Payment Systems Regulator

MR18/1.7

Market review into the supply of card-acquiring services

Interim report

September 2020

We welcome your views on this consultation. If you would like to provide comments, please send these to us by **5pm on 8 December 2020**.

You can email your comments to **cards@psr.org.uk** or write to us at:

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We will consider your comments when preparing our response to this consultation.

We will generally seek to make all non-confidential responses to this consultation available for public inspection in full or in part.

We will not accept blanket claims of confidentiality, such as a standard confidentiality statement in an email message. If you wish to claim confidentiality over specific items in your response to the consultation, you must identify those specific items which you claim to be confidential, and explain the basis on which confidentiality is sought. If you include extensive tracts of confidential information in your response, we will ask you to submit a non-confidential version.

We may nonetheless be required to disclose information marked as confidential in order to meet our legal obligations. This would be the case, for example, if we are asked to disclose confidential information under the Freedom of Information Act 2000. We will endeavour to consult you if we receive such a request under the Freedom of Information Act 2000. Any decision we make not to disclose information can be reviewed by the Information Commissioner and the Information Rights Tribunal.

You can download this consultation paper from our website:
www.psr.org.uk/psr-publications/market-reviews/card-acquiring-services-market-review/market-review-into-the-supply-of-card-acquiring-services-interim-report

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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 provisionally find that the supply of these services works well.
- We provisionally 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've proposed some measures that we think will help these merchants get a better deal and lead to better outcomes for merchants, and ultimately consumers.
- We're now consulting on the contents of this interim report and are keen to hear what stakeholders think. The deadline for feedback is 8 December 2020.

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 163 million cards in issue in the UK and consumers made 14.8 billion debit card payments in 2019.[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're doing 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 Our aim is to provide the first holistic overview of this sector, and assess whether the supply of card-acquiring services is working well for merchants, and ultimately consumers. In line with our objectives, we consider how competition is working and any impact on innovation or the interests of service-users.

1 UK Finance, *UK Payment Markets 2020* (2020), page 14.

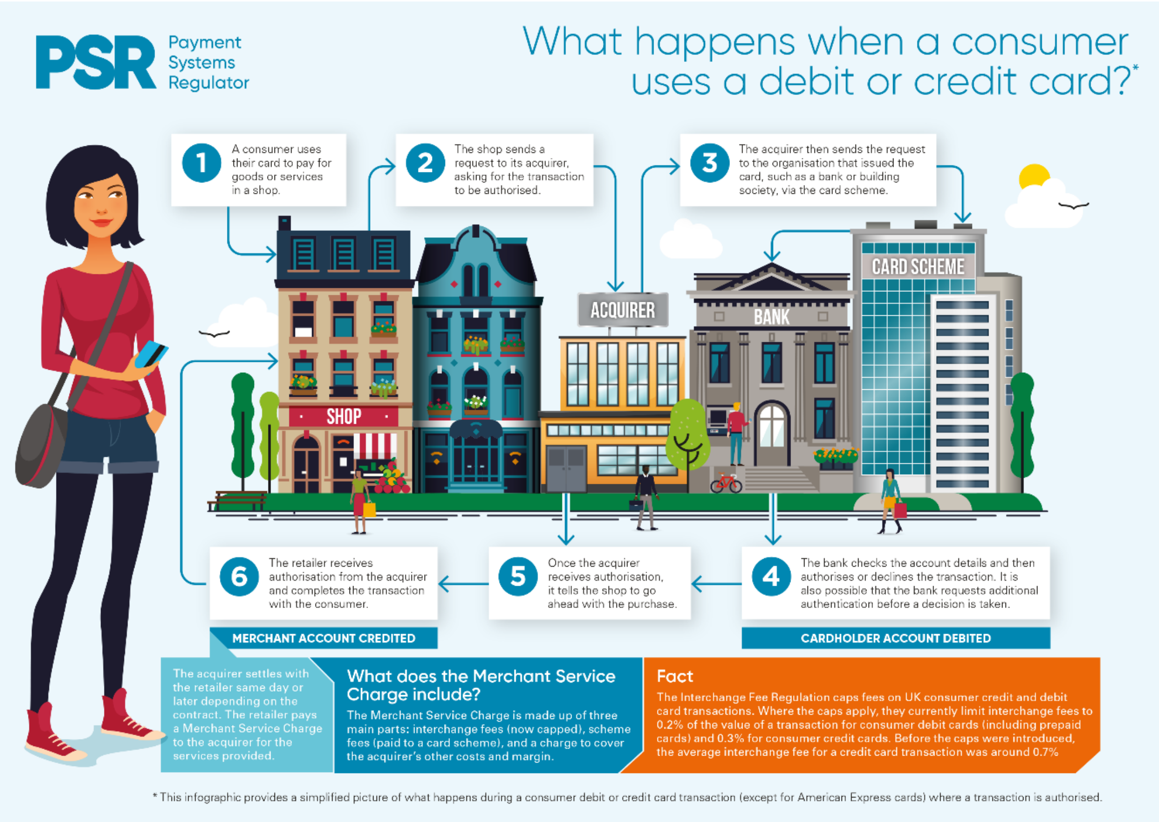
Considering COVID-19

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 may accelerate 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 amongst 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:



The main players in card-acquiring

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	Organisation that licences card issuers and acquirers to recruit cardholders and merchants respectively. It manages the rules that govern how card payments are made and provides processing services that manage the movement of funds between issuers and acquirers.
Merchant	Business 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 and 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 iZettle brand), Square and SumUp.

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)[2]
- **acquirer net revenue**, which recovers the acquirer's other costs and margin

2 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.

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.

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 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 overall value of card transactions.

Our key findings

1.14 Having reached the interim report stage of our market review, these are our key findings[3]:

- A majority of the available IFR savings were passed through to merchants because merchants with interchange fee plus plus pricing received full pass through. Although few in number, this group was responsible for around 77% of the overall value of transactions in 2018.
- We estimate the benefit of the savings to these merchants was around £600 million in 2018.

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

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.
- 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.
- 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.
- The pricing outcomes we observe show that 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:
    - They got little or no pass-through of the IFR savings (on average)
    - New customers pay less than existing customers (on average)
    - Some have tried to negotiate with their provider – nearly 90% of those that did were successful in getting a better deal
- We've identified three features of concern which – individually and in combination – restrict small and medium-sized merchants' ability and willingness to search and switch:
    - **Acquirer and ISO pricing** which creates significant search costs for merchants because of the absence of published prices and the complexity of comparing prices.
    - **The indefinite duration of merchant contracts for card-acquiring services** doesn't provide a clear trigger point for merchants to think about searching for another provider and switching and, for this reason, isn't in merchants' interests. This applies to both acquirer and payment facilitator contracts.

  - **Acquirer and ISO POS terminal contracts** with long initial terms of three to five years or that automatically renew for successive fixed terms, which represent a barrier to switching to a different provider of card-acquiring services.

- Because of these features, our provisional finding is 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.

Large merchants

- Large merchants typically buy card-acquiring 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 primarily focuses on acquiring card transactions for e-commerce merchants. Adyen – a new entrant – has significantly grown its share of supply between 2015 and 2018.
- On average, large merchants with annual card turnover between £10 million and £50 million got little or no pass-through of the IFR savings – just like small and medium-sized merchants. Many have the same sorts of contracts for card-acquiring services and POS terminals and the same types of pricing options as small and medium-sized merchants. So, the features which restrict the searching and switching behaviour of small and medium-sized merchants will affect large merchants with annual card turnover between £10 million and £50 million in the same way. Our provisional finding is therefore that the supply of card-acquiring services does not work well for them.
- The largest merchants – which have annual card turnover above £50 million – can access information about providers and assess their requirements. While they sometimes face significant switching costs, including because of the complexity of integrating payments with their systems, they achieve good pricing outcomes. Our provisional finding is that the supply of card-acquiring services works well for them.

Scheme fees

- Fees paid by acquirers to Mastercard and Visa for scheme services rose significantly from 2014 to 2018 and even after adjusting for changes in the volume, value and mix of card transactions, they approximately doubled over this period. For merchants in all turnover groups, the evidence available to us and our current analysis indicates that scheme fees were passed through by acquirers in full.

Action we're considering

1.15 We're considering actions to remedy the three features we've identified. At this stage, we're outlining some potential high-level approaches we could take. We welcome early feedback and proposals from stakeholders about how we could address these concerns.

1.16 We expect to carry out further detailed work to consider the most effective way to design and implement any remedies. Remedies are contingent on our final conclusions.

Contracts for card-acquiring services

1.17 The indefinite duration of merchant contracts for card-acquiring services don't provide a clear trigger point for merchants to think about searching for another provider and consider switching.

1.18 We want to encourage merchants to shop around more regularly – evaluating if their current provider still offers the best deal and considering alternative providers or renegotiating with their current provider.

1.19 We're considering a remedy requiring all contracts for card-acquiring services to have an end date. This would apply to both acquirer and payment facilitator contracts with small and medium-sized merchants and large merchants with annual card turnover of up to £50 million.

ISO and acquirer POS terminal contracts

1.20 To change provider of card-acquiring services, merchants that obtain a POS terminal from an acquirer or ISO need to terminate their POS terminal contract because typically they cannot use their existing POS terminal with another provider. Some POS terminal contracts from acquirers or ISOs (or from third-party POS terminal providers working with such firms) have long initial terms, of three to five years, and/or automatically renew for successive fixed terms and also include early termination fees. These contracts act as a barrier to switching.

1.21 We don't want POS terminal contracts to be a barrier to merchants changing their provider of card-acquiring services.

1.22 The remedies we're considering include:

- Limiting the length of POS terminal contracts, for example to align with the 18-month limit set in the Consumer Credit Act 1974.
- Ending POS terminal contracts that automatically renew for successive fixed terms.
- Linking the contracts for card-acquiring services and POS terminals, where they are sold together as a package by acquirers or ISOs. For example, by making it easy to exit POS terminal contracts if terms change in the card-acquiring services contract (including price) without incurring termination fees.[4]

1.23 These remedies would apply to acquirers and ISOs. They would not apply to payment facilitators, who sell card readers to merchants upfront.

4 Note that the Payment Services Regulations 2017 require that contracts for card-acquiring services can be terminated after the initial term of six months.

ISO and acquirer pricing of card-acquiring services

1.24 ISO and acquirer pricing creates significant search costs for merchants because of the absence of published prices and the complexity of comparing pricing.

1.25 Once a merchant has decided to shop around, we want to make it easy for them to research prices and compare different offerings.

1.26 The aims of a remedy in this area would be to facilitate shopping around and increase customer awareness of the prices and offerings of different firms, and enable easy comparison of firms' prices.

1.27 There are already obligations on acquirers in the IFR and the Payment Services Regulations 2017 to provide information to merchants on their prices. A remedy in this area would be designed to complement existing requirements and could take several forms, including:

- enabling or enhancing tools to facilitate price comparison for merchants
- requiring acquirers and ISOs to provide pricing information in an easily comparable format

Next steps

1.28 We welcome stakeholder feedback on our provisional findings and potential remedies, including on the following questions:

1. Do you have views on the provisional findings set out in this report?
2. Do you have views on the potential remedies set out in this report? What are the potential benefits, challenges and unintended consequences that may arise from these, both individually and as a package?
3. Do you think there are other remedies that we should be considering? If so, what remedies and how do you think they would address the concerns we have identified?
4. How does COVID-19 impact on our review?

1.29 Given the impact of COVID-19 on all stakeholders, this report will be followed by an extended consultation period of 12 weeks. Please send views on the above questions to cards@psr.org.uk by Tuesday 8 December 2020. We'll take these views into account in our final report. We'll also be engaging directly with stakeholders to discuss this interim report. We're grateful to all those who have provided information that has informed this interim report.

2 Introduction

2.1 This is the interim report of our market review into the supply of card-acquiring services in the UK. It contains our provisional 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 is 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[5] 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[6] 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 the supply of card-acquiring services in relation to the Mastercard and Visa card payment systems, we've also considered what we've learned about the supply of card-acquiring services for other card payment systems operating in the UK.

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5 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

6 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 fees acquirers pay to Mastercard and Visa have changed between 2014 and 2018, and whether these changes were passed on to merchants.[7]

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 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

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.

2.15 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.

2.16 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.

2.17 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).

