# Your Guide to Embedded Payments

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## INTRODUCTION: PAYMENTS IS A GROWING OPPORTUNITY

Electronic payments acceptance has long been largely the domain of a handful of large payments providers and banks. It was a world of lengthy, complex contracts and long onboarding times that was geared mostly to the needs and resources of larger businesses.

A number of trends driven by changes in consumer behavior and outside economic forces are forcing the payments industry to adapt. Even though payments growth overall slowed somewhat due to the pandemic, industry forecasts say that digital commerce revenue is expected to grow 22% between 2019 and 2023.[i] Value-added services, such as innovative fraud mitigation tools and buy now pay later capabilities, are a key driver of that digital commerce revenue growth.

At the same time, 76% of revenue growth within merchant services, the segment of companies that enable payments acceptance, is coming from small to medium enterprises.[ii]

Traditional merchant acquirers were not well equipped historically to meet today's evolving digital payments needs, particularly when it comes to the needs of small businesses. In response, the payments environment is evolving, and a new model known as *embedded payments* is taking center stage.

[i] 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

[ii] ibid.

## WHAT IS EMBEDDED PAYMENTS?

Put simply, embedded payments is the seamless integration of a payments function and its supporting processes into a software application. Embedded payments providers are often companies that offer software platforms to support the needs of a specific industry's business operations. These software providers are sometimes known as independent software vendors (ISVs). They might include booking software for salons or scheduling and routing software for field service businesses.

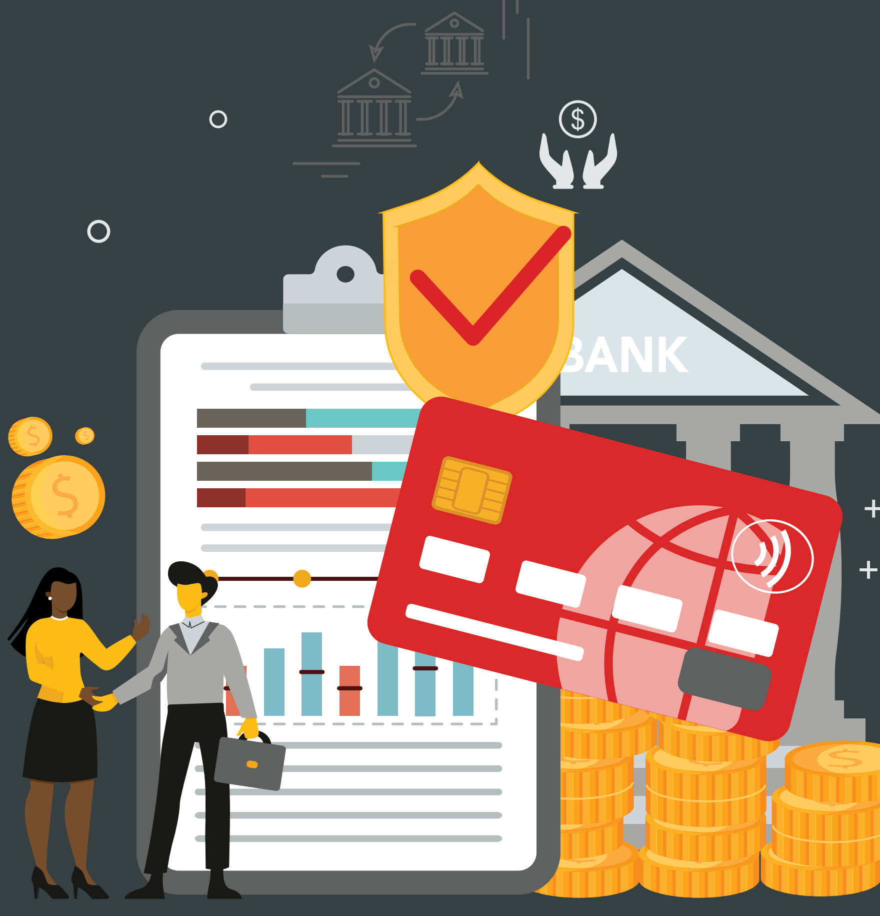
When ISVs embed payments into their solutions, their customers who wish to accept card payments electronically can quickly and easily access those capabilities through their existing relationship. They no longer have to look past their current vendor to the payments industry for help.

