

Board of Education

An informed board of directors helps mitigate ISO and MSP risk, but knowing what you should disclose is the tricky part

By Julie Ritzer Ross

Although risk management has always been a critical business strategy in the electronic payments space, it's recently become a major component to ISOs', acquirers', and merchant service providers' (MSPs) survival.

Given an environment that is rife with data breaches and M&A activity, and also suffering the effects of a languishing economy, proper risk management calls for keeping the board of directors abreast of internal and market developments. Left unaddressed, even slight business changes could lead to major consequences, such as merchant attrition, financial loss, and even organizational failure.

"Without a handle on areas of potential risk, directors will have trouble fulfilling their management obligation to stockholders to oversee the operation of the business and support viability going forward," says Nicholas Baxter, ETA president and senior vice president of First National Bank in Omaha. "Boards cannot be expected to do this" in a vacuum.

While due diligence in board education covers a multitude of topics, following are seven major areas of focus:

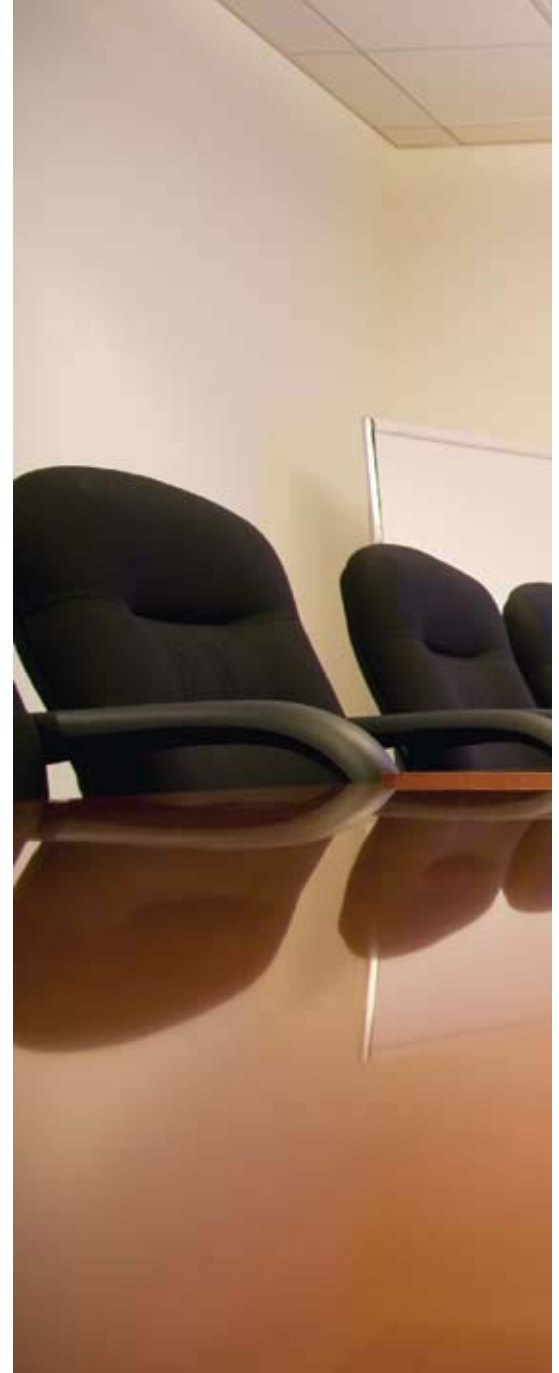
Basic business structure. Because part of the board's role is to monitor the manage-

ment of business operations, members need a working knowledge of how the organization makes its money and sets its pricing structure. They also must understand how services are sold to merchant customers as well as which parties within an organization are authorized to enter into agreements with merchants.

Armed with a thorough knowledge of these basics, board members have a foundation for properly assessing company operations and ensuring change occurs in line with its overall structure.

Portfolio composition and underwriting practices. Heightened competition among merchants, coupled with the already risky nature of some businesses, means industry players cannot afford to underwrite merchants indiscriminately. Consequently, board members must be abreast of prudent underwriting practices, such as maintaining a balance between high- and low-risk accounts.

"You wouldn't want a portfolio comprising 75 percent travel agencies, which pose a significant risk in terms of volume and other factors, and 25 percent low-risk accounts, such as merchants that sell everyday necessities," says Deana Rich, owner of Rich Consulting in Van Nuys, California. She also serves as president of the MerchantAc-



quirers Committee (MAC), an organization of bankcard professionals involved in the risk-management side of card processing, and as vice chair of ETA's Risk and Fraud Management Committee.

