Processors from Mars, Bankers from Venus

Processors are still struggling to become fully customer-focused and move to an orbit that synchronises with banks rather than collides – while banks want tailor-made services for a commodity price.

Earlier this year Visa Europe and Payments Systems Europe (PSEL) conducted a survey interviewing senior executives at 20 major banks and 11 larger processing companies to understand their views on the **Future of Card Processing in Europe**.

The rationale for the survey is that times are changing. Increasingly Europe's decision makers in the European Commission (EC), the European Central Bank (ECB) and the European Payments Council (EPC) are recognising that card processing is the glue that holds together an infrastructure handling over 30 billion transactions per annum. Many believe that Europe's card processing sector has to change radically if it is to serve effectively the planned Single European Payments Area (SEPA).

So the survey set out to establish bank and processor opinions on the major drivers for change, the key enablers to deliver a new infrastructure and the influence of banks, card schemes and interbank and third party processors on the future processing market. We were seeking feedback on the operational models major banks have adopted, as well as understanding how well the processor sector serves Europe's banks.

The survey identified many controversial views and opinions. These are reviewed in the survey overview and detailed output, which can be obtained either from Visa Europe or from Payment Systems Europe.

However, the 55 to 60 hours of interviews also highlighted some unexpected misunderstandings between banks and processors. Several relate to confusion over the terms used by both parties to describe their requirements, propositions and products. Others relate to the different business models used by US and British Isles based processors and those adopted in several mainland European countries.

Problems sometimes occur as soon as banks go out to RFI or RFP for processing services (Table 1). As this summary shows, mainland European banks do not always receive the responses they anticipate. Too often, processors jump to conclusions or offer solutions which are either over-sophisticated, or misaligned with their customers needs.

Mainland EU Bank Requirements	Unexpected Processor Offers
• EftPos processing solution • Low cost credit card processing • Standard utility service • Pan EU/multi-country processing • Debit card processing solutions	• Merchant portfolio acquisition • High cost complex Anglo-Saxon applications • Complex bespoke solutions • Very limited functionality – few features • Credit card variant offers

Table 1 What Mainland EU Banks Want and What They Are Offered

This confusion extends to the terms used to describe processing functions. Banks sometimes misunderstand the key differences and benefits associated with "facilities management (FM) outsourcing" and "multi-client processing". Both parties have different perceptions of market drivers and trends.

Banks believe processors will have limited impact on Europe's payments business, while some processors have an opposing view and believe they can be key influencers and can help set overall strategies. Similarly, many processors perceive strategic outsourcing to be a major growth market. However, many of the large banks interviewed are committed to in-house processing, will only outsource on a tactical basis and believe that outsourced processing will grow only modestly.

So the survey highlights many different views and perceptions. Can it be argued that this is not surprising because processors are from **Mars** and bankers from **Venus**? There are three key areas of difference. First, the requirements of the pan-European bank. Second, the confusion over the merchant asset purchase business models and third, the style of Anglo-Saxon/US processor marketing and selling.

The first misunderstanding relates to multi-country or cross border processing. Aggressive M&A within the new CEE countries by old EU banks over the past decade has created several banks with multi-country operations, including ING, Erste Bank, KBC, UniCredito and Bank Austria. Within the old EU, Danske, Nordea, SCH and Barclays have extensive and growing EU wide operations.

The synergies and benefits generated from cross border M&A are substantially less than those to be won from domestic M&A, where there is great potential for branch and head office rationalisation – with Royal Bank of Scotland's acquisition of NatWest perhaps the outstanding example.

Pan-European banks are, therefore, focusing on the concept of developing common products which can be sold to customers via common delivery channels in each country. Most pan-European banks believe that major savings can be made through the centralisation of product development and marketing and the phased replacement of each country's domestic systems. To be effective, this concept needs common delivery platforms and processing infrastructures.

As a result, many pan-European banks are looking to the processor sector to provide multi-country solutions. However, some are disappointed to find that processors can only meet 50% - 60% of their requirements. Table 2 provides a summary of the typical requirements of a pan-European bank compared with PSEL's estimation of the capability of the top five EU processors to meet these needs.

