average annual rate of 35% over the last eight years, from \$14.6 billion in 1998 to \$120.8 billion in 2005 (with spending in 2006 projected to reach \$157.1 billion).

Growth in Prepaid Spend, 1998-2006



Source: Nilson Report/Dove Analysis

Gift cards represent an estimated 41% of the overall prepaid space, with gift card spending eclipsing \$51 billion. Today, gift cards are almost universally offered by merchants (nearly all of the top 100 retailers offer a gift card), as well as by many financial institutions.

Given the growth—and potential for continued growth—of prepaid cards, it is not surprising that prepaid cards overall, and gift cards in particular, have attracted such a high level of attention within the financial services industry.

Merchants vs. Financial Institutions

Gift cards have their roots in the retail business, and were first issued in the mid 1990s as replacements for traditional gift certificates, allowing retailers to reduce the costs and service hassles of processing paper gift certificates. These cards are usually 'closed loop' cards, proprietary gift cards that can only be used at a particular merchant's store or merchant chain (for example, a Starbucks card, which can be purchased at Starbucks locations across the country and can be used only at participating Starbucks). Today, many merchants market closed loop gift cards as stand-alone products, with attractive packaging and in-store displays.

Financial institutions entered the market to capitalize on the increasing popularity of gift cards as a consumer payment method. Instead of issuing closed loop cards that could be used only within a single merchant's system, financial institutions offer 'open loop' gift cards that are branded by one of the payment networks (such as Visa, Discover, MasterCard, American Express, STAR, NYCE and PULSE), and can be used anywhere that those card brands are accepted. Gift cards were among the first prepaid applications implemented by financial institutions, and have provided a foundation for the broader array of open loop prepaid products now offered by financial institutions, such as payroll and teen cards.

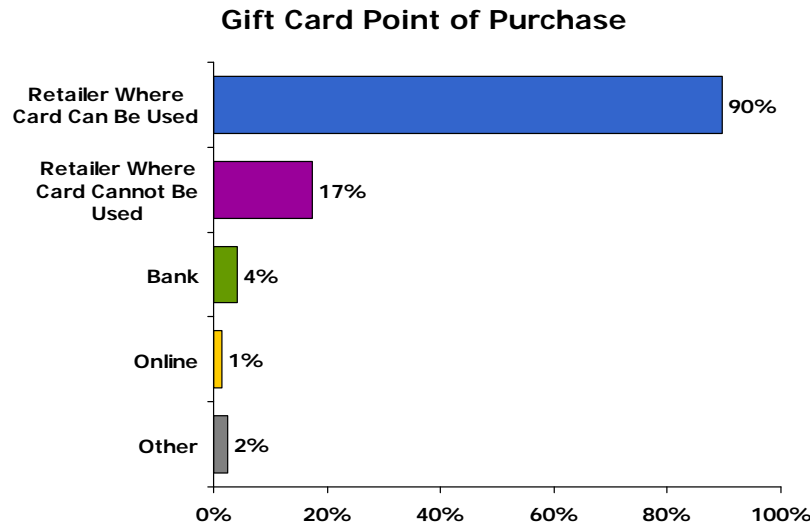
The point of purchase and the designated point of use are not the only differences between retailers' closed loop gift cards and financial institutions' open loop cards. They also vary in terms of features/functionality, marketing, and fees—differences that have played a role in consumer adoption of the two different 'flavors' of gift cards.

Closed vs. Open Loop Gift Cards

Closed Loop	Open Loop
<ul style="list-style-type: none"> ■ Can be used only at one store/chain ■ May come loaded with pre-denominated amounts or be able to be loaded with flexible amounts ■ May be single-use or reloadable ■ Have multiple card designs (e.g., holiday cards) ■ Usually issued at no cost to the consumer 	<ul style="list-style-type: none"> ■ Can be used at millions of store locations ■ Loaded with flexible amounts ■ Typically reloadable ■ Typically have up front/activation fees and account maintenance/dormancy fees

To date, retailers' closed loop cards have dominated the gift card space. Some of the most recent research has put annual spending on closed loop gift cards at \$50 billion, while spending on open loop gift cards is considerably smaller, although estimates of the volume vary.

Based on our research, of consumers that have purchased a gift card, 90% did so directly from a retailer, compared to just 4% that purchased a gift card from a financial institution.



Source: ABA/Dove Consulting, 2005/2006 Study of Consumer Payment Preferences

Given this dominance by retailers, the outlook for future closed loop growth may be less rosy since most, if not all, of the top retailers have adopted and implemented gift card programs and the majority of adults are already in the habit of purchasing these cards. As a result, growth in closed loop card spending needs to come from convincing consumers to purchase more cards for higher values, since the market (merchants and consumers) is already well penetrated.

Will Open Loop Overtake Closed Loop?

If growth in closed loop gift cards slows, and open loop card growth accelerates as FIs attack this opportunity, will open loop gift cards ever surpass their more limited use counterparts? No.

Retailers have achieved their position today because consumer preferences, sales and marketing, and economic incentives tend to favor retailers over financial institutions, and those advantages are not likely to diminish in the future.

Consumer Preferences

When it comes to purchasing gift cards, consumers' top priorities are a 'personal' gift and no fees—both of which are strengths of retailers' closed loop cards—while the strengths of open loop cards (that the cards can be used anywhere, are reloadable, etc.) resonate less strongly with gift card purchasers.

