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INFORMATION



Lowering Acceptance Costs – A Focus on Electronic Payments

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About First Annapolis

First Annapolis's expertise spans multiple parts of the payments industry and geographic markets.

Background:

- Founded in 1991; privately held.
- Headquartered in the Baltimore area.

Professional Staff:

- Approximately 70 billing professionals.
- Balanced combination of industry, functional, and consulting experience.

Service Offerings:

- Management consulting and M&A advisory services.
- Practice areas serve payments businesses.

Clients:

- Banks and specialty finance companies.
- Card associations and EFT networks.
- Processors and technology providers.
- Retailers, manufacturers, and membership organizations.
- Private investment firms.
- Government entities.

First Annapolis Market Coverage

Management Consulting

Industry-Facing Practices

- *Credit Card Issuing*
- *Debit & ATM*
- *Merchant Acquiring*
- *Commercial Payments*

Subject Matter Expertise-Based Practices

- *Emerging Payments*
- *Loyalty*
- *Risk Management*
- *Strategic Sourcing and Vendor Selection*

Primary Geographies

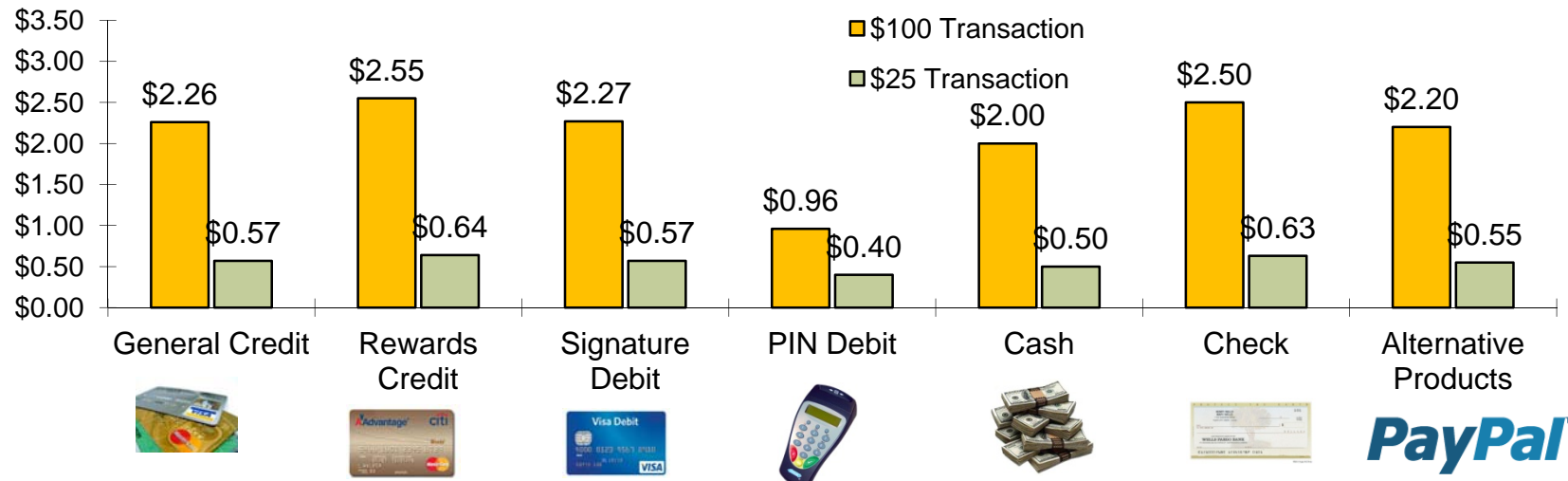
- *Europe*
- *North America*
- *Latin America*

M&A Advisory

Cost of Payment Acceptance

All Payments Have Some Costs Associated With Them

Sample Merchant Costs Per Transaction by Product Type



As a percentage of the transaction:

\$100 Transaction	2.26%	2.55%	2.27%	0.96%	2.00%	2.50%	2.20%
\$25 Transaction	2.29%	2.56%	2.28%	1.60%	2.00%	2.50%	2.20%

