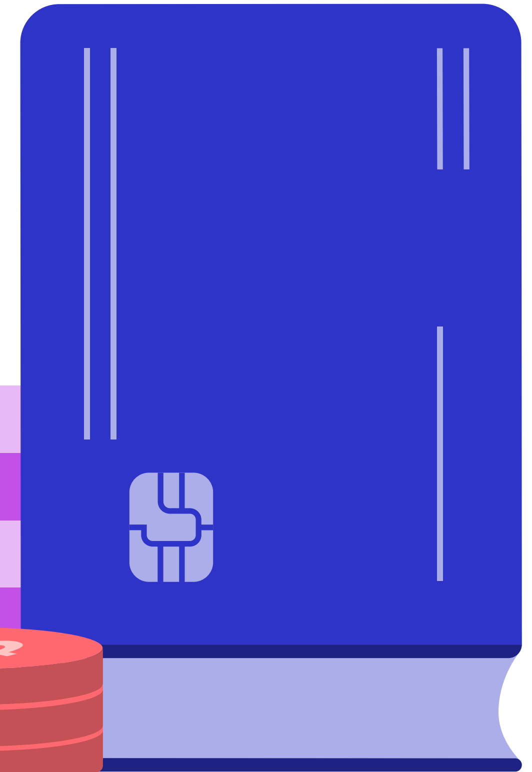
[ ] Payrix

Payment Facilitation 101

Understanding the Basics of Embedded Payments



Introduction

The world of embedded payments is complicated, evolving, and exciting all at the same time. If you're new to it, the lure of payments revenue – and in particular payment facilitation – are often tempered with caution of the unknown. As a PayFac-as-a-Service partner to many growing verticals, we understand. Hopefully, this e-book begins to shed some light on the questions and concerns you have about payment facilitation. More importantly, we can help you find your place in the payments world and make the most of the opportunities that it brings you.

Which business model is right for you?

With Embedded Payments, You've Got Options

There's more than one way to embed payments into your software stack. This hasn't always been the case, but continued focus on embedded payments is driving opportunities for SaaS companies selling to vertical markets. No doubt that's why you're reading this.

Thanks to continuous innovation there are a growing number of business models for realizing the benefits of embedded payments. Choosing the right model comes down to your goals and how much you want to take on as a business.

First, let's define what embedded payments are. Simply put, embedded payments refer to a payments solution that is built or embedded into a software offering. Embedded payments is often the final piece in creating an all-in-one business management solution for your customers that also adds a new revenue stream to your bottom line.

Monetizing payments isn't reserved for the big guys anymore. As of this writing, there are three primary business models a software company can use to generate revenue from payments.

- Set up a referral partnership with a payment processor.
- Become a payfac (a.k.a. payment facilitator).
- Choose an embedded payments technology partner that offers a middle ground.

HERE'S MORE ABOUT EACH MODEL.

Referral Partnership

This is the traditional model you may be familiar with. Your software company makes an agreement with a payment processor to become a referral partner. When your customer needs to set up payments for their business, you refer them to the payment processor. In return, the payment processor pays you a referral fee. The end.

In this scenario, your customer is using a bolt-on payments solution that doesn't necessarily integrate fully or at all with your platform. Therefore, someone else has control over merchant onboarding, customer service, and all facets of payment processing for your customer. The only thing you do is make the referral.

However, this hands-off approach does come with the risk of your customer having a bad experience with the payment processor, which in turn, could sour your relationship with your customer. In addition, your customer is left managing a separate system for payments that creates more work for them. The user experience for customers making payments is typically less than ideal as well.

Payment Facilitator

PayFacs are at the opposite end of the spectrum from referral partnerships. Often these are software companies who aspire to become payments companies and want to reap the maximum benefits of embedded payments.

With the payfac business model, your SaaS company establishes a master merchant account through an acquiring bank to process or facilitate payments. Your customers can then set up a sub-merchant account under your master account, making it much easier for them because you've done all the heavy lifting with the bank.

You've monetized your payments by collecting processing fees, but you've also taken on all the risks of becoming a processor, such as underwriting, compliance, investment in new technology, disruptions to your strategic plan, distraction from your core business, and managing the full payments experience.

