

Unlocking The Value Of Payment Services: A Comparative Analysis Of Commercial And Contractual Models, A Guide For Merchants

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ABSTRACT

In recent years, the payments industry has gone through massive innovations. New technological modernization has brought significant changes in the eCommerce industry. Merchants and regulators are moving from traditional payments to real-time payment systems.

Merchants now have a diverse array of payment model options with their distinct challenges and pricing structures. This research will prove handy for the merchants. It gives a deep knowledge and understanding of the three most common commercial and contractual models offered by Payment Service Providers (PSPs). These models are Payment Facilitation (PayFac), Integration-Only, and Merchant-of-Record Model (MoR).

This research will enable the merchants to align smoothly and help them make informed decisions, eventually reducing business risks and catering to their needs.

KEYWORDS: Global Payment Services, Regulatory Compliance, Cross-border Payments, International Business, Payment Facilitation, FinTech.

INTRODUCTION

Being the backbone of the digital economy, the FinTech and Global Payment Services industry facilitates seamless and secure electronic transactions. Recently, there has been a significant surge in innovative payment solutions. It has improved the way businesses accept and process payments. Merchants now have many options to enhance their customer experience, increase

efficiency, and create distinctive offerings for customers.

In growing this ecosystem, PSPs have emerged as essential links between merchants, customers, and acquiring banks. PSP is a direct connection to the payment grid; it helps merchants get fast and secure payments from customers worldwide. The process saves a lot of time and helps merchants to focus more on business operations.

This research will act as a guidebook for merchants looking to gain insight into the advantages and disadvantages of each payment model. Merchants can make informed decisions that align with their specific business needs. It will also give inputs on financial considerations. With the help of these payment models, payment processing strategies can be optimized, thereby enhancing customer satisfaction. This will prove to be a greater success in the dynamic FinTech and Global Payment Services industry. This research aims to:

- **Explain the Payment Models:** Touching down on various payment processing models under the FinTech and Global Payment Services sector. Showcasing the factors that led to the emergence of models like PayFac, Integration-Only, and MoR.
- **Business Implications:** Exploring the impact of different payment models on businesses, acknowledging their operational efficiency, risk management, and overall competitiveness. Analyzing case studies and empirical evidence showcasing real-world applications and outcomes.
- **Tech-Advancements:** Inspect the technological advancements that have shaped and continue to influence the design and functionality of payment processing models. This also considers how innovations in technology impact the feasibility and effectiveness of each model.

Literature Review

The research part lies in a detailed review of relevant publications that address various aspects of payment processing models. Key publications consulted are as follows:

- **Acquiring Models, CGAP Research & Analysis Publication** (October 2019): This source is a foundational reference for understanding the broader context of merchant payment strategy. It also reflects valuable insights into evolving acquiring models in the payment industry,
- **"Identity Crisis in Payment Aggregator Models: Merchant-of-Record, Payment Facilitator, Marketplace, or Staged Digital Wallet?"** by Venable LLP in 2018: This publication offers an in-depth exploration of identity-related challenges in payment aggregator models. It also contributes to the understanding of challenges faced by merchants while pursuing each business model.
- **"Payment Options in the World of Subscription Commerce"** by Voice of the Industry (2019): Insights from this publication were instrumental in understanding payment dynamics within the context of subscription-based commerce, offering a specialized perspective on merchant-consumer interactions.
- **"The 2021 McKinsey Global Payments Report"** by Global Banking Practice, McKinsey & Company (2021) gives critical insights on global payment trends. It also offers a contemporary lens that helps analyze the models under consideration. It also helps in determining the market trajectory.

Industry Experience Integration

In addition to the above review, the author has blended his extensive industry experience in the FinTech and Global Payment Services sectors. With a strong background in hands-on involvement in payment processing, compliance models, and product innovation, the author has successfully applied practical insights gained through real-world scenarios to enhance the analysis.

Synthesis of Knowledge

The knowledge accumulated from the literature review and industry experience was systematically integrated to create a coordinated narrative in the research paper. The intention was to bridge theoretical insights with practical implications, which offers a global

understanding of the intricacies associated with each payment processing model.

