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Picking up the Tempo

You may have only recently started to hear about payments orchestration. You're going to hear a lot more about it as payment methods and routing choices multiply.

Volume Twenty, Number Four • DigitalTransactions.net • April 2023

ALSO IN THIS ISSUE:

Mercedes's In-Car Payments

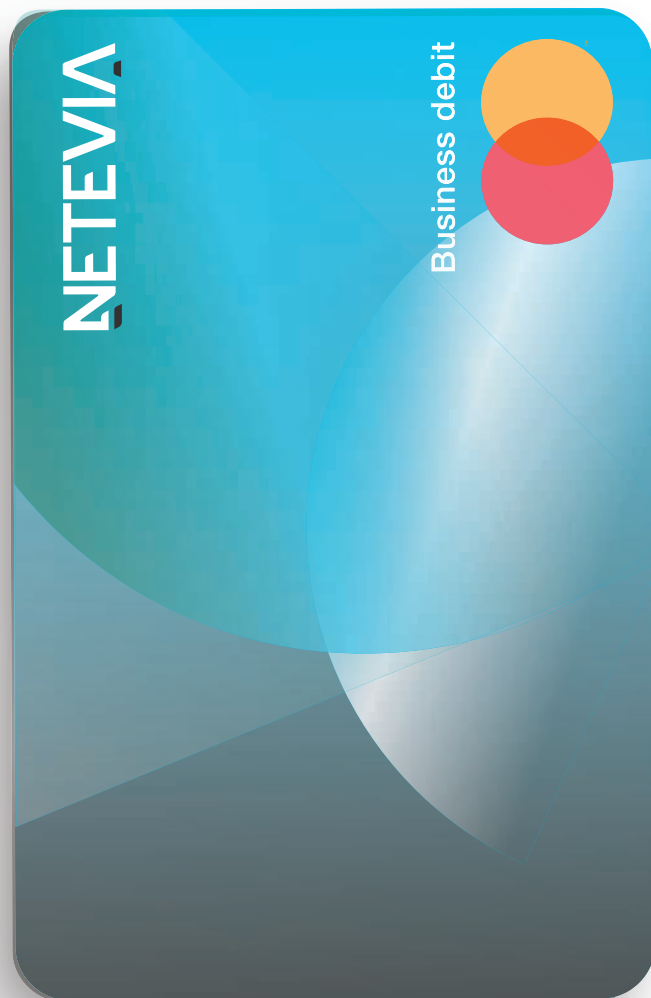
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contents

APRIL 2023 • VOLUME 20, NUMBER 4

Picking up the Tempo

22

You may have only recently started to hear about payments orchestration. You're going to hear a lot more about it as payment methods and routing choices multiply.

THE GIMLET EYE Don't Blame Crypto

4

TRENDS & TACTICS

6

Mercedes Turns the Car into a Payment Device

After years of testing and speculation, payments are coming to the dashboard. How will consumers react to the latest option?

Has Bruce Lowthers Turned Around Paysafe?

The hard-charging executive arrived from FIS a year ago to find a mess. So far, his clean-up strategy seems to be working.

Shift4 Shifts to a Higher Gear

While it tries to close on its big Finaro deal, it keeps converting more gateway traffic to a more profitable platform.

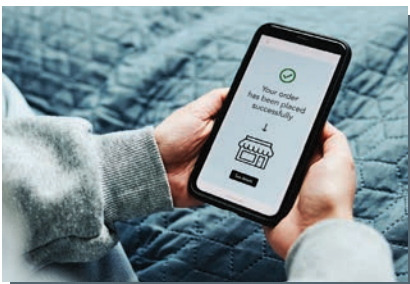
Plus, Security Notes explains how the art of recovery can turn failure into success; and Payments 3.0 argues the CFPB is wrong to attack prepaid cards backed by state benefits.

ACQUIRING

14

How Smaller ISOs Can Thrive

The big may get bigger, but there's plenty of room for smaller ISOs and payments companies to thrive and capitalize.



Cover Illustration: Elizabeth Novak, 123rf.com



SECURITY

18

Why the Password Is Going Extinct

The vulnerability of passwords to hackers is giving rise to a host of passwordless authentication solutions.

NETWORKS

28

The Rules of the Game

Regulations are coming for blockchain and crypto. Here's what they'll look like and how to interpret them.

ENDPOINT

31

It's Time For Digital Driver's Licenses

It's the surest way to combat application fraud, which may reach \$1 billion this year.

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DON'T BLAME CRYPTO

CRYPTOCURRENCY HAS TAKEN a beating in the headlines ever since the FTX scandal broke last fall. But last month it got much worse as a trio of banks known for their crypto-friendly lending collapsed, sending shock waves through the larger economy.

The fate of Silicon Valley Bank was especially egregious, representing the second-largest bank failure in U.S. history after that of Washington Mutual Bank in 2008, during a broader financial crisis. But also going down the drain were Signature Bank and Silvergate Capital Corp., two other well-known friends of fintechs and cryptocurrency.

SVB's collapse hit crypto especially hard, impacting even well-managed companies. Circle Internet Financial, a customer of SVB, saw its stablecoin depeg from the U.S. dollar over the weekend the bank failed because of the company's \$3.3-billion in cash reserves held there to back the coin.

The knock-on effects of these events took a further toll days later when First Republic Bank, SVB's San Francisco neighbor, had to be rescued by a hastily assembled consortium of nine banks from around the country, led by JPMorgan Chase. The institutions steadied First Republic with a \$30-billion infusion of deposits after customers, spooked by SVB's fate, rushed to withdraw their money.

But while crypto may have been a common denominator, it's unfair to blame blockchain for what turned out to be one of the worst months in U.S. banking history. As the example of Circle demonstrates, blockchain may have been the victim in this sorry episode more than the villain.

The real culprit is interest rates, which have been steadily rising as the Fed battles to tame red-hot inflation. But when rates rise, asset values take a hit, leaving institutions with a weaker balance sheet. You didn't have to be a genius to figure that news that inflationary pressure was scarcely under control would lead the Fed to hike rates again, making it even harder for some banks to meet customer demand for withdrawals. Indeed, First Republic may have enjoyed geographic nearness to SVB, but there's little evidence crypto had much to do with its problems.

But crypto is an asset, as well, and ironically Bitcoin, the leading cryptocurrency, has done swimmingly through all this. After plunging in the wake of the FTX fiasco, the coin's value has soared 70% since the start of the year, according to data source Coinmarketcap.com. Nor is Bitcoin alone in this runup. Ethereum, the second-largest digital currency by market value, shot up 50% from the first of the year to mid-March.

Inflation stood at 6% for the 12 months through February, according to a U.S. Labor Department announcement on March 12. We can all fret about that.

John Stewart, Editor | john@digitaltransactions.net

PUBLISHER Robert A. Jenisch

EDITOR-IN-CHIEF John Stewart

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DIRECTOR OF ADVERTISING
Robert A. Jenisch, 877-658-0418
bob@digitaltransactions.net

ADVERTISING SALES REPRESENTATIVES
Robert Mitchell, 877-658-0418, x7
bmitchell@digitaltransactions.net

Rob Akert, 877-658-0418, x6
rakert@digitaltransactions.net

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John Stewart, Managing Director
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trends & tactics

MERCEDES TURNS THE CAR INTO A PAYMENT DEVICE

Mercedes-Benz's new Mercedes pay+ in-car payment service is coming to five models manufactured by the German luxury-car maker.

Though earlier efforts from a variety of car makers put in-car payments on the road, Mercedes-Benz is the first, with its Mercedes pay+ technology, to use Visa Inc.'s Delegated Authentication and Cloud Token Framework.

The Delegated Authentication service enables an issuer to "delegate authority" to a third party, such as a wallet provider or merchant. Its Cloud

Token Framework enables a connected device to become a secure channel for digital commerce. Mercedes-Benz announced in 2021 that it and Visa were working on a native in-car payment service that it had hoped to launch in 2022, *Digital Transactions News* reported then.

In Mercedes pay+, the technologies are integrated into the native in-car payment service, enabling the vehicle itself to provide biometric two-factor authentication in conjunction with a fingerprint sensor. Earlier versions of in-car payment services relied on

a user's mobile phone as one element of the two-factor setup.

The first Mercedes models to have Mercedes pay+ are the EQS and EQE series, the S-Class, C-Class, and the GLC. The technology is only available in Germany for now, though the carmaker intends to launch it in other European markets this year. A Mercedes-Benz spokesperson confirms Mercedes pay+ will come to its U.S. vehicles, but could not say when.

Currently, drivers with eligible Visa credit or debit cards can use the service by linking the card with their Mercedes me accounts and activating Mercedes pay+ in the vehicle. More card systems will be added later, Mercedes-Benz says.

