

Innovations in Payments and Decoupled Debit Reshape the Power of Merchant Loyalty Programs

How merchants can drive customer loyalty and lower the cost of doing business through customer incentives and payments

By Timothy Horton, Vice President of Product Management

Executive Summary

Unprecedented competitive pressures and a slowing economy are driving merchants to look for innovative ways to reduce operating expenses and increase revenues. However, cost reductions have to be invisible to the customer, who shops with high expectations of good value for his money as well as superior service and convenience. For this reason, merchants who want to attain and hold a competitive advantage will scrutinize every opportunity to improve the efficiencies and cost-effectiveness of their behind-the-scenes business processes.

At the same time, many merchants are using loyalty reward programs to increase customer lifetime value and drive incremental sales from repeat customers. Calling loyalty reward programs “a paramount competitive force,” the research and advisory firm Aite Group says such programs “shape the behaviors of a whopping 38 percent of the U.S. population.”¹ That’s close to 83 million adults—an astounding figure, to be sure. With so many people showing a preference to patronize merchants who reward loyalty, it’s no longer a question of if, but when every merchant will have a loyalty rewards program to derive more revenue from long-term customer relationships.

Innovations in technology allow merchants to address both needs at once. It’s now possible to reduce operating expenses by enticing customers through loyalty programs to utilize lower cost-per-transaction payment types. Programs are emerging that allow new and existing merchant loyalty or membership cards to be linked to customers’ preferred payments types, such as demand deposit accounts (DDAs), debit or credit accounts. Merchants can save money on payment processing fees by steering loyal customers toward DDA payments, known as decoupled debit, which are then processed as low-cost Automated Clearing House (ACH) payments.

Through decoupled debit, payment processors now have the means to “electronify” the processing of this non-check payment type through ACH, allowing merchants to reap the benefits of more payments from DDAs while providing convenience and choice to customers. When paired with a merchant’s

¹“The State of Rewards: The consumer voice,” March 2008, Aite Group, LLC.

own loyalty rewards program, the new payment process can reduce operating costs, increase customer spending and loyalty, and provide a real competitive advantage to a merchant.

What's unique about this approach is that it's truly merchant-centric. Most forms of decoupled debit are intended to profit the financial institution (FI) but not necessarily the merchant. This new "payment plus loyalty" approach shifts the value proposition to the merchant by enabling it to own the customer relationship (and all the insightful information the relationship yields), improve the customer experience (which in turn deepens loyalty), and streamline and reduce the cost of many payment processes.

The Payment Conundrum: How to Provide Customer Convenience and Choice While Still Controlling Costs

There are two elements to this integrated consumer payment and loyalty strategy. The payment process is a fresh approach enabled by the innovative use of existing technology that most merchants already have in place. The merchant-driven loyalty program is a proven solution that is the key to steering customers into the new lower-cost payment process. Linking these processes yields the greatest benefit for both the merchant and its customers.

There are so many choices today for how a customer can pay for his purchase, including cash, check, PIN debit, signature debit and credit. Each method has its pros and cons from both the merchant's and the customer's perspective. However, what's good for the customer is not always good for the merchant. For example, customers like the convenience and the payment time lag of credit cards. However, credit transactions are the most expensive payment type for merchants, due to the interchange fees that must be paid to the credit processing networks. Merchants usually absorb these fees as a cost of doing business.

Perhaps even more problematic for the merchant is that it typically has little influence over what form of payment the customer chooses to use, short of offering discounts for cash or refusing to accept certain forms or brands of payment. Merchants would prefer to gently steer the customer toward a payment method that is both convenient for the customer and cost-effective for the merchant. Therein lies the conundrum; customers like having a broad range of payment choices, but merchants want to control costs by reducing use of the high-cost payment methods such as credit and signature debit.

Using Decoupled Debit to the Merchant's Advantage

Merchants and customers today are familiar with the convenient process of using a debit card as payment for a purchase. In a typical PIN-based debit transaction, the customer swipes his card, enters his PIN and waits for approval of the transaction. In the background, the PIN is validated through a processing network and the funds are earmarked to be withdrawn from the customer's account, usually a DDA that is held by the FI that issued the debit card. Transaction approval, or denial, happens quickly, typically within a few seconds. The merchant account receives the funds usually within one business day.

