payments system research briefing

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Developments in Merchant Acquiring

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When thinking about the participants involved in card-payment transactions, four of the parties involved—the card network, the card issuer, the consumer to whom the card is issued, and the merchant that accepts the card for payment—immediately come to mind. But, another important participant is the merchant acquirer. Though not frequently discussed, merchant acquirers play a vital and evolving role in the card-payments process.

This Briefing article will discuss the origin and roles of merchant acquiring; the models for acquiring; and relevant developments in legislation, PCI compliance, and the Single Euro Payments Area.

Merchant Acquiring

Merchant acquiring has its roots in the promotion of credit cards as a consumer-payment method. Issuing financial institutions, having worked to get cards into consumers' wallets, needed to increase the number of merchant locations at which these same cards were accepted. Initially, financial institutions that were issuers of cards also typically worked with their business clients to adopt card acceptance. That process of signing up business clients to adopt card acceptance is what merchant acquiring has come to entail and is much more than it might appear on its face.

Acquiring these merchants not only involves signing them up to accept network-branded card payments, but underwriting them as well. In underwriting the merchant, the acquirer essentially assumes the risk for ensuring that the merchant meets the card networks' requirements for financial stability and other conditions. And, in so doing, the acquirer assumes responsibility for the transactions the merchant initiates into the network. The level of risk the acquirer assumes varies based on considerations such as whether the merchant operates in a physical or solely online environment, the merchant's size, and the goods and services the merchant offers.

Merchant acquirers also provide the means by which merchants are able to accept card payments and authorize the validity of those payments. The acceptance component requires that the merchant be provided with the appropriate equipment, such as card readers, point-of-sale terminals, and software. Authorization, which essentially entails verifying various cardholder and transaction information, means that barring future disputes against currently authorized transactions, the acquirer is guaranteeing the merchant payment for its transactions.

Once acceptance and authorization have taken place, the merchant acquirer performs the functions of facilitating the clearing and settlement of the transactions on the merchant's behalf. In so doing, the acquirer submits the merchant's sales information to the appropriate card payment network, which calculates each member financial institution's net position, taking into account relevant fees. After the settlement among the card network's member financial institutions, the acquiring bank credits the merchant's account for the net of the transaction amount, the network's fees, and fees charged by the acquirer.

With clearing and settlement complete, the merchant acquirer provides its merchant client with account maintenance and support, preparation of billing statements, and other services like analysis of transaction information.

Acquiring Models

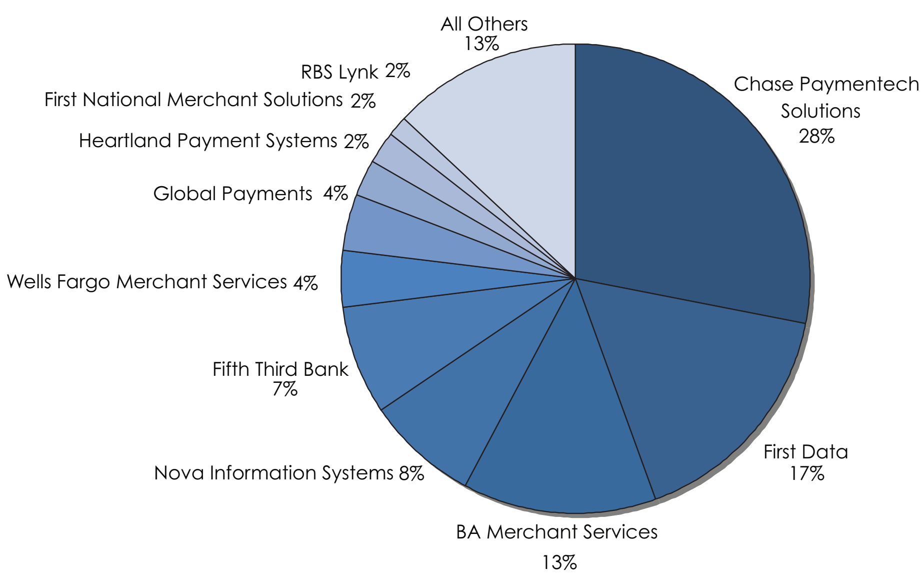
The models that support merchant acquiring run along a continuum, where at one end banks provide acquiring services, in the middle banks and nonbanks form joint ventures and alliances, and at the other end nonbanks provide merchant acquiring services.

The previous discussion of the origin of merchant acquiring is representative of the bank as acquirer model, with the bank performing each of the activities involved in the process. Bank of America and Fifth Third Bank are among the financial institutions that are regarded as full-service merchant acquiring banks. However, given the myriad of activities merchant acquiring involves, some merchant banks utilize the services of nonbanks to perform various aspects of the acquiring process. For example, banks may partner with nonbanks to sell their card acceptance and account maintenance services to merchant clients. Banks may enlist the services of nonbanks to provide merchants with terminals, card readers, and software. Nonbanks may also route transaction authorization requests and facilitate clearing on behalf of banks. Such relationships are representative of the joint venture/alliance acquiring model, an example of which is Chase Paymentech[1], a joint venture between JP Morgan Chase and First Data Corporation.

