

Consultation by the Board of Link Scheme Holdings Ltd
LINK's Interchange Rate
Public

1st November 2017

Purpose of this Consultation

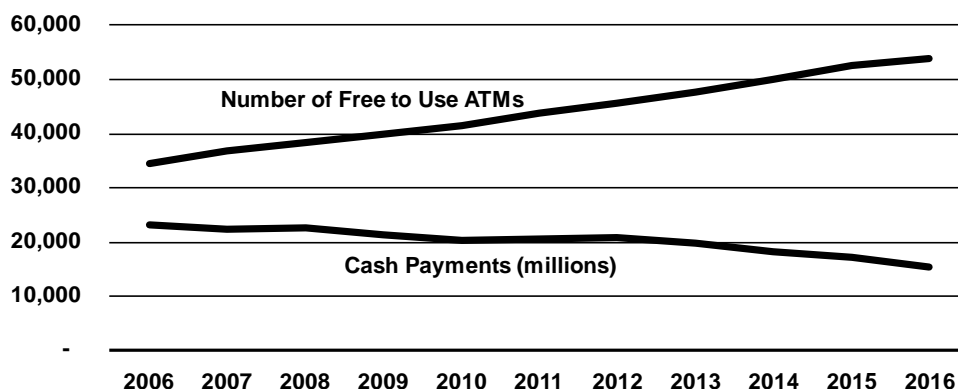
1. Within the next few weeks, it is intended that responsibility for setting interchange rates will move from the Members of LINK to the Board of LINK, in order to meet the requirements of the Bank of England's Governance Code of Practice.
2. The Working Group which has been reviewing interchange met on Monday 9th October. It concluded that, as LINK's Board will become responsible for interchange towards the end of this year, the consideration of the issue should pass to the Board immediately.
3. This Consultation sets out the proposed approach of the Board of Link Scheme Holdings Ltd to setting interchange. It is structured as follows:
 - a. The Board's objectives for LINK's interchange.
 - b. The principles that the Board has adopted in reaching its interchange proposal.
 - c. The Board's proposal.
 - d. Consultation questions.
 - e. Impact assessment.
 - f. Appendices.
4. The views of Members and of the LINK Consumer Council are sought to the consultation's questions by 30th November 2017.
5. Responses will be confidential to the Board of LINK and will not be published by the Board. However, a summary of views will be published when the final decision is made.
6. The Board will consider all of the responses received in reaching its final decision. The aim will be to set an interchange approach that is in the interests of UK consumers, and in line with Link Scheme Holdings Ltd's Objects and its role as the regulated operator of the systemically important LINK payment system.
7. Members and the LINK Consumer Council are invited to comment on this basis. The Board notes that Members have a competitive choice of ATM networks in the UK, can negotiate interchange bilaterally under LINK's rules, and can use surcharging as an alternative revenue model. The Board is not aiming to influence the business models of individual Members.
8. It is expected that the final decision will be published by 31st January 2018 and implemented by 1st April 2018.
9. During 2017, there have been detailed discussions between a group of eight LINK Members under the instruction of the (now abolished) Network Members Council to seek to agree a revised formula for setting interchange rates. These discussions have

not led to a firm agreement, although they have confirmed Members' commitment to consumers and financial inclusion, and developed a greater understanding of the issues associated with ATM provision. A summary of the Working Group's proposals, as far as they were developed, is included as Appendix 1 for information.

The Board's Objectives for LINK's Interchange

10. The Board is particularly mindful of its public interest remit and of the obligations placed on it as a regulated payment system operator. Its overriding objective in setting LINK's interchange is to operate the LINK Network in a way that meets the reasonable demands of the public for access to cash and other banking services, including in areas where standard interchange rates are not adequate to support ATMs but there is consumer need.
11. The Board is committed to retaining free access to cash for as long as required by consumers and with a broad national geographical coverage of ATMs. This means that the Board, in relation to any changes to interchange, will maintain LINK's support for:
 - a. Free machines in areas of consumer demand.
 - b. Financial inclusion subsidies, where demand is insufficient to justify a machine receiving standard interchange rates and where there is consumer financial detriment arising as a result of the lack of an ATM. In particular, LINK intends to continue to use and strengthen the well-established Financial Inclusion Programme. The Programme's key parameters will be retained, including the 1 kilometre distance to a free machine criterion for subsidy for all of the most deprived areas in the country (defined as the lower quartile of all Super Output Areas ranked by deprivation).
12. The Board anticipates that overall numbers of free-to-use machine will reduce as consumer demand for using cash as a mechanism for making payments drops. Currently, the number of free ATMs is increasing despite declining consumer demand for cash for making payments (see Exhibit 1 comparing consumers' use of cash for payments with the total number of free ATMs over time). It is difficult to see how a sustainable system can be based on these trends continuing in the future.