This collective approach combines the theoretical foundations from reputable publications with industry knowledge; this helps in forming the backbone of the research methodology employed in this study. The research output is grounded in established scholarship. As a result, it reflects the practical realities merchants and Payment Service Providers face in the dynamic landscape of FinTech and Global Payment Services.

RESEARCH METHODOLOGY

The research methodology employed in this study is an extensive and integrative approach that combines a thorough review of existing material with the author's in-depth industry experience. The aim was to create a meticulous and informed analysis of the prominent commercial and contractual models offered by Payment Service Providers (PSPs) to merchants: the Payment Facilitation Model (PayFac), the Integration-Only Model, and the Merchant-of-Record Model (MoR).

OBJECTIVES OF THE STUDY

- To analyze the Operational Mechanics: Examine and annotate the operational intricacies of each payment processing model. It will spon the roles and responsibilities of merchants and PSPs in the PayFac, Integration-Only, and MoR models.
- To evaluate Regulatory Compliance: Evaluate the regulatory compliance requirements connected with each payment model. It investigates how adherence to regulations impacts the operational and strategic choices of merchants engaged with these models.
- To examine Tax Implications: Investigate the tax inference and challenges merchants face operating under the PayFac model. It focuses extensively on cross-border transactions and compares these findings with the tax dynamics of the MoR model.
- To understand Technological Dependencies: Explore the technological dependencies inherent in each model. It ponders factors like API integration, data security, and the technological framework required for seamless payment processing.

HYPOTHESIS OF THE STUDY

- **MoR Model Reduces Tax-Related Burdens:** It is hypothesized that the Merchant-of-Record Model reduces tax-related complexities and burdens on merchants in cross-border transactions compared to the other two models.
- **The PayFac Model Expedites Merchant Onboarding:** We hypothesize that by undertaking the MoR and the PayFac model, the merchant onboarding process is relatively more manageable than the Integration-Only and MoR models.
- **Integration-Only Model Requires Higher Technical Expertise:** We hypothesize that the Integration-Only Model offers high customization. It also entails a higher level of technical expertise on the merchants' part compared to the PayFac and MoR models.
- **MoR Model Results in Greater Cost Savings:** It is hypothesized that the Merchant-of-Record Model, though it could lead to higher fees charged by PSPs, by handling extensive aspects of payment processing, results in more significant cost savings for merchants as compared to the PayFac and Integration-Only models.

LIMITATIONS OF THE STUDY

This research endeavors to provide an encompassing study of the Payment Facilitation Model (PayFac), the Integration-Only Model, and the Merchant-of-Record Model (MoR) in the context of Payment Service Providers (PSPs) and merchants. It is crucial to consider certain limitations inherent in the study.

Generalization Challenges:

The findings and conclusions drawn in this research are based on a combination of existing material, industry experience, and observations. However, it is crucial to recognize that the FinTech and payment industry dynamics are varied and rapidly changing. Establishing the findings in every business context may oversimplify the complexities across different sectors and geographic locations.

Temporal Factors:

FinTech and payment services experience constant innovation, regulatory changes, and technological expansion. At the time of this study, the insights reflect the industry outlook up to the latest available publications and the author's industry experience. Subsequent developments may have occurred, potentially influencing the significance and relevance of certain findings.

Data Limitations:

The research relies on publicly available literature and the author's industry insights; this introduced potential limitations in access to confidential information. The absence of specific data points or proprietary details may impact the depth of analysis in certain areas.

Industry-Specific Variation:

The study aims for broad relevance but may need to fully capture the variations specific to certain industries or niche markets. Payment processing models may vary due to their implications based on industry characteristics, though this study may not account for all possible variations.

Regulatory Dynamics:

Regulatory frameworks in payment services can vary significantly across jurisdictions. Efforts have been made to consider a global perspective; specific modulations related to regional regulations may still need to be fully explored, which might impact the general ability of regulatory insights.

