# COMMON BENCHMARK FOR THE SETTING OF CREDIT CARD INTERCHANGE FEES

**NOVEMBER 2005**

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ISBN 0-9752213-7-X (ONLINE)

# Common Benchmark for the Setting of Credit Card Interchange Fees

## 1. Introduction

This document sets out the Bank's revised Standard for the setting of interchange fees in the three designated credit card schemes (Bankcard, MasterCard and Visa). The revisions are principally technical in nature. They do not affect the average level of interchange fees across the three schemes. The effect of the revisions is to replace scheme-specific benchmarks for the setting of interchange fees with a common benchmark that will apply to all three schemes.

The Bank's reasons for considering a change to the current arrangements was set out in a Consultation Document released on 20 July 2005.[1] This earlier document also set out in draft form two possible standards through which a common interchange fee could be set (identified as Version A and Version B). After consultation with interested parties, the Bank has elected to determine draft Standard Version A, with some minor modifications to the drafting.

This document provides some background on the existing standards, summarises the rationale for the variations and the consultation undertaken by the Bank, and presents the final form of the Standard to be implemented. A revised Guidance Note for schemes, participants and independent experts is attached.

## 2. Background

In April 2001, the Bank designated the Bankcard, MasterCard and Visa credit card schemes as payment systems under the *Payment Systems (Regulation) Act 1998*. In August 2002 it determined a standard for interchange fees in each of these schemes.[2]

These standards were introduced to improve competition and efficiency in the Australian payments system. In the Bank's view, interchange fees in the credit card systems are not subject to the normal forces of competition and were set at levels that did not promote the efficiency of the payments system. A comprehensive discussion of these issues can be found in the four volumes entitled *Reform of Credit Card Schemes in Australia* released by the Bank in 2001 and 2002 and available on the Bank's website.[3]

Under the current standards, each scheme appoints an expert to collect cost data from nominated scheme participants and to verify that the costs are eligible costs as defined in the standard. These eligible costs include issuers' authorisation and processing costs, fraud-related costs, and the cost of funding the interest-free period. The expert then provides the data and its

1 A copy of the Consultation Document can be found at: http://www.rba.gov.au/PaymentsSystem/Reforms/CCSchemes/ConsultDocJul2005/index.html

2 Reserve Bank of Australia *Media Release* 2002-15, 27 August 2002.

3 http://www.rba.gov.au/PaymentsSystem/Reforms/CCSchemes/index.html

calculation of a benchmark based on those costs to the Bank. The standards then require that in each scheme the weighted-average interchange fee be no higher than that benchmark.

The current benchmarks came into force on 30 October 2003. The effect of the standards has been to reduce the average interchange fee from around 0.95 per cent of the credit card transaction value to a little below 0.55 per cent.

The individual credit card schemes are not required to publish the scheme-specific benchmarks, but they are required to publish any interchange fees they set. These fees differ slightly across the schemes, reflecting differences in the benchmarks. The average interchange fee is lowest in the Bankcard system and highest in the MasterCard system (see Table 1). Each of the interchange fees in the MasterCard scheme are around two basis points higher than the equivalent fees in the Visa scheme.

**Table 1: Interchange Fees, June 2005**
Per cent of transaction value

| | Bankcard | MasterCard | Visa |
|---|---|---|---|
| Electronic | 0.49 | 0.46 | 0.436 |
| Standard | 0.49 | 0.62 | 0.595 |
| Commercial | n.a. | 1.12 | 1.095 |

Sources: Bankcard, MasterCard and Visa websites
The electronic rate applies to transactions where the card is swiped and the signature verified. The standard rate applies to most other transactions, including those using manual processing and those over the internet or telephone. The commercial rate applies to transactions involving commercial cards.

Under the existing standards, the current benchmarks are due to be recalculated no later than 30 September 2006, and interchange fees are required to be in conformity with them from 1 November 2006. This timetable has not been affected by the change in standards discussed in this document.

