

Making An Informed Decision: Get the Facts About Credit Card Processing

Understanding Rates and Fees Charged by Processors and Banks Levels the Playing Field for Merchants

The credit card processing industry is a complex, difficult to understand conglomeration of banks, businesses and credit card companies, causing the average business owner to wonder how he or she could possibly know a good deal from a bad one when it comes to setting up a merchant account.

This paper provides an in-depth analysis of the process of accepting credit cards, the key organizations involved and the important, often undisclosed information regarding rates and fees.

In order to obtain the best program, a merchant should be well informed and understand the process. The industry is full of sub-standard salespeople who are out for a quick profit, rather than a long-term business relationship.

Merchants who are armed with information will be able to discern truth from fiction and can seek out a processor who will not only

provide reasonable rates, but also timely service and support.

So, How Does It Work?

A consumer presents a credit card for purchase and the merchant swipes the card. When a credit card terminal “dials out” it is connecting to a front-end network. The card number, sale amount and merchant identification number are transmitted electronically via the processing or front-end network to the credit card network (Visa or MasterCard usually) and to the member bank that issued the card.

Most front-end networks process transactions over a phone line, IP connection (i.e. DSL modems, cable modems, etc.) or via a wireless/satellite connection. The front-end certifies the transaction through the issuing bank, which verifies the customer has sufficient credit to cover the purchase. The bank then sends the merchant an authorization over the network,

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It's helpful to understand who the players are and how it all fits together. There are numerous aspects of a credit card transaction, and different channels that each transaction must go through in order to be processed.

Associations: At the top of the food chain are Visa, MasterCard and Discover Network, also known as the associations. The associations represent thousands of banks, who represent millions of merchants and cardholders.

Non-Bankcards: American Express is a Non-bankcard, and differs from the association in that they rely on their own bank to issue credit cards to consumers and process credit cards for businesses. Currently, American Express is the only Non-bankcard.

Issuing Bank: An issuing bank is a member of one of the associations. The issuing bank issues credit cards to consumers.

Acquiring Bank: The acquiring bank is a type of clearinghouse for transactions. The acquiring bank loans the money to a merchant for a credit card transaction until the issuing bank reimburses them.

Processor: A processor oversees the flow of funds from the time a transaction is authorized until the merchant gets paid. The processor has all the operational responsibilities and holds all the risk and liability on the merchant's credit card transactions. A processor must be sponsored into the associations by an acquiring bank.

ISO/MSP: The industry's sales force comprises ISOs (Independent Sales Offices) and MSPs (Member Service Providers). There are tens of thousands of them in the industry, each operating independently. They work for themselves but must do business as the processor that they work under. Each ISO/MSP is an agent

of their processor and must use that company's brand and logo. This is a rule of the associations to ensure compliant business practices. The only real responsibility an ISO/MSP has is to sign up new merchant customers and provide a limited amount of customer service for their merchant customers.

Registered ISO/MSP: This is typically a large ISO/MSP with a high volume of new merchants. The difference between a registered ISO/MSP and a normal ISO/MSP is that they are registered with the associations by the acquiring bank and they have paid a licensing fee in order to be registered. A registered ISO/MSP typically goes through a processor, but they are able to do business as their own company name/brand. It is not uncommon for large ISO/MSPs to do some of the functions a processor would normally do such as customer service and technical support.

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typically in the form of a six-digit numerical code. The transaction and authorization code are stored in a "batch," along with other transactions of the day.

The merchant prints a receipt which the customer signs, and for the customer, the transaction is complete.

However, there is still a lot going on behind the scenes. No money has actually changed hands at this point.

Behind the Scenes

At the end of the day, the merchant sends that day's charges to the processing network

as a settlement or batch. This is a request to "capture the funds" for the day's transactions.

After a transaction has been authorized and captured by the front-end, it is then transferred to a back-end network. The back-end analyzes the transaction to determine what type of transaction it is (credit card, check card, reward card, etc).

There are over a hundred different types of credit card transactions.

The back-end then "scrubs" the transaction and determines what interchange rate it requires. Finally, the transaction is "settled." At this point the back-end creates an ACH file so that the acquiring bank can

pay the merchant for the sale and simultaneously submits a credit request through the association network for the issuing bank to reimburse the acquiring bank. The issuing bank must debit the cardholder's account.

The issuing bank holds the risk of the consumer paying their credit card bill and for that they charge interest, part of what's known as interchange. The back-end network also performs other functions including generating merchants' month-end statements, performing voice authorizations and managing consumer disputes or chargebacks.

The Key Component: Rates and Fees

Every player involved in processing credit card transactions charges fees for their portion of the work — they must, in order to sustain a business, just as a merchant must charge its customers enough to make a profit. These fees are passed on to the merchant in the form of transaction fees and discount rates, as well as monthly service fees.

The majority of the per-item and percentage fees are passed through the merchant account processor to the credit card issuing bank according to a schedule of rates called interchange fees, which are set by Visa and MasterCard.

