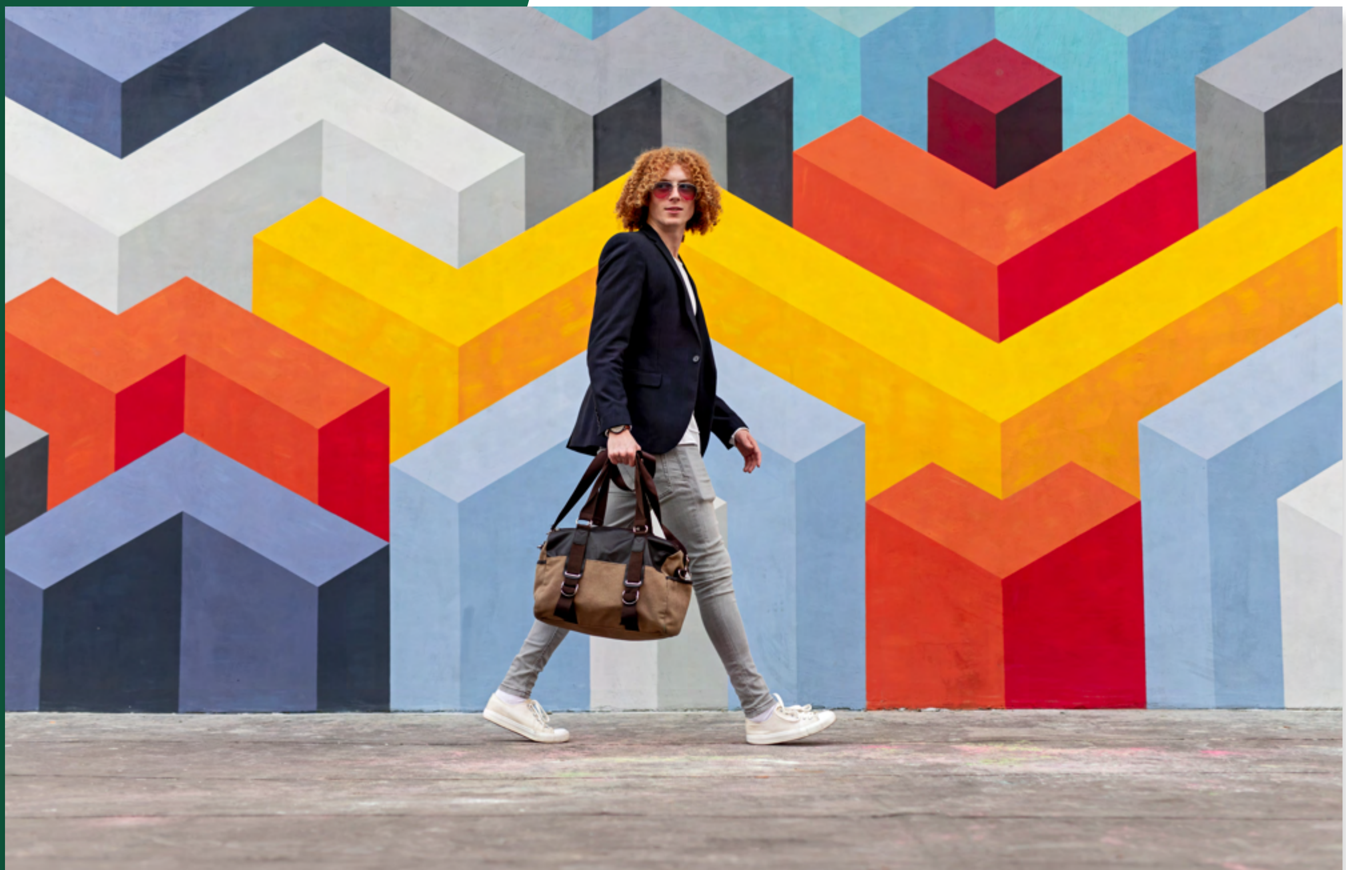

Understanding Payment Facilitation

Keeping up with an *Evolving* Payment Landscape

This white paper explores how payment facilitators differentiate from others in the global payments ecosystem by driving value to customers and striving to build a future out of the challenges and opportunities presented.

Written by TSG Senior Associate, Steve Hoofring

Payments Experts. Powerful Data.
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ABOUT THE AUTHOR

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CONNECT:

LONG LIVE PAYMENT FACILITATION

Payment Facilitation has played a large and interesting role in financial technology over the last two decades. Starting as an effort, in part, to avoid an overload in payment systems, it has evolved into multiple models, created new service priorities, and even spawned new businesses. Payment Facilitation has made a deep impression on our industry.

