ISO & AGENT
www.isoandagent.com November/December 2013

The Sum Of The Parts

Merchant aggregation requires that ISOs manage risk and find a way to convince banks to accept change.

BY ELIZABETH WHALEN

Merchant aggregation may be a hot topic in the payments world, but the risk management it requires has not caught up with the hype.

While conferring with clients interested in aggregation, TriSource Solutions LLC, an ISO and processor based in Bettendorf, Iowa, discovered some common misconceptions.

"There's this sense that aggregation is a simple process; that it's just a matter of figuring out how to pay different people," says Michael Cottrell, senior vice president and chief business development officer for TriSource. "There's oversight. There's risk. As you start walking through these types of things, it's eye-opening to them."

Risk management isn't the only obstacle to wider adoption of aggregation. Banks are notoriously cautious of change, Cottrell notes, and some may not understand aggregation well enough to feel safe involving themselves in the process. However, banks are realizing they need to learn more, he says.

"They are taking a look at it and seeing, from a competitive space, that they need to figure out how they can become engaged in the process because there is going to be a shift in some of the business," Cottrell says. "And if they're not able to embrace it or at least understand enough why they may not embrace it, it's going to leave them at a competitive disadvantage at some point down the road."

TriSource recently launched a system for aggregators that manages many aspects of boarding and serving sub-merchants, including risk management, but it has not yet chosen to become an aggregator, Cottrell says.

Host Merchant Services, an ISO based in Newark, Del., would like to aggregate payments directly for its clients as well as board customers that aggregate for other companies,

says CEO Lou Honick. But the ISO is still working out how to do that while managing risk and complying with the applicable rules, regulations and reporting requirements.

Today, the path to becoming an ISO seems fairly well-defined, Honick says, but the path to becoming an aggregator, especially a profitable one, isn't as clear.

"I think there is still a lot of work to be done in terms of proving out the long-term profitability of an aggregation model. While Square is interesting and certainly a good success story, I don't think they're a profitability story by any means at the moment," he says. "I haven't seen anybody say, 'We got rich doing aggregation' just yet."

Early Aggregators Will Benefit

However, as the path to profitable aggregation becomes clearer, it may become more difficult for an ISO to benefit, Honick says. He believes organizations that forge the path instead of following it will win the rewards, so he's put his firm on the fast track to become an aggregator.

Host Merchant Services' clientele, which includes several web hosting and e-commerce companies, is another reason Honick is pursuing aggregation. Right now, many small e-commerce sites that are not yet ready for their own merchant accounts rely on PayPal and Google Wallet, he says. As aggregators pursue those accounts, he believes his firm's experience will give it an edge.

Although the process of becoming an aggregator or serving aggregators remains a bit murky, what potential customers want is becoming clear, he says.

"There is still a lot of work to be done in terms of proving the profitability of an aggregation model."

– Lou Honick, Host Merchant Services

"From a small merchant's perspective, they don't necessarily say, 'I want to do business with an aggregator.' They want simplicity in terms of creating a merchant account," Honick says. "And there's a lot faster and clearer of a path to being able to take payments as a sub-merchant of an aggregator versus having a full merchant account with an ISO."

Reducing the friction involved in boarding a small merchant doesn't necessarily require aggregation, but aggregation is one well-established way to reduce that friction, says Todd Ablowitz, president of Double Diamond Group, a payments consulting firm based in Denver, Colo. Missing the trend of making boarding easier could cause an ISO to lose business to competitors, he adds.

"The boarding process is hugely important, but many ISOs find that they're unable to get as far as they want to go without enabling an aggregation component," he says. "Either their processor can't support it or their sponsor can't support it. There are hurdles when not doing aggregation. The large companies that have control over their systems and have a very wide berth from their bank have the best chance of doing more of this without technically doing aggregation."

And even ISOs that aren't interested in becoming aggregators should understand the process, says Ablowitz.

"We've found that many ISOs already have aggregators in their portfolios, and they sometimes have not yet been registered," he says.

Their bank or a card brand may alert the ISOs to the presence of the aggregators and tell the ISO that the unregistered aggregators must be sponsored, Ablowitz says. If ISOs ignore the possibility that unregistered aggregators are lurking in their portfolios, those aggregators may not effectively underwrite the account or properly monitor and control the funds, says Deana Rich, president of Rich Consulting of Los Angeles. She and Ablowitz collaborate on aggregation.

