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# Current Problems of Banking Sector Functioning in Poland and in East European Countries

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Current Problems of Banking Sector Functioning in Poland and in East European Countries ISSN 1899-3192

**Janina Harasim**
University of Economics in Katowice

# INTERCHANGE FEE AND THE COMPETITION IN THE PAYMENT CARD MARKET IN POLAND

**Summary:** This paper explores the role of the interchange fee in the payment card market and makes an assessment of its impact on market competition. The subject of analysis has been the interchange fee practices in Poland and the EU on the basis of the European Commission and NBP survey results. The analysis has demonstrated that the fee may have a positive impact on the development of the payment card market, yet it may also work to restrict market competition and market entry for innovative payment instruments. Market regulators and competition authorities in Poland and the EU have taken initiatives to reduce interchange rates. While facing much resistance from the card industry, they do begin to produce measurable results.

**Keywords:** interchange fee, retail payment market, payment cards.

## 1. Introduction

Payment cards are nowadays a common payment instrument, which is a consequence of the dynamic growth of the payment card market in Poland in the recent dozen years. Consumers use them more and more when paying for goods and services, also in low-amount transactions, which so far have been dominated by cash payments. This is accompanied by a systematic development of the network of points of sale accepting payment cards. However, further growth of the payment card market will depend on a number of factors – the key ones being the costs of payment card acceptance and the method of charging the parties involved in a transaction with those costs, whose level, in turn, is mostly dependent on the interchange fee collected by card issuing banks from acquirers. Agreements concerning those fees have been common in the payment card market, but they have come under criticism as anticompetitive.

This article aims at defining the role of the interchange fee on the payment card market and evaluating its impact on competition. Further, it will present measures directed at reducing the level of those fees in Poland and across the European Union.

## 2. Specifics of competition in the payment card market as a two-sided market

Retail payment market is a so-called two-sided market, i.e. the one in which goods and services are delivered to two different groups of end-users, at prices determined in such a way as to encourage participation of both groups, because benefits gained by one group increase with the rising number of participants in the second group.[1] With reference to the payment card market, as the object of further deliberations, the first group of end-users is comprised of payment cardholders, while the second group consists of points of sale (merchants) who make card payments possible. Interaction between these two groups takes place on platforms that act as a venue for communication and transactions – in the case of the payment card market the function of the platform is fulfilled by card schemes. Two-sided markets experience the so-called network effects where the value of a product owned by a user increases with the number of other users of the same product. In the case of the payment card market, the growing number of card users translates into greater acceptance of cards among points of sale, which in turn makes them an increasingly more convenient payment instrument and induces their more frequent use. This contributes to a rise in sales, thus encouraging new points of sale to start accepting payment cards, which, as a result, further gain in value in the user's perception.[2]

Next to network effects, another characteristic feature of a two-sided market is a particular price-setting mechanism that considerably differs from the classic rules typical of one-sided markets, in which defining the price starts with the size of marginal costs of production. The price paid by consumers in two-sided markets rarely equals the value of the expenditure that goes into the production of a good or service.[3] The level of prices of goods and services in two-sided markets is an outcome of many factors, among which the most important one is a different level of price elasticity of the demand for payment services in each group of end-users.[4] The price elasticity of consumer demand for payment services in two-sided market is higher than that of merchants, since the latter must provide consumers with an opportunity to purchase their goods and services and to pay for them. When making a decision to start accepting a new payment instrument, merchants hope for

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[1] S. Chakravorti, R. Roson, *Platform Competition in Two-Sided Markets: The Case of Payment Networks*, Federal Reserve Bank of Chicago, Working Paper Series, No 9, Chicago 2004, p. 1.

[2] J. McAndrews, Network issues and payment systems, *Business Review* 1997, Federal Reserve Bank of Philadelphia, November/December, pp. 22–23.

[3] J. Wright, One-sided logic in two-sided markets, *Review of Network Economics* 2004, Vol. 3, p. 62.

