A First Data White Paper

How Merchants Can Maximize Cost Savings in the Post-Durbin Era of Debit Payments

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Introduction

The Durbin Amendment of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 is dramatically changing the landscape for how merchants process consumers’ electronic debit payments. Under the law, the U.S. Federal Reserve Board (FRB) issued regulatory provisions that affect debit interchange rates, debit network processing, and merchant payment acceptance options. For merchants, the new regulations enhance competition in the payments market and provide new opportunities to control and optimize costs associated with payment acceptance.

There are three major aspects of the Durbin regulations that are sure to have tremendous impact on merchants:

1. The regulation of interchange fees has lowered debit payment acceptance costs on cards issued by financial institutions with greater than $10 billion in assets. Beginning October 1, 2011, interchange rates for these debit transactions will be capped at $0.21 per transaction, plus an ad valorem component of 5 basis points on the total transaction value, as well as a $0.01 addition if the issuer meets general fraud prevention standards.

2. Starting October 1, 2011, payment card networks and issuers will no longer be able to control the routing of debit card transactions.

3. As of April 1, 2012, debit card issuers must participate in two unaffiliated networks without regard to the authorization method (e.g., one signature network and one unaffiliated PIN network, two unaffiliated PIN or signature debit networks).

These three items mean a new way of doing business for merchants where electronic debit payments are concerned. Many merchants have the expectation of a reduction in the cost of payment acceptance, which today is a significant cost of doing business.

But along with opportunity comes potential confusion and complexity.

Now that the Federal Reserve has communicated the final regulations, financial institutions and the payment networks will have to determine how they will price their services, both initially and over the long term. In addition, there are other key unknowns that make it challenging, at best, for merchants to solidify their plans on how to adapt to and benefit from the changes. In response to the new rules, financial institutions and networks will likely try out various rates and pricing models in order to understand what will best serve their businesses in terms of balancing the need for revenue with the need to gain/retain customers. It is uncertain how long this variability will go on, and how often merchants and acquirers can expect to see participants adjust their rates.

All parties in the payments value chain—merchants, acquirers/processors, networks and issuers—are navigating their way through the strategic and operational upheaval created by the new regulations. Without a doubt, “change” is likely to be the watchword for some time as all parties adapt to the new landscape and as regulations and network services evolve.

With the new regulations, many merchants are beginning to get their first taste of the complexity of payment routing. Until now, routing choice and control has generally been unavailable to merchants because many of the FIs and the networks determined how PIN debit transactions were routed; merchants simply followed the rules. Starting October 1, 2011, however, merchants will have options in how to route payments based on the brands and networks that coexist on a card. While the merchant’s desired outcome of routing to the lowest cost network is relatively straightforward, how this is actually achieved can be quite complex.
Routing determination is not a core competency for merchants—nor should it be. This is a function that has been performed by acquirers and processors for decades based on network and issuer routing rules. While it’s true that merchants will now have routing options where before they had practically none, the real decision for any merchant should be which acquirer to align with in order to achieve the most favorable routing economics without expanding internal debit network expertise.

Merchants should be aware that there are important strategic advantages to partnering with an acquirer/processor with both the experience and the innovative solutions to navigate this new era. Now is the time to form strategic partnerships with organizations that provide a greater breadth of options and deeper value propositions than simply low cost routing. By being proactive, retailers can position themselves advantageously relative to the impending changes.

Capturing the benefits of routing options

For the first time, merchants and acquirers/processors will soon have control over routing PIN 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 can offer to the merchant, 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” capabilities, such as First Data’s Smart Routing™ service, to take advantage of cost reduction opportunities. Intelligent routing utilizes sophisticated technology to instantly calculate the optimal lowest cost path for routing and processing each transaction based on numerous factors (business rules) that didn’t exist before the Durbin regulations. These factors create significant complexity that the routing technology must accommodate. Examples of these factors include:

- The pricing rules for regulated financial institutions (those with more than $10 billion in assets), and the individual fees set by each network. Keep in mind that each network can change its fees at any time, as well as vary them according to merchant category code (MCC), average ticket size, network agreements or other business arrangements, as long as they comply with the Durbin regulations.
- The pricing rules for unregulated financial institutions (those with less than $10 billion in assets), and the individual fees set by each network. Like their regulated brethren, the unregulated smaller banks’ and credit unions’ transactions fees can vary at any time, but they don’t have to observe the interchange fee restrictions the government is now imposing on larger institutions.
- Payment network fees that factor into every transaction. These are additional transaction charges (such as switching fees) that aren’t regulated under Durbin. Similar to fees mentioned, they are also subject to change and should be another factor to consider when evaluating your routing options and the related economics.

These examples are just a few of the factors that intelligent routing must accommodate. It’s easy to see how complex the business rules can become and how sophisticated the technology must be in order to maintain compliance with all the rules and regulations while optimizing the end results for the merchant.

