Negotiating Credit Card Processing Agreements

November 19, 2013
John Barton
Part I: Negotiating Processing Agreements for Card and Merchant Portfolios
Definitions and Process

Types of Card Processing Agreements

- Issuing Agreements: Processing for issuers that require processing for payment card portfolios
- Merchant Portfolio Agreements: Processing for banks, ISOs, PSP / aggregators and other entities that have merchant portfolios

Negotiation Process

- Objectives and requirements
- Potential processors
- RFP and evaluation
- Term sheet negotiations
- Contract negotiations

Contract Documents

- Customer or processor paper
- Content and structure
What’s Important?

**Customer Priorities**
- Scope definition
- Performance
- Pricing
- Flexibility and leverage
- Compliance
- Fair allocation of risk

**Processor Priorities**
- Same priorities as customer, but with different perspective
- Standard processes
- Flow-through of network requirements
- Expand relationships with customer (and merchants)
Scope

**Implementation and Conversion**
- Requirements definition
- Gap analyses
- Contract documents
- Change management
- Acceptance testing

**Recurring Services**
- Scope descriptions
- “Sweep” clauses
- Retained responsibilities
- Service evolution
- Enhancements
- New services
- Business continuity
Performance - Generally

Performance Standards
- Service descriptions and documentation
- Warranties
- Customer policies and procedures
- Processor policies and procedures
- Industry standards
- Service Levels

Service Level Methodology
- Metrics – objective and quantifiable
- Measurement tools and process
- Measurement period (typically monthly)
- Reporting
- Baselining
## Performance - Sample Metrics

<table>
<thead>
<tr>
<th>Category</th>
<th>Sample Metric</th>
</tr>
</thead>
<tbody>
<tr>
<td>Availability of each key system</td>
<td>99.xxx% availability during scheduled uptime</td>
</tr>
<tr>
<td>Processing timeliness</td>
<td>Structure depends on function – e.g.,:</td>
</tr>
<tr>
<td></td>
<td>• System update to occur by 7:00 am each day</td>
</tr>
<tr>
<td></td>
<td>• If input is in by x time, output must be delivered by y time.</td>
</tr>
<tr>
<td>System Response</td>
<td>Response time for authorization transaction &lt; 1 second</td>
</tr>
<tr>
<td>Processing accuracy</td>
<td>Accuracy of key processing and reporting functions - measured through incident reporting and/or sample audits</td>
</tr>
<tr>
<td>Service Desk</td>
<td>ASA and Abandonment Rates</td>
</tr>
<tr>
<td>Incident Management</td>
<td>Response within ___ and resolution within ____ for x% of incidents</td>
</tr>
<tr>
<td>Merchant Metrics</td>
<td>Dispute Management - Retrieval request fulfillment and resolution times</td>
</tr>
<tr>
<td>Merchant Services (as applicable)</td>
<td>• X% boarded and set-up within ____</td>
</tr>
<tr>
<td></td>
<td>• Timely and accurate statements</td>
</tr>
<tr>
<td></td>
<td>• Service desk</td>
</tr>
<tr>
<td></td>
<td>• Online response times</td>
</tr>
<tr>
<td>Compliance</td>
<td>Timely / successful completion of compliance requirements (e.g., SSAE audits, DR testing)</td>
</tr>
<tr>
<td>Customer satisfaction</td>
<td>Surveys, call monitoring</td>
</tr>
</tbody>
</table>
# Performance - Service Level Credits

<table>
<thead>
<tr>
<th>Issue</th>
<th>Customer</th>
<th>Processor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Credit calculation</td>
<td>- Fixed amount</td>
<td></td>
</tr>
<tr>
<td></td>
<td>- X% (Weighting Factor) * Y (% of fees)</td>
<td></td>
</tr>
<tr>
<td>Amount at Risk</td>
<td>10 – 15%</td>
<td>0 – 10%</td>
</tr>
<tr>
<td>SLA Weighting</td>
<td>150 - 250 points (dynamic)</td>
<td>100 points (fixed)</td>
</tr>
<tr>
<td>Applicable Fees</td>
<td>% * Total Monthly Fees</td>
<td>% * Fees for Specific Service</td>
</tr>
<tr>
<td>Escalating $</td>
<td>Yes</td>
<td>Depends</td>
</tr>
<tr>
<td>Other Remedies</td>
<td>Non-exclusive remedy</td>
<td>Sole and exclusive remedy</td>
</tr>
<tr>
<td>Earn-back</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Improvement</td>
<td>Automatic</td>
<td>Negotiated</td>
</tr>
<tr>
<td>Termination</td>
<td>Specific SLA threshold</td>
<td>Only if material breach</td>
</tr>
<tr>
<td>Excuses</td>
<td>Specific and limited</td>
<td>General and broad</td>
</tr>
<tr>
<td>Bonuses</td>
<td>Depends</td>
<td>Yes</td>
</tr>
</tbody>
</table>
Pricing – Implementation and Conversion