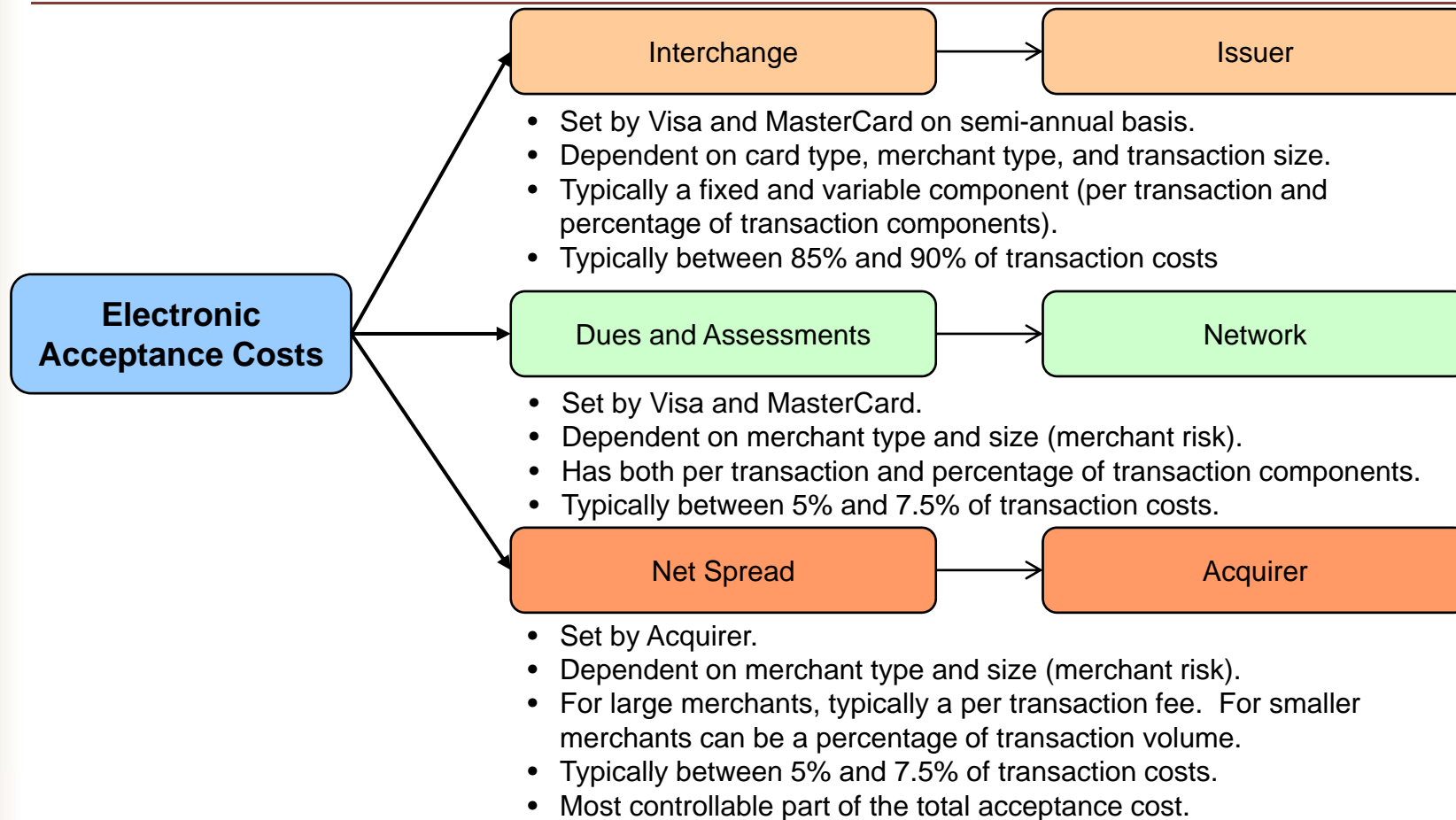
Cost of Payment Acceptance

Unexpected Costs of Payment Acceptance - Cash

Cost of Cash Acceptance	Explanation
1. Labor	Cash transactions may take more time per transactions, requiring more employee resources. Further, handling cash requires preparing registers, daily reconciliation, preparing deposits, etc.
2. Increased Risk	Having cash on hand increases a merchant's risk of theft, accepting counterfeit funds, and human error.
3. Security	Cash requires increased and sometimes costly security measures, including surveillance cameras, security guards, safes or vaults, and counterfeit fund detection training.
4. Insurance	Merchants' insurance costs may go up because of the increased risks associated with cash payments.
5. Reporting	It may be more costly for merchants to maintain accurate reporting of individual cash transactions because they will not receive monthly statements from a third party processor or vendor.
6. Banking Fees	Merchants may incur fees related to checking accounts, including for cash deposits, cash withdrawals, and coin ordering.
7. Time	An employee will need to make frequent bank deposits to reduce the amount of cash being stored at the merchant site.
8. Transportation	Depending on the merchant's size, it may require an armored car service to facilitate secure cash deposits.

