

Challenges & Opportunities for Merchant Acquirers

In the rapidly changing global payments landscape, merchant acquirers face increasing challenges which bring new opportunities



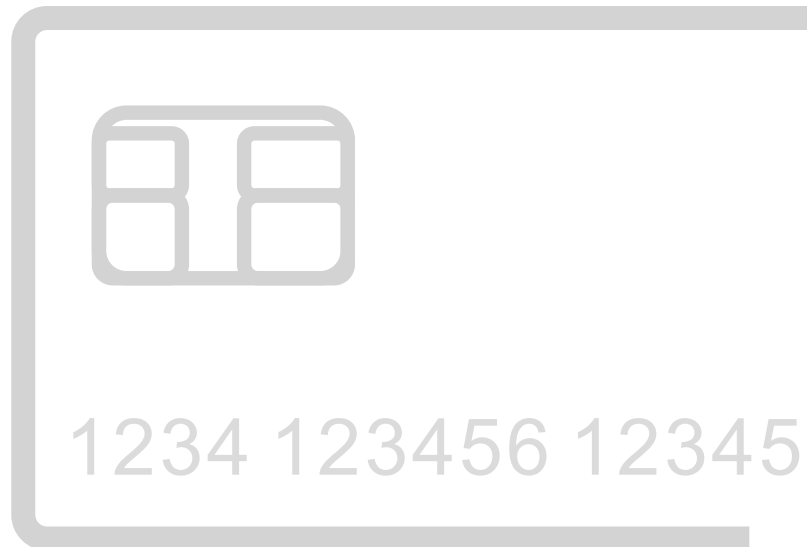
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1. Highlights

Merchant acquiring is an integral part of card payment transactions processing. Acquirers enable merchants to accept card payments by acting as a link between merchants, issuers, and payment networks—providing authorization, clearing and settlement, dispute management, and information services to merchants. The merchant acquiring industry is dominated by a few large players across the globe, with the top ten acquirers in the world handling nearly 50%¹ of the global cards transaction volume in 2010.

This paper identifies key challenges faced by merchant acquirers in a rapidly changing payments landscape. These challenges are making it more difficult for merchant acquirers to sustain and grow their business. The paper also explores the drivers behind these challenges and proposes probable solutions which can be used to address the key challenges. Finally, we analyze these solutions to map the effectiveness of each one.



¹ The estimate is based on data from *Top 150 Acquirers Worldwide*, Nilson Report, October 2011

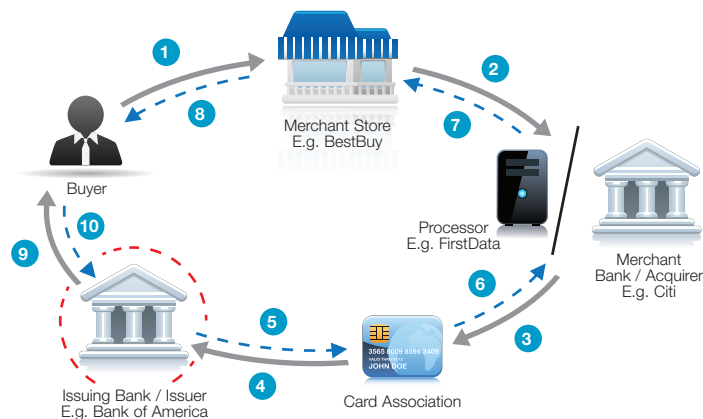
2. The Basics of Merchant Acquiring

The acquiring industry constitutes a network of highly advanced intermediaries that help to complete card payment transactions.

Merchant acquirers enable merchants to process credit and debit card payments and help in increasing sales by accepting the most popular cards to attract customers to their businesses. Typically, a card payment transaction involves two sides: the first between the cardholder and the bank that issued their card; and the second between the merchant and the acquiring bank. This paper focuses on the second: the merchant acquiring side of the industry. Cardholders only deal with merchants and the issuing bank while performing card transactions; they are not concerned with the merchant acquiring side of the industry. However, this second acquiring side of the industry contains a network of highly advanced intermediaries who handle card transactions via authorization, clearing and settlement, and dispute management.

The role of key intermediaries in a typical card payment transaction is illustrated below.

Exhibit 1: Steps in Typical Card Payment Transaction Flow



- 1 Cardholder uses a card as a payment mode
- 2 Merchant sends transaction information to the Acquirer by swiping or manually feeding card information
- 3 The acquirer or third party processor on acquirer's behalf sends the transaction information to the card association
- 4 The card association sends the transaction information to the Issuer for authorization
- 5 Issuing bank pays the card association network once it validates the transaction (after deducting its charge)
- 6 Card association pays the acquirer or processors on acquirer's behalf (after deducting its charge)
- 7 Merchants account is credited for the transaction amount by the processor (after deducting its charge)
- 8 Purchase transaction is completed
- 9 Issuer bills the Buyer for the transaction.
- 10 Buyer settles the bill

Source: Capgemini Analysis, 2012; *Global Trends in the Payment Card Industry: Acquirers*, Capgemini, 2011

The merchant acquiring business dynamics are dependent on smooth linkages of all industry participants—merchants, acquiring and issuer banks, independent sales organizations (ISOs), third-party processors, and payment card associations.

2.1. Key Participants

The acquiring side of the industry typically involves interaction among various stakeholders including merchants, acquirers, processors, independent sales organization (ISO), and payment networks. Each of the stakeholders has an incentive to play its specific role in completing the payment transaction:

- **Merchant:** A merchant accepts payment from the cardholder by swiping the user's card at its terminal, increasing the chance of a sale by accepting popular cards used by cardholders. For example, retailers such as Walmart who accept these cards have higher chances of sale compared to local retailers without card processing capability
- **Acquiring Bank:** The acquiring bank provides payment processing services to the merchant, enabling him to accept payments from cardholders. The bank levies a merchant service charge (MSC) on every transaction at the merchant's point of sale (POS) terminal to generate revenue. The MSC is usually 2% of the transaction amount and contains an interchange fee, the fee paid to card network associations such as Visa and MasterCard, and the acquirer fee
- **Independent Sales Organizations (ISOs):** The ISOs solicit merchant accounts on behalf of acquirers and charge a service-based fee from the acquirers. ISOs also manage risky merchant accounts with a higher possibility of credit fraud, for which they charge a higher fee. Examples include: Cornerstone Credit Services LLC, and Bankcard Systems of Newport
- **Third-Party Processors:** Third-party processors provide transaction processing services to acquirers as they possess economies of scale and advanced technological systems for cost effective processing. Processors charge a service-based or fixed fee from acquiring banks based on the type of pricing contract. Examples of third-party processors include: Global Payments Inc. and First Data
- **Payment Card Network Provider (Card Association):** Card associations, such as Visa and MasterCard, act as the link between the issuer bank and the acquiring bank. The payment card network validates the availability of credit or funds with the issuing bank and communicates the same to the acquiring bank. The payment card network provider charges a fee for each transaction processed through its branded card by the card issuer/acquiring bank

2.2. Key Functions

Merchant acquirers help in completing the card payment transaction cycle by ensuring the flow of funds to respective parties. To ensure this flow of funds, acquirers perform four key functions.