**Implementation**

- Pricing methodology
  - Fixed fee or T&M
  - Payments terms – monthly, milestones and/or hold-back
- Allocation of risk
  - Budget overruns
  - Delay
  - Scope changes
- Processor Bonuses

**Conversion**

- Initial conversion
- New portfolios
Pricing – Recurring Fees

**Metrics**
- Bundled vs. a la carte fees
- Card Processing Metrics – active vs. inactive accounts
- Merchant Processing Metrics – typically transaction-based
- Tiers

**Baselines or “fence posts”**
- Volumes assumed in bundled fee
- Variable fees
- Pre- or post-contract validation

**Productivity Commitments**
- Self-executing
- Cumulative
Pricing – COLA and MRC

**COLA**

- In limited circumstances
- Linkage to renewal terms
- Mechanics: Timing, index, collars, and inflation factor

**Minimum Revenue Commitments**

- Commitment
  - Fixed commitment – annual or term
  - Variable commitment – x% of prior year
- Aggregate commitment or by service category
- What fees count?
- Exclusions and adjustments (divestiture, downturn, SLA failure, discontinued service, regulatory guidance)
- Remedy for shortfall
Pricing - Enhancements

- Classification and allocation of cost

<table>
<thead>
<tr>
<th>Classification</th>
<th>Definition</th>
<th>Cost Allocation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mandatory</td>
<td>Regulatory or card rules</td>
<td>Processor</td>
</tr>
<tr>
<td>Roadmap</td>
<td>Processor priorities</td>
<td>Processor</td>
</tr>
<tr>
<td>Custom</td>
<td>Customer requirements</td>
<td>Customer (or shared)</td>
</tr>
</tbody>
</table>

- Input into roadmap
- Development pools
- Rate structure
  - Onshore / offshore
  - Dedicated or variable
  - COLA
- IP Rights
Pricing – New Services and Other Issues

**New Services**
- Pre-negotiated – options
- Non-exclusivity
- Controls
  - Commercially reasonable price
  - MFC
  - Margin cap
- Accelerated arbitration

**Other Issues**
- Most Favored Customer
- Volume discounts
- Pass-through expenses – administration fees and mark-ups
- Invoicing and payment terms
- No back-billing
Flexibility and Leverage

**Term**

- 3 to 7 years
- Renewal options

**Non-Exclusivity**

- Use of other processors for any services / portfolios
- Cooperation and compliance issues
- Often subject to minimum commitments

**Permitted Users / Reselling**

- Account types
- Affiliates
- Partners
- Sub-processors
- Geography
Flexibility and Leverage

Termination rights

- Convenience
- Cause
- Financial instability
- Regulatory change
- Other material change

Termination for Convenience Fees

- Fixed (declining) fee schedule
- Balance of MRC
- x% of remaining baseline fees
- x% of prior average monthly fees * y months
- Wind-down costs
Flexibility and Leverage

**Negotiated deconversion terms**

- **Scope**
  - Continued right to receive services
  - Knowledge transfer
  - Return of Data

- **Other issues**

<table>
<thead>
<tr>
<th>Issue</th>
<th>Customer</th>
<th>Processor</th>
</tr>
</thead>
<tbody>
<tr>
<td>Time Period</td>
<td>6 - 24 months</td>
<td>0 – 12 months</td>
</tr>
<tr>
<td>Triggers</td>
<td>Expiration or termination for any reason</td>
<td>N/A if customer is in breach</td>
</tr>
<tr>
<td>Fees and rates</td>
<td>Negotiated rates continue</td>
<td>Then-current standard rates or existing plus premium</td>
</tr>
<tr>
<td>Impact on Exclusivity/MRC</td>
<td>Exclusivity / MRC cease to apply</td>
<td>MRC continues</td>
</tr>
<tr>
<td>Extension Rights</td>
<td>Yes (with reasonable notice)</td>
<td>No</td>
</tr>
<tr>
<td>Non-solicit</td>
<td>Merchants</td>
<td>Employees</td>
</tr>
</tbody>
</table>
Flexibility and Leverage