Customers in Germany can use the service to pay for digital services and on-demand hardware upgrades in the Mercedes me store. Examples include apps that control comfort functions and weather information along a route. Eventually, a fuel-payment capability and other features will be added. Motorists can use the store to pay for access to remote parking assist or adaptive high-beam headlight assist.

—Kevin Woodward



A driver touches the fingerprint sensor in a Mercedes-Benz car to make an in-car payment.

HAS BRUCE LOWTHERS TURNED AROUND PAYSAFE?

Bruce Lowthers came over from FIS Inc. last spring to run a stumbling Paysafe Ltd., and in the ensuing months the new chief executive delivered a series of candid assessments of his new company. “Bluntly, we’ve lost our way here,” he told equity analysts in November, adding, “We’re impeding our growth... we have to execute better.”

The message must have been received. Lowthers’s assessment last month was considerably sunnier during a conference call to discuss the London-based processor’s fourth-quarter and full-year results, which included improved numbers

for its crucial digital-wallet and merchant-acquiring businesses.

“We said we’d return to growth in the back half of [2022] and we’ve done exactly that,” Lowthers said, pointing to total payments volume of \$33 billion for the quarter and \$130 billion for the year, year-over-year increases of 5% and 6%, respectively.

The wallet business (chart), which includes the Skrill and Neteller products, has posted five consecutive months of growth, he said. It also accounts for 45% of Paysafe’s revenue.

Total active users for the products reached 25.9 million in the fourth

PAYSAFE’S DIGITAL WALLET BUSINESS

Volume	\$21B
Take rate	3.33%
Active users	
eCash	16.4 mil
Classic digital wallets	2.3 mil
Total	18.7 mil
Cash in/out distribution points	1.2 mil

Source: Paysafe

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quarter, up 34% since the final quarter of 2021 as the company has worked to broaden the user base beyond iGaming to more general entertainment and smooth out the technology to improve the user experience. Wallet revenue for the quarter rose 6% to \$177.1 million and 1% for the year, to \$686.2 million.

Lowthers projected further gains. “We expect [the number of] users to accelerate around the second quarter,” he noted, as the company concentrates on boosting the value users store in their wallets. Total deposits rose 14% to \$262 million in the fourth quarter compared to the same period in 2021.

At the same time, Lowthers pointed to rising opportunities in North American iGaming and recent client conversions as encouraging signs the company is back on track. Ten months after taking over, he added, “I’m more excited ... about the opportunity we have...we expect to be very competitive in U.S. iGaming.” Paysafe now supports digital

gaming payments in 25 U.S. states, Lowthers reported. Last year, North America accounted for 55% of the company’s revenue.

Paysafe’s other crucial business, merchant acquiring, posted improved financial results on better volume totals. Revenue rose 10% for the quarter, to \$208.5 million, as well as for the year, to \$817.4 million. Lowther ruled out any impacts from a possible recession in markets like the United States. “This is really about us going out and executing,” he said. “If we do have a recession, it will be mild.”

Paysafe reported \$384 million in revenue overall for the quarter, up 8%, and \$1.5 billion for the year, up 5%. Adjusted net income for the quarter was \$33 million, down from \$52 million in 2021’s fourth quarter. For the year, it came to \$137 million, down from \$185.8 million.

“We’re prepared to grow in 2023,” Lowthers said. “We have stabilized the company.”

—John Stewart

SHIFT4 SHIFTS TO A HIGHER GEAR

If any doubt remains that payment processors are rebounding strongly from the pandemic and all the restrictions it brought with it, Shift4 Payments Inc. likely dispelled it with the final-quarter 2022 results it posted on the last day of February.

And if there’s a cloud on its horizon, it’s the waiting time the company has had to contend with in closing on one of its biggest acquisitions—the \$525-million deal for Finaro, a 15-year-old Israel-based e-commerce acquirer Shift4 is counting on for global expansion.

“We expect to receive regulatory approval on Finaro shortly,” chief executive Jared Isaacman said during a call with equity analysts to present Shift4’s fourth-quarter results. In November, Isaacman had indicated the deal would likely close by March 31.

On the call, president and chief strategy officer Taylor Lauber added the company now expects to close in the second quarter of 2023. “We need to close on Finaro as soon as we’re allowed to,” he said.

The urgency to close the deal stems from Finaro’s extensive reach. The company processes transactions in the United Kingdom, Europe, Hong Kong, and Japan, and supports more than 170 alternative payment methods, a portfolio that will vastly expand Shift4’s currency capabilities in addition to extending the company into overseas markets in a major thrust. Still, despite the lengthy regulatory process, the delay “is no more than mildly frustrating,” Lauber said.

Domestically, Allentown, Pa.-based Shift4 saw its end-to-end payments

MONTHLY MERCHANT METRIC Total Same Store Sales YOY Growth %

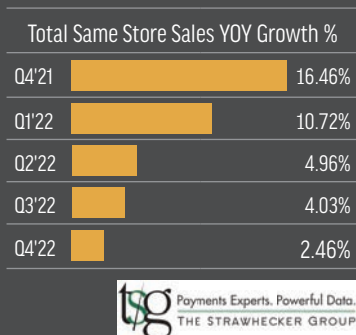
This is sourced from The Strawhecker Group’s merchant datawarehouse of over 3M merchants in the U.S. market. The ability to understand this data is important as SMB merchants and the payments providers that serve them are key drivers of the economy.

All data is for SMB merchants defined as merchants with **less than \$5M in annual card volume** as well as **Standalone Merchants Only**.

Metric Definitions: (Only use definitions related to an individual month’s release)

Same Store Sales YOY Growth % - Annual volume change/growth of retained (non-attributed merchants with positive revenue and volume) accounts for given period divided by total portfolio volume from same period of the prior year. Note: Previous metric included all active merchants, those with positive revenue, whereas the new metric shown only includes merchants with positive revenue **and volume**.

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volume climb a record 55% year-over-year to \$20.7 billion for 2022's final quarter (chart). The growth was partly a result of a years-long effort by the company to shift clients to end-to-end processing from its less profitable gateway service. "Our gateway sunset is a multi-year initiative," said Isaacman. "It's in the early innings."

On the end-to-end processing front, Shift4 also reported some 10,000 integrations for one of its most ambitious point-of-sale technologies, SkyTab POS, which it launched officially in September.

The system, which is aimed at restaurants and sports stadiums, has helped move more of the company's volume to "higher-end" merchants, Isaacman reported. Another initiative with the same potential is a deal with PayPal to enable PayPal Checkout with Venmo and PayPal Pay Later, PayPal's buy now, pay later technology, which is aimed at larger merchants.

The advantage of large enterprise deals on the end-to-end platform is profitability, Shift4's top management stressed during the call.

"It's more labor to support a gateway customer than an end-to-end merchant," said Isaacman, who added venues like sports stadiums magnify that profitability. While gateway service is labor intensive, "a single stadium can be covered by the same person," he said. With the gateway service, Shift4 passes on transactions to other processors for settlement, cutting into the profitability of each transaction.

For the quarter, Shift4 reported \$537.7 million in gross revenue, up 35% year-over-year. Revenue for all of 2022 totaled \$1.99 billion, a 46% increase over 2021. The company

THE WHOLE ENCHILADA

(End-to-end payment volume, in billions, in the fourth quarter each year)



Source: Shift4

swung from a loss of \$74 million in 2021 to net income of \$86.7 million last year. Net income for the quarter came to \$38.5 million, compared to a loss of \$13.7 million in the same period in 2021.

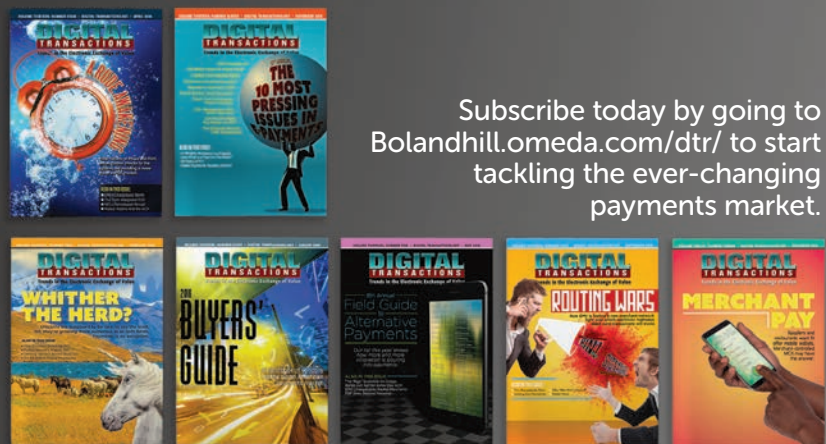
The company made it plain it intends to expand profitability markedly this year, in part through growth. End-to-end payment volume, it projects, will fall into a range of \$100 to \$109 billion, helping to yield gross revenue of \$2.5 billion to \$2.7 billion.