- **Cash vs. Gift.** One of the advantages open loop cards offer over closed cards is that they can be used at any merchant location. While this trait is an important attribute for other prepaid products (employee incentive cards, payroll cards, etc.), it is not necessarily an advantage in the gift card space. Closed loop cards have a retailer brand association that open loop cards lack, and that brand has caché and an image associated with it. Ultimately, for many consumers, an open loop gift card is perceived as giving cash, while a closed loop card represents giving a gift from a particular store.

- **Fee vs. No Fee.** Fees play a big part in why consumers will continue to prefer closed loop cards over open loop cards. As a general rule, retailers do not charge fees for closed loop cards, while financial institutions and other issuers of open loop gift cards typically charge up front fees when open loop cards are purchased ranging from \$1.95 to \$7.95, and sometimes charge maintenance fees as well. Some closed loop card programs will eventually charge dormancy fees on balances that are left on old cards, but these fees are still much less common than those found on open loop gift cards.

Sales & Marketing

Although financial institutions have increased the marketing and visibility of their gift card programs, this remains the domain of retailers.

- **Branch vs. Store.** Retailers have an inherent advantage over financial institutions when it comes to selling gift cards, because when consumers go shopping for a gift they typically go to a store—not to their bank. In addition, closed loop cards are also available at a variety of places other than at the stores at which they can be redeemed, such as gift card malls and on the Internet. Open loop cards, on the other hand, are generally obtained by going to a financial institution. While some open loop cards can be purchased over the Internet, most consumers buy them at a bank branch.
- **Product vs. Payment Option.** Retailers are generally better able to market and sell gift cards than financial institutions, because in many ways, managing gift cards is more similar to managing general merchandise than to managing a credit or debit card program. The retailers with the most successful gift card programs manage their cards as a SKU, with visible shelf space, attractive packaging, and promotional incentives. Financial institutions, whose primary focus is usually not on managing goods and inventory, are hard-pressed to create a similar sales environment via their branches or online banking website.

Economic Incentives

The economics of gift cards are significantly more attractive for merchants than for financial institutions, both in absolute terms and on a relative basis. Merchants will continue to invest in and market closed loop cards as they drive store sales, while financial institutions may not push gift cards as hard as some are projecting.

- **Absolute Return.** The revenue financial institutions receive from open loop gift cards comes from three sources: interchange, consumer fees, and unspent funds. For many financial institutions, it is the consumer fees that makes the business case for gift cards work—but which also curbs consumer adoption. In the absence of consumer fees, the economics of gift cards become less lucrative for financial institutions. The estimated \$0.80 in interchange that a financial institution would receive for a \$50 gift card used twice before the value is depleted may not cover the cost of card production, customer service, processing fees, fraud/write-offs, program marketing, and other expenses associated with offering gift cards. Additionally, over time, unspent funds have to be escheated to the state where the card was issued.

The business case for merchants, on the other hand, is much more compelling because gift cards offer them a number of benefits that simply do not accrue to financial institutions:

- With gift cards, merchants receive the money before they have sold (or in some cases, even ordered) the goods, allowing some merchants to finance their entire inventory with gift card funds.
 - Gift cards guarantee that the full amount of money on the card will be spent in the retailer's store (or even better, not spent at all).
 - Gift cards also increase consumer spending on both the front end and the back end: 80% of consumers who purchase gift cards indicate that they spend as much or more on a gift card than they would on a traditional gift, and 54% of consumers always or often spend more than the face value of the card.
- **Relative Return.** Unlike most merchants, financial institutions' prepaid product offerings are not necessarily limited to gift cards—and some of those other prepaid products (such as HSAs and payroll cards) may offer a greater return on investment than gift cards. As a result, these other prepaid products may be accorded a higher priority within the financial institution.
- Payroll cards and HSA cards are recurring-use products, and cardholders use these cards much more frequently than they do gift cards, which tend to be single-use products. As such, they produce higher revenue from transactions, and provide a platform for building stronger customer relationships.
 - Payroll cards and HSA cards are marketed to business customers rather than consumers, which means that financial institutions can typically charge higher fees for these products than they can for gift cards. They can also leverage them to strengthen their relationships with their commercial customers, which adds value to the financial institution beyond the card itself.

New Gift Card Models

In short, given current dynamics, the retailer-issued closed loop gift card is likely to remain the primary market segment for prepaid cards. In many households, gift cards have become a standard part of holiday gift giving, and their popularity continues to increase. They have become part of the mainstream, and are clearly here to stay.

To maximize future growth potential, issuers of closed loop cards and issuers of open loop cards may each benefit from taking a page from the other's book—as some are already beginning to do. A hybrid gift card model is emerging that combines the freedom and flexibility of an open loop gift card with the brand caché and merchant incentives that have made closed loop cards successful. These 'semi open loop' cards are able to be used at any merchant within a set geographic area, but not at locations outside that area (e.g., a resort gift card that can only be used at stores and restaurants within the resort). Some leading processors have identified hybrid cards as a potential growth opportunity, and we expect to see more variations in gift card models going forward.

As a result, the lines between closed and open loop gift cards will blur, and the debate between the two models will diminish. In the future, growth may come not just from pure closed loop cards or pure open loop cards, but from alternative gift card models that leverage the strengths of both approaches.

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