Merchant Sign-Up

The first function of acquirers is to sign-up merchants to accept card-based payments. Some acquirers outsource this function to ISOs and pay them a fee. After signing up the merchant, the acquirers underwrite the merchants to ensure their financial stability, which is important in checking the credit-worthiness of the merchant. Acquirers at times also provide point-of-sale equipment and other services to the merchants if specified in the merchant agreement.

Acquirers help in completing the payment transaction cycle by ensuring the flow of funds to respective parties through authorization of transactions and clearing & settlement.

Transaction Authorization

Authorizing transactions is a critical function of acquirers as it ensures that the payment is guaranteed and that there will be no dispute in the future settlement. Operationally, when the card is swiped at the merchant's POS terminal, the acquirer receives an authorization request from the terminal. This request contains transaction details such as the cardholder's information and amount of the transaction. The request is forwarded to the card association/network, for example Visa / MasterCard, which in turn validates the availability of funds with the issuing bank. The issuing bank sets aside the funds from the cardholder's account for the transaction and sends an authorization code to the network. The network forwards the code to acquirer and then to the merchant's POS terminal.

At this point, the funds are not yet transferred to the merchant's account but the issuing bank agrees for a future settlement with the acquiring bank and, in turn, the merchant. After the authorization is complete, the merchant records the sales transaction information and sends it to the acquirer for processing at the end of the day.

Clearing and Settlement

The merchant acquirer transmits the sales transaction data received from the merchant to the respective card-issuing bank via the payment card network. The issuing bank charges the cardholder's account and sends the funds to the acquirer through the payment network, subtracting its fee. The acquirer then credits the merchant's account, after deducting the fees paid to the issuer and the payment network, and the fee for its own services.

Dispute Management and Information Services

Acquirers provide dispute management services including charge-backs, refunds, and claims to the merchants. Further, as a value-added service to the merchants, acquirers compile and report the merchant's transaction data. The acquirers also offer analytical services to merchants to help them to manage and improve their card processing functions and decrease costs.

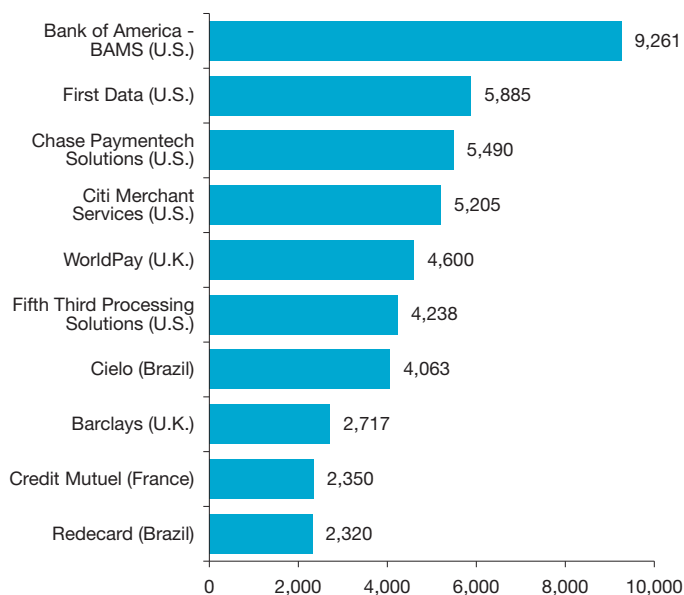
3. A Look at the Global Acquiring Industry

The acquiring industry has witnessed consolidation since 2001, resulting in the dominance of a few large players in the industry. For example in 2010, the top ten acquirers in the world handled nearly 50% of the cards transaction volume.

The global acquiring industry is dominated by a few large players, who have grown inorganically through mergers and acquisitions. In 2010, the top 10 acquirers handled nearly 50%² of the global transaction volume due to the consolidation in the industry in past ten years.

Even the top acquirers in the world have revenue sharing alliances and joint ventures among them. For example, First Data owns 51% in Bank of America Merchant Services (BAMS); has a revenue sharing alliance with Sovereign/Santander, Citi, and SunTrust Merchant Services, and also owns 40% equity in Wells Fargo Merchant Services and PNC Merchant Services. The consolidation has enabled these large acquirers to leverage economies of scale and provide more cost effective solutions to customers.

Exhibit 2: Top Acquirers Worldwide by Transaction Volume (million), 2010



Note: The data is based on only Visa and MasterCard payment transactions volume and the data does not take into account any partnerships, alliance or joint venture

Source: Capgemini Analysis, 2012; *Top 150 Acquirers Worldwide*, Nilson Report, October 2011

Consolidation has resulted in acquirers having multiple inflexible IT systems which hinder innovation.

On the other hand, consolidation in the industry has also resulted in many acquirers having multiple legacy technology systems which are built on mainframes in a layered manner over many years based on changing business requirements. These systems operate in silos and the applications running on these systems are not integrated. As a result, the duplication and inefficiency of these unintegrated applications hinders innovation and results in increased maintenance cost.