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

Structure of this report

2.18 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 provisional findings and next steps, including the action we are considering and the feedback we are seeking from stakeholders

2.19 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

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 that 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. Between 2009 and 2019, the number of debit card payments in the UK nearly trebled. Use of credit cards increased by around half that amount.[8]

3.3 Causes of the recent growth in card payments include the rapid growth in adoption of contactless card payments and new ways of paying by card, changing shopping preferences (including the growth of online shopping – debit cards are the most popular payment method for consumer online shopping) and increasing levels of card acceptance among businesses (particularly among smaller businesses).[9] 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.[10] The impact of COVID-19 may accelerate these well-established trends.

3.4 In recent years, new ways of paying by card have also emerged. For example, consumers can now initiate a card payment in a shop using a mobile phone 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 store card details securely in different ways and can also be used online.

8 UK Finance, *UK Payment Markets 2020* (2020), Tables 3 and 4.

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

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

3.5 Surveys show the majority of businesses in the UK accept card payments.[11] In some sectors, cards are the most frequently used payment method. In 2019, credit and debit cards accounted for 78%, 67% and 61% of spontaneous payments in the travel, retail and entertainment sectors respectively.[12] In other sectors, card payments are much less prevalent. Most consumers pay utility bills and make monthly mortgage repayments by direct debit.[13]

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

3.7 Annex 1 provides more information on different card types.

Card payment systems

3.8 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.

3.9 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.[14]

3.10 There are at least five parties involved in four-party card payment systems:

- **Cardholders** – individuals or businesses that use cards to buy goods and services.
- **Merchants** – businesses that accept payment by card.
- **Operators** of card payment systems – organisations that license issuers and acquirers to recruit cardholders and merchants respectively.[15] 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 the card payment system.[16] Operators of card payment systems also provide processing services that manage the movement of funds between issuers and acquirers.[17]
- **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 3.16 to 3.21).

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11 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 5004 businesses with a turnover of £50,000 to £25 million. Data weighted by region and turnover to be representative of businesses in G.B.

12 UK Finance, *UK Payment Markets 2020* (2020), page 24.

13 UK Finance, *UK Payment Markets 2020* (2020), page 12.

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

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

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

17 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.

- **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.

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

3.12 In a three-party card payment system, the operator of the system generally performs the issuing and acquiring functions itself.[18] 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

3.13 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[19]
- **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

3.14 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.

3.15 Interchange fees and some scheme fees[20] 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, e-commerce or face-to-face)
- the way the cardholder authenticated themselves (for example, by entering their PIN)

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18 In some circumstances, American Express licences 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.

19 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.

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

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

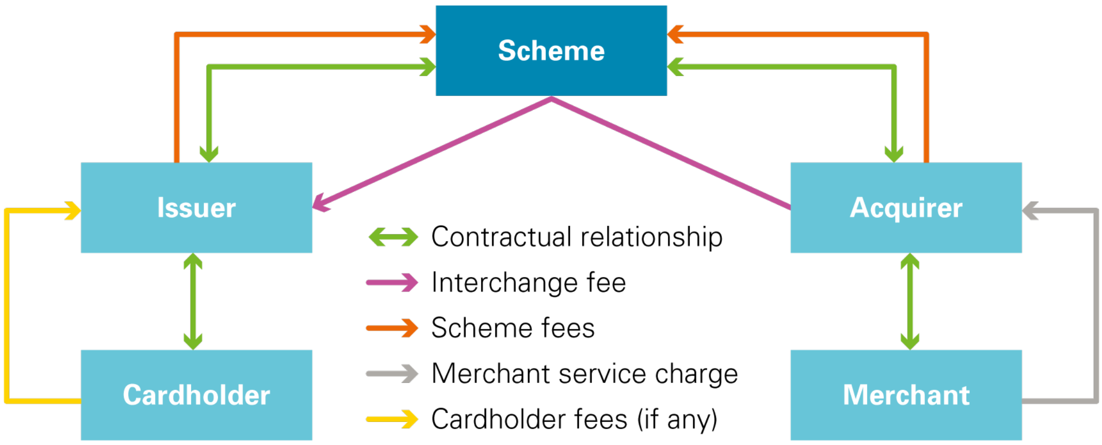

Diagram provides a simplified representation of a four-party card payment system

Role of the acquirer

3.16 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
- settling with the merchant – that is, transferring to the merchant the funds for the card payments it accepts less any applicable fees (see paragraph 3.13)
- ensuring merchants comply with scheme rules.

3.17 Acquirers may also offer other goods and services to merchants as described in paragraphs 3.52 to 3.59.

3.18 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.[21]

21 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.

3.19 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).

3.20 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.

3.21 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

3.22 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.

3.23 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.

3.24 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.

3.25 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.

3.26 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

3.27 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[22] for card payments accepted face-to-face and payment gateways for e-commerce card 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[23] – 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 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.

3.28 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)[24] 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.

3.29 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 card-not-present transactions (such as e-commerce transactions and mail order and telephone order – MOTO – transactions).

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

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22 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 standalone devices while card readers must be connected to an app on a smartphone or tablet to operate.

23 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.

24 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 systems, with input from other parties such as acquirers and merchants. Scheme rules require that acquirers ensure their merchants comply with PCI DSS requirements.

3.31 Online marketplaces are websites or apps that bring together buyers and sellers such as Etsy and Just East. 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).

3.32 Most small and medium-sized merchants also accept payment methods in addition to cards. However, we have not seen evidence that currently there are effective substitutes to 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 pay with – so they will have a strong incentive to continue accepting cards, which are 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.

Providers of card-acquiring services

3.33 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

3.34 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

3.35 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[25] for payment services.

25 Passporting allows a business authorised in an EEA state to offer certain products or services in the UK and other EEA states if it has the relevant passport.

3.36 In 2013, the European Commission proposed a new package of legislation that aimed – like PSD 1 – 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 as 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

3.37 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[26] 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[27] broken down for the various different categories[28] 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 (Article 9(2)). Article 12 IFR requires that merchants' payment service providers (PSPs) [29] 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.[30]

3.38 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.

3.39 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.

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

27 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 as a competent authority for the EU Interchange Fee Regulation* (2016, updated 2020), paragraph 5.34.

28 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.

29 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 and the PSRs 2017. In this report, when we use the term payment service provider (PSP), we mean PSP as defined in the IFR and the PSRs 2017.

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

Divestments, mergers and acquisitions

3.40 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 3.45) 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[31] and other payment facilitators.** For example, in 2018 PayPal Holdings Inc[32] acquired a payment facilitator called iZettle (which continues to operate as a separate brand). 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.[33]

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

32 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.

33 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.

Entry by new providers

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

- **Cross-border acquirers.** Adyen began offering card-acquiring services to UK merchants in 2015 and currently serves the UK on a cross-border basis for card-acquiring services.
- **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 3.40).

3.42 New payment facilitators have also started offering card-acquiring services to merchants. iZettle (now owned by PayPal – see paragraph 3.40) 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.

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

Overall shares of supply in card-acquiring services

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

3.45 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.[34] 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, iZettle[35], Square and SumUp.

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

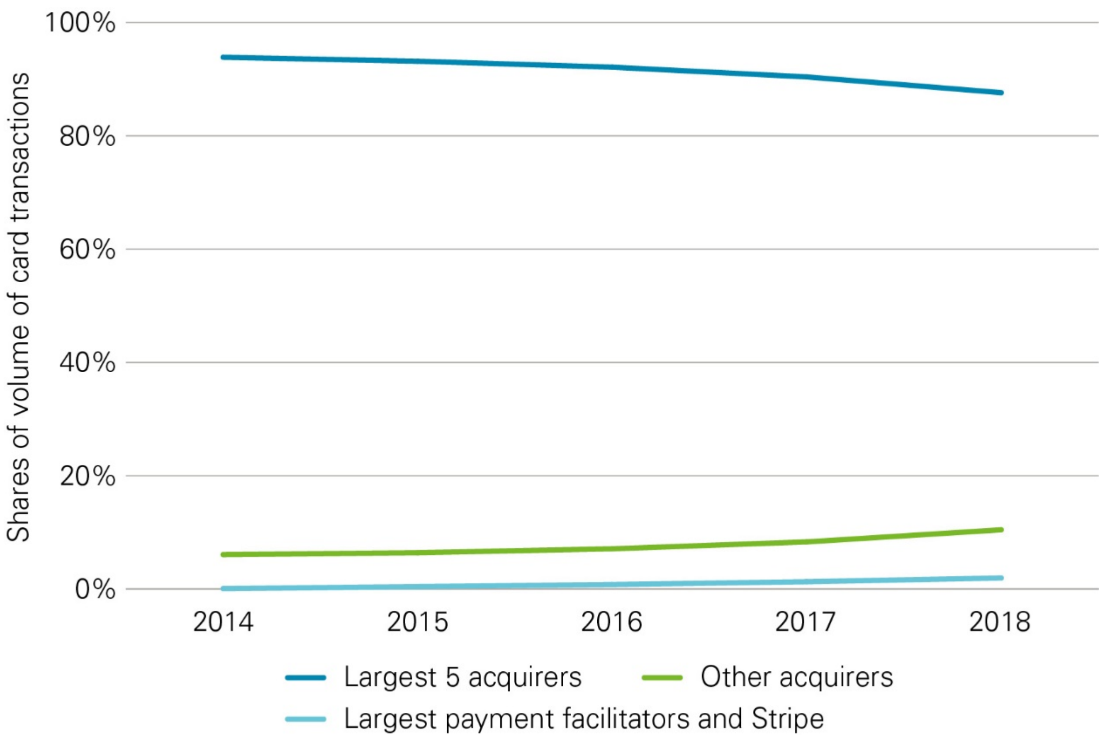
35 PayPal Europe ('PayPal') and iZettle are both owned by PayPal Holdings Inc. iZettle operates as a separate brand and hence is referred to separately in this document.

3.46 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[36]) or serve the UK on a cross-border basis (like Adyen). Annex 1 provides more information on the providers of card-acquiring services.

3.47 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.

3.48 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.

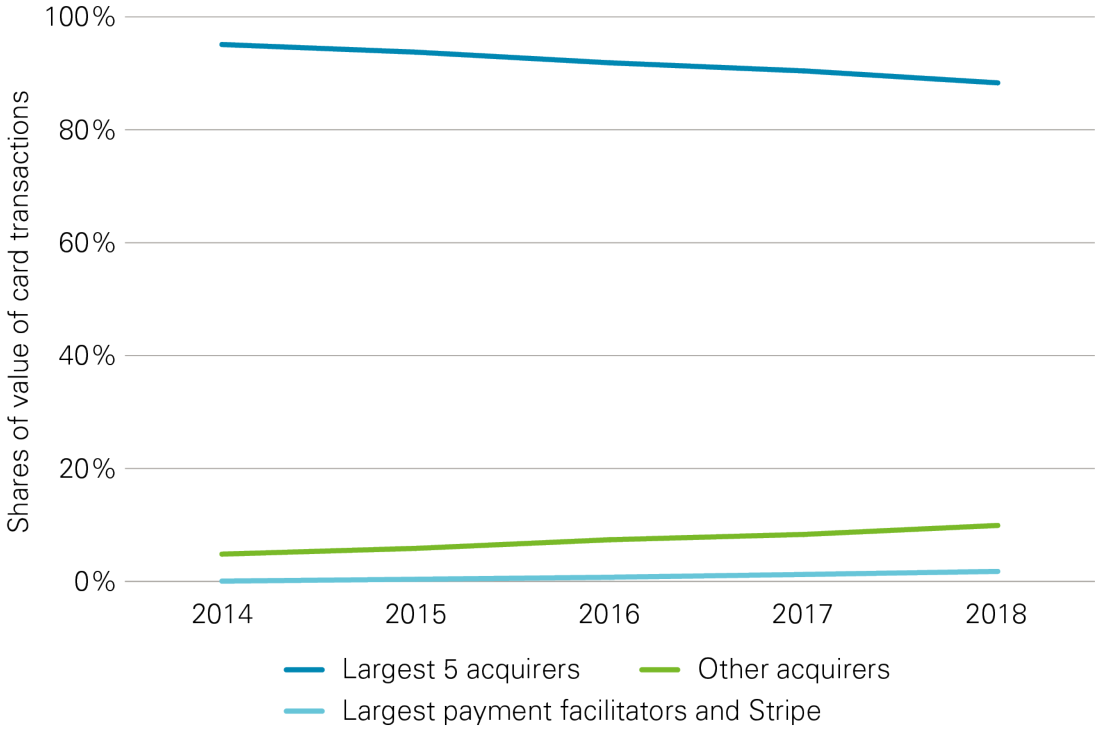
Figure 2: Volume of card transactions acquired for merchants by providers of card-acquiring services from 2014 to 2018



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.

