

TO TAKE RISK OR NOT TO TAKE RISK – THAT IS THE QUESTION

By Paul A. Rianda, Esq.

Many of my clients that want to become an ISO are faced with the decision of whether or not they should take the risk for merchant losses. Below I will discuss what that actually means and will review a number of different issues to consider when making that decision.

What is Taking Risk?

Generally speaking, “taking risk” occurs when an ISO agrees that the ISO is liable for any debts and obligations under any merchant agreement that are not paid by one of the ISO’s merchants. The largest exposure is usually chargebacks that the merchant cannot pay. Typically this takes the form of a merchant taking deposits for goods or services before the customer actually gets what it ordered and subsequently the merchant goes out of business.

As an example, a number of airlines that took payment for tickets for future travel went out of business recently. When the airlines went out of business, the unhappy ticket holders called up their credit card issuing companies to have the ticket’s price refunded to their cards since the airline never delivered the promised air travel. Assuming there is no money in the bank account of the failed airline any more, all those losses must be paid by the next party up the chain that is taking risk which is usually the ISO.

In addition to chargeback losses, taking risk also includes things like merchant fines, unpaid merchant processing fees, rejects and any other liabilities of the merchants for unpaid obligations under merchant agreements.

Playing with the Big Boys.

Taking risk often is part of a larger strategy to gain more control over an ISO’s merchants. If you expect to have any meaningful portability of merchants, most of the card processors require you to take risk. As a “full service” ISO with portability, taking risk is just one of the requirements. You also must usually perform risk monitoring of transactions, merchant underwriting, merchant customer service, equipment deployment and all the things generally necessary to take care of the merchants. Unless you do all those things, most card processors will not allow you to have any meaningful portability of your merchants.

The merchant portability aspect can be important to the end value of your merchants if you decide to sell your merchants. When you are a “full service” ISO, potential buyers often pay a significant premium for your company and merchants because the buyer is getting more for its money. The buyer gets an entire infrastructure it can use to acquire more merchants or merge into the buyer’s existing operations to gain economies of scale which are important in bankcard industry. If you don’t take risk, when you sell your company and merchants all you are really offering the buyer is the right to get paid your residuals, which does not command a premium price. In order to play with the big boys and get the potential huge payday, you have to take risk.

Can I Afford It?

Another decision point in determining whether to take risk is taking stock of your financial ability to absorb a loss. The processor above you will expect immediate payment in full for any losses. You have to be able to absorb a loss without having a substantial negative impact on your business. So, if you are processing for a large merchant that potentially could have a million dollar loss, you need to have that million dollars available or on standby to pay the loss. If you believe that you could not fund the size of a loss that is likely to occur, you may want to stay away from taking risk.

Make More Money.

Another reason to take risk is that you can obtain better pricing if you do so. You are usually able to get your transaction price down if you take risk along with many of the other fees the typical ISO pays. So, if you are planning on competing to get merchants and agents, this lower pricing can mean the difference between you being able to compete or not for merchants and agents.

However, the pricing differences are usually very slim when you do take risk as opposed to when you do not take risk. So, you need to be doing significant volume in order to make taking risk and the associated lower pricing worth it. Someone doing less than 100 average accounts per month probably is not going to get enough of a financial benefit to take risk as compared to the potential losses the ISO could suffer. On the other hand, if you are originating 1000 or more accounts per month you almost certainly would be able to take advantage of the lower pricing. It becomes more difficult to balance the risk of losses versus the financial incentives from lower pricing when you fall somewhere in the middle of that range like most ISOs do.

Who are My Merchants?

Another important point to consider when looking at whether or not to take risk is the merchants that you are originating. Some ISOs focus on a particular niche that may not have very many losses. You may be able to make that assessment by analyzing the historical losses in any existing portfolios you may have, including those where you are not now taking risk. That might give you a good gauge if you should be taking risk and the potential losses you could be taking if you do take risk. Also, that analysis could lead you to the conclusion that for some segments of the merchants you originate you want to take risk and for other segments you do not. There is no rule that you have to take risk on all your merchants.

Part of that analysis should also involve reviewing trends in the economy. Some merchants do not perform well in a down economy like we have now. There are certain parts of the economy, the casual dining establishments and even some large chains like Starbucks, for example, that have been having trouble as people have less and less disposable income in this economy. This analysis may reveal that the merchants as a whole are not a good risk right now or that you should not take risk for certain industry segments.

There are many different things that to consider when deciding to take risk or not to take risk. Hopefully, this article will give you some ideas of the things to consider when looking at this issue.

You can use it in conjunction with other considerations important to you as well as your overall inherent level of risk tolerance to arrive at the right decision for you.

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