## 3. The Effect of Scheme-specific Benchmarks

As discussed in the earlier consultation document on these standards, some participants in the credit card schemes have argued that a scheme with relatively high interchange fees enjoys a competitive advantage in attracting issuers of credit cards, as the higher interchange fees deliver more revenue to the issuer per dollar spent by cardholders. This argument raised questions about whether the efficiency of the system could be further improved by a modification to current arrangements.

In evaluating this argument, the Bank considered whether the additional interchange revenue was offset by additional costs to the issuer from issuing cards under a scheme with relatively high interchange fees. Here, two types of costs are relevant: those that are scheme specific and those that are issuer specific. If higher interchange fees are fully explained by differences in scheme-specific costs (such as scheme fees), there would appear to be little incentive to issue cards in the scheme with relatively high interchange fees, since the higher interchange revenue would simply be offset by higher payments to the scheme. On the other hand, if differences in the benchmarks are explained by costs specific to issuers, such an incentive may exist.

The cost data available to the Bank suggest that most of the eligible costs are specific to the issuer – these include the cost of fraud and fraud mitigation, as well as the cost of funding the interest-free period. These costs are largely invariant to which scheme cards are issued under, as they reflect the nature of cards offered by the financial institution (for example, the institution's choice about the length of interest-free period it offers on its cards) more than the scheme they are issued under. Importantly, the data available to the Bank also suggest that the variation between scheme benchmarks is, to a significant extent, explained by these issuer-specific costs, rather than scheme-specific costs. Taking this into account, earlier this year the Bank came to the view that competition and efficiency may be improved by adopting a common benchmark, rather than scheme-specific benchmarks.

## 4. Consultation

Given the above assessment, in February this year, the Bank sought comments from interested parties as to whether establishing a common benchmark was in the public interest. In total, the Bank received nine submissions and provided an opportunity to those who had made submissions to discuss their submissions with the Bank; five parties took up this opportunity. All submissions are on the Bank's website.

One group (the majority) argued that the Bank should change the Standard to require a common cost-based benchmark for all designated schemes.[4] These parties argued that the current differences in interchange fees are a factor in the marketplace.

Amongst the submissions supporting a common benchmark there were two broad approaches advocated.

The first, by the Australian Merchant Payments Forum (AMPF), was to base a common benchmark on the costs of the *lowest-cost* scheme. Other submissions did not support this approach on the basis that it would result in Bankcard's costs providing the benchmark. They argued that Bankcard's costs reflect those of a small, domestic scheme and are not representative of the costs of credit card issuing more generally. Visa, in particular, argued that Bankcard's costs are not reflective of a growing dynamic network and that if the Bank were to adopt such a benchmark, the capacity of schemes to develop new products for the benefit of society would be reduced.

The second, and more widely supported approach, was to base the benchmark on the weighted-average costs across the schemes. Some submissions argued that Bankcard should be excluded from this weighted-average on the basis that its costs are not representative of the industry as a whole.

In contrast to the submissions supporting a common benchmark, MasterCard and the Commonwealth Bank argued that the Credit Card Interchange Standard should not be changed.

MasterCard argued that establishing a common benchmark would eliminate the remaining competition in the setting of interchange fees. It argued that competition between schemes with respect to product offerings and scheme fees would be diminished. MasterCard also argued that

4 See submissions by ANZ, the Australian Merchant Payments Forum, Creditlink, CUSCAL, National Australia Bank and Visa.

a common benchmark would result in under compensation of issuers in the higher-cost scheme and over compensation of issuers in the lower-cost scheme.

The Commonwealth Bank argued that if a cost-based methodology is to apply, it should reflect actual costs incurred; an outcome which would not be achieved by setting a common benchmark. It also argued that facilitating different interchange fees between schemes is pro-competitive and noted that, in its view, the independent experts appointed by the schemes to calculate their benchmarks play an important role, and it would be undesirable to abolish this role.

Westpac indicated that it was not convinced of the need for change but, if the Bank were to institute such a change, it would support a common benchmark determined by costs averaged across the three schemes.