36 Originally, GPUK LLP (Global Payments' UK subsidiary) was partly owned by a bank and Worldpay was fully owned by a bank. See paragraph 1.45.

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



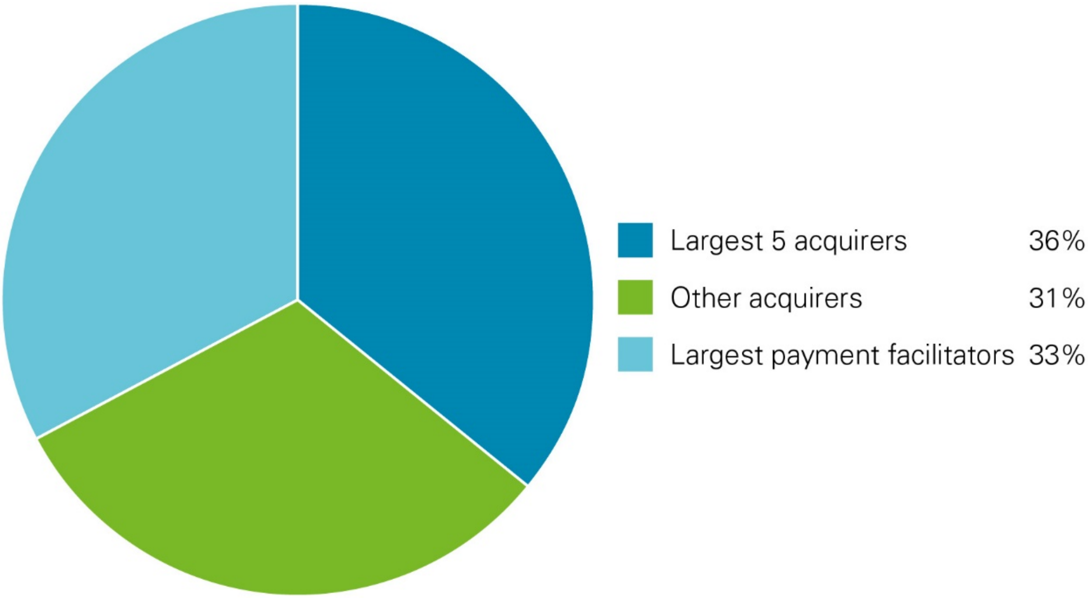
Source: PSR analysis of data provided by acquirers and payment facilitators on the value of purchase transactions, refunds and chargebacks acquired for UK merchants at their UK and non-UK outlets. Stripe (an acquirer) is grouped with the payment facilitators because it was a payment facilitator for the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

3.49 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

3.50 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 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

3.51 The five largest acquirers and some of the other acquirers identified in paragraph 3.46 serve merchants selling face-to-face, online and through other channels.

3.52 Most acquirers can provide card-acquiring services as a standalone 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).

3.53 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.[37] 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

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

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

3.55 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.

3.56 Merchants can also buy value-added services from their acquirer (see paragraph 3.28).

3.57 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.

3.58 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

3.59 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, hereby 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.[38]
- 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).

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

3.60 Over 95% of acquirers' merchants have standard pricing[39], 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[40] 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

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

3.62 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)

3.63 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 3.15. 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.

3.64 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.

39 PSR analysis of data provided by acquirers.

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

3.65 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

3.66 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 the EEA and one for cards issued outside the EEA.[41] 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.

3.67 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 3.20).

Payment facilitators' offering

3.68 The largest payment facilitators – iZettle, PayPal (through its PayPal Here product), Square and SumUp – predominantly[42] 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 paragraph3.72). The largest payment facilitators offer:

- card-acquiring services
- a card reader

3.69 Unlike most acquirers, the largest payment facilitators do not offer a standalone product to help merchants comply with PCI DSS requirements. They cover PCI compliance on behalf of their merchants[43], or assist with this, as part of the overall fee for card-acquiring services.

3.70 While POS terminals are usually standalone 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.

41 Stripe also offers IC++ pricing.

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

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

3.71 Card-acquiring services provided by iZettle, PayPal, Square and SumUp are intended to be used with the card readers they sell. Merchants cannot buy card-acquiring services from these payment facilitators and use hardware for capturing card details bought from another party.

3.72 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. iZettle, Square and SumUp also enable merchants to accept payments online.

Pricing of card-acquiring services and other products

3.73 The payment facilitators that predominantly serve merchants selling face-to-face – iZettle, 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[44]

3.74 Merchants do not pay any additional fees for card-acquiring services or the POS app (see paragraph 3.70).

3.75 PayPal Here has a tiered pricing structure. Merchants pay one of four headline rates depending on their card turnover in the previous month for Chip and PIN and contactless 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 triggered by transactions involving cards outside the UK and for chargebacks.

3.76 Merchants using PayPal's Braintree and Payments 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 are triggered by chargebacks (for Braintree) and certain other events (for Payments Pro), and for purchase transactions with cards issued outside the Europe region (which broadly corresponds to the EEA)

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

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

Independent sales organisations and other third parties

3.78 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.

3.79 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

3.80 There are over 60 ISOs operating in the UK[45]; 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.[46]

3.81 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.

3.82 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 3.10) 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.

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

46 PSR analysis of data provided by ISOs.

3.83 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 3.82, 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. Merchant may also 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.

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

Summary

3.85 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. Other digital payment methods have also grown over recent years, though to a much lesser extent.

3.86 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 parties: 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).

3.87 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.

3.88 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).

3.89 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.

4 Competition between providers of card-acquiring services

- Providers of card-acquiring services apply different strategies when 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 and 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 do not consider any of the individual potential barriers to entry and expansion that we assessed based on stakeholders' concerns to be significant for providers serving large 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.[47] 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 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 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

47 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 how 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.

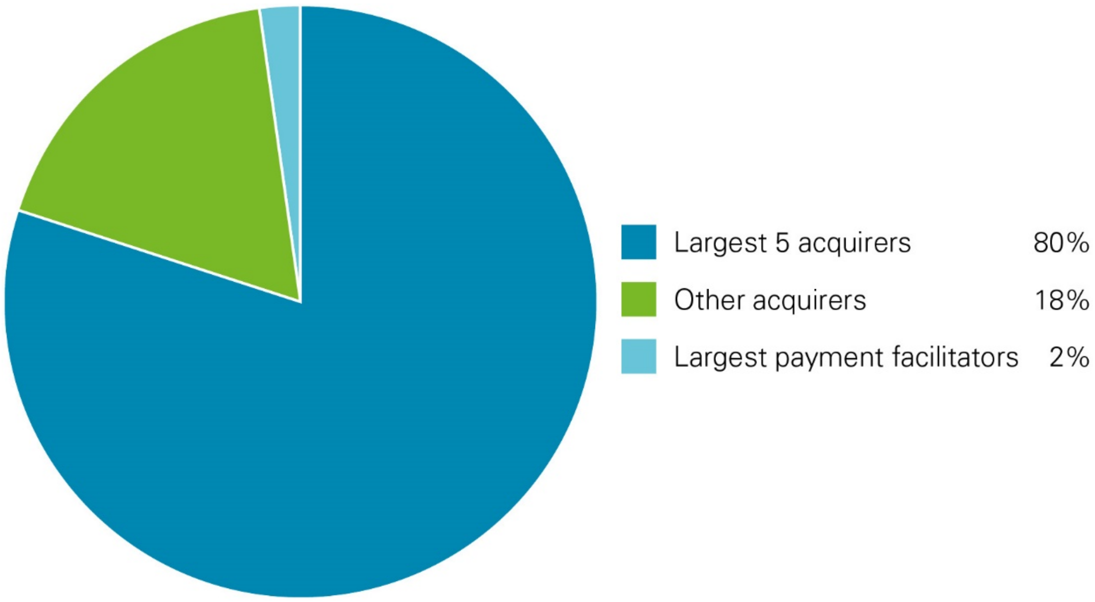
Large merchants

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.[48]

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.

48 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 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 it predominantly focuses on large enterprise merchants and Chase Paymentech said it predominantly provides card-acquiring services to large multi-national merchants (though both also serve 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. It now serves [5-10]% of large merchants and as a result its overall share of card transactions (by volume and value) increased by [0-5]% between 2015 and 2018.

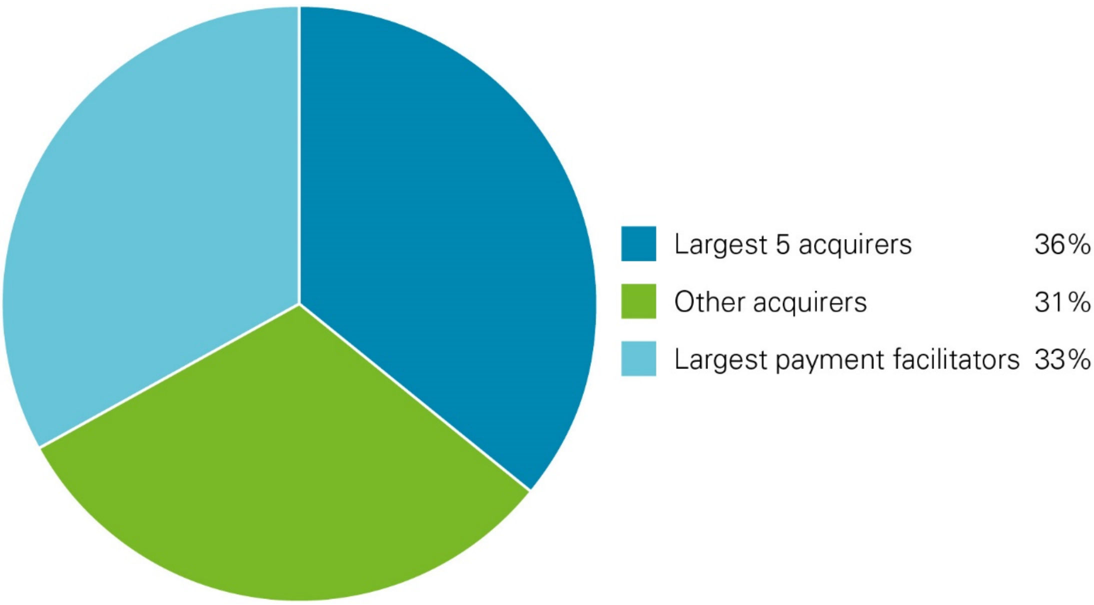
4.15 Acquirers generally compete for the largest merchants by approaching them directly or by bidding in response to tenders. Acquirers that are fully or partially owned by, or have a referral relationship with, banks also receive large-merchant referrals from banks.

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.[49] The main difference compared to Figure 5 is that the largest payment facilitators – iZettle, 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.

