Payment Systems Regulator

Market review into card-acquiring services

Final report

November 2021

MR18/1.8

Contents

Note: The places in this document where confidential material has been redacted are marked with a [✂]

1 Executive summary

Card-acquiring services enable merchants (like a newsagent or supermarket) to accept card payments.

Our review considered whether the supply of these services was working well for merchants, and ultimately consumers.

For the largest merchants with annual card turnover above £50 million, we did not find any evidence that the supply of these services does not work well.

We find that the supply of card-acquiring services does not work well for small and medium-sized merchants, and large merchants with annual card turnover up to £50 million. These merchants could make savings by shopping around or negotiating with their current supplier – but many don't.

We will work with industry to develop remedies that increase merchant engagement and ensures that the market works better for them.

Introduction

1.1 Every time somebody makes a card payment – for example, when buying their weekly groceries – the merchant uses card-acquiring services to accept the payment. These services are critical to the UK economy because they enable consumers and businesses to use their cards to pay for goods and services. There are around 157 million cards in issue in the UK, and consumers made 15.5 billion debit card payments in 2020.[1] The crucial role card-acquiring services play in the payments sector means that it's important that they work well for merchants, and ultimately consumers.

Why we've carried out a market review

1.2 We launched our market review because we had concerns that card-acquiring services may not offer value for money for merchants. As an economic regulator with a focus on competition, innovation and the interests of service-users, we consider it important that merchants can shop around for a good deal, consider alternative providers or renegotiate with their current provider.

1.3 We believe this is the first comprehensive overview of this sector. In line with our objectives, we've considered how competition is working and any impact on innovation or the interests of service-users.

1 UK Finance, *UK Payment Markets 2021* (2021).

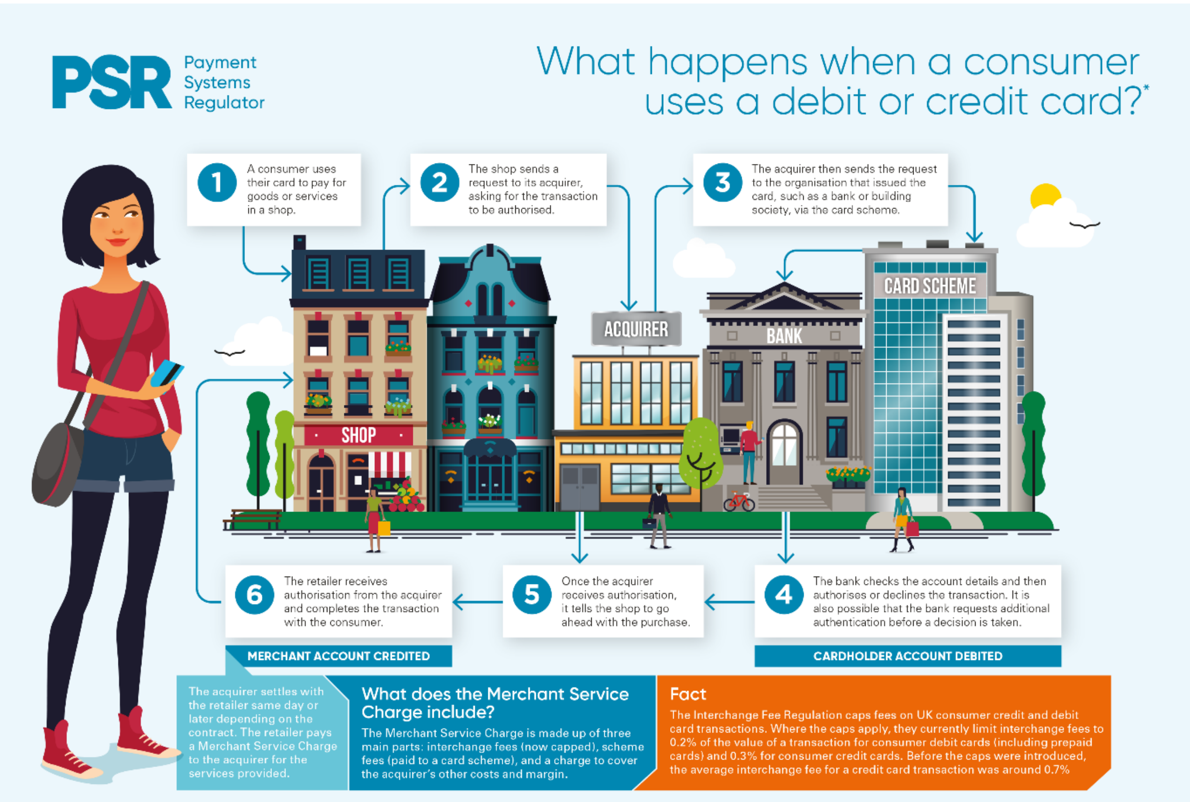
Considering COVID-19

1.4 We're aware that COVID-19 is having an extraordinary impact on the UK economy. The evidence is visible on high streets, in workplaces and in homes. It continues to affect merchants, who must buy card-acquiring services to accept card payments, as well as the acquirers and payment facilitators who supply these services. It also affects third parties, such as independent sales organisations (ISOs), that procure merchants for acquirers and provide them with other goods and services (such as point-of-sale (POS) terminals).

1.5 COVID-19 has accelerated many well-established trends, such as the growth in card payments, changing shopping preferences (including the shift to online spending), and increasing levels of card acceptance among businesses (particularly small businesses). If these trends continue to accelerate, it's even more important that the supply of card-acquiring services works well for merchants.

How card-acquiring works

1.6 Card-acquiring services are services to accept and process card payments on behalf of a merchant, resulting in a transfer of funds to the merchant. The supply of card-acquiring services is an important part of a complex system that enables merchants to accept card payments.



* This infographic provides a simplified picture of what happens during a consumer debit or credit card transaction (except for American Express cards) where a transaction is authorised.

The main players in card payments

Acquirer	Bank or other organisation licensed by the operator of a card-payment system to recruit merchants to accept card payments. Acquirers provide card-acquiring services to merchants, as well as other goods and services.
Cardholder	Consumer or business using a card to make a payment.
Card issuer	Bank or other organisation licensed by the operator of a card payment system to provide cards to cardholders.
Operator[2]	Organisation that licenses card issuers and acquirers to recruit cardholders and merchants respectively. It manages the rules that govern how card payments are made, sets interchange fees and scheme fees, and provides processing services that manage the movement of funds between issuers and acquirers.
Merchant	Organisation that accepts card payments.
Payment facilitator	Organisation that provides card-acquiring services to a merchant alongside other goods and services, but has no direct contractual relationship with the operator of the card payment system. It uses an acquirer to access the card payment system.
ISO	Organisation that doesn't provide card-acquiring services itself, but acts as an outsourced sales function for acquirers – selling card-acquiring services on their behalf to merchants, alongside other goods and services.

1.7 Merchants can buy card-acquiring services from acquirers or payment facilitators, which also offer other goods and services merchants need to accept card payments, such as POS terminals. The five largest acquirers – by number and value of card transactions – are Barclaycard, Elavon, Global Payments, Lloyds Bank Cardnet and Worldpay. The largest payment facilitators are PayPal (which owns the Zettle by PayPal brand), Square and SumUp.

2 The focus of our market review was card-acquiring services for Mastercard and Visa, and our findings relate to card-acquiring services for these card payment systems.

1.8 Various fees flow between parties when a card payment is made. For the merchant, the crucial fee is the merchant service charge (MSC), which is the total amount it pays for card-acquiring services to its acquirer. The MSC comprises:

- **interchange fees**, paid by the acquirer to the issuer
- **scheme fees**, paid by the acquirer to the operator of the card payment system (such as Mastercard and Visa)[3]
- **acquirer net revenue**, which recovers the acquirer's other costs and margin

1.9 The coming into force of the Interchange Fee Regulation (IFR) caps in December 2015 provides an important backdrop to this review. The IFR capped interchange fees on most card transactions, but did not cap MSCs that merchants pay. Instead, the IFR relied on competition between providers of card-acquiring services to ensure that the cost savings they realised ('IFR savings') were passed through to merchants.

1.10 We've listened to the concerns of stakeholders, who told us that acquirers had not passed the savings they made from the IFR caps through to smaller merchants. These concerns and others prompted us to examine whether the supply of card-acquiring services was working well.

1.11 We investigated the extent to which the IFR savings were passed through to merchants, and used this as an indicator for how well the supply of card-acquiring services is working.

1.12 Stakeholders also told us that scheme fees paid by acquirers to Mastercard and Visa have increased significantly in recent years. As part of this review, we've collected data on how these fees changed between 2014 and 2018, and whether these changes were passed through to merchants.[4]

1.13 To structure our analysis and present our findings, we use two broad merchant segments within the supply of card-acquiring services:

- **Small and medium-sized merchants**, with annual card turnover up to £10 million. Almost all merchants are in this segment, although they are only responsible for around 17% of the value of card transactions. The **smallest merchants** within this segment, with annual card turnover up to £380,000, account for around 90% of the overall merchant population.
- **Large merchants**, with annual card turnover above £10 million. This segment is dominated by a very small number of the **largest merchants,** with annual card turnover above £50 million, who are responsible for around 76% of the overall value of card transactions.

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3 We use the term 'scheme fees' to refer to all fees acquirers pay to operators of card payment systems, including fees for scheme services and fees for processing services.

4 This data therefore does not reflect changes since the IFR was retained and amended in UK law to focus on domestic payments and any other changes which took effect at the end of the Brexit transition period.

Our findings

1.14 We published our provisional findings in an interim report in September 2020.[5] We received 37 responses from a range of stakeholders, including merchants and merchant representatives; acquirers; ISOs and leasing firms; payment processors; card schemes; payment facilitators; banks and other stakeholders. We have carefully considered the submissions, and this has led us to adapt our analysis and findings in some areas.

1.15 In summary, our findings are:

Small and medium-sized merchants

- The five largest acquirers and First Data serve small and medium-sized merchants of all sizes that sell face to face, online and through other channels. Other acquirers are significantly smaller (in terms of number of merchants served) or target specific types of merchants (for example, those selling online).
- For most acquirers serving merchants selling face to face with annual card turnover up to £1 million, ISOs are an important customer acquisition channel and accounted for over 50% of all customers onboarded by them in 2018.
- In recent years, the largest payment facilitators and Stripe have expanded significantly. The largest payment facilitators now serve nearly 80% of merchants that only or mainly sell face to face with annual card turnover below £15,000, although their share of supply decreases sharply as merchants' card turnover increases above this level. Stripe – which is now an acquirer but entered as a payment facilitator – accounts for a large proportion of the merchants with annual card turnover below £380,000 that only or mainly take card-not-present transactions (such as those made online, over the phone or by mail order) though it serves merchants of all sizes.
- The rapid expansion of the largest payment facilitators and Stripe is mainly driven by their success in onboarding merchants new to card payments, which suggests low barriers to entry and expansion for providers that target such merchants. By contrast, the largest payment facilitators' offering is likely to be less attractive for merchants with higher card turnover; their share of merchants with annual card turnover above £15,000 is much lower.
- Beyond the largest payment facilitators and Stripe, there has been some, more limited, entry and expansion by providers serving small and medium-sized merchants – for example, by EVO Payments and Tyl by NatWest.

5 PSR, Market review into the supply of card-acquiring services: interim report (2020).

- Despite having a variety of providers to choose from, many existing small and medium-sized merchants don't regularly (if ever) search for providers and rarely consider switching their provider. This could discourage acquirers wishing to serve particular merchant segments from entering and expanding, and may have the effect of weakening competition between providers who currently do serve those merchants.

- The pricing outcomes we observe show that small and medium-sized merchants would benefit from searching for a better deal and, if they find one, negotiating with their current provider or switching to a different one:

  - On average, they got little or no pass-through of the IFR savings.[6]

  - New customers pay less on average than existing customers.

  - Some have tried to negotiate with their provider – nearly 90% of those that did were successful in getting a better deal.

- An important focus of this market review has been to understand why many small and medium-sized merchants do not search around and switch. Merchants can benefit from more actively searching for another provider more regularly. In particular, merchants with growing card turnover may benefit from comparing offers to see if their current deal still fits their needs. If they don't do this, they may end up paying too much.

- We examined a range of factors and conclude that the following features (both individually and in combination) restrict small and medium-sized merchants' ability and willingness to search and switch, and explain the pricing outcomes that we observe for small and medium-sized merchants:

- **Acquirers and ISOs** do not typically publish their prices for card-acquiring services. Their pricing structures and approaches to headline rates vary significantly. This makes it difficult for a merchant to compare prices for ISOs, acquirers and payment facilitators.

- **The indefinite duration of acquirer and payment facilitator contracts for card-acquiring services** may explain, at least in part, why many merchants don't consider switching or searching for other providers regularly. This is because they do not provide a clear trigger for merchants to think about searching for another provider and switching. After a certain point, merchants that grow their card turnover will particularly benefit from comparing different offers, to see if their current deal still fits their needs. If they don't do this, they may end up paying more than they need to.

6 As noted in Chapter 5 and explained in Annex 2, we do not make a finding for merchants with annual card turnover up to £15,000.

- **POS terminals and POS terminal contracts that prevent or discourage merchants from searching and switching provider of card-acquiring services**. This can occur because of a combination of two factors:

    1. A merchant typically cannot use its existing POS terminal with a new card-acquirer. If it switches provider of card-acquiring services it may need a new POS terminal and to cancel its existing POS terminal contract.

    2. A merchant could incur a significant early termination fee when cancelling its existing POS terminal contract, even if no such fee would apply when cancelling its card-acquiring services contract.

- This situation can arise because POS terminal contracts can have longer initial/renewal terms than card-acquirer contracts (for example, of three and five years) and/or they may renew automatically for successive fixed terms. Early termination fees for these contracts can include, for instance, all outstanding payments due up to the end of the initial/renewal term. Therefore, there may be situations where the lack of portability of POS terminals and early termination fees for cancelling an existing POS terminal contract together prevent or discourage merchants from switching provider of card-acquiring services.

- These features explain our finding that the supply of card-acquiring services does not work well for small and medium-sized merchants. Remedying these features will improve outcomes for small and medium-sized merchants by:

    - encouraging them to search and switch, or negotiate a better deal with their existing provider

    - reducing the obstacles to getting a better deal

- It was not possible for us to reliably estimate the degree of pass-through of IFR savings for merchants with annual card turnover below £15,000. However, we expect that these merchants suffer harm due to the features outlined above. These features affect this group as they do other small and medium-sized merchants.[7] Our merchant survey also indicates that they share similar characteristics with other small and medium-sized merchants that received little or no pass-through. Many do not regularly search, consider switching provider, or negotiate with their current provider.

7 Although there is a greater likelihood that these merchants may not be affected by all three features (or not to the same extent). For example, merchants contracting with payment facilitators will typically purchase a card reader up front, rather than having a POS terminal contract.

Large merchants

- Large merchants typically buy card-acquiring services from acquirers. The five largest acquirers – together with Adyen, AIB Merchant Services and First Data – all serve large merchants that sell face to face, online, and through other channels. Chase Paymentech currently focuses on acquiring card transactions for e-commerce merchants. Adyen – a new entrant – has significantly grown its share of supply between 2015 and 2018.

- Large merchants with annual card turnover between £10 million and £50 million were not represented in the merchant survey. It is plausible they have greater buyer power or more internal resource to assess card acquiring options compared to small and medium-sized merchants. Nevertheless, on average, they got little or no pass-through of the IFR savings – just like small and medium-sized merchants. The features which restrict the searching and switching behaviour of small and medium-sized merchants will also apply to this group. The evidence suggests that any differences between these large merchants and small and medium-sized merchants were not enough to counteract the impact of the features we identified, and to ensure pass-through of the IFR savings. We conclude that the supply of card-acquiring services is not working well for large merchants with annual card turnover between £10 million and £50 million.

- For the largest merchants (with annual card turnover above £50 million), our pass-through analysis was inconclusive for those on standard pricing because the IFR had little effect on their average interchange fees. Merchants on IC++ pricing, which are typically the largest merchants, received full pass-through of the IFR savings, and we estimate that the benefit of the savings to these merchants was around £600 million in 2018. The merchants in this segment can access information about providers and assess their requirements. While they sometimes face significant switching costs – for example, due to the complexity of integrating payments with their systems – they achieve good pricing outcomes. We did not find any evidence as part of this market review that the supply of card-acquiring services does not work well for these merchants.

Scheme fees

1.16 In our final Terms of Reference, we said we would also examine how scheme fees have changed over the period 2014 to 2018. Our analysis indicates that:

- scheme fees increased significantly over the period

- a substantial proportion of these increases are not explained by changes in the volume, value or mix of transactions.

Actions we're taking

1.17 Remedies to the problems we have identified are a critical next step in this market review process. For instance, more can be done to make comparisons easier, and to ensure merchants consider their supply options more frequently.

1.18 That is why our next step will be to publish a remedies consultation in early 2022. This will set out our views on the most suitable remedies package to address our concerns. As part of that consultation, we will seek views and information from stakeholders, and we expect the payments industry to play a key role in developing effective and proportionate measures that increase merchant engagement and ultimately improve choice and prices.

1.19 We will then publish our provisional decision on remedies (and potentially a draft remedies notice) for consultation later that year.

2 Introduction

2.1 This is the final report of our market review into the supply of card-acquiring services in the UK. It contains our final findings. We've conducted the market review using our general powers under Part 5 of the Financial Services (Banking Reform) Act 2013 (FSBRA).

2.2 Our aim was to assess whether the supply of card-acquiring services is working well for merchants, and ultimately for consumers.

2.3 Our work was prompted by concerns about card payments raised by various stakeholders, including the PSR Panel (our independent advisory body). Issues raised included a concern that acquirers might not have passed on to smaller merchants[8] the savings they made from the interchange fee caps introduced by the Interchange Fee Regulation (IFR). Among other concerns are a lack of transparency around the fees merchants pay to accept card payments and that it is hard for them to compare and switch providers.

Scope of our work

2.4 The final Terms of Reference (ToR) for this review were published on 24 January 2019. We defined card-acquiring services as services to accept and process card payments on behalf of a merchant, resulting in a transfer of funds to the merchant.

2.5 We've assessed whether the supply of card-acquiring services is working well for merchants, and ultimately consumers. We've considered how competition in the supply of card-acquiring services to UK merchants[9] by acquirers and payment facilitators is working. We've also considered the role that third parties, such as independent sales organisations (ISOs), have in the supply of card-acquiring services and the effects of the supply of other related goods and services, including products that help merchants accept card payments, as well as services provided by the operators of card payment systems to acquirers, on the supply of card-acquiring services.

2.6 In line with our objectives, we've considered whether there are any aspects that might adversely affect competition, or cause harm to innovation or the interests of service-users, in the supply of card-acquiring services.

2.7 Although we've focused on card-acquiring services in relation to the Mastercard and Visa card payment systems, we've also considered what we've learned about card-acquiring services for other card payment systems operating in the UK.

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8 Our assessment uses two broad segments: large merchants, and small and medium-sized merchants (see Chapter 4). The term 'smaller merchants' was used by stakeholders.

9 A UK merchant is a merchant with at least one UK outlet. An outlet is the location at which a card transaction is completed.

2.8 Finally, we've also gathered data on how scheme fees acquirers pay to Mastercard and Visa have changed between 2014 and 2018, and considered whether these changes were passed on to merchants.[10]

Issues the market review addresses

2.9 To understand whether the supply of card-acquiring services works well, we examined:

- the nature and characteristics of these services
- how providers of these services compete
- how merchants buy these services and the price and quality outcomes they achieve
- potential barriers to entry or expansion
- potential barriers to searching or switching faced by merchants

Evidence to support our analysis

2.10 We gathered information from a wide range of different parties – this included formal and informal information requests, and meetings.

2.11 Sources of information included acquirers, banks, ISOs, gateway providers, independent software vendors, online marketplaces, operators of card payment systems, payments consultancies, payment facilitators and trade associations.

2.12 We collected evidence from some large merchants. We also commissioned IFF Research, an external market research agency, to carry out a survey of small and medium-sized merchants ('the merchant survey').

2.13 We sought views on our analytical approach at an early stage by publishing three papers for consultation covering our proposed approach to:

- the pass-through analysis
- the merchant survey
- the profitability analysis[11]

2.14 We also published for consultation a draft of the merchant survey questionnaire. The final version of the questionnaire is available on our website.

10 In line with our final Terms of Reference, we have not reviewed whether these fees are excessive.

11 For reasons explained in Annex 3, we subsequently carried out a financial review of acquirer net revenue.

2.15 We published an interim report in September 2020, which set out our provisional findings and sought stakeholder feedback.

2.16 The feedback we received from stakeholders on these documents informed how we progressed with our work. In this document and the relevant annexes, we explain how we took account of this feedback.

2.17 In addition to responses to information requests and consultation documents, we also received several submissions from stakeholders that helped inform our assessment. We've published non-confidential versions of these on our website.

2.18 During our review, we also engaged with other relevant authorities, such as the Bank of England, the Competition and Markets Authority (CMA), the European Commission and the Financial Conduct Authority (FCA).

Structure of this report

2.19 This report is structured as follows:

- **Chapter 3** sets out the industry background.
- **Chapter 4** describes how providers compete.
- **Chapter 5** sets out our analysis of pricing and quality outcomes.
- **Chapter 6** sets out our analysis of merchants' ability and willingness to search and switch provider.
- **Chapter 7** sets out our findings and next steps.

2.20 As part of this report, we are publishing the following annexes and two reports by IFF Research:

- **Annex 1** provides additional background information on the industry.
- **Annex 2** explains our methodology for the pass-through analysis and presents the results.
- **Annex 3** presents the results of our financial review.
- **Annex 4** explains our approach to assessing how scheme fees have changed and presents the results.
- **Annex 5** contains our assessment of several barriers to entry and expansion we considered.

- IFF Research report – the merchant survey methodology.
- IFF Research report – the results of the merchant survey.

We are also publishing stakeholder responses to our interim report.

3 Industry background

Card payments are critical to the smooth running of the UK economy. Use of cards is high and has grown significantly in recent years.

Over the past 15 years, the types of firms providing card-acquiring services to merchants have changed considerably due to factors such as regulatory changes, entry, and mergers and acquisitions.

Today, many merchants are served by non-bank providers – including payment facilitators, which tend to serve the smallest merchants.

Various third parties, including ISOs, help merchants accept card payments, including by referring them to acquirers and payment facilitators.

Introduction

3.1 This chapter sets out background information on the industry. It describes the importance of cards, how card payment systems work and the products merchants buy to accept card payments. It also introduces the providers of card-acquiring services and some third parties that help merchants accept card payments (but do not themselves provide card-acquiring services).

The importance of cards

3.2 Card use is high in the UK and has been growing strongly in recent years. The number of debit card payments in the UK more than doubled between 2010 and 2020, while the number of credit card payments increased by around a third.[12]

3.3 Causes of recent growth in card payments include:

- rapid growth in the adoption of contactless card payments and new ways of paying by card
- changing shopping preferences (debit cards are the most popular payment method for consumer online shopping, which is also increasing)
- increasing levels of card acceptance among businesses (particularly among smaller businesses)[13]

12 UK Finance, *UK Payment Markets 2021* (2021), Table 3.

13 UK Finance, *UK Payment Markets 2020* (2020), page 11.

3.4 At the same time, the use of cash has declined. In 2017, the value of payments made using debit cards exceeded the amount spent using cash for the first time.[14]

3.5 The impact of COVID-19 has accelerated these well-established trends towards cards. According to responses to our interim report, it has also spurred some providers to innovate and seek to serve merchants in different ways – for example, helping merchants to move their trading online.[15]

3.6 In recent years, new ways of paying and accepting payments by card have emerged. For example, consumers can now initiate a card payment in a shop using a smartphone or a device with contactless payment functionality (such as a smartwatch). These devices work in conjunction with digital wallets, such as Apple Pay and Google Pay, which securely store card details in different ways and can also be used online. Merchants can also accept payments using card readers that connect to their smartphone or tablet, rather than requiring a POS terminal.

3.7 Surveys show the majority of businesses in the UK accept card payments.[16] In some sectors, cards are the most frequently used payment method. In 2020, credit and debit cards accounted for 80%, 73% and 73% of spontaneous payments in the travel, retail and entertainment sectors respectively.[17] In other sectors, card payments are much less prevalent. Most consumers pay utility bills and make monthly mortgage repayments by direct debit.[18]

3.8 Other digital payment methods have also grown over recent years, though to a much lesser extent than card payments.

3.9 In response to our interim report, some respondents noted that the wider digital payments sector is changing:

- UK Finance said that, in its view, traditional merchant acquiring no longer exists, and that the appropriate focus should be on payment acceptance (that is, the means by which a consumer transacts with a merchant at the POS as opposed to one of the means that they use to 'pay' the merchant).[19]

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14 UK Finance, *UK Card Payments 2018* (2018), Table 4.

15 Visa Europe response, page 5.

16 A survey carried by the RFi Group for the UK Merchant Acquiring Council in 2019 found that 58% of UK businesses accepted payment by card, increasing to 63% as of H1 2020. A payments survey carried out by Savanta in 2018 found that 53% of UK businesses had received payment by card in the last six months. MarketVue Business Payments from Savanta, YE H2 2018 data, based on 5,004 businesses with a turnover of £50,000 to £25 million. Data weighted by region and turnover to be representative of businesses in G.B.

17 UK Finance, *UK Payment Markets 2021* (2021), page 25.

18 UK Finance, *UK Payment Markets 2021* (2021), page 13.

19 UK Finance response, page 6.

- Visa Europe told us that the digital payments sector is vibrant, highly competitive, and one in which cards are only one player. It drew attention to the shift to open banking, where increasingly sophisticated merchants are looking across payment systems to determine the best solutions for their businesses.[20]

3.10 We agree that the sector is dynamic and that future changes could offer merchants and their customers more choice about how to pay. For instance, open banking is enabling interbank systems (where a payment is made directly from one account to another) to be used for a wider set of payments. Payments made using interbank systems currently account for a very small share of spontaneous consumer retail payments.[21] The renewal of the infrastructure behind most interbank payments provides a potential route to their share increasing going forward. It nevertheless remains the case that card payments are important to the majority of UK businesses. Our merchant survey supports this conclusion: card payments were merchants' preferred payment method more than any other and also the payment method that accounted for the highest number of sales (see Annex 1 and IFF survey).

3.11 Annex 1 provides more information on different card types.

Card payment systems

3.12 Card payment systems enable people to make payments using cards. There are two types of card payment systems: four-party card payment systems and three-party card payment systems.

3.13 Our market review focuses on the supply of card-acquiring services in relation to Mastercard and Visa, which are both examples of four-party card payment systems. Together, transactions involving Mastercard and Visa cards accounted for around 98% of all card payments at UK outlets in 2018, both by volume and value.[22]

3.14 As well as cardholders (that is, individuals or businesses that use cards to buy goods and services), there are at least four other parties involved in four-party card payment systems:

- **Merchants** – organisations that accept payment by card.
- **Operators** of card payment systems – organisations that license issuers and acquirers to recruit cardholders and merchants respectively.[23] They manage the 'scheme rules' that govern how card payments are made and set the basis on which issuers, acquirers, merchants, cardholders and other parties participate in

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20 Visa Europe response, page 6.

21 Faster Payments and other remote banking options are indicated to have accounted for 3% or less of all spontaneous consumer retail payments in 2020. Spontaneous payments are defined as spending that a person is not committed to in advance. These could include purchases of clothes, food, alcohol and so on. Source: UK Finance, UK Payment Markets 2021 (June 2021), page 25.

22 PSR analysis of data submitted by operators of card payment systems.

23 The operator of the card payment system has no direct contractual relationship with cardholders or merchants.

the card payment system.[24] Operators of card payment systems may also provide processing services that manage the transactions between issuers and acquirers.[25]

- **Acquirers** – banks or other organisations licensed by the operator of a card payment systems to recruit merchants to accept card payments. Acquirers provide card-acquiring services to merchants and play a key role in enabling card payments (as described in paragraphs 3.20 to 3.23).

- **Issuers** – banks or other organisations licensed by the operator of a card payment system to provide cards to cardholders. The issuer pays to the acquirer the money the merchant is owed for the transaction (less interchange fees) and debits the cardholder's account.

3.15 Annex 1 provides more information on how a card payment is made and the roles of the different parties.

3.16 In a three-party card payment system, the operator of the system generally performs the issuing and acquiring functions itself.[26] American Express is the only three-party card payment system operating in the UK, and is the only acquirer of transactions for UK merchants involving its cards. Annex 1 provides more information on American Express. Unless otherwise stated, the quantitative analysis we present in this document and the annexes excludes American Express in its capacity as an acquirer.

Fees flowing between parties in a four-party card payment system

3.17 Figure 1 below shows the main flow of fees between parties in a four-party card payment system, specifically:

- **interchange fees**, which acquirers pay to issuers each time a card is used to buy goods or services

- **scheme fees**, which acquirers and issuers pay to the operators of card payment systems for their services[27]

- **merchant service charge (MSC),** which is the total amount merchants pay to acquirers for card-acquiring services

- **cardholder fees,** which cardholders may pay to issuers

24 Annex 1 provides more information on scheme rules and Annex 5 considers scheme rules relating to collateral requirements.

25 Processing services provided by operators of card payment systems can be procured by acquirers and issuers from third parties. We are not aware of any acquirers doing this in the UK.

26 In some circumstances, American Express licenses third parties to act as an issuer or acquirer while continuing to issue cards and acquire payments itself. American Express has discontinued these arrangements in Europe.

27 We use the term 'scheme fees' to refer to all fees acquirers pay to operators of card payment systems, including fees paid for scheme services and fees paid for the processing services they provide.

3.18 The MSC comprises interchange fees, scheme fees and acquirer net revenue. Acquirer net revenue includes the costs the acquirer incurs (other than interchange fees and scheme fees) to provide card-acquiring services, plus the acquirer's margin. Annex 1 provides more information on the pricing options available to merchants.

3.19 Interchange fees and some scheme fees[28] vary depending on the characteristics of a transaction, such as:

- the card type (for example, whether a credit or debit card was used)
- the card payment system (such as Mastercard or Visa)
- the location (of the parties involved in the transaction)
- the channel (for example, online-commerce or face to face)
- the way the cardholder authenticated themselves (for example, by entering their PIN)

Figure 1: Main fees flowing between parties in a four-party card payment system

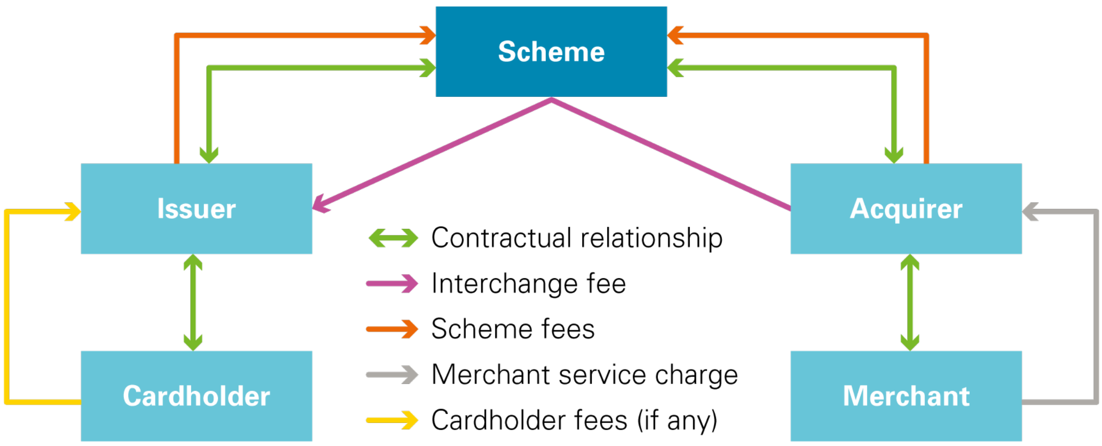

Diagram provides a simplified representation of a four-party card payment system

Role of the acquirer

3.20 Acquirers provide card-acquiring services to merchants. Annex 1 lists the activities involved in providing card-acquiring services, which include:

- onboarding merchants to accept card transactions under one or more card payment systems
- supporting the merchant with the authentication, authorisation, clearing and settlement of card payments through the card payment system – see Annex 1 for more information on these processes

28 Some scheme fees are not directly attributable to transactions – see Annex 4.

- settling with the merchant – that is, transferring to the merchant the funds for the card payments it accepts less any applicable fees (see paragraph 3.17)
- ensuring merchants comply with scheme rules

3.21 Acquirers may also offer other goods and services to merchants as described in paragraphs 3.55 to 3.62.

3.22 In onboarding merchants, the acquirer assumes responsibility for the risks associated with granting them access to the card payment system. These risks include the credit risk that comes from being liable under scheme rules for disputes between cardholders and merchants. There is a range of circumstances in which a cardholder might contact their issuer to dispute a card payment. For example, this might happen where goods and services are not delivered or if a card payment appears fraudulent. If the issuer considers the cardholder has the right to dispute a card transaction under scheme rules, it will raise a chargeback.[29]

3.23 The chargeback process gives rise to a credit risk for acquirers because an acquirer may not be able to recover the amount it must pay to the issuer if a chargeback is upheld (for example, if the merchant becomes insolvent or acts fraudulently). Certain types of merchants carry a higher credit risk, such as those who typically accept payment for goods and services some time before they are provided (which includes furniture retailers and airlines). Acquirers carry out due diligence on merchants as part of the onboarding process and on an ongoing basis to help them manage the credit risk and other risks they carry. For example, acquirers carry out know your customer and anti-money laundering checks. These checks help maintain the integrity and security of the card payment system and prevent financial crime. Acquirers also help merchants to reduce the likelihood of chargebacks and fraud. Under scheme rules, acquirers may choose to outsource some activities to other parties. Wherever an acquirer outsources its activities, under scheme rules it remains responsible for making sure that those it outsources to perform the activities in accordance with scheme rules.

Payment facilitators

3.24 A card payment may involve additional parties to the cardholder, merchant, issuer, acquirer and operator of the card payment system. An important example for the purposes of this report is where a merchant buys card-acquiring services from a payment facilitator, rather than directly from an acquirer. Payment facilitators tend to focus on serving merchants with low levels of card turnover as discussed in Chapter 4.

29 A chargeback is different from a refund. The latter is a transaction initiated by the merchant as part of the normal course of business. A chargeback is initiated by the issuer where it considers the cardholder has the right to dispute a transaction.

3.25 Payment facilitators are intermediaries between acquirers and merchants. Under scheme rules, acquirers can permit payment facilitators to recruit merchants on their behalf and contract with these merchants for card-acquiring services. Typically, when a merchant contracts with a payment facilitator for card-acquiring services, there is no direct contractual relationship between the merchant and the acquirer. There is also no direct contractual relationship between the payment facilitator and the operator of the card payment system.

3.26 The payment facilitator provides card-acquiring services to merchants, which includes onboarding merchants to accept card transactions and transferring them the money they are owed.

3.27 The acquirer continues to play an important role in enabling card payments involving merchants recruited by payment facilitators. The acquirer supports payment facilitators with the authentication, authorisation, clearing and settlement of card payments involving their merchants through the card payment system and transfers the money those merchants are owed to the payment facilitator (for onward settlement to the merchant). The acquirer is also responsible for ensuring that the payment facilitator and the merchants it recruits comply with scheme rules, and is ultimately liable for any chargebacks involving the payment facilitator's merchants.

3.28 Acquirers place certain conditions and restrictions on the activity of payment facilitators, which are outlined in Annex 1.

Products merchants buy to accept card payments

3.29 To accept card payments, merchants need the following:

- **Card-acquiring services**, which can be bought from acquirers or payment facilitators.
- **Hardware and software** to capture the card details at the point-of-sale (POS) and transmit these to the merchant's acquirer or payment facilitator. This includes card readers and POS terminals[30] for card payments accepted face to face and payment gateways for e-commerce payments. In its most basic form, a payment gateway is software that captures the card details and translates them into a message that is sent to and understood by the acquirer's systems. Merchants can also buy payment gateways for card payments accepted face to face[31] – unless otherwise stated, where we refer to payment gateways, we mean payment gateways that help merchants accept e-commerce payments. POS terminals, card readers and payment gateways – which we refer to as card acceptance products – can be

30 Card readers and POS terminals are hardware used to capture card details for card payments accepted face to face. They differ because POS terminals are stand-alone devices while card readers must be connected to an app on a smartphone or tablet to operate.

31 In simple terms, a payment gateway for card payments accepted face to face is software loaded on to a POS terminal that translates card details into a message that is sent to and understood by the acquirer's systems.

obtained from acquirers, payment facilitators or third parties, and may or may not be integrated with the merchant's own systems.

- A **bank account** to receive the funds for card payments from the acquirer or payment facilitator. Where an acquirer is part of a banking group, the merchant can obtain card-acquiring services and a bank account from the same firm.

3.30 Merchants also buy from acquirers and payment facilitators other goods and services, which we refer to as **value-added services**. For example, merchants can buy services from acquirers to help them comply with the Payment Card Industry Data Security Standard (PCI DSS)[32] requirements or allow cardholders to pay in their home currency when shopping abroad. Some of these value-added services are also available from third parties.

3.31 A merchant's specific requirements for accepting card payments will depend on a variety of factors: including its size, its willingness and capability to carry out certain activities in-house, and whether it accepts card-present transactions (that is, a transaction where the cardholder is present at the outlet and presents the card or smartphone/smartwatch) or card-not-present transactions (such as e-commerce transactions and mail order and telephone order – MOTO – transactions).