Exhibit 1: Number of Free ATMs versus Consumer Cash Payments



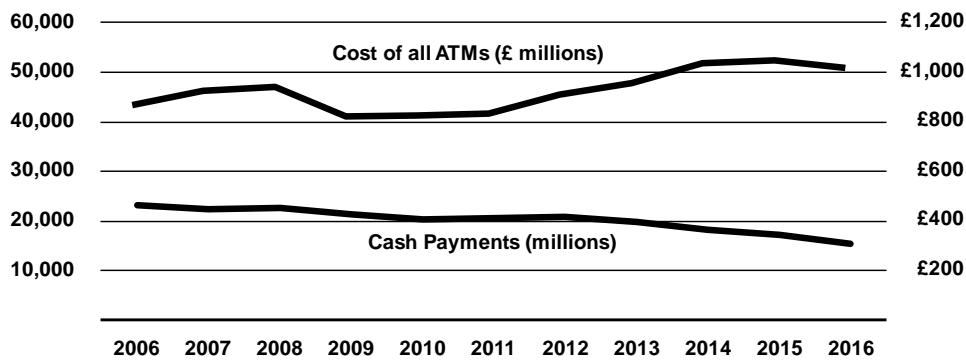
Total Cash Payments: Payments UK, UK Payments Markets 2017.
 Number of ATMs: LINK Data.

13. The Board's fiduciary duties require directors to act in the way that they consider, in good faith, would be most likely to promote the success of the company for the benefit

of its Members as a whole. The Board interprets this as in part requiring it to take steps to optimise Link Scheme Holding Ltd's competitive position in order to ensure its long-term survival. LINK's interchange methodology results in a LINK interchange cost that is around 30% higher than what it would be under the rates of at least one major competitor for the same number of transactions. This results in an obvious threat to the competitive position of LINK. Card issuers have the option of moving to a cheaper service provided by competitors, but have indicated to the Board that they would generally prefer to remain in LINK, as they recognise the wider public benefits that the LINK Scheme provides.

14. The Board notes that there is a desire by many Members to revise the way that LINK sets interchange. This is in part because many Members consider that there is a general presumption in the sector that the overall cost of ATM provision in the UK should be falling, given the reduction in consumer demand for cash as a way of making payments, and this fall is not happening (see Exhibit 2 comparing consumers' use of cash for payments with the total cost of ATM provision over time).

Exhibit 2: Cost of all ATMs versus Consumer Cash Payments



Total Cash Payments: Payments UK, UK Payments Markets 2017.
 Cost of ATMs: LINK Data.

15. The model currently used to set LINK's interchange is the Cost Study. This is summarised in Appendix 2. Whilst it has played an important role in underpinning the current network, a number of Members have become increasingly dissatisfied with the methodology in light of the broader trends in consumers' use of payment systems. In short, whilst the use of cash by consumers for payments has declined by about one-third in the last decade, there has been a steady increase in the cost of the ATM network by about one-fifth, and some large card issuers have been making higher interchange payments than they consider reasonable in respect of the services provided to their customers.
16. Overall, the Board's view is that a revision to the interchange methodology should be considered.

The Principles that the Link Scheme Ltd Board has Adopted in Reaching its Interchange Proposal