Just recently, the practice of decoupled debit came to market. In this case, the “debit card” is issued by an organization other than the FI that holds the DDA. There are multiple forms of decoupled debit today, and the differences are primarily how the transactions are processed, where the funds are drawn from, and whom the process is designed to benefit. Here are a few example implementations of decoupled debit:

- Capital One acts as the issuer of a co-branded decoupled debit card. It’s co-branded in the sense that it carries the logo of both MasterCard® and a major merchant. Capital One doesn’t hold the DDA; instead, the payment is processed through the MasterCard network as a signature debit or credit transaction. Although the merchant’s name and logo are on the card, the merchant still pays the costly interchange fees assessed by the MasterCard network
- PayPal issues a VISA®-branded small-business debit card that the business owner can use to access the funds in his PayPal account. The funds are actually held behind the scenes by a bank in a stored-value account

Now there is a new merchant-centric form of decoupled debit taking hold in the marketplace. In this scenario, the loyalty or membership card issued by a merchant is linked to the customer’s preferred payment method—for example, a DDA, Discover® Network, VISA, MasterCard or American Express®. In effect, the loyalty card becomes a PIN-protected decoupled payment or debit card. However, it functions as a payment card only when the customer shops at that specific merchant’s stores; it cannot be used at other merchants’ facilities.

Figure 1. Processing cost per transaction of payment types.

On a \$100 transaction	Interchange Fee	Other Costs	Total Cost of Transaction
Credit Card	\$1.68	\$0.32	\$2.00
Signature Debit	\$1.20	\$0.20	\$1.40
PIN Debit	\$0.40	\$0.15	\$0.55
Electronified ACH*	-	\$0.20	\$0.20

*Based on cost of First Data® CONNECTPAYSM solution.

How does this card benefit the merchant, especially in terms of lowering the cost of doing business? If the merchant has a good relationship with the customer, the merchant can persuade the customer to use lower-cost payment types. Here’s where payment innovation comes into play.

Using existing technology in innovative ways, payment processors can take a decoupled debit DDA transaction and process it through the ACH network. The merchant’s cost saving from this electronified ACH payment is substantial. Pushing an electronic payment transaction through the ACH costs much less than putting it through the debit or credit networks, as shown in Figure 1.

What’s more, the merchant account receives payment the next business day, and there are also means to minimize risks from nonpayment. There are many more merchant benefits that we’ll come back to in a moment. Meanwhile, let’s look at the linchpin element that entices customers to use the electronified ACH payment method: The merchant’s customer loyalty program.

Steering Customer Behavior with Real-Time Rewards

In 25 years, customer rewards have risen from the status of a marketing gimmick into a paramount competitive force, according to Aite Group. The firm’s 2007 research shows that over 85 percent of U.S. households participate in at least one rewards program. Such programs are important to merchants because rewards “trigger a higher spend that not only pays for the cost of the program but also generates incremental transactions, revenues and profits.”²

²“Buying Loyalty: An Evaluation of Merchant Loyalty Vendors,” June 2008, Aite Group, LLC.

When a customer enrolls in a loyalty rewards program, he gives the merchant information that is valuable in establishing and maintaining a relationship with that customer. The information could include name, address, phone number, driver's license number, e-mail address, airline frequent flyer number, household demographics and so on. Each time the customer shops and presents his loyalty card or token, the merchant is able to track the customer's shopping habits, including how often he comes into the store, the time of the purchase, the amount of the spend, and even what he buys, all the way down to the SKU level. Such details build an incredibly valuable database of information about the customer and his household.

As a result of this new business intelligence, the merchant can begin to design personalized shopping experiences and relevant rewards that further shape the customer's behavior and grow the merchant's business. Merchants now have the ability to shower more valued rewards on their highest-value customers, driving them to an even higher level of purchasing. For example, the merchant can issue customized coupons based on a specific customer's buying habits to entice him back into the store to purchase items of high interest.

And now, loyalty reward programs are moving from offline redemption, calculation and communication to real time at the point-of-sale (POS), making the interaction with the customer even more personal. When a customer swipes or scans his loyalty card at checkout, he may be able to do a variety of things, such as check the balance of his accrued points, receive discounts on items in the shopping cart, redeem accrued points for the current sale, or print coupons for a future visit. What's more, merchants can provide customized messages at the POS, such as the number of points needed to attain a specific reward. Consumers like the immediacy and intimacy of being acknowledged, appreciated and rewarded as they are making a purchase. The potential for customer-centric real-time rewards is great, and Aite Group believes that real-time point-of-sale loyalty will grow in importance.

The Synergy of Pairing Merchant-Driven Payment Types with Real-Time Rewards

Now let's take it to the next level: Merging the merchant's rewards or membership program with the payment process so that it is one smooth, integrated experience for both the customer and the merchant. By linking the customer's preferred payment account (e.g., DDA, Discover Network, VISA, MasterCard or American Express) to the store-issued rewards or membership card, the merchant card becomes a decoupled payment or debit card that can initiate the payment transaction as well as trigger the calculation and appropriate usage of the reward.

The customer can choose what payment type he prefers to use with this merchant card, but it's in the merchant's best interest to steer the customer toward linking a DDA to the card because of the lower transaction processing fee. So, the merchant can bestow better rewards to the customer if he links to his DDA instead of a credit card account. For example, if a customer receives one "reward point" for every dollar spent, the merchant could offer two reward points for every dollar spent if the customer links his DDA to his loyalty card, or it could provide a one-time reward point bonus at sign-up. With the right incentive, the customer's behavior can be influenced.