Evolutionary Nature of Technology:

The rapid advancement of technology in the FinTech sector means that the state of technological infrastructure, security standards, and industry best practices may have evolved since the release of this study. The research provides a snapshot at a specific time, and technological advancements may not be fully incorporated after this period.

DISCUSSION

This research focuses on three prevalent commercial and contractual models offered by PSPs to merchants:

1. **Payment Facilitation Model (PayFac):** In this model, the PSP handles all payment processing aspects that focus on risk management and compliance.
2. **Integration-Only Model:** This model grants merchants complete control over payment processing. It also allows them to manage customer data and directly handle risk management and compliance.
3. **Merchant-of-Record Model (MoR):** PSPs retain full responsibility for payment processing in this model, which includes account risk management, compliance, customer data handling, and tax-related compliances.

The research analyzes each model's value proposition, challenges, indicative pricing structure, and fund flow intricacies. Further, it examines each model's legal implications, highlighting the significance of regulatory compliance and risk alleviation strategies.

PayFac or Payment Facilitation Model:

Payment facilitation is a payment processing model offered by the Payment Service Providers (PSPs). It allows businesses to accept payments without obtaining their own merchant account. In this model, the PSP acts as a master merchant account holder. It also handles all of the underwriting and processing for the businesses onboard, known as sub-merchants; this simplifies the payment processing experience for businesses and allows them to focus on their core capabilities.

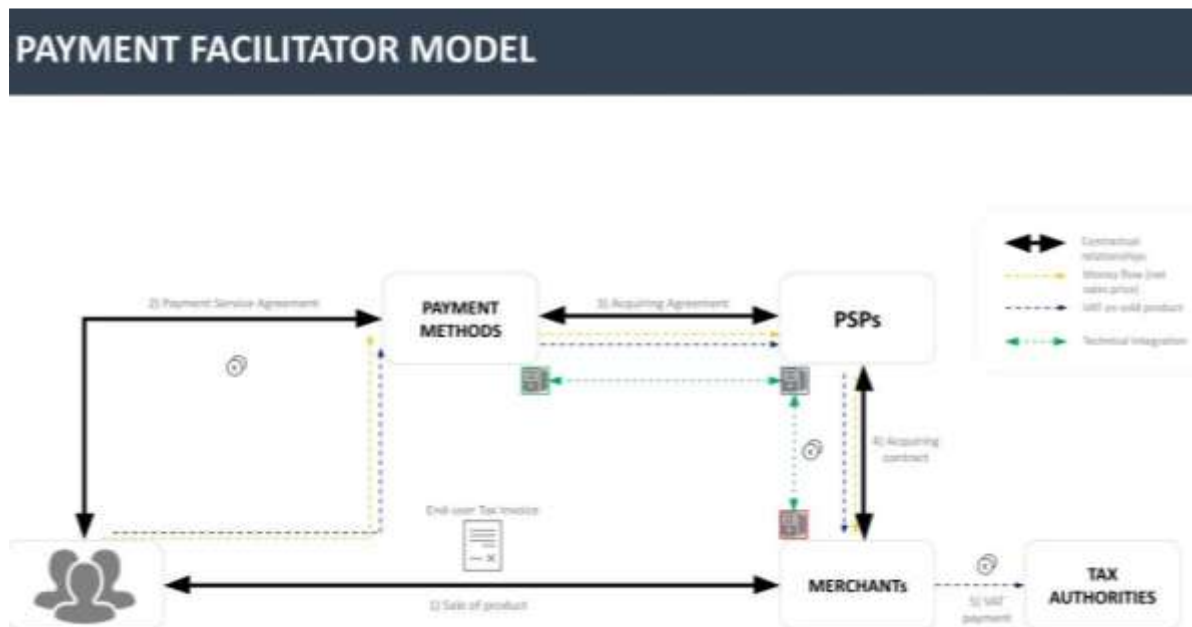
Licensing Requirements for Payment Facilitators

To operate as a PayFac, PSPs must obtain licenses from the relevant regulatory authorities. The specific licensing requirements vary depending on the PSP's jurisdiction. However, some common licensing requirements include:

- **Payment Institution (PI) License:** A PI license is required for PSPs that engage in certain payment activities, such as issuing payment instruments (e.g., prepaid cards) or handling funds. These services are distinctly mentioned in the license.

