



UNDERSTANDING THE COST OF PROCESSING CARD PAYMENTS

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Acknowledgements

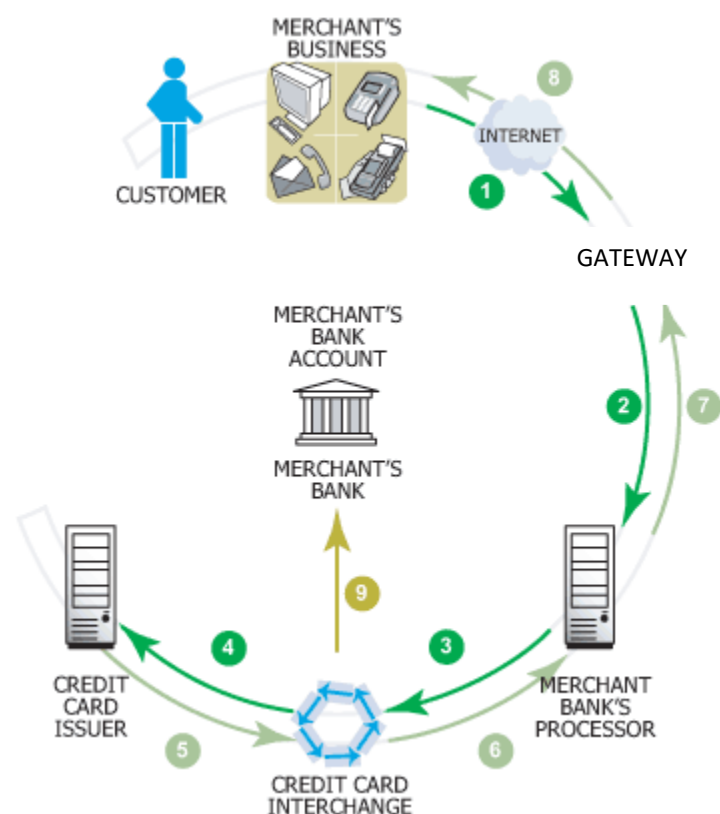
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Introduction

This paper focuses on understanding the costs of accepting card payments. However, before diving into the costs discussion, it's important to understand the basic credit card payment process flow as the costs of card payments are associated with the entities and services provided to support the processes. When a customer makes a credit card payment, a whole series of information exchanges occurs prior to the payment being approved. The chart below provides an illustration and description.

Chart 1 – Flow of a Credit Card Transaction



1. The merchant submits a credit card transaction to processor from a Web site, retail location, call center, or a wireless device.
2. Transaction is routed through a gateway, if applicable, to the merchant acquirer or processor
3. Processor submits the transaction to the card network or card interchange system (a network of financial entities that communicate to manage the processing, clearing, and settlement of credit/debit card transactions).
4. The Credit Card Interchange routes the transaction to the customer's Credit Card Issuer.
5. The Credit Card Issuer approves or declines the transaction based on the customer's available funds and passes the transaction results, and if approved, the appropriate funds, back through the Credit Card Interchange.
6. The Credit Card Interchange relays the transaction results to merchant processor.
7. Merchant processor relays the transaction results to gateway, if applicable.
8. Gateway stores the transaction results and sends them to the merchant. This communication process averages three seconds.

In support of this model, pricing in the credit card processing industry is very complex and merchant statements can be challenging to understand. There are so many technical and industry laden terms (interchange, qualification tiers, downgrades, batch fee, ACH fee, authorization fee, settlement fee, AVS fee, PCI compliance fee, etc.) that it can be difficult to understand the cost of processing card transactions.

To make it simpler, the fees/charges can be broken down into the 3 key drivers that impact the cost of processing credit/debit cards:

- Interchange
- Assessments & dues
- Acquirer fees

Interchange

Interchange is the single largest expense for card processing. For most merchants, it represents 70 to 85 percent of the total cost of processing. Interchange is the price charged by the card networks (Visa, MasterCard, Discover, American Express) for settling a transaction. All the interchange that a merchant pays goes to the bank that issued the card. Interchange fees typically consist of a percentage of each transaction accompanied by a flat per transaction fee (e.g. 1.51% + \$0.10). For card issuers, interchange revenue pays for the cost of money (the bank provides an interest free loan, to a person's credit limit, if the card balance is paid in full), rewards programs, internal costs including fraud, and profit.

The interchange rate you pay for a transaction varies depending on the merchant industry type, type of card used (credit, debit, rewards, corporate/purchasing, etc.), type of transaction (swiped, keyed, internet, etc.), and additional information sent with the transaction (address verification, tax amount, CVV2 (Card Verification Value is the 3-digit number printed in the signature space on the back of Visa, MasterCard & Discover Cards and the 4-digit number on the front of AmEx cards).