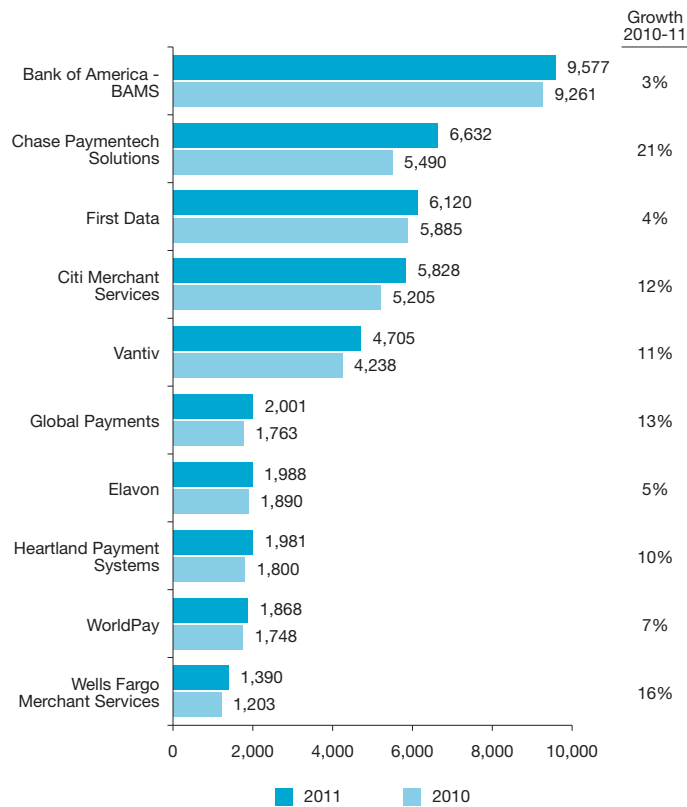
² The estimate is based on data from *Top 150 Acquirers Worldwide*, Nilson Report, October 2011

The global trend of dominance of large players in the industry is also reflected in the U.S., as the top ten acquirers in the market handled 73% of the cards transaction volume.

3.1. U.S. Acquiring Industry Structure

As shown in the previous section, the largest acquirers in the world are headquartered in the U.S. It is therefore important to analyze the industry structure in the U.S. to understand the global acquiring industry. The U.S. acquiring industry is also dominated by a few large players, with these players showing strong growth in 2011. For example in 2011, Chase Paymentech Solutions registered a growth of 21% in number of transactions handled, followed by Wells Fargo with 16% increase. Six of the top 10 acquirers in the U.S. registered double digit growth in the volume of transactions handled in 2011 over 2010³.

Exhibit 3: Top U.S. Acquirers by Transaction Volume (billion), 2010–2011



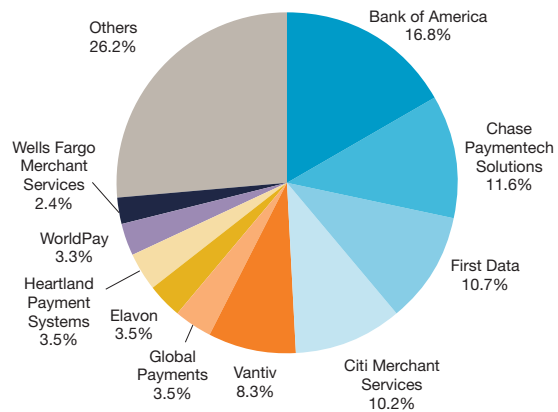
Note: The data is based on only Visa and MasterCard payment transactions volume and the data does not take into account any partnerships, alliance or joint ventures
Source: Capgemini Analysis, 2012; Nilson Report, March 2012

As merchant services are highly commoditized, price is the most important competitive element while acquiring new business.

As shown in the following exhibit, the top ten acquirers in the U.S. handled more than 73% of the transaction volume in the country in 2011. First Data was the third largest acquirer with 10.7% market share individually (businesses distinct from alliance and joint ventures), but if the majority stake in Bank of America Merchant Services and the revenue sharing alliances with Citi Merchant Services, SunTrust, and Sovereign/Santander are considered, it held 38.9% market share with 22.20 billion transactions in 2011 in U.S.⁴

The size of these acquirers helps them provide cost efficient solutions to merchants as operational efficiency generally increases with size.

Exhibit 4: Market Share of Top U.S. Acquirers (%), 2011



Note: Market share is calculated based on number of transactions handled in the year
 Source: Capgemini Analysis, 2012; Nilson Report, March 2012

The need for consolidation arose in the industry to meet the demands from large retail merchants—who negotiate hard and secure rock-bottom prices for acquiring contracts. As a result, large retailers often pay less cost per payment transaction than smaller merchants, squeezing acquirers’ margins. To leverage the benefits of economies of scale and to do profitable business, acquirers often opt for consolidation.

Large retailers such as Walmart, Carrefour, Kroger, and Target negotiate hard with acquirers to obtain cheaper rates. As a result, large retailers pay less per transaction as compared to small merchants resulting in squeezing acquirers’ margins. Therefore, the big retailers with high sales volumes generate significantly lower revenues for merchant acquirers compared to small merchants⁵.

⁴ Nilson Report, March 2012; Visa and Master Card Operational Performance Data, 2012

⁵ *The Merchant-Acquiring Side of the Payment Card Industry: Structure, Operations, and Challenges*, by Ann Kjos, Federal Reserve Bank of Philadelphia, October 2007

4. Key Trends

The January/February 2011 issue of *ISO&Agent* highlights six key trends effecting merchant acquiring. These trends surround increasing regulatory scrutiny on debit-interchange fee, design of sales force, Payment Cards Industry Data Security Standards (PCI-DSS) compliance, rising need of training for sales agents, increased usage of mobile payment solutions, and the need of differentiating merchant services to gain competitive advantage.

4.1. Increasing Regulatory Scrutiny on Debit Interchange

In 2011, acquirers and ISOs were getting prepared to deal with the expected changes in debit interchange-fee. The fee was decreased with the Durbin Amendment⁶ in 2011, putting extra pressure on the thin margins of acquirers. However, the direct impact of fee reduction would be borne by issuers who are expected to lose \$8.4 billion on annual basis in U.S. At the same time, acquirers, ISOs, and processors will need to improve their systems, work on ways to prevent fraud and remove unnecessary middlemen to cut overall costs.

4.2. Dilemma of Having Independent Sales Agents versus In-house Sales Force

In 2011, the independent sales organizations (ISOs) had a dilemma: choose between an in-house sales force and independent sales agents. An in-house sales force gives more control over the sales-pitch made by the agents since they are employees, while independent sales agents can reduce merchant acquisition costs as ISOs do not have to bear overhead charges. Independent sales agents also act as entrepreneurs and can acquire business in those areas of the country where it might be difficult for an organization to reach, thus helping increase the reach of the organization. However, the challenge is to get these agents to convey the exact message from the ISOs/acquirers to the market as accuracy is the most important parameter to establish trust with the customer.

4.3. Lack of Awareness About PCI-DSS Among Small Merchants

Although small merchants observe caution and try to avoid information security breaches, they are not always aware of the overall benefits of Payment Cards Industry Data Security Standards (PCI-DSS), which provide primary security guidelines to protect sensitive cardholder data. As per a recent survey by ControlScan, 53% of small merchants were either unsure about the PCI standards or were not familiar with the standards at all, while 42% of the small merchants said that the PCI-DSS was not applicable to their business⁷. This situation puts acquirers in a challenging position as non-compliance to PCI-DSS may result in a data breach leading to increased liability for acquirers.