## The draft standard

Reflecting the results of its own analysis and the above consultation, the Bank released two versions of a draft standard for public consultation on 20 July 2005. The draft standards proposed that a common benchmark, equivalent to the weighted-average of the current individual benchmarks, would apply to all schemes. Under one version (Version A), each scheme would continue to appoint an independent expert to calculate a scheme-based measure, equivalent to the current benchmarks, with the Reserve Bank calculating the common benchmark as a weighted-average of these measures. Under the other version (Version B), a single expert would verify costs and conduct calculations across all issuers, with issuers not having to identify costs by scheme.

In addition to further comment on the arguments for a common benchmark, the Bank sought specific comment on three issues. The first was the method for calculating a common benchmark. The second was the date when the changes should be introduced. And the third was whether Version A or Version B was preferred.

Three parties made submissions by the due date of 23 August 2005, and a further four parties made late submissions. All submissions have been considered and posted on the Bank's website. Parties who made submissions were also offered the opportunity to meet with the Bank and three parties took up this opportunity.

All submissions were relatively short, with most parties having set out their views on the substantive arguments in the earlier round of consultation. Some reiterated previous opposition to a common benchmark but then put their views about their preferred form of a common benchmark should one be introduced. MasterCard argued strongly against any regulation of interchange fees in the four-party systems.

On the first issue – the method of calculation for the common benchmark – comments largely reiterated those that had been made earlier in the consultation process. The AMPF argued that the benchmark should be calculated based on the lowest-cost scheme, while most other submissions argued for a weighted average across schemes. The National Australia Bank added that the Bank should consider requiring schemes to adopt the same interchange rate for each transaction type.

With respect to the question of timing, there was general agreement that, should a change be made, it should be implemented to take effect at the time that the existing benchmarks are due to be recalculated in 2006.

On the issue of how the calculation should be performed, submissions were relatively evenly divided. A number of banks (but not all) supported Version B (under which a single expert would be appointed), while MasterCard and Visa supported Version A (under which there is one expert per scheme). Those supporting Version A noted that there were practical difficulties associated with Version B, particularly in choosing a single expert that was acceptable to all the nominated participants. Notwithstanding this, a view that was frequently expressed was that it would not make a significant difference one way or another which version was chosen.

The other main issue to receive comment was the method for selecting the nominated scheme participants. The draft standard proposed to move to a method where cost data had to be collected from the minimum number of financial institutions required to reach 90 per cent of the transactions in the scheme in Australia. This is in contrast to the current arrangements which allow the schemes to choose the financial institutions to be included in the cost study, provided that the chosen institutions account for *at least* 90 per cent of the transactions in the scheme in Australia. Visa argued that this proposed change would mean that there would be delays in identifying the nominated participants and that this could create undue burden for the marginal institutions as they could not effectively plan for the cost study because they would be uncertain if they were included or not.

## 5. Analysis of Issues

The consultation process confirmed that the current arrangements have created, at the margin, an incentive for issuers to issue credit cards under the scheme with the highest interchange fees. This is despite the difference in interchange fees in the two largest schemes being only two basis points.

The consultation process also highlighted the fact that there is little competitive discipline on schemes with relatively high interchange fees. While higher interchange fees mean higher costs to acquirers, these higher costs are not transparently passed on to merchants who are offered a bundled price for accepting cards of all three designated credit card schemes. As a result, a scheme with relatively high fees does not find itself at a competitive disadvantage in terms of merchant acceptance. This would likely remain the case even if acquirers charged merchants more for accepting cards issued under the higher-cost scheme given that many merchants currently accept higher-cost cards.

Some submissions argued that the recalculation of the current benchmarks every three years will ameliorate any competitive advantage enjoyed by the scheme with the highest interchange fee. In particular, if it were the case that it was predominantly issuers with lower costs that are attracted to the scheme with the high interchange fee, the benchmark would fall when it was recalculated, offsetting the gain those issuers achieved from switching. However, the offset would not be complete and, thus, an incentive to switch to the scheme with the relatively high benchmark would remain. Even if the offset were complete, a year or two of higher interchange fees may still be of commercial benefit and worth the costs of a switch in scheme.

