ATTACHMENT 5: GUIDANCE NOTE

Implementation of the Standard on Interchange Fees

The Reserve Bank of Australia is providing this Guidance Note to facilitate compliance with Standard No. 1 - The Setting of Wholesale ("Interchange") Fees (the Standard) which comes into force on 1 July 2003. This Guidance Note is intended to provide practical assistance to the participants in the credit card schemes designated under the *Payment Systems (Regulation) Act 1998*. This Guidance Note does not have legal effect and does not vary the Standard; however the Reserve Bank expects participants in the designated credit card schemes to use this Guidance Note to ensure consistency in the collection of cost data and to aid in the implementation of the Standard. The Reserve Bank may update the Guidance Note in future as necessary.

For each designated credit card scheme, the Standard requires the periodic calculation of a cost-based benchmark using data on "eligible costs" of certain scheme participants. A weighted average of interchange fees applied to transactions in the scheme in Australia must then be compared to this cost-based benchmark. Interchange fees in the scheme are in compliance with the Standard if this weighted average, calculated using interchange fees in effect on certain specified dates, does not exceed the cost-based benchmark. This document provides a description of the types of costs to be included in the calculation of the cost-based benchmark and other guidance on the practical operation of the Standard.

I. Measurement of Eligible Costs

Nominated scheme participants

"Eligible costs" for use in calculating the cost-based benchmark in a scheme are based on costs of certain "nominated scheme participants". The nominated scheme participants may be different for each scheme.

At a minimum, the nominated scheme participants are those issuers in the scheme whose credit card transactions together make up at least 90 per cent of the value of domestic purchase transactions in the scheme in Australia for the prior financial year. A scheme or its participants may also choose to nominate additional participants as nominated scheme participants.

It is anticipated that the nominated scheme participants will be determined by the scheme administrator, which operates or governs the credit card scheme and which would normally have access to the necessary transaction data. The Standard also provides that the participants themselves may determine the nominated scheme participants, for example, by providing data to an independent expert if the scheme administrator is unable to do so.

Time period for data collection

The cost-based benchmark must be calculated within three months after the Standard comes into effect, ie by 1 October 2003, using data for the financial year ending 30 June 2003. The benchmark must be recalculated every three years thereafter, ie by 1 October 2006 and 1 October 2009, etc. With the Reserve Bank's agreement, the cost-based benchmark may also be recalculated at an interim date. It is anticipated that the nominated scheme participants in each scheme will report their cost data to the independent expert for the scheme as soon as possible after the end of the relevant financial year in order to provide adequate time for that expert to review the data and perform the required calculations.

Except where otherwise noted, eligible costs are actual costs incurred as recorded in the general ledger or other appropriate accounting records and systems of the nominated scheme participants for the entire relevant financial year ending 30 June. Estimated or anticipated costs should not be included.

The Reserve Bank recognises that scheme participants may need to make initial system or procedural changes to their accounting systems to accurately measure the eligible costs as defined in the Standard. As a result, the Standard includes a Transition Provision that allows a scheme to determine the cost-based benchmark using eligible cost data only for the six months ended June 30, 2003. In such a case, the cost data should be annualised (if necessary) such that it is consistent with the transaction data used to calculate the cost-based benchmark.

Definition of eligible costs

Under the Standard, eligible costs for inclusion in the calculation of the cost-based benchmark are limited to:

(i) issuers' costs incurred principally in processing credit card transactions, including the costs of receiving, verifying, reconciling and settling such transactions;

(ii) issuers' costs incurred principally in respect of fraud and fraud prevention in connection with credit card transactions;

(iii) issuers' costs incurred principally in providing authorisation of credit card transactions; and

(iv) issuers' costs incurred in funding the interest-free period on credit card transactions, calculated using the average of the cash rate published by the

Reserve Bank over the three financial years prior to the date by which the cost-based benchmark must be calculated.

Costs to be included for each scheme are limited to those arising from domestic credit card purchase transactions for credit cards issued by each nominated scheme participant under the rules of that scheme. Costs associated with cash advances, balance transfers, international transactions or transactions for cards of other card schemes are not included in eligible costs.

All cost and transaction value amounts described in this Guidance Note refer to Australian dollars.

