A First Data White Paper

Merchant Options for Lowering Payment Costs

Introduction

Economists say the Great Recession technically ended in June 2009, but the effects linger as consumers remain wary about household spending and retail sales continue to languish. Now more than ever, it's important for merchants to take every opportunity to increase their sales while squeezing costs out of operational processes—hopefully emerging from this economic malaise in a better position than those who don't.

One bright spot for some merchants is the newly revised cost equation for accepting debit payments at checkout. The Durbin Amendment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 (the "Durbin Amendment") has significantly changed the payments landscape where debit card payments are concerned. This has generated a more focused interest from merchants to identify other options for reducing overall payment costs, both in-store and online, and not just with debit.

However, managing costs is only half of the story. Merchants also want to increase customer loyalty and overall spend to drive growth. Below we'll explore ways merchants can accomplish cost savings, customer loyalty and increased spend using proven programs that are yielding great success for merchants who deploy them.

Durbin Regulations Give Merchants New Options

The Durbin Amendment includes three elements pertaining to debit payments that are favorable to most merchants (except for those relying heavily on small-ticket debit transactions):

- **Regulated interchange fees** – Effective October 1, 2011, there is a cap on the point-of-sale interchange fee that merchants' acquirers pay to networks for processing most of their debit payments: $0.21 per transaction, plus an ad valorem component of 5 basis points (bps) on the total transaction value (plus an additional $0.01 if it meets general fraud prevention standards). The one major exception to the new rule is for cards issued by financial institutions with less than $10 billion in assets, which are not required to observe the interchange rate cap.
- **Routing control** – Payment card networks and issuers are no longer able to control the routing of point-of-sale debit card transactions to networks for processing. Now merchants and their acquirers/processors determine the preferred routing based on a number of business rules.
- **Network non-exclusivity** – Effective April 1, 2012, payment card network exclusivity arrangements between debit card issuers and payment card networks are null and void for point-of-sale debit card transactions. For the first time, issuers must provide merchants with the choice of at least two unaffiliated debit networks over which to process point-of-sale payments.

Several points about these regulations are important as we look at options for low-cost payments. First, the Durbin Amendment only affects point-of-sale debit payments; there is no impact on other forms of electronic payments such as credit or ACH. Many merchants, depending on their average ticket size, may experience lower debit payment acceptance costs.

Second, Durbin eliminates the difference in the regulated bank interchange rate between signature debit and PIN debit, which means banks and merchants may drive consumers to use PIN over signature authentication given the lower fraud rates for PIN debit transactions.

Third, there's no longer a regulated bank interchange fee differential for debit payments when the card is not present. Merchants now have an incentive to steer consumers toward lower-cost debit payments rather than higher-cost credit payments for online, mail and phone transactions.

Finally, the routing control and network non-exclusivity regulations means that merchants can choose to route a payment over whichever network affiliated with a card offers the lower total cost for interchange rates and processing fees. This calculation can be made instantly at the time a card is presented.

Payment Trends and Preferences

The 2010 Federal Reserve Payments Study indicates that debit has become the most popular form of noncash payment in the U.S., having overtaken both checks and credit. But debit isn't the only payment type on a growth path; ACH and prepaid cards also are increasing in their use, as shown in Table 1.

These payment trends are also supported by the Visa Payment Panel Study, which includes ongoing detailed consumer research that began in the early 1990s and continues to the present day. Among other observations of this long-term research:[1]

- **Debit card ownership is rising.** In 1997, 60 percent of the research panelists in Visa's study reported owning a debit card, with just 17 percent actually using them. By 2008, debit card ownership reached 92 percent of the research subjects, with 60 percent of the owners reporting usage.

TABLE 1: NUMBER OF NONCASH PAYMENTS AND THEIR GROWTH RATES

U.S. Noncash Payments			
	2006	2009	Compound Annual Growth Rate
Total Payments (billions)	95.2	109.0	4.6%
Debit card	25.0	37.9	14.8% ▲
Checks (paid)	30.5	24.5	-7.1% ▼
Credit card	21.7	21.6	-0.2% ▼
ACH	14.6	19.1	9.4% ▲
Prepaid card	3.3	6.0	21.5% ▲

Source: 2010 Federal Reserve Payments Study

- **Dollar expenditures on debit are rising.** Consumer dollar expenditures using signature and PIN debit grew from 7 percent of consumer purchases in 2001 to 19 percent in 2008. Thus, changes in American consumer payment preferences caused a shift from only $1 in every $14 being paid for with a debit card to nearly $1 in every $5.

