

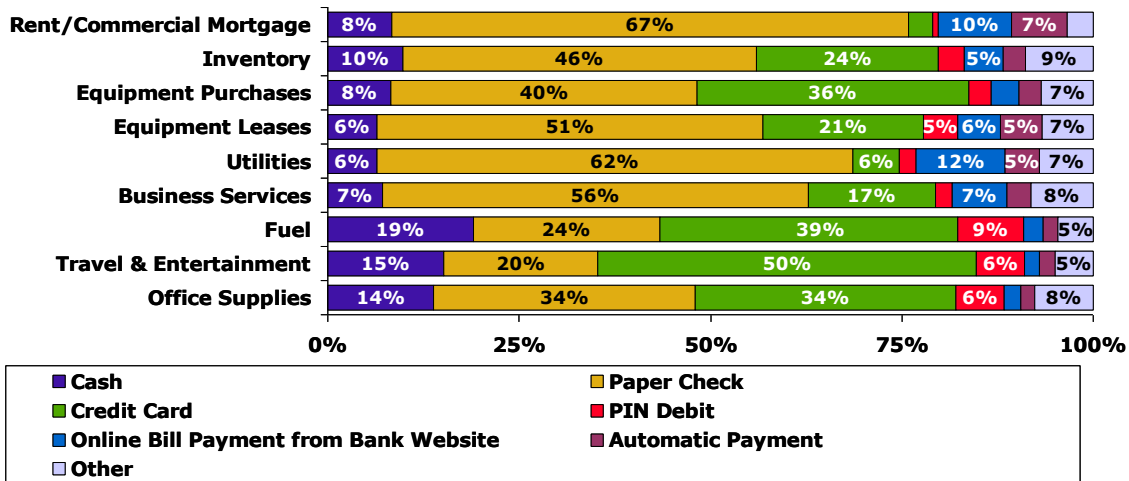
**It's All About the Barriers:
Migrating Small Business Invoice Payments
from Paper to Plastic**

When business leaders hear about multi-trillion dollar opportunities, their ears usually perk up. As such, it is not surprising that credit card executives are talking about the small business market. After all, the segment's total spending has been sized at approximately five trillion dollars. While experts disagree about the percentage of this spending that can be migrated onto plastic, they all agree that the opportunity could be a windfall for issuers. In order capture the market, many FIs have created targeted offerings geared toward the small business segment. Despite these efforts, however, small business spending remains largely 'un-plasticized' and the opportunity is still largely untapped.

Card Opportunity

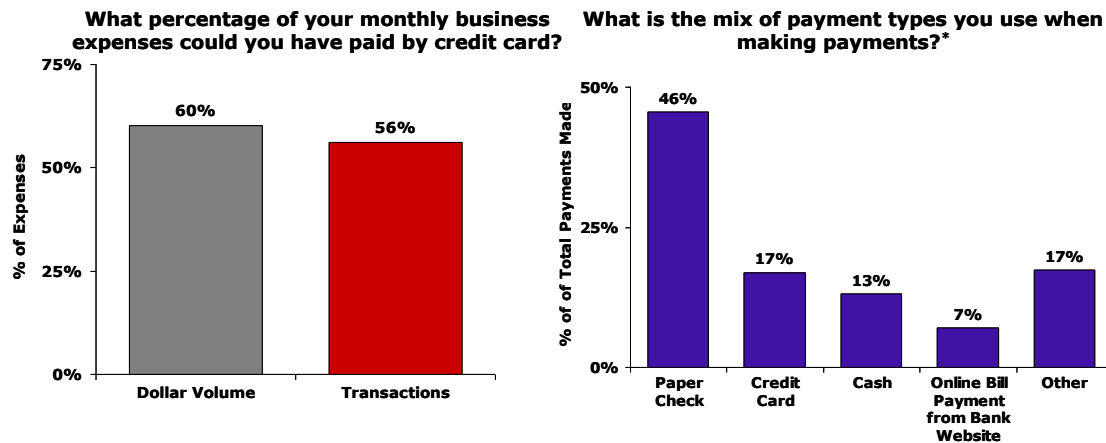
In a recent study on small business payment preferences, we found that many of the large small business spending categories are dominated by paper checks, while only a few of the categories are highly penetrated by plastic.

