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2am Wake Up Call

It only took five minutes to realize that the future of my first start-up, a payment processing ISO, and that of the entire payment industry, was at risk. It happened in the five minutes that it took to sign up for a credit card processing account with Square. I founded a payment ISO in 2010 with the intention of being the best processor in the country for my target vertical (rental businesses).

I downloaded the app onto my iPhone, tapped in a few details, verified my identity, and in minutes had processed my first transaction.

In contrast, my customers had to wait three weeks to process their first transaction. Although I pitched my ISO as uniquely customer-centric, my process required a complicated three-page application, countless emails back and forth due to inevitable application errors, and significant supporting documentation. After every hoop and jump was completed, my customer still had to wait for the underwriting department; underwriting took five days in a good week, and up to two weeks in a bad one.

In the wee small hours of a weekend, when my underwriters were safely tucked into their beds, Square ate my lunch.

They came to the table to disrupt my plans and, in truth, disrupt our industry forever.
What is a disruptor?

Clayton Christensen and Joseph Bower’s groundbreaking work\(^1\) points to two key indicators for a disruptive technology: generally disruptive technologies are not initially valued by important customers of well-managed, established companies, and disruptive technologies fly under the radar until they can invade the established market with a new value proposition. That new value proposition is at first less functional, but is offered at a much lower cost and with a much larger reach than traditional products or solutions. Disruptive micro-merchant processing targets a large population of customers that don’t have the budget to onboard with traditional merchant-acquiring banks.

To figure out my next move I needed to know if Square was a rogue product pioneer with a high-likelihood of failure, or if other software companies were approaching merchant acquiring in the same way.

I found bad news – software companies were indeed nibbling at the edge of this market. Three leaders, Square, PayPal, and Intuit, were my new competition.

My ISO was not equipped to compete. It was time to refresh my resume. I had been disrupted.

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Square is building a relationship with both merchants and consumers: they now offer consumer-to-consumer cash transfers using only an email.
The Big Three software-to-payment players: Square, PayPal, and Intuit

Merchant acquirers can’t be lulled into thinking that disrupters are frivolous fly-by-night start-ups. Do not dismiss these game-changers as hobby efforts by your fraternity friends or some school project by your daughter’s BFF. Uniquely, these competitors will create their own market before they take yours. If we don’t learn from Kodak’s experience with the shift from film to digital imagery, IBM’s commitment to the mainframe at the expense of the personal computing market, or even Apple’s disruption of MP3 domination with their own smart phone, we will be the losers.

Micro-merchant processing is not a different domain with a radically different clientele. Often, when acquirers, ISOs, and Super ISOs are cautioned, they have the same response: “Those are ‘micromerchant’ processors. We don’t target that market.”

Be advised. Three companies have already begun to move from a folksy fringe clientele to the kind of market share that is causing your customers to ask questions about price and value.

After gaining a stronghold over the micro-merchant market, Square, PayPal and Intuit have become the ‘Big Three’ with a strong revenue base from which they can build. They are using that base to launch new products, improve existing applications, and increase their capabilities. They are listening to their customers and building new features that are important to them. Inevitably, they take advantage of new technology, solve modern problems, and monetize novel business models.

As the Big Three move up market, they pose a very real threat to acquirers targeting merchants of all sizes.

How do we know this? They’ve started already.

Mobile payments are expected to reach $90 billion in 2017 — a 48 percent compound annual growth rate from $12.8 billion spent in 2012.
How the Big Three take advantage of new technology

The Big Three’s business models depend on extremely low-cost onboarding when compared to the traditional market and they are using technology to gain a competitive cost and time advantage.

Transaction World Magazine, the acquiring industry trade publication, explored the impact of the primary players in the mobile POS market in their March 2012 cover story. The magazine estimated what the Big Three spend to board a merchant ($14-$35), suggesting that traditional acquirers were spending up to 10 times more than the Big Three per merchant acquisition. In addition, these players are signing up new merchants in only five minutes, while traditional acquirers take three-to-five days. The Big Three have built automated boarding platforms that do not require intensive underwriting processes used by traditional acquirers and ISOs. Credit checks, identity verification, underwriting decision-making, and portfolio monitoring are performed automatically.

