DISCUSSION PAPER
PAYMENT CARDS CENTER

Getting Down to Business: Commercial Cards in Business-to-Business Payments

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March 2011

Summary: *Providing efficiency and cost-savings over paper payments (cash and checks), commercial payment cards are among the fastest growing card segments in recent years. Today, they account for nearly one in every five dollars spent using general-purpose payment cards. And since business and government payments are three times larger than consumer transactions, there is ample room for future growth. Adoption by government and small business has been especially noteworthy. Adoption among large companies, which account for half of commercial expenditures, has been more modest. This paper provides an overview of the commercial card product set, its successes and challenges, and the adaptations that have been made to meet market demands and expectations.*

Keywords: commercial payment cards, small business credit cards, small business financing, procurement cards, use of payment cards in the public sector
JEL Classification Numbers: G21

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I. Introduction

In its March 2007 issue, *American Heritage* magazine listed the invention of the credit card as one of 50 seminal events in the U.S. economy's 400-year history, in recognition of the card's significance to the American consumer.[1] The card industry itself, however, recognized that the convenience and utility of the general-purpose credit card could be expanded beyond use by individual consumers. Building on a global infrastructure and a codified set of rules and standards that provided payment system integrity – and its by-product, public confidence — the industry began to develop card products designed for use by businesses, from large corporations to small sole proprietorships.

Encouraged by cards' success in replacing paper-based (cash and check) consumer transactions, industry leaders anticipated that similar efficiencies could be realized in commercial payments, reducing the costs incurred by businesses and government for check production and reconciliation, travel advances to employees, purchase order processing, and other expensive paper-based practices. This vision has met with a fair amount of success: commercial cards have been among the fastest growing card products in recent years and account for nearly one in every five dollars spent using general-purpose payment cards. The *share* of commercial payments made with cards, however, remains very small. Card-based transactions account for only about 3 percent of total commercial consumption expenditures, compared with a 35 percent share for cards in consumer payments.

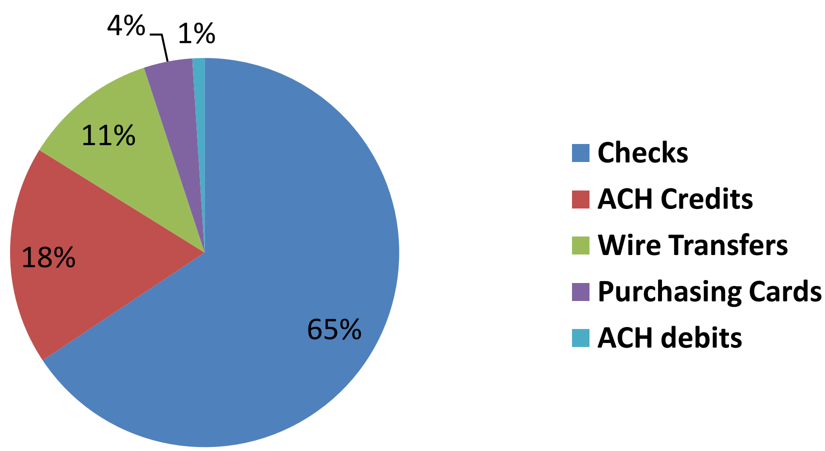
Clearly, cards have not achieved the level of adoption in the commercial payment system that they have in its consumer counterpart. In part this reflects the shorter time span in which cards have been a fixture in commercial payments, but that is only part of the reason. The drivers for businesses to adopt card payments (or not) are different from those operating in the consumer arena, and they vary depending on the size of the business and the type of card product being

[1]John Steele Gordon, "10 Moments That Made U.S. Business," *American Heritage* (March 2007), pp. 23-33.

considered. Likewise, the relative attractiveness of other forms of payment varies between consumers and businesses. While certain aspects of the consumer card payment system can be leveraged for use by business and government, product and process adaptations are necessary. Some of these were anticipated in the original product development efforts at the time the industry expanded into the commercial area, while others have emerged since.

A glimpse of the variation in payment options and preferences for consumers and businesses is provided in Figures 1-3. The data represented in these figures are from different sources and gathered by different means, but they are all from 2007. Striking differences are observed in cash, check, and card use across consumers, small businesses, and large corporate payers.[2]

Figure 1: Preferred Method of Large and Mid-sized Companies for Paying Major Suppliers



Source: 2007 AFP Electronic Payments Survey

[2]Note: Throughout this paper, the most recent available data, most from 2008, are used. For these figures, 2007 was the most recent year for which comparable information for consumers, small businesses, and larger businesses was available. The financial professionals responding to the Association for Financial Professionals' (AFP) survey mostly represent large organizations. Median annual revenue among participants was $1.13 billion; only 7 percent had annual revenues under $50 million.

Figure 2: Small Business Payment Method Transaction Share 2007

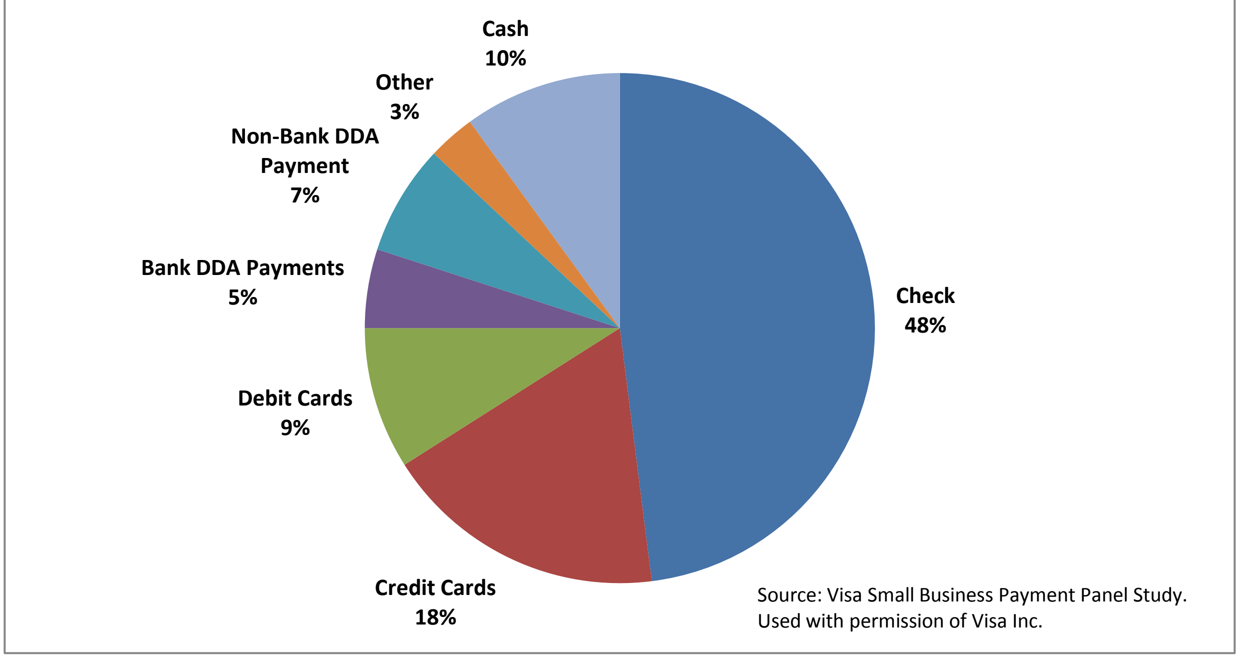
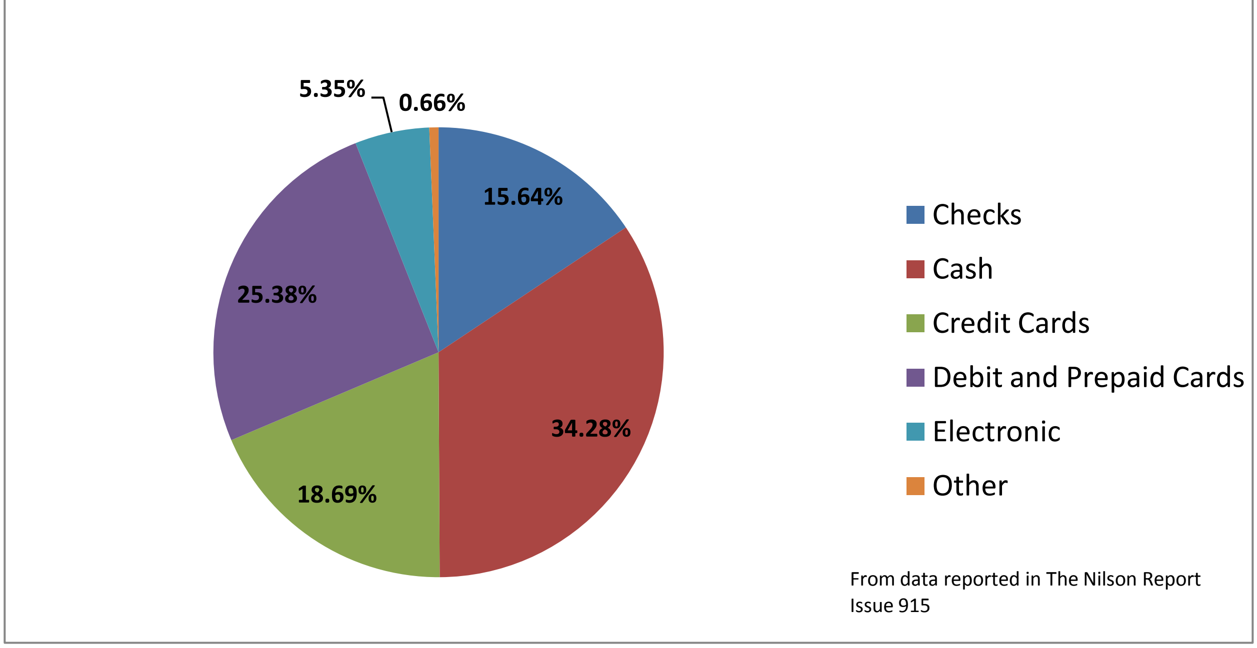


Figure 3: Consumer Payment Method Transaction Shares 2007



Despite commercial cards' modest progress in gaining a significant share of commercial payments, the card industry continues to invest in enhanced payment solutions for government and business. The return on investment from developing and delivering these products could be very substantial. That is because the commercial payments market is about three times the size of the market for consumer payments. (See Section II.) Each 1 percent that migrates to card transactions is equivalent to an additional $200 billion processed by the card payment system.