MasterCard and Visa are at the center of the transaction process, maintaining the flow of funds between issuers and acquirers. ***A financial institution can be both an issuer and an acquirer.*** In essence, the issuer pays the acquirer for the transaction, via the MasterCard or Visa interchange system.

Interchange makes it possible for the issuing banks and acquiring banks to exchange

information, transactions and money on a standardized basis. During Interchange, fees are deducted by the issuer from the transaction amount and the net amount is paid by the issuer to the acquirer. These are called interchange fees.

MasterCard and Visa each own and operate their own international processing system. These systems connect thousands of banks around the world. Member Institutions use these networks to transmit information about bankcard transactions.

Interchange fees vary depending on card type and the circumstances of the transaction. For example, if a transaction is made by swiping a card through a credit card terminal it will be in a different category than if it were keyed in manually.

Discount Rates

The discount rate comprises a number of dues, fees, assessments, network charges and mark-ups merchants are required to pay for accepting credit and debit cards, the largest of which is the interchange fee.

Each processor or ISO/MLS has real costs in addition to the wholesale interchange fees, and creates profit by adding a mark-up to all the fees mentioned above. There are a number of rate structures processors and ISOs/MLSs use to bill merchants for the services rendered. The most common models are listed below:

Three-Tier Program

The Three-Tier program is the most common pricing method and the simplest system for most merchants. In Three-Tier Pricing, the merchant account processor groups the transactions into three groups

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(tiers) and assigns a rate to each tier based on a criterion established for each tier.

First Tier - Qualified Rate

A qualified rate is the percentage rate a merchant will be charged whenever they accept a regular consumer credit card and process it in a manner defined as standard by their merchant account processor using an approved credit card processing method. This is usually the lowest rate a merchant will incur when accepting a credit card—and is also usually the rate a merchant is quoted by a salesperson. The qualified rate is created based on the way a merchant will be accepting a majority of their credit cards.

Second Tier - Mid-qualified Rate

Also known as a partially qualified rate, the mid-qualified rate is the percentage rate a merchant will be charged whenever they accept a credit card that does not qualify for the lowest rate (the qualified rate). Reasons may include:

- *The credit card is keyed into a credit card terminal instead of being swiped*
- *A particular type of credit card is used, such as a rewards card or business card*

A mid-qualified rate is higher than a qualified rate. Some of the transactions that are usually grouped into the mid-qualified tier can cost the processor more in interchange costs, which results in higher costs to the merchant as well. Merchants cannot always tell when a credit card is a rewards card and will fall into a higher tier.

Third Tier - Non-qualified Rate

The non-qualified rate is usually the highest percentage rate a merchant will be charged for a credit card transaction. In most cases all transactions that are not qualified or mid-qualified will fall under this rate.

Reasons may include:

- *The credit card is keyed into a credit card terminal instead of being swiped and address verification is not performed*
- *A particular type of credit card is used, such as a business card, and all required fields are not entered*
- *A merchant does not settle their daily batch within the allotted time frame, usually past 48 hours from time of authorization.*

A non-qualified rate can be significantly higher than a qualified rate and can cost the processor much more in interchange costs, which results in higher costs to the merchant as well.

Six-Tier Program

As a result of a settlement with Wal-Mart a few years ago, and to compete against PIN-based debit cards (which are processed outside of the Visa and MasterCard networks), Visa and MasterCard lowered the interchange rates for debit cards well below those for credit cards. Some processors may pass on the lower cost of these cards directly to merchants. Consequently, the three-tier programs have added 2 classifications for debit cards that are processed without a PIN or with a PIN for a total of 6 rate classifications.

Interchange Plus Program

Some processors offer merchant account services priced on an “interchange plus” basis. These accounts are based on the interchange tables published by both Visa and MasterCard (and available for viewing on the Internet).

As previously discussed, these fees are set by the credit card associations, and are the largest component of the fees that banks deduct from merchants’ credit card transactions, representing 70% to 90% of the fees.

Other Important Terms.

Credit card terminal: A credit card terminal is a stand-alone piece of electronic equipment that allows a merchant to swipe or type a consumer's credit card number, sales amount and transaction amount and any additional information required to process a credit card transaction.

A credit card terminal is a dedicated piece of equipment that processes credit and gift cards. The terminal typically must be plugged in to a power supply and connected to a telephone line. However, some terminals may be powered by batteries, communicate over the Internet or through the cellular phone

networks. There are many varieties of terminals with different memory capacities and other features such as built-in printers and debit card pinpads. These additional features may affect the manufacturing cost of a credit card terminal.

Automated Response Unit: An ARU (also known as a voice authorization or dial-pay) allows the manual keyed entry and subsequent authorization of a credit card over a cellular or land-line telephone. With this method a merchant makes an imprint of the consumer's credit card with a manual imprinter to create a customer receipt and then processes the transaction over the phone.

