

Call for views

Considering the incentives to deploy free-to-use ATMs in the LINK network

Review of the structure of LINK interchange fees: Call for views

June 2019

We welcome your views on the issues discussed in this paper. If you would like to provide comments, please send these to us by **5pm on 5 July 2019**.

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

PSR Access to Cash project team
Payment Systems Regulator
12 Endeavour Square
London E20 1JN

We will consider your comments in developing our further work in this area.

We will make all non-confidential responses to this paper available for public inspection.

We will not regard a standard confidentiality statement in an email message as a request for non-disclosure. If you want to claim commercial confidentiality over specific items in your response, you must identify those specific items which you claim to be commercially confidential. We may nonetheless be required to disclose all responses which include information marked as confidential in order to meet legal obligations, in particular if we are asked to disclose a confidential response under the Freedom of Information Act 2000. We will endeavour to consult you if we receive such a request. Any decision we make not to disclose a response 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/consultations/cp195-Call-for-views-Review-of-the-structure-of-LINK-interchange-fees

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<https://www.psr.org.uk/privacy-notice>

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1 Objectives and Background

The PSR wants everyone to have a good choice of how to make payments that work for them. Our overall objective in this area is to support cash access which meets the needs of users, including widespread geographic access, for UK consumers who need or want to use it as a payment method.

This means that we are considering ways to protect the current spread of free-to-use ATMs, while also improving the access to cash more generally.

This paper focuses on the LINK interchange fee structure, which has a significant impact on the incentives for providing ATM services around the UK. We will engage widely with the industry at every stage of its workplan in this area and seek to ensure that all views are heard and considered.

Purpose

- 1.1** We want this paper to prompt a discussion and to seek views on whether the current way that banks are charged when their customers withdraw money from free-to-use ATMs is appropriate or could be improved.
- 1.2** Central to this is the LINK interchange fee structure. This structure determines the amount that a customer's bank pays to an ATM provider when cash is withdrawn or other services (such as balance inquiries) are provided. ATMs are provided by both banks and independent ATM deployers (IADs). Their decisions on where to locate an ATM, whether it should remain open, or whether it should be free-to-use or pay-to-use are affected by the interchange fees (alongside a range of other considerations that affect the overall profitability of that ATM).
- 1.3** This means that the interchange fee structure is one important factor affecting the geographic and socio-economic distribution of free-to-use ATMs. The focus of this paper is on the **structure** of interchange fees, and not on the precise **level** of interchange fees.
- 1.4** We want to explore whether – looking ahead – the current approach is likely to deliver better outcomes for customers and society, considering the outcomes that we are seeking to promote in line with our statutory duties. This could support a discussion of whether there are different fee structures that would deliver better outcomes for UK consumers. This paper sets out our current view of the key issues and invites comments on our initial assessment of how changes to these fee structures might better promote our overall objective in this area. We are inviting views on the analytical approach and premises we set out. We particularly encourage stakeholders to provide relevant evidence supporting their views in their responses.

Our policy objectives

1.5 Our overall objective in this area is to support cash access which meets the needs of users, including widespread geographic access, for UK consumers who need or want to use it as a payment method. This means retaining a choice of different ways to pay – including cash – for those who want or need to use a particular method of payment.

An important part of this is making sure ATM providers have appropriate incentives to maintain a suitably wide geographic spread of ATMs. Such incentives would promote an economically efficient spread of ATMs, reflecting the value consumers and society place on such access and the efficient costs of provision.

1.6 Further, we would expect such incentives to appropriately promote future investment and innovation (in both the LINK ATM network and potentially other ways of accessing cash). The predictability of future charges is likely to be an important part of this.

1.7 The incentives also require a practical system, which does not have excessive transactions costs, such that individual parties can understand and react appropriately to the incentives. More practically, any charging scheme needs to be capable of being implemented at reasonable cost.

1.8 This work will help us get a better understanding of the impacts that the current structure of interchange fees for use of the LINK free-to-use ATM network could be having over time, including the impacts that this structure may be having on the commercial decisions of ATM deployers. As part of our wider work on cash, this will inform our understanding of the case for any further changes to the structuring of ATM interchange fees that might better protect the interests of service users by providing better incentives to those who operate and use free-to-use ATMs.

1.9 We will directly engage with relevant stakeholders in this area in the coming weeks. We are also planning related work to improve our understanding of:

- end users' needs
- the cost of cash acceptance
- how to enable and promote innovation in the provision of cash services

Background and context

1.10 Before January 2018, the level of LINK interchange fees was based on an approach that was developed in 2001. This was subject to an individual exemption by the Office of Fair Trading (OFT) under the Competition Act 1998.¹ That exemption was provided by a decision dated 16 October 2001 (lasting for five years). It was focused on whether setting multilateral interchange fees (MIFs) had the potential to distort competition and whether the benefits of setting a MIF outweighed the effects of any restriction on competition. A key element of this decision was whether – in the absence a suitable MIF arrangement – interchange fees would be set bilaterally at an excessively high level. Annex 1 describes the OFT 2001 decision in more detail.