The embedded payments model allows companies of all sizes around the world to participate in the digital economy. It enables more democratized digital commerce while still keeping the bad guys out of the financial system.

And for software providers who choose to embed payments into their platforms, it has a number of benefits. It provides them with a new recurring revenue stream – payments fees – which often in turn boosts their company valuations. It enables them to better control the experience for their merchants and improve their product offerings. And it speeds onboarding for their merchants, getting them accepting payments more quickly.

## HOW DID WE GET HERE?

Traditionally, businesses have accepted payments through relationships with providers known as merchant acquirers. These are typically banks that offer merchant accounts and are members of the card networks, like Mastercard or Visa. They also might be bank-sponsored companies that specialize in offering payment acceptance services. They receive the merchant's card transactions, pass them to the appropriate card networks for processing and facilitate settlement of funds between the merchants' and the consumers' banks.




For merchants, applying to accept payments through traditional acquirers could be complex and time-consuming. Underwriting was an extensive process geared to the needs of large merchants. Applications contained the same questions whether you were planning to process hundreds of thousands in sales a month, or you were a small startup hoping to process a few thousand in a year or two. Contracts were detailed and complicated. It could often take weeks to obtain an account and begin accepting payments.

This dynamic began to shift in the 1970s and 80s. In fields such as floral delivery and petroleum, centralized merchants collected settlement for multiple locations through a single merchant account and then passed the funds on to each location. Companies operating online in the late 1990s leveraged this model to assist small to medium-sized businesses more easily accept payments online. However, this model was actually against card network rules at that time.