This paper provides an overview of the commercial card category, the products it includes, growth statistics, major card programs, and other payment practices that compete with cards for use by government and business. It will review drivers of commercial card adoption along with the factors that have caused resistance to use, in particular, the obstacles confronting procurement cards, and the innovations and adaptations that have been developed in response to those market challenges. The discussion will emphasize the small business segment, which uses general-purpose payment cards at a rate disproportionate to its share of total commercial spending, and which has come to rely on credit cards as a major lending source. Because this paper was written during a transformational period influenced by economic recession and new regulations for the card industry, it will also draw inferences for how these events may shape the commercial card landscape of the future.

The paper is organized as follows. Section II briefly compares the size and payment mix of the potential market for commercial card payments. Section III describes the diverse mix of card products available for commercial applications. Section IV examines the use of payment cards by small businesses in closer detail and reviews some of the developments during the recession of 2008-2009. Section V focuses on the challenges to wider payment card adoption among large companies and their suppliers and how card issuers have responded to those challenges. Section VI concludes.

II. The Opportunity for Cards in Commercial Payments

Business and government spending in the U.S. reached $20.3 trillion in 2008,[3] continuing a pattern of year-over-year increases that yielded 25 percent growth over the previous four years. Large corporations accounted for half of total expenditures in 2008, while medium-sized businesses accounted for about one in every five dollars of commercial consumption expenditures. Small business spending accounted for less than one-quarter, with government spending accounting for the remainder (approximately 7 percent).[4] In contrast, in 2008 the transactional component of *personal consumption expenditures* was $7.84 trillion, an amount equivalent to just 38 percent of that year's commercial consumption expenditures.[5] (See Box 1 for a comparison of commercial consumption expenditures and personal consumption expenditures.) Given the vast sums transacted by business and government, it is understandable that providers of payment solutions would seek opportunities to penetrate the commercial, or business-to-business (B2B), payments arena.

Payment cards — debit, credit, and prepaid — have experienced noteworthy success in the consumer payments arena. In 2008, 46 percent of consumer payment transactions were conducted with cards; in 2000, card share was only 26.5 percent of total consumer transactions. Over time, consumers have been substituting card transactions for payments made by checks, cash, and other paper forms of payment.[6] The Automated Clearinghouse (ACH) has also experienced growth as consumer payments have shifted to electronic transactions, but ACH

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[3]"U.S. Commercial Spending Estimates at $20.3 Trillion in 2008," *Reuters Newswire* (September 28, 2009).

[4]*Reuters Newswire* (2009).

[5]"U.S. Consumer Payment Systems," *The Nilson Report,* Issue 939 (December 2009), pp. 1, 9-11.

[6]See the analyses of the U. S. consumer payment system in *The Nilson Report*, Issue 869 (December 2006), pp. 1, 7-9 and Issue 939, (December 2009), pp. 1, 9-11. Paper payment forms also include money orders, official checks, traveler's checks, and food stamps. Card payments also include electronic benefit transfer (EBT) cards.

growth has been more modest, increasing from 11 percent to 18 percent of *noncash* payments from 2003 to 2009.[7]

Coupled with the consumer trend toward greater card use was awareness that individuals often use their personal cards for business expenditures. According to one estimate, 5 to 15 percent of card spending attributed to consumers is actually business related.[8] So the concept of repositioning the payment card developed for consumers for use in the much larger commercial payments arena was a logical progression in the evolution of payment cards.

Box 1. Calculating the Mix of Payments in Commercial and Consumer Segments

The statistics on the penetration rate of cards for commercial and consumer transactions are derived from two different sources.

The share of commercial transactions accounted for by payment cards is based on the Commercial Consumption Expenditure Index, which is constructed by Visa Inc. This is a measure of the total dollar value of commercial transactions derived using data from the Bureau of Economic Analysis (BEA) and the Census Bureau and proprietary data from the consulting firm Global Insight. In these data, intermediate inputs account for 56 percent of commercial consumption expenditures; wholesale and retail purchases, 36.5 percent; private fixed investment, 3.5 percent; and government capital expenditures, 4 percent. Additional information about commercial consumption expenditures is available at PhoenixHecht.com/treasuryresources.

The share of consumer payment transactions shown on page 3 is based on that portion (about 77 percent) of personal consumption expenditures that involves actual transactions. The remainder of personal consumption expenditures consists of "imputed purchases" such as health services that are paid for by the consumer's insurance. The share of consumer payments reported on page 5 takes into account payments made by cards, checks, cash, money orders, official checks, traveler's checks, food stamps, and preauthorized and remote electronic payments.

It should be noted that these two measures of purchases (commercial consumption expenditures and the transaction component of personal consumption expenditures) are not analogous. For example, personal consumption expenditures represent final purchases of goods and services by consumers as reported in the National Income and Product Accounts. As noted above, the majority of commercial consumption expenditures involves purchases of intermediate inputs. One reason the dollar value of commercial transactions is so much larger is that many intermediate purchases may be required in order to deliver a good to a consumer for the final sale. The differences in these two measures make comparisons between the two somewhat imperfect. Nevertheless, within the payment cards industry, these are commonly used metrics for calculating the penetration rate of various forms of payment.

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[7]See "The 2007 Federal Reserve Payments Study: Noncash Payment Trends in the United States 2003-2006" and "The 2010 Federal Reserve Payments Study: Noncash Payment Trends in the United States: 2006-2009."

[8]Frank B. Martien, "Cross-Selling Commercial Cards," *First Annapolis Navigator* (April 2008).

High growth rates, a $20 trillion spending pool, and a payment medium that has proven to be a juggernaut within the consumer payment system would appear to be a formula for unfettered success for commercial cards. But challenges have emerged. Thus far, the evolution in commercial cards has not followed the pattern observed in consumer payments. Nonconsumer payers have largely retained traditional payment methods, with 97 cents of every business-to-business (B2B) dollar transacted by cash, checks, and wire transfers.[9] And in cases where an electronic shift has occurred, the ACH has gained a greater share of commercial payments than have cards. According to one projection, by 2009 the number of ACH B2B transactions would have been 2.8 times that of commercial cards. The disparity in the expected dollar volume for ACH B2B was much greater — 20 times that expected for commercial cards.[10]

This impression of market shares is consistent with the AFP's Electronic Payments Survey, which reflects the views of respondents at large firms. By a wide margin, checks remain the preferred means of paying major suppliers, followed by ACH credits and wire transfers. Among small businesses, the mix is more diverse.[11] Checks account for just under half of all payment transactions, while debit and credit cards account for 27 percent.

The degree of friction encountered by commercial cards varies by card product along several dimensions, including similarity to consumer payments, relative efficacy of cards over existing payment methods, and the power dynamics between the payer and payee companies. Before reviewing these drivers, it is important to review the diversity of commercial card offerings.

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[9]From Visa USA as reported in *Cards & Payments* (June 2007). The wire transfer system was designed and priced for high dollar transactions, rendering it impractical for all but the exceptional consumer transaction.

[10]Brian Rogal, "Card Issuers Finding It Tough to Crack B2B Payments," *Cards & Payments* (April 2006). Bank-to-bank wire transfers were not included in the payment methods reviewed in this article.