¹ See <https://assets.publishing.service.gov.uk/media/555de4c2e5274a708400015e/link.pdf>

- 1.11** At that time, the vast majority of ATMs were operated by banks or building societies (the first IAD joined LINK in 1998).² ATMs tended to be located in, or on the wall of, retail bank branches. In 2001 there were around 36,000 ATMs in total in the UK.
- 1.12** The methodology developed in 2001 was essentially one calculated by:
- i) adding up the total annual cost of operating the free-to-use ATM estate, including the cost of the rent (or equivalent) of the space the ATM occupies (in a previous year – say year 1), and
 - ii) dividing it by the number of relevant transactions in that year (again in year 1), to give an average cost per transaction for the following year (year 2)
- 1.13** This average cost was then applied broadly uniformly as the interchange fee to every individual free-to-use ATM.
- 1.14** At the time this approach was introduced, one of the key benefits was that it intended to provide an incentive for ATM providers to become more efficient by incentivising lower than average costs. In due course, this would feed into lower MIFs in subsequent years, sharing the benefit of these efficiencies. Four different LINK interchange fees are estimated: cash transactions and non-cash transactions for branch and remote transactions.³
- 1.15** After 2006, under LINK’s Financial Inclusion Programme, ATM deployers can also be paid an additional premium above the interchange fee for operating a free-to-use ATM at specific locations.⁴ Since 2018, this programme has included a public commitment to protect those free-to-use ATMs which are 1km or more from another free-to-use ATM. In October 2018, the PSR placed Specific Direction 8 on LINK, which requires it to have in place suitable policies and procedures for applying and implementing these public commitments.
- 1.16** Since 2001, we have seen the following changes:
- There are many more ATMs. In 2018, LINK reported a total of around 52,000 free-to-use and around 11,000 pay-to-use ATMs, representing a 73% increase in the total number of ATMs over that period.
 - A greater proportion of ATMs are free-to-use. Between 2008 and 2018, the number of free-to-use ATMs increased by 35%, whereas the number of pay-to-use ATMs decreased by 56%.
 - Most ATMs are now operated by IADs, currently around 60% of the total number of ATMs.⁵
 - Most ATMs are not in or on bank branches, but are located remotely from bank branches (we estimate more than 70%).

2 See https://ira.le.ac.uk/bitstream/2381/8163/1/ATM_v7_wtables.pdf, page 28.

3 For an overview of this process see Appendix 2 of LINK (2017) Consultation by the Board of Link Scheme Holdings Ltd LINK’s Interchange Rate Public, 1 November 2017: <https://www.link.co.uk/media/1316/h-documents-projects-interchange-2018-model-and-plan-interchange-consultation-public-final.pdf>. In this context, ‘remote’ refers to ATMs which are not in a branch.

4 See the LINK Financial Inclusion Programme: <https://www.link.co.uk/initiatives/financial-inclusion/>

5 See the Cash Review Final Report: <https://www.accesstocash.org.uk/media/1087/final-report-final-web.pdf>, page 67.

1.17 We have also seen a number of other changes:

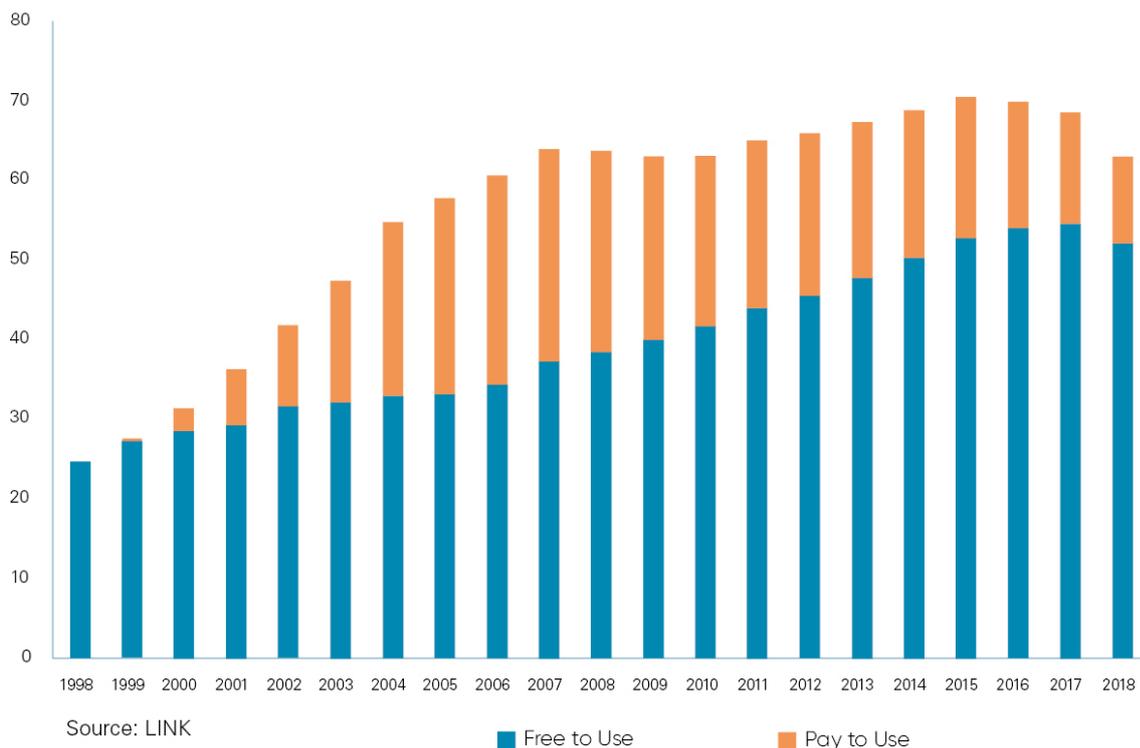
- There are materially fewer bank branches.
- There has been a reduction in cash use and an increase in the use of other payment methods. Statistics from UK finance state that cash was used for 34% of all payments in 2017, down from 61% a decade earlier.

