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The FTC's Potential Impact on the Merchant Acquiring Industry

Prepared for the Electronic Transactions Association

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I. Introduction

This paper discusses the qualitative and quantitative impact of the Federal Trade Commission's ("FTC") potential aggressive actions against card-based payment transaction processors and merchant acquirers (herein referred to as "acquirers") and models at a high-level the potential financial impacts of those actions on the broader market.

First Annapolis is a management consulting firm focused exclusively on the payments industry. For over 20 years, First Annapolis has specialized in advising clients on payments-related strategies, products, and services; the First Annapolis practice areas serve all stakeholders in the payments industry. First Annapolis is able to leverage the knowledge gained by having teams dedicated to every link of the payments value chain. First Annapolis clients include the most prominent financial institutions, retailers, manufacturers, merchant acquirers, transaction processors, payment networks, government entities, and affinity organizations throughout the world. First Annapolis is well versed in risk management, risk operations, risk and fraud management policies and procedures, and many other issues impacting acquirers on a day-to-day basis.

The FTC is considering potential action against acquirers and processors alleging that the acquirers in specific cases are abetting merchants engaged in illegal activity by processing transactions while knowing, or consciously avoiding knowing, that the merchant was violating the Telemarketing Sales Rule ("TSR") or that the acquirer's conduct was otherwise illegal. The TSR has traditionally been applied to merchants rather than to those that support merchant operations. However, the emerging trend from the FTC is to sue and penalize the acquirers that are processing the transactions for merchants who violate the TSR. Through these actions, the FTC would have acquirers effectively repay consumers for transactions consumers conducted with merchants. For clarity, the acquirers were not a party to these transactions; they simply provided electronic payment services to make the payment more convenient for the consumers and merchants in return for a small fee. The consumers were unaware of who the acquirer was and had no expectation that a third party would provide any form of guarantee or repayment if goods or services did not meet expectations. The FTC's expectation that the acquirer should repay consumers for transactions that were not even disputed is far outside the long-established operating model utilized in the card-based payments industry.

In some of the recent FTC investigations, the merchant acquirer appears to have conducted ample upfront due diligence and performed ongoing credit monitoring that is in line with industry standards but failed to identify that the merchant provided false information (such as covering up the fact that the merchant was selling debt relief services in violation of the TSR). In other instances, in the view of the FTC, the acquirer may not have conducted sufficient upfront diligence on the merchant to identify potential consumer harm or the acquirer failed to act on potential red flags such as Better Business Bureau scores. Seeking to impose liability in these types of fact scenarios raises significant issues for the acquiring industry and the economy as a whole.

Acquirers are service providers, and in that capacity they contract with businesses to provide access to the electronic payment card networks such as Visa, MasterCard, American Express, and others ("Card Networks"); facilitate payment card transactions over those networks; and settle sales made via payment cards to their merchant-customers' bank accounts. In the same way that an office supply company or an electric utility is not required to audit the use of the product or service, acquirers are not, as service providers, based on the current Card Network rules, required to perform a comprehensive review of the business practices of their customers to ensure compliance with each individual law or regulation applicable to the merchants' business. Acquirers are also not specifically restricted from doing a comprehensive business review or audit of a prospective merchant applicant, but competitive pressures limit the information that merchants are willing to share and access they are willing to provide.

It is our view that the possible actions by the FTC will set a precedent detrimental to merchant acquirers, as well as business service providers more generally, and be detrimental to society in that it will create a supply disruption to merchants who are ethical and honest but now will bear the higher costs as acquirers who cannot cost effectively monitor the additional risk, or choose not to, will simply avoid the risk for large groups of potential customers, potentially leaving many businesses without access to electronic payment acceptance.

Including acquirers as defendants in FTC lawsuits will result in significant impacts on the business practices of merchant acquirers, including what acquirers charge their merchants and what types of merchants the acquirers choose to serve. This paper will lay out our views on the harmful consequences likely to impact merchant acquirers, small businesses, and the economy more generally should the FTC continue with its current initiative.

A. Executive Summary

The emerging trend for the FTC to target acquirers who do not deliberately or intentionally assist merchants in violating laws will change current risk models. The potential consequences for consumers and legitimate merchants would likely be quite adverse. Merchant acquirers incur risk when transactions are disputed by cardholders, resulting in chargebacks. When this occurs, or has the potential to occur, acquirers act in accordance with standard and well-established risk practices to protect themselves from a loss of capital.

Summary of Key Points

1. Holding processors and/or acquirers liable for all transactions processed by a merchant that has allegedly performed illegal acts, as determined by the FTC, rather than the long-established industry practice of being liable only for transactions disputed by cardholders in accordance with Card Network rules, exponentially increases the risk exposure for acquirers and materially lowers the risk-adjusted returns generated by the industry. With this change in exposure and risk, it is likely that the small number of sponsor banks in existence today would be further reduced. The exit of sponsor banks could cripple the acquiring industry absent changes to the existing U.S. Card Network rules that mandate only financial institutions qualify to be members of the Card Networks.

2. Acquirers have implemented comprehensive risk controls to monitor accounts for unusual activity based on a long history of established rules and protocols in the acquiring industry, especially related to chargebacks and return risk. The industry has processed billions of transactions to draw on as experience.

3. Auditing or investigating a merchant's business practices to determine compliance with laws specifically applicable to individual merchants (which could number in the thousands of laws) and the hundreds of industries they represent are not performed by acquirers in the normal course of business. Nor is this done by the merchants' other vendors such as banks, utilities, or suppliers. It

would be unreasonably burdensome for acquirers to become experts in all of the industries in which their merchants participate or to hire numerous legal and audit firms to do so on their behalf.