As of today, software businesses typically become a payfac in one of two ways:

1. Build it – Requires engineering resources that are expert in payment software development

2. Buy it – Requires a partner that provides expert guidance on operating a payments business and a complete payment infrastructure as-a-service.

Payfac-as-a-Service

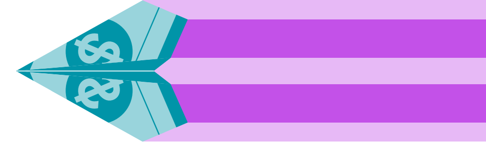
This is the newest model and better overall for monetizing payments, one that offers much more upside and control than referral partnerships (namely revenue) and mitigates many of the drawbacks of being a registered payfac when you're not ready.

A payfac as a service partner provides the infrastructure you need to offer payments to your customers in the form of a white-labeled solution. To your customers, the payments experience is seamless and fully integrated with your SaaS platform. It looks like you're processing their payments, but your partner is absorbing the risks, build-out costs, and complexity of managing payments in-house. Plus, they're decreasing your time to market.

This model is also inherently flexible, so you can have as much control over onboarding and customer service as you want. Plus, it offers more recurring revenue from a share of processing fees compared to one-time referral fees you get with a referral partner.

Ultimately, the right partner will offer a solution that can help you become a full payfac if and when it's right for you.

MODEL COMPARISON.



Referral Partner Model	PayFac Model	Payfac as a Service Model
Traditional model	You become the processor	White-labeled technology solution
Revenue from one-time referral fees	Maximized revenue potential Increased risks and costs	Seamless integration with your SaaS platform
Your customers manage the relationships with the processor and payments technology solution provider	Responsible for technology infrastructure, underwriting, onboarding, and customer service	Revenue from customizable pricing/processing fees
		Partner assumes most of the risks and cost of build-out
		Fast and efficient onboarding
		Choose your level of control
		Path to becoming a full PayFac
		Decreased time to market

Are you factoring in costs and other expenses?

Seeing Dollar Signs: The Revenue Potential of Embedded Payments

The allure of embedded payments success stories tend to blur or gloss over the reality that many revenue factors are in play when you become a payment facilitator, all of which can impact your return on investment.

This article will explore on a high level the revenue potential of a payment facilitator as well as expenses and other factors that can impact what you ultimately net from embedded payments.

More Risk. More Ownership. More Revenue.

Generally speaking, the evolution of embedded payments has shown that when you take on more risk or have more ownership in the process, your return will also increase.

In the old referral models, a software company took on little or no risk. The return followed suit, ranging from zero to up to 20 basis points (bps) on Gross Merchant Volume (GMV) if you've negotiated well.

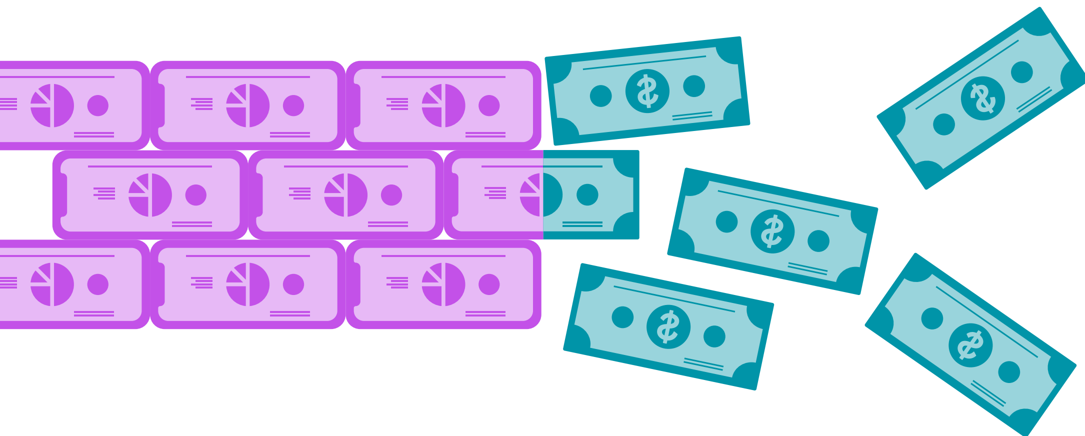
With traditional integrated payments, you take on more ownership of the process than in the referral model, so your revenue share increases as well – up to 40 bps of the GMV processed.

