

## **ATM Surcharging: 10 Years Later A Look Back, A Look Forward**

April 1, 2006 marked the ten year anniversary of a day that changed the ATM industry forever—the day that the national ATM networks, Plus and Cirrus, lifted their bans on ATM surcharging.

Surcharging did not come into existence on April 1, 1996. It was not even a new concept. Some regional networks, most notably PULSE, were already permitting surcharges at the time, and banks were increasingly pushing for the ability to surcharge. As long as it was restricted by the national networks, however, surcharging was limited to small pockets of the market.

Once the national networks lifted their surcharging bans—quickly followed by most of the regional EFT networks—the ATM industry immediately experienced several fundamental changes:

- Independent Sales Organizations (ISOs) entered the market
- Growth of terminal deployments—particularly off-premise—accelerated rapidly
- ATMs became profit centers

Prior to surcharging, ATMs were primarily deployed as a customer distribution channel. There were relatively few terminals and the average transaction volume per ATM was high. With surcharging, however, the role of ATMs shifted: revenue generation became the name of the game. As a result, a frantic period of ATM deployment ensued. However, as terminal deployments moved further and further downstream, from highly-desirable locations to less-desirable locations, many ATMs struggled to generate sufficient transaction volume to remain profitable.

Ten years later, the industry is in need of—and may indeed have found—a new model. There are signs that the industry has come full circle, with banks and credit unions once again focusing their ATM channel on customer servicing opportunities instead of stand-alone revenue generation.

In order to maintain a high-quality ATM network that simultaneously maximizes cardholders' ATM access and minimizes ATM expenses, many financial institutions have recently turned their attentions to ATM branding partnerships (in many respects, a byproduct of surcharging). Other deployers are investing in new ATM software capabilities, linked to Customer Relationship Management (CRM) applications, to offer a more personalized ATM experience, with the potential to (finally) use the ATM as a sales channel. Additionally, after several years of hype, it appears as though ATM check imaging will finally start to gain broader deployment, initially led by a few large banks.

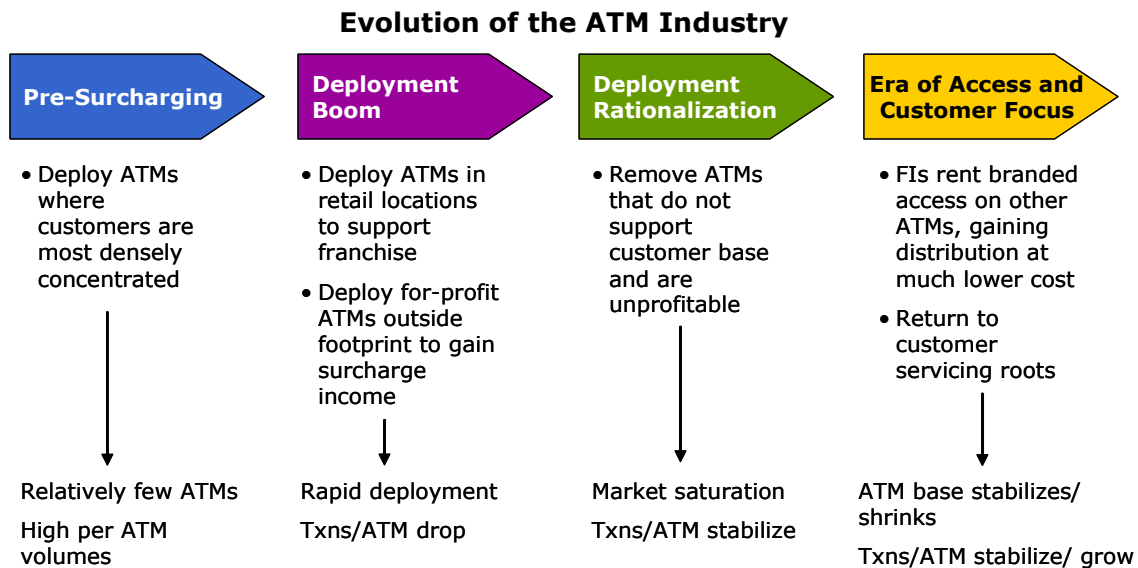
All of these developments have one thing in common—they are driven by customer needs. This new-found focus will ensure the ATM business remains vibrant for at least the next 10 years.

