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Cashless Customers Hold Riches for Retailers

By ELIZABETH A. HARRIS and DAVID GELLES MAY 18, 2014

Standing in line at Starbucks, customers are presented with an array of options beyond just flavors and foam: They can pay with cash, credit, debit, a Starbucks card or with their mobile phone in two different ways.

That list is expected to grow in the coming years, not only at Starbucks but also at retailers around the country, and an enormous hacking of customer data at Target that was revealed five months ago has only intensified the pace of change in the way Americans pay for goods.

Usually, the conversation about where to go from here is presented narrowly, either in terms of the security of new cards or perhaps the convenience of paying by phone. But behind the scenes, there are other issues in play, including the jealous guarding of customer data. And there is an enormous amount of money to be made, especially for businesses catering to the cash-free consumer.

"There is money at stake all around the room, whether it's the banks and payment processors or the retailers," said Suzanne Martindale, a staff lawyer at Consumers Union who specializes in payments. "It's a battle between the two parties."

Every time a customer pays with a credit or debit card, the retailer pays a fee to have the payment processed. According to the Nilson Report, a payment card trade publication, merchants in the United States spent $71.7 billion on these fees last year.

The most immediate change will occur with EMV, the technology that uses an embedded chip to protect against counterfeit cards and can also require a PIN to keep thieves from using stolen cards. Widely used in Europe and elsewhere, EMV is considered more secure than magnetic strip cards mostly used in the United States. At the end of April, Target said it would speed up its introduction of chip-and-PIN technology on all its branded credit and debit cards and would be fully equipped by early next year.

For their part, Visa and MasterCard are pushing EMV technology, and have instituted new rules that say retailers will bear more fraud liability by the end of next year if they do not have the capability to process such cards.

Some retailers are hoping that the move to EMV cards would reduce interchange and other processing fees, with more competitive and potentially cheaper networks that process PINs instead of signatures, or eventually from savings if fraud rates declined.

"Banks and networks for years have claimed that a significant component of interchange is the cost of fraud," said Mike Cook, assistant treasurer at Walmart. "So one would hope with the investment merchants are making to implement EMV or chip technology, as fraud goes down, that interchange would go down."

Retailers have higher hopes for savings that might come with mobile payment. In some places, those savings are already a reality.

Take Starbucks. There, customers can use their phone to pay for a latte or biscotti by loading money via the company's app onto a Starbucks rewards card. The app entices customers to return with free drinks, and it keeps the lines moving quickly, all of which is good for business.

It also saves Starbucks money, a spokeswoman said. Instead of paying for 10 cups of coffee individually, say at $1.75 each, customers can put $17.50 on their phone just once — which means Starbucks has to pay only one transaction fee, not 10.

Several leading retailers, including Walmart, Target and Gap, have also banded together to form a group called the Merchant Customer Exchange, known as MCX, which aims to come up with a mobile payment system of its own. MCX would allow retailers to circumvent the credit card companies, tapping directly into customers' bank accounts. Retailers said they would also then retain control of their customer data, rather than having to share it as they might if customers paid with a service like Google Wallet.

To attract customers, MCX plans to offer a loyalty points program to receive discounts on future purchases at stores including Banana Republic, Wendy's and Kmart.

But MCX, which was announced nearly two years ago, has yet to unveil a working product. MCX declined to comment or to provide an updated timeline.

Chris McWilton, president of North American markets at MasterCard, pointed to failed efforts by mobile telephone companies to develop payment networks some years ago.

"The retailers are going to go through a similar experience if they try to create their own payment network," Mr. McWilton said. "It's not going to be as easy as they think."

He also cautioned new entrants against underestimating the security risks.

"We get hundreds of attempted hacks a day on our network," he said. "We spend billions on security. Do you really want to play this game?"

Nonetheless, the MCX effort, backed by some of the biggest retailers in the country, speaks to their continued distaste for the so-called processing fees.

"The core motivator behind MCX is a deep-seated hatred of interchange fees for credit and debit cards," said Jordan McKee, an analyst at the Yankee Group. "On the surface it looks like a means for merchants to engage with customers, but it's really about shifting consumers to a less costly means for paying for goods and services."

Indeed, there is a tremendous amount of bad blood swirling around behind the scenes. In interviews, Mallory Duncan, the general counsel for the National Retail Federation, called Visa and MasterCard a "duopoly" and some of their behavior "devious." Mr. Duncan asserted that Visa's push into EMV chip technology is motivated less by security concerns than by a desire to get EMV terminals into wide circulation. Those are often installed with Near Field Communication readers, Visa's preferred mobile payment technology, and would give the company a head start in the move to mobile and "lock in Visa's dominance of payments well into the 21st century," Mr. Duncan said in an email.

(American Express fees tend to cost retailers more, but the company has a much smaller share of the market than either Visa or MasterCard.) In a lawsuit filed against Visa this spring, in United States District Court in Arkansas, Walmart, the country's largest retailer, said that Visa had "engaged in a conspiracy with some of the nation's largest banks to illegally fix" and inflate various fees.

"They don't want customers to know how much this is costing merchants, and ultimately, most likely, the consumer," Mr. Cook of Walmart said.

In an earnings call early last year, Visa's chief executive, Charles Scharf, talked about the need to improve relationships with merchants.

In response to those claims by Walmart and the retail federation, a Visa spokesman pointed to a $5.7 billion settlement approved by a United States District Court in the Eastern District of New York in December, in which the judge wrote “it is no sure thing, to put it mildly” that merchants would be able to prove card rules anticompetitive. That deal would allow retailers to charge more when customers use cards instead of cash, but many of the country’s largest retailers, including Walmart and Target, rejected the settlement.

Experts caution that any reduction in fees is far from certain. The pace of change to mobile, on the other hand, is almost guaranteed to be a crawl, and not only because customers are so used to pulling out their wallets to pay for their coffee.

“You have to remember that we’re talking about payments, which means we’re talking about banks, which means we’re talking about slow,” said David Robertson, publisher of the Nilson Report. “Traditional retail banking is kind of stodgy. And by and large, that’s O.K. with us.”

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