

## Time for Banks to Rethink the ATM Business Model?

Through the early and mid 90s managing ATM service provision was a role avoided by ambitious European bankers who wanted challenges. Networks had matured, interbank frameworks were in place, customer demand for cash anytime, anyplace, anywhere, was high and counter cash displacement was being achieved. Banks were fully in control. The ATM became an important extension of the bank's brand and was often the closest customers got to entering a branch. Nearly all banks were focused on service provision and little attention was paid to running ATMs as a business. Those who managed ATM operations could arrive late, leave early and look forward to easily earned annual bonuses.

However in some countries those involved in the current ATM business now look back and wonder why a one time banking backwater is being turned upside down by market pressures.

The clearest example of this coming change is in the UK and Ireland, always a pre-continental European test-bed for concepts pioneered in the USA. The mainland watches and waits to see how well (or badly) the British Isles succeeds and then develops and adapts solutions to their local markets. Consciously or unconsciously the traditional model for the ATM business is being severely tested in Britain. What lessons can the rest of Europe learn from this painful British experience?

Key UK ATM Statistics	
• Number of bank owned ATMs	28k
• Number of ISO owned ATMs	8k
• Total transactions per annum	2,100m
• Annual Growth	46%
• Disloyal Transactions	47%
• ISO Players	11

**Table 1 – UK ATM Market Data**

ATM operations have many similarities to the POS cards business in that large banks support both issuing and acquiring functions. But there are radical differences in the frameworks they adopt. Each internal business has very different perceptions of the role of the ATM and the strategies that should be followed to win in the marketplace.

The ATM Issuing Business (typically the Retail bank) builds "**convenient ATM cash access**" into its product propositions. The ATM is a brand extension as well

as an important service to customers. The issuer business suffers from mild schizophrenia. On one hand it demands customer loyalty but recognises that ATMs are costly and that a limited service (or reach) can be delivered by bank owned ATMs. It accepts that full national ATM coverage can only be achieved by paying (through negative interchange) for customers to use competitor ATMs, a practice it finds thoroughly distasteful. Thus card issuers seek the lowest level of interchange cost and, to minimise outflows, want customers to be loyal to the bank brand. Issuers also use disloyalty fees as a crude behaviour change tool to persuade customers not to use competitors' ATMs. On the other hand when customers are promiscuous it is delighted to receive disloyalty revenue, which offsets interchange costs and improves the profitability of current and savings accounts.

The ATM Acquiring Business is also similar but different from the POS plastic card payments model. It is positioned much closer to conventional retailing with the bank owning, installing and operating ATM devices. In addition to delivering services to the issuer businesses' customers the ATM acquirer seeks to sell or "retail" cash and to generate revenue streams. The acquirer business is less concerned with loyalty or disloyalty and will sell cash to any banks' customer for a fee. The acquirer business wants interchange to be set as high as possible. It also supports directly surcharging non-customers for cash withdrawal rather than bank customers indirectly through disloyalty fees.

Both businesses also have different perceptions of their customers. Issuers seek to sell services to personal customers via the ATM channel. Non-customers are a secondary target. The acquirer business sees the issuer as an internal client that uses its ATMs free of charge. Non-customers are a vital source of interchange revenue. Similarly acquirers focus on external clients, large corporates and supermarkets to locate ATMs at their outlets and to generate interchange and fees. The acquiring business perceives other ATM operators and 3<sup>rd</sup> party independent deployers or sales organisations (ISOs) as their primary competitors, less so retail banks.

These major differences in perception are contrasted within Table 2 below.

Issuer Business Perceptions	Acquirer Business Perceptions
• Perceives ATM as a service	• Perceives ATM as a business
• Supports bank customers only	• Sells cash to anyone
• One customer group	• Several customers
• Supports Disloyalty fees	• Supports Surcharging
• Wants lowest possible interchange	• Wants highest possible interchange
• Competitors – other retail banks	• Competitors other acquirers, ISOs, cash back, counter cash

**Table 2 - Differing Internal Perceptions of the Role of the ATM**

Many would argue that the divisions that have occurred in the UK ATM market over the past four years are a direct result of the collective tensions between these issuing and acquiring businesses. Each has jockeyed for ownership of revenues and the consumer relationship often with highly damaging consequences. These subtle tensions have most clearly expressed themselves at an interbank level resulting in conflicts over commercial frameworks, pricing, and transfer costing. In turn, as these conflicts have become public they have drawn in regulators, government and the media. The following paragraphs describe their powerful effect and the way in which they have undermined the banks' control of their ATM businesses, destroyed revenues and left many UK banks

searching for new strategies. Table 3 provides a Timeline of events since the mid 1990s, which are reviewed in more detail within the following paragraphs.

