CBO TESTIMONY

Statement of
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NOTICE

This statement is not available for public release until it is delivered at 10:00 a.m. (EDT), Wednesday, July 15, 1998.

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Mr. Chairman and Members of the Committee, I am pleased to appear here today. My testimony is based on research that the Congressional Budget Office (CBO) has conducted at the Committee's request concerning automated teller machine (ATM) fees and the state of competition in markets related to ATMs. Several findings have emerged from that research:

- ATM cardholders have responded to surcharges by changing their use of ATMs, which is blunting the effects of high ATM fees. To avoid being charged twice for an ATM transaction—once by their own bank when they use an ATM that their bank does not own and once when the ATM owner charges them a fee—cardholders are shifting their use of ATMs to machines owned by the bank at which they have their account. As a result, the number of transactions that cardholders conduct at ATMs owned by institutions other than their bank declined in absolute terms for the first time in 1997. Moreover, many small- and medium-sized card-issuing banks have reduced the fees they charge their cardholders for using another institution's ATM.

- There has been a significant increase in the number of ATM installations in the past two years, with a large fraction of the new machines being owned by nonbanks. Paradoxically, that increase in supply has not led to the kind of reduction in ATM charges that would generally follow from supply-and-demand conditions. Instead, it may have brought about more segmentation in the market for ATM services. Nonbank owners of ATMs frequently compete on features unrelated to price, such as convenience and location. Meanwhile, banks have generally used prices for strategic purposes. To enhance their customer base, they have kept ATM fees high for other banks' customers and at the same time generally provided transactions at their own ATMs without charge to their own depositors.

- In the overall competition among banks for depositors, the increase in ATM fees has generally strengthened the hand of banks that own many ATMs. However, the statistical evidence of shifting of deposits by consumers in response to ATM fees is mixed at best. In states in which double ATM fees had been the general rule before 1996, banking concentration, measured as the share of all deposits held by large banks, rose more rapidly than in the country as a whole. But in those same states, banking concentration was so much lower to begin with that it is difficult to attribute the increased concentration to the existence of ATM fees.

- Shared regional ATM networks face competitive pressures both from below and from above. Growth in banks' own networks of proprietary ATMs is reducing the market share of the regional networks from below. From the top, the national ATM networks are aggressively pursuing markets that were formerly served by the regional networks.

INTRODUCTION

Most automated teller machines in the United States are connected to one or more computer networks that let depositors access their accounts virtually anywhere. No longer must depositors hunt for an ATM connected to “their” bank to get cash from their account. However, ATM owners, which are principally banks but increasingly include nonbanks, have begun to impose a fee for that convenience. (In this testimony, the term "bank" encompasses all institutions that both take deposits and make loans, including commercial banks, savings banks, savings and loans, and credit unions.)

The perception among cardholders that they are often being charged twice for ATM transactions—once by their own bank and once by the owner of the ATM—has fueled cardholders' ire. Meanwhile, federal policymakers have expressed concern about how ATM fees may be affecting concentration and competition in both the banking industry and the market for ATM networks, which connect the fleets of ATMs owned by various banks.

CBO’s report, which is being released today, examines the structure of the fees associated with ATM transactions as well as the status of competition among ATM owners and among ATM networks. A further focus of the paper is how such competition interacts with competition among banking institutions.

In my testimony, as in the CBO report generally, the term "surcharge" refers to fees imposed on the cardholder by the ATM owner, whether the owner is a bank or nonbank. Some analysts use the term "surcharge" to refer only to fees imposed by ATM owners that are financial institutions. CBO follows general industry practice, which disregards ownership of the ATM and refers to all such fees as surcharges.

HISTORY OF SURCHARGES

Before 1996, the national ATM networks Plus and Cirrus, which are run by the major credit card associations, banned surcharges; that is, no ATM owner who wanted to connect to their networks could impose a surcharge on users. Despite that national ban, some regional networks, most notably Pulse (in and around Texas), permitted surcharging. In several other states, regulators and legislators made bans on surcharging illegal. In addition to action by the states, ATM owners who wanted to impose surcharges began to file antitrust suits against the national ATM networks. In the face of such legal challenges, the Cirrus and Plus networks lifted their ban on surcharging on April 1, 1996.

