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Payments 101:

A Guide to Who Does What in Payments

Whenever a consumer pays for a good or service, either online or in person, the process is quick and easy. Whether they tap their card on a terminal or type their card details into a form online, they're on their way in a matter of seconds.

But behind the scenes, a massive system is humming, making that transaction and more than a billion[i] like it possible every day.

Even though it's mostly invisible to many people, payments is a growing $2 trillion industry. In fact, during the last decade, payments revenue outpaced GDP growth. While growth overall has slowed somewhat due to the pandemic, industry forecasts still point to an active sector. For example, digital commerce revenue is expected to grow 22% between 2019 and 2023.[ii]

Established players in the payments system can be broken down into a few key types. But the industry is rapidly evolving to support the needs of small businesses and entrepreneurs with new models as well. Within the segment of companies that enable payments acceptance, 76% of revenue growth is coming from small to medium enterprises.[iii] These smaller businesses are driving a transformation.

Understanding the primary players, the new entrants, and how they all fit together is an important first step to understanding the payments industry as a whole.

Who's Who in Payments

The payments system is an interconnected network of companies with specialized functions. Each business in the chain has a critical role to play in getting transaction information from the point of sale or service to the cardholder's bank and back again, keeping it secure along the way.

While other entities may be involved, there are a few primary players that are a part of every transaction: **card networks, issuing banks, payment processors,** and **acquiring banks**. A new group known broadly as **embedded payments providers** is also increasingly involved.

Here's more on the roles each of these types of businesses play and how they relate to each other:

ISSUING BANKS

Issuing banks are the banks that issue credit and debit cards to consumers. They are also often known simply as issuers. Issuers are important partners of the card networks; they're responsible for their cardholders' activity and adherence to card network rules.

When a consumer makes a payment at a retailer or other merchant, the issuer is responsible for authorizing the transaction. Primarily, this involves verifying the account and making sure the consumer has the available credit or the funds required for the purchase. The bank will also subject the transaction to its own set of fraud and risk rules.

If the transaction is authorized, the funds must then be moved from the issuing bank to the acquiring bank, a process known as settlement. This is a separate step from authorization, and it is usually handled later in batches with other transactions.

CARD NETWORKS

The card networks with the largest market share are American Express, Discover, Mastercard and Visa. These companies provide the infrastructure needed to move and settle transactions between banks. They also create the rules that everyone in the payments ecosystem must follow, and they enforce compliance with those rules.

The card networks also set interchange rates. Interchange is a fee that acquiring banks pay to issuing banks as part of every transaction to cover the costs of issuing cards and the risk associated with enabling payments.

Finally, the networks are fundamental to driving growth in card usage, resulting in more payments revenue for everyone in the ecosystem. They do this by developing new products and services, pursuing and enabling new market segments, and promoting brand recognition and card acceptance.

PAYMENT PROCESSORS

Payment processors manage moving the transaction and settlement data between issuing and acquiring banks. They provide connections to the card networks, and they provide other back-office services to issuing and acquiring banks as well. They're also responsible for complying with card network rules and regulations.

ACQUIRING BANKS

Acquiring banks are the financial institutions that are responsible for getting the funds to the merchants. They are clients of the card networks, and they enable merchants to access the payments system through their relationships with the networks.

Acquiring banks underwrite and execute agreements with their merchant customers, collect fees from them, and often provide them with additional services related to payments. Acquiring banks carry and manage all of the risk associated with their merchants. They're responsible for their own and their merchants' compliance with network rules and government regulations.

In addition to performing these functions, acquiring banks may sponsor other entities to do so on their behalf as well. So, a merchant may actually get its payments services from other companies, such as resellers or embedded payments providers, rather than from acquiring banks directly. Any business wishing to offer payment services to merchants will need to have an agreement with an acquiring bank. They will also of course need to comply with card network rules.

Acquiring banks are often referred to as "merchant acquirers" or simply "acquirers." But the term merchant acquirer is not defined by the card networks, so companies other than banks that connect merchants to the payments ecosystem may sometimes call themselves acquirers.

EMBEDDED PAYMENT PROVIDERS

Today, there is a new approach to marketing and selling merchant services. Merchant services are increasingly being offered through an "embedded payments" approach. The term embedded payments refers to the seamless integration of a payments function and its supporting processes into a software application.

Using this model, merchants might accept payments through the vertical software provider they use for their other business functions. Or they might accept them through a web site where they are selling their goods. These are some of the more common embedded payments approaches:

Marketplaces. Marketplaces bring together cardholders and retailers on an e-commerce website or mobile application. A marketplace does not own the goods or services; it simply provides a platform for sellers and conducts a single checkout and payment process for goods from multiple sellers. Marketplaces must perform merchant underwriting and risk monitoring on sellers on their platforms.

Payment facilitators. Increasingly, software providers are offering payments through their platforms. Doing so allows them to offer a more comprehensive set of services to meet their customers' business needs. Payments can be integrated with other business functions to streamline operations and reduce the need for manual processes.

Many ISVs are taking on responsibility for payments themselves by becoming what is defined by the card networks as "payment facilitators." The term is often shortened to "Payfac©." Payfacs provide underwriting, onboarding, pricing, risk mitigation and funds settlement to a range of merchant types.

Vertical software companies have an advantage in underwriting and risk management because of their familiarity with the industry in which they operate. They know things about their customers and their environment that general payment providers will not.

Payfacs have full control over their payment function and claim the most revenue from the processing fees. They typically have a two-party agreement directly with their merchant clients, called submerchants.

Software companies that prefer not to take on the responsibility of being a full payment facilitator may choose to partner with outside payments providers. These providers contract with the merchant and offer a spectrum of other services related to payments, depending on how much the ISV wants to take on.

On the simplest end of this spectrum, the ISV refers its customers directly to the provider in what is known as a referral agreement and receives a modest referral fee in return. ISVs using this model typically have no risk, liability, or control over their customers payments, and they receive the least revenue from processing fees.

Some payments providers now offer more choices, such as customized, white-labeled merchant applications and underwriting processes and more streamlined onboarding. They typically offer more of a share of the payments revenue than was traditionally available in the referral model and more visibility into underwriting decisions. The treatment of risk and liability varies with these companies, and ownership of customer data is often unclear.

Conclusion

As the payments industry continues to evolve, the players involved are finding better ways to reach and serve more businesses. The new models that support embedding payments into software are the latest example of how this established industry is securely connecting consumers and businesses, bringing the convenience of digital payments to more people.

To speak with a payments expert or to learn about how Infinicept can help you better understand the world of payments, contact us.

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[i] https://www.cardrates.com/advice/number-of-credit-card-transactions-per-day-year/

[ii] McKinsey & Company: The 2020 McKinsey Global Payments Report. https://www.mckinsey.com/~/media/mckinsey/industries/financial%20services/our%20insights/accelerating%20winds%20of%20change%20in%20global%20payments/2020-mckinsey-global-payments-report-vf.pdf

[iii] ibid.

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