Perhaps most noteworthy, adjusted EBITDA—earnings before interest, taxes, depreciation, and amortization—will fall between \$410 million and \$435 million, the company forecasts—up dramatically from \$86.7 million in 2022.

This is a number Isaacman is watching closely. He's aiming at a goal of \$1 billion in EBITDA, he said. "That's the journey we're on right now," he said.

—John Stewart

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RECOVERY: THE FOUNDATION OF PROGRESS

BIOLOGISTS POINT OUT that Darwinian evolution was so spectacularly successful not because of exceptional wisdom going forward, but on account of a robust means of recovery. Countless errors and myriad missteps were followed by effective recovery, so the process was ready to try again. Indeed, recovery is the silent foundation of progress. In our business, we need to focus on financial recovery on both fronts: the value of money and the holding of money.

Money must continue its service to society through good times and bad times. Good times are powered by hope; bad times are driven by panic. If money is anchored on hope, then it is not there for us when hope fades. Silicon Valley Bank soared on two hopeful premises: innovation pays off, and unanchored money will stay afloat. The bank was betting with crypto and intoxicated by the promise of innovation. The trajectory was upward.

Successful innovators become news stories, however few they are in a crowd of failing innovators nobody ever hears of. The luster of innovation mostly reflects the light of hope and expectations rather than an inner glow. All the while, SVB relied on unanchored crypto coins, which presented themselves as stable because their value was determined by complex algorithms no one fully

BY
**GIDEON
SAMID**

gideon@bitmint.com



understood. And then a perfect storm happened (as they always do).

For money to be there when panic washes away reason, it must be anchored to the most solid assets we can think of: a fiat currency like the U.S. dollar or the euro, precious metals, oil reserves, real estate, manufacturing facilities, and the like. A smart combination of such assets should serve as an anchor for the newly developed universal digital money.

Imagine a coin that represents a fraction of the wealth of humanity. This coin will not fluctuate in value because it has no reference to fluctuate against. It is like the universe, which cannot move up or down because there is nothing to measure its position against. It is not easy to mint such a stable coin, but we can come ever closer. And the closer we come, the more we will have money to help us recover from our mistakes.

So, while Bitcoin started the digital-money revolution with the idea of unanchored money, floating on hope and expectations, its mature descendants are becoming more anchored than any form of money

otherwise. Stablecoins based on a complex probability calculus are neither stable nor coins. A counter breed of coins, BitMint among them, is generating the full scale of digital-money magic, but each coin is redeemable by assets that are not defined by the algorithms that mint that coin. Read more about it here: Bitmintcash.com/anchor.

The second element of recovery works against theft and misappropriation. Digital money flows and stays in the labyrinths of mathematical procedures and communication technology, a juicy target for those who abuse their talent and occasionally outsmart the financial network. A prudent security team will build a robust recovery plan for the day they are outsmarted. One powerful means of recovery is the use of an identity-bearing financial language. It is the digital equivalent of imprinting a dollar bill with a serial number. Such imprinting creates a traceable digital coin that will not be redeemed if any former owner receives it fraudulently. Check out U.S. Patent 11,107,156.

Innovation is the fuel for our survival. Innovation requires daring. Daring results in a few spectacular successes flanked by many monumental failures. We need to have a good means of recovery to prevent the latter from voiding the former. **DT**



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PREPAID CARDS, STATE AID, AND THE CFPB

LAST MONTH, THE Consumer Financial Protection Bureau released an “Issue Spotlight” on government benefits that attacked the use of prepaid cards for delivering state benefits. The agency cited what it sees as a lack of choice for consumers, inadequate customer service, and, of course, fees.

“In 2020, for example, issuers of government-administered prepaid cards collected approximately \$1.3 billion in fees,” the “Issue Spotlight” item said. “While this fee revenue reflects only 0.3% of the \$409 billion distributed, these fees may have a significant impact on the individual consumers that pay them.”

It is an interesting choice of data, since the Federal Reserve noted in its latest report to Congress on government prepaid cards that “[f]or cardholder fees, government offices negotiate rates for each program with issuers and often restrict the number and type of cardholder fees an issuer can charge.”

The Fed also noted that, since the time mentioned by the Bureau, cardholder fees have fallen: “Total cardholder fee revenue received by issuers of government-administered, general-use pre-paid cards decreased 16 percent between 2020 and 2021, from \$271.5 million to \$228.6 million.”

The Bureau’s critique seems to ignore the cards’ cost savings for governments. Fair enough. This is the Consumer Financial Protec-



BY **BEN JACKSON**

bjackson@ipa.org

tion Bureau. But it also ignores the cost of the alternative for unbanked recipients. Paper checks would lead to check-cashing fees and costs for things like money orders, as recipients without cards would be cut off from electronic payments.

Additionally, the Bureau’s critique about choice ignores the reality that governments are not going to pay the cost of contracting with multiple vendors, and that recipients have the choice to use accounts not offered by the government. And, as always, the discussion of fees ignores the costs of offering a service.

For example, when the Department of the Treasury first put the Social Security program out for bid, six applicants offered to provide prepaid cards for Social Security recipients at no cost, according to a report by the Treasury Office of the Inspector General. Comerica won the bid in 2008, but in June 2013 the government paid the bank \$32.5 million for enrollment fees and infrastructure costs. Without that payment, Comerica would have lost \$24.1 million, the report said. When businesses cannot afford a product’s costs, they typically stop offering it.

Some banks may have already gone down that path at the state level. In December 2021, Illinois announced it would no longer offer prepaid cards for unemployment benefits. Instead, cardholders would receive paper checks. The state said this was because KeyBank had decided to stop providing cards. To my knowledge, KeyBank has not spoken publicly about why it stopped offering the cards, but it is not a big leap to think the program was too costly.

Before condemning government prepaid programs, the Bureau should take a holistic look at the benefits the programs provide and what would happen if they disappeared. Forcing unbanked recipients back to paper checks would not protect them. Their costs would increase, and they would be at increased risk of fraud. In February, for example, the Financial Crimes Enforcement Network warned of a surge in mail-theft check-fraud schemes.

All forms of payment have their pros and cons. But when the Treasury Department renewed its contract with Comerica for Direct Express, it said the program “has maintained cardholder satisfaction ratings of 94% or higher for the last 10 years.”

Instead of hunting for opportunities to take action against financial institutions, and encouraging state agencies to drop prepaid cards, the Bureau should help them make programs more effective and sustainable. **DT**



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HOW SMALLER ISOS CAN THRIVE

The big may get bigger, but there's plenty of room for smaller ISOs and payments companies to thrive and capitalize.

BY KEVIN WOODWARD

WITH MEGAPROCESSORS, fintechs, payfacs, and integrated payments providers abundant in the payments world, smaller independent sales organizations and software sellers may feel some pressure. But the competition does not automatically mean dire straits for them. A nimbleness in customer service, products, and sales can contribute to survival strategies for smaller ISOs.

And more than a few smaller ISOs are doing more than just surviving. They're competing and growing, just as their larger counterparts are. How they do that, however, has some unique characteristics and opportunities.

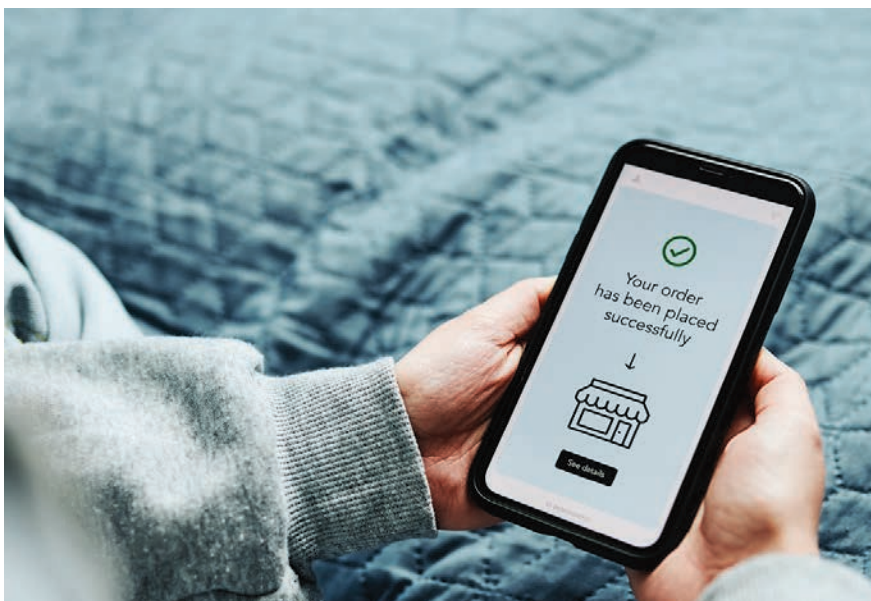
"Flexibility is the key," says Jeff Fortney, senior associate at The

Strawhecker Group, an Omaha, Neb.-based advisory firm. Fortney was an executive at ISOs TouchSuite and Clearent prior to joining TSG. "Flexibility in target merchants, flexibility where marketing funds are invested (if at all), and the ability to pivot when an opportunity presents itself."