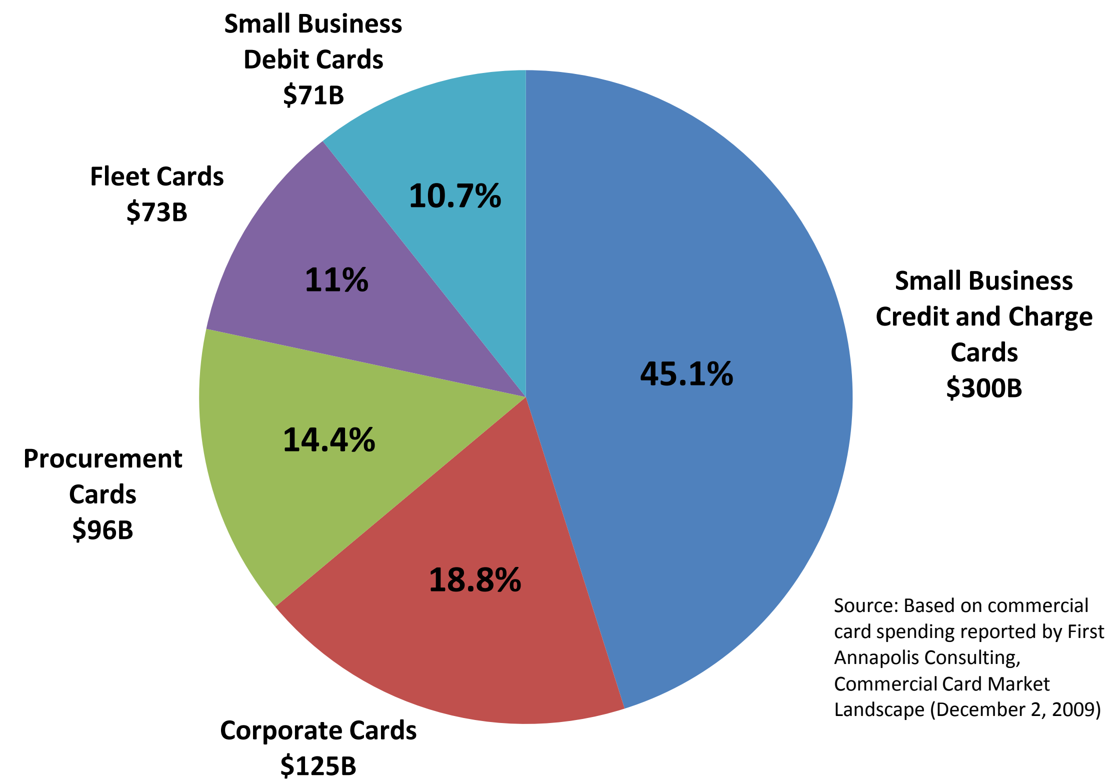
[11] Definitions of small business are discussed in "What Is a Small Business?" in Box 2 in Section III.A.

III. Commercial Card Segments

The first business payment cards were envisioned primarily as business travel and entertainment (T&E) cards; Diners Club was a very early example. The concept fit well with the network of merchants, which included airlines, hotels, and car rental agencies, that were already accepting consumer payment cards at the time. Over time, the early adopters of commercial cards began to use cards for non-T&E purchases. The payment card networks recognized this and began to develop variations on the original business payment card to serve other needs. Today, the commercial card product set includes a number of discrete products, customized for specific audiences. These can be distinguished along at least two dimensions: the size of the organization served, and the features and functionality incorporated into product design.

In 2008, commercial card products were used to purchase $665 billion worth of goods and services for U.S. businesses and government offices. Figure 4 illustrates the portion of that total accounted for by the products and segments described in Sections A and B, which follow.

Figure 4: $665B in U.S. Commercial Card Volume 2008



A. Payment Cards for Small Organizations

Card products intended for small businesses have been the best performers within the commercial card product suite, despite the fact that roughly half of small business spending is done with vendors who do not accept payment cards. Lack of card-accepting merchants may also be a reason why checks remain the dominant mode of payment used by small businesses. Despite these constraints, an analysis by First Annapolis Consulting revealed that the dollar volume of spending within this card category increased nearly 230 percent over the five-year period 2003-2008. The $371 billion spent by small businesses in 2008 using payment cards accounted for 55.8 percent of total commercial card spending that year.[12]

[12] From Commercial Card Market Landscape, First Annapolis Consulting, December 2, 2009. Because there is no universally applied definition of small business, the spending and share attributed to small

Business Credit Cards. Once the only card product designed for commercial use, business credit cards have been repositioned as the card product for small businesses. In addition to using business credit cards for purchases, small businesses also use the cards' credit facility. Indeed, credit cards have become the most common source of financing for small businesses' capital needs. The 2009 Small Business Credit Card Survey conducted in December 2008 by the National Small Business Association found that 59 percent of the companies surveyed had used credit cards to fund capital expenditures in the previous 12 months. The next most frequently cited source was "earnings of the business" (51 percent), followed by "bank loans" (45 percent), "vendor credit" (30 percent), and "private loans" (from family or friends, 19 percent). Only 5 percent had Small Business Administration loans, and 19 percent used no financing.

At least since the mid 1990s, the trend has been for small businesses to increasingly rely on credit cards for their borrowing needs. In 1993, only 17 percent of small businesses reported using credit cards as their primary source of capital; this had doubled to 34 percent by 1997. Over the same period, there was a steady decline in the use of more traditional loans from commercial banks. In 1993, 49 percent of small businesses used commercial bank loans as their primary source of capital; by 1997, this had declined to 38 percent.[13] This experience among small businesses parallels what occurred among consumers, who, over time, used general-purpose credit cards as a substitute for personal and installment loans and seller financing.

Debit. Debit cards attached (primarily) to small business checking accounts provide the same functionality as consumer debit cards: They are used to access funds on deposit. Debit cards are used at the point of sale as an alternative to writing a check, and they can also be used like an ATM card to make cash withdrawals from ATMs. Dollars spent with small business debit cards increased 15 percent in 2008 compared with the previous year and accounted for 10.6

business are based on the card product used or on the reported activity by small businesses as defined by the source.

[13] These statistics are from the Arthur Andersen/National Small Business United Survey.

percent of total commercial card volume, based on figures from *The Nilson Report* and First Annapolis Consulting.

Box 2. What Is a Small Business?

There is no universally accepted definition of small business. Most definitions are based on a threshold of revenues and number of employees. MasterCard's website defines small businesses as those with less than \$10 million in revenues, while Visa's site indicates a higher threshold of \$25 million. Bank issuers of Visa and MasterCard cards are not obliged, however, to use the network definition, nor is there consistency from one bank to the next on the parameters determining "small business." What is considered a small business by one banking organization might be classified as middle market by another. The Small Business Administration has created a 35-page table of criteria defining small businesses for specific industries. See http://www.sba.gov/idc/groups/public/documents/sba_homepage/serv_sstd_tablepdf.pdf.

B. Payment Cards for Large Organizations

With the original business payment card product repurposed as a small business credit card, there was a need for a T&E card for use by large businesses and organizations. And as card issuers and networks continued to research the commercial payments arena, they saw opportunities to develop card applications for other corporate payment needs.

Corporate Cards. This card type is intended for large companies to provide to their employees to use for business-related travel and entertainment expenses, dues and subscriptions, and other small-ticket purchases that in an earlier era might have been purchased with petty cash. While American Express has offered cards of this type for over 40 years, availability expanded considerably in the mid 1990s when Visa and MasterCard developed corporate cards that banks could add to their commercial product suites. This expanded product distribution also tapped into the larger networks of merchants that accepted Visa and MasterCard.

As experienced lending institutions, banks were able to apply credit underwriting criteria to client companies' employee bases. This allowed corporate decision-makers to more confidently provide cards to larger numbers of employees at more levels of the organization, knowing that those employees' credit profiles indicated they could responsibly handle credit privileges. Decisions to expand deeper into the employee base were reinforced by the development of robust control and reporting tools that companies could use to monitor the purchase and repayment activity of their employees.

Spending on corporate cards grew 192 percent from 2003-2008, according to an analysis by First Annapolis, reaching $125 billion in 2008, when it accounted for 18.8 percent of total U.S. commercial card dollar volume. Decline in business-related travel as a way to control costs during the recession of 2008-2009 has had a mitigating effect on growth rates for this product. In 2008, the growth rate was 6.8 percent, less than half the 14 percent average annual growth rate for 2003-2008.

Purchasing Cards. Also known as procurement cards, or simply P-cards, this form of commercial card was originally developed to replace the costly purchase order process for small-ticket expenditures. It has since been expanded to the type of large-dollar purchases that are often managed by corporate procurement departments or made through a purchase order process. P-cards were offered under the American Express, Visa, and MasterCard brands beginning in the mid 1990s. Spending on P-cards was about $96 billion in 2008, 200 percent higher than in 2003. Despite being designed for large-ticket expenditures, P-cards captured only 14.4 percent of total commercial card volume in 2008.[14] Some of the unique challenges for P-cards will be addressed in Section V.

Fleet Cards. This card product was designed for a very specialized purpose within a discrete sector: commercial use of passenger cars and trucks. Fleet cards are issued to cover fuel and other expenses, such as vehicle maintenance and cash disbursements, incurred by local and long-haul drivers. Fleet card systems have authorization, reporting, and control features — foremost of which is the capture and tracking of fuel data — that are essential to efficiency and

[14] These statistics on purchasing cards are from First Annapolis' Market Landscape (December 2009).

fraud control (e.g., preventing fuel purchases for personal use) in commercial vehicle fueling. In 2008, total dollar volume transacted on fleet cards reached $73 billion, 11 percent of total U.S. commercial card volume. From 2003 through 2008, fleet card spending grew 261 percent, largely driven by increases in average per gallon fuel costs during that time. While the growth of fleet cards issued under the general-purpose card brands has been strong in recent years, the most prominent competitors in this area are specialty players. FleetCor, Wright Express, and ComData are the three largest.

Transactions on fleet cards alone account for over 14 percent of card transactions occurring at gas stations, even though not all merchants in this segment accept all fleet card brands for payment.[15]

C. Commercial Applications for Prepaid Cards

Prepaid cards issued under the logos of the major U.S. card networks — American Express, Discover, MasterCard, and Visa — constitute a fairly new and small but growing product category. Prepaid cards provide debit access to funds held on behalf of the cardholder, rather than in a deposit account in the cardholder's name. At present, prepaid cards account for less than a 3 percent share of either consumer or commercial expenditures, but this is changing rapidly. Businesses large and small as well as government agencies are adopting prepaid cards for a variety of purposes.