- **Money Transmitter License (MTL):** An MTL is required for PSPs that transmit money across borders or within certain jurisdictions.
- **PCI DSS Certification:** PCI DSS certification is a security standard that ensures that credit card data is protected from unauthorized access. PSPs must be Level 1 PCI DSS certified to process credit card payments.

Diagram A: PayFac Model



In the Payment Facilitation model, the merchants sell the products directly to the end-users. PSPs and Payment Methods collect such funds on the merchants' behalf. As the seller of the product, the merchant is responsible for clearing the VAT to the relevant tax authority:

- VAT-inclusive price is collected from the end-user
- VAT is then passed to the merchant (plus the payout)
- The Merchant pays the applicable taxes.

Additional Considerations for PSPs Offering Payment Facilitation:

Apart from obtaining the necessary licenses, PSPs offering payment facilitation should have robust fraud prevention and risk management practices in place. They must also meet all applicable data privacy regulations like the General Data Protection Regulation (GDPR).

Benefits of Payment Facilitation for Businesses

The payment facilitation model offers several benefits to businesses, including:

- **Faster and easier onboarding:** Businesses can start accepting payments quickly and effortlessly without the hassle of applying for and underwriting a traditional merchant account.
- **Reduced complexity:** Businesses do not need to deal with the complexities of payment processing, as the PSP handles all technical aspects.
- **Access to a broader range of payment options:** PSPs typically offer a wider range of payment options than conventional merchant acquirers.
- **Lower costs:** PSPs often have lower fees than conventional merchant acquirers, especially for small businesses.

Overall, payment facilitation is an apt tool for all businesses that want to accept payments online or in person. It offers a simplified, cost-effective, and secure way to process payments and business growth.

Merchants often face crucial challenges in cross-border payments when navigating the intricacies of tax invoicing and settlement in multiple foreign countries; this proves true for the merchants who choose the Payment Facilitator (PayFac) model offered by Payment Service Providers (PSPs). The merchant is responsible for end-user tax invoicing and settlement with local tax authorities. It can be an intimidating task for businesses without the necessary expertise and resources.

The complex nature of tax regulations across different jurisdictions makes it difficult for merchants to stay compliant and avoid costly penalties. Managing tax filings, understanding local tax codes, and ensuring accurate remittance can be immense for small and medium-sized businesses.

PayFac model often requires merchants to form local legal entities or engage third-party tax representatives in each country; this further adds to the complexity and expense and can be a hurdle for businesses looking to expand their reach into new markets.

This reason is enough for many merchants to find the PayFac model challenging. They may prefer

By choosing alternative payment processing solutions, the tax-related complexities can be solved. Merchants can expand their cross-border operations with greater ease and efficiency. It will help merchants save time, reduce costs, and avoid potential tax compliance issues.

The Merchant-of-Record (MoR) Model is an entity that is responsible for selling services to an end customer. When a PSP acts as an MoR, it allows merchants/businesses to sell goods and services online without setting up merchant accounts. It helps businesses focus on what they do best - running their business without worrying about international payments and tax compliance complexities. In this model, a third-party MoR provider assumes responsibility for all financial aspects of the transaction, which includes payment processing, currency conversion, tax collection, and fraud prevention.

THE MERCHANT-OF-RECORD (MoR) MODEL

The diagram illustrates the Merchant-of-Record (MoR) model, showing the flow of goods, money, and data between a Merchant, a Payment Service Provider (PSP), and a Merchant of Record (MoR).