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Over the last ten years, the evolution of the ATM industry has moved through four distinct phases:

1. Pre-Surcharging

2. Deployment Boom
3. Deployment Rationalization
4. Era of Access and Customer Focus



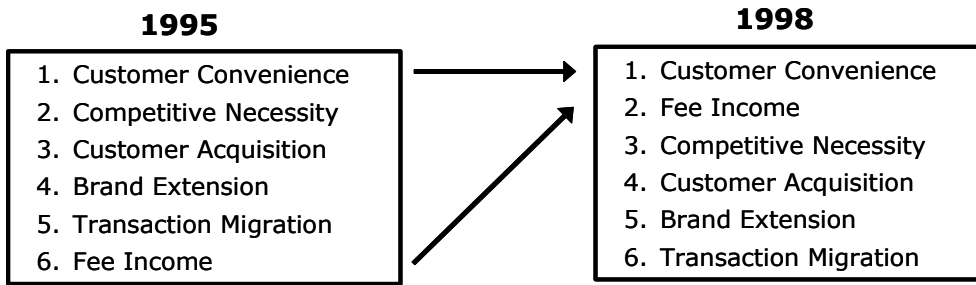
**Pre-Surcharging**

Introduced in the late 1960s as an innovative technology offering designed to increase customer convenience, by 1996 the ATM channel had matured into a core delivery channel that consumers had come to rely upon and expect. During this time, the ATM industry evolved from proprietary ATM networks solely accessible by a single financial institution’s cardholders into the system of shared EFT networks in existence today, whereby a consumer can put their ATM card into just about any ATM in the country and expect it to work.

Prior to surcharging, most ATMs were deployed in locations where they could service the greatest number of customers possible. ATMs were deployed primarily at branches where they could easily be monitored, maintained, and replenished with cash. Off-premise machines were selectively deployed at high-volume merchant sites such as malls or shopping plazas where financial institutions could offer customer convenience and display their brand in a prominent location.

In the early 1990s, the average monthly volume per ATM in the U.S. was between 6,000 and 7,000 transactions. Deployment volumes and transaction volumes kept pace with each other, each growing at approximately 8% per year. Financial institutions cited customer convenience, keeping up with the competition, and acquiring new customers as the primary drivers behind new ATM deployments. In 1995, fee income was at the bottom of the priority list—but that was soon to change.

## Ranking of ATM Deployment Goals in Order of Priority

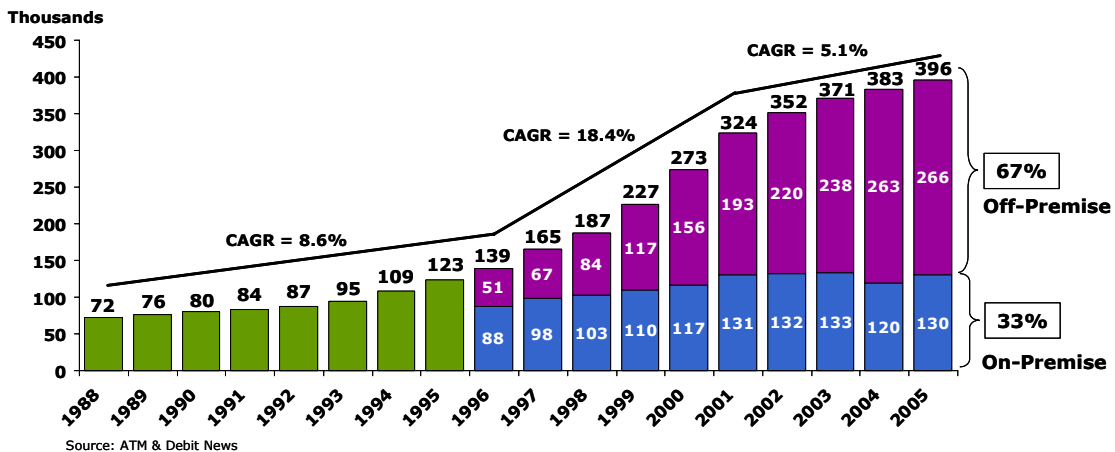


### Deployment Boom

Following the April 1996 decision to permit surcharging at the national level, the practice of surcharging expanded quickly. By June 1998, more than 90% of banks—and all ISOs, of course—had implemented ATM surcharging. In less than three years, surcharging bumped fee income from the least important ATM deployment goal to the second most important, close behind customer convenience.

Surcharging made it possible for banks to deploy ATMs in locations that had previously been economically untenable. It also created a compelling business case for non-bank deployers to enter the market. With the ability to collect revenue for foreign acquired transactions, ATM deployments grew rapidly. Prior to 1996, the number of ATMs in the U.S. had been growing at a rate of 8.6% per year. From 1996 to 2001, ATM growth jumped to a brisk 18.4% per year. From 1996 to 2001, ATM growth jumped to a brisk 18.4% per year.