The Strawhecker Group (TSG) is pleased to provide this focused "practical" discussion on Payment Facilitation. We'll compare and contrast Payment Facilitation to traditional merchant systems and provide the basics of how a Payment Facilitator functions.

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The Four Monetization Models

Contrary to what many "experts" preach, there are many ways to monetize payments. It is essential for management at ISVs to understand their options in assessing which payment monetization model works best for their business.

Download the Infographic
The Four Models of Payment Monetization

REFERRAL MODEL

The referral model is perhaps the most commonly executed model as it is the simplest to implement, but it is also the least lucrative. Under this model, an ISV will partner with an established merchant acquirer. Then, when a client of the software company wishes to accept payments through the platform, the ISV then refers them to the selected payment partner(s). If the referral is completed successfully, the ISV may receive a small flat success fee for referring business to their designated acquiring partner or a small percentage of the recurring revenue. Under this model there are very few regulatory requirements, liabilities, and close to no resource requirements on the side of the ISV. In some arrangements, the payment partner will have a designated representative or sales team dedicated to managing the referrals from the ISV.

RETAIL ISO

For ISVs looking for a bit more control of their client's experience, becoming a registered retail ISO is a more attractive option, from a financial perspective. Similar to the previous model, the ISV will need to establish a relationship with an established merchant acquirer and sponsor bank. Under this model, the ISV may support some operational aspects of managing the merchant/client relationship, such as customer service, sales, boarding, and more. In taking on these additional responsibilities, the merchant acquiring partner will typically share a percentage of the processing revenue generated from volume flowing through the ISV's platform. This model has drastically higher upside from the referral model, but also comes with increased responsibilities, resources, and infrastructure required.

PAYMENT FACILITATOR

As expected, the payment facilitation model takes on a more complexity than the previous two options. This model requires ISVs to establish an operational posture reviewed and approved by their sponsor bank, processing partner, and technology partner(s) to facilitate the transaction processing service. It also requires registration with governing entities, substantial operational/technological resources, along with payment processing competency. Software players looking to become payment facilitators typically assume full financial liability, comply to higher PCI security standards, and assume responsibility for sales, support, risk management, credit risk, and full management of the payment processing services offered through their business. Full financial liability means that a payment facilitator will take on all credit losses, fraud losses, and responsibility for daily funding of sub-merchants. With these increased responsibilities, the ISV is able to earn a larger percentage of the payment revenue for the volume they are facilitating and maintain greater control of the customer experience. This model also requires in-depth understanding of the payment's ecosystem and chain of risk. ISVs attempting to successfully implement this model should be prepared to make substantial investments into technology and talent to support such a significant undertaking.

WHOLESALE ISO

The wholesale ISO model is very similar to the payment facilitator model, with a few distinct differences. Like the previous model, it requires the establishment of an operational payments business, a sponsor bank and high-volume processor, registration with the card networks, and a hefty support structure to sustain such an operation. This model requires a substantial amount of resources, as it brings full fiscal liability, compliance with data security standards, and full support of sales, underwriting, fraud, and more. This model allows the ISV to have complete control of the merchant experience. While this model does come with a financial barrier due to the amount of resources it takes to support, it is among the most lucrative models in terms of the percentage of payment volume the software company is able to monetize.

Payment Facilitator Overview

THE WHO'S WHO OF PAYMENT PROCESSING

Working together, these entities provide payments to the globe.

Acquiring banks are the foundation of payment processes. They maintain contracts with the card networks to sponsor credit and debit card processing. As a bank, they have a charter to support bank accounts and move money throughout the US. There will always be an acquiring bank (also known as a sponsor bank) somewhere in the picture.

Acquiring banks, ISOs and Payment Facilitators contract Processors to process the payments. They are certified by the card networks and typically provide the backbone systems and services that perform both Authorization and Clearing functions. They can provide additional services depending on the needs of their clients and their own technical capabilities.