Board members also should be aware of the number of merchant applications received and approved by ISOs and MSPs as well as overall portfolio volume and top-producing merchants. In addition, Rich suggests notifying members of problematic accounts because they may want to investigate those accounts individually or all accounts in the same category.

Directors may be unaware of the fact that in using the ACH network, merchants—in line with their merchant/processor agreements—share monetary responsibility for



violations of regulations and rules with sponsoring and originating financial institutions (ODFIs).

Taking on a “bad” originator or merchant that violates rules and regulations “typically hurts an organization’s reputation and financial status, and it can be difficult, and therefore costly, for ODFIs to terminate a poor relationship,” says Jan Estep, COO and president of NACHA-The Electronic Payments Association.

Familiarity with the underwriting process is also essential because ODFIs “assume the ultimate risk if merchants go under, or their transactions result in a high volume of unauthorized entries being returned.” That risk intensifies when there are more parties between the ODFI

and the originator.

Moreover, organizations should make certain that board members and senior management have defined risk parameters so new customers continue to be “scaled” according to their size, origination type, volume, and complexity. “Those risk parameters should include setting exposure limits that ensure that more risky activity will be noted and reviewed appropriately,” notes Estep.

Transaction processing risks. Because financial responsibility for violating NACHA rules and regulations rests on the shoulders of financial institutions and merchants alike, ISOs need to educate the board on the risks inherent to each step of the transaction process. They should also make sure

KEY NOTES

- ▶▶ Board members must be abreast of prudent underwriting practices, such as maintaining a balance between high- and low-risk accounts.
- ▶▶ ISOs must educate the board on the risks inherent to each step of the transaction process and ensure merchants are following the necessary steps to minimize risk.
- ▶▶ Boards need assessments of the company’s ability to fund and service debt, including full reports on cash flow status.
- ▶▶ Relevant state and federal legislation should include in board reports.

that merchants are following the necessary steps to minimize risks—and board members may want assurance that those steps are being taken.

“The method of authenticating customers should be scaled to how the authorization is obtained,” Estep says. “For more remote applications, where the authorization is obtained over the telephone or Internet, two-factor authentication is prudent. The merchant should take steps to ensure that customers are who they say they are and use appropriate technology (PINs, passwords, tokens, and so forth) to personally identify them.”

Besides monitoring for data breaches, organizations must encrypt and secure personally identifiable customer and account data when transmitted, she adds. And customer and account data needs to be securely stored or disposed of by the merchant.

At the batch processing stage, an entry, file, or batch could be duplicated or even transmitted by mistake. “ODFIs/operators must have processes in place for detecting

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—Deana Rich, owner, Rich Consulting, and president, MAC

these types of mistakes,” says Estep. “The ACH Network allows the party that made the mistake on the origination side to initiate a reversal to correct the problem. This type of mistake can also be handled by a return.”

Because the ACH Network is not a real-time network, it has an inherent “temporal risk” as well. “This type of risk related to a batch processing system means that an entry may not post to an account because the account number is not valid, the account has been closed, or funds are not in the account when the entry actually posts to the account,” Estep says.

When moving information across the ACH Network—as opposed to a physical network—the risk is smaller. “Some delay is caused in processing that is beyond the reasonable control of financial institutions or

ACH operators. Adequate backup processes minimize these types of risks, except the most extreme cases—9/11, for example.”

The board of directors must understand that while no risk factor can be totally eliminated, it can be effectively mitigated. “The consequences of not mitigating the risk include negative effects on an organization’s financial condition, reputation, regulatory oversight, and potentially on other organizations,” Estep notes.

Financial and contractual liabilities. Every board must be kept in the loop regarding where a company stands compared with its merchant base. For example, they need to know whether merchants are paying their bills and handling chargebacks per their contractual obligations. They also need to know when chargebacks and credits are trending up or down and

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when interchange rates change.

“Boards don’t want to be blindsided by losses they did not foresee,” Rich observes. If they are aware of a downward trend, they can at least anticipate more of the same and formulate future plans accordingly.