This automation brings the real cost of onboarding to a fraction of that of a traditional acquirer.

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![Cost to Onboard Chart](chart.png)

Does this look familiar? How long can you survive?

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Each of the Big Three is solving a number of different merchant and consumer payment problems. Here are a few examples:

Square has addressed the problem of fraudulent credit card use with Square Wallet which allows merchants to verify the identity of their customers using a picture that appears on their POS terminal. No signature or PIN required.

Square has also built the Square Register, a free POS system that runs on tablets. Square Register offers merchants inventory management, and allows consumers to make payments without taking their smartphone out of their pocket. It also gives merchants a seamless online and offline payment system.

Intuit has addressed the problem of reconciling credit card payments with accounting records. Integrated with their accounting software, almost ubiquitous among small merchants, payments made with Intuit are automatically recorded in the merchant’s accounting system removing the time-consuming need to reconcile statements.

PayPal offers working capital loans that are paid off with a percentage of PayPal sales as opposed to a fixed periodic payment. Using your processing history to adjudicate the account takes only a few minutes to get setup. PayPal also offers instant access to funds accepted via credit card to their customers, which can then be spent from their PayPal account or using a PayPal debit card.
Monetizing new business models

Traditional acquirers profit from a margin earned on the dollar volume processed through their payment networks. The Big Three have each built business models that allow them to profit in different ways. In addition to earning a margin on dollar volumes processed on their networks, with scale, they can also cross-sell other services (Intuit’s accounting software and PayPal’s working capital loans), access new markets (previously underserved micro-merchants), and offer innovative pricing structures (flat percentage charge, regardless of card type).

Square will soon be used to process transactions in over 7,000 Starbucks stores and 7 Whole Foods markets.

The move up market

As Christensen and Bower’s research predicts, the Big Three are moving up market by targeting small and medium businesses, the bread and butter of many traditional acquirers and ISOs.

In November 2013, Square announced that Square Wallet would be accepted in over 7,000 Starbucks locations across the United States⁴ and in February 2014, they announced a deal with Whole Foods to put the Square Register at deli counters, cafes, and wine bars⁵.

Intuit’s GoPayment targets micro-merchants but they also offer e-commerce payment services and in-store payments. Mobile purchases automatically reconcile with QuickBooks accounting software and in-store and e-commerce payments synchronize with inventory.
PayPal has targeted large e-commerce merchant markets for a long time, but now they have begun to process in-store purchases as well. Consumers can make payments at the point-of-sale using only their phone number or by using a PayPal payment card. Despite the ability to develop similar products, traditional acquirers are not likely to enter the micro-merchant market because products cost them more to offer than they generate.

In December 2012, a veteran of the payments industry (admittedly not an acquirer, but a company very familiar with the acquiring business), VeriFone, announced it would stop its micro-merchant offering, SAIL, because it was unprofitable. “Our experience through 2012 with tens of thousands of these micro-merchants tells us that the standalone economics of micro-merchant acquiring are fundamentally unprofitable,” Doug Bergeron, chief executive of VeriFone, said during a conference call with analysts [in December, 2012].

The innovative products offered to micro-merchants demand extremely low-cost operations to be profitable, which is exactly where the disruptors are developing a competitive advantage.

Square’s sales are expected to be close to $1 billion from processing roughly 30 billion in total transactions in 2014.
Reed Clayton, Vice President of Electronic Transactions and Banking at Recombo, explains that the secret to success is in building automated platforms that can board merchants without human intervention. “The Big Three have built straight-through boarding processes to board merchants automatically. We recommend traditional acquirers do the same.”