⁶ A detailed analysis around the impact of the Durbin Amendment is provided in *Debit Card Interchange*, Capgemini, 2011

⁷ The survey was conducted by ControlScan in partnership with the Merchant Acquirers' Committee in October 2011. The survey covered 146 companies including banks, acquirers, payment processors and ISOs

4.4. Rising Need of Training and Educating Sales Agents

Sales agents need to upgrade their knowledge to keep up with the increasing competition; new regulations; ongoing changes in interchange rates; changing PCI-DSS requirements; growing sophistication among merchants; and a rapidly growing list of value-added services that provide additional sales. The need of effective training is increasing day by day. To serve this need, new training resources are being introduced in the market. For example, some industry veterans such as Mark Dunn have been launching training materials which are also available online. ISOs are also attracting new agents by promising to provide effective training.

4.5. Expanding Usage of Mobile Payments Solutions

The usage of mobile payment solutions and near field communication (NFC⁸) is increasing in the industry as companies like Square, Isis, PayPal, and Apple are offering new and innovative solutions. This situation presents a mix of opportunities to ISOs and acquirers. New competitor solutions may impact the acquiring business revenues but at the same time they offer a new opportunity to ISOs for marketing these new solutions to merchants.

4.6. Compelling Need for Providing Differentiated Service

ISOs and acquirers cannot sustain their market share by reducing prices and promising to offer only best customer service. They require a new idea to compete, which may be new product offerings or use of technology to create an integrated solution for point-of-sale systems and electronic cash registers. They also need to provide excellent after sales support to their customers in order to develop long-term loyal relationships.

These key trends in the acquiring industry highlight the transformations underway due to a combination of factors such as regulatory updates, increasing competition, and changing payments landscape with introduction of mobile and NFC solutions. All of these factors contribute to the increasing need to provide a differentiated offering to merchants to retain and grow market share for the acquirers.

8 NFC technology is a standards-based wireless communication technology that allows data to be exchanged between devices that are a few centimeters apart. NFC-enabled mobile phones incorporate smart chips (called secure elements) that allow the phones to securely store the payment application and consumer account information and to use the information as a “virtual payment card”

5. Key Challenges

The Durbin Amendment has resulted in 45% decrease in interchange rates, causing an estimated loss of \$8.4 billion annually to card issuing banks in the U.S.

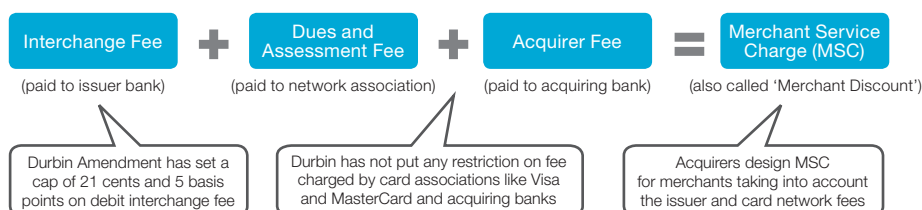
5.1. Debit Interchange Fee Regulation

Australia became the leader in regulating the debit interchange fee by introducing a regulation around interchange fees in 2006. In more recent years, other countries/regions such as Canada, Europe and New Zealand also implemented a series of reforms designed to improve interchange process transparency, foster competition, and break the duopoly of Visa and MasterCard.

The Durbin Amendment, though relevant to the U.S. only, is a big step towards increasing the transparency in interchange process. It can also be seen as a trendsetter since the U.S. is one of the biggest markets for card transactions, and regulatory authorities in other countries may follow the U.S.

In the U.S., the Dodd-Frank Wall Street Reform and Consumer Protection Act has given regulatory power to the Federal Reserve to cap payment network interchange rates for debit card transactions. The Fed will now also govern the rules that guide merchant, processor, and bank routing of debit card transactions.

Exhibit 5: Merchant Service Charge Break-up



Source: Capgemini Analysis, 2012; *Debit Card Interchange*, Capgemini, 2012

The decrease in the interchange fee will also put an extra pressure on acquirers as the new economic model may eventually lead to the end of free complimentary services and supplies (such as payment terminals) from issuers to merchants.

To make the interchange fee proportional to the cost incurred by the issuing bank for the respective transaction, the Federal Reserve has cut the interchange rates by around 45%. The interchange fee is now capped at 21 cents per transaction plus five basis points multiplied by the value of the transaction and an additional cent to cover fraud losses. As per the latest estimates, the rate cut will result in a loss of \$8.4 billion annually to card issuing banks in the U.S.⁹

However, in the short term the Durbin Amendment—which took effect on October 1, 2011—has created a profit opportunity for acquirers, as they are under no obligation to cut the merchant service charge (MSC) and pass on the full benefit of decreased interchange fee to merchants. In the long term, competition is likely to eliminate this extra margin and acquirers will have little option but to design an innovative and personalized MSC for merchants while keeping their own margins intact. The cut in the interchange fee is likely to reduce the portion of the discount rate paid to ISOs by acquirers, and may cause other business-process issues for acquirers and processors.

As noted above, the decrease in the interchange fee may lead to reduction in the overall merchant service charge, leaving a small margin window for designing bundled and tiered pricing models and putting extra pressure on acquirers

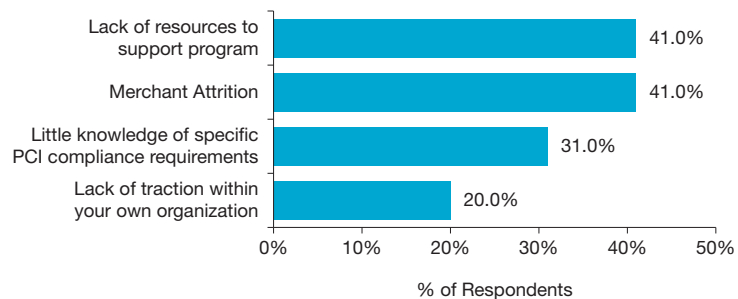
9 Interchange Fee Study - Durbin Amendment, CardHub, 2012 Impact Study, www.cardhub.com

as the services they offer are highly commoditized. The new economic model may eventually lead to an end of free complimentary service and supplies such as payment terminals for merchants. Acquirers and ISOs may have to provide merchants with some of these services at a higher fee. Eventually, for long-term sustainability in this highly competitive market acquirers will need to innovate to have better systems in place to cut operational costs and develop new measures to prevent fraud losses and save unnecessary costs by reducing the number of middlemen.