- **Consumers prefer to pay with debit.** Representing the largest single group in the payments study, 36 percent of the subjects say they would prefer to pay with a debit card "all the time." Their primary impediments are lack of merchant acceptance and insufficient funds in the cardholder's deposit account.

- **The recession affected payment type usage.** Although credit card spending declined between 2008 and 2010 (while debit card spending increased), the panel data shows this is not indicative of a long-term trend of debit supplanting credit. Rather, it's fallout from the recession when consumers curtailed discretionary and big-ticket spending. Consumers prefer debit cards for non-discretionary spending (such as groceries), which was not curtailed during the recession.

The cost of acceptance

There is considerable variance between a merchant's transaction costs on different types of payments, and merchants would obviously like their customers to always use a form of payment that has a low total transaction cost. Typically, credit cards have the highest transaction processing fees for merchants, followed by debit cards, checks and ACH payments. However, what consumers want to do is often at odds with what merchants would like them to do. It is also important to note that transaction fees are not the only component of payment acceptance cost. Risk, or the possibility of financial loss due to fraud and/or chargebacks, also plays a role. Some forms of payment carry a much higher risk than others, and merchants often end up paying extra fees to have those risky transactions processed. Merchants usually accept the risks and the associated fees to drive overall sales and to provide customer convenience. The primary risk areas include:

[1] Susan Herbst-Murphy, "Trends and Preferences in Consumer Payments: Lessons from the Visa Payment Panel Study," a discussion paper published by the Payment Cards Center of the Federal Reserve Bank of Philadelphia, May 2010

Signature and PIN authentication for debit transactions

Using a signature on a point-of-sale terminal or a printed receipt is a much weaker form of authentication than entering a multi-digit PIN. Fraud losses to financial institutions average about 6.4 basis points for signature debit, and 2.4 basis points for PIN debit, according to the Federal Reserve Board. Prior to the Durbin Amendment, card issuers took this risk into account and charged a higher interchange rate for signature debit transactions. Now, however, Durbin prohibits larger financial institutions from charging a higher fee for signature debit transactions, so we're likely to see these large issuers become greater advocates for PIN debit.

Card-not-present fraud

Whether credit or debit, the overall fraud rate for card-not-present transactions is much higher than for card-present transactions. Merchants who accept payments over the phone, over the Internet, or via the mail sustain a much lower total payment acceptance cost by encouraging consumers to use their debit or checking account rather than credit.

Paper checks

Though paper checks have one of the lowest acceptance costs among various payment types, merchants face a high fraud risk with the acceptance of checks unless they subscribe to a check verification or guarantee service. Such services can require a monthly fee, a per transaction fee, and in some cases, even a fee based on a percentage of the sale—in effect driving up the overall cost of acceptance to ensure payment.

Low-Cost Steering Options

Regular PIN debit transactions, as well as electronic checks processed as ACH payments, hit the sweet spot of being low cost, low risk and preferred or accepted by consumers. Merchants can steer payments into these categories through:

- **Intelligent routing** – using technology to determine the network offering the low cost path for routing and processing each debit transaction.
- **ACH-based payment cards** – closed loop electronic check cards that allow electronic payments to be processed through the low-cost ACH system.
- **Customer loyalty and other incentives** – shaping consumers' behavior through incentives they find beneficial when they use a certain low-cost payment type like paying directly from their checking account.

Intelligent Payment Routing in the Post-Durbin Era

For the first time, merchants and acquirers/processors have control over routing PIN point-of-sale debit payments for processing based on the networks affiliated with a particular card. It's expected that networks will compete for each transaction based on the overall value proposition they offer, as well as on price.

For merchants, the ability to truly optimize costs through routing options will depend on a number of complex factors that vary from one transaction to another. This new approach requires intelligent routing that uses technology to instantly calculate the optimal low-cost path for routing and processing each debit transaction based on numerous business rules that didn't exist before the Durbin regulations.

The factors behind the routing rules are complex, and they can change frequently. The sophisticated technology used to calculate the low-cost routing path must maintain compliance with all the rules and regulations of the payment networks' requirements while optimizing the end results for the merchant. Regardless of size, few merchants wish to develop or maintain the necessary routing technology for themselves, with most preferring to form a strategic relationship with an acquirer with the knowledge, experience and technical capability to make sense of the complexities. Merchants should choose innovative and experienced partners to help them navigate the waters and drive maximum benefits.