The decline was attributed to increased use of debit cards, especially to make contactless payments. They also state cash withdrawals from ATMs as a whole have fallen by around 17% since their peak in 2012.⁶

1.18 Despite the recent reduction in the number of transactions using cash and in the volume of total withdrawals from ATMs, there has been a significant increase in the number of ATMs over the last decade (see figure 1). Free-to-use ATMs were at their highest ever levels in 2017 even though cash withdrawal volumes have been falling year-on-year since 2012.

1.19 The geographic distribution of these ATMs has not been even. For example, we observe very large numbers of ATMs in some urban locations, while there are some areas where ATMs are few and far between. We have previously highlighted that specific circumstances of different local areas are important to consider.⁷

Figure 1: LINK ATMs (thousands)



⁶ See <https://www.ukfinance.org/system/files/Summary-UK-Payment-Markets-2018.pdf> and <https://www.link.co.uk/about/statistics-and-trends/>

⁷ See the speech by Charles Randell, Chair of the Financial Conduct Authority and Payment Systems Regulator 'Is it a Wonderful Life?' (13 March 2019): <https://www.fca.org.uk/news/speeches/is-it-a-wonderful-life>

1.20 Over the last year, we have observed the following additional developments.

- A reduction in the overall number of free-to-use ATMs. LINK reports that currently there are 4,500 fewer ATMs than when the network was largest in 2017. Between January 2018 and December 2018, the number of free-to-use ATMs reduced from 54,500 to 52,000.
- A number of free-to-use ATMs have been switched to pay to use. Cardtronics, one of the major IADs, has publicly stated that it intends to convert around 3,000 ATMs to pay to use following the LINK interchange fee cut in January 2019.
- LINK implemented 5% cuts to interchange fees in July 2018 and January 2019, and has a further cut for January 2021 under review. This is prompting concerns from IADs about how interchange fees will be set in future and uncertainty about the impact on profitability of a significant number of machines.
- LINK also introduced additional measures to protect free-to-use ATMs that are 1km or more from another free-to-use ATM (as described above).

2 The Structure of LINK Interchange Fees

Scope

- 2.1** The developments described in the previous section raise the question of whether setting the MIF in the way first established in 2001 incentivises the appropriate geographic coverage or provides an ATM estate that efficiently delivers what today's ATM users want and indirectly pay for. Through this paper we are seeking views on the impact of the current interchange fee **structure** (including the likely impact of the recent changes in the structure introduced by LINK) on the distribution of FTU ATMs. We are not seeking views on the **level** of interchange fees at this time.
- 2.2** This paper seeks to set out the relevant facts and our understanding of the key drivers and impacts of the current approach to interchange. This will support engagement with industry and other stakeholders.