4. Suing acquirers for all funds paid by consumers, many of which did not even dispute their transactions, rather than follow long-established standard industry business practices established by the Card Networks, would have deleterious effects on the credit card acquiring industry as a whole. An increase in risk exposure (real or perceived), and the subsequent internal policy and procedure modifications related to this increase, is only the tip of the iceberg with respect to industry reaction to the FTC's actions. Acquirers would need to revise their risk modeling and risk policies, which, in time, could ripple through to other participants in the payments value chain, namely merchants and consumers.

5. Numerous businesses across the U.S. may be displaced from the electronic payments system and forced to accept only cash and checks.

6. New business will no longer have easy access to the electronic payments systems.

7. The FTC's filing of these complaints will set a precedent detrimental to merchant acquirers as well as business service providers more generally, and would be detrimental to society in that it will create a supply disruption to merchants who are ethical and honest but now will bear higher costs as acquirers who cannot cost-effectively monitor the additional risk will simply avoid risk or charge higher fees.

8. Merchants are likely to see pricing increases of between 9% and 61%. It is our expectation that these pricing increases will be passed on to the consumer, and consumers are likely to see collective pricing increases of $900 million to $5.9 billion annually.

9. It is almost guaranteed that small merchants will be disproportionately impacted by pricing increases.

10. Acquirers may be less inclined to provide services to merchants that operate in an environment where the card is not present during the transaction since these transactions inherently have a higher percentage of disputes and the merchants' actions are more difficult to monitor. A reduction

of service to this segment of the market could be detrimental to the large and growing percent of the U.S. economy made up by e-commerce as e-commerce merchants' sales volume is a subset of card-not-present transactions, the largest growing segment of card-based transactions.

II. Card Network Rules

The primary, overarching guidelines by which all acquirers base their business practices and procedures are the Card Network operating rules. Each of the Card Networks (Visa, MasterCard, American Express, Discover, the PIN Debit networks, PayPal, and any other payment network) publishes a set of rules that govern how each of the parties that utilize its network must act. These operating rules cover the actions of network member financial institutions (both acquiring banks and issuing banks), agents of the financial institutions (merchant acquirers, independent sales organizations, etc.), and merchants.

Although each network has its own unique set of rules, the guiding principles and overarching themes are quite similar. In the words of Visa, the operating rules "are designed to minimize risks and provide a common, convenient, safe, and reliable global payment experience." For example, any Card Network's operating rules will provide guidance on how payment system players interact with and utilize a payment network. The rules cover broad concepts, such as which parties have the right to utilize the payment network, as well as minutiae, such as where and how a Card Network's logos will be displayed at the merchants' point of sale. The Card Networks set these rules at their sole discretion and require all parties using their payment network to follow them, reserving the right to penalize or prohibit a party from using the Card Network should the rules be violated.

Payment network operating regulations form the foundation by which merchant acquirers build their underwriting and risk management practices and procedures. In general, the rules here take the form of broad concepts and guidelines, with few specific instructions on how exactly an acquirer should act (nonetheless, the acquiring industry has used these guidelines to develop a set of fairly common risk management practices, which we cover in *Section III: Industry Risk Overview*). Also note that in the following paragraphs, we utilize examples from the Visa and MasterCard operating rules. While every Card Network has its own set of rules, the networks by and large adopt the same general regulations. For the sake of brevity, we present here only the rules of the two largest U.S. Card Networks, but bear in mind that each Card Network provides similar rulemaking.

A. Credit/Underwriting

The Card Networks have very broad requirements for their members when it comes to the underwriting of merchant accounts. Visa's operating regulations mandate that, "A U.S. acquirer must implement an underwriting, monitoring, and control policy for its merchants. The acquirer must provide the policies to Visa upon request." As such, the acquirer itself is left with much leeway to determine the actual business practices that it wishes to operate by. Visa only asks that the acquirer <u>have</u> a set of these policies.

That being said, both Card Networks do go on to define a few items of credit and underwriting policy specifically. Visa requires that the acquirer "determine that a prospective merchant is financially responsible and that there is no significant derogatory background information about any of its principles. The acquirer **<u>may</u>** obtain this information through credit reports, business financial statements, tax returns, other information lawfully available to the acquirer" (emphasis added). Visa only requires that the acquirer must "query the Terminated Merchant File to determine if the prospective merchant has been terminated for cause and, whenever feasible, conduct a physical inspection of the business premises of a prospective merchant." For mail and telephone order ("MO/TO") and e-commerce merchants, the acquirer must obtain a detailed business description. MasterCard also recommends, but does not require, that "the acquirer perform an inspection of the merchant's premises (physical and Internet URLs)." In practice, physical inspections of storefronts are infrequent and visits to Internet companies are rare due to acquirers having access to other electronic information used to verify address, such as Google Earth.

B. Ongoing Monitoring (including Credit Card Fraud Monitoring)

In addition to initially screening merchants, the networks require that acquirers practice some level of ongoing monitoring of their merchant portfolios. Such a practice is meant to ensure that the merchants continue to operate in accordance with the Card Network rules, that the merchants remain financially stable, and that the merchants are not engaging in credit card fraud. (Throughout this document we define fraud and credit card fraud as a merchant attempting to conduct electronic payments fraud against an acquirer. It specifically excludes fraud between a merchant and its customers). There is no mandate or recommendation with regards to conducting audits or background checks to determine whether merchants comply with all applicable federal, state, or local laws. However, standard merchant contracts contain language that warrants that the merchant "… will comply with all applicable state, federal, and local laws and government rules and regulations…"