In addition, merchants can take other actions to maximize the benefits they can derive from the intelligent routing of PIN point-of-sale debit payments:

- Gain knowledge about how intelligent routing and other network innovations work.
- Add diversity to network routing choices to capture a broader spectrum of benefits.
- Get trained on new tools, services or procedures to take advantage of the ability to route transactions to capture maximum savings.
- Gain insight on network routing data for analysis and business process improvement.
- Implement updates or enhancements to point-of-sale equipment and software.
- Develop partnerships with innovative parties that have the vision and ability to deliver the desired payment network features and functionality of the future.

ACH-based Payment Cards

In terms of payment acceptance, ACH payments sit at the low end of the cost spectrum—below debit, and far below credit. ACH payments are an attractive option for merchants looking to drive lower costs so they can either improve cost efficiencies or drive more loyalty by giving better incentives to consumers with the savings. The key is to put an ACH-based payment card into customers' hands and get them to prefer its use over other forms of electronic payment.

There are two elements to this strategy: a closed loop electronic check card and a loyalty rewards program. The approach uses a new merchant-branded closed loop payment card in which the loyalty or membership card issued by a merchant is linked to the customer's checking account. In effect, the loyalty card becomes a PIN-protected payment card. It functions as a payment card only when the customer shops at that specific merchant's stores. As a closed loop card, it cannot be used at other merchants' facilities.

If the merchant has a good relationship with the customer, the merchant can persuade the customer to use lower-cost payment types. The optimal scenario is for the customer to link his checking account to the loyalty card, which enables payment innovation to come into play. Using existing technology, payment processors can process the transaction through the ACH network. The merchant's cost savings from this electronic ACH payment are substantial. What's more, the merchant account receives payment the next business day.

Now let's look at the linchpin element that entices customers to use this method of payment: the merchant's customer loyalty program.

Enticing customers with real-time rewards

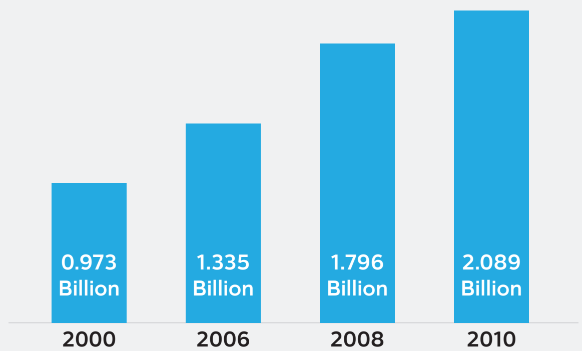
In 25 years, customer rewards have risen from the status of a marketing gimmick into an important competitive force, according to Aite Group. Such programs are important to merchants, because rewards "trigger a higher spend that not only pays for the cost of the program but also generates incremental transactions, revenues and profits."[2]

Loyalty programs are certainly popular among consumers: according to loyalty research and consulting company COLLOQUY, the number of loyalty memberships in the U.S. now exceeds 2 billion, netting out to more than 18 memberships per household. That's up 16 percent from the almost 1.8 billon memberships counted in 2008.[3] Figure 1 shows the growth in loyalty program memberships in recent years.

When a customer enrolls in a rewards program, he gives the merchant information that is valuable in establishing and maintaining a relationship (name and address or even more extensive information such as phone number, driver's license number, email address, airline frequent flyer number, household demographics and so on). Each time the customer shops or dines and presents his loyalty card or token, the merchant is able to track the customer's buying habits, including how often he comes into the store or restaurant; the time of the purchase; the amount of the spend; and even what he buys, all the way down to the SKU level.

The merchant can now begin to design personalized shopping experiences and relevant rewards that further shape the customer's behavior. Merchants can shower more valued rewards on their highest-value customers, driving them to even higher levels of purchasing.

FIGURE 1: TOTAL U.S. LOYALTY PROGRAM MEMBERSHIPS BY CENSUS YEAR



Source: The 2011 COLLOQUY Loyalty Census

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. In addition, merchants can provide customized messages at the point of sale, such as the number of points needed to attain a specific reward level. 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.

[2] Aite Group, LLC, "Buying Loyalty: An Evaluation of Merchant Loyalty Vendors," June 2008
[3] Kelly Hlavinka and Jim Sullivan, *COLLOQUY, The Billion Member March: The 2011 COLLOQUY Loyalty Census*, 2011

The synergy of pairing merchant-driven payment types with real-time rewards

Now let's take it to the next level: combining the merchant's rewards or membership program with the payment process so that it is a single integrated experience. By linking the customer's checking account to the store-issued rewards or membership card, the merchant card becomes a payment card that can initiate the payment transaction as well as trigger the calculation and appropriate usage of rewards.

