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Building After the Bubble Has Burst

by Jim Romeo

Economic conditions just seem to get worse. Unemployment numbers, retail sales and our overall GDP are steadily losing wind. Widespread enterprise is longing for an economic stimulus package of some sort to prevent the economy from a sustained free fall.

For now, it seems that as the economy goes, so goes the card industry. How the card industry will weather the storm and get back on its feet is the question that history will ultimately answer. As for now, credit card delinquencies continue to grow and retail sales continue to fall.

Also of concern is a swell of fraud and crime. During a down-swing in the economy, crime rates tend to rise. As such, card fraud incidents surface and rise - as if you didn't have enough to worry about already.

What's the biggest thing that ISOs and acquirers have to worry about in the months ahead?

The answer is always the same: it depends on to whom you talk. We spoke to several industry players to find out what's on their minds and see what worries them.

"Declining transaction volume," says Tom Dailey, a former executive with Discover Card and a consultant to the card processing industry. "Statistics are showing that while the average number of credit card transactions is fairly stable, the average sale amount is running about 20% lower than prior year. Since ISOs and Acquirers charge the merchant a percentage of the sale, this means that they are receiving less revenue even though their transaction processing costs are staying about the same."

But remember that weakening economy and proclivity toward crime I was talking about? Well that must be factored into the bigger equation.

"The biggest worries will be avoiding liability and surviving the weak economy. Careful merchant monitoring will become a necessity," says Steven Schneider, an attorney with Mitchell Silberberg and Knupp in Los Angeles, California.

"That said, ISOs and Acquirers who can provide lower-cost transactions to merchants should continue to do well. Merchants will be looking to cut expenses any way they can and that need to pay less could be helpful. Merchant poaching will increase, but greater attention should be paid to the survivability of merchants, both existing and new prospects."

"I think ISOs and acquirers should be concerned about increases in fraud and data breaches," adds Judith Rinearson, an attorney and authority in the areas of payment systems for the law firm of Bryan Cave LLP. "They should also consider the impact on their businesses of moving to EMV standards for credit cards. There has been increasing concern that the implementation of EMV in places like Europe and Canada will mean more fraud here in the U.S."

John Atrato, President of the Retail Business Unit of MagTek, an equipment vendor to the card processing industry concurs. What would he worry about if he were an ISO or acquirer?

"Merchant attrition," he says. "Losing existing customers continues to be the biggest issue facing the acquiring channel. Merchants would be more receptive to hearing about competitive offers given the economic climate today. ISOs will need to stay as close as possible to their customers to maintain their merchants."

I know it's not what you want to hear. But just when you think you've heard enough, without an effective economic stimulus, small business could suffer as well.

"Small merchants may not be able to survive a decline in consumer spending and the expectation is that we will see a spike in small businesses closing their doors which will of course translate into higher attrition," says Henry Helgeson, president and co-CEO of Merchant Warehouse. "We'd expect that as businesses close their doors, losses from uncollected chargebacks will climb as well. 2009 will undoubtedly be a tough year, as it looks like there won't be much going in the ISO's favor."

The New Congress

As of this writing, the new Congress has just moved in and an inauguration just took place with a new administration. The question on the minds of many is whether or not this Congress will be a boon or a liability to the electronic payments industry.

"The combination of the credit squeeze and the new proposed credit card regulations from the Fed will make it more difficult for the credit card industry, and may also make it more difficult for those with 'iffy' credit histories to get a credit card," says Rinearson. "On the other hand, this might be a favorable development for debit cards and prepaid card issuers. In general, I think one needs to assume an increase in regulation for all financial products."

Tom Dailey says that it's the issuers who will be most in the scope of our new Congress. "While some of the recent congressional actions addressed some long-standing industry abuses such as double cycle interest rate calculation and default pricing, other new rules will greatly affect issuer income by limiting the ability to impose penalty fees or make interest rate changes applicable to prior balances," he says. "One threat to the acquiring industry would be if the government imposed interchange caps such as was done in Australia. There is no current talk of doing that, but Congress is probably more willing to intervene, so anything could happen."

Steve Schneider does not see the new Congress as a boon by any measure and more like "trying to run a race with weights on."

"Look for new pro-consumer and probably some pro-merchant regulations, which when effective will increase costs," he says. "As we have painfully learned, not everyone in the U.S. should own a home. We will also learn that not everyone in the U.S. should have a credit or debit card. The expansion of carhldership will reverse or at least markedly slow in 2009, even without Congressional action."

Henry Helgeson is upbeat for the moment. "It appears we may have received a reprieve for the time being," he says. "Given the banking situation Congress is going to have a tough time cracking down on interchange rates, a major source of revenue for banks and financial institutions. For the time being I don't foresee any changes regarding interchange rates."

Playing Defense

Sometimes the best offense is a good solid defense. So what's an ISO to do in times like these to best position themselves for a prosperous future?

"I'd be most concerned about managing risk," says Tom Dailey. "I'd take a good look at any merchant with forward sales such as mail [or] phone order or travel and make sure I have either a reserve account or personal guarantee in place to cover losses that might be incurred should the merchant cease doing business. I'd also monitor any merchant with above-average chargeback and dispute ratios. From a revenue perspective, I would think about ways to mitigate my reduced discount fee income by considering other fees such as monthly statement fees."

"I would take aggressive steps to protect my merchant portfolio and customer base," says Atrato. "These steps would include offering product platforms that would make it tough for the merchant to switch. Given that PCI Compliance and Card Data Security continue to be the merchants' hot buttons, the product offering should include not only the PCI Compliance certification, but also full encryption for all card data at the point-of-card sale."

Henry Helgeson says that his firm is looking at their costs, line by line, to make sure we can remain aggressive and growth-oriented in the down economy. "If the average margin per account has decreased, that means it may not be reasonable to spend as much money bringing in new accounts," says Helgeson. "Additionally, ISOs must be careful and in close contact with their merchants engaged in future delivery, such as bridal shops and cabinet makers, in order to avoid being held responsible if these merchants go out of business and have not been able to deliver the orders. And lastly, it may seem like common sense, high-level customer service and regular contact with merchants is key to avoiding surprise losses of accounts. Since every ISO will be looking to get every new customer they can, it is even more important to make sure existing customers are satisfied with regards to service and fees."

Looking forward one year, it's difficult to assess exactly where the industry will be; however, it's important to try and be optimistic.

"I think average tickets will begin to climb again by the end of the year, which should help acquirers' bottom lines," says Dailey. "There will be continued consolidation in the industry on both the acquiring and issuing side, especially in this time of economic pressure. Credit card default rates are likely to reach historic highs in 2009, meaning transaction counts may not grow year-over-year or could dip slightly. Margins in the processing industry will continue to be razor thin and competition for merchants in a mature market will continue to be fierce. Highly efficient ISOs and acquirers will fare best in this environment."

Steve Schneider sees less competition, but fewer retail merchants and restaurants. However, he believes that new small business formation should pick up in the second half of the year which will offset the shrink in retail and restaurants. "When Americans lose their jobs, many start their own businesses," he adds.

Helgeson is upbeat for a turnaround also. "It is not going to be an easy year and I do expect the year to end with fewer ISOs competing for fewer merchant accounts. With that said, innovative products, a strong focus on costs and a good strategy to deal with the changing landscape will allow some in the industry to survive and be stronger in the end. Quite possibly there may be more advancements in payment applications in the next 12 months than we have seen in the past 10 years.