With the PayFac as a service and payment facilitator models, you can move from revenue sharing to full payments monetization. You can still partner with a payments expert to save time and money building out systems and infrastructure, but your revenue potential increases to 60-100 bps on your GMV. Take on 100% of the risk and management of your payment business, and you're looking at up to twice that or 100-120 bps on the total annual volume of payments processed on your platform.

Turning Up the Volume

Do you know the total available payment volume (GMV) on your platform? It's equal to the total value of the goods and services sold by your customers. That's what you're working with and want to capture through your payments offering. Obviously, the more transactions you process or increase your volume, the more payments revenue you can make.

Your payment volume is a critical factor in deciding to become a payment facilitator. As mentioned above, you need to reach a certain scale for it to make sense. For example, if your volume is less than $750 million, becoming a registered payment facilitator and taking on all the risks, infrastructure, and business functions of a comprehensive payments business may not be justified. In this case, the payfac-as-a-service model may be a smarter choice.



When calculating your total available payment volume, consider:

- Some of your customers using legacy payment providers may not switch to processing through your platform quickly. Change is not easy for everyone.
- If your customers accept cash or check payments in any volume, those transactions won't be captured through your platform. The same goes for countries that are not supported.

Sharing the Spoils

Again, in the payments business, you have to play nice with others, including sharing revenue with your acquirer and the card brand networks (Visa, Mastercard, Discover, American Express, etc) in the form of fees and interchange rates, respectively.

The good news about acquirer fees is they can decrease as your processing volume increases. The same can't be said for interchange rates charged by card brands. They are mostly fixed and the highest cost for a payment facilitator at around 1-1/2% to 3%.

Name Your Price

The easiest factor to understand is how your pricing structure affects your revenue. With old-school ISOs, it used to be a race to the bottom where pricing and basis points were concerned, because those were the only selling points. Cheaper equaled better.

Now, vertical SaaS companies who provide embedded payments in their offering are much more valuable to merchants, because they're helping merchants manage their entire business. The SaaS company is taking much more of the burden off merchants, so merchants are willing to pay more for the software. It's a win-win.

As a payment facilitator, you also have a lot more flexibility when it comes to the pricing you offer merchants. You don't get stuck with all the ancillary fees that ISOs typically charge merchants, so you can streamline pricing for a better customer and merchant experience.

Cut Upfront Costs

Starting a payment facilitator from scratch is incredibly expensive, time consuming, and will eat into your return on investment. A payments partner can greatly reduce your upfront costs and get your embedded payments solution to market (and revenue flowing) much quicker.

What could go wrong?

Risk Management and Payment Facilitation: Are You Up to the Challenge?

The rewards of payment facilitation are well known at this point. That's why it's an attractive prospect for SaaS businesses in vertical industries that are looking to grow, build value, and gain more control over their customer experience.

All the upside does come at a cost though. The risks you take on as a payfac are complex and wide-ranging, from compliance, fraud, and PCI to card regulations and merchant due diligence. Basically, all the responsibilities that would traditionally fall under the purview of a merchant acquirer (bank or financial institution) are now in your court as a payfac to manage and mitigate.

Succeed and the rewards can be great. Fail and you could pay a heavy price. It's a balancing act between how much risk you're willing and able to take on and the rewards you want to attain. Once you find that balance, it can impact your decision to become a payfac as well as which business model you ultimately choose.

SO, WHAT ARE THE MAJOR RISKS YOU FACE AS A PAYFAC? LET'S TAKE A LOOK.

Transactional Risks

These are inherent risks associated with the processing of transactions for your sub-merchants. As a payfac, you're responsible for the transactions of every sub-merchant on your platform. To reduce risk and losses, you have to constantly monitor their transactions for all types of payment fraud and institute controls when necessary.

One type known as friendly fraud occurs when a real customer orders a product online and receives the goods or products, but claims they didn't and proceeds to ask their bank for a chargeback rather than ask the merchant for a refund. If you provide processing, settlement of funds, and bill your merchants, you're responsible for handling chargebacks.

Settlement of funds comes with risks as well, because payfacs will often settle transactions with a sub-merchant before goods are delivered. This means you're extending them a line of credit in a sense. If you try to collect funds from a merchant for a chargeback you paid out and that merchant has gone out of business, you're stuck with losses that can quickly add up as you grow.