[4] Other factors include: nature and intensity of indirect network effects occurring between groups and the size of marginal costs of production – calculated separately for each "side" of the market – D. Evans, R. Schmalensee, *Markets with Two-Sided Platforms*, American Bar Association Section of Antitrust Law, Issues in Competition Law and Policy, Chicago 2008, Vol. 1, p. 67.

higher revenues. Other qualities that consumers associate with a given payment instrument, such as savings, security or convenience, are of secondary importance to merchants.[5] As a result, they are more willing to accept higher user fees than consumers would.[6] Taking advantage of this relationship, payment card companies usually charge merchants with transaction fees. Cardholders, on the other hand, may have to pay only some fixed fee for using a card or, as it frequently happens, no fee at all.[7]

The most important conclusion reached by theorists studying two-sided markets is that both groups of a good or service users do not have to be charged with the cost of its production to the same extent – in certain cases, some groups can be subsidized by others.[8] It is their view that a situation in which one group of customers (merchants) is asked to pay a price exceeding by far marginal costs, while another group (cardholders) is charged with fees far below marginal costs or with no fees at all, is in such markets both, reasonable and fair, as it allows both sides of the market to profit ("both sides on board"), and the providers can still generate earnings. They also believe that this kind of pricing strategy initially helps to overcome problems related to the insufficient size of user group and subsequently allows maximizing network effects.[9]

Another characteristic feature of the retail payment market is the nature of its competition. In one-sided markets, the competition among sellers of goods and services usually works to enhance the overall effectiveness of the market. In two-sided markets with network effects, such as the payment market, the situation may be slightly different – the advantages of competition understood in a traditional sense can be accompanied by the benefits of cooperation that is inevitable among market actors and helps to facilitate payment processing. The basic benefits include an easier path to reaching the critical mass (i.e. a sufficiently large number of cardholders) if a well-developed infrastructure is in place, and a possibility to increase the scale effects in the case of network expansion. However, as the actors of the retail payment market engage in shared undertakings (joint ventures) and jointly maintain and operate the payment infrastructure, new threats may emerge,

[5] Even a small rise in sales, at a 29% margin (average value for large merchants), brings more gains to a seller than savings made on payment fees (usually 1–2% of transaction value) as a result of accepting a new, presumably cheaper, payment method. See: D. Evans, R. Schmalensee, *Innovation in Payments*, Market Platform Dynamics, 2008, p. 14, http://ssrn.com/abstract=1277275 [accessed: 14.06.2013].

[6] W. Bolt, A. Tieman, *Social Welfare and Cost Recovery in Two-Sided Market*, IMF Working Paper, No 05/194, 2005, [after:] J.C. Rochet, Competing payment systems: Key insights from the academic literature, [in:] *Proceedings of Payments System Review Conference*, Reserve Bank of Australia, Sydney 2008, p. 15.

[7] *Ibidem*.

[8] S. Chakravorti, R. Roson, p. 2.

[9] J. Górka, *Konkurencyjność form pieniądza i instrumentów płatniczych*, Wydawnictwa Fachowe CeDeWu, Warszawa 2009, pp. 174–175.

including the danger of monopolistic price setting and using a dominant market position to restrict competition. An example of agreements that may hinder competition in the payment market and that raise concerns of possible abuse of a strong market position are agreements concerning interchange fee, which is a price that the issuing banks charge the acquirers for each non-cash transaction made using a payment card.[10]

## 3. Role of the interchange fee in the payment card market

The interchange fee is a distinctive feature of four-party (open) systems or schemes,[11] in which the issuing of cards and the processing of transactions can be done by separate, independent entities, i.e. the issuers and the acquirers. Interchange fees can be determined either by members of payment card organizations (usually banks or, more precisely, their associations) or by payment card organizations themselves, in the form of rules. It should be noted though that fee rates are set by payment organizations, which at the same time declare to derive no revenue from those charges.

The interchange fee is just one of the fees present in the business model of a four-party payment card system – see Figure 1. Other charges include the merchant fee, the cardholder fee and system or scheme fees. The merchant fee (merchant service charge) is levied by the acquirer on the merchant for each accepted card transaction. It is usually calculated as a percentage of the transaction value and set at a negotiated rate. The interchange fee makes up the bulk of the merchant fee.[12] Merchants are also charged by acquirers additional fees for point-of-sale terminal lease and maintenance and for the costs of phone/online connections with the merchant service provider's server for card verification purposes. Retailers may raise the prices of goods and services or charge additional fees to customers paying with a card (surcharge) in order to recoup the costs they must bear for the privilege of accepting payment cards, but only if they are allowed to do so by the policy of payment organizations or by law. Cardholders, except if surcharged by the acceptant, are not charged with any costs of non-cash transactions made using a payment card. While they could be charged with a small fixed fee by card-issuing banks, there will be usually no fees at all, rather additional rewards granted to

[10] Interchange fees can also be charged using payment instruments other than payment cards, e.g. in direct debit transactions, bank/wire transfers or ATM withdrawals.