After the decision by the national networks, many regional networks that had previously banned surcharges quickly lifted their prohibitions, presumably to avoid losing members. ATM owners quickly took advantage of the end of the bans. Current surveys indicate that between two-thirds and three-quarters of all banks now impose surcharges on ATM transactions by cardholders whose accounts are carried at a different bank—so-called foreign transactions.

ATMs AND SHARED ATM NETWORKS: BACKGROUND INFORMATION

Each ATM is typically connected to at least three computer networks—some shared and some not. The first connection is to the (usually proprietary) network of the bank or firm that owns the ATM. The second connection is to a shared network that links many of the banks operating in a state or region of the country and allows their customers to use (or share) all the ATMs of the member banks. The third connection is to the national networks operated by the major credit card associations. The national networks permit ATM cardholders from other states, regions, or nations to use an ATM. Typically, when cardholders insert their cards into the ATM, the machine checks to see which network connection would be the most appropriate, starting with the bank's proprietary network and expanding regionally.

The Rise and Consolidation of Shared Regional ATM Networks

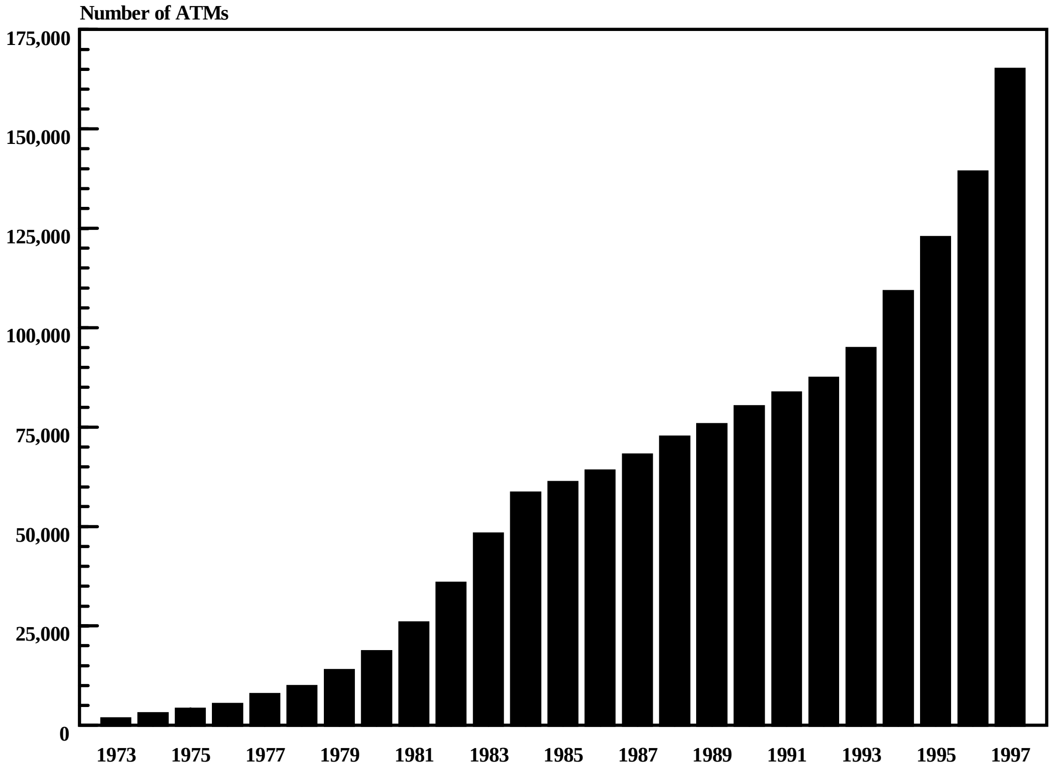
When banks first started installing ATMs, they quickly found that they could not individually provide all of the access to ATMs that cardholders desired. In response, the banks formed coalitions and developed state and regional networks to which virtually all ATMs today are connected.

