

## **WHY THE TREND TOWARD CONSOLIDATION?**

A continuing and accelerating trend in our industry is the consolidation of credit card processors through a series of mergers and acquisitions. The reason for these mergers and acquisitions can be explained by simple economic theory. Below, I will discuss the concepts of commodity and economies of scale and how they are the driving forces behind the consolidation in the bankcard industry.

### **What is a Commodity?**

One of the first reasons that mergers and consolidations are taking place in our industry is due to the fact that what credit card processors are selling can be viewed as a commodity. A commodity can be defined as something that “is a comparatively homogeneous product that can typically be bought in bulk.”

The term commodity is usually used in reference to manufactured goods, such as oil or agricultural products such as wheat, but can also be used in the bankcard industry to describe the main products that credit card processors are selling; namely the ability to process credit card transactions. Credit card processors sell credit card processing services to agents who then resell those services and related products to merchants.

The sale of credit card processing services is becoming a commodity to the extent that all the credit card processors are offering the same homogeneous product. Because there is little to differentiate the product offered by one credit card processor from another, the credit card processors all have to sell at basically the same price plus or minus a small pricing difference or else no one would buy from them. This is because the sales agents have little incentive to use one credit card processor over another, given the fact they are all selling essentially the same product.

For the credit card processors, the question becomes how do they differentiate themselves from the market in order to make higher profits. Since the product they are selling is essentially the same as every other one of their competitors, they must figure out a way to differentiate themselves in order to attract agents.

Some companies try to do this through various measures, such as offering cash incentives, superior customer service and other things to entice agents. However, when all of their competitors are trying to offer these same incentives, the only way to make a higher profit is to be more efficient in providing credit card processing services. This leads to the next question of how can a credit card processor increase its profits given it is selling the same products as everyone else? The answer to this question lies in the definition of the next term we are going to discuss, economies of scale.

### **Economies of Scale**

In the credit card processing industry, bigger is generally better. In our industry, economies of scale occur as processing volume increases. Economies of scale can be defined as a situation where as output increases, the average costs per unit that is produced falls. What this means is that, as a credit card processor increases its transaction volume, the cost per transaction to the credit card processor falls. This is because its overhead and other fixed costs generally do not increase much, if at all, as the transaction volume increases. This allows these fixed costs to be spread out over a larger transaction volume base, reducing the average cost per transaction to the credit card processor.

A typical credit card processor has a lot of people and equipment it must put in place to operate efficiently. The credit card processor must hire a risk department, put in place an underwriting department, obtain the appropriate office space, purchase computer equipment and other goods and services. However, once it purchases all these items, it does not need to increase its head count significantly in order to increase its processing volume.

For example, in the ISO that I worked for, once we had put in place the risk department, we could have processed two or three times the transaction volume without having to hire any more employees for that department. This example is typical of other departments where without much increase in head count, we could increase our production volume substantially. This demonstrates the power of economies of scale. A credit card processor can spread out the cost of its risk department, for example, over more transactions as volume increases, without increasing its overall fixed costs and thereby reduce its average cost per transaction.

### **More Consolidation is Inevitable**

There have traditionally been many mergers and acquisitions in our industry and that trend is accelerating. The reason for the trend can be explained by the economies of scale theory and how it impacts our industry.

If you are a credit card processor, it makes sense to purchase or merge with your competitors. For example, two companies of equal size with 1,000 employees each can agree to merge their businesses. In most instances, the combined companies will not need 2,000 employees to service existing merchant and agent bases of both companies. They can usually shed hundreds of workers by consolidating and end out with a company that perhaps has 1,500 employees versus the 2,000 that were previously employed. This allows the credit card processor to service the same number of agents and merchants at a much lower average cost to the company.

This leads to a situation where the combined companies are able to be more competitive in the marketplace and offer lower rates to agents and merchants allowing them to capture a greater market share. This is exactly what is happening in our industry and it continues to happen on a regular basis.

A consequence of this consolidation is that if someone wants to enter the industry, it is very difficult to do so, given that they have to have a very large operation in order to survive. Companies with smaller organizations are not able to spread out their overhead costs over a large number of transactions like the bigger processors. This leaves the smaller companies at a disadvantage and they are often priced out of the market.

I have had an increasing number of clients who have seen this in operation. They entered the business to try to acquire merchants through an agent base. They try to recruit agents dutifully, but it is difficult to lure the agents away from the larger processors given that they don't have much in the way of incentives to provide. This problem is further exacerbated by the fact that if they do obtain agents, the agents want such a large portion of the profits obtained from the merchants that the credit processor or ISO has a difficult time making any money.

We are entering an era where the smaller ISO, given the competitive disadvantage it has from its small size, is almost unable to compete with the larger processors. This will lead to a situation where the smaller players in the industry will continue to either be absorbed by larger entities or go out of business. It is possible that in the near future we will only have a few large processors left that will monopolize the industry.

Basic economic theory, and the fact that the main products we sell are becoming a commodity, is fueling further consolidation in our industry. It appears that this trend will continue for the foreseeable future.

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