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

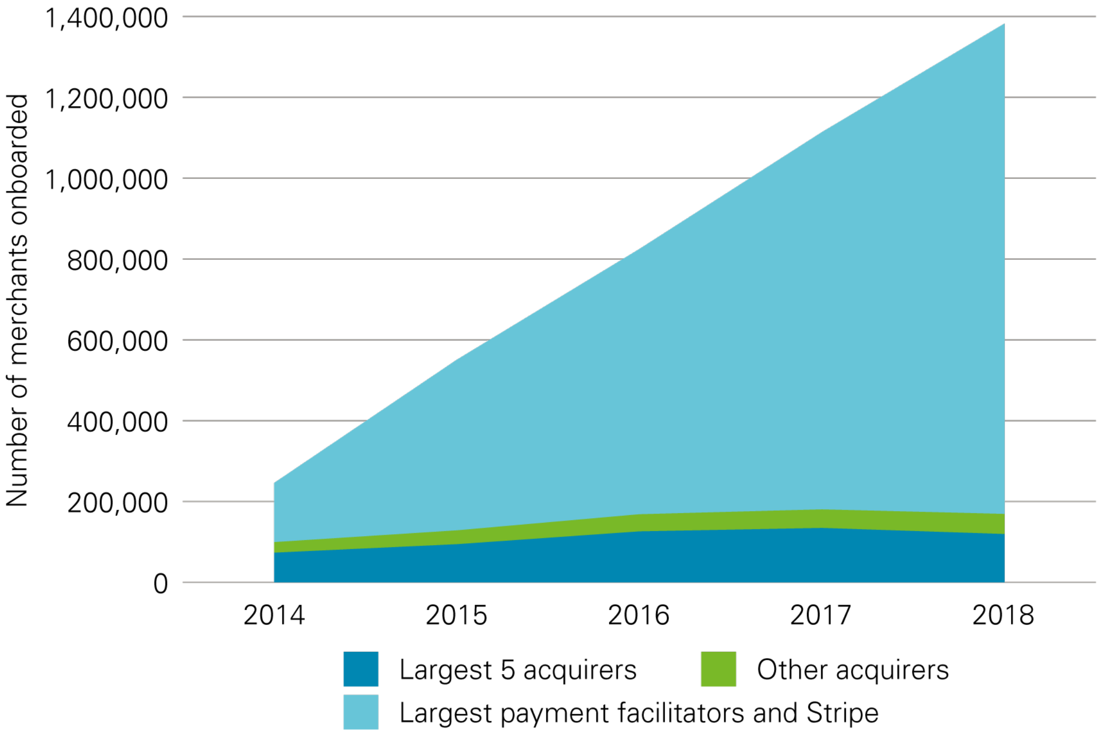
4.18 The largest payment facilitators serving merchants selling face-to-face have grown significantly in recent years. They have expanded the number of merchants accepting card payments by targeting merchants that were traditionally underserved by acquirers.

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 (and

49 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).

Stripe, which we discuss in paragraphs 4.31 to 4.35 to and which we group with the payment facilitators in Figure 7 because it was a payment facilitator for the period under consideration) has increased significantly. 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 offering of the largest payment facilitators that primarily serve merchants selling face-to-face – iZettle, PayPal (through its PayPal Here product), Square and SumUp – differs from acquirers' typical offering in several ways:

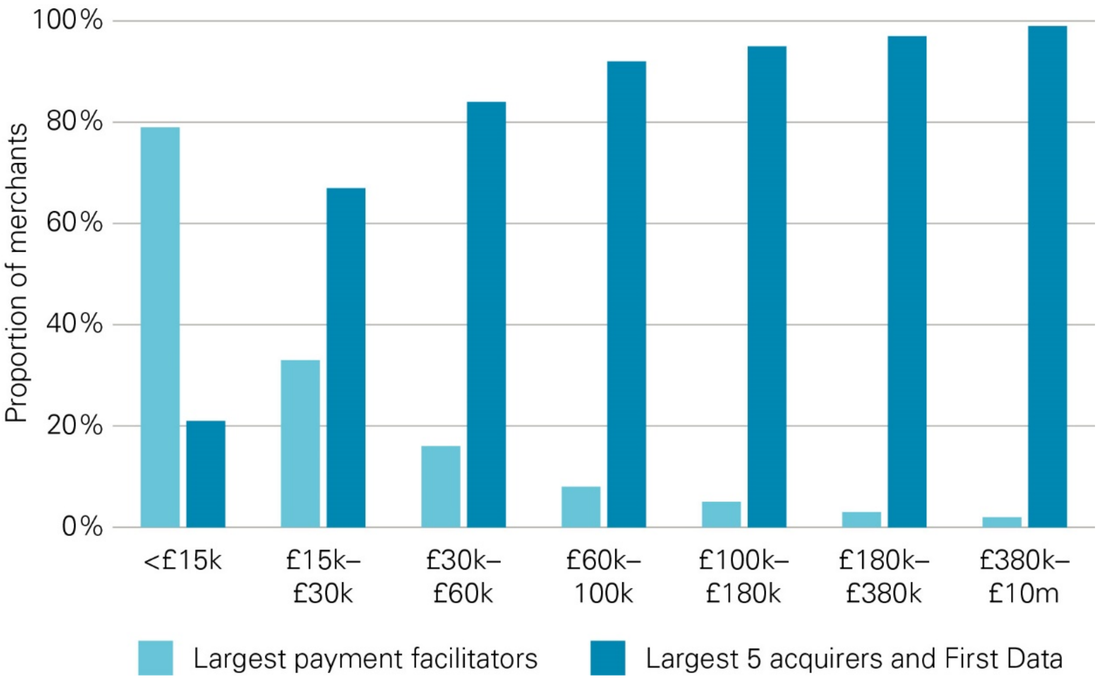
- They have **simple standard pricing** of card-acquiring services by applying one headline rate for card-present transactions (irrespective of the characteristics of a purchase transaction) and no additional fees (except for PayPal Here – see Annex 1). By contrast, acquirers' standard pricing typically consists 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 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.[50]

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%.

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.

50 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.

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.[51]

4.24 The largest payment facilitators use advertising on internet search engines and social media[52] 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.[53]

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 annual card turnover above $1 million must also contract with an acquirer.[54]

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. [✂] iZettle said that some acquirers may not consider iZettle 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).

51 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.

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

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

54 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.

4.29 However, 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[55] – characteristics that may be of more importance to merchants with higher annual card turnover. As set out in paragraph 4.21 – there is evidence that indicates the largest payment facilitators' offering is less price competitive as the value of card transactions accepted by merchants increases. Although in some cases, merchants can negotiate lower prices with the largest payment facilitators.

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 Stripe 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 EEA cards and one for non-EEA 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[56], 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.[57]
- 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.

55 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.

56 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.

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

- 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.

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[58], 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.[59]

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[60] – 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. iZettle, 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.

58 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.

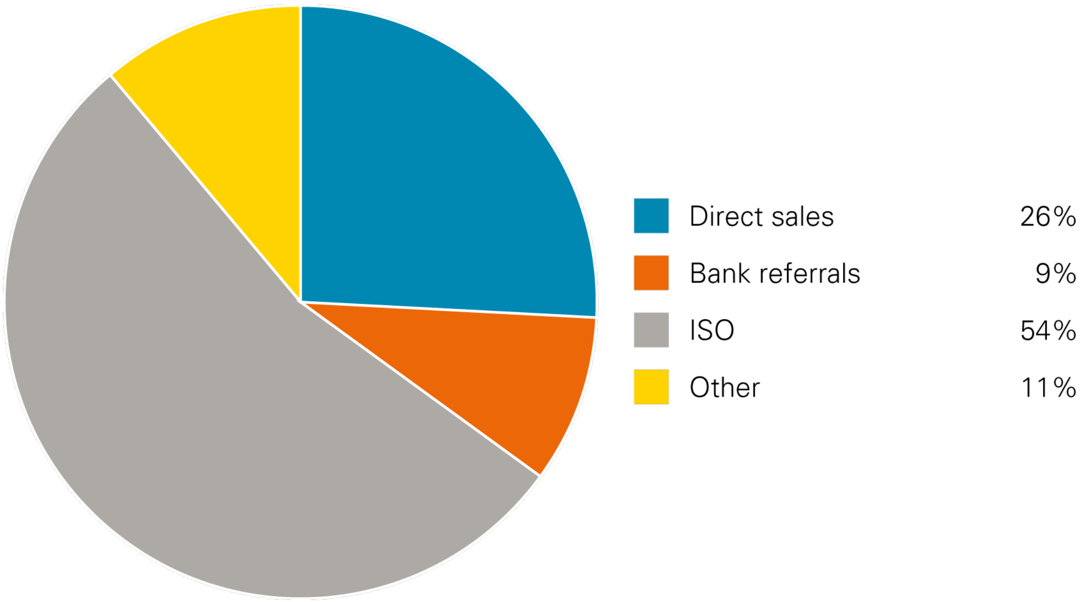
59 Excludes merchants that have never transacted or have only accepted test transactions. PSR analysis using data submitted by Stripe.

60 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[61]; Handepay, Paymentsense, takepayments, RMS and UTP are five of the largest and together have approximately 175,000 merchants at the end of 2018.[62]

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.

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.

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

62 PSR analysis of data provided by ISOs.

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 4.34) 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 4.74.

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 3.15). Around 35% of large merchants have IC+ or IC++ pricing; typically they are the largest merchants with annual card turnover above £50 million.[63]

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

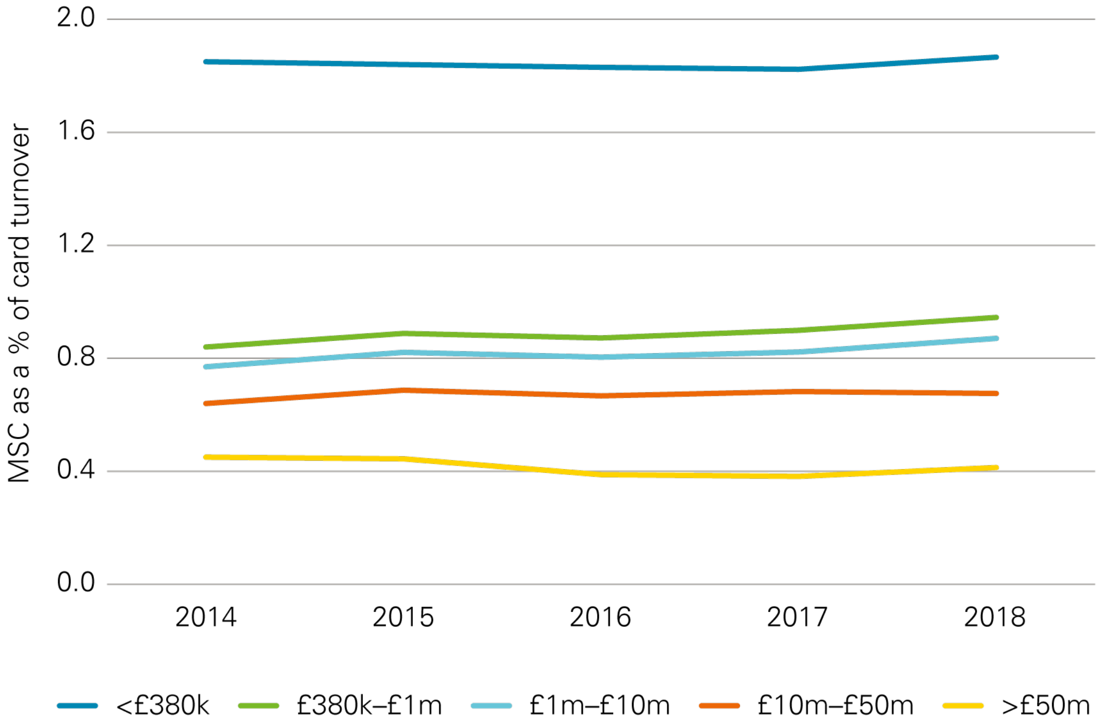
4.51 With IC+ and IC++ pricing, acquirers compete on the processing fee (also called a management fee), which is applied for each purchase transaction (and in some cases, for each refund). IC++ pricing automatically passes on interchange fees and scheme fees at cost to the merchant so the processing 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 the of 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.

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 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 4.52) – 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.
- 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).[64]
- 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).[65]

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 4.21).

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

65 PSR analysis of data submitted by the five largest acquirers.

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

- iZettle 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 heading 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 4.70).

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 4.26). 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 setup 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 4.44).

Barriers to entry and expansion

4.77 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, together with Barclaycard, serves [40-50]% of small and medium-sized merchants only or mainly selling face-to-face with annual card turnover above £60,000 and [40-50]% of merchants only or mainly accepting 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

4.78 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.

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

- the collateral requirements in scheme rules
- structure of Mastercard and Visa scheme fees
- economies of scale
- regulation
- referral relationships with banks and ISOs
- restrictions on payment facilitators

4.80 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
- 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
- restrictions on payment facilitators have not affected their ability to onboard merchants, and they have not expressed concerns about the restrictions
- 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

4.81 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 acquirer processors reduces advantages from economies of scale due to processing costs. In addition, we considered any advantages for larger acquirers from the structure of scheme fees was more likely to affect competition for the largest merchants. As set out in Chapter7, we our provisional finding is that these merchants can access information, assess their requirements and achieve good pricing outcomes despite sometimes facing significant switching costs.

4.82 We do not, therefore, consider any of the individual potential barriers to entry and expansion listed in paragraph 4.77 to be significant (except potentially the structure of scheme fees, which would be unlikely to affect providers serving small and medium-sized merchants and most large merchants).

