Innovative Business Strategies
Chicago Federal Reserve Board
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... Or its consultants
Payers Diagram

BARTER – Un-banked

Transactions

“Currencies”
Abstract representations of value
- Faith of government -

“Accounts”
Abstract of currencies
- Faith in institution -

“Economic Value”
Commodities, labor, etc.

The Association for Convenience & Petroleum Retailing
Current State of Abstraction: Convenience/Petroleum

2008 Industry Sales by Transaction Type

- Cash: 42%
- MC & Visa: 32%
- Discover: 2%
- Proprietary: 7%
- PIN Debit: 7%
- 3rd Party Fleet: 7%
- AMEX: 3%

$624.1 Billion Total Sales
Source: NACS, Nilson (Various)
Innovation KFS

**RETAIL**
- Tran Cost
- Fraud Cost
- Customer Relationship

**CARD BRAND**
- Tran Revenue
- Brand value

**BANK**
- Tran Revenue
- Fraud Cost
- Differentiation
- Customer Relationship

**CONSUMER**
- Value
- Security
- Simplicity
- Convenience
- Control

The Association for Convenience & Petroleum Retailing
The Focus - Consumers

- Value
  - Costs
  - “Rewards”
  - Terms
- Simplicity
  - Ease of use
- Convenience
  - Ubiquity
- Security
  - Identity entire lifecycle
- Control
  - Payment type by purchase
Barriers to Innovation - Consumer

• Value Distortion
  – Current absence of price discrimination
    • Transaction cost comparison is to “zero”
    • Rewards are tangible, transaction costs are not

• Security
  – Consumers are largely insulated from fraud
  – Higher security means lower convenience

• Control
  – No infrastructure ready for multi-homing

• Habits

• Current state of “incrementalism”
Catalyst – Retail Costs Increasing

Interchange Costs Rising & Converging

Source: Federal Reserve Bank of Kansas City

The Association for Convenience & Petroleum Retailing
PIN Debit & Signature Converged in ‘08

**Current Interchange Charged per Average Transaction by Network**
2008 NACS Card Processing Program Data

- **Average PIN Debit Cost – 34.8 Cents**
- **Average cost if all PIN Transactions went “offline” 34.5 cents**

*Includes new network access and chargeback fees*
Catalyst – Retail Cost

3rd Party Card Cost v. Pretax

Source: NACS

The Association for Convenience & Petroleum Retailing
Growth Rate of Key Expenses
2006 - 2008, 12 Month Moving Average

Source: NACS State of the Industry Survey of 2008 data powered by CSX
Cost-based Innovation

• Private Label
  • The least expensive strategy
  • Very difficult to implement in multi-homing economy

• ACH: “Electronic Checks”
  • Can be linked to Private Label
  • Fixed fee transactions < 18 cents guaranteed
  • Could address micro-payments

• Steering
  • Ineffectual in non-face to face
  • Pricing is hard to implement
Catalyst – Retail Fraud Cost

2009 Visa/MasterCard Transaction Cost Components

YTD $23.28 average transaction
Source: NACS CPP (N=900)

- Interchange Fee, $0.4470
- Network Fees, $0.0428
  - Fraud Chargebacks, $0.0116
  - Non-Fraud Chargebacks, $0.0016
  - RC96 Chargebacks, $0.0003

$.5033 Total
Fraud-Based Innovation

• Authentication
  – Reduce fraud charge-backs
    • Verify card in possession
    • Authenticate cardholder (e.g. Zipcode/ID)

• Breach Risk Reduction
  – Reduce cost of PCI compliance
    • Point to point encryption
    • Tokenization
Infrastructure-based Innovation

• De-coupled Debit
  • ACH on ISO rails
  • Developing as multi-merchant

• NFC
  • Emulates MSR cards
  • First step to electronic wallet

• Transaction Routing
  • Least cost processor
  • Creates security risks
Retail economics are ripe for innovation

BUT ....

The Association for Convenience & Petroleum Retailing
Retail Scorecard – 3rd Party Innovation

• Better
  • Reduce/eliminate fraud \( \times \)
  • Eliminate cost of PCI compliance \( \times \)

• Faster
  • Consumer adoption \( \times \)
  • Checkout speed \( 0 \)

• Cheaper
  • Minimal infrastructure investment \( -/0 \)
  • Reduced transaction costs \( -/0 \)
Innovation Landscape: Some Final Thoughts

• Economic incentives between merchants and banks are at odds

• Banks have a problem
  – Revenue under pressure
    • Credit accounts/usage is falling
    • Debit usage increasing, but at lower revenue rate
    • Increasing regulatory oversight of debit costs
  – Security costs will rise
    • Chip and PIN close to zero sum game

• Consumers bored of incremental innovation