[11] However, it needs to be noted that three-party schemes, such as American Express and Diners Club, where cardholders and merchants are served by a single supplier of payment services, have a hidden interchange fee, which may cause similar problems resulting from the absence of competition.

[12] Findings of the survey conducted among acquirers in Poland by the National Bank of Poland show that in the period between 2008 and 2010 the share of the interchange fee in the merchant service charge rose from 79% to 84.9% – *Analysis of the Functioning of the Interchange Fee in Cashless Transactions on the Polish market*, National Bank of Poland, Payment Systems Department, Warsaw, January 2012, p. 65.

frequent card users. Acquirers and card issuers are in turn charged by payment organizations membership fees for operating within their payment card schemes. Those are called system fees or scheme fees.

The analysis of the flow of payments in a four-party scheme leads to the conclusion that the main beneficiaries of the system are issuing banks and acquirers, while the group who carries the bulk of the financial expenditure are acceptants/ merchants, who seem to "support" the whole system. It should also be noted that while payment organizations are not directly involved in the above business model, they do generate substantial revenues for creating and managing these four-party schemes.

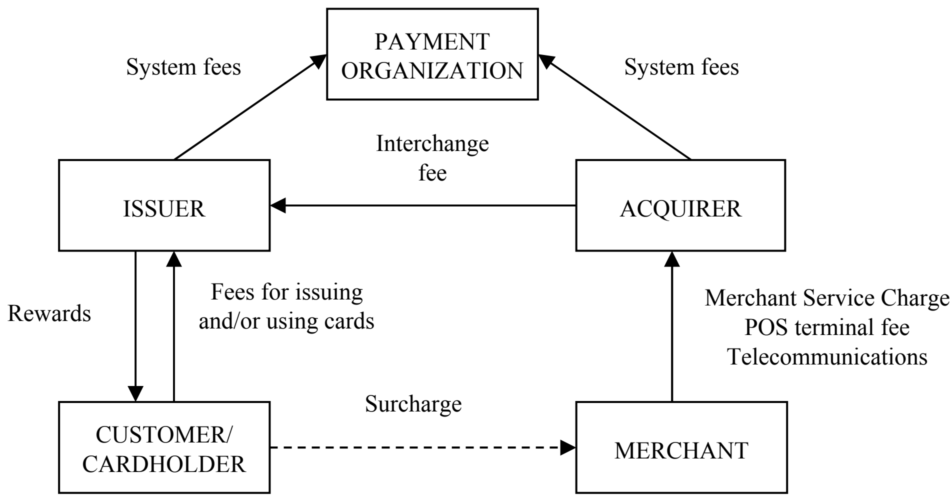


**Figure 1.** Business model of a four-party payment card system

Source: Analysis of the Functioning of the Interchange Fee in Cashless Transactions on the Polish Market, National Bank of Poland, Payment Systems Department, Warsaw, January 2012, p. 44.

According to payment organizations, the basic function of the interchange fee is to keep balance in cost terms between card issuers and acquirers, who process payments for merchants. While the majority of expenditures is carried by the first of the two groups (promotion, production, issuing and processing of cards; technological upgrade of cards and bank systems), acquirers are the ones who generate the majority of revenues (transaction processing and registration, point-of-sale terminal lease and maintenance). This imbalance requires a compensating mechanism, where revenues can be transferred via the interchange fee from the acquiring party processing the payment for a merchant to the bank which issued the card used in a transaction. Payment organizations claim that the interchange fee fulfills other positive functions as well. It aids issuers in encouraging consumers to use payment cards, since these can be issued at no or just minimum charge to the customer and offer discounts or rewards. Further, it motivates banks to invest in new technologies in order to keep payment instruments and electronic transactions secure and fraud-free as well as increasingly reliable and convenient.