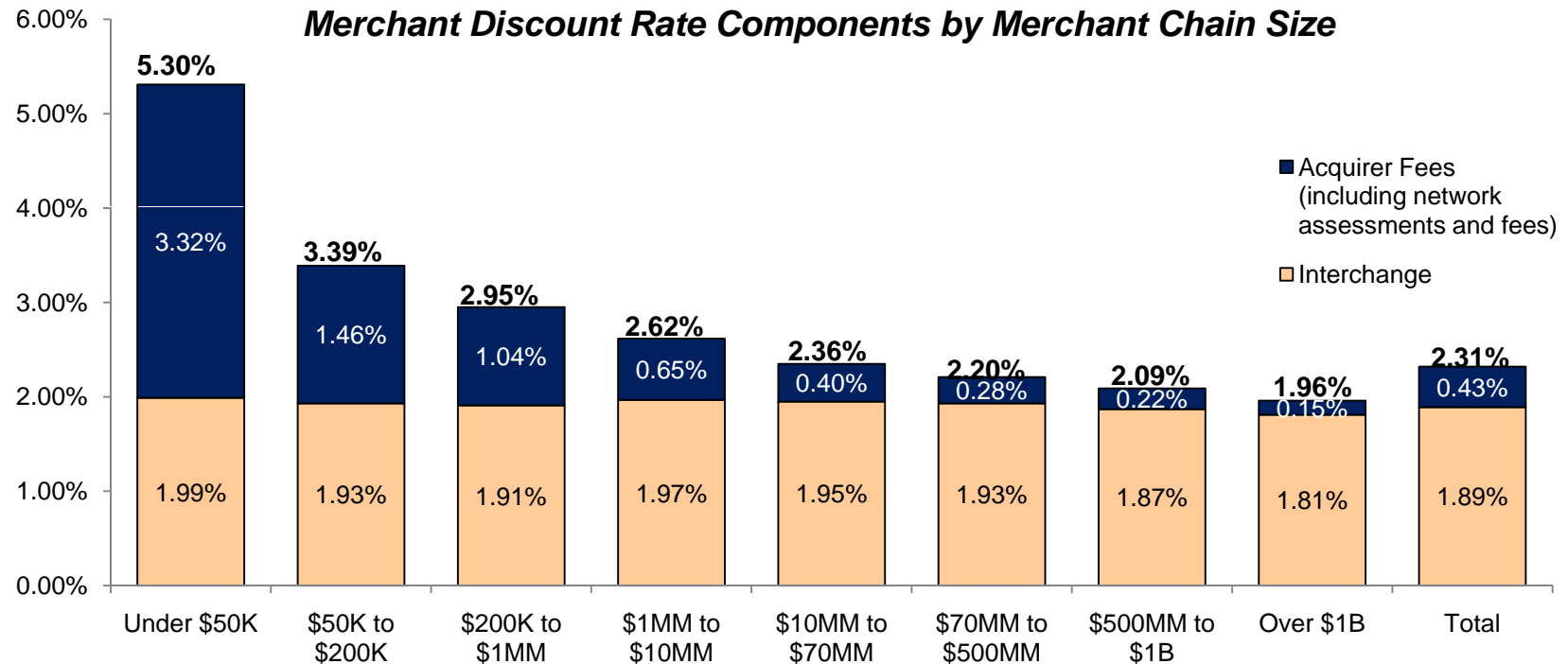
Cost of Electronic Payment Acceptance

Three Major Parts of Electronic Acceptance Costs



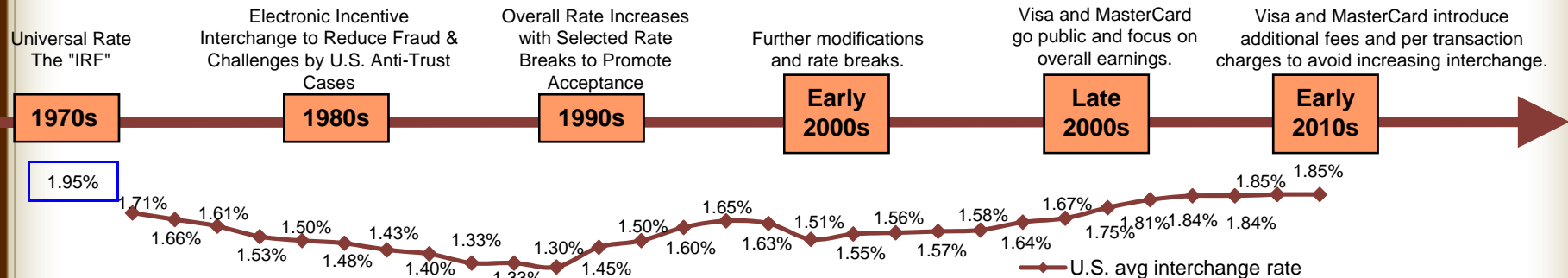
Cost of Electronic Payment Acceptance

Merchant Cost by Merchant Size



Cost of Electronic Payment Acceptance

Interchange rates have steadily risen over the last three decades.



1970s: Interchange was set by U.S. card associations at a universal rate of 1.95%.

Early 1980s: "Electronic Incentive Interchange" rates introduced.

Mid 1980s: Interchange survived two antitrust challenges in the U.S. by NaBanco and First Texas.

Early 1990s: Different types of transactions emerge (e.g., MO/TO) and new category rate increases implemented (e.g., Visa's PS2000 program)