As banks have spread geographically, increasingly crossing state boundaries, so, too, have the shared networks. Furthermore, like the banks they serve, the larger networks have in many cases taken over smaller networks whose regions they have moved into. As a result, the number of shared regional networks has dropped substantially over the past 10 to 15 years, from over 150 in the early 1980s to less than 50 today. And industry analysts expect further consolidation. In essence, the consolidation of the regional networks reflects—perhaps in an exaggerated way—consolidation in the banking industry.

The Proliferation of ATMs

Consolidation of the shared regional networks coincides with rapid growth in the number of ATMs, which have increased from fewer than 100,000 units in the early 1990s to over 165,000 today (see Figure 1). Since the number of ATM transactions

FIGURE 1. ATMs IN OPERATION, 1973-1997



SOURCE: Congressional Budget Office using data from the Board of Governors of the Federal Reserve System and the *Debit Card Directory, 1998 Edition* (New York: Faulkner & Gray, 1997), p. 20.

NOTE: ATM = automated teller machine.

has not risen as rapidly as the number of ATMs, the number of transactions per ATM has fallen.

Most of the recent increase in the number of ATMs has come from extending their reach away from banks and into new corners of the American landscape (convenience stores, shopping malls, and so forth). ATMs located off bank premises account for a large majority of the growth since 1994. However, most ATMs are still located at banks.

The Fee Structure in Shared ATM Networks

Five general classes of fees structure the relationships in an ATM system (see Table 1). The first three—membership, switch, and interchange fees—are set by the ATM network. The foreign fee is set by the card-issuing financial institution and the surcharge by the ATM owner. An ATM owner pays a membership fee to belong to an ATM network; such fees range from hundreds to thousands of dollars per year or per month. Card-issuing banks pay a so-called switch fee for each transaction made by their customers—usually ranging from 2.5 cents to 12 cents—to the network itself. Card-issuing banks pay the interchange fee to the ATM owner for each transaction made by their customers. For cash withdrawals, interchange fees typically range from 20 to 60 cents. Cardholders pay the foreign fee, which usually

TABLE 1. ATM FEES

Fee	Who Pays It?	Who Receives It?	Who Sets It?	Range
Network Membership[a]	Card-issuing bank	Network	Network	\$0 - \$125,000
Switch[b]	Card-issuing bank	Network	Network	2.5¢ - 12¢
Interchange[b]	Card-issuing bank	ATM owner	Network	20¢ - 60¢[c]
Foreign or User[b]	Cardholder	Card-issuing bank	Card-issuing bank	\$0 - \$2.50
Surcharge[b]	Cardholder	ATM owner	ATM owner	\$0 - \$3.00

SOURCE: Congressional Budget Office based on the *Debit Card Directory, 1998 Edition* (New York: Faulkner & Gray, 1997), and Government Accounting Office, *Automated Teller Machines: Survey Results Indicate Banks' Surcharge Fees Have Increased* (April 1998).

NOTE: ATM = automated teller machine.

a. The membership fee is usually paid either monthly or annually.

b. This fee is paid per transaction.

c. The range stated is for a cash withdrawal. Interchange fees vary for different types of transactions. For example, the interchange fee is usually higher for a deposit transaction than for a balance inquiry.

averages from \$1.00 to \$1.30, to their own bank when they use a foreign ATM (one owned by another bank). Cardholders may also be required to pay a user surcharge to the ATM owner. Those fees average from \$0.50 to \$1.50 but may be higher in some locations. The combination of the last two fees—the foreign fee and the surcharge—constitutes the so-called double-charging that is at the heart of many consumer complaints.

BANKING COMPETITION AND THE REGIONAL ATM NETWORKS

Shared regional ATM networks have reduced their numbers, growing in geographic size and dominance by merging with or simply swallowing their neighbors. Among policymakers, the geographic structure of the industry has raised concerns about the exercise of market power by the networks against the banks—their direct customers and, for the most part, their owners. A common criticism of the shared ATM networks is that they have become tools of the largest of their member banks and are acting against the interests of the majority of smaller member banks that are also connected to the network.

Declining Network Switch Fees

The fees charged by networks for their own activities—that is, switch fees—have been falling, not rising. Industry-compiled data on the switch fees of 10 of the largest ATM networks show that the networks lowered their average reported switch fee on ATM transactions by 22 percent between 1993 and 1997. In 1993, the average ATM switch fee was 8.5 cents; it had fallen to 6.7 cents by 1997.