Measurement of eligible costs

Eligible costs (with the exception of the interest-free period which is purely a funding cost) includes the following types of costs to the extent they arise out of the relevant activities:

(i) direct internal staff costs (including for example salaries, benefits, recruitment, travel and related costs, where charged directly to the credit card issuing business), and direct ongoing costs of systems, materials, premises and equipment;

(ii) direct software, hardware and other capital expenditures, amortised according to accounting requirements for the relevant time period;

(iii) external charges for services from third-party providers. These could include, for example, switching and stand-in authorisation processing costs and insurance premiums paid for operational or fraud-related coverage; and

(iv) internal charges or allocations from other business units where costs have been identified through appropriate activity-based methods. These could include, for example, the share of call centre, branch and other processing staff and related costs incurred in responding to authorisation or retrieval requests, chargebacks, lost/stolen card reports and customer enquiries on suspect transactions. The allocation of telecommunication costs in respect of processing and authorisation activities are also included. Other indirect costs that are not specifically related to the eligible cost categories, such as general corporate overheads, are not included in eligible costs.

Activities and costs for inclusion in eligible costs

Transaction processing and authorisation

Eligible costs for processing and authorisation are those related to the following activities and costs:

(i) receiving, posting to cardholder accounts and other processing of data for domestic credit card transactions;

(ii) receiving and processing authorisation requests for domestic credit card transactions;

(iii) receiving and processing retrieval requests;

(iv) receiving and responding to referral enquiries;

(v) investigating and processing exception transactions;

(vi) maintaining and updating card authorisation files;

(vii) clearing and settlement of domestic credit card transactions;

(viii) receiving and processing chargebacks and representments;

(ix) net chargeback write-offs;

(x) scheme fees for processing and authorisation, clearing and settlement, retrievals and chargebacks; and

(xi) compliance with scheme requirements related to processing and authorisation, clearing and settlement.

Fraud and fraud prevention

Eligible costs for domestic fraud investigation and fraud prevention are those related to the following activities and costs:

(i) investigation of suspect credit card transactions;

(ii) processing fraud files;

(iii) developing and maintaining fraud management systems, including detection and prevention systems;

(iv) developing and implementing measures to monitor cardholder usage for potential fraud;

(v) developing and operating fraud detection measures in cardholder application processing and the opening of new accounts;

(vi) development and production of card security features where such features are implemented principally for the purposes of fraud prevention;

(vii) compliance with scheme fraud mitigation measures, such as fraud reporting, blocking accounts, logging lost/stolen cards, paying card capture rewards and maintaining hot card files and card recovery bulletins;

(viii) assisting and liaising with other members, schemes, law enforcement and other relevant parties for fraud investigations and prosecution;

(ix) secure delivery of cards where such delivery is employed principally to prevent fraud;

(x) scheme fees related to fraud prevention and investigation, such as for recovered cards, bulletin and file updates and payments to other members for captured or recovered cards under scheme rules; and

(xi) total domestic fraud losses net of recoveries.

Costs that are not principally related to fraud prevention, such as routine card production and delivery, statement production and credit assessment on new accounts, are not included in eligible costs. Costs incurred from scheme fines and penalties from failure to comply with scheme rules are also not included in eligible costs.

Interest-free period

An interest-free period on some credit cards is available to cardholders who pay off their entire balance by the required date or, in some cases, prior to the date on which interest begins to accrue on unpaid balances. The cost of funding the interest-free period is calculated by applying a cost of funds rate (the daily cash rate) over the prior three years, in order to take into account cyclical fluctuations in interest rates, to the average daily balances outstanding on credit cards that are attributable to the interest-free period.

Eligible costs for funding the interest-free period are calculated as follows:

(i) the value of any advances outstanding on credit card accounts that did not accrue interest is determined for each day in the prior financial year. The value of cash advances, international transactions, fees and any other transactions other than domestic credit card purchase transactions that may be reflected in those advances are subtracted from these advances;

(ii) the average daily value of advances not accruing interest is determined by summing the daily value of these advances calculated in (i) and dividing by the applicable number of days in the year;

(iii) the average daily cash rate for the prior three financial years is determined using the cash rate for each business day published monthly in the Reserve Bank of Australia *Bulletin*. For example, for the initial cost-based benchmark that must be determined by 1 October 2003, the daily cash rate would be averaged for the three years between 1 July 2000 and 30 June 2003; and

(iv) the average daily value of advances calculated in (ii) is multiplied by the average daily cash rate to obtain the total cost of funding the interest-free period.

II. Calculation of the Cost-based Benchmark

The cost-based benchmark for each scheme is calculated by summing all of the reported and verified eligible costs of the nominated scheme members, and dividing that amount by the aggregate value of credit card transactions for the prior financial year on credit cards of that scheme issued by the nominated scheme participants. For example, for the initial cost-based benchmark that must be calculated by 1 October 2003, the independent expert for each scheme must obtain the transaction value of all domestic purchase transactions on credit cards issued by each nominated scheme participant for that scheme, for the period 1 July 2002 to 30 June 2003.