5.2. Challenge to Make Small Merchants PCI-DSS Compliant

Acquirers feel that merchants and sales representatives offer resistance to PCI compliance due to the lack of complete understanding of the scope, need, and benefits of PCI Data Security Standards (DSS). The non-compliance to PCI increases the probability of card data breaches, which results in both financial and non-financial repercussions including loss of reputation and customer trust.

Exhibit 6: Key Challenges Faced by Acquirers while Implementing PCI-DSS



Source: Capgemini Analysis, 2012; *Benchmarking Level 4 Merchant PCI Compliance: The Acquirer's Perspective*, ControlScan, January 2012

Small merchants' low awareness of PCI-DSS and their potential apathy about the risks of a data compromise poses a challenge to acquirers as it shifts the financial liability to acquirers if the merchants are not capable to pay the losses.

For an average small merchant, the cost of breach comes out to be around \$40,000 which includes fines, fees, notifications, and recompense¹⁰. If the merchants are not able to pay the losses, the liability shifts to ISOs and acquirers.

In a survey conducted by ControlScan in collaboration with Merchant Acquirers' Committee in 2011, 41% of the respondents cited both the lack of resources to support the PCI implementation program and merchant attrition as the key challenges. 31% of the respondents cited lack of knowledge of specific PCI compliance requirements as the third biggest challenge.

Meanwhile, acquirers are trying to coerce small merchants into complying with security standards by charging extra fees from non-compliant merchants. Acquirers also give discounts to merchants who are compliant with PCI-DSS. Acquirers and ISOs have also started to offer breach protection or breach insurance to merchants to cut losses from data breach scenarios. As a positive development, more than a million merchants—representing 10% of the U.S.'s total merchants—have deployed some kind of breach protection solutions.




¹⁰ *More ISOs Offer Merchants Breach Protection*, by Ed McKinley, ISO&Agent, February 2012

5.3. Competitive Threat from Non-Traditional Players

The payments industry is now rapidly evolving and new solutions are frequently being introduced. Non-traditional players such as Square, PayPal, Apple, and Intuit, some of whom may not have payments as their core business, are coming up with solutions which are transforming the way payments are conducted.

With the evolving payments landscape, non-traditional players like Square, PayPal, Apple, and Intuit are offering alternate payment-acceptance options for merchants. As a result, the future potential growth for acquirers is under threat as small merchants are accepting these new, smart, and easy-to-use mobile solutions.

Exhibit 7: Non-traditional Payments Solutions

New Solution	Description
 <p>Square Card Reader</p>	<ul style="list-style-type: none"> • Square enables small merchants to accept payments from major credit cards through its card reader, which can be used with any smart phone (iphone or android)
 <p>PayPal Here</p>	<ul style="list-style-type: none"> • 'PayPal Here' launched in March 2012, enables small businesses to accept almost any form of payments globally • Merchants can accept payments by swiping cards with a fully encrypted card reader, or use a phone camera to scan and process cards and checks
 <p>GoPayment</p>	<ul style="list-style-type: none"> • Intuit's GoPayment enables merchants to accept major credit cards through their smart phone • Merchants can key in card information in their phone or swipe the cards with an optional GoPayment-compatible card reader

Source: Capgemini Analysis, 2012

The new solutions such as mobile card-readers including Square card-reader, Paypal Here, and Intuit GoPayment, can be attached to iPhones and iPads. These card readers eliminate the need to have point-of-sale terminals and merchant accounts for small businesses, as they can process the transactions directly through these instruments. These solutions are being accepted readily by small merchants because of their ease-of-use and zero upfront investments.

To be competitive in the market and increase their top-line, acquirers and ISOs have started looking at new business models such as merchant aggregation. In this model, ISOs become the merchant for the card brands, while small merchants become sub-merchants.

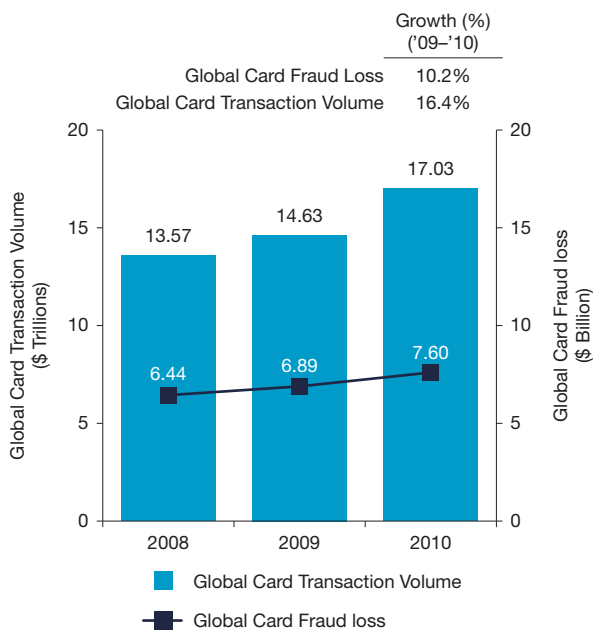
Small retailers benefit from aggregation as they avoid the hassle and cost of signing up as merchants with the card brands. ISOs and acquirers benefit as they are able to compete with new players by offering customized service to small businesses. ISOs are closest to the merchants and understand their pain points, so they may also act as consultants to merchants for advising them on solutions based on digital wallets and other new and related solutions from new players.

5.4. Increasing Card Fraud in 'Card-Not-Present' Situations

In 2010, global card-fraud loss increased by 10.2% to \$7.60 billion as the global card transaction volume registered an increase of 16.4% to reach \$17.03 trillion¹¹.

Exhibit 8: Global Card Transaction Volume and Global Card Fraud Loss, 2008–2010

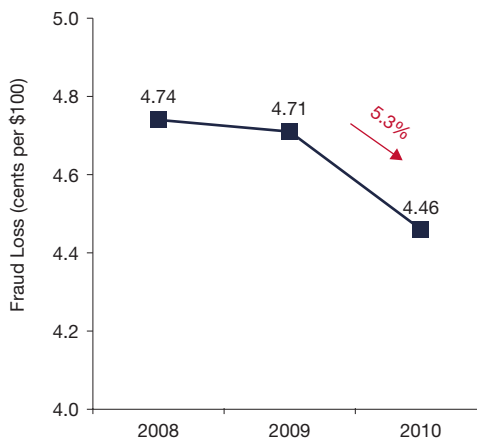
Global card-fraud increased by 10.2% in dollar terms in 2010, but it registered a decline of 5.3% in percentage terms as the industry participants made conscious efforts including PCI Compliance, EMV adoption, and dynamic passwords to tackle the fraud.