MasterCard argued that a common benchmark would 'eliminate to a great extent the remaining degree of competition between the credit card schemes in the setting of interchange fees' and that the schemes should be allowed to set interchange fees themselves. In contrast, the Bank's view is that interchange fees are not set under normal competitive conditions, with competitive pressures tending to push intercharge fees up not down.

MasterCard also argued that a common benchmark would lead to greater homogeneity in credit card offerings in the Australian market place and increase the attractiveness of the three-party schemes to issuers. The Bank does not accept either of these arguments. There is strong competition amongst issuers of credit cards in terms of both price and product characteristics. In the Bank's opinion, this situation would not be adversely affected by a common benchmark. Similarly, a common benchmark, which results in interchange fees at around the current level, is unlikely to increase the attractiveness of the three-party schemes to issuers, since it would not change the average interchange revenue of issuers in the four-party schemes.

Finally, MasterCard argued that a common benchmark would 'under-compensate the issuers in the more expensive scheme(s), and over-compensate the issuers in the lower-costing scheme(s)'. As noted above, the Bank's opinion is that a common benchmark would improve the incentives for the schemes to lower their costs and for issuers to issue under the lower-cost scheme. Also, it is worth noting that under current arrangements the eligible costs of issuers span quite a wide range, with some issuers having lower costs than the relevant benchmark, and others having higher costs than the benchmark.

## Regulatory action

Given the above considerations the Bank considered whether a change to a common benchmark would meet the public interest test set out in the *Payment Systems (Regulation) Act 1998*. The Bank came to the conclusion that a common benchmark would provide a stronger incentive towards cost savings (that is, both technical and dynamic efficiency) and promote more-soundly based competition between the schemes for issuers. As such, the Bank determined that such a change would be in the public interest as it promoted both efficiency and competition in the designated credit card systems.

The Bank determined that a common benchmark calculated as a weighted average across the schemes is likely to promote efficiency and competition in two main ways. First, all else constant, it is likely to make schemes with lower costs more attractive to issuers. Second, it provides stronger incentives for issuers and schemes to pursue cost reductions over time. Under the current arrangements, any cost reductions that a scheme achieves lead to a reduction in the scheme's benchmark when it is recalculated, reducing the incentive to reduce costs. In contrast, under the new standard, the benchmark, because of the averaging across schemes, is only reduced by a fraction of any cost saving when it is recalculated.

The Bank also considered whether to base a common benchmark on a weighted average of costs, or whether to use the costs of the scheme with the lowest costs. The Bank has decided to use the weighted average of costs, reflecting the view that this amendment to the standard is designed to improve the operation of the existing Standard, rather than to further lower the average level of interchange fees in the credit card systems. The Bank has previously indicated that it will conduct a major review of the regulations in 2007, and at that time it will consider the broader question of whether the level of the benchmark continues to be appropriate.

As noted above, the draft Standard also proposed selecting nominated scheme participants in a way that would remove any discretion from the scheme in selecting which issuers were to be included in the benchmark calculations. This is in contrast to the current standard, where the schemes have some limited discretion as to which issuers are to be included. Visa has argued that the revised approach could create considerable practical problems, particularly where it was not clear at an early stage which participants would be included. While the Bank was not convinced that the problems were significant, it nonetheless decided that there was not a strong case for change at this time. As such, it has decided not to change the method of selecting the nominated scheme participants.

## 6. Final Standard

Reflecting consultation and the analysis above, the Bank has decided to modify the Standard on interchange fees in the designated credit card schemes. A copy of the new Standard is attached. The current scheme-specific benchmarks will be replaced with a common benchmark for all schemes. The common benchmark is to be calculated by the Bank as a weighted average of scheme-specific measures. In determining the benchmark, the Bank will use as weights the shares of each scheme in the total value of credit card transactions undertaken in all the schemes. The Bank will publish the common benchmark by 30 September of any year that the benchmark is calculated. The first such calculation will be done in 2006.