Others echo Fortney. "You have to be willing to change with the times," says Juan Ortiz, partner at Juan Ortiz Inspires and consulting partner at Field Guide Enterprises LLC, an acquiring consultancy.

In 2019, the upper end of the payment-services continuum stretched to an unprecedented size when six already large payments companies merged in three separate deals. The three surviving companies—Fiserv Inv., FIS Inc., and Global Payments Inc.—had combined total revenue, which included more than solely payments revenue, of \$41.24 billion in 2022, up 18.4% from \$34.82 billion for 2020. (In February, FIS announced its intention to spin off the big processor Worldpay, effectively undoing its 2019 merger).

To get a better idea of the scale just among acquiring companies, the total processing volume among the top 10 acquirers in the 2023 Directory of U.S. Merchant Acquirers from The Strawhecker Group was \$8.8 trillion. The combined volume for the remaining 202 acquirers in the directory was





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less than half that figure, for a total of \$3.3 trillion.

'DOORS HAVE OPENED'

One byproduct of that heft is that it tends to produce a lot of merchant churn, especially following a merger or acquisition. One smaller ISO survival strategy is being able to quickly pursue merchants that might be unsatisfied with their new, larger provider.

As *Digital Transactions* reported in February (“A Mixed Payoff for the Megamergers”), these mergers “also created opportunities for emerging players to capture market share by offering solutions on newer platforms or with different capabilities or functionalities,” as Thad Peterson, strategic advisor at Aite-Novarica Group in Boston, said then.

That’s a notion echoed by Tim Russo, senior director of liquid fintech partnerships and business development at Palo Alto, Calif.-based TripActions, a card, travel, and expense-management services company. “In the wake of these mergers and the support gaps, doors have opened for existing companies to expand their footprints and for fintech[s] to move into the marketplace,” Russo said.

Mark Dunn, founder and president of Field Guide Enterprises, shares a clear example of that nimbleness. One particular ISO, a startup in the late 1990s, capitalized on a local bank merger when a Wisconsin bank was acquired by a Minnesota-based bank. The new owner had sent letters to the merchants notifying them of the combination.

The ISO, sensing many of the merchants wanted to retain a local connection, got hold of one of the letters and approached the merchant, holding up the letter during the sales pitch and asking if the merchants had received the letter and if officials were happy about the change. When the merchants said no, they weren’t happy, the ISO’s sales took off, Dunn recalls. Their pitch? “We’re in Wisconsin and we’re going to take care of you,” he says.

“That’s the kind of thing that happens where there are these mergers,” Dunn says. “Many ISOs are doing the basic blocking and tackling they always have—good customer service, good follow-through, and taking care of people. Taking care of people just works.”

Fortney says customer service is critical, especially for small and medium-size businesses. “SMB[s] with a large ISO are one of many,”

Fortney says. “As a result, they are not known by anyone in the company until there is a serious issue. It can be difficult to get an issue addressed. There are limited to no retention efforts for the SMB.”

As Ortiz says, smaller ISOs can offer a personal touch that might be more difficult for a sprawling organization to do. “Even the big ISOs know they need that,” he says. “They need people in the streets... There are millions of small merchants that don’t trust the big companies.” That’s why being smaller continues to have advantages, Ortiz says.

'NICHE VERTICALS'

One disadvantage, however, is that the smaller ISO may not be able to provide every element of the service merchants expect, such as technical support. “When you run a larger account, you have to have a partner to support you,” Ortiz says.

That means ensuring the partner can deliver the service level merchants have come to expect from the primary company. The merchant, when faced with a problem with payment services, is very likely to call the salesperson for help.

That expectation confers responsibility for knowing the partner’s



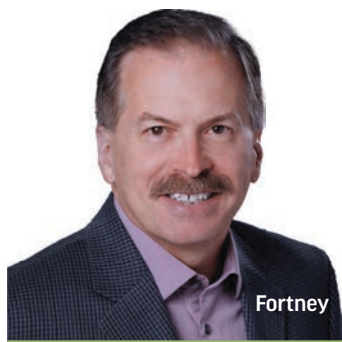
Passalaqua: “There’s always going to be problems that need to be solved in the commerce of our world.”

structure and staff, Ortiz says. “If I’m registered with a big office, I need to know the staff there because when I need help, I need to pick up the phone, shoot a text, or send an email to get help,” he says.

Assistance from a partner can be invaluable, especially because a smaller ISO’s focus is intrinsically on sales, says Fortney. “Hiring support staff is not an issue, as many will leverage their processing partners’ after-hours support, underwriting, risk management, and their approved solutions,” he says.

That’s part of the role for Worldline’s North America operations, says Justin Passalacqua, country director. Worldline is a large international processor. “We have more than a thousand ISO partners in North America,” Passalacqua says. “There are still plenty of opportunities for smaller organizations,” he adds.

These opportunities might be in niche markets or underserved ones, for example. “It’s important for Worldline and some of the larger companies to not forget about these specific needs,” he says. “It’s important for us to consider these niche verticals and how do we empower them.”



Fortney

Fortney: “The small ISO is a primarily a sales engine. Their sole goal should be to sell.”

Partners like Worldline should ask about tools they can provide smaller ISOs and independent software vendors to serve these specialized markets, Passalacqua says. These tools can help the ISO make an entry, such as with an easy pricing model or education.

‘GREATER MARGINS’

It’s sales, however, that is the primary engine of the smaller ISO or independent software vendor. These sales will drive revenue growth and scale. Scale eventually becomes more important for many. But they’ll have to grow first to reap the benefits.

“Scale may be important to payments companies,” Fortney says, “but the smaller ISOs must first grow to get to the point that scaling is a benefit. The small ISO is primarily a

sales engine. Their sole goal should be to sell.”

That means their primary effort should be in adding merchants to their portfolios. “Concentrating on the SMB marketplace commonly allows for greater margins and short sales cycles,” Fortney says.

And once a merchant agreement is secured, the ISO should have a retention plan in place. It could be as simple as a newsletter, Fortney says. “The key is that their name is at the forefront when a merchant thinks of merchant services,” he says. “And not solely when there is a problem.”

Passalacqua has known plenty of ISVs that were content with their growth. An example he cites is an ISV that provides summer-camp management software that dominates that segment.

Eventually, though, an ISO or ISV will need some sort of exit plan. “Since they are primarily sales offices in action, it’s not possible to stay a small ISO,” Fortney says. “You can grow into a medium-sized ISO.”

These payments experts continue to see opportunities for smaller payments companies.

“There’s plenty of opportunity for smaller ISOs and ISVs,” Passalacqua says. “There’s always going to be problems that need to be solved in the commerce of our world.” DT



security

WHY THE PASSWORD IS GOING EXTINCT

The vulnerability of passwords to hackers is giving rise to a host of passwordless authentication solutions.

BY PETER LUCAS

WHETHER IT'S A financial account, an account with an e-commerce retailer, or medical records, user names and passwords have been the most common authentication method for digitally accessing an account. Trouble is, passwords are prone to being compromised through a variety of attack vectors.

Three of the most common forms of password attacks are: spray attacks, in which a criminal acquires a list of user names, then attempts logins across all the names using the same password; a phishing expedition, in which the criminal attempts to trick a consumer into turning over her username and password; or a brute-force attack in which a hacker uses a computer program to try all possible letter, number, and symbol

sequences character-by-character, until hitting the combination that accesses the user's account.

Passwords can also be forgotten, which requires consumers to reset it. But resets can be annoying for consumers, as it means they have to create and remember a new password or write in down and keep it in a safe place.

On average, consumers and workers spend nearly 11 hours a year setting, entering, and resetting passwords, according to a 2019 study conducted by the Ponemon Institute LLC and sponsored by Yubico, a provider of hardware authentication.

