

Merchant Accounts

MERCHANT ACCOUNTS

A merchant account is a contract under which an acquiring bank extends a line of credit to a merchant who wishes to accept payment card transactions of a particular card association brand. Without such a contract, one cannot accept payments by any of the major credit card brands.

Methods of processing credit cards

Today a majority of credit card transactions are sent electronically to merchant processing bank for authorization, capture and deposit. The method of processing credit cards will vary by industry. In all circumstances either the entire magnetic strip is read by a swipe through a credit card terminal/reader or the credit card information is manually keyed in to a credit card terminal, a computer or website. Whenever practical it is best to swipe a credit card because the rates will be much lower and the incidence of stolen credit card number fraud is greatly reduced.

Credit card terminal

A credit card terminal is a stand-alone piece of electronic equipment that allows a merchant to swipe or key-enter a credit card's information as well as additional information required to process a credit card transaction. A credit card terminal is a dedicated piece of equipment that only processes credit cards although it is common for related transactions including gift cards and check verification to also be performed. A credit card terminal typically must be plugged in to a power supply and connected to a telephone line. However, some terminals may be powered by batteries, communicate over the Internet or through the cellular phone networks. When a credit card is processed (either swiped through the magnetic stripe reader or keyed in to the keypad), it contacts the network to verify if the credit card can be authorized. The most popular credit card terminals consist of a modem, keypad, printer, magnetic stripe reader, and power supply and memory card. They have had the same basic design since the 1980s. As with computers, there is a wide range of memory capacities and other features like built-in printers and debit card pin pads that affect the manufacturing cost of a credit card terminal.

A merchant may lease or purchase the terminal, or receive it free in exchange for a long-term contract or higher processing fees. Some providers use the general lack of knowledge regarding the cost of a credit card terminal to inflate prices into the thousands of dollars for a few hundred dollar device. They may also provide the merchant with a credit card terminal that is "locked" into only one provider, making it useless if the merchant wants to switch service.

When a terminal is leased there is usually a 3rd party leasing company involved and it is not uncommon in many U.S. states for these leases to be non-cancelable and possibly never ending unless notice is given to the leasing company at the end of the original term.

Automated Response Unit (ARU)

An ARU (also known as a voice authorization, capture and deposit) allows the manual keyed entry and subsequent authorization of a credit card over a cellular or land-line telephone. With this method a merchant typically imprints their customer's card with an imprinter to create a customer receipt and merchant copy, then process the transaction instantaneously over the phone.

Payment gateway

A payment gateway is an e-commerce service that authorizes payments for e-businesses and online retailers. It is the equivalent of a physical POS (point-of-sale) terminal located in most retail outlets. A merchant account provider is typically a separate company from the payment gateway. Some merchant account providers have their own payment gateways but the majority of companies use 3rd party payment gateways. The gateway usually has 2 components: a) the virtual terminal that can allow for a merchant to securely login and key in credit card numbers or b) have the website's shopping-cart connect to the gateway via an API to allow for real time processing from the merchant's website.

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Level 2 or Level 3 Processing - Purchasing Cards

Visa and MasterCard have created a specialized type of credit card used primarily by government agencies and businesses. Increasingly, corporations and government agencies are relying on this form of payment to compensate their service providers and suppliers. Businesses benefit by receiving their funds quickly and by winning competitive bids and government contracts where purchasing cards are the required form of payment. The downside, however, is the increased costs associated with receiving these payments. These costs will usually be much higher than accepting a standard consumer credit card.

The solution is that some businesses may qualify for ways to process these transactions that allow them to pay lower fees if they can supply additional information, called "level 2 or level 3 data". For example, if government transactions are over \$5,000, businesses can significantly reduce their transaction costs by including "level 2 or level 3 data" about the purchase along with each transaction. Examples of level 2 or level 3 data is a purchase order number associated with the transaction that the credit card will be paying. This data is passed on to the purchaser so that it may be many times easier to reconcile the transaction. If all the required data is not collected and passed on during the transaction, the merchant can have surcharges added to the basic fees or be forced into a non qualified transaction category.