First in the late 1990s three far-sighted UK banks moved from simple ATM service provision to an aggressively acquirer based strategy of ATM placement, selling remote ATMs to major supermarkets and offering high rentals as an inducement. Consumers were delighted to withdraw cash when shopping. Transactions moved out of branches to high volume remote sites resulting in a gradual shift of interchange flows to these acquiring banks. Although not evident at the time this was an important victory for acquirer led ATM marketing strategies.

Second, from 1998 the UK clearing banks joined the shared Link network and wound up their two limited proprietary networks, increasing their reach to 23,000+ ATMs and substantially enhancing the consumer proposition. A common network was perceived to be to be a victory for consumer lead strategies although acquirers benefited from additional interchange revenues.

Third, by Q3 1999 major banks completed the implementation of Disloyalty fees. Customers who withdrew cash from competitors' ATMs outside a free-of-charge reciprocity group were charged 80p - £1.50 per withdrawal. Many were not deterred. The issuer businesses received substantial new incomes, offsetting a high proportion of interchange. Issuer driven strategies reached a high point as revenues soared.

Fourth, at an interbank level there was recognition that the UK had too few ATMs compared with other European countries. This view coincided with new higher interchange costing data and a higher differential rate for remote locations. Acquirers won a substantial increase in revenues encouraging investment in remote ATMs.

Years	Event	Impacted
Pre 1997	ATMs a consumer 'Service'	Issuer strategies predominate
1997-1998	Aggressive banks win supermarket remote ATMs	Acquirer strategies win
1998-1999	Major shift of transactions to remote sites	Acquirer revenues rise
1999	Major banks - separate networks wound up.	Issuer strategies benefit
1999	Interchange costs rise substantially	Acquirer revenues rise
1999	Banks implement Disloyalty Fees	Issuer revenues rise
1999	Surcharging concept floated. Government, media consumer groups object	Acquirer strategies damaged
1999-2000	Regulatory referral -. Link becomes more transparent, opens up to ISOs	New competition for acquirers
2000	Banks drop all charges from 2001 onwards	Fatally damages issuer revenues
2000-2001	ISOs join Link. Enabled to Surcharge	Surcharging becomes primary revenue generator
2001	Imbalances in interchange flows appear and all revenues disappear	Issuers move to loss
2002	Interbank costs fall. Acquirers move to loss.	Issuers benefit
2002	Consumer promiscuity accelerates	Acquirer revenues damaged

**Table 3 Timeline of Issuer/Acquirer Conflict**

Fifth, the predominant consensus on the use of issuer disloyalty charging was undermined in late 1999 when "**Surcharging**" non-customers was promoted by a

minority of banks. This was an acquirer driven strategy which could damage issuer revenue streams. A minority of non-charging banks also objected strongly. Surcharging and the potential for double charging resulted a regulatory investigation under government direction. Added pressure came from the media, major supermarkets and consumer lobbies. Banks were forced to agree to drop all charging fatally damaging their issuer business revenues.

Sixth, under similar regulatory pressure the Link network was opened to ISOs. ISOs chose to surcharge customers fees of £1.25 per withdrawal much to the chagrin of banks who had just agreed to drop charges. The ISOs are now impacting the UK market with over 8k ATMs installed in convenience locations. ISOs have now established surcharging as the primary ATM revenue stream.

Seventh, by early 2001 the distribution of interbank revenues between issuer and acquirer banks showed severe imbalances just as all revenues disappeared. Issuers forecast severe losses over the next five years.

Eighth, in late 2001 the annual regulatory review reduced interchange fees by almost 30% (as a result of rapid growth and lower operating costs), severely damaging acquirer' incomes.

