



AN ISTREAM FINANCIAL SERVICES AND CENPOS WHITE PAPER

Technology

New developments from Third-Party Providers (TPP) allow ISOs to provide additional value and services to the merchant.

Bank and ISO Partnership

Individually and collectively can bring value-added, products and services to the merchant.

Jorge Fernandez, CEO
First Payment Systems and CenPOS
(305) 260-4442
jorge@firstpaymentsystems.com

Robin Ferrari, Director of Marketing
iStream Financial Services
(262) 432-1574
rferrari@istreamfs.com

**THE EVOLUTION OF THE ELECTRONIC PAYMENTS
INDUSTRY: HOW ELECTRONIFICATION IS CHANGING
THE PAYMENT LANDSCAPE YET AGAIN.**

INTRODUCTION

The Electronic Payments Industry has evolved over the last 25 years to include a number of participating organizations. Among them are: Banks, Merchants, Independent Sales Organizations (ISO) or Merchant Service Providers (MSP) and Third-Party Providers (TPP). While there are multiple business models serving this industry, it is important to understand the differences among these organizations and how they evolved via one simple change -electronic transactions.

The “Early Days”

In its infancy, credit card transactions were authorized using telephones to verify the card number against a hard copy negative file booklet. Merchants would then manually complete a sales draft and physically deposit the paper drafts at the end of each business day with their local acquiring bank. This process was no different than the traditional paper deposit of a check item. Ultimately, the merchant would receive credit but the acquiring bank would have to wait days before it received settlement from the card associations. The only merchant acquirers at the time were Banks. The depository requirements of credit card slips mandated that a Member Bank or Agent Bank accept those deposits. The interchange rate system for fees charged to the merchant for taking this transaction was very simple; it was a one-rate system – paper.

“The Future is Here”

In 1984, VeriFone manufactured and delivered the ZON terminal, the first electronic card reading device that would electronically authorize the card but not capture the transaction. As a result of electronic draft capture, the credit card terminal was the beginning of the electronic payment industry. The new industry created opportunities for entrepreneurial independent providers, commonly known today as ISOs, MSPs and Third-Party Providers, to sell merchant services.

In the 1980’s, ISO/MSPs focused on the sale and lease of card processing equipment. As the industry pioneers, ISO/MSPs were successful in articulating the value of electronic payment processing to merchant prospects. The financial motivation tied to the benefits of electronic payment processing for merchants caused ISO/MSPs to become more successful than Banks in the selling and distribution of electronic payment solutions. The plan was simple as ISO/MSPs operated out of small sales offices across the U.S. with an aggressive sales force and an eye on profitability. The success of the ISO/MSP was imminent and they quickly began operating on regional and national levels. Some built their own front-end and back-end core-processing platforms. In 1987, VeriFone received its largest order, to date, from Citibank for 14,000 terminals to be delivered over an 18-month period. Meanwhile, Peach Tree Bancard deployed about 500-600 terminals a month. Thus, the electronic payments industry was in its infancy stages!

ISO AND BANK MARKET SHARE

ISO/MSPs

Large terminal manufacturers, such as Hypercom and VeriFone, continued developing new hardware technology containing terminal chips that held and processed more information. Leveraging the benefits of this new technology, the larger ISO/MSPs were able to provide value-add services, thus, further consolidating the industry with acquisitions of merchant portfolios and other small operations. This new era of ISO/MSPs involved providing full service and turnkey

business solutions to merchants. It was the answer to all of their card payment processing needs. Attracted by high profit margins, ISO/MSPs rapidly recruited skilled “feet on the street” sale associates, also known as Merchant Level Salesperson (MLS). The competition for merchants between banks and ISO/MSPs became relentless as the ISO/MSP’s aggressive sales tactics began eroding the banks’ merchant processing market share in record numbers.

By the late 1990s and early 2000, large ISO/MSPs or “Super ISOs” emerged. Companies such as iPayment, Heartland Payment Systems, First Data Corporation (FDC), and Global, some of which are publicly traded companies, continued to acquire merchant portfolios causing further consolidation of the industry. Due to the potential size of the market base, some Super ISOs focused on certain niche markets. For example, Concord EFS (now FDC) primarily focused on Fuel and Supermarket, First Tennessee focused on Travel & Entertainment (T&E), and Paymentech, formerly known as First USA, focused on card-not-present merchants.

Today’s Super ISO has developed even further. They now resell everything from the traditional merchant acquiring services to payroll services, Remote Deposit Capture (RDC) products, card issuing products, gift, loyalty and rewards and much more. However, many small to mid-market merchants buy direct from Third-Party Providers to achieve competitive pricing along with a wide range of financial products and services. Thus, the competition in the marketplace today is more fierce than ever.

ISO/MSPs Strengths and Weaknesses

Gone are the days of buying services from the large acquirers and reselling them to the end merchant with a significant mark up. This is especially true in the large merchant markets like Miami, Los Angeles and New York.

The traditional ISO/MSP business model faces many challenges and may not survive in the near future. ISO/MSPs must identify true, tangible operating efficiencies for merchants that address real problems such as interchange expenses, back office automation, consolidated real-time reporting, real-time fraud detection tools, and more. Technology has made the merchant more sophisticated, but segmented, thus leaving them hungry for ways to become more efficient. Unfortunately, the card associations have not helped in this matter as interchange rates spiral out of control and the merchant’s effective costs continue to soar.