Merchant Account Marketing

Merchant accounts are marketed to merchants by two basic methods: either directly by the processor or sponsoring bank, or by an authorized agent for the bank and additionally directly registered with both Visa and MasterCard as an ISO/MSP (Independent Selling Organization / Member Service Provider). Marketing details are by card issuers like Visa and MasterCard, and are enforced by various rules and fines.

Marketing by Banks

A bank that has a merchant processing relationship with Visa and MasterCard, also known as a member bank, can issue merchant accounts directly to merchants. In practice it is usually harder to obtain a merchant account directly through a bank than it is through an ISO/MSP, and fees may be somewhat higher.

To reduce risk, some banks limit approval to merchants in its geographical area, those with a physical retail storefront, or those that have been in business for 2 years or more. These limitations along with different customer focus motivate some banks to sponsor ISO/MSPs to do the marketing and customer support directly, leaving the bank to do the accounting and processing.

Marketing by ISO/MSPs

To market merchant accounts, an ISO/MSP must be sponsored by a member bank. This sponsorship requires that the bank verify the financial stability and suitability of the company that will be marketing on its behalf. The ISO/MSP must also pay a fee to be registered with Visa and MasterCard and must comply with regulations in how they may market merchant accounts and the use of copyrights of Visa and MasterCard. One way to verify if an ISO/MSP is in compliance is to check a website or any other marketing material for a disclosure "company is a registered ISO/MSP of bank, town, state. FDIC insured". This disclosure is required by both Visa and MasterCard and will cause a fine of up to \$25,000 if it is not clearly visible. In almost all cases, if there is no disclosure, the company is likely to be an uninformed 4th party or worse. In many cases unregistered operators have been responsible for some of the worse horror stories from merchants.

Obtaining a merchant account through a registered ISO/MSP is the most common way to obtain an account. The process is usually much simpler than going directly through a bank. One reason is that the merchant approval process and underwriting is streamlined and more favorable to a variety of business types and products sold. ISOs/MSPs also add value to the basic services of card authorization and deposit. Many work directly with the underwriting bank to assure

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that support and customer service is targeted to many segments of merchants with unique needs. In many cases, merchant accounts obtained through an ISO/MSP can cost less than if the merchant contracted with the bank directly.

Rates and fees

A Merchant Account has a variety of fees, some periodic, others charged on a per-item or percentage basis. Some fees are set by the merchant account provider, but the majority of the per-item and percentage fees are passed through the merchant account provider to the credit card issuing bank according to a schedule of rates called interchange fees, which are set by Visa and MasterCard. Interchange fees vary depending on card type and the circumstances of the transaction. For example, if a transaction is made by swiping a card through a credit card terminal it will be in a different category than if it were keyed in manually.

Discount Rates

The discount rate comprises a number of dues, fees, assessments, network charges and mark-ups merchants are required to pay for accepting credit and debit cards, the largest of which by far is the Interchange fee. Each bank or ISO/MLS has real costs in addition to the wholesale interchange fees, and creates profit by adding a mark-up to all the fees mentioned above. There are a number of price models banks and ISOs/MLSs use to bill merchants for the services rendered. Here are the more popular price models:

3-Tier Pricing

The 3-Tier Pricing is the most popular pricing method and the simplest system for most merchants, although the new 6-Tier Pricing is gaining in popularity. In 3-Tier Pricing, the merchant account provider groups the transactions into 3 groups (tiers) and assigns a rate to each tier based on a criterion established for each tier.

Qualified rate

A qualified rate is the percentage rate a merchant will be charged whenever they accept a regular consumer credit card and process it in a manner defined as "standard" by their merchant account provider using an approved credit card processing solution. This is usually the lowest rate a merchant will incur when accepting a credit card. The qualified rate is also the rate commonly quoted to a merchant when they inquire about pricing. The qualified rate is created based on the way a merchant will be accepting a majority of their credit cards. For example, for an internet merchant, the internet interchange categories will be defined as Non-Qualified, while for a physical retailer only transactions swiped through or read by their terminal in an ordinary manner will be defined as Qualified.