3.32 Annex 1 provides more information on the products merchants buy to accept card payments and on merchant characteristics.

3.33 Online marketplaces, such as Etsy and Just Eat, are websites or apps that bring together buyers and sellers. In many cases, the operators of online marketplaces enable buyers to pay sellers by card without leaving the website or app (including by contracting with acquirers or payment facilitators for card-acquiring services). Often, sellers (that is, merchants) are not able to choose their own provider of card-acquiring services for transactions made on the online marketplace. Therefore, for the purposes of our market review, we consider the supply of card-acquiring services to online marketplaces but not individual sellers using those marketplaces (except insofar as those sellers may buy card-acquiring services from an acquirer or payment facilitator if selling via other channels, such as their own website).

3.34 Most small and medium-sized merchants also accept other payment methods in addition to cards. However, as we noted in paragraph 3.10, cards are an important payment method. We have not seen any evidence of reasonable substitutes for Mastercard and Visa cards for merchants, which would exert a competitive constraint on the supply of card-acquiring services for these cards. The merchant survey of small and medium-sized merchants we commissioned found that around 90% did not take steps to influence their customers' choice of payment method in the last year, and many merchants said card payments were their preferred choice of payment method. Moreover, merchants want to accept the payment methods their customers want to

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32 PCI DSS is a set of standards designed to protect the security of card payments and reduce fraud. The standards are maintained by a council consisting of certain operators of card payment schemes, with input from other parties such as acquirers and merchants. Scheme rules require that acquirers ensure their merchants comply with PCI DSS requirements.

use; as such, they will have a strong incentive to continue accepting cards, as it's the most frequently used payment method in the UK. While there are a range of ongoing developments (including regulatory and technological developments) that may change the payment methods available to merchants, they have not made any significant impact to date in retail payments. Annex 1 provides more information. As noted in paragraph 3.10, payments made using interbank payments currently account for a very small share of spontaneous consumer retail payments.

Providers of card-acquiring services

3.35 Historically, merchants could only buy card-acquiring services from acquirers, which were UK-based banks. Merchants are now served by acquirers and payment facilitators with varied business models. Some of these firms are based in other jurisdictions. In this section, we describe the factors that led to these changes and introduce the main providers of card-acquiring services serving merchants. Unless otherwise stated, when we refer to providers of card-acquiring services in this document, we mean those that are authorised to provide those services.

Recent developments in card-acquiring services

3.36 Over the past 15 years, the types of firm supplying card-acquiring services to merchants have been shaped by several important factors, including regulatory changes; divestments, mergers and acquisitions; and entry by new providers.

Regulatory changes

3.37 The first EU Payment Services Directive (PSD1) was implemented into UK law by the Payment Services Regulations 2009. It allowed non-banks to provide payment services – including card-acquiring services – for the first time. PSD1 also made it easier for acquirers authorised anywhere in the European Economic Area (EEA) to offer card-acquiring services to merchants by introducing passporting[33] for payment services.

3.38 In 2013, the European Commission proposed a new package of legislation that aimed – like PSD1 – to create an integrated and competitive market for payment services and consisted of:

- the IFR, which came into force in June 2015 (though not all the provisions came into force at the same time)
- the second Payment Services Directive (PSD2), which replaced PSD1 and was implemented into UK law by the Payment Services Regulations 2017 (PSRs 2017); most of the provisions in the PSRs 2017 came into force in January 2018

33 Passporting allows a business authorised in an EEA state to offer certain products or services in other EEA states if it has the relevant authorisation.

3.39 The IFR introduced caps on interchange fees on certain card transactions and introduced several business rules, one of which (Article 6) aimed to promote cross-border acquiring[34] by banning territorial restrictions that would limit acquirers' ability to operate freely within the EEA. Other business rules require acquirers to offer and charge MSCs[35] broken down for the various different categories[36] of cards and different brands of cards (such as Mastercard and Visa) with different interchange fee levels (Article 9(1)), and specify the amount of each MSC, and show the applicable interchange fee and scheme fees separately for each category and brand of cards in their agreements with merchants (Article 9(2)). Article 12 IFR requires that merchants' payment service providers (PSPs) [37] provide (or make available) certain information to the merchant on each card transaction. The European Commission recently published a report on the application of the IFR.[38]

3.40 PSD2 widened the scope of PSD1 so that, with certain exceptions, everyone providing payment services as a business activity, including card-acquiring services, is subject to regulation – for example, around conduct. Other new requirements included the implementation of strong customer authentication (SCA), which is designed to make payments safer and limit fraud.

3.41 Annex 1 provides more information on the regulatory framework that applies to acquirers and payment facilitators, and some of the voluntary industry standards to which they commonly adhere.

3.42 Since the interim report was published in September 2020, a set of new rules now apply to the relationship between the UK and EU following the end of the Brexit transition period. Effects on the supply of card-acquiring services include the following:

- The IFR has been retained in UK law and revised to focus on domestic card payments (UK IFR).
- Caps on interchange fees for payments to and from the EU are no longer covered by UK or EU legislation (IFR and UK IFR).
- Payment services may no longer be passported between the EU and UK. Temporary permissions may have been given to EEA providers for continued access to the UK market. Some UK providers have also set up operations within the EU and EEA.

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34 Cross-border acquiring is where the acquirer is located in a different country to the merchant's point of sale.

35 For the purposes of our market review, we use the term MSC to refer to the total amount the merchant pays for card-acquiring services. However, the IFR defines an MSC as 'a fee paid to the payee to the acquirer in relation to card-based payment transactions'. As set out in our guidance on our approach to monitoring and enforcing the IFR, we consider that one-off or periodic fees are not part of the MSC. PSR, *Guidance on the PSR's approach to monitoring and enforcing compliance with the Interchange Fee Regulation* (September 2021), paragraph 4.34.

36 In the market review, we use the term 'type of card'. This is similar to, but not the same as, the term 'category of card' used in in the IFR, which refers to the following four types of card only: prepaid, debit, credit and commercial.

37 The legislation that established the PSR – the Financial Services (Banking Reform) Act 2013 – has a different definition of payment service provider to that used in the IFR. In this section, when we use the term payment service provider (PSP), we mean PSP as defined in the IFR.

38 European Commission, *Report on the application of Regulation (EU) 2015/751 on interchange fees for card-based payment transactions* (2020).

Divestments, mergers and acquisitions

3.43 There have been many mergers, acquisitions and divestments involving acquirers and payment facilitators operating in Europe over the last 10 years. Broadly, those involving the main acquirers and payment facilitators (see paragraph 3.49) can be categorised as follows:

- **UK high-street banks selling their acquiring businesses after 2008**. Royal Bank of Scotland (RBS, now NatWest Group) sold its acquiring business (called RBS Worldpay at the time) to two private equity firms in 2010 to meet state aid commitments made to the European Commission. HSBC had its own acquiring business until 2008, when it created a joint venture called GPUK LLP with Global Payments Inc and then sold its stake to Global Payments Inc the following year.

- **Acquirers buying businesses active in other parts of the card acceptance value chain**. For example, Elavon announced in 2019 that it was buying Sage Pay – a payment gateway provider – for various reasons that included expansion of its presence in the UK and the Republic of Ireland among small and medium-sized merchants.

- **US providers of financial services technology buying or merging with acquirers from 2017 onwards.** For example, Worldpay was acquired by Vantiv in 2018, and then Vantiv was in turn bought by Fidelity National Information Services, Inc (FIS) in 2019. Also, in 2019, Fiserv Inc acquired First Data Corporation and Global Payments Inc merged with Total System Services, Inc. These mergers and acquisitions had various aims, including to create scale and deliver a broader product offering by bringing together businesses carrying out complementary activities in the payments value chain.

- **Payment facilitators buying providers of e-commerce platforms**[39] **and other payment facilitators.** For example, in 2018 PayPal Holdings Inc[40] acquired a payment facilitator called iZettle (which now operates as Zettle by PayPal). Square and SumUp bought Weebly and Shoplo – both e-commerce platforms – in 2018 and 2019 respectively. A common aim of these acquisitions was to broaden the firms' offerings to merchants – for example, by strengthening their omnichannel offering.[41]

Entry by new providers

3.44 New acquirers have started offering card-acquiring services to merchants in recent years, including:

- **Cross-border acquiring.** Passporting of services ended when the UK left the EU/EEA. However, a number of acquirers are currently operating under temporary permissions while they apply for authorisation in the UK. Adyen began offering

39 An e-commerce platform is software that allows a merchant to build and manage a website.

40 PayPal Europe ('PayPal') is ultimately wholly owned by PayPal Holdings Inc and provides a range of payment services, including as a payment facilitator. We provide more information on PayPal in Annex 1.

41 There is no single definition of omnichannel services, but broadly this can be defined as provision by a single firm of services integrating payments made via different channels (for example, e-commerce and face to face). Annex 1 has more information.

card-acquiring services to UK merchants in 2012 and currently serves the UK under the temporary permission regime having filed its UK branch licence application.

- **Payment gateway providers.** Some new entrants previously offered payment gateways to merchants before becoming acquirers themselves. Examples include Paysafe and Nuvei (previously SafeCharge), which both began providing card-acquiring services to UK merchants in 2015.

- **Tyl by NatWest.** NatWest Group announced the launch of Tyl by NatWest in 2019. NatWest Group was previously a significant acquirer before it sold this part of its business in 2010 (see paragraph 3.43).

3.45 New payment facilitators have also started offering card-acquiring services to merchants. Zettle (now owned by PayPal – see paragraph 3.43) and SumUp both began serving UK merchants that sell face to face in 2012. Square began providing card-acquiring services to UK merchants in March 2017. Stripe started providing card-acquiring services mainly to online merchants as a payment facilitator in 2013 before becoming a direct Visa and Mastercard acquirer. Since 2019, Stripe has served all its European merchants as a Visa and Mastercard acquirer.

3.46 In addition, Revolut – an e-money issuer – announced in 2018 that it planned to set up an acquiring business in the UK.

3.47 In response to our interim report, Stripe told us that there have been recent new entrants that we did not mention, particularly to service the online segment of the market.[42]

Overall shares of supply in card-acquiring services

3.48 In 2018, there were over 100 acquirers and over 50 payment facilitators providing card-acquiring services to UK merchants.

3.49 A small number of providers account for around 95% of card transactions acquired at UK outlets by volume (that is, number) and value of transactions.[43] We categorise these providers as follows:

- The **five largest acquirers** (as measured by the volume and value of card transactions acquired in 2018) – Barclaycard, Elavon, Global Payments, Lloyds Bank Cardnet and Worldpay.

- **Other acquirers** – Adyen, AIB Merchant Services, Chase Paymentech, EVO Payments, First Data and Stripe.

- The **largest payment facilitators** – PayPal, Zettle[44], Square and SumUp.

42 Stripe response, page 2.

43 PSR analysis of data provided by acquirers and operators of card payment systems.

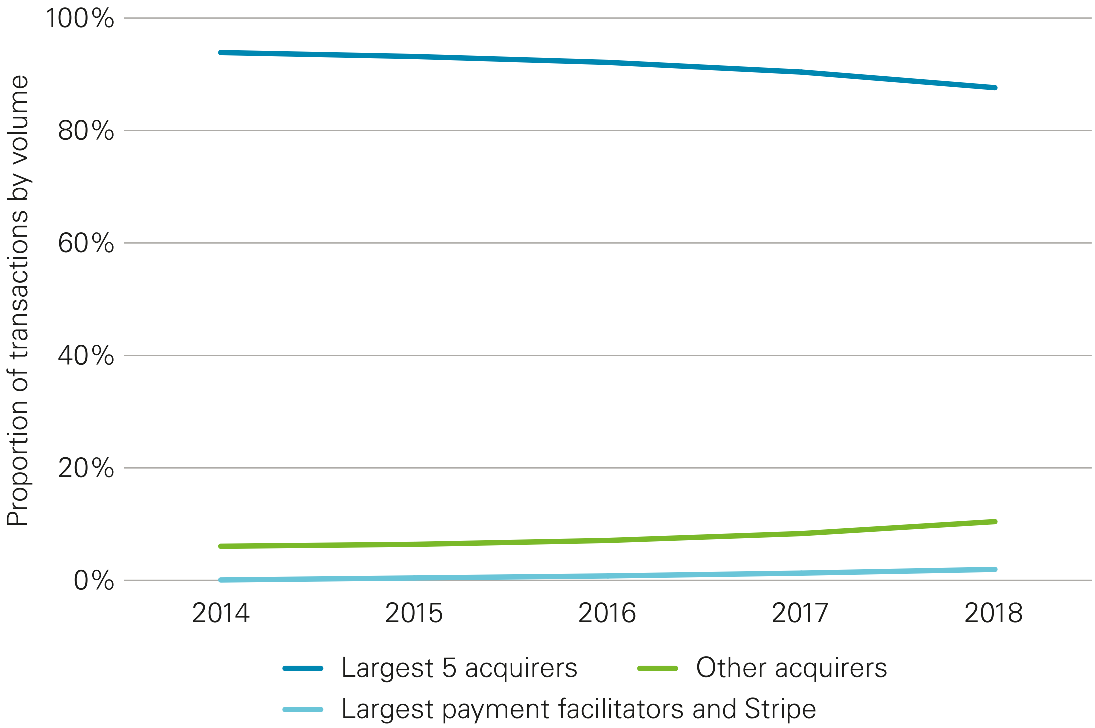
44 PayPal Europe ('PayPal') and Zettle by PayPal are both owned by PayPal Holdings Inc.

3.50 Providers of card-acquiring services have differing business models. Only two are fully or partially owned by UK headquartered banks – Barclaycard and Lloyds Bank Cardnet. Some are non-bank acquirers (such as First Data, Global Payments and Worldpay[45]) or have their primary operations outside the UK (like Adyen). Annex 1 provides more information on the providers of card-acquiring services.

3.51 In this section, we focus our analysis on overall shares of supply of providers of card-acquiring services. In Chapter 4, we present shares of supply for different merchant segments.

3.52 Figure 2 and Figure 3 show the overall shares of supply of providers of card-acquiring services as measured by the volume and value respectively of card transactions acquired for merchants from 2014 to 2018.

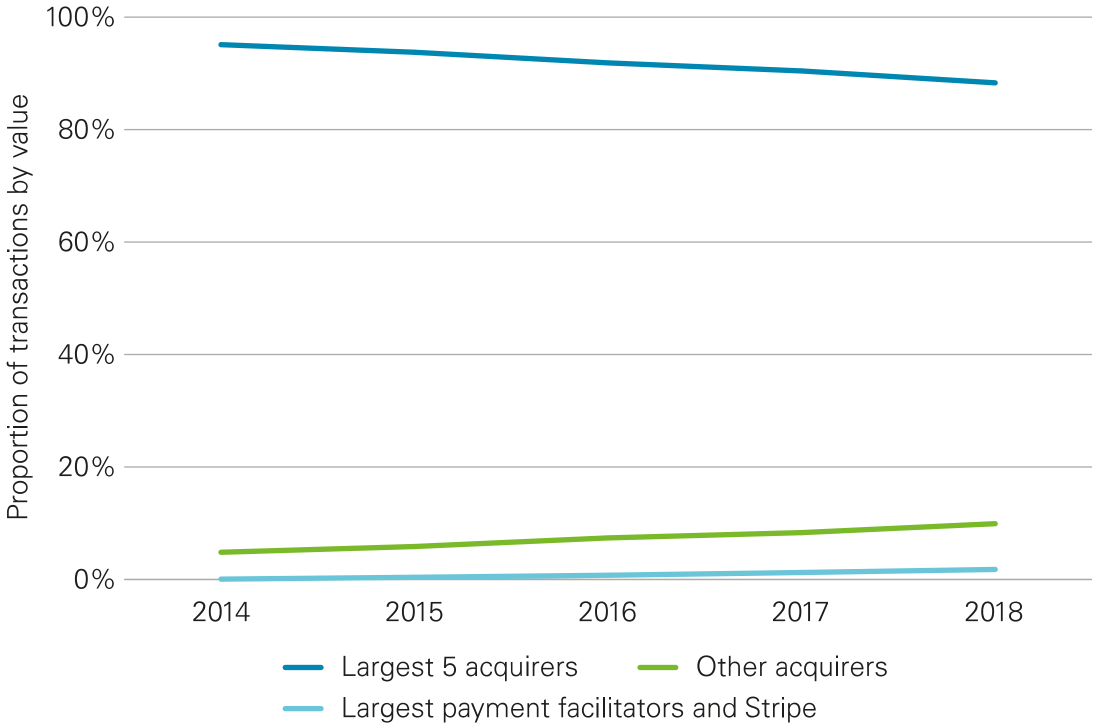
Figure 2: Volume of card transactions acquired for merchants by providers of card-acquiring services from 2014 to 2018



Source: PSR analysis of data provided by acquirers and payment facilitators on the volume of purchase transactions, refunds and chargebacks acquired for UK merchants at their UK and non-UK outlets. Stripe (an acquirer) is grouped with the payment facilitators because it was a payment facilitator for the period under consideration.

45 Originally, GPUK LLP (Global Payments' UK subsidiary) was partly owned by a bank and Worldpay was fully owned by a bank. See paragraph 3.43.

Figure 3: Value of card transactions acquired for merchants by providers of card-acquiring services from 2014 to 2018



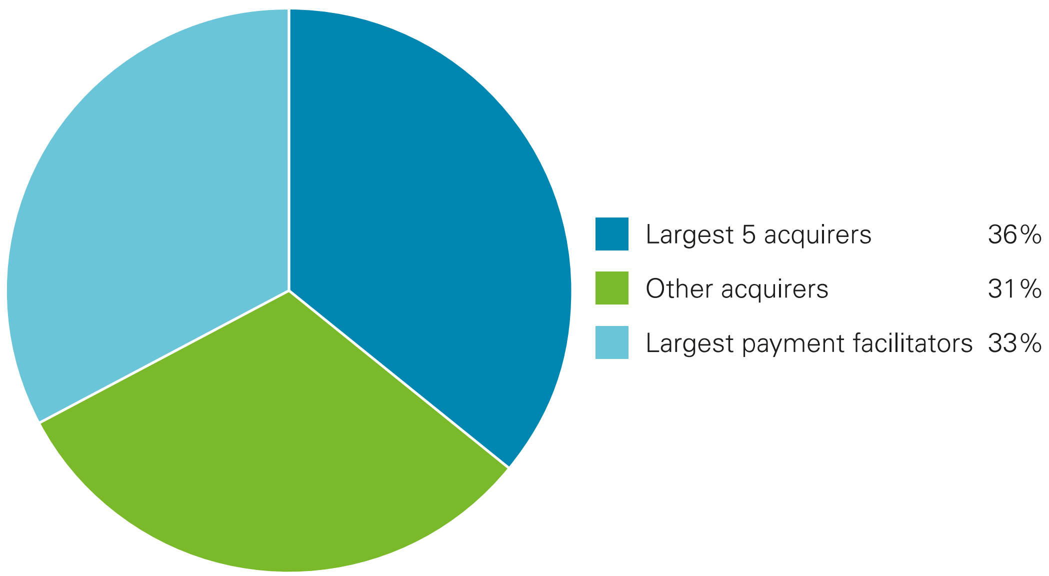
Source: PSR analysis of data provided by acquirers and payment facilitators on the value of purchase transactions, refunds and chargebacks acquired for UK merchants at their UK and non-UK outlets. Stripe (an acquirer) is grouped with the payment facilitators because it was a payment facilitator for the period under consideration.

3.53 From 2014 to 2018, we observe that:

- two providers – Barclaycard and Worldpay – accounted for [70-80]% of card transactions by volume and [60-70]% of card transactions by value in each year
- the shares of supply of four of the five largest acquirers have fallen steadily. One driver of this trend is the expansion of new entrants, especially Adyen
- the largest payment facilitators have a very small share of supply

3.54 Figure 4 shows overall shares of supply as measured by the number of merchants served by the providers for card-acquiring services in 2019. Shares of supply based on number of merchants by provider are significantly less concentrated than when measured by the volume and value of transactions acquired. One reason is that the largest payment facilitators and Stripe have expanded significantly in recent years by growing the number of merchants that accept card payments. This is discussed further in Chapter 4.

Figure 4: Shares of merchants served by the main providers of card-acquiring services in 2019



Source: PSR analysis of data provided by acquirers and payment facilitators on the number of merchants served in August 2019. Merchants that did not accept any card transactions or only accepted test transactions in the 12 months prior to August 2019 are excluded.

Acquirers' offering

3.55 The five largest acquirers and some of the other acquirers identified in paragraph 3.49 serve merchants selling face to face, online and through other channels.

3.56 Most acquirers can provide card-acquiring services as a stand-alone product. Large merchants with annual card turnover above £10 million (and particularly the largest merchants with annual card turnover above £50 million) are more likely to buy only card-acquiring services from their acquirer and source card acceptance products from third parties (for example, by buying POS terminals direct from the manufacturer or sourcing a payment gateway from a business that specialises in providing this software).

3.57 However, many small and medium-sized merchants prefer to 'one-stop shop' – that is, look for one firm that offers everything they need to accept card payments.[46] Acquirers usually offer a package of goods and services that together enable merchants to accept card payments. A typical basic offering for a merchant selling face to face would include:

- card-acquiring services
- one or more POS terminals, which the merchant hires
- services to enable the merchant to certify (and in some cases, assist) their compliance with PCI DSS requirements

46 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 20.

3.58 Some acquirers offer card readers as well as POS terminals, which we discuss in Chapter 4.

3.59 For merchants selling online that want to buy everything they need to accept card payments from an acquirer, the typical basic offering is the same as that for merchants selling face to face except that the acquirer provides a payment gateway rather than a POS terminal.

3.60 Merchants can also buy value-added services from their acquirer (see paragraph 3.30).

3.61 Some acquirers may offer POS terminals, payment gateways, PCI DSS compliance services and other value-added services in partnership with third parties. For example, AIB Merchant Services and Lloyds Bank Cardnet refer merchants that want a POS terminal to third-party POS terminal providers. Annex 1 provides more information on third-party POS terminal providers.

3.62 Overall, for the five largest acquirers, acquirer net revenues (after deduction of interchange and scheme fees) for card-acquiring services accounted for 62% of total revenues. Card acceptance devices (that is, card readers and POS terminals) and payment gateways together provided 15% of revenues and value-added services provided the remaining 23%. See Annex 3 for more information.

Pricing of card-acquiring services and other products

3.63 Acquirers tend to price card-acquiring services separately from card acceptance products and value-added services. Merchants served by acquirers have one or more of the following pricing options for card-acquiring services, which are described in more detail in Annex 1:

- Standard pricing, whereby for any given transaction the acquirer does not automatically pass through at cost the interchange fee applicable to the transaction and the pricing option does not satisfy the criteria for IC+, IC++ or fixed pricing.
- Interchange fee plus (IC+) pricing, whereby for any given transaction the acquirer automatically passes through at cost the interchange fee applicable to that transaction.
- Interchange fee plus plus (IC++) pricing, whereby for any given transaction the acquirer automatically passes through at cost the interchange fee and scheme fees applicable to that transaction.[47]
- Fixed pricing, whereby the merchant pays a fixed, periodic fee for card-acquiring services (the amount of which does not depend on the volume or value of transactions it accepts or the characteristics of these transactions, within specified limits).

47 The acquirer may also pass through at cost scheme fees that are not directly attributable to transactions.

3.64 Over 95% of acquirers' merchants have standard pricing[48], which typically consists of:

- several 'headline rates' that are applied to different types of purchase transactions (and sometimes refunds) and can take the form of a pence per transaction fee, an ad valorem fee[49] or a combination of the two
- one or more additional fees or rates, which are mainly triggered by:
  - specific events (such as chargebacks, refunds and PCI DSS non-compliance), and/or
  - specific types of purchase transactions (and sometimes refunds), such as e-commerce transactions

3.65 The MSC is the total amount the merchant pays the acquirer for card-acquiring services, including any additional fees.

3.66 The structure of acquirers' standard pricing varies widely. For example, depending on their acquirer and preferences, a merchant might pay:

- a different headline rate depending on the card type (for example, one headline rate for credit cards and another for debit cards)
- a different headline rate depending on the card type and card payment system (for example, one headline rate for Visa debit cards and another for Mastercard debit cards)
- a different headline rate depending on the card type, card payment system and how the card is authenticated (for example, one headline rate for secure transactions involving Visa debit cards and another for non-secure transactions involving these cards)

3.67 Headlines rates can vary by card type, card payment system or the way a card transaction is authenticated because interchange fees and scheme fees also vary according to these transaction characteristics (and others) – see paragraph 3.19. However, unlike IC+ and IC++ pricing, with standard pricing there will always be circumstances in which the same headline rate applies to transactions that attract different interchange fees. As a result, the acquirer net revenue for transactions that have the same headline rate can vary. The acquirer needs to set the headline rate (and any additional fees) at a level that allows it to recover interchange fees (as well as its other costs) across the mix of transactions that the merchant accepts.

48 PSR analysis of data provided by acquirers.

49 An ad valorem fee is a fee that is expressed as a percentage of the value of the transaction.

3.68 Outside of the headline rate, acquirers also have different additional fees or rates. For example, a merchant with one acquirer might pay an additional fee for e-commerce transactions but not with another acquirer. Most acquirers have additional fees for authorisation requests but some have different fees depending on the type of the request.

3.69 The other components of an acquirer's typical offering are usually priced as follows:

- merchants hire POS terminals for a monthly fixed fee
- payment gateways attract a fixed monthly fee (for a specified number of transactions), a fee for each transaction or a fixed monthly fee plus a fee for each transaction
- services to enable the merchant to certify (and, in some cases, assist) their compliance with PCI DSS requirements attract a fixed monthly or yearly fee

3.70 Stripe's pricing structure is simpler than most other acquirers'. Most of Stripe's merchants pay, for card-acquiring services, one headline rate for cards issued in Europe and one for cards issued outside Europe.[50] The headline rate includes a payment gateway. Stripe's merchants also pay an additional fee for the administration of each chargeback incurred (which is reimbursed to the merchant if the disputed payment is found in their favour). Several other acquirers have also simplified their standard pricing in recent years, which we discuss in Chapter 4.

3.71 Most acquirers that use standard pricing do not publish their prices. Instead, the price they quote to a merchant is determined by the information that a sales agent collects about the merchant's characteristics during the sales process, such as the merchant's actual or expected annual card turnover and the mix of cards they accept or plan to accept. Once the sale is agreed, the acquirer then carries out due diligence on the merchant as part of the onboarding process (see paragraph 3.23).

Payment facilitators' offering

3.72 The largest payment facilitators – Zettle, PayPal (through its PayPal Here product), Square and SumUp – predominantly[51] provide card-acquiring services to merchants selling face to face (though PayPal has other products that it provides as a payment facilitator that are aimed at merchants selling online – see paragraph 3.76). The largest payment facilitators offer:

- card-acquiring services
- a card reader

50 Stripe also offers IC++ pricing.

51 One payment facilitator reported higher volumes of card-not-present transactions since the COVID-19 crisis began.

3.73 Unlike most acquirers, the largest payment facilitators do not offer a stand-alone product to help merchants comply with PCI DSS requirements. They cover PCI compliance on behalf of their merchants[52], or assist with this, as part of the overall fee for card-acquiring services.

3.74 While POS terminals are usually stand-alone devices, the card reader must be connected to an app on a smartphone or tablet to work. The apps offered by the largest payment facilitators allow the merchant's smartphone or tablet to be used as a POS system. For example, the merchant can add products to an order at the checkout, track their inventory and access information on the transactions they accept. The largest payment facilitators do not charge the merchant for the apps they provide. Payment facilitators also offer value-added services.

3.75 Card-acquiring services provided by Zettle, PayPal, Square and SumUp are intended to be used with the card readers they sell. Merchants cannot use card-acquiring services from these payment facilitators with hardware from another party.

3.76 PayPal (for the Braintree and PayPal Pro products) targets merchants that sell online. PayPal's offering includes card-acquiring services and a payment gateway. PayPal does not offer a stand-alone product to help merchants comply with PCI DSS requirements. PayPal assists its merchants with compliance as part of the overall service, although merchants may have their own obligations for PCI DSS compliance. Zettle, Square and SumUp also enable merchants to accept payments online.

Pricing of card-acquiring services and other products

3.77 The payment facilitators that predominantly serve merchants selling face to face – Zettle, Square and SumUp – have standard pricing whereby merchants typically pay:

- a one-off fee for a card reader (which the merchant buys upfront and owns)
- one headline rate for card-acquiring services for card-present transactions[53]

3.78 Merchants do not pay any additional fees for card-acquiring services or the POS app (see paragraph 3.74).

3.79 PayPal Here has a tiered pricing structure for chip-and-PIN and contactless payments. Merchants pay one of four headline rates, depending on their card turnover in the previous month for transactions involving UK-issued Mastercard and Visa cards. There are separate headline rates for transactions authenticated in other ways, and transactions involving American Express cards. There are also additional fees for transactions involving cards issued outside the UK and for chargebacks.

52 In some cases, merchants may not need to self-certify.

53 Zettle, Square and SumUp predominantly serve merchants selling face to face but also serve merchants selling online. Square and Zettle have a single headline rate for card-not-present transactions and SumUp has two.

3.80 Merchants using PayPal's Braintree and PayPal Pro products pay:

- two headline rates – one for purchase transactions with Mastercard and Visa cards, and one for purchase transactions with American Express cards
- additional fees, which could be triggered by chargebacks and certain other events, and for purchase transactions with certain non-UK cards. For PayPal Pro, merchants also pay a fixed fee of GBP20 per month

3.81 The largest payment facilitators publish the headline rates that their merchants typically pay.

Independent sales organisations and other third parties

3.82 There are a variety of third parties that help merchants accept card payments but do not themselves provide card-acquiring services. For example:

- **ISOs** sell card-acquiring services to merchants on behalf of one or several acquirers alongside card acceptance products and value-added services.
- **Gateway providers** specialise in providing payment gateways (sometimes alongside POS terminals) and have referral arrangements in place with acquirers.
- **Independent Software Vendors** (ISVs) specialise in offering software (and in some cases, complimentary hardware) that helps merchants run their businesses and often have referral arrangements in place with acquirers and payment facilitators.
- **Third-party POS terminal providers**, which supply POS terminals to merchants. They work with acquirers and ISOs, who receive commission for referring merchants that want a POS terminal to a third-party POS terminal provider.

3.83 Third parties can be an important entry point for merchants looking to buy card-acquiring services, which we discuss in more detail in Chapter 4. Annex 1 provides a description of some third parties that help merchants accept card payments. The remainder of this section focuses on ISOs, which are an important customer acquisition channel for acquirers.

Independent sales organisations

3.84 There are over 60 ISOs operating in the UK[54]; Handepay, Paymentsense, RMS, takepayments (formerly Payzone) and UTP are five of the largest, and together they had approximately 175,000 merchants at the end of 2018.[55]

3.85 ISOs are tasked by acquirers with procuring new merchant relationships in return for commission. ISOs refer merchants to acquirers for card-acquiring services; ISOs do not provide these services themselves. ISOs differ from other third parties that refer merchants to acquirers because in most cases they are permitted to agree with merchants the price they will pay for card-acquiring services. The acquirer has no direct involvement in the sales process, which is outsourced to the ISO.

3.86 Once a sale is agreed, ISOs help merchants to complete the acquirer's application form for card-acquiring services and submit this to the acquirer. The acquirer then carries out its usual onboarding process (see paragraph 3.23) to decide whether to serve the merchant and has the option to reject the application. ISOs also commonly provide ongoing customer services to merchants (including in relation to card-acquiring services) after completing the sale. Annex 1 has more information on ISOs.

3.87 Like acquirers, ISOs offer a package of goods and services that together enable merchants to accept card payments. A typical offering would include:

- **Card-acquiring services.** As explained in paragraph 3.85, ISOs refer merchants to acquirers for card-acquiring services. Merchants referred by ISOs nearly always have standard pricing, which is like that generally offered by acquirers and consists of several headline rates and one or more additional fees triggered by specific types of purchase transactions and/or specific events.
- **POS terminal(s).** An ISO may hire one or more POS terminals to a merchant or refer merchants that want a POS terminal to a third-party POS terminal provider. In both cases, the ISO agrees with the merchant the fixed monthly fee the merchant will pay for hiring one or more POS terminals and signs them up to a rental agreement. Merchants may also pay for services or membership from the ISO (or third-party provider), for which they receive a POS terminal free of charge to use in conjunction with other services.

3.88 ISOs may also offer payment gateways and value added-services, such as services to help the merchant certify their compliance with PCI DSS requirements.

54 PSR analysis of data provided by 19 acquirers on third parties that refer merchants.

55 PSR analysis of data provided by Handepay, Paymentsense, RMS, takepayments and UTP.

Summary

3.89 Card use is high in the UK and has been growing strongly in recent years for several reasons, including the rapid adoption of contactless card payments and new ways of paying by card, changing shopping preferences and increasing levels of card acceptance. COVID-19 has accelerated these well-established trends. Other digital payment methods have also grown over recent years, though to a much lesser extent.

3.90 Card payment systems enable people to make payments using cards. Mastercard and Visa are both examples of four-party card payment systems, which involve at least five participants: cardholders, merchants, operators of those systems, issuers, and acquirers. Acquirers play an important role in enabling card payments by providing card-acquiring services to merchants; these services can also be bought from payment facilitators. There are various fees flowing around card payment systems, including interchange fees (paid by acquirers to issuers), scheme fees (paid by acquirers and issuers to the operator of the card payment system) and MSCs (paid by merchants to acquirers for card-acquiring services).

3.91 To accept card payments, merchants need card-acquiring services, card acceptance products and a bank account. Acquirers and payment facilitators provide card-acquiring services and card acceptance products plus value-added services. Card acceptance products and value-added services can also be bought from third parties.

3.92 Over the past 15 years, the types of firms providing card-acquiring services to merchants have changed considerably due to factors such as regulatory changes, entry, and mergers and acquisitions. Today, many merchants are served by non-bank providers (including payment facilitators).

3.93 Various third parties help merchants to accept card payments, including by referring them to acquirers and payment facilitators (though do not provide card-acquiring services themselves). For example, ISOs are an important source of customers for acquirers. ISOs sell card-acquiring services to merchants on behalf of one or several acquirers alongside card acceptance products and value-added services.

3.94 In response to the interim report, some stakeholders told us that there are an increasing number of 'ways to pay' and that non-card digital payment methods are important. We agree that non-card payments, such as interbank payments, have the potential to increase their share of spontaneous consumer retail payments. However, as we noted in paragraph 3.10, card payments will continue to be an important payment method used by the majority of UK businesses. Our merchant survey showed that card payments were merchants' preferred payment method more than any other (see Annex 1 and merchant survey).

4 Competition between providers of card-acquiring services

Providers of card-acquiring services have different strategies for competing for merchants of different sizes. For the purposes of our market review, we use two broad segments: small and medium-sized merchants with annual card turnover up to £10 million; and large merchants with annual card turnover above £10 million.

Small and medium-sized merchants buy card-acquiring services from acquirers or payment facilitators, but large merchants typically buy these services from acquirers.

The largest payment facilitators have expanded significantly in recent years by growing the number of merchants that accept card payments. Stripe – which is now an acquirer mainly serving merchants selling online – has also expanded significantly.

ISOs procure merchants – predominantly merchants selling face to face with annual card turnover of up to £1 million – for acquirers and provide them with card acceptance products and value-added services. They are an important source of customers for acquirers.

Acquirers, payment facilitators and ISOs compete for merchants based on price and non-price factors.

We assessed potential barriers to entry and expansion. We don't consider these barriers to be significant for providers serving merchants with less than £50 million annual card turnover.

Introduction

4.1 Providers of card-acquiring services have different business strategies that vary primarily by merchant size as measured by annual card turnover. For example, most segment their customers by merchant size, though they use different segmentations.

4.2 For the purposes of our market review, we use two broad segments within the supply of card-acquiring services to structure our analysis and present our findings:

- **Small and medium-sized merchants, with annual card turnover up to £10 million**.[56] Almost all merchants are in this segment, although they are only responsible for around 17% of the value of card transactions. The **smallest merchants** within this segment, with annual card turnover up to £380,000, account for over 90% of the overall merchant population.

- **Large merchants**, with annual card turnover above £10 million. This segment is dominated by a very small number of the **largest merchants** with annual card turnover above £50 million, who are responsible for 76% of the value of card transactions.

4.3 We also consider some additional sub-segments within the broad card turnover groups.

4.4 Table 1 shows the proportion of merchants in these two broad segments (and in some additional sub-segments), and the proportion of card transactions they accepted in 2018.

Table 1: Merchant segments

Merchant segment	Sub-segment (annual card turnover)	Proportion of merchants	Proportion of transactions (2018 volume)	Proportion of transactions (2018 value)
Small and medium-sized	Less than £380k	93.7%	8.1%	6.5%
	£380k – £1m	4.1%	3.3%	3.8%
	£1m – £10m	1.9%	5.3%	7.3%
Large	£10m – £50m	0.2%	4.8%	6.4%
	More than £50m	0.1%	78.6%	76.0%

Source: PSR analysis based on data provided by acquirers and payment facilitators on merchants served in April 2019 (or in one case, August 2019). Active merchants only. Figures may not sum to 100% due to rounding.

4.5 This chapter describes for each of the two broad segments:

- the providers that compete and the customer acquisition channels they use, and how both have changed over time, including due to entry and expansion
- how providers and ISOs compete on price
- how providers and ISOs compete on quality and other non-price factors

56 We note that some merchants that are categorised as small and medium-sized merchants based on their annual card turnover may be large businesses that take payment through other methods.