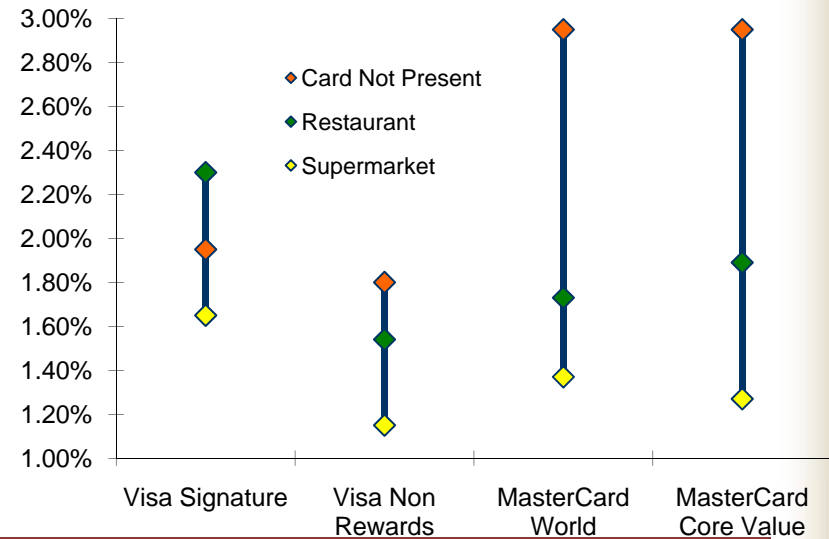
Mid 1990s – Early 2000s: Card associations consistently raise overall interchange rates to promote the issuance and acceptance of their brands.

2004 – 2005: Visa and MasterCard introduced tiered interchange pricing to favor larger volume merchants. Higher interchange was also introduced on rewards cards.

2006 – 2009: Visa and MasterCard publicly released interchange rates, previously available to only merchant acquirers and card issuers.

2010: Legislative focus on reducing interchange

2010 Interchange Rates by Category



Regulation

Regulatory Bodies will Impact Costs in the Future

Interchange Governing Bodies



Federal Reserve	Comptroller of Currency / Office of Thrift Supervision	Credit Card Associations	U.S. Congress	Judicial System
<ul style="list-style-type: none"> Moderates long term interest rates. 	<ul style="list-style-type: none"> Ensures fair and equal access to financial services for all Americans. 	<ul style="list-style-type: none"> Originally founded as governing bodies of the U.S. electronic payments system. 	<ul style="list-style-type: none"> Authority over U.S. budgetary and financial matters. 	<ul style="list-style-type: none"> System for resolving disputes.
<ul style="list-style-type: none"> Supervises and regulates banking institution. 	<ul style="list-style-type: none"> Supervises holding companies and thrift institutions. 	<ul style="list-style-type: none"> Founded by member banks. 	<ul style="list-style-type: none"> Has power to introduce proposals / bills. 	<ul style="list-style-type: none"> Develops and enforces common law.
<ul style="list-style-type: none"> Primarily acts as a regulator and implementer (i.e. Regulation Z). 	<ul style="list-style-type: none"> Primarily makes recommendations on interchange regulation and anti-trust issues amongst banks. 	<ul style="list-style-type: none"> Set and modify interchange rates for various merchant groups and payment types. 	<ul style="list-style-type: none"> Introduces and lobbies for most bills related to interchange. 	<ul style="list-style-type: none"> The court system has been responsible for hearing and resolving most interchange disputes.

In July, the President signed into law the Durbin Amendment, which requires the Federal Reserve to regulate debit interchange.

Regulation

The Impact of the Durbin Amendment - Certain Change for Debit Interchange

Provision

1. Debit interchange must be reasonable relative to incremental cost of a debit transaction.
2. The Fed has 9 months.
3. Banks with less than \$10 billion in assets are exempted.
4. Pre-paid is included.
5. Interchange is defined to include the fees the networks charge.
6. Discount/surcharging and minimum/maximum transactions sizes are permitted.



Implication

1. The Fed's interpretation is key.
2. However, taken literally, the legislation would require an enormous reduction in debit interchange.
3. The legislation would also have a material impact on debit network switch fees and on Visa/MasterCard "assessments".
4. Likewise, pre-paid interchange will fall dramatically in all likelihood.
5. The \$10 billion bank exemption is more meaningful in pre-paid.
6. The surcharge and min/max aspects of the amendment require that merchants actually put the new policies in to play.

Regulation

The impact of the Durbin Amendment - Unintended Consequences

Potential Credit Implications

1. Credit interchange is an enormous hole, from the point of view of the merchant community.
2. With credit interchange unregulated, networks and issuers are free to focus on product development.
3. European-style deferred debit products.
4. Charge card products.

Unintended Side Effects

1. Elimination of an investment rationale
 - Regarding payment innovation
 - Regarding consumer promotion
 - Regarding PIN debit acceptance
2. Change in mix between credit and debit over the years.
3. No \$10 billion bank exclusion.

The Durbin amendment is the most important event in merchant acceptance costs in the US for a very long time, and it is hard to view it negatively from a merchant point of view. However, it is not good legislation, and there is a very high probability of unintended side effects eroding the intended benefit.

Benefits of Electronic Payment Acceptance

Electronic payments offer merchants and consumers benefits that often outweigh acceptance costs.

Benefit of Electronic Payment Acceptance	Explanation
1. Access to Credit	<ul style="list-style-type: none">• A consumer with a credit card has access to more funds allowing bigger and more frequent purchases.
2. Security	<ul style="list-style-type: none">• Consumers may feel more secure carrying a credit or debit card than large amounts of cash.• Merchants may feel more secure conducting electronic transactions than collecting large amounts of cash.
3. Convenience	<ul style="list-style-type: none">• Consumers and merchants may perceive it is more convenient to pay using a credit or debit card because it is quick and easy to use.
4. Expectation	<ul style="list-style-type: none">• There is an expectation that debit and credit cards will be accepted and merchants risk not meeting customer expectations if the option is not available.• Further, consumers expect a choice in payment type.
5. Efficiency	<ul style="list-style-type: none">• Accepting debit and credit cards can be more efficient for merchants, requiring fewer employee resources.
6. Data collection	<ul style="list-style-type: none">• Merchants may be able to more easily track consumer purchasing decisions when credit and debit cards are used.