Mid-qualified rate

Also known as a partially qualified rate, the mid-qualified rate is the percentage rate a merchant will be charged whenever they accept a credit card that does not qualify for the lowest rate (the qualified rate). This may happen for several reasons such as:

- A consumer credit card is keyed into a credit card terminal instead of being swiped.
- A special kind of credit card is used like a rewards card or business card
- A mid-qualified rate can be from 1.50%-2.50% higher than a qualified rate. Some of the transactions that are usually grouped into the Mid-Qualified Tier can cost the provider 0.30%-0.50% more in interchange costs, so the merchant account providers do make a markup on these rates.

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The use of "rewards cards" can be as high as 40% of transactions. So it is important that the financial impact of this fee be understood.

Non-qualified rate

The non-qualified rate is usually the highest percentage rate a merchant will be charged whenever they accept a credit card. In most cases all transactions that are not qualified or mid-qualified will fall to this rate. This may happen for several reasons such as:

- A consumer credit card is keyed into a credit card terminal instead of being swiped and address verification is not performed.
- A special kind of credit card is used like a business card and all required fields are not entered
- A merchant does not settle their daily batch within the allotted time frame, usually past 48 hours from time of authorization.
- A non-qualified rate can be from 2.00%-2.50% higher than a qualified rate and can cost the provider 0.50%-1.50% more in interchange costs, so the merchant account providers do make a markup on these rates.

6-Tier Pricing

As a result of the Wal-Mart Lawsuit and to compete against PIN-based debit cards (which are processed outside of the Visa and MasterCard networks), Visa and MasterCard lowered the interchange rates for debit cards well below those for credit cards. Some providers can pass on the lower cost of these cards directly to merchants. Consequently, the 3 tiers programs have added 2 classifications for debit cards that are processed without a PIN or with a PIN for a total of 6 rate classifications.

Interchange plus Pricing

Some providers offer merchant account services priced on an "interchange plus" basis. These accounts are based on the "interchange" tables published by both Visa Interchange and MasterCard Interchange. This type of pricing creates a discount rate by adding interchange rates, fees, assessments, markups and other costs.

Bill Backs

A bill back is a relatively new price model and a variation on interchange plus pricing. It has some variations but the basic concept is that the merchant pays interchange on the statement that the transactions took place and then pay all other fees, like dues, fees and assessments, etc on the next month's statement. It requires a great deal of time to research the actual cost per transaction with the bill back system. Some merchants feel this form of pricing is very misleading.

Other Fees

Authorization fee

The Authorization fee (may also be known as a Transaction fee but can also be a separate fee) is charged each time a transaction is sent to the card-issuing bank to be authorized, usually between 10 and 35 cents each. Usually the fee is charged, even if the transaction is declined. It is industry standard to charge an authorization fee.

Statement fee

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The statement fee is a monthly fee associated with the monthly statement that is sent to the merchant at the end of each monthly processing cycle, usually a flat \$5 or \$10. This statement shows how much processing was done by the merchant during the month and what fees were incurred as a result. Statement can be by both paper and/or web base. The merchant statement may be very difficult to understand and reconcile for most merchants. It is industry standard to charge a statement fee.

Monthly minimum fee

The monthly minimum fee is a way to ensure that merchants pay a minimum amount in fees each month to cover costs from the provider to maintain the account and to create minimal profits. If a merchant's qualified fees do not equal or exceed the monthly minimum they will be charged up to the monthly minimum to satisfy their minimum fee requirements.

Example: A merchant has signed a contract with a \$25.00 monthly minimum fee. If all the fees for the most recent month of processing total only \$15.00, this merchant will be charged an additional \$10.00 to meet their monthly minimum requirements. Sometimes there are fees that are charged that are not a part of the monthly minimum, such as statement fees. It is industry standard to charge a monthly minimum.

