Trends in the Electronic Exchange of Value

2019 saw three of the biggest combinations in the history of the electronic payment business. **What happens now?**

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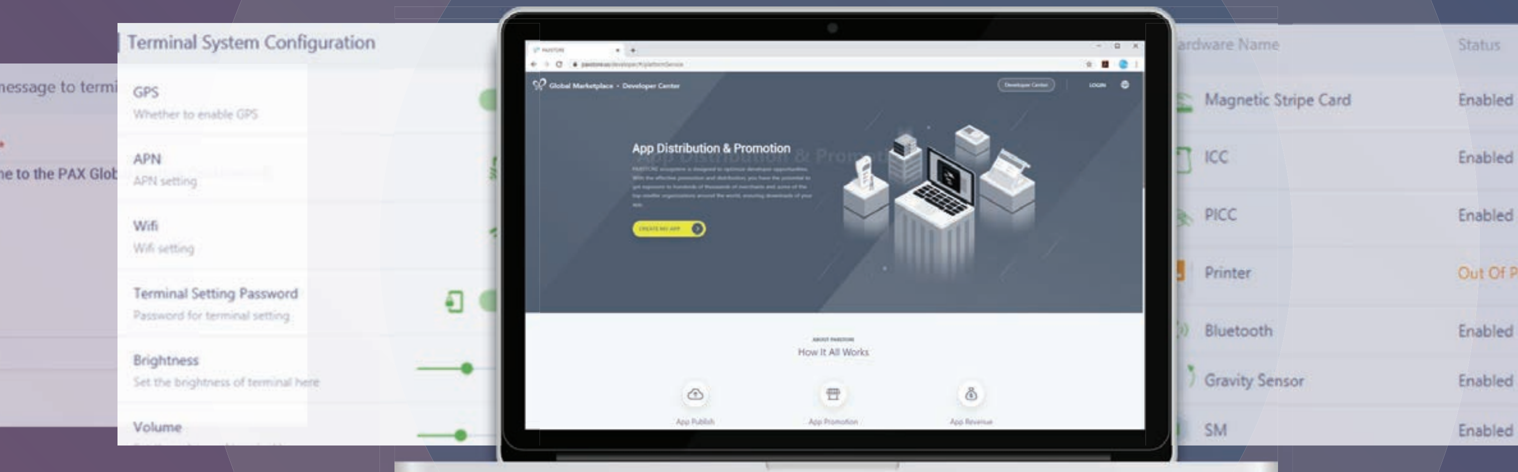

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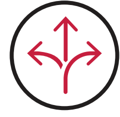

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the gimlet eye

CHUCKING THE CHECKOUT

JUST AS WE WERE PREPARING to send this issue to press, news came about an interesting effort in Germany to steal a march on developing a checkout-free store. An outfit called VR Payment has created a service called payfree that uses radio-frequency identification technology to let stores scan tags on merchandise as customers traverse the open area toward the store's exit. No checkouts, no checkout lines, no fuss, no muss.

Just one hitch. Or maybe several. First, there's no word on when this system will actually be available commercially, let alone what it will cost. VR Payment, a payments unit of Volksbanken Raiffeisenbanken Cooperative Financial Network, was demonstrating payfree at EuroShop, a retail trade show in Dusseldorf, late last month.

Also, questions remain about how well it will work. The idea is to scan RFID tags on the merchandise in customers' bags or baskets as they exit the store, then charge a payment card embedded in a payfree app set up by the customer. The system will also generate a receipt that can be sent to the app. But how accurate will this scanning be? In busy stores, you could have quite a few people exiting all at once with items buried deep inside those bags.

Working with a software partner, VR Payment says it has cracked that nut by widening the range, speed, and accuracy of RFID scanning, which was once limited to handheld devices checking individual items at close range. The proof will come, we suppose, as payfree reaches commercial applications.

The wider complication could be political. Efforts such as Amazon.com Inc.'s celebrated Amazon Go stores ("Checkout Re-Imagined," April), which wipe out the familiar checkout by similarly tracking what customers put in their shopping baskets and then charging a card on file, have run into a rough time with legislators who fear the system discriminates against cash-using customers. Not always, but usually, these customers come from lower income brackets.

Another potential hurdle lies in one of the selling points for systems like payfree: store savings through eliminating checkout infrastructure and cashier jobs. That could rouse considerable labor opposition—and political trouble—in any number of countries.

Technology usually wins when confronted by political roadblocks like this. Consider how advanced telephone-system switching swept away many thousands of jobs for what we once called "telephone operators," people—usually women—who manually connected callers to the parties they were calling. The genius of free markets is that they ultimately find solutions for dislocations like this—and ones that are better-paying, to boot.

Now technology like payfree will test that proposition again in an area of central importance to the digital-payments revolution.

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INTERCHANGE: TWEAKS OR TROUBLE?

After a long period of stability, bank card interchange rates may be about to change.

Visa Inc. reportedly is planning adjustments that could raise merchants' acceptance costs for card-not-present transactions but lower costs in some other categories, including purchases at big grocery-store chains.

Citing a Visa document circulating among the network's client banks, the Bloomberg news service reported last month that interchange for a $100 card-not-present purchase with a premium credit card could rise 4% to $2.60 from the current $2.50. Costs for the same purchase with a standard Visa credit card would increase nearly 5% to $1.99 from the current $1.90.

Interchange on a $50 premium card transaction at a high-volume supermarket, however, will drop 33%, to 77 cents from $1.15. (Visa's current interchange schedule for high-volume supermarket transactions lists the fee for "traditional rewards" and certain other credit cards at 1.15% of the sale plus 5 cents.) Rates in some services categories, including education and real estate, also are expected to decline, the news service said.

Visa reportedly will roll out the new rates in April and October to give processors time to implement the changes, according to Bloomberg. Both Visa and Mastercard Inc. typically update their interchange rate schedules in April and sometimes make further adjustments six months later.

Visa declined a *Digital Transactions* request for comment. Apart

VISA'S INTERCHANGE LABYRINTH

(Selected credit card interchange rates from April 2019 U.S. schedule)

SUPERMARKET

At least **five rates** apply, depending on volume and card product, ranging from **1.15% of the sale plus 5 cents** to **2.10% plus 10 cents.**

RETAIL

At least **eight rates** ranging from **1.43% plus 5 cents** to **2.40% plus 10 cents.**

CARD NOT PRESENT

At least **nine rates** ranging from **1.54% plus 10 cents** to **2.40% plus 10 cents.**

Source: Visa

from occasional minor adjustments, interchange rates—always a controversial topic among merchants, who ultimately bear the cost—have been stable since at least 2012, according to studies by the Federal Reserve Bank of Kansas City ("Merchants' Double Whammy," December 2019). Since then, however, the use of higher-interchange premium cards has increased, and merchants are paying more in network fees.

"Let's be blunt," the Retail Industry Leaders Association trade group said in a statement. "Visa teasing that rates will go down for 'some' is masking the true impetus for this plan—their aim is to hike rates on the vast majority of merchants."

The Bloomberg report claims "Visa is planning the biggest changes to swipe fees in a decade." Quoting from the Visa document, the report says "'the U.S. credit interchange structure has been largely unchanged for the past 10 years. Based on the most recent review in the U.S., Visa is adjusting its default U.S. interchange rate structure to optimize acceptance and usage and reflect the current value of Visa products.'"

An analysis from New York City-based investment firm Keefe Bruyette & Woods says the coming Visa changes will likely affect small and mid-sized businesses more than big ones. Large national merchants with enough transaction clout can negotiate their own rates with the networks, whereas smaller retailers' card costs follow the official schedules. The networks charge interchange to merchant acquirers, who pass the cost on to their merchants.

The KBW report by analyst Sanjay Sakhrani says Visa's planned changes will help realign "some aspects of the company's interchange structure between high-value card-not-present transactions and lower-value card transactions. Over time, we think the changes could help Visa volumes, as SMBs could be more inclined to accept card[s] with the lower rates."

Sakhrani further said he expects Mastercard to follow suit "if it hasn't done so already." And for American Express Co., "we believe that the change is mildly positive as it strengthens [AmEx's] argument that in many cases the rates on premium Visa (and Mastercard) credit cards are equal to or higher than the discount rate it charges merchants."

—Jim Daly

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SURCHARGING'S OPEN ROAD

With only four remaining states effectively banning the practice, surcharges on credit card transactions are poised to pick up momentum.

That was the conclusion of a panel of experts last month at the Northeast Acquirers Association annual conference in Boston. The momentum may benefit not only merchants wary of card-acceptance costs but also merchant-service providers that focus on surcharging as a business opportunity, the panel indicated.

Even recent publicity about litigation over surcharging has lent impetus to programs offered by some independent sales organizations and other merchant-service providers eyeing the niche service.

"The focus on surcharging has had a tremendous impact on our business from a profit standpoint," said panelist John Barrett, president of Nxgen Payment Services, which helps merchants set up surcharging programs.

As an official matter, surcharging is now banned outright only in Colorado, Connecticut, Kansas, and Massachusetts. Challenges have opened the door to surcharging in six other states that had made the practice illegal. The most recent case was that of Oklahoma, where the state's attorney general in December said the ban was an unconstitutional restriction of free speech.

Panelist Jonathan Razi, founder and chief executive of Chicago-based CardX LLC, estimated that, with these legal barriers having fallen, "94% of the U.S. population is open to surcharging." CardX specializes in creating surcharging programs that can be offered to merchants via merchant-service providers.

The opportunity takes on more urgency with indications that interchange costs on card transactions may rise for some merchants given the news that Visa Inc. is making major revisions to its network fee structure, Razi said. Acquirers pay interchange but pass it on to merchant clients.

"Swipe fees are going up," he said.

With the prospect of rising fees, interest among merchants in the surcharge option is "picking up dramatically," noted Barrett, whose company began focusing on surcharging as a strategic opportunity three years ago. "There's much more interest [among merchants] in figuring out a way to get rid of those costs."

Panel members, however, stressed the importance of merchant education in the matter. While state bans may be falling, the card networks maintain rules that restrict the practice. Merchants, and not third parties, must do the surcharging, for example. Also, network rules do not permit surcharging on debit or prepaid card transactions. And they require specific disclosures on receipts in a font size no smaller than other matter on the document.

The opportunity in surcharging, however, could soon grow even larger if the four states that still ban the practice relent. Razi, for example, says CardX already is "actively engaged" with these governments. In such talks, the company stresses a social-justice angle.

"Merchants raise prices on all customers if credit card costs go up," he said. "That's regressive for cash customers from a lower-income bracket."

—John Stewart

THE NEW FISERV'S LIFT FROM FIRST DATA

It's been more than seven months since Fiserv Inc. closed on its $22 billion acquisition of leading payment processor First Data Corp. In February Fiserv dropped some tantalizing hints about the deal's early benefits for the combined company.

For example, First Data's Clover app-based platform for merchant checkouts saw its gross payment volume grow fully 40% in 2019, Fiserv chief executive Jeff Yabuki told analysts on a conference call. He did not reveal the absolute numbers, but clearly singled out the point-of-sale device unit as a standout.

"It was a stellar performance," Yabuki said of Clover while discussing Fiserv's fourth-quarter results. "Not only is Clover an attractive vehicle, but one sees better [merchant] retention and happier clients."