"If you're not making sure that they're doing their job, they may run away one day. They may close because they just didn't have the funds to do what they were doing," she says. "Then, they're probably going to use the sub-merchant's funds, and you as the ISO are going to be responsible for funding those sub-merchants that you didn't even know existed."

"The key is to have a competency around this," says Ablowitz.

Actively pursuing aggregation is not an ideal strategy for all ISOs, and the risk-management hurdles reflect that, Rich says.

"Some of the barriers, which are the hefty requirements that the banks are putting on the ISOs to ensure they have all their ducks in a row with this program, are appropriate and should be in place because this is not a program for everybody," she says.

For firms that focus on serving small merchants in a specific niche, aggregation can be a good fit, says Theo Monroe, principal of the Law Offices of Theodore F. Monroe, a Los Angeles firm that serves payments providers. Specialization helps improve risk management.

"It allows the underwriting to be fast. If it's the only thing [the ISO does], odds are they're going to know the industry better. They're going to know the players. They're going to know the fraud patterns," he says.

If a merchant lacks enough processing volume to make a traditional merchant account worthwhile, it may not spend much time or energy selecting a payments provider. For example, a charity may simply want an easy way to set up a website and collect donations, says Ablowitz.

"They're more interested in the software than they are in who's doing their processing," he says. "They enroll in that software, and they're just fine with the processing that comes with it. So, as an ISO, if you have access to software like that, or you build something like that, you very well may want to be an aggregator to help serve that market."

"Aggregation in a vacuum isn't very valuable," says Ablowitz. "It is when it's tied with a seamless set of products and services for a particular merchant community."

Have A Lawyer Review Contracts

Aggregation's complexity means ISOs should have an attorney review not only their contracts but also their business practices, Monroe says. Payments Facilitators should make sure they understand what sub-merchants are selling and ensure that sub-merchants exercise best practices when it comes to handling data.

"The rules regarding this area constantly change," he notes. "They've changed about every two years since I've been in this space, about fourteen years. They're going to keep changing. Odds are, we're going to see an increased focus on knowing your customer—knowing what they're selling and being responsible for it."

Knowing your customers is an ongoing process, says Thomas Kirchner, head of client services for processor Computop, which has U.S. headquarters in New York City. For instance, a sub-merchant could start out selling watches and later switch to selling unapproved prescription drugs.

"You don't just set up a merchant and see that things are looking great, their volumes keep going up and up and up," says David McDonnell, Computop's senior vice president of sales. "There needs to be a monitoring process in place. Go back and see—have they changed their web site? What are they now selling?"

> "Aggregation in a vacuum isn't very valuable. It is when it's tied with products and services."
>
> – Todd Ablowitz, Double Diamond Group

One potential risk-mitigation tool for ISOs is instituting a corporate compliance program and expecting merchants and sub-merchants to have them, too, McDonnell says.

"It has nothing to do with PCI. It all has to do with how this entity, whether it's the ISO or the end merchant actually runs its day-to-day business," he says.

Compliance programs may include a code of ethics, personnel policies and procedures, and other elements that indicate the business complies with domestic and international guidelines, says McDonnell.

"That's part of the whole monitoring process to make sure the business is still operating under sound principles and is doing what it said it was going to do," he says.

The popularity of aggregation points to a larger trend in the acquiring industry, says Monroe.

"It had done business so long the same way. It took time to underwrite merchants. There was a strong lack of trust between merchants and their processors, and no price transparency. Square changed all that," he says. "Square doesn't have that many merchants yet. It's a micro piece of the industry, but it changed the rest of the industry."

As a result, even ISOs not pursuing aggregation need to adapt to the trends aggregation is driving, he says. He suggests ISOs embrace technology and focus on the merchant experience.

The clear lesson of aggregation for the industry is that merchants and developers, especially tech-savvy ones, are sick of the traditional payments processing pricing structures, says Mark Fischer, CEO and co-founder of Inspire Commerce, an ISO and gateway based in Boulder, Colo.

"They are sick of all the fees that get tacked on. They just want to know exactly how much they are going to pay, period," he says. "I think aggregation was the first time we really started to see that in the industry."

Many new merchants want a fixed price for its simplicity and predictability, Fischer says.

"They might be willing to pay even more just for the simplicity of it," he adds.

Despite the high level of interest in aggregation, Fischer advocates ISOs focus first on their specialty.

"When aggregation is a fit, it is an awesome tool," he says. "But I have always said that the most important thing is owning and specializing in specific verticals. Aggregation is a tool, but being incredibly competent in a specific vertical is hands-down the most important thing that an ISO can do." **ISO**