Reducing Payment Costs

Understand Your Pricing

Category	Definition
Interchange Plus	<ul style="list-style-type: none">• The acquirer passes through interchange and assessments at par and typically quotes the merchant basis point amount and transaction fee plus other fees.
Downgrade Surcharge	<ul style="list-style-type: none">• Also known as Enhanced Billback.• Acquirers quote a single rate based on an interchange level. If the transaction qualifies at that interchange, the rate applies.• If not, the acquirer passes through the differences in interchange rates.• Some Acquirers surcharge these transactions.
Tiered	<ul style="list-style-type: none">• Also known as Three-tier pricing.• Associates interchange rates with categories (typically Qualified, Mid-Qualified, and Non-Qualified) and quotes merchants three discount rates.
Downgrade	<ul style="list-style-type: none">• Similar to Downgrade Surcharge, but no surcharge is passed to the acquirer.

Ways to Reduce Acceptance Costs

Follow Best Practices to Reduce Interchange Costs

Managing Interchange Merchant Best Practices	Explanation
1. Swipe Customer Cards Whenever Possible	<ul style="list-style-type: none"> Swiped cards clear at rates lower than hand-keyed transactions. Using a key-pad to manually enter card information is a common reason for interchange downgrades. Train sales personnel to avoid unnecessarily entering transactions by hand and report ongoing equipment problems.
2. Check with Acquirer to Take Advantage of Money-Saving Programs	<ul style="list-style-type: none"> Associations may create lower interchange rates for merchants based on business types as defined by MCC (may also qualify for small-ticket merchant programs). New point-of-sale technologies may also affect interchange transaction levels.
3. Be Aware of Voice Authorization Costs	<ul style="list-style-type: none"> Voice authorizations do not capture the information necessary for lower interchange rates and can generate downgrades. Merchants will be charged a fee for dialing the service, whether or not positive authorization is obtained. Avoid unauthorized voice authorizations when possible (check reason codes for electronic authorization declines).
4. Send Settlements on Time	<ul style="list-style-type: none"> Transactions that do not clear 48 hours after authorization are downgraded to the standard rate. For CNP transactions, merchants have seven days from date of authorization to submit settlements before downgrades apply.
5. Avoid Authorization and Settlement Amount Mismatches	<ul style="list-style-type: none"> Variations between authorization and settlement amounts are another common cause of downgrades. As of July 2009, Visa charges merchants 4.25 cents per authorization that is not matched to a timely clearing transaction. Card associations do not grant special permission for mismatches for e-Commerce sales.