Prepaid cards pose some challenges when dividing transactions between commercial and consumer applications. In principle, these can be divided into two categories. First, there are applications in which prepaid cards provide a means for a business to make payments using its own funds. Second are a variety of other applications —established by organizations — in which the funds belong to the employee or client. Other than value loads initiated by the business, the

[15] See "Gasoline Cards," *The Nilson Report,* Issue 887 (September 2007), pp. 1, 10-11.

resulting transactions involving this second type of prepaid card are typically described as consumer, rather than commercial, payments. Nevertheless, both types are included in the discussion to highlight their role in reducing the costs to businesses (or governments) of disbursing funds.

Examples of card use in the first model include travel advance cards, cash-access cards, and relocation expense cards. Small businesses have capitalized on the intrinsic flexibility of prepaid cards to gain some of the control and functionality of fleet, purchasing, and corporate cards, without the scale often required to qualify for these kinds of card programs. Using prepaid cards, small businesses can enable employees to make purchases on behalf of the company without providing access to the company's entire credit line (via a business card) or its total funds on deposit (via a debit card).

Examples of card use in the second model include electronic payroll disbursement to unbanked employees, flexible spending accounts for benefits distribution,[16] customer rebate and refund cards, and employee incentive cards. Companies see prepaid cards as an electronic alternative to paper checks in distributing funds to employees, customers, and clients. These prepaid cards can be used anywhere that credit and debit cards of that brand are accepted. Merchant acceptance of general-purpose cards has become ubiquitous, as have ATM locations. These factors combine to make the use of prepaid cards sufficiently convenient for the consumer end-user such that receiving funds by card instead of check is generally acceptable. Some consumers still prefer to receive checks, but others actually prefer cards, which can be used immediately, compared with checks, which must be deposited, with full use of funds perhaps not available until the check has cleared.

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[16] See, for example, Ann Kjos, "New Prospects for Payment Card Application in Health Care," Federal Reserve Bank of Philadelphia (November 2008). Kjos's study includes a discussion on card access to health care savings and flexible spending accounts.

The efficiencies of distributing funds by prepaid card, including the cost savings in check production, mailing, and reconciliation, have been recognized by government agencies that have adopted this method as a way of distributing food stamps, Social Security and unemployment payments, and other public benefits.[17] Prepaid cards' potential within the public sector alone has been forecast to be $284 billion by 2015.[18]

Because commercial prepaid cards are a new and relatively insignificant part of U.S. payments, little consistent and standardized reporting is available. *The Nilson Report* began including prepaid cards in its annual commercial card rankings in 2005 (2004 data). In June 2010, Nilson ranked the top 15 issuers of commercial prepaid cards based on 2009 dollar volume, including both models reported on in this section. The combined dollar volume of prepaid transactions among these issuers was $55 billion, about the same as the dollar volume among the two largest issuers of small business credit cards in 2009. From its small base, however, commercial prepaid volume is growing at an impressive rate. About half the issuers in Nilson's tabulation reported annual volume growth of 100 percent or more in 2009.[19]

D. Summary of Commercial Card Segments

It is useful to review the mix of commercial card segments and compare them with each other and with other electronic payment options that serve consumers and businesses. Figure 5 plots the dollar volume of payments as areas along the horizontal axis and growth rates on the vertical axis. Relative to consumer electronic payments, the commercial card segments remain small. The largest commercial card segment is small business cards, with $371 billion in combined debit, credit, and charge card volume. The growth rates of the commercial card

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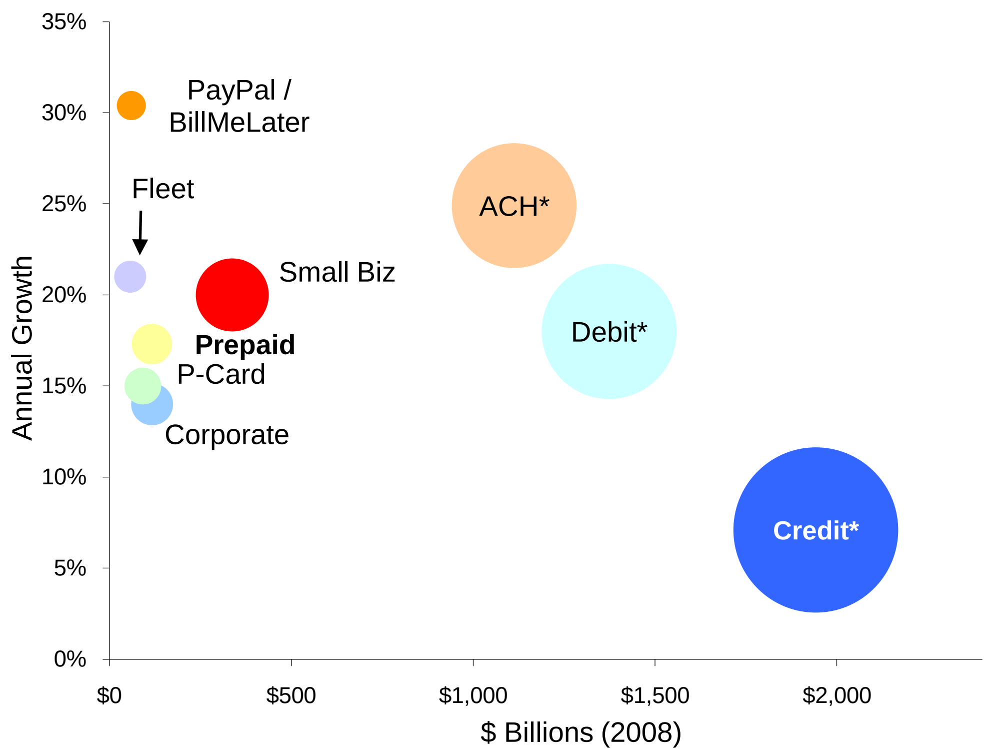
[17]Over 30 states use prepaid cards as a means of distributing unemployment benefits, child support, and other funds. See slide #26, "Presentation to the Federal Reserve on Debit Card Regulation," Visa Inc., July 23, 2010. http://www.federalreserve.gov/newsevents/files/visa_20100723.pdf

[18]CommercialPaymentsInternational.com report of research conducted by BCG.

[19]"U.S. Commercial Bank Cards," *The Nilson Report*, Issue 951 (June 2010), pp. 1. 9-11.

segments are impressive — on par with the growth rates of ACH and debit in consumer payments and much higher than for credit cards. Small business has experienced one of the most rapid growth rates among commercial card products; corporate and purchasing cards have lagged by comparison. Business-to-business ACH volume — too outsized to appear in this graph — has captured the lion's share of commercial electronic payments.

Figure 5: Electronic Payment Volumes and Growth Rates, 2003-2008



Source: Commercial Card Market Overview, First Annapolis Consulting. Reprinted with permission. Original source material from *The Nilson Report*, Visa, MasterCard, Celent, and Federal Reserve Payment Systems studies. Growth rates are 2003-2008 compound annual growth rates. Small business includes Visa, MasterCard, Amex, and Discover credit, charge, and debit cards. Fleet includes "universal" closed-loop issuers as well as MasterCard and Visa fleet volume. * denotes consumer volumes. Credit* includes general-purpose and private-label consumer credit card volume. Debit* includes Visa and MasterCard POS PIN and Signature volume minus Visa and MasterCard small business debit volume of $71 billion in 2008. ACH* includes POP, TEL, and WEB volume. B2B ACH value was estimated in 2001 by Celent at $10.6 trillion (excludes cash concentration transactions used by corporations to consolidate accounts). Prepaid includes closed-loop, open-loop, and gift card volume.

IV. Small Business, Payment Cards, and Changing Realities

Small businesses, which have been important contributors to economic growth for the past quarter-century, have also been the biggest driver of growth in commercial cards. Cards designed for use by small businesses have experienced early adoption and use in part because the payment behavior of small business owners resembles consumer behavior. Entrepreneurs and small business managers are likely to use payment cards for personal use and bring that experience and familiarity to their small business operations. In addition, for half of the purchases made by small businesses, their providers already accept cards for payment. Both of these factors have been significant in the robust adoption and use of payment cards by small businesses.

A. Development of the Market for Small Business Credit Cards

In 2008, spending on business debit, credit, and charge cards reached an estimated $371 billion and accounted for 55.8 percent the year's total commercial card spending.[20] This does not include an estimated $108 billion of small business spending that is transacted using consumer payment cards.[21] The use of payment cards by small businesses is disproportionate to their share of commercial consumption expenditures, which is only 23.8 percent.[22]

Another impetus to card use by small business is the loan utility of general-purpose credit cards, which is used by small businesses as a primary source of borrowing.[23] This sector has historically relied on alternative sources of funding capital because small, undercapitalized, and start-up businesses typically do not meet the underwriting criteria required for traditional bank

[20]First Annapolis Consulting (December 2, 2009).

[21] TowerGroup, reported in *Cards & Payments* (June 2007).

[22] *Reuters Newswire* (September 28, 2009). Mid-sized businesses contribute 19 percent to commercial consumption expenditures and government spending, 6.9 percent.

[23] Alicia Robb et al., "An Overview of the Kauffman Firm Survey," Ewing Marion Kauffman Foundation (April 2009).

commercial loans. Other financing options offer only partial solutions: Venture capital funds only one in 100 proposals, with only 11 percent of funded proposals going to start-ups. Venture capital funds are also concentrated in a few industries (over half of 2007 deals went to biotech, software, and medical devices firms) and in certain regions (41 percent in California, 13 percent in New England).[24] The Small Business Administration provides loan guarantees for some bank loans as a way of reducing creditors' exposure to losses associated with small and young companies. But the SBA induces participating lenders to underwrite SBA loans nearly as conservatively as they would for nonguaranteed loans. SBA loans can also carry up-front fees of as much as 5 percent of the loan amount, decreasing their attractiveness to small business borrowers.[25]

Undaunted, entrepreneurs, who by necessity and by definition are innovative and resourceful, identified funding solutions from other sources, including family and friends, home equity loans and lines,[26] and personal credit cards[27] and through early adoption of business credit cards. Credit card issuers responded to this demand by adapting their automated scoring models for application to the small business market. This made possible mass customization of credit card issuing to small businesses.[28] Issuers targeting small business customers also adopted direct mail techniques learned from consumer marketing. Mercator Advisory Group has reported that 12

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[24]John Tozzi, "The Truth about Venture Capital," *Business Week* (February 1, 2008).