Visa defines a minimum amount of monitoring that its acquirers are required to practice. At a minimum, acquirers must monitor unusual return activity, chargeback activity, deposit activity, and net zero balance deposits (merchant deposits where the total processing deposits do not exceed the returns, chargebacks, and fees). Acquirers must also calculate weekly, for each merchant, gross volume, average ticket, number of transactions, time elapsed between transaction and settlement, and the number of chargebacks. The acquirer must then compare the weekly activity to historical merchant averages for any signs of payment-related fraud. Acquirers have developed automated fraud systems that perform these activities and generate output indicating suspicious activity. MasterCard again has similar rules. For example, MasterCard rules state that an acquirer must maintain an ongoing credit card fraud prevention relationship with merchants. Furthermore, the acquirer must "regularly, as reasonably appropriate… review and monitor the merchant's web sites and business activities." Note that there are no Visa or MasterCard regulations requiring or recommending acquirers to audit or investigate the business practices of its merchants to validate compliance with applicable federal, state, or local laws, and based on our experience, it is not a common industry practice, if done at all, since acquirers are service providers.

C. Chargebacks

Finally, the Card Networks have specific rules related to an acquirer's handling and monitoring of chargebacks. MasterCard defines chargeback thresholds that, when reached, require merchants to be monitored. A "chargeback monitored merchant ("CMM")" is a merchant with at least 100 chargebacks in a given month <u>and</u> a "chargeback to transaction ratio ("CTR")" of at least 100 basis points (e.g., 1.0%). Similarly, an "excessive chargeback merchant ("ECM")" is a merchant that has a minimum chargeback ratio of 150 basis points for at least two consecutive months <u>and</u> at least 100 chargebacks in each month. MasterCard requires that an acquirer "calculate, for each calendar month, the CTR in basis points for each of its merchants and report to MasterCard any merchant that is a CMM or ECM."

Visa also maintains a 100 chargeback per month threshold, although its chargeback ratios vary slightly, ranging from 3.0% of transaction sales volume to 1.0% of interchange volume. There is no mandate for acquirers to act on merchants below these chargeback thresholds, although acquirers do so in practice. Of note, acquirers are fined by the Card Networks for every chargeback once a merchant has been identified as having excessive chargebacks for several consecutive months.

Both networks also maintain a list of "chargeback codes" that they require be carried on any chargeback transaction record. These codes are meant to, among other things, assist the acquirer in understanding the reasons that chargebacks are occurring at a given merchant. The acquirer can utilize this information to help it determine whether the merchant is engaging in fraudulent activity (with respect to payments-related credit card fraud) versus whether the chargebacks are more likely occurring through the normal course of business. Visa lists 23 chargeback codes while MasterCard's list contains 15 codes.

Table 1: Network Chargeback Codes Examples

Network	Code	Description
Visa	30	Services Not Provided or Merchandise Not Received
Visa	53	Not As Described or Defective Merchandise
Visa	83	Fraud - Card Absent Environment
Visa	75	Transaction Not Recognized
MC	4831	Transaction Amount Differs
MC	4849	Questionable Merchant Activity
MC	4850	Installment Billing Dispute
MC	4834	Duplicate Processing

D. Summary of Other External Rules

In addition to the network operating rules, acquirers, whether directly or indirectly, are subject to a litany of other banking-related rules and regulations outside the Card Networks' rules. Acquirers or their bank sponsors must, for example, comply with any relevant rulemaking from bank regulators. Industry-specific regulations such as the Payment Card Industry Data Security Standards ("PCI-DSS"), which regulates how industry participants store and use payment card data, are a material operational and financial investment for acquirers. Federal regulations relating to Know-Your-Customer ("KYC"), anti-terrorism, and anti-money laundering regulations are also very relevant for acquirers during the merchant application and underwriting process. Finally, acquirers and their merchants are often subject to laws that vary from state to state. For example, whereas the Visa/MasterCard operating rules allow for merchants to surcharge credit card transactions at the point of sale, several states expressly forbid this practice. Another example is the escheatment laws of each state. Acquirers must be aware of these nuances.

Table 2: Acquirer Legal Requirements Examples

Law / Rule	Description
Know Your Customer	As part of the Bank Secrecy Act and the USA PATRIOT Act, banks must collect and verify client information including: • Name • Date of Birth • Address (P.O. boxes are not acceptable) • Identification Number (either a Tax ID or Social Security Number)
PCI-DSS	PCI-DSS is an information security standard applicable to all organizations that handle cardholder data. PCI-DSS was created to increase data control and reduce credit card fraud. Acquirers must comply with all PCI-DSS standards, which are validated through annual audits performed by Qualified Security Assessors ("QSAs").
IRS 1099 Reporting	The IRS requires that acquirers verify their merchants' taxpayer ID numbers ("TINs") and report each merchant's annual credit card sales via Form 1099-K.

III. Industry Risk Overview

The first and primary risk that acquirers face is liability for transactions processed by a merchant that are subsequently disputed by the cardholder and/or issuer (chargebacks). In the normal course of business, per the Card Network rules, if the dispute is valid, the merchant is responsible for reimbursing the cardholder. This takes place via normal, daily settlement among the issuer, network, acquirer, and merchant. However, if the merchant is unable to fund the disputed amount, per Card Network rules, the acquirer is responsible for reimbursing the cardholder. This effectively creates off-balance-sheet credit risk in acquiring. The risk is that the merchant will fail and the acquirer will be liable for refunding cardholders using its own capital. For example, when the FTC files suit against a merchant and freezes their assets, which effectively closes the company, there is no longer a viable merchant to pay for chargebacks. This financial responsibility then falls to the merchant acquirer, which pays for the chargebacks out of its own capital. It is this financial risk that acquirers price for and manage on a day-to-day basis.

