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SPECIAL REPORT

FUTURE OF PAYMENTS

Acquirers Open Doors in Card Acceptance

By Chris Costanzo

For years credit card merchant acquirers had only two main product types to offer: **Visa Inc.** and **MasterCard Inc.**

But **Discover Financial Services** announced in 2006 that it would break with its long-standing model and let acquirers add its cards to the payment options they offer merchants. **American Express Co.**, which also has been known for handling its merchant sales in-house, said in December that it would begin working with acquirers.

Those shifts were aimed at driving up merchant acceptance for the two card companies, and Discover says that is exactly what happened; feedback from Amex suggests its acceptance will increase when its first acquirer relationship goes into effect this quarter.

And these relationships are proving equally significant for the acquirers. "We are now the owners of the merchant account," said Charles Drucker, the president of Fifth Third Processing Solutions, which began acquiring merchant accounts on Discover's behalf in mid-2007. "We do from A to Z all the processing and services, and that provides us with additional fee income and revenue opportunity."

FASTER GROWTH

The new strategies at Discover and Amex are one reason the acquiring side of the card business is expected to increase its revenue faster than the issuing and network sides, said a February report by Aite Group LLC. Acquirers' revenue is expected to reach $7.9 billion this year and grow to $10.9 billion in 2012, the report stated.

Johanson says that permitting acquirers to combine Discover acceptance with other services "opens a bevy of additional revenue opportunities."

In reaching out to the merchant acquiring industry, Discover and Amex are recognizing the skills these specialists have to offer and "are looking to be relevant in a competitive industry with our treatment," according to Stuart C. Harvey Jr., the chief executive officer of Elavon, U.S. Bancorp's acquiring unit (known as Nova Information Systems until April).

At the end of 2006, Nova signed an agreement allowing it to offer merchants the choice of accepting Discover cards. The arrangement also gave the unit the ability to set pricing, deliver reporting to merchants, and perform underwriting, risk management, processing, settlement, and customer service. All these activities command fees that Elavon can incorporate into its contracts with the merchants.

"Because we've taken on sales and service, there's more opportunity for us financially," said Rebecca Clements, Elavon's vice president of pricing and profitability.

Traditionally, acquirers earned only referral fees from Discover and Amex. According to Aite Group, the companies typically paid acquirers $25 to $50 for selling an account, up to $50 for activating it, and a yearend residual of 10 to 20 basis points per transaction that was paid for one to three years after the merchant was signed. (Industry participants confirmed the characterization of these fees but said individual arrangements differ.)

The new model allows acquirers to earn a share of the processing fees paid by merchants for Discover and Amex purchases for the life of the contract. "Certainly, they're making more, and they're making it for longer," said Matt Johanson, the vice president of acquirer relations at Discover. The new model also "opens a bevy of additional revenue opportunities through additional (paid) services."

Adil Moussa, an analyst at Aite, agreed that the new arrangements are more rewarding for merchant acquirers. Discover and Amex "are hoping acquiring banks will be pushing this model further."

The two card companies hope to close the gap with Visa and MasterCard on acceptance rates and transaction volumes. This year Aite expects Visa and MasterCard to generate $49.5 billion of revenue from merchant transactions, far more than the $13.4 billion expected from Amex and the $1.7 billion from Discover.

For a long time Discover and Amex have had "a necessity to expand their merchant base," said Paul R. Martaus, the president of the Mountain Home, Ark., payment consulting firm Martaus & Associates. "Working directly with the acquirers gives them the opportunity to do that."

Merchants are also expected to benefit, since acquirers can now offer them the ability to accept all four brands through a single, bundled acceptance arrangement.

Traditionally, merchants have received three different monthly statements — one covering both Visa and MasterCard, one from Discover, and one from Amex — and were required to contact the companies individually to resolve service issues. As Amex and Discover pass on more of their acquiring to the specialists, businesses will receive a single statement covering all four card brands and will have one point of contact for service.

The new acquiring method is not a huge departure from the past, Mr. Martaus said, since merchants were already capable of accepting all four brands. "But the way you got there was ugly. Now it's a lot smoother."

ONE-STOP SHOPPING

For Cathie Lanser, who handles accounts receivables for C.C. Dickson Co., a Rock Hill, S.C., supplier of heating and cooling equipment, Discover's shift in acquiring "means one less Web site I have to go into every month," and "my spreadsheets are smaller."

In addition, her company is receiving funds from Discover transactions much faster, she said. When C.C. Dickson dealt with Discover directly, it received funds once or twice a week, but now it gets paid for Discover purchase in one or two days.