When a merchant qualifies for a less than optimal interchange rate, it is called a downgrade. The card networks have interchange qualification guidelines that outline the requirements a transaction must meet for various interchange categories. Transactions that don't meet these requirements will downgrade to an interchange category with a higher rate. A transaction can be downgraded for a number of reasons. Some common reasons for downgrades include not settling the transaction after authorization within the allotted timeframe, failing to perform AVS (Address Verification) for keyed or card-not-present transactions, or having different authorization and settlement amounts.

Interchange rates are set by the card networks; and they have more than 700 interchange rates. Various considerations are involved in how interchange rates are set in the U.S., including the following market and merchant specific considerations illustrated in these charts

Interchange Macro Considerations

- Competition amongst card networks
- Card network and issuer strategies
- Emerging markets/verticals
- Legislation

Interchange Micro Considerations

- Merchant's industry type (MCC – Merchant Category Code)
- Type of card (e.g., Visa Traditional, Visa Rewards, Visa Signature, Visa Debit, etc.)
- Method of entry (swiped vs. keyed)
- Risk and adherence to compliance standards

The latest interchange tables can be found here:

Visa – [April 22, 2017 Schedule](#)

MasterCard – [April 1, 2017 Schedule](#)

Discover – Does not publically disclose, table can be obtained through acquirer

American Express – Not published

For most merchants, interchange cannot be negotiated but it can be optimized. Since there are multiple interchange categories that can apply to a single transaction, it is incumbent upon a merchant to qualify for the best available rate for every transaction. Many companies have saved tens of millions in interchange fees per year by qualifying for the best available rates.

Assessments & Dues

Assessments and dues are the second largest cost of card processing and make up about 10% to 15% of the total cost of card processing. Assessments, ranging from 0.12% to 0.14%, are the flat-rate percentages that the card networks charge against total gross monthly sales. Dues is a grouping of all the various, small miscellaneous fees charged by the card networks. These are mostly per item transaction fees that are charged per authorization and settlement of a sale. Some dues fees are charged on every transaction, whereas, others are charged based on the characteristics of a transaction.

Assessments and dues are paid directly to the card associations and cover the operating costs of managing their networks. All credit card processors are subject to the same assessment fees, and these fees are passed on to merchants at cost. However, a few acquirers tend to markup some of these fees. There are about 30 different assessments and dues fees.

Like interchange, assessments and dues cannot be negotiated but there are a few areas where these fees can be optimized.

Acquirer Fees

Acquirer fees are charged by the payment processor or merchant acquirer (acquirer), the organization that provides authorization, reporting and settlement. On average, these fees make up about 5% to 20% of the total cost of card processing. For small merchants, acquirer fees can be as high as 50% of the total cost of processing cards. Acquirer processing fees are paid to the merchant processor for authorization, settlement, reporting and account management services.

There are numerous acquirer fees and the names can vary depending on the acquirer. Sometimes it's difficult to understand acquirer statements as fees may be bundled, or presented as tiered rates.

Some acquirer fees you may see on your statement can include:

- | | | |
|-----------------------|---------------------|-----------------|
| • Terminal Fees | • Gateway Fee | • Service Fee |
| • Monthly Minimum Fee | • Authorization Fee | • Account Fee |
| • Statement Fee | • Settlement Fee | • Reporting Fee |
| | • Processing Fee | |

All of these fees are negotiable. Merchants, billers, suppliers, etc. who take the time to review and understand their monthly statements and effectively negotiate with their acquirers may be able to save significantly

To get the best pricing from your acquirer:

- Favor Interchange pass-through pricing so you have transparency and are able to identify fees that form interchange, assessments and dues, and processor fees.
- Favor consolidating your accounts under one acquirer for better pricing and security management if you have multiple sales channels with multiple merchant accounts.
- Renegotiate all of your fees when renewing your card processing contract.

Pricing for Acquirer Services

Now that we have an understanding of the components of credit card processing costs, let's look at the different pricing structures you may be presented with from your acquirer. There are 3 main types of pricing models for processing card payments.

1. Interchange Pass-Thru Pricing
2. Tiered Pricing
3. Bundled Flat Rate Pricing

Interchange Pass-Thru Pricing (also known as Interchange Plus)

This type of pricing allows the actual cost of processing (interchange + assessments) to be passed directly to your business. Processors take the interchange rates and add a fixed markup for every transaction. With this type of pricing, you'll know exactly how much of a markup over the interchange rate you are paying. This is the preferred and recommended pricing solution for merchants and others accepting card payments because it provides transparency into the true cost of card processing.

Tiered Pricing (also known as Bucket Pricing, Standard Pricing, or Qualified Pricing)

This pricing method allows acquirers to bundle several hundred different processing interchange rates into multiple pricing tiers, typically 2 to 5 tiers with 3 tiers being the most common. Many acquirers will present the following 3 tiers - Qualified, Mid-Qualified, and Non-Qualified. The acquirer charges a merchant a fixed amount for any transaction in that tier, regardless of the credit card acquirer's underlying cost.