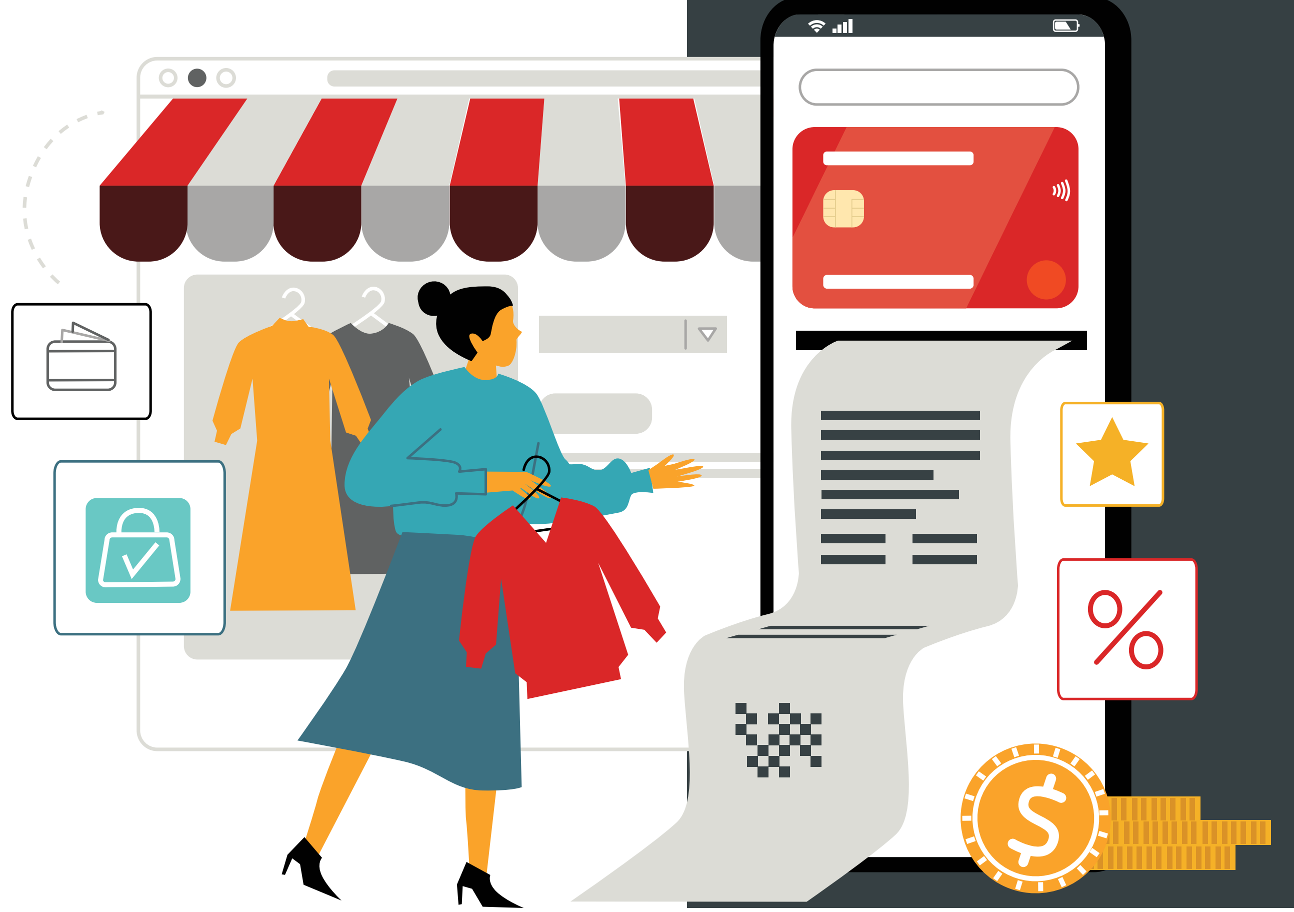
The first rules meant to provide a framework for this new way of enabling payments started to emerge in the early 2000s with the creation of the Internet Payments Service Provider (IPSP) – a precursor to rules that govern the space today.

As the space continued to evolve, different payments models arose as ways to further close that gap for small businesses, but each had its own drawbacks. These included independent sales organizations (ISOs) and merchant of record aggregators.

**ISOs.** ISOs serve as intermediaries that provide smaller merchants with access to the payments system, essentially reselling payment processing services for merchant acquirers or payment processors. ISOs are typically divided into two types: retail and wholesale. A retail ISO acts like an extended sales force for its provider partners. A wholesale ISO takes on additional operational and support responsibilities.

This model provided acquiring banks and processors access to markets they couldn't access or support well for decades. Increasingly, however, the markets ISOs targeted are being served better now with vertical software.

**Merchant of record aggregator**. In this scenario, some B2B software platforms would get one merchant account, process and aggregate the transactions of all their clients, then transfer the owed funds to each client. Unfortunately, like some of its predecessors, this model violated card brand rules at the time.