Transactions processed, but not disputed, are not considered a financial risk to acquirers based on Card Network rules. Under today's Card Network rules, only a transaction disputed by the cardholder in accordance with chargeback rules can result in financial risk for the acquirer. For example, if an airline pre-sells tickets but suddenly grounds its planes and files for bankruptcy without giving refunds to its customers, the merchant acquirer is not immediately responsible for refunding all ticket sales back to the cardholders. Acquirers are <u>not</u> guarantors for their merchants. However, the acquirer is responsible for reimbursement to each cardholder that disputes its valid transaction with their card issuing bank.

Over the years, merchant acquirers have developed policies, procedures, reports, tools, and technologies for managing these risks. Every year, tens of thousands of businesses apply for merchant accounts and billions of transactions take place. Given this experience, acquirers have the benefit of looking back in time to identify the types of merchants that are more or less risky. Acquirers use this information to predict future merchant behavior and estimate overall merchant chargeback risk that may result in financial loss, enabling acquirers to effectively manage risk.

A. Policy

The credit policy, which some acquirers may refer to as an underwriting manual or risk management policy, is an acquirer's primary control for minimizing loss. Credit policies are required by the Card Networks and, per Visa, must be approved by the acquirer's Board of Directors. For non-bank acquirers, the credit policy must be approved by the sponsor bank and is often integrated into the sponsorship agreement requiring bank approval of any changes. Credit policies are designed to provide formal guidelines for employees to follow for managing risk.

Certain types of businesses are more prone to chargebacks due to their business models, whether due to the product or service sold or the method of sale. Acquirers vary in the types of merchants they are willing to approve or decline. These executive decisions, as reflected through the credit policy, inherently define the acquirer's risk appetite and credit culture. Acquirers do not, in our experience, consider the laws specific to the industry in which a merchant operates and how that may correlate to financial risk to the acquirer since the acquirer has no expertise in this area, unless there is a compelling reason to do so, such as gambling or online tobacco sales. The acquirer's primary concern with the merchant's industry is the extent to which it impacts chargebacks.

B. Credit Underwriting of New Merchant Applications

New merchant underwriting is the process of adjudicating new merchant applications, which includes (1) gathering and assembling legal and financial information from the merchant; (2) obtaining information from third parties to verify and supplement information received from merchants; (3) performing underwriting functions such as documentation verification, site inspection, financial analysis, risk scoring, and risk exposure calculations; (4) comparing the merchant application to an acquirer's credit policy; (5) using risk mitigation tools during underwriting; and (6) finalizing the decision and implementing the approval process, which involves a systematic process flow leading to the ultimate approval decision.

Acquirers generally have a specific approval hierarchy in place with underwriters typically holding varying levels of authority. The risk level of the merchant dictates the required approval level. Additionally, leading acquirers typically have personnel specializing in the underwriting approval of specific merchant categories such as travel, MO/TO, and e-commerce.

Typically, an application is declined when the acquirer is unwilling to accept the risk inherent in processing the merchant, which may be caused by the type or size of the business, the products or services sold, poor credit history, questionable reputation, or numerous other factors. Many acquirers try to decline as few applications as possible by permitting the merchant to partially secure the account over time with cash collateral to minimize the acquirer's risk to chargeback exposure.

C. Ongoing Monitoring

Ongoing monitoring is a key piece of an acquirer's overall risk strategy. There are two forms of ongoing monitoring performed by merchant acquirers. The first type of ongoing monitoring concerns the credit standing of existing merchants. This involves identifying merchants that pose a higher level of risk to the acquirer due to various characteristics such as size, exposure, growth, business type, financial condition, or delayed delivery, and periodically re-underwriting these accounts to prevent future losses. The second form of ongoing merchant oversight entails monitoring merchant activity for credit card fraud. In this case, we are specifically referring to credit card fraud perpetrated by the merchant, not consumers. Acquirers have implemented multiple controls to identify this type of fraudulent activity and thus prevent large scale chargeback liabilities due to merchant credit card fraud.

D. Exposure Modeling

Sophisticated acquirers have developed models to estimate potential loss if a merchant were to close due to bankruptcy or other financial reasons, leaving the acquirer responsible for funding chargebacks. Industry leaders use the credit exposure modeling output to determine whether or not to approve a merchant, whether to hold reserves, how to price the merchant, whether to terminate the merchant, and other important decisions. The credit exposure presented by merchants varies significantly depending on expected chargeback and return rates, product sold, advance deposits, timing of payment, whether the card was present at the time of the sale, and other relevant factors.

IV. Implications of the FTC's Proposed Action

The FTC may consider legal action that would seek to hold acquirers liable for "assisting and facilitating deceptive and abusive telemarketing acts or practices" per the Telemarketing Sales Rule, 16 C.F.R. §310.3(b) or under other legal theories. As we understand it, the FTC believes acquirers should be held liable for <u>all sales</u> processed by a merchant during the course of the merchant's business relationship with an acquirer regardless of whether the cardholder actually disputed a transaction. The industry is not designed by the Card Networks to operate in this manner, and acquirers are not guarantors to consumers or merchants except when a transaction has been disputed.

The decision to include acquirers as defendants would not only have deleterious impacts on individual acquirers but on the payment card acquiring industry as a whole. An increase in risk exposure (real or perceived), or potential losses due to merchants acting in violation of federal law, and the subsequent internal policy and procedure modifications related to this increase, is only the tip of the iceberg with respect to this proposed action. The industry reaction will result in acquirers revising their risk modeling and risk policies, which would ripple through to other participants in the payments value chain, namely merchants and consumers. To some extent, this has already begun.