But the honor roll for First Data products didn't end there. In the important integrated-payments market, the roster of connected independent software vendor partners increased 25% for the year, while ISVs added 25,000 new merchant locations for the company, Fiserv reported. Again, Fiserv did not reveal the actual number of partners.

And in another key development, Yabuki reported some 80 e-commerce retail brands joined Fiserv's platform for processing, a gain Yabuki credited to First Data and Frank Bisignano, formerly First Data's chief executive and now president and chief operating officer of what both he and Yabuki referred to as "the new Fiserv." Yabuki attributed the e-commerce client gains to "a continuation of a strategy Frank and his team started, and we continue to make it a high priority," he told the analysts.

FISERV'S REVENUES

(Full years in $ millions)

	2019	2018	Change
First Data	$8,825	$8,245	7%
Payments	$3,263	$3,111	5%
Financial	$2,403	$2,330	3%
Corporate/Other	-$74	-$67	n/m
Total	**$14,417**	**$13,619**	**6%**

Notes: Revenues are internal revenues adjusted for currency impacts, acquisitions, and divestitures. Payments and Financial revenues originate with pre-merger Fiserv units. Source: Fiserv Inc.

One mop-up operation left over from the massive acquisition is apparently on track, as Bisignano reported Fiserv is working closely with Bank of America Corp. to dissolve a leading merchant-acquiring joint venture, Bank of America Merchant Services, that had been an unresolved question in the immediate wake of the merger. The formal separation is set for June, Bisignano told analysts.

All in all, Yabuki said, the First Data acquisition, which was announced Jan. 16 and closed July 29, made 2019 "a watershed year for Fiserv." He went on to laud the deal as a "market-defining transaction." (See page 26 for more on the aftermath of 2019's mega-mergers).

Clearly, First Data has become the tail wagging the dog, accounting for 61% of Fiserv's $3.67 billion of internal revenue in the fourth quarter. The unit is also growing slightly faster than other operations at the company, with 6% fourth-quarter revenue growth compared to 5% for payments outside of First Data and nil growth for financial services.

Fiserv is a major provider of core account processing services for financial institutions and also provides third-party bank services, such as peer-to-peer payments processing for both the bank-owned Zelle service and for Fiserv's proprietary Popmoney product.

All told, Fiserv ended 2019 with $14.42 billion in internal revenue, a measure that adjusts for currency impacts and acquisitions and divestitures. That volume represents a 6% rise over 2018 on a like-for-like basis. "We've made substantial progress against our goals," Yabuki said, adding that he is "even more bullish" about First Data than he was at the time the acquisition was announced.

—John Stewart

WASHINGTON'S 'VITRIOLIC' MOOD

Payment executives hoping that all the infighting in Washington, D.C., will spare their industry from regulation might need to think again.

"This is Washington," Scott Talbott, senior vice president of government relations for the Electronic Transactions Association, said last month at the Northeast Acquirers Association's annual conference in Boston. "They're going to regulate."

Indeed, there's plenty of proposed legislation and rule changes affecting the payments business just now. But the present atmosphere of extreme partisanship does makes it hard for merchant acquirers, software vendors, payment facilitators, and the banks that back them to predict how key regulatory questions will be resolved.

"The mood in Washington is vitriolic, childish. It's all-out war," Talbott told the NEAA audience.

At the federal level, a key concern right now is how Congress will legislate the messy issue of consumer privacy. "Privacy is a hot topic," Talbott said. "Policy makers are focused on it acutely."

Specifically, any legislation will regulate how companies handle and protect personally identifiable information. Merchants, banks, and processors could all be caught up in that net, Talbott warned, because of their need to access PII for authorizations, at a minimum. "If you track PII, you will have new restrictions," he said.

But one federal law, complicated though it may be, will be better than multiple state laws, Talbott said. Some nine states have now introduced proposed privacy regulations. "We want a national standard, not 50 privacy laws," he said.

A related concern is the so-called right to be forgotten, which would compel companies to wipe out personal data at the consumer's request. Such a provision is already contained within the European Union's General Data Protection Regulation, which took effect in May 2018.

"We have an issue here, we need to be able to see your data to fight fraud," said Talbott. "We can take a flyer or deny the transaction. Neither [option] is palatable."

Key to the issue is that both GDPR and similar laws in Canada and California make some allowance for legitimate fraud concerns—an allowance the ETA wants any federal legislation to include. "The permissible use to fight fraud is our main message," said Talbott.

But, from the Washington.-based ETA's standpoint, not all the mischief is at the federal level. "States have stepped forward," Talbott warned, adding they pose "a lot more risks to our industry. In the last two years, we've seen that in spades."

Besides the privacy laws, 48 states already have enacted data-breach notification laws, but Talbott said privacy statutes are likely to be much more challenging for payment companies. The difference, he said, is that the notification rules lie dormant until a breach happens, whereas privacy laws demand immediate compliance.

"They are live ammunition now," he told the audience. "The fines and penalties are very challenging. There are lawyers out there sharpening their pencils waiting for somebody to make a mistake."

On yet another key issue, Talbott said the ETA scored a partial victory by getting the federal government to reduce its tariff on point-of-sale terminals imported from China to 7.5%. The toll on Chinese terminal parts, however, remains at 25%. "We're hopeful we'll continue to get them down to zero," he said.

—John Stewart

—SCOTT TALBOTT, SENIOR VICE PRESIDENT OF GOVERNMENT RELATIONS, ELECTRONIC TRANSACTIONS ASSOCIATION

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THE BIG APPLE EMBRACES CASH

Start spreading the news: cashless stores will not be a part of it, that is, New York City's retail scene.

The nation's largest city in late January became the third U.S. city to ban cashless-only payments in restaurants and stores with the passage of a measure to prohibit merchants from refusing to accept cash. San Francisco and Philadelphia have similar bans, as does the state of New Jersey.

Originally proposed by New York City Council member Ritchie Torres in 2018, the measure went Mayor Bill de Blasio's desk for his expected signature.

Among the ordinance's provisions is a prohibition against charging cash customers a higher price than that for another payment method. Online, phone, or mail-order transactions are exempt. Penalties for violations are $1,000 for a first instance and no more than $1,500 for subsequent violations.

For its part, the Retail Council of New York State issued a statement of cooperation. "Our members welcome every shopper, from the people who want to pay with cash to the people who want us to be wired with the latest technology," Ted Potrikus, president and chief executive of association, says in an email. "We're sensitive to the concerns that the City Council put on the table and are happy to be working with them to make this work for everyone."

Measures banning cashless merchant locations often are viewed as a way to protect consumers who prefer to use cash or have limited credit and debit card options. Torres told *The New York Times* that consumers should be able to choose if they want to pay with cash or not.

Amazon.com Inc.'s launch of its cashless Amazon Go stores in 2018 and 2019 brought the issue of card- and mobile-payment-only stores to the fore. Amazon is now enabling the stores to take cash. Indeed, cash inclusion should be part of the payments industry's objectives, suggests Krista Tedder, head of payments research at Pleasanton, Calif.-based Javelin Strategy & Research.

"The ban on cashless payments will assist consumers who do not have access to, or do not want to use, digital currency everywhere they go," Tedder tells *Digital Transactions* by email. "The payments industry will need to innovate solutions that move beyond digitizing everything. Consumer choice in how to pay, including cash, is a seen as a positive step of payment innovation." DT

—*Kevin Woodward*

MONTHLY MERCHANT METRIC

Q4 2019 Account Attrition And Growth

Account Attrition: Total attrited accounts in given period divided by total portfolio active accounts from same period of the prior year.

New Accounts Added: Total new accounts in given period divided by total portfolio accounts from same period of the prior year.

Beginning	Account Attrition	New Accounts	Ending
100.0%	-22.6%	+24.2%	101.6%

Note: This is sourced from The Strawhecker Group's merchant data warehouse of over 3 million merchants in the U.S. market. The ability to understand this data is important as small and medium-size businesses (SMBs) and the payments providers that serve them are key drivers of the economy. All data are for SMB merchants defined as merchants with less than $5 million in annual card volume.

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RANSOMWARE: A STRATEGIC RESPONSE

BY GIDEON SAMID
gideon@bitmint.com

WHEN TWO HACKERS SHARE A BEER, they lament the diminishing returns from hacked privteware, as they call it. "My clients get angry when I sell them private credentials of people that had been hacked before," says one. "You cannot re-steal a Social Security number! Monetizing becomes a challenge."

"So go ransomware!" his pal cheers him up. "Instant monetizing, safe, secure. You can build a solid business. Paying clients get their decryption key with utmost courtesy, along with detailed instructions, a help page, and, a 'most-frequent questions' log. Like an honorable business, you offer a warranty to your clients against re-attack for 90 days or a year. And, most intriguing, you can gauge the price to be just below the level of refusal and a report to the authorities. Some get creative, using two or three encryption keys and releasing them gradually only if the victim keeps quiet."

Cyberspace is under a strategic attack that requires a strategic response. Alas, security companies ride on ransomware fears and tout their tools as "anti-ransomware," while in fact the tools are just regular fences, walls, and filters of all sorts. Ransomware per se deserves head-on countermeasures.

Here's a two-pronged strategy: core technology and digital payment vulnerability. From a technology point of view, the fundamental countermeasure to a ransomware attack is best captured in one word: rewind. That involves a built-in bitwise capability to run the clock back. A common back-up system may be regarded as a course-resolution rewind, and today it is the best one can do. However, a finer-resolution rewind would minimize any damage from a ransomware attack, and a complete bitwise rewind would put ransomware out of business.

Today, a new rewind technology is capable of bytewise rewind. Instead of erasing the data, one keeps the data around and marks it as "dead," specifying "time of death." When a crypto crawler garbles your data, you stop the clock and rewind. When the clock returns to a past point, the computer scans all its data and brings up every byte that was still alive at that time point, while keeping away every byte of data that was not yet born at that time point.

This process faithfully rebuilds your data as it was at a time before the attack. But it is memory-costly. Consider an account balance. Each time it changes, the old figure is not erased. It is preserved and assigned a "time of death." The dead data builds up. Fortunately, memory is cheap and getting cheaper. Also, old history can be safely erased.

Ransomware flourishes because of cash-like digital payment. But distributed-ledger payments are definitely not cash transfers. The big difference: witnesses. I can pass to you a $100 bill in a process that involves me, you, and the banknote. If I do the same with Bitcoin, everyone knows about our transaction.

True, we transact while wearing masks, but masks can be ripped off. It is a matter of the community coming together to put the "scarlet letter"' on accounts receiving ransom payments. A distributed ledger of shame will give pause to any recipient of money coming out of a condemned account.

Together, core technology and disabling the payment route are strategic responses to this threat that becomes ever more popular on account of its strategic advantages to the hackers.

When Alan Turing and John Von Neumann designed their computing machine in the first part of the 20th century, hacking was not on the horizon, and the machines they built reflected this innocence. It may be necessary to go to first principles to make cyberspace livable. DT

ACCEPTANCE IS THE KEY

BY BEN JACKSON
bjackson@ipa.org

CREATING A NEW PAYMENTS FORM FACTOR is one of the ways the industry likes to add excitement to its innovations for consumer transactions.