Source: Capgemini Analysis, 2012; Nilson Report, June 2010; Nilson Report, September 2011

The rise in card-fraud loss has been relatively lower when compared to the growth in card transactions. Fraud loss as a percentage of total card transactions has fallen due to the continuous efforts by industry participants.

Exhibit 9: Global Card Fraud Loss (in Cents on Purchase of \$100), 2008-2010

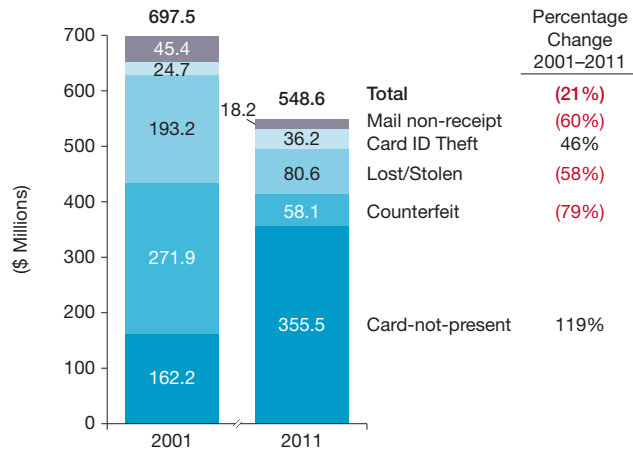


Source: Capgemini Analysis, 2012; Nilson Report, June 2010; Nilson Report, September 2011

11 Nilson Report, September 2011

However, the dollar amount of fraud losses has increased with rising cost of fighting fraud. With the advancement of technology, criminals are able to hack merchant/processor data-centers, making it difficult for the industry participants to tackle the fraud. At the same time, the industry is implementing measures such as PCI-DSS, EMV¹² chip cards, and dynamic codes for payment authorization to counter fraud. However, in the U.S. which accounts for nearly 47% of global fraud losses¹³; the response to EMV has not been at par with global growth, indicating that there is further room for fraud loss to fall.

Exhibit 10: Card Fraud Losses by Type, U.K. Issued Cards, (\$ millions)



Note: Period average exchange rate has been used for converting GBP to dollars from OANDA
Source: Caggemini Analysis, 2012; U.K. Payments Admin (www.ukpayments.org.uk)

There has been an overall shift in the type of card-fraud losses as is evident from the case of U.K. Card frauds in U.K. decreased by 21% over the last decade due to adoption of certain fraud protection measures such as EMV and PCI. But, the share of fraud loss from card-not-present (CNP) transactions increased by 119% to reach \$355.5 million in 2011¹⁴. This shift is primarily due to the growth of E-commerce during this time period accounting for nearly 6% of retail sales in Europe¹⁵. The importance of tackling CNP frauds is increasing as the share of e-commerce in retail sales is increasing globally.

The situation becomes more challenging for acquirers and merchants as in CNP transactions, because chargeback rules favor issuers putting the liability of losses on merchants and acquirers.

12 EMV stands for Europay, MasterCard and Visa, a global standard for integrated circuit cards (IC cards or "chip cards")
13 Nilson Report, September 2011.
14 U.K. Payments Admin, www.ukpayments.org.uk
15 *Online Merchant Acquiring: Innovating Beyond Payments*, by Robert Byrne, Olivier Denecker, Dan Ewing and Flavio Litterio, McKinsey, March 2012

5.5. Merchant Attrition

Merchant attrition has always been a challenge for acquirers; however the average rate of attrition has increased after the financial crisis that began in 2008. The key reasons for the increase in attrition are explained below:

Economic Slowdown

The economic slowdown that began in 2008 resulted in loss of business for merchants across the globe as consumer confidence became very low, resulting in decreased sales and therefore losses for the merchants. The data from the American Bankruptcy Institute also highlights the rise in bankruptcy filings which peaked in 2009 at 60,837, resulting in higher merchant attrition rates. After the downturn, average attrition rates increased to 20% from around 16% in 2005¹⁶. This increase in attrition rate combined with high unemployment rate of 8.1% (April 2012) and low consumer confidence added to the miseries of acquirers.

Durbin Amendment

The changes due to the Durbin Amendment will allow merchants to renegotiate their pricing contracts with acquirers. In the process, merchants are likely to seek more favorable terms from new acquirers and terminate existing contracts. This will act as a further challenge for the acquiring industry, which is already facing customer attrition and mass churn challenges.

EMV Implementation

In a recent survey conducted by Aite Group, 40% of the respondents—ISOs and acquirers—cited EMV's potential to generate merchant attrition. The migration to EMV-compliant POS terminals also presents a potential opportunity to generate \$6 billion in revenues for ISOs and acquirers. However, there are operational and competitive risks associated with the opportunity. As the acquirers will be dealing with a highly competitive environment, desperate selling measures by acquirers may lead to pricing mistakes, resulting in losses.

Pricing and Other Factors

For merchants with annual volumes above \$20 million, attrition is primarily—in 90%¹⁷ of the cases—driven by pricing. Though small merchants may not be as highly price sensitive, other reasons such as service disruptions including poorly handled charge-backs; banking disruptions; new technology offerings; and external factors such as events in the payments industry can prompt small merchants to switch acquirers.

¹⁶ *The War on Attrition*, by Jane Adler, Digital Transactions, February 1, 2011

¹⁷ *Pricing and Attrition in Merchant Acquiring*, by Marc Abbey and David Woynerowski, First Annapolis Consulting

6. Areas of Focus

Acquirers can address the commoditization of acquiring services by differentiating themselves by introducing innovative value-added solutions for merchants, and reducing their operational costs.

The fundamental challenge for acquirers globally is the commoditized nature of the services offered. This commoditization has led to price wars and brought down acquiring margins to very low levels, propelling the industry to opt for consolidation in order to leverage economies of scale.

Now, one of the only ways left to compete in this market is by increasing operational efficiency by breaking technology silos and use of flexible systems; outsourcing of non-core activities; and creating differentiation by offering innovative value-added services like analytics to customers. In addition, acquirers should focus on several key areas to enhance their competitiveness in the market and address the prevailing challenges in the industry.