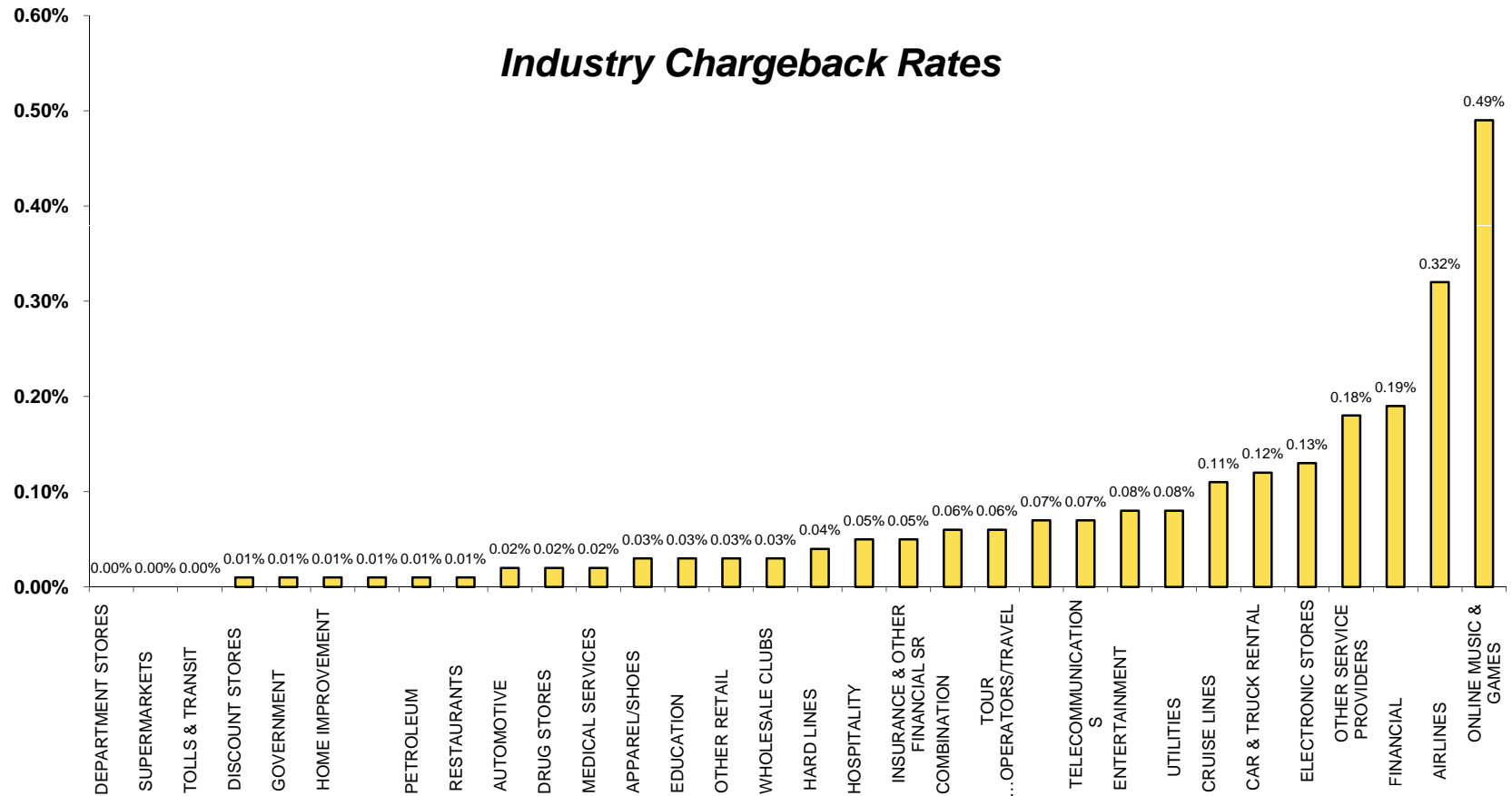
Ways to Reduce Acceptance Costs

Follow Best Practices to Reduce Interchange Costs

Managing Interchange Merchant Best Practices	Explanation
6. Isolate CNP Payment Operations if Possible	<ul style="list-style-type: none">• CNP transactions that appear to come from card present channels may be subject to interchange downgrades.• To qualify for more favorable CNP rates, Sony should make sure that these transactions are easily distinguishable from hand-keyed transactions where the card is present.• If possible, Sony should keep these payment operations separate and use specific account configuration for each.
7. Ensure that Business Phone Number and Unique Order Number are Passed to Card Processor for Each Transaction	<ul style="list-style-type: none">• If customers have easy access to Sony's phone number and order number on their bill, they may contact Sony directly rather than disputing a transaction, which may help avoid costly chargebacks fees.• CNP transactions that do not have the phone number and a unique order number not only carry a higher risk of costly chargebacks, but they also automatically downgrade to a more expensive interchange rate.
8. Reverse Amounts Authorized for Items not Shipped	<ul style="list-style-type: none">• A settlement amount that is less than the authorized amount causes a downgrade.• In order to avoid downgrades: Reverse authorization for the specific amount of items not shipped, settle only for amount shipped, once the remainder of the order is available for shipping submit a new and separate authorization, settle for newly authorized amount.
9. Capture Additional Security Information	<ul style="list-style-type: none">• To qualify for the lower interchange rate, merchants must submit the billing address and zip code for CNP transactions. Using the Address Verification Service (AVS) can help avoid downgrades.• For online sales, confirm that the check-out form on website includes a requirement for shoppers to input complete billing address.
10. Capture Levels II and III Data when Accepting Commercial Cards	<ul style="list-style-type: none">• Business, commercial, and purchasing cards carry higher interchange rates because they offer employers high value features such as enhanced reporting and statements.• Many merchants can qualify for lower commercial rates (especially in CNP environments) by collecting more in-depth Level II and Level III data.