Finally, given that some nonbanks have expertise in each aspect of the merchant acquiring process, they may become full-service merchant acquirers, operating independent of a bank. In this model, the nonbank performs each of the tasks that a bank would, and accordingly, assumes the risk for its merchant clients and their transactions. To perform in this capacity, nonbank merchant acquirers must become licensed as members of the card networks, which ultimately requires the sponsorship of a member bank.[2] First Data Corporation, Global Payments, and Heartland Payments Systems are examples of nonbank providers of end-to-end merchant acquiring services.

The chart below shows merchant acquirers' share of Visa/MasterCard credit and debit card purchase volume for 2007. In particular, it highlights the top ten acquirers, which account for 87 percent of overall Visa/MasterCard purchase volume.

Acquirers' Share of Visa/MasterCard Purchase Volume, 2007[3]



Legislative Developments

There are a number of congressional statutes either pending or waiting to take effect that could impact the merchant acquiring market. Among these are The Housing and Economic Recovery Act, The Credit Card Fair Fee Act of 2008, and The Credit Card Interchange Fees Act of 2008. The Housing and Economic Recovery Act has a direct effect on merchant acquirers, while the latter two acts may result in an indirect impact.

The Housing and Economic Recovery Act (H.R. 3221) was signed into law by President Bush on July 30, 2008. While the majority of this act deals with issues that largely do not apply to the acquiring industry, one provision in the act will create new reporting requirements for merchant acquirers and third party settlement organizations beginning in January 2012. The new reporting requirement will mandate that these parties report the gross value of their merchants' transactions to the IRS, the thought being that there is a substantial amount of merchant activity (such as Internet transactions) that is not currently being reported as taxable income. This revenue provision is expected to raise $9.8 billion in tax revenue over the next ten years. The associated implementation costs to acquiring and settlement entities are difficult to estimate, but could be quite significant.[4]

The Credit Card Fair Fee Act of 2008 (H.R. 5546) is a bill that has recently been approved by the House Judiciary Committee and awaits a vote in the House of Representatives. This bill seeks to create an antitrust exemption for merchant groups in order for them to negotiate collectively with the largest credit card networks and their affiliated issuers and acquirers to determine access rules and merchant fees. It is unclear exactly what effect the bill will have on the acquiring industry, but since merchant fees are at the heart of the planned collective bargaining process, it is possible that merchant acquirers' processing fee margins could be impacted.

The Credit Card Interchange Fees Act of 2008 (H.R. 6248) is a bill that is still being discussed in legislative committee. This bill serves chiefly to promote fee transparency and prohibit a number of merchant restrictions currently found in merchants' credit card contracts. Some elements in this bill, such as allowing merchants to accept payment cards at some locations while not in others, the removal of minimum transaction penalties, and the removal of "honor all cards rules," could affect merchant acquirers' fee revenue by discouraging card acceptance/usage and thus lowering card-processing volume. However, since the overall effect of this bill is decidedly merchant-friendly, it is possible that new merchants would be attracted to accepting card payments, thereby boosting card-processing volume. The net effect this bill would have on acquiring is unclear.

Impact of PCI Compliance

Changes from within the card industry also are impacting merchant acquirers. In 2004, the Payment Card Industry (PCI) Security Standards Council, which was formed when Visa, MasterCard, American Express, Discover, and JCB aligned their individual data security policies, created the PCI Data Security Standard (DSS). The PCI DSS was designed to be a standard used by organizations that process card payments to help them prevent card fraud, hacking, and various other threats. Because these networks' primary relationship in card payment transactions is with a bank—in this instance either a bank that is a full-service merchant acquirer, a bank that works with nonbanks, or a bank that sponsors a nonbank to perform acquiring activities—the consequence of the PCI standards is that the bank has responsibility for monitoring and enforcing compliance for their merchants as well as all other parties with whom they may partner to provide services to those merchants.

The PCI DSS categorizes merchants based on annual transactions volume. With regard to large merchants (those that process more than 6 million transactions a year) and middle-sized merchants (those that process from 20,000 to 6 million transactions a year), acquirers are responsible for ensuring that procedures for compliance are followed. Additionally, acquirers must supply the tools that merchants need to achieve compliance, maintain a tracking system to monitor compliance, and have the appropriate reporting capabilities to provide required information to the networks. Worth noting is that though the networks have agreed upon common security standards, what is required to comply with those standards may vary for each of the participating networks. As it relates to small merchants (those that process less than 20,000 transactions a year), acquirers are required to identify security risks among their small-merchant customers and develop an educational program to raise awareness and understanding of the PCI standards.