[25]Jeremy Quittner, "Fees Get Fatter," *Business Week* (June 20, 2005).

[26] The 2009 National Small Business Association's (NSBA) Small Business Credit Card Survey found that 29 percent of surveyed firms use a second mortgage to leverage business loans. Small business surveys conducted by Arthur Andersen found that by the late 1990s, personal and home equity loans were being used by nearly one in five small businesses. The U.S. Census Bureau's Survey of Business Owners (2002) found that over half used personal or family savings to start or acquire their businesses.

[27]Based on TowerGroup figures reported in *Cards & Payments* magazine (June 2007), in 2002, 50 percent of small business spending using credit cards took place on personal accounts. The reader is reminded that there is no single definition for small business and TowerGroup's estimates will reflect its definition for this sector.

[28]Allen N. Berger and W. Scott Frame, "Small Business Credit Scoring and Credit Availability," Federal Reserve Bank of Atlanta Working Paper 2005-10 (May 2005).

percent of the billions of recent direct mail credit card offers have been for small business credit cards.[29]

The convergence of these innovations by card issuers with the small business sector's inclination to use payment cards resulted in credit cards becoming "central to the financing of small business in the twenty-first century," in the words of the chief economist for the Small Business & Entrepreneurship Council.[30] According to a Department of Commerce publication, credit cards have become "one of the most reliable sources of start-up funds for new entrepreneurs ... [offering] simple and rapid access to capital that has helped a significant number of U.S. entrepreneurs establish new businesses."[31] Nearly one in four small companies uses four or more credit cards for business purposes, and 46 percent leverage business loans with personal or business credit cards.[32]

With expanded access to credit cards specifically designed for use by small business, entrepreneurs shifted spending from personal cards to business cards. The 50:50 ratio that existed in 2002 was 34:66 in 2007 and was projected to be 25:75 in 2009.[33] But the economic downturn of 2008-2009 has affected the small business sector and its use of, and access to, card products. This has undoubtedly altered the growth curve on which such projections were based.

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[29]John Tozzi, "Credit Cards Replace Small Business Loans," Business Week.com (August 20, 2008). Tozzi notes within the article that this amounts to 720 million offers, which equates to 26 for each small firm in the U.S.

[30]Raymond J. Keating, "Credit Cards and Small Business: The Benefits, Opportunities and Policy Debate," Small Business & Entrepreneurship Council's Small Business Policy Series Analysis #34 (March 2009).

[31] "Credit Card Market: Economic Benefits and Industry Trends," U.S. Department of Commerce (March 2008).

[32]2009 Small Business Credit Card Survey, National Small Business Association. http://www.nsba.biz/docs/09CCSurvey.pdf

[33] Based on TowerGroup figures reported in *Cards & Payments* magazine (June 2007).

B. Impact of the Recession

Declining demand for credit, a hallmark of recessionary periods, is observable among small businesses. Business development, an activity for which business owners often turn to outside financing, is ebbing. A Discover Financial Services survey conducted in September 2010 found that 57 percent of small business owners planned to decrease spending in this category.[34] In October 2010, the National Federation of Independent Business (NFIB) reported that, on net, small business continued to shrink inventories.[35] An economist with the Small Business Administration has stated that small businesses are "sitting on their hands" due to uncertainties in the current economy.[36]

But prevailing economic forces have affected the supply side, as well. The title of a 2008 *Business Week* article, "SBA Loans Plummet," said it all: By the spring of 2008, SBA 7(a) loans had already declined 18 percent from the previous year.[37] According to the National Venture Capital Association, venture capital investment funds raised only $4.3 billion in the first three months of 2009, compared with $7.1 billion January through March 2008.[38] For four successive quarters (second quarter 2008 through first quarter 2009), over half the respondents to the Federal Reserve's Senior Loan Officer Opinion Survey said that their organizations had tightened

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[34]This statistic averaged 34 percent in 2007 and 42 percent in 2008.

[35]This statistic is from the NFIB's Small Business Optimism Index. Respondents have reported declining inventories for 39 consecutive months.

[36]Chad Moutray, chief economist of the SBA, quoted in the *New York Times* article, "Small Businesses Feeling the Chill," October 2, 2008.

[37]Jeremy Quittner, "SBA Loans Plummet," *Business Week* (May 14, 2008). After declining at a much lower rate in 2009, SBA loans rebounded in 2010, due in part to stimulus provided under the auspices of the American Recovery and Reinvestment Act of 2009, which was extended under the Small Business Jobs Act of 2010. In 2010, combined SBA 7(a) and 504 loans surpassed $22 billion, up 6.4 percent from pre-recession 2007 levels. See Kate Davidson, "SBA Lending Increases 29%," *American Banker* (October 5, 2010); "Agency Supported More than $22 Billion in Small Business Loans," press release by the Small Business Administration (October 4, 2010) http://www.sba.gov/about-sba-services/7367/5527; "Fourth Quarter 2009: The Economy and Small Business," *Quarterly Indicators,* Small Business Association Office of Advocacy (February 17, 2010); and "Third Quarter 2010: The Economy and Small Business," *Quarterly Indicators,* Small Business Association Office of Advocacy (November 20, 2010).

[38] "Venture Capital in America: The Brightest and the Rest," *The Economist* (July 11, 2009).

standards for approving loan applications from small firms. Survey responses also revealed that banks had somewhat limited the credit lines extended and had tightened costs during the recession. While some easing was reported in the third and fourth quarters of 2010, previously tightened credit policies remained unchanged at the majority of the institutions surveyed in the last half of 2010.

The small business credit card star, which had risen and shone so brightly in the previous decade, also dimmed with the darkened economy. Responding to increasing charge-offs and the corresponding need for higher loan-loss reserves, card issuers raised rates and lowered credit lines. The Small Business & Entrepreneurship Council reported a 30 percent decrease in small business credit card lines,[39] while 41 percent of small businesses responding to the NSBA's survey reported reduced credit limits between April 2008 and April 2009.[40] In what may have been the most dramatic example of retrenchment in card lending to small businesses, Advanta, then the fifth largest small business card lender, announced in May 2009 that it would cease allowing new transactions on its 2.5 million cards in circulation and effectively placed its 1.3 million accounts in payoff status.[41]

All this comes at a time when small businesses (but not only small businesses) are feeling stress. According to Discover's monthly survey of small businesses, in September 2010, 46 percent of respondents had to defer paying a bill in the previous 90 days.[42] The NSBA survey found that a declining percentage of small businesses pay their credit card bills in full each

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[39] Keating (March 2009).

[40] See the 2009 NSBA Small Business Credit Card Survey. The survey also reported that 63 percent of respondents claimed to have had an interest rate increase during the same period.

[41] *American Banker*, May 23, 2009; *The Nilson Report*, Issue 925 (May 2009); *Cards & Payments* (June/July 2009). In November 2009, the company filed for Chapter 11 bankruptcy. In March 2010, the FDIC and the Utah Division of Financial Institutions closed Advanta and placed it in FDIC receivership (www.advantareorg.com).

[42] This statistic averaged 39 percent in 2007, 42 percent in 2008, 46 percent in 2009, and 48 percent in 2010.

month.[43] There has been a rise in home mortgage delinquency among owners of small businesses,[44] and bankruptcies filed by businesses of all sizes began to rise in 2006.[45]

C. Regulatory Changes

Both users and issuers of small business credit cards also face uncertainties about the effects of the Credit Card Accountability Responsibility and Disclosure Act (the Credit CARD Act) signed into law in May 2009. While the provisions of the act directly apply only to consumer accounts, the seamlessness with which entrepreneurs mingle their personal and business finances means that regulatory changes on one side can likely have effects on the other. The interactions could be complex.

One response may be that entrepreneurs will shift a greater proportion of their credit usage to personal credit cards, which, under the Credit CARD Act, gain increased protection from repricing of existing balances.[46] Access to personal card lines by some entrepreneurs, however, may be more limited after the card industry adapts to the new law. With more limited flexibility in pricing to risk, lenders will likely recalibrate their models and may adjust their underwriting accordingly. For those applications that are approved, borrowers may receive higher interest rates and lower credit lines than what they might have obtained in the recent past.

The reasons behind this have to do with the credit scoring models used to underwrite credit cards for small businesses and patterns of behavior more commonly observed among

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[43] "US Small Businesses Feeling Credit Card Pain," Commercialpaymentsinternational.com (August 2009).

[44] First Annapolis Consulting, "Commercial Card Market Overview," presentation prepared for the Payment Cards Center, Federal Reserve Bank of Philadelphia, April 16, 2009.

[45] Quarterly statistics from the U.S. bankruptcy courts indicate that business bankruptcy filings peaked at 16,017 in the second quarter of 2009. They were just under 14,000 in the third quarter of 2010. The trend in bankruptcies is complicated by the spike in filings induced by the Bankruptcy Abuse Prevention and Consumer Protection Act, which came into effect in the last quarter of 2005. Still, the earlier peak was surpassed in the third quarter of 2008 and bankruptcy filings remain elevated.