ISO/MSPs have always looked for ways to expand their market share through strategic partnerships, especially today when margins are significantly lower than ever. Being more flexible, ISO/MSPs have polished their craft, listened and responded to the market more quickly than Banks. The forward thinking ISO/MSPs have learned that the key to future success depends largely on creating value for the client in two fronts: 1) reducing core-processing costs while helping the client fight fraud at the point of sale, and 2) selling additional value-add services.

ISO/MSPs have proven to be risk-takers, innovative, and many are on the cutting edge of technology. They have realized that some TPP partners have not developed any real solutions for merchants simply because they are too far removed from the real needs of the end user (the merchant). As a result, ISO/MSPs have had no choice but to individually develop front-end applications in order to provide their clients with a comprehensive processing solution that addresses the client’s real needs.

Banks

Banks need to continue in their quest to create new ways to generate additional fee income and strengthen depository relationships. They can't continue to use traditional fee income techniques that are becoming antiquated. The greatest success for Banks will be achieved by adapting and implementing new innovative ways to reduce cost for the merchants.

Traditionally, Banks have been very conservative in developing and rolling out new products and services, especially in the payment processing arena. Bankers have always depended on core processors or TPPs to develop new products. The question bankers must ask themselves is "when was the last time your TPP offered tools that you and your merchant needed that truly made a difference in the market place?" If Banks asked their current TPP providers about new technology and products, most likely there will be nothing new or innovative. Banks need a TPP partner that can provide a solution that will "stick" for their customers. Simply competing on price is no longer a viable position. Merchants are willing to pay for solutions that address their real problems and create value for them. Merchants are starting to evaluate the full Return on Investment (ROI).

That being said, Banks must align themselves with TPPs that offer both innovative technology and a true business partnership.

CO-OPETITION: COOPERATIVE COMPETITION

Is it possible for the competition to cooperate with one another? For the survival of all parties (Banks, ISO/MSPs and TPPs) the relationship among the parties must become more cooperative. Although there will be overlap, leaving some competition, there must be an element of cooperation for the benefit of the merchant relationship. There is a tremendous opportunity for all parties to leverage each others competitive advantage while learning from past successes and failures.

Each party brings a competitive advantage for the better of one another. But the key to creating the next generation of products and services for merchants between Banks, ISO/MSPs and TPPs is to make sure the interests among the parties align. It is of the utmost importance that the parties at hand share the same goals and objectives when it comes to merchant relationship management: customer service, pricing and ownership of the relationship.

FRAUD FOR ALL

It is not uncommon for new types of risk and fraud to emerge as technological advancements or changes in process flow are introduced. This is a topic of discussion on its own, but one that Merchants, Banks, ISO/MSPs and TPPs should not and cannot ignore. It is no surprise that with the introduction of electronic payment processing, new types of fraud developed. It started simply with the fraudulent use of complete credit card numbers imprinted on receipts that consumers left around. More sophisticated methods, such as card skimming, and now even more complex data breaches at the merchant and processor level, have rapidly evolved.

As a result, the industry is forced to react and educate while quickly creating new technology in an attempt to curtail fraud, not only at the processor locations, but at the merchant locations, as well. In some cases, new compliance rules tied to heavy fines for non-compliance have been created by the card associations. These rules range from the truncation of the credit card number on receipts to triple DES (Data Encryption Standard or Algorithm) pin pads and now the newest compliance requirement, PCI DSS (Payment Card Industry Data Security Standard). Unfortunately, not all cases of fraud can be solved with one level of compliance and implementing the rules is costly and time consuming, but necessary.

The transformation of fraud represents one of the biggest challenges for all parties affected by data breaches and other fraud attempts occurring daily at the merchant and processor levels. Fraud has evolved from small crime to international organized crime. Combating fraud is a never ending battle that all parties need to be prepared to address. This preparedness begins with proactively educating the consumer and merchant, and then moves to the processor and bank that need to protect the sensitive data utilizing layered security models and new innovative technologies.

Just as fraud has evolved, the methods used to combat it must also keep pace and evolve.

CONCLUSION

The payment industry is becoming more dynamic every day. The level of disintermediation with the emergence of alternative payments and payment gateways is increasing. In the near future, consumers will be able to buy goods and services at many retail establishments with traditional credit cards, Google Check out™, Revolution Money, Amazon.com Rewards Visa®, mobile phones, and more. Businesses will increasingly look for products that make their business more efficient and attractive to the consumer. From TPP gateways to streamlined services, chances are the business will also look to other sources besides a Bank for the solution.

From businesses to consumers, this should be motivation enough to create a co-opetition (discussed earlier) among the parties to leverage each others strengths and relationships to create a win-win combination. Banks can continue their focus to develop core deposits and loans. ISOs can focus on meeting the merchant's needs and sales. TPPs can focus on technology and developing the best solutions to meet the Bank and Merchant's needs. The reality in the end is if the Merchant's needs are met, it will be a win-win situation for all parties involved.



YOUR ELECTRONIC PAYMENTS PARTNER

Led by a team with over 30 years of experience in the electronic payments industry, CenPOS has been dedicated to enabling retail merchants around the world to accept, process and reconcile electronic payments, including credit and debit card processing, check authorization, EBT authorization, gift and loyalty authorization as well as solutions for eCommerce. The company is primarily focused on developing and implementing leading edge technology platforms within the electronic payments industry.



iStream Financial Services is a vertically integrated technology company in the business of managing payments. The foundation of iStream was Corporate Remote Deposit Capture, but our knowledge and experience directed us to a bigger picture, a bigger solution for businesses. We have a customer-oriented strategy focusing on streamlining finances for businesses. We have built our solutions from the ground up using our Team's knowledge of technology, data processing, investing, banking and financial services. Our ability to react in days, not months, to new market opportunities makes us second to none.