Whether it's mobile phones, watches, or (shudder) implantable chips, a new form factor can offer a way to stand out from the competition and build in tools like location-based offers, instant rewards, or combining payments with access control.

All these tools can seem exciting on a demo stage, but customers are disappointed when they walk into a store and their new device isn't accepted. Merchant acceptance is critical for the adoption of any new payments technology, so providers need to design products that make it easy for both consumers and merchants to use. Otherwise, the inertia of legacy systems will prevent adoption of new tools.

Given that inertia, it's not surprising that growth in new payment types has come from outside the traditional payments system. The most successful example of this is, of course, the Starbucks payments app. It managed to combine payments, loyalty, and rewards in an intuitive app that led to Starbucks sitting on billions of dollars in what was once a gift card program. It helped that Starbucks could control its own environment.

For multi-merchant solutions, LevelUp, a Boston-based fintech, provides an example of how one company solved the acceptance problem. Its system enables users to make payments and receive special offers for patronizing participating businesses. It bundled coupons, rewards, and payments into a single, seamless transaction. To accomplish this, it developed a QR-code-based system for smart-phone users.

However, merchant acceptance still needed to be sorted out. To resolve that issue, LevelUp supplied its clients with branded QR readers that would connect to their point-of-sale systems. This way, a customer who got an offer and wanted to try a place for the first time could see instantly where the QR code would be read (assuming the terminal was prominently displayed).

LevelUp's parent company, SCVNGR Inc., was bought by Grubhub Inc. in September 2018 for about $390 million. In its press release, Grubhub said that LevelUp's point-of-sale capabilities were a key part of its decision because that integration would help Grubhub supply restaurants with additional data on customers and give it a comprehensive ordering tool for customers.

Readers may be thinking that acceptance will not be a concern going forward because contactless payments and QR codes are gaining rapid adoption and may soon be ubiquitous.

But the growth of cryptocurrencies shows up the fallacy in that way of thinking. Bitcoin is the most common, though there are a number of others. However, their value lies more in their use as a commodity investment than as a transaction tool. Low acceptance is why crypto has become more a store of value than a medium of exchange.

A digital currency seems like a great idea, given how much commerce happens online. But with limited acceptance, Bitcoin and the other cryptocurrencies are not competing as currencies in general circulation. Many merchants do not want to accept cryptocoins because it is not easy to do, especially in an offline environment. They need to create their own systems for storing and securing the cryptocurrency, and they can't be sure that they can use it to pay vendors and suppliers. On top of all of that, because the value fluctuates, every transaction carries a currency-exchange risk.

Crypto is a perfect example of how payments players must keep both sides of the coin in mind when designing a product. Ease of acceptance is the cornerstone of ease of use, which is the cornerstone of payments success. DT

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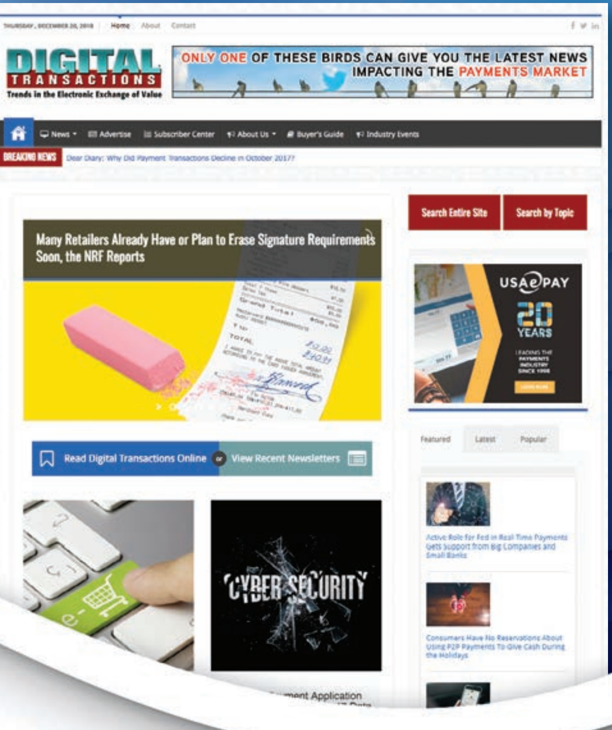

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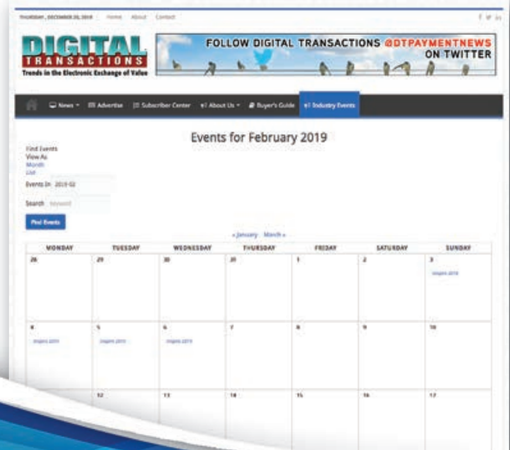


Detailed listings of payments market suppliers

WHY PAYMENT FACILITATORS ARE THRIVING

As small businesses increasingly look for help in adopting digital payments, PFs are generating more and more payment volume—and more revenue.

BY **DEANA RICH**

Deana Rich is co-founder and co-chief executive of Infinicept, Denver.

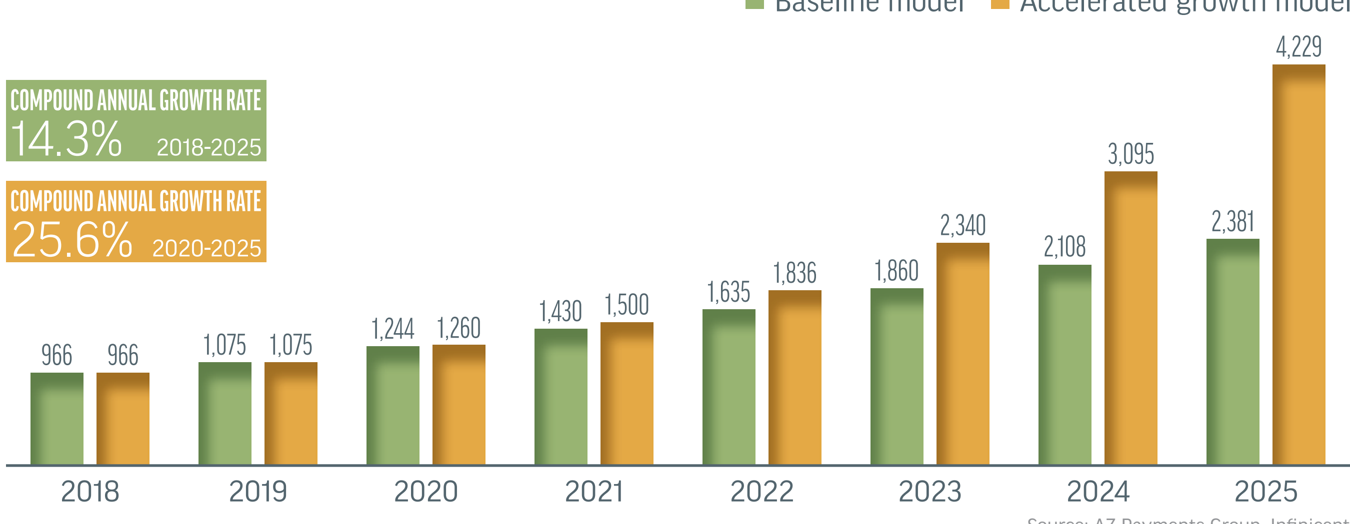
WHEN PAYMENT-FACILITATOR MEGAPLAYERS, like Square Inc. and Stripe Inc., first entered the scene more than a decade ago, many within the payments industry viewed the model as too risky. Despite early skepticism, the payment-facilitator (PF) market is experiencing strong growth because it benefits the entire payments ecosystem, including banks, card brands, merchants, consumers, and economies worldwide.

According to recent research conducted by AZ Payments Group in partnership with Infinicept, we can expect to see significant market growth for payment facilitators worldwide over the next six years. If the current baseline growth rate continues as illustrated in Figure 1, the number of global payment facilitators is expected to expand from 1,075 in 2019 to nearly 2,400 by 2025. This represents a compound annual growth rate of 14.3%.

However, with payment networks heavily investing in the growth of PFs worldwide, it is foreseeable that the market will grow

Figure 1

NUMBER OF GLOBAL PAYMENT FACILITATORS



Source: AZ Payments Group, Infinicept

at a more accelerated pace. Under an accelerated growth rate of 25.6% (Figure 1, page 16), we could easily see the number of PFs reach more than 4,000 by 2025—which would be four times the number of PFs we have today.

In either the baseline or accelerated growth rate scenario, the market expansion of PFs is expected to have a significant impact on the payments industry.

> The market expansion of payment facilitators is expected to have a significant impact on the payments industry.

WHAT'S DRIVING GROWTH?

The PF model was conceived by Square and Stripe, then embraced by Visa Inc. and MasterCard Inc., to help drive the ubiquity of electronic payments worldwide. Before it was introduced, small merchants faced significant challenges in offering their customers the same digital payment choices that larger companies were able to provide, mainly because the payments ecosystem was not built with small merchants in mind.

Today, payment facilitators provide small merchants with a smoother onboarding process and a better payment experience. By removing digital-payment acceptance barriers for small merchants, Visa and MasterCard are earning more revenue by converting more non-card volume onto their networks.

This provides a strong financial incentive for the card networks to push the rest of the payments ecosystem into accepting this new model of merchant processing.

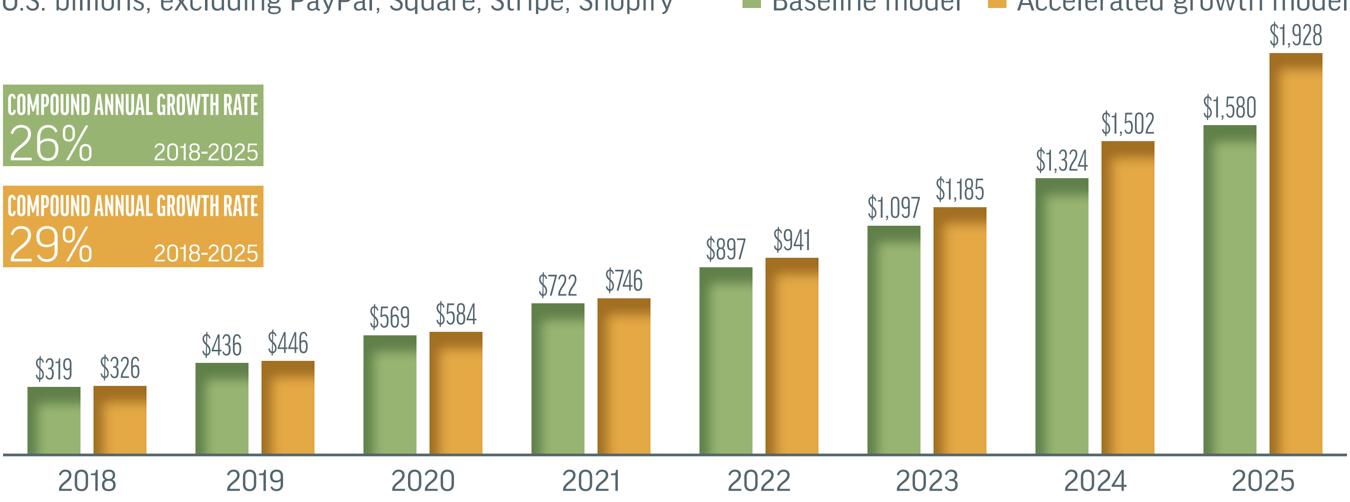
Payment facilitators like PayPal Holdings Inc., Square, Stripe, and Shopify Inc. have proven that offering a seamless path to electronic payment acceptance, especially for small and micro-merchants, helps grow digital payments. Their success has set the stage for other companies to follow suit. Innovative companies worldwide are becoming PFs to provide a better payment experience for their customers, increase their revenues, and improve their business valuations.

