

Good Advice

Industry leaders talk about weathering the current economic storm and suggest strategies for tackling the challenges to come

Edited by Angela Hickman Brady



Participants:

- Facilitator **Michael Hursta**, vice president, prepaid category manager, First Data
- **Len Sutton**, chief security officer, Apriva
- **Ross Federgreen**, founder, CSRSI
- **John Lorenz**, senior vice president, Brown Brothers Harriman
- **Michael Fisher**, president, Acquiring Solutions International
- **Howard Haffner**, director of MSP relationship management, Elavon
- **Kevin Kidd**, attorney, Waller Lansden Dortch & Davis LLP

The bursting of the credit bubble in late 2008 left many industries reeling. Reduced lending and stricter access to credit led to a reduction in spending by both businesses and consumers. Add to that increased government influence in the sector and highly publicized data security breaches, and the merchant processing industry faces a perfect storm of challenges.

Several leaders in the electronic transactions business sat down at the 2009 ETA Conference to talk about these challenges and offer some advice and recommendations to companies trying to navigate the storm. That discussion, moderated by First Data's Michael Hursta, follows.

Hursta: *With credit being harder than ever to access in recent years, and ISOs' execution on their capital management strategy more important than ever, what advice would you offer to small business ISOs in need of a capital infusion?*

Lorenz: Obviously, credit markets are currently extremely tight. But previously, credit was abundant for middle market companies, as it had been for consumers—each maximizing their borrowings while increasing their cash flow leverage. Credit was cheap, easy, and free flowing, both for personal loans and corporate loans.

Currently, however, banks are tightening their underwriting standards, while offering more conservative loan structures and higher pricing to borrowers. There were too many companies getting too many dollars on terms that were significantly looser than they should have been. Borrowing was influenced by wants instead of needs. Now, you have the economy working against us, and company profits are down for many organizations. If a company had not been disciplined in its borrowings previously, it's hard for them to go back to their bank seeking the liquidity they actually need now to run their business day to day. The terms and structures that are being offered by banks are significantly different than what was available previously. Levels of acceptable leverage are much lower today.

Companies should be looking inward for sources of capital—putting the scarce dollars that you do have to work in the right ways, and maybe pruning back your business, focusing on profitable relationships, and curtailing spending unless necessary. The fact of the matter is, it's not going to be easy to get dollars from the bank or investor at this point. You have to do what you can to improve your own situation.

With regard to the banks, always be ready with a plan B, no matter how good your banking relationship is. A public institution is answering to the expectations of its investors and regulators constantly. That impacts how free they

are to lend to a client, no matter how long the relationship, no matter what industry they're in. Open dialogue with an alternate bank would be a wise move. You don't want to wake up one day to realize your bank is exiting loans within your industry, may have curtailed lending totally, or whatever.

Kidd: There's a difference between businesses that need cash to make payroll in a couple of weeks versus the businesses who are raising money to start a new sales channel or develop new technology. ISOs that need the money in two weeks to make payroll are going to have a hard time these days with the tight credit markets. Two years ago, it was much easier to raise capital either through debt or equity financing. Now that the credit markets have contracted, it's very difficult.

There are ways to raise capital in this difficult market, though. Many smaller ISOs that don't have portability can sell their rights to residuals. ISOs with portability rights can sell their portfolios—though multiples for both types of sales are much lower these days and attrition protection (higher holdbacks, earn-outs, claw-backs, etc.) is more prevalent. There are also lenders out there who will make advances on residuals, which can be an expensive way to raise cash, with higher interest rates, fees, etc., but ISOs don't have to sell their residuals or merchants. There are also mezzanine lenders like Harbert Mezzanine Partners and senior debt lenders like Wells Fargo Foothill who are actively seeking good credits.

Federgreen: From an institutional basis, I would say several things: Number one, valuation is the Holy Grail today, and nobody knows what it is. The other problem with valuation is that nobody's willing to risk their career on valuing something they are not sure of. Another issue is that the institutions want to do business—because that's how they make money—and are unable to do business because of an unknown and absolutely quicksand-like changing regulatory atmosphere. So, people have to understand



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that it's not because they've done something wrong, it's just that there's no direction as to who has authority and what they have authority over.


So I would say this: If you do have free cash flow, you should be thinking about reinvesting it in your business core or key functional areas, rather than spending it. I also think you need to prune the tree. The 80/20 rule is really applicable in today's environment. Find out who gives you 80 percent of your revenue and focus on them. And whatever happens to the other 20 percent, which may be the mass number of your clients, don't worry about it.