Pan-European Bank Requirement	Top EU Processor % Fit
Multi-country ATM driving-switching	30 – 40
Multi-country POS driving-switching	60 – 65
Multi-country merchant back office – clearing settlement	75 – 80
Multi-country ATM back office – clearing settlement	30 – 40
Multi-country card production-personalisation	80 – 90
Multi-country current (debit card) account engine	10 – 20
Multi-country loan/mortgage account engine	60 - 70
Multi-country savings account engine	10 – 20
Multi-country personal account back office	10 – 15
Multi-country credit card engine	85 – 90
Multi-country credit card back office	85 - 90

Table 2 % Fit Top Five EU Processors Capability to Meet Multi-Country Needs of Pan-EU Bank

Not unreasonably, banks find it difficult to understand why the processor sector cannot deliver all their requirements. But from a processor perspective the reasons are clear. Constructing multi-country cross border processing solutions are undeniably high risk, high cost and for possibly limited rewards. The small number of processors which have built, or are building, solutions have incurred cost over-runs, primarily because of the complex interfaces and country specific features which have to be developed to link into legacy systems in each country.

Most processors traditionally work on the basis of "sell and build". None has speculatively built a single fully integrated multi-country solution, able to deliver ATM, EftPos debit and credit card processing. In addition, pan-European bank account and card volumes may be too low to interest the largest processors. Inevitably, processors are bidding high prices, leaving pan-European banks with the impression that their needs cannot be met.

Can this impasse be resolved? In the end, banks will get what they pay for – and pioneering developments do not come free. Provided prices are realistic and justifiable, pan-European banks may be best advised to pay the price for a high risk venture, particularly where they want an exclusive contract to prevent competitors benefiting from any service developed.

The alternative is to build in-house, using a mixture of modified proprietary software components. For some banks this is a possibility, but few have the experience and skills to manage complex multi-vendor solutions. In addition, the software sector is unlikely to provide solutions that have a greater percentage fit than those offered by the processing business.

The second misunderstanding relates to confusion (by those interviewed) over the meaning of "full bank acquiring", "acquirer processing", "transaction acquisition" and "merchant portfolio/asset purchase". Some banks struggle to understand the different commercial frameworks which apply to each. As a result, many interviewed were highly defensive of their merchant relationships (when discussing acquirer processing), claiming that these were strategic to the bank and could not be passed to a third party processor (TPP).

Framework Component	Full Bank Acquiring	Acquirer Processing only	Transaction Acquisition	Non Bank Merchant Portfolio / Asset Purchase	
				Visa	MCE
Scheme Membership	✷				
Merchant Contracts	✷			✷	S
Merchant Pricing/MSC	✷			✷	S
Payments Guarantee	✷			✷	
Payment of Interchange	✷				
Merchant Marketing/Selling	✷			✷	✷
Merchant Risk					
◆ Fraud	✷			✷	
◆ Bankruptcy	✷				
◆ Chargebacks (write off)	✷			✷	✷
◆ Settlement	✷			✷	
Terminal/Network Provision	✷	✷	✷	✷	✷
Merchant Processing					
◆ Front End (routing/auth)	✷	✷	✷	✷	✷
◆ Back End (accounting)	✷	✷		✷	✷
◆ Merchant Support/Voice Auth	✷	✷		✷	✷
◆ Chargebacks	✷	✷		✷	✷
◆ Fraud Monitoring	✷	✷		✷	✷
◆ Settlement/Control	✷	✷		✷	✷
✷ = component offered **S** = shared					

Table 3 Analysis of Acquiring and Processing Frameworks

As the summary of the four commercial frameworks shows (Table 3), the difference between full bank acquiring and processing is relatively distinct. Acquiring is a risk based offer. The acquirer takes on the risks associated with transaction settlement - the payments guarantee to the merchant, merchant fraud or bankruptcy and chargebacks - and settles with the merchant and card issuer. The acquirer also, either directly or indirectly via a TPP provides all the components of acquirer processing.

Acquirer processing is what it says - the provision to a bank of all the IT processing components of acquiring, often with the option of terminal provision, merchant support and back office clerical processing. Acquirer processors are not on risk, do not have direct merchant contracts and charge banks a processing fee of €0.07 to €0.09 per transaction.

The term "transaction acquisition", which also causes misunderstanding, typically applies where three-party schemes (American Express, Diners Club or JCB) or finance house like GE Capital or Cetelem contract with an acquirer to enable its terminal to accept their cards. These deals also route authorisations and electronic drafts from the acquirers' terminals to the scheme or finance house card processing operations, but nothing more. Acquirers usually charge a premium processing fee to cover terminal and support costs.

However, most confusion occurs over the difference between acquirer processing and "merchant portfolio" or "asset" purchase. A merchant portfolio purchase proposition is typically made by a non bank, usually a TPP or Independent Sales Organisation (ISO), to an acquirer to buy the right to an existing "on risk" merchant revenue stream, and also to grow the business, often using bank sourced leads.