### Number of ATMs in the U.S.



The ability to collect revenue from foreign acquired transactions also changed the nature of ATM placements. In 1996, non-branch locations accounted for 37% of total ATMs. Much of the ATM growth over the past decade, however, has occurred at non-branch (i.e., off-premise) locations. By 2002, non-branch ATMs represented 63% of the total (and today they account for 67% of all ATMs).

For financial institutions, the incremental revenue from surcharging funded the expansion of their distribution footprints. However, bank deployers now faced competition from ISO deployers for these sites. With the advent of surcharging, dozens of ISOs sprang up across the country almost overnight, each attempting to secure the best possible merchant locations.

Before nationwide surcharging went into effect, there were essentially only three ISOs deploying ATMs: ACS, EDS, and Fiserv. By 1999, it is estimated that between 200 and 250 ISOs had entered the ATM deployment business.

Focused solely on placing off-premise ATMs in order to make a profit, ISOs quickly pursued merchant locations, with many going after smaller merchants that had been ignored by financial institutions. Pre-surcharging, many merchants were satisfied just to be able to offer an ATM to their customers. In fact, some merchants initially paid the ISOs a monthly service fee for the privilege of having an ATM in their store.

Intensifying competition soon led merchants to realize the value of their ATM 'real estate.' Banks and ISOs began bidding against each other for ATM placements, and merchants quickly began to demand higher rent payments from deployers wanting to place ATMs in their stores. This pressure has only increased over time, with much of the economic benefit from surcharging accruing to the location owner, not the ATM operator.

For consumers, surcharging was (and remains) a mixed blessing. The proliferation of ATMs has made it easy to get cash virtually anytime, anywhere. The price for this convenience, however, has been strongly contested, even from the beginning.

Surcharging opponents have claimed that the surcharge fee constitutes double-dipping, since consumers were already paying their own bank a foreign fee when using another deployer's ATM and the ATM operator is receiving interchange on these foreign transactions. Legal battles flared up nationwide. In California, San Francisco and Santa Monica each attempted to ban surcharging, but those bans were overturned. Regulators in Iowa and Connecticut used existing authority to ban surcharges. In 1999, the Connecticut Supreme Court overturned the ban in that state, and Iowa's ban was also struck down by a federal judge in 2002.

### ***Deployment Rationalization***

Where legal battles failed to stop the proliferation of surcharging, simple economics may succeed. Ten years ago, it was fairly typical to be charged a surcharge fee of \$1.00. Today, however, many ATM deployers have implemented a surcharge fee of \$2.00 or higher.

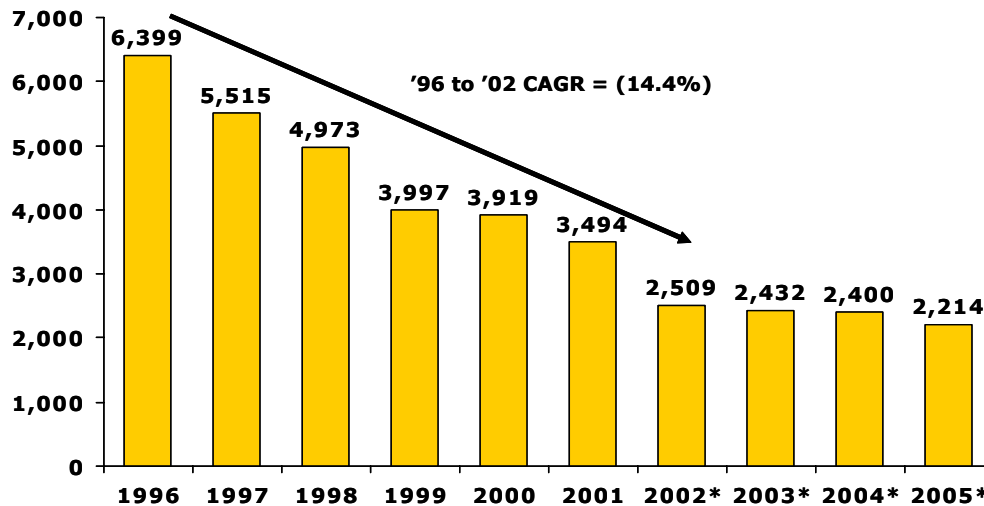
Industry-wide, the average surcharge is now close to \$1.75. When the foreign fee is added on, consumers are typically paying over \$3.00 for a single foreign ATM transaction.

