

## MONEY GUY

# WHAT'S YOUR PORTFOLIO TELLING YOU ABOUT FEES?

by Harold Montgomery



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Over the last few years, I have noticed that a larger and larger percentage of ISO revenue comes from fees levied on merchants. These fees include PCI compliance fees and other miscellaneous charges. These are typically fixed fees that are not tied to processing activity.

The revenues derived from fees have become an important part of the ISO's total revenue stream, especially in an era where merchant sales volumes are weak or down. Fees are beneficial to ISOs since they smooth revenue that could otherwise be volatile, making budgeting easier and generally increasing the level of predictability of the business.

As merchants seek lower and lower processing rates, fixed fees have been an important element sustaining ISO profitability. A little of this kind of thing is natural and to be expected. The industry has long included statement fees and monthly minimums as part of its price table. Merchants are long used to seeing both of these charges on their billing statement.

As processing revenue falls through price compression and fixed fees stay the same, what's the overall percentage of fixed charges vs. processing volume-related (variable) charges the ISO is receiving? While ISO revenues were never 100% composed of processing-based charges (discount rate and transaction fees,) they have never been as dependent on fixed fees as they are today. Some ISOs I have seen have PCI fees alone comprising 40% of total revenue. Annual or semi annual fees likewise have become quite popular and make up a substantial part of some ISO revenue streams.

The issue with these kinds of fees is that they are of a different quality of revenue than volume-based processing charges. Revenue quality can be thought of as the character of the revenue and is

based on an analysis of what drives the revenue stream and how stable it is over time. For example, what triggers the revenue stream? Does it require the merchant to do anything to trigger being charged? Is the revenue stream protectable? Is it stable over time?

These are all the kinds of issues that a financial analyst will ask when assessing the various revenue streams that make up the ISO portfolio. Everyone's used to processing revenues and we all know what actions are required to produce it – consumers need to make transactions at the retail POS. As long as they keep doing that, the revenue will be there, even if margins do decline over time.

What about annual fees to merchants? No action is required to trigger that charge. Couldn't merchants wait until 11 months of a 12 month contract have passed and not pay the annual fee? The contract might have enforceable provisions in it, but the cost of collection is real and at least means the net value of the fee collected is well under 100%.

PCI fees are more stable since they have the umbrella of legitimacy from the Card Associations. But how were PCI fee levels set in the first place? Mostly, they're about \$20 per month. But who came up with that number and why? Why couldn't that be \$19 per month or \$15 per month, or \$10 per month? What are we selling the merchant for that charge? Unfortunately, it's not a tangible product that one can compare from one vendor to another. So why can't one ISO's charge be cheaper than another's? What happens to this revenue stream when ISOs in search of new merchants start cutting it back to win the business?

In the ISO portfolios where PCI fee revenue makes up 40% of the total revenue stream, they project that it will grow to 60% in coming years. The clear expectation is that processing volume revenue

will fall over time even as volumes themselves pick up. But ISOs who have become overly dependent on PCI fee revenues would find their profit margins diminished quickly if PCI fees come under competitive pressure.

ISOs looking to attract new merchants through gradual price cutting has been the main driver of margin decline in the merchant processing space for the last ten years. PCI and other fixed fees have been a help to ISOs by adding a new and highly profitable element to the overall revenue stream. But, what happens when those fees come under competitive attack? ISOs will no longer be guaranteed a minimum amount of revenues from a merchant, but will resort to the old days where gaining a high percentage of revenues from processing volume won't be workable since margins came down long ago and aren't going back up.

The appearance of PCI fees probably accelerated the rate of margin decline on processing activity. Many ISOs figured they could give a bit on rate with the PCI fee balancing out the total package. Viewed that way, the salesperson can actually give quite a bit on rate and still make out OK overall.

Price competition isn't the only reason PCI fees will come down. There's also moves within the industry to make PCI fees irrelevant. Heartland Payment Systems' end-to-end encryption model would eliminate the need for PCI fees entirely.

This process is part of an overall progression evident in the industry. Margins fall on the basic product, so a new service or fee is levied on the customer to keep margins intact. I wonder how many new fees there are out there for us to look to when PCI fees start to come down? ■