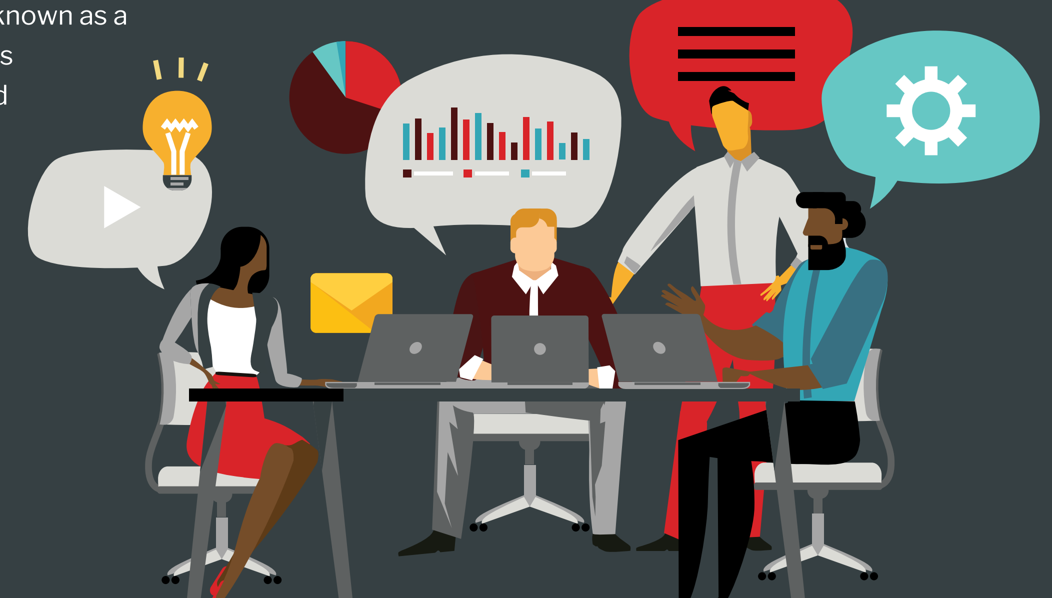


# Payment facilitators and other approaches to embedding payments

For the reasons cited above, these first two models are largely being abandoned in favor of embedded payments. Now, providers like software companies are creating front-end processes and interfaces that better meet the expectations of today's end users. And the advent of cloud computing and technological tools – most notably APIs – means that it's easier than ever before to securely connect to the payments system.

## PAYMENT FACILITATORS = FULL OWNERSHIP AND CONTROL

In the last few years, a new way for software companies and other businesses to offer payments has emerged with full support from the card networks. This model, known as a **payment facilitator (PayFac®)**, is responsible for underwriting and onboarding merchants and providing them with the technology they need to process and receive funds from electronic payments.



Payment facilitators embed payments into their own platforms, positioning themselves as a single point of contact for all of a business's operational needs, including payments.

Today, PayFacs eliminate the need for individual merchants to establish their own accounts with payments providers. Typically, this model involves a two-party agreement between the PayFac and the submerchant. A PayFac integrates its own technology with that of its provider partners. The company then facilitates payments on behalf of its individual merchant customers, which are known as submerchants in this ecosystem.

A software company that becomes a PayFac manages the underwriting, onboarding, pricing, risk mitigation and funds settlement for its submerchant. The PayFac is allowed to set payment processing fees and recognize them as top-line revenue.

PayFacs have full ownership of the data they collect on their submerchants. They also have full control over the customer experience they provide. They can tailor underwriting and onboarding processes to the unique needs of their industry. They can also control funding – how and when merchants can have access to the money from their sales.

PayFacs answer to acquiring banks. An acquirer will base its approval of the PayFacs it decides to sponsor into the networks on a review of their business, risk profile, and policies and procedures outlining risk and compliance management. PayFacs also need to connect to a payments processing platform to process their submerchants' transactions.