Divestitures
- Right to continue processing
- Impact on minimum commitments, fixed fees and termination fees

Other sources of flexibility / leverage
- Threat of damages – requires clear performance obligations
- Service level credits
- References / Publicity
- New business
- Benchmarking
- Disputed fees
- Controls
  - Approval of key people
  - Delivery Centers
  - Subcontractors
  - Policies and procedures
  - Change control
Flexibility and Leverage – License Option

**Option**
- Source code license to a processor’s system
- Any time if trigger event occurs
- After x years for any reason

**Pricing**
- Recurring license fee
- Declines over time

**Other Considerations**
- Knowledge transfer – during and after term
- Custom instance
- Third party software
- Escrow
- Ongoing support and IP issues
Compliance

**Compliance**

- Laws and regulations
  - Laws applicable to processor
  - Laws applicable to customer
- Industry rules and standards – PCI, NACHA
- Network rules Applicable laws / regulations
- Customer policies and procedures
- Processor policies and procedures

**Controls and Monitoring**

- SSAE 16 – SOC 1, 2, 3 audits
- Data security and financial audits
- Service locations
- Subcontracting
- Background checks
Cost of a Data Breach (US)
- $188 / record (increases to $277 when breach is malicious or criminal)
- Average size of breach: 28,765 records
- $5.4m / incident
- Data excludes mega breaches (>100,000 records)
- Actual costs vary significantly by industry

Type of Costs
- Direct costs include (i) engaging forensic experts, (ii) outsourcing hotline support, (iii) providing free credit monitoring subscriptions and discounts for future products and services.
- Indirect costs include (i) in-house investigations and communications, (ii) value of customer loss resulting from turnover or diminished acquisition rates.

Causes (roughly 1/3 each)
- Malicious or criminal attack
- Human error system glitch
- Process failure

Data on this slide is from the Ponemon Institute 2013 Cost of Data Breach Study: Global Analysis, May 2013
Allocation of Risk

Data Privacy

- Types of Data
  - Cardholder data
  - Merchant data
  - Transaction data
- “Big data” implications
- Liability – caps and breach or strict liability standard
- Cyber-insurance

Business continuity

- Increased focus from regulators
- Process DR plan and testing
- Additional risk mitigation
  - Step-in rights
  - Direct relationship with DR provider
  - License option
Allocation of Risk

**Key indemnities**
- IP infringement
- Compliance with laws, PCI, card brand rules
- Claims by subcontractors
- Breach of confidentiality
- Data security – breach or strict liability standard
- (Gross) negligence or willful misconduct

**Liability**
- Direct damage cap + exclusion of consequential damages, with exceptions:
  - Exclusions generally mirror indemnities
  - Improper termination / abandonment
  - Employee fraud, criminal activity, misconduct
  - Misdirection of payments
  - Customer payment obligations

- “Super caps”
- Definition of direct damages
Part II: Negotiating Card Processing Agreements for Merchants
Definitions and Process

Overview
- Agreement between a merchant and a Acquirer/Processor.
- Terms vary significantly depending on context
  - Deal size (processing volume)
  - Acquirer/Processor
  - Business model

Business models
- Traditional channels - banks, processors, ISOs, (some) networks
- New channels - PSPs / aggregators and other software solutions
- Convergence of models
  - Software companies have full-featured, mobile, integrated POS products
  - Large Acquirer/Processors investing in software (e.g., TSYS/Pro-Pay, FDMS/Clover, Heartland/Leaf, PayPal/Braintree).

>150 digital wallets
Definitions and Process

Practical considerations
- Is the contract negotiable – yes with exceptions
- Negotiation process
- Form of contract

Contract Structure
- Terms and conditions
- Addendums for ancillary services (direct or with third parties)
  - E-check
  - Gateways
  - Fraud mitigation
  - Consulting/analytics
  - Tokenization
- Separate card acceptance agreements for AXP and Discover (sometimes), PayPal
What’s important?