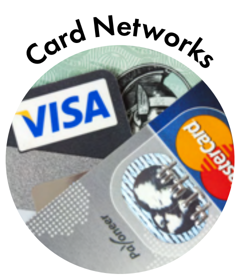
The acquiring bank may contract with a sales organization, known as an Independent Sales Organization, or ISO to provide merchant acquiring services to merchants. Banks can provide services directly to merchants, but an ISO cannot – they require a bank to move money. A Payment Facilitator is a unique type of ISO. In addition to providing similar services we see from an ISO, the Payment Facilitator can also provide additional services to a new class of merchant called "Sub-Merchants." These services typically include payment request and unique settlement services. Payment Facilitators must abide by all the rules and laws that govern an ISO or an acquiring bank.

A Sub-Merchant is a name assigned to the Payment Facilitator's merchant. It is called Sub-Merchant because the payment transactions initiated by the Payment Facilitator use the Payment Facilitator identifiers in the payment network. The Sub-Merchant has no identifier, typically called a Merchant ID. A Payment Facilitator will append Sub-Merchant information to the Payment Facilitator payment request to share some information about the Sub-Merchant to the other participants.

Processors and ISOs may offer their own 'white label' Payment Facilitation services. These programs allow folks who want the benefits of being a Payment Facilitator without having to develop their own systems and services – and there are cases where these new entities will offer operational services.

Card Brands are networks, connecting the Card Holder and Merchant typically through Processors.

IT'S ALL CONNECTED



UNDERWRITING AND BOARDING

Because Payment Facilitators are selling to and on-boarding sub-merchants for payment processing (much as ISOs or acquiring banks acquire merchant accounts), they must comply with federal/state/local laws as well as card network rules and regulations. Payment Facilitators must underwrite sub-merchants: they must verify the identity of the business, its principles, bank accounts and credit worthiness. A Payment Facilitator must meet all pertinent regulatory requirements. While Payment Facilitators market their abilities in 'faster approval', this is all subject to their systems and processes. The Payment Facilitator must still comply with all regulations and rules – all of that work must be completed behind the scenes. A Payment Facilitators staff must be trained in underwriting merchant accounts and the business must have a system to support sub-merchant records addition/change as well as systems and services to underwrite the sub-merchant. Compliance many fall under FinCEN, Patriot Act, AML, BSA, KYC, OFAC. FFIEC as may be required by the acquiring bank, and of course, card network rules.

COMPLIANCE AND REGULATORY

A Payment Facilitator must comply with each card acceptance participants' regulations to include card networks, acquiring banks and regulatory agencies. Third-party vendors such as processors may also have specific requirements. The Payment Card Industry, (PCI), also mandates requirements as defined by the card networks; PCI is administered by a separate council. A Payment Facilitator must also comply with Federal, State, and Local rules and regulations. Scope will vary based on each Payment Facilitation model. A number of Payment Facilitation models sought classification as "Money Service Businesses". The MSB laws are generally applied at the state level. Additional regulations include FinCEN, Patriot Act, AML, BSA, KYC, and banking regulations as it applies to each vendor relationship. This is not a full list of all possible compliance/regulatory conditions and it appears these are changing rapidly and at an even faster pace. Working in Payments requires 'material' investments to maintain solid compliance. Payment Facilitation and traditional merchant acquiring have nearly the same requirements, but Payment Facilitation may also have some additional requirements hinging on the respective industries they serve. Understand the model for your Payment Facilitator and seek counsel as needed.

Payment Facilitators must abide by all the rules and laws that govern an ISO or an acquiring bank.

RISK MANAGEMENT

A critical dimension of support is managing risk. In the acquiring space "We move money and manage risk". Therefore, risk systems and staff are necessary to help detect potentially risky transactions and take appropriate actions to mitigate the risk for the Payment Facilitator. Payment Facilitators are generally responsible for losses resulting from their sub-merchants. This can be a challenging business proposition for new Payment Facilitators.

ACCOUNTING AND RECONCILIATION

A critical and often overlooked function is reconciliation. The Payment Facilitator utilizes the bank card systems to receive funds so they can pay their sub-merchants. There are multiple reconciliation points along this path and as the responsible entity for accurate payments to sub-merchants, the Payment Facilitator needs to verify authorized funds are accurately paid to the Payment Facilitator and subsequently to the sub-merchant.

Make no mistake: this is accounting heaving lifting – you are literally accounting for the transfer of millions to billions of dollars. You must have a manager and/or team with the skills and tools necessary to manage that aspect of the business.

POLICIES, PROCEDURES, AND TRAINING

All operations in the payment industry require policies, procedures, and training documents. Proper training ensures consistent and uniform application of the services and maintains compliance. As a payment entity, the Payment Facilitator is subject to audit by their acquiring bank, card, brands, or other affiliated entities. To remain in compliance requires commitment to strict document maintenance, documentation of training and rigorous management practices.