Open dialogue is critical. If you're going south as a business, don't wait until it's two or three weeks before you have to shut your doors. I think bankers like to know well ahead of time. Bankers feel good about helping people, in general. And, the more lead time you give your institutions, the better position you put yourself in.

Lorenz: As banks are tightening credit standards, they're also taking the opportunity to reprice many credit facilities to reflect the scarce availability of capital. Companies should be very vigilant to stay within the guidelines of their credit agreement, if at all possible. If not, there is a very strong likelihood repricing or restructuring of the terms of the facility could occur, even for the smallest of violations. So companies really have to mind their P's and Q's to make sure they're hitting their financial covenants, getting their financial statements to the bank on time, etc. Whatever they

promised the bank they were going to do, they should do. Otherwise, the repricing that's going to occur on a deal that happened two years ago will be significant. And, on a company that is experiencing constrained cash flow, any incremental cash flow requirements associated with a rate adjustment or a restructuring could have a material negative impact on that company.

Haffner: I think it's important for an ISO to partner with an acquirer that's willing to infuse cash into their business and values a residual stream as an asset with a willingness to lend against that. I think that, as opposed to selling the residual



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stream, lending against it is a lot smarter option and then the residuals are still there after the loan's repaid.

Hursta: *Some would argue that merchants are even more receptive in times like these to product offerings that could help build their business. Examples would be prepaid, loyalty, and mobile solutions. How should an ISO position these offers to get the best reception?*

Haffner: ISOs have to help a merchant accept all forms of payment from their customer right now. Traditional consumers, who would normally be putting things on a credit card, may not have that same credit availability right now. Merchants have to open up as many different payment options for consumers as possible. And ISOs have to help the merchant do that.

ISOs should rethink the existing products they have and how to reposition those, like gift cards. Rethink using that

product from a traditional gift card program to a marketing strategy for your merchants to bring in additional customers: Launch a marketing campaign with that merchant to bring in new customers through the use of gift cards. ISO, should make sure that they've partnered with an acquirer that offers many types of payments so they can deliver those to the merchant. Then, the ISO can help the merchant think creatively about how to accept the various forms of payments.

Hursta: *With regard to mobile payments, I think we're starting to see some areas where critical mass is being reached—in particular, taxis, mass transportation, and other verticals like that, where mobile payments really open up a brand new opportunity for merchant acquiring. Can ISOs take advantage of these sorts of opportunities?*

Sutton: The mobile opportunity is so huge and is perhaps the best kept secret in merchant services right now. I think that the number of merchants that are using mobile solutions is going to track very similarly to what cell phones have done over the past 15 years, and will track very similarly with the issues related to nonmobile communications that are rapidly being dwarfed by the mobile alternatives in personal and other types of communications.

AT&T has somewhere in the neighborhood of half again more customers in the mobile arena than they do in the landline arena, and I think that's where we're headed within the merchant services business, as well. There are so many aspects of the mobile alternatives that provide more flexibility to merchants, regardless of whether they're working inside or outside of brick-and-mortar facilities, that together make a very compelling business for mobile solutions. If you extrapolate the various opportunities and cost benefits over a couple of years' time, it just makes a lot of sense to be seriously looking at mobile capabilities. The cost of technology and infrastructure is just more favorable over the longer term with mobile, and you continue to see competition in the mobile service provider arena, that will keep costs competitive in that area

Haffner: The challenge for ISOs is considering where the merchant is with mobile devices—in a traditional brick and mortar setting or on the Internet. At least on the Internet, you know there's a domain associated with it. For brick and mortar, obviously, there's a physical address associated with it. ISOs should be aware of that, especially liability-holding ISOs—understanding the risk and possibly pushing that risk to the acquirers because of their level of sophistication in dealing with the risks.

Sutton: I agree. I think ISOs also need to be sensitive to merchants needing to transition their business model from strictly retail to a mixture of e-commerce and mobile or vice versa. I've spoken with merchants and some of the providers in the e-commerce arena, and as the smaller and middle-tier e-commerce merchants begin to develop some degree of momentum, they're starting to look at ways that they can branch out and reach more customers, and mobile solutions tend to be very accommodating to that type of transition—and more so than most nonmobile approaches.