Large merchants were the first to be required to be PCI compliant and were given a September 30, 2007, deadline. Middle-sized merchants were required to be PCI compliant by December 31, 2007. Small merchants are actively being encouraged to become compliant, but have not been assigned a compliance deadline. Based on data from Visa and CyberTrust, as of February 2008, 77 percent of large merchants and 56 percent of middle-sized merchants were PCI compliant.

A worst-case consequence of noncompliance with PCI standards can be that a network terminates the merchant's (and/or the parties' that facilitate the merchant's card payments) ability to perform card acceptance. Alternatively, the network may assess substantial fines, ranging from $5,000 to $25,000 per month, against the merchant and its acquiring bank. With that said however, this liability typically is contractually shifted back to the merchant. The network also may levy higher per-transaction card-processing fees.

While the goal of the PCI compliance standard is to help organizations that process card payments prevent card fraud, hacking, and various other threats, it is too early to know how effective the standard is in doing so. Further, it is unclear how liability will be impacted should compliant organizations experience such events in the future.

Single Euro Payments Area

The Single Euro Payments Area (SEPA) is an European initative to improve the efficiency of cross-border payments and turn what historically have been fragmented national markets for euro payments into a single domestic market. Once accomplished, consumers, companies, and other economic participants will be able to make cashless euro payments to anyone located anywhere in the euro area using a single bank account and a single set of payment instruments.

The SEPA initiative includes the development of common financial instruments, standards, procedures, and infrastructures to enable economies of scale. As it relates to achieving economies of scale, the SEPA presents U.S. merchant acquirers an opportunity to extend their service offerings abroad. It is estimated that the top three European acquirers have a 30 percent market share;[5] in contrast, the top three U.S. merchant acquirers have a nearly 60 percent share of their's. This market concentration has resulted in economies of scale, which well may be useful for a European acquiring market that is estimated to be worth over €4 billion a year and accounts for about a quarter of the global acquiring market.[6]

Merchant acquirers like First Data Corporation, Nova (now Elavon), and Global Payments already have an established presence in the euro area and are building upon it. Others, like Euronet Worldwide, are benefiting from the SEPA and are among the new entrants to cross-border merchant acquiring. More likely will follow.

Summary

Merchant acquiring is a vital component of the card-payments process. Acquirers not only promote adoption of card acceptance services, but perform a myriad of activities, including underwriting merchant acceptance, routing transaction authorization requests, and providing statements and a host of other informational services to their merchant customers. Acquiring activities may be performed entirely by banks, solely by nonbanks, or by some combination of these participants. No matter the provider, the environment in which merchant acquiring is conducted is being impacted by a number of factors. These factors include new congressional legislation that has resulted in additional merchant reporting requirements and proposed legislation that may impact processing margins as well; PCI requirements that have increased merchant acquirers' responsibilities in preventing card fraud, hacking, and various other compromises of consumer information; and the SEPA initiative, which is creating new opportunities in Europe for U.S. merchant acquirers.

Endnotes

[1]JP Morgan Chase and First Data Corporation have announced that they will dissolve their joint venture, Paymentech, in 2008.

[2]American Express and Discover now also utilize nonbank merchant acquirers to expand their merchant portfolios.

[3]The Nilson Report, March 2008.

[4]"Critics Decry a Costly Merchant Reporting Rule, But It's Now the Law," Digital Transactions, September 10, 2008.

[5, 6]"Merchant Acquiring - Cinderella Goes to the Ball," Banking Automation Bulletin, Issue 254, July 2008.

Some useful resources for readers desiring more information about merchant acquiring include the following:

The Merchant-Acquiring Side of the Payment Card Industry Structure, Operations, and Challenges
http://www.philadelphiafed.org/pcc/papers/2007/D2007OctoberMerchantAcquiring.pdf

Merchant Acquirers and Payment Card Processors A Look inside the Black Box
http://www.frbatlanta.org/filelegacydocs/erq106_degennaro.pdf

The Housing and Economic Recovery Act:
Democratic Policy Committee summary
http://dpc.senate.gov/dpc-new.cfm?doc_name=lb-110-2-123
Senate Republican Policy Committee legislative notice
http://rpc.senate.gov/public/_files/L62HR3221Houseamendments0618SN.pdf
The text of the bill
http://www.govtrack.us/congress/billtext.xpd?bill=h110-3221

The Credit Card Fair Fee Act of 2008
http://www.govtrack.us/congress/billtext.xpd?bill=h110-5546

The Credit Card Interchange Fees Act of 2008
http://www.govtrack.us/congress/billtext.xpd?bill=h110-6248

PCI Compliance Guide
http://pcicomplianceguide.org/

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Web site: *www.KansasCityFed.org/home/subwebs.cfm?subweb=9*

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