6.1. New Pricing Strategies

Acquirers generally price their services using one of three models: interchange-plus, bundled pricing, and tiered pricing. Merchants generally prefer bundled and tiered pricing, though the interchange-plus model is more transparent than the other two. The interchange-plus pricing model is not preferred by merchants because it involves complex calculations for the estimation of the acquirer fee. Further, the merchants do not want to devote significant time to understanding such a complex system and prefer to adopt simple pricing models.

The merchant charges vary across markets as additional services such as reporting, troubleshooting, and charge-backs are priced differently in different markets. Generally, in the case of bundled and tiered pricing, no distinction is made in pricing of transactions based on card-type and/or transaction type; credit, debit, card-present and card-not-present transactions are priced the same.

On the cost front, acquirers generally go for a mix of fixed and bundled pricing contracts, while outsourcing transaction processing services to third-party processors. This approach results in higher fixed costs and impacts the bottom-line for acquirers. The acquirers should therefore consider both the top-line and bottom-line while designing their pricing strategy.

The new pricing strategy should focus on increasing revenues and decreasing the overall operational costs.

The changing payments landscape requires acquirers to upgrade their pricing strategies using analytical pricing techniques and moving to pay-per-use model for outsourcing. Profit margins can be further improved by adopting effective-portfolio management.

Analytical Pricing Capability

In their pursuit to acquire new business in the highly commoditized acquiring market, acquirers generally lower their prices and, as a result, their profit margins become negatively impacted. Acquirers can make well-informed pricing decisions using analytical pricing techniques to acquire new customers as well as to re-price offerings for existing customers. The analytics can help in adjusting their price levels to take into account the margins, attrition data, and merchant industry type. This type of adjustment in prices can help in increasing profit margins for acquirers.

Effective Portfolio Management

Acquires should improve their portfolio management. This can lead to increased value as the loss-making accounts are weeded out or re-priced. Also, the industry has developed a rough consensus¹⁸ that three-tier discounting creates the highest margin opportunity. In this pricing model, an acquirer quotes three discount rates—dubbed qualified, mid-qualified, and nonqualified—with interchange rates bucketed and associated with one of the three discount rates. This results in significantly higher margins. We suggest that acquirers should move some parts of the portfolio from interchange-plus to a tiered pricing contract to increase their margins without increasing attrition.

Pay-Per-Use Model

Considering the business volume, instead of investing significantly in IT infrastructure, acquirers, particularly smaller ones, should go with processors who earn their margin by sharing the infrastructure with multiple members and who can take care of the end-to-end acquiring lifecycle—starting from merchant boarding to disputes management. This will help acquirers to leverage the benefits of economies of scale. Further, volume-based, transaction-based, and profile-based payment contracts with processors will help acquirers to cut costs, increase efficiency, and save them from making huge investments for infrastructure as well as improving time to market for new offerings.

Card-type Based Pricing

The decrease in interchange fees for debit cards, as a result of the Durbin Amendment, has resulted in a shift in consumer preference towards using debit cards. To maintain profit margins and pass on the benefits of the decrease in interchange fees to merchants, acquirers should create new pricing tiers for debit card transactions—both signature- and PIN-based—at a price level lower than that for credit card transactions. Also, acquirers can tweak tiered rates by putting debit and credit transactions in different categories and setting different prices for each of the categories.

18 *The Threat to Price Stability in the Small Merchant Market*, by Charles Marc Abbey, First Annapolis Consulting

Acquirers should build highly flexible acquiring systems to quickly adapt to dynamic changes in the payments industry. Technology investments will help the industry to do away with existing multiple IT systems (evolved due to consolidation) and develop a strong foundation for innovation in acquiring.

6.2. Technological Investment Areas

The next biggest focus area for acquirers is to invest in technology to cut operational costs and improve efficiency. Technology investments should develop a highly flexible merchant-acquiring system. Below, we discuss the key technological focus areas in detail.

Upgrade Legacy Systems

Acquirers' legacy systems run on mainframes and were built over the years in fragments as per the changing business needs. The systems are therefore not very flexible for changing global requirements. Further, the maintenance and upgrade of such legacy systems result in large expenses. Acquirers should migrate in one go to improved systems through configurations that can support multi-country, multi-language, multi-currency, and multi-time zones.

Adoption of Flexible IT Systems

The acquiring industry has witnessed significant consolidation during the past decade, which has resulted in acquirers having multiple IT systems. And, the applications running on these systems usually work in silos. The unintegrated applications result in increased maintenance cost and also hinder innovation. These multiple inflexible legacy systems should be replaced with new systems in one go while managing the risk involved in adoption of new systems.

System Innovations

For acquirers, moving towards open systems (such as Unix/Windows systems and Java-based programs that are platform independent) is a key need. Acquiring solutions based on open systems can be built using modular architecture, which will make them highly flexible to quickly adapt to a rapidly changing payments landscape (such as inclusion of new channels and various regulations pertaining to fees).

Applications Innovation

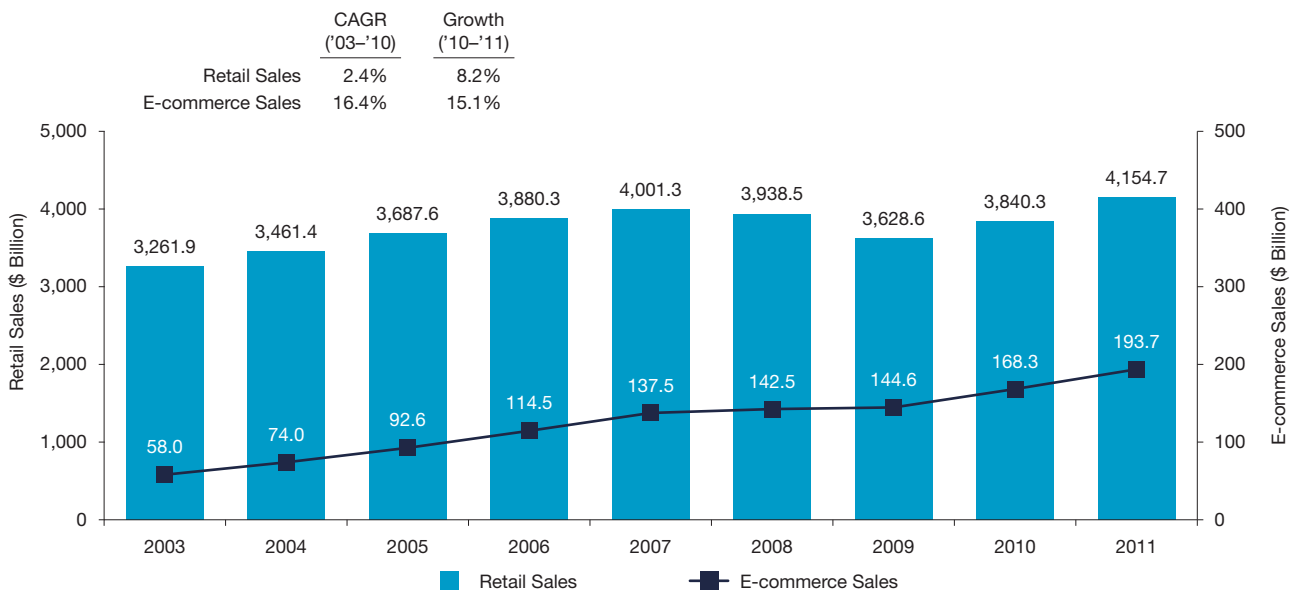
There is room for innovation at both the systems level and the application level. Innovative applications should have efficient back-office processing capacity along with streamlined billing, clearing, settlement, and reporting capabilities, which will help acquirers to manage their staff productivity and portfolio profitability. The innovative solution should be able to align with growing security requirements, either to tackle fraud or as a result of upcoming regulations such as 3D secure and SEPA. The system should also have the capability to adapt in a timely manner to strategic changes around pricing and other areas.