Last, by early 2002 a no charge environment radically reduced consumers' loyalty. Promiscuity growth of 30% is now being observed. The beneficiaries are acquirer banks with well-located ATMs but lower interchange rates has driven some banks into loss and halted the expansion of remote ATM siting.

These events have caused great disruption to the UK ATM businesses. Non Interchange revenue streams for both businesses have totally disappeared and new competitors have seized the initiative. Clearly banks need to take radical action.

To some extent the damage is self inflicted. Banks install expensive full function ATMs in branches and also at remote sites. Costs of equipment, installation and operation are high reflecting a perceived need for high availability and security. However, banks' greatest disadvantage is their limited commercial focus and their inability to continue to win prime sites that generate profitable transactions.

ISOs on the other hand have the key advantage of charging and thus can offer site owners' attractive rental and revenue sharing deals. ISOs also have flexible business models, offer lower cost devices and operational costs. They operate to principles that ensure a compelling 'convenient' cash retailing proposition. Just like conventional retailing, ATM economics are driven by the mantra "location, location, location". Selling cash is just like any other form of retailing. Well-located devices generate traffic and income. Networks with powerful **'convenience propositions'** win in the marketplace.

ISOs have a growing share of the UK market and within 2 years ISO owned ATMs are expected to exceed 25k winning up 20-25% of the market's transaction volume. Competitive advantage appears to be moving away from banks to the independents and large supermarkets' own brand ATMs. Also many believe that bank ATM acquirers cannot survive with only low interchange as income.

If the ATM business is all about cash retailing and powerful convenience propositions then banks clearly have to re-examine their position. What strategies can they adopt? Should the damaging conflicts continue or can new strategies be identified to correct some of the imbalances?

There is a pressing need to review the UK's ATM commercial models, infrastructures and sources of income. Traditional frameworks no longer reflect the market realities. Adjustments are needed at a macro level. If the primary cause of tension between the issuing and acquiring businesses is competition for revenue, banks need to decide how more fairly to share incomes. A strong case can be made to reverse interchange flows and to introduce a positive commission fee of (say) 20p per transaction surcharged. This would bring cash retailing in line with the debit POS model, where the merchant pays a unit MSC, and would cover issuer' costs incurred in recruiting, supporting and guaranteeing the funds of customers. Initially this would have a marginal impact but would provide issuers with a new and growing revenue as consumers obtain more and more cash from non-branch locations. Commission could eventually become the major source of revenue if surcharging predominates. Negative interchange would slowly decline reducing issuer pressure to drive down interchange costs.

Strategic Action	Expected Outcome
<ul style="list-style-type: none"> <li>• Positive interchange for surcharged transactions</li> </ul>	<ul style="list-style-type: none"> <li>• Issuer income streams grow</li> </ul>
<ul style="list-style-type: none"> <li>• Multilateral Interchange becomes Bilateral</li> </ul>	<ul style="list-style-type: none"> <li>• Competition improves, less regulation, fairer returns</li> </ul>
<ul style="list-style-type: none"> <li>• ATM becomes a business</li> </ul>	<ul style="list-style-type: none"> <li>• Lower costs, less capital, more revenue</li> </ul>
<ul style="list-style-type: none"> <li>• Encourage new cash handling entrants</li> </ul>	<ul style="list-style-type: none"> <li>• More efficient services</li> </ul>
<ul style="list-style-type: none"> <li>• Encourage new ATM Processors</li> </ul>	<ul style="list-style-type: none"> <li>• Lower cost switching services</li> </ul>
<ul style="list-style-type: none"> <li>• Implement selected Surcharging</li> </ul>	<ul style="list-style-type: none"> <li>• Direct revenue replaces interchange</li> </ul>
<ul style="list-style-type: none"> <li>• Less reliant on bank branded ATMs</li> </ul>	<ul style="list-style-type: none"> <li>• Smaller networks, ATM sharing, cost reduction</li> </ul>

**Table 4 – Summary of Possible Strategic Actions**

A second and equally important initiative would be to completely restructure the way interchange is agreed. Traditionally large scale ATM schemes implement multilateral interchange based on average member costs of service provision. This approach has the benefits of relative simplicity but also many disadvantages. As volumes grow and banks become more efficient, interchange costs fall. This disadvantages many banks that have invested in new technology because often their costs are higher than the average. It also discourages new investments because future revenues decline. In addition, multilateral has to be registered with the regulatory authorities. A common fee also means acquirers cannot compete on service and leverage the convenience factor in their network.