The strategy is paying off for companies of all sizes. Patientco Holdings Inc. became a PF to simplify payment processing for their health-care system clients. As a result, they are able to offer clients greater flexibility to respond to patients' financial needs and

Figure 2

GLOBAL PAYMENT-FACILITATOR GROSS PAYMENT VOLUME

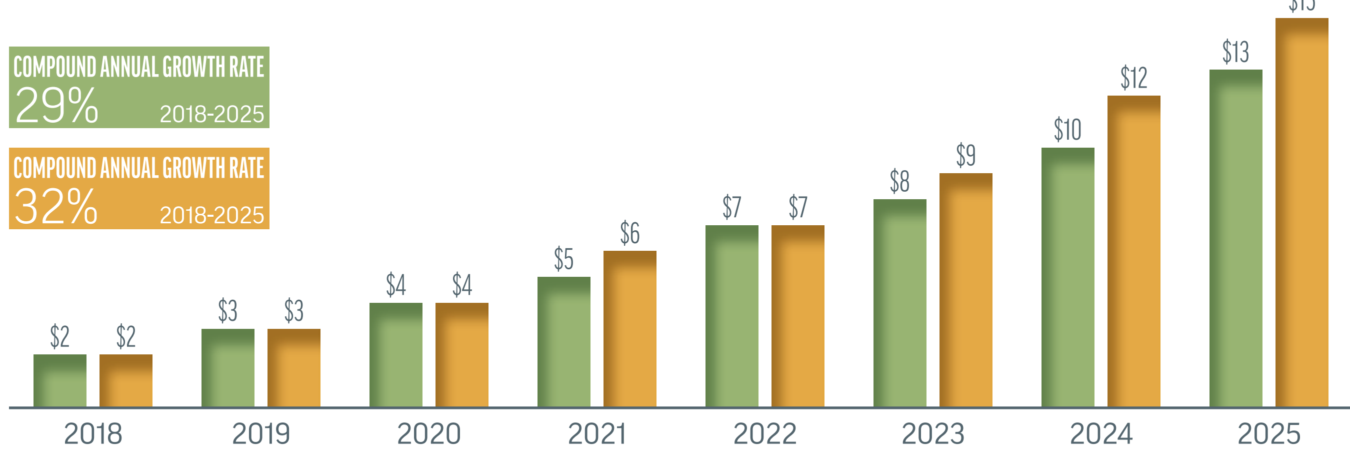
U.S. billions, excluding PayPal, Square, Stripe, Shopify ■ Baseline model ■ Accelerated growth model



Source: AZ Payments Group, Infinicept

Figure 3

GLOBAL PAYMENT-FACILITATOR REVENUE



Source: AZ Payments Group, Infinicept

implement new, intuitive payment tools that today's patients expect.

After becoming a payment facilitator, Five Stars Loyalty Inc. expects to generate $1 billion in annualized gross payment volume in its first year of operation and $6 billion in cumulative gross payment volume in three years.

For acquirers, PFs provide a strategic opportunity to expand transaction volumes, cut the cost of doing business, and offset risks. PF business lines are typically higher-margin while requiring less work to maintain than is the case with maintaining all submerchants individually.

PFs also assume a portion of the risk and can bring net-new transaction volume to acquirers through emerging electronic payments categories such as business-to-business and government payments.

Looking ahead, acquirers have an opportunity to increase profits by 5% to 8% with no incremental interchange or assessments by offering value-added services designed to meet the unique needs of vertically focused PFs. In response, many of large financial institutions, including Wells Fargo & Co., JPMorgan Chase & Co., and Fifth Third Bancorp are enabling PFs. They are looking to capitalize on the 208,000 or so software companies worldwide that could benefit from becoming PFs, according AZ Payments Group research.

As PFs form in developing countries, they bring new opportunities for economic expansion. This makes the digitization of payments a key priority for many large payment players and governments across the globe. Countries like India, Nigeria, and Vietnam are using PFs to fuel economic growth and support emerging markets in fintech.

Card usage makes the economy more efficient, yielding a meaningful boost to economic growth year after year through a multitude of factors. These include transaction efficiencies, consumer access to credit, and increased consumer confidence in the payment system overall.

A recent study conducted for Visa by Moody's Analytics concluded that growth in the use of electronic payment products, such as credit and debit cards, added $983 billion to the gross domestic product of the 56 countries examined between 2008 and 2012. Since PFs help fuel electronic payment acceptance, especially among small merchants, the rise in PFs globally is directly tied to increased GDP for countries that have adopted the model. It's safe to conclude, then, that the roster of countries embracing PFs will only increase in the coming years.

MARKET BARRIERS FALL

In the early days, becoming a payment facilitator was a difficult, complex, and a time-consuming task. Today, the market barriers are crumbling, in large part because PF-as-a-service (PFaaS) companies are offering turnkey solutions

that help banks and their customers dramatically decrease the time, cost, and headaches involved in moving to the PF model.

These new software platforms and API stacks take all the heavy lifting out of the equation. PFaaS customers gain access to all the underwriting, risk, and compliance capabilities and expertise they need to quickly onboard and manage submerchants. This allows their sponsors to earn more revenue with less effort and risk.

In 2019, payment facilitators processed $929 billion in gross payment volume globally, which represented 6% of all transactions worldwide. Under the baseline growth-rate scenario, global gross payment volume (GPV) flowing through payment facilitators (not including PF megaplayers PayPal, Square, Stripe, and Shopify) is expected to more than triple from $436 billion to $1.58 trillion by 2025 (Figure 2, page 17).

Under the accelerated growth rate scenario, PF GPV (again, not including PayPal, Square, Stripe, and Shopify) could reach almost $2 trillion by 2025 (Figure 2).

As gross payment volumes increase, the revenue PFs generate from payment processing will significantly increase as well. In 2019, PFs generated $3 billion in revenue. Depending on the market growth rate, PFs could be generating $13 billion to $15 billion in revenue by 2025 (Figure 3, page 18).

The global retail transaction processing industry moves nearly $16 trillion annually and generates $371 billion in revenue. The growth of the PF model, fueled by supporting products and services, represents a significant opportunity for thriving software-as-a-service companies across every industry to own a piece of the payments pie.

As the payment-facilitator model matures, we're seeing companies spanning every imaginable software vertical take control of their payments offerings. These software companies serve verticals like wellness (ClubReady LLC), restaurants (Toast Inc.) and health care (Phreesia Inc.), and countless others.

Today, it's not surprising many software businesses are realizing they can provide a better experience for customers, while increasing revenues and business valuation, by becoming a payment facilitator. DT

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networks

ROUTING RUMBLE

The Federal Trade Commission once again is looking into debit card transaction routing, and the focus is mostly on online payments.

BY JIM DALY

HERE WE GO AGAIN: federal regulators are probing the seemingly arcane issue of how debit card transactions are routed. Anybody care for some caffeine? Abstruse as it may seem, this issue is anything but dry to those paying attention, and it affects every card-accepting merchant, not to mention card issuers and payment networks.

If merchants could only exercise in full their transaction-routing rights as spelled out in the Dodd-Frank Act's Durbin Amendment they could save more than $600 million a year in card-acceptance costs, most of that in interchange, some merchant advocates say.

Of course, merchant savings translate into lost interchange revenue for card issuers, so the decades-old, built-in tension between the issuing and accepting sides of card payments is bubbling up to the surface yet again.

Enter the Federal Trade Commission. Late last year, Visa Inc. revealed in a Securities and Exchange Commission filing that the FTC, which has oversight authority over the card networks regarding competition issues, had asked it to voluntarily provide "documents and information for an investigation as to whether Visa's actions inhibited merchant choice in the selection of debit payments networks in potential violation of the Durbin Amendment to the Dodd-Frank Wall Street Reform and Consumer Protection Act."

Visa said in the filing that it was cooperating with the FTC, and a spokesperson says the company has no further comment.

Mastercard also acknowledged the FTC had requested information regarding Durbin-related routing requirements, and that it, too, was cooperating.

"But, to be clear there is no specific claim or complaint being made and, importantly, there has been no finding of any violation," a Mastercard spokesperson tells *Digital Transactions* by email. "This is an

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initial, preliminary investigation by the FTC. Once they have completed this exercise, we'll understand their next steps and plans."

The commission isn't talking. "The FTC does not comment on or disclose the existence of investigations," a spokesperson says in an email message. "If a company chooses to disclose an investigation, the FTC does not comment further."

THE REAL ISSUE

While the FTC is mum, signs are appearing about which rocks it's turning over. Merchants and the so-called PIN-debit networks—Star, Pulse, Shazam, etc.—contend the global networks—Visa and Mastercard—through their rules and technical requirements support issuers by making it difficult if not impossible to route card-not-present debit transactions, including online, card-on-file, and in-app payments, to the PIN networks.

Merchant groups and PIN-debit networks have brought their concerns to the Federal Reserve, which has regulatory authority over banks and implemented the Durbin Amendment through its Regulation II. It's a fair guess that merchant and PIN-debit partisans have brought these same concerns directly to the FTC, or that the FTC has learned about them through the Federal Reserve.

On June 11, some 15 lawyers and executives representing several merchant trade groups, two PIN-debit networks, a processor, and retailers Walmart Inc. and Target Corp. met with eight Federal Reserve Board staff members "to discuss their observations pertaining to card-not-present routing of debit card transactions and tokenization in the market," says a brief summary of the meeting by the Fed.

The group also brought to the Fed's attention their concerns about the new Secure Remote Commerce specification for e-commerce purchases from EMVCo, the standards body owned by Visa, Mastercard, American Express Co., Discover Financial Services, China's UnionPay, and Japan's JCB. Merchant groups have long claimed EMVCo's standards reinforce the global networks' control of card payments, an assertion the networks deny.

That meeting came one day after five Mastercard representatives and an attorney spoke with Fed staff about the same topics.

The real issue behind the routing dispute is money—who pays or receives the most revenue from a debit transaction. PIN-debit networks generally charge merchants less in interchange, which is paid by the merchant to the issuer of the card the consumer used in a transaction, than do Visa and Mastercard for so-called signature-debit purchases.

'HUNDRED YEARS' WAR'

The PIN-signature debit conflict started in the late 1980s and early 1990s when Visa- and Mastercard-branded debit cards first appeared, years after issuers added point-of-sale functionality to their PIN-based ATM cards.