Our current understanding

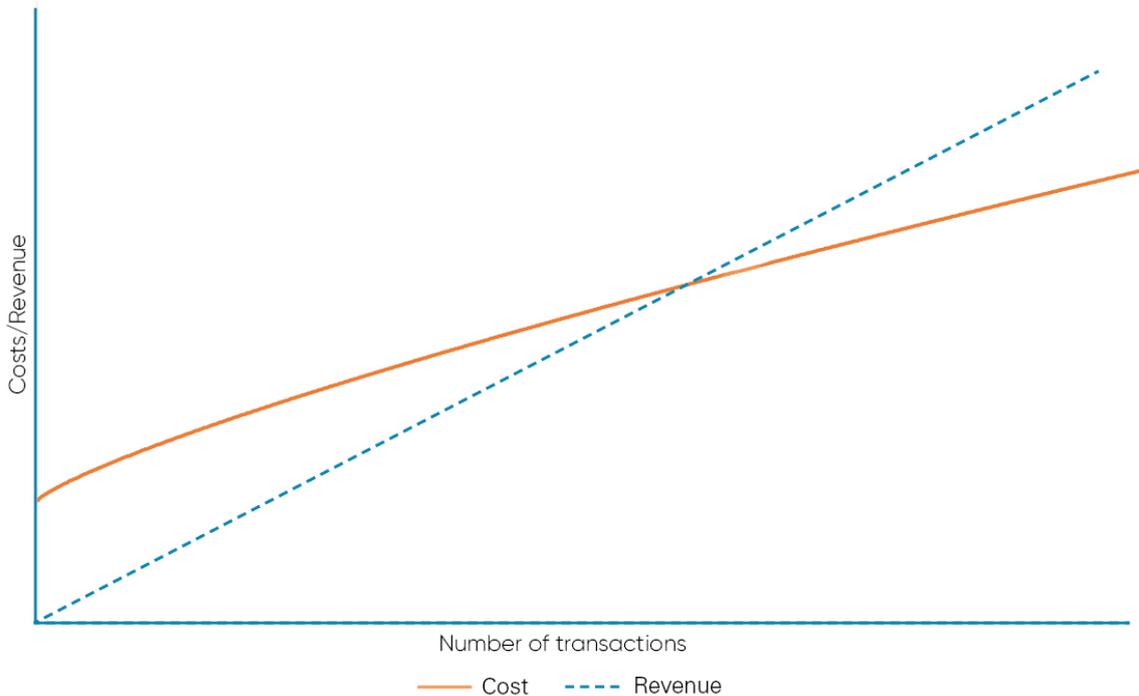
Individual ATM cost structure

- 2.3** The information currently available to us suggests that:
- there are fixed costs associated with individual machines (for example, capital cost of the machine, installation costs, opportunity cost of the space the machine takes up)
 - there are costs that vary more or less proportionally with the number of transactions and the value of cash withdrawals (for example, the cost of refilling with cash)
 - the level of fixed costs and the level of variable costs for ATMs with similar volumes can also vary from location to location, the pattern of which is quite complex (for example, it will cost more to send a technician to very remote machines)
 - there could be scope for network effects in this area – the cost of an individual machine related to the proximity and convenience of a 'route' for an engineer and for someone to restock it (if filled that way)
 - despite this pattern of costs, similar machines doing similar volumes of transactions can have quite different total costs
- 2.4** If the above is a reasonable characterisation of the cost structure, then:

Observation 1: The average cost per withdrawal (or other service) will fall significantly as volume of usage increases. This will be particularly apparent at the low volume end of usage.

2.5 Setting the interchange fee at the average cost of a transaction for the entire estate of free-to-use ATMs will mean that, other things being equal, ATMs with much higher volumes of transactions will tend to generate significant surplus income over costs, while those with very low volume of usage will tend to generate no surplus or make a material loss (that is, the income will not cover the costs of supply). Figure 2 gives an illustration of this.

Figure 2: High level relationship between revenue and costs



2.6 As illustrated in this Figure, the ATMs that have an average cost per transaction that is higher than the interchange fee (where the cost line is above the revenue line) are unlikely to be profitable and thus they would be at risk of closing. This suggests that, in general terms, the average cost per transaction at an individual ATM falls as transaction volumes increase.

2.7 There are other drivers of cost that affect the profitability of each ATM. Higher cost locations are likely to be:

- more remote
- not on a convenient logistical 'route' where there is more than one ATM to be refilled
- subject to security concerns arising from crime where money is stolen from ATMs
- where ATMs do not drive other spending (for example, not on a high street)

2.8 While the current structure may create limited incentives for free-to-use ATMs in lower-transaction, higher-cost areas, at the same time, it could also be creating strong incentives for free-to-use ATMs to be situated in higher-footfall, lower-cost urban

locations.⁸ This increases the overall level of costs that need to be recovered from the interchange fee, which can further exacerbate the reduction in the number of low-volume free-to-use ATMs.

2.9 This description is based on there being economies of scale (arising from fixed costs) for individual machines. We invite views on how well this describes the cost structure or what other factors would need to be taken into account.

2.10 We will also consider a number of related questions.

- To what extent do low-transaction machines correlate with ATMs in rural or more remote locations and, related to this, are the ATMs with high transaction volumes all in dense urban areas?
- To what extent are there economies of density – that is, the extent to which costs vary on the basis of how close a particular operator’s machines are to each other?
- Are there other economies of scale or material fixed costs at the level of the firm operating ATMs, the area or the route?
- What is the relevance of how any fixed cost are allocated using the current LINK cost model?
- What is the impact of ATM revenue streams other than LINK interchange fees?
- Are there any other competition impacts relating to interchange fees, including in terms of competition between schemes (for example, between LINK and alternative ATM schemes)?

Individual ATM value to consumers

2.11 Turning to the needs of consumers in accessing cash through ATMs, we currently consider that these can be characterised as follows.

- UK consumers continue to place a significant value on ‘free’ access to cash, which is largely delivered at present through the free-to-use ATM network.
- Removing an existing free-to-use ATM, or converting it to a pay-to-use one, may create considerable inconvenience and potentially have knock-on effects on the local economy. This impact is likely to be lower, or even largely non-existent, if there is another free-to-use ATM within a very short distance.

⁸ By late 2017, 80% of free-to-use ATMs were within 300m of another free-to-use machine.

