Exploratory analysis of the prospects for, and potential impacts of, ATM scheme competition

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Executive Summary

i. This report considers the prospects for, and potential impacts of, greater competition between Automatic Teller Machine (ATM) schemes in the UK, particularly the LINK scheme and alternative ATM schemes, such as those operated by Visa and MasterCard. The report is intended to be exploratory in focus, and to advance discussion and thinking on how competition between ATM schemes might work in practice, and what impacts it could have on Payment Service Providers (PSPs) and ATM users. In this respect, the report does not advocate for competition between ATM schemes, nor for any particular competitive arrangements. Rather its focus is speculative, and involves identifying possible scenarios of how competition between schemes might emerge/work, and then conjecturing about how different participants would be affected in these scenarios.

ii. The economic issues raised in this report are complex, and economic opinion on the issue of the impacts of ATM scheme competition is mixed: some analysts have suggested that competition among ATM schemes will lead to a 'race to the bottom', while others see potential efficiency benefits from greater competition.

iii. To enable customers of any bank/Payment Service Provider (PSP) to use their card at almost any ATM, card issuers (such as banks) and ATM acquirers (those who own and deploy ATMs) have developed shared governance and access arrangements known as ATM Schemes. ATM acquirers can belong to multiple schemes (i.e.: multi-home), but card issuers must choose a single ATM scheme by which its domestic debit card transactions are processed as a default (i.e.: single home).

iv. ATM schemes are multi-sided platforms, meaning that the volume of transactions is determined both by the number of cardholders on one side <u>and</u> by the number of ATM machines on the other side. The challenge of the operator of a multi-sided platform – such as an ATM scheme – is to apply a pricing policy such that the platform can increase the number of interactions between the two groups (i.e.: cardholders and ATM acquirers).

v. Three shared ATM schemes operate in the UK: LINK (a not-for-profit membership organisation), Visa and MasterCard. LINK is connected to almost all ATMs, while Visa and MasterCard also have high levels of ATM connectivity.

vi. ATM schemes determine the level and structure of interchange fees and other charges for use of ATMs that participate in their scheme. An interchange fee (or ATM service fee) is a payment by a cardholder's bank (on behalf of the cardholder) to the ATM acquirer to compensate the acquirer for the costs it incurs in operating the ATM. The interchange fee (or ATM service fee) is intended to be a proxy for the price that an

ATM acquirer could have charged the cardholder if they levied the charge directly. Evidence submitted to the Treasury Select Committee in 2012 estimated the average cost of ATM/Interchange Fees was between £10 per customer per year (for RBS) and £12 per customer per year (for Lloyds).

vii. The LINK interchange fee has historically been calculated by estimating the total annual cost of operating the free-to-use (FTU) ATM estate in the previous year and dividing it by the number of transactions in that year, to give an average price per transaction for the following year. In principle, the cost-based LINK methodology for estimating the interchange fee has been argued to ensure that the deployment of ATMs is responsive to user demand, and creates incentives for ATM acquirers to be efficient. However, in practice, the number of FTU ATMs has continued to grow despite declining consumer demand for cash payments, and the overall cost of ATM provision has been increasing over time despite expectations of efficiency gains. These factors have led to a review of the LINK cost-based methodology, and to various proposals for changes to that methodology.

viii. The ATM charging approaches adopted by the alternative ATM schemes are commercially confidential. Accordingly, it is not clear how the alternative ATM schemes determine their charges, and in particular the extent to which such charges reflect underlying ATM acquiring costs. In addition, it is not clear how the usage charges levied by the alternative ATM schemes on Card Issuers relate to the ATM Service Fees paid by the alternative ATM schemes to ATM acquirers.

ix. One way to conceptualise the current LINK scheme is as a franchise that comprises all of the ATM acquirers in the UK (the ATM estate). Two questions arise when thinking about competition within this franchising frame: (i) could alternative ATM schemes operate the entire ATM estate at lower cost than LINK? (i.e.: less than £1 billion a year), or (ii) could alternative ATM schemes operate some part of the existing ATM estate at lower cost than LINK, and what implications would this have for interoperability, pricing and overall system costs?

x. The potential impacts of greater ATM competition are explored in this report under three different scenarios for how the alternative ATM schemes (e.g.: Visa and MasterCard) might choose to compete with LINK in relation to domestic ATM transactions. The main insights from this analysis:

- Card Issuers who switch to the alternative ATM schemes could benefit in the short-term (if charges are lower). Over the long-term, the impact for Card Issuers will depend on the extent of competition between ATM schemes, and whether the alternative ATM schemes choose to increase prices and/or reduce coverage.

- ATM acquirers could observe reduced LINK revenues in the short-term. However, additional revenues from alternative ATM schemes in the form of ATM

Service Fees may offset this. Over the long-term, whether or not the revenues derived from the alternative ATM schemes are sufficient to offset the loss of LINK revenues will depend on whether the ATM Service Fee offered by alternative ATM schemes is higher or lower than the LINK interchange fee and the number of transactions processed.

- The impact on LINK is likely to depend on whether its cost-reflective methodology for estimating the interchange fee is adapted as competition develops. If it is not adapted, then LINK may not be sustainable over the long-term.

- The impact on the alternative ATM schemes will depend on their pricing strategy and the overall strategic motivation for competing.