Merchants scored their biggest victory in 2010 when Congress passed Dodd-Frank with its pivotal debit card amendment sponsored U.S. Sen. Richard Durbin, D-Ill. Durbin's amendment capped the interchange large issuers could receive from a debit transaction at about 22 cents, and, as implemented by the Fed's Regulation II, required all issuers' cards to give merchants access to at least two unaffiliated debit networks for routing.

Durbin's idea behind the routing provision was to promote network

'Obviously e-commerce is growing faster than other payment types.'

—CALLUM GODWIN, CHIEF ECONOMIST, CMSPI

competition and break up the common practice of issuers striking exclusive deals with the global networks.

For example, many issuers cranked out cards that routed signature-debit transactions over the Visa network and PIN-debit purchases only over the Visa-owned Interlink network. Ditto for exclusive deals involving Mastercard, which owns the Maestro PIN-debit network ("The Durbin Amendment Half a Decade Later," July, 2017). Interlink's volumes took a huge hit after the routing provisions kicked in.

The conflict flared again about six years ago with the coming of EMV chip cards, which in their original European iteration could not route transactions to the U.S. PIN-debit networks. Fixing that problem to comply with Durbin required the payments industry to develop the so-called common application identifier, or common AID, that in effect lifted the gate at the entrance ramp to the PIN-debit road.

"This is like the Hundred Years' War," says Jeff Tassey, chairman of the Electronic Payments Coalition, a Washington, D.C.-based advocacy group for networks and banking trade groups.

In recent years, the PIN-debit networks have broadened their product offerings from their original single-message debit (PIN-based authorization and settlement in one transaction) to dual-message (authorization and settlement in separate transactions, as in Visa/Mastercard signature-authorized debit), to PIN-less debit, and other services.

Now the spotlight is turning to fast-growing online and mobile payments, a market the global networks

A CROSS-BORDER CONTROVERSY

Disputes over debit card transaction routing are hardly confined to the United States. Routing has been a contested topic for years in Australia, and recently the country's central bank signaled it might force banks to send more contactless debit transactions to the local EFTPOS network rather than automatically sending them over the Visa and Mastercard networks.

As in the United States, Australian card issuers earn more interchange revenue from Visa and Mastercard transactions than they do from alternative debit networks. But Australian financial regulators want to reduce payment costs in the economy, and they appear sympathetic to merchants' arguments that retailers deserve more choice in how transactions are routed.

An Australian retail trade group estimates merchants pay A$300 million to A$500 million ($200 million to $340 million) in extra costs per year under current routing practices that favor the bank card networks, the Reuters news service reported in February.

The spotlight is turning to rapidly growing contactless payments, which Visa and Mastercard dominate. By 2016, contactless payments had already accounted for one-third of face-to-face card payments, according to research for the central bank, the Reserve Bank of Australia.

"We have made it very clear to the banking industry that we expect them to develop the functionality to allow the merchant to choose which payment rails it goes through, the international schemes or the EFTPOS schemes," RBA Governor Philip Lowe told reporters after a recent speech, according to Reuters. "If that process doesn't work then we would have to consider a regulatory solution."

Last May, an RBA board responsible for payments policy issued a statement "that the benefits to competition from least-cost routing [of debit transactions] should not be prevented by issuers removing networks from dual-network cards."

'There's just no way to have a government intervention like this on behalf of one party in the two-sided (issuer/merchant) market without having unintended consequences.'

—**JEFF TASSEY**, CHAIRMAN, ELECTRONIC PAYMENTS COALITION

dominate. In a recent report, CMS Payment Intelligence Ltd., a Manchester, England-based merchant-oriented consulting firm with a U.S. office in Atlanta, cites Federal Reserve research saying card-not-present transactions now account for about 30% of all card spending.

But merchants can't route many online debit purchases to the PIN-debit networks because of the global networks' policies and technical requirements, according to CMSPI. If they could, the savings to merchants as of 2017 would have been "more than $600 million per annum," says Callum Godwin, the firm's chief economist.

"That number is going up real fast—obviously e-commerce is growing faster than other payment types," he says. In fact, CMSPI pegs the potential savings at about $1 billion by the end of next year.

CMSPI compiled its estimates based on proprietary data it receives from its merchant clients, which include Marriott, Panera Bread, Shell, Red Lobster, and others.

Adds Owen Glist, a partner with Constantine Cannon LLP, a New York City-based antitrust law firm that advocates for merchants in major payments cases: "The pie of routable transactions is shrinking if e-commerce transactions are not available to be routed." Glist attended the June 11 meeting with Fed staff.

Merchant advocates say their routing choices for POS transactions are largely respected. But with online, card-on-file, and in-app mobile payments, the global networks have policies and operational requirements that wall off the PIN-debit networks from this growing transaction market in violation of the Durbin Amendment, they say.

'A BUSINESS ISSUE'

"The technologies being deployed are drivers behind the questions," says Dan Kramer, executive vice president of government and community relations at Johnston, Iowa-based Shazam Inc., a debit network and payment processor.

A 21-page paper compiled by the National Retail Federation that the merchant groups left with Fed staff details their concerns. Much of the report is technical, but claims it makes include:

- Requirements that tokenized in-app and card-on-file transactions be routed only to the global networks. Tokenization is the system in which a 16-digit primary account number is replaced by digits useless to fraudsters, enhancing security. Merchants say Visa and Mastercard have refused to de-tokenize transactions processed by other networks, shutting out the alternative networks.
- Issuers not enabling bank identification numbers so that certain debit transactions can access PIN-debit networks. "The functionality is not being enabled on the card by the issuer," says attorney Glist.
- Prioritizing the so-called global application identifier, which, depending on the brand on the face of the card, routes a debit transaction to either Visa or Mastercard, over the common AID that can access the alternative networks.

Other issues include policies that reward issuers and merchants for sending transactions to the global networks, or in Mastercard's case, penalize issuers with fees for transactions originated on a Mastercard-branded card that went to the PIN networks.

And, back in the physical world, the global networks have policies that give them the upper hand in very fast contactless transaction environments—think New York subways, according to Paul Tomasofsky, executive director of the Debit Network Alliance industry group. Here, PINless transactions could be an option but global network policies allegedly thwart that.

"It has nothing to do with technology functionality, it's a business issue," Tomasofsky says.

Erecting high technical requirements especially hurts small merchants looking to make the most of

their debit-routing options, according to researcher Sarah Grotta, director of the debit and alternative products advisory service at Mercator Advisory Group Inc., Marlborough, Mass.

"My understanding is that it can be done, you've got the really big guys, the Walmarts and the Targets, they've got the tech teams," Grotta says. But for smaller retailers, "it's simply not in their purview."

Both the FTC and the Fed have refereed routing disputes before. In 2016, both agencies made inquiries into Visa's rules and technical specifications that resulted in some POS terminals requiring consumers to make a choice of AID. The Fed ultimately issued guidance that any network rule giving consumer choice priority over merchant routing choice violated the Durbin Amendment.

MERCHANT RIGHTS

The FTC ended its investigation when Visa made changes making clear that "merchants can continue to route debit transactions to any payment card network enabled on the card for that transaction and that merchants are not required to display these application selection screens to their customers," a November 2016 FTC letter to Visa says.

It's unknown how long the FTC's current investigation will take and what it will conclude. But merchant advocates hope the result will be unequivocal guidance from regulators that Durbin applies to all forms of debit, card not present in addition to the point of sale.

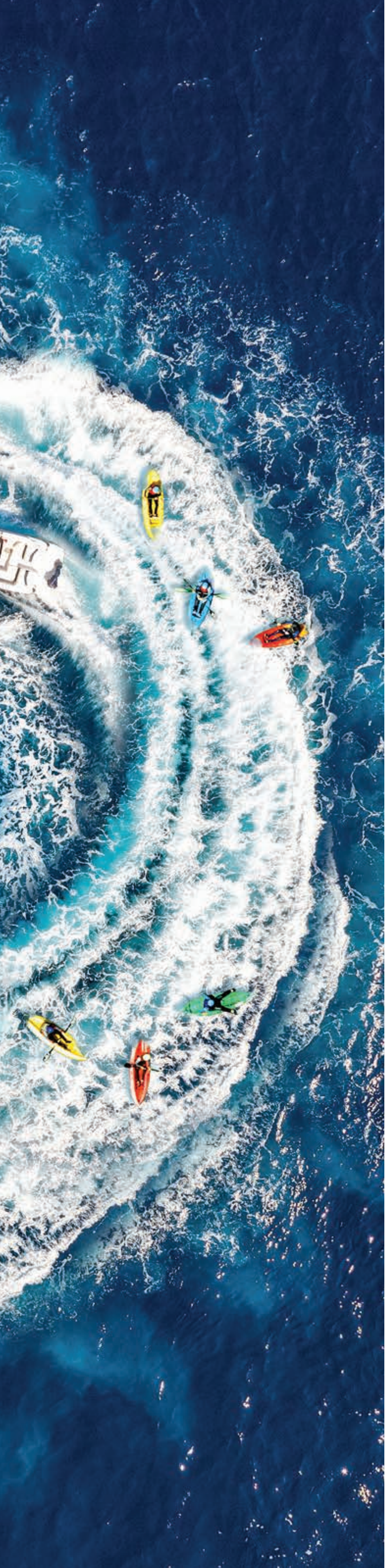
Still, Tassey of the Electronic Payments Coalition hopes regulators won't mess with the debit market too much. He notes that, after it took effect, the Durbin Amendment spurred many banks to scale back free checking because they lost so much debit revenue from the interchange cap. (The price cap initially cut big issuers' interchange revenues by about 50%). Some issuers also ended debit card rewards programs.

"There's just no way to have a government intervention like this on behalf of one party in the two-sided (issuer/merchant) market without having unintended consequences," he says. DT

IN THE **WAKE** OF THE **MEGA-MERGERS**

2019 saw three of the biggest combinations in the history of the electronic payment business. The deals closed months ago. **What happens now?**

BY JOHN STEWART



GOTTEN OVER MERGER SHOCK YET? Well, fasten your seat belt. The effects from last year's trio of mega-combinations are likely to ripple through the payments industry for some time to come, reshaping business relationships, shifting market share, spurring innovation, and—at least for a while—spawning confusion and dysfunction.

In short, prepare for fundamental change in an industry already roiled by a decade's worth of revolutionary technological overhaul. "There's going to be a new normal," predicts O.B. Rawls, chief executive of global payment processing for processor Paysafe Group.

And, to top it off, the mega-merger wave hasn't exhausted itself. In February, two French behemoths, Worldline S.A. and Ingenico Group S.A., agreed to combine in a deal valued at $8.6 billion (box, page 30).

The agreement may have come in part as a reaction to the big combinations in the U.S. market resulting from the deals between Fiserv Inc. and First Data Corp., Global Payments Inc. and Total System Services Inc. (TSYS), and Fidelity National Information Services Inc. (FIS) and Worldpay Inc. But one thing is sure: it will have ramifications for U.S. processors and merchants. Ingenico is a major supplier of point-of-sale devices in America, and experts see Worldline using that position to launch an expansion play here.