**Merchant priorities**
- Pricing
- Scope (and value-add) and Performance
- Flexibility and leverage
- Fair allocation of risk

**Acquirer/Processor Priorities**
- Same as merchant priorities, but with different perspective
- Standard processes and flexibility to change them
- Flexibility to change policies and pricing
- Flow-down rights
- Right to use data
- Limiting liability
- Credit risk policies / reserves
- Long-term commitment / exclusivity
- Auto-renewal
- Ancillary services
Pricing

Overview

- Primary factor in processor selection
- Increasing number of pricing models
- Components of price: (Interchange + Assessments) + Processing fees

Tiered Pricing

- Opaque – blends ~ 300 interchange rates (0.05% to >1.65% into 3 categories)
- “Inconsistent buckets”

Interchange +

- Pass-through without mark-up
- Processor fee is incremental

“Fixed” Fee Models
Pricing

Minimum Volume Commitments / Assumptions

- Deadbands
- Pricing adjustments (+ / -)
- Exit rights

Regulatory / Card Brand change

- Pass-through or allocation
- Notice and documentation

Additional Fees

- Bundled or variable
- Pass-through – “third party provider” fees

Price protection and renewal rights
Scope and Performance

**Scope**
- Standard descriptions
- Documentation
- Business continuity
- Ancillary services

**Performance Standards**
- Implementation commitments
- Compliance with network and acquire/processor rules
- Performance warranties
- Service levels
Flexibility and Leverage

Term:
- 30 days to 5 years
- Renewal options

Non-exclusivity / Preferred Provider

Multi-provider environment?

Termination rights
- Convenience (for a fee?)
- Cause
- Material change

Transition assistance

Acquisitions and divestitures

Notice requirements

Ancillary services
Allocation of Risk

**Key Indemnities**
- IP infringement
- Breach of confidentiality
- Breach of data security
- Violation of law, PCI or network rules
- (Gross) negligence or willful misconduct

**Liability limits**
- Direct damages cap
- Consequential damages exclusion
- Exceptions to limitations or “super-caps”
- Definition of direct damages
Data Security and Fraud

**Acquirer/Processor Services**
- Basic protections – e.g., address verification system (AVS) and credit card ID (CVV2 or CVC)
- Tokenization - eliminates need to store sensitive card data by sending back minimal information (e.g., transaction ID, reference ID and authorization code)
- Fraud monitoring

**Allocation of Risk**
- Breach or strict liability standard
- Caps and “super” caps
- Definition of direct damages

**Rights in Data**
- Merchant data
- Cardholder data
- Transaction data
EMV

Overview
- EMV = Europay, MasterCard, Visa
- Global standard for chip-based credit and debit card processing – established to enhance security and global interoperability
- Merchant terminals can use contact and/or contactless acceptance
- Cardholders use “chip-and-PIN” or “smartcards” with embedded microchips that store and encrypt information
- > 1.5B EMV cards in circulation by mid-2012

Visa Technology Innovation Program
- Goal is to accelerate EMV implementation
- Eliminates PCI validation requirement if 75% of a merchant’s VISA transactions originate from chip-enabled terminals. Terminals must enable contact and contactless chip acceptable
- Acquirer/Processors required to support EMV
- Liability shift
  - Most POS fraud liability is currently absorbed by issuers
  - Liability will shift to acquirer / processors for merchants that do not have an EMV terminal when presented with an EMV card
  - Effective 10/1/15 for most merchants (10/1/17 for gas stations)
Durbin Amendment

**July 2010:** Durbin Amendment to the Dodd-Frank Act
- “Reasonable fees and limits” to debit interchange rates
- Provide debit network exclusivity (for in-scope networks)
- Applies to transactions on debit cards issued by banks with over $10 billion assets

**June 2011:** Federal Reserve Board issues rules to implement Durbin
- Average cost pre-Durbin averaged $0.44/transactions.
- Debit interchange is set at 0.05% + $0.21 / transaction (+ $0.01 per transaction for issuers with fraud prevention programs).
- Issuers must use two unaffiliated networks for debit authorization and processing – e.g., one network for PIN debit, one network for signature debit.

**July 2013:** DC District Court (Judge Leon) decision
- Overturns cap on interchange rates – Congress intended to cover only incremental costs incurred by an issuer in authorization, clearly and settlement (and not other processing fees and fraud losses).
- Overturns network exclusivity rules – Congress intended for merchants to have routing choices between at least two unaffiliated PIN networks and two unaffiliated signature networks at the transaction level – not at the card level.
- Ordered a stay of the current regulation to the Fed rules (Reg II) remain in effect, pending appeal (12-18 months).
Contact Information

- **John Barton**
  Partner
  Pillsbury Winthrop Shaw Pittman LLP
  202-663-8703
  john.barton@pillsburylaw.com