CUSTOMER SERVICE

Once boarded and processed, the Payment Facilitator must also provide customer service to the sub-merchant for payment processing. Customer service representatives need training on the various incoming business conditions to resolve problems associated with the services. These calls span from point-of-sale interaction all the way through settlement and reporting of funds. Training of these resources may also include support for upstream systems and services as they may impact the transaction.

OTHER SERVICES

Payment Facilitators may offer many other services to their sub-merchants and their customers. These can range from customer relationship management services to specialized settlement and reporting services. By more closely connecting the customer to the seller, Payment Facilitators can improve service and other critical dimensions, beating out the competition.

Payment Facilitators offer many services to their sub-merchants and customers, and continuously work to improve their offerings to beat out the competition.

Traditional Processing vs Payment Facilitation

CREDIT CARD AUTHORIZATION – THE REAL TIME TRANSACTION

Authorization is the real-time portion of the payment request for credit card processing. A card holder will interact with some form of a point-of-sale interface to input card data at the completion of a sale. The point-of-sale interface (often paired with a gateway) will generate an authorization request that is sent to the processor – who then sends it to the card network who in turn sends it to an issuing bank for approval. The bank returns a 'yes-no' response (in reverse) through each party. This is a complex, real-time, and very security sensitive function.

The Payment Facilitator Authorization differs slightly from a traditional merchant account authorization in that the payload for an authorization request is modified, typically at the gateway level. The Payment Facilitator will append sub-merchant data to the traditional authorization request. To do this, the Payment Facilitator must have a merchant management system that can maintain this data and make available to the real-time authorization transaction.

The presence of sub-merchant data will be detected by processors, card networks, and banks and will be used for the process of authorization. Real time processing is one of the more complex functions payments and requires specific skills to build and maintain.

Authorization is also the portion of payment processing where card holder management services may be performed. These may include functionality for recurring or subscription management businesses; card holder management services can greatly improve the user experience. But card holder management services are NOT dependent on Payment Facilitation and can work in either Payment Facilitation or traditional merchant accounts. Card holder management services show up in the Payment Facilitation model because they allow for the use of applications that integrate payments into the user functions.

BEEP BEEP

A great example: your rider account with a ride-share company

CLEARING - GET THE MONEY FROM THE CARD HOLDER

Processors prepare funds for settlement at the end of each business day. They generate a file that is transmitted to the card networks; the card networks organize the transactions via issuing bank then debit/credit an account at the acquiring bank. Clearing is distinct to processors, card networks, and acquiring banks. Once the money is deposited by the card network into an account owned by the acquiring bank (sometimes referred to as a 'bin') the processor will begin the merchant settlement process. For Payment Facilitators, clearing is a dependent function performed by other participants and is required prior to their settlement and reporting functions. Beyond receiving the funds and reconciliation, the Payment Facilitator does not participate in clearing funds.