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 visits, plus increased ticket 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.

Benefits to customers and merchants

Customers enjoy an easy and convenient way to enroll and participate in a rewards program while accessing their checking account funds through a PIN-protected closed loop card. They also appreciate the expediency of using a single card for both rewards and payments.

Merchants deliver superior customer service by providing improved convenience to loyal customers. Wait times during peak business hours are reduced through faster payment acceptance. 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 their bottom line with an increase in store traffic and higher per-ticket purchases. Moreover, payment transaction costs can be reduced, since payments are routed through the lower-cost ACH network. In addition, the cost of back-office processes is reduced as more payments are handled online.

Other ACH Payment Technologies

Other innovative solutions are designed to draw payment funds from a consumer's checking account for processing through the lower-cost ACH network.

Virtual mobile wallet

Merchants embracing the new trends in mobile can also drive low-cost payments and loyalty with a program geared to allow consumers to use their mobile smartphones for payment. Merchants can develop or leverage their existing mobile application to allow consumers to shop and scan items using their mobile phones, and check out from their phone using the payment type they registered for when they downloaded the app. Similar to the way merchants can link loyalty rewards to a closed-loop card-present card, they can also link the consumer's loyalty program to their virtual wallet and drive low-cost payment types through incentives and discounts. For example, a consumer would register for a merchant's closed-loop wallet by entering their checking account information when registering, and every time they check out using their phone they would automatically receive loyalty rewards while the merchant tracks their purchasing behavior. Once the consumer checks out on their phone, they could scan the bar code on their phone and receive their receipt via email.

ACH online checks

eCommerce merchants have the option of allowing online shoppers to pay by electronic check as an alternative to debit or credit card. The customer enters his checking account number when prompted for payment information. The customer can register and file his payment information with the merchant before proceeding to the checkout, or he can enter the checking information upon checkout for one-time use. Either way, the merchant processes the payment through the ACH network. Merchants can encourage customers to use this online check payment method by making it the first choice on the list of payment options.

ACH prepaid reload

Prepaid cards are growing in popularity and usage. Table 1 above shows a growing trend toward more in-store transactions being completed with a gift or prepaid card, many of which can be reloaded with funds from a consumer's own account. Merchants can capitalize on this trend and drive low-cost payments using ACH to pull funds from a consumer's checking account to reload a prepaid card. Again, this is a low-cost option that could be promoted as the first payment method to drive down operational costs.

Summary

Many merchants are still considering how the Durbin Amendment affects them and their business operations for processing debit payments. This is the perfect time to look beyond the legislated debit fee reductions and consider wider opportunities for lowering the total cost of accepting and processing electronic payments.

With the U.S. economy struggling to overcome the lingering effects of the recession, merchants need to constantly innovate to drive growth and reduce costs. Among the keys to success are increasing revenue through increased customer spend per visit; increasing return traffic through improved customer loyalty; and reducing operating expenses through innovative payment processes.

Here's a short list of what merchants can do today to lower the cost of accepting payments and improve their competitive stance:

- **Prompt for a PIN at the POS when a customer presents a debit card.** Although the Durbin Amendment eliminated the cost differential of processing a signature debit versus a PIN debit transaction from cards of larger issuers, PIN transactions offer better security as well as new opportunities for routing payments to low-cost networks.
- **Prompt for a checking account number for online transactions.** eCommerce merchants can steer customers' payments by first asking them to pay with a checking account before giving them the alternative to pay with debit or credit.
- **Consider adopting intelligent routing.** Reducing costs through intelligent routing is not as complicated as one might think if the merchant partners with an acquirer/processor with the experience, knowledge and tools to do this.
- **Link a loyalty program to lower-cost payment types.** Enhance or initiate a loyalty or membership program by integrating the customers' loyalty/rewards card with the preferred form of payment the merchant wants, such as a checking account processed through the ACH network. Innovative programs like the First Data CONNECTPAY℠ solution make this easy to implement.
- **Influence consumer behavior through incentives.** Consumers have indicated a willingness to change their payment behavior based on incentives offered by merchants; for example, earning a discount on a future purchase by using a debit card instead of a credit card on the current purchase.
- **Form a strong partnership with an innovative acquirer/processor.** Merchants can benefit from leveraging the experience, technology and scale of a truly innovative acquiring partner.

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