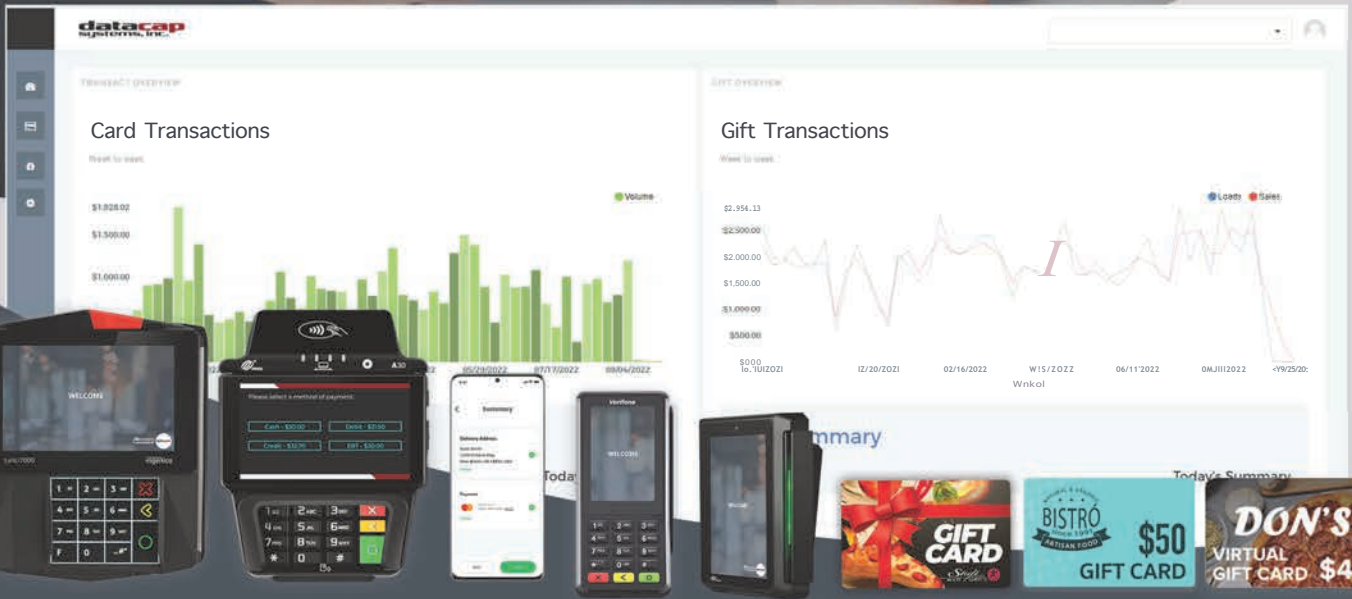
Yet, from a business's perspective, having customer-service representatives help consumers reset their passwords can be costly. A substantial fraction of consumers needs help resetting passwords, and the average call to a help desk costs \$50, according to authentication experts.

Further, because it can be difficult for consumers and workers to remember all their passwords, they tend to create weak passwords or reuse the same one, or a slight variant of it, across multiple accounts and devices, which makes them vulnerable to hackers.

The Ponemon study also estimates the annual cost of productivity and labor loss per company for entering, setting, and resetting passwords averages \$5.2 million a year.



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For online merchants, 50% of shopping-cart abandonments are due to forgotten passwords. And e-commerce shoppers who have to reset their passwords typically spend less, according to the FIDO Alliance, which develops and promotes authentication standards that help reduce over-reliance on passwords.

DOWN WITH PASSWORDS

“Passwords are fundamentally flawed, because they can be hacked, forgotten, and stolen,” says Andrew Shikiar, executive director and chief marketing officer for the FIDO Alliance. “It’s also tough to enter passwords on keyboardless devices. Plus, more than 80% of data breaches can be tracked back to passwords.”

That last point has spawned a saying among cybersecurity experts that hackers don’t hack any more, they simply log-in. Enabling hackers to come in through the front door using a password can be costly to businesses. The average cost of a data breach is \$4.24 million, accord-

ing to IBM Corp.’s 2022 Cost of a Data Breach report.

“It takes a slip by just one employee when it comes to password management to unlock the door for hackers,” says Mike Engle, chief strategy officer for 1Kosmos Inc., a provider of cloud-based distributed-identity solutions. “One of the best safeguards that can be taken is to eliminate passwords altogether.”

So what technologies will supplant passwords? One of the most popular alternatives is passkeys, which use cryptographic keys to identify devices.

A passkey consists of a key pair that includes one public key, which is registered with the Web site or app being used, and one private key, which is held only by the user’s device. Public passkeys are linked only with the Web site or app they were created for, which protects users from being tricked into using a passkey to sign in to a fraudulent site or app.

The private key never leaves the user’s device, such as a mobile phone or computer, so it can’t be leaked from a Web site or app. And consumers never have to remember or reset their passkey.

Passkeys, the FIDO Alliance says, are resistant to phishing, reliably strong, and are designed so there are no shared secrets.

‘GET RELIGION’

In October, PayPal Holdings Inc. announced it was adding passkey technology to replace passwords. To set up a passkey, PayPal customers log into PayPal.com with their existing PayPal credentials and are presented with an option to create a passkey.

Customers who choose to set up a passkey are asked to authenticate

themselves with Apple Face ID or Touch ID, after which the passkey is automatically created. On the next visit to PayPal that requires a log in, the passkey will be used, eliminating the need to use or manage a password.

PayPal’s passkeys are synced with Apple’s iCloud Keychain, a secure credential-storage service, to help make them easier to use on iOS16, iPadOS 16.1, and macOS Ventura devices. For devices that don’t support passkeys, consumers can use an iPhone to scan a quick response code that appears after entering PayPal user-ID credentials.

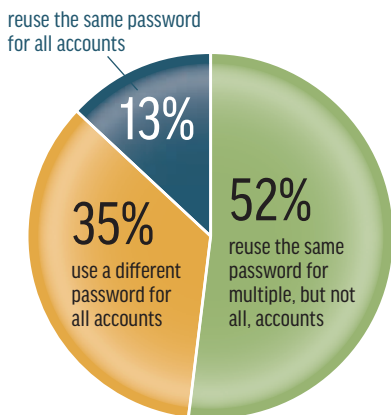
At the time of the announcement, PayPal said passkeys would help improve the checkout experience by eliminating the risks of weak and reused credentials, and spare its customers from remembering a password.

One advantage of passkeys is that the public key has no value by itself, as it must be matched to the private key. “Passkeys represent the ability to create strong and unique authentication effortlessly,” says Gary Orenstein, chief customer officer for Bitwarden, a Santa Barbara, Calif.-based open-source password-management service.

Earlier this year, Bitwarden acquired Passwordless.dev, a European-based open-source startup. It enables developers to trim the work around cryptographic operations and technical flows to create passkeys and other forms of WebAuthn passwordless experiences in minutes using out-of-the-box code.

WebAuth is a core part of the FIDO2 specification, and is a modern open-authentication standard supported by browsers and technology giants such as Apple Inc. Google, and Microsoft Corp.

HOW COMMON IS PASSWORD REUSE?



Source: Google

In 2022, Apple, Google, and Microsoft announced plans to expand their support for the passwordless sign-in standard created by the FIDO Alliance and the World Wide Web Consortium. In doing so, the three tech giants opened the door for consumers to automatically access their FIDO sign-in credentials, which are often referred to as a passkey, on many of their devices, even new ones, without having to re-enroll every account.

In addition, consumers will be able to use FIDO authentication on their mobile devices to sign into an app or Web site on a nearby device, regardless of the operating system or browser they are running.

“With the major tech companies adopting the FIDO standard, now it’s up to merchants to request customers to adopt passwordless authentication,” says 1Kosmos’s Engle. “As competitors start to roll out passwordless capability we will start to see merchants get religion when it comes to passwordless authentication.”

A POCKET SCANNER

But another form of passwordless authentication is also gaining momentum. This is biometrics, which authenticates individuals by unique physical characteristics, such as a fingerprint or facial recognition.

“Biometrics [is] definitely growing as an alternative to passwords. The largest driver of this is the incorporation of fingerprints and facial recognition in mobile devices,” says Michael Greenwood, a research analyst for Juniper Research. “This means that significant proportions of populations are walking around with biometric scanners in their pockets. The availability of built-in biometric

frameworks within devices, such as Apple’s Face ID, makes it easier for these services to be leveraged.”

In many cases, biometrics is used in conjunction with passkeys to create layered, and hence stronger, authentication, Orenstein says.

One advantage of biometrics is that the technology is not vulnerable to many techniques used by hackers, such as brute-force and dictionary attacks. A dictionary attack attempts to break into a password-protected device or network by entering every word in a dictionary as a password.

The cost effectiveness of biometric authentication depends on the solutions and the use case, experts say. “Implementing fingerprint scanning for a banking app, or utilizing a mobile device’s pre-existing fingerprint scanner, can be very cost effective,” Greenwood says. “Alternatively, using hardware fingerprint scanners for employee authentication to log onto a company’s system would be more expensive and is significantly less scalable.”

One point businesses looking at biometrics for customer authentication need to keep in mind is that consumer preferences for the technology can vary widely. For example, consumers who use fingerprint technology to access their mobile phones tend to be accepting of the technology when used for authentication in other scenarios.