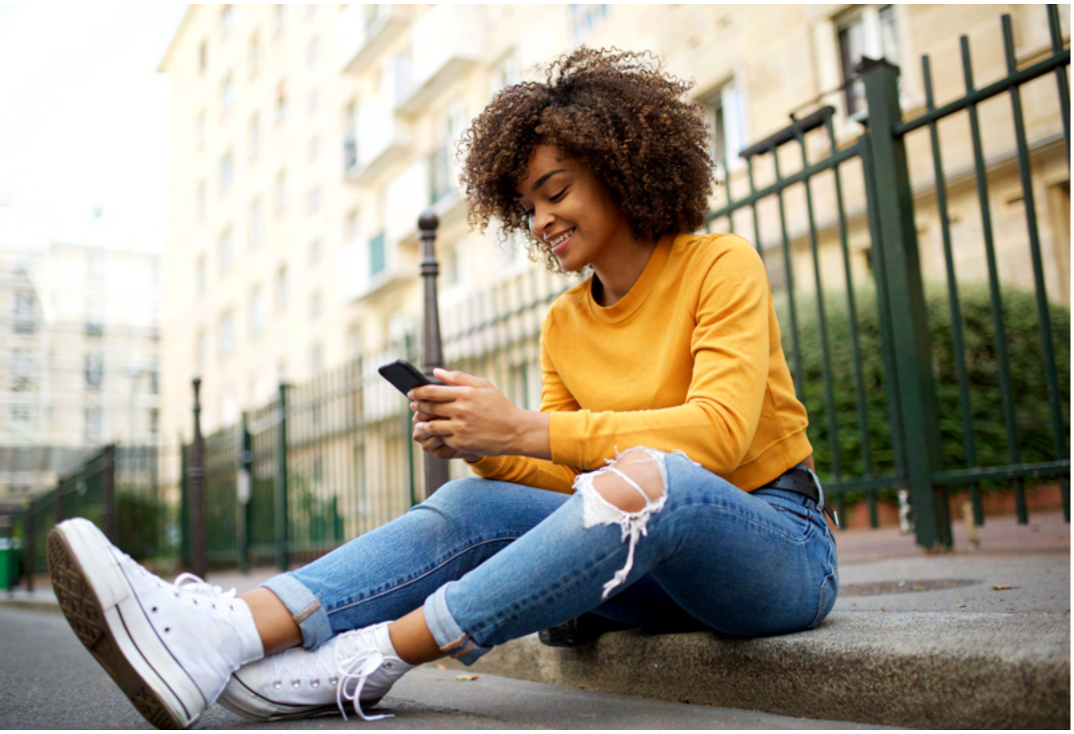
SETTLEMENT - PAY THE MERCHANT ACCOUNT

At the conclusion of clearing, the processor prepares for their settlement process. This function will debit the funds cleared by the networks and credit merchant settlement accounts. There are many functions to consider: billing, interchange, card network fees, risk management settings, and reserves.

In a Payment Facilitation Program, a Payment Facilitator account looks like a merchant account but typically contains no risk management or billing setup. Consequently all 'cleared' funds for all sub-merchant transactions processed for the Payment Facilitation are deposited into that Payment Facilitator's account (a bank account at the acquiring bank or another bank used by the Payment Facilitator for further processing).

PAYMENT FACILITATOR SETTLEMENT, REPORTING, AND BILLING DIFFERENTIATORS

Once funds are deposited into a Payment Facilitator's account the Payment Facilitator is ready to disperse funds to sub-merchants. The services will debit the Payment Facilitator account and credit all the sub-merchant accounts who are owed funds (typically an ACH transfer). To accurately calculate settlement, the Payment Facilitator must consider billing, risk management, settlement delay or other functions that may affect the accuracy of the deposit. This is a critical aspect of Payment Facilitator functionality: it may take a host of services to accurately move the funds. Common considerations: ACH, billing, risk management, merchant accounting, reporting, and chargeback management functions to name only a few.



Payment Facilitators allow for the use of applications that integrate payments into the user functions.

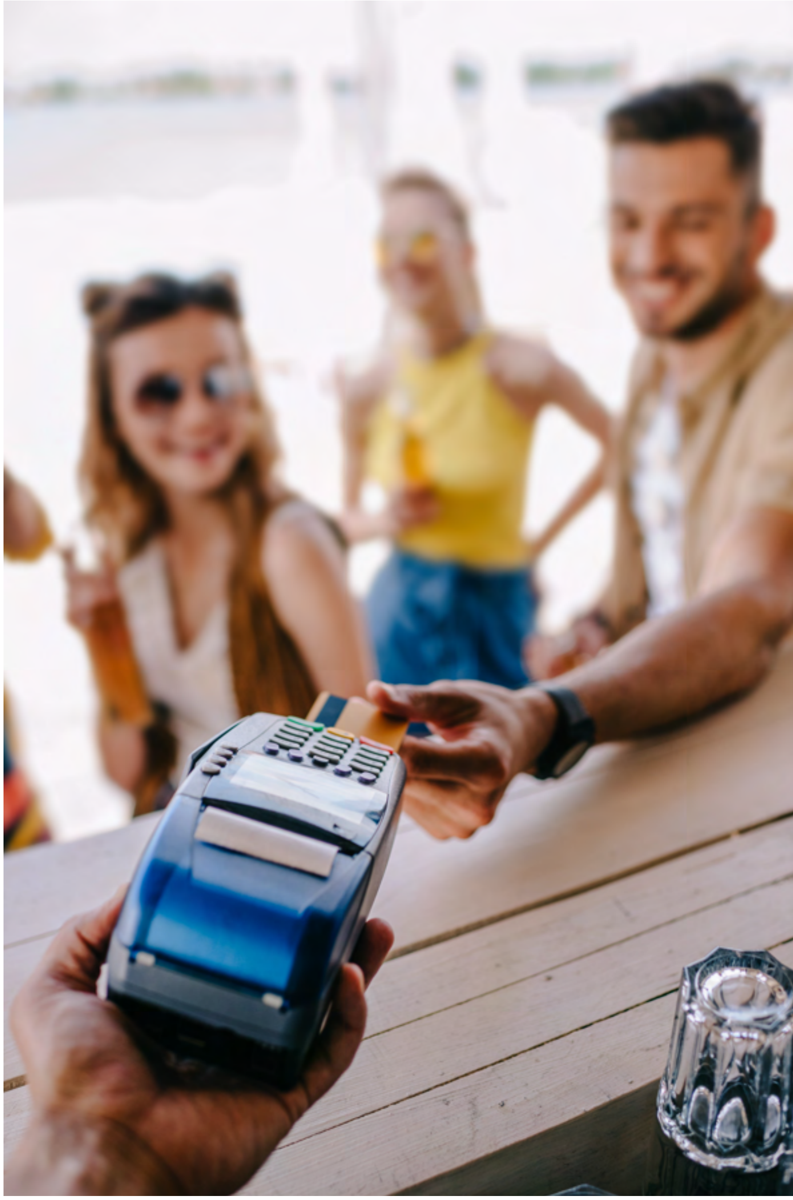
PAYMENT FACILITATORS DESCRIBE THEIR BENEFITS TO INCLUDE:

- Better Pricing
- Multi-Currency
- Instant Boarding
- Fraud Protection
- Smart Routing
- Dashboard
- Controlled Payout Timing
- Online Reporting
- Omni-Channel
- Recurring Payments
- Subscription
- Software Enablement

While attractive, it should be noted that all of these services, features and benefits may also be available with traditional merchant accounts.

SO WHY BECOME, USE, OR BUY A PAYMENT FACILITATOR?

Much of the benefit has to do with the new and unique ways Payment Facilitators have pulled the card holder and merchant closer together. Leveraging the ability to initiate the authorization request, at the right time, in a way that is easy for the customer builds value. In turn, leveraging the settlement and reporting capabilities can also improvement the sub-merchant experience. This combination has generated powerful models that create new segments and modes of leveraging assets.



When considering Payment Facilitation versus traditional processing, innovators, executives, and investors must consider all these dimensions to challenge the benefit of one model versus another.

FOOD FOR THOUGHT

To successfully move funds, a Payment Facilitator must have the ability to manage sub-merchant accounts that are not on processor systems. They may have unique needs for billing services, risk management services, reporting services, and a chargeback system – all specifically to accommodate sub-merchants. Consideration of every operational need, unique to your product or service, must be vetted prior to building or acquisition of a Payment Facilitation processing model.

Indeed, take note of all these systems prior to evaluating a Payment Facilitation solution:

- Merchant Manage System
- Merchant Account System
- Modify Authorization Request – real-time
- Settlement Engine
- Billing System
- Risk Management Services
- Reporting Services
- Chargeback Management

Payment Facilitation, using financial technology, will drive value to the customer.

There will be great challenges in the future, leading to even greater opportunities. The Payments ecosystem will be there to meet those challenges and continue to support our digital transformation as a society.

LOOK FORWARD

Digital transformation will drive innovation in and around our customers. The needs of novel delivery in both B2C and B2B will drive change.

A Payment Facilitator puts your business squarely in the path of the customer, in both authorization and settlement, and enables the Payment Facilitator to continue to build new and unique models.

Don't discount traditional merchant relationships: their foundations may still provide the horsepower required by our change agents with less investment and faster delivery.

TSG can help.

Does your company have software that processes transactions that leaves you wondering about becoming a payments provider?

Our team of seasoned experts has helped hundreds of software companies drive revenue in payments.