- The distance required to travel to an ATM represents a suitable proxy for time taken to travel to ATMs. This is one proxy for inconvenience, but it is more complicated than a simple straight-line distance measure because:
 - In practice, many consumers will not make a journey specifically to access cash, but combine it with another journey (for example, to make purchases or on a journey to work) and therefore the key concept is whether consumers need to travel out of their way to access cash.
 - A simple distance measure is not always a good proxy for time taken (which is what consumers in fact care about) as there may be barriers or difficulties to traveling in a straight line (both natural barriers such as a river or hill, and issues such as crossing motorways or railways).
- Another factor which needs to be taken into account is the accessibility of a particular site in terms of whether it is open to members of the general public and, even if so, whether it is accessible for all users (including, for example, those in wheelchairs or other particular needs); accessibility could relate to both the site of the ATM itself but also the features of a particular ATM (such as whether it has features which cater for the needs of those who are visually impaired).
- While the above factors relate to the whether a suitable ATM is available for consumers, another aspect of availability is that the ATM is operational and stocked with cash – that is, consumers care not just about the existence of an ATM but the existence of an ATM which is able to dispense cash for the vast majority of the time. Consumers also value the ability to use ATMs interchangeably and not be linked to any particular brand, or face different charges at the same ATM with different cards. This interoperability between ATMs and cards is a key feature provided by having a scheme that all or most ATMs are connected to, such as the LINK scheme.
- Very heavily used ATMs may have queues at busy times, which is another form of time taken and inconvenience.

2.12 If the above is a reasonable summary of what consumers value, then:

Observation 2: The ATMs that consumers value the most are those which provide free access to cash and where there are no other free ways to withdraw cash (including alternative free-to-use ATMs, regardless of who provides them) nearby as long as those ATMs represent a reliable and accessible way to withdraw cash.

Observation 3: Consumers will also value free-to-use ATMs most which provide convenience in terms of allowing access to cash as part of their daily routine (i.e. are where they need to spend cash or are on transport routes).

Observation 4: Customers would rather not queue, even at busy times.

Comparing the impact of cost with value

2.13 The interaction between the interchange fee and the cost of running a particular ATM is likely to result in ATMs not being located where usage would be materially below the threshold where costs are recovered, even if the consumer need for access to cash is high (for example, because the next ATM is many miles away).

2.14 At the other end of the spectrum, where there is a very high demand for withdrawals, it is likely to be economically viable for a new ATM deployer to add an additional ATM at these locations, as long as its particular usage takes it over the threshold at which more than its costs are recovered.

This can occur even when the existing machines close to that location are very rarely, if ever, congested ('congested' meaning that users have to wait a material time for an ATM to become free).⁹ If the customer experience is not significantly degraded from using ATMs with high volumes of monthly transactions, this could lead to an 'over-supply' of ATMs in locations where there is a high demand for transactions.¹⁰

2.15 This suggests that in high demand locations, fewer ATMs with higher individual usage (and hence lower unit costs) may be a preferable outcome and more economically efficient. At the other end of the spectrum, where the density of demand for transactions is low (in a sparsely populated rural area, for example) the benefits of an ATM with low usage (and therefore high unit costs) may still be worthwhile as, in the absence of such a machine, potential users would need to travel a long way to reach the next available free-to-use ATM.¹¹

2.16 Combining the observations set out above, we invite views on whether this is likely to mean that the current structure of interchange fees could lead to free-to-use ATMs closing or being switched to a pay basis, even where they are valued highly by consumers. Conversely, where machines are clustered in a dense urban setting, we invite views on whether they could still be commercial to run and retained even where they are valued less (or not at all) on an individual machine basis by consumers.

2.17 The recent initiatives from LINK appear to be designed to address this issue, at least in part. Certain low volume ATMs which are further than 1km from the next free-to-use ATM receive an interchange fee of up to £2.75 per transaction to try to ensure they continue to be financially viable.¹² We consider the impacts of the existing LINK arrangements in more detail in Annex 2, but invite views on whether LINK's approach to meeting its commitment addresses the issues raised in this paper (or what incremental adjustments could be made to improve LINK's approach). In this context, we note that the additional interchange fees available are focused on the existing ATM estate (that is, they do not incentivise new machines in under-served areas) and on a relatively small percentage of existing machines.

⁹ The latest intervention from LINK in relation to protected ATMs introduces an increased interchange fee where the volume of transactions is below 4,500 per month. If this is about the break-even point for the standard interchange fee, and the usage of an ATM is assumed to be concentrated into 12 hours per day, this represents an average of roughly 1 transaction every 5 minutes. See: https://www.link.co.uk/media/1437/v-96-link-scheme-ltd-change-control-method4-change-2019-1030_19-protected-atm-policy-effective-1st-april-2019.pdf

¹⁰ For example, there are at least 23 separate locations of free-to-use ATMs within 500m of the centre of Canary Wharf. Many of these locations contain multiple ATMs.

¹¹ This would be in contrast to areas like Canary Wharf where the removal of one ATM would be likely to mean that potential users would have to travel only a matter of feet to find another free-to-use ATM.

¹² See: <https://www.link.co.uk/about/news/super-premiums/>

Aims of any changes to the structure of interchange fees

2.18 If what is described above is approximately correct then there is a reasonable chance that the current interchange fee structure (or at least the version that existed before 2018) is not delivering the best geographic or socio-economic coverage for the total costs being incurred by, and paid for by, users indirectly through their banks.