As surcharge fees have spread and increased over the past ten years, consumers have responded by using ATMs less, at least on a per-machine basis. By taking out larger sums of money, by using a surcharge-free ATM (e.g., their own bank's) more often, and by getting cash back at the POS—which is typically a free transaction—consumers have placed downward pressure on ATM transaction volumes, and particularly on foreign acquired (i.e., revenue producing) transaction volumes.

Unfortunately, this behavior has created a negative market dynamic. Lower per-ATM foreign usage generates less revenue for ATM operators. Earning less total revenue, deployers increase their prices – the surcharge fee on foreign transactions. In the short-term, this higher price achieves the deployer's objective of maintaining or even increasing revenue. Over time, however, higher ATM access prices across the industry lead consumers to use ATM less. And lower ATM transaction volumes mean less revenue, further exacerbating the challenge and leading to additional price increases.

Bottom line, transaction volume growth has been unable to keep pace with ATM deployment growth. As deployments took off following 1996, the average monthly transaction volumes at ATMs began to plummet. Between 1996 and 2002, average monthly ATM transactions declined from 6,399 to 2,509, an average annual growth rate of -14.4%.

### Average Monthly Transactions per ATM



Source: ATM & Debit News; \*In 2002 ATM & Debit News changed its sizing methodology and re-stated transaction volumes.

Since ATMs generate revenue on a variable per-transaction basis, yet have costs that are primarily fixed, many low-performing terminals became unprofitable. Banks with grandiose ATM deployment plans began to scale back.

The boom years for ISOs in the late 1990s also began to come to an end. Fierce competition put downward pressure on revenues while costs stayed relatively flat (and revenue shares or residuals increased). Maintaining profitability became increasingly challenging, sparking consolidation among ISOs, a trend that is still taking place today. Today, the top ten ISOs collectively account for approximately 85,000 ATMs, about 43% of all ISO ATMs deployed in the U.S.

Deployment rationalization poses a dilemma for financial institutions: how to balance the financial institution's need to manage costs (as ATMs become an increasing resource burden) with consumers' increasing demand for fee-free ATM access (as consumers seek ways to avoid ever higher surcharge fees).

One solution that has been adopted by many financial institutions, particularly smaller financial institutions, is participation in a Selective Surcharge Alliance (SSA). SSAs have existed as long as surcharging itself, and they provide participating financial institutions' cardholders with surcharge-free access to any deployers' ATMs participating in the SSA.

SSA options and structures continue to proliferate, and new 'surcharge-free' models are being developed. Providing low-cost surcharge-free access to ATMs has become a defining feature of many deployers' ATM strategies and will likely play a pivotal role in the future evolution of the ATM industry.

## ***Era of Access and Customer Focus***

Declining revenues, coupled with fixed or increasing costs driven by regulatory requirements (e.g., Triple DES) and increased rent and cost of funds, puts increasing profitability pressure on ATM deployers. As a result, the ATM industry is searching for a new model—one that, at the industry level, addresses the need to balance deployers' costs and cardholders' access.

In this environment, we see the emergence of a new phase in the evolution of the U.S. ATM industry, one that is focused on customers and their needs/preferences. This new focus, as contrasted with earlier periods that often put cost saving (through transaction migration) and revenue generation (through surcharging) ahead of customer interests, has the potential to re-energize the market for all participants.

This industry phase will be shaped by three key developments: ATM branding, new ATM software, and ATM deposit automation.

### **ATM Branding**

ATM branding may very well succeed at redefining the economics of the industry. By separating ATM ownership from cardholder access, ATM branding offers a strong value proposition for all industry players:

- **Financial Institutions:** Financial institutions have the ability to offer surcharge-free ATMs that are branded with the FI's name. To the consumer, the ATM looks and feels like a bank-owned machine. The financial institution gains a larger distribution footprint and more consumer touch points at a much lower cost than if it deployed the machines on its own.
- **ISOs:** ATM branding opportunities have the potential to improve ISOs' profitability. With branding, ISOs receive a new revenue stream—rent income from financial institutions—instead of relying solely on surcharge and interchange revenue. ISOs also continue to receive surcharge income from cardholders who are not customers of the financial institution(s) branded on the ATM.
- **Merchants:** Merchants stand to come out ahead with ATM branding. Instead of having a 'white-label' ATM in their store, merchants now are able to place a bank-branded machine, which is likely to bring incremental customers of that bank into the store who would have not used the ATM previously, but who will use it now because it is surcharge-free. More foot traffic (and more people with cash) should generate incremental merchant sales.
- **Consumers:** Consumers also win with ATM branding. Branding allows financial institutions to expand their footprint, providing consumers with fee-free access to machines at locations where they otherwise would have to pay a surcharge. There is also no question in the consumer's mind (as there sometimes can be with selective surcharge alliances) regarding whether or not they will be charged a surcharge fee, since their FI's brand is clearly displayed on the ATM.