4.83 Annex 5 presents our analysis in more detail.

4.84 Features that restrict merchants willingness and ability to search and switch may also be a barrier to entry and expansion; these are considered in Chapter 6.

Summary

4.85 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.

4.86 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 primarily focuses on acquiring card-not-present transactions for e-commerce 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 multi-national merchants. Adyen is a new entrant that has grown its share of supply of large merchants significantly in recent years.

4.87 An important development in recent years is the expansion of the largest payment facilitators – iZettle, 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.

4.88 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.

4.89 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.

4.90 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.

4.91 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.

4.92 Acquirers, the largest payment facilitators and ISOs compete for merchants based on price factors. Around 45% 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).

4.93 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.

4.94 We do not consider any of the individual potential barriers to entry and expansion that we assessed based on stakeholders' concerns to be significant for providers serving merchants with less than £50 million annual card turnover. Features that restrict merchants' willingness and ability to search and switch can also be a barrier to entry and expansion. Chapter 6 considers this in more detail.

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. It 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 may not be working well for these merchants. The evidence is slightly less clear for merchants with annual card turnover below £15,000.
- 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.
- Fees paid by acquirers to Mastercard and Visa or scheme services rose significantly from 2014 to 2018 and even after adjusting for changes in volume, value and mix of card transactions, they approximately doubled over this period. For merchants in all turnover groups, the evidence available to us and our current analysis indicates that scheme fees were passed through by acquirers in full.

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 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'. Generally, prices in a competitive market would, in the longer term, reflect input cost. A reduction in the input costs would therefore result in lower prices.[66] Limited or slow pass-through is one indicator that competition is weak.

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

5.3 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, and help create an integrated and competitive market for payment services. Annex 1 provides more information on the IFR.

5.4 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.

5.5 Before the launch of our market review, stakeholders raised concerns with us that acquirers had not passed through the IFR savings to smaller merchants.[67]

5.6 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.

5.7 Drawing on data obtained from the five largest acquirers, Mastercard and Visa, 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 pass-through rate varied between
  - merchants in the different segments introduced in Chapter 4, but with additional detail to allow us to examine any differences between merchants with varying levels of annual card turnover
  - acquirers' new and longstanding customers
- acquirers used IFR savings to invest in and improve their quality of service[68]
- scheme fees paid by acquirers increased
- acquirers passed through changes in scheme fees to merchants

5.8 We investigated these questions using both descriptive statistics and econometric analysis. In the descriptive statistics, we observed changes in average interchange fees[69] and average MSCs[70] between the periods before and after the IFR caps came into force,

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

68 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.

69 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.

70 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.

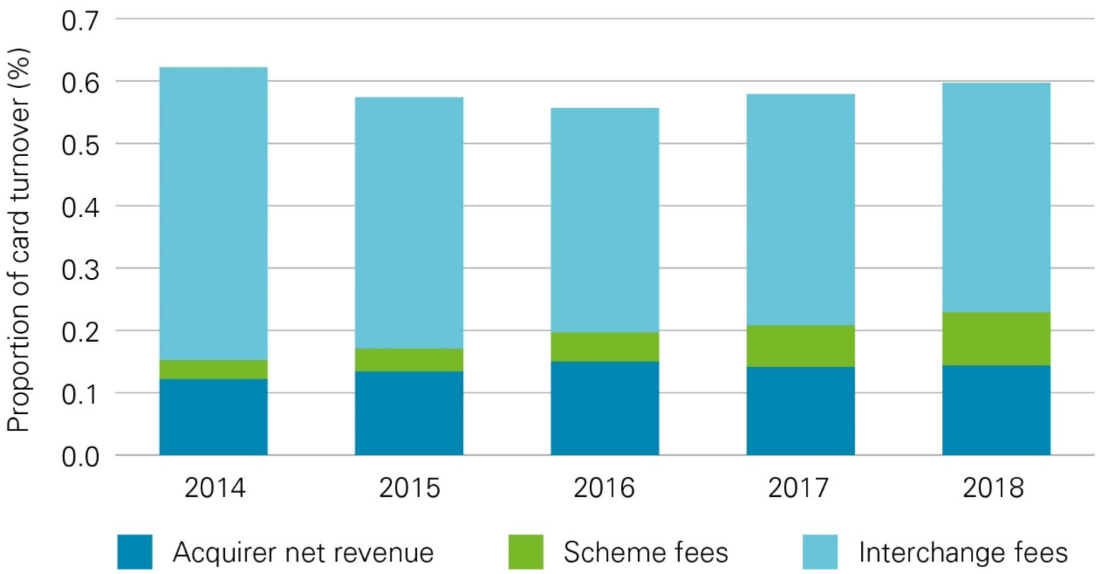
and examined whether they moved in parallel. However, MSCs may also have been affected by variables other than interchange fees over the period 2014 to 2018, including the characteristics of merchants within each size group, changes in the mix of transactions, or changes in scheme fees (see Annex 2 for 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

5.9 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

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.

5.10 We gathered financial information from the five largest acquirers (see Annex 3). Figure 11 shows aggregated interchange fees, scheme fees[71], 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 constant.[72] Approximately half of this reduction happened between 2014 and 2015 and the remaining half between 2015 and 2016.[73]
- **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.
- **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, then flattened off. This shows that acquirers increased their net revenue at the same time as interchange fees fell.

5.11 This analysis indicates that, overall, acquirers may not have fully passed on the IFR savings to merchants. At the same time, it indicates that acquirers may have passed on nearly all the scheme fee increases to merchants. This aggregate view does not distinguish between merchants of different sizes. Before the launch of this market review, stakeholders told us they were particularly concerned about IFR savings not being passed on to smaller merchants[74], and 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.

5.12 For more information on our aggregate-level analysis of MSCs, interchange fees, scheme fees and acquirer net revenue, please see Annex 3.

71 Figure 12 shows scheme fees for all four-party card payment systems. The vast majority of these are Mastercard and Visa fees.

72 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.

73 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.

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

Pass-through of IFR savings – descriptive analysis

5.13 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).

5.14 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 receive automatic pass-through this group serves as a useful comparator. There were fewer than ten merchants in our sample on IC+ pricing. These IC+ merchants are included in the aggregate analysis and excluded from the analysis of the different merchant groups.

5.15 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.

5.16 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 Figure 11.[75]

75 The main reason why the 'All merchants' figures in Table 3 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 in 2018 for over £100 billion of transactions (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.

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	-0.16	-0.15	-0.14	-0.15	-0.14	-0.13	0.06	-0.12	0.00
Difference in average MSC before and after IFR caps	0.02	0.04	0.03	0.02	0.00	0.03	0.09	-0.12	0.06

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

5.17 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.[76] 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 0.16 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 0.12 percentage points.

5.18 An exception are the largest merchants on standard pricing with annual card turnover greater than £50 million. This group saw an increase in average interchange fees. This appears to be because of a change in Visa's interchange fees after the IFR caps came into force that resulted in high-value transactions incurring higher interchange fees than before the IFR caps came into force (this is discussed further in Annex 2). The overall finding that the difference in interchange fees before and after the IFR caps came into force across all merchants is zero is heavily influenced by the largest merchants on standard pricing with annual card turnover greater than £50 million and the IC++ group.

5.19 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 interchanges fees were larger for those with lower annual card turnover.

76 We calculate average pre-IFR interchange fees as a percentage of card turnover by: (1) adding all observations relevant to the calculation being made (all merchants and all months for a particular group) for interchange fees that fall into the pre-IFR caps period; (2) adding all relevant observations (all merchants and all months) for transactions values that fall into the pre-IFR caps period; and (3) dividing the former by the latter; doing the same calculation for the post-IFR caps period; (5) subtracting the pre-IFR caps period from the post-IFR caps period.

5.20 In contrast to average interchange fees, average MSC rose by 0.06 percentage points for all merchants (again influenced heavily by the change in the relative weight of the largest merchants on standard pricing with annual card turnover more than £50 million and the IC++ group). However, looking across groups of merchants, there are notable differences:

- Merchants on IC++ pricing saw their average MSC fall 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 an increase in their average MSC of 0.09 percentage points closely aligned with the increase 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 increased slightly 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.

5.21 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 unchanged, or even rose, as interchange fees fell.

5.22 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

5.23 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.

5.24 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.

5.25 The results presented in this section focus on the evolution of the difference between the MSC and interchange fees ('the interchange fee margin'). This is a useful way to look at the relationship between the MSC and interchange fees because it allows for straightforward interpretation – if the interchange fee margin remains flat over time (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. We considered alternative ways of examining the relationship between the MSC and interchange fees as set out in Annex 2, but the key results 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	0.13	0.11	0.12	0.11	0.10	0.00	0.09
IFR effect	0.3261	0.1742	0.1390	0.1367	0.1141	0.1218	0.0459	-0.0225

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

5.26 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.

5.27 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 5.23. 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 the 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 little or no pass-through; if it is less than the IFR savings, it indicates partial pass-through.

5.28 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 (-0.0225). 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 5.14, 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 (0.0459). As with merchants on IC++ pricing, the interchange fee margin for this group remains flat. However, as explained above in paragraph 5.18, these merchants did not see a reduction in their average interchange fees following the IFR caps coming into force, so there were no IFR savings to be passed through. 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 that 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.

5.29 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). Overall, we do not place weight on the econometric results for this group and rely on the evidence of the descriptive statistics.

5.30 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).

5.31 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'[77] inability to switch acquirers and limited bargaining power may have impeded immediate changes to MSCs, reductions in interchange fees led to reductions in MSCs.[78] A study prepared to inform the European Commission's report estimates that from 2015 to 2017 interchange fees fell by €2,680 and MSCs declined by €1,200 from 2015 to 2017.

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

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

Over the same period, that study estimates the acquirer margin increased by €1,200 (after taking account of increases in scheme fees).[79] The European Commission also reports that merchants with 'unblended fees'[80], such as IC++ pricing, appear to have benefited 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.

5.32 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.

5.33 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.

Quality of service

5.34 Some acquirers told us that an alternative 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 rather than lower prices. 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.

5.35 The information we received showed that the five largest acquirers monitored a range of aspects of their performance, such as call centre and onboarding performance. [✂].

5.36 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.

5.37 In addition, 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).

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

80 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.

New and longstanding customers

5.38 We consider the possibility that acquirers may compete more intensively for new customers[81] 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.

5.39 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.

5.40 We present the complete analysis in Annex 2. In general, regardless of merchant size, new customers pay less. Small and medium-sized merchants who signed up with their acquirer within the previous year paid between 0.03 and 0.3 percentage points less than merchants who have been with their acquirer for several years. Large merchants with annual card turnover between £10 million and £50 million who signed up with their acquirer within the previous year paid between 0.03 and 0.07 percentage points less than merchants who have been with their acquirer for several years. Small and medium-sized merchants who signed up with their acquirer after the IFR caps came into force paid between 0.06 and 0.2 percentage points less than merchants who signed up with their acquirer before the IFR caps came into force. Large merchants with annual card turnover between £10 million and £50 million who signed up with their provider after the IFR caps came into force paid 0.05 percentage points less than merchants who signed up with their provider before the IFR caps came into force.

5.41 This shows that when merchants switch provider of card-acquiring services, they can secure better prices in the form of lower MSCs. It 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 5.28, some of the largest merchants may also have benefitted from switching to IC++ pricing after the IFR caps came into force.

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

Scheme fees

5.42 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 is 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.[82] 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.

5.43 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.

5.44 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.

5.45 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 represents a change in the level of the fees (that is, the price) or new fees being introduced. Our analysis focuses on mandatory[83] fees for scheme and processing services that are directly attributable to transactions[84] at UK outlets (see Annex 4 for a full explanation of our econometric methodology).

5.46 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[85] (see Annex 4 for a fuller description of the data).

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

83 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.

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

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

5.47 Average fees for scheme services per GBP transacted paid by acquirers to Mastercard and Visa between 2014 and 2018 – after controlling for increases in transaction volume and value and changes in mix – approximately doubled (see Annex 4). This indicates that there has been a significant increase in the level of fees for scheme services as a proportion of transaction value.

5.48 Average fees for processing services as a percentage of GBP transacted increased for Visa by [✂]. However, most of this increase occurred in 2018. We do 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 conclude that there is not enough evidence to assert that the level of fees for processing services have increased for Visa or Mastercard.

