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Three Ways ATM Processing Can Maximize Interchange Revenues

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With falling interchange and the complexities of network processing, IADs must be diligent in managing this vital revenue stream.

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Business models for independent ATM deployers (IADs) may vary, but all of them are based in part on revenue from interchange fees paid by the processing networks. As the major processing networks continue to reduce the interchange fees paid to IADs, business models for some operators may be in jeopardy. One national network recently reduced interchange rates for ATM transactions, in a move that's expected to cost the nonbank ATM industry up to $26 million per year.

It is incumbent upon IADs to understand the network interchange rules and the priorities and connections of their networks. Some processors, for example, have only gateway access to certain networks, rather than direct access. That means the processor pays a gateway fee to access the network, which adds to the cost of each transaction. All too often, the processor passes that fee on to the IAD in a way that's not always clear to the operators.

Most IADs are at the mercy of their processors to implement and monitor processing rules in an effective manner — i.e., routing transactions via networks that pay the highest interchange rates. Processors' own business agreements, however, may put them in conflict with the best interests of the IADs, resulting in routing priorities that may differ from those of the IAD.

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To ensure maximum interchange revenue, an IAD should understand what networks it is a member of, the fee structure of the networks and the routing priorities of those networks. That can help an IAD deal with falling interchange revenues, said Steve Gernes, ISO/IAD segment manager for Elan Financial Services, a Minneapolis-based provider of payment services.

"National and regional networks over the last several years have reduced interchange, so even a penny makes a difference," Gernes said. "It's important to understand all the differences, what you're getting in interchange and where your transactions are going."

This white paper examines three steps IADs can follow to maximize interchange revenues with their processing networks, including reviewing network agreements, understanding gross and net interchange by network and ensuring network priority routing.

Review network agreements

Each IAD belongs to at least one processing network via their sponsoring financial institution. Understanding the complex rules and priorities of those networks can help an IAD make the most of those relationships, said Fred Wich, CEO of F.A.M. Capital, a Long Island City, N.Y.-based IAD and ATM operator that manages more than 6,000 ATMs in the Northeast.

Recently, Wich's ATM operations reviewed interchange revenues from the various networks to which the portfolio is connected. They found that in some cases the payments did not align with the published rates from the networks, including at least one instance where the network overpaid interchange.

One national network's reduction of interchange rates for ATM transactions is expected to cost the nonbank ATM industry up to $26 million per year.

"Virtually everybody in the industry assumes the processors are getting it right, and they normally do but they are not always getting it right," Wich said.

In pursuit of interchange, IADs should consider joining additional networks, depending on the networks offered by the sponsoring FIs, according to Jeremy Inman, executive vice president and COO of Aptus Financial, a Portland, Ore.-based IAD. His company found additional revenue opportunities by joining smaller regional networks, such as Credit Union 24 and Armed Forces Financial Network.

"You have to go to the sponsor bank and ask what networks are you directly related to and look at all the network routing tables," Inman said. "We did that and said we wanted to be a part of all the networks."

The goal of the review is to understand the interchange rules and rates for each network and how the processor routes transactions through the networks. Belonging to more networks offers more options for the IAD to route transactions.

"The IAD should make sure transactions are routed to the networks that provide the maximum amount of interchange income," Gernes said. "The networks are vastly different in what they pay."

What to look for in a network agreement

- What are the rules of the processing network?
- What are the processing network's priorities?
- What networks is the IAD directly related to?
- What are the published rates from the network, and is that what the IAD is being paid?

Understand gross and net interchange by network

Many IADs may not realize there are different levels of connection that processors may have with the processing networks. A direct connection with a network means lower fees for the IAD. A direct connection typically requires investment by the processor to secure the direct relationship.

On the other hand, processors may have a gateway relationship with the network. This more distant relationship typically entails additional fees from the processor to the network, so the net interchange to the IAD will be less, or the per-transaction cost will be more if the processor passes the fees through.

The ATM user won't notice a difference in the speed or cost of the transaction, Gernes said, but the IAD will net less with a gateway transaction, often without knowing it.

"That could lead to additional fees for the IAD," Gernes said. "IADs need to be aware of the network connections their processors have and what the impact is from the revenue and cost perspectives."

Because the gateway fees usually are not visible in the network transactions, an IAD must analyze gross and net interchange revenues by network. Transactions routed through a gateway connection will have a lower net interchange or a higher per-transaction cost due to the gateway fees.

"Processors get charged a fee of usually two to three cents for a gateway transaction and most processors pass that on to

Gateway transactions can cost IADs two to three cents per transaction — a hidden cost with a big impact.

the IAD without necessarily breaking it out," Wich said. "In a business where a penny makes a lot of difference, two or three cents in gateway fees can have a material impact if those networks are a large part of your portfolio."

Inman recommended analyzing transactions on a quarterly basis to compare interchange revenues among processors.

"We look at each network and the gross and net interchange by network, by processor," he said. "You'll find that you're earning two cents less with a processor that has a gateway connection."

Wich and Inman urge IADs to discuss with their sponsoring banks and processors the types of relationships that are available to the networks.

"Due to gateway fees, IADs may not be earning what they think they're earning, and they don't understand why they continue to make less money and less money," Inman said.

Ensure network priority routing

Once IADs understand their network relationships, then they can work with the processors to establish routing priorities. While an IAD cannot determine routing — the issuer controls what networks its cards route to and if there is any priority routing — it is incumbent upon the processor to route in the best interest of the IAD. For its processing clients, Elan uses routing tables to define the priorities for which transactions are routed over which networks. Elan has worked with IADs to establish routing groups that rank networks by net withdrawal interchange and set routing priorities accordingly. Routing transactions to higher paying networks could mean as much as 53 cents more in interchange income, according to Gernes.

"It's critical that IADs understand and challenge their processor to make sure the transactions are getting routed to the appropriate network," Gernes said.

Successful IADs recommend reviewing routing priorities with processors to ensure that transactions are moving through the networks that provide the highest interchange. However, processors have agreements and priorities of their own that govern transaction routing.

"Some processors don't have the ability to control the routing totally because of their agreements and the rules they have to abide by in regard to the networks," Inman said.

In addition to the announced cuts in interchange fees, a lack of knowledge of how processors operate and how transactions are routed makes profitability a tough goal for many IADs. That knowledge could spell the difference between success and failure.

"For those IADs whose business model is to make a spread on the processing fees, with interchange continuing to go down it's very difficult to make money, so even half a penny is meaningful," Wich said.

About the sponsor: Elan Financial Services has provided a full range of payments, products and services to IADs and financial institutions for 40 years. Elan has offices in Pittsburgh; Irving, Texas; Lafayette, La.; Palm Desert, Calif.; and Richfield, Minn. Visit www.elanfinancialservices.com/atm-debit for more information about Elan and ATM processing services.