4.6 Although ISOs do not provide card-acquiring services, as explained in Chapter 3, they sell these services on behalf of acquirers. They have some discretion as to how they win customers for the acquirers they work with – for example, in most cases they can agree with the merchant the price of card-acquiring services. Therefore, we describe in this chapter how they seek to win customers based on price and non-price factors.

4.7 This chapter also summarises our analysis of a number of potential barriers to entry and expansion, which were identified based on stakeholders' concerns.

Providers serving different merchant segments

4.8 This section examines the providers of card-acquiring services that operate in each merchant segment and the customer acquisition channels they use.

4.9 We focus this section on which providers compete for merchants of different sizes. We also bring out differences in providers' strategies and risk appetites. Annex 1 provides more information on the risks providers of card-acquiring services carry in serving individual merchants or certain types of merchants.

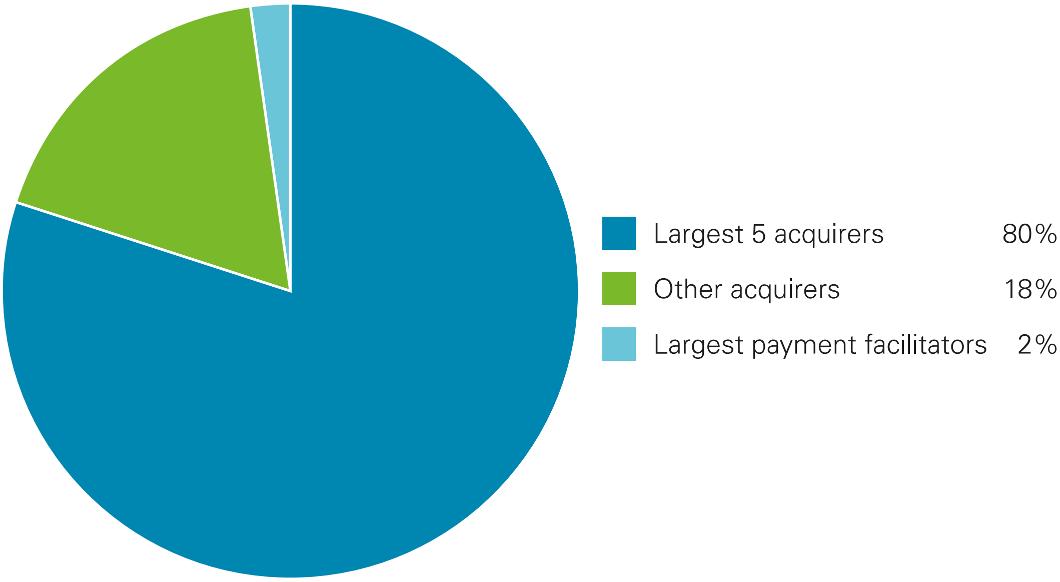
Large merchants

4.10 As we see in the next section, small and medium-sized merchants buy card-acquiring services from acquirers and payment facilitators, but large merchants typically buy these services from acquirers.[57]

4.11 Figure 5 shows the shares of supply of providers serving large merchants as measured by the proportion of merchants served. Two acquirers – Barclaycard and Worldpay – provide card-acquiring services to [50-60]% of large merchants. Adyen, AIB Merchant Services, Lloyds Bank Cardnet, Elavon, Global Payments and First Data together serve [40-50]% of merchants.

57 Two of the largest payment facilitators provide card-acquiring services to a small number of large merchants.

Figure 5: Shares of large merchants served by the main providers of card-acquiring services in 2019



Source: PSR analysis of data provided by acquirers and payment facilitators on numbers of large merchants served in August 2019. Merchants that did not accept any card transactions or only accepted test transactions in the 12 months prior to August 2019 are excluded.

4.12 The acquirers serving large merchants differ in their business strategies:

- Adyen told us that it initially focused on large enterprise merchants but now also serves 'mid-market' merchants.[58] Chase Paymentech said it predominantly provides card-acquiring services to large multinational merchants but also serves a small number of small and medium-sized merchants. Other acquirers serving large merchants, including the five largest acquirers, all provide card-acquiring services to significant numbers of small and medium-sized merchants.
- Some acquirers target specific types of large merchants. For example, Chase Paymentech currently primarily focuses on acquiring card-not-present transactions for e-commerce merchants while Elavon specialises in serving airlines (which carry a higher credit risk than many other merchants) and merchants in the hospitality sector. Worldpay's large corporate field sales team focuses on large merchants in the [✂]. Worldpay also specialises in serving global e-commerce merchants.

4.13 The above variation in acquirer strategies means that large merchants will have a different choice of acquirers depending on their needs.

4.14 Adyen is a new entrant that has grown its share of supply significantly since it started providing card-acquiring services to UK merchants in 2015. Its overall share of card transactions (by volume and value) increased by [0-5]% between 2015 and 2018; as of 2019, it served around [5-10]% of large merchants.

58 See also Adyen response, page 2.

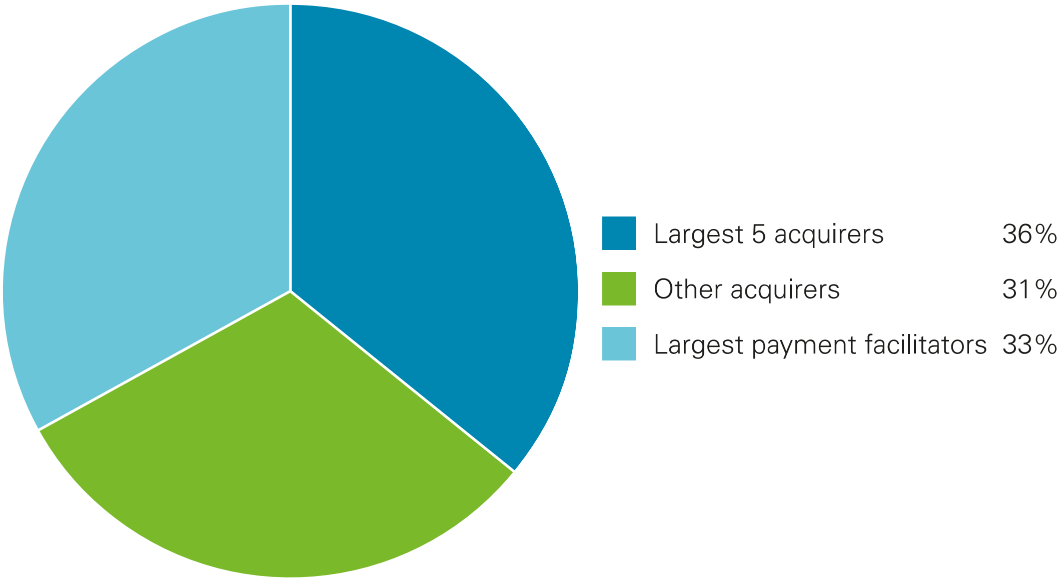
4.15 Acquirers generally compete for the largest merchants by approaching them directly or by bidding in response to tenders. Acquirers that are fully or partially owned by, or have a referral relationship with, banks also receive large-merchant referrals from banks.

Small and medium-sized merchants

4.16 Figure 6 shows shares of supply of providers serving small and medium-sized merchants as measured by the proportion of merchants served in 2019.[59] The main difference compared to Figure 5 is that the largest payment facilitators – Zettle, PayPal, SumUp and Square – serve around one third of merchants. Over 36% are served by the five largest acquirers, though the number of merchants served by [✂] have declined since 2014. The other acquirers serve around 31% of small and medium-sized merchants; most have slowly increased the share of merchants they supply over time, though Stripe has expanded significantly.

4.17 In the remainder of this section, we describe the expansion of the largest payment facilitators in recent years. We then describe the customer acquisition channels used by acquirers, focusing particularly on ISOs.

Figure 6: Shares of supply of small and medium-sized merchants in 2019



PSR analysis of data provided by acquirers and payment facilitators on merchants served in August 2019. Merchants that did not accept any card transactions or only accepted test transactions in the 12 months prior to August 2019 are excluded.

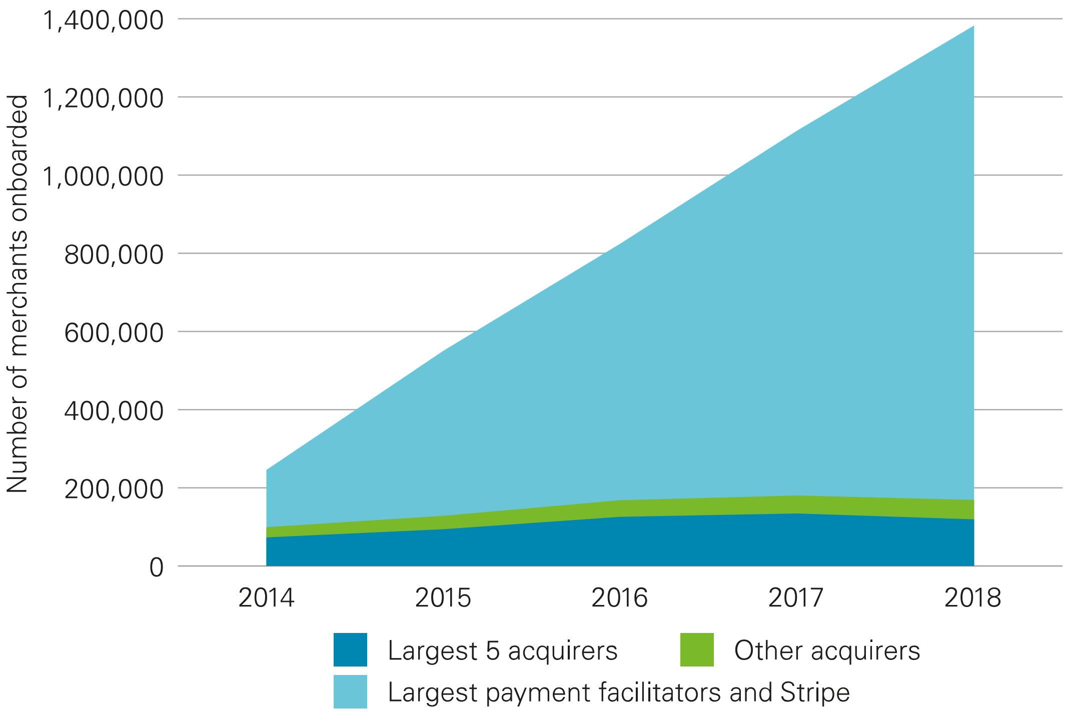
59 Figure 4 is the same as Figure 6 because Figure 4 is dominated by small and medium-sized merchants, which account for over 99% of merchants (see Table 1).

Expansion of the largest payment facilitators serving merchants selling face to face

4.18 The largest payment facilitators serving merchants selling face to face have grown significantly in recent years. They have expanded the number of merchants accepting card payments by targeting merchants that were traditionally underserved by acquirers.

4.19 Figure 7 shows the share of merchants onboarded by acquirers and payment facilitators in each year from 2014 to 2018. It mostly represents shares of supply of the smallest merchants onboarded, as these merchants account for over 90% of all merchants (see Table 1). The number of merchants onboarded by the largest payment facilitators has increased significantly. Stripe is included with the payment facilitators in Figure 7 because, although now an acquirer, it was a payment facilitator for the period under consideration (see paragraphs 4.30 to 4.34). The largest payment facilitators and Stripe onboarded over 80% of merchants between 2014 and 2018. Over the same period, the total number of merchants served by acquirers increased by over 7% and most acquirers served more merchants in 2018 than in 2014. This indicates that the growth of the largest payment facilitators and Stripe is mainly due to their success in onboarding merchants that did not previously accept card payments. Overall, the largest payment facilitators and Stripe have continued to expand in 2019.

Figure 7: Number of merchants onboarded from 2014 to 2018



PSR analysis of data provided by acquirers and payment facilitators. All merchants are included (including those that have not transacted). Stripe – an acquirer – is grouped with the payment facilitators because it was a payment facilitator for the period under consideration.

4.20 The offerings of the largest payment facilitators that primarily serve merchants selling face to face – Zettle, PayPal (through its PayPal Here product), Square and SumUp – differ from acquirers' typical offerings in several ways:

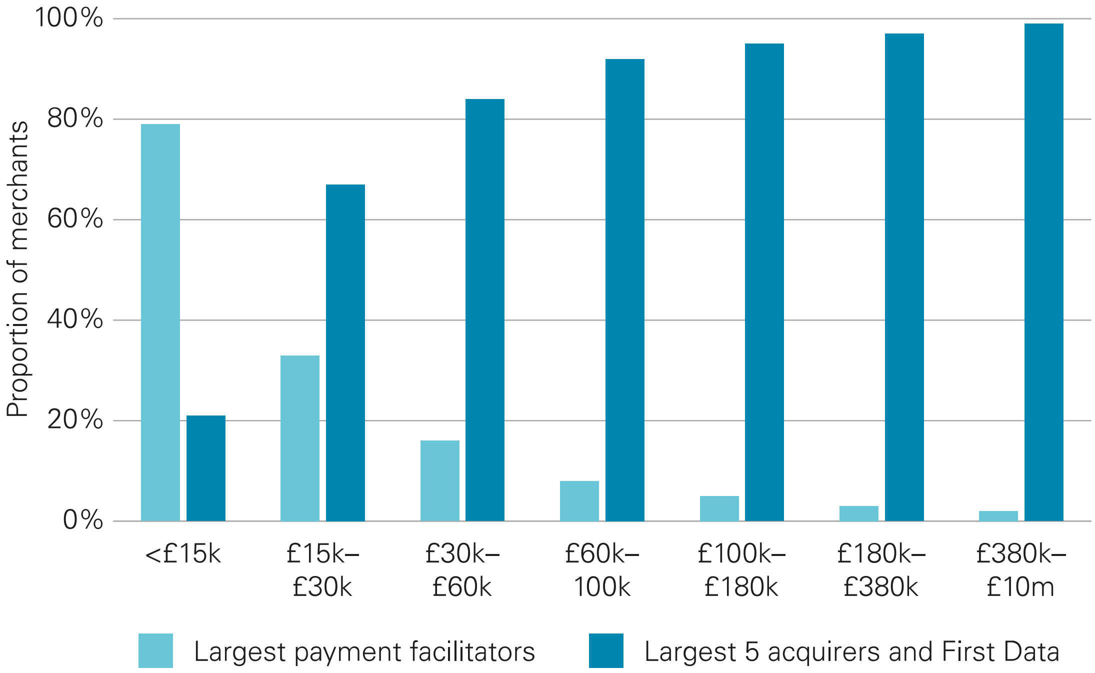
- They have **simple standard pricing** of card-acquiring services by applying one headline rate for card-present transactions (irrespective of the characteristics of a purchase transaction) and no additional fees (except for PayPal Here – see Annex 1). By contrast, acquirers' standard pricing typically consist of several headline rates and a number of additional fees (see Chapter 3).
- They offer **low-cost hardware** for capturing card details at the POS. The largest payment facilitators sell card readers for between £15 and £45. Acquirers typically charge between £10 and £40 per month to hire a POS terminal, depending on various factors, including the length of the hire and the number of devices hired.
- **They do not have non-transactional fees for card-acquiring services**, so the merchant only pays fees when it accepts a card transaction. By contrast, some acquirers have a minimum monthly service charge, which applies if the amount a merchant pays for card-acquiring services in a month falls below a specified threshold. Acquirers also typically have a monthly fee for services to help the merchant comply with PCI DSS requirements and for the hire of a POS terminal.
- They have a **quick and simple onboarding process**. The largest payment facilitators use a fully digital process with automated decision-making on whether to accept the merchant as a customer (with manual intervention limited to exceptions). Acquirers generally use an onboarding process that requires at least some manual intervention or relies on paper-based signatures.

4.21 Figure 8 shows the 2019 shares of supply of acquirers (specifically, the five largest acquirers plus First Data) and the largest payment facilitators of small and medium-sized merchants that sell only or mainly face to face.[60]

4.22 The largest payment facilitators serve nearly 80% of merchants with annual card turnover up to £15,000 and fewer than 5% of small and medium-sized merchants with annual card turnover above £60,000. Above £60,000 annual card turnover, over 95% of small and medium-sized merchants are served by acquirers – [40-50]% by Barclaycard and Worldpay, with most of the other acquirers individually accounting for less than 15%.

60 We did not have data to break down other acquirers' shares of supply of the smallest merchants into different size groups, but they would not materially affect the graph.

Figure 8: Shares of supply of small and medium-sized merchants selling only or mainly face to face in 2019



Source: PSR analysis of data provided by acquirers and payment facilitators on merchants served in April 2019. Active merchants only. Graph shows shares of supply of merchants that accept only or mainly (that is, more than 70%) card-present transactions.

4.23 The largest payment facilitators' pricing is likely to be most attractive to merchants with low levels of annual card turnover. The headline rates for card-acquiring services of the largest payment facilitators are typically higher than those offered by the acquirers (see Figure 11 and Annex 1). However, they are often cheaper overall for merchants with low annual card turnover because (once the card reader is bought) the merchant only pays when accepting a card payment. By contrast, acquirers typically have monthly fees for card-acquiring services and hire of POS terminals (see paragraph 4.19). Analysis carried out by the CMA in its investigation of the PayPal/iZettle merger indicated that, in general, for larger micro and small merchants, acquirers' traditional POS offerings were better value than iZettle's and PayPal's offerings, but for nano merchants, generally traditional POS is substantially more expensive than both parties' offerings.[61]

61 The CMA defined nano merchants as those with less than £21,000 annual card turnover, micro merchants as those with annual card turnover between £21,000 and £160,000, and small merchants as those with annual card turnover between £160,000 and £380,000. CMA, *Completed acquisition by PayPal Holdings, Inc of iZettle AB* (2019), paragraphs 6.12 and 8.152.

4.24 The largest payment facilitators use advertising on internet search engines and social media[62] to direct merchants to their websites where they self-onboard by completing a form and purchasing a card reader. Overall, a large majority of the merchants onboarded by the largest payments facilitators in 2018 self-onboarded via their websites.[63]

4.25 Acquirers impose restrictions on the types and size of merchants that payment facilitators can contract with for card-acquiring services. These reflect laws and scheme rules that apply to acquirers, as well as the acquirer's own risk appetite. For example, acquirers may place restrictions on payment facilitators serving merchants they consider carry higher risk. Annex 5 considers the requirement in Mastercard and Visa scheme rules that merchants who are customers of a payment facilitator and have card annual turnover above $1 million must also contract with an acquirer.[64] As noted in Annex 5, our view is that these have not, to date, acted as a significant barrier to entry or expansion.

4.26 Some acquirers offer card readers. For example, Barclaycard introduced Barclaycard Anywhere in 2014, which consists of card-acquiring services and a card reader and is aimed at 'micro-merchants'. Worldpay launched Worldpay Zinc in 2013, which was later withdrawn and replaced by Worldpay Reader in 2018. Global Payments and Elavon also offer card readers.

4.27 Acquirers differ in the extent to which they compete for merchants with low levels of annual card turnover. Barclaycard and Worldpay told us they compete for merchants of all sizes. [✂]. Zettle said that some acquirers may not consider Zettle as a competitor because it is serving merchants that the acquirers do not target. SumUp said it targets merchants that are underserved for whom accepting card payments is otherwise too expensive.

4.28 Several acquirers said that one of the challenges they expect to face over the next five years in supplying card-acquiring services is stronger competition from payment facilitators. Global Payments said that payment facilitators are already a credible provider of card-acquiring services to small and medium-sized merchants (not just 'micro-merchants' with less than £50,000 annual card turnover).

4.29 However, there is evidence that the largest payment facilitators' prices become less competitive as the value of transactions increases[65] (although, in some cases, merchants can negotiate lower prices). And while the functionality of card readers and POS terminals is similar, they differ in their characteristics. POS terminals tend to be more robust and reliable than card readers, have a longer battery life and can print receipts without using an additional printer[66] – characteristics that may be of more importance to merchants with higher annual card turnover.

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62 One payment facilitator also told us it uses traditional media channels such as television and radio advertising.

63 PSR analysis of data provided by the largest payment facilitators.

64 The Mastercard scheme rules require that a merchant that accepts over $1 million of Mastercard card transactions must also contract with an acquirer, and the Visa scheme rules require that a merchant that accepts over $1 million of Visa card transactions must do the same.

65 See paragraph 4.22.

66 As reported to the CMA during its investigation of the iZettle/PayPal merger. CMA, *Completed acquisition by PayPal Holdings, Inc of iZettle AB* (2019), paragraph 28.

4.30 In addition, the largest payment facilitators' strategies differ in the extent to which they target or plan to target merchants with higher annual card turnover that are more commonly served by acquirers. [✂]. Square said the growth of its business partly depends on attracting 'larger' merchants, and said its products are built to scale so merchants can continue to use them as their businesses grow. However, SumUp said it plans to continue to focus on merchants that are not traditionally targeted by acquirers.

Expansion of Stripe and the largest payment facilitators in serving merchants selling online

4.31 Stripe is an acquirer that mainly serves merchants selling online and in-app. Initially, it enabled start-ups to accept payments online, but today works with organisations of all sizes to manage their payments.

4.32 Although Stripe is now an acquirer, it initially entered as a payment facilitator in 2013 – and like those providers, its offering differs from those of most other acquirers. Stripe has a quick and simple onboarding process, and offers simple standard pricing for card-acquiring services consisting of two headline rates (one for European cards and one for non-European cards), plus an additional fee for the administration of each chargeback incurred (which is reimbursed to the merchant if the disputed payment is found in their favour).

4.33 Stripe has expanded significantly in recent years. Examining shares of supply of acquirers (specifically, the five largest acquirers plus First Data and Stripe) and the largest payment facilitators of small and medium-sized merchants that only or mainly accept card-not-present transactions[67], we observe that in 2019:

- Most of these merchants are served by acquirers. The largest payment facilitators account for around 6% of small and medium-sized merchants that only or mainly accept card-not-present transactions across the merchant sub-segments we examined.[68]
- Stripe – an acquirer – accounted for [60-70]% of these merchants. Most are the smallest merchants with annual card turnover of less than £380,000. Stripe serves [10-20]% of small and medium-sized merchants that have an annual card turnover above this amount.
- Worldpay and Barclaycard serve [40-50]% of these merchants with annual card turnover above £380,000; other acquirers individually serve 10% or less of merchants above this amount.

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67 Merchants that only or mainly accept card-not-present transactions are those that accept more than 70% card-not-present transactions. We use card-not-present transactions as a proxy for transactions accepted online. It is an imperfect proxy as card-not-present transactions includes those accepted over the phone and via mail order. Analysis includes active merchants only.

68 The boundaries between the sub-segments we examined are £380,000, £1 million and £10 million.

4.34 One reason for Stripe's rapid growth is its integrations with e-commerce platforms (commonly considered as a type of ISV in the payments industry) that allow merchants to build a website and sell online (such as Shopify and Wix.com). Typically, e-commerce platforms have integrations with several acquirers and payment facilitators[69], which gives merchants using these platforms a choice of provider.

4.35 Shopify Payments is a payments processing service available on the Shopify platform that allows Shopify merchants to accept card payments through Stripe. Stripe is currently the sole provider for Shopify Payments in the UK. Merchants using Shopify Payments contract with Stripe, which provides them with card-acquiring services. Shopify merchants are opted in by default to Shopify Payments, though they can choose to buy card-acquiring services from a different acquirer or payment facilitator. Shopify Payments is an important source of merchants for Stripe; approximately [✂] of Shopify's merchants use Shopify Payments.[70]

4.36 Several acquirers told us that some merchants prioritise choice of the e-commerce platform – that is, the merchant chooses the e-commerce platform first and then chooses a provider of card-acquiring services that is integrated with that platform, rather than choosing a provider of card-acquiring services and then finding an e-commerce platform that is integrated with that provider. In such circumstances, to be considered by the merchant, a provider of card-acquiring services needs to be integrated with the e-commerce platform. Several acquirers told us that building and improving integration with ISVs is a priority.

4.37 PayPal – in its capacity as a payment facilitator[71] – has a number of products aimed at merchants selling online: Braintree, PayPal Commerce Platform and PayPal Pro. Braintree is targeted at large merchants (though it is also used by small and medium-sized merchants). The number of merchants using Braintree has grown in recent years but the product provides PayPal with a small share of supply (overall and of large merchants that accept only or mainly card-not-present transactions). PayPal Pro is aimed at small and medium-sized merchants. PayPal [✂] has recently introduced a replacement product (PayPal Commerce Platform).

4.38 The largest payment facilitators that predominantly serve merchants selling face to face also serve merchants that accept card payments online. Zettle, Square and SumUp offer services that help merchants build their own websites (for Square and SumUp, assisted by acquisitions – see Chapter 1) and have integrations with ISVs that offer the same service. All are seeking to build their omnichannel offering to merchants. However, they have a small share of supply.

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69 An e-commerce platform may also integrate with gateway providers. A merchant that chooses a gateway provider will also need to contract for card-acquiring services with an acquirer. See Annex 1.

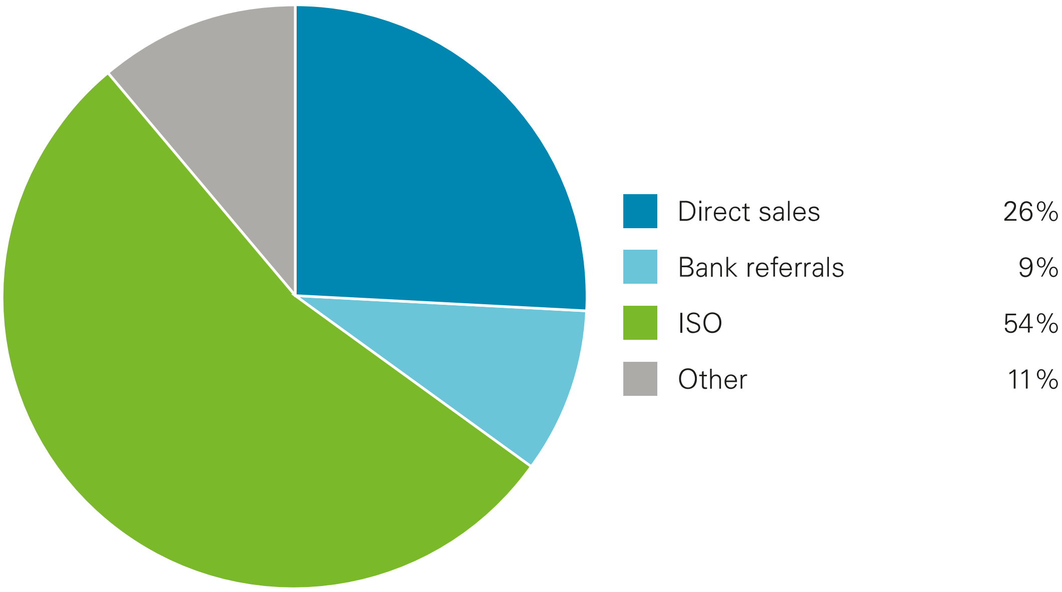
70 Excludes merchants that have never transacted or have only accepted test transactions. PSR analysis using data submitted by Stripe.

71 PayPal also enables merchants to accept payments online via its digital wallet. PayPal does not act as a payment facilitator when providing this product, and hence it is outside the scope of our market review.

Role of ISOs and other third parties

4.39 Figure 9 shows the main customer acquisition channels for acquirers (excluding Stripe) in 2018. While it covers all merchants, it mainly represents the customer acquisition channels used to procure the smallest merchants, given they account for nearly 90% of merchants served by these acquirers. In 2018, ISOs accounted for over 50% of all new customer acquisitions for acquirers. They were significantly more important than acquirers' own direct sales channels and bank referrals.

Figure 9: Acquisition channels used by acquirers in 2018



Source: PSR analysis of data provided by acquirers. Stripe is excluded. Other includes referrals from ISVs, payment gateways, price comparison websites and trade associations.

4.40 As described in Chapter 3, ISOs are tasked by acquirers with procuring new merchant relationships in return for commission. ISOs (like acquirers) offer a package of goods and services that together enable merchants to accept card payments, which would typically include card-acquiring services and POS terminal(s). ISOs do not provide card-acquiring services to merchants; they refer merchants to acquirers for these services. There are over 60 ISOs operating in the UK[72]; Handepay, Paymentsense, takepayments, RMS and UTP are five of the largest, and together have approximately 175,000 merchants at the end of 2018.[73]

4.41 ISOs predominantly refer merchants that sell face to face to acquirers, and most of these merchants have an annual card turnover of up to £1 million. The ISOs we spoke to all said that they target small and medium-sized merchants. Annex 1 provides more information on the merchants' ISOs target.

72 PSR analysis of data provided by acquirers on third parties that refer merchants.

73 PSR analysis of data provided by ISOs.

4.42 ISOs have large sales teams working to procure new merchant relationships. An important part of their customer acquisition strategies involves field sales or telesales agents cold calling merchants.

4.43 Some ISOs work with one acquirer and others work with more than one. Acquirers compete against each other for ISO partnerships, though we found limited evidence of ISOs changing the acquirer they primarily or (where they work with one acquirer) exclusively refer to (see Annex 5).

4.44 Acquirers often place restrictions on the types of merchants that ISOs can procure – for example, in relation to merchants that are considered high risk to serve.

4.45 Most acquirers use ISOs to procure new merchants (though several do not or have chosen to focus on developing their own direct sales channels). Those that work with ISOs gave different reasons for doing so. [✂]

4.46 Although ISOs were the most important source of merchants for acquirers in 2018 (see Figure 9), several acquirers told us that they are increasingly focusing on ISVs as a customer acquisition channel. ISVs include e-commerce platforms (see paragraph 4.35) and businesses that sell electronic point of sale (EPOS) systems (such as EPOS Now and Vend).

4.47 An EPOS system is a combination of hardware and software that helps merchants selling face to face run their businesses by supporting, for example, inventory management, payroll and management information reporting. Card acceptance products can be integrated with the EPOS system so that, for example, the value of the item being bought in a shop is automatically displayed on the POS terminal after being scanned.

4.48 Merchants may want a provider of card-acquiring services that can integrate with their EPOS system or look to their EPOS system provider to recommend an acquirer (or payment facilitator). For these reasons, several acquirers said ISVs will be an increasingly important customer acquisition channel in the coming years, and are focusing on technical integration with EPOS systems and establishing referral relationships with providers of these systems. Some acquirers are also offering their own EPOS systems – see paragraph 4.75.

Competition on price

4.49 Chapter 3 summarised the four pricing options that providers of card-acquiring services have: standard pricing, IC+ pricing, IC++ pricing and fixed pricing. (Annex 1 provides a more detailed description). In this section, we describe how providers of card-acquiring services and ISOs compete on price for the broad segments identified in paragraph 4.2.

Large merchants

4.50 Large merchants served by acquirers have standard, IC+ or IC++ pricing. Most acquirers told us that IC+ and IC++ pricing is only available to, or suitable for, large merchants. One acquirer said that both options, compared to standard pricing, are more complex and volatile because the cost per transaction for the merchant varies according to the various transaction characteristics that drive interchange fees and scheme fees (see paragraph 3.19). Around 35% of large merchants have IC+ or IC++ pricing; typically they are the largest merchants with annual card turnover above £50 million.[74]

4.51 With IC+ and IC++ pricing, acquirers compete on the processing fee (also called a management fee), which is applied for each purchase transaction (and, in some cases, for each refund). IC++ pricing automatically passes on interchange fees and scheme fees at cost to the merchant, so the processing fee recovers some or all the acquirer's other costs plus a margin. With IC+ pricing, only interchange fees are automatically passed on at cost. The processing fee recovers some or all of the scheme fees an acquirer pays and the acquirer's other costs plus a margin.

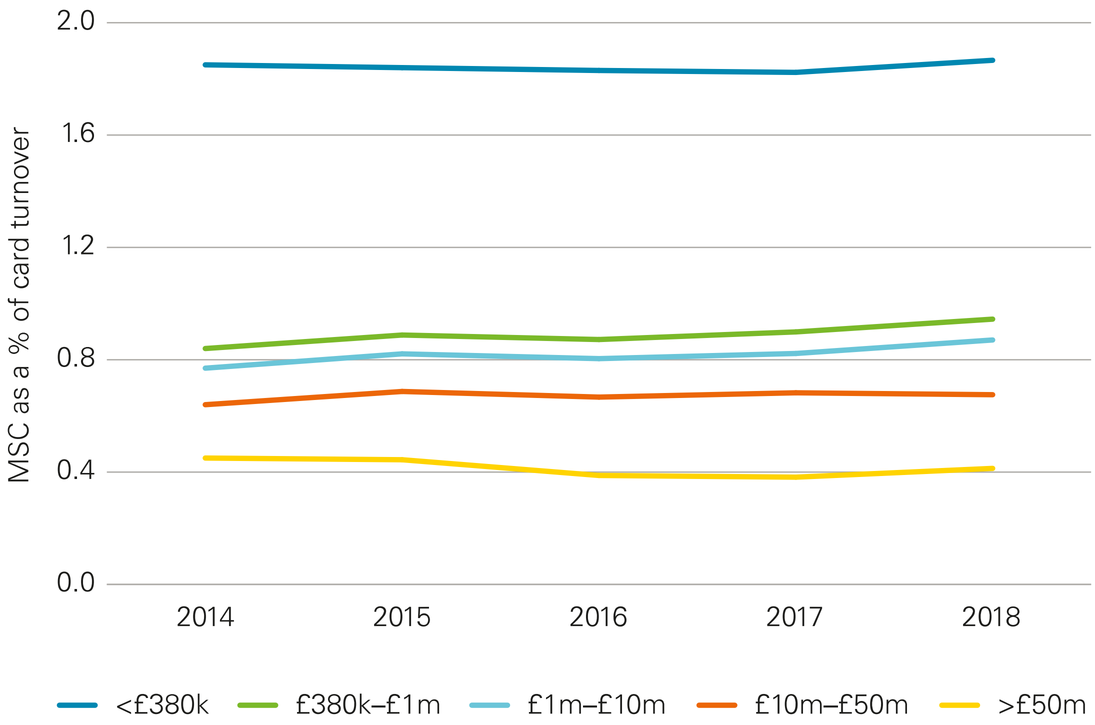
4.52 In addition to the processing fee, merchants on IC++ pricing typically pay additional fees triggered by specific events (such as authorisation requests and chargebacks). Acquirers said these fees may be negotiated with large merchants; several said IC++ pricing tends to be highly bespoke. Merchants on IC+ pricing also pay additional fees triggered by specific events and, in some cases, for certain types of transactions. As with IC++ pricing, acquirers told us they may negotiate these additional fees with the merchant.

4.53 Around 55% of large merchants have standard pricing. Competition on price for these merchants focuses on the headline rates, which recover some or all the interchange fee and scheme fees applicable to a transaction plus the acquirer's other costs and margin. Some acquirers may also negotiate the additional fees that are triggered by specific events or certain types of transactions.

4.54 We observe that large merchants – irrespective of the pricing option they have – pay lower prices than small and medium-sized merchants, as shown in Figure 10. Several acquirers told us that the value of card transactions a merchant accepts is the most, or one of the most, important considerations when providing a quote to a merchant. Several of the largest merchants we collected evidence from said that the volume of transactions they bring to an acquirer gives them a strong bargaining position.

74 PSR analysis of data provided by acquirers.

Figure 10: Prices paid for card-acquiring services by merchants of different sizes



Source: PSR analysis of data provided by the five largest acquirers. The average MSC is calculated by dividing the total value of fees paid for card-acquiring services by the total value of purchase transactions.

Small and medium-sized merchants

4.55 Approximately 98% of all small and medium-sized merchants are on standard pricing, which is offered by most acquirers, ISOs and payment facilitators.

4.56 Most acquirers and ISOs that use standard pricing do not publish their prices. Instead, the price they quote to a merchant is determined by the information they collect about the merchant's characteristics during the sales process (see Chapter 1). Several ISOs – like some acquirers (see paragraph 4.53) – said that the merchant's annual card turnover is the most, or one of the most, important characteristics used to quote a price to the merchant.

4.57 Acquirers' and ISOs' sales staff can often negotiate on price within defined parameters with a prospective merchant. Several acquirers and ISOs said that negotiation tends to focus on the headline rate for credit and debit cards because these cards are most frequently accepted by small and medium-sized merchants. Acquirers and ISOs vary in the extent to which they negotiate additional fees for card-acquiring services (see Chapter 3) and fees for other aspects of their offering (such as card acceptance products) with small and medium-sized merchants.

4.58 Most acquirers identified competitive pricing as one factor that is important to winning or retaining merchants, and several acquirers told us they have taken steps to simplify their standard pricing, including:

- Worldpay, which has introduced three simpler tariffs for merchants with annual card turnover below £[✂] (that also meet certain other criteria), which are available to merchants accepting payments online or face to face: a fixed tariff, a pay-as-you-go tariff and a simplicity tariff. See Annex 1 for more information on these tariffs.[75]
- EVO Payments, which does not have any additional fees (other than for chargebacks and refunds). It also offers a fixed pricing option available to merchants with monthly card turnover of up to £[✂].

4.59 However, most acquirers report that they differentiate their card-acquiring services offering mainly based on quality and other non-price factors. In addition, most do not identify price as a key consideration in how they plan to develop their offering, though the five largest acquirers said they keep their pricing under continuous review (or, in one case, review pricing periodically), including to take account of recent changes to interchange fees and scheme fees.