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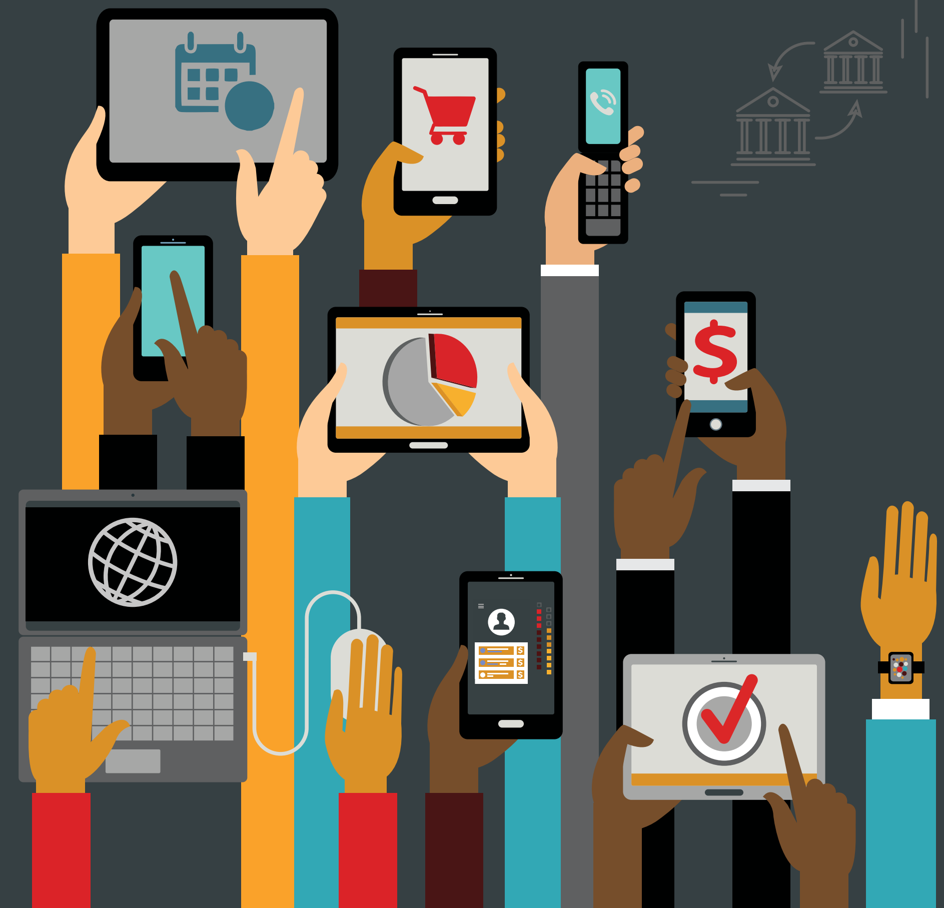
Companies considering becoming PayFacs will first build a business case. They need to identify or establish the functions they'll need to support their payments business, including sales and customer support; IT and development; operations; and legal support. They'll also need to establish risk management and regulatory and card network rule compliance processes and procedures.

As more and more software providers choose to embed payments in some way, support has grown up around the market. Today, many providers and experts are available to help prospective PayFacs with all of these efforts, making it easier than ever before.

## USING A THIRD-PARTY PROVIDER

Depending on where they are on their payments journey and how payments fits into their business, some software providers may feel they are not interested in becoming PFs or not yet ready. Perhaps they don't think they would have the payments volume to justify the move, or they don't feel that it is strategically important enough to their business to merit owning the payments function.



In recent years, these companies have signed up with outside payment providers for referral programs. With the referral model, software platforms with clients that needed to accept payments from consumers integrated the technology to support payments into their software and set up referral agreements with a payments processor, merchant acquirer or ISO. They would then refer their clients to this partner for underwriting and contracting.

In this model, software companies typically have no liability for payment risk, and they receive a referral fee. However, the model does not scale well. The merchant experience is typically slow and disjointed. Sometimes it is difficult to end contracts or move clients to another provider.

Software companies also typically have no control over the payments process, ownership of or visibility into the data, or ability to provide customer support. The biggest problems occur when a valued client is rejected or has a poor experience with the third-party payment provider, creating customer service headaches for the software provider.

Increasingly, payments providers are improving on the old referral model. Many of these companies are new entrants to the market, and many have become payment facilitators themselves.

These providers still contract directly with the merchant for payments, but they have developed more modern infrastructure, better tools and more nimble processes that enable them to offer 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, so it's important for ISVs to fully understand their liability and not assume the payment provider is taking it on. Ownership of customer data is sometimes negotiable.

While ISVs working with newer third-party payment providers look more like payment facilitators, with customized and branded applications and better processes, they still lack the control over payments that full PFs enjoy. ISVs that would like to control settlement or funding or have specialized needs for how their payments function fits in with their platform and serves their customers' needs will still need to build that technology out themselves (or buy it separately).