“On the other hand, there are some consumers that don’t like biometrics,” Orenstein says. “There is a wide range of user personas, and they should be kept in mind when developing passwordless authentication solutions. Some consumers favor convenience, while some people also want a physical security key, and others prefer more battle-hardened security elements.”

‘UNFIT FOR ONLINE’

Another option gaining momentum is digital Identities. A recent study by Juniper Research forecasts that more than 4.1 billion apps that enable consumers to verify their identity online are projected to be in use globally by 2027, up 82% from 2.3 billion in 2023. Juniper defines a digital identity as a digital representation of an entity, which can be one or more individual pieces of identity data, an event, or a signal.

As adoption of these apps increases, Juniper projects consumers will move away from reliance on passwords in favor of biometric verification and multi-factor authentication under a zero-trust model, where identities are continuously authenticated.

While digital-identity apps are expected to grow in popularity, so too are digital wallets, which can hold key pieces of identification, such as a driver’s license, to verify a consumer’s identity online, Juniper says.

Digital wallets may be the primary competitor to identity apps, but one downside with wallets is that wallet providers struggle to monetize identity in the same way as they have payments, due to competition from government-run schemes. This limits adoption, according to the Juniper report.

As passwordless authentication solutions become more commonplace, educating consumers about the importance of backing up their authentication apps will become a necessity. “A lot of people use authentication apps, but they don’t back them up across their devices,” says Orenstein. “There needs to be redundancy in passwordless authentication.” DT

Picking up the Tempo



You may have only recently started to hear about payments orchestration. You're going to hear a lot more about it as payment methods and routing choices multiply.

BY JOHN STEWART



Everybody in the business has heard for years how complicated payments are. In the old days, merchants were local, and all they accepted was coins and greenbacks. Now, because of online commerce, even mid-size sellers can operate worldwide, deal in multiple currencies, and accept a dizzying array of local payment methods.

And that's before you add in the multiple gateways, processors, payment service providers, and routing choices that can confront and confound online merchants doing business these days. It's enough to befuddle even experienced merchandisers.

Smart merchants can keep track of all that, though, right? Sure, maybe with the right technical help. Just bring on more of that as sales climb and customers are added around the world. But, wait a minute, hiring that help isn't so easy these days, is it?

"It's gotten more difficult to find really good payments engineers, cloud engineers. It's like finding a flying pink pig," notes John Lunn, founder and chief executive of Gr4vy Inc., a San Mateo, Calif.-based company whose technology helps merchants untangle these payments complexities.

And complexities they are. The beauty of e-commerce is that it lets even middling merchants sell to anyone anywhere at virtually any time. But selling into multiple continents was already challenging a few years ago. It took on dizzying proportions when Covid hit and everyone everywhere, it seemed, went online.

Now, sellers are confronted with enormous increases in demand from jurisdictions where parsing currency conversions, local payment methods, alternative payment methods, routing choices, and payment processors got to be a very bad headache very fast. "With Covid, everybody decided they had to go online—that accelerated everything," recalls Lunn, who worked at PayPal and CyberSource before founding Gr4vy in 2020.

'Where the Magic Happens'

Not only do these complexities have to be untangled fast, the solution has to be efficient and cost-effective for the merchant while satisfying the customer's expectations for quick transactions and delivery tomorrow.

"Merchants are struggling with the rise of [card-not-present commerce]—the pandemic made it worse," says Rene Pelegero, a former Amazon.com executive and principal and founder of Retail Payments Global Consulting.

So what's the answer for overwhelmed sellers? Pelegero and others point to a concept called payments orchestration. Just as a conductor evokes sweet notes from a collection of players who could just as easily be producing a cacophony, this technology uses application programming interfaces to select just the most efficient providers and payments routes to handle the customer's payment choice at just the moment of the transaction.

The technology is very recent, but already the payments industry seems to be settling on the proper vocabulary for it. The programming is widely referred to as a “payments-orchestration layer” that lies between the merchant and his processor.

“That’s where the magic happens,” says Rodney Bain, president for North America at Apexx Global, a London-based company that competes with Gr4vy and a handful of other firms that specialize in providing this layer for online merchants.

The idea is to orchestrate all the elements of a transaction—acceptance of the customer’s payment choice, just the right gateway, and the right processor—to satisfy the customer. That avoids cart abandonment and keeps the merchant’s transaction price at the lowest level that can still meet all the various networking costs.

Transaction cost, as always, is critical, but it helps if you’re processing enormous volumes. “Walmart will have a team focused on nothing but payments orchestration. Shaving even an eighth of a cent off at Walmart is going to have a big impact,” says Rob Gatto, chief revenue officer at Paysafe Ltd., which works with Spreedly Inc., a Durham, N.C.-based orchestrator, but also does some orchestration of its own.

‘Super High Value’

But it’s about more than minimizing cost while maximizing the ability to accept the customer’s chosen payment method, no matter how obscure. It also seeks to “ensure regulatory compliance, enhance fraud prevention, and enable global payments coverage,” according to a one-paragraph definition supplied by sources reached for this article.

This doesn’t mean the cheapest transaction, either. It just means the most efficient channel

that still enables conversion of the maximum possible payment methods, no matter how obscure. For example, Apexx, which caters largely to airlines, connects to more than 150 acquiring banks while managing more than 120 payment methods across hundreds of payment platforms, says Bain.

“You’ve got a ton of [alternative payment methods] outside the United States. Payments orchestration is not always needed, but it’s super high-value in many cases,” says Todd Ablowitz, co-chief executive and cofounder of Infinicept, a payments-technology company. This is because, he says, “The more payments mature and the more flows get expanded, the more complicated the steps can get in the background.”

It’s hard to say with any precision when payments orchestration became a thing to be reckoned with—or even who came up with the name. Many credit Pelegero, who authored a detailed paper on the subject in 2019—just ahead of the pandemic that multiplied online transactions and made the concept so critical—and followed up with a sequel last year.

Widespread awareness, he says, “began as early as 2020. People were adopting the name ‘payments orchestration’ because merchants said that’s what they’re looking for.” Not by coincidence, the dollar volume of e-commerce transactions that year, in the U.S. market alone, shot up 43% to \$817 billion, according to the Census Bureau (chart, page tk).

Confronted suddenly with a flood of volume, merchants struggled with establishing connections to multiple acquirers outside their usual scope, Pelegero adds, as acquirers were tied contractually to single processors that in turn were scrambling to forge more links.

As more and more specialists saw the opportunity and entered the market, the roster of providers of



Gray: “Everything is API now. API is the channel.”

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Peterson: “Payments were “getting more complex in 2020, 2021.”

orchestration layers grew steadily and now stands somewhere between 20 and 30, Pelegero estimates. This is how many “vendors around the world ... claim to have some level of orchestration—smart routing, multiple networks, cascading,” and so on, he says.

“Cascading” refers to the practice of pinging one processor for a price, then another, then another, until the least cost is found that can meet a merchant’s need.

‘It Was Getting More Complex’

But another factor was at work, as well, besides the urgent need to process transactions flooding in from all over the world. The underlying technology had to be ready. “The reason payments orchestration is so recent is that API technology wasn’t fully embraced until three or four years ago,” notes Thad Peterson, a strategic advisor in payments at Aite-Novarica, a consultancy.

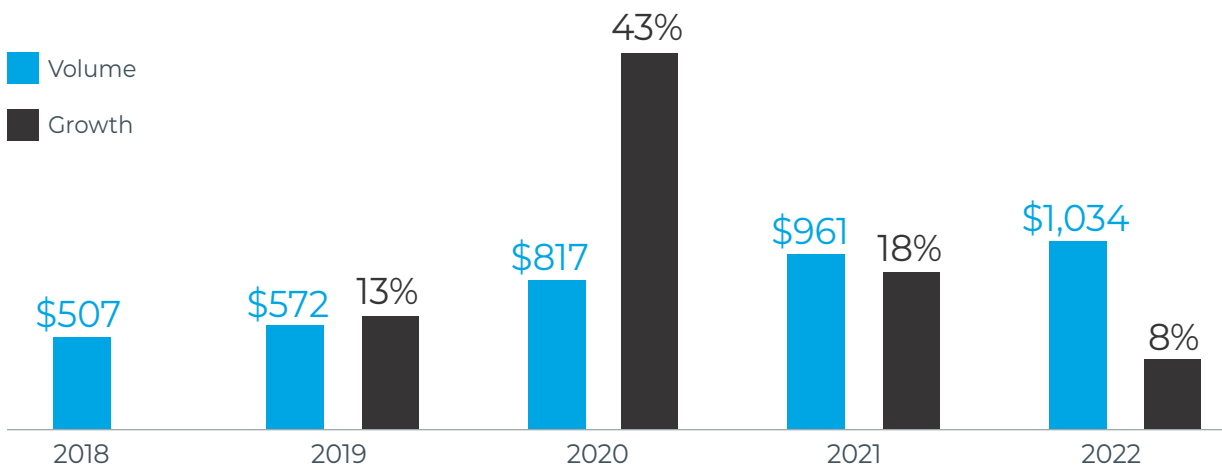
An API, or application programming interface, is critical software that manages communication between linked systems. “You can have a single API running orchestration [with] fraud control and foreign exchange,” not just payment methods, Peterson adds. “It was getting more complex in 2020, 2021.”