Legend:

- Double-headed arrow: Commercial relationship
- Dashed yellow arrow: Money flow (not within period)
- Dashed black arrow: Not an asset product
- Dashed green arrow: Technical connection

Flow Diagram:

- Merchant** (represented by a group of people icon) is connected to the **PSP (acting as MoR)** via a double-headed arrow labeled "1) Sale of product".
- The **PSP (acting as MoR)** is connected to the **MERCHANTS** (represented by a storefront icon) via a double-headed arrow labeled "2) Distribution / Retail agreement".
- The **PSP (acting as MoR)** is connected to the **PAYMENT METHOD** (represented by a credit card icon) via a double-headed arrow labeled "3) Acquiring contract".
- The **PSP (acting as MoR)** is connected to the **TAX AUTHORITY** (represented by a document icon) via a dashed black arrow.
- The **PSP (acting as MoR)** is connected to the **Merchant** via a dashed green arrow labeled "4) Service provisioning & SaaS".
- The **PSP (acting as MoR)** is connected to the **PAYMENT METHOD** via a dashed yellow arrow labeled "5) Payment Service Agreement".

- Local payment providers (eWallets, cards) will settle the collected amounts with the PSP as the legal owner of the funds. (incl. VAT)

- PSP pays VAT amounts to local tax authorities.
- PSP settles net amount with Merchant.

Key Features

- **Local bank accounts are not required:** Merchants do not need to set up local bank accounts to accept multi-currency payments.
- **Simplified compliance:** The MoR provider handles all compliance requirements, including PCI-DSS, data protection, and tax regulations.
- **No local legal entity required:** Merchants are not required to establish a local legal entity in countries where their PSP acts as an MoR.
- **Centralized payment processing:** All payments are processed through a centralized platform.
- **Global tax compliance:** The MoR provider calculates, files, and revokes taxes in all applicable jurisdictions.

Benefits:

- **Reduced costs:** Merchants will be free from paying the cost of setting up and maintaining merchant accounts. They are also free from managing international payments and complying with tax regulations.
- **Increased efficiency:** All the focus will be on the core business operations while the MoR provider manages the complexities of payment processing and compliance.
- **Expanded reach:** Merchants can sell to customers in multiple countries, and the MoR will handle all local regulatory and tax requirements.
- **Reduced risk:** Merchants are not accountable for any financial or legal risks associated with payment processing or compliance.

How it Works:

- The merchant integrates their website or online store with the MoR provider's platform.
- Customers are directed to the MoR provider's payment gateway during purchase.
- The MoR provider processes the payment and collects the necessary information for tax compliance.

- The merchant will receive the net amount of the sale minus any fees or taxes deducted by the MoR.
- MoR does the filing and tax remittance to the appropriate authorities.

The MoR Model is ideal for businesses that:

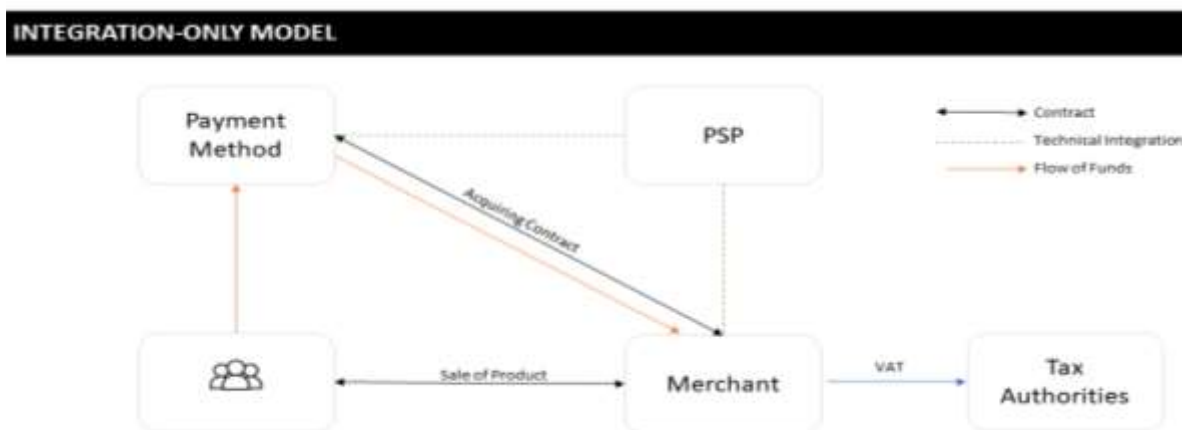
- Sell goods or services to customers in multiple countries.
- Do not want to deal with international payments and tax compliance complications.
- Looking for a cost-effective and efficient way to process payments online.