Any action taken by a regulatory agency against a similar business should also be brought to the board’s attention. For instance, Baxter points out, a number of ISOs have been closed down or sanctioned by the FTC as a result of engaging in deceptive business practices. In January 2007, the agency filed a complaint in Florida against Global Marketing Group Inc., Global Business Solutions LLC, Globalpay Inc., Synergy Consulting Services LLC, and First Processing Corp., alleging that the processors had debited funds, deducted processing fees, and forwarded the balance of the proceeds to telemarketers. Three months later, the FTC took action against Merchant Processing Inc., Vequity Financial Group Inc., and Direct Processing Inc., claiming that they had engaged in fraudulent and deceptive trade practices while selling debit and credit card processing services.

When these incidents occurred, it was incumbent on other ISOs not only to convey the relevant information to their boards, but also to provide evidence that their operations did not conduct business in the same manner and therefore “had no chance of falling into the same bad bucket,” Baxter says.

Accounting practices merit full disclosure as well. At a minimum, “vital” accounting information encompasses the specific accounting rules that have been put into place, how the company is accounting for depreciation, and what measures are being taken to ascertain accurate amortization of sales expenses.

Similarly, boards should be given assessments of companies’ ability to fund and service debt. Full reports of cash flow status are essential, according to Baxter. In addition, ISOs and MSPs need to share industry financial metrics, such as losses being incurred by comparable entities across the board.

“This (yields) them a benchmark against which to compare the business with others in the market” and, in turn, to set direction in line with the bigger picture, Baxter says.

Current business climate. As another tool for helping them to formulate more informed decisions, board members will want to identify which entities pose significant competition to their company and the direction the latter is following in terms of pursuing specific merchant segments and adding new services and products.

For the same reason, board members need to be cognizant of upcoming mergers, acquisitions, and dissolutions as well as the effect such moves may have on the business. Baxter cites the decision by JPMorgan Chase and First Data Corp. to end Chase Paymentech Solutions, their joint venture, as an example. When the news broke earlier this year, he says it should have immediately been brought to the attention of board members at other payment processing operations in order to proactively address any opportunities or difficulties it may have created.

Legislative and regulatory issues. Baxter also recommends citing relevant state and federal legislation in board reports. Currently, a proposal by the IRS calls for so-called “qualified payment facilitators” to be required to disclose information about their merchant clients’ annual receipts to the agency. Acquirers would report network-specific annual charge volume from each merchant to the appropriate card network, which, in turn, would pass the data on to the IRS.

Should the proposal become law, acquirers might be compelled to impose new record keeping and reporting requirements on merchants. Acquirers may also be compelled to obtain merchants’ taxpayer numbers. Because this is new information being collected and the potential for error is high, the impact of the proposal should not be concealed from the board.

RISK MITIGATION at the executive level will be one of the topics covered during the 2008 Strategic Leadership & Networking Forum in a session titled “Legislative and Regulatory Issues—Compliance and Best Practices.” The session will touch on a wide range of issues, from compliance best practices, ACH, and prepaid, to legislative and regulatory developments. For details, go to www.electran.org.

Also worth discussing, according to Baxter, is a proposal by the Federal Reserve to establish rules prohibiting unfair practices regarding credit cards and overdraft services and, among other issues, protecting consumers from unexpected increases in the rate charged on pre-existing credit card balances.

The rules would also forbid banks from imposing interest charges using the “two-cycle” billing method, require that consumers receive a reasonable amount of time to make their credit card payments, and prohibit the use of payment allocation methods that unfairly maximize interest charges. The rules include protections for consumers who use overdraft services offered by their banks as well.

“The proposed rules are intended to establish a new baseline for fairness in how credit card plans operate,” said Federal Reserve Chairman Ben Bernanke when the proposal was announced in May 2008.

Card company rules and standards. Perhaps most importantly, board members must be informed of the degree to which merchants in their organizations’ portfolios are adhering to the PCI Data Security Standard.

“If you’re working with Level 1 and Level 2 merchants, it’s critical that the board understand how you’re ensuring that they use only PCI-compliant software and terminals,” Rich says. “The risks to the reputation are huge if merchants aren’t in compliance. Boards have to be aware of that.”

In addition, any changes to card company rules and practices merit discussion. “Like many other factors, these changes figure into the big picture, and there should be full disclosure as a result,” Rich says. About 18 months ago, she notes, MasterCard altered its method of calculating chargebacks. “That would have been something for a report to the board,” she asserts.

As technologies advance and the industry landscape evolves, players in the electronic payments space will continue to face new challenges. ISOs and MSPs can play a role in shaping the development of the business, but only if they maintain open lines of communication about risk factors both in the short and long term. **TT**

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