For ease and consistency of implementation, the Standard requires the cost-based benchmark to be expressed as a percentage of transaction value, eg 0.52 per cent. However, as discussed below, this does not require that interchange fees must be set only as percentages of transaction values. The cost-based benchmark, expressed as a percentage, should be calculated to at least two decimal places.

III. Application of the Benchmark to Weighted Average Interchange Fees

The Standard requires that the cost-based benchmark for each scheme be compared to a weighted average of all domestic interchange fee rates in the scheme, where the weights are the respective shares of transaction value for each interchange fee rate. (An interchange fee *rate* is the percentage of transaction value, per-transaction amount or other formula that determines the dollar amount of interchange fees paid on a particular transaction, eg 0.6 per cent, 20 cents per transaction, etc.)

Calculation of weighted average

If there is only one interchange fee rate in a scheme in Australia, no weighted average calculation is necessary. This rate is simply compared to the cost-based benchmark. If there are multiple interchange fee rates applicable to different types of transactions, each of these rates must be weighted by their respective transaction shares, by value, to arrive at a weighted average that is compared to the cost-based benchmark. The weighted average, expressed as a percentage, should be calculated to at least two decimal places.

Where an interchange fee rate includes a flat fee or other fee formula, the rate must be converted to a percentage of transaction value. This can be done by dividing the amount of the interchange fee applicable to the average transaction amount by the average transaction size for transactions to which that fee rate applies or, equivalently, by summing all interchange fee revenue paid for a particular transaction type and dividing this amount by the aggregate value of transactions to which that interchange fee rate applies. This is illustrated in the following calculation.

Example

(i) A card scheme applies three interchange fee rates to domestic purchase transactions: (1) a rate of \$0.25 + 0.3% of transaction value for electronic transactions at hotels, (2) a rate of 0.5% for all other electronic transactions, and (3) a rate of 0.7% for non-electronic transactions;

(ii) the respective shares of transaction value in the financial year ending 30 June 2003 for these transaction categories were: (1) 10% for electronic transactions at hotels; (2) 60% for all other electronic transactions; and (3) 30% for non-electronic transactions;

(iii) for electronic transactions at hotels, where a blended flat and *ad valorem* rate is applied, the average transaction size for the year ended 30 June 2003 is equal to the total value of transactions in this category divided by the number of those transactions. Assume this average transaction size amounts to \$200. The interchange fee rate expressed as a percentage of average transaction size for this category is therefore: $(0.25 + 0.3\% \times 200)/200 = 0.425\%$; and

(iv) the weighted average of interchange fees, which must be equal to or less than the cost-based benchmark, is equal to:

$$10\% \times 0.425\% + 60\% \times 0.5\% + 30\% \times 0.7\% = 0.55\%.$$

Timing of compliance

The Reserve Bank recognises that, due to trends in different types of transactions, the weighted average of interchange fees may change over time, even though interchange fee rates themselves have not changed. Adjusting interchange fee rates on an ongoing basis to ensure that the weighted average remains at or below the benchmark would be unduly cumbersome. For this reason, the requirement that the weighted average of interchange fees be equal to or less than the cost-based benchmark does not apply at all times, but at certain times only.

First, the requirement applies to the interchange fees in effect thirty days after the date by which the cost-based benchmark must be calculated or, in future, recalculated. Thus, the initial compliance date is 31 October 2003.

Secondly, the requirement applies at the time any new or modified interchange fee rates are implemented. For example, if an interchange fee rate is being modified (whether it is being raised, lowered or a different formula applied) on 1 February

2005, the weighted average of all interchange fees, calculated according to the Standard, must be based on the interchange fee rates that will be in effect on 1 February 2005 and the transaction shares, by value, for these interchange fee rate categories for the financial year ending 30 June 2004. This weighted average must not exceed the cost-based benchmark that was previously calculated as at 1 October 2003.

If a scheme introduces a new interchange fee category for existing transactions (eg an interchange fee for Internet transactions), the transaction share to be used is the share of transactions to which that fee rate *would have* applied had it been in effect during the previous financial year. If a scheme introduces an interchange fee category for a new type of transaction or product that did not previously exist, the relevant share to be used is zero until the next time the weighted average is calculated.

Reserve Bank of Australia
SYDNEY
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