Pass-through of scheme fees

5.49 Our analysis confirms that, overall, fees for scheme services paid by acquirers to Mastercard and Visa increased significantly between 2014 and 2018. 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.

5.50 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. However, we have some concerns around 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.

Summary

5.51 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.

5.52 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.

5.53 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.

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

5.55 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 rely on the evidence of the descriptive statistics for this group.)

5.56 Taken together, this is robust evidence that, on average, merchants with annual card turnover up to £50 million got little or no pass-through of the IFR savings and indicates that the supply of card-acquiring services may not be working well for these merchants.

5.57 Our analysis also shows that small and medium-sized merchants with annual card turnover up to £10 million and large merchants with annual card turnover between £10 million and £50 million secured better deals in the form of lower MSC by switching their provider of card-acquiring services – on average, new customers pay less.

5.58 Some acquirers told us that an alternative 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 rather than lower prices. However, the data we reviewed did not show evidence of improved quality of service in the period. In addition, the information available from the acquirers on costs suggested that over the period, unit costs fell, which is not consistent with rising unit costs due to investments in quality of service over the period (although care needs to be taken in generalising, because this information related to only two acquirers).

5.59 Fees paid by acquirers to Mastercard and Visa for scheme services rose significantly from 2014 to 2018 and even after adjusting for changes in the volume, value and mix of card transactions, they approximately doubled over this period. For merchants in all turnover groups, the evidence available to us and our current analysis indicates that scheme fees were passed through by acquirers in full.

5.60 In the next chapter, we consider whether merchant behaviour may explain the pass-through findings.

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 identify three features that, individually and in combination, restrict small and medium-sized merchants' willingness and ability to search and switch, and result in worse outcomes for them:
    1. acquirer and ISO pricing
    2. the indefinite duration of merchant contracts for card-acquiring services
    3. POS terminal contracts with a long duration
- These features will also affect large merchants with annual card turnover between £10 million and £50 million, which share characteristics of small and medium-sized merchants.

Introduction

6.1 As set out in Chapter 5, on average merchants with annual card turnover up to £50 million received little or no pass-through of the IFR savings – indicating that the supply of card-acquiring services may not be working well for these merchants. Our analysis also shows that, on average, merchants who have switched their provider of card-acquiring services get a better deal.

6.2 This suggests 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.

6.3 We apply a well-known assessment – the 'three-As' framework[86] – 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

6.4 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)

6.5 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 share characteristics with small and medium-sized merchants.

6.6 We published for consultation a working paper[87] setting out our proposed approach to the merchant survey and the draft questionnaire.[88] 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 from one to two to qualify as an active merchant to avoid including in our sampling frame merchants that accept a test transaction and then never use card-acquiring services again. We lowered the

86 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.

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

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

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 [70-80]% coverage of the target population of small and medium-sized merchants.[89]
- We allocated merchants into strata based on their annual card turnover and operating environment (that is, the channels through which they accept card payments)[90] though not risk as we proposed in our working paper because Merchant Category Codes[91] were not sufficiently informative about the risk profile of an industry in which a merchant operates.
- We took steps to minimise for 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.

6.7 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

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

Large merchants

6.9 The evidence we collected showed that the largest merchants with annual card turnover above £50 million:

- are sophisticated buyers, who may use more than one provider of card-acquiring services, and typically engage in competitive tenders when selecting a provider
- face search costs, due to their complex requirements, but can overcome these through dedicated internal resource or by working with specialist consultants

89 PSR analysis of data provided by acquirers and payment facilitators

90 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)

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

- can incur significant costs when moving to a new provider due to the complexity of their requirements and the complexity of integrating payments with their systems, which can act as a switching barrier
- are in a relatively strong bargaining position with providers of card-acquiring services because of the significant revenue they generate for acquirers as a single customer

6.10 Chapter 5 showed that the largest merchants achieve better pricing outcomes than merchants with lower card turnover. Our provisional finding is that these merchants can access information, assess their requirements and achieve good pricing outcomes despite sometimes facing significant switching costs.

6.11 Chapter 5 showed that large merchants with annual card turnover between £10 million and £50 million achieve worse pricing outcomes than the largest merchants. Many large merchants in this category 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.[92]

Do small and medium-sized merchants search and switch?

6.12 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

Frequency of searching and switching

6.13 The merchant survey asked small and medium-sized merchants how often they search for providers[93] – that is, assess their own needs, access information about providers and compare provider offerings.[94] 43% of merchants reported that they never search and 17% said that they do so less than once every three years or hardly ever.[95] 30% search for providers at least once every two years.[96]

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

93 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.

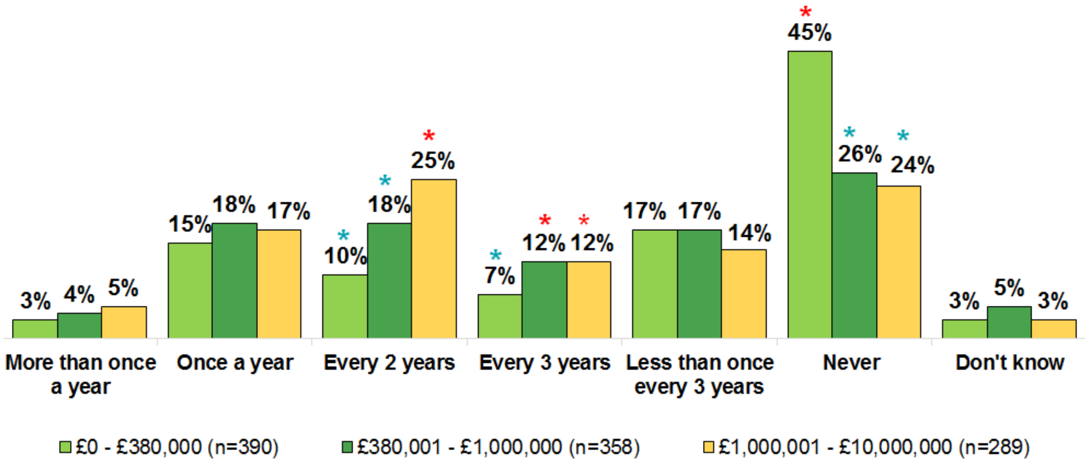
94 In the merchant survey, the term 'shop around' was used.

95 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.

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

6.14 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.

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.

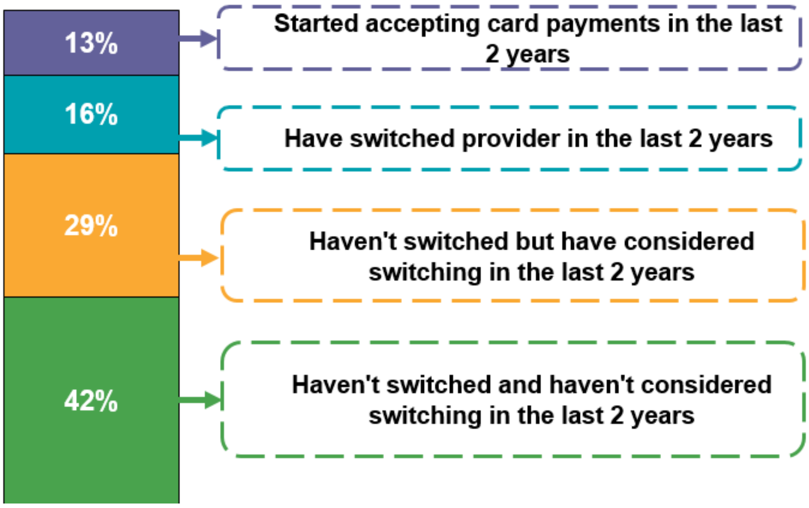
6.15 Figure 13 below shows that 16% of small and medium-sized merchants in the merchant survey switched in the last two years and 29% had considered switching but ultimately didn't switch. Most merchants that searched and considered switching compared three or more providers.[97] 42% of merchants had not considered switching their provider in the last two years. Of these, 61% reported they had never searched for other providers.[98]

6.16 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.[99]

6.17 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.[100] 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.[101]

97 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 82.
98 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 78.
99 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 23.
100 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 11.
101 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.

6.18 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.[102]

6.19 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.

6.20 We next consider whether merchants report any difficulties when searching and switching.

Ease of searching and switching

6.21 The merchant survey showed that 76% of merchants who recently switched found it easy.[103] 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.[104]

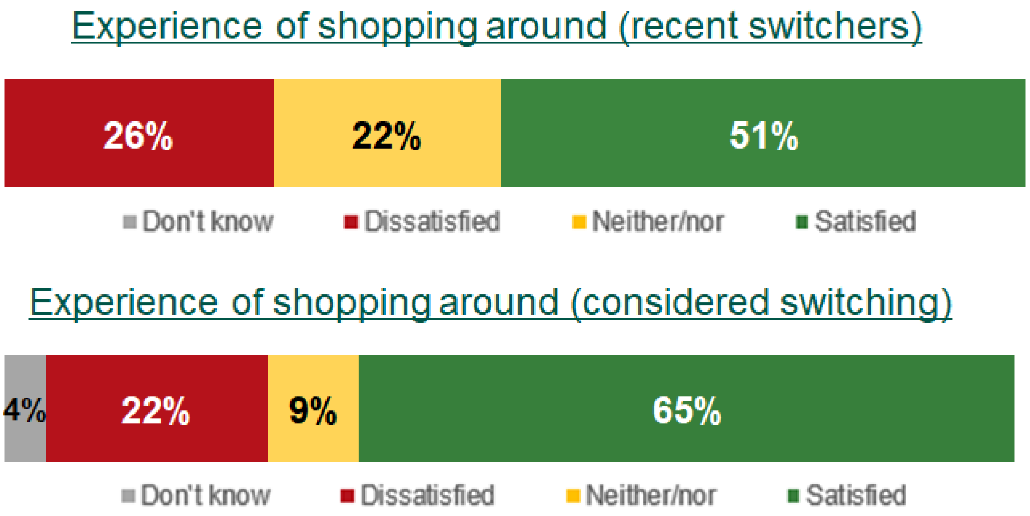
6.22 Figure 14 below shows that just over 50% of merchants that recently switched, and 65% of merchants that recently considered switching and searched for providers, reported that searching was easy. 26% and 22% of merchants, respectively, found it difficult.

102 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.

103 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 29

104 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 27

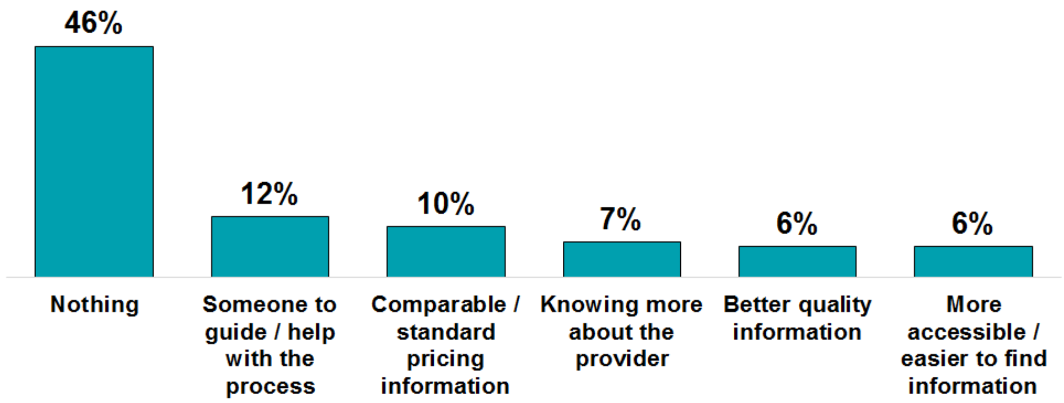
Figure 14: Small and medium-sized merchants' experience of searching (n=123, 250)



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%.

6.23 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.[105]

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.

6.24 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 30% of merchants stated that access to more comparable pricing information, knowing more about the provider, better quality and more accessible information would have made them feel more confident about deciding which provider to switch to.