LEARN MORE

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stay connected:

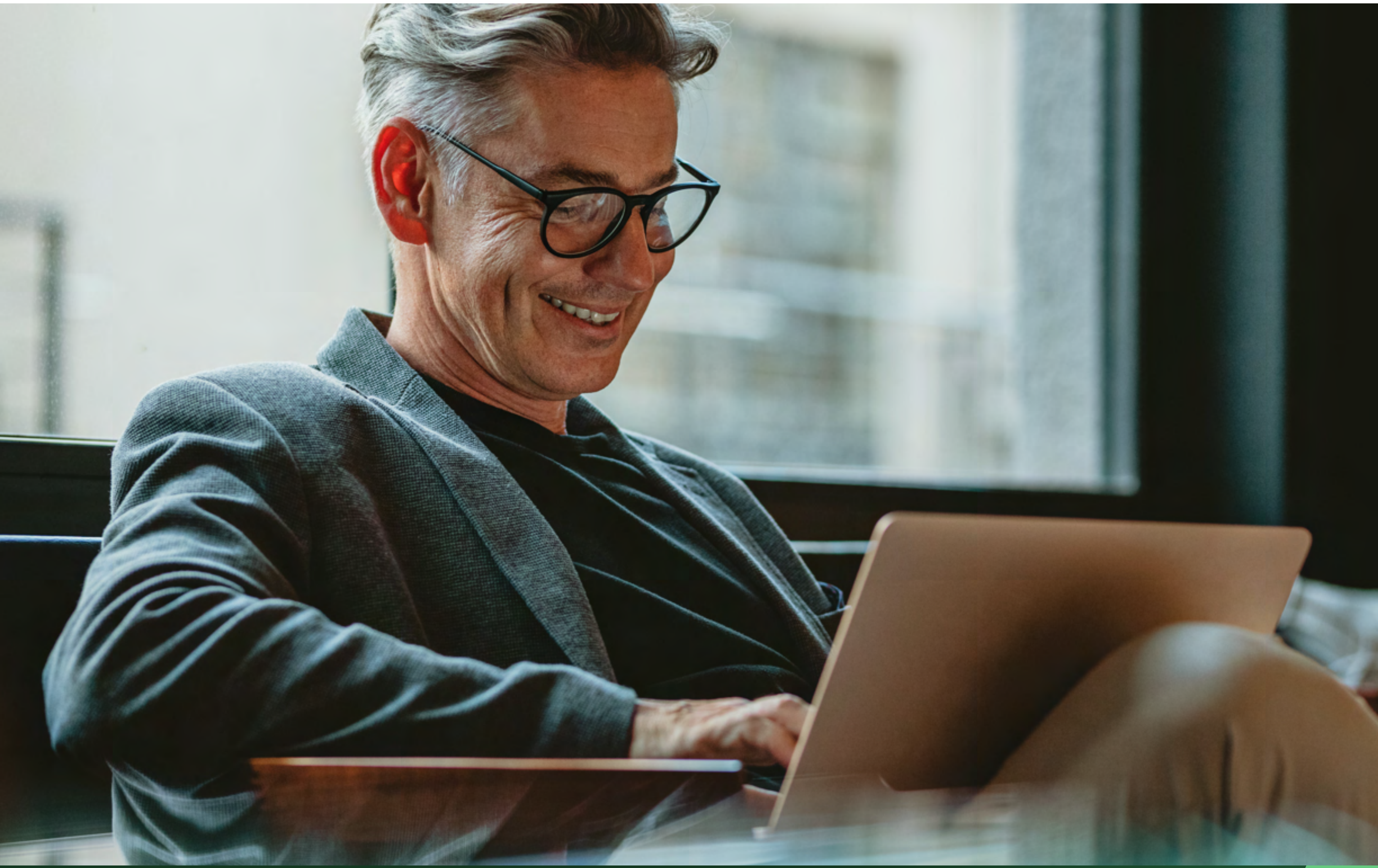
ADDITIONAL RESOURCES

Infographic | *The Four Models of Payment Monetization*

Case Study | *The ISV Mindset*

Article | *The Merging of Software and Payments*

Article + Infographic | *Defining Success in the ISV Channel*



Payments Experts. Powerful Data.

THE STRAWHECKER GROUP®

ANALYTICS + CONSULTING

The Strawhecker Group (TSG) is a fast-growing analytics and consulting firm. The company serves the entire payments ecosystem, from fintech startups to Fortune 500 companies. The firm provides its clients with advisory services, research and analytics to help them plan and execute their strategic initiatives. Based in Omaha, a recognized payments industry hub, TSG is an established leader in this high-growth, ever-evolving space.

40+
of the top 50 merchant acquirers served, including 9 of the top 10

250+
Completed payments company valuations; as well as ~30 buy/sell/investment advisements

1,000+
Clients advised, including many in the Fortune 500

23+ Years
Average associate experience in the payments industry

~4M
card-accepting merchants in TSG's AIM analytics platform, driving millions of dollars in ROI for its users