'MERGER HELL'

But while the three completed combinations gear up with expanded sales forces, capabilities, and product lines, the immediate impact down the line on independent sales organizations, independent software vendors, payment facilitators, and the merchants they serve can be described in two words: "We call it merger hell," says Trent Voigt, chief executive of Paynetworx, a Dallas-based processor.

Voigt and other ISO executives see opportunity in the momentary distraction caused by knitting six big operations into three even larger ones. The confusion largely results from disconnects between differing accounting systems, Voigt says.

"We're getting numerous ISOs and ISVs [coming to us] that have built integrations around reporting structures, and now the reporting structures are changing. It breaks their automation," Voigt explains.

Companies like Paynetworx are the beneficiaries of the new business. "I'm loving every bit of that," Voigt adds.

He's not the only one looking to benefit from what is likely to be momentary confusion while the big firms iron out system issues. Rivals are thinking the same way, and laying out the welcome mat for any straying players. "We'll strike while people are looking around," says Ryan Malloy, senior vice president of partner relations at North American Bancard LLC., a Troy, Mich.-based processor.

The opportunity to grab business will be short-lived. Paysafe's Rawls gives it three to six months

MEGA-MERGERS AT A GLANCE

FISERV-FIRST DATA

Closed: July 29, 2019
Price Paid: $22 billion (stock)
Merchant Locations: 6 million plus
Revenue Q4 2019: $4.05 billion
Revenue Q4 2018: $1.55 billion

FIS-WORLDPAY

Closed: July 31, 2019
Price Paid: $43 billion (90% stock/10% cash)
Merchant Locations: 1.3 million (U.S.)[1]
Revenue Q4 19: $3.34 billion
Revenue Q4 18: $2.17 billion

GLOBAL PAYMENTS-TSYS

Closed: Sept. 18, 2019
Price Paid: $21.5 billion (stock)
Merchant Locations: 3.5 million
Revenue Q4 2019: $1.99 billion
Revenue Q4 2018: $880 million

1. *Digital Transactions* estimate

before the new combinations get their systems humming on a single standard. "Then things will settle down," he notes.

Other long-time industry observers agree, arguing too much business is at stake to long neglect system incompatibilities or enforce new formats that annoy clients. "I heard about it on the street. I don't think the window is going to be open that long," says Rod Hometh, a former Ingenico executive who is now a partner with the payments-advisory service RPY Innovations.

For their part, the big processors aren't likely to take key reseller relationships lightly. FIS and Global Payments did not respond to a request for comment for this story. "We have the top program out there for ISOs," says Jason Williams, a long-time payments executive and senior vice president and head of ISO solutions for Fiserv.

He points out that Fiserv has already committed to spend $500 million over the next five years to support innovation in merchant solutions and risk-management technology, among other priorities.

But in the meantime? "There are opportunities everywhere you turn" to leverage "client dissatisfaction," notes Robert Carr, chief executive of merchant-service provider Beyond Inc. Carr formerly was chief executive of Heartland Payment Systems Inc., which Global Payments acquired in 2016 for $4.3 billion.

"This is where ISOs, and even big companies like us, feel a little lonely as a client," says Paysafe's Rawls. "Roles change, people change, pricing changes. It takes a while to figure all that out." Some players will figure it out, others will make a move, he says, and that movement creates opportunity for nimble players. "I think you'll see share shift in the light of the three mergers," he adds.

> **'You'll see share shift in light of the three mergers.'**
>
> **–O.B. Rawls,** chief executive of global payment processing, Paysafe Group

THE UPSIDE

That's the downside risk. There's upside, also. Fiserv, Global, and FIS have acquired considerable financial and technological muscle with these deals, and won't be afraid to wield it. Fiserv, for example, now controls Clover, a highly promising line of app-based POS devices that First Data acquired in 2012.

Payments volume running through Clover's installed base rose 40% year-over-year, Fiserv reported last month, without naming figures. In a conference call to discuss Fiserv's fourth-quarter results, company chief executive Jeff Yabuki called out Clover's performance as "stellar."

Meanwhile, the ISV partnerships First Data brought to its new owner

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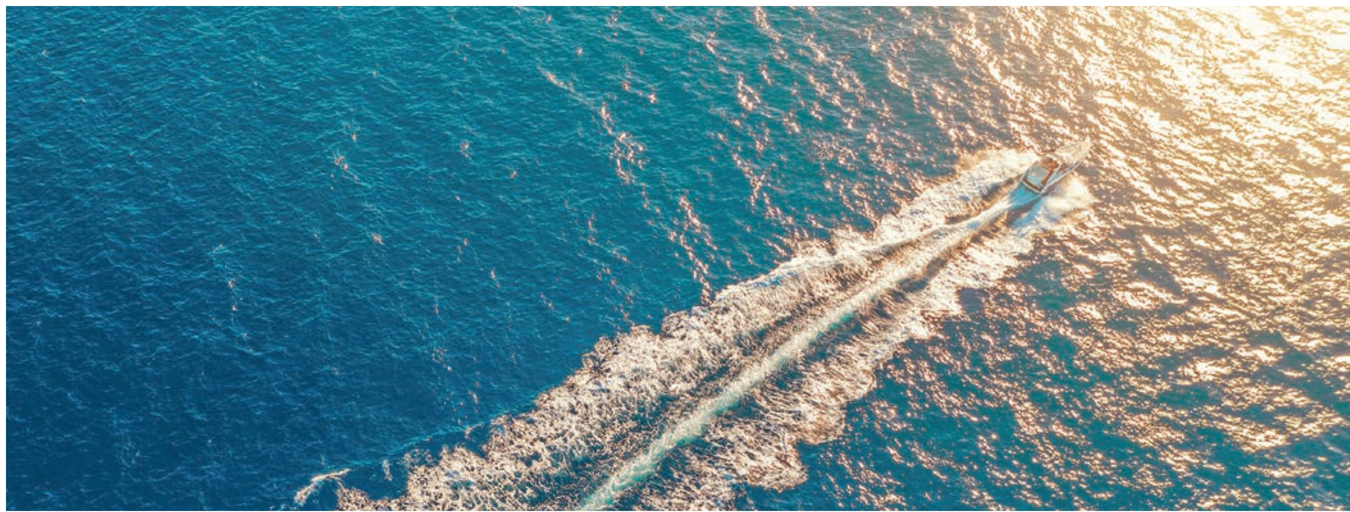

WORLDLINE'S $8.6 BILLION DEAL FOR INGENICO

In one of the latest signs that the mega-mergers aren't over yet, Ingenico Group S.A. said last month it has agreed to be acquired by Worldline S.A. for cash and stock consideration totaling approximately $8.6 billion. The two firms are French, but the combination is a global move with potentially major implications for the U.S. payments market.

Indeed, the transaction, expected to close in the third quarter, brings together two companies with far-reaching stakes in the electronic payments business. Ingenico is a principal supplier of point-of-sale terminals in North America and other regions that has in recent years expanded its reach in e-commerce transaction processing.

Its worldwide terminal base totals 30 million, accounting for a 37% share of installations, Ingenico says. It processes for 550,000 merchants either online or in-store, or both, across 170 countries.

Worldline is a top provider of payments processing in Continental Europe that has not shied away from acquisitions to expand its business. These targets have included Digital River World Payments, a Swedish processor that had been a unit of U.S.-based Digital River Inc.

When the deal for Ingenico closes, the new Worldline will boast $331.6 billion in annual purchase volume, good for a third-place ranking worldwide, according to data the companies released at the time of the merger agreement.

With major assets in North America, Ingenico offers Worldline "a footprint in the U.S. market," notes Jared Drieling, senior director of consulting and market intelligence at The Strawhecker Group, an Omaha, Neb.-based payments consultancy.

That footprint could expand quickly. While the combined Worldline-Ingenico is likely to have a more immediate impact in Europe, it also sets up the newly expanded company to exploit hardware and online-processing capabilities in other regions, Drieling says. "It's a pretty big deal from an international standpoint. However, they do have their sights set on North America," he adds.

Verifone Inc., a chief POS terminal competitor to Ingenico, was taken private in 2018.

Drieling sees the merger as a "scale play," at least partly in reaction to the trio of huge U.S. processor mergers that sent ripple effects last year far beyond American borders. These combinations included Fiserv Inc.'s acquisition of First Data Corp., Fidelity National Information Services Inc.'s deal for Worldpay Inc., and Global Payments Inc.'s merger with Total System Services Inc.

This latest combination will produce a company with $5.85 billion in annual revenue, of which $2.76 billion comes from merchant services. Ingenico shareholders will own approximately 35% of the combined company, with Worldline shareholders owning the remaining 65%, according to the announcement from the companies.

yielded 25,000 new merchant locations last year, Fiserv said. And the First Data unit's ISO connections are net new to the company. "Fiserv did not have an ISO channel, so there's not much noise there," notes Williams, who came to Fiserv through the First Data deal.

Indeed, now that it's fully integrated, First Data has become the tail wagging the Fiserv dog. Its sales represented 61% of Fiserv's $3.67 billion in total internal revenue (revenue adjusted for currency fluctuations and acquisitions and divestitures) for the fourth quarter. The merger closed in July.

Global and FIS also gained significant advantages. Through its acquisition of TSYS, the largest such deal in its history, Global picked up two key POS product lines, the Vital brand smart terminals and the Genius POS software. Vital competes with Clover in the crucial market for app-based devices. Genius will give Global an edge with ISVs in the all-important restaurant market.

Global's plan with Vital is to start rolling out the devices this month through its Heartland unit. "We think it competes very well for that register-replacement market," noted Cameron Bready, Global's president and chief operating officer, during the company's earnings call last month. All in all, because of the merger, Global's expanded merchant-solutions unit now accounts for fully 65% of its total revenue.

What Worldpay has done for FIS is even more dramatic. The enormous $43 billion deal (including assumption of Worldpay debt) creates huge leverage in e-commerce processing, a key Worldpay strength, as well as in integrated payments. The latter is a crucial market involving close relationships with ISV partners who fold payments functionality into business software they're writing for specific business segments.

'There's still a lot of cheap acquiring out there.'

—Patricia Hewitt, principal at PG Research & Advisory Services

In the fourth quarter, e-commerce and integrated-payments revenue grew to 45% of sales in the company's merchant unit, up from 37% a year earlier. All in all, the addition of Worldpay grew revenue in the company's merchant-solutions unit to $1.12 billion in the fourth quarter, up from $71 million a year earlier. The merger has been "the most significant and transformational acquisition in our history," pronounced Woody Woodall, FIS's chief financial officer, during the company's earnings call last month.

NICHE PLAYS

A key unanswered question is the extent to which the sheer hugeness of these new companies will confer pricing strength. Naturally, the firms won't comment on a matter this sensitive, but questions did crop up during the most recent earnings calls regarding impending interchange-rate revisions planned by Visa Inc., including increases for card-not-present transactions.

Both Global Payments and FIS said the changes will simply be pass-throughs to merchants. "We're not in the business of absorbing that," noted Global's Bready.

One thing remains clear: the era of the mega-merger, inaugurated by these six companies, is just getting under way. Observers say more such deals are likely soon, and not necessarily where you might expect them.