Primary Method of Paying for Business Expenses



Moreover, those categories where cards are most prevalent, such as T&E, fuel and office supplies, tend to be those completed at the point of sale, while invoiced categories, such as inventory, equipment and business services are most often settled by paper checks. While the total size of the plastic opportunity that is invoiced is unclear, it is much larger than the roughly \$300 billion that small businesses spend on credit and debit cards today.

Our research also demonstrates that across small businesses, there was an opportunity to put 56% of all transactions on credit cards, yet credit cards were utilized for only 17% of transactions.



With all of the efforts from large FIs focused on driving card usage amongst small businesses, why does the opportunity remain largely under-penetrated, particularly for invoiced expenses?

Barriers to Card Use

The answer is barriers—deep structural barriers that cannot be overcome by consumer-centric solutions such as rewards and cash back. The key barriers to migrating invoice payments from checks to cards include:

- Record keeping capabilities
- Trade terms
- Office process disruption
- Interchange
- Credit risk

First generation small business products, which were generally consumer products with a small business label, did not address these barriers and built a perception among business owners that cards were not designed for invoice payments. Ironically, in the early days of small business cards, when issuers were less comfortable managing the risk of small business portfolios, FIs would dissuade businesses from putting invoiced expenses on their cards—but those times have passed. Today card issuers are actively developing programs to facilitate the migration of invoice payments onto plastic.

How Issuers Are Addressing Barriers

Despite all of the effort that has been focused on this segment, issuers have not developed products and services that adequately address all of these barriers. Most FIs have focused their efforts to date on addressing only a few of these obstacles.

Record Keeping Capabilities

One barrier that many FIs have attempted to address is limitations in credit card record keeping—but small business owners find the solutions that they have developed to be sub par. Today many issuers offer small businesses statement integration with accounting software. However, reviews from business owners indicate that these processes are very cumbersome and often mis-categorize expenses in the general ledger, adding more time than they save. In addition, most issuers do not support project-level tracking, a key record keeping requirement for project-based businesses such as consultants, contractors and attorneys.

Trade Terms

More recently, several issuers have focused on developing products that provide trade term-like features. These generally come in the form of special discounts and/or additional float. Examples of these products include 'The Plum Card' from American Express, 'Advantage 60' from Capital One, and 'Contractor Cash Rewards' from Chase. While compelling, these cards' value propositions are also more complex than consumer-centric offerings, so issuers have to invest in educating their prospects on the unique elements of their solution-set. In addition, delivering a customer experience that does not place additional administrative burden on the card holder is critical to their success, as small business owners are busy and have little patience to change their ways.

What Else Issuers Need To Address

In order to significantly increase plastic penetration, issuers must expand their focus to break down additional barriers that they have not yet begun to address. Along with the record keeping and trade terms, FIs should focus on the three remaining barriers to help spur rapid migration of invoices to plastic.

Office Process Disruption

Migrating invoice payment to cards can be very disruptive to the procedures within the small business, as many are still utilizing paper-intensive systems to process invoices. Processes that would seem archaic in a large institution, such as filing invoices in shoe boxes or stapling cancelled checks to the paid invoice are common-place in the small business. After all, these processes provide an element of control that business owners desire for the large purchases that are typically billed via invoice. Overcoming these barriers requires primary research to identify the key elements of control to business owners and common practices across the segment so that FIs can develop solutions that can quickly be adopted by large groups within the small business marketplace.