Qualified transactions (the best rate) generally include signature swiped debit card transactions and non-rewards cards (traditional credit cards that don't offer miles or points programs), while Mid-Qualified and Non-Qualified rates are applied to business cards, rewards cards, foreign cards, and card-not-present transactions. Qualified transactions must meet all of the processor's criteria for processing. Failure to meet one or more criteria can result in a downgraded transaction from Qualified to Mid-Qualified or Non-Qualified. This type of pricing can make it very difficult for a merchant to know exactly how much the acquirer is making on each transaction. Merchants may end up paying more with this type of pricing.

Bundled Pricing (also known Flat Rate Pricing)

This pricing model is similar to tiered pricing but the tiers are combined together into a single rate. The acquirer combines the interchange fees paid to the card issuer, the assessment rates paid to the card networks, and adds in their processing fees to create a single flat percentage and per item rate for each transaction. All transactions cost the exact same percentage and transaction fee, regardless of the wholesale cost. This pricing model is attractive for smaller merchants or merchants with a very steady or

low ticket size. This model offers a simplified fee structure but like tiered pricing, it doesn't provide transparency into actual costs.

Effective Cost

By now, you have a sense of the complexity of card payments and the numerous types of fees. It is very difficult to analyze mounds of data from daily or monthly acquirer statements. To simplify this complexity, we recommend that, at minimum, you measure and monitor a single figure – the weighted average effective cost of card payments. This figure expressed as a percentage and trended over time will tell you more about the cost and effectiveness of your payment operations than any other set of data.

Simply, effective cost is total card processing fees divided by net sales (gross sales minus refunds). Effective cost can be calculated for all card brands (e.g. Visa, MasterCard, Discover and AmEx) or a single card brand. A similar approach can be used to calculate effective cost for individual card brands where you would isolate fees and net sales associated with each card brand.

3-Step approach to Calculating Effective Cost

1. Obtain your most recent monthly merchant statement for your processor and American Express, if applicable
2. Sum all fees, regardless of name. The total fees figure will include interchange, assessments/dues, acquiring fees and AmEx's discount fees.
**Note that some processors bill fees one month in arrears. So, the June 2017 statement will have May 2017 fees debited. You'll notice the June 2017 fees in the 'Pending Fees' section.*
3. Divide the sum of all the above fees by net sales (total sales minus refunds/credits). The result is the effective rate or cost for accepting cards.

Determining if your effective cost is reasonable or high really depends on your industry, whether cards are swiped or key entered or combination of both, average ticket and mix of card types.

As a rough rule of thumb, the following matrix identifies the savings opportunity based on a company's overall effective cost if it processes at least \$5 million in annual credit/debit card sales. For instance, if annual card sales for a company are \$50 million and the overall effective rate to process these sales is 2.65% then there is a high probability that savings can be realized if payment products, pricing, and processes are optimized. A few exceptions to this rule include grocery stores, utilities, and businesses with an average sales ticket of less than \$10. Grocery stores and utilities have effective rates well below 1.80% due to lower interchange rates for these industries. And businesses with small average tickets have effective rate skewed higher due to the significant role per transaction fees play in the overall effective cost.

Savings Opportunity Based on Effective Rate			
	<1.80%	1.81% - 2.50%	>2.51%
Retail	Low-Medium	High	High
Internet/Not Face to Face	Low	Medium	High

Example:

Based on OPC's analysis, the average effective cost of card processing in the healthcare industry is 2.52%. In other words, \$2.52 is being paid in credit card and debit card processing costs for every \$100 in billable services. The exhibit above identifies the savings opportunity based on a healthcare organization's overall effective rate if it processes at least \$5 million in annual credit card or debit card payments.

For instance, if annual card sales—both credit and debit—for a hospital, health system, or physician group is \$5 million, and the overall effective rate to process these transactions is 3.5%, then there is potential to save up to 1.0% (i.e., $3.5\% - 2.52\% = \text{approximately } 1.0\%$). For a health system processing \$5 million in card transactions, the 1.0% translates to a savings of \$50,000 per year. That's a significant improvement to any organization's revenue cycle.

Many finance leaders will be surprised to learn of their effective rate; it will be much higher than they expected. The next step is to take action to lower your effective rate. Invest time to learn the nuances of the industry or hire a consultant who can quickly help you decipher the industry jargon and lead you to sizeable savings. Small reductions in overall effective rates can yield profound savings when applied to any company with significant card sales as shown above. In the current economic environment, any and every savings opportunity is significant.

Summary of Key Points

- Interchange, dues/assessments and acquirer fees together comprise most of the all-in costs of accepting card payments.
- Interchange and assessments/dues cannot be negotiated but can be optimized to qualify for the best rate.
- Acquirer fees are negotiable, and there are pricing structures that lead to better understanding of the fees being charged.
- Knowing your effective rate is key to assessing the costs and efficiencies for accepting card payments.



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