Hursta: *A recent poll by creditcards.com asked the public if the government should regulate the credit card industry more closely. Nearly three quarters of the respondents indicated that they either strongly or somewhat agreed that the government should. Do you expect to see more regulation of the credit card industry? What sort of immediate impact might this have on the merchant processing portion of the credit card industry?*

Kidd: The entire industry will see much more regulation in the next year and beyond. Many bills proposed in Congress over the last months are attempting to regulate the issuing side of the business as well as aspects of the card business that would affect ETA members. The issuing side of the business is getting most of the attention in Congress since consumer protection is a big deal to the Obama administration. The Credit Card Bill of Rights has been proposed in Congress and it attempts to regulate fees, interest

rates, and various other practices. [Note: This bill has since been passed by Congress and signed into law by President Obama.] Other bills have been proposed over the last few months related to regulating interchange or the discount rate, data security, and databreach notification and these will affect our members.

I think it's pretty clear that Congress and other folks in DC do not understand the differences between the issuing and acquiring side of the business, and that affects the bills that are proposed. For example, regulation of interchange is frequently discussed as a "consumer protection" issue, but it is clearly more of a business-to-business issue. Advertisements propagated by retail associations in support of interchange regulation have tried to paint interchange as a "hidden fee" consumers pay, and that is clearly not the case, though Rep. John Conyers (D-Michigan) and others in Congress would have their fellow members believe it. I think the most problematic thing we could see this year would be an interchange bill that is drafted broadly to include not just interchange but the entire discount rate. This would have a direct negative impact on our members.

The ETA Government Relations Committee, and especially ETA's Mary Bennett, have done a great job this year in keeping members in the loop with alerts and action e-mails. And with all the legislation that is being proposed and the changes in the regulatory framework of the financial sector, this may be the most important year for ETA's involvement in government relations.

Federgreen: I think we all have to accept and agree that, as an industry, we're salmon swimming upstream. The political consequence is so great for Congress not to do something that something is going to happen. And it's much easier here to target the villain, being the banking industry.

When you look at the legislative history, over the last three congresses, you'll see that the number of bills introduced has increased. The first day of the 111th Congress, which is our current Congress, three bills were introduced related to data security. But, not known as PCI because, frankly, nobody knows what PCI is. It's under identity theft,

and identity theft is a political, beautiful thing. Everybody is against it. Nobody is for it. And, there's no political capital to be expended.

Our position as an industry has to be, 'Yes, something is going to happen, and, yes, we agree that something needs to happen.'

I think there's a great opportunity for institutional acquirers with regulation. The vast majority of merchants have absolutely no clue what interchange is. The ugly truth is the vast majority of people in our industry have no idea what interchange is. They don't understand what it is, how it's derived, how it's made, what it accounts for.

Hursta: Last month, there was a House subcommittee that held hearings on the efficacy of PCI standards. A lot of the questions that were asked during that session presumed an inability of PCI to properly protect cardholder data. How do you expect the PCI SSC or other stakeholders to raise competence levels on payment security? How should ISOs talk to their clients about what PCI does or doesn't provide for?

Haffner: PCI standards are very similar to airport security. They are designed primarily to make us feel we have a safe system. But, currently, I don't think it's particularly effective because so much is dependent on self-assessment. The TSA questions about 'Have your bags been outside of your control and do you have anything in them' were dropped because it didn't really have a whole lot of effectiveness in changing anything. PCI self-assessment is much that same thing.

As an industry, we have to figure out what we are trying to accomplish. Are we trying to get a perfect system, and what is the cost of that—of getting to that point where there is zero loss? Do we still have acceptance from cardholders and their ability to use cards at that point? Do we still have the ability for merchants to accept cards at that point? And, what is the realistic scenario, because a perfect system only exists in academia.

Sutton: There's no security system that is absolutely fail-proof. The card industry has done its best efforts of stepping



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up to the challenge with PCI, although I think there is acceptance of the reality that there are a lot of vulnerabilities and a lot of touch points of opportunities for compromise and for failures to occur. There are a lot of very motivated and very smart people out there exploring every one of those opportunities.

It's kind of like the joke about the two guys on the sinking boat surrounded by sharks, and the issue is not whether or not you can out-swim the sharks. It's whether or not you can out-swim the other guy. We're very much still in that mode in dealing with the risk of data compromise and identity theft in that arena. PCI has been the target of much criticism, but I don't think the answer is to throw the PCI baby out with the bathwater. At the same time, an organization that is following its best efforts at trying to comply and show good efforts in protecting data should not necessarily be sent into the wilderness because of a failure that does occur. But for now, PCI is really the only platform we have to start from, and we have to go forward with what it is.