This raises the possibility that a different interchange fee structure could deliver better coverage at the same overall cost, or at a lower cost.¹³

2.19 In looking at whether a different fee structure could deliver a better outcome, we would like to understand the impacts of any fee structures on (among other issues):

- the incentives to over-supply in areas of high demand – that is, customers do not value the addition of *another* machine at this location, but it is economic to do so
- the incentives to under-supply in areas of low or dispersed demand (where individual machines may provide significant value) – that is, customers do value the positioning of a machine at a particular location higher than its costs, but it is not economic to supply such a machine because the interchange fee income that it would generate would not cover its costs
- the ability of deployers to effectively compete with each other when faced with any particular fee structure
- the incentives on deployers to optimally locate ATMs where characteristics other than volume lead to higher or lower unit costs – for example, areas where enhanced security is needed, or where operational costs are higher than average
- the ability and ease of any particular fee structure to evolve as cash usage or overall demand for ATM transactions changes
- the ability of the fee structure to incentivise the location of ATMs where there is a social demand for access to cash that would otherwise not be met

2.20 An important focus of the first stage of the review will be to understand how the current structure of interchange fees relates to underlying cost structures and how this affects the incentives to deploy ATMs at different locations. Our focus in this particular strand of work is on the interactions between ATM deployers (banks and IADs) and LINK through interchange fees, but we also invite views on how this flows through to the owners of sites where ATMs are deployed, such as convenience stores, shopping centres and petrol stations.

¹³ In principle, it may also be possible that a fee structure exists that would produce much better coverage at a higher total cost, but one that users would be prepared to pay for because it is so much better.

2.21 Once we have developed a better understanding of how the current interchange fee structure interacts with the real cost structure of supplying ATMs, we will then seek to assess how this structure compares to various alternative structures. We are interested in views on a wide range of potential alternative fee structures, including, but not limited to:

- multi-part tariffs – that is, an interchange fee approach that might involve a fixed payment per ATM and a per transaction fee (for example, based on the incremental cost of supply)
- a menu of differentiated, or banded, interchange fees where the bands used reflect key differentiators of value and/or cost (such as urban or rural interchange fees)
- a structure where additional ‘premiums’ are offered above the standard interchange fee to ATMs that face specific demand and cost conditions (the current LINK approach is one version of this)

2.22 In considering these different options, the appropriate measure of cost (including how fixed costs are either recovered directly or allocated to different volume measures) needs to be taken into account. Balancing the complexity of the system, both in terms of the calculation of appropriate charges and the ability of different parties to react to the incentives they provide, is another relevant factor. One key aspect of this is the stability and predictability of the charging system, as this will affect the degree of investment uncertainty and therefore the incentives to invest and innovate. Any approach that introduces different bands or different charges in different geographies would need to ensure that those bands reflect appropriate differences in cost drivers or value. We particularly encourage stakeholders commenting on these, or any other approaches, to provide views on how these different aspects should be taken into account.

3 What we are seeking from stakeholders

- 3.1** We welcome all views on the issues raised by this paper, including on the current structure of the LINK interchange fees and the merits of possible alternatives. Please note that the focus of this review is on the **structure** of interchange fees, and not on the precise **level** of interchange fees. We particularly encourage stakeholders to submit any relevant evidence supporting your views in your responses to this paper.
- 3.2** We invite views on the following questions in particular.
- Q1** Do you agree with the description and framework (including the objectives we set out) for considering the costs of providing ATMs and the value they provide that are set out in this paper? If not, please explain why and set out your view of the alternative way these issues should be analysed.
 - Q2** Are there any other factors we should take into account when analysing the incentives to provide ATMs?
 - Q3** What incentives and impacts do the existing LINK interchange fee arrangements as described in this paper (including in Annex 2) have?
 - Q4** What structure of interchange fees would have appropriate incentive effects going forward?
- 3.3** You can answer as many or as few of the questions as you wish. We welcome all responses to the paper, including less formal responses such as emails, bilateral or multilateral discussions on any aspects covered in the paper, as well as alternative ideas and proposals.

Next Steps

- 3.4** We welcome responses and supporting evidence to this paper by **5 July 2019**. While we have set this deadline, this should not prevent stakeholders from responding ahead of this date. Furthermore, given our work in this area is ongoing, stakeholders will have further opportunities to engage with us on this. Please note that we generally seek to publish written responses (particularly more formal responses) in full or in part. Our disclosure of information statement is set out below.
- 3.5** You can email your response to PSRcashaccess@psr.org.uk or write to us at the following address:
- PSR Access to Cash project team
Payment Systems Regulator
12 Endeavour Square
London
E20 1JN
- 3.6** As well as seeking written responses and evidence, and in order to facilitate engagement with our work in this area, we intend to discuss these issues with interested stakeholders.

We will engage on these issues with key stakeholders on a bilateral basis, and **we are planning a roundtable discussion in the summer** to seek views and discuss the work we are doing. If you would like to attend, please contact us on PSRcashaccess@psr.org.uk **by 21 June**. We may hold more than one roundtable event to ensure that these are useful discussions, depending on the number of stakeholders who express an interest in attending.