## 4. Impact assessment of the interchange fee on competition in the payment card market

The necessity of charging the interchange fee is rarely called into question; however, much doubt is raised by its real purpose and charging methods, in particular the size of its rates. Critics of the interchange fee point to the fact that it may not be doing what it is supposed to do, which is to encourage consumers to pay with cards, but worse than that – it may actually have a counterproductive effect. Above that, they blame it for distorting and restricting market competition by creating a situation where the fee is formally levied by the issuing bank on the acquirer, while in economic terms it is charged to the merchant, who ultimately transfers it to the consumer, either in higher retail prices or as surcharge to the cardholder.[13]

Furthermore, competition watchdogs argue that the benefits alleged by the fee setting parties are but a declaration without any evidence of their existence. A broad scope inquiry into the payment card market, carried out by the European Commission, found that rising interchange rates charged in the EU member states did not translate into lower cardholder fees. On the contrary, the business of issuing payment cards was exposed as a very lucrative activity suggesting that the fee itself may be, first and foremost, a source of considerable income, rather than a subsidy intended to lower cardholder charges.[14]

It is for those reasons that competition authorities and national regulators in many countries have been looking into the issue of interchange fees for a long time. Some countries, including the United States and Australia, solved it by means of regulation. Some legal measures concerning interchange fees have been adopted in Hungary and Spain. Within the European Union, both the European Commission and national competition authorities have issued a number of decisions prohibiting certain interchange fee arrangements under the EU competition law.[15]

The problem of interchange fees has been the subject of inquiry for the European Commission since the early1990s. The Commission has published a number of

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[13] *Interchange. Katastrofalne skutki źle przeprowadzonych regulacji*, Raport pod kierunkiem dra hab. R. Gwiazdowskiego, Centrum im. Adama Smitha, 14 November 2012, pp. 62–63.

[14] *Interim Report I: Card Payments*, Sector Enquiry Retail Banking, European Commission, http://ec.europa.eu/comm/competition/antitrust/others/sector_inquiries/financial_services/interim_report_1.pdf [accessed: 15.07.2013].

[15] These included decisions concerning the VISA and MasterCard companies in Poland and MasterCard in Hungary and Italy.

decisions concerning the dominant payment organizations, i.e. VISA and MasterCard, urging them to reduce interchange fee rates in proportion to the real costs incurred in the course of payment processing, and to ensure their transparency.[16] The Commission has also taken a stance on this matter in the report on the retail banking sector in the EU countries, published in January 2007.[17] The results of the Commission's inquiry have demonstrated that interchange fees are not indispensable for the efficient operation of payment card systems – there are national systems that refrain from interchange mechanisms and, as a result, lower fees are charged to merchants. The report has also brought to light considerable variations in the weighted average of national interchange fees for VISA and MasterCard credit card transactions across the EU member states. Some findings make it clear that the setting of interchange fees may, in certain EU countries, be subject to the exercise of market power and market entry restrictions by banks.[18] The inquiry has further revealed that interchange fees may work to increase the profits of payment card issuers. Its results point to the fact that 62% of the surveyed banks would still profit from credit card issuing even if they did not receive any interchange fee related income.[19]

The conclusions of the European Commission concerning interchange fees in domestic markets are as follows:[20]

– the cost of interchange fee is passed on to consumers in retail prices of goods and services, thus affecting all consumers, including non-cardholders,
– the cost rates are far from transparent and, as such, cannot act as a signal for choosing the most effective payment instrument,
– the Commission does not advocate the abolition of interchange fee, but it will take action to ensure that it is set at a reasonable level by stimulating competition and enforcing fee transparency for all market actors,
– there is no economic evidence to support the card industry's claim that reducing the interchange fee would necessitate higher charges to cardholders; most card issuers would generate revenues, even if all interchange fees were abolished,
– the reason behind establishing interchange fees at such high levels, without any differentiation due to card type, issuer or system, is the lack of competition at the retail level,[21]

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[16] For more on the subject see: Analysis of the Functioning…, *op. cit*., pp. 32–36.

[17] *Report on the Retail Banking Sector Inquiry*, European Commission, Directorate-General for Competition, 31 January 2007 SEC(2007) 106, p. 117, http://ec.europa.eu/competition/sectors/financial_services/inquiries/sec_2007_106.pdf [accessed: 12.04.2013].

[18] *Ibidem*, p. 117.

[19] *Ibidem*, p. 127.

[20] N. Kroes, *Introductory Remarks on Final Report of Retail Banking Sector Inquiry*, Speech/07/50, Press conference, Brussels, 31 January 2007, http://europa.eu/rapid/press-release_SPEECH-07-50_en.htm?locale=en [accessed: 12.04.2013].

[21] This practice of card fee blending is strongly criticized by the European Commission.