Primary among these impacts would be the incremental risk of losses that merchant acquirers, sponsor banks and, ultimately, the payment Card Networks, would be exposed to. The fact that acquirers will need to respond to this increased risk will change acquirers' business operations at a macro level. Simply put and as described in *Section III: Industry Risk Overview* the industry today manages risk based on a well-defined set of factors. Suspicion that any acquirer is responsible for a violation of the TSR (or any number of federal, state, or local laws) committed by a merchant, especially when there is no involvement by the processor in the merchant's business, would single-handedly increase the risk exposure of all participants across the entire payments industry.

The FTC's proposed course of action would cause all acquirers to re-examine their risk since exposure would increase from a small percentage of recent sales to <u>all sales since inception of each merchant that may violate federal law</u>. This would result in changes to underwriting policies, sales processes, credit fraud management rules and processes, and ongoing business decisions. It is our belief that the increased operational burden will be felt by all acquirers due to the fact that acquirers will need to go to greater lengths to validate or audit merchants' business models.

A. Increased Exposure

The FTC's effort to expand an acquirer's responsibility changes the basic nature of the acquirer's role, forcing acquirers to pass judgment on the legality of a merchant and the potential deceptive nature of its business. This effectively mandates that acquirers become the police force for merchant activity, which is not a role acquirers desire or are equipped to handle today.

From a risk manager's perspective, we need not go much further than the *possibility* that FTC action opens the door for other legal judgments of processor liability to believe that acquirers would begin modifying their risk practices accordingly. Rightly or wrongly, the risk manager might believe that due to FTC legal actions, its risk exposure has increased significantly. Further, risk mitigation techniques such as cash collateral cannot be relied on since the FTC has the power, and uses it, to require the merchant acquiring bank to forfeit all held reserve funds to the FTC. Despite the fact that acquirers hold merchant reserves for the purpose of repaying consumers that dispute transactions with that merchant, the FTC has mandated that acquirers forfeit reserve funds directly to the FTC.

Depending on how wide one believes the precedent set by this type of action would extend, industry-wide risk exposure could increase by a factor of ten or more. Exposure is calculated by acquirers using a combination of information such as chargeback and credit refund history, dollar volume processed, timing between purchase and delivery, and timing between purchase date and chargeback or return. The overall industry holds nearly $22 billion in credit risk exposure today based on existing Card Network rules, but that could increase to $258 billion if acquirers were held liable for all transactions instead of just those disputed.

Table 3: Illustrative Impact of Potential FTC Action on Industry Risk Exposure

Scenario (Industries Covered by Action Precedent)	Est. Total Industry Exposure Volume ($B)	Est. Total Industry Exposure (bps)
Status Quo – Current Exposure	$21.5	86
Outbound Telemarketing Only	$21.5	86
Outbound & Inbound Telemarketing	$22.9	92
All MO/TO	$106.2	425
All Card Not Present	$258.2	1,034

Note: In each scenario, we assume that the risk-exposed volume in any industry is equal to the total estimated full year volume in that industry because liability would extend to any and all sales processed by the acquirer's merchant customers in that industry. This understates actual exposure since the FTC can require repayment from previous years' transactions as well.

Now, instead of simply prohibiting outbound telemarketing merchants in the portfolio, as many acquirers do today, an acquirer might think twice about signing inbound telemarketing merchants as well, or perhaps even certain types of e-commerce businesses. The acquirer will change its operations for underwriting and monitoring. What initially seems to be a relatively modest project to revise risk and monitoring rules associated with outbound telemarketing merchants will quickly become a large scale overhaul of the acquirer's practices across the entire merchant acquiring value chain including sales, underwriting, pricing, and ongoing risk management for multiple industry verticals.

B. Operational Changes

The payments industry will see operational changes throughout its value chain. Here we highlight the operational changes we expect to see at acquirers, banks, merchants, and networks.

1. Acquirers

Banks and acquirers would have to re-formulate and re-write their risk and underwriting policies to consider not just the TSR but many other industry-specific laws. These changes will materially impact acquirers' operations.

Beginning with underwriting, acquirers would now be required to complete substantially increased due diligence of every potential new merchant. All acquirers would likely revise their risk policy and underwriting operations to include stricter evaluation of each merchant's business model and its compliance with all applicable laws. For example, the up-front diligence requirement (per Visa and MasterCard guidance) of a "detailed business description" might be replaced by a required site visit to the merchant's call center or operating location or the requirement that underwriters scrutinize or audit every business. Acquirers today do not have the level of knowledge and experience necessary to support this level of due diligence. It is our expectation that acquirers would be required to build new capabilities or use third parties with knowledge of specific industries to perform initial and ongoing due diligence. Diligence would now need to include merchants' operations to ensure compliance with laws and regulations not monitored by acquirers today such as the TSR and other laws specific to each industry served by the acquirer. This due diligence may need to include periodic audits and investigations into business contacts, contacting and surveying the merchants' customers, and mystery shopping. This would require highly skilled and experienced staff, which will be costly and result in expenses being **passed on to merchants and, ultimately, to consumers in the form of higher prices.**

Today, the average time from receipt of merchant application to approval is one day. The time to underwrite a merchant application would significantly increase even if an acquirer chooses not to service telemarketing or other card-not-present merchants. We can easily see the time to underwrite a merchant increasing by 300% to 500% and the cost increasing in a similar fashion.

Operational consequences would not stop in the underwriting back-office. Sales staffs would need to be informed and educated about underwriting requirements. Portfolio managers would likely need to examine their existing books of business for examples of merchants that might now fall under the new policies. Numerous legal businesses across the U.S. may be displaced from the payments system and forced to accept only cash and checks.