Ways to Reduce Acceptance Costs

Understand Chargebacks

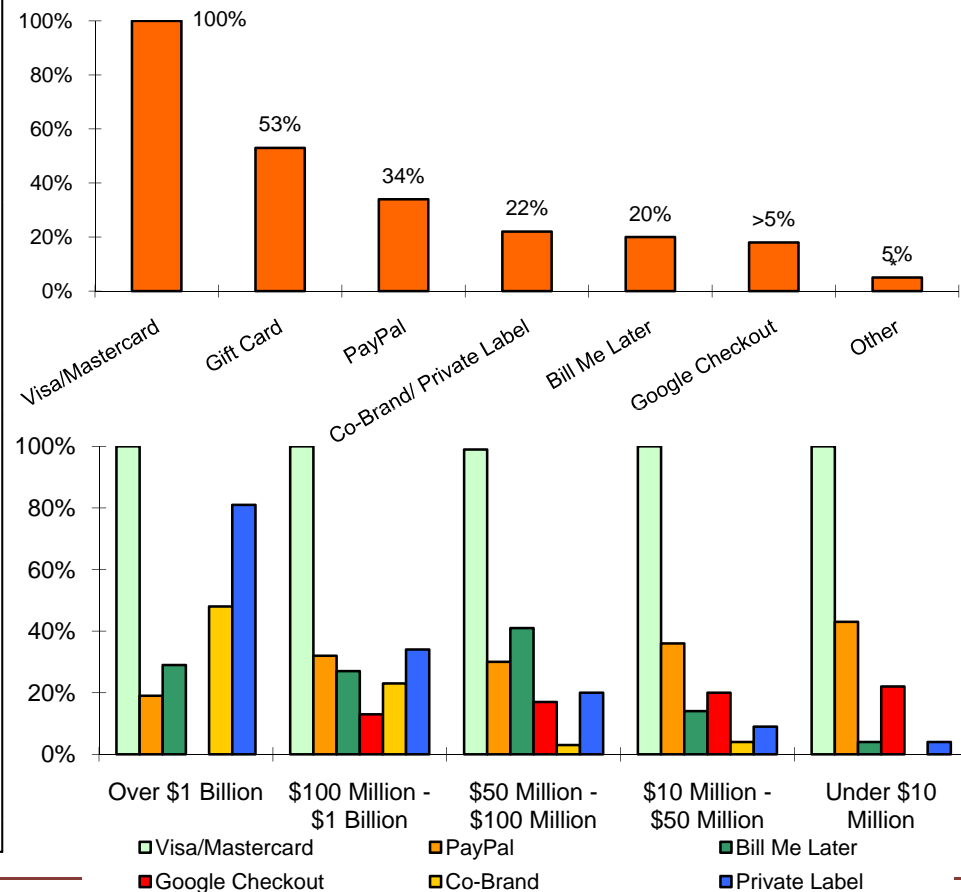


Ways to Reduce Acceptance Costs

Consider Emerging Payments





















- 47% of the Top 500 Internet retailers accept at least one alternative payment method.
- Only 5% of the Top 500 accept three or more products, suggesting limited diversified emerging payments acceptance strategies and opportunities for growth.
- Medium and small e-commerce merchants are most aggressive at adopting emerging payments in an effort to minimize acceptance and processing expenses.
- Medium and small e-commerce merchant segments benefit from additional out-of-the-box e-commerce solutions offered by select emerging payments providers (storefronts, gateways, shopping carts, advertising, etc.).

Online Payments Adoption Among Top 500 Internet Retailers (CY2009)



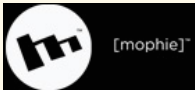






Ways to Reduce Acceptance Costs

Sample Emerging Payment Options

Emerging Payment Provider	# of Accepting Top 500 E-commerce Merchants	Examples	Comments
	21 (~4%)	  	<ul style="list-style-type: none"> • Consumers can pay for purchases and have the payment billed to their bank like a utility • 15% acceptance among computer/electronic, 10% among home furnishing merchants
	14 (~3%)	   	<ul style="list-style-type: none"> • E-wallet developed by Amazon to compete with PayPal • Consumers can pay using a credit/debit card or bank account/ACH transfer • 11% acceptance among computer/electronic, 8% among jewelry merchants
	3 (~1%)	  	<ul style="list-style-type: none"> • ACH-based payment network, limited acceptance • ~1% acceptance overall • 8% acceptance among flowers/gift merchants, 4% among health/beauty
	2	 	<ul style="list-style-type: none"> • Added Petco and PC Rush as first Top 500 merchants to accept Mazooma in Q3 2009 • Allows billing directly to a customer bank account
	1		<ul style="list-style-type: none"> • ACH-based product deducts amount of purchase directly from the consumer's bank account, disintermediating traditional cards, cash, or checks
	1		<ul style="list-style-type: none"> • Generally marketed to banks: allows customers to pay for goods using their bank account through ACH