– the Commission has serious concerns about the level of multilateral interchange fees in several of the new member states (where the fee can be up to four times higher than in other countries); in the Commission's view, this has been caused solely by the lack of competition in those markets, and reducing the fees is recommended as it would surely benefit consumers.

In its Green Book of 2012 devoted to the subject of an integrated European market for card, internet and mobile payments, the Commission remarked that high interchange fees may act as entry barriers to low-cost card schemes and other payment systems (e.g. electronic payments and mobile payments).[22]

The question of the interchange fee has also been raised by the European Central Bank, which assuming a neutral position in this matter has not denied its legitimacy; however, voiced its opinion that card schemes need far more clarity. As for interchange fees, if they are here to stay, they should be set at an economically reasonable level, compatible with the principles of competition and law.[23]

## 5. Program of interchange fees reduction in Poland

Interchange fee rates vary widely and depend on many variables such as card type, authorization method, transactional environment and circumstances, the relationship between the country of the merchant and the country of card issue, or the category of the merchant. The analysis of the size and diversification of interchange fees in Poland, carried out by the National Bank of Poland (hereinafter the NBP) in comparison to other EU member states, has shown that domestic interchange fee rates – for both, VISA and MasterCard – are among the highest in the European Union. Also, the level of fees charged in domestic payments usually exceeds by far the fees collected in cross-border transactions. Moreover, Poland is one of the relatively few countries where debit card charges are higher than credit card fees, even though debit cards are the most popular ones in the Polish market. According to the NBP, it is difficult to rationalize such high interchange fee rates. Another worrying aspect of the situation is the rapid growth of bank revenues generated from interchange fees. While interchange rates have slightly gone down in recent years (from 1.7%–2.5% a few years back to 1.1%–1.3% now), bank revenues have shown the opposite tendency. Since 2007, the market of interchange fees has been growing faster in transaction value terms than the whole market of payment cards.[24]

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[22] *Green Paper. Towards an Integrated European Market for Card, Internet and Mobile Payments*, European Commission, COM(2011) 941 final. Brussels, 11 January 2012, p. 9.

[23] See more in: A. Börestam, H. Schmiedel, *Interchange Fees in Card Payments*, European Central Bank, Occasional Paper Series, No. 131, September 2011, pp. 37–38.

[24] *Analysis of the Functioning…*, *op. cit.*, pp. 60–64.

In Poland the issue of the interchange fee has been raised for the first time in the course of the antitrust proceedings conducted at the Office of Competition and Consumer Protection (hereinafter the OCCP), following the motion submitted by the Polish Trade and Distribution Organization against banks – members of the VISA and MasterCard payment schemes and the payment organizations, for using anticompetitive practices, price fixing and agreements concerning interchange fees, which make up the bulk of the merchant service charge. On 29 December 2006, the OCCP stated in its decision that such price setting practices were restricting competition and, as such, they would be prohibited from then on. However, following an appeal lodged by the banks and payment organizations against the OCCP decision, the dispute has been unresolved to this day, and the problem of high merchant service charges remains. Merchant dissatisfaction with the fees has been steadily growing ever since the obligation to publish interchange rates was imposed on payment organizations. This frustration was also reflected in the parliamentary debates and works on the formulation of the Act on Payment Services, but did not find a satisfactory solution there either. The initiatives aimed at reducing interchange rates in Poland, undertaken between 2001 and 2012, are presented in Table 1.

One of the last initiatives aimed at reducing interchange rates in Poland has been the "Program of card charges reduction in Poland" developed under the auspices of the NBP, with the input from commercial banks, and approved by the Payment System Council on 30 March 2012. The Program was to be implemented between 2012 and 2017; however, initial interchange fee reductions were expected to come into effect still in 2012 or 1 January 2013 at the latest. Subsequent interchange reductions were scheduled for the years 2014–2016 depending on the fulfillment of the conditions set out in the Program. 2017 was designated as the year of introducing an unconditional interchange reduction with the objective to reach the level of the average EU interchange fees (unless earlier reductions reached that level at an earlier date).

Eventually, however, it turned out that interchange fees would be reduced sooner. The Act on Payment Services of 19 August 2011 was amended in August 2013 to include a stipulation setting the upper limit of interchange fee to 0.5% per transaction value. The new law came into force in January 2014 giving payment organizations half a year since its introduction to reduce fees accordingly.