Ongoing risk management would face similar, additional operational requirements to reconfirm the diligence done during the initial underwriting process. Ongoing "triggers" would need to be updated to include merchants that may not meet Visa and MasterCard definitions for high chargeback merchants as well as merchants that may now be in violation of any number of federal, state, or local laws. In short, acquirers would need to work through a process of revising their pre-existing risk policies, operations, and procedures, which would have a ripple effect through the rest of their businesses, increasing overall time and cost to underwrite an account.

2. Merchants

Merchants would be required to make operational changes if the FTC continues with its current actions. Today, only a very small percentage of merchants are required to post reserves in order to process credit card transactions. With few exceptions in high-risk verticals, virtually all accounts across the industry are unsecured. The FTC's proposed actions would likely change that and make it more difficult for merchants to gain access to the electronic payment system. Today, most merchants in the U.S. are paid credit card receipts one to two business days after transactions are processed. Other countries take up to thirty days to pay the merchant. Acquirers in the U.S. would likely want to hold merchant funds longer as a risk mitigation strategy, which will impact the cash flow of merchants, especially small businesses that have limited access to credit. These factors would impact small business cash flow and borrowing needs.

In addition to potentially being required to post collateral and suffering from delayed settlement, merchants may be subject to invasion of their business privacy by their merchant processors as merchant processors will need to audit the business to validate compliance with laws. This will impact businesses that incur the costs of the audit and distraction of their key personnel.

3. Networks

In response to FTC actions, the Card Networks will likely implement more restrictive rules and penalties. First, this could entail higher capital requirements to achieve the principal acquirer status needed to be an acquiring member bank. Alternatively, additional capital could be required to process merchants in certain industries that are considered higher risk. "Higher risk" in this sense would not be based on traditional risk models and experience, but rather defined as the potential for government actions, fines, and penalties. The Card Networks may also restrict acquirers from serving certain industry verticals, require collateral to protect the payments system, or implement higher pricing at the network level.

C. Pricing Increases

It is our expectation that a perceived or real increase in risk exposure will dramatically increase pricing to all merchants (and merchants will pass that increased pricing on to consumers). We believe the increase in pricing will come from three main sources: increase in risk exposure, the incremental operational support, and insurance premiums.

1. Pricing Increases Due to Increase in Risk Exposure

Acquirers expect a certain average losses-to-exposure ratio under the current risk environment. Assuming that ratio would stay roughly the same in an environment of increased exposure to risk, acquirers would have no choice but to increase pricing to cover the increased exposure (and, therefore, increased losses). These price increases from acquirers to merchants would most certainly be passed on to consumers in order to cover the increased cost of card acceptance. While it is impossible to predict exactly how this would be implemented, it may come in the form of surcharging for payments made with cards or an overall increase in a merchant's price of goods.

In order to assess the impact of this increased exposure on pricing, First Annapolis looked at four potential scenarios of increased exposure. As a baseline case, we applied 2013 industry bankcard volumes to a standard exposure model in order to assess how much exposure is in the market today, resulting in a calculation of 86 bps of exposure compared to an average loss rate of about 1.5 bps (approximately a 57 to 1 ratio). The second scenario looks at what pricing impact would result from the most conservative application of the FTC's proposal (i.e., an acquirer is now exposed to the entire volume of telemarketing transactions, not just chargeback volume). In this scenario, an acquirer would be potentially liable for the face value of all transaction volume, past and future, for an individual merchant in the telemarketing industry. If exposure were calculated based on 2013 industry volume, then total exposure increases by $1.4 billion, resulting in a pricing increase of 0.1 bps. Applying that increase in pricing across the entire industry (and assuming the increase is directly passed on to consumers), consumers would pay an additional $26 million annually for products and services.

If, however, there are more significant risk exposure changes in the industry (as we expect) and acquirers adjust their models to calculate exposure for all MO/TO or all card-not-present transactions, pricing could increase to an average of 44 bps or 54 bps, respectively, which would result in merchants (and consumers) paying an extra annual amount of $1.5 billion or $4.1 billion, respectively, for goods and services.

Table 4: Potential Pricing Implications

Case	Estimated Risk Exposure	Potential Pricing Increase	Impact to Merchant on $100 Transaction	Total Impact to Cardholders
Most Conservative Impact – Telemarketing Transactions	91 bps	0.1 bps	$0.38 → $0.38 per Transaction	$26 Million
Expected Impact – All MO/TO Transactions	424 bps	6 bps	$0.38 → $0.44 per Transaction	$1.5 Billion
All Card-Not-Present Transactions	1,033 bps	16 bps	$0.38 → $0.54 per Transaction	$4.1 Billion
Aggressive Impact – All Volume	10,000 bps	173 bps	$0.38 → $1.75 per Transaction	$43 Billion

Finally, we contemplated a scenario in which acquirers would face exposure for 100% of all volume processed for all merchants, or 10,000 bps of exposure, meaning acquirers have a contingent liability equal to all card sales for all merchants in their portfolios. While this is not contemplated by the industry today as a realistic risk, the FTC's actions set a precedent for any other government agency of any form to hold acquirers liable for the actions of its merchants. This exposure translates into aggregate pricing increases of almost $43 billion annually for consumers.

2. Increase in Pricing Due to Required Operational Changes

Changes to the acquirer's liability and risk exposure will result in incremental infrastructure over what is in place today. This will increase the cost of providing processing services. First Annapolis estimates that the change in risk exposure will double to triple the cost of on-boarding and monitoring each merchant account. That translates to 3 to 6 bps of additional cost for each merchant.

3. Increase in Pricing Due to Additional Insurance Requirements

Acquirers will consider purchasing insurance to offset the additional risk of loss. This cost would ultimately be passed on to merchants and consumers. We estimate this could increase pricing 0.5 to 1 bps.

4. Total Pricing Increase

Merchants are likely to see pricing increases of between 9% and 61%. As discussed previously, these pricing increases will be passed on to the consumer, which will see collective pricing increases of $900 million to $5.9 billion annually.

Table 5: Total Pricing Increases

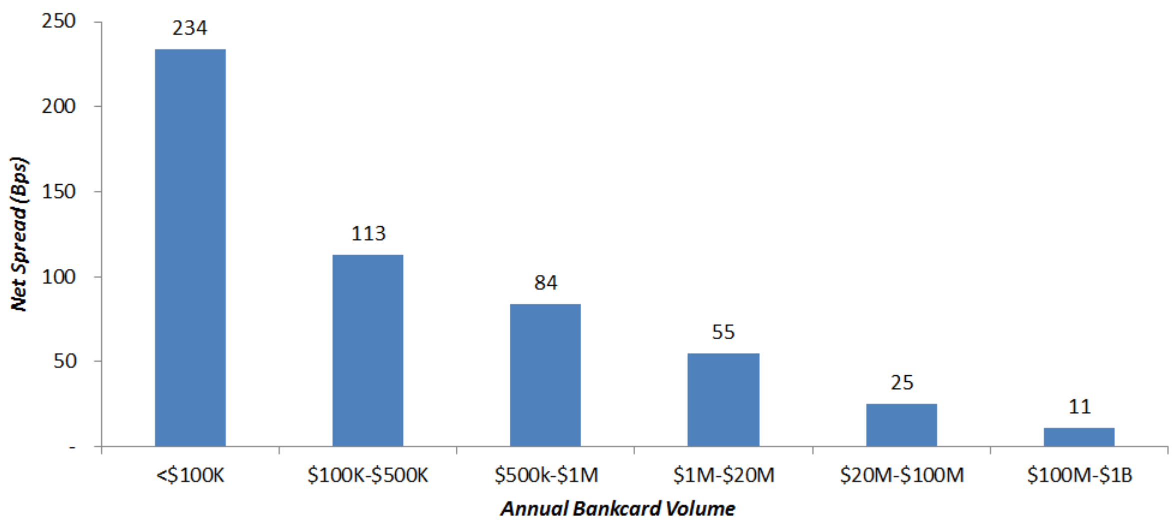
Reason	Pricing Increase (bps)	Pricing (% Increase)	Impact to Merchant ($100 Txn)	Impact to Consumer in Dollars
Increased Risk Exposure	0.1 - 16.5 bps	0.2% - 43%	$0.001 - $0.165	$26M - $4.1B
Operational Changes	3.0 - 6.0 bps	8% - 16%	$0.030 - $0.060	$750M - $1.5B
Insurance	0.5 - 1.0 bps	1% - 2%	$0.005 - $0.01	$13M - $250M
Total	3.6 - 23.5 bps	9% - 61%	$0.036 - $0.235	$900M - $5.9B

D. Small Merchant Pricing Increases

An increase in acquirer pricing will not be felt equally by all businesses, and it is almost guaranteed that small merchants will be disproportionately impacted by pricing increases. Today, as shown in *Figure 1: Net Spread by Merchant Size*, merchant pricing and average merchant size have an inverse relationship, with small merchants paying much higher acquirer fees in terms of bps on volume than large merchants.

Net Spread is defined as gross revenue collected from the merchant less interchange and Card Network pass-throughs, such as Payment Network Fees, divided by Visa and MasterCard volume.

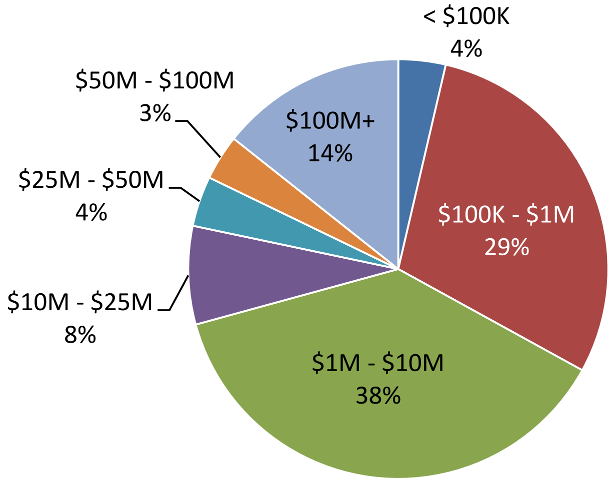
Figure 1: Net Spread by Merchant Size (2013)



According to the Small Business Administration, small businesses account for nearly half of U.S. economic output. Additionally, according to U.S. Census data[1], nearly half of Americans are employed by small businesses, and small businesses represent 99.7% of all businesses. This data does not include non-employer businesses, which would add another 22 million employees to the "small business" pool. It is likely that this disproportionate pricing increase on small merchants will have far reaching negative consequences to a substantial part of the U.S. economy. While the average industry net spread is 38 bps, merchants that have less than $10 million in annual volume contribute 70.1% of that net spread as shown in *Figure 2: Contribution of Net Spread by* Size Category.

[1] The U.S. Census defines a small business as any business with less than 500 employees.

Figure 2: Contribution of Net Spread by Size Category



Due to the contractual and other pricing vagaries within the industry, we expect that small merchants (merchants with less than $10 million in annual Visa/MasterCard volume) will bear most, if not all, of the increase in pricing.

In response, merchants may re-evaluate the extent to which they accept cards as a form of payment. Currently, just under 50% of consumer spend is on credit and debit cards, and the FTC's proposed changes could result in an unknown impact on tender mix at individual merchants as well as in the economy at large.