Ms. Lanser said she is hopeful C.C. Dickson's Amex service will be integrated with the other three card brands soon. "That would be great. It's like one-stop shopping."

Not surprisingly, the more streamlined service has helped Discover close its acceptance gap with Visa and MasterCard. At the start of last year Discover was accepted at 77% as many merchants as Visa and MasterCard; by yearend that figure was 85%, Mr. Johanson said.

Elavon's experience confirms Discover's numbers. About 85% of the merchants the acquirer signs up now accept Discover, Mr. Harvey said; before Elavon had an acquiring relationship with Discover, it could offer the card to merchants through a referral agreement, but only about 40% of its merchant customers chose to accept Discover.

Amex expects a similar boost once its program gets underway. Tom Pojero, the senior vice president of merchant acquisition and field client management in its U.S. merchant services group, said integrating Amex with other card brands "makes it an easier decision [for merchants] to accept ours."

PRICING SHIFTS

Pricing for merchants appears to be getting more competitive under the new model. Discover has long been known for low transaction fees, but Mr. Johanson said certain inefficiencies under the old method pushed its merchant service prices higher than they needed to be. For example, both Discover and the referring acquirer charged fees for generating paper statements, and referring acquirers also tacked on per-item fees.

"All-in, the pricing looked pretty bad," he said.

Under the new system, Discover no longer controls merchant pricing beyond setting the wholesale price that acquirers pay. The company said it could not discuss how retail pricing is playing out, but Mr. Johanson said, "A lot of the inefficiencies have been driven out of the model."

C.C. Dickson would concur. "We've definitely saved some money," Ms. Lanser said. "That was part of the pitch."

It is unclear how Amex's pricing might change under its new model. Unlike Discover, it intends to retain control over retail pricing to merchants. Observers say that control is crucial, given Amex's reputation as a high-end provider of card services.

"They would be going against themselves if they left pricing up to anyone else," Mr. Moussa said.

Mr. Martaus agreed with that assessment. "Amex believes they've got a premium product and should charge a premium price," he said.

However, Elavon, which signed a merchant services and sales agreement with Amex in January, indicated the card company may be softening a bit on price.

"Amex has lowered rates in certain sectors to be more competitive," Mr. Harvey said.

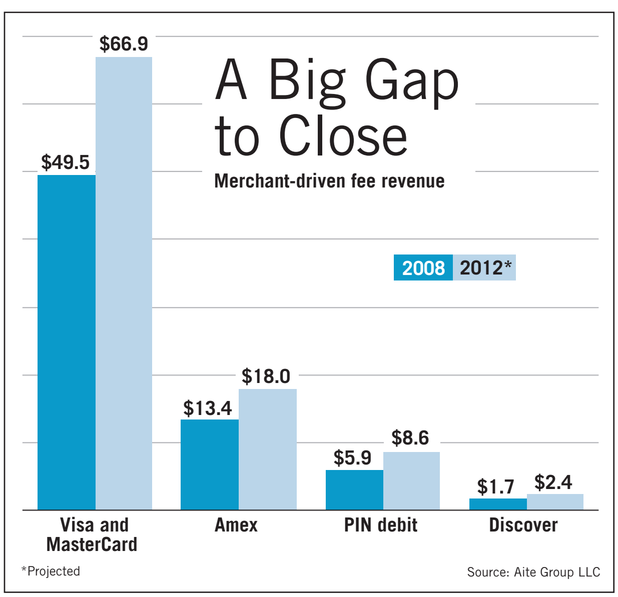
All this activity in acceptance and pricing will play out mostly in the market for small and midsize merchants. Mr. Pojero said Amex intends to continue deploying its proprietary sales force to offer services to "higher charge-line merchants" and use third parties to go after smaller ones.

And Mr. Johanson said Discover is retaining its direct relationships with top retailers.

Even though merchant acquirers can expect bigger revenue streams from the new Amex and Discover arrangements, they continue to earn far less than other members of the card industry. This year issuers are expected to generate $41.9 billion of revenue from credit card transactions, while the card networks are expected to capture $16.7 billion, compared to only $7.9 billion for the merchant acquirers, according to Aite Group.

And Mr. Moussa said one side effect of bundling all four card brands into one package for merchants is that it will be harder for merchant acquirers to differentiate themselves. As a result, the issuing side of the business will become more important, he said. Once everyone on the merchant acquiring side "is on equal footing, it will be up to the issuers to differentiate themselves and offer more to the cardholder."

At least the acquiring industry can take comfort in knowing it has earned the confidence of Amex and Discover to take over duties they once handled on their own. As Mr. Martaus put it, "Nobody does it like the acquirers."



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