4.60 Most ISOs we collected information from reported that they win customers based on price. For example:

- Handepay said it differentiates its offering by having no additional fees (except for refunds and chargebacks) and provides merchants with an incentive to switch by offering to pay a lump sum payment if it cannot reduce their costs.
- takepayments reported that it differentiates its offering through transparent pricing and by not charging set-up fees or exit fees (provided the merchant gives sufficient notice of termination). [76]
- Handepay covers some of the fees the merchant might incur for switching (for example, fees for early termination of a POS terminal contract that can be applied, up to specified limits), and takepayments offers rent-free periods for POS terminals as a financial incentive to offset the remaining rental fees the merchant incurs on the remaining term of their existing contract.

4.61 We also observe that, for two of the five largest acquirers, customers referred to them by ISOs paid less on average than other merchants these acquirers served between 2014 and 2018 (though this was not the case for a third acquirer).[77]

75 As explained in Annex 1, pricing information shown may reflect pricing that was in place at the time the interim report was published in September 2020. In Annex 1, we indicate where this information has been updated.

76 Several acquirers also said they do not have and/or may waive set-up or termination fees and termination fees.

77 PSR analysis of data submitted by the five largest acquirers to inform the pass-through analysis. One of the five largest acquirers said it did not work with ISOs from 2014 to 2018.

4.62 The largest payment facilitators' simple pricing structure is one way they seek to appeal to the smallest merchants, and some said this is one way they differentiate their offering from acquirers (see paragraph 4.19). The prices they set are likely to be most attractive to merchants with low levels of annual card turnover (see paragraph 4.22).

4.63 The largest payment facilitators have amended their pricing over time:

- Zettle originally used a tiered pricing structure whereby the headline rate decreased as the value of transactions accepted increased. In September 2017, this was changed to a single headline rate of 1.75% for all card-present transactions.
- In the same month, SumUp reduced its headline rate for card-present transactions from 1.95% to 1.69%.
- PayPal reduced the rates for the PayPal Here product for merchants with monthly card turnover above £1,500 in February 2018.

Competition on quality and other non-price factors

4.64 Acquirers, ISOs and payment facilitators reported that they seek to differentiate their offering along various non-price factors. The importance of some of these factors varies by size of merchant. This section describes how firms compete on non-price factors for large merchants, and small and medium-sized merchants.

Large merchants

4.65 For large merchants, acquirers reported that they compete on the following non-price factors:

- authorisation performance – in simple terms, the proportion of transactions that are authenticated and approved by the issuer
- customer service and support
- ease and speed of onboarding and set-up
- fraud detection and reduction
- geographic reach – that is, the extent to which the acquirer operates in all the jurisdictions the merchant sells in
- integration with other products merchants buy to run their businesses, such as accounting software
- omnichannel services
- quality and range of value-added services sold alongside card-acquiring services, such as provision of management information and support for non-card digital payment methods

- reliability and stability of the service
- settlement speed – that is, how quickly the acquirer transfers the money owed to the merchant
- understanding of, and support in responding to, regulatory change and changes to scheme rules

4.66 The relative importance of some of these factors varies by type of large merchant. For example, geographic range and certain value-added services (such as multi-currency conversion that allows a merchant to offer local currencies) are more relevant to winning business from the largest merchants operating in multiple jurisdictions. Acquirers vary in the geographic range and value-added services they offer, which means that not all can compete for the largest merchants that value these factors.

4.67 Some of these factors are also relevant to competition for small and medium-sized merchants, such as customer service and reliability and stability of the service.

4.68 However, the way acquirers provide customer service differs across the merchant segments. For example, acquirers tend to provide customer service to large merchants through relationship managers with sector expertise who, among other things, are tasked with helping merchants grow their businesses. Generally, for small and medium-sized merchants, customer service is provided by acquirers via call centres and, in some cases, online self-serve portals (see paragraph 4.71).

4.69 An emerging trend in payments is the supply of omnichannel services. There is no single definition of this term, but broadly this can be defined as provision by a single firm of services integrating payments made via different channels (for example, e-commerce and face to face). Annex 1 provides more information on the characteristics of omnichannel services. Several acquirers said that they are looking to strengthen their omnichannel services offering.

4.70 For a small number of the largest merchants, many acquirers agree bespoke commitments and service level agreements (SLAs) that commonly cover customer service (such as time taken to resolve problems) and uptime (that is, availability of card-acquiring services). Acquirers can incur large penalties if these commitments are not met. By contrast, small and medium-sized merchants generally sign standard contracts with limited room for negotiation and no SLAs.

Small and medium-sized merchants

4.71 Acquirers reported that customer service is important for winning and retaining small and medium-sized merchants. Most acquirers' senior management use metrics that monitor call centre performance, such as time taken to answer calls and speed of resolution of queries.

4.72 Several acquirers have taken steps to improve the customer service they offer to small and medium-sized merchants in recent years. Worldpay has created a team that proactively engages with these merchants during the life of their contract – for example, to gauge customer satisfaction. Elavon and Global Payments said that they have enhanced the online portals merchants can use to perform various self-service tasks. One small acquirer – Paysafe – aims to differentiate its offering by providing named points of contact for small and medium-sized merchants.

4.73 For small and medium-sized merchants, the quality and range of card acceptance products is likely to be more important than for the largest merchants because they tend to 'one-stop shop', which is consistent with firms' offerings (see Chapter 3). Acquirers, ISOs and the largest payment facilitators reported that they had invested or were investing in technology for capturing card details at the POS. For example, several acquirers have introduced card readers (see paragraph 4.25). SumUp said it differentiates its offering by selling a card acceptance device that does not need to be connected to a mobile phone to operate.

4.74 Ease and speed of set-up and onboarding is one distinguishing characteristic of the largest payment facilitators' and Stripe's offering. The largest payment facilitators use a fully digital process with automated decision-making on whether to onboard the merchant, which enables them to offer a quicker onboarding process compared to acquirers. Several acquirers reported that they have or are taking steps to streamline the onboarding process – for example, by reducing reliance on paper. One new acquirer – Tyl by NatWest – has made a streamlined onboarding process a central component of its offering.

4.75 Some acquirers and payment facilitators compete to offer faster settlement, which was commonly cited by small and medium-sized merchants as a factor considered when choosing a provider of card-acquiring services (see Annex 1). For example, Square offers next business day settlement as standard and offers same day settlement for a fee. [✂]. Settlement times offered by acquirers vary; several said they are looking to roll out faster settlement to more small and medium-sized merchants.

4.76 Another way that some acquirers and payment facilitators differentiate their offering is through the offer of software that helps merchants build a website, EPOS systems and business management services (all examples of value-added services). For example, AIB Merchant Services, Lloyds Bank Cardnet and First Data all refer merchants to Marketplace Merchant Solutions (a Fiserv entity) for Clover – a cloud-based EPOS system that helps merchants manage their business and includes hardware to capture card details at the POS. One payment facilitator – SumUp – said building business management services is an important part of its strategy over the coming years, and the largest payment facilitators offer software that enables merchants to build their own websites. Other firms, including ISOs, partner with ISVs rather than (or as well as) investing in developing their own business management services (see paragraph 4.45).

Stakeholder views on quality and non-price factors of competition

4.77 In response to the interim report, a number of stakeholders made points about the importance of non-price aspects of competition:

- American Express told us that the provisional findings do not fully consider the value of non-price considerations to merchants.[78]
- The Association of Convenience Stores told us that their members consider the following factors as key when approaching the acquirer market: price, fast settlement, ease of onboarding, assistance with legal requirements, customer service and omnichannel services.[79]
- Barclays submitted that the interim report's focus on pricing fails to account for the complexity of the market, and the fact that merchant decisions are often driven or influenced by non-price factors.[80]
- Mastercard told us that although we referred to quality and non-price factors, we did not appear to consider them in reaching our provisional findings about how well the market is working. In their view, many merchants (particularly smaller merchants) consider these other non-price factors to be equally, if not more, important in their assessment of how well card payments are working for them.[81]
- Stripe also told us that non-price aspects of competition (such as technology quality, reliability, customer service and innovation) are 'hugely important' to their merchants and that price is rarely the main differentiating factor in a merchant's decision to use Stripe. They noted the distinction between the offline and online acquiring segments, and the implications this has in terms of the differences in technologies offered and the quality of offerings. They submit that small and medium-sized merchants who may appear to the PSR to not be engaged, may still be holistically evaluating the offerings in the market (both price and non-price) but decide to remain with their incumbent provider.[82]
- UK Finance told us that merchants decide to switch because they may obtain better value elsewhere, and that the interim report does not address what merchants value and what they are willing to pay for that value. In their view, although acquiring price is relevant, value is derived from other factors too.[83]
- Worldpay said that significant competition takes place between providers based on non-price aspects, and that we need to take account of the importance of such

78 American Express response, page 3.

79 ACS response, page 2.

80 Barclays response, paragraph 31.

81 Mastercard response, page 2.

82 Stripe response, pages 4 and 5.

83 UK Finance, paragraph 1.9.1.

elements – for example, choice, customer service, quality and innovation across a range of products – in our final conclusions.[84]

4.78 We acknowledge that non-price factors (including quality) may be important to some merchants when choosing card acquirer. However, the merchant survey shows that both price and non-price factors influence the decisions of merchants, with price-related factors mentioned more frequently:

- Merchants who had been with the same provider for more than two years considered a range of factors when choosing a provider. Price was the factor most commonly considered (named by 74% of such merchants); followed by the payment methods available (48%); settlement times (44%); and the price of other products (41%).[85]
- Similarly, the factor most commonly considered by merchants when shopping around was price (98%), with other factors including the price of other products (66%), settlement times (61%), and payment methods available (60%).[86]
- Merchants who had considered switching but did not do it gave various reasons for thinking about it, including: they wanted to pay a lower price/find better deal (52%); because of a price increase (13%); approached by a provider with better terms (12%); better settlement times (9%); wanted better customer service (5%); and wanted to accept a new payment method (4%).[87]
- For merchants who had switched within the last two years, the reasons given included: wanted to pay a lower price/find better deal (57%); because of a price increase (16%); approached by a provider with better terms (16%); wanted better customer service (9%); wanted to accept a new payment method (8%); saw a better deal being advertised (7%); and change of software/better integration (4%).[88]

4.79 The importance of price was supported by some stakeholder responses to the interim report. For example, UTP (an ISO) said that the UK card-acquiring market is already highly competitive, with a significant number of market participants competing predominantly on the basis of price.[89]

4.80 Overall, we conclude that price and non-price factors are both important in the supply of card-acquiring services. We still consider pricing outcomes to be a meaningful indicator of how well the supply of card-acquiring services is working. This includes outcomes after the IFR caps were introduced. Our assessment takes evidence on both price and non-price factors into account. For instance, in the next chapter, we investigate whether the lack of pass-through of IFR savings is explained by acquirers investing the savings in improvements to their services.

84 Worldpay response, paragraph 16b.
85 IFF Annex, slide 33.
86 IFF Annex, slide 34.
87 IFF Annex, slide 26.
88 IFF Annex, slide 28.
89 UTP response, page 2.

Barriers to entry and expansion

4.81 Our analysis of shares of supply finds that:

- the shares of supply of four of the five largest acquirers, as measured by the volume and value of card transactions acquired for merchants, have fallen steadily from 2014 to 2018 (Chapter 1)
- around [50-60]% of large merchants are served by Barclaycard and Worldpay, but one new entrant – Adyen – has grown its share of supply significantly in recent years and now serves [5-10]% of large merchants
- the largest payment facilitators have significantly expanded the number of merchants that accept card payments face to face in recent years, and together they serve nearly 80% of merchants that only or mainly accept card-present transactions with annual card turnover up to £15,000, though their share of supply decreases sharply above this level
- Stripe has significantly expanded the number of merchants that accept card payments online in recent years; it serves [60-70]% of small and medium-sized merchants that only or mainly accept card-not-present transactions (most of which are the smallest merchants)
- Worldpay and Barclaycard serve [40-50]% of small and medium-sized merchants that only or mainly sell face to face, with annual card turnover above £60,000 and [40-50]% of merchants that only or mainly accept card-not-present transactions, with annual card turnover above £380,000
- most other acquirers have gradually increased the number of merchants they serve but individually they have a small share of supply of small and medium-sized merchants; less than 10% of merchants with annual card turnover up to £380,000 and between 10% and 15% of small and medium-sized merchants with annual card turnover above this level

4.82 Although there has been entry and expansion in both merchant segments from 2014 to 2018, the main changes we observe are due to the expansion of the largest payment facilitators and Stripe. This is predominantly due to their success in onboarding merchants new to card payments, which suggests low barriers to entry and expansion for providers that target such merchants.

4.83 We assessed several potential barriers to entry and expansion based on concerns raised by stakeholders:

- the collateral requirements in scheme rules
- referral relationships with banks and ISOs
- restrictions on payment facilitators

- regulation
- economies of scale
- the structure of Mastercard and Visa scheme fees

4.84 Based on the evidence we have seen, we do not consider collateral requirements, referral relationships, restrictions on payment facilitators or regulation as likely to be barriers to entry and expansion because:

- collateral requirements, where applied, for nearly all UK-registered acquirers are small either in absolute value or as a proportion of the value of card transactions acquired[90]
- referral relationships with banks are not a significant source of customers for acquirers, and, while ISO relationships are more significant, acquirers can hire their own sales teams and gradually scale up according to their needs[91]
- restrictions on payment facilitators have not, to date, affected their ability to onboard merchants, and they have not expressed concerns about the restrictions[92]
- regulation was not raised as a barrier to entry and expansion by smaller providers, and regulatory requirements apply to all providers of card-acquiring services and do not discriminate against new entrants or smaller providers[93]

4.85 Conversely, we consider that economies of scale due to processing costs and the structure of scheme fees may provide some advantages to larger acquirers. However, the ability to use third-party acquirer processors reduces advantages from economies of scale due to processing costs.[94] In addition, we consider any advantages for larger acquirers from the structure of scheme fees is more likely to affect competition for the largest merchants with annual card turnover above £50 million.[95]

4.86 In the interim report we therefore provisionally concluded that none of these barriers are significant for providers seeking to compete for merchants with annual card turnover below £50 million.[96] Conversely, we found that there may be barriers to serving the largest merchants. Annex 5 presents our analysis in more detail.

90 See Annex 5, paragraphs 1.17 to 1.25.

91 See Annex 5, paragraphs 1.49 to 1.59.

92 See Annex 5, paragraphs 1.60 to 1.63.

93 See Annex 5, paragraphs 1.46 to 1.48.

94 See Annex 5, paragraphs 1.42 to 1.45.

95 See Annex 5, paragraphs 1.26 to 1.41.

96 As explained in Annex 5, we consider that the structure of scheme fees may impact competition for the largest merchants. These merchants achieve good price outcomes, and we did not find any evidence as part of this market review that the supply of card-acquiring services does not work well for these merchants.

Stakeholder views on barriers to entry and expansion

4.87 In response to the interim report, many stakeholders agreed with our conclusion that there are no significant barriers to entry and expansion. For instance, Mastercard refers to anecdotal evidence from smaller/new entrant acquirers who have not highlighted any significant concerns regarding barriers to entry or expansion.[97]

4.88 Some respondents also indicated that low barriers are consistent with strong competition and the card-acquiring sector (one respondent referred specifically to the online segment) working well:

- Barclays agrees that there are clearly low barriers to entry in relation to the supply of acquiring services to merchants of all sizes, and that this is consistent with its own experience of an increasingly crowded and competitive market. In its view, the trend of entry and expansion is likely to have continued and accelerated since 2018, particularly in light of an increase in e-commerce and card-not-present transactions. Overall, it submits that the success of market entrants and shifting shares of supply provide compelling evidence of the highly competitive nature of the market – with larger acquirers being under constant pressure.[98]
- Worldpay agrees with our assessment of low barriers to entry and expansion but notes that the interim report does not sufficiently acknowledge that this feature of the market (along with other features, such as the large number of active players and different types of provider, and a decline in share of supply of traditional market players) demonstrates that competition is intense.[99]
- Stripe said that there are notable new entrants in this online-focused acquiring segment that weren't mentioned in the interim report due to their relatively recent entry. It submits that there are more than 20 full stack online payments options for SME merchants in the UK, and that it anticipates further new entrants in the coming years given the relatively low barriers to entry. In Stripe's view, the ability of online players to enter and gain share in the market is clearly not indicative of an uncompetitive or poorly served market.[100]

4.89 Other comments included the following:

- Elavon suggested that the chargeback risk and capital and funding costs act as a potential barrier to entry for new acquirers in the UK market for card-acquiring services.[101]

97 Mastercard response, page 1.
98 Barclays response, paragraph 11.
99 Worldpay response, paragraph 1.23.
100 Stripe response, page 2.
101 Elavon response, page 3.

- GPUK raised a concern that low barriers to entry for ISOs and a lack of regulatory oversight has resulted in a proliferation of ISOs, especially small organisations, that provide a low level of service and typically include tie-ins[102] and cross-subsidisation in their contracts which do not serve merchants well.[103]

4.90 In conclusion, we still consider that, in general, the potential barriers to entry and expansion listed in paragraph 4.83 are not significant for providers serving merchants with annual card turnover below £50 million. Although there may be barriers to serving the largest merchants with higher card turnover, we did not find any evidence that the supply of card-acquiring services does not work well for these merchants. However, we do not agree that low barriers to entry and expansion (as defined in Annex 5) are necessarily a sufficient condition for strong competition between acquirers for all merchant segments below £50 million. For instance:

- The analysis of merchant behaviour in Chapter 6 suggests that, for a variety of reasons, many small and medium-sized merchants do not actively search and switch acquirers. This could discourage acquirers wishing to serve particular merchant segments from entering and expanding, and may have the effect of weakening competition between providers who currently do serve those merchants.
- The largest payment facilitators and Stripe have expanded, but this is mainly due to their success in onboarding merchants new to card payments. Figure 8 shows that their share of the smallest merchants that sell only or mainly face to face (those with annual card turnover below £15,000), is almost 80%. By contrast, the largest payment facilitators differ in how far they plan to compete for merchant segments with higher card turnover. The evidence indicates their offering is less attractive to such merchants (see paragraph 4.22) and their share of merchants with annual card turnover above £15,000 is much lower.
- On average, small and medium-sized merchants, and merchants with annual card turnover between £10 million and £50 million, got little or no pass-through of the IFR savings. Limited or slow pass-through is one indicator that competition is weak. We discuss this further in Chapter 5.

Summary

4.91 Providers of card-acquiring services apply different competitive strategies when competing for merchants of different sizes as measured by annual card turnover. For the purposes of our market review, we use two broad segments: small and medium-sized merchants with annual card turnover up to £10 million; and large merchants with annual card turnover above £10 million.

102 In Chapter 6, we discuss various features of merchant contracts.

103 See GPUK response, paragraph 2.17.

4.92 While small and medium-sized merchants buy card-acquiring services from acquirers and payment facilitators, large merchants typically buy these services from acquirers. The five largest acquirers, Adyen, AIB Merchant Services and First Data all serve large merchants selling face to face, online and through other channels; while Chase Paymentech currently focuses primarily on acquiring card-not-present transactions for e-commerce merchants selling online. Most of these acquirers also have significant numbers of small and medium-sized merchants, but Adyen predominantly focuses on large enterprise merchants and Chase Paymentech predominantly provides card-acquiring services to large multinational merchants. Adyen is a new entrant that has grown its share of supply of large merchants significantly in recent years.

4.93 An important development in recent years is the expansion of the largest payment facilitators – Zettle, PayPal (through its PayPal Here product), Square and SumUp – that predominantly serve merchants selling face to face. Their offering differs from that of most acquirers in several ways – for example, through simple pricing structures and low-cost hardware.

4.94 The largest payment facilitators' offering is likely to be most attractive to merchants with low levels of annual card turnover, which is reflected in their shares of supply of merchants that only or mainly sell face to face. They serve nearly 80% of merchants with annual card turnover below £15,000 but their share of supply decreases sharply above this level. Acquirers differ in the extent to which they compete for merchants with low levels of annual card turnover. Several acquirers said that they expect to face stronger competition from payment facilitators over the coming years, but the largest payment facilitators differ in the extent to which they plan to compete for merchants with higher card turnover and the evidence indicates their offering is less attractive to such merchants.

4.95 Stripe – which is now an acquirer but entered as a payment facilitator and predominantly serves merchants selling online – has also expanded significantly. One reason for its expansion is the integrations it has with e-commerce platforms, especially Shopify. Stripe accounts for a large proportion of the smallest merchants that only or mainly accept card-not-present transactions (though it serves merchants of all sizes). The largest payment facilitators also enable merchants to accept payments online but have a small share of supply.

4.96 Most other acquirers have steadily increased the number of small and medium-sized merchants they serve from 2014 to 2018. New acquirers have entered in recent years that target small and medium-sized merchants, including EVO Payments, but they have a small share of supply. Worldpay and Barclaycard serve [40-50]% of merchants only or mainly selling face to face with annual card turnover above £60,000 and [40-50]% of merchants that accept mainly or only card-not-present transactions with annual card turnover above £380,000.

4.97 For most acquirers serving small and medium-sized merchants selling face to face, ISOs are an important sales channel and accounted for 50% of all merchants onboarded by them in 2018. ISOs act as an outsourced sales function for acquirers – selling card-acquiring services on their behalf, alongside other card acceptance products and value-added services. Most merchants referred by ISOs to acquirers have an annual card turnover of up to £1 million. Over the coming years, several acquirers said that ISVs will become an increasingly important way of procuring new merchants.

4.98 Acquirers, the largest payment facilitators and ISOs compete for merchants based on price factors. Around 35% of large merchants have IC+ or IC++ pricing; most of the remainder have standard pricing. Irrespective of the pricing option a large merchant has, they generally pay lower MSCs for card-acquiring services than small and medium-sized merchants. Around 95% of small and medium-sized merchants have standard pricing. Using simple pricing structures is one way that several acquirers and the largest payment facilitators differentiate their offering. ISOs also reported that they compete on price factors and there is some evidence that merchants referred to acquirers by ISOs pay less for card-acquiring services (though this is not always the case).

4.99 Firms also seek to compete for large merchants and small and medium-sized merchants based on a range of non-price factors, including customer service, omnichannel services, quality and range of card acceptance products, ease and speed of onboarding, faster settlement and offer of business management software. The relative importance of these factors varies depending on the size of merchant. As discussed in Chapter 6, while a range of price and non-price factors can affect merchant behaviour, our merchant survey shows that price-related factors feature prominently in the decisions of merchants who have considered switching or who have switched.

4.100 We assessed several potential barriers to entry and expansion based on stakeholders' concerns. We conclude that these barriers are not significant for providers serving merchants with less than £50 million annual card turnover. However, given the evidence on pricing outcomes and merchant behaviour set out in Chapter 5 and Chapter 6, this finding does not undermine our overall conclusion that competition is not working well for these merchants.

5 Pricing and quality outcomes

The IFR capped interchange fees paid by acquirers to issuers on most card transactions, but did not cap the MSC paid by merchants. The IFR relied on competition between acquirers to ensure that acquirers' cost savings were passed through to merchants. We used the introduction of the IFR caps as an indicator for how well the supply of card-acquiring services is working by investigating the extent to which the IFR savings acquirers realised were passed through to merchants.

As a group, merchants on IC++ pricing, which are typically the largest merchants, received full pass-through of the IFR savings. Although small in number, this group is responsible for around 77% of the value of transactions. We estimate the benefit to these merchants from the pass-through of the IFR caps was around £600 million in 2018.

Merchants with annual card turnover up to £50 million received, on average, little or no pass-through of the IFR savings – indicating that the supply of card-acquiring services is not working well for these merchants. The evidence is less reliable for merchants with annual card turnover below £15,000, and we therefore make no finding about pass-through for these merchants.

For merchants in all turnover groups, the evidence available to us indicates that scheme fees were passed through by acquirers in full.

Evidence indicates that small and medium-sized merchants can secure better deals in the form of lower MSCs by switching their provider of card-acquiring services – on average, new customers pay less.

Introduction

5.1 The MSC is the total amount that merchants served by acquirers pay for card-acquiring services (see Chapter 3). It comprises:

- interchange fees, which the acquirer pays to the issuer
- scheme fees, which the acquirer pays to the operator of the card payment system
- acquirer net revenue, to cover the acquirer's other costs of providing card-acquiring services (such as regulatory, staff and technology costs) plus the acquirer's margin

5.2 We refer to the extent to which the MSC changes in response to changes in interchange fees and scheme fees as the 'pass-through rate'. The degree of pass-through can be measured over an extended period of time, such as a long-term pass-through rate (which we call 'general pass-through'), or in response to specific changes – for example, following an increase or decrease in the cost of a key input (before and after an event). As described below, our focus in this section is on a comparison of the pass-through of the reduction in interchange fees associated with the IFR (which we refer to as 'IFR pass-through').

5.3 We focus on the change in interchange fee margins before and after December 2015, as this was the time at which the IFR caps were implemented[104], which led to a reduction in interchange fees larger than any other change during this period.

5.4 Prices in a competitive market would generally, in the longer term, reflect input costs. A reduction in the input costs would therefore result in lower prices.[105] Limited or slow pass-through is one indicator that competition is weak, unless there are other factors affecting price at the same time.

5.5 In response to our interim report, GPUK and Worldpay suggested that the pass-through analysis cannot be used to assess the intensity of competition.[106] We agree that there are specific limited circumstances in which non-pass-through of cost reductions could be consistent with a high degree of competition (i.e. where other forces are driving up costs at the same time). However, we have seen no evidence that these circumstances were relevant in this case and to our assessment of the pass-through of the IFR reduction (the IFR pass-through rate).

5.6 The IFR capped interchange fees on consumer debit and credit card transactions where the acquirer and issuer are in the EEA ('capped transactions'). These caps on interchange fees (the 'IFR caps') came into force on 9 December 2015 and aimed to:

- reduce the costs of card payments for merchants and consumers
- help create an integrated and competitive market for payment services

Annex 1 provides more information on the IFR.

5.7 The IFR did not cap MSCs paid by merchants. Instead, the IFR relied on competition between acquirers to ensure that the cost savings acquirers made from the caps ('IFR savings') were passed through to merchants. However, acquirers can hold on to cost savings if they don't feel under pressure to keep their prices down. We used the introduction of the IFR caps as an indicator for how well the supply of card-acquiring services is working.

104 As discussed in Annex 2, there were some changes in debit card interchange fees introduced in March 2015 and September 2016. However, we note that the largest reduction in interchange fees associated with the IFR was for capped credit cards which became effective in December 2015, and the reductions in interchange fees for debit cards was much less significant (see figures 2 and 4 in Annex 2).

105 The degree of long-term pass-through depends on several demand and supply factors.

106 GPUK response, paragraph 3.5, and Worldpay response, paragraph 3.52.

5.8 Before the launch of our market review, stakeholders raised concerns with us that acquirers had not passed through the IFR savings to smaller merchants.[107] These concerns were reiterated in the responses to our interim report by the Association of Convenience Stores[108] and the British Retail Consortium.[109]

5.9 Stakeholders also told us that scheme fees have increased significantly in recent years. This represents an increase in acquirers' costs. If acquirers passed these increases on to merchants, while at the same time holding on to IFR savings – that is, they passed through cost increases and decreases asymmetrically – this could constitute further evidence that the supply of card-acquiring services is not working well, because it would suggest that acquirers did not face competitive pressures to absorb cost increases or to pass through cost decreases.

5.10 Drawing on data obtained from the five largest acquirers, covering the period from 2014 to 2018, we investigated whether:

- acquirers made IFR savings
- acquirers passed through the IFR savings to merchants in the form of lower MSCs
- the IFR pass-through rate varied between
  - merchants in the segments we describe in Chapter 4; we also looked at additional detail to examine any differences between merchants with varying levels of annual card turnover
  - acquirers' new customers pay less than long-standing customers, and merchants who signed up with an acquirer after the IFR caps came into force pay less than those who joined before
- acquirers used IFR savings to invest in and improve their quality of service[110]
- acquirers passed through changes in scheme fees to merchants
- scheme fees paid by acquirers increased (we also drew on data from Mastercard and Visa)

107 Our assessment uses two broad segments: large merchants, and small and medium-sized merchants. The term 'smaller merchants' was used by stakeholders.

108 ACS response, paragraph 7.

109 BRC response, paragraph 1.1.

110 We examine this because respondents to the working paper on our proposed approach to the pass-through analysis argued that looking only at the MSC would discount any pass-through that occurs in the form of higher quality of service.

5.11 We investigated these questions using both descriptive statistics and econometric analysis. In the descriptive statistics, we observed changes in average interchange fees[111] and average MSCs[112] between the periods before and after the IFR caps came into force, and examined whether they moved in parallel. However, MSCs may also have been affected by variables other than interchange fees over the period 2014 to 2018, including the characteristics of merchants within each size group, changes in the mix of transactions, or changes in scheme fees (see Annex 2 for a full description). Using econometric analysis, we estimated how much of any change in MSCs following the IFR caps coming into force can be explained by changes in these other variables, and therefore how much may be attributed to the IFR.

Overview of the MSC and its components

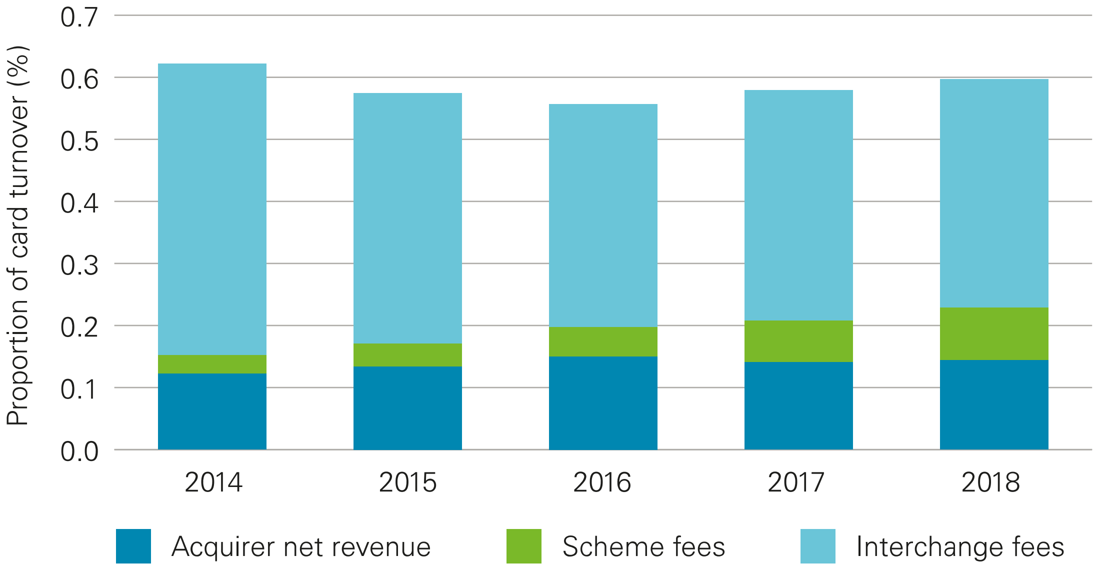
5.12 In this section, we describe how the MSC and its components – interchange fees, scheme fees and acquirer net revenue – changed over the period 2014 to 2018, at an aggregated level, by looking at annual averages (without distinguishing between different merchant segments). This allows us to examine:

- whether interchange fees fell following the IFR caps coming into force in December 2015
- whether scheme fees increased between 2014 and 2018
- how the MSC responded to any changes in interchange fees and scheme fees
- how acquirer net revenue (that is, MSC less interchange fees and scheme fees) evolved from 2014 to 2018

111 The value of interchange fees paid by the five largest acquirers over a defined period (and in some instances, a specific set of merchants) divided by the value of purchase transactions.

112 The value of the MSC – that is, the total amount merchants (or a specific set of merchants) served by the five largest acquirers paid for card-acquiring services over a defined period – divided by the value of purchase transactions.

Figure 11: Average MSC as a percentage of card turnover split by interchange fees, scheme fees and acquirer net revenue.



Source: PSR analysis of data provided by the five largest acquirers. Weighted average of the five largest acquirers (weighted by card turnover) expressed as a percentage of card turnover from 2014 to 2018.

5.13 We gathered financial information from the five largest acquirers (see Annex 3). Figure 11 shows aggregated interchange fees, scheme fees[113], and acquirer net revenue (which together make up the MSC) as a percentage of card turnover for the period 2014 to 2018. It shows that:

- **Average interchange fees** fell significantly between 2014 and 2016 and then remained approximately at the same broad level.[114] Approximately half of this reduction happened between 2014 and 2015, and the remaining half between 2015 and 2016.[115]
- **Average scheme fees** more than doubled over the period from 2014 to 2018, with most of this increase occurring between 2016 and 2018, after the IFR caps came into force. Scheme fees made up a much smaller proportion of the MSC than interchange fees, over the period between 2014 and 2018. However, during that period, the share of the MSC relating to scheme fees rose, whereas the share relating to interchange fees reduced. This means that while the effect of scheme fee increases on the MSC is likely to be less significant than changes in interchange fees, it isn't negligible.

113 Figure 11 shows scheme fees for all four-party card payment systems. The vast majority of these are Mastercard and Visa fees.

114 We observe average IFs remaining above the level of the caps because the data includes transactions involving commercial cards and transactions where the issuer was located outside the EEA, which were not capped by the IFR.

115 See Annex 3 for an explanation of why we observe a reduction in interchange fees between 2014 and 2015 before the IFR caps came into force.

- **Average MSC** fell as interchange fees fell between 2014 and 2016. However, the decrease in the average MSC is less than the decrease we observe in interchange fees, resulting in a higher acquirer net revenue. After 2016, the MSC increases, mainly driven by a rise in scheme fees.

- **Average acquirer net revenue** rose between 2014 and 2016. This shows that acquirers increased their net revenue at the same time as interchange fees fell. After 2016, it fell slightly at the same time as scheme fees increased.

5.14 This analysis indicates that, overall, acquirers may not have fully passed on the IFR savings to merchants. At the same time, acquirers may have passed on nearly all the scheme fee increases to merchants. In their responses to our interim report, ACS[116], BRC[117] and Card Switcher[118] all broadly agreed with our finding that acquirers had not fully passed through the interchange fee reduction. Conversely, takepayments said that most SMEs did receive some benefit, and one acquirer said that it substantially passed on changes to interchange fees to merchants.[119]

5.15 More details of our financial analysis are presented in Annex 3. While the analysis was restricted by data limitations, our findings support our assessment in this chapter. They also help us understand how the IFR caps affected the relationship between interchange fees and the MSC.

5.16 This aggregate view does not distinguish between merchants of different sizes. As noted above, before we launched this market review stakeholders told us they were particularly concerned about IFR savings not being passed on to smaller merchants.[120] The analysis above is dominated by results for the largest merchants, which account for most of the transactions. In the following sections, we investigate whether there are differences between merchants of different sizes.

Pass-through of IFR savings – descriptive analysis

5.17 In the previous section, we described evidence at an aggregate level that indicates that acquirers may not have fully passed on the IFR savings to merchants. In this section, we explore this issue in more detail, by dividing merchants on standard pricing into size groups defined by annual card turnover. The boundaries between groups are £15,000, £180,000, £380,000, £1 million, £10 million and £50 million. This segmentation follows that introduced in Chapter 4 but with additional detail to allow us to examine any differences between merchants with varying levels of annual card turnover (see Annex 2 for more information).

116 ACS response, paragraph 7.

117 BRC response, paragraph 1.1(b).

118 See Card Switcher response to interim report.

119 takepayments response, page 1. [✂]

120 Our assessment uses two broad segments: large merchants, and small and medium-sized merchants. The term 'smaller merchants' was used by stakeholders.

5.18 In addition, we have a separate group of merchants on IC++ pricing, which are typically the largest merchants. Under IC++ pricing, acquirers automatically pass through changes in interchange fees and scheme fees (see Chapter 3). We treat merchants on IC++ pricing as a single, separate category to serve as a benchmark against which to compare merchants of different sizes on standard pricing. Because merchants on IC++ pricing should have received automatic IFR pass-through, this group serves as a useful comparator of whether the IFR savings were passed through to all merchants. There were fewer than ten merchants in our sample on IC+ pricing. These IC+ merchants are included in the aggregate analysis but excluded from the analysis of the different merchant groups.

5.19 We compared average interchange fees and the average MSC before and after the IFR caps came into force for each merchant group. Table 2 summarises these descriptive statistics.

5.20 The figures in Table 2 below are calculated from data sampled from the population of merchants of the five largest acquirers for the purpose of conducting the pass-through analysis. The approach to sampling is detailed in Annex 2. It was designed to result in a random sample in which each merchant has an equal probability of being entered into the sample so that the statistics describe the market experience of typical merchants. The sample is not representative of the transactions of the population as a whole, and the 'All merchants' column in Table 2 – which is included only for completeness – is not comparable with the figures in Table 1.[121]

Table 2: Average interchange fees and average MSCs before and after the IFR caps came into force by merchant type

	Small and medium-sized merchants				Large merchants				All merchants
	<£15k	£15k–£180k	£180k–£380k	£380k–£1m	£1m–£10m	£10m–£50m	>£50m	IC++	
Difference in average *interchange fees* before and after IFR caps	-0.19	-0.17	-0.16	-0.16	-0.15	-0.13	-0.07	-0.18	-0.17
Difference in average *MSC* before and after IFR caps	-0.03	-0.02	0.00	-0.00	-0.02	0.01	-0.07	-0.2	-0.02

Source: PSR analysis of data provided by the five largest acquirers.