105 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 36

6.25 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

6.26 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.[106]

6.27 In addition, all merchants report high satisfaction with:

- the customer service they received when they last contacted their provider[107]
- the level of information they received to help them comply with rules allowing them to accept card payments from customers[108]
- 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[109]

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

6.29 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).[110]

6.30 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[111]

6.31 In one survey submitted by an acquirer, merchants report that they don't switch because:

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

106 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 40.
107 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 16
108 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 17
109 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 17
110 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 25.
111 IFF Research, PSR Card-Acquiring Market Review: Merchant survey results, slide 27.

6.32 In a survey submitted by another acquirer, merchants were presented with a list of 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

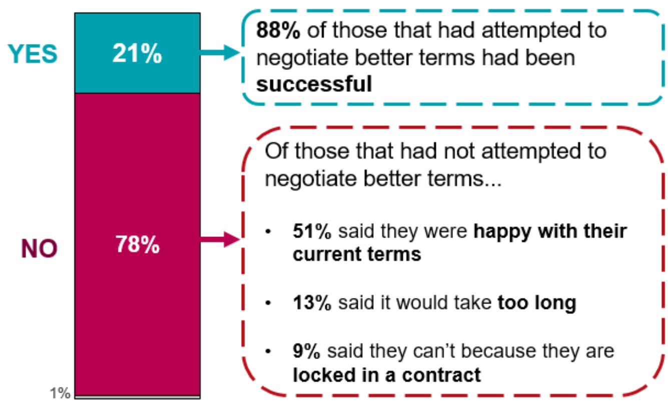
6.33 The results of both these surveys are broadly consistent with the merchant survey we commissioned and suggest merchants may face barriers restricting their willingness and ability to search and switch to a different provider.

Merchants' ability to negotiate a better deal

6.34 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.

6.35 Figure 16 shows that in the merchant survey, 78% of small and medium-sized merchants have never attempted to negotiate with their provider. 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.[112]

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.

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

6.36 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.[113] This shows that merchants can get a better deal if they consider switching their provider and may have some bargaining power if they threaten to switch.

Summary – searching and switching

6.37 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
- 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

6.38 We tested if certain types of merchants were 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)[114]
- providers as reported by the merchant (acquirer, payment facilitator, third party)

6.39 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 the smallest 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.

6.40 The other sources of survey evidence we reviewed to examine merchants' switching behaviour reveal some information about merchants' willingness and ability to search and switch. They reveal high levels of merchant satisfaction and some potential barriers to searching and switching to a different provider – for example, due to difficulties understanding pricing, being locked into contracts or having other priorities.

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

114 We collected 69 responses from online-only merchants. We therefore undertook internal 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.

Features affecting merchants' willingness and ability to search and switch

Introduction

6.41 We now examine whether the following – identified through the merchant survey, other surveys we've seen and concerns raised by parties during the market review – affect merchants' willingness and ability to search and switch and ultimately contribute to the price outcomes we observe:

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

Pricing

6.42 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.

6.43 Generally, merchants cannot access easily 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)
- giving permission for a third party to provide their contact details (and potentially other information) to the acquirer or ISO

6.44 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.

6.45 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

6.46 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)

6.47 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.

6.48 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.

6.49 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 issued cards
- involve commercial cards

6.50 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.

6.51 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).

6.52 The variability of pricing makes 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).

6.53 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.

6.54 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.

6.55 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 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.

- Article 9(1) of the IFR requires that acquirers offer and charge MSCs[115] broken down for the various different categories[116] of cards and different brands of cards (such as Mastercard and Visa) with different interchange fee levels unless the merchant in writing requests to be charged a 'blended' MSC.
- 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 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.

6.56 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.[117] Article 12 aimed to improve transparency of the MSC.[118]

6.57 The European Commission's report on the application of the IFR found that the majority of merchants have unblended MSCs and that merchants with unblended MSCs appear to have benefited most from IFR savings. However, the European Commission cautions that there is some uncertainty about whether small retailers[119] have unblended MSCs due to limited responses to the survey conducted to inform the report and argues they may be inclined to request blended MSCs because of limited administrative capacity to manage a large number of fees and complex fee structures. The European Commission recommends further monitoring and evidence gathering on the implementation of transparency requirements in the IFR.[120] We have a programme of work outside the market review that monitors compliance with the IFR.

6.58 Taken together, the absence of published prices, and the complexity of comparing prices quoted by different firms due to the variation in pricing structure, creates a search cost for small and medium-sized merchants that restricts their willingness and ability to search and switch, or negotiate a better deal.

115 See footnote 27.

116 See footnote 28.

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

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

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

120 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.

Merchant contracts and interoperability

6.59 We reviewed a sample of standard contracts with merchants:

- The five largest acquirers' contracts for card-acquiring services and, where applicable, POS terminal hire.
- 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).

6.60 To examine whether these contracts could contribute to the searching and switching behaviour we have observed for small and medium-sized merchants, 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.

6.61 Acquirers generally have different card-acquiring services contracts (and, in some cases, different terms for POS terminal hire) for merchants of different sizes (and categorise merchants by size differently – see Chapter 4). Many merchants that we categorise as large merchants are on the same contracts for card-acquiring services or have the same terms for POS terminal hire as those we categorise as small and medium-sized merchants.

6.62 We also collected evidence on interoperability 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

6.63 Merchants have a statutory right to terminate their card-acquiring services contract at any time – unless a notice period of not more than one month has been agreed. Also, once the contract has been running for at least six months, the acquirer can't apply a termination fee.[121]

6.64 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.

6.65 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 in the first six months of the contract. As a result, it doesn't appear that the initial term in these contracts would restrict merchants' ability to switch.

6.66 The PSRs 2017 require PSPs (including acquirers and payment facilitators) in certain circumstances to notify the merchant of proposed changes to the contract for card-acquiring services before such changes are due to take effect.[122] If the contract provides that the PSP may make any proposed changes unilaterally when the merchant doesn't reject such proposed changes before the date of their entry into force, merchants have the right to terminate their contract, without incurring fees, by giving notice to the provider at any time before that date. In practice, a merchant

121 Regulation 51 of the PSRs 2017.
122 Regulation 50 of the PSRs 2017.

would need to find another provider before any such proposed change takes effect if they decided they were not happy with a change to their terms and conditions and wanted to switch.

6.67 Once any initial term expires, typically the contracts automatically continue until terminated or, in the case of one acquirer, the contract renews for successive one-year terms. Whether or not there is an initial term, the contract continues indefinitely, until the contract is terminated by either party in accordance with the terms of the contract.

6.68 The indefinite duration of contracts for card-acquiring services doesn't provide a clear trigger point for merchants to think about searching for another provider and switching and, for this reason, isn't in merchants' interests. This feature explains, at least in part, why we find many merchants don't consider switching or searching for other providers regularly, if at all.

Payment facilitator contracts for card-acquiring services

6.69 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.

6.70 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).

6.71 When a merchant contracts with a payment facilitator for card-acquiring services, 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 and, for this reason, are not in merchants' interests. This feature explains, at least in part, why we find many merchants don't consider switching or searching for other providers regularly, if at all.

ISO and acquirer contracts for POS terminals

6.72 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 small and medium-sized merchant switching provider will generally need to terminate their contract for card-acquiring services and their contract for their POS terminal together

6.73 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.

6.74 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.

6.75 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.[123] 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. For the majority of the five largest acquirers, the contractual terms around POS terminal hire will be the same for merchants of all sizes.
- 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.

6.76 Typically, where a merchant does not source POS terminals itself, the POS terminal supplied (whether by an acquirer, ISO or third-party POS terminal provider) is compatible with only one acquirer. We understand that this is because POS terminals are configured by manufacturers 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.

6.77 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 make it hard for merchants to terminate the contract and therefore affect merchant searching and switching behaviour in relation to card-acquiring services.

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123 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.

6.78 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. In the contracts regulated by the CCA, the merchant has a statutory right, subject to meeting certain conditions, to terminate the POS terminal hire contract without charge by giving one month's notice (if the merchant pays monthly) after the contract has run for 18 months.

6.79 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.

6.80 The contracts we've reviewed have initial terms ranging from [✂] to [✂]. In contracts regulated by the CCA, the initial term is set at 18 months.

6.81 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 not regulated by the CCA 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 an initial term of less than 3 years (between 12 and 24 months depending on the firm).

6.82 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.[124]

6.83 Merchants with long initial terms in their POS terminal contracts could face significant costs if they want to switch before the end of the initial term. These costs will affect 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. While monthly fees for POS terminals can be lower for contracts of longer duration, we have not seen evidence that explains why initial terms of three years or more, which are significantly longer than in POS terminal hire contracts regulated by the CCA, are in merchants' interests given the barrier they create to searching and switching.

6.84 Several acquirers said they do not always enforce early termination fees stipulated for 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.

6.85 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

124 Merchants typically rent terminals for between £10 and £40 per terminal per month.

the end of the renewal term, otherwise the contract will renew for another term. These restrictions on the merchant's right to terminate will discourage merchants from searching for other providers and create a barrier to switching.

Contracts for payment gateways

6.86 Contracts for payment gateways[125] 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

6.87 Many firms offer payment gateways, including acquirers, ISOs[126], payment facilitators and gateway providers.

6.88 Gateway providers are firms that specialise in providing payment gateways. They do not provide card-acquiring services.[127] 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.

6.89 Many small and medium-sized merchants prefer to one-stop-shop, and as explained in Chapter 3, acquirers' and payment facilitators' typical offering for a merchant selling online includes card-acquiring services and a payment gateway.

6.90 Based on information from ten acquirers, we note that in some (but not all) cases, acquirers' payment gateways are acquirer agnostic – that is, 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.

6.91 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.

125 In this section, where we refer to payment gateways we mean payment gateways for e-commerce transactions.

126 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.

127 Annex 1 provides more information on gateway providers.

6.92 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.

6.93 Generally, the largest payment facilitators do not offer standalone 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.[128] The terms are the same as for card-acquiring services (see paragraph 6.58).

Summary

6.94 The merchant survey showed that small and medium-sized merchants tend not to regularly search, consider switching their provider or negotiate with their provider. Most merchants reported high levels of satisfaction with their current provider and this was frequently cited as a reason for not searching and switching. However, some merchants also reported they had not searched or switched due to lack of business resources and other surveys we've seen – while also finding high levels of merchant satisfaction – reveal some potential barriers to searching and switching to a different provider.

6.95 We examined whether the following factors affect small and medium-sized merchants' willingness and ability to search and switch, and ultimately contribute to the price outcomes we observe:

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

6.96 The factors we examined were identified based on the merchant survey we commissioned to inform our market review, other surveys we've seen and concerns raised by parties during the market review.

128 Merchants using PayPal Pro that have custom pricing may pay separate fees for a payment gateway. [✂].

6.97 We provisionally find three features of concern which, individually and in combination, restrict small and medium-sized merchants' ability and willingness to search and switch:

- **ISO and acquirer pricing** creates significant search costs for merchants because of the absence of published prices and the complexity of comparing pricing.
- **The indefinite duration of merchant contracts for card-acquiring services** doesn't provide a clear trigger point for merchants to think about searching for another provider and switching and, for this reason, isn't in merchant's interests. This applies to both acquirer and payment facilitator contracts. Small and medium-sized merchants that grow their card turnover, after a certain point, will 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 too much.
- **ISO and acquirer POS terminal contracts** with long initial terms or which automatically renew for successive fixed terms represent a barrier to switching. Typically, a POS terminal from an acquirer or ISO (or from a third-party POS terminal provider working with such firms) cannot be used with another provider of card-acquiring services. To change provider of card-acquiring services, merchants need to terminate their POS terminal contract. Long initial terms, of three to five years, or contracts that automatically renew for successive fixed terms, where the merchant cannot terminate before the end of the minimum or renewal term without incurring early termination fees, affect merchants' willingness to search for other providers and switch and are not in merchants' interests. Some merchants will be prevented from switching to a different provider because the financial cost of doing so is too high. Some merchants may be able to absorb this cost, but many will be unwilling to do so.

6.98 We provisionally find that acquirer and gateway provider contracts for payment gateways are unlikely to restrict merchants' willingness and ability to search and switch acquirer.

6.99 Although large merchants with annual card turnover of between £10 million and £50 million weren't covered by the merchant survey, many are clustered at the lower end of this turnover range. Many have the same contracts for card-acquiring services and the same terms when contracting for POS terminals, and also have the same pricing options, as small and medium-sized merchants. Therefore, the features that restrict small and medium-sized merchants' ability and willingness to search and switch will affect many large merchants with annual card turnover between £10 million and £50 million.