Compliance Risks

These are risks related to non-compliance with all the governmental and card-brand regulations you're subject to as a payfac. You're responsible for who's on your platform and must have processes and procedures in place that prove to your acquirer who your sub-merchants are.

Payfacs must ensure their sub-merchants are covered for money laundering, terrorist financing, and all other risks, including Know Your Customer (KYC), Anti-Money Laundering (AML), and Office of Foreign Asset Control (OFAC) requirements.

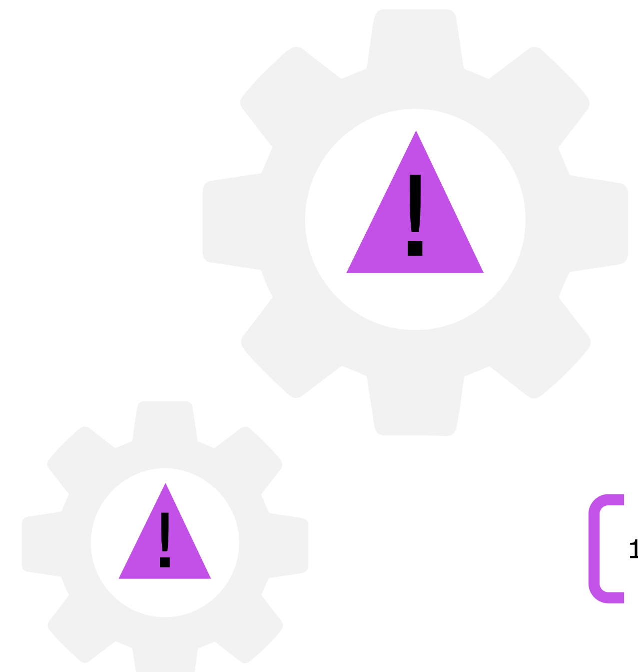
During the underwriting process, you're also required to identify the business owner(s) of your sub-merchants, according to rules and regulations set by the U.S. Patriot Act, Bank Secrecy Act, AML laws, and the Financial Crimes Enforcement Network (FinCEN).

Card brands have their own set of rules and regulations that you must follow and ensure your sub-merchants are following. Arguably the most important is PCI compliance to protect customer data. All merchants must meet Payment Card Industry Data Security Standards (PCI DSS), but payfacs must also register as a Level 1 PCI DSS. Failure to meet these requirements can lead to fines, higher transaction fees, and contract termination.

Operational Risks

These are risks stemming from inadequate or failed internal processes, procedures, systems, or employees. Operational risks include:

- Old hardware failures or other disruptive threats to networks, malware, or employee errors can hinder payfac operations.
- The struggle to attract top talent can lead to less experienced staff moving into high-pressure roles, increasing the likelihood of errors.
- The organizational shake up when you become a payments business can lead to costly disruptions to your core business.



Reputational Risks

These are risks that can negatively affect your industry and public reputation. This happens all too often these days with data breaches, bad customer service reviews that go viral, executive scandals, and so on.

Since you're required as a payfac to know your customer (see KYC above), you're responsible for any illegal or illicit activity of your sub-merchants. The types of sub-merchants you board can also cause issues even if they're not illegal, per se. Examples include massage parlors, vaping products, firearms, and drug trafficking, because they often get approved as legitimate merchants.

Getting on the wrong side of regulators, card brands, and acquirers can also create lasting damage to your reputation and could expose your company to substantial fines.

HOW TO PROTECT YOURSELF

The least risky move you can make is to partner with a payment facilitation expert like Payrix, who can safely guide you through the process of becoming a payfac and set you up for long-term success. For example, Payrix Pro provides you with a payfac-like experience without the risks, while Payrix Premium offers all the tools you need to process payments and successfully manage risk.

How much work goes into standing up a payfac?

A Birds-Eye-View of the PayFac Journey

Sooner or later, most vertical SaaS companies will have to become some form of a payment facilitator (a.k.a. payfac) in order to stay competitive and capture the revenue required to scale. With payments as a feature of your software, you can finally offer a seamless payments experience and other valuable efficiencies to your merchants. You also gain a new line of revenue from payment processing fees.