121 The main reason why the 'All merchants' figures in Table 2 is not comparable with the accounting figures on which Figure 11 is based is that our sample happens not to include the very largest merchants. The five largest merchants accounted for over £100 billion of transactions in 2018 (14% of the value of transactions of the population as a whole) while the largest merchant in our sample had under £6 billion of card transactions in 2018.

5.21 The first row of Table 2 shows the difference in average interchange fees paid by acquirers before and after the IFR caps came into force. Average interchange fees fell for *most* merchant size groups, with those with lower annual card turnover seeing a larger fall. For example, average interchange fees for merchants with annual card turnover of less than £15,000 fell by 0.19 percentage points compared with a fall of 0.13 percentage points for large merchants on standard pricing with turnover between £10 million and £50 million. Average interchange fees for merchants on IC++ pricing fell by 0.18 percentage points.

5.22 For the largest merchants on standard pricing with annual card turnover greater than £50 million, the change in average interchange fees was relatively small. This appears to be because of a change in Visa's interchange fees after the IFR came into force that resulted in high-value transactions incurring higher interchange fees than before the IFR came into force (this is discussed further in Annex 2).

5.23 The change in interchange fees shown in the first row of Table 2 includes effects other than the introduction of the IFR caps – including changes in the interchange fees on uncapped transactions, and changes in the proportions of capped debit and credit card transactions, for example. It shows that for merchants on standard pricing, the reductions in interchange fees were larger for those with lower annual card turnover.

5.24 In contrast to average interchange fees, the average MSC fell very slightly by 0.02 percentage points for all merchants. However, looking across groups of merchants, there are notable differences:

- Merchants on IC++ pricing saw their average MSC fall broadly in line with the fall in average interchange fees following the IFR caps coming into force. This indicates that they received pass-through of IFR savings in the form of lower MSCs. This is consistent with the IC++ pricing structure, under which acquirers automatically pass through changes in interchange fees (and scheme fees).
- The largest merchants on standard pricing with annual card turnover greater than £50 million saw a decrease in their average MSC closely aligned with the decrease in their average interchange fees.
- The average MSC for large merchants with annual card turnover between £10 million and £50 million increased slightly, even though their interchange fees fell, indicating – on average – that they got little or no pass-through of the IFR savings in the form of lower MSCs.
- Average MSCs changed only very slightly or remained constant for small and medium-sized merchants with annual card turnover up to £10 million following the IFR caps coming into force, indicating – on average – that they also got little or no pass-through of the IFR savings in the form of lower MSCs.

5.25 Overall, these statistics indicate that, on average, merchants with annual card turnover up to £50 million got little or no pass-through of the IFR savings. The average MSC for these merchants was broadly unchanged as interchange fees fell.

5.26 However, MSCs may have been affected by other factors, including changes in the characteristics of the merchants within each size group, in the mix of transactions, and in scheme fees. To draw firmer conclusions, we need to rule out these alternative explanations of the patterns in the data. To do this, we used econometric analysis, described in the next section.

Pass-through of IFR savings – econometric analysis

5.27 Using econometric analysis, we controlled for factors that could affect the MSC, including the characteristics of merchants within each size group, changes in the mix of transactions, and changes in scheme fees. We analysed each size group separately.

5.28 In this section, we present the results from the econometric analysis. Annex 2 provides a full description of the methodology and analysis, which includes several checks we did to test the robustness of the results presented in this section. The results are consistent across these checks. Annex 2 sets out the responses we received from stakeholders to the IFR pass-through analysis presented in the interim report and how we have considered them when updating our analysis.

5.29 As set out below and in Annex 2, the main change since the interim report relates to our treatment of outliers. Worldpay told us that we had unnecessarily dropped observations due to a rounding error[122], and their advisers indicated that we had used an erroneous sequential process to identify outliers in different variables.[123] In response, we changed our approach: we have not used the variables with rounding errors in our analysis, and we only identify outliers for the three dependent variables (MSC, scheme fees, interchange fees). In the course of dealing with Worldpay's suggestion we judged that, for the three dependent variables, truncation should be at the 95th, rather than 99th, percentile. The changes that we made to our methodology did not affect our findings. We also did various sensitivity analyses that showed our results were robust.[124]

5.30 The results presented in this section focus on the evolution of the difference between the MSC and interchange fees ('the interchange fee margin') before and after the introduction of the IFR caps. This is a useful way to look at the relationship between the change in the MSC and the change in interchange fees associated with the IFR caps, because it allows for straightforward interpretation. If the interchange fee margin remained flat both before and after the introduction of the IFR (after controlling for other factors that affect the MSC), it indicates that the MSC and interchange fees moved in parallel with each other. This in turn indicates pass-through of IFR savings in the form of lower MSCs. In Annex 2, we also

122 Worldpay response, paragraph 3.42.

123 Worldpay technical annex, paragraph 3.5.

124 Our sensitivity tests involved moving a dummy variable to capture the reduction in debit card interchange fees in September 2016; estimating several regressions that included a time trend variable to the previously estimated models; and re-running our analysis, excluding chargeback risk and the share of face-to-face transactions as control variables. See Annex 2 for more details.

describe alternative ways of examining the relationship between the MSC and interchange fees following the introduction of the IFR caps, but our key conclusions do not change.

Table 3: What happened to the interchange fee margin after the IFR caps?

	Small and medium-sized merchants					Large merchants		
	<£15k	£15k–£180k	£180k–£380k	£380k–£1m	£1m–£10m	£10m–£50m	>£50m	IC++
IFR savings	0.17	0.14	0.13	0.13	0.11	0.11	0.01	0.10
IFR effect	0.2226	0.1821	0.1601	0.1542	0.1248	0.1465	0.0519	-0.0200

Source: PSR analysis of data provided by the five largest acquirers. The IFR effects are statistically significantly greater than the IFR savings.

5.31 The first row of Table 3 shows a calculation of the direct effect of the IFR caps on the interchange fees for capped transactions. The reductions in interchange fees after the IFR caps came into force on the two types of capped transactions are weighted by the respective proportions of these transactions in the post-IFR caps period transactions mix. This removes the effects of any changes in uncapped transactions and in the proportions of capped debit and credit card transactions in the numbers shown in the first row of Table 2. The calculations broadly confirm that average interchange fees fell for most merchants, with the exception of the largest merchants on standard pricing, who saw close to no change in average interchange fees, and suggest that the IFR caps were the main explanation of the changes shown in the first row of Table 2.

5.32 The second row of Table 3 presents our estimates of the 'IFR effect', which measures the impact of the IFR caps on the interchange fee margin which cannot be attributed to the alternative explanations identified in paragraph 5.27. The value of the coefficient is the estimated shift (in percentage points) of the interchange fee margin following the IFR caps coming into force. A value close to zero indicates that the interchange fee margin remained flat following IFR caps coming into force because MSCs fell in line with interchange fees, as any IFR savings were passed through. On the other hand, a positive coefficient would indicate that the interchange fee margin increased, which is to say MSCs did not fall in line with interchange fees and there was either no pass-through or an incomplete pass-through of any IFR savings. We compare this with the direct effect of the IFR on interchange fees shown in the first row of Table 3 ('IFR savings'). If the IFR effect is bigger than or equal to the IFR savings, it indicates no pass-through; if it is less than the IFR savings, it indicates partial pass-through.

5.33 Table 3 shows that:

- For merchants on IC++ pricing, which are typically the largest merchants, the value of the IFR effect is close to zero (-0.020 with low significance). It indicates that for this group of merchants, the interchange fee margin remained flat, and that there was full pass-through of IFR savings. The result for this group is consistent with the IC++ pricing structure, under which acquirers automatically pass through changes in interchange fees (and scheme fees). For this reason, and as explained in paragraph 5.18, this group serves as a comparator for merchants of different sizes on standard pricing.

- For the largest merchants on standard pricing with annual card turnover greater than £50 million, the value of the IFR effect is also close to zero (0.0519), but positive and statistically significant. The statistics suggest the interchange fee margin has increased a little, indicating no pass-through. However, for the reasons explained in paragraph 5.22, the interchange fee savings for this group (shown in the first row of the table) were also very small – there was little IFR saving to pass through. We do not think it appropriate to come to a finding on the basis of the comparison of these two small numbers for an idiosyncratic group of merchants. Our sample also shows a reduction in the number of the largest merchants on standard pricing after the IFR caps came into force and an increase in the number of merchants on IC++ pricing. If this is representative of the population of merchants, it suggests many of the largest merchants were able to benefit from the IFR caps by switching to IC++ pricing.
- For merchants with annual card turnover between £15,000 and £50 million, the IFR effect is higher than the average reduction in their interchange fees, indicating that these merchants, on average, received little or no pass-through of the IFR savings.

5.34 For completeness, Table 3 includes the results for merchants with annual card turnover up to £15,000. The findings for this group are less stable and need to be caveated. This is because this group comprises merchants whose card turnover can vary significantly from month to month. They may have months with positive card turnover, followed by months with no card turnover. This impacts our calculations, and as a result, the analysis for this group is particularly sensitive to how we treat outliers. This issue is discussed in more detail in Annex 2. Moreover, our sample, drawn from the five largest acquirers, does not include the largest payment facilitators, who have a significant share of supply of merchants with annual card turnover of less than £15,000 (see Chapter 4). For the reasons given in Annex 2, we do not place weight on the econometric results for this group and make no finding about the degree of IFR pass-through for merchants up to £15,000.

5.35 The merchants on IC++ pricing that received full pass-through are very few in number but represent 77% of transaction value. We estimate the benefit to these merchants was around £600 million in 2018 (see Annex 2).

5.36 The European Commission's report on the application of the IFR found that significant declines in interchange fees on consumer card transactions (particularly consumer credit card transactions) delivered significant cost savings for acquirers. It also found that, while long-term contracts and many small merchants'[125] inability to switch acquirers and limited bargaining power may have impeded immediate changes to MSCs, reductions in interchange fees led to reductions in MSCs.[126] A study prepared to inform the European Commission's report estimates that from 2015 to 2017 interchange fees fell by €2,680 million and MSCs declined by €1,200 million from 2015 to 2017. Over the same period, that study estimates the acquirer margin increased by

125 Our assessment uses two broad segments: large merchants, and small and medium-sized merchants. The term 'small merchants' was used by the European Commission.

126 European Commission, *Report on the application of Regulation (EU) 2015/751 on interchange fees for card-based payment transactions* (2020), pages 5 to 7.

€1,200 million (after taking account of increases in scheme fees).[127] The European Commission also reports that merchants with 'unblended fees'[128], such as IC++ pricing, appear to have benefitted most from IFR savings. The European Commission expects further reductions in MSCs over time and recommends continued focus on acquirers to measure future pass-through of IFR savings.

5.37 The European Commission's work has a different scope and objectives to our market review. We are examining whether the supply of card-acquiring services is working well for UK merchants, whereas the European Commission considered the application of the IFR in the EU. EY, who carried out the study that informed the European Commission's report, also used a different methodology to us to assess pass-through of IFR savings to merchants and was unable to examine fully the relationship between MSC and merchant size due to limited responses from small merchants to a survey used to collect evidence for the analysis. By contrast, we collected data from the five largest acquirers that enables us to investigate differences in the pass-through of IFR savings to merchants of different sizes.

5.38 However, the European Commission's finding that acquirers have partially passed through IFR savings in the form of lower MSCs broadly aligns with the results of our analysis. We find that merchants on IC++ pricing – who are very few in number but account for 77% of transaction value – on average received full pass-through of the IFR savings. We also find that, on average, merchants with annual card turnover up to £50 million got little or no pass-through of the IFR savings.

Stakeholder responses to the pass-through analysis

5.39 In response to the interim report, some stakeholders challenged the methodology, data and results of our IFR pass-through analysis. We address these criticisms and suggested changes in detail in Annex 2. However, the main points raised, and our response, are briefly summarised below.

Methodology and approach

5.40 Some stakeholders criticised our approach to the econometric assessment. Among the various submissions made on the approach:

- Barclays indicated that we should have used transaction volumes rather than values in order to account for declining average transaction values.[129]
- GPUK and Worldpay told us that the analysis was flawed because it is based on data for all card transactions, rather than capped card transactions.[130]

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127 EY and Copenhagen Economics (2020), *Study on the application of Interchange Fee Regulation* (2020), page 158.

128 Unblended MSC means that all components of the merchant service charge, including the interchange fee, are specified and billed separately. European Commission, *Report on the application of Regulation (EU) 2015/751 on interchange fees for card-based payment transactions* (2020), footnote 36.

129 Barclays response, paragraph 23.

130 Worldpay response, paragraphs 3.41, 3.45 and GPUK response, paragraph 3.22.

- GPUK and Worldpay also indicated that we should have included cost and time trend variables.[131]
- Worldpay submitted that we wrongly assume that the IFR reductions are instantaneously passed through to merchants. It states that some customers' MSCs may be set in contracts and will not change until the contract is renegotiated.[132]
- Worldpay was also critical of the fact that, in its view, the baseline model used by the PSR was not consulted on at the start of the project.[133]
- Finally, GPUK note that our baseline model assumes pass-through was 100% and that, in their view, it is the wrong model on which to draw conclusions.[134]

5.41 We set out our views and approach given all these points in Annex 2. In summary:

- We do not consider that Barclays provided sufficient supporting evidence that we should have used transaction volumes rather than values. For instance, [✂].[135]
- We focused on capped and uncapped card transactions because we wanted to understand how competition was working in the sector as a whole, and not just a sub-segment. In addition, we only had data disaggregated into commercial and consumer cards for [✂] acquirers.
- We did not include a time trend variable because our focus was on a before and after analysis (an event), not a general trend. We were not provided with any convincing explanation for why a time trend is needed and how it might explain the step increase in the IF margins following the IFR caps for smaller and medium-sized merchants but not merchants on IC++ pricing. Similarly, we did not include a cost trend variable because no evidence was presented that could be used in the modelling to assess whether and to what extent costs trended upwards in the period examined. The econometric analysis showed that the change in the interchange fee margin over time was better described as a step increase for small and medium-sized merchants than as a time or cost trend.
- We tested whether the IFR reduction was gradually passed through. However, when we allowed for annual post-IFR shifts in the interchange fee margin, there was no evidence of gradual pass-through; on the contrary, the interchange fee margin seemed to widen over time.
- We consulted on a model in February 2019 which reflected our thinking at that time. We specifically noted that the approach would be refined and updated as the analysis progressed. Following that consultation, we developed the baseline model which we consider allows us to focus specifically on whether the IFR reduction was passed through to merchants: the IFR pass-through rate. Stakeholders again

131 GPUK response, paragraphs 3.11 and 3.23. Worldpay response, paragraph 3.28d.

132 Worldpay response, paragraph 3.41b.

133 Worldpay response, paragraph 3.31.

134 GPUK response, paragraph 3.10.

135 [✂]

were consulted on our approach at the time of the interim report and we have fully considered their views when updating our analysis.

- On the issue of whether the baseline model is the right model from which to draw conclusions, we reiterate that our specific focus was investigating how the MSC changed in response to the introduction of the IFR caps. We present models in Annex 2 that show the long-term relationship between changes in the MSC and changes in the interchange fees over the period 2014 to 2018. In our view, the baseline model allows for the most straightforward interpretation of the extent of IFR pass-through. We examined the change in interchange fee margins before and after December 2015, as this was the time at which the greatest reduction in interchange fees occurred.
- While Worldpay told us that we should have focused our attention on models that do not have an IFR dummy, we find that models which include an IFR dummy variable perform better than models where it is excluded (as explained in Annex 2). Specifically, we find that the IFR dummy is highly significant in the baseline model, and the coefficients on the interchange fee variable showing general pass-through are higher than in models which do not include an IFR dummy.

Data

5.42 Some stakeholders were critical of the data we used in our analysis:

- Worldpay's advisers suggested that we should have made various adjustments for data outliers.[136]
- Worldpay criticised our approach to imputing the missing scheme fee data.[137] Its advisers suggested we should have used average scheme fees for the four acquirers instead.[138] GPUK submitted that data limitations mean that we can not properly account for the influence of scheme fees on the MSC.[139]
- Paypal/Zettle noted that our analysis does not include information from payment facilitators.[140]
- takepayments stated that the data may have been affected by the increase in the number of micro merchants taking cards since 2015 and the high MSC that they pay.[141]
- GPUK and Visa Europe submitted that, given the data limitations, any conclusions should be made with caution.[142]

136 Worldpay technical annex, paragraphs 3.3–3.25.
137 Worldpay response, paragraph 3.45cii.
138 Worldpay technical annex, paragraphs 4.11-4.12.
139 GPUK response, paragraphs 3.20-3.21.
140 Paypal/Zettle response, page 1.
141 takepayments response, page 1.
142 GPUK response, paragraph 3.3.4, and Visa Europe response, page 16.

5.43 In response to these points:

- We have undertaken additional analysis to address the submissions made on data outliers. With the exception of Group 1 merchants (those with annual card turnover below £15,000), about whom we make no finding, results do not materially change.
- We changed the approach to imputing scheme fees, using average scheme fees as suggested. The change in approach does not materially change our findings. More generally, we acknowledge that the need to impute scheme fees for one acquirer for two years is a limitation of our scheme fee analysis. However, because scheme fees are a small portion of the MSC, we do not expect this to have a significant impact on the results.
- We acknowledge that the analysis was limited to data for the five largest acquirers and does not include data for payment facilitators. However, the five largest acquirers accounted for nearly 90% of transactions by number and value at UK merchants in 2018.
- We have acknowledged the data limitations where they exist and the implications they have for our analysis and conclusions. For instance, we make no finding about the degree of IFR pass-through for merchants with annual card turnover below £15,000 (Group 1) and over £50 million (Group 7).

Robustness and accuracy of results

5.44 Some stakeholders raised concerns about the accuracy and robustness of the results of the analysis in the interim report:

- Worldpay and GPUK focus on estimates of general interchange fee pass-through in some of the specifications. They argue these show a high correlation between changes in the interchange fee levels and the MSC level over the four-year period from 2014 to 18.[143]
- GPUK and Worldpay suggest it's likely that the increasing interchange fee margin in the baseline model reflects the rising costs to acquirers.[144]
- GPUK's advisers and Worldpay's advisers also indicate that the baseline model is not robust when adding a trend variable or taking account of lags.[145]

5.45 In response to these points:

- We agree that that the general level of pass-through in some specifications is high, and the baseline model assumes 100% **general** pass-through by assumption for this reason. Making this assumption allows us to separate our focus on **IFR** pass-through from **general** pass-through. In other words, the baseline model allows us

143 GPUK response paragraph 1.4.1. Worldpay response, paragraph 3.33-3.40.

144 GPUK response 3.15. Worldpay response, paragraph 3.17.

145 GPUK technical annex, section 3.3. Worldpay technical annex, paragraphs 2.9 and 4.22-4.24.

to focus on the specific question of whether the significant one-off reduction in interchange fees associated with the IFR was reflected in changes in the interchange fee margin, assuming that the general or long-term level of pass-through of interchange fee is one.

- On the issue of whether the increasing interchange fee margin reflects rising costs, we note that: (a) we have not seen a compelling explanation for why costs might have risen disproportionately more than transactions value (i.e. statements submitted about costs increasing were quite general in nature); and (b) we were not presented with suitable evidence about costs rising specifically during the relevant period of 2016 to 2018.[146]

- We have already noted in paragraph 5.41 that the econometric analysis supported the modelling of the change in the interchange fee margin as a step increase rather than a time trend. We investigated the use of lagged effects but found no evidence of gradual pass-through; on the contrary, the interchange fee margin seemed to widen over time.

5.46 More generally, some stakeholders compared the results of the analysis to their own experience and evidence.

- One acquirer submitted that our results are inconsistent with its experience and [✂]. It suggests the reason some merchants received less of an IFR saving was because of the increase in fixed costs experienced throughout the period.[147]

- The British Retail Consortium disagreed with the finding that the market 'works well' for larger merchants. It said it considers interchange fees to be anti-competitive and they should be abolished. It also said scheme fees have risen significantly and should fall within the UK IFR.[148]

- One acquirer told us that it substantially passed on changes to interchange fees to each respective merchant.[149]

- takepayments submits that most SMEs will have seen some benefit from the IFR savings.[150]

5.47 These submissions present a mixed picture about the extent to which the IFR savings were passed on to merchants. For example, while one acquirer says that it substantially passes through interchange fee changes to each merchant, another acquirer appears to accept that the IFR savings were not passed through to some merchants. These points are difficult to verify and to generalise across the sector. We consider that it is therefore right to give weight to the detailed analysis and evidence we have described in this chapter.

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146 As discussed below, while Barclays, GPUK and Worldpay all submitted examples of investment costs that they have incurred, we note that they don't necessarily correspond to the period we are examining.

147 [✂].

148 BRC response, paragraphs 9, 23 and 24.

149 [✂].

150 takepayments response, page 1.

Quality of service

5.48 Some acquirers told us that an explanation for a lack of pass-through of the IFR savings could be that they were invested in providing a higher quality of service to their customers. Acquirers also reported that customer service and other non-price factors are important for winning and retaining small and medium-sized merchants (see Chapter 4). Therefore, we asked the five largest acquirers to provide us with information on their quality of service metrics over time.

5.49 Our provisional findings in the interim report were:

- The five largest acquirers monitored a range of aspects of their performance, such as call centre and onboarding performance. [✂].
- We reviewed the metrics over the period 2014 to 2018 and compared them against the acquirers' own targets and external benchmarks, such as [✂]. Our assessment showed a mixed picture of the quality of service and, overall, we didn't find evidence of improved quality of service in the period.
- The information available from the acquirers on costs – which would be an important indicator of increased spending on quality of service – suggested that over the period, unit costs fell. Although care needs to be taken in generalising, because this information related to only two acquirers, it is not consistent with rising unit costs due to investments in quality of service over the period (see Annex 3).

Stakeholder responses on quality of service

5.50 In response to the interim report, Barclays, GPUK and Worldpay all raised concerns that we had not appropriately taken account of changes in quality in our analysis:

- Barclays said that it has made very large investments in its acquiring offering, including: the introduction of Barclaycard Anywhere in 2015; [✂]; and the expansion of Barclays' card-acceptance capacity through commercial agreements with Discover Global Network and UnionPay (both made in 2019).[151]
- GPUK notes that our consideration of investment levels on which we conclude that total unit costs decreased over 2014 to 2018 was based on the data of two acquirers. It suggests this ignores the high levels of investment made by acquirers such as GPUK, which would not have been captured in the revenue and direct cost data we requested as they are not costs that can be measured at transaction level. Furthermore, the assessment does not consider material investments made since 2018.[152]
- Worldpay told us that the analysis in the interim report does not consider improvements in choice, quality or innovation. In particular, it has only looked at a limited subset of internal service metrics, which does not capture the full array of

151 Barclays response, paragraph 34.

152 GPUK Response 2.9.

product developments that have taken place. It suggests that the interim report's finding that an absence of unit cost increases is evidence of a lack of non-price pass-through is fundamentally flawed, both as a matter of economic theory and in practice. Quality, choice and innovation have all improved over the five-year period, in a sector that is undergoing a period of rapid and unprecedented change.[153] [✂].[154]

5.51 We would expect firms to invest in improved/new services in the ordinary course of business, particularly as service quality is an important factor for merchants' choice of provider. We also note that firms would have to make investments in their services in order to achieve compliance with new regulatory requirements, for example the new IFR obligations introduced during the period we were concerned with. However, in this instance, limited evidence was provided to us to show how specific investments led to improved/new services during the period under investigation. For instance, in their responses to the interim report, Barclays and GPUK both refer to investments made during during 2018 or 2019, while [✂]. Furthermore, it is not clear to what extent the IFR savings made by acquirers directly led to improved/new services. Accordingly, we consider that the acquirers have not clearly shown the extent to which the costs of specific investments could explain the increases in the interchange fee margin over the period 2014 to 2018. We therefore do not consider that investments in improved/new services explain the lack of pass-through of the IFR savings to merchants with annual card turnover up to £50 million.

New and long-standing customers

5.52 We consider the possibility that acquirers may compete more intensively for new customers[155] by charging them lower prices than existing customers. We also consider whether this increased competition for new customers may have further intensified after the IFR caps came into force.

5.53 The sample we used for our analysis contains merchants who signed up with their current provider of card-acquiring services at different dates, either before or during the period from 2014 to 2018. We can therefore distinguish between merchants who have been with their current provider for less than a year, between one and two years, between two and three years, and more than three years. We're also able to distinguish merchants who signed up with their current provider before or after the IFR caps came into force. We compare MSCs for merchants across these groups controlling for factors that could affect the MSC, including the characteristics of merchants, changes in scheme fees, and changes in the mix of transactions.

5.54 We present the complete analysis in Annex 2. In general, for small and medium-sized merchants, new customers pay less. Small and medium-sized merchants who signed up with their acquirer within the previous year paid between 0.05 and 0.19 percentage points less than merchants who have been with their acquirer for several years (that is, more than two years). Small and medium-sized merchants who signed up with their acquirer

153 Worldpay response, paragraph 23(e).

154 [✂].

155 New customers could include merchants that switched from other providers, as well as those who are new to card payments.

after the IFR caps came into force paid between 0.08 and 0.2 percentage points less than merchants who signed up with their acquirer before the IFR caps came into force.

5.55 This analysis also shows that merchants who joined their acquirer after the IFR caps came into force pay less than those who signed up before. This highlights that merchants on standard pricing could secure better deals in the form of lower MSCs that pass through IFR savings by switching to a different provider of card-acquiring services. As mentioned in paragraph 5.33, some of the largest merchants may also have benefitted from switching to IC++ pricing after the IFR caps came into force.

Stakeholder responses on new and long-standing customer analysis

5.56 GPUK and Worldpay challenged our approach to this analysis and suggested that it is not possible to estimate the gains from switching using the available data. They also questioned whether the approach we adopted was robust.[156]

5.57 The purpose of our analysis was to better understand how prices varied between different types of merchant. We did not differentiate between merchants that are new to card payments and those that are switching provider, so cannot precisely estimate the gains from switching, and it is also possible that merchants who have already switched were those who could gain more from switching. Nevertheless, the analysis shows that small and medium-sized merchants who signed up with their acquirer recently pay less compared to those that have been with their acquirer for several years. Merchants that joined their acquirer after the IFR caps came into force pay less than those that joined before. These results are strongly indicative that many merchants on standard pricing could get better deals by switching.

Scheme fees

5.58 Figure 11 showed that aggregate total scheme fees are smaller than interchange fees. However, they still represent a non-negligible component of the MSC. Stakeholders raised concerns that scheme fees have increased significantly in recent years. In our final Terms of Reference, we said we would examine how scheme fees have changed over the period 2014 to 2018.[157] We also said we would look at whether the structure of scheme fees could have an impact on the supply of card-acquiring services. Annex 5 considers the structure of Mastercard and Visa scheme fees (see also Chapter 4). In this section, we examine how Mastercard and Visa scheme fees evolved between 2014 and 2018, and the effect of any changes on the MSC.

5.59 We use the term scheme fees to refer to all fees acquirers pay to operators of card payment systems, including fees paid for scheme services and fees paid for the processing services they provide. Mastercard and Visa also charge fees for services that are neither scheme nor processing services.

156 GPUK response, paragraph 3.16. Worldpay response, paragraph 4.51.

157 PSR, *Market review into the supply of card-acquiring services: Final terms of reference* (2019).

5.60 Figure 11 shows that Mastercard and Visa scheme fees as a percentage of card turnover more than doubled between 2014 and 2018. However, there are several possible explanations why these fees may increase, namely:

- **Increases in total transaction volume or value:** If the total volume or value of transactions increases, this could lead to increases in total scheme fees, as well as scheme fees per GBP transacted, depending on the structure of scheme fees.
- **Changes in transaction mix:** If the underlying composition of transactions shifts towards those that incur higher fees (such as card-not-present transactions, which generally incur higher fees than card-present transactions), we can expect total scheme fees to increase.
- **Increases in price (that is, fee levels):** if Mastercard and Visa raise the level of existing fees or introduce new fees, we can expect total scheme fees to increase. Changes to the structure of fees may also cause total scheme fees to increase.

5.61 We use econometric techniques to control for the effect of the main drivers of scheme fees, including volume, value and mix of card transactions, to isolate any change in scheme fees that represent a change in the level of the fees (that is, the price) or new fees being introduced. In the interim report, our analysis focused on mandatory[158] fees for scheme and processing services that are directly attributable to transactions[159] at UK outlets (see Annex 4 for a full explanation of our econometric methodology).

5.62 We draw on data obtained from Mastercard and Visa to analyse prices acquirers paid for scheme and processing services separately over the period 2014 to 2018. The dataset covers 14 acquirers, including the five largest acquirers, but also some smaller ones[160] (see Annex 4 for a fuller description of the data).

5.63 In the interim report, we provisionally concluded that:

- Average fees for processing services as a percentage of GBP transacted increased for Visa by [✂]. However, most of this increase occurred in 2018. We did not consider growth in one year to constitute strong enough evidence to conclude that fees for Visa's processing services are rising over time. Mastercard's average fees for processing services increase in 2016 then fall back [✂]. Overall, we concluded that there is not enough evidence to assert that the level of fees for processing services have increased for Visa or Mastercard. Average fees for scheme services per GBP transacted paid by acquirers to Mastercard and Visa approximately doubled between 2014 and 2018, after controlling for increases in transaction volume and value and changes in mix. This indicated that there has been a significant increase in the level of fees for scheme services as a proportion of transaction value.

158 Mandatory fees are fees paid by the acquirer to the operator of the card payment system as a condition of its participation in the system.

159 Fees directly attributable to transactions are fees incurred as a direct consequence of a card transaction involving a merchant.

160 We weight the data by value of transactions acquired to reflect the relative importance of the largest acquirers in driving the findings.

5.64 Stakeholder comments on these provisional findings, and our conclusions on how scheme fees have changed over the period 2014 to 2018, are set out below in paragraphs 5.67 and 5.68.

Pass-through of scheme fees

5.65 We return to the data obtained from the five largest acquirers to investigate whether scheme fee increases have been passed through to merchants by acquirers. We note that the acquirers' data does not distinguish between fees for scheme and processing services.

5.66 Our econometric analysis, presented in detail in Annex 2, indicates that Mastercard and Visa scheme fees were passed through by acquirers in full to merchants in all turnover groups. Evidence that acquirers passed through cost increases but not cost decreases (the IFR savings) could constitute further evidence that the supply of card-acquiring services is not working well. However, we have some concerns about the data on scheme fees that underpin the pass-through analysis, and the evidence is therefore less strong. We present our methodology and the full results in Annex 2.

Stakeholder responses on scheme fees analysis

5.67 Three general themes emerged from the stakeholder responses to our analysis of scheme fees in the interim report:

- AIRFA, BRC and Tesco agreed with our finding that scheme fees had increased between 2014 and 2018 and were fully passed on to merchants.[161] Some stakeholders urged us to take action.[162] BRC noted that, based on its member data since 2018, scheme fees have subsequently increased to 0.14%, five times higher than (that is, they have increased by 400%).

- In contrast, Mastercard challenged our decision not to consult on our approach to examining how scheme fees have changed, and questioned the relevance of the analysis to the market review.[163] It suggested that our analysis does not distinguish between scheme and switch fees[164], contains some stark and potentially inaccurate statements[165], and contains significant weaknesses which undermine our provisional findings that fees for scheme services approximately doubled.[166]

- Visa Europe did not comment in detail on our analysis of how scheme fees have changed or the conclusions drawn. However, it noted that, for a typical domestic transaction, its charges to acquirers remain very low. It also told us that the period of our analysis was a highly atypical phase for the company, as it was a period

161 Tesco response, AIRFA response, page 2.

162 Tesco response. AIRFA response, page 3. The Money Charity response, pages 2, 4 and 5. BRC response, paragraph 1.1(a).

163 Mastercard response, page 12.

164 Mastercard response, page 13.

165 Mastercard response, page 12.

166 Mastercard response, page 15.

where the company was acquired by Visa Inc. This led to a substantial transformation and fundamentally changed its relationship with its acquirers.[167]

5.68 In response, we note that:

- Our analysis of how fees for scheme services and fees for processing services have changed was based on data supplied by Mastercard and Visa. Neither scheme said that our results were far out of line with their own understanding of how their scheme fees have changed.
- Visa Europe made no technical comment on our results, but noted that during the period its ownership and business model had changed.
- Mastercard's advisers suggested further analysis that we could have done on the data, which they said might have produced different results.[168] However, our judgement was that the analysis we did was at an appropriate level for the dataset we had. We note that they did not undertake this additional analysis themselves.
- Mastercard noted that we had analysed fees for scheme services and fees for processing services separately. It said the regulatory requirement for these fees to be separately accounted for from 2016 onwards might have led to changes in internal accounting, so our analysis should have been of the sum of both types of fee.[169] We ran this additional analysis, and it indicates that average fees for scheme services and processing services combined per GBP transacted increased significantly between 2014 and 2018. These increases were not explained by changes in the characteristics of transactions over the period.
- In conclusion, our analysis indicates that:
  - average fees for scheme services
  - average fees for scheme services and processing services combined

  per GBP transacted paid by acquirers to Mastercard and Visa increased significantly between 2014 and 2018. This suggests that average scheme fees per GBP transacted increased significantly between 2014 and 2018. A substantial proportion of these increases are not explained by changes in the volume, value or mix of transactions.

Summary

5.69 The IFR capped interchange fees on consumer debit and credit card transactions where the acquirer and issuer are in the EEA. The IFR caps came into force on 9 December 2015 and aimed to reduce the costs of card payments for merchants and consumers, and help create an integrated and competitive market for payment services.

167 Visa Europe response, page 16.

168 For example, Mastercard technical annex, page 8.

169 Mastercard response, page 14.

5.70 The IFR capped interchange fees paid by acquirers to issuers, but did not cap MSCs paid by merchants. It relied on competition between acquirers to ensure that IFR savings were passed through to merchants. We used the introduction of the IFR caps as an indicator for how well the supply of card-acquiring services is working by understanding the extent to which these savings were passed through to merchants.

5.71 Merchants on IC++ pricing received full pass-through of the IFR savings. They are very few in number but represent 77% of transaction value. We estimate the benefit to these merchants was around £600 million in 2018. Some of the largest merchants may also have benefitted from switching to IC++ pricing after the IFR caps came into force.

5.72 The statistical evidence suggests that, on average, merchants with annual card turnover up to £50 million got little or no pass-through of the IFR savings.

5.73 The econometric analysis confirms that, on average, merchants with annual card turnover between £15,000 and £50 million got little or no pass-through of the IFR savings, after controlling for possible effects of changes in the characteristics of merchants within each size group, changes in the mix of transactions, and changes in scheme fees. (We do not place weight on the econometric results for merchants with annual card turnover below £15,000, and therefore make no finding about pass-through for this group.)

5.74 Taken together, this is robust evidence that, on average, merchants with annual card turnover between £15,000 and £50 million received little or no pass-through of the IFR savings. This indicates that the supply of card-acquiring services may not be working well for these merchants. In response to the interim report, some acquirers challenged the data and methods underlying this conclusion. However, for the reasons set out above (and as explained in detail in Annex 2), we do not consider that these submissions undermine the results of the baseline model we use to reach our final conclusion.

5.75 Our analysis also shows that small and medium-sized merchants with annual card turnover up to £10 million secured better deals in the form of lower MSC by switching their provider of card-acquiring services – on average, new customers pay less.

5.76 Some acquirers had told us that an explanation for a lack of IFR pass-through could be that they invested the savings in providing a higher quality of service to their customers, rather than lower prices. However, the data we reviewed on quality of service metrics did not show evidence of improvements during the period. Similarly, in response to the interim report, acquirers told us that the increase in interchange fee margins reflects their rising costs. However, the information they supplied on costs suggested that unit costs fell over the period. The information related to only two acquirers and does not necessarily point to general conclusions, but it is not consistent with unit costs rising because of investments in service quality. Limited evidence was provided to show how specific investments led to improved/new services during the period under investigation. Furthermore, it is not clear to what extent the IFR savings made by acquirers directly led to improved/new services. Accordingly, we consider that the acquirers have not clearly shown the extent to which the costs of specific investments could explain the increases in the interchange fee margin over the period 2014 to 2018. We therefore do not consider that investments in improved/new services explain the lack of pass-through of the IFR savings to merchants with annual card turnover up to £50 million.

5.77 In our final Terms of Reference, we said we would also examine how scheme fees have changed over the period 2014 to 2018. Our analysis indicates that:

- scheme fees increased significantly over the period
- a substantial proportion of these increases are not explained by changes in the volume, value or mix of transactions

5.78 For merchants in all turnover groups, the evidence available to us and our analysis indicates that scheme fees were passed through by acquirers in full. This could constitute further evidence that the supply of card-acquiring services is not working well, because it suggests that acquirers did not face competitive pressures to absorb cost increases or to pass through cost decreases. However, we have some concerns about the data on scheme fees that underpinned our pass-through analysis, and the evidence is therefore less strong.

6 Merchants' willingness and ability to search and switch

This chapter examines whether there are features in the supply of card-acquiring services that restrict merchants' willingness and ability to search and switch provider.

The largest merchants, with annual card turnover above £50 million, are able to access information, assess their requirements and achieve good outcomes despite facing switching costs.