- Cardholder impacts will depend, in part, on: (i) whether any reduction in card issuing costs are passed on to cardholders by the Card Issuers; (ii) whether LINK adapts its cost-reflective interchange fee methodology to account for competition; and (iii) how the alternative ATM schemes manage both sides of the market, and in particular, whether the ATM Service Fee is set at a level sufficient to compensate the majority of FTU ATM acquirers' costs (i.e.: such that there is no significant change in the FTU ATM footprint).

xi. The scenario analysis suggests that, from a consumer/cardholder perspective, there is a potential (static) trade-off associated with greater ATM scheme competition. Greater ATM scheme competition *may* reduce prices for banking services (because of reductions in ATM attributed card issuer costs), but this could be associated with a reduction in quality (in terms of a reduced footprint of FTU ATMs). This raises two immediate questions: (i) which do consumers value more in the short-term: potentially lower prices for banking services or greater access to FTU ATMs?; and (ii) are there any potential dynamic benefits for consumers of greater ATM scheme competition, including a reduced footprint of FTU ATMs? (e.g.: in terms of a shift towards non-cash forms of payment and innovation).

xii. To the extent to which ATM scheme competition results in lower revenues for some FTU ATM acquirers, and this results in some ATM acquirers exiting the market or closing down specific FTU ATM facilities, this will reduce the size of the FTU ATM footprint and could have implications for the size of any financial inclusion fund/payments. If the current FTU ATM footprint is to be maintained as competition develops it may be necessary to re-design the LINK financial inclusion programme to provide an appropriate surcharge/uplift to sustain access to a minimum acceptable level of ATMs. Alternatively, consideration might be given to whether the financial inclusion programme should be funded by other ATM schemes in addition to LINK. When considering such changes it should be recognised that convenient access to cash is not costless and involves the cross-subsidisation of one group of consumers by another group. This means that any re-design of the financial inclusion programme should ensure that highly inefficient FTU ATMs are not funded, and that the costs of convenience associated with subsidising a FTU ATM are compared to the costs of inconvenience associated with other non-cash forms of payment.

xiii. Multiple domestic ATM schemes/networks operate in other countries. However, the existence of multiple schemes does not necessarily equate to 'competition' among ATM schemes, and greater levels of competition tend to exist in countries, like the USA, where the schemes are not all bank/PSP-owned and operated. The existence of multiple ATM schemes/networks is often accompanied by surcharges being levied for connections made across schemes, and in some cases, card issuers also levy charges directly on cardholders for the use of another scheme's ATM (so-called 'foreign fees'). Notably, in all countries surveyed, the level of per-transaction surcharges levied is generally considerably higher than the current LINK interchange fee.

xiv. Notwithstanding the current low share of ATM transactions of the alternative ATM schemes (which relate mainly to transactions involving international cards and credit cards) it is realistic to think that ATM scheme competition could intensify for the following reasons. First, the conditions to facilitate/enable competition between ATM schemes already exist, as many ATMs are connected to LINK, Visa and MasterCard. Second, as noted in media articles in early 2017, one Card Issuer has decided to switch away from LINK and there are suggestions that another large Card Issuer may have contemplated leaving LINK. Third, there are some suggestions that alternative ATM schemes are seeking to be more active in the domestic ATM market, and are offering rates that are 30% lower than those offered by LINK. Finally, domestic inter-scheme ATM competition already exists in other countries.

xv. The potential impacts of greater ATM scheme competition will depend not only on the form of competition, but also on the behaviour of different participants. Important determinative factors of the impacts include: whether and how LINK adapts its methodology for estimating the interchange fee; whether the alternative ATM schemes decide, or are required, to establish cost-reflective tariffs; how the costs incurred by the alternative ATM schemes for servicing the ATM estate compare to those of LINK; the pricing approach adopted by the alternative ATM schemes to the different sides of the market; the strategic motivations of the alternative ATM schemes, and in particular, whether they focus on maximising profits from ATM activities on a stand-alone basis, or see it as part of a wider profit maximising strategy across all activities including their non-cash activities; the extent to which Card Issuers are concerned about the size of the ATM footprint of different schemes; and the extent to which different FTU ATM acquirers remain sustainable if the combined revenues from the LINK interchange fee and the alternative schemes' ATM Service Fee are reduced from current levels.

xvi. The precise implications of greater ATM scheme competition will depend significantly on how the competitive *process* evolves. However, based on general economic principles, and the experience of ATM competition in other countries, the following might be observed: (i) alternative ATM schemes seeking to compete with LINK will likely focus attention on the Card Issuing side of the market rather than the ATM acquiring side (as ATM acquirers can 'multi-home'); (ii) if the current membership of LINK does divide, and multiple domestic ATM schemes emerge, there will likely be a need for interoperability agreements between the multiple schemes; (iii) surcharges may be levied on cardholders for connections made across networks; (iv) there is no guarantee that the existing footprint of FTU ATMs will remain intact. Competition should determine the number of ATMs deployed and at what price.

xvii. Building on the exploratory analysis in this report, the PSR might consider, as a possible next step, further developing its own understanding of the potential forms that ATM-scheme competition could take, and its associated implications. Among the issues that may be useful to consider further include the plausibility of the different scenarios set out in this paper for how ATM scheme competition might evolve, and the importance of convenience to consumers including how much cardholders are prepared to pay for such convenience.