Thus the multilateral model appears to have reached the end of its life. It no longer serves the best interests of banks. An alternative and market facing solution is to replace with bilaterals between individual banks. Bilateral agreements enable banks to bargain and negotiate fees based on actual costs, not the industry average. Smaller banks could contract on a published tariff. Longer term contracts and volume discounts would also be possible. Concepts such as voluntary negotiation time outs and forced arbitration could ensure speedy and final agreement and avoid the need for multilateral fallback rates.

A move to bilaterals would have a profound effect on the current ATM business model, re-introduce competition and also remove a great deal of interbank debate and conflict.

A third macro level initiative could again borrow from the POS model. 10-15 years ago Visa and EPI/MasterCard encouraged banks to separate card issuing from acquiring and to run each as linked but separate business units. A similar initiative is required in the ATM sector. This would encourage banks to bring greater cash retailing focus to ATM acquiring and to copy or collaborate with the ISO sector. A more professional approach could create larger businesses able to reduce capital and operational costs through increased purchasing power. A professional operation would also use stricter siting criteria and thus increase the convenient location content of the total network.

In addition, operating as a business will ensure banks clearly define the objectives and roles of issuers and acquirers. A solid definition of the commercial boundaries will also help reduce collective conflict.

As is well known, cash and cash handling are the highest cost component in the ATM business. For a variety of reasons the UK cash handling market has stagnated over the past 5 years and the number of providers has declined. Processes, technology and methods need to be overhauled and lower cost vendors encouraged to offer services. If this happens there is a good potential for all acquirers to reduce their costs.

A fifth macro market initiative would be to encourage the provision of more front-end ATM operational switching services. The UK ATM market is constructed on software switching dinosaurs. No provider offers a low cost operational switching service as an alternative to in-house processing. Front end switching costs of 8-10p are no longer credible when fees of <4p are feasible. Lack of modern switching solutions is also limiting the growth of the ISO sector. In addition bank acquirers are locked into monolithic software platforms are unable to offer flexible and speedy services to their internal and external clients.

For individual banks stability could be achieved by greater direct revenue streams for the acquirer business and less reliance on interchange. The solution must be the gradual and selected introduction of charges to non customers. The concept of surcharging is slowly being accepted by the British public as the rapid growth in surcharging incomes shows. Within 2 years over 30% of all UK sites will be surcharging including those within Post Offices. Smaller banks already charge non-customers. Larger banks could extend the reach of their free of surcharge networks by reciprocity agreements with other banks. A variety of different surcharging propositions with higher charges for the best locations and other flexible charging options would help consumers accept a charge for convenience. In addition, surcharging will also help limit promiscuity and encourage consumers' loyalty.

Marketeers in the issuing business face some of the most difficult strategic issues. If they believe the cash convenience proposition is moving away from banks, then they need to review their ATM propositions. In addition, if their acquiring businesses cannot compete with independents for key non-branch locations then the link between the bank brand and its ATMs may have to be gradually decoupled. Consumers could be offered access to a smaller number of own brand/full service ATM's plus access to cash only reciprocal partners or possibly a commonly branded ATMs. The consequence would be a shrinking and rationalisation of bank networks, the greater use of partnerships, shared operations, pooling of devices and a substantial reduction in costs.

So what can the rest of Europe conclude from this sorry British experience? First the trend towards ATM siting in non-branch locations is unstoppable, reflecting

consumer demand for convenient access to cash. To grow this sector banks need to re-organise their ATM operations and create acquiring businesses that operate to P & L principles. ISOs are already selling and installing in mainland European markets. Whilst a competitive threat they are also potential partners who can deliver skills and perspectives that many banks lack.

European banks also need to carefully examine interbank cost transfer frameworks and decide how future ATM acquiring businesses will generate revenues. A strong case can be made for changing the traditional models and to implement surcharging. Mainland bankers also need to examine their cost frameworks for costs will come under great pressure if the market follows the UK pattern.

Finally, unless they take action, Europe's bankers must strap themselves in for a very bumpy ride over the next five years.

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