

HOW MUCH LONGER WILL PROCESSORS GET THEIR CUSTOMERS FOR FREE?

by Harold Montgomery



In my last article, I talked about the phasing out of the residual payments model in the merchant acquiring business (*Transaction World Magazine*, May, 2009, "RIP Residuals, It Was Nice Knowing You.") Residuals have been the backbone of ISO revenues since the inception of the industry. But, through a natural progression of competitive forces, residuals have gradually declined over time at a rate of about 10% per year, measured in dollars per merchant per month, according to my research.

That means residuals are no longer sufficient to support smaller ISOs. And of course, as margin falls, the definition of smaller gets bigger, so to speak – meaning that an ISO has to have more and more merchants to sustain the same overhead structure as margins fall. With lease revenue also falling over time due to saturation in the POS terminal market, the ISO business model is under serious pressure to change.

And change it will. The point of all that is not that the ISO is going away - ISOs as a delivery channel for

processing services are too important to let go. Everyone in the small/medium merchant processing space has ISOs in their marketing plan at least in the second or third position, if not the primary one. Take ISOs away, and there's a serious deficit of methods to reach merchants and deliver services. Rather, the point is that the ISO business model, meaning its compensation structure, has to change. The old one simply doesn't work anymore.

One can hardly complain about that. It's been at least a twenty five year run of success. Since inception, the ISO business has generated billions in revenue and many millionaires among its ranks. It's been a huge success by any measure. ISOs have done what no bank in the world could ever have done – put POS terminals in every small/medium-sized retail store in the U.S. – many of them in remote small towns with little corporate infrastructure to reach them. In all, it's been a fabulous record of success and prosperity.

But nothing lasts forever. If you don't believe me, ask as Rick Waggoner, CEO of General Motors. He has lots of time to tell you all about wrenching corporate change brought on by progressively changing industry economics. As a distant observer of his recent experiences, I would not be surprised if he offered this up: "Ignore trends at your peril. Change is the only constant in busi-

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ness today. It happens faster than you think and faster than your company can handle.”

So, if ISOs are too important to processors and other product originators to be allowed to disappear and their business model has to change, what comes next? In a word — compensation structures. Merchants will still buy card processing services and ISOs will still sell it to them. The only difference coming is that residual splits will phase out in favor of up-front payments for originating new merchant processing agreements.

Who's going to make these payments? I think processors will. Why? Because they have to. They need the merchants ISOs produce. But how the ISO gets paid to originate merchant contracts can and will change.

You might think the ISO will suffer under this arrangement. But, interestingly, I think the ISOs will handle this change in stride. If nothing else, ISOs are adaptable and creative. A change in compensation structure is no problem for an industry that thrives on deal-making. Of course, there will be ISOs that can't adapt, but I think most will. It's the processors that will have the bigger issues with this change. Of course, ISOs that recall the good old days of fat residuals and hefty lease payments may not be able to cope with a world where they get paid for the merchants they produce and at much thinner margins, but I think many will make the transition.

Processors will struggle with this seemingly simple change in compensation structure — from a monthly residual split to an up-front payment for three key reasons that are not so easy to overcome:

■ **Their systems don't account for it.**

Processors are used to programming in residual splits and other revenue share components into their systems. Dealing with a one time up-front payment will be an important change with some complexities to it. For example: for an ISO making the switch from residual split to up-front payment, the processor will have to establish a new ISO code number to keep the merchant bases separate. Will this affect the ISO's contract? Will the new merchants count for monthly minimums? There are a host of other questions this model brings up.

■ **Their mindset doesn't allow for it.**

Processors are not ready to calculate the life span of a merchant or the earning power of the merchant over time. In short, they aren't ready to assign a value to a given merchant contract and so, therefore, won't know how much to pay an ISO for a given contract. It's a tough bit of analysis. The value of a merchant depends on how much volume that merchant drives and what the price spread and other factors are. Not all merchants are created equal and neither will the compensation for them be equal. That's easy to say, but the real questions ISOs and processors will be asking is “How Much?” and “When?” For example, if a processor pays for a merchant contract on day one and the merchant cancels or goes out of business within a year, will the ISO be liable for chargeback on the commission?

■ **Their capital structures don't support it.**

If processors make it to up-front payments, they're going to have to

find a way to pay for the merchants. Right now no processors have this line item in their spending budgets and my guess is that they are not ready to write checks to buy merchants this way. This issue raises many difficult questions regarding where the financing to do this will come from, what that financing will cost and who will provide it to what this means for the value of a processor. These are all profound and challenging questions that won't be settled overnight.

Other than that, this transition should be a snap.

In short, processors are used to getting their customers without having to spend current cash dollars to do it — in essence, for free. You can think of residual splits as rewarding ISOs with a future revenue stream which shields the processor from risk that the merchant doesn't perform. If the ISO signs up a small volume merchant or one that goes out of business soon after executing a contract, the processor paid a portion of the revenue generated and no more. In short, the processor took no risk on the merchant's future.

Now, they will be confronted with taking that risk and keeping their sales channel alive, or finding another way to originate merchant contracts. Neither one will be easy. ■

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