[46] Generally speaking, the interest rate on existing balances cannot be raised unless the consumer is 60 or more days delinquent on the account. Interest rates on new purchases may be increased 45 days after providing notice of the increase to the consumer.

entrepreneurs that can affect those scores. First, the scoring models rely heavily on business owners' personal creditworthiness.[47] Second, small business owners often comingle their personal and business finances. Third, entrepreneurs often have a higher level of risk tolerance (including becoming indebted in order to finance their business), which can work at cross-purposes to the characteristics that will produce a high credit score.

This combination of factors could lead to small business owners being over-represented in the ranks of higher risk consumers whose access to personal and business credit cards may be curtailed. In the commonly used FICO credit scoring model, "amounts owed" constitute 30 percent of one's credit score.[48] Only "payment history," at 35 percent, has a greater impact on credit score. Part of what is considered in "amounts owed" is the total amount of debt, the amounts owed on specific types of accounts, the number of accounts with balances, and the proportion of credit lines used. These factors can be evaluated using statistics for households headed by a self-employed individual in the Survey of Consumer Finances.[49]

On the one hand, compared with all families participating in the survey, the self-employed were heavier credit users on nearly every dimension. Self-employed households carried total debt that was 84 percent higher than that of families in general ($123,000 versus $67,000) and were more likely to have a mortgage (65 percent versus 49 percent among all families).[50] Self-employed households were significantly more likely to have second mortgages or other mortgage debt (15 percent versus 6 percent). The median balance owed on those

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[47] Allen N. Berger and W. Scott Frame, "Small Business Credit Scoring and Credit Availability," Federal Reserve Bank of Atlanta Working Paper 2005-10 (May 2005). The authors observe that small business credit scoring "involved analyzing *consumer data about the owner of the firm* and combining it with *relatively limited data* about the firm itself" (emphasis added).

[48] See, for example, MyFICO.com/Credit Education/WhatsInYourScore.

[49] Brian K. Bucks, Arthur B. Kennickell, and Traci L. Mach, and Kevin B. Moore, "Changes in U.S. Family Finances from 2004 to 2007: Evidence from the Survey of Consumer Finances," *Federal Reserve Bulletin*, 95 (February 2009), pp. A1-A55. http://www.federalreserve.gov/pubs/bulletin/2009/pdf/scf09.pdf Note, the SCF does not contain information about credit scores.

[50] Median dollar values reported.

mortgages was also significantly higher for the self-employed than for all households. Median balances on installment loans, credit cards, nonequity lines of credit, and "other loans" (against life insurance policies, retirement accounts, etc.) were all higher for the self-employed than for American families as a whole.

On the other hand, self-employed households also report having twice the median assets and three times the median net worth of families in general. They also report substantially higher median incomes ($75,700 versus $47,300).[51] These resources contribute to small business owners' ability to service their debts and thus preserve the good payment history that accounts for 35 percent of their credit score.

For the 30 percent of the credit score that reflects balances owed, however, the self-employed may look more leveraged than the "typical" family, and their credit score may be affected. And since credit scores for underwriting small business credit cards factor in personal credit profiles, access to loan products may be affected as card issuers redefine their risk models in the aftermath of the recession and the new regulatory environment.

Credit lines have already been reduced. Since September 2008, total credit card lines have fallen by $1.4 trillion, a 24 percent decline.[52] The number of open accounts has fallen 30 percent.[53] Most of those cuts have occurred among unused accounts held by consumers, who rarely use more than a fraction of available credit lines. But small business owners are atypical in their card usage. Whereas the average balance in 2007 was $5,000 for the 30 percent of

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[51]Assets of the self-employed include business equity, which is held by 68 percent of the self-employed compared with only 12 percent of all American families.

[52]These numbers are from Call Report data.

[53] This statistic was calculated by the Payment Cards Center using TransUnion's TrenData.

households carrying the highest credit card debt, the NSBA survey found that more than one-third of small business respondents carried credit card debt in excess of $10,000.[54]

Recognizing the symbiotic relationship between small business owners' personal and business finances, Section 506 of the Credit CARD Act included a requirement that the Federal Reserve Board of Governors prepare a report on card-related activity in the small business sector.[55] In that report, the Board examined a different risk measure, Dun & Bradstreet's PAYDEX score, to assess credit risk in the small business sector. Using a PAYDEX score below 80 (the threshold at which the creditor can expect payment in line with the terms of the credit agreement) as a proxy for nonprime borrowers, the report found that only "34 percent of small firms scored 80 or above." Credit supply to the small business sector will continue to be an important research topic as the economy emerges from the recession and industry adapts to new regulation.

V. Large Businesses, Payment Cards, and Challenges Encountered

With half of B2B spending in the control of corporations and large businesses, this sector is very attractive to payments providers. Commercial cards have made inroads, but there have been significant challenges, as well. Some of those challenges entail achieving critical mass in a two-sided market. Like its consumer card antecedent, the commercial card market had to be built by getting a sufficient number of cards in the market so that vendors would consider it worthwhile to become card-accepting merchants. At the same time, corporations that were prospective clients for card issuers had to be able to tap into a network of card-accepting vendors for it to be worth their while to adopt cards as a payment tool.

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[54]This comparison to the 2009 NSBA Small Business Credit Card Survey is based on analysis of total credit card balances for consumers in the 70th percentile of card balances in a representative sample of credit bureau data from 2007.

[55]See *Report to the Congress on the Use of Credit Cards by Small Businesses and the Credit Card Market for Small Businesses* (May 2010) at http://www.federalreserve.gov/BoardDocs/RptCongress/smallbusinesscredit/smallbusinesscredit.pdf.

There has been resistance both from vendors that are reluctant to accept cards and from businesses that have been hesitant to adopt cards for their spending. Procurement cards, in particular, have confronted obstacles. To spur momentum, card issuers have offered rebates to card-using companies, but this tactic may be unsustainable over the long run. In the interim, card issuers are demonstrating that companies can achieve efficiency with electronic payments. They are also enhancing and expanding original products and delivery designs to better meet the requirements of their corporate clients.

This section will discuss the evolution of this segment of the commercial card arena. It will discuss why card products (particularly procurement cards), which were designed for corporations and large businesses, were slow to be embraced by those companies and their vendors. How the payment card industry addressed initial resistance with solutions that could be implemented quickly, as well as those requiring longer development, will be explored. It will end with a look at how the feedback from the marketplace influenced first-generation product concepts to create more comprehensive solutions for corporate purchasing.

A. Reservations on the Part of Corporate Payers

Some businesses have been reluctant to adopt cards for making their payments. Some fear losing the control provided by the purchase order process. Some have concerns that employees will misuse cards. Others have made significant investment in other methods of payment, specifically checks, which they are reluctant to abandon. This is especially true when the payment procedure is integrated with accounts payable, general ledger, management reporting, electronic data interchange,[56] and other processes. The efficiencies that result from these integrated solutions often offset the efficiencies that might otherwise be obtained by paying with plastic.

[56] Electronic data interchange is the electronic transmission of routine business documents, such as purchase orders, invoices, and bills of lading, between computers in a standard format.

According to a Visa commercial payments executive, the greatest challenges exist "in complex payments on the large-business side, where you have existing processes in place between different departments. In a company, the more processes you have to change the harder it is to change them."[57] In addition, trading partners may frequently have negotiated payment arrangements that work to the benefit of both parties and which might be disrupted by introducing payment cards into the equation.

The Role of Rebates in Card Adoption. To overcome the initial resistance, card issuers employed rebates to client companies to give them an incentive to adopt payment cards. These rebates are often referred to as "interchange rebates" because they are based on purchase volume, as is the interchange revenue received by the issuer of a general-purpose card. Rebates have been used most prominently as an inducement to corporations to adopt purchasing cards. Among respondents to the AFP survey, 45 percent listed rebates as one of the top three benefits of using purchasing cards, the second most frequently cited reason.[58]

It appears that the majority of P-card deals provide some level of rebate flowing from the issuer to the corporate client. First Annapolis Consulting conducted an analysis of information on rebates for purchasing card programs in four different states. Using this publicly available information as a proxy for rebate payment across the industry, First Annapolis estimated that about one-fourth of interchange revenue from P-card transactions flows to P-card clients in the form of rebates. The analysis noted that rebates can range from a low of 5 basis points on volume

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[57]Darren Parslow, senior vice president, Visa Commercial Solutions, quoted in *Cards & Payments* (June 2007).

[58]See "AFP Electronic Payment Survey: Report of Survey Results," Association for Financial Professionals (October 2007). The most frequently cited reason was reduced paper processing from purchase orders and invoices.

to as high as 160 basis points on transaction dollar volume. The percent of rebate paid is often tiered to increase with higher annual volume and with quicker payment by the client.[59]

In the consumer card arena, issuers can afford to provide cardholders with rebates and rewards in part because the revenue stream includes interest income. With commercial card accounts, however, little to no interest is paid (with the exception of credit cards for small business). In order to minimize the impact on the cost of funds, grace periods for repayment of procurement cards are shorter than those for consumer cards. The length of time will vary by negotiation, but 10 and 15 days to repay are common, and there are P-card programs that feature billing cycles of every two weeks, every week , or even daily. (As noted in the previous paragraph, the velocity of payment will affect the amount of the rebate.) Commercial cards also offer issuers some opportunities to generate fee income (for a management reporting package, for example) that do not exist for consumer card issuers. Nonetheless, card providers to large commercial and government entities remain heavily dependent on interchange revenues.