Batch fee

A batch fee (also known as a batch header fee) can be charged to a merchant whenever the merchant "settles" their terminal. Settling a terminal, also known as "batching", is when a merchant sends their completed transactions for the day to their acquiring bank for payment. Some providers perform this automatically. It is important to close a batch every 24 hours or a higher rate will be assessed by Visa or MasterCard.

Customer Service fee

The customer service fee (also known as a maintenance fee) can be charged by some providers to pay for the cost of customer service. The fees can be from \$5-\$25.

Annual fee

The Annual fee can be charged by some providers to pay for costs of maintaining the merchant's account. Sometimes these fees can be quarterly. The fee can be from \$49-\$399.

Early Termination fee

The early termination fee can be charged by some providers if the merchant ends the contract before the end of the contract term. Some providers have terms of up to 5 years with a one year prior notice to cancel or the fee will be assessed. The fees can be from \$99-\$1000+. Some providers also assess all statement fees and monthly minimums remaining when the contract is terminated. Some providers may also assess a "lost profit" fee based on an assumption of profits they concluded they may have made during the term of the contract. These fees can be thousands of dollars.

Chargeback fee

The chargeback is the largest risk that is presented to banks and providers and therefore their biggest fear. This is not to be confused with a refund, which is simply a merchant refunding a transaction. In the Visa and MasterCard rules, the merchant's processing bank is 100% responsible for all the transactions that the merchant performs. This can leave the provider open to millions of dollars of potential losses if the merchant operates in an illegal or risky manner and generates many charge backs. The providers pass this cost on to the merchant, but if the merchant is fraudulent or simply does not have the money, the provider must pay all the costs to make the card holder whole. The chargeback risk is the largest

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part taken into consideration during the contract application and underwriting process. Some banks are many times more stringent than others when assessing a merchant's chargeback risk.

If a merchant encounters a chargeback they may be assessed a fee by their acquiring bank. A potential chargeback is presented on behalf of the card holder's bank to the merchant's credit card processing bank. A reason code is established by the card issuer to properly identify the type of potential chargeback based on the card holder's complaint. The most common complaint is that the card holder can not remember the transaction. Usually, these potential charge backs are corrected when the merchant's processing bank sends over more details about the transaction. Some providers charge a fee for this service, known as a "Retrieval Request". A chargeback can also be related to a fraud or similar dispute that the card holder is claiming to the merchant. This fee can be charged by some providers whether the chargeback is successful or not and is not dependent on the amount of the chargeback.

Currently both Visa and MasterCard require all merchants to maintain no more than 1% of dollar volume processed to be charge backs. If the percentage goes above, there are fines starting at \$5000 - \$25,000 to the merchant's processing bank and ultimately passed on to the merchant.

In all cases, a successful chargeback will cost the merchant the chargeback fee, usually \$25-\$50, plus the cost of the transaction and the amount processed.

Controversies

The merchant account industry has developed a reputation that is not very favorable at times. This seems to be directly linked to companies that are not registered with Visa and MasterCard and use high pressure marketing tactics with 100% commissioned salespeople.

As with any contractual relationship, it is important to become as informed as possible, before any commitment. Merchants have few third party resources to guide them in the process of full evaluation of the many providers. The most widely used third party is the Better Business Bureau BBB --or Merchant Service Bureau these maintain a list of most providers with a rating based on the number of complaints and how the complaints were addressed.

Merchant services are the name given in the United States to a broad category of financial services intended for use by businesses. In its most specific use, it usually refers to the service that enables a business to accept a transaction payment by use of the customer's credit or debit card. More generally, the term includes the following in its use:

- Credit and debit cards payment processing
- Check guarantee and check conversion services
- Automated Clearing House check drafting services
- Gift and loyalty card programs

Other services include age verification (used by age-restricted businesses), employee payroll tracking functions, electronic benefits transfer programs such as food stamps.