Haffner: I think the industry is doing a decent job across the board. If you look at overall fraud-loss, and basis points in this country, it's much lower than other regions around the world. That says a lot right there—that our system, for many different reasons, is a lot more secure than other systems, even though we don't have as close of regulations on it as other places do.

An interesting point that you talk about is identity theft. And I think the media has done a good job of confusing consumers about that term. I hear people talking all the time, saying they had their card number compromised through

whatever means, and they say that their identity has been stolen. Well, it's not the same thing. I think that there's a huge fear factor going on there, generated by the media, having to do with identity theft, and equating that to card number compromise, and that's a problem.

Sutton: If we can take the idea of disclosure of personal information out of the equation, and look at the identity theft as when someone actually is successful in conducting some type of transaction impersonating you. We need to separate the ability to actually perform a fraudulent transaction from simply having knowledge of someone's social security number. We need to have a better means of more accurately authenticating parties to the transactions, using something other than static ID numbers and dates of birth has to come into the fray. Then, preventing the fraudulent transactions



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from occurring will be a separate issue from protecting the data from being disclosed. And, if we can do a better job of authenticating the parties to the transaction, that may take some of the pressure off of the extraordinary means we have to go through to try to make sure that information ever disclosed.

Hursta: *Is there an opportunity here for ISOs to position data security as a competitive advantage?*

Haffner: Absolutely. Because of the flight to quality, I think that they can definitely use it as a selling tool, and tout the need for complying with PCI standards, and also understanding what the different regulations are, and being able to bring

those things together and create their own value to a merchant. I think the reputational risk of a breach to both large and small merchants is definitely something that should be considered. With a large merchant, obviously, it would be highly publicized. And, with a small merchant, they're very entrenched within their own communities and don't want to be known as that merchant that compromised cardholder information.

Kidd: There are over 45 states that have databreach notification laws, and a lot actually require public disclosure. And all of those laws have different standards, different notice requirements, etc. When a data breach occurs, it's difficult to determine how to comply with all of the different state data breach notification laws. There is actually a national data breach bill (HR 2221) that has been proposed that would create a national standard for notification in a data breach situation. As it's drafted, it would preempt most of the state data breach notification laws and could really help those who have suffered a breach understand how to cope with it from a compliance standpoint.

Hursta: *Are there any cost benefits, beyond just reputational risk? For example, interchange rate reduction, or chargeback reduction? Can it be said that data security has led to improvements in the cost for taking payment?*

Haffner: I don't think that you can really point to an overall decrease in interchange that happens because you're more secure, with the exception possibly of e-commerce. And, I think that the chargeback implications are secondary to the issues of dealing with those chargebacks that could come from a data breach. I don't think necessarily that there's a cost reduction ability with making sure that you're compliant.

Federgreen: The other side of that shoe is that, in every standard merchant acquirer relationship now, there are codicils that address failure to become PCI compliant. And, therefore, that failure leads to the potential of the acquirer to raise rates

and to assess the merchant supplemental fees and even terminate the relationship regardless of whether or not there was an actual breach. So, the penalty for noncompliance, regardless of the lack of statistical validity is there.

So, you can look at it as a positive result that we're doing this, or you can say there's a negative reinforcement. If you don't do this, you're going to get yourself boxed. There's real teeth that the average acquirer has. They have to make sure that PCI is, in fact, attempted, if not validated, by their individual merchants, which I think is a good thing—and also probably lessens the ultimate legal burden on the part of the ISO and the acquirer or the chain further.

Haffner: Those teeth are definitely present on our overall merchant realm. But, it's very hard for an ISO to actually make that argument when dealing with a merchant. Right now, there's not necessarily a perceived value, as far as monetarily.

Fisher: So how often have you all seen the sale of the PCI compliance as kind of data breach insurance?

Haffner: Starting this year, more so than any other time—and mostly because of PCI mandates.

Federgreen: I think the next step of the transition is that, right now there's a lot of 'stick' involved. But the other misnomer that many merchants have is, 'I completed my SAQ, whatever it is this week. And, that's the end of the story.' Well, really, guys, that's the beginning of the story. The remediation is the real expensive side. And that gets lost in the translation. The remediation part is the real sticky wicket. And, the requirements for ongoing logging and auditing and all the rest of it are not fully there yet. But, the good news out of this is, yes, the education is beginning to occur.

What do we do with these millions of merchants that are traditional Level 4? How do we get the message across, and how do they do it in this very tight, tough economic time? It's a real issue.