Since the assets funding these short-term loans produce little interest income, the interchange-dependent commercial card model is sensitive to cost of funds, which in recent years has been at its lowest levels since the advent of the general-purpose payment card. Eventually, funding costs will increase, making this model vulnerable. Interchange rebates will be affected in two ways. As rising cost of funds increases issuer costs, less revenue will remain to support rebates. Client companies may also reconsider whether the relative value of making payments in 10 to 15 days, with a rebate, would offset the float on their deposits (in a higher-rate environment) if they were to defer payments to suppliers for 45 to 60 days. Additionally, any scenario that would cause a decrease in interchange rates could also prove disruptive.

[59] Frank B. Martien and Allie Chafey, "Commercial Card Rebates – A Snapshot from the Public Sector," *First Annapolis Navigator* (March 2009). In an article posted on businessfinancemag.com by Karen M. Kroll ("The P-Card's Journey Upstream," April 1, 2008), Aberdeen Group Research Analyst Amit Gupta is quoted, saying that P-card rebates range from about 1 to 3 percent.

A Boost from the Public Sector. Critical early momentum came from local, state, and federal government agencies, which were early adopters of payment cards, particularly procurement cards. The U.S. government's General Services Administration (GSA) SmartPay program is not only one of the single largest card portfolios in existence; it was also instrumental in advancing the adoption curve for P-cards.[60] Certain players, SmartPay being one of them, have sufficient size to influence the market. In addition to being a large enough customer to increase merchant acceptance, SmartPay wielded sufficient weight to advance the practice of transmitting Level III data with card transactions.[61] Inability to obtain this line item detail from their vendors had been a barrier to P-card usage in many companies. As a customer, the U.S. government was one of a few entities with purchasing power of the magnitude to compel its vendors to make the infrastructure adaptations needed to provide Level III data as part of the P-card transaction. Once built for its largest customers, this capability could then be extended to other companies using P-cards, removing what had been a barrier to adoption by those companies.[62]

Evolution in commercial cards is being advanced by the federal government in other ways. The Department of Labor has made grants to 20 states to help fund efforts to distribute unemployment benefits via prepaid cards.[63] The Department of the Treasury launched a program in 2008 for distributing Social Security disability benefits via prepaid cards to approximately 4 million recipients who, lacking bank deposit accounts, were not able to receive direct deposits.

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[60]TowerGroup reported that SmartPay accounted for 18.5 percent of total P-card volume in 2007, or nearly one in every five dollars transacted on purchasing cards. The SmartPay program is administered by the General Services Administration. Card issuers are selected through a request for proposal process. Information is available at:
http://www.gsa.gov/Portal/gsa/ep/channelView.do?pageTypeId=17112&channelId=-24785

[61]Level III data, also called "line item detail," provide a breakdown of all items comprising a purchase, the quantity of each and their product codes and descriptions, and shipping information.

[62]"Multi Service Corporation: Perspectives on Commercial Payments from the President, Mark O'Connell," *First Annapolis Navigator* (May 2009).

[63]*ATM & Debit News,* 10:34 (July 23, 2009).

This initiative was subsequently expanded to include ordinary Social Security disbursements.[64] More recently, the Treasury Department announced an initiative to disburse income tax refunds on prepaid cards as a means to transmit funds electronically to individuals without bank deposit accounts.[65]

The impetus behind migrating to cards is cost savings for the government. While the incremental cost of distributing benefits by check costs around $1 per payment per recipient, an electronic disbursement to a card costs about 12 cents, according to an official with the Treasury Department. [66] This is consistent with figures attributed to the American Payroll Association, which pegged the costs of payroll checks at $1 to $2 per item and electronic transfer at about 20 cents per item.[67] And these savings reflect only the actual cost for the payment, not the back-end reconciliation and other costs associated with checks, including replacing lost and stolen checks, which the American Payroll Association suggests cost another $8 to $10, according to a report published by Oliver Wyman Financial Services.

In its report, Oliver Wyman mentions other cost savings afforded by cards. Citing estimates by American Express, the report notes that the average cost to provide employees with a cash advance is $24 per transaction, a cost rendered unnecessary if employees are provided with cards for their travel expenses. The report goes on to cite RPMG Research findings that the administrative expense for processing those card-related travel expenses yielded a cost savings of

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[64]Note: These are examples of the second type of "commercial" prepaid card discussed in Section III, cards adopted to reduce the cost of disbursing funds that will result in consumer payments. For more information on the use of prepaid cards to distribute Social Security payments, see "U.S. Treasury Introduces Direct Express® Debit Card for Social Security Payments," U.S. Department of Treasury press release, June 10, 2008. http://www.fms.treas.gov/news/press/directexpress_launch.html

[65]"Treasury Launches Pilot Program of Prepaid Debit and Payroll Cards for Fast, Safe and Convenient Tax Refunds," U.S. Department of Treasury press release, January 13, 2011. http://www.treasury.gov/press-center/press-releases/Pages/tg1021.aspx

[66] See "Treasury Satisfied with Debit Cards for Social Security Payment," *Cardline* (July 24, 2009), which quotes Financial Management Commissioner David Lebryk.

[67]Zilvinas Bareisis and Paul Mee, *Payments Opportunities: Finding the White Space* (Oliver Wyman 2009).

$10 per report compared with paper expense reporting ($12 vs. $22).[68] The National Association of Purchasing Card Professionals advises that administrative costs can be reduced by up to 85 percent per transaction using electronic processes, including payment cards. A separate cost comparison conducted by Accenture suggests a potential savings of $78 per transaction using a P-card compared with a fully manual and paper purchase order and payment process ($19 vs. $97).[69]

As more evidence of hard-dollar savings through the use of P-cards is demonstrated, the rationale for implementation may be more strongly based on controlling costs and less on the rebates that motivated early adopters.

B. Reservations on the Part of Corporate Payees

Among the card products targeted to medium and large companies, corporate cards have been the most successful in capturing business spending. Since business travel and entertainment are a primary reason for their use, corporate cards tapped into a network of merchants already equipped to accept card payments. The types of merchants where T&E spending takes place — airlines, restaurants, hotels — were among the first to begin accepting general-purpose credit cards. Likewise, prepaid cards provided by businesses are often intended for a consumer end-user who will be purchasing within the already established network of merchants who accept payment cards. In the case of procurement cards, however, many suppliers of goods and services to corporations do not serve the consumer segment and so have never found it necessary to be set up as card-accepting merchants. Furthermore, they may not be easily convinced that they should become merchants who accept commercial cards.

Nearly 80 percent of consumer households have some type of general-purpose debit or credit card, and with the introduction of prepaid cards, the potential universe of cardholders

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[68]Bareisis and Mee (2009).

[69]Frank B. Martien, First Annapolis Consulting, “Commercial Card Market Overview,” presentation to Payment Cards Center, Federal Reserve Bank of Philadelphia (March 24, 2008.).

approaches 100 percent. This broad base gives consumer cardholders some collective clout in influencing merchants' decisions to accept payment cards. For some B2B vendors, however, responding to customer payment preferences may not be an imperative, depending on the relative importance of the customer to the supplier (or vice versa)[70] and the number of customers who are asking to make payments by card. Underscoring the resistance to card acceptance is the associated cost: Interchange fees on commercial cards can cost providers 2 percent of the sale.[71]

A survey conducted by the Association for Financial Professionals adds an interesting dimension to the discussion of interchange costs. The survey questioned vendors about their reasons for and against card acceptance. The responses were then broken into two categories: those vendors who accept cards for payment, and those who do not. In the latter category, only 18 percent cited interchange as a reason for not accepting payment cards. The primary reason for nonacceptance was that cards are "not applicable to business/customer base." By contrast, in the card-accepting group, interchange was the primary disadvantage (noted by 68 percent of respondents) of card acceptance, with its most frequently cited benefit (noted by 88 percent) being that it "satisfied customer payment preference."[72] These findings indicate that the decision to accept cards is not simply a question of costs; instead, it depends on a comparison of incremental costs and benefits, and interchange costs alone are not an insurmountable barrier to adoption.

Card-accepting respondents also cited other benefits of card acceptance. Eighty-one percent said cards enabled "faster receipt of payments" and decreased the number of days of payments outstanding; 70 percent said cards eliminate collection activity. One interpretation of the survey, then, is that interchange fees are a significant cost to vendors who accept cards, but

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[70]For a discussion on the relative power of suppliers to industry, see Michael E. Porter, "The Five Competitive Forces that Shape Strategy," http://hbr.org/2008/01/the-five-competitive-forces-that-shape-strategy/ar/1#.

[71]*ISO & Agent* (April 2009).

[72]See "AFP Electronic Payment Survey: Report of Survey Results," Association for Financial Professionals (October 2007).

not so significant that the fees offset the benefits of accepting cards, including satisfaction among their customers. Among vendors who do not accept cards, until there is sufficient demand from their customers, the costs of adopting payment cards are difficult to justify.

Over time, some providers to commercial customers may arrive at the same conclusion that many retailers reached several decades ago: The cost of card acceptance can be less than managing accounts receivable internally, including the costs of underwriting, billing, receivables processing, and collections. These can substantially exceed 2 percent of applicable sales revenues when such costs are fully considered, according to Frank Martien, a partner in First Annapolis Consulting, and an expert in commercial payment cards.[73] The immediate, guaranteed payment of a card transaction can sometimes offset the internal costs of carrying and managing receivables (and taking the occasional credit loss), especially if a discount to the buyer for expedited payment is part of the terms.