One ripe market could be remittance, observes Patricia Hewitt, principal at PG Research & Advisory Services, a Savannah, Ga.-based consultancy. "There's a lot of juice in remittance," she says. "We'll see some M&A there." And, without naming targets, she speculates that consolidation in acquiring is bound to grow more intense. "There's still a lot of cheap acquiring out there," she says.

But with the large growing suddenly larger, what can mid-size and smaller players do to find growth? For some observers, the best strategy is playing to strengths in niches such as health care, high-risk merchants, or even something as specific as parking.

Consolidation by the big players "always opens the door for competitors," notes Hewitt. "For smaller acquirers, the best go-to-market strategy is specialization. There are dozens of specific markets that are very large. You can do a good business as a niche player."

But be forewarned: in the era of the mega-merger, "pricing is a commodity," says Hewitt, "you're not going to differentiate on that." DT

SMALL STEPS IN CHINA

U.S. payment companies finally appear to be gaining some traction in China, but how—and when—that foothold will develop is still unknown.

BY **KEVIN WOODWARD**

CHINA, AS THE WORLD'S SECOND-LARGEST ECONOMY, has long been an attractive market for U.S. payments companies. It's only in recent years—starting in 2005 and accelerating in the past few—that a handful of these companies began to announce the first steps to doing business in mainland China.

The most recent activity is Mastercard Inc.'s joint venture with NetsUnion Clearing Corp. to establish a domestic bank card clearing entity. In February, the entity formed from the joint venture—Mastercard NUCC Information Technology (Beijing) Co. Ltd.—received in-principle approval from the People's Bank of China.

Mastercard says within a year the joint venture will be able to apply to the bank for formal approval to begin clearing transactions.

PayPal Holdings Inc., too, is readying for more transactions in China. It has two programs in preparation. One stems from its 70% stake in Guofubao Information Technology Co. Ltd., better known as Gopay. With that deal, PayPal won the right to be the first foreign company to offer online payments in China's vast market.

The other is an acceptance deal with UnionPay International that sees PayPal support UnionPay cards in its digital wallets, enabling those cards to be used for online payments at PayPal merchants. By 2020, PayPal says the capability will be available in more than 30 markets.

In late 2018, American Express Co. was the first major U.S. payment network to get a so-called preparatory approval for a clearing-and-settlement license. This action is through a joint venture with a Chinese financial-technology company, Lianlian Yintong Electronic Payment Co. Ltd., to process domestic transactions on AmEx cards.

"[O]ur license has been accepted, we are waiting for the final approval, and hopefully some time this year, we will launch the network," Stephen J. Squeri, AmEx chairman and

chief executive, said in a January earnings call, according to a transcript from SeekingAlpha.com.

That venture will increase not only coverage in China, but it also will put more cards on the network as AmEx engages "with the Chinese banks to have more Chinese travelers as they go into—and the reality is, they are going to go into a lot [of] European and Asian cities, which is going to put more demand and will actually then help drive more coverage," Squeri said.

Other deals, such as Discover Financial Services' pact with UnionPay for mutual acceptance on their respective networks, and Total System Services Inc.'s stake in China UnionPay Data Co. Ltd., the processing unit of the card brand, started in the mid-2000s. TSYS is now part of Global Payments Inc.

Overarching these ambitions is the newly signed 86-page trade agreement between the United States and China. The agreement, in its first phase, enables U.S. electronic payments providers to operate in China as wholly foreign-owned entities. The agreement also provides a mechanism and timeframe for Chinese authorities to review applications.

> 'Access to the payments market in China has … blown up into a global trade issue.'
> —**GILLES UBAGHS**, SENIOR ANALYST, AITE GROUP LLC

CHINESE CULTURE

The big question remains: Does all of this bode well for U.S. payments companies and their prospects in China after decades of having been shut out of this enormous market?

"At this time it's too volatile of a market to provide any solid feedback on payments in China," says Krista Tedder, director of payments at Javelin Strategy & Research, a Pleasanton, Calif.-based payments research firm. "You will continue to see Chinese payment methods acceptance at merchants, however, it is to facilitate international commerce [and] travel."

Tedder discounts the trade deal's provisions. So much depends on Chinese approval. "To deliver services in China requires a partner," she says. "I do not anticipate non-Chinese companies will ever be allowed to work on their own without a Chinese backer. American Express is a bank themselves, yet they still required a partner. The U.S./China deal should

KEY EVENTS FOR U.S. PAYMENT COMPANIES IN CHINA

Organization	Project	Announced
PayPal Holdings Inc.	PayPal will support UnionPay International in its digital wallet.	2020
United States and China	A new U.S.-China trade agreement is signed that allows U.S. payment firms to operate independently in China and stipulates an approval timeframe for applications to operate in China.	2020
Mastercard Inc.	Mastercard's joint venture with NetsUnion Clearing Corp. receives in-principle approval to establish a domestic bank card clearing entity.	2020
The Western Union Co.	Launches Western Union international money transfers in real time in conjunction with Du Xiaoman Financial.	2020
PayPal	Takes 70% stake in Gopay with expecations of eventually directly offering online payments.	2019
American Express Co.	In 2018, AmEx's prepatory approval for a clearing-and-settlement license marked it as the first overseas network to receive the OK from Chinese authorities.	2018
Discover Financial Services	Discover and China UnionPay announce a mutual acceptance deal.	2005
Total Systems Services Inc. (now part of Global Payments Inc.)	Acquired a minioritiy stake in China UnionPay Data.	2005

have little impact on the payment strategy of China. This has been their plan for decades."

Still, U.S. payments companies are undeterred. "We are delighted and encouraged by this latest decision from the PBOC," Ajay Banga, Mastercard president and chief executive, said in a statement. "China is a vital market for us, and we have reiterated our unwavering commitment to helping drive a safer, more inclusive and seamless payments ecosystem for Chinese consumers and businesses. We remain focused on working with the Chinese government and local partners to grow the overall payments infrastructure."

And Visa Inc. views the trade agreement as providing another opportunity. "Visa welcomes the signing of the Phase One trade agreement between the United States and People's Republic of China, as well the Chinese authorities' decision ... to continue expanding opportunities for international players in the domestic payments market," a Visa spokesperson says in a statement.

"Visa is working closely with the Chinese government, including the People's Bank of China, throughout the application process for a Bank Card Clearing Institution license," the statement continues. "We see significant potential for Visa to support the continued growth and evolution of digital payments in China, including through the 2022 Beijing Olympics. Visa is approaching the Chinese domestic market entry opportunity with a long-term focus."

License approval is a few major steps away from actually processing domestic China transactions. But U.S. companies, experts warn, could stir a

'The corporate strategies and American business principles of free markets and free speech do not fit with Chinese culture.'

—**KRISTA TEDDER**, DIRECTOR OF PAYMENTS, JAVELIN STRATEGY & RESEARCH

culture clash. "The challenge American companies will need to face is if they really want to work with China," Tedder says. "The corporate strategies and American business principles of free markets and free speech do not fit with Chinese culture."

Sometimes U.S. companies have tried to resolve issues by taking steps they figure will please Chinese authorities. One example is Apple Inc., which recently removed two apps from its store, according to Wired.co.uk. One was for a news site that reported on Hong Kong protests and the other enables individuals to locate police on a map.

"Companies may be forced to not be as inclusive socially in China," Tedder says.

UNKNOWNS ABOUND

Still, the trade agreement, in particular, is a major step ahead, says Gilles Ubaghs, a senior analyst at Boston-based Aite Group LLC. "The announced news marks a major move in global payment schemes finally getting access to the Chinese market, after years of battles taken to the [World Trade Organization], where China was found at fault, and foot dragging by the regulators on allowing Western firms into the enormous domestic payments market," Ubaghs says.

"Chinese payments have long been a goal market for Western payment firms, but access to the market has been extremely limited if not reversed, most notably Yahoo losing out in its ownership dealings with Alipay," he says.

In 2011, according to the *Financial Times*, Yahoo was a major stakeholder in the mobile-payments service owned by e-commerce behemoth Alibaba. When Alibaba's ownership structure changed, Yahoo feared the value of its share in the company might decrease. Yahoo acquired its 43% share in Alibaba in 2005 for $1 billion. Alibaba then was valued at about $2.5 billion and now is valued at $24.6 billion, according to BusinessInsider.com.

"Access to the payments market in China has since blown up into a global trade issue, while domestic payments in China exploded in size and scale, particularly in the realm of mobile payments with Alipay and WeChat Pay," Ubaghs says. Alipay has more than 1.2 billion users and WeChat Pay 900 million users.

The unknowns abound about when and to what degree U.S. payments companies might succeed in China. But, as Aite's Ubaghs says of the Mastercard/NetsUnion deal, "This is still early stages, and it is likely the devil will prove to be in the details on any finalized deal." DT

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HOW THE FED HAS BUNGLED DURBIN

Nearly a decade after the banking regulator's debit regulation took effect, the legacy has been dramatically higher costs for merchants than Congress intended.

BY **MARK HORWEDEL**

Mark Horwedel is a special consultant for CMSPI, an Atlanta-based consultancy.

IT'S BEEN 10 YEARS since Congress enacted debit card reforms to rein in runaway fees and inject competition via the Durbin Amendment to the Dodd-Frank Financial Reform Act.

Unfortunately, the statute gave the Federal Reserve the authority to develop the ensuing regulations to enact those reforms. The Fed is primarily charged with maintaining the safety and soundness of banks and is conflicted in the role of regulator with respect to debit reforms.

The Fed has failed us all—merchants, consumers, the entire economy—by completely ignoring the clear language in the law. Since the inception of the Fed's regulation, its actions and inactions have cost merchants and consumers more than $60 billion for debit use in stores, according to estimates from consultancy CMSPI and the Fed.

Total costs have likely exceeded $100 billion once fees related to debit acceptance at online merchants are factored in, along with the fee reductions that should have followed each of the Fed's own unaudited surveys of the regulated banks.

Furthermore, the Fed has essentially ignored the clear requirements within the law that issuers enable multiple routes for all debit purchases, including online purchases. As a result, online merchants have been denied any opportunity to create competition for online debit purchases ("Routing Rumble," page 20).

MARKET POWER

It comes as no surprise that, recently, one of the biggest global networks announced increases in fees for using its branded cards for online "purchases ("Interchange: Tweaks Or Trouble?" page 6). This is further evidence of the market power the networks enjoy over

online merchants, which are denied the competition afforded to them by the law by virtue of the Fed's inaction in enforcing debit routing in the online-payments venue.

While bank executives and shareholders, rewards junkies, and the big networks prosper under the Fed's oversight, all consumers have suffered and continue to suffer. The cost of payments acceptance is now ranked by most face-to-face merchants as the third highest cost of operation, trailing only the costs of occupancy and labor. For online merchants, it's often cited as second only to labor.

The high costs associated with payments acceptance factor into the prices all consumers pay for goods and services, including recipients of federal benefits programs as well as those who never use rewards programs.

The banks and the networks have positioned themselves to redistribute wealth by taking away from the poor and giving to the rich by indirectly increasing costs for goods and services and rewarding only those who can afford to enjoy the benefits of their rewards programs.

Those of us who were involved in the political struggle that culminated in the passage of these debit reforms have a vivid recollection of how the Fed mishandled its Durbin regulation, known as Regulation II. We particularly recall the pseudo-logic that it sold to the public, which basically ignored the "incremental cost" mandate in the law.