There is an important caveat to Clayton’s advice: traditional acquirers – and their shareholders – will not accept the risk of throwing away underwriting standards to board merchants quickly and inexpensively. “It’s important to realize that traditional acquirers have significant experience identifying and catching fraudulent accounts before they are boarded. Rather than flinging the gates wide open, we recommend that acquirers maintain underwriting standards with platforms that will board merchants faster and less expensively. Our clients conduct credit checks, build risk score cards, verify business locations, check the MATCH list when appropriate, and even check websites for words that indicate high-risk products automatically,” shared Clayton.

Global banking crises and POS information security breaches are leading the public to a more cautious relationship with disruptive pioneers. This will benefit traditional acquirers who can emphasize established records of customer satisfaction and consumer confidence and remove the burden of the manual boarding process.
The secret is to achieve stellar underwriting standards automatically

The Big Three software companies are successfully disrupting the payment space by taking an innovative look at underwriting, risk monitoring, and boarding processes to reduce cost and cycle time, even at large scale. However they lack the understanding of underwriting merchant accounts that comes with decades of experience. Traditional acquirers built their businesses on sound underwriting and knowledge of how to identify the markers of a fraudulent account, but they lack the software development expertise needed to automate their underwriting processes.

Big Three disrupters are aware that their own success in this space will rely upon determining how to scale the complexity of the underwriting experience within the new value network that they have created. Traditional acquirers and ISOs need to become aware that they rely upon the ability to match or beat the Big Three’s cost and time advantage to continue to be competitive.

The challenges on both sides of the equation are the complexity of the problem – speed, value, price, accuracy, and scale – and a public with little patience for error.
The ideal merchant boarding platform helps the customer complete an application quickly and correctly. Information from the customer is validated as it is entered into the application with prompts to assist the customer as they complete the process. The customer should only be asked questions that are absolutely necessary to the process, and those questions should change as the customer completes their application. For example, if a merchant inputs a partial or incomplete taxation identification number, your boarding platform should prompt the correction before the application can be submitted. If the location address is the same as their billing address, the customer should not have to input the data twice. When a merchant identifies the country, province, or state on a digital application, the boarding platform should ‘know’ if the address provided fits the standard for the mailing region and it should offer corrections if a mistake is identified.

The ideal merchant boarding platform processes new accounts automatically using third-party information sources to verify the identity of the merchant, check their credit score, and assess the risk profile of the business. Credit reports from Experian, Equifax, or TransUnion can be auto-integrated allowing approval decisions to be made using scoring criteria like the business type and the personal credit score of the business’s owner. Only if an account fails the automated underwriting process should an underwriter review the account.
Building an automated boarding platform

An automated boarding platform needs to have one objective - to vastly reduce the cost and time of boarding a merchant without increasing the risk of the acquirer’s portfolio.

Acquirers need to look at three key metrics to determine if they can compete with disrupters in this domain: the time it takes a customer to complete an application; the average time it takes the underwriting team to process an application; and the percentage of applications that are submitted complete and correct the first time.

It is obvious how the first two metrics decrease the time and cost of processing an application, but why does it matter that the application is completed correctly and completely the first time? Applications that are not submitted correctly cannot be boarded automatically. Errors on the application may need input from your underwriting team, sales force, or worse, the customer. In order to build an effective onboarding experience, it has to be efficient. Time is money.

Merchant Boarding Benchmarks

1) It must take the customer less than 15 minutes to complete the merchant application. The Big Three exceed this goal. Increased volume isn’t slowing them down.

2) The back office should spend less than five minutes on average processing an application. At minimum, 80% of applications should be onboard automatically. This gives the underwriting team time to focus on adjudicating high-risk accounts and increases customer satisfaction.

3) The percentage of applications that are submitted completely and correctly the first time should be 98%.
Making good underwriting decisions automatically

Automated underwriting processes do not benefit from human intuition, so good decision-making requires more information to compensate.