Ways to Reduce Acceptance Costs

Sample Emerging Payment Options

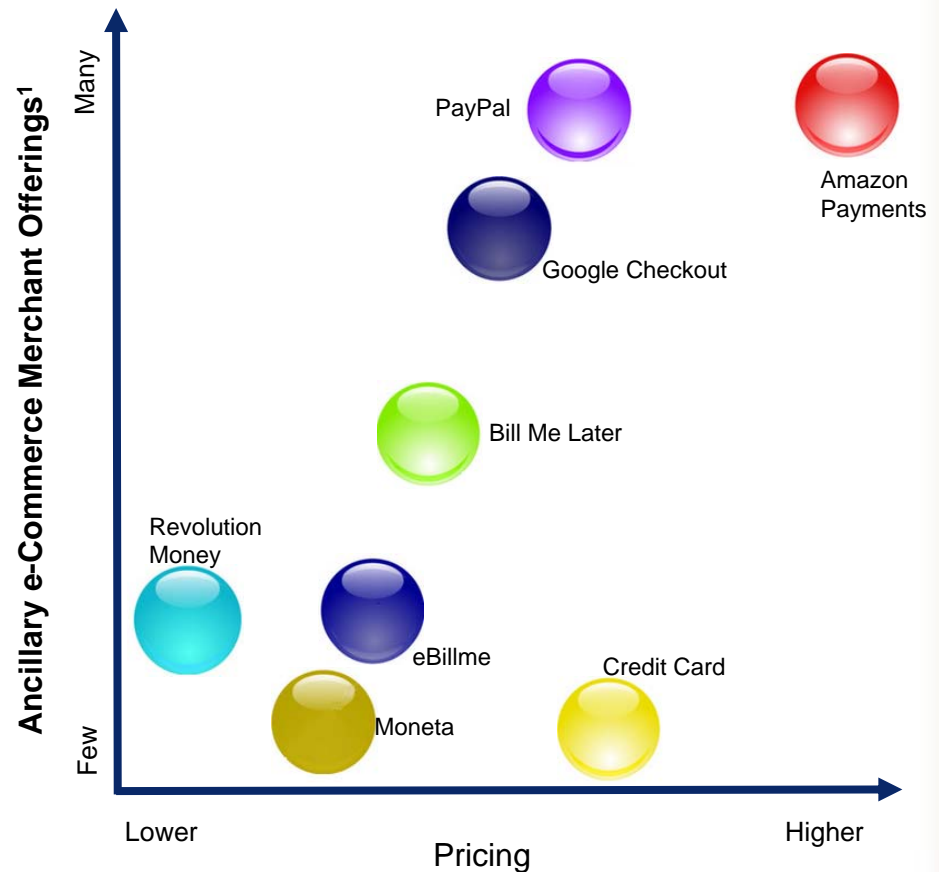
Provider	Eligible Platforms	Discount Rates	Other Pricing and Fees	Merchant Account Required	Comments
 [mophie] [™]	<ul style="list-style-type: none"> iPhone / iPod Touch 	No details available	<ul style="list-style-type: none"> No information on fees available, likely to be on par with competing products 	<ul style="list-style-type: none"> Yes, Mophie claims that service will "work with most merchant accounts" 	<ul style="list-style-type: none"> Announced 12/09, expected full rollout 2010 Accompanies a payment acceptance app QuickBooks integration Tech: Case with Mag-stripe Reader
	<ul style="list-style-type: none"> iPhone / iPod Touch Blackberry and Android versions in development 	~3.50% (rumored)	<ul style="list-style-type: none"> App: \$1 (rumor) Dongle included free (rumor) Loyalty service extra 	<ul style="list-style-type: none"> No, according to Square: currently unclear how this will work 	<ul style="list-style-type: none"> Expected full rollout: Early 2010 Currently in limited beta Tech: Audio Jack, Mag-stripe Reader
 GoPayment	<ul style="list-style-type: none"> iPhone / iPod Touch Blackberry Android Most smartphones 	1.64% to 2.44%	<ul style="list-style-type: none"> \$19.95 monthly fee \$0.27 pre-auth / trans. \$59.95 setup fee 	<ul style="list-style-type: none"> Yes, offered by Intuit 	<ul style="list-style-type: none"> Limited time offer to waive first month of fees Card-reader and printer optional Tech: Bluetooth Mag-stripe Reader
	<ul style="list-style-type: none"> Blackberry 	2.00% to 3.00%	<ul style="list-style-type: none"> \$15-\$30 monthly fee \$40-\$50 setup fee (estimate) 	<ul style="list-style-type: none"> Yes, offered by TSYS 	<ul style="list-style-type: none"> Limited information on service Tech: Bluetooth Mag-stripe Reader
 PAYware Mobile	<ul style="list-style-type: none"> iPhone / iPod Touch 	\$0.17 flat fee (rumored)	<ul style="list-style-type: none"> \$49 activation fee \$15 per month Dongle included free 	<ul style="list-style-type: none"> Yes, offered by Verifone: <ul style="list-style-type: none"> PAYware Connect 	<ul style="list-style-type: none"> Expected full roll out: Early 2010 No known beta testing Tech: Case with Mag-stripe Reader
	<ul style="list-style-type: none"> iPhone / iPod Touch Blackberry 	2.07% to 3.55%	<ul style="list-style-type: none"> \$0.19 fee / trans. Statement Fee: \$8.95 	<ul style="list-style-type: none"> Yes, via: <ul style="list-style-type: none"> Authorize.net 	<ul style="list-style-type: none"> Amex acceptance requires separate merchant account Tech: Manual Entry Only
	<ul style="list-style-type: none"> iPhone / iPod Touch 	2.09% to 3.09%	<ul style="list-style-type: none"> App: temporarily \$0.99, usually \$49.99 \$0.24 fee / trans. 	<ul style="list-style-type: none"> Yes, via: <ul style="list-style-type: none"> Authorize.net PayPal Beanstream 	<ul style="list-style-type: none"> \$50 gift card for new merchants Tech: Manual Entry Only

Ways to Reduce Acceptance Costs

More Favorable Merchant Pricing

Merchant Value Proposition Positioning

- Emerging payments transaction fees typically fall in the 1%-3% range, with most including an additional flat fee of \$0.10-\$0.30.
- Amazon and Google bundle payments acceptance (and its cost) with other advertising and content offerings.
- PayPal provides a suite of merchant gateway, fraud protection, and other solutions, with broad pricing ranges.
- Other providers leveraging the ACH infrastructure have low, flat fee oriented approaches.



QUESTIONS?