6.3. Multichannel Acquiring

Online commerce is growing rapidly and emerging as an important channel for retailers across the world. Online merchant acquirers are blurring the lines between brick-and-mortar points-of-sale (POS) and online sales, extending services to merchants that go far beyond payment acceptance. Most traditional merchant acquirers have not invested heavily in online acquiring capabilities; as a result, there is much room for growth here.

The exhibit below summarizes the growth of e-commerce as a percentage of total retail sales in the U.S. over the last nine-years.

Exhibit 11: Key Facts on Rise of E-commerce in U.S.



Source: Capgemini Analysis, 2012; U.S. Census (www.census.gov)

E-commerce sales are increasing as a percentage of total sales and emerging as an important channel for retailers across the world. With the rise in alternative purchasing channels, the need for an integrated multichannel acquiring solution—which can handle POS, e-commerce, and mobile based transactions—to provide a seamless experience to the merchants is also increasing.

In 2011, e-commerce sales in U.S. grew by 15.1%, almost twice the rate total retail sales, and e-sales formed 4.7% of the total retail sales. E-commerce sales even grew in 2009 when the total retail sales declined by 8%, indicating the shift to online sales as a preferred mode of shopping.

The similar trend is observed in Europe as well where online retail sales in 17 major markets is expected to grow at a CAGR of 12.2% from \$129.6 billion in 2011 to \$230.4 billion in 2016.

In the U.K., online sales are expected to account for more than 14% of total retail sales by 2016. Similarly in Germany the share of online sales is expected to be 10% by that time. While the growth rate of e-retail sales in U.K. and Germany is estimated to be 11% and 12% respectively through 2016, the growth is expected to be faster in countries where consumers have been slower to embrace online shopping. For example, annual growth projections for Spain and Italy are 19% and 18% respectively¹⁹.

This growth trend highlights the need for an integrated multichannel acquiring solution, which can handle POS, e-commerce, and mobile based transactions, to provide a seamless experience to merchants. Further, as the lines between the virtual and the physical world are blurring, the development of an online model would be the first step in a broader transformation of the merchant acquiring industry.

With the emphasis on mobile devices across the payments market, merchant service providers have started focusing resources on the micro/mobile customer space. This has motivated some acquirers to bring mobile solutions to national retail brands, however smaller players with agile solutions are encroaching on this segment. Acquirers have become active in the mobile space but the key need is to develop an integrated solution which can take care of merchant needs spanning both physical and digital channels.

¹⁹ "European Online Retail Forecast: 2011 to 2016" Forrester Research Inc., February 2012

7. The Way Forward

The key challenges faced by the acquiring industry can be addressed through a combination of the proposed solutions in this paper. A matrix mapping these solution approaches to the challenges is provided below.

Exhibit 12: Matrix Mapping Key Challenges to Solutions

Acquirers can address the challenges faced by the industry through the combination of technology investments, pricing strategies and designing integrated multichannel acquiring systems.

Key Challenges	Relevance of Solution Approach to Address the Challenge		
	Technology Investments	New Pricing Strategies	Multichannel Acquiring
Debit Interchange			
PCI Compliance			
Card Fraud			
Competition from Non-traditional Players			
Merchant Attrition			

Source: Capgemini Analysis, 2012

- Debit Interchange:** This challenge can be addressed through improving pricing strategies, as the new pricing can enable acquirers to maintain and increase profit margins. Technology investments will help in increasing efficiency and cutting operational costs
- PCI-DSS Compliance:** This challenge can be addressed through technology investments as that will help in making systems flexible in order to adapt to current and future regulations
- Card Fraud:** Card fraud can be addressed through robust technical systems which use the latest encryption techniques and help in reducing security data breaches. Acquirers can also improve their profit margins by designing new rates for risky transactions
- Competition from Non-Traditional Players:** Technology investments will help in developing highly flexible systems capable of handling multiple channels for processing transactions. These investments should provide an edge to the acquirers who have already developed strong relationships with merchants. Further, the use of analytics to design new pricing strategies and multichannel merchant-acquiring can enable the acquirers to increase their profit margins and gain new business
- Merchant Attrition:** Acquirers can address merchant attrition through a combination of technology investments, new pricing strategies, and multichannel acquiring solutions. Enhanced systems will help in improving the merchant experience and the adoption of new pricing strategies will help in providing customized rates to merchants. Further, through multichannel acquiring acquirers will be able to enrich the merchant experience by providing a seamless, integrated acquiring solution

Acquirers need to adopt a comprehensive approach which will enable them to provide cost-effective differentiated solutions to merchants and remain competitive in the market.



8. Conclusion

In conclusion it can be said that the acquirers need to update and upgrade their business as per changing business requirements. To gain a competitive edge in the market and provide cost-effective services to merchants, acquirers should improve their operational efficiency by focusing on core areas and outsourcing of non-core activities.

Acquirers need to address the key challenges faced by their industry. Practices such as analytical pricing, effective portfolio management, and card-type based pricing can enable the acquirers to increase their profitability through intelligent pricing and increased focus on high margin business. Multichannel acquiring solutions along with investments in technology for system enhancements and innovations can further help acquirers to reduce costs while enhancing the merchant experience through value-added offerings. Acquirers should therefore focus on these areas and develop a strong execution strategy to stay ahead of competition.



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