- 3.7** Following our consultation and stakeholder engagement on this paper, we plan to publish non-confidential responses (particularly more formal responses). We will inform stakeholders of how we propose to take this work forward. In particular, once we have considered different stakeholder responses and inputs, we will consider whether there is a case for further work on the issues discussed in this paper, which of the options set out above we will assess in more detail and the approach to that assessment.
- 3.8** We currently anticipate that this work will take a number of months but expect to identify a clear direction of travel by the end of 2019.

Disclosure of information

- 3.9** Generally, we seek to publish views or submissions in full or in part. This reflects our duty to have regard for our regulatory principles, which include those in relation to:
- publication in appropriate cases
 - exercising our functions as transparently as possible
- 3.10** We will not regard a standard confidentiality statement in an email message as a request for non-disclosure. If you wish to claim commercial confidentiality over specific items in your response, you must identify those specific items which you claim to be commercially confidential.
- 3.11** We may nonetheless be required to disclose all responses which include information marked as confidential in order to meet legal obligations, in particular if we are asked to disclose a confidential response under the Freedom of Information Act 2000. We will endeavour to consult you if we receive such a request. Any decision we make not to disclose a response can be reviewed by the Information Commissioner and the Information Rights Tribunal.
- 3.12** We take our data protection responsibilities seriously and will process any personal data that you provide to us in accordance with the Data Protection Act 2018, the General Data Protection Regulation and our PSR Data Privacy Policy. For more information on how and why we process your personal data, and your rights in respect of the personal data that you provide to us, please see our website privacy policy, available here: <https://www.psr.org.uk/privacy-notice>.

Annex 1

Summary of the OFT 2001 exemption decision

- 1.1** On 13 April 2000, LINK Interchange Network Limited (LINK) notified certain agreements to the Director General of Fair Trading (DGFT). Following the introduction in the UK of the Competition Act 1998, LINK requested for these agreements to be considered as not infringing the Chapter I prohibition on anticompetitive agreements or, in the alternative, to benefit from an individual exemption.¹⁴ Part of the agreements notified was the fallback multilateral interchange fee (MIF), which set the fee which would be paid by the card issuer to the ATM owner when a transaction was performed on the ATM owner's machine with a card issued by that card issuer.
- 1.2** The DGFT considered that there were three potentially adverse effects raised by a MIF set by a payment system network:
- the restriction of members' ability to set their own prices
 - the distortion of members' behaviour towards their customers
 - the restriction of competition among payment systems
- 1.3** For example, the MIF could restrict the ability of members to determine their own pricing policies, effectively excluding some potential competitors. Alternatively, the MIF could adversely affect competition by reducing the incentives for members to compete for each other's customers, dampening competition between them. The DGFT concluded that the MIF appreciably prevents, restricts or distorts competition on the basis that it restricts the freedom of the LINK members individually deciding their own pricing policies and is restrictive of intra-bank competition.
- 1.4** However, the DGFT went on to assess whether the benefits of the MIF outweighed the effects of the restriction on competition. The DGFT found that, in the absence of any collective agreement on fees, each member of a network individually has the incentive to set their own fee without taking into account the effect on the whole system, and so to set their fees to other members excessively high. This, in turn, would lead to all fees being set excessively high. In addition, all members entering into a series of bilateral agreements would involve significant transactional costs in terms of negotiation time, search and verification costs. The DGFT also noted how access to ATMs plays an important role in the provision of current account facilities, as ATMs may be used by cardholders regardless of the financial institution with whom they hold their current account. In particular, it allows smaller institutions to provide their customers with access to a large network of ATMs.

¹⁴ There has since been a change in the competition law regime. It is no longer possible to notify the competition authorities in order to be granted an individual exemption. The businesses must now self-assess whether their agreements infringe competition law.

- 1.5** The DGFT also considered whether the methodology used to derive the MIF would result in a MIF being set higher than it needs to be for cost recovery. The DGFT stated that LINK members must demonstrate that the MIF is set (and revised regularly) at the level of the average additional costs of participating members. The cost study was noted as a way of deriving the average unit cost of a transaction, which it then took to represent the underlying cost of supporting the total volume of activity across the LINK ATM network. For a given MIF, a LINK member can only increase profitability by becoming more efficient. Such efficiencies were, in turn, expected to lead to a lower average transaction cost the following year and, so, a lower MIF.
- 1.6** Finally, the DGFT considered that the MIF did not eliminate competition because the majority of cardholders at that time used the ATM facilities of the card-issuing bank and that each of the four largest banks, and other LINK members, owned an extensive network of ATMs. The DGFT considered that these proprietary networks provided an alternative to the LINK network and imposed a competitive restraint on LINK's ability to set prices at uncompetitive levels. For these reasons, the DGFT found that the MIF benefited from an individual exemption, granted on 16 October 2001.