Like all things worthwhile, becoming and successfully operating as a payfac takes work. In some cases, a tremendous amount of work at a high price. Deciding if becoming a payfac makes sense for your business is the first of many strategic decisions you'll have to make on your journey to embedded payments. A strategy is definitely in order. A partner who understands the endless nuisances of the payments ecosystem is also a must, if you don't have the requisite experience yourself.

What's your ultimate goal? What's your deadline? How much time, money, and manpower can you afford to invest? These are basic questions you'd ask yourself starting any new business venture, because payment facilitation can be like running a business in and of itself.

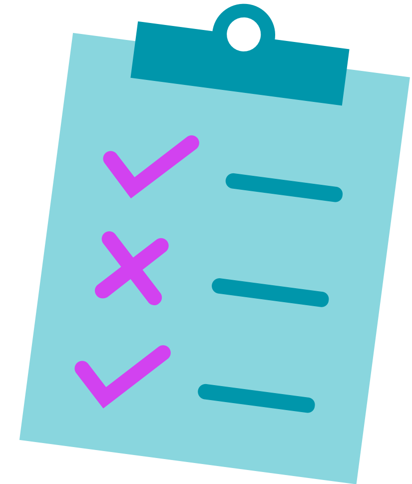
Taking a Closer Look

There are many considerations in becoming a payfac. Your approach to achieving what's involved will depend on how you answer basic questions as mentioned above. For example, if you're up against a tight deadline, you probably need to be shopping for an embedded payments technology partner who has already developed the necessary technology and infrastructure to shoulder most of the issues around compliance and risk.

WELL, THAT GIVES YOU A LITTLE PREVIEW OF WHAT'S INVOLVED IN BECOMING A PAYFAC, SO LET'S GET TO IT.

1. Being a payfac means you've successfully established a master merchant identification account with an acquiring bank. As a master merchant, you can take on the responsibility of facilitating payments for your software customers (sub-merchants) under your master account.
2. Responsibility is a keyword. You have control as a master merchant, but you also have new liabilities. Master merchants designated as money services businesses are subject to laws and regulations at both the state and federal level. You'll have to set up and actively manage several programs and systems, including ways to:
   - Perform KYC (Know Your Customer) due diligence on customers before accepting them as sub-merchants.
   - Monitor and report sub-merchants for suspicious activity, including money laundering, fraud, and tax evasion, and mitigate risks as needed.
   - Ensure you don't do business with sub-merchants who are on OFAC or terrorist lists.
   - Identify and eliminate sales of counterfeit products sold by sub-merchants.
   - Control how you receive, store, and report sub-merchant information.
   - Potentially register as a money transmitter in each state you do business.
   - File annual tax forms to report payment transactions you process for sub-merchants.

3. On a related note, there are also industry-governed, payment processing regulations that require your compliance as a payfac. These are rules and regulations set out by Visa, Mastercard, Discover, and American Express. In addition to annual registration as a payfac with each card network, you'll most importantly have to meet and maintain the Payment Card Industry Data Security Standard (PCI DSS) to ensure the sensitive data moving through your systems is secure.
4. Regarding systems and development, payfacs invest a substantial amount of money and time building out their payments infrastructure. Since you're new to payment facilitation, it's easy to underestimate the costs. You'll need to:
    - Integrate payment gateways into your payment platform that connect sub-merchants' checkout pages to the processing network. The same functionality, for example, as a point-of-service device that reads your card, when you check out at the grocery store.
    - Build a settlement and reconciliation engine that pays out what is due to sub-merchants in a timely and accurate way. Basically, funds from processed payments will need to be transferred from your master merchant account to the sub-merchant account, minus processing fees and other charges.
    - Build a compliance infrastructure to identify and manage risk, including systems for due diligence and internal employee policies.
    - Build a system for identifying and managing chargebacks and disputed payments. Payfacs incur a chargeback fee from its acquiring bank on every refund given to a sub-merchant's customer. Those fees can add up if they're not properly collected from the sub-merchant.
    - Build and service a sub-merchant dashboard that documents and reports on all the sub-merchant's payments activity.