Hursta: *With TARP and other federal funds going to many financial*

institutions, especially large name brands, which often have merchant processing divisions, has this created any negative perceptions in the merchant marketplace toward those institutions? Have the independent sales channels benefited from any shift in public opinion toward banks?

Kidd: I think public opinion has certainly turned on the banks that have gotten the TARP money. I'm not sure it's made its way down to the ISO level or the merchant level, in terms of who they're going to use with respect to their acquiring relationship. Probably, if someone in the industry is looking for financing, even though a bank may have gotten TARP funds, the fact of the matter is there's not a whole lot of banks lending today. So, if that bank is lending, they're probably going to have to talk with them.

Lorenz: I think some may feel that they may have an issue with a certain bank, or with how a certain bank is acting. People need to be aware that with any bank that has accepted TARP funds, the only certainty is that there's going to be uncertainty right now. We have seen that conditions attached to programs such as TARP have changed, been added to, etc. All of these changes could affect how a given bank makes credit available. Have other options out there. Talk to your bank and others. You need to have a plan B all the time.

Hursta: *As merchants are faced with managing through this recession, the opportunity exists for ISOs to become trusted advisors on new technologies, services, pricing programs, things of that nature. What are some key strategies ISOs should be actively talking to their customers about? And, what are some of the ways ISOs can provide value to a merchant?*

Sutton: ISOs have really got to spend time knowing their merchant and developing a relationship between themselves and their merchant base, so that they're perceived by the merchant not as just trying to sell them something else—but

as a partner of the merchant, working together to address the risk landscape.

Haffner: I think that ISOs have to understand what their value proposition is before they can go out and sell that value. I think it's something that doesn't often happen, where an ISO sits down and thinks about the value they're bringing to the table and why they should be there in that relationship. But, I definitely agree with a consultative and cost-reduction type of approach—not necessarily, 'Can I lower your rate?' but 'How can I improve your acceptance means, and how can I increase the amount of technology within your business that will allow for you to bring overall cost reduction?' That will help the ISO be able to understand how they're bringing value to that merchant.

Being consultative in your sales and understanding the regulations that are affecting your customers is important. Are you bringing to merchants the actual solutions that they need in that particular industry? That means staying ahead of the regulations, compliance, and what's happening as far as the trends go and accepting payments in their business.

Hursta: *Merchants under financial stress will naturally turn to cost reductions wherever they can. What is the message ISOs should be promoting to sell the value of their services to keep the conversation away from purely rate reductions? Are there pricing strategies that more effectively deflect competitive offers?*

Haffner: Absolutely. They need to make sure that their acquirer is giving them the ability to break out association fees separately, so that merchants can understand what those association fees are versus what the other fees are that they're being billed. What's happening is there's a continuous downward pressure on the rate, but there's no downward pressure on the association fees and on the interchange. So what needs to happen is that you have to be able to have the ability to break those out, so that merchants understand the difference, and understand that that overall

2 percent or whatever it is that they're paying does not all go to that ISO.

Federgreen: Do you think there's any advantage for an ISO to present a traditional three-tier program or an interchange program, or some blending of each? When you talk about splitting out nine-and-a-half basis points for this one or that one, whatever it might be, versus just giving somebody a number?

Haffner: I think the best way to present pricing to a merchant is to discuss the overall cost of processing. As an industry, we have trained merchants to talk about a qualified rate. And when really thinking what a qualified rate is, very few card products now fall into that.

Hursta: *Are there any particular sales models or practices you'd recommend when it comes to lead generation, telesales, anything else that you see as particularly advantageous today to getting the attention of merchants?*

Haffner: We've got ISOs that run the gamut as far as different types of strategies. We've got ISOs that are focusing on particular niches, ISOs that are very diverse and cast a very wide net. I think that diversifying your lead sources is the most reliable strategy, not bringing in all of your leads just from a banking relationship or just from an association relationship, and not bringing in all of your new business just through agents or just through a direct sales force.

You've got to think about how your business is coming in, and what happens if one of those particular lead sources dries up. It's important to look at your model and understand if it's diversified enough. 'Do I have enough diversity that, if I have one large referral bank, and that bank is acquired by another bank that does not have processing through me, am I going to be able to sustain that?' You know, 'What is my plan for when that goes away?'

Also, there are a lot of ISOs that make the mistake of focusing in on a very few customers. When one of those customers goes away, which inevitably it will, what happens at that point? **TT**