Added complexity only made APIs more essential. “Everything is API now. API is the channel,” says Cliff Gray, a senior associate at The Strawhecker Group, a payments consultancy, and a former executive with Chase Merchant Services and First Data Corp. “It’s far easier to orchestrate when everyone’s on the same page.”

But as is always the case with transaction processing, cost is critical. Because efficiency is one of the attributes these layers seek out, they can shave off some of the overall cost merchants must pay for processing. But that service, in turn, comes with a price of its own. Estimates, as anyone might

THE DOUBLING OF E-COMMERCE

(Online sales in the U.S. market, in billions)



Source: U.S. Census Bureau

expect, vary, and many providers contacted by *Digital Transactions* demurred when asked about their costs.

A not uncommon pricing scale is anywhere from 2 cents to a dime per transaction, depending on volume, Pelegero has found. That can add up fast. Spreedly charges a platform fee, plus a usage fee linked to volume. For a small merchant, this can come to anywhere from \$20,000 to \$25,000 per year, while a mid-size seller or larger might pay \$100,000 to \$500,000, according to chief executive Justin Benson.

But it could be getting harder for payments orchestrators to maintain pricing schedules as more providers—including payments processors themselves, like Paysafe—bust into the market. And some processors are getting more nuanced about what they offer and how they work with orchestrators.

“We prefer the merchant connect directly to us,” says Trevor Nies, senior vice president and global head of digital at Adyen NV, which Nies says works with Spreedly and “several other” companies. “Certain services are hard to make work through payments orchestration, [such as] real-time account updates.”

The thrusts by processors don’t surprise some observers, who see these moves as a response to a natural fear that orchestration could ease them out of the concert hall. “Payments orchestration is about removing the processor from the technology and making it agnostic,” says Greg Cohen, chief executive of Fortis Payment Systems LLC, a Novi, Mich.-based independent sales organization.

And while per-transaction pricing is common, not all orchestrators are following that tune. “We said let’s not do transaction-based pricing,” says

Gr4vy’s Lunn. “We’re leasing you infrastructure, we boot you up that infrastructure, so it’s a usage model. This costs you less than half an engineer per year.”

‘It Took a Long Time’

In any case, some practitioners of the orchestration arts aren’t in fear of pricing pressure from new entrants, including fintechs gone astray. The key, says Benson, is to prepare for the inevitable shakeout.

“We feel we’re in a very good place. I feel very good about the strength of our business,” says Benson. “But we’re in a time where fintechs are being aggressively funded, way too many [orchestration] firms are being funded and chasing too few merchants. We have 10 competitors—we won’t have 10 twelve months from now, maybe 24 months.”

Traditional processors, on the other hand, could present opportunity. Orchestration as a third-party deliverable remains a relatively new concept, but processors and orchestrators are learning to work together, even if tentatively.

“It took a long time. Acquirers initially were reluctant to work with us, afraid we’d take volume away from them,” says Apexx’s Bain. “It’s a mutual relationship we’ve built up. Now acquirers are saying, ‘We can’t to this [request for proposal] without you.’”

At bottom, Pelegero reminds the industry, payments orchestration is about moving transactions along the most efficient route. And that need may not always demand the most sophisticated technology. “The least-cost path is what payments orchestration is all about,” he says. “Anyone who has a gateway has some limited payments orchestration.” **DT**



Cohen: “Payments orchestration is about removing the processor from the technology and making it agnostic.”

networks

THE RULES OF THE GAME

Regulations are coming for blockchain and crypto. Here's what they'll look like and how to interpret them.

BY FELIX XU

Felix Xu is a co-founder of ARPA Network and Bella Protocol.

BLOCKCHAIN AND CRYPTO had quite a year in 2022. A crash in liquidity during the first half of the year was quickly followed by the FTX collapse in the second—all of which generated negative press. While some of these problems were not without precedent, it was their speed that altered the general public's perception of cryptocurrency and blockchain technology. Unlike previous issues, these will cause changes in the markets and institutions themselves.

However, the most important changes that are coming for the industry are the pending regulations that these crises have kicked off. It is evident that more regulations, likely stringent ones, are going to be issued in the coming months in

a number of countries. Let's take a look at why these regulations are coming, what their effects will be, and how to prepare for them.

As mentioned, last year was a rocky one for many crypto and blockchain projects. In addition to the problems faced by those in the industry, the adoption of many cryptocurrencies by members of the general public, along with increasing interaction between the crypto economy and the rest of the global financial system, meant that the problems facing crypto became problems for large numbers of people.

The collapse of FTX is a great example of this—and is proving to be a catalyst for regulation. After all, vast fortunes were wiped out. The general health of several ecosystems, including Solana, has been viewed as weaker. BlockFi, which had been bailed out by FTX earlier in 2022, has ceased operations. The FTX contagion has spread to lenders, funds, and asset managers such as Genesis, Galois Capital, Sequoia Capital, Wintermute, Multicoins Capital, Amber Group, Paradigm, and Nexo, among others.

But the FTX collapse raises questions over which federal agency will regulate the company. While this issue is likely to be resolved fairly quickly, the general question of how crypto service providers will be regulated is still to be resolved, and will likely be addressed in the light of these events.



Stablecoins have also emerged with challenges. It became clear that many coins were not backed by enough assets to warrant being pegged to fiat currencies, and algorithmic controls were insufficient to maintain their desired price levels. This came on the heels of the crash of many coins in May, an event that wiped out huge sums of money and caused a general souring towards crypto. These issues led to the collapse of Luna, UST, and 3AC and its related parties, such as Voyager Digital.

Because of the scale of these issues, and because stablecoins are the connection between crypto and the rest of the economy, these two crises were perhaps the first crypto crashes to impact the larger economy in a meaningful way. They alone would have been enough to make new regulations likely. Any industry that can damage the economy in general is going to be of interest to regulators, however the nature of these crashes has been the cause of nightmares.

A CHILLING EFFECT

So, what regulations are already on the table or are very near implementation?

In California, the state senate passed a bill that would limit

trading stablecoins to those who weren't licensed by a bank or backed by secure reserves or by the state of California. The bill, which as of early February had not yet been signed into law, would severely limit crypto exchanges.

At the federal level, the Treasury Department has also called for stablecoin regulation, and a bill has been read before the Senate Finance Committee, though by early February it had yet to be voted on.

There is also support in the Senate for the Digital Commodities Consumer Protection Act, DCCPA. However, this bill was closely tied to FTX and its chief executive, Sam Bankman-Fried, and it may well be delayed as a result of recent events. Still, the Senators who supported it then continue to do so.

The Federal Commodity Futures Trading Commission is also considering the use of its existing authority to address cases of fraud involving digital assets, including digital currencies.

In Europe, the crypto-assets bill MiCA, which would set reserve requirements for stablecoins and require authorization for wallet providers and exchanges, was set to be voted on this month. It has already passed some bureaucratic hurdles. In Singapore, which already employed

a regulatory scheme for crypto companies, a parliamentary inquiry into why FTX was not included on a list of risky investments has led to calls for more regulation.

The idea that any of these proposals are now less likely to pass or to be strongly enforced, in light of recent events, is ludicrous. If anything, these bills are likely to become even more stringent as they pass through committee.

It is highly probable that additional regulations will be issued, as well. As in other industries, this will increase the cost of doing business and may slow the industry. In the lead-up to implementation and the full establishment of the letter of the law, it is also probable that a chilling effect will impact the industry.

POSSIBLE BENEFITS

What form these regulations will end up taking is uncertain. As we can see in some of these proposed laws, as well as existing laws in the state of New York, it is possible that some new regulations will make doing business impossible for certain companies, or make certain territories unattractive.

In the worst case, many large states may be essentially locked out of the crypto market or abandoned by companies as new regulations pass.



Xu: “There is ... the possibility that regulation could benefit the industry after the implementation of the new standards has been worked out.”

However, there is also the possibility that regulation could benefit the industry after the implementation of the new standards has been worked out. The confidence of the general public in crypto, blockchain, DeFi, and other related concepts has been shattered, and a sense of reassurance by the government that an FTX-like collapse will be less likely is critical for restoring that confidence.