For the customer, having a speedy checkout using a PIN-secured transaction and access to real-time rewards could not be easier or more convenient—and convenience for the customer is proven to drive incremental trips plus increased basket size. For the merchant, running more payments through the ACH process reduces operating expenses, and capturing more information about the customer through the rewards program provides insight that can help improve the relationship. Here's an example of how an integrated program would work:

Step 1: Merchant setup

First, the merchant selects a vendor to provide deployment and processing for the electrified ACH payment program. Depending on the current POS system in use and the vendor selected, there should be no required

changes to the store's existing POS system.

If the store already has a customer loyalty or store membership program, the software for this program needs to be coded to an industry-standard specification in order to integrate it with the payment processing system. (Depending on the vendor the merchant works with, this process normally takes 10 man-hours or less, if needed at all.) If the store does not yet have a loyalty program, the merchant can choose a vendor to provide a turnkey solution.

Step 2: Customer enrollment

Now the store encourages customers to enroll in the enhanced rewards program. Depending on the processor the merchant chooses to work with, rewards program marketing services may be provided. Customers complete enrollment forms that allow their preferred payment account to be linked to their store loyalty account. The merchant may offer extra incentives to entice the customers to enroll and continue to use the program. The best incentives may be offered to those customers who enroll their DDAs instead of a bankcard—a key to lowering payment transaction fees.

Step 3: Customer use

Each time the customer shops and goes to check out, he scans or swipes his store loyalty card and enters the appropriate PIN. There's no need to swipe an additional payment card, as the loyalty card activates the payment system using his predetermined account. His real-time rewards are calculated and accrued or assigned as determined by the loyalty program. Within seconds, the payment transaction is complete and the customer is on his way. The key value proposition to the customer is the benefits of the rewards program in addition to the extra convenience of a speedy one-step checkout process.

How a Decoupled Debit Transaction is Processed

Now let's look at the transaction from the merchant's viewpoint. (Note that this process is proprietary to each processing vendor and can vary by vendor. We'll speak in general terms to give the reader an overview of a typical process.)

When the customer scans or swipes his loyalty card or token and enters his PIN, he initiates two transactions: One for payment, and one for the rewards program. Let's look at the rewards program first. Once the merchandise is tallied, the loyalty rewards are calculated and applied to the transaction. Depending on how the merchant structures the program, rewards can occur in real time, such as delivering a discount on items in the cart.

Next, the payment transaction is processed according to the predetermined payment type chosen by the customer during program enrollment. If the payment type is a regular debit or credit payment, it's handled by the merchant's normal process of accepting payment and sending the transaction to the acquirer. There is no change to how these types of payments have always been handled.

However, if the payment is tied to the customer's DDA via the loyalty card program, the payment is processed as an electrified ACH transaction. Depending on the merchant's setup and preference, the payment may be run through a risk assessment engine to determine if the payment has a high likelihood of becoming a returned item. If it does, the payment may be declined. If the risk prospect is low, the processor creates an ACH file and submits it overnight to the network for processing. The following day, the processor directs payment to the merchant's receiving depository financial institution (RDFI).

While policies and processes vary by vendor, some vendors guarantee to assume the risk if an approved item is returned. In this case, the merchant has no risk of a returned item and does not have to attempt to collect, further reducing the merchant's liability and cost.

The most obvious advantage to the merchant of using electrified ACH payments is the significant savings in transaction processing costs: The transaction cost is as low as \$0.20 on a \$100 transaction, versus approximately \$2 for credit cards. This program also lowers operating costs as well, by taking some of the paperwork out of back-office systems, reducing the costs of courier and banking fees, and reducing the costs and risk associated with returned items.

Benefits to Customers and Merchants

Customers enjoy an easy and convenient way to enroll and participate in a rewards program while having the flexibility of choosing their preferred payment method. They also appreciate the convenience of a speedy checkout and enjoy the perquisites of "relationship shopping."

Merchants deliver superior customer service by providing additional choice and convenience to loyal customers. Wait times during peak business hours are reduced with faster payment processing. Merchants can focus on serving customers and building deeper relationships through the business intelligence garnered through the loyalty program.

Merchants enjoy financial benefits as well. Through the loyalty program, a merchant improves the bottom line with an increase in store traffic and higher per-ticket purchases. Moreover, payment transaction costs can be reduced, even while customers retain choice over their preferred payment method. The cost of back-office processes is reduced as more payments are handled online. With the electrified ACH payments, the merchant has less risk exposure to returned and uncollectible items.