Numerous ATM branding partnerships have already been struck. With the largest ISO, Cardtronics, taking the initial lead, many financial institutions—including JP Morgan Chase, PNC Bank, BB&T, Huntington, Wachovia, Commerce Bank and others—have already placed their brand on hundreds of ATMs at merchant locations. Other ISOs and FI deployers are following close behind.

## **New ATM Software**

For much of the ATM's thirty-plus year life, an ATM has been an integrated device, combining hardware, software and, in most cases, service from one provider. As ATMs move away from OS/2 based operating systems to Windows, this dynamic is changing.

With Windows, deployers have much more flexibility as to what application software to run on their ATMs. Both Diebold and NCR have compelling next generation software applications, Agilis and Aptra, respectively. However, independent software developers are now also offering software solutions for ATMs, pitching greater flexibility and true multi-vendor interoperability. Additionally, some banks—notably Citibank and Wells Fargo—have chosen to develop their own ATM software in order to offer a richer, bank-specific interface.

All of these new software applications have one thing in common: the capability to offer a more flexible, more engaging experience for ATM users. In the short-term, this will mean the end to 'Choose your language' prompts for the umpteenth time. It will mean remembering cardholders' preferences and presenting a more visually appealing screen.

The real value, however, will be seen over time. As the ATM channel is integrated into banks' other delivery channels, and these in turn interface to a common Customer Relationship Management (CRM) system, the ATM experience will be customized to each user. Some customers will receive messages for special promotions, others will not; non-customer usage will be tracked and used to develop specific customer acquisition campaigns; and ATMs in different locations will offer a different look-and-feel from those elsewhere (just as bank branches have different formats).

The one-size-fits-all model of the past will be replaced by smart ATMs, offering services that best meet the needs of each customer.

## **ATM Deposit Automation**

The third plank of this new era is ATM deposit automation, specifically check imaging. Lots of hype surrounded the passage of Check 21 in October 2004, with predictions and expectations that the whole ATM industry would rapidly embrace check imaging. In reality, of course, very little has happened so far from a customer interface perspective—but that is now set to change.

Behind the scenes, banks have been investing aggressively in back office image technology, and the results of their efforts are beginning to show. From a relatively slow start, the number of checks that are now sent for collection via image exchange is exploding, more than doubling between March and May 2006. All signs point to strong continued growth.

The successes in back office check imaging will extend to the ATM channel. The vendors are improving their solutions (although no image solution is as reliable as an envelope-based deposit which, for consumers, works 100% of the time), and the banks are beginning to move from pilot mode to full scale deployment. According to a recent article in the Wall Street Journal, Bank of America will add imaging capabilities to 1,500 of its ATMs later this year, presumably with more to follow in 2007.

While the technology remains expensive, the rationale is clear. Feedback from customer surveys is very positive—customers like this capability. Seeing the image

on the ATM screen and receiving a printed copy on the receipt provide clear evidence that the funds will be correctly added to the customer's account. This confidence, in turn, is likely to spur greater use of ATMs for deposits (the share of all ATM transactions that are deposits has been relatively constant). Banks benefit by significantly reducing their deposit processing costs (daily collection by armored couriers and the labor associated with processing) and by eliminating their fraud losses associated with empty envelopes. Additionally, if a sufficient number of branch deposits do migrate to the ATM channel, banks have an opportunity to realign their branch staff resources.

This change will not happen overnight. Nevertheless, it is our expectation that fully one-third of deposit-taking ATMs will be image-enabled within the next five years. In this environment, the customer is the clear beneficiary.

### **Conclusion**

The April 1996 decision to allow ATM surcharging on a national basis dramatically altered the direction of the ATM industry in the U.S.

Surcharging facilitated the boom in deployments that has made ATMs a ubiquitous banking channel—and ultimately precipitated the decline in ATM profitability. Increases in surcharge fees to help make up for declining revenues have only increased the downward pressure on transaction volumes, pushing cardholders to use proprietary ATM networks or to use debit cards in lieu of cash.

Ten years later, the shock waves from surcharging are still reverberating throughout the industry. With surcharging as a catalyst, we are on the verge of a new era in the ATM industry's evolution, one built around access and customer focus. ATM branding that expands cardholder access without deploying more ATMs, new ATM software that can offer a richer, more personalized experience, and ATM check imaging that increases customer confidence in making ATM deposits, all point to the future direction of the industry.

This focus marks a new era for ATMs and will ensure that the ATM business remains vibrant for at least the next 10 years.

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