Substantial reduction of interchange fees has been recently announced also by the European Commission. Its new Interchange Fees Regulation and the projected Payment Services Directive transposition are to introduce maximum levels of interchange fees for transactions based on consumer debit (0.2%) and credit (0.3%) cards. Further, the Commission expects new players to enter the market of mobile payment service providers, which should promote development of innovative payment methods for mobile devices and the internet across Europe.

**Table 1.** Initiatives aimed at reducing interchange rates in Poland

| Timeframe | Type of initiative | Results/conclusions |
|---|---|---|
| Since 20.04.2001 | Antitrust litigation before the OCCP following the motion by the Polish Trade and Distribution Organization against anticompetitive practices, involving price fixing and interchange agreements, by banks – members of the VISA Poland Forum (later VISA Poland National Organization) and the Europay/MasterCard Poland Forum. | –OCCP's decision prohibiting interchange fee-setting agreements and ordering 20 banks to pay a total fine of PLN 164 million.<br><br>Banks appeal OCCP's decision to the Court of Appeal – the dispute has remained unresolved to date. |
| 22.04.2007 | Establishment of the Interchange Fee Working Group (NBP and Polish Bank Association representatives) with the objective to draw a comprehensive report on the interchange situation. | Recommendations:<br>– the four-sided business model of payment card schemes in Poland should be maintained and attempts should be made to find new ways of working out interchange fee rates,<br>– there is a potential for further reduction of interchange rates in Poland,<br>– this requires legal certainty and clear operating rules to let market players know how to define interchange fees in line with the competition law. |
| 29.11.2007 | Submission of the full version of "Report on Interchange Fee" to the NBP Board. | |
| 2008–2009 | Discussion of interchange fees in the draft *Program for the Development of Cashless Transactions in Poland in 2010-2013* (Measure 10). | Objective – optimum adjustment of interchange rates to the structure and nature of various merchant groups and types of card payments.<br>The program has not been approved by the Polish Cabinet. |
| 03.10.2011 | Report on "Analysis of the functioning of the interchange fee in cashless transactions on the Polish market, version 1.0" prepared by the Payment Systems Department of the NBP. | Establishment of the Interchange Fee Task Force with the representatives of all interested parties (merchants, card issuers, card organizations, acquirers, consumers, government institutions) to analyze the possibility of changing the interchange fee structure and rates in Poland. |
| 2011–2012 | Development of the "Program of card charges reduction in Poland" approved by the Payment System Council on 30 March 2012. | 30.04.2012 – the Program is approved by VISA<br>31.05.2012 – MasterCard declares it will not join the Program, but announces a unilateral reduction of interchange rates until 01.01.2013. |

Source: own compilation.

## 6. Conclusion

The interchange fee is a product of the peculiar nature of the payment card market, which is a two-sided type of market where network effects occur. While the fee may have a positive impact on the development of that market, a point is often raised that the charge also works to restrict market competition and market entry for innovative payment instruments such as mobile payments. As a result, competition authorities and national regulators in many countries, including Poland, have been looking into the issue of interchange fees for some time and taking initiatives to reduce their rates. Experience sp far has shown that those undertakings, while unremarkable and facing much resistance from the card industry at first, do begin to produce measurable results. It must be said though that to this point only a few countries have had the interchange fee regulated by law. However, recent initiatives of the European Commission and national regulators in a number of countries (including Poland) clearly communicate that the legislative pressure to reduce interchange rates is becoming more and more effective.

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## OPŁATA *INTERCHANGE* I KONKURENCJA NA RYNKU KART PŁATNICZYCH W POLSCE

**Streszczenie:** Celem artykułu jest ustalenie roli opłaty *interchange* na rynku kart płatniczych oraz dokonanie oceny jej oddziaływania na konkurencję. Przedmiotem analizy były zasady stosowania *interchange fee* w Polsce oraz UE w oparciu o wyniki badań prowadzonych przez Komisję Europejską oraz NBP. Wykazała ona, że opłata ta może mieć pozytywny wpływ na rozwój rynku kart płatniczych, jednak jej pobieranie może ograniczać konkurencję oraz stanowić barierę dla wprowadzania innowacyjnych instrumentów płatniczych. Regulatorzy rynku oraz organy ds. konkurencji w Polsce i UE podejmują działania zmierzające do redukcji *interchange fee*. Mimo że spotykają się one z oporem banków i organizacji płatniczych, ostatnio zaczynają przynosić wymierne rezultaty.

**Słowa kluczowe:** opłata *interchange*, rynek płatności detalicznych, karty płatnicze.