Adoption Considerations

A unified decoupled debit program that joins the customer loyalty program with efficient electrified ACH payments puts the merchant in control of the customer relationship and helps to manage expenses. There are myriad ways this can be implemented, and several viable processors/vendors offer all or part of a solution. Here are some adoption considerations for the merchant to investigate in-depth as it evaluates the various solutions and the companies that provide them.

- **Ease of implementation** – How does the "consumer payment + loyalty rewards" application leverage the merchant's current POS system? Can these systems easily be integrated quickly and with little expense to create one seamless solution? Is there a plug-and-play solution so the merchant won't need to make any changes to the existing POS? If the merchant doesn't currently have a loyalty program, can the solution provider help implement one? Can the payment process integrate with a store membership program? Can the solution be customized to meet specific merchant and customer needs?
- **Payment processing expertise** – Does the solution provider have proven expertise in processing ACH payments? What risk avoidance techniques are used to ensure the merchant is not liable for returned items? What payment guarantees does the vendor make to the merchant?
- **Back-office support** – What costs can be taken out of the back office with this program? How can back-office processes such as reconciliation of payments be streamlined? What training and ongoing support does the solution provider offer to the merchant and his staff?

- **Consumer adoption strategy and support** – Does the solution provider offer marketing support to help launch the program and inspire consumers to activate, try and continue to use the solution? What communications can be leveraged to inform customers and prospects of the new program's availability and benefits? Does the solution provider offer a call center or other means of support for customers who choose to enroll? What levels of rewards are proven to entice consumer enrollment in the program?
- **ROI** – Is there an ROI model to help the merchant estimate the financial benefits to be derived from customer return visits/incremental sales and expense reduction in payment processing? What impact do variations in the rewards program have on ROI?
- **Other considerations** – Can the solution provider support alternative access devices and form factors (such as smart phones, contactless payment cards and electronic wallets) that make the checkout process easier for the customers? Is the processor innovating new ways to lower merchants' costs through new methods and technologies?

Conclusion

The retail industry is brutally competitive, and merchants need to constantly innovate to maintain a competitive advantage. Among the keys to competitiveness are: Increasing revenue through increased customer spend per visit, increasing return traffic through improved customer loyalty and reducing operating expenses through innovative payment processes. Now merchants can leverage all three keys with a decoupled debit payment solution tied to a strong customer loyalty rewards program. It's the future of the shopping experience, and it puts more control over payments into the merchant's hands.

About The Author

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Prior to joining First Data, Tim worked for First National Bank of Omaha in its Bankcard Division as a Senior Business Analyst. He has his BSBA in Finance and Banking and his MBA from the University of Nebraska at Omaha.

First Data® CONNECTPAYSM

Deliver superior service by providing additional payment choices and convenience to customers while increasing participation in your loyalty and membership programs.

Innovative solutions from First Data make it easier and more convenient for consumers to pay for their purchases while enabling you to grow and differentiate your business. Customers in your loyalty or membership programs can link to their preferred payment account for secure and even faster checkout.

The Challenge

Offering convenience to customers, building loyalty and making your business distinct in the marketplace require continuous adaptation to evolving customer demand. Driven by technology, new pricing or business models, a challenging economy, and savvy consumers, implementing new methods of payment is possible and active in the market today.

The Solution

The latest payment innovations from First Data provide end-to-end, comprehensive products and services that deliver new value propositions. Enabling most any payment, on any device, to be authenticated, authorized and settled to any customer account, the First Data® CONNECTPAYSM solution can enhance your new or existing loyalty or membership programs with a customer's choice of payment. The solution supports many payment types, including a demand deposit account (DDA) and a credit or a signature debit card account, all of which are protected by a self-selected Personal Identification Number (PIN).

Here's How It Works

Participating customers register their favorite payment method with the new or existing loyalty or membership account and select a PIN. Then, when customers make a purchase and enter their PIN, the payments are processed through their chosen payment account.

Deliver superior service by providing additional payment choices and convenience to customers while increasing participation in your loyalty and membership programs.

Help Your Business

- Improve your bottom line with an increase in store traffic and higher per-ticket purchases
- Deliver superior customer service by providing additional choice and convenience to loyal customers
- Reduce wait times during peak business hours with fast payment processing for all payment types
- Increase participation in your loyalty and membership programs since your customers can choose their preferred payment method
- Reduce cost, in some cases

Help Your Customers

- Enjoy an easy and convenient way to participate in programs and pay for goods and services
- Appreciate the convenience of a speedy checkout
- Benefit from the flexibility of choosing their preferred payment method
- Reap the rewards of your membership and loyalty programs with easy online or retail enrollment

Features

- DDA-specific or multi-funded payment solutions
- Quick activation and usage
- Consumer adoption strategy and support
- Advanced technologies that facilitate easy implementation
- Leverage of existing POS technology and processes
- Secure and easy integration with a broad range of First Data products and services
- Focus on operational ease

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