Resistance from vendors and suppliers may also subside as the card industry and its partners retool their offerings to provide more benefit to all parties. The "build it and they will come" confidence that infused the early expectations of merchant adoption has encountered some strong and entrenched resistance. As card networks' efforts to find a foothold in commercial payments have evolved, and their understanding of corporate needs and practices has expanded, the result has been a sharper focus on win-win solutions that provide value for both parties to the transaction. Steve Abrams, former senior vice president for MasterCard's commercial card products, expressed this focus this way: "Everybody has to win. Suppliers want to pay less in acceptance costs. The companies using cards want to be able to conduct more of their purchases with their cards, without paying the high costs that result when acceptance costs are artificially

[73] Martien's statement reflects the market observation of First Annapolis Consulting based on client engagements in which such costs have been estimated.

forced down. Issuers want the whole thing to work. The process has to be effective, end to end."[74]

C. Responding to the Challenges

The promise of reduced payment costs has been realized by early adopters of commercial cards, but marketplace realities made clear that this value proposition by itself was insufficient to displace established corporate payment practices. The initial prototypes for commercial cards have been enhanced to provide card-deploying companies with additional benefits, including regulatory compliance. Twenty percent of companies participating in a purchasing card benchmark study conducted by the Aberdeen Group credited purchasing cards as useful in being compliant with Sarbanes-Oxley legislation.[75] Expense categorization by merchant type and capture of a taxpayer identification number (TIN) as part of the transaction data set also facilitate IRS 1099 reporting.[76] Other value derived from cards and their ancillaries includes expense consolidation, management reporting, fraud controls, stronger position in vendor negotiations, spending controls at the card level, and enhanced visibility into cash position.[77]

Along with these product improvements, the economic landscape may accelerate adoption of commercial cards. As companies deal with the aftermath of the recession, they are looking for

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[74] From my interview with Steve Abrams, January 11, 2010.

[75] The 2005 Purchasing Card Benchmark Report by the Aberdeen Group, as cited in American Express' Executive Briefing Series (2007).

[76] Visa USA, *Purchasing Cards and IRS Requirements: A Look at the Issues* (undated).

[77] Dave Lindorff, "The Plastic Revolution," *Treasury & Risk* (September 1, 2003); American Express, "Overview of Commercial Card Products That Can Increase Expense Management and Controls" (undated); TowerGroup, "US Commercial Cards: Safe Haven in Heavy Weather for Issuing Banks" (March 2009); the Visa Cash Management Survey, October 2006; The Aberdeen Group, "Commercial Cards: Delivering Savings across Procurement and A/P" (November 2008).

ways to reduce costs and streamline processes. Some observers believe that companies may take a second look at the efficiencies of card-based electronic payments.[78]

Two strategic initiatives undertaken by card networks and issuers — supply chain integration and expansion into global markets — may provide additional opportunities for commercial cards.

Integrating Electronic Payments with Supply Chain Systems. One of the more interesting ways in which the earlier prototypes have evolved is in their integration with activities on either side of the payment transaction, specifically with supply chain management and the procurement/accounts payable process. These efforts at integration acknowledge the complexities that exist in the B2B world, which differ from consumer payments, particularly in larger organizations and with big-ticket purchases. To these ends, all three major general-purpose commercial card brands have reconstituted their networks to incorporate processes beyond payment transactions and enhanced data capture.

American Express purchased Harbor Payments Inc. and relaunched it as S2S eInvoice & Pay in 2007. Later that year, MasterCard Inc. released Payment Gateway, and most recently Visa announced Syncada LLC, a joint venture with U.S. Bancorp, to create "the first global supply chain network that focuses on payment processing, electronic invoicing and trade finance," according to Visa's Darren Parslow.[79] Within these new integrated services, the card no longer is the "featured player," but rather just one component of a set of activities employed by businesses buying from and selling to each other. In its coverage of the launch of Syncada, for instance, *The*

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[78]Sources include Joanne Robinson, "Is the Current Financial Crisis Possibly the Best Opportunity the Commercial Payments Industry Has Ever Seen?" commercialpaymentsinternational.com (November 3, 2008), and my interview with Steven Murphy, research director, Wholesale Banking, TowerGroup.

[79]Steve Bills, "Global Reach is Key to Visa, USB B-to-B Venture," *American Banker* (July 30, 2009).

Nilson Report, observed that "cards will never account for more than 20 percent of the dollar value of payments in Syncada – or any other B2B network."[80]

Endeavors to integrate the information and financial components of supply chain management should also yield benefits and efficiencies for the supplier side of a commercial card transaction. This may mitigate resistance to paying the cost of commercial card acceptance. In addition, if commercial card issuers can generate new revenue streams by offering a broader suite of services to users of commercial cards, issuers' dependence on interchange revenues could be relaxed. This, in turn, might enable a restructuring of interchange to reduce the costs faced by vendors accepting payment cards, especially for big-ticket transactions.

International Opportunities. The global nature of the Syncada joint venture signifies another area of strategic realignment that has occurred in commercial cards: moving outside the borders of the United States to pursue growth opportunities worldwide. At the start of the century, residents of the U.S. and Canada accounted for nearly one-third of global consumer spending,[81] but commercial consumption is not quite so heavily skewed to North America, which accounts for just under one-fourth of global commercial consumption expenditures. In addition, expected rates of economic growth also suggest that the greatest opportunities may lie outside North America. In 2008, the U.S. experienced 5.25 percent growth in commercial consumption expenditures and Canada, 4.5 percent. This compares unfavorably with the 13.6 percent growth in commercial consumption expenditures for the Asia-Pacific region, 9.6 percent in Europe, and 16.3 percent in Latin America.[82] Thus, while it made sense for consumer card issuers to concentrate on the American market further into the product life cycle of consumer payment

[80]"Visa's Global B2B Network," *The Nilson Report,* Issue 931 (August 2009).

[81]According to Worldwatch Institute, in 2000, 31.5 percent of world private consumption expenditures were made by Americans and Canadians.

[82]Visa Commercial Consumption Expenditure Index 2008.

cards, commercial card players may find it attractive to expand into overseas markets earlier in the life cycle of commercial cards.[83]

In certain regions of the world there is a closer alignment between the core deliverables of commercial cards and the solutions being sought by corporations. In Europe and Latin America, a majority of respondents (69 percent and 70 percent, respectively) to a payments survey conducted by the Aberdeen Group said that simply eliminating cash advances was a significant goal. Customized reporting and improved cash management were also considered important by about six in 10 of the responding organizations in Latin America.[84] So for businesses in these regions, the existing features of commercial payment cards are enough to achieve their objectives. By contrast, for North American companies, system integration was the top driver (80 percent of respondents). While this is occurring, as noted earlier, it is not as perfected as the features of commercial cards that can readily solve the needs of businesses in Latin America, Europe, and the Asia Pacific regions.

VI. Conclusion

While the earliest concepts for commercial cards may have been imperfect (particularly, perhaps, for P-cards), commercial cards have delivered on the core promise of cost reduction to the buyer. While they still comprise a very small portion of overall commercial payments, their adoption is noteworthy in certain areas: travel and entertainment, small business, and prepaid cards. Additional benefits not originally envisaged, such as providing a paper trail for regulatory compliance, have emerged. While U.S. businesses have not adopted payment cards in the same proportions as American consumers have, commercial cards have become a fixture in the

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[83] "New Aberdeen Report Finds That Globally the Amount of Spend Being Processed via Purchasing Cards and Corporate Cards Is on the Rise," *Market Wire* (May 10, 2007).

[84] *Market Wire* (May 10, 2007).

commercial banking product suite significant enough such that many banks that serve commercial clientele offer at least one or two types of commercial payment cards.

The consumer general-purpose payment card required substantial retrofitting to meet the needs of commercial payers — particularly large corporations and the federal government — and the card industry has demonstrated a willingness to make those adaptations. Growth rates have been encouraging, and new opportunities for growth are still being identified, particularly for card issuers working with the federal government and for those with global reach.[85] The current economic and regulatory environment, while presenting certain challenges, may also contain elements conducive to the expansion of commercial cards and, increasingly, to the integrated solutions now being provided by the payment card networks. Pressures to reduce costs may impel corporations to re-examine the efficiencies to be gained by introducing changes to their purchasing and payment practices.

Commercial payers have already recognized the cost-reducing qualities of prepaid cards, making prepaid commercial cards something of a surprise breakout category rather early in the life cycle of general-purpose prepaid cards. Because of the very specific but differing needs for which prepaid cards are being used, participants in the commercial payment card market may anticipate continued innovation and development of customized solutions built around prepaid products.

For corporate travel and entertainment cards and fleet cards, innovation will be more incremental. The core functionality of these products is sufficiently developed to fulfill their intended purpose. Dollar volumes transacted with these kinds of products are likely to fluctuate due to corporate travel budgets and volatility in fuel prices, rather than from significant advances in product development or a surge in product adoption.

[85] See Kate Fitzgerald, "More U.S. Issuers Going Abroad to Pursue Commercial Card Stakes," *Payments Source* (May 2010).

For small businesses, access to credit, as well as payment efficiency and convenience, drives card use. For small businesses that can maneuver the current economy without much need for credit, their use of commercial debit and credit cards to make purchases should continue with little impediment. For those who depend on cards for financing, however, and for the card issuers who serve them, challenges reside not only in the credit contraction that is characteristic of recessions but also in the potential for a "new normal" that may exist as the card industry and the larger economy adapts to both post-recession conditions and an altered regulatory environment.