17. In setting the interchange methodology, rules, and rates, the Board will work within the Objects as set out in the Articles of Association of the company. The relevant ones are:
 - a. To maintain the operation of the LINK Network in the United Kingdom in an efficient, accessible, competitive, innovative and sustainable manner.
 - b. To promote continuous improvement and updating of the LINK Network within the United Kingdom.
 - c. To put in place and oversee the appropriate infrastructure and other resources to deliver the LINK Scheme and to ensure the resilience of the infrastructure.
 - d. To facilitate the operation of a wide range of business models in the provision of access to cash through the LINK Network in the United Kingdom.
 - e. To support the stability of the financial system in the United Kingdom with due regard to the CPSS-IOSCO Principles for Financial Market Infrastructures or such equivalents as may be recognised in future.
 - f. To improve public, government, and industry understanding of the role and contribution of the LINK Network within the United Kingdom financial sector and the United Kingdom economy.
 - g. To promote innovation and competition in the provision of payment services for the benefit of end-users.
 - h. To do all things necessary for and incidental to the advancement of the above Objects, having always due regard to the public interest.
18. As stated above, the Board is particularly mindful of its public interest remit and of the obligations placed on it as a regulated payment system operator. Its overriding objective in setting the LINK interchange is to operate the LINK Network in a way that meets the reasonable demands of the public for access to cash and other banking services, including in areas where the standard interchange rates are not adequate to support ATMs but there is consumer need for free access to cash.
19. Accordingly, the Board proposes to adopt the following principles:
 - a. The starting point for setting interchange should be rates that are set no higher than the average costs identified in the most recent Cost Study and no lower than the average marginal cost of additional transactions (with regular on-going benchmarking to ensure that this remains the case).
 - b. Interchange rates should recognise changes in consumers' use of payment methods, and should over time facilitate a corresponding change in the cost and nature of the LINK Network.
 - c. Interchange rates should support a geographical location of ATMs that is in line with consumers' needs, and through the Financial Inclusion Programme should increase the number of ATMs in areas that could not otherwise support them.
 - d. Any significant changes in rates should be phased in, recognising the terms of contracts that ATM providers have with property owners, and other costs that cannot be varied in the short term.
 - e. In setting interchange rates, LINK will consult with Members and with the LINK Consumer Council and will take their views into account.

The Board's Proposal: Reduce Overall LINK Interchange Rates by Around 20% Over Four Years and Enhance Financial Inclusion

20. The Board has provisionally decided to set a four-year approach to provide increased certainty and allow time for the market to adjust.
21. Against the background of changing patterns in consumer payments, rising costs of the network, and the presence of significantly cheaper competitive alternatives, the Board's provisional judgement is that a reduction of around 20% from current interchange rates is consistent with the principles set out in paragraph 19. This provisional judgement has been made by balancing the following factors:
 - a. The interchange rates, alongside the proposals on financial inclusion, will support a network that meets the needs of consumers.
 - b. The interchange rates will reflect the changing needs of consumers for access to cash for making payments.
 - c. The interchange rates will support a sustainable position for LINK against its competitors.
22. The interchange rates will be consistent with the requirement to prevent cost over-recovery. The Board is proposing to reduce the unit interchange rates by approximately 20% from the approved 2017 Cost Study rates. It is expected that this will feed through to a reduction in the overall LINK interchange cost of ATMs by approximately 20%. Should overall costs not decline as expected, then the Board would consider revising its approach in order to maintain adequate free access to cash for consumers and LINK's competitive attractiveness to its Members.
23. It is proposed that this change should be phased in over the next four years starting on 1st April 2018.
24. A revised Cost Study may need to remain in place so that the Board can evidence that interchange rates do not exceed average costs (or fall below average marginal cost) and more generally are not excessive or to the detriment of consumers. The details would be developed with support from LINK's legal advisers (with input from economic consultants). Members would be informed of any revised requirements. The existing Cost Study approach remains in force until any changes are made.
25. The Financial Inclusion Programme is a proven mechanism to maintain financial inclusion and this would be retained, and strengthened with a new 30p premium to supplement the existing 10p premium. The total cost of the Programme, including the 30p premium, is expected to rise to £2-3m in additional interchange over the four-year period. There would also be an implementation cost of £0.5-£1m to introduce the 30p premium. As the 10p premium significantly exceeds the total proposed reduction in interchange, there should be no adverse financial inclusion impact. This is because the total proposed reduction of approximately 20% over the four-year period will be less than the 10p premium. Any area where an ATM closes, and which then qualifies for the premium, will be eligible for a higher total rate than was previously received at that site. Given the effective competitive operation of the marketplace (as set out below in paragraph 30) this should mean that a new free-to-use machine will be installed. Should that 10p premium for some reason prove insufficient (for example, because of changes in the cost of operation at the site) then the 30p premium will be available at the Board's discretion.
26. The Board intends to revise interchange rates annually on 1st January each year in line with the proposed 20% target. It would advise Members of its proposals in advance

and seek their views, with the intention of confirming rates in advance by 1st September each year. The Board considers that this mechanism would allow it to make any adjustments that it deems necessary to maintain the effectiveness of LINK in meeting the needs of consumers and Members. It would also allow Members to budget under the same timetable as operating now.