Payment gateway: A payment gateway is an e-commerce service that authorizes payments for e-businesses and online retailers. Some merchant account processors have their own payment gateways, but the majority of companies use 3rd party payment gateways such as Authorizenet. The gateway can be used either manually by the merchant by securely logging in to the system and keying in the credit card information, or as a website component with a shopping cart which connects to the gateway via an API to allow for real time processing from the merchant's website.

Interchange fees have a complex pricing structure, which is based on the card brand, the type of credit or debit card, the type and size of the accepting merchant, and the type of transaction (i.e. retail, mail-order, Internet).

Further complicating the rate schedules, interchange fees are typically a flat fee plus a percentage of the total purchase price (including taxes). ***There are more than 300 interchange rates.***

Interchange plus is the exact rate charged by the credit card issuing companies plus the processing acquirer's processing fee, and in many cases, results in lower overall costs for the merchant.

Interchange plus programs used to be reserved for merchants processing large volumes of transactions each month, although many processors will now offer smaller merchants the same program.

On the interchange rate structure, the transaction fee is usually reduced and funds may be deposited into the merchant's account quicker than on a set rate program. The monthly statement is more detailed because the merchant has a broader spectrum of card types.

Bill Backs

A bill back is not so much a pricing program, but more of a strategy employed by some processors and a slight variation on interchange plus pricing. The basic concept is that the merchant pays interchange on the statement that the transactions took place and then pays all other fees, like dues, fees and assessments, etc. on the next month's statement. It requires a great deal of time for a merchant to research the actual cost per transaction with the bill back system.

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Other Fees

Authorization fee

The Authorization fee (actually an authorization request fee) is charged each time a transaction is sent to the card-issuing bank to be authorized. The fee applies whether or not the request is approved. This is not the same as a transaction fee.

Statement or Service fee

The statement fee is a monthly fee associated with the monthly statement that is sent to the merchant at the end of each monthly processing cycle. This statement shows the breakdown of processing done by the merchant during the month and what fees were incurred as a result. This fee helps to cover the processor's overall operating costs for the merchant account..

Monthly minimum fee

The monthly minimum fee is a way to ensure that merchants pay a minimum amount in fees each month to cover costs from the processor to maintain the account and to create minimal profits. If a merchant's qualified fees do not equal or exceed the monthly minimum they will be charged up to the monthly minimum to satisfy their minimum fee requirements.

Batch fee

A batch fee may be charged to a merchant whenever the merchant batches their terminal. Batching a terminal is when a merchant sends their completed transactions for the day to their acquiring bank for payment. Some processors perform this automatically.

It is important to close a batch every 24 hours or a higher rate will be assessed by Visa or MasterCard.

Customer Service fee

The customer service fee (also known as a maintenance fee) can be charged by some processors to pay for the cost of customer service.

Annual fee

The annual fee may be charged by some processors to pay for costs of maintaining the merchant's account or in some cases this fee may be associated with free equipment programs as a cost of maintaining the equipment. Sometimes these fees can be quarterly. The fee may range from \$79–\$399.

Early Termination fee

The early termination fee may be charged by some processors if the merchant ends the contract before the end of the contract term. While contract terms of 1–3 years are typical, some processors have terms of up to 5 years with a one year prior notice to cancel or the fee will be assessed. Some processors also assess all statement fees and monthly minimums remaining when the contract is terminated. Some processors may also assess a "lost profit" fee based on an assumption of profits they concluded they would have earned during the full term of the contract.

Chargeback fee

The chargeback is the largest risk that is presented to banks and processors.

When an issuer disputes a transaction (either at the request of the cardholder or for reasons of its own), the matter is handled through a chargeback or compliance case.

In a chargeback, the issuer returns a transaction to the acquirer, and the acquirer returns the payment previously made in interchange.

Chargebacks result either from cardholder disputes or from rules violations by the merchant or acquirer; they help enforce operating rules and correct transaction errors.

According to Visa and MasterCard regulations, the merchant's processing bank is 100% responsible for all the transactions that the merchant performs, leaving the processor open to millions of dollars of potential losses if the merchant operates in a fraudulent or risky manner and generates many chargebacks. This is why assessing potential chargeback risk is an important part of the merchant account approval process.

In all cases, a chargeback will cost the merchant the chargeback fee, typically \$15–\$30, plus the cost of the transaction and the amount processed.

Putting It All Together

It's easy to get bogged down in the minutiae of running a business, and overlook the costs involved with a merchant account. However, a merchant who is informed and understands how the system works will understand the importance of selecting a processor who provides upfront information, charges reasonable rates and supports the merchant with customer service and technical knowledge 24/7. No merchant should accept anything less.

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Contact CSA Business Solutions

Telephone:
866-400-0272

Email:
information@csamail.net

Website:
www.CSABusinessSolutions.com

Mail:
P.O. Box 801088
Acworth, Georgia 30101