We surveyed merchants with annual card turnover of up to £10 million. We identified three features that, individually and in combination, restrict small and medium-sized merchants' willingness and ability to search and switch, leading to worse outcomes for them:

- **Acquirers and ISOs** do not typically publish their prices for card-acquiring services. Their pricing structures and approaches to headline rates vary significantly.
- **The indefinite duration of acquirer and payment facilitator contracts for card-acquiring services** do not provide a clear trigger for merchants to think about searching for another provider and switching.
- **POS terminals and POS terminal contracts.** The lack of portability of POS terminals and significant early termination fees for cancelling an existing POS terminal contract can together prevent or discourage merchants from searching and switching provider of card-acquiring services.

These features will also affect large merchants with annual card turnover between £10 million and £50 million.

Introduction

6.1 In this chapter, we explore how merchants choose their provider of card-acquiring services. In particular, we consider whether there may be features in the supply of card-acquiring services that restrict merchants' willingness and ability to search and switch. If merchants face barriers to searching and switching, providers will face fewer incentives to compete for these merchants – for example, through lower prices – resulting in worse outcomes for merchants.

6.2 We apply a well-known assessment – the 'three-As' framework[170] – to identify whether merchants face barriers to searching and switching. Using this framework, we examine merchants' willingness and ability to:

- access information on the price and quality of card-acquiring services
- assess their own requirements and then compare different offerings of card-acquiring services
- act on the information based on a comparison of different offers by staying with their current provider of card-acquiring services or switching to a different one

6.3 Within this framework, we considered all merchants and relied on various sources of evidence, including:

- the merchant survey of small and medium-sized merchants
- survey research submitted to us by parties in response to information requests
- responses to our information requests from various parties, including a selection of large merchants (nearly all of whom had an annual card turnover above £50 million)
- analysis of merchant contracts for card-acquiring services with acquirers and payment facilitators, and for POS terminals with acquirers and ISOs
- business strategies of providers of card-acquiring services (see Chapter 4)
- pricing outcomes (see Chapter 5)

6.4 Our focus in this chapter is on small and medium-sized merchants, with annual card turnover up to £10 million. These merchants experienced worse pricing outcomes than the largest merchants with annual card turnover above £50 million (see Chapter 5). The results of the merchant survey show that many small and medium-sized merchants do not regularly search for other providers or consider switching their provider. We also consider where large merchants with annual card turnover between £10 million and £50 million may be affected by the same features that affect small and medium-sized merchants.

170 For more information on this framework, see: Competition and Markets Authority and Financial Conduct Authority, *Helping people get a better deal: Learning lessons about consumer facing remedies* (2018), page 9.

6.5 We published for consultation a working paper[171] setting out our proposed approach to the merchant survey and the draft questionnaire.[172] The responses we received informed our approach to the survey and the questions we asked participants. To take account of respondents' views:

- We changed our proposed definition of an active small and medium-sized merchant to any merchant that accepted at least two card transactions and had annual card turnover up to £10 million in the calendar year 2018. We increased the number of card transactions a merchant must accept to qualify as an active merchant from one to two, to avoid including in our sampling frame merchants that accept a test transaction and then never use card-acquiring services again. We lowered the maximum value of card transactions a merchant could accept to be categorised as a small and medium-sized merchant in response to comments on the consultation and our review of how providers of card-acquiring services segment their customers.

- We increased the number of providers of card-acquiring services that were asked to provide customer lists from which we drew the sample of merchants to participate in our research. We collected customer lists from six acquirers and the largest payment facilitators, and achieved around 72% coverage of the target population of small and medium-sized merchants.[173]

- We allocated merchants into strata based on their annual card turnover and operating environment (that is, the channels through which they accept card payments)[174], though not risk (as we proposed in our working paper) because Merchant Category Codes[175] were not sufficiently informative about the risk profile of an industry in which a merchant operates.

- We took steps to minimise different sources of bias in the design of the merchant survey and questionnaire, and considered if there was systematic variation between merchants across our research objectives based on differences in merchants' annual card turnover, operating environment and provider type in the analysis of survey data.

- We updated the questionnaire, including by amending some of the draft questions, adding new questions and removing others.

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171 PSR, *Market review into the supply of card-acquiring services: Consultation on the approach to the merchant survey* (May 2019).

172 PSR, *Market review into the supply of card-acquiring services: Consultation on our merchant survey questionnaire* (July 2019).

173 PSR analysis of data provided by acquirers and payment facilitators.

174 We used card-present and card-not-present transactions as a proxy for the operating environment. The approach to stratification itself is set out in IFF's technical report. IFF, *Card-acquiring services market review: Technical report* (July 2020).

175 The Merchant Category Code is a four-digit code used to classify the merchant by the types of goods or services it provides.

6.6 Using the framework and evidence set out above, we:

- briefly summarise our assessment of large merchants' willingness and ability to search and switch provider
- outline the characteristics of small and medium-sized merchants' searching and switching behaviour
- assess whether there are features in the supply of card-acquiring services that may restrict small and medium-sized merchants' willingness and ability to search and switch

6.7 Annex 1 sets out some of the characteristics of merchants that buy card-acquiring services.

Large merchants

6.8 The evidence we collected shows that merchants with annual card turnover above £50 million:

1. are sophisticated buyers, who may use more than one card-acquiring service provider, and typically use competitive tenders to select providers
2. face search costs due to their complex requirements, but can overcome these by using dedicated internal resources or specialist consultants
3. can incur significant costs when switching provider due to the complexity of their requirements and the complexity of integrating payments with their systems
4. are in a relatively strong bargaining position with card-acquiring service providers because they generate significant revenue for the acquirers

6.9 Chapter 5 showed that the largest merchants achieve better pricing outcomes than merchants with lower annual card turnover. The largest merchants can access information, assess their requirements and achieve good pricing outcomes, despite sometimes facing significant switching costs.

6.10 Chapter 5 showed that large merchants with annual card turnover between £10 million and £50 million achieve worse pricing outcomes than the largest merchants. In our interim report, we noted that many large merchants in this category appeared to share characteristics with small and medium-sized merchants. Many of these merchants are clustered at the lower end of this card turnover range; approximately 35% have an annual card turnover between £10 million and £15 million, and a further 20% have an annual card turnover between £15 million and £20 million.[176]

176 PSR analysis of data provided by acquirers and payment facilitators.

6.11 In response to the interim report, almost all stakeholders agreed with our assessment that the largest merchants with annual card turnover above £50 million can access information, assess their requirements and achieve good pricing outcomes. However, a number of respondents disagreed with our conclusion that merchants with annual card turnover between £10 million and £50 million shared characteristics with small and medium-sized merchants.

6.12 GPUK, American Express and Worldpay suggest that it is inappropriate to include merchants with annual card turnover between £10 million and £50 million in the finding that the supply of card-acquiring services is not working well because these merchants were not represented in the merchant survey.[177]

6.13 We acknowledge that the merchant survey did not include merchants with annual card turnover between £10 million and £50 million, and that they may tend to have different characteristics to those that were included. However, we consider that this does not undermine our finding that the supply of card-acquiring does not work well for these merchants, for the reasons explained in paragraph 7.33.

Do small and medium-sized merchants search and switch?

6.14 This section examines small and medium-sized merchants' searching and switching behaviour. It outlines:

- the frequency of searching and switching
- the ease of searching and switching
- the reasons merchants report for not searching and switching
- merchants' ability to negotiate a better deal

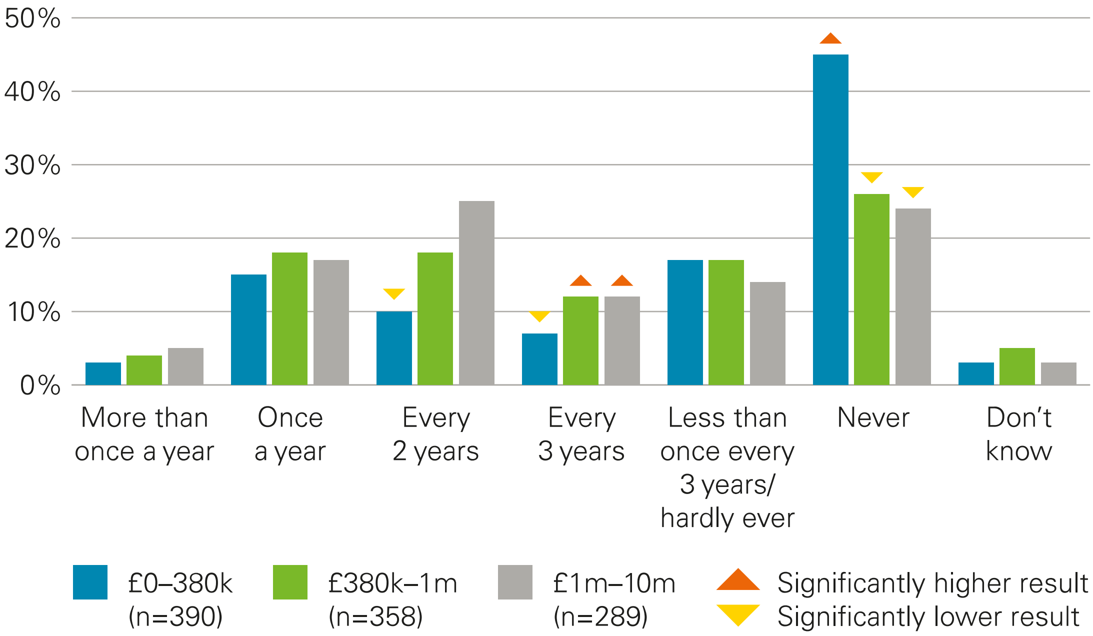
177 GPUK response, paragraphs 4.16 – 4.17. American Express response, page 3. Worldpay response, paragraph 4.9.

Frequency of searching and switching

6.15 The merchant survey asked small and medium-sized merchants how often they search for providers[178] – that is, assess their own needs, access information about providers and compare provider offerings.[179] 43% of merchants reported that they never search and 17% said that they do so less than once every three years or hardly ever.[180] 30% search for providers at least once every two years.[181]

6.16 Figure 12 below shows that, across all card turnover groups, fewer than a quarter of small and medium-sized merchants reported searching for providers at least once a year, and over 50% do so no more often than every three years, if at all. The smallest merchants are the least likely to have ever searched for providers.[182]

Figure 12: How frequently do merchants in different card turnover groups search for providers? (n=1,037)



Source: IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 79.
Note: arrows are used to denote significant differences between a group and the total population. An orange arrow signifies a result which is significantly higher and yellow significantly lower.

178 Some participants in the merchant survey identified third parties – that is, firms that are not acquirers or payment facilitators – as their main provider of card-acquiring services. When describing the results of the merchant survey, where we use the term providers, we mean the firm the merchant identified as its provider of card-acquiring services. See Annex 1 for more information.

179 In the merchant survey, the term 'shop around' was used.

180 We checked if these results were being driven by merchants that started accepting cards recently who may be less likely to have searched for providers. We found that the results were very similar when merchants that had accepted cards for less than two years were excluded.

181 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 39.

182 77% of merchants with annual card turnover under £21,000 said they search less than once every three years.

6.17 Figure 13 below shows that 16% of small and medium-sized merchants in the merchant survey switched in the last two years and 29% had considered switching but ultimately didn't switch. Most merchants that searched and considered switching compared three or more providers.[183] 42% of merchants had not considered switching their provider in the last two years. Of these, 61% reported they had never searched for other providers.[184]

6.18 Merchants with annual card turnover between £1 million and £10 million are more likely to have considered switching, and those with annual card turnover between £380,000 and £1 million are more likely to have switched in the last two years.[185] [186]

6.19 Of those merchants that had switched in the previous two years, the majority of merchants did so because they wanted to pay a lower price/find a better deal; 16% stated that they were motivated by a price increase; and 16% that they were approached by a provider with better terms.[187]

6.20 The merchant survey also shows that over 70% of small and medium-sized merchants have been with their provider for over two years, though length of relationship varies across card turnover groups.[188] Merchants with annual card turnover between £1 million and £10 million have the longest relationships with their providers – over half have been with their provider for more than five years. By contrast, 65% of the smallest merchants have been with their provider for less than five years.[189]

183 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 82.

184 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 78.

185 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 23.

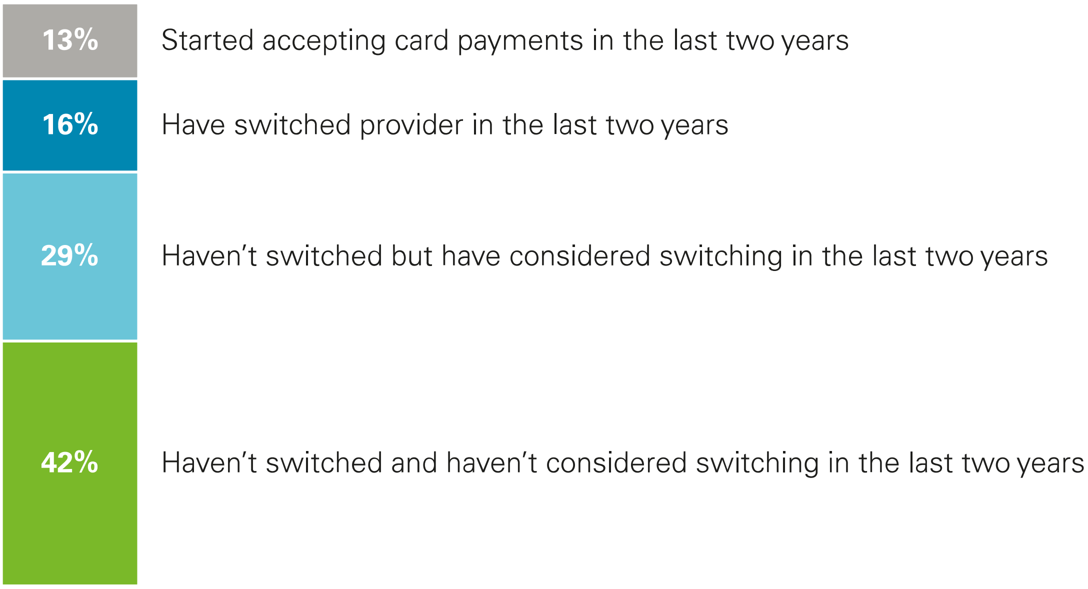
186 Similarly, 44% of merchants with annual card turnover under £21,000 had not considered switching in the previous two years.

187 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 28.

188 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 11.

189 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 66.

Figure 13: Small and medium-sized merchant considerations of switching and actual switching in the last two years (n=1,037)



Source: IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 22.

6.21 Other surveys we've seen do not ask merchants about how often they search for other providers or consider switching. However, these surveys do look at rates of switching among merchants. These results suggest that anywhere between 15% to 25% of small and medium-sized merchants switched in the last two years. These results are broadly consistent with the merchant survey we commissioned.[190]

6.22 The results above show that many small and medium-sized merchants do not regularly search for providers and do not always compare other providers before choosing their current one. They also show that many small and medium-sized merchants do not often consider switching their provider.

Stakeholder submissions on merchant switching and search behaviour

6.23 We noted above that merchant switching can be motivated by wanting to get a lower price or better deal. Some stakeholders provided evidence indicating that there can be material gains to switching.

- Bename (an ISO) told us that switching small and medium-sized merchants with turnover of £1,000 to £100,000 a month is its unique selling point. It says it always manages to save merchants money on their MSC and other ancillary fees.

190 We also asked providers of card-acquiring services to provide us with data on merchant switching to complement the merchant survey. However, most were unable to identify whether merchants they onboard (or lost) switched to them from (or away from them to) another provider.

It estimates that in a three or four-year contract, it can save the merchant an average of £600 annually or £2,400 over four years.[191]

- The National Federation of Retail Newsagents (NFRN) said that the potential for retailers to save money through switching has been shown by retailers who have taken up an offer with a major acquirer negotiated by the NFRN or its members. It estimates that members have seen savings of between £100 and £450 per month on the cost of services, including the costs of terminals.[192]
- UTP (an ISO) submitted data which showed that average rates paid by UK-based SME merchants for consumer credit cards had fallen from [✂] to [✂] (a fall of [✂]) over the 12 years from 2008. It considers this relevant because it covers the period of time when ISOs first appeared.[193]

6.24 Some stakeholders, however, challenged our interpretation of the results of the merchant survey.

- American Express and Barclays said that the merchant survey does not support a finding that the supply of card-acquiring services is not working well for the merchants surveyed.[194] GPUK also told us that an objective interpretation of the results concludes that merchants are engaged, that they do search and switch, and that there are no material barriers restricting merchants' willingness and ability to do so.[195]
- Barclays also drew attention to the results of the merchant survey, which it said showed that merchants at all levels consider searching and switching: in particular, that 30% of SME merchants search for providers at least once every two years.[196] [✂].[197]
- Barclays, GPUK and Mastercard all submitted that the main reason some merchants might not look to switch acquirers is their satisfaction with an existing provider which is shown in the merchant survey.[198] Mastercard noted that although our focus is 'naturally' on the 71% of non-switchers (that is, the 29% who had considered switching but had not, and the 42% who had not considered switching), the majority of respondents who neither switched nor considered switching tended to cite either broad satisfaction with their current provider or a perceived lack of benefit or reason to switch to an alternative.[199] Similarly, GPUK noted that the majority of merchants who did not consider switching or did not shop around reported that this is because they are satisfied with their current provider, and very few identified any 'pain points' in the market that prevent them from switching.[200]

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191 Bename response, page 1.
192 National Federation of Retail Newsagents response, paragraph 8.
193 UTP response, page 2.
194 American Express response, page 4. Barclays response, paragraph 6.
195 GPUK response, paragraph 1.4.2.
196 Barclays response, paragraph 13.
197 [✂].
198 Barclays response, paragraph 18.
199 Mastercard response, page 6.
200 GPUK response, paragraph 4.8.

- Stripe told us that online merchants do shop around and switch, and that the online segment shows very different characteristics to the legacy acquiring segment. It stated that we did not adequately address this in the interim report.[201] In addition, it submitted that where small and medium-sized merchants appear in our analysis to not be engaged, it could be because they've holistically evaluated the offerings in the market (both price and non-price) and decided to remain with their incumbent provider.[202]

- Worldpay told us that switching levels presented in the merchant survey are not low. It submits that the merchant survey shows that 57% of SME merchants do shop around at some point, with 37% of them doing so at least every three years, and that switching levels are materially different by merchant turnover size. Worldpay also told us that switching levels presented in the merchant survey are high compared to other market investigations and market studies that have given rise to remedies.[203]

6.25 Our responses to these submissions on the interpretation of the results of the merchant survey are as follows.

- On the issue of the merchant survey's consistency and whether it supports the conclusion that the supply of card-acquiring services is not working well, we note two key findings. Firstly, over four out of ten (43%) merchants said that they never shop around; secondly, the implied annual switching rate could be as low as around eight out of 100 merchants (8%)

- Worldpay said that switching levels are high relative to those found in other market studies and investigations. We do not consider that there is a threshold level of switching that indicates a sector or market is working well. We considered evidence on merchants' searching and switching behaviour alongside other evidence, including the lack of pass-through of IFR savings and the barriers to searching and switching.[204]

- We acknowledge that the low rate of switching could be due to merchants being satisfied with their provider, and seeing no need to search for another acquirer or switch provider. However, there could be a number of other reasons. Respondents suggested various barriers that may make it difficult or costly for small and medium-sized merchants to search and switch effectively. We explored barriers in our merchant survey, and consider the results below.

- We agree with Stripe that online and offline merchants can have different characteristics; we included a mix of online and offline merchants in our survey for this reason. We analysed data from 217 merchants that said they accept more than 50% of card transactions online, to examine whether they differed in their searching, switching and negotiating behaviour. We found that they generally exhibit the same behaviour as other merchants.

201 Stripe response, page 3.

202 Stripe response, page 5.

203 Worldpay response, paragraph 4.10 and 4.26.

204 We note that the levels of switching shown in our merchant survey are comparable to (or potentially lower than) those in some other reviews of markets found not to be working well. These include the CMA's Energy market investigation (2016) and the FCA's General insurance pricing practices (2019).

6.26 Stakeholders also referred to other research or evidence on switching rates, or on how common switching is in the market:

- The Association of Convenience Stores (ACS) referred to a November 2020 polling of 1,210 independent and symbol retailers that finds that 61% have not compared or switched acquirers in the past three years; and 48% of retailers who have compared providers in the past three years did not choose to switch.[205]
- Barclays said that its own business experience shows that merchants are able to switch, and do so. [✂].[206]
- Paytek told us that it finds switching between ISOs is increasingly common, noting that some ISOs may provide some contribution to the costs of settlement in order to make the switch easier.[207]
- Visa Europe told us that our findings that 16% of merchants had switched card-acquiring services in the last two years 'chimed' with their own research which had found that 17% of merchants had switched in the past two years.[208]
- Worldpay submitted that other survey/analysis evidence contrasts with the interim report's findings. [✂].[209]

6.27 In response, we note that:

- Several of the above submissions, such as ACS and Visa Europe, appear broadly consistent with the low rates of searching and switching indicated by our merchant survey.
- With regard to Worldpay's submission, [✂].
- With regard to Barclays submission, [✂].
- Overall, the evidence suggests that merchant switching rates are low, as indicated by our merchant survey.

6.28 Worldpay noted that 94% of the merchants surveyed had a card turnover of less than £3 million. It suggested that the interim report therefore provided insufficient evidence to support its overall findings for merchants with revenue between £3 million to £10 million.[210]

205 ACS response, paragraph 3.
206 Barclays response, paragraph 40.
207 Paytek response, page 6.
208 Visa Europe response, page 31.
209 [✂].
210 Worldpay response, paragraph 4.9.

6.29 In response, we note that:

- We did further analysis of the survey data for merchants with annual card turnover between £3 million and £10 million. The results are broadly consistent with our finding that many small and medium-sized merchants do not regularly search, consider switching, or negotiate with their provider (see Figure 16).[211] These results are based on a smaller sub-sample of merchants, and we should be cautious about drawing inferences to the wider population of merchants with these levels of card turnover.

- We do not, however, rely on this evidence in reaching our overall finding for this segment. The evidence we discuss in Chapter 6 shows that small and medium-sized merchants face barriers to searching and switching. The analysis in Table 3 and paragraph 5.33 also indicates that merchants in this segment, on average, likely got little or no pass-through of the IFR savings.[212] For these reasons, we do not accept that this segment should be excluded from our overall findings on small and medium-sized merchants.

Ease of searching and switching

6.30 The merchant survey showed that 76% of merchants who recently switched found it easy (19% found it fairly or very difficult).[213] And only around 1% of merchants that considered switching in the last two years didn't switch because they were unsuccessful in carrying it out.[214]

6.31 Figure 14 below shows that just over 50% of merchants that recently switched, and 65% of merchants that recently considered switching and searched for providers, reported that searching was easy. 26% and 22% of merchants, respectively, found it difficult.

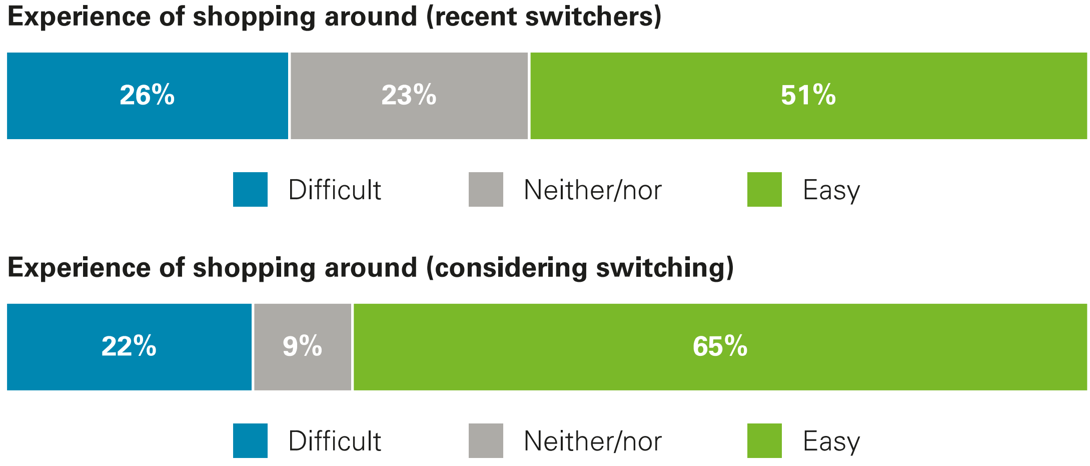
211 For instance, 32% had not considered switching in the previous two years, and 36% stated that they search no more often than every three years. Only 7% had switched in the previous two years, and 38% had not tried to negotiate better terms with their provider.

212 For instance, this analysis indicates that merchants with annual card turnover between £1 and £10 million, on average, received little or no pass-through of the IFR savings.

213 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 29.

214 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 27.

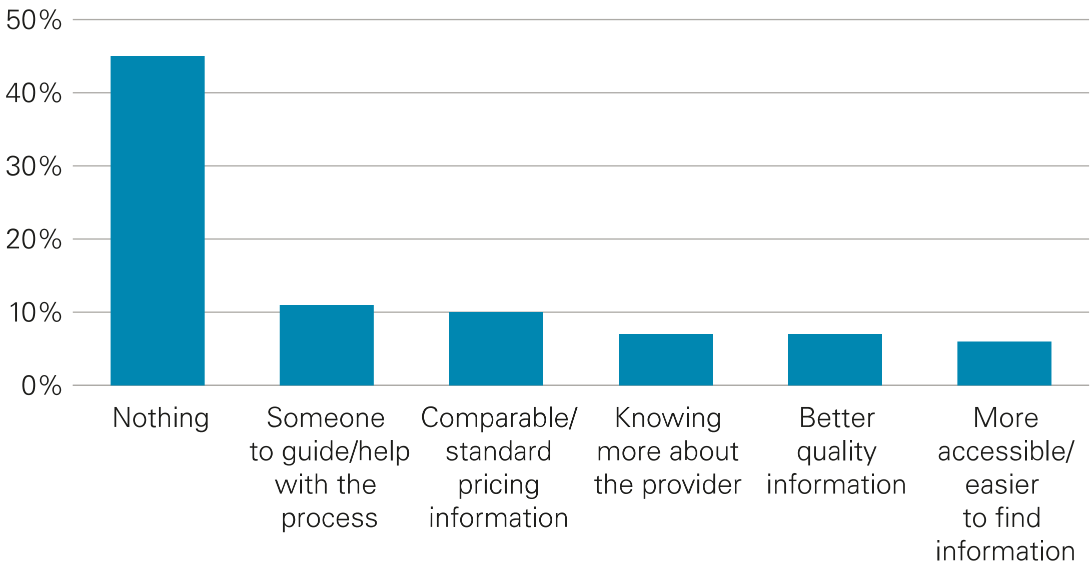
Figure 14: Small and medium-sized merchants' experience of searching (n=123, 250)



Source: IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slides 36 and 34. Rounding means that the figures for recent switchers do not sum to 100%.

6.32 We asked merchants that switched their provider in the last two years, what, if anything, would have made them feel more confident about deciding which provider to switch to – the results are in Figure 15. Around 60% of these merchants searched for other providers before choosing their current one.[215]

Figure 15: What, if anything, would make small and medium-sized merchants feel more confident about deciding which provider to switch to? (n=181)



Source: IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 30.

215 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 36.

6.33 46% of participants said that there was nothing that would make them feel more confident about deciding which provider to switch to. The second most common response related to having better quality information. Around 23% of merchants stated that access to more comparable pricing information, knowing more about the provider[216], better quality or more accessible information would have made them feel more confident about deciding which provider to switch to.

6.34 The results in Figure 14 and Figure 15 show that most small and medium-sized merchants that search and switch don't report facing difficulties when doing so.

Reasons merchants report for not searching and switching

6.35 When we asked merchants that never search for other providers why this was, 54% said they were satisfied with their current provider and 29% said they have no time or that searching would take time away from running the business. Other reasons were cited by 10% or less of merchants.[217]

6.36 In addition, a high proportion of merchants report high satisfaction with:

- the customer service they received when they last contacted their provider[218]
- the level of information they received to help them comply with rules allowing them to accept card payments from customers[219]
- the level of information provided to them by their current provider in order for them to understand the price they pay for card-acquiring services[220]

6.37 In other surveys submitted by acquirers, merchants also reported high satisfaction with the level of customer service and information they receive from their providers.

6.38 In the merchant survey, 64% of merchants that had not considered switching in the last two years reported satisfaction with their provider as a reason for this (other responses accounted for less than 10% of merchants).[221]

216 Responses were coded as 'reputation of the provider'.

217 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 40.

218 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 16.

219 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 17.

220 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 17.

221 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 25.

6.39 We also asked merchants that considered switching in the last two years but didn't switch, why they chose not to switch:

- 35% of those merchants stated they stayed with their provider because they thought their current provider was still the best option
- 25% of merchants said their current provider gave them a discount or better offer
- 10% of merchants stated they did not switch because they were tied into a contract
- 10% said they lacked time or were too busy[222]

6.40 In one survey submitted by an acquirer, reasons given by merchants for not switching included:[223]

- they're locked into contracts
- it's too much hassle
- switching is not a priority
- it would cost too much

6.41 In a survey submitted by another acquirer, merchants were presented with a list of potential barriers and asked to indicate how much of a barrier each would be if they were considering switching. No barrier was considered difficult to overcome by more than 21% of merchants. Those that were considered to be most difficult to overcome were:

- fear of downtime
- lack of understanding of pricing models
- lack of time and/or resources
- lack of understanding about how payments and payment providers work

6.42 In summary, most surveyed merchants that shopped around or switched found it easy (with around one in five finding these difficult). The merchant survey suggests that, despite this, some merchants may face barriers that restrict their willingness and ability to search and switch. This is consistent with other survey evidence.

222 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 27.

223 Surveyed merchants that reported being likely to consider switching acquirer in the subsequent 12 months were asked what had prevented them from switching so far.

Stakeholder submissions on ease of searching and switching

6.43 In response to the interim report, stakeholders made various submissions on the ease of searching and switching, and the reasons merchants give for not switching.

6.44 As previously noted, several stakeholders highlighted that many surveyed merchants reported not searching for other providers because they are satisfied with their current provider.

6.45 There were differing perceptions of how difficult it is for smaller and medium-sized merchants to search and switch acquirers. Some merchant/merchant representatives submitted that they find it difficult to search and switch acquirers.

- The Association of Convenience Stores told us that the complexity of switching acquirers makes it difficult for retailers to find the best deal for them. They told us that switching acquirers is especially complex for unaffiliated independent retailers. These retailers cannot draw on payments' expertise or symbol group oversight when comparing acquirers.[224]

- North East Interiors told us that although it had changed providers a few times in order to get a better deal, it was a time-consuming and difficult task. In its view, a more open and easier comparison system would improve the process.[225]

6.46 Conversely, a range of stakeholders, including acquirers and ISOs, said that it is not difficult to search and switch acquirer.

- Barclays, GPUK, Paytek, Visa Europe and Worldpay all referred to the results of the merchant survey, which showed that 76% of merchants surveyed said it was very or fairly easy to switch. They argue that this indicates that there are no material barriers to switching.[226]

- GPUK submitted that a failure to shop around regularly does not demonstrate an absence of merchant engagement, as merchants may be approached with a better offer.[227]

- Takepayments told us that most businesses will have several approaches a year with offers to switch. It notes that it called [✂] different merchants last year, and that merchants can easily access different providers through a Google search.[228]

- UTP said that merchants who are interested in reducing their costs of card-acquiring can very easily contact a large array of providers in order to quickly assess whether it is commercially viable for them to switch to a new supplier.[229]

224 ACS response, paragraph 3.

225 North East Interiors response.

226 GPUK response, paragraph 4.7. Visa Europe response, page 31. Paytek response, page 7. Barclays response, paragraph 13. Worldpay response, paragraph 4.10bi.

227 GPUK response, paragraph 4.6.

228 Takepayments response, page 1.

229 UTP response, page 1.

- Worldpay told us that small and medium-sized merchants have a significant amount of choice, and that the merchant survey found that only 1% of surveyed merchants that considered switching in the last two years were unable to switch. It submits that the merchant survey shows that, of the merchants that considered switching in the last two years, 70% had shopped around; 65% of respondents said that it was easy to shop around; and only 22% said that it was difficult.[230]

6.47 In response to these submissions:

- We acknowledge that most surveyed merchants that shopped around or switched found it easy. However, around one in every five surveyed merchants that had shopped around – and a similar proportion of those that had switched – found the process difficult. Furthermore, around 23% of merchants that had switched indicated that more or better information would have made them more confident about choosing a provider (paragraph 6.33).
- Although many surveyed merchants found searching or switching easy, many do not regularly search or consider switching. Many said this is because they were satisfied with their current provider (and some don't switch because they are offered a discount). However, other survey responses indicated that some merchants face potential barriers.

6.48 In summary, many merchants do not regularly search or consider switching. Some gave reasons indicating potential barriers to doing so, and some that have searched or switched found those processes difficult. We consider these factors to be consistent with there being potential barriers that restrict some merchants' willingness and ability to search and switch provider.

Merchants' ability to negotiate a better deal

6.49 Some acquirers have also told us that merchants negotiate with providers by threatening to switch. We asked small and medium-sized merchants if they engage in negotiations with their providers.

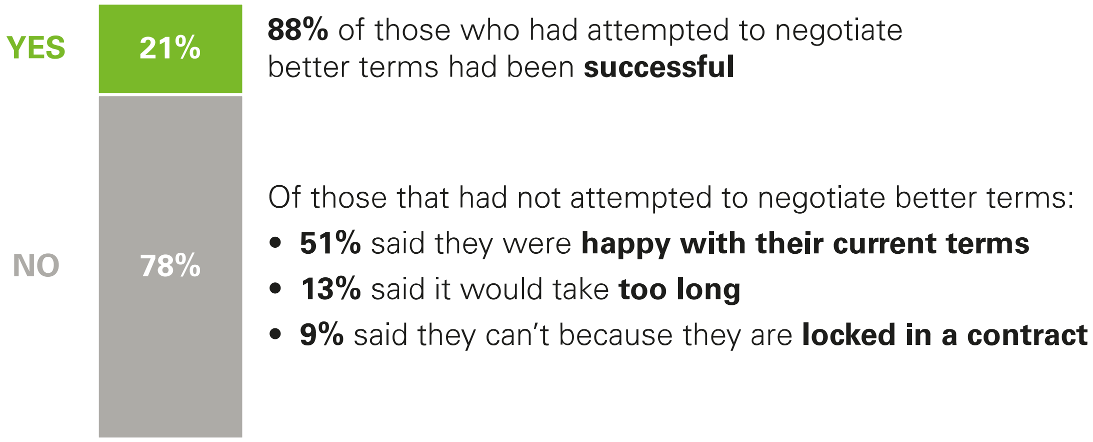
6.50 Figure 16 shows that in the merchant survey, 78% of small and medium-sized merchants have never attempted to negotiate with their provider.[231] However, of the 21% of merchants that did negotiate, nearly 90% were successful in negotiating better price or non-price terms. Merchants with a higher card turnover were more likely to negotiate with their provider and slightly less likely to be successful.[232]

230 Worldpay response, paragraph 4.10.

231 For surveyed merchants with the lowest annual card turnover, less than £21,000, 84% had not tried to negotiate better terms with their provider.

232 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 71.

Figure 16: Have small and medium-sized merchants ever negotiated with their current provider? (n=1,037)



Source: IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 15.

6.51 The merchant survey also identified that 25% of merchants that recently considered switching, but ultimately did not switch, reported they chose not to switch because they received a better offer from their provider.[233]

6.52 The merchant survey therefore shows that merchants can get a better deal if they consider switching their provider and have some bargaining power if they threaten to switch.

Stakeholder submissions on ability to negotiate a better deal

6.53 Some stakeholders noted that the merchant survey shows 88% of merchants who tried to negotiate with their current provider were successful in getting a better deal, and queried the evidence on merchants' ability to negotiate a better deal.

- American Express suggested that respondents may have interpreted 'better terms' differently, and the data does not demonstrate the relative value of these terms nor provide insight into how these compare to the time and resource costs of negotiating.[234]
- Mastercard indicated that the 'better terms' obtained are not weighed or considered against other factors that could be relevant to whether or not the merchants have benefitted overall. For example, a reduced price might be accompanied by a longer contract to which the merchant is now tied, or a new terminal that they did not need.[235]
- On the other hand, [✂].[236]

233 IFF Research, *PSR Card-Acquiring Market Review: Merchant survey results*, slide 27.
234 American Express response, page 5.
235 Mastercard response, page 7.
236 [✂].

6.54 Overall, the submissions on this issue do not challenge our finding that many small and medium-sized merchants do not negotiate with their current provider, and that they can get a better deal if they consider switching or have some bargaining power when threatening to switch.

6.55 The submissions of American Express and Mastercard appear to raise a question about whether the 'better terms' that some merchants' obtained by negotiating with an acquirer were offset by the time and resource costs of negotiating or new contractual terms (a longer contract or new terminal). In effect, they seem to be suggesting that the merchants may not be better off overall as a result of negotiating with their acquirer.

6.56 In our view, these submissions highlight how important it is for merchants to face a more straightforward and low-cost search and switching process that allows them to easily compare different providers and deals.