The MoR Model is a valuable solution for businesses that want to simplify their payment processing and compliance efforts; this helps expand their reach into new markets.

Integration-Only Model for Payment Processing:

With the help of this model, PSPs provide businesses with a payment processing API which allows them to integrate payment functionality into their websites or applications. Businesses will get more control over the payment experience and require more technical expertise.

Diagram C: Integration-Only Model



Key features of the integration-only model:

- The payment experience can be customized to match the business's brand and branding.
- PSPs charge lower fees to the merchants as merchants handle more of the payment processing on their own.

Benefits of the Integration-Only model:

- Businesses that deal with complex payment frameworks will benefit from the integration-only model.
- Businesses can reduce downtime risk or service disruption by not relying on third-party providers.
- This model will bring more visibility into the payment processing process for all businesses.

The integration-only model is apt for businesses with technical expertise and those needing a high degree of customization over the payment experience. The only constraint is that this model may not be the best choice for businesses new to online payments or with low transaction volumes. Merchants must establish direct payment processing contracts with each payment method they offer while using this model; this might be complex and time-consuming. Merchants are required to manage settlements and integrate each payment provider separately; this adds to the administrative burden.

FEES CHARGED BY PSPs TO MERCHANTS:

Integration-only model:

In the integration-only model, the merchant is responsible for handling all aspects of payment processing, including underwriting, merchant account management, authorization, and settlement of payments. The PSP provides merchants with a payment processing API to integrate payment functions into their website or application. As a result, the fees charged by PSPs in the integration-only model are typically the lowest, as they only provide a limited range of services.

Payment Facilitator (PayFac) model:

In the PayFac model, the PSP assumes control over some aspects of payment processing, such as underwriting and merchant account management. The merchant still retains responsibility for sanctioning and settling payments. They do not need to obtain their own merchant account. The payment processing experience for businesses gets simplified, allowing them to focus on their core competency, i.e., running the business.

However, the fees charged by PSPs in the PayFac model are typically higher than those in the integration-only model. The PSP is assuming more risk.

Merchant-of-Record (MoR) model:

In the MoR model, the PSP assumes responsibility for all aspects of payment processing. MoR allows businesses to offload their operational work; this is the most comprehensive payment processing model. The fees charged by PSPs in the MoR model are typically the highest, as PSPs are assuming higher risk.

Here is a table summarizing the key differences between the three payment processing models and their fee structures:

	Integration-only model	PayFac model	MoR model
PSP involvement	Provides payment processing API	Handles underwriting, merchant account management	Handles all aspects of payment processing, including tax invoicing and settlement
Merchant involvement	Handles all aspects of payment processing	Retains responsibility for authorizing and settling payments	Does not handle any aspects of payment processing
Fees	Lowest	Medium	Highest
Suitability	Businesses with technical expertise and control over the payment experience	Businesses without technical expertise or those that want to reduce their payment processing overhead	Businesses that want to outsource all aspects of payment processing and tax compliance

CONCLUSION

This extensive research has provided a detailed comparative analysis of PSPs' three key commercial and contractual models. These models are the Payment Facilitation Model (PayFac), the Integration-Only Model, and the Merchant-of-Record Model (MoR). Each model has been reviewed in detail, revealing its strengths and accompanying challenges. This study enables merchants to optimize payment processing strategies, enhance customer satisfaction, and strategically grab emerging business opportunities.

Merchants are now equipped to make informed decisions with the help of streamlined onboarding, enhanced customization, and comprehensive

outsourcing of payment responsibilities. These decisions align seamlessly with their unique operational strategies. The insights in this research will significantly change how vital decisions are made in global payments.

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