An automated boarding platform should do much more than automatically check the credit of the owner of the business and verify their identity. It should also check the corporate credit score, conduct an audit of the business’s website for prohibited words or terms, and verify the business’s location and bank account. Smart web-based data collection and interpretation can flag applications in high-risk geographies, check that identified directors are actually officers of the company, and check for persons of interest, or worse, known criminals. Where permitted by law, the system should automatically check against the Member Alert to Control High-risk Merchants (MATCH) list to determine if additional conditions are needed to reduce the acquirer’s risk. Sources need to be accessed immediately and influence the automated decision making process.
Getting a high return on investment from your automated merchant boarding platform

Requiring a significant investment, automated boarding platforms need to support all the regions you operate in and all the product lines you offer today, and be prepared for new regions and product lines in the future.

Micro-merchant accounts generally process small amounts where underwriting decisions are simpler and can be made using the credit score of the owner, identity verification, and the business type. These disrupters may end up being the 100-mile diet of the underwriter world – a great idea but not always viable in practice.

Underwriting a multi-million dollar retail account requires, at the very least, a review of the website for high-risk products (or products that cannot be legally distributed by certain mechanisms). Different third-party services need to be used in different countries. If you are using postal codes for verification, you not only need to consider the alpha, numeric, and alpha-numeric models, you need to recognize that some places in the world don’t use the protocol at all.

You may not be worried about obscure places on the globe but Ireland has one of the highest concentrations of information and communication technology activity among OECD countries. But they don’t use postal codes. Your boarding platform will need to be able to access an alternative tool to ensure the location of those businesses.

A nimble automated boarding platform should be able to toggle third-party verification services on-and-off depending on region and product line using the user interface. This provides an agility that is uncommon in financial services. A well-built boarding platform allows an acquirer or ISO to launch new boarding processes for new products or regions in hours instead of the weeks or months it takes today.
The Big Three are waging war; what can traditional acquirers do about it?

The victors of the disruption of the payments market will be the companies that are first able to make sound underwriting decisions quickly and inexpensively. The next acquiring leaders will either be the Big Three (after addressing underwriting practices) or traditional acquirers who are able to bring their merchant boarding time and cost down substantially without compromising the risk level of their portfolios. To come out on top, acquirers will have to build low-cost, fast underwriting processes.

If traditional acquirers want to maintain their market share, they will need support where they are at a disadvantage: software development. Banking and software development are very different businesses. The next acquiring leaders will find a way to benefit from leadership in both. A McKinsey Quarterly article, ‘Automating the bank’s back office’, cites a lack of robust procedures, complicated architecture, internal agendas, and limits to internal capabilities as the four obstacles to change that prevent banks and financial institutions from achieving the automation they need to be competitive. Acquirers have two options: acknowledge and address these obstacles and build software that rivals that created by some of the most innovative software minds of the past decade (i.e. Jack Dorsey and Elon Musk); or, work with partners who can do the development work for them.

Once the scale of the challenge is recognized, it is clear that the return on investment will point to a strong partner who can develop strong agile tools and protect underwriting standards.

Recombo has been recognized as a best practice partner in this domain through its work with four of the top seven acquirers. Recombo has experience helping acquirers, ISOs, and Super ISOs build fast, low-cost merchant boarding platforms that can be scaled across regions and product lines quickly. Using the Rapid Customer Onboarding platform Agreement Express, Recombo is configuring component-style boarding platforms that fit together into new customized boarding processes in a fraction of the time.
The process can be readily modified for the next product line, region, or partner by toggling data sources and adjusting workflows - without any new code. Specific boarding metrics are tracked to give process managers the information they need to optimize their boarding process. Real-time statistics give operations and sales managers concrete data about the number of applications sent out, in-process, and completed. Finally, a full audit trail of every action taken to send, complete, process, and access the application is recorded giving compliance teams and auditors a full record of the boarding transaction.

These are the kinds of best practices that acquirers need to benchmark against. It is tough to look inside and ask whether you have the ability to build in-house, but the cost of failure to act is high.

The Big Three won’t be the only disrupters on the horizon. They are just the ones blocking the view. The solution, like the one offered by Recombo, is to disrupt the disruptors by bringing smart technology together with a track-record of success in the traditional merchant acquiring market.

The next time someone wants to eat my lunch, I’ll be ready for them.

To shake things up, maybe I’ll pick the restaurant.
The authors

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