E. Systemic Impacts to Payments Value Chain

1. Destabilization of Payment Network

Acquirers today process over 25% of the entire U.S. GDP with a total exposure (as calculated using today's risk models) of $21.5 billion. Should the FTC actions continue, there will be systemic changes along the entire payments value chain starting with the destabilization of the payments network. The ultimate responsibility of exposure resides with the Card Networks. Today, Card Networks, primarily Visa and MasterCard, are the final backstop to ensure the payments system does not collapse. If the non-bank acquirer is unable to absorb the chargeback and return losses due to bankruptcy, the liability moves to the sponsor bank. If the sponsor bank is unable to absorb the loss, the liability shifts to Visa or MasterCard (i.e., the Card Network). Using today's risk exposure models, the total industry exposure is currently 3.5 times Visa and MasterCard's combined 2012 operating income. If overall industry exposure increased to $258.2 billion (if exposure were recalculated for all Visa/MasterCard card-not-present transactions), then the exposure to operating income ratio would increase to 42.5x, causing a severe destabilization of the entire payments value chain and risking 25% of the U.S. GDP.

2. Removal of Certain Industries from Payment Network

Acquiring industry leaders could adjust to the new risk environment by eliminating certain industries in which they do business today. This would include outbound telemarketing specifically, but may also include other telemarketing industries as well as any industry that sells a product that could naturally lead to higher disputes such as health and wellness, vitamins and supplements, pharmacy, and credit repair. Acquirers may even be less inclined to provide services to merchants that operate in an environment where the card is not present during the transaction, since the chargeback rules are more in favor of the cardholder, or industries in which payment takes place prior to delivery of goods and services. This would encompass a significant segment of the acquiring industry to include all e-commerce, MO/TO, airlines, and furniture stores, for example.

E-commerce makes up almost 5% of total U.S. GDP, with roughly $118 billion in bankcard volume, and is expected to grow by 10% a year through 2016. The expected U.S. GDP growth according to the World Bank is 2.76% over the next five years. The expected growth rate drops to 2.37% if there is no growth in the e-commerce sector (based on First Annapolis analysis), which is possible if e-commerce merchants were prohibited or restricted from accepting cards either by acquirers' unwillingness to process for card-not-present merchants or the inability of some e-commerce merchants to absorb the price increase.

Removing certain merchants from the current payments value chain would create a void that would either not be filled (impacting the economy) or would be filled by less experienced, smaller, and under-capitalized acquirers unable to manage the risks (impacting the viability of the payments network) or by off-shore bank acquirers that are not subject to U.S. jurisdiction.

3. Change in the Fundamental Role of Acquirers

The role of acquirers and processors would change based on the precedent of holding acquirers responsible of all transactions processed by a merchant client despite the processors' role being limited to that of a credit card factoring service provider. The acquirers' new role would now include the requirements to opine on the potential deceptive nature of a merchant's business practice and its compliance with all federal, state, and local laws on an ongoing basis, well outside of its responsibility today. Effectively, acquirers are being mandated by the FTC to police merchants.

4. Change in the Competitive Environment

Smaller acquirers may opt to not serve one or many merchant verticals due to fear of government penalties or the increased cost of doing business, thereby granting large acquirers an oligopoly. New risk management costs and requirements may present barriers to entry for new players in a market that has experienced a large number of new and innovative players in the recent past (e.g., Square, Braintree, Groupon). Any of these changes would have a severe impact on the highly competitive merchant acquiring market.

5. Exit of Sponsor Banks

Today, sponsor bank fees average only about $0.01 per transaction. It is our belief that this pricing does not completely account for the risk sponsor banks absorb even today, and with a change in exposure, it is likely that the small number of sponsor banks that are in the market would be further reduced. As current Visa and MasterCard regulations require a sponsor bank for non-bank acquirers, the exit of sponsor banks will cripple the acquiring industry.

V. Conclusions

The acquiring industry has a proven track record of providing safe, reliable, secure, and predictive settlement of card-based payments and quickly facilitates the transfer of funds between the card issuer, the consumer, and the merchant. The acquiring industry serves all constituents in the payments chain.

The responsibility to deliver the services or products as represented between a merchant and the cardholder is the responsibility of the merchant and not that of the acquirer or sponsor bank. The acquirer's role is to facilitate the transfer of funds between the customer/cardholder account with the issuer and provide to the payments system a reliable financial backstop and financial assurance in the event the merchant is unable to resolve legitimate customer disputes due to the merchant going out of business. (If the merchant was still in business and processing with the acquirer, the cost of the chargeback will be borne by the merchant via daily settlement.)

The acquiring industry understands and prefers that most merchants resolve a legitimate customer dispute by issuing a refund or credit back to the cardholder. If a merchant is unable or unwilling to do that, the industry rules afford the cardholder a more formal dispute resolution via a specified chargeback process. In these instances, the acquiring industry bears the financial risk inherent in disputes that result in a merchant's inability to cover refunds or legitimate disputes resulting in chargebacks. Acquirers provide this role and cover the risk for the payments system with respect to merchants. However, the implications of the FTC's recent actions are far reaching and go well beyond the intended scope of risk that an acquirer should reasonably be expected to bear in facilitating a card-based payment. In sum, the FTC's threats assert that an acquirer has the same responsibility for the delivery of goods and services to a cardholder, and resolution of disputes, that the merchant business has. This is an unreasonable expectation to place upon any acquirer and would significantly impact participants in the payments system in a negative manner.

In conclusion, it is our opinion that the inclusion of acquirers as defendants has harmful, wide-ranging consequences on the electronic payments industry and beyond.