In promulgating Regulation II:

1. The Fed ignored the plain language of the statute, and instead granted itself broad authority to include costs that clearly fall outside

> While bank executives and shareholders, rewards junkies, and the big networks prosper under the Fed's oversight, all consumers have suffered and continue to suffer.

of the incremental costs allowed by the statute in its calculation of the costs incurred by regulated banks.

2. The Fed arbitrarily based the 21-cent fee cap on the costs of the 80th percentile among the regulated issuers that responded to its initial, voluntary survey. This decision flew in the face of the statute's clear instruction that the allowable fees were to be based upon each issuer's costs.

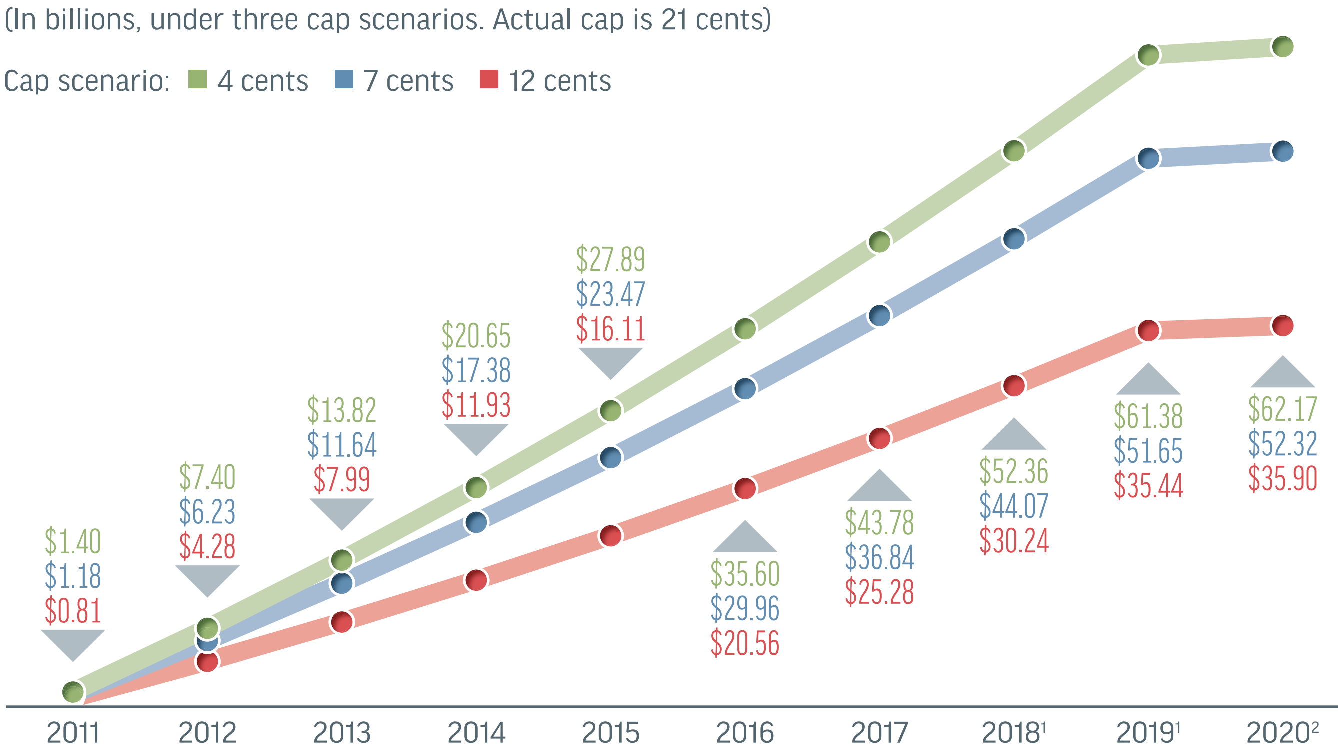
3. The Fed awarded issuers a 5-basis-point premium to reimburse them for their fraud losses.

With respect to this last point, despite the fact that U.S. banks and their networks operate one of the most fraud-prone card-payments businesses in the industrialized world, these 5 basis points ironically result in issuers receiving fraud reimbursements that exceed the total amount of fraud. The Fed has essentially turned fraud into a profit center for banks. Remarkable.

A BETTER OUTCOME

The Fed's actions and inactions subsequent to Reg II continue to illustrate the Fed's contempt for debit reforms, coziness with banks, and disregard

WHAT THE CUMULATIVE SAVINGS COULD HAVE BEEN



1. Estimates 2. Projected Source: CMSPI

for the interests of merchants and consumers. These include:

1. The Fed's failure to enforce the debit-routing requirements of the law in all channels, particularly online sales, which have grown to account for nearly one-third of all debit transactions.

2. The Fed's failure to reduce or eliminate the 5-basis-point premium it initially awarded banks when clearly merchants are saddled with increasing responsibility for fighting fraud and for the actual costs of fraud due to the actions of the banks' networks in shifting liability for fraud to merchants and away from the issuers. The networks tout the efficacy of EMV chip cards in reducing in-store fraud, and yet the premium remains unchanged.

3. The Fed's failure to reduce the fee cap, even though the banks themselves have informed the Fed that their costs have declined more than 50% since the regulation was put into place.

In contrast to the U.S. Fed, payments regulators outside the United States have administered their laws and regulations far more effectively. Laws curtailing the abuses of the global networks have been passed in Europe, Australia, and Canada, where regulators are more objective and more concerned with sticking to the letter of the law.

Also in contrast to the Fed, international regulators in all of these jurisdictions have mechanisms to periodically review regulations and modify interchange rates accordingly. In the United States, the Fed chooses to review but ignore the results.

The Fed has not acted as an objective regulator, adopting and maintaining a flawed regulation that ignores the law in favor of enriching the big banks. The Fed's behavior gives us all reason to doubt that it can be trusted to act in the best interests of the country as a whole.

At the very least, the Fed must revise its rule to adopt a rate that is proportional to the most recent survey results. It must also develop an objective mechanism for updating the rate in accordance with the results of future periodic surveys to ensure it is proportional to issuer costs. For all future surveys, the issuer responses must be audited for accuracy and adherence to the regulation.

Merchants and consumers deserve better and Congress surely intended a better outcome than what has been delivered by the Fed! DT

Wallets, contactless, P2P—get ready to take them all.

endpoint

DITCH THOSE CLUNKY CHECKOUTS

Merchants must install the technology today's customers demand—or risk losing sales.

BY **MAURICIO CHACON**

Mauricio Chacon is group product manager for Epson's North America point-of-sale (POS) solutions division.

MILLENNIALS AND GEN Z CONSUMERS are not only more tech-savvy and better-informed shoppers than prior generations, they're also seeking a greater connection to their preferred brands. And they desire a more curated shopping experience that feels unique and genuine to them.

As a result, retailers must capitalize on available technology to understand these customers' preferences and provide them with exactly what they want, when they want it, in the way they want to receive it.

The checkout process plays an invaluable role in the user experience no matter the devices, technology, or method used to complete the transaction. One of the biggest mistakes in today's hyper-competitive retail landscape—and one of the quickest ways to kill customer loyalty—is to make the checkout process long, difficult, or limited.

A report from Adyen NV, which surveyed more than 2,200 consumers and 500 retailers, found that 85% of merchants cite poor payment experiences as the key reason for lost sales. Additionally, 56% of respondents indicated they wanted more payment options, and 34% admitted they would abandon the checkout if the store requires them to create an account.

FOUR KEY TRENDS

While there are lots of ways merchants can improve their checkout processes, here are four specific payment trends that should inform retailers' point-of-sale strategies:

M-commerce. According to the latest estimate from Pew Research Center, more than 5 billion people have mobile devices today, and over half of those devices are smart phones. In the United States, 81% of adults report owning a smart phone.

Similarly, 80% of Americans shop online, and more than half use their phones to make purchases. Smart phones, always in hand or close by, are a convenient way to place restaurant orders, purchase items for in-store pick up, or pay a bill.

The shopping-via-smart phone trend doesn't appear to be slowing down. Mobile e-commerce sales accounted for 34.5% of total e-commerce sales in 2017, and by 2021 that number is projected to be 54%. Total annual m-commerce sales are expected to increase from $207 billion in 2018 to $338 billion in 2020, according to Statista.

Mobile/Contactless. Although mobile wallets are still in the early adoption stages, payment processor Total Merchant Services declared mobile wallets would be the most significant trend of 2019. Major mobile wallet providers such as PayPal, Apple Pay, Samsung Pay, and Google Pay use near-field communication (NFC) technology, which allows devices to communicate with each other when they're in close proximity.

Some of the advantages of mobile wallets are that payments can be made by simply logging into your account with an email or user name and password (a process that's further simplified with biometric-based logins such as retina or thumbprint scans).

Additionally, transactions and balances can be viewed online via a browser or mobile app. Plus, money can be sent and received quickly, and currency-exchange services are available for international purchases for a fee.

A 2018 study by Merchant Machine revealed that 39% of the global population of smart-phone users owned mobile wallets. Other studies estimate that 58% of all Millennials are ready to make the complete switch to mobile wallets right now.

Unattended payments. A 2018 SOTI consumer survey found 66% of shoppers favor self-service technology over interacting with sales associates. Additionally, 77% of consumers say they'd be comfortable in a retail setting where there's only self-checkout—no sales associates at all. Some merchants also find that self-service kiosks can help increase average tickets with consistent upsell offers.

P2P Payments. Many consumers have discovered the convenience of peer-to-peer payment apps such as PayPal's Venmo, Square's Cash App, or Zelle when they're transferring money to family or friends.

The P2P trend picked up steam during the second half of 2019 with providers like Venmo enabling instant transfer of digital funds into bank accounts. As younger consumers move further away from traditional banking—seeking speed in payments, where settlement is marked in minutes and seconds instead of days—P2P will continue to enjoy a meteoric rise.

By the end of 2022, eMarketer predicts over half of mobile phone users, or 52.5%, will have made at least one P2P payment within the past month. Millennials will drive the growth, the research firm predicted. P2P payment apps are making their way into the business world, too, allowing consumers to use them to make online purchases and retailers should be taking note.

CLOSING SALES

One of the biggest challenges retailers face today is consumers' differing payment preferences. Apple users may prefer Apple Pay, whereas Android users may like Google Pay or Samsung Pay. Other customers may prefer Venmo, PayPal, Square, or WeChat.

The point is that there's no de facto standard when it comes to mobile and P2P payment preferences, and merchants shouldn't try to force customers into just one or two options. The best practice to follow when you're evaluating payment terminals is to find out which contactless mobile payments the hardware vendor and payment processor support and give preference to those offering more choices.

When it comes to serving today's tech-savvy consumers, removing friction from the checkout process is a vital step to closing more sales (online as well as in-store) and gaining a real advantage over your competitors. DT

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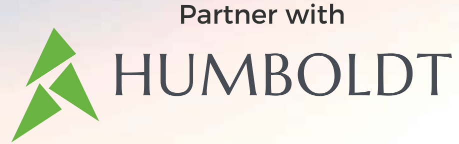

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