Although the switch fees that networks charged all institutions were reduced by the same amount, the fees that they charged larger institutions went down by substantially more in percentage terms than did the fees imposed on smaller institutions. The reason is that the ATM switch fee structure of many networks is tiered: a card issuer with many transactions pays a lower fee per transaction than a card issuer with relatively few transactions. (Generally, CBO assumes that large institutions will have more transactions than small ones because large banks have more depositors.) The median fee declined by 1.5 cents per transaction for both large- and small-tier institutions. But because the large institutions were paying a lower fee to begin with, their percentage reduction was larger than the percentage reduction for the small institutions. CBO has been unable to determine whether the tiered fee structure is justified by the costs that the networks incur.

Increasing Relative Interchange Fees

The regional networks play a role in ensuring that the fees going to ATM owners remain high—in particular, the interchange fee paid by a card-issuing bank to the institution that owns the ATM. Because bigger banks play a disproportionate role in the shared regional networks and own a sizable fraction of all ATMs connected to even the largest such networks, they may exert their influence to keep interchange fees high.

Consequently, despite a drop in costs in the electronics and telecommunications markets, interchange fees in nominal terms have remained stable or have risen since the mid-1980s. In actuality, however, the stability seen for the fee suggests an increase in the interchange fee relative to general costs and would thus represent increased profits for ATM owners.

The shared networks argue that they have difficulty adjusting the fees once they have been set. They note that although equipment and telecommunications costs have decreased substantially, more ATMs are now located off bank premises and so cost more to service. Another weakness in the argument that networks are keeping interchange fees artificially high is that this pattern of stable interchange fees dates back to a period before substantial network consolidation, when networks presumably were more competitive than they are today.

Decreasing Use of Shared Networks

At the same time that total ATM transactions have been rising, the number of transactions handled by shared regional networks has fallen, both in absolute terms and as a share of all ATM transactions. Foreign ATM transactions have dropped somewhat since the widespread introduction of surcharges in 1996. (Monthly foreign ATM transactions in 1997 were 2 percent lower than in 1996.) Considering that total ATM transactions have continued to rise, that decline is all the more telling—and all the sharper when contrasted with the healthy rise that preceded it. (Foreign ATM transactions had been rising at a rate of 9 percent per year for the three years before 1996.)

Simultaneously with the drop in transactions handled by the shared networks, banks' own networks have increased in importance. The vast majority of cardholders wish to avoid surcharges and thus increasingly use only their bank's ATMs rather than those of other banks on the network. Moreover, given the relative shift in prices, the prominence of the banks' networks would be expected, even without the surcharges. Shared ATM networks were created when ATMs were few and expensive. As the machines have become cheaper to own and operate, the level of investment needed by the bank to service its customers and maintain its market share has fallen. That change alone would suggest a relative shift in the use of the bank's own network compared with the shared networks, but growth in the size of the regional banks exaggerates that shift even further.

COMPETITION AMONG ATM OWNERS

Competition among ATM owners occurs at two levels. For banks, ATMs are one of the means by which institutions compete for customers. Among other things, banks may compete on the basis of the size and diversity of their proprietary network, the level of their foreign fees, and their surcharges. Therefore, ATM surcharges should be viewed as one facet of banks' competition for customers in general. For nonbanks that own ATMs, the competition focuses more on placing ATMs in locations that capture ATM users who are willing to pay for the service. But all ATM owners—banks and others—have to compete for transactions, because if no one uses the machine, the investment will lose money.

The development of the ATM market cannot be viewed separately from changes that are occurring in the financial services industry generally. Most important, the industry is rapidly consolidating. Banks, thrifts, and other financial services firms are merging, which reduces the number of firms even as they increase their capacity to provide services to cardholders and other depositors.