Summary – searching and switching

6.57 The merchant survey of small and medium-sized merchants shows that:

- many don't regularly search for providers and do not always compare other providers before choosing their current one
- many don't often consider switching their provider
- most of those that do search and switch don't report facing barriers but some report that the process was difficult
- most report high levels of satisfaction with their provider, customer service and the information they receive
- some report business resources as a reason for not searching and thinking about switching
- some attempt to negotiate with their provider – of those that do, nearly 90% are successful in negotiating better terms

6.58 In the interim report, we investigated whether certain types of merchants were more willing and more likely to search and switch. We looked at variation in behaviour between merchants with different:

- annual card turnover (£0 – £380,000, £380,000 – £1 million, and £1 million – £10 million.)
- operating environment (online, face to face, mail order/by phone and mixed)[237]
- providers as reported by the merchant (acquirer, payment facilitator, third party)

6.59 Despite there being some variation between merchants with different characteristics, merchants of all types consistently tend not to regularly search, consider switching their provider or negotiate with their provider. We also found that merchants with annual card turnover up to £380,000 are the least likely to search and consider switching compared to merchants with higher annual card turnover.

6.60 Since publishing the interim report, we did further analysis of the survey data for merchants with annual card turnover between £3 million and £10 million[238], and for merchants with annual card turnover below £21,000.[239] The results were broadly consistent with our finding that many small and medium-sized merchants do not regularly search, consider switching providers, or negotiate with their provider.

6.61 In response to the interim report, some stakeholders challenged our interpretation of the merchant survey. We remain of the view that the survey results show that many merchants do not regularly search or consider switching. Around one in every five surveyed merchants that had shopped around – and a similar proportion of those that had switched – found the process difficult. This evidence, together with the reasons cited by some merchants for not searching and switching (such as being locked into contracts or having other priorities), is consistent with there being potential barriers that restrict some merchants' willingness and ability to search and switch provider. Furthermore, the merchant survey shows that almost four in five merchants do not attempt to negotiate with their provider, despite evidence that they could achieve a better outcome.

237 As noted in paragraph 6.25, we collected 69 responses from online-only merchants. We therefore undertook further analysis of the survey data, using a sample size of 217 merchants that reported to accept more than 50% of card transactions online, to examine whether they differed in their searching, switching and negotiating behaviour. We found that merchants that operate only online, or reported accepting more than 50% of card transactions online, generally exhibit the same searching, switching and negotiating characteristics as other merchants.

238 See footnote 211.

239 See footnotes 182, 186 and 231.

Features affecting merchants' willingness and ability to search and switch

Introduction

6.62 We will now explore whether the following factors affect merchants' willingness and ability to search and switch, and ultimately whether these factors contribute to the price outcomes we observe (including those after the IFR caps were introduced) for both small and medium-size merchants and larger merchants with annual card turnover up to £50 million.[240] The factors were identified through the merchant survey, other surveys we've seen, and concerns raised by parties during the market review:

- variability in pricing structures and absence of published prices
- merchant contracts for card-acquiring services
- merchant contracts for and portability of POS terminals
- merchant contracts for and portability of payment gateways

Pricing

6.63 Below we consider whether pricing of card-acquiring services creates search costs for merchants that restricts their willingness and ability to search and switch. We focus on standard pricing, which is used by approximately 98% of small and medium-sized merchants and most large merchants with annual card turnover between £10 million and £50 million. We look at the standard pricing of acquirers, payment facilitators and ISOs. As explained in Chapter 3, ISOs sell card-acquiring services on behalf of acquirers and agree with merchants the price they pay for these services.

6.64 Generally, merchants cannot easily access information on acquirers' and ISOs' pricing for card-acquiring services. Typically, their prices aren't published. Instead, acquirers and ISOs usually quote a price for card-acquiring services based on information about the merchant's characteristics collected during the sales process (see Chapter 3). To access information on prices, typically a merchant would need to speak with a sales agent over the phone or in person after:

- approaching the acquirer or ISO (for example, by filling out a form on the acquirer's website asking to be contacted)
- being approached by the acquirer or ISO (some acquirers and ISOs use cold calling as an important part of their customer acquisition strategy – see Chapter 4)

240 As explained in Chapter 5, we make no finding on the extent of pass-through of the IFR savings for merchants with turnover below £15,000.

- giving permission for a third party to provide their contact details (and potentially other information) to the acquirer or ISO

6.65 There is one price-comparison website for card-acquiring services called Cardswitcher that presents merchants with a comparable list of quotes for card-acquiring services (and other products they might need, like POS terminals). However, the quotes presented are mainly from ISOs. Other websites enable a merchant to obtain several quotes but operate on a different model by providing leads to partners (such as acquirers) who then contact the merchant. Annex 1 provides more information on price-comparison websites.

6.66 The structure of acquirers' and ISOs' standard pricing is described in Chapter 3 and Annex 1, and varies significantly because firms differ:

- in how they vary the headline rate according to the characteristics of a transaction
- in how they express the headline rate(s)
- in the additional transactional fees they have
- in the additional non-transactional fees they have

6.67 Typically, acquirers and ISOs have different headline rates depending on the type of card that is used, and in some cases, depending on the card payment system and how a transaction is authenticated. Depending on the acquirer or ISO, a merchant might pay:

- a different headline rate depending on the card type (for example, one headline rate for credit cards and another for debit cards)
- a different headline rate depending on the card type and card payment system (for example, one headline rate for Visa debit cards and another for Mastercard debit cards)
- a different headline rate depending on the card type, card payment system and how the card is authenticated (for example, one headline rate for transactions involving Visa debit cards authenticated securely and another for transactions using such cards that are not authenticated securely)

6.68 Even where two acquirers apply the same approach, there can still be differences in their pricing structure. For example, acquirers that vary the headline rate by card type generally use different card types.

6.69 Acquirers and ISOs differ in how they express the headline rate. Some firms express headline rates as an ad valorem fee, some use a pence-per-transaction fee and others use a combination of the two.

6.70 Some acquirers and ISOs recover all the interchange fees and scheme fees through the headline rates. But others recover some of these costs by applying additional transactional fees to transactions that attract higher interchange fees and scheme fees, such as transactions involving cards issued outside the EU. As a result, two acquirers' debit card headline rates, for example, may not be directly comparable if one has additional fees for transactions involving debit cards issued outside the EU and the other does not. Depending on the acquirer or ISO, merchants may pay additional fees for transactions that:

- are card-not-present
- are e-commerce
- are MOTO
- involve non-EU or non-UK issued cards
- involve commercial cards

6.71 In addition, acquirers and ISOs differ in the additional non-transactional fees they apply for specific events. For example, most acquirers apply additional fees for authorisation requests but some apply different fees depending on the type of the request.

6.72 The largest payment facilitators' standard pricing is simpler than that generally used by acquirers and ISOs. Three of the four largest payment facilitators that predominantly serve merchants selling face to face typically have one headline rate for card-present transactions and do not have any additional fees (see Chapter 3 and Annex 1). Stripe, which mainly serves merchants selling online and started providing card-acquiring services as a payment facilitator, has two headline rates and one additional fee for administration of chargebacks. The largest payment facilitators and Stripe publish their prices. Several other acquirers have introduced simpler pricing options for certain merchants and publish the prices merchants with these options pay (see Chapter 4).

6.73 The variability of pricing structures and different approaches to headline rates make it complex for a merchant to compare the quotes it receives from acquirers and ISOs during the sales process, or compare quotes from these firms against payment facilitators' prices. The merchant would need information on the number, value and mix of purchase card transactions it accepts (or is likely to accept), and a detailed understanding of the quotes it receives (including any additional fees that apply for card-acquiring services).

6.74 Where a merchant already buys card-acquiring services, some acquirers and ISOs help the merchant compare their current price against the price being quoted. For example, one ISO estimates the total monthly saving that the merchant would make by switching. Another example is where an acquirer estimates the average per-transaction cost the merchant pays now and would pay by switching. However, firms use different approaches to the calculations and some do not offer any comparison.

6.75 Other evidence also suggests that acquirer and ISO standard pricing creates search costs for small and medium-sized merchants. One acquirer and one ISO said that comparing headline rates can be misleading because this ignores the additional fees that acquirers apply for card-acquiring services. The same ISO also said that merchants often do not understand the quotes they receive. One acquirer said that some of its rivals promote a low headline rate and then have significant additional fees. Another party said merchants can find it difficult to work out what they are paying for card-acquiring services from the statements they receive from their provider.

6.76 Existing regulations place obligations on acquirers and payment facilitators to provide information to merchants about their pricing:

- Regulation 48 of the PSRs 2017 requires PSPs[241], including acquirers and payment facilitators, to provide details of all charges payable by the merchant to the PSP and, where applicable, a breakdown of them before a contract is entered into.
- Regulation 54 of the PSRs 2017 requires PSPs to provide specified information to merchants on transactions, including the amount and, where applicable, a breakdown of any transaction charges and/or interest payable in respect of the transaction.[242]
- Article 9(1) of the IFR requires that acquirers offer and charge MSCs[243] broken down for the various different categories[244] of cards and different brands of cards (such as Mastercard and Visa) with different interchange fee levels. An acquirer can charge a merchant 'blended' MSCs, but only if the merchant has first requested in writing to be charged 'blended' MSCs.
- Article 9(2) of the IFR requires that acquirers' agreements with merchants specify the amount of each MSC, and show the applicable interchange fee and scheme fees separately for each category and brand of payment cards. Merchants can subsequently make a request in writing to receive different information.
- Article 12 of the IFR requires the merchant's PSP[245] to provide (or make available) certain information to the merchant for each card-based payment transaction, including the amount of any charges for the card-based payment transaction, indicating separately the MSC and the amount of the interchange fee.

241 The legislation that established the PSR – the Financial Services (Banking Reform) Act 2013 – has a different definition of payment service provider to that used in the PSRs 2017. In this section, when we use the term payment service provider (PSP), we mean PSP as defined in PSD2.

242 Regulation 48 and Regulation 54 are contained within Part 6 of the PSRs 2017. As noted in paragraph 6.92, payment service providers may, in certain cases, agree with business customers to different terms in relation to rights and obligations (the 'corporate opt-out'). They could therefore also agree that these provisions, as set out in Regulation 48 and Regulation 54, do not apply to their contract.

243 See footnote 35.

244 See footnote 36.

245 See footnote 37.

6.77 Regulation 48 of the PSRs 2017 aims to ensure the customer understands what the payment services to be provided under the contract will cost them. Article 9 of the IFR aims to improve transparency of the MSC and its components so that merchants can decide which categories and brands to accept or steer customers to and enhance competition at the point of sale. It was also intended to allow merchants to check whether interchange fee savings are passed through and give them stronger bargaining power with their acquirer.[246] Article 12 aimed to improve transparency of the MSC.[247]

6.78 We note that, if a merchant obtained offers from different providers, the detailed information they may need to provide under these regulations could in theory help the merchant compare them. However, a study commissioned by the European Commission recognised that fee transparency in itself does not necessarily promote better pricing outcomes if the fees are not simple:

'…fee transparency may not necessarily mean better understandability if the number of reported fees is large and the fee structure complex. The extra administrative capacity that is needed to handle and exploit the additional information may only be available to large merchants and not to small merchants. It means that simplicity may be a pre-condition for transparency to be able to discipline pricing.'[248]

6.79 The European Commission's report[249] on the application of the IFR also suggests that some 'small retailers' (defined as those with a turnover below EUR 50m) may be inclined to request blended MSCs because of their limited administrative capacity to manage a large number of fees and complex fee structures.[250]

6.80 In summary, the evidence indicates that ISO and acquirer pricing (blended or unblended) creates significant search costs for small and medium-sized merchants. This is because:

- ISOs and acquirers do not typically publish their prices
- Comparing prices is complicated because ISOs and acquirers have different pricing structures and approaches to headline rates

The regulations set out above do not seek to address these specific factors.[251]

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246 European Commission, *Report on the application of Regulation (EU) 2015/751 on interchange fees for card-based payment transactions* (2020), page 10.

247 European Commission, *Competition policy brief: The Interchange Fees Regulation* (2015), page 5.

248 *Study on the application of Interchange Fee Regulation* (2020), prepared by Ernst&Young and Copenhagen Economics, page 151. Large merchants were defined as those with turnover above EUR 50m.

249 European Commission, *Report on the application of Regulation (EU) 2015/751 on interchange fees for card-based payment transactions* (2020), pages 10,11, 13 and 14.

250 We note that the European Commission's report found that the majority of merchants have unblended MSCs. However, there was some uncertainty about whether 'small retailers' have unblended MSCs due to limited responses to the survey that informed the report.

251 We note that the European Commission recommends further monitoring and evidence gathering on the implementation of transparency requirements in the IFR. We have a programme of work outside the market review that monitors compliance with the IFR in the UK.

6.81 Large merchants with annual card turnover between £10 million and £50 million have the same types of pricing options as small and medium-sized merchants, so are likely to face the same search costs. These search costs restrict merchants' willingness and ability to search and switch, or negotiate a better deal.

Stakeholder submissions on pricing as a factor affecting a merchant's ability to search and switch

6.82 Submissions are mixed in relation to whether acquirer and ISO pricing creates a search cost for merchants that restricts their willingness and ability to search and switch, or negotiate a better deal.

6.83 Some stakeholders appear to agree that pricing can make it difficult for merchants to compare offers:

- The Association of Convenience Stores said that the complexity of fee structures makes it difficult for retailers to find the best deal for them, and that increasingly complex fee structures make comparisons between acquirers more difficult.[252]
- American Express told us that although it does not have the fees involved in four-party payment systems, it recognises that such complexity may be a concern for small merchants of the four-party schemes and that anecdotal experience supports our finding.[253]
- The British Retail Consortium strongly agreed with our finding in the interim report that pricing of card-acquiring services discourages searching and switching due to the absence of transparent published prices, and the complexity of comparing quotes.[254]
- The Federation of Small Businesses told us that the current picture of fees and charges is too complex for many small businesses to spend resource understanding. As well as the MSC (and the complex and multiple ways in which it is represented), there are also a number of additional charges that many smaller businesses could incur, and may not understand.[255]
- The National Federation of Retail Newsagents (NFRN) said it is aware of the tendency for busy retailers not to have the time to properly investigate the comparative costs of services from different acquirers.[256]
- North East Interiors told us that it had experiences of being offered good rates to switch, only to then see rates jump after the initial contract term, so it would help if it was easier to shop around and move when necessary.[257]

252 ACS response, paragraph 3.
253 American Express response, page 6.
254 BRC response, paragraph 2.11.
255 Federation of Small Businesses response, pages 5 and 6.
256 The National Federation of Retail Newsagents, paragraph 7.
257 North East interiors response.

- The Scottish Grocers Federation told us that it agrees that in some instances ISO and acquirer pricing methods may create significant search costs for merchants due to the absence of published prices and the complexity of comparing pricing.[258]

6.84 Some acquirers and payment facilitators emphasised the importance of simplicity and transparency, with some noting that transparency is currently not as good as it could be and others noting that they fully support the need for comparable card-acquiring services. Specifically:

- Adyen told us that it was pleased to see the importance of fair and transparent pricing for all card-acquiring merchants being highlighted, including to ensure merchants can benefit from the cap on interchange as intended by the IFR.[259]

- Elavon told us that it agreed that increased transparency and simplicity in pricing is particularly important to smaller merchants. It noted that it had sought to meet this need through its 'Simplicity MSC Proposition' launched in the UK in 2019.[260]

- Square told us that it has a simple and transparent pricing model and that it fully supports the need for comparable card-acquiring services.[261]

- Stripe told us that it aims to be as transparent and straightforward as possible in its pricing. It also submitted that it thinks that there are instances in the market where pricing is not as transparent as it could or should be, but it is also important to ensure that merchants have access to the granular IC++ pricing if it best suits their needs.[262]

6.85 In contrast, some stakeholders (including acquirers, ISOs and card schemes), did not consider there to be sufficient evidence to conclude that acquirer and ISO pricing restricts merchants' ability and willingness to search and switch. They refer to various results in the merchant survey, particularly the finding that only 1% of the small and medium-sized merchants who never shopped around said that the reason for this is how difficult it is to compare providers:

- Barclays told us that it does not believe the interim report contains evidence to support the conclusion that current pricing structures create significant search costs or that merchants face significant search costs which affect their willingness (or the ability) to switch, or to negotiate a better deal. They note that the merchant survey does not offer any indication that current pricing models create significant search costs for merchants or that this forms a barrier to switching.[263]

- GPUK argue that the results of the merchant survey confirm that merchants already have access to the information that they need to understand pricing.[264]

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258 Scottish Grocers Federation response, page 2.

259 Adyen response, page 1.

260 Elavon response, page 6.

261 Square response, page 2.

262 Stripe response, page 4.

263 Barclays response, paragraphs 69 and 71.

264 GPUK response 5.6.

- Mastercard told us that although merchants consistently cite the importance of price considerations, they seem to have no significant difficulty in searching and do not suggest that more easily comparable pricing information is necessary or currently insufficient. It notes that this view aligns with anecdotal feedback it has received, along with the fact that many smaller merchants do not actually want more detailed pricing information as it is more likely to confuse, rather than assist them.[265]

- Paytek[266] told us that there is no 'one size fits all' homogenous pricing structure, and that factors such as technology type, merchant risk, business volumes, card types, card present/not present ratios and many other variables all dictate the final pricing formulas. In its view, this is precisely why ISOs can provide such a valuable service to merchants.[267]

- Takepayments disagrees that acquirer and ISO pricing creates significant search costs for merchants because of the absence of published prices and complexity of comparing prices. It submits that most businesses will have several approaches a year offering to switch.

- UTP said that the absence of published prices does not result in significant costs for merchants. In its view, the majority of a merchant's costs can be attributed to the rate charged for consumer debit cards, and quotes for consumer debit can generally be obtained from one simple call to an acquirer or ISO.[268]

- Visa Europe questions the size and detail of the evidence base that underscores these findings, noting that it relies on specific statements from acquirers and ISOs about pricing – which may be true but represent a very small sample size.[269]

- Worldpay told us that it does not consider pricing information and complexity to be a barrier to switching, and that the vast majority of merchants in the merchant survey felt that they received enough information to understand the cost of card-acquiring services and are provided with enough support to comply with requirements.[270]

6.86 Some acquirers that challenged our preliminary conclusions acknowledged that more could be done to make it easier for merchants to compare acquirer offerings.[271]

265 Mastercard response, page 6.
266 Paytek is a provider of finance and support to Independent Sales Organisations (ISO).
267 Paytek response, page 7.
268 UTP response, page 3.
269 Visa Europe response, page 20 – 21.
270 Worldpay response, paragraph 4.47.
271 For example: [✂]; GPUK response, paragraphs 5.10 and 5.13 – 5.18; Worldpay response, paragraph 6.54.

6.87 We have given careful consideration to stakeholder views and note that only a small proportion of respondents to the merchant survey specifically indicated that it was difficult to compare providers. Nevertheless, we remain of the view that ISO and acquirer prices for card-acquiring services create a search cost that restricts some merchants' willingness and ability to search and switch, or negotiate a better deal. In arriving at this finding, we note that:

- Acquirer and ISOs do not typically publish their prices for card-acquiring, and their pricing structures and approaches to headline rates vary significantly. In our view, this makes it difficult for many merchants to compare prices.
- The merchant survey indicates that many merchants did not compare providers at all, or only to a limited extent. This is consistent with high search costs.[272] We would also not necessarily expect merchants that did not compare providers to have highlighted difficulties. However, some merchants (16% of those that had switched) stated that access to more comparable pricing information, better quality or more accessible information would have made them feel more confident about deciding which provider to switch to.
- The balance of stakeholder submissions, including those from merchants and their representatives, indicates that some merchants do face challenges comparing providers' pricing.
- We note that the intentions of the regulations set out in paragraph 6.76 include improving transparency. However, some of the information that ISOs and acquirers provide may be too detailed for many merchants to exploit. Furthermore, the regulations do not aim to address the specific factors we have identified that can make it difficult for merchants to make comparisons.

6.88 We think more can be done to allow merchants to easily access pricing information in a way that enables them to compare and make good choices regarding their card-acquiring services provider. Improvements that reduce the difficulties in comparing prices (for example, simplification of the way key pricing and other terms are presented) would help merchants that search/shop around, and may also lead to more merchants comparing providers to get the best deal.

Merchant contracts and portability

6.89 We reviewed a sample of standard contracts with merchants:

- The five largest acquirers' contracts for card-acquiring services and, where applicable, POS terminal hire.

272 Including the large proportion (42%) of merchants that had not considered switching in the previous two years and potentially some of the two-fifths of merchants that had switched in the last two years who had not shopped around.

- The largest payment facilitators' terms and conditions for card-acquiring services.
- The POS terminal contracts available from five ISOs (including where the ISO refers the merchant to a third-party POS terminal provider).

6.90 To examine whether these contracts could affect merchants' searching and switching behaviour, and contribute to the price outcomes we observe, we focused our analysis on provisions relating to the duration of the contracts (including any initial term, renewal and termination) and the interaction between different contracts.

6.91 We also collected evidence on portability of POS terminals and payment gateways – that is, whether and how easily they can be used with more than one provider of card-acquiring services.

Acquirer contracts for card-acquiring services

6.92 There is a statutory right under the PSRs 2017 for merchants to terminate their card-acquiring services contract at any time – unless they have agreed to a notice period of not more than one month.[273] The PSRs 2017 also provide that, once the contract has been running for at least six months, the acquirer can't apply a termination fee.[274] We note, however, that payment service providers may, in certain cases, agree with business customers (that is, payment service users who are not consumers, small charities or micro-enterprises) to different terms in relation to rights and obligations (referred to as the 'corporate opt-out'), including the right to terminate the framework contract.[275] The five largest acquirers typically have different card-acquiring services contracts for merchants of different sizes (they categorise merchants by size differently – see Chapter 4).

6.93 Based on our review of the five largest acquirers' contracts for card-acquiring services for small and medium-sized merchants:

- All merchants can terminate their contract by giving one month's notice to their provider.
- The majority of the five largest acquirers have a default initial term in their contracts. Where an initial term applies, this tends to be relatively short: up to 12 months. Some contracts specify that an early termination fee applies if the merchant terminates the contract within the first six months or before the end of the initial term of the contract.

273 Regulation 51(1) of the PSRs 2017.

274 Regulation 51(3) of the PSRs 2017.

275 The provisions on the application of Part 6 of PSRs 2017 (which includes Regulation 51) are found in Regulation 40 to 42, PSRs 2017.

6.94 Three of the five largest acquirers categorise merchants with card turnover between £10 million and £50 million as small and medium-sized merchants. However, two acquirers had different contractual terms for merchants of this size group:

- The notice period to terminate the contract is two or three months, and it cannot expire before the end of the initial/renewal term.
- Initial default terms are up to three years.

6.95 As a result, it doesn't appear that the initial term in these contracts would, in itself, restrict most merchants' ability to switch.

6.96 In certain circumstances, the PSRs 2017 require PSPs (including acquirers and payment facilitators) to notify a merchant of proposed changes to its contract for card-acquiring services before they take effect.[276] Some contracts allow the PSP to make the changes unilaterally if the merchant hasn't rejected them before the date they take effect. In these cases, the merchant has the statutory right to terminate its contract, without incurring fees, by giving notice to the PSP at any time before that date. PSPs are required to inform merchants of their right to terminate.[277] [278]

6.97 The contracts that we reviewed for small and medium-sized merchants typically include the right for a merchant to terminate the contract before the change takes effect. The conditions for exercising that right vary slightly. Some acquirers allow termination with two months' notice from the merchant, while others allow one month.[279] For the two of the five largest acquirers that have different contracts for merchants with annual card turnover between £10 million and £50 million, one contract included a right for the merchant to terminate the contract for no charge if the acquirer notified it of variations to the contract. It was unclear if the other large acquirer contract gave merchants this right. In practice, if a merchant was not happy with a change to its terms and conditions and wanted to switch, it would need to find another provider before the change took effect.

6.98 Where there are initial terms, the contracts either continue automatically until terminated by either party, or renew for successive fixed terms. Contracts that don't have initial terms continue indefinitely until terminated. The contracts for card-acquiring services can continue indefinitely unless the merchant or acquirer decides to terminate. The indefinite duration means there is no clear trigger point for small and medium-sized merchants or large merchants with annual card turnover between £10 million and £50 million to think about searching for another provider and switching or renegotiating. Therefore, the indefinite duration of contracts for card-acquiring services, may explain, at least in part, why we find many merchants don't consider switching or searching for other providers regularly, if at all.

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276 Regulation 50 of the PSRs 2017.

277 s50(3)b PSRs 2017.

278 The provisions in PSRs 2017 referred to here (from Part 6 of PSRs 2017) are subject to the corporate opt-out (see paragraph 6.92).

279 One acquirer told us that it does inform the merchant of the right to terminate when it notifies changes.

Payment facilitator contracts for card-acquiring services

6.99 Unlike acquirers, the largest payment facilitators' contracts for card-acquiring services with merchants don't have an initial term, and they sell the merchant a card reader upfront rather than offer them a POS terminal for hire. Merchants do not pay any fees when they're not accepting card transactions. Chapter 3 has more information on the largest payment facilitators' offering.

6.100 A merchant using a payment facilitator therefore doesn't need to terminate a contract to switch to another payment facilitator or acquirer (they can close their account with the payment facilitator but that is not a condition for switching). The switching cost they would face, if they operated in a face-to-face environment, would be the price of the card reader or POS terminal they would need to buy or hire to connect to their new provider (and potentially any costs to integrate this with their own systems such as an EPOS system).

6.101 When a merchant contracts with a payment facilitator for card-acquiring services, they may be notified about proposed changes to the contract. However, the services will continue for an indefinite duration as there is no end date. Our assessment is that such contracts do not provide a clear trigger point for merchants to think about searching for another provider and switching. The indefinite duration of these contracts may explain, at least in part, why we find many merchants don't consider switching or searching for other providers regularly, if at all.

Stakeholder submissions on whether the indefinite duration of merchant contracts for card-acquiring services affects a merchant's willingness and ability to search and switch

6.102 Submissions on whether the indefinite duration of merchant contracts for card-acquiring services reduce a merchant's willingness and ability to search and switch were mixed.

6.103 Some stakeholders, including merchant representatives, were broadly of the view that the automatic roll-over of contracts is not typically beneficial for merchants and results in a lack of trigger points for merchants to think about searching for another provider and switching:

- The British Retail Consortium agreed with our proposition that the indefinite duration of merchant contracts for card-acquiring services does not provide a clear trigger point for merchants to think about searching for another provider or consider switching.[280]
- Elavon generally agreed that the indefinite duration of card-acquiring contracts could result in merchants not seeking out better card-acquiring solutions or offerings.[281]

280 BRC response, paragraph 2.3.

281 Elavon response, page 4.

- The National Federation of Retail Newsagents (NFRN) told us that it is aware of the tendency for busy retailers to allow their contracts to roll on without proper review and consideration. It agreed that automatically rolling over of contracts is one of the issues that need to be addressed to achieve potential for greater movement between acquirers.[282]

- Retail Merchant Services agreed that having indefinite durations for merchant contracts does not provide a clear trigger point for merchants to consider changing supplier.[283]

- Square told us that it believes that no merchant should be required to serve minimum contract terms.[284]

- The Scottish Grocers Federation agreed that the indefinite duration of merchant contracts for card acquiring services is an issue which needs to be looked at.[285]

6.104 Acquirers and payment facilitators such as PayPal, Stripe and Square told us that they typically do not require merchants to enter fixed-term contracts and/or that contracts can be terminated at will.[286] [287] Therefore, merchants that want to switch provider are able to switch away when it suits them.

6.105 Other stakeholders challenged the interim report's provisional findings that the indefinite duration of merchant contracts present a barrier to switching:

- American Express told us that it does not agree that contracts without a fixed-end date act as a barrier to switching if a merchant is able to terminate at will on reasonable notice.[288]

- Barclays told us that the acquirer/merchant contract terms work well for merchants and do not present a barrier to switching. It points to findings in the interim report that show that merchants can generally terminate their acquiring contracts at short notice (one month) and that the initial terms in acquirer contracts tend to be relatively short (12 months) and would not restrict merchants' ability to switch.[289]

- Takepayments disagreed that the indefinite duration of merchant contracts for card-acquiring services means merchants aren't provided with a clear trigger point to think about searching for another provider and switching. It notes that most contracts have definite end dates and notice is needed following that date.[290]

282 The National Federation of Retail Newsagents, paragraph 7.

283 Retail Merchant Services response, page 1.

284 Square response, page 1.

285 Scottish Grocers Federation, page 2.

286 Stripe notes that while the majority of its users 'self-serve' and are not tied into any minimum contract term, larger users tend to agree negotiated contracts which a specified duration. However, they note that because the merchants are large they suffer no detriment from such arrangements. Stripe response, page 5 – 6.

287 Paypal response, page 2. Square response, page 1.

288 American Express response, page 7.

289 Barclays response, paragraph 38.

290 Takepayments response, page 2.

- UTP do not agree that indefinite contracts are detrimental to merchants, noting that many acquirers do not enforce exit penalties on merchants who want to move to an alternative provider; from this perspective, it believes the merchant is currently getting a 'good deal'.[291]

6.106 Some stakeholders submitted that the expiry of a contract for card-acquiring services would not necessarily trigger many merchants to switch in the future. In support, some stakeholders point to the results of the merchant survey, including that only 1% of merchants surveyed said the expiry of a contract would be a trigger for them to switch in the future:

- Electronic Money Association told us that the causal link between the finding that merchants do not shop around and any proposed remedy that imposed an end date on merchant contracts has not been substantiated.[292]
- GPUK said that the merchant survey provides no evidence that the expiry of a contract for card-acquiring services would trigger many merchants to switch in the future.[293]
- Judopay told us that it does not have restrictive contracts in place, and that its experience has not been that its merchants are opting to terminate at the end date.[294]
- Lloyds Bank Cardnet told us that although we highlight the possibility of enforcing end dates on acquiring contracts, only 1% of merchants interviewed said that the expiry of the contract would make them switch and indicated they had managed to negotiate a better acquiring deal.[295]
- Mastercard told us that the merchant survey results do not suggest that merchants being tied into contracts is a barrier to search or switching, nor that the expiry of a contract would act as an effective prompt. It submits that this is in line with the (albeit anecdotal) feedback Mastercard has received from a variety of market participants.[296]

6.107 Other stakeholders also submitted that there are other prompts for merchants to search and switch:

- UK Finance submitted that there are already several prompts for merchants to consider their existing acquiring relationship (including regular billing, approaches from rival acquirers, etc).[297]

291 UTP response, page 3.
292 Electronic Money Association response, page 6.
293 GPUK response 4.12.
294 Judopay response, page 2.
295 Lloyds Bank Cardnet, section 3.1.
296 Mastercard response, page 6.
297 UK Finance response, page 8.

- Worldpay submit that there is no evidence in the merchant survey to suggest any issue relating to a lack of trigger points. It also notes that there are numerous trigger points throughout a merchant's relationship with their provider of card-acquiring services (such as monthly invoices, price change notifications, contact by rival providers) which could prompt them to consider searching and switching to another provider. It does not agree that contracts prevent switching, noting that only 10% of respondents to the merchant survey referred to being 'tied into a contract' as a reason for not switching; and that only five merchants attempted to switch but were unable to because the cost of terminating the contract with their existing provider was too high.[298]

6.108 Various acquirers explained how they could 'trigger' merchants to consider switching more frequently.[299]

6.109 We have considered these submissions carefully. In response to some of the specific stakeholder responses, we note that:

- The evidence suggests that many merchants don't consider switching or searching for other providers regularly, if at all, despite evidence that they could benefit from being more actively engaged.
- With regard to the merchant survey, we note that surveyed merchants were not specifically asked what they would do upon contract expiry, but rather they were asked more broadly what would cause them to think about switching to another provider. Because responses were unprompted, it is reasonable to expect that the likely effect of contract expiry on merchant behaviour is understated.
- With regard to the factors that stakeholders listed as 'prompts', we note that these have not had the effect of promoting switching. The provision of information during a contract may draw a merchant's attention to pricing, but if the information is difficult to assess, it may be unlikely to prompt the merchant to consider switching. For instance, if approached by a rival provider, a merchant may find it difficult to compare that provider's prices to its current deal.

6.110 In conclusion, we remain of the view that the indefinite duration of acquirer and payment facilitator contracts for card-acquiring services may explain, at least in part, why many merchants don't consider switching or searching for other providers regularly. This is because they do not provide a clear trigger for merchants to do so. After a certain point, merchants that grow their card turnover will particularly benefit from comparing different offers to see if their current deal still fits their needs. If they don't do this, they may end up paying more than they need to.

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298 Worldpay response, paragraphs 34b and 4.31.

299 Barclays response, paragraph 50 – 51. GPUK response, paragraph 5.21, Lloyds Bank Cardnet, section 3.1. Worldpay response, paragraph 6.26.

ISO and acquirer contracts for POS terminals

6.111 Contracts for POS terminals are important because:

- merchants selling face to face need hardware (a POS terminal or card reader) to capture the card details at the POS
- POS terminals offered by an acquirer or ISO typically operate with only one acquirer (including where the acquirer or ISO refers the merchant to a third-party POS terminal provider)
- the merchant survey found that small and medium-sized merchants prefer to one-stop shop
- a merchant switching provider will generally need to terminate their contract for card-acquiring services and their contract for their POS terminal together

6.112 Many respondents to our information requests identified contracts for POS terminals as a possible restriction on merchants' willingness and ability to switch their provider of card-acquiring services. Therefore, we examined whether there is anything in contracts for POS terminals that could affect merchant searching and switching behaviour.

6.113 A merchant may choose to obtain POS terminals separately from card-acquiring services – for example, by purchasing them from a manufacturer. Typically, acquirers allow merchants to use POS terminals they have sourced themselves, but the merchant must seek the acquirer's approval first.

6.114 However, many small and medium-sized merchants prefer to one-stop shop – that is, source everything they need to accept card payments from one firm. As described in Chapter 3, acquirers' and ISOs' typical offering for a merchant selling face to face includes card-acquiring services and a POS terminal.[300] There are different commercial arrangements, depending on the firm:

- Some merchants hire one or more POS terminals from acquirers and ISOs for a fixed monthly fee.
- Some merchants pay for services or membership from the ISO for which they receive a POS terminal free of charge to use in conjunction with the ISO's other services.
- Some merchants are referred by acquirers and ISOs to a third-party POS terminal provider, which supplies the POS terminal(s) to the merchant. The fixed monthly fee the merchant pays for the POS terminal(s) is generally agreed between the merchant and the acquirer or ISO that makes the referral. The contract is between the merchant and the third-party POS terminal provider.

300 Small and medium-sized merchants may also obtain POS terminals from a gateway provider supplying them with a payment gateway for card payments accepted face to face. We understand that POS terminals obtained from gateway providers can be configured to operate with different acquirers, and hence we do not consider them further in this section.

6.115 Typically, where a merchant does not source POS terminals separately itself, the POS terminal supplied (whether by an acquirer, ISO or third-party POS terminal provider) is configured to work with only one acquirer. We understand that this is because POS terminals are configured to ensure compatibility with the acquirer's POS terminal software. Therefore, if the merchant switches acquirer, it will typically require a new POS terminal. Moreover, this may be the merchant's preference given that many merchants prefer to one-stop shop. We note that, even where merchants source their POS terminals separately, the POS terminals must be configured to work with their acquirer. If the merchant switches acquirer new POS terminals might be needed.

6.116 We considered whether there is anything in the contracts for POS terminals of acquirers or ISOs (or third-party POS terminal providers) that we reviewed that could adversely affect small and medium-sized merchants' searching and switching behaviour in relation to card-acquiring services.

6.117 For some of the smallest merchants, the hire of POS terminals is regulated by the Consumer Credit Act 1974 (CCA) – see Annex 1 for details. The CCA provides a statutory right to terminate a regulated hire contract, subject to meeting certain conditions, without charge by giving one month's notice (if the merchant pays monthly) after the contract has run for 18 months.

6.118 Where the contract is not regulated by the CCA, the contract for POS terminal hire will either be incorporated into the contract for card-acquiring services or it will be set out in a separate contract. The hire of POS terminals may or may not be subject to a separate initial term that is different from the contract for card-acquiring services.

6.119 We found that the majority of the five largest acquirers don't have separate templates for POS terminal contracts depending on the size of the merchant.[301] This means that many merchants that we categorise as large are also on contracts for POS terminals with similar provisions to those of small and medium-sized merchants.

6.120 The POS terminal contracts we've reviewed have initial terms ranging from [✂] to [✂]. In contracts regulated by the CCA, the initial term is set at 18 months.

6.121 Based on our review of contracts for POS terminals and other engagement with stakeholders, we have found or been told about examples of POS terminal contracts that have long initial terms, of between three and five years. These contracts are offered by some acquirers and ISOs (or by third-party POS terminal providers working with such firms). Firms that offer such contracts simultaneously present the merchant with the option to choose a shorter initial term (between 12 and 24 months depending on the firm).

301 Except where the CCA applies, see paragraph 6.117.

6.122 If the merchant wishes to terminate the contract before the end of the initial term, the merchant may have to pay termination fees to the provider. In the contracts we reviewed, these early termination fees include, in some cases, the total value of outstanding payments due up to the end of the initial term, plus administrative fees.[302]

6.123 Consequently, there are situations where merchants switching card-acquiring service provider would face costs related to their POS terminal contract. This is because a merchant cannot typically continue to use an existing POS terminal with a new card-acquirer, and termination fees may apply if they cancel their existing POS terminal contract. In some cases, the termination fees will reduce as the contract gets nearer to the end of the initial or renewal term. This means the merchant will pay a higher fee for an earlier termination.

6.124 Similarly, merchants that prefer to one-stop shop can face barriers to switching provider due to termination fees associated with their POS terminal contract, which may apply even if there are no termination fees associated with cancelling their card-acquiring service contract.