Likewise, the various practices that caused the recent slew of problems, including unbacked stablecoins and what appears to be outright fraud at FTX, would become less likely under a system of robust regulation.

Over the long term, protections against these issues could benefit the crypto industry in terms of a healthier ecosystem. While regulations may increase the cost of doing business for many companies and might even make some operations unable to engage with customers in

some markets, the possible benefits that regulations might provide must also be considered.

Examples of how regulation could be a positive development are easy to find in other sectors of the economy, banking in particular. The number of global banking crises went to nearly zero during the years of the Bretton Woods system, suggesting that certain regulatory systems can prevent major crises at the cost of increased oversight.

Here in the United States, banking regulations implemented in the 1930s provided protections for consumers and helped to prevent general calamities up until the Savings and Loan Crisis in the 1980s.

TOO SOON TO JUDGE

As was the case in the 1930s, when banking regulation restored public confidence in banks, regulations could help restore public confidence in crypto and DeFi. Regulations that

help prevent fraud, Ponzi schemes, or pump-and-dump operations would also help to rehabilitate crypto in the eyes of many people who are concerned about consumer protections.

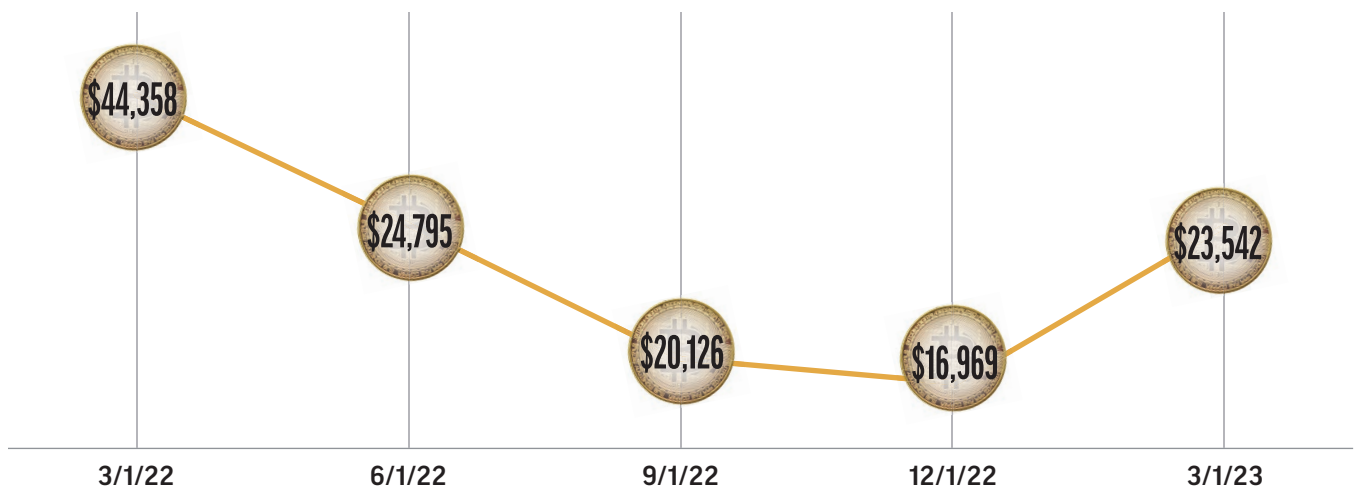
However, it is still too soon to judge exactly what the effects of the proposed legislation will be, given the shifting political attitudes toward crypto and its institutions. For example, while DCCPA may threaten DeFi's unique features of composability and permissionless characteristics, the FTX collapse may prompt rewrites that change several aspects of the bill.

In any case, centralized regulations will cause some disruption to the industry and will certainly clash with the ethos of decentralization so prevalent in crypto.

Given recent events, increased regulation of crypto is all but certain. What that regulation will look like is still undetermined, but existing regulations and proposals can give us an idea. DT

BITCOIN'S DOWNWARD SPIRAL—AND PARTIAL REBOUND

(Closing price at each date)



Source: Coinmarketcap

IT'S TIME FOR DIGITAL DRIVER'S LICENSES

It's the surest way to combat application fraud, which may reach \$1 billion this year.

BY AL PASCUAL

Al Pascual is senior vice president, Enterprise Risk Solutions, at TransUnion.



ALTHOUGH TODAY'S account-opening paradigm is guided by sound regulations and solid best practices, vulnerabilities remain. Indeed, for as long as they've existed, digital applications have been a veritable playground for identity criminals.

Barring a dramatic improvement in how the financial services industry collectively verifies identity, application fraud losses on demand deposit accounts (DDAs) are expected to reach nearly \$1 billion in 2023, according to Early Warning.

Thanks to a set of new rules and innovations, however, that may be about to change.

With scams and fraud occurring at record rates, the profitability of any customer — especially a digital one — hinges on the legitimacy of that customer's identity. Verifying that legitimacy doesn't always gel with delivering a smooth, digital-first experience. In fact, most times the two strategies are at odds.

Even with advanced technologies, plug-ins for application programming interfaces, and promises from fintech partners, financial institutions continue to roll out "digital window dressing." While the allure of online account opening may bring digital-first consumers to the brand, its failure to

follow through on its promises inevitably disappoints. Because the institution is struggling behind the scenes to reconcile analog identities with digital experiences, it simply can't deliver what today's consumer demands.

SUPPLY AND DEMAND

Fortunately, one of the bedrocks of analog identity—the driver's license—is maturing into the digital age. With it comes an opportunity for financial institutions, as well as retailers, processors and others within the digital-transactions ecosystem to have a meaningful leg up on application fraudsters while also meeting consumer demands for modern transactions.

Application-fraud losses come down to supply and demand, where financial institutions represent supply and fraud cases represent demand—and demand is rising exponentially.

Data breaches and scam proliferation aside, just look at the overwhelming number of new drop accounts in existence today. Fraudsters use these accounts to receive funds taken from their victims through authorized push payments and peer-to-peer schemes, not to mention good old-fashioned check fraud. Those scams

and many others are behind the net-new number of drop accounts, which went through the roof in 2022.

As for the supply side, banks and credit unions are still deploying their strongest identity controls on credit accounts, not demand-deposit accounts. That’s not terribly surprising when you consider the practical matter of return on investment. Dollars spent preventing application fraud must be weighed against the revenue generated from the portfolio that investment is protecting. Credit portfolios, by their very nature, produce more revenue than their debit counterparts.

Therein lies the real benefit of migrating consumers to digital driver’s licenses. The shift would dramatically raise the bar for true-name and synthetic ID fraudsters who rely on weak online application controls to establish drop accounts. Yet, it would not require a large investment from financial institutions. In fact, it may reduce some expenses.

Impersonating a legitimate (or even half-legitimate) person would be much harder if a digital driver’s license were required. That’s because the licenses are verifiable and secure. The party

relying on that information—a bank, a retailer, or a fintech—can verify the identity with the source of record, in this case, a state department of motor vehicles. And digital driver’s licenses are designed to combat efforts to alter, copy, or otherwise tamper with them.

Beyond effectively reducing fraud, the ubiquitous issuance and acceptance of digital driver’s licenses would also greatly reduce the need for a multitude of identity-proofing technologies. This, in turn, would open room in the fraud-fighting budget for some DDA protection.

As an added outcome, financial institutions would reduce friction for legitimate consumers during account opening, improving the first-impression digital experience and setting up the new relationship for long-term profitability.

CAREFUL EXECUTION

Adoption of digital driver’s licenses is gathering steam. About 30 states are already offering or testing digital driver’s licenses to their citizens, according to StateTech Magazine.

The Digital Identity Act (or some

version thereof) will ensure uniform standards for the issuance and validation of the digital driver’s license. Most issuing bodies already follow International Organization for Standardization (ISO) specifications, which has given financial-services vendors a head start in the race to develop validation systems.

Apple and Google are also now in the fray, so millions of Americans will have an easy, secure way to further migrate their once-analog credentials to their smart phones for use in the physical and digital realms.

Some financial institutions, retailers, and processors will be slow to adopt the technology, waiting until digital driver’s licenses reach their potential. Early adopters, on the other hand, will simultaneously repel fraudsters and attract new customers. Those slower competitors, impressed and scrambling to catch up, will have the added pressure of battling the opportunistic fraudsters who target their ill-equipped systems.

Like every innovation, the effectiveness of digital driver’s licenses in mitigating application fraud will come down to careful, security-aware execution.

There is little doubt criminals will attempt to circumvent the verification process. We can easily anticipate the “digital fake,” which will quickly become the bane of institutions relying on visual verification only. Farther up the sophistication chain, hackers are likely to work toward compromising the authentication technology used to digitally verify licenses.

While digital driver’s licenses may not put a total end to application fraud, it is one of the rare innovations that could end application fraud as we know it today. **DT**

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