# How do you know what's right for your company?

Resources are available to help software companies fully evaluate the role of payments within their business and calculate their potential return on investment. But a good place to start is by asking three fundamental questions:

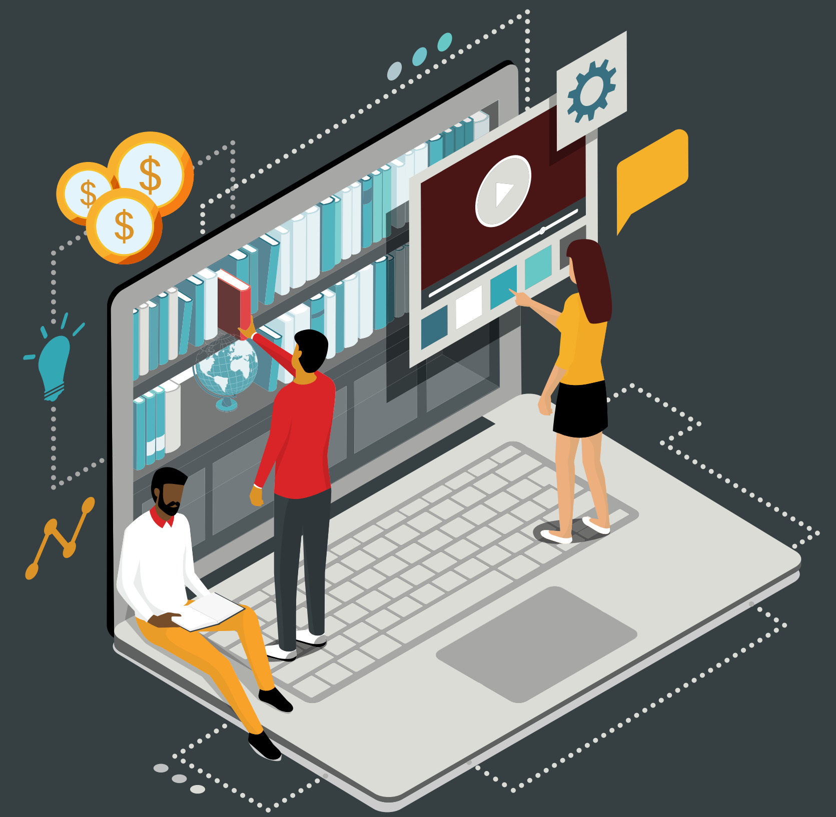
- How much of the customer experience do you want to control and integrate into your offering?
- How much risk and ownership over operational processes are you willing to undertake in exchange for economics and control of that experience?
- How important is payments as a value driver for your business, in both the short and long term?

To keep it simple initially, a rule of thumb would be: The more you answer "*a lot*" to the above questions, the more you are embedding payments into your business. You would be a candidate for becoming a payment facilitator – if not right away, then perhaps after spending some time working with a third party.

The more you answer, "*not much,*" or "*maybe someday,*" the more you would consider working with another provider.

WHERE TO NEXT: EMBEDDED FINANCE

As embedded payments becomes more mainstream, many software providers are looking to the next logical step, embedded finance. Embedded finance is the delivery of banking, payment and financial services (for example, lending, card issuing, or treasury and cash management) within the context of a user experience. Increasingly, this type of service is also being delivered through a software platform. The financial service offering is positioned at the most relevant point of a business process for the platform customer.



For example, imagine that a business owner for a small chain of local bakeries is placing an order for $10,000 of confectioner's sugar. Within the order management system, the software platform can present the manager with options to finance the order that are based specifically on that bakery's business data profile.

This is possible in part because payments provide the foundation for a whole universe of financial services. Embedded payments companies have deep insight and data from a risk and underwriting perspective. This can feed into a data profile that supports other extended services, such as risk modeling to help determine creditworthiness. Technological tools and infrastructure that are now available are making delivering on this concept easier than ever.