The final Standard involves relatively minor changes from both the Version A draft Standard that was released in July and the existing Standard. The only substantive change from the Version A draft is that the new method for selecting nominated scheme participants proposed in that draft has been removed and replaced with the existing method. Compared with the existing Standard, the new Standard includes an extra step where the scheme-specific benchmarks under the old standard are averaged to create the new common benchmark.

All other aspects of the current arrangements will be retained. Schemes will continue to select the nominated scheme participants as under the current Standard and individual scheme experts will continue to be used. There have been other minor changes from the existing Standards that are not substantive.

### Implementation

This Standard applies to all three designated credit card schemes. It will come into force on 1 July 2006 and the benchmark set under it will become effective from 1 November 2006. The current standards, 'Standard No. 1, *The Setting of Wholesale ('Interchange') Fees*' which apply to each of the schemes individually, will be revoked on 1 July 2006. The transition provision in the new standard provides that the scheme-specific benchmarks determined under the existing Standards will be effective until 31 October 2006.

The cost-based measure for each Scheme must be calculated and provided to the Bank by 15 September 2006 and each third anniversary thereafter. If the Bank agrees in writing, a recalculation of the cost-based measure for each Scheme and of the common benchmark may be undertaken at other times if changes in eligible costs or other factors warrant.

# Standard

## The Setting of Wholesale ('Interchange') Fees in the Designated Credit Card Schemes

### Objective

*The objective of this Standard is to ensure that the setting of wholesale ('interchange') fees in each designated credit card scheme is transparent and promotes:*

*(i) efficiency; and*

*(ii) competition*

*in the Australian payments system.*

### Application

1. This Standard is determined under Section 18 of the *Payment Systems (Regulation) Act 1998*.
2. This Standard applies to the payment systems operated within Australia known as the Bankcard scheme, the MasterCard system and the VISA system, which were designated as payment systems on 12 April 2001 by the Reserve Bank of Australia under Section 11 of the *Payment Systems (Regulation) Act 1998*, each of which is referred to in this Standard as a Scheme.
3. In this Standard:

   an 'acquirer' is a participant in a Scheme in Australia that provides services to a merchant to allow that merchant to accept a credit card;

   'credit card' means a card issued under the rules of a Scheme that can be used for purchasing goods or services on credit, or any other article issued under the rules of that Scheme and commonly known as a credit card;

   'credit card transactions' or 'transactions' means transactions in the relevant Scheme in Australia between a credit cardholder and a merchant involving the purchase of goods or services using a credit card of that Scheme (net of credits, reversals and chargebacks);

   'financial year' is the 12-month period ending 30 June;

   an 'issuer' is a participant in a Scheme in Australia that issues credit cards to the issuer's customers;

   'merchant' means a merchant in Australia that accepts a credit card for payment for goods or services;

'nominated Scheme participants' for a Scheme are those issuers that issued, in aggregate, credit cards which were used in at least 90 per cent of credit card transactions by value in the Scheme in Australia in the financial year prior to the date by which the applicable cost-based benchmark must be calculated, those issuers being determined by the administrator of the Scheme or the other participants in the Scheme in Australia;

'rules of a Scheme' mean the constitution, rules, by-laws, procedures and instruments of the relevant Scheme as applied in Australia, and any other arrangement relating to the Scheme by which participants in that Scheme in Australia consider themselves bound;

terms defined in the *Payment Systems (Regulation) Act 1998* have the same meaning in this Standard.

4. This Standard refers to wholesale fees, known as 'interchange' fees, which are payable by an acquirer, directly or indirectly, to an issuer in relation to credit card transactions in a Scheme.
5. Each participant in a Scheme must do all things necessary on its part to ensure compliance with this Standard.
6. If any part of this Standard is invalid, it is ineffective only to the extent of such part without invalidating the remaining parts of this Standard.
7. This Standard is to be interpreted:
   - in accordance with its objective; and
   - by looking beyond form to substance.
8. This Standard comes into force on 1 July 2006.
9. This Standard replaces Standard No. 1, *The Setting of Wholesale ('Interchange') Fees* which applies to each Scheme.