Regardless of size, few merchants desire to develop or maintain the necessary routing technology for themselves. Most prefer to form a strategic partnership with an acquirer that has the knowledge, experience and technical capability to make sense out of all the complexities inherent in the new routing rules.
Selecting an acquiring partner in the post-Durbin landscape

Once all the Durbin regulations are fully in effect, merchants will have a tremendous opportunity to reduce operating costs and boost the bottom line by optimizing their debit payment routing. And, as previously described, the routing decision process can be prohibitively expensive and complex for merchants to do internally. Thus, having the right acquiring partner for these new times is important—in fact, it is a critical success factor in reaping the maximum economic benefits from the new regulations.

Here is a look at the new value propositions for selecting an acquiring partner that will help yield the greatest rewards from the altered regulatory landscape:

- **Innovative services and solutions**: The Durbin regulations don’t just change the playing field where debit payments are concerned; it changes the entire game. The old rules no longer apply, and the complexity of the new rules is growing exponentially. Innovative new services and technology solutions are needed to help a merchant find the most efficient and effective ways to process electronic payment transactions and to derive incremental benefits from insight into transaction scenarios. Examples of such innovation include:
  - Sophisticated intelligent routing capabilities
  - Reporting and analytic tools that allow a merchant to track the cost savings related to PIN debit routing optimization and/or model potential benefits based on various routing scenarios

An acquiring partner must be willing to make the ongoing investment in technology infrastructure to create state of the art solutions that provide meaningful benefits to the merchant.

- **Experience**: Though the payments landscape is changing and the rules and procedures for routing will be quite different in a few months, merchants should seek an acquiring partner with deep experience in the payments market and a thorough understanding of the coming changes. This experience enables the acquirer to understand how merchants should now be thinking about routing and what kinds of tools they’ll need. The acquirer’s expertise in the field will ensure that all bases are covered.

- **Knowledge of the merchant’s business**: To be a true trusted advisor, an acquirer should know a merchant’s payments processes and procedures in conjunction with the merchant’s key business drivers and overall objectives. This knowledge allows the acquirer to recommend and implement cost-saving measures for the merchant.

- **Knowledge of the payment networks and their operating models**: An acquiring partner should have a thorough understanding of the offerings from all of the networks; the prices of those offerings (which may change frequently); and which offerings make sense for that merchant’s business on a per-transaction basis. This knowledge is critical in developing sophisticated routing solutions, which require detailed and current knowledge of all the networks and brands.

- **Timeliness**: There is an aggressive timeline for the implementation of the final Durbin regulations, with the interchange and routing provisions becoming effective on October 1st of this year. Merchants will want to begin reaping the benefits of routing choice as soon as the law allows. An acquiring partner should have the ability to put innovative routing tools and other services to work for the merchant as quickly as possible.

- **Responsiveness**: An acquirer must maintain nimbleness and a sense of urgency in order to respond to pricing and routing rule changes that are expected to happen quickly and often. With fourteen networks, multiple card brands and numerous financial institutions (both regulated and unregulated) to follow, the acquirer must stay on top of new developments.

- **Simplicity**: While there’s more to fully benefiting from routing choice than simply picking a network off the back of a debit card, merchants shouldn’t have to worry about all the complexity that goes into making the most beneficial routing decision. It’s important that an acquirer offers simplicity via a turnkey solution that fully addresses a merchant’s needs.

- **A forward-looking posture**: It’s incumbent on the acquirer to maintain a watch on not only what is happening in the market today, but also what might happen in the future, and how future changes could impact the merchant’s business. This includes macroeconomic trends, new or amended legislation, changes in the payments industry (like EMV and mobile commerce), and other market dynamics.

- **Responsibility and accuracy**: And of course, it goes without saying that an acquirer must commit to manage all processes and solutions to ensure they are current, accurate and compliant with federal regulations and industry standards.
Why act now?

The scheduled dates for change are rapidly approaching; merchants should act now to attain maximum benefits, including:

- Becoming knowledgeable and gaining confidence about how intelligent routing and other innovations work
- Positioning themselves to capture new business opportunities as soon as possible
- Adding diversity to network routing choices to capture a broader spectrum of benefits
- Receiving advance training on new tools, services or procedures
- Gaining insight on network routing data that can be used for analysis and business process improvement
- Scheduling and implementing any necessary updates or enhancements
- Developing partnerships with innovative parties that have the vision and ability to deliver the desired payment network features and functionality of the future

Conclusion

The Federal Reserve Board’s final rules have now been released, and merchants have reason to be optimistic about the great opportunities ahead of them. First, the new rules provide a potentially significant reduction in interchange fees. Second, the regulations usher in real choice for merchants in how to process their consumers’ debit payments. How a merchant implements its routing rules will determine how low the merchant can drive its operational costs. But the new business landscape is more complex than before, so merchants should choose innovative and experienced partners to help them navigate the waters and derive maximum benefits from all the changes.

Merchants should choose their acquiring partner based on long-term value and a commitment to apply real innovation to new business processes—like intelligent routing, which calculates the least cost payment route based on numerous variables such as interchange fees, switching fees, negotiated contracts with networks, and average ticket size.

The new Durbin regulations are an important reason for merchants to evaluate their acquiring partnership—to get the most value from the regulatory changes and the new market conditions. They should act quickly to be ready to maximize their operational savings as soon as the new rules go into effect.