6.125 These costs will affect a merchants' willingness to terminate their POS terminal contract early and therefore act as a barrier to switching provider of card-acquiring services. The costs could also discourage merchants from searching for other providers.

6.126 Several acquirers said they do not always enforce early termination fees stipulated in their contracts, and some ISOs offer to pay off (or compensate the merchant for) some or all of the termination fees incurred for switching (see Chapter 4). However, even if that's the case, the existence of contractual provisions stating that such fees are payable if the merchant terminates early, will affect merchants' willingness to search and switch.

6.127 Once the initial term has ended, typically the POS terminal contract (irrespective of duration or whether the contract is regulated by the CCA or not) will automatically continue on a rolling one-month basis or renew for successive fixed terms [✂]. Alternatively, the parties may enter into a new fixed term contract. In contracts that renew for successive fixed terms, the merchant can only terminate at the end of any such renewal term. The merchant is required to give between [✂] notice before the end of the renewal term, otherwise the contract will renew for another term. In the interim report, we provisionally concluded that these restrictions on the merchant's right to terminate will discourage merchants from searching for other providers and create a barrier to switching.

302 Merchants typically rent terminals for between £10 and £40 per terminal per month.

Stakeholder submissions on ISO and acquirer POS terminal contracts as factors affecting a merchant's willingness and ability to search and switch

6.128 Many stakeholders appeared to support our preliminary finding that acquirer POS terminal contracts with long initial terms or which automatically renew for successive fixed terms are factors that reduces a merchant's willingness and ability to search and switch. Among the submissions made:

- Adyen agreed that extensive lock-in periods and/or automatic renewal for lengthy fixed terms are typically not beneficial. However, it told us that automatic termination can also result in detriment for merchants, including a lack of certainty and continuity and the potential for unnecessary re-contracting (including related efforts and costs). Most importantly, it may leave merchants that don't have a system or focus on expiry of these contracts without payment processing capabilities, which may create a harmful business interruption.[303]
- The Association of Convenience Stores told us that switching card acquirers can become a drawn-out process for retailers when handling the switchover of acquirer-supplied payment terminals. Contracts for these terminals typically run for five-year terms and auto renew. The associated termination fees are a barrier to switching, especially as this hardware often only works with a specific acquirer.[304]
- The British Retail Consortium shared our concern over the coupling of card-acquiring and POS terminal contracts for certain merchants, and the associated length of those contracts, automatic fixed-term renewals, and termination fees.[305]
- North East Interiors told us that stopping long-lease contracts for equipment is a good idea. It said it had paid for a card terminal it no longer used for around two years, because it would have cost more to cancel the lease due to early cancellation penalties.[306]
- Retail Merchant Services noted that feedback from its sales team suggests that many potential customers are unaware that their POS terminal contracts are linked to the merchant acquiring contract, and so that while they think they have short-term flexibility, the reality is that they are locked in for a longer period that they had envisaged.[307]
- The Scottish Grocers Federation agreed that the long length and apparent inflexibility of ISO and acquirer POS terminal contracts is an important finding which needs to be addressed to allow small and medium-sized merchants to get a better deal that suits the specific requirements of their business.[308]

303 Adyen response, page 1. Adyen's response indicates that its concerns over automatic termination applied also to card-acquiring services contracts.

304 ACS response, page 2.

305 BRC response, paragraph 2.7.

306 North East Interiors response, page 1.

307 Retail merchant services response, page 1.

308 Scottish Grocers Federation response, page 2.

- GPUK agreed that the length, automatic renewal and exit fees of POS terminal contracts may represent a barrier to small and medium-sized merchants switching to a different provider of card-acquiring services.[309]
- UTP agrees that the auto-renewal of long-term POS rental contracts is not in the interests of merchants. The rationale for a fixed term contract is to allow the ISO to recoup their costs of asset deployment and customer acquisition. They note, however, that this argument falls away when contracts automatically renew.[310]

6.129 Other stakeholders appeared to agree to the principle that POS terminal contacts should not act as a barrier to merchants switching their provider of card-acquiring services:

- American Express told us that while it does not supply POS terminals to merchants, it was broadly supportive of our aim of ensuring that POS terminal contracts do not act as a barrier to merchants switching their card-acquiring services provider.[311]
- Elavon generally agreed that unreasonably lengthy POS contracts should not act as a barrier to merchants obtaining better acquiring solutions or offerings.[312]
- Stripe agreed that contract lengths, termination fees and other exit hurdles should not be used to unfairly prevent small and medium-sized merchants from switching and/or renegotiating their agreements.[313]
- UK Finance noted that, as a general principle, merchants should not be locked into contracts because of onerous ancillary obligations that are disproportionate to the upfront investment costs borne by the payments provider.[314]

6.130 Some stakeholders advised that their merchants are not constrained by POS terminal contracts:

- PayPal told us that their merchants can essentially terminate their contracts at will and that PayPal merchants are not constrained by ongoing rentals of POS devices. Therefore, merchants that want to switch provider are able to switch away easily.[315]
- Square told us that it does not require its merchants to enter fixed-term contracts for the use of either software or hardware. This flexibility was particularly important for small to medium-sized merchants, particularly those who are just starting out and don't want to sign up for a fixed-term contract or merchants who run seasonal businesses and for whom it is uneconomical to pay fees throughout the year.[316]

309 GPUK paragraph 5.24.
310 UTP response, page 3.
311 American Express response, page 8.
312 Elavon response, page 5.
313 Stripe response, page 6.
314 UK Finance response, page 8.
315 Paypal response, page 2.
316 Square response, page 1.

6.131 In contrast, some stakeholders either disagreed that POS contracts can be a barrier to switching or emphasised the need for some minimum commitment in order to provide the services at an economic cost. They argued that if shorter time periods were to be mandated this could lead smaller ISOs to exit the market which would reduce the choice and options available to merchants:

- Bename told us that the leasing revenue a small ISO receives from a three or four-year lease can be a significant contributor towards the payment of the physical payment device. Without this payment, the ISO may require significant upfront investment, which could infringe on the autonomy of the model and limit the scope of any new potential entrants. They also submitted that they were not aware of anyone selling five-year leases, and agreed these are too long.[317]
- Breathe Payments told us that they offer [✂]-month or [✂]-month contracts, and that a longer contract is a better option for merchants. While they agree that anything longer than 36 months is not necessary, they caution that stopping 36-month contracts will just lead to smaller businesses being locked out of the market, and that moving to a maximum of 18-month contracts would mean it would no longer be profitable to offer services that provide merchants with a lower cost solution to paying 1.75% per transaction.[318]
- The Electronic Money Association queried why we did not comment on the reasons as to why contracts for POS are so long – for example, three to five years, in some cases – in the interim report.[319]
- Nets told us that it is less concerned than us about technical challenges faced by merchants when switching. This is because, in its experience of other jurisdictions where Nets has its primary business, there are acquirer and PSP agnostic processing platforms with no technical obstacles when merchants want to change, add or remove acquirers.[320]
- Paytek notes that the cost of hardware elements are not insignificant and they are high depreciation items. An ISO must also provide additional services (e.g. back office, help desks). Consequently, it suggests there must be some minimum commitment from the merchant in order for the ISO to provide the services at an economic cost, particularly where complex or integrated devices are required. It submits that restricting commitments to a maximum 18-month term would increase monthly charges for terminals and processing services, and technology/service levels could be compromised. It could also create a barrier to entry for smaller/new ISOs that do not have access to sufficient liquidity. Paytek told us that while we might consider the current commitment periods to be long, best practice from the ISOs would entail keeping in regular contact with their merchant customers – particularly when approaching the end of term. [321]

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317 Bename response.

318 Breathe Payments response.

319 Electronic Money Association response, page 8.

320 Nets response, page 4.

321 Paytek response, pages 5 – 8,

- UTP told us that the length of a POS contract should not be longer than the expected life of the asset, and that three and four-year contracts are reasonable based on UTP's experience of hardware reliability and performance. In addition, it noted that while the existence of long-term POS contracts undoubtedly discourages merchants from switching providers in the early years of such a contract, long-term contracts enable many of the smaller, undercapitalised ISOs to operate. UTP believes that the benefits of promoting competition and driving down acquiring charges more than offsets the restrictions imposed by the long-term contract associated with the equipment.[322]

- Worldpay noted that, in relation to stand-alone POS terminal hire contracts, [✂]. It argues that larger merchants are capable of assessing the benefits of a shorter or longer POS contracts and choosing the one that best meets their needs. Worldpay disagreed that POS contracts can be a barrier to switching, noting that the merchant survey reveals that only 4% of merchants who were asked to explain why they had never considered switching indicated that they felt that they could not switch provider as they were currently in a contract; and of those merchants who responded that they had considered switching, but had decided not to, only 10% reported that this was because they were tied into a contract. Of the 1% of merchants who said that the expiry of a contract would make them consider switching in the future, only six of these merchants were referring to a contract with a provider of card-acceptance products (for example, POS terminals).[323]

6.132 In response to the statements that relatively few respondents to the merchant survey raised contracts as the reason they had not considered switching or switched:

- These responses were unprompted and it is possible that some merchants that had not shopped around or considered switching may not have been aware that they would have faced early termination charges if they had attempted to switch.

- Although only five merchants attempted to switch but were unable to, we note this was typically because they felt the cost of terminating the contract with their existing provider was too high.

6.133 In response to Worldpay's statement that [✂].

322 UTP response, pages 3 and 4.

323 Worldpay response, paragraphs [✂], 5.57, 5.59.

6.134 Overall, we have carefully considered stakeholder submissions regarding our interim report findings. We conclude that there are circumstances where a merchant's POS terminal and POS terminal contract may prevent or discourage it from switching provider of card-acquiring services. Specifically, there are two factors that together can restrict merchants' ability and willingness to search and switch card-acquiring service provider:

- **A merchant typically cannot use their existing POS terminal with a new card-acquirer.** This may be because POS terminals are typically configured to operate with only one acquirer.[324] Merchants that switch card-acquirer may therefore need a new POS terminal and to cancel their existing POS terminal contract.

- **Significant early termination fees may apply if the merchant cancels its existing POS terminal contract**. Initial terms for acquirer contracts for card-acquiring services tend to be relatively short: up to 12 months.[325] POS terminal contracts can have longer initial/renewal terms (including of three and five years) and/or renew automatically for successive fixed terms. Therefore, there may be circumstances where, a merchant would, for instance, face no early termination fees if they cancel their card-acquiring service contract, but they would with regard to cancelling their existing POS terminal contract. These early termination fees can be significant – for instance, including all outstanding payments due up to the end of the POS contract initial/renewal term.

- Therefore, there may be situations where the lack of portability of POS terminals, and early termination fees for cancelling an existing POS terminal contract, together prevent or discourage merchants from switching provider of card-acquiring services.

- Stakeholder views and results from the merchant survey are consistent with this feature discouraging some merchants from searching and switching provider of card-acquiring services. It is not clear how widespread the problem is, or how widespread it would be if more merchants considered searching and switching. Nevertheless, given low levels of merchant switching and lack of pass-through of the IFR savings, we think that it is important to explore different options to remove or mitigate the barriers to searching and switching that we have identified.

- We will consider whether there are options to increase the 'portability' of POS terminals that could sufficiently mitigate the harm from this feature, without introducing disproportionate costs or burdens. If POS terminals could more easily be used with a new card-acquirer, this may allow merchants to switch provider of card-acquiring services without necessitating they cancel their existing POS terminal contract. In this case, early termination fees associated with cancelling the POS terminal contract would not necessarily be a barrier to searching and switching provider of card-acquiring services.

324 We also note that merchants that source their own POS terminals must also typically seek the acquirer's approval first.

325 Although some acquirers had longer initial default terms up to three years for large merchants with annual turnover between £10 million and £50 million.

- If we cannot find a remedy route that is based on increased 'portability', we will consider other potential remedies, and this may include options such as limiting the maximum length of POS terminal initial/renewal terms.

- We recognise that some form of minimum commitment from merchants is likely to be both necessary and beneficial for both providers and merchants. Stakeholders have submitted that minimum commitment terms contained within POS terminal contracts could benefit merchants. For instance, they may allow for lower monthly fees and underpin the viability of some suppliers' business models, particularly ISOs.

- We also note that POS terminal contract initial/renewal terms that are the same length or shorter than those of the merchant's card-acquiring services contract appear less likely to raise barriers to switching.

- Any consideration of a remedy option to, for instance, limit the length of POS terminal contract initial/renewal terms would include an assessment of both their harm and any countervailing benefits. This will include taking account of potential adverse effects that limiting their length could have on providers (which, in turn, could harm merchants). We would consider whether any less intrusive remedy option (or potentially no remedy option) exists to remove or mitigate the feature we have identified, and whether the remedy produces disadvantages that are disproportionate to its aim.

- Stakeholders will be consulted and invited to submit evidence on all of these issues as part of our forthcoming remedies consultation.

Contracts for payment gateways

6.135 Contracts for payment gateways[326] are important because:

- merchants operating online need a payment gateway to capture the card details at the POS

- some payment gateways only work with one provider of card-acquiring services

- the merchant survey found that small and medium-sized merchants prefer to one-stop shop

6.136 Many firms offer payment gateways, including acquirers, ISOs[327], payment facilitators and gateway providers.

326 In this section, where we refer to payment gateways we mean payment gateways for e-commerce transactions.

327 Some ISOs offer payment gateways for e-commerce payments, but since they predominantly serve small and medium-sized merchants selling face to face, they are not considered in this section.

6.137 Gateway providers are firms that specialise in providing payment gateways. They do not provide card-acquiring services.[328] Some of these providers target large merchants while others serve significant numbers of small and medium-sized merchants. The gateway providers we requested information from said they offer a product that is 'acquirer agnostic' – that is, it's integrated with multiple acquirers operating in the UK (generally between five and 15). Where such integrations exist, they also explained that configuring a small and medium-sized merchant's payment gateway so that it can work with a new acquirer is straightforward, and that they would assist with this for no charge. Given this, we consider it unlikely that contracts between merchants and gateway providers would restrict merchants' willingness and ability to search and switch acquirer.

6.138 Many small and medium-sized merchants prefer to one-stop shop, and – as explained in Chapter 3 – acquirers and payment facilitators typically offer both card-acquiring services and a payment gateway to merchants selling online.

6.139 Based on information from 10 acquirers, we note that in some (but not all) cases, acquirers' payment gateways are compatible with card-acquiring services provided by other acquirers. Where an acquirer's payment gateway is integrated with another's card-acquiring services, merchants that choose to switch to that acquirer for card-acquiring services do not pay additional fees.

6.140 Some acquirers' payment gateways are not compatible or integrated with card-acquiring services provided by other acquirers. However, the contracts for such payment gateways usually have either no initial term or an initial term of less than 12 months.

6.141 Given acquirers either offer payment gateways that are compatible with card-acquiring services from other acquirers or, where this is not the case, offer contracts with short initial terms, we consider it unlikely that contracts between merchants and acquirers for payment gateways would affect merchants' willingness and ability to search and switch acquirer.

6.142 Generally, the largest payment facilitators do not offer stand-alone payment gateways. Their offering to merchants selling online includes card-acquiring services and a payment gateway, and there are no separate fees for the payment gateway.[329] The terms are the same as for card-acquiring services (see paragraph 6.100).

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328 Annex 1 provides more information on gateway providers.

329 Merchants using PayPal Pro that have custom pricing may pay separate fees for a payment gateway. [✂].

Summary – features affecting merchants' willingness and ability to search and switch

6.143 To understand why many small and medium-sized merchants were not fully engaged in the market, we examined whether the following factors might be affecting merchants' willingness and ability to search and switch:

- variability in pricing structures and absence of published prices
- merchant contracts for card-acquiring services
- merchant contracts for and portability of POS terminals
- merchant contracts for and portability of payment gateways

6.144 We identified these factors after assessing:

- the merchant survey we commissioned to inform our market review
- other surveys we've seen
- our analysis of provider contract terms and pricing structures
- concerns raised by parties during the market review

6.145 We conclude that the following features (both individually and in combination) restrict merchants' ability and willingness to search and switch, and explain the pricing outcomes that we observe for small and medium-sized merchants:

- **Acquirers and ISOs** do not typically publish their prices for card-acquiring services. Their pricing structures and approaches to headline rates vary significantly. This makes it difficult for a merchant to compare prices for ISOs, acquirers and payment facilitators.
- **The indefinite duration of acquirer and payment facilitator contracts for card-acquiring services** may explain, at least in part, why many merchants don't consider switching or searching for other providers regularly. This is because they do not provide a clear trigger for merchants to think about searching for another provider and switching. After a certain point, merchants that grow their card turnover will particularly benefit from comparing different offers to see if their current deal still fits their needs. If they don't do this, they may end up paying more than they need to.

- POS terminals and POS terminal contracts that prevent or discourage merchants from searching and switching provider of card-acquiring services. This can occur because of a combination of two factors:

    1. A merchant typically cannot use its existing POS terminal with a new card-acquirer. If it switches provider of card-acquiring services, it may need a new POS terminal and to cancel its existing POS terminal contract.

    2. A merchant could incur a significant early termination fee when cancelling its existing POS terminal contract, even if no such fee would apply when cancelling its card-acquiring services contract.

  This situation can arise because POS terminal contracts can have longer initial/renewal terms than card-acquirer contracts (for example, of three and five years) and early termination fees can include, for instance, all outstanding payments due up to the end of the initial/renewal term. Therefore, there may be situations where the lack of portability of POS terminals, and early termination fees for cancelling an existing POS terminal contract, together prevent or discourage merchants from switching provider of card-acquiring services.

6.146 We find that contracts for payment gateways are unlikely to restrict merchants' willingness and ability to search and switch acquirer.

6.147 Our findings also apply to large merchants with annual card turnover between £10 million and £50 million. These merchants face the same types of pricing options as small and medium-sized merchants, so it can be difficult for them to compare prices across providers. The contracts for card-acquiring services that we reviewed also have an indefinite duration, not providing a clear trigger for them to think about searching for another provider and switching or renegotiating. With respect to POS terminal contracts, they may similarly be unable to use existing POS terminals with a different card-acquirer but may face termination fees if they cancel their current POS terminal contract. They could therefore face costs associated with their POS terminal contract that may prevent or discourage them from switching to a different provider of card-acquiring services.

7 Findings

Card-acquiring services

7.1 The aim of this review was to examine whether the supply of card-acquiring services is working well for merchants, and ultimately consumers. This includes how competition is working and whether there are aspects of the supply of card-acquiring services and related goods and services that might adversely affect competition in, and cause harm to, the supply of card-acquiring services. It also included considering whether any aspects might affect innovation or the interests of service-users in the supply of card-acquiring services.

7.2 The focus of our market review was card-acquiring services for Mastercard and Visa, and our findings relate to card-acquiring services for these card payment systems.

7.3 We've also gathered data on how scheme fees that acquirers pay to Mastercard and Visa have changed between 2014 and 2018, and considered whether these changes were passed on to merchants.[330]

Background to card-acquiring services

7.4 Card use is high in the UK and has been growing strongly in recent years for several reasons, including the rapid adoption of contactless card payments and new ways of paying by card, changing shopping preferences and increasing levels of card acceptance. COVID-19 has accelerated these well-established trends. Other digital payment methods have also grown over recent years, though to a much lesser extent.

7.5 In order to accept card payments, merchants need to purchase card-acquiring services. These services accept and process card payments on behalf of a merchant, resulting in a transfer of funds to the merchant. The supply of card-acquiring services is an important part of a complex system that enables merchants to accept card payments.

7.6 Over the past 15 years, the types of firms providing card-acquiring services to merchants have changed considerably due to factors such as regulatory changes, new market entrants, and mergers and acquisitions. Merchants can buy card-acquiring services from different types of organisation:

- Acquirers are banks or other organisations that are licensed by the card-payment system operator to recruit merchants to accept card payments.
- Payment facilitators are intermediaries that tend to focus on serving merchants with low levels of card turnover. The largest payment facilitators predominantly provide card-acquiring services to merchants selling face to face.

330 In line with our final Terms of Reference, we have not reviewed whether these fees are excessive.

7.7 Various third parties help merchants to accept card payments, including by referring them to acquirers and payment facilitators (the third parties do not provide card-acquiring services themselves). For example, ISOs are an important source of customers for acquirers.

7.8 As well as card-acquiring services, in order to accept card payments merchants also need hardware and software to:

- capture the card details at the point-of-sale (POS)
- transmit card details to the merchant's acquirer or payment facilitator

This includes card readers and POS terminals for card payments accepted face to face, and payment gateways for online payments. These, and other value-added services, can be obtained from providers of card-acquiring services or third parties.

Providers of card-acquiring services

7.9 Providers of card-acquiring services apply different competitive strategies when competing for merchants of different sizes (measured by annual card turnover). We used two broad merchant segments within the supply of card-acquiring services to structure our analysis and present our findings:

- **Small and medium-sized merchants**, with annual card turnover up to £10 million. Almost all merchants are in this segment, although they are only responsible for around 17% of the value of card transactions. Merchants with annual card turnover up to £380,000 account for around 90% of the overall merchant population.
- **Large merchants**, with annual card turnover over £10 million. This segment is dominated by a very small number of the largest merchants**,** with annual card turnover above £50 million, who are responsible for around 76% of the value of all card transactions.

7.10 We gathered evidence on the providers supplying card-acquiring services to small and medium-sized merchants:

- The five largest acquirers and First Data serve small and medium-sized merchants of all sizes that sell face to face, online and through other channels. Other acquirers are significantly smaller (in terms of number of merchants served) or target specific types of merchants (for example, those selling online).
- For most acquirers serving face-to-face merchants with annual card turnover up to £1 million, ISOs are an important sales channel. They accounted for 50% of all customers signing up with these acquirers in 2018. ISOs act as an outsourced sales function for acquirers, selling card-acquiring services on their behalf, alongside other card acceptance products and value-added services.

- In recent years, the largest payment facilitators – in particular, Zettle, PayPal (through its PayPal Here product), Square and SumUp – have expanded significantly. They predominantly serve face-to-face merchants with low levels of card turnover. Their offering differs from that of most acquirers in several ways – for example, through simple pricing and low-cost hardware.

7.11 The largest payment facilitators have been very successful in expanding the overall number of merchants that accept card payments, by targeting merchants that were traditionally underserved by acquirers; they now serve nearly 80% of merchants that only or mainly sell face to face with annual card turnover below £15,000. However, the largest payment facilitators' share of supply decreases sharply as merchants' card turnover increases above this level. Several acquirers said that they expect to face stronger competition from payment facilitators over the coming years. However, the largest payment facilitators differ in the extent to which they plan to compete for merchants with higher card turnover. The evidence indicates that their offering is less attractive to such merchants.

7.12 Stripe – which entered the market as a payment facilitator and is now an acquirer, and predominantly serves online merchants – has also expanded significantly. One reason for its expansion is the integrations it has with e-commerce platforms. Stripe accounts for a large proportion of the smallest merchants that only or mainly sell through card-not-present transactions (though it serves merchants of all sizes).

7.13 The rapid expansion of the largest payment facilitators and Stripe is mainly driven by their success in onboarding merchants new to card payments, which suggests low barriers to entry and expansion for providers that target such merchants. By contrast, the largest payment facilitators' offering is likely to be less attractive for merchants with higher card turnover; their share of merchants with annual card turnover above £15,000 is much lower.

7.14 Beyond the largest payment facilitators and Stripe, there has been some, more limited, entry and expansion by providers serving small and medium-sized merchants – for example, EVO Payments and Tyl by NatWest.

7.15 Large merchants typically buy card-acquiring services from acquirers. The five largest acquirers, plus Adyen, AIB Merchant Services and First Data, all serve large merchants selling face to face, online and through other channels; while Chase Paymentech currently focuses primarily on acquiring card-not-present transactions for online merchants. Most of these acquirers also have significant numbers of small and medium-sized merchants, but Adyen predominantly focuses on large enterprise merchants and Chase Paymentech predominantly provides card-acquiring services to large multinational merchants. Adyen is a new entrant that has grown its share of supply of large merchants significantly in recent years.

7.16 Acquirers, the largest payment facilitators and ISOs compete for merchants based on price and non-price factors:

- Most acquirers identified competitive pricing as one factor that is important to winning or retaining small and medium-sized merchants. Using simple pricing structures is one way that several acquirers and the largest payment facilitators differentiate their offering. ISOs also reported that they compete on price factors, and there is some evidence that merchants referred to acquirers by ISOs pay less for card-acquiring services (though this is not always the case). Competition for large merchants on standard pricing focuses on the headline rates. For those on IC+ or IC++ pricing, acquirers compete on the processing fee, although acquirers may negotiate with merchants over additional fees (for example, fees triggered by specific events).
- Firms also seek to compete for large merchants and small and medium-sized merchants based on a range of non-price factors, including:
    - customer service
    - omnichannel services
    - quality and range of card acceptance products
    - ease and speed of onboarding
    - faster settlement
    - offer of business management software
- The relative importance of these factors varies, depending on the size of merchant.

7.17 A range of both price and non-price factors can affect merchant behaviour. Non-price factors (including quality) may be important to some merchants when choosing card-acquirer. However, our merchant survey shows that price-related factors feature prominently in the decisions of merchants who have considered switching or who have switched.

The pricing and quality outcomes

7.18 The IFR caps coming into force in December 2015 forms an important backdrop to this review. The IFR capped interchange fees paid by acquirers to issuers on most card transactions, but did not cap the MSC paid by merchants. The IFR relied on competition between acquirers to ensure that acquirers' cost savings were passed through to merchants.

7.19 We used the introduction of the IFR caps as an indicator for how well the supply of card-acquiring services is working, by investigating the extent to which acquirers passed their IFR savings through to merchants. Some stakeholders submitted that pass-through cannot be used to assess the intensity of competition. We agree that there are specific limited circumstances in which non-pass-through of cost reductions could be consistent with a high degree of competition (that is, where other forces are driving up costs at the same time). However, we have seen no evidence that these circumstances were relevant in this case.

7.20 We investigated the extent of pass-through of the IFR savings using descriptive statistics and econometric analysis. We received extensive comments from stakeholders in response to our interim report. In response to these comments we updated our econometric analysis, the main change being to our treatment of data outliers. The changes that we made to our methodology did not affect our findings, and various sensitivity analyses showed that our results were robust.

7.21 Despite having several providers to choose from, our analysis provides robust evidence that, on average, merchants with annual card turnover between £15,000 and £50 million served by the five largest acquirers got little or no pass-through of the IFR savings.[331] This indicates that the supply of card-acquiring services is not working well for small and medium-sized merchants and large merchants with annual card turnover between £10 million and £50 million.

7.22 We also observe that new small and medium-sized customers pay less, on average, than existing customers. Some stakeholders submitted that it is not possible to estimate the gains from switching using available data. We acknowledge that our analysis does not precisely estimate gains from switching, but it does indicate that many small and medium-sized merchants on standard pricing could get better deals by switching.

7.23 Conversely, merchants on IC++ pricing received full pass-through of the IFR savings. They are very few in number but represent 77% of transaction value. We estimate the benefit to these merchants was around £600 million in 2018. Some of the largest merchants may also have benefitted from switching to IC++ pricing after the IFR caps came into force.

7.24 For merchants in all turnover groups, the evidence available to us also indicates that scheme fees (which increased significantly over the period) were passed through by acquirers in full. This could constitute further evidence that the supply of card-acquiring services is not working well, because it suggests that acquirers did not face competitive pressures to absorb cost increases or to pass through cost decreases. However, we have some concerns about the data on scheme fees that underpinned our pass-through analysis, and the evidence is therefore less strong.

7.25 Some acquirers had told us that an explanation for a lack of IFR pass-through could be that they invested the savings in providing a higher quality of service to their customers, rather than lower prices. However, the data we reviewed on quality of service metrics did not show evidence of improvements during the period. Similarly, in response to the interim report, acquirers told us that the increase in interchange fee margins reflects their rising costs. However, the information they supplied on costs suggested that unit costs fell over the period. The information related to only two acquirers and does not necessarily point to general conclusions, but it is not consistent with unit costs rising

331 As noted in Chapter 5, we do not make a finding about the degree of IFR pass-through for merchants with annual card turnover up to £15,000. We included these merchants within our findings for the reasons given in paragraph 7.32.

because of investments in service quality. Limited evidence was provided to show how specific investments led to improved/new services during the period under investigation. For instance, in their responses to the interim report, Barclays and GPUK both refer to investments made during 2018 or 2019, while [✂]. Furthermore, it is not clear to what extent the IFR savings made by acquirers directly led to improved/new services. Accordingly, we consider that the acquirers have not clearly shown the extent to which the costs of specific investments could explain the increases in the interchange fee margin over the period 2014 to 2018. We therefore do not consider that investments in improved/new services explain the lack of pass-through of the IFR savings to merchants with annual card turnover up to £50 million.

Merchants' willingness and ability to search and switch

7.26 The pricing outcomes we observe show that many small and medium-sized merchants would benefit from searching and, if they find a better deal, negotiating with their current provider or switching to a different one. In particular, merchants with growing card turnover may benefit from comparing different offers to see if their current deal still fits their needs. If they don't do this, they may end up paying more than they need to. However, in order to benefit from choice and better deals, merchants need to be willing and able to search and consider switching.

7.27 Despite having a variety of providers to choose from, the merchant survey of small and medium-sized merchants showed that many don't regularly (if ever) search for providers and rarely consider switching their provider. In addition, only around 20% of surveyed merchants have ever attempted to negotiate a better deal with their existing provider (despite evidence they could achieve a better outcome). This shows that merchants' ability to negotiate a better deal doesn't explain the limited searching and switching we observe.

7.28 This could discourage acquirers wishing to serve particular merchant segments from entering the market and expanding, and may weaken competition between providers who currently do serve those merchants.

7.29 Most surveyed merchants that shopped around or switched found it easy to do so. A high proportion of merchants reported being satisfied with their provider. One possible explanation for the low rate of switching is therefore that some merchants are satisfied with their existing provider and they see no need to search for another acquirer or to switch provider. However, those merchants that rarely or never consider switching may have little to no knowledge of alternative options – so may not be able to tell if they are getting a good deal or not.

7.30 Other survey responses are consistent with there being barriers that restrict some merchants' willingness and ability to search and switch provider. Aside from the low rates of searching and switching, around one in every five surveyed merchants that had shopped around – and a similar proportion of those that had switched – found the process difficult. Around 23% of merchants that had switched indicated that more or better information would have made them more confident about choosing the right provider. Some merchants also reported not searching and switching for reasons including being locked into contracts or having other business priorities.

Features affecting merchants' willingness and ability to search and switch

7.31 We examined a range of factors and conclude that the following features (both individually and in combination) restrict merchants' ability and willingness to search and switch, and explain the pricing outcomes that we observe for small and medium-sized merchants:

- **Acquirers and ISOs** do not typically publish their prices for card-acquiring services. Their pricing structures and approaches to headline rates vary significantly. This makes it difficult for a merchant to compare prices for ISOs, acquirers and payment facilitators.

- **The indefinite duration of acquirer and payment facilitator contracts for card-acquiring services** may explain, at least in part, why many merchants don't consider switching or searching for other providers regularly. This is because they do not provide a clear trigger for merchants to think about searching for another provider and switching. After a certain point, merchants that grow their card turnover will particularly benefit from comparing different offers to see if their current deal still fits their needs. If they don't do this, they may end up paying more than they need to.

- **POS terminals and POS terminal contracts that prevent or discourage merchants from searching and switching provider of card-acquiring services**. This can occur because of a combination of two factors (i) a merchant typically cannot use its existing POS terminal with a new card-acquirer. If it switches provider of card-acquiring services it may need a new POS terminal and to cancel its existing POS terminal contract; and (ii) a merchant could incur a significant early termination fee when cancelling its existing POS terminal contract, even if no such fee would apply when cancelling its card-acquiring services contract. This situation can arise because POS terminal contracts can have longer initial/renewal terms than card-acquirer contracts (for example, of three and five years) and/or they may renew automatically for successive fixed terms. Early termination fees for these contracts can include, for instance, all outstanding payments due up to the end of the initial/renewal term. Therefore, there may be situations where the lack of portability of POS terminals, and early termination fees for cancelling an existing POS terminal contract, together prevent or discourage merchants from switching provider of card-acquiring services.

7.32 It was not possible for us to reliably estimate the degree of pass-through of IFR savings for merchants with annual card turnover below £15,000. However, we expect that these merchants suffer harm due to the features outlined above. These features affect this group as they do other small and medium-sized merchants.[332] Our merchant survey also indicates that they share similar characteristics with other small and medium-sized merchants that received little or no pass-through. Many do not regularly search, consider switching provider, or negotiate with their current provider.

332 Although there is a greater likelihood that these merchants may not be affected by all three features (or not to the same extent). For example, merchants contracting with payment facilitators will typically purchase a card reader up front, rather than having a POS terminal contract.

7.33 Large merchants with annual card turnover between £10 million and £50 million were not represented in the merchant survey. It is plausible they have greater buyer power or more internal resource to assess card acquiring options compared to small and medium-sized merchants. Nevertheless, on average, they got little or no pass-through of the IFR savings – just like small and medium-sized merchants. The features which restrict the searching and switching behaviour of small and medium-sized merchants will also apply to this group. The evidence suggests that any differences between these large merchants and small and medium-sized merchants were not enough to counteract the impact of the features we identified, and to ensure pass-through of the IFR savings. We conclude that the supply of card-acquiring services is not working well for large merchants with annual card turnover between £10 million and £50 million.

7.34 For the largest merchants (with annual card turnover above £50 million), our pass-through analysis was inconclusive for those on standard pricing because the IFR had little effect on their average interchange fees. Merchants on IC++ pricing, which are typically the largest merchants, received full pass-through of the IFR savings, and we estimate that the benefit of the savings to these merchants was around £600 million in 2018. The merchants in this segment can access information about providers and assess their requirements. While they sometimes face significant switching costs – for example, due to the complexity of integrating payments with their systems – they achieve good pricing outcomes. We did not find any evidence as part of this market review that the supply of card-acquiring services does not work well for these merchants.

7.35 With regard to pricing, we gave careful consideration to stakeholder responses to the interim report, including that only a small proportion of respondents specifically indicated that it was difficult to compare providers. However, we have found that there is an absence of published prices and that it is complex to compare prices due to variation in pricing structure and different approaches to headline rates. We would also not necessarily expect merchants that did not make comparisons to have highlighted difficulties. We note that some merchants that had switched stated that access to more comparable pricing information, better quality or more accessible information would have made them feel more confident about deciding which provider to switch to. There are existing regulations that place obligations on acquirers and payment facilitators to provide information to merchants about their pricing. However, the information provided may be very detailed. The regulations do not aim to address the specific factors we have identified that can make it difficult for merchants to make comparisons.

7.36 With regard to card-acquiring services contracts, some stakeholders highlighted that only 1% of surveyed merchants said that the expiry of a contract would be a trigger for them to switch in future. Some also submitted that there are already 'prompts' for merchants to search and switch. With regard to these points, we note that responses to the merchant survey were unprompted and it is reasonable to expect that the likely effect of contract expiry on merchant behaviour is understated. Factors that stakeholders asserted could work as 'prompts' have not had the effect of promoting switching. Where they relate to the provision of pricing information, if that information is difficult to assess, the potential for it to prompt a merchant to consider switching may be small.

7.37 Some stakeholders emphasised the need for merchants to provide a minimum commitment period with regard to their POS terminal contract. We will consider whether there are options to increase the portability of POS terminals and, if so, this may allow merchants to switch provider of card-acquiring services without necessitating they cancel their existing POS terminal contract. In this case, early termination fees associated with cancelling the POS terminal contract would not necessarily be a barrier to searching and switching provider of card-acquiring services. To the extent that we consider remedy options related to POS terminal contract terms, this would include an assessment of both their harm and any countervailing benefits. This will include taking account of potential adverse effects that limiting their length could have on providers (which could, in turn, harm merchants). At this stage, however, we acknowledge that some form of minimum commitment from merchants is likely to be necessary and beneficial for both providers and merchants. POS terminal contract initial/renewal terms that are the same length or shorter than those of the merchant's card-acquiring service contract also appear less likely to raise barriers to switching card-acquirer. We would also consider whether any less intrusive remedy option (or potentially no remedy option) exists to remove or mitigate the feature we have identified, and whether the remedy produces disadvantages that are disproportionate to its aim.

7.38 In conclusion, we find that the supply of card-acquiring services does not work well for small and medium-sized merchants and large merchants with annual card turnover between £10 million and £50 million. This is explained by the features identified that restrict their willingness and ability to search and switch and result in worse outcomes for them. Remedying these features will improve outcomes for these merchants by:

a. encouraging them to search and switch or negotiate a better deal with their existing provider

b. reducing the obstacles to getting a better deal

Scheme fees

7.39 In our final Terms of Reference, we said we would also examine how scheme fees have changed over the period 2014 to 2018. Our analysis indicates that:

- scheme fees increased significantly over the period
- a substantial proportion of these increases are not explained by changes in the volume, value or mix of transactions

Actions we're taking

7.40 Remedies to the problems we have identified are a critical next step in this market review process. For instance, more can be done to make comparisons easier, and to ensure merchants consider their supply options more frequently.

7.41 That is why our next step will be to publish a remedies consultation in early 2022. This will set out our views on the most suitable remedies package to address our concerns. As part of that consultation, we will seek views and information from stakeholders, and we expect the payments industry to play a key role in developing effective and proportionate measures that increase merchant engagement and ultimately improve choice and prices.

7.42 We will then publish our provisional decision on remedies (and potentially a draft remedies notice) for consultation later that year.

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