7 Provisional findings and next steps

Provisional findings

Card-acquiring services

7.1 The aim of this review is 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 includes considering whether any aspects might also 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 provisional findings relate to card-acquiring services for these card payment systems.

7.3 We use 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. 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 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 card transactions.

7.4 Both our pass-through analysis and merchant survey use these broad segments to facilitate and present their analysis and consider some additional sub-segments within the broad card turnover groups.

7.5 The IFR caps coming into force in December 2015 forms an important backdrop to this review. The IFR introduced caps on interchange fees paid by acquirers to issuers for consumer debit and credit card transactions where the acquirer and issuer are in the EEA, but did not cap MSCs paid by merchants.

7.6 Instead, the IFR relied on competition between providers of card-acquiring services to ensure that the cost savings they realised were passed through to merchants. We investigated the extent to which the IFR savings were passed through to merchants by acquirers and used this as an indicator for how well the supply of card-acquiring services is working.

7.7 Overall, a majority of the available IFR savings were passed through to merchants because merchants on IC++ pricing – typically the largest merchants – received full pass-through. Although few in number, this group is responsible for around 77% of the value of transactions at UK outlets. We estimate the benefit of the savings to these merchants was around £600 million in 2018.

Small and medium-sized merchants

7.8 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).

7.9 For most acquirers serving merchants selling face-to-face with annual card turnover up to £1 million, ISOs are an important sales channel and accounted for 50% of all customers 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.

7.10 In recent years, the largest payment facilitators – iZettle, PayPal (through its PayPal Here product), Square and SumUp – have expanded significantly. They predominantly serve merchants with low levels of card turnover selling face-to-face and 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, 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.

7.12 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. Stripe accounts for a large proportion of the smallest merchants that only or mainly sell 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.

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 by EVO Payments and Tyl by NatWest.

7.15 Despite having several providers to choose from, our pass-through analysis provides robust evidence that, on average, merchants with annual card turnover up to £50 million served by the five largest acquirers got little or no pass-through of the IFR savings. This indicates the supply of card-acquiring services may not be working well for small and medium-sized merchants (and large merchants with annual card turnover between £10 million and £50 million).

7.16 Some acquirers told us that an alternative 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 rather than lower prices. However, the data we reviewed did not show evidence of improved quality of service from 2014 to 2018.

7.17 The pass-through analysis is based on data from the five largest acquirers, so its conclusions do not apply to merchants who are customers of the largest payment facilitators, who serve nearly 80% of merchants with annual card turnover below £15,000 that only or mainly sell face-to-face. The entry and expansion of the largest payment facilitators may have delivered good outcomes for their customers, but it has not put sufficient competitive pressure on the largest acquirers to improve the pricing outcomes for their merchants.

7.18 Our analysis also shows that, while small and medium-sized merchants did not receive pass-through of IFR savings from their existing provider, they could secure better deals in the form of lower MSCs either by switching to a different provider of card-acquiring services or by negotiating with their existing provider.

7.19 However, in order to benefit from choice and better deals, merchants need to be willing and able to search and consider switching.

7.20 The merchant survey showed that many small and medium-sized merchants don't regularly (if ever) search for providers and rarely consider switching their provider. In addition, only around 20% of merchants have ever attempted to negotiate a better deal with their existing provider, so merchants' ability to negotiate a better deal doesn't explain the limited searching and switching we observe.

7.21 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.

7.22 Merchants generally report few difficulties with searching and switching, and report high levels of satisfaction with their provider. However, many merchants have little to no experience of assessing their own needs, accessing information (including prices) about different providers and assessing that information – so they won't be able to tell if they are getting a good deal or not.

7.23 Some merchants report business resources as a reason for not searching and thinking about switching, reflecting the fact that there is a cost involved in searching for different providers. Other surveys we have seen reveal similarly high levels of satisfaction but also some barriers to searching and switching, such as difficulties understanding pricing, being locked into contracts and having other priorities.

7.24 We provisionally find three features, which individually and in combination, restrict small and medium-sized merchants' ability and willingness to search and switch:

- **ISO and acquirer pricing** creates significant search costs for merchants because of the absence of published prices and the complexity of comparing pricing.
- **The indefinite duration of merchant contracts for card-acquiring services** doesn't provide a clear trigger point for merchants consider switching, searching or negotiating with their provider and, for this reason, isn't in merchant's interests. This applies to both acquirer and payment facilitator contracts. Small and medium-sized merchants that grow their card turnover, after a certain point, will 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 too much.
- **ISO and acquirer POS terminal contracts** with long initial terms or which automatically renew for successive fixed terms represent a barrier to switching. Typically, a POS terminal from an acquirer or ISO (or from a third-party POS terminal provider working with such firms) cannot be used with another provider. To change provider of card-acquiring services, merchants need to terminate their POS terminal contract. Long initial terms, of three to five years, or contracts that automatically renew for successive fixed terms, where the merchant cannot terminate before the end of the minimum or renewal term without incurring early termination fees, affect merchants' willingness to search for other providers and switch. Some merchants will be prevented from switching to a different provider because the financial cost of doing so is too high. Some merchants may be able to absorb this cost, but many will be unwilling to do so.

7.25 These features are consistent with the outcomes we observe, where small and medium-sized merchants, on average, got little or no pass-through of the IFR savings and new customers pay less than existing customers.

7.26 Our provisional finding is that the supply of card-acquiring services does not work well for small and medium-sized merchants. This is explained by a combination of features that restrict their willingness and ability to search and switch and result in worse outcomes for them. Remedying these three 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.

Large merchants

7.27 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 primarily focuses on acquiring card-not-present transactions for e-commerce merchants.

7.28 Most of these acquirers also serve 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 multi-national merchants. Adyen (a new entrant) has significantly grown its share of supply between 2014 and 2018.

7.29 The largest merchants – which have annual card turnover above £50 million – can access information about providers and assess their requirements. While they sometimes face significant switching costs, including because of the complexity of integrating payments with their systems, they achieve good pricing outcomes. Our provisional finding is that the supply of card-acquiring services works well for them.

7.30 On average, large merchants with annual card turnover between £10 million and £50 million got little or no pass-through of the IFR savings, just like small and medium-sized merchants. This indicates that the supply of card-acquiring services may not be working well for them. Our analysis also shows that these merchants secured better deals, in the form of a lower MSC, if they switched their provider of card-acquiring services.

7.31 While these merchants weren't covered by the merchant survey, many have the same sorts of contracts for card-acquiring services and POS terminals and the same types of pricing options as small and medium-sized merchants. The features which restrict the searching and switching behaviour of small and medium-sized merchants will affect this group in the same way. Our provisional finding is therefore that the supply of card-acquiring services does not work well for them.

Scheme fees

7.32 Aggregate scheme fees are smaller than interchange fees as a proportion of card turnover. However, they represent a non-negligible component of the MSC.

7.33 Fees paid by acquirers to Mastercard and Visa for scheme services rose significantly from 2014 to 2018 and even after adjusting for changes in the volume, value and mix of card transactions, they approximately doubled over this period. For merchants in all turnover groups, the evidence available to us and our current analysis indicates that scheme fees were passed through by acquirers in full.

Action we're considering

7.34 Our provisional findings identify features that are causing harm to small and medium-sized merchants with annual card turnover up to £10 million and large merchants with annual card turnover up to £50 million.

7.35 We're considering actions to remedy these features that restrict those merchants' willingness and ability to search and consider switching provider. At this stage, we briefly outline our objectives and some potential high-level approaches we could take. We welcome early feedback and alternative proposals from stakeholders on how we could effectively address the concerns we have identified.

7.36 We expect to carry out further detailed work to consider the most effective way to design and implement any remedies. Remedies are contingent on our final conclusions.

Contracts for card-acquiring services

7.37 The indefinite duration of merchant contracts for card-acquiring services do not provide a clear trigger point for merchants to think about searching for another provider and consider switching.

7.38 We want to encourage merchants to shop around more regularly – evaluating if their current provider still offers the best deal and considering alternative providers or renegotiating with their current provider.

7.39 We're considering a remedy requiring all contracts for card-acquiring services to have an end date. This would apply to both acquirer and payment facilitator contracts.

7.40 This remedy would be targeted at contracts with small and medium-sized merchants and large merchants with annual card turnover of up to £50 million. However, rather than using an annual card turnover limit, there may be more practical ways to target merchants in this segment, such as applying the remedy to all merchants on standard pricing (many merchants with annual card turnover up to £50 million have standard pricing).

7.41 Contracts with no end date may provide benefits for some merchants. For example, merchants who want to renew with their provider do not need to invest time in agreeing a new contract and they also protect merchants by providing continuity of service for those who have forgotten to renew. This is something we would consider further if we decide to develop this remedy.

ISO and acquirer POS terminal contracts

7.42 To change provider of card-acquiring services, merchants need to terminate their POS terminal contract because they cannot use their existing POS terminal (where this is provided by an acquirer or ISO directly or by partnering with a third-party POS terminal provider) with another acquirer. Some POS terminal contracts offered by acquirers and ISOs (or by third-party POS terminal providers working with such firms) have long initial terms, of three to five years, and/or automatically renew for successive fixed terms and also include early termination fees. These contracts act as a barrier to switching.

7.43 We don't want POS terminal contracts to be a barrier to merchants changing their provider of card-acquiring services.

7.44 The remedies we're considering include:

- Limiting the length of POS terminal contracts, for example to align with the 18-month limit set in the Consumer Credit Act 1974.
- Ending POS terminal contracts that automatically renew for successive fixed terms.
- Linking the contracts for card-acquiring services and POS terminals, where they are sold together as a package by acquirers or ISOs. For example, by making it easy to exit POS terminal contracts if terms change in the card-acquiring services contract (including price) without incurring termination fees.[129]

7.45 These remedies would apply to acquirers and ISOs. They would not apply to payment facilitators, who sell card readers to merchants upfront.

7.46 They would be targeted at small and medium-sized merchants and large merchants with annual card turnover of up to £50 million. However, rather than using an annual card turnover limit, there may be more practical ways to target merchant in this segment (see paragraph 7.39).

129 Note that the PSRs 2017 require that contracts for card-acquiring services can be terminated without charge after the initial term of six months.

7.47 Longer POS terminal rental contracts may provide some benefits to merchants, for example by reducing the monthly fee merchants pay for hiring a POS terminal. Lengthier contracts may also help new firms establish themselves in the small and medium-sized merchant segment and compete with others. This is something we would consider further if we decide to develop one of these remedies.

ISO and acquirer pricing of card-acquiring services

7.48 ISO and acquirer pricing of card-acquiring services discourages searching and switching due to the absence of published prices, and the complexity of comparing quotes, which together create a search cost for small and medium-sized merchants and large merchants with annual card turnover up to £50 million.

7.49 Once a merchant has decided to shop around, we want to make it easy for them to research prices and compare different offerings.

7.50 The aims of a remedy in this area would be to i) facilitate shopping around and increase customer awareness of the prices and offerings of different firms, and ii) enable easy comparison of firms' prices.

7.51 There are already obligations on acquirers to provide information to merchants on their prices. The IFR requires acquirers to offer and charge MSCs broken down for the various different categories of cards and different brands of cards 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 card in their agreements with merchants (Article 9(2)). Article 12 IFR requires that merchants' PSP provide (or make available) certain information to the merchant on each card transaction (Article 12). The PSRs 2017 include requirements to provide information on all charges payable (Regulation 48) and provide certain information on transactions (Regulation 54).

7.52 A remedy in this area would be designed to complement existing requirements and could take several forms, including:

- enabling or enhancing tools to facilitate price comparison for merchants
- requiring acquirers and ISOs to provide pricing information in an easily comparable format

Stakeholder feedback and next steps

7.53 We welcome stakeholder feedback on our provisional findings and potential remedies, including on the following questions:

1. Do you have views on the provisional findings set out in this report?
2. Do you have views on the potential remedies set out in this report? What are the potential benefits, challenges and unintended consequences that may arise from these, both individually and as a package?
3. Do you think there are other remedies that we should be considering? If so, what remedies and how do you think they would address the concerns we have identified?
4. How does COVID-19 impact on our review?

7.54 We also want to hear from industry about actions it might take to address the features of concern we have identified.

7.55 The consultation on our interim report will close on Tuesday 8 December 2020.

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