## Transition provision

10. If, prior to 1 November 2006, any interchange fee is introduced, varied, or removed in a Scheme, the average of interchange fees implemented in that Scheme in Australia on the date of that change, calculated in accordance with paragraph 19 below, must not exceed the benchmark for that Scheme calculated under Standard No. 1, *The Setting of Wholesale ('Interchange') Fees*.

## Interchange fees

11. From 1 November 2006, on each of the dates specified in paragraph 12, the average of interchange fees implemented in a Scheme in Australia, calculated in accordance with paragraph 19 below, must not exceed the common cost-based benchmark calculated in accordance with paragraphs 13 to 17 below.

12. For the purposes of paragraph 11, the dates are:
   (i) 1 November in any year the measure must be calculated; and
   (ii) the date any interchange fee is introduced, varied, or removed in that Scheme.

## Methodology

13. The cost-based measure for each Scheme is calculated as the value of eligible costs of the nominated Scheme participants in that Scheme for the financial year prior to the date by which the cost-based measure must be provided to the Reserve Bank of Australia, divided by the value of credit card transactions for the same period undertaken using credit cards issued by those nominated Scheme participants, expressed as a percentage. Eligible costs are:
   (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 of Australia over the three financial years prior to the date by which the cost-based benchmark must be calculated.
14. Data on eligible costs must be drawn from accounting records of the nominated Scheme participants, prepared in accordance with generally accepted accounting principles and Australian accounting standards.
15. Data on eligible costs and the value of transactions of each nominated Scheme participant in each Scheme must be provided by that participant to an independent expert proposed by that Scheme and agreed to by the Reserve Bank of Australia. The expert must review the data to determine if the costs included are eligible costs and must use the data on eligible costs to calculate the cost-based measure for that Scheme.
16. The nominated Scheme participants for a Scheme must provide to the Reserve Bank of Australia by 15 September of the year in which the cost-based measure must be calculated:
   (i) the cost-based measure, the data on eligible costs and the value of transactions undertaken by each of the nominated Scheme participants used by the independent expert to calculate the cost-based measure;
   (ii) the data on eligible costs described in (i) divided into the categories identified in paragraph 13 (i) – (iv) and the number of transactions undertaken by each of the nominated Scheme participants in the financial year prior to the date by

which the cost-based measure must be calculated using credit cards issued by those nominated Scheme participants.

The administrator of a Scheme must provide to the Reserve Bank of Australia, by 15 September of the year in which the cost-based measure must be calculated, the number and value of transactions undertaken by all of the participants in the Scheme in the previous financial year.

17. The common cost-based benchmark is calculated by the Reserve Bank of Australia by weighting the individual scheme cost-based measures by the shares of each Scheme in the value of credit card transactions undertaken in all the Schemes. The Reserve Bank of Australia will publish the common cost-based benchmark by 30 September of the year in which the cost-based measure must be calculated.

18. The cost-based measure for a Scheme must be calculated in 2006 and each third year thereafter. If the Reserve Bank of Australia agrees in writing, a recalculation of the cost-based measure for a Scheme and of the common cost-based benchmark may be undertaken at other times if changes in eligible costs or other factors warrant.

19. For the purposes of paragraphs 10 and 11, the average of interchange fees in a Scheme is to be expressed as a percentage of transaction values. It is to be calculated by dividing the total interchange revenue that would have been payable had the interchange fees implemented on the dates specified in paragraph 10 or 12 been applicable in the previous financial year, by the value of transactions in that year.

## Transparency

20. The administrator of a Scheme or a representative of the participants in the Scheme in Australia must publish the interchange fee rates of the Scheme in Australia on the Scheme's website or make the interchange fee rates generally available through other means.

21. The administrator of a Scheme must certify annually in writing to the Reserve Bank of Australia, on or before 30 November each year, that interchange fees of the Scheme in Australia over the prior twelve months ending 31 October were in compliance with this Standard.