Annex 2

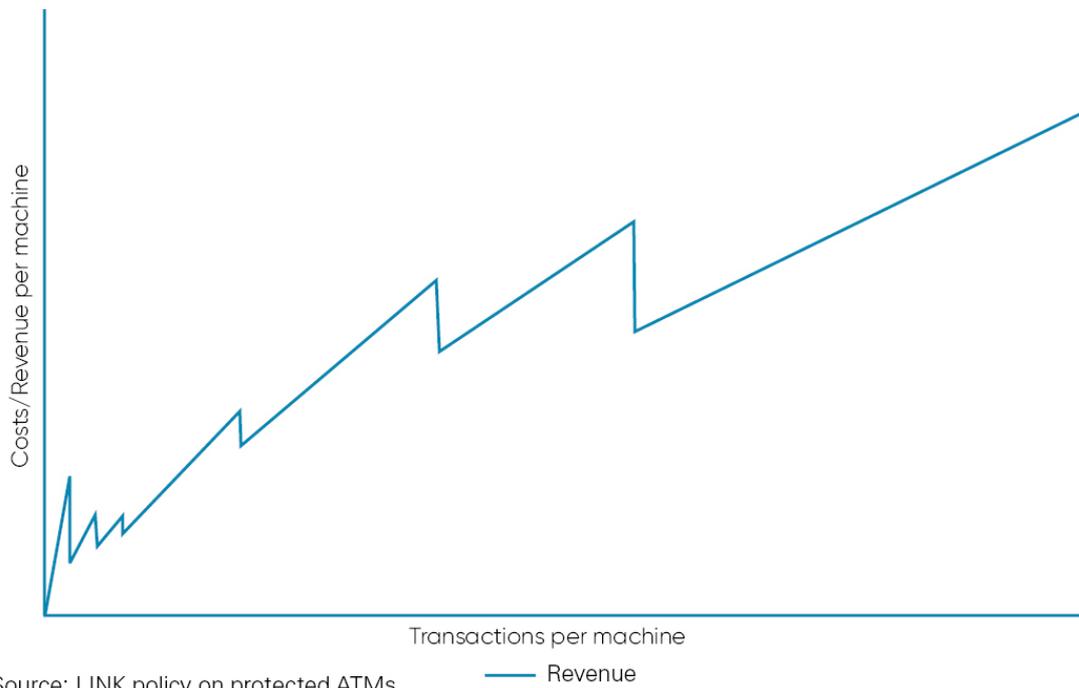
Impact of current LINK interchange fee arrangements

- 2.1** As described in the main body of this paper, interchange fees until recently were set on the basis of an average cost per transaction. While the current interchange fee levels have been reduced by 5% steps from these average total cost measures, that average cost was still the starting point. However, through the financial inclusion program – and especially the arrangements put in place by LINK to meet its commitment on maintaining the existing geographic spread of ATMs – there are important additional aspects.
- 2.2** We continue to monitor the extent to which protected FTU ATMs are maintaining the existing geographic spread of access to cash through our work on SD8. We also invite evidence on the impact of the FTU ATM closures, in terms of the areas being served, which have occurred since January 2018. The overall number of free-to-use ATMs declined by 8% between January 2018 and March 2019.¹⁵ Overall cash usage as measured by volume of cash withdrawals has continued to decline over the same period.¹⁶
- 2.3** The impact of the measures LINK has introduced to protect low-volume machines is illustrated in Figure 3.

15 See <https://www.link.co.uk/initiatives/financial-inclusion-monthly-report/>

16 See <https://www.link.co.uk/about/statistics-and-trends/>

Figure 3: Revenues per machine (taking low volume premiums into account)



Source: LINK policy on protected ATMs

2.4 The banding approach for interchange fees for low volume machines effectively creates a 'saw tooth' pattern of revenue for an individual ATM as transaction volumes increase. For these very low volume machines there is therefore likely to be a mix of machines both under- and over-recovering costs depending on exactly where they are on this diagram. Whether this is appropriate depends on the extent to which the saw tooth pattern represents a reasonable approximation of actual cost differences.

2.5 The actual charging bands are set out in Table 1, with the additional interchange fee for each band over and above the standard interchange fee.

Table 1: Additional low volume/protected ATM interchange fees¹⁷

Average number of monthly cash withdrawals	Enhanced premium per cash withdrawal
0 to 199	£2.75
200 to 399	£0.81
400 to 599	£0.43
600 to 1,500	£0.30
1,501 to 3,000	£0.20
3,001 to 4,500	£0.10
4,501+	£0.00

2.6 We also understand this approach to be focused on the existing ATM estate and ATMs subject to the Financial Inclusion Programme, so currently do not consider that it creates incentives to locate ATMs in areas which are currently not served by an ATM.

2.7 Another aspect of the current LINK arrangements, as described in the LINK policy on protected ATMs¹⁸, is the direct commissioning of ATMs to replace closed protected ATMs if the additional interchange fees do not lead to sufficient progress in replacing those machines within 2 months. Factors which might lead to the number of machines subject to direct commissions growing over time include machines that are more remote, with increasingly lower transaction volumes and higher costs (given the cost structures described above).

¹⁷ See https://www.link.co.uk/media/1437/v-96-link-scheme-ltd-change-control-method4-change-2019-030_19-protected-atm-policy-effective-1st-april-2019.pdf

¹⁸ https://www.link.co.uk/media/1437/v-96-link-scheme-ltd-change-control-method4-change-2019-030_19-protected-atm-policy-effective-1st-april-2019.pdf

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