Consultation Questions

27. The Board would welcome views on the following questions:
- a. Do you agree with the principles set out in paragraph 19 above that the Board has adopted in setting interchange rates? If not, what changes should be made to those principles? What other principles do you think the Board should take into account?
 - b. Is a reduction in the interchange rate needed in order to ensure the long-term viability of the LINK Scheme?
 - c. If you consider that no reduction is needed, please explain your reasons.
 - d. If you consider that a reduction is needed, how much do you consider to be necessary, and over what period?
 - e. If a reduction in interchange rates is considered necessary, what should be the phasing of implementing the reduction? For example, should the phasing be front-loaded, back-loaded, or in even steps?
 - f. If a reduction in interchange rates is considered necessary, should the reduction be applied at the same percentage for cash withdrawal rates and balance enquiry rates? Or should the total reduction be delivered through a higher cut in balance enquiry rates on the basis that they have a very low marginal cost?
 - g. Should branch and non-branch ATMs be treated the same, or should any reduction only be required on remote machines on the basis that this is where previous studies have found evidence of cost over-recovery?
 - h. Should the Board consider reforming Common Ownership rates at the same time as reducing interchange, drawing on some of the thinking from the Network Member Representative meeting on 5th September where this was considered?
 - i. In reaching your view, what do you consider is the evidence that consumers will be well served by the provision of ATMs in the resulting network?

Impact Assessment

28. In considering these options, Members naturally want to know what impact they will have on total interchange fees and some will also be concerned about the impact on the number of ATMs. Unfortunately, it is difficult to answer these questions with precision as they depend on business models of Members of LINK that are confidential to those Members.
29. However, the Financial Inclusion Programme premium at 10p significantly exceeds the total proposed reduction in interchange. Therefore, assuming that competitive markets are effective in the provision of remote ATMs in areas that would qualify for the subsidy, there should be no adverse financial inclusion impact. The addition of the new 30p premium will improve the financial inclusion position.
30. There are many deployers operating in the remote ATM marketplace. It is therefore expected that competitive markets will operate effectively and ensure the provision of ATMs where needed by consumers. No single deployer has sufficient market share in

the number of remote free-to-use ATMs to distort the provision of financial inclusion machines and there appear to be no significant barriers to entry or expansion. As at June 2017, the remote market in free-to-use ATMs had the following market shares:

- a. Market share of the top four suppliers: 75% (Cardtronics: 38%, NoteMachine: 16%, RBS: 13%, Bank of Ireland: 8%).
- b. Another four other suppliers have more than 1% market share (YourCash: 7%, PayPoint: 5%, Sainsbury's: 5%, Barclays: 4%).

Appendix 1: Key Elements of a Model that was Considered by the Working Group

1. The Working Group had been developing an approach that is noted in this appendix for information. As the Working Group decided not to support this approach, it is not a viable way forward. The key features were:
 - a. Cap total system costs based on 2017 amounts, but with a number of adjustments.
 - b. Reduce the total system cost amount year-on-year with an efficiency factor.
 - c. Give operators some relief for a number of factors including inflation and interest rates.
 - d. Adjust the total amount in the branch and remote cost pools (which added together give the total system cost) to reflect some of the impact from the expected closure of branch machines and movement of volumes to remote ATMs.
 - e. Put in place a system of caps and collars at the level of the unit rates to offer protection from unexpected swings up and down.
 - f. Put in place a number of break clauses to protect against unexpected events in the security and regulatory space, and with consumer demand.
 - g. With these adjustments, calculate the unit rates annually by dividing the total system cost by actual consumer volumes in the previous year.
 - h. Lock in issuers to LINK for a period (two to five years had been discussed).
 - i. Protect consumers from undesirable loss of free ATMs in deprived areas through an enhanced Financial Inclusion Programme.

Appendix 2: The Current Position and Cost Study

1. This Appendix briefly describes the current mechanism for setting interchange rates. The current mechanism is a multi-lateral interchange rate based on average network costs. Total network costs from the previous calendar year are collected through a KPMG-administered Cost Study, divided by total transaction volumes from the previous calendar year, and these form the interchange rates for the following year. There are separate calculations for branch and non-branch ATMs. Cash costs (such as purchase, delivery, insurance) are calculated separately and added to the underlying transaction cost. There are hence four main rates:
 - a. Branch cash withdrawals.
 - b. Branch balance enquiry (ie excluding the cash costs).
 - c. Non-branch cash withdrawal.
 - d. Non-branch balance enquiry (ie excluding cash costs)
2. These rates are modified by the Financial Inclusion Programme for a number of qualifying sites where the rates are not sufficient to support a free ATM.
3. The rates are also modified by a “Common Ownership” discount designed to reflect the perceived cost advantage to an ATM operator when the site is owned by the same Group (normally associated with supermarkets).