Frequently the payment processes are controlled by an office manager, rather than the business owner. These staff members are often hesitant to modify the systems they manage, even when it leads to process improvement, as they are fearful that their role will be marginalized. Since office managers often serve as an obstacle between the FI and the business owner, issuers must learn to communicate with these people in a manner that will gain their buy-in, turning them into advocates rather than adversaries.

Interchange

Another challenge that issuers face is the higher interchange rate that the card networks often apply to small business transactions, as Visa Signature and MasterCard World rates usually apply. This seems out of alignment with the rest of the interchange pricing, where standard rates decrease for commercial card purchases to encourage higher ticket purchases.

Interchange Rates

	Consumer Card	World Card	Commercial Card
MasterCard Standard Credit Card Interchange*	2.75 + USD 0.10	2.95 + USD 0.10	2.70 + USD 0.10



Many Small Business Portfolios

*MasterCard Worldwide U.S. and Interregional Interchange Rates, effective October 2006. Rates quoted are standard rates.

Due to these higher rates, many B2B suppliers are looking to prevent the migration of invoices onto plastic. For suppliers (both large and small) credit card fees are a significant line item on the company's financial statements and are often under tremendous scrutiny from finance departments. For some suppliers this means that they do not accept card payments, while for others it translates into dissuading customers from using cards for large purchases. It may be surprising for issuers to learn that suppliers can be very effective in this practice, as these buyer-supplier relationships are often personal and long-standing. Since these relationships represent the supply chain and are critical to the businesses' success, owners are often hesitant to do anything that could prove to be disruptive. In order to break this barrier FIs will need to work closely with the card networks and merchant acquirers to develop and articulate strong B2B merchant value propositions that will share some of the value of the purchase volume migration with the suppliers.

Credit Risk

The risk management departments within FIs have made it difficult for some small business owners to obtain credit cards, leaving many firms without the option of placing invoices on cards. The liability structure of most business cards, referred to as joint and several liability, causes FIs to evaluate both the personal credit of the applicant and the history of the business. This double screening process leads to low approval rates for business card applications. Furthermore, due to this liability structure, many business owners do not feel comfortable placing large expenditures on cards, as they are putting their personal credit profile at risk. To solve this problem FIs will have to look at developing business liability products, or consider migrating these customers up to commercial portfolios.

When they do approve small businesses for credit, FIs continue to limit the migration of invoices to plastic through their issuance of insufficient credit lines. In speaking to small business owners, line size is a common complaint, as it is not unusual to receive a credit line that is similar to that of their consumer card.

Small credit lines further perpetuate the owner's perception that the card is designed for 'incidental' expenses, rather than invoices.

Small credit lines can also lead the business owner to seek out alternative sources of working capital. They may turn to a competitor's card offering or look for another product, such as a business line of credit, to support their cash flow needs. Either way, the owner will be forced to look elsewhere for financing, which provides a competitor with the opportunity to establish a relationship with the customer.

Moving Ahead

Five trillion dollar opportunities are not easy to find, so we expect the small business market will continue to be an area of focus for FIs. However, issuers should look to modify their approach if they want to significantly increase their share of this segment. In order to catalyze the opportunity issuers must invest by addressing all of the key barriers that are preventing the migration from check to plastic. The solutions that they create must work within the payment processes currently used by small businesses. Doing so will not be easy, as it will require extensive research to fully understand the small businesses' systems. This in turn will lead to new initiatives, including new product development, marketing-communication plans, and risk management strategies as well as coordination with card networks. The institutions that do so most effectively will be best positioned to capture the tremendous value associated with the category.

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Founded in 1981, Dove Consulting, a division of Hitachi Consulting, is a Boston-based consulting firm specializing in financial services, with a particular focus on payments strategy and payments compliance. Dove's value proposition—deep expertise for immediate value, sincere collaboration with clients, and the delivery of clear results—has enabled the firm to become a highly valued and trusted advisor to leading financial institutions, networks, processors, and other providers all over the world.

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