# Guidance Note

## Implementation of the Standard on Interchange Fees

The Reserve Bank of Australia is providing this updated Guidance Note to facilitate compliance with the standard *The Setting of Wholesale ('Interchange') Fees* in the Designated Credit Card Schemes (the Standard) which comes into force on 1 July 2006. 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 measure using data on 'eligible costs' of certain scheme participants. A common cost-based benchmark is then calculated by the Reserve Bank. A weighted average of interchange fees applied to transactions in each scheme in Australia must then be compared to this common 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 measures and other guidance on the practical operation of the Standard.

## 1. Measurement of Eligible Costs

### Nominated scheme participants

'Eligible costs' for use in calculating the cost-based measure in each 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 on transaction values to an independent expert if the scheme administrator is unable to do so.

## Time period for data collection

In the first instance, the cost-based measure and the underlying data described in paragraph 16 of the Standard must be calculated and submitted to the Reserve Bank by 15 September 2006, using data for the financial year ending 30 June 2006. Thereafter, the measure and underlying data must be recalculated and submitted every three years, i.e. by 15 September 2009 and 15 September 2012, etc. 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.

## Definition of eligible costs

Under the Standard, eligible costs for inclusion in the calculation of the cost-based measure 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 measure 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 on 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) include 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 re-presentments;

(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.

There are potentially a number of ways of calculating the cost of the interest-free period which are essentially equivalent. One way is 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 rate for the interbank cash market for each business day published monthly in the Reserve Bank of Australia *Bulletin*. As at November 2005, this rate was published in *Bulletin* Table F1. For example, for the initial cost-based measure that must be calculated by 15 September 2006, the daily cash rate would be averaged for the three years between 1 July 2003 and 30 June 2006; 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.

If agreed to by the Reserve Bank, an alternative method of calculating the cost of the interest-free period which is equivalent to the above method may be used.

## 2. Calculation of the Cost-based Measure

The cost-based measure for each scheme is calculated by summing all of the reported and verified eligible costs of the nominated scheme participants, 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 measure that must be calculated by 15 September 2006, 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 2005 to 30 June 2006.

The common cost-based benchmark is calculated by the Reserve Bank by weighting the individual scheme measures by the shares of each scheme in the value of credit card transactions undertaken in all the schemes. The Reserve Bank of Australia will publish the common cost-based benchmark by 30 September of the year in which the measures must be calculated.

## 3. Application of the Benchmark to Weighted Average Interchange Fees

The Standard requires that the common cost-based benchmark be compared to a weighted average of all domestic interchange fee rates for each scheme, where the weights are the respective shares of transaction value for each interchange fee rate.

### *Calculation of weighted average interchange fees*

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 common 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 common cost-based benchmark. Where an interchange fee rate includes a flat fee or other fee formula, the rate must be converted to a percentage of transaction value.

The weighted average, expressed as a percentage, should be calculated to at least two decimal places.

The weighted average can be calculated by summing all interchange fee revenue due for all transactions and dividing this amount by the aggregate value of transactions in a scheme. This is illustrated in the following calculation. Mathematically equivalent calculations may also be performed.

### *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 total value of transactions in the scheme was \$200 000 in the financial year ending 30 June 2006. The respective shares of transaction value 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. Assume there were 100 transactions at hotels with an average transaction size of \$200;

(iii) Total interchange fee revenue is then:

100*\$0.25 + 0.003*\$20 000 + 0.005*\$120 000 + 0.007*\$60 000 = \$1 105

and the weighted average of interchange fees, which must be equal to or less than the cost based benchmark, is equal to \$1 105/\$200 000 = 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 applies only at specified times.

First, the requirement applies to the interchange fees on 1 November in any year the measures must be calculated.

Second, the requirement applies at the time any new or modified interchange fee rates are implemented. For example, if an interchange fee rate is modified (whether it is being raised, lowered or a different formula applied) on 1 February 2008, 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 2008 and the transaction shares, by value, for these interchange fee rate categories for the financial year ending 30 June 2007. This weighted average must not exceed the cost-based benchmark published by the Reserve Bank.

If a scheme introduces a new interchange fee category for existing transactions (e.g. 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.