Competition Among Banks

All other things being equal, a bank with more ATMs is more valuable to customers than a bank with fewer machines, especially now that surcharges have become more widespread. Consequently, ATMs and ATM fees form part of a bank's strategy to attract customers. For example, most banks will not impose surcharges on their own customers for fear of driving them away. However, large banks with large numbers of proprietary ATMs typically find it to their strategic advantage to impose high surcharges for foreign transactions. By contrast, in response to the spread of surcharges, an increasing number of smaller and medium-sized banks—banks that presumably have fewer ATMs to offer their customers—have had to drop the foreign fees they were charging their cardholders who used other banks' ATMs, presumably in response to cardholders' complaints at being double-charged. In 1996, only 20 percent of banks did not have foreign fees. By 1997, 33 percent of banks charged no foreign fees on cash withdrawals.

What effect do ATM surcharges have on the ability of banks to attract and retain deposits? One way to answer that question is to compare the experience of banking institutions in the eight states that passed laws either prohibiting network surcharge bans or explicitly permitting ATM surcharging by 1995 with the experience of banks in the rest of the United States. If ATM surcharging induced people to move their accounts to banks that owned large numbers of ATMs, one would expect to see a greater increase in the concentration of deposits in banks in those states allowing surcharging than in the rest of the United States during the same time frame. And a greater-than-average increase in concentration has, indeed, resulted. However, the states allowing surcharging started from a lower level of bank deposit concentration than did the nation as a whole. Consequently, the data are not conclusive with respect to the change that has occurred.

Even before the nationwide spread of ATM surcharges, big banks were growing at the expense of small banks. In 1991, commercial banks with $1 billion or more in assets held 67 percent of all deposits: in 1995, they held 72 percent, and in 1997, their share was 76 percent. The smallest commercial banks, those with assets of $100 million or less, experienced shrinkage in their share of deposits nationally, which went from 12 percent in 1991 to 9 percent in 1995 and 7 percent in 1997. Moreover, the Riegle-Neal Interstate Banking and Branching Efficiency Act took effect in the last quarter of 1995. The act expanded the ability of banks and bank holding companies to operate across state boundaries and may have contributed to the climbing rate of concentration in the industry. Thus, it is difficult to disentangle the effects of ATM fees from the preexisting trend of industry consolidation.

Competition Among All ATM Owners

ATM owners generally have to balance several factors in their calculations regarding both the number of ATMs in which to invest and the charges they need to impose. As more ATMs are deployed, especially by new entrants to the market, competition may force fees to drop. Nevertheless, some ATM deployers may be able to continue to charge high fees in certain market segments. (Market segments may be based on location, such as airports or recreation areas, or on cardholders' willingness to pay.)

The increasing number of ATMs and the decreasing number of transactions per machine suggest that high ATM surcharges may not be sustainable. If simple supply and demand were at work in the ATM market, the entry of nonbank deployers in particular should undermine high and increasing surcharges. But a large part of the market response to ATM surcharges is exhibited in changes in frequency and patterns of use, not in changes in price. Cardholders typically arrange their affairs so that most of the time, they do not pay surcharges at all. Thus, firms that surcharge see a drop-off in the number of their foreign transactions—but usually not by enough to make them lift the surcharge. Nonbanks have every incentive to surcharge because all of their transactions are foreign transactions and surcharging is the primary way that they make money from their investment. To ensure their profits, nonbanks may focus on placing ATMs in locations where people may be more willing to pay surcharges for the sake of convenience or because they have fewer alternatives for getting cash.

In sum, widespread surcharging is a recent phenomenon, and the market is still adjusting. Cardholders may discover that competitive pressures are operating on surcharges and foreign fees as the market matures over the next few years. Another possibility is that surcharges may remain in place even as average total cardholder fees—the total of foreign fees plus surcharges—drop. The potential for that outcome derives from the segmentation in the market and the fact that foreign fees and surcharges are set independently by two different market participants.

CONCLUSIONS

Shared regional ATM networks do not appear to wield worrisome market power. Although the regional networks have been consolidating, they still face competition from both the ever-larger proprietary networks and the national networks operated by the credit card associations.

The current flux in the ATM market is the result not only of the advent of ATM surcharging but of shifts in other charges associated with ATMs and in usage patterns. For example, foreign fees are dropping in some cases, and the average number of transactions per ATM has started to decline. In such unsettled circumstances, the effects of any legislation or regulatory change may be difficult to determine in advance and could produce unintended effects.