Deals like these come in many shapes and sizes. A substantial upfront payment is often made to "buy the exclusive rights to the asset" and exploit the bank's brand. Variations include revenue sharing and phased payments of tranches of capital when milestones are reached. The bank may employ the non bank as its "on risk" acquiring agent, sometimes subcontracting all aspects of the merchant relationship to the TPP or ISO; in other cases, it may retain control of marketing and selling.

The differences between processing and portfolio purchase are further complicated because the two international card schemes have adopted different approaches to these deals. Visa's rules relating to Non Member Agents (NMAs) are not onerous. Provided the member ensures the agent operates to rules which conform to Visa regulations, and the member clearly communicates the role of its agent to merchants, then Visa is likely to approve the agreement.

On the other hand, MasterCard Europe does not allow third parties or Member Sponsored Processors (MSPs) the same degree of freedom. Their rules limit the assignment of risk and of settlement processes, while the member bank also has to be a party to merchant contracts. Given these differences, together with the fact that NMAs/MSPs are typically processors as well, it is not surprising that banks are easily confused.

So how should banks react to approaches from processors? Table 4 summarises the advantages of asset purchase over conventional processing contracts.

Advantages	Disadvantages
• Substantial upfront payment • Long term revenue streams • Reduction in staff/operating costs • Substantial reduction in cost of change (EMV etc) • Option of controlling marketing/sales • Release of resources skills for high margin products • Delivers processing solution at same time	• Loss of merchant card acceptance relationships • Residual merchant card scheme risk • Loss of control and management • Lead generation but no/low reward • Loss of acquiring skills/knowledge • Complex agreements with cost of monitoring • Internationally branded cards only – not domestic scheme • Too few players

Table 4 Advantages and Disadvantages of Merchant Portfolio Purchase Deals

Upfront portfolio purchase payments can be between €1,500 to €3,000 per active merchant account. The TPP or ISO takes on the high costs of systems change, resulting in lower bank staff levels and the release of management to develop and promote higher value corporate products.

There are disadvantages too, including the limited number of European providers. Nova/euroConex has deals with Alliance & Leicester in the UK, Bank of Ireland and CardPoint in Poland, while First Data International has a deal with HBoS in the UK. The terms inevitably involve some loss of merchant acquiring relationships. Banks also continue to carry elements of scheme and merchant risk. In addition, TPP or ISO deals generally apply to internationally branded cards; for mainland Europe, this means local debit card scheme brands are excluded, limiting the scope of any offer.

The third misunderstanding relates primarily to processor culture and style. Several banks interviewed complained that US processors do not understand their requirements and typically propose products more suited to the US or British Isles marketplaces. Some claimed this to be a long standing misconception that has existed since the early 1990's.

Have processors misaligned their selling, and have their sales messages been poorly constructed? Following their entry into the massive UK market, US perceived mainland Europe as a marginal credit card processing opportunity.

But for mainland European banks, the credit card was a niche product. Many lacked the skills to set up and operate a new product and concept and turned to US processors for services. Confusion sometimes occurred when mainland banks bought over-complex US or UK products which their less sophisticated customers used infrequently.

Processors tended to sell reactively and failed to recruit local sales staff, instead using English speakers who inevitably sold an Anglo-Saxon model in an Anglo-Saxon style. Many banks also wanted low cost debit card processing services, but debit processing was outside the ambit of the US

card processors, which had little knowledge of current account infrastructures.

Feedback from the survey indicates that processors are changing, although there is still much to be achieved. Most now sell in the local language. Most understand the mainland European banks requirements are for simple, low cost, credit and card management solutions. Most now work hard at adapting US and UK solutions before they go to market.

To sum up, meeting the needs of the pan-European banks is a key opportunity for processors, but banks need to understand that in pioneering a concept they cannot ask processors to carry all the risks. Banks must also accept that no one processor has a universal solution and that, at very best, a 60% to 70% fit can be expected.

Decisions relating to the purchase of acquirer processing services have become more complex as a result of the US asset purchase model. Naturally banks want to protect merchant relationships and do not wish to be disintermediated by third parties.

On the other hand, merchant acquiring is an increasingly complex business which suffers from a constant stream of expensive mandated change. Provided banks retain control, there are benefits to be obtained from revenue sharing agreements and from portfolio sale.

The issues of US-owned processor culture and style are perhaps a reflection of our times. All the evidence shows that these processors are hearing the message and are taking action to improve their marketing and selling.

So are processors from Mars and bankers from Venus? Clearly not, but processors are still struggling to become fully customer focused and move to an orbit that synchronises with banks rather than collides. Good communication between the players is an essential feature if competitive processing services are to develop across Europe to deliver the SEPA concept.

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