**From a business standpoint, embracing embedded finance delivers on three fronts.**

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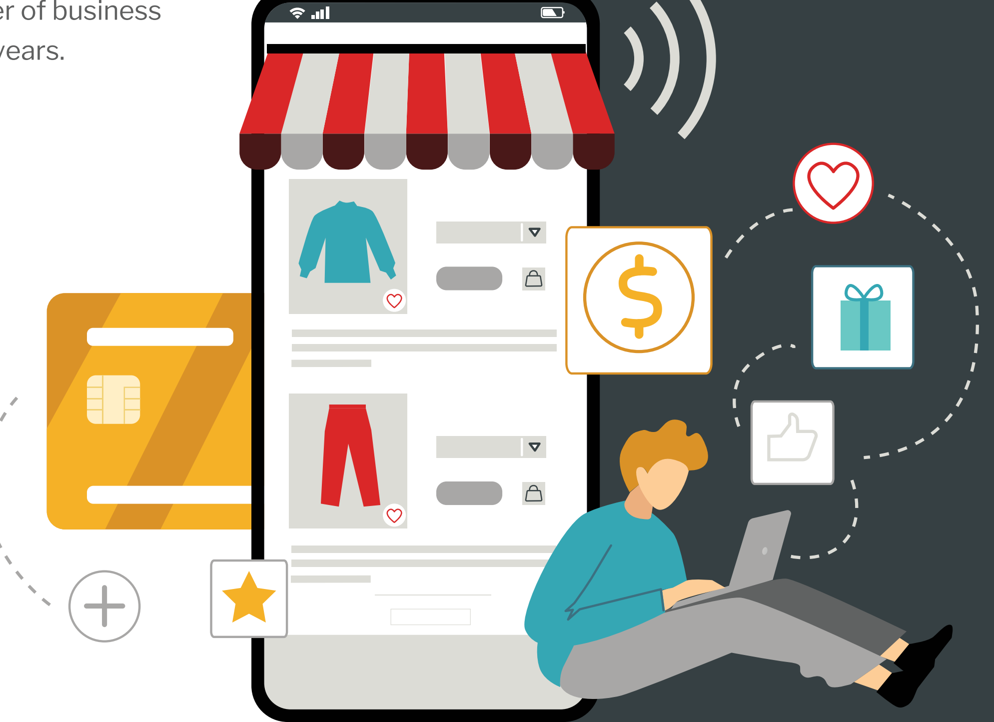
First, embedded finance creates better user experiences and ultimately greater stickiness with customers. The ISV starts with a piece of software that serves as the control panel for the business. Then they bring in payments. Then, they offer even more products and services to help their customers expand. The value journey is natural and seamless, and it cements the ISV as the long-term provider for their business customers.

Second, embedded finance is a competitive hedge. In highly competitive software markets, those with just a software offering are at a disadvantage compared to those competitors that bundle software and payments. Those that include a financial offering create further differentiation.

Put simply, if you're offering a software platform for restaurants and the competitor down the street is now offering a similar platform that includes payments and financial service offerings, all other things being equal, the business customer is more likely to gravitate toward the solution that can be a one-stop shop.

Finally, embedded finance offerings are attractive economic line items. Consider revenue share opportunities for issuing and cash disbursements to a virtual or an account-linked card program. A typical model would see 30-40% revenue share on interchange margins with little overhead. Short-term and working capital solutions also offer attractive origination and revenue share options.

All of these factors point to a trend that's poised to be a strategic driver of business decisions over the next few years.



## Conclusion

Embedded payments has created an opening for new entrants to offer better products and services, expanding the market to bring far more entrepreneurs and small businesses into the payments system. Embedded payments providers can deliver scalable solutions to meet SME needs.

In this rapidly changing environment, companies that provide a better merchant experience and more functionality will win the battle for market share.

To speak with a payments expert or to learn about how Infinicept can help you evaluate your embedded payments options, contact us.