



Payments Gateways Opportunities for Acquirers

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Europe's acquiring market place has never been more competitive. All players are chasing revenues and volumes with the expectation of medium to long term profits. Merchants have increasingly sophisticated requirements and many acquirers are struggling to deliver solutions to meet the rigorous standards of PCI DSS and to keep up with change and innovation.

In recent years banks have seen radical change in the ownership of the acquiring landscape as a result of rapid growth of non-bank competitors. Some observers believe that with the RBS sale of Worldpay non-banks share of Visa and MasterCard brand acceptance now exceeds 50% of the EU market.

But is there room for everyone and room for more competition? Let's face it, Europe's acquiring market is large with annual net acquired revenue (Merchant Services Charge (MSC) less Interchange and scheme fees) of over €4.6 billion and a debit and credit transaction volume of over 34 billion. Acquiring revenues are even greater when highly profitable Value Added Services (VAS) are included.

The key driver, with the greatest potential for competitive change, has been the Payment Services Directive (PSD) which allows non-banks to become Payment Institutions (PIs), join the card schemes and become acquirers in their own right. This option is increasingly perceived by processors and other providers as enabling a move up the card payments value chain and the opportunity to generate up to ten times more revenue than pure play processing.

However in recent times the acquiring market has come under regulatory attack by DG Competition and national market regulators, encouraged by the merchant lobby, have first reduced interchange payments to issuers. Secondly, they are now focusing on the contractual terms which come with International Card Scheme (ICS) membership. Potentially all cards acceptance, surcharging, brand and card type selection, central acquiring rules and high MIF premium loyalty cards are targets for detailed regulatory assessment. These interventions will compound the decline in MSCs, a trend established in the mid-1990's and which is accelerating, primarily driven by the European Commission's flagship benchmark intra EU (Multi-lateral Interchange Fee) MIF of 0.2% for debit and 0.3% for credit.

In addition, the market is also changing as a result of innovation. Many new entrants and potential acquiring players are using new technology to win a share of the acceptance business. Traditional bank acquirers are struggling to keep abreast of developments such as

integrated loyalty reward, instant reward redemption, data mining, contactless and Near Field Communication (NFC) technology. They also find difficulties in delivering the more sophisticated VAS such as prepaid top-up, full feature Payment Service Providers (PSP) provision and the coming range of low cost mobile POS devices. The days of Mondex and similar large bank independent payments technology innovations are now long past! Acquiring banks are increasingly followers not leaders and reactive rather than pro-active in developing innovation strategies.

Given these tensions and pressures, where is the crucial pinch point that has potential to destabilise banks conventional positioning in the acquiring market place? Many observers suggest that a key battle ground is in the provision of eCommerce and IP based front end services often referred to as the IP Payments Gateway Market. Two clear trends are emerging, both from different starting points, but both with potential to converge and in so doing create new entities which may upset banks traditional relationships with merchants.

The first trend was established five to ten years ago with the emergence in Northern Europe of independent eCommerce PSPs such as DataCash, Secure Payments, Bibit, Ogone and others. These companies survived the dot.com bubble and have grown in the sophistication and maturity of their acceptance portfolio and the services they offer to online merchants. Yesterday's PSP service offering appears distinctly crude compared with today's range of ICS, domestic debit, ACH, own label/wallet and invoicing payment services offered. More importantly PSPs have successfully interposed their gateway platforms between the merchant (with whom they contract direct) and the bank acquirer. Many acquirers (with a few exceptions) have accepted the role of these new players because they were specialist providers in a niche sector. However increasingly banks have reservations as online payments share of transactions accelerates and eCommerce moves to become a business as usual sector.

The second trend is linked to the high cost and complexity of implementing the PCI DSS rules and associated security mandates for integrated physical world POS. For Level 1 merchants, implementation costs can exceed €2 million and for Levels 2 and 3 often €250,000. For many merchants these costs and the associated risks and collateral damage from a breach, have encouraged the outsourcing of their payment infrastructure to a second form of gateway provider. New processors have emerged offering integrated IP based end to end security linked to the provision of a secure Pin Entry Device (PED) at the merchant's POS. These new IP POS gateway businesses are growing rapidly in the UK and Scandinavia. Again these new players place their gateway services between the merchant and its bank acquirer and most seek to contract directly with retailers.

The driver for convergence between these two different gateway providers comes from merchants increasing recognition that if they outsource PCI DSS compliance to an IP/POS processor then they should logically wish to buy eCommerce gateway PSP services at the same time thus enabling a multi-channel service. The emergence of mobile payments adds a third channel to this mix. The obvious benefits include: a single point of compliance; integrated management information; integrated settlement; support for multiple acquirers; and most importantly a single contract with a single supplier.

So gateway convergence is gradually happening in several European countries, new platforms are developing and larger merchants are seeking single providers who offer one platform to support both physical and virtual Points of Interaction (POI).

Are these trends an opportunity or a threat to traditional bank acquirers? This depends on how banks perceive their future positioning in the acquiring market place. It can be argued that market forces are driving Europe's banks to reposition as providers of back end clearing and settlement services much as in the US, leaving front end processing to the new breed of multi-channel gateway providers. Many small and medium sized acquirers may be happy to accommodate this subordinate role. However larger banks for whom corporate merchant relationships are strategic may be uncomfortable. They face a dilemma. Do they continue to allow non-banks to contract directly with their merchant clients knowing that potentially their merchant relationships may be eroded?

The answer is that some larger banks are now reviewing their approach to the provision of acquiring processing services. Some are in "wait and see" mode. Others are looking at acquiring JVs with non-banks as a means of growing rapidly. A small number may exit.

However those with a longer term vision and the technical resources can consider the "compete option." However to be a player in the converging gateway world banks must invest in building the missing component namely a multi-channel gateway platform. This strategy need not be too disruptive. Many banks can place their new gateway platforms in front of their traditional physical world switches and replicate the services of current gateway providers. This approach, although costly, will enable larger banks to defend against loss of relationships and also to pro-actively offer PCI DSS and PSP services to merchants who increasingly demand multi-channel solutions.

Banks have many choices for gateway solution delivery and can talk to proprietary platform providers and systems integrators. There are available flexible and proven solutions which

can enable acquirers to compete and deliver a modern infrastructure within reasonable timeframes and cost.

So, to conclude, competition is driving change in EU's acquiring business. Non banks are replacing the traditional role of bank acquirers, some enabled by the PSD and regulatory intervention. EU acquirer's grip on large merchant relationships is weakening and potentially banks' services will shrink to that of providers of back-office services only. Large bank acquirers need to be nimble and build and own new gateway platforms to ensure they are able to compete and remain players.

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