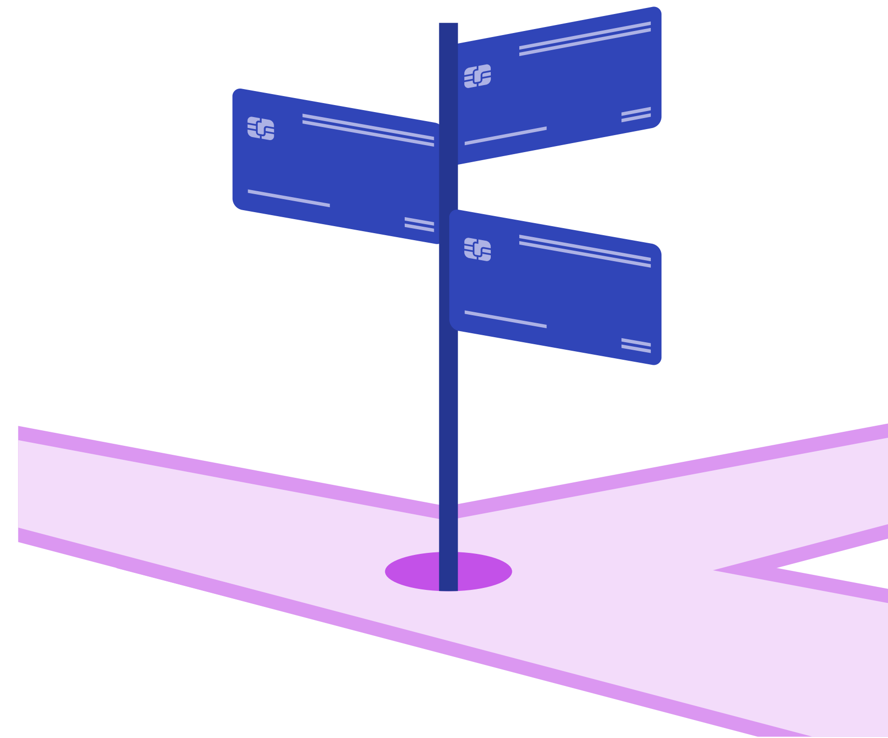


This isn't an exhaustive list by any means. You'll also need to develop a pricing and fee strategy, figure out additional staffing needs, understand the impact on your core software business, and obviously have available capital to stand up and maintain your payments business.

Again, having a payments expert on your side, one who has worked the day-to-day of payment facilitation, is the way to go for software companies with big dreams. Payrix is the leading expert and embedded payments technology partner who offers two solutions – a payfac as a service model to get you up and running quickly and maximizing every transaction and a payment infrastructure as a service model for registered payment facilitators.

Conclusion

The route to becoming a full registered payfac is comparable to starting a whole new business. For many SaaS providers, that level of investment is unrealistic. The good news is we make it much easier and faster to start monetizing payments without the upfront costs, managerial headaches, and risks. With Payrix, you get expert payfac technology to grow with, a better payments experience for you and your customers, and the ability to become a full payfac if and when the time is right for you.



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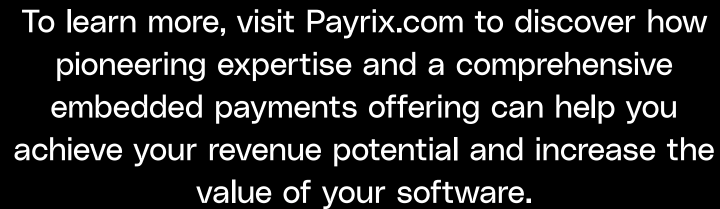

To learn more, visit Payrix.com to discover how pioneering expertise and a comprehensive embedded payments offering can help you achieve your revenue potential and increase the value of your software.

Ready to unleash your possibilities?
GET STARTED TODAY.

About Payrix

Payrix is a passionate team of payments and software experts who provide vertical software companies with an all-in-one platform and a white-glove approach to capitalize on the opportunities within embedded payments for growth, innovation, and transformation.

Led by forward-thinkers from PayPal, Worldpay, Elavon, Chase Paymentech and more, Payrix is committed to delivering more freedom and peace of mind to its clients through a proven solution that helps eliminate friction, unleash their possibilities with new revenue, and makes their customers' lives easier.

Payrix is a privately-held company headquartered in Atlanta, GA and is backed by Providence Strategic Growth and Blue Star Innovation Partners.

For more information visit payrix.com.

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