Financial System Development in Poland 2005
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In 2005, the importance of the financial sector in the Polish economy continued to increase. The value of assets of this sector as a share in GDP equalled 86.4%, which was higher by 7.7 pp. than in the previous year. All types of financial institutions recorded a rise in the value of assets. No substantial changes occurred in the Polish financial system structure in the discussed period. As in previous years, banks were the most important institutions in the Polish financial system. However, a rise in the value of assets of non-banking financial institutions and the financing of companies directly on the capital market were observed.

### Assets of financial institutions in Poland, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th>Amount (PLN billion)</th>
<th>Growth (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2002</td>
<td>2003</td>
</tr>
<tr>
<td>Commercial and cooperative banks</td>
<td>466.5</td>
<td>489.0</td>
</tr>
<tr>
<td>Credit unions</td>
<td>2.5</td>
<td>3.4</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>57.6</td>
<td>65.7</td>
</tr>
<tr>
<td>Investment funds</td>
<td>22.8</td>
<td>33.2</td>
</tr>
<tr>
<td>Open pension funds</td>
<td>31.6</td>
<td>44.8</td>
</tr>
<tr>
<td>Brokerage companies</td>
<td>2.8</td>
<td>3.7</td>
</tr>
<tr>
<td>Total</td>
<td>583.8</td>
<td>639.8</td>
</tr>
</tbody>
</table>

Source: NBP calculations based on NBP, Insurance and Pension Funds Supervisory Commission, Securities and Exchange Commission and Chamber of Funds and Assets Managers data.

Positive economic trends in 2005 created favourable conditions for the development of the banking sector in Poland. The growth rate of lending continued to rise, in particular in the segment of housing loans for households. Improvement of the financial standing of companies contributed to an increase of the value of their bank deposits.

In 2005, investment preferences of individuals changed. Considering historically low interest rates, which had an impact on bank deposit interest rates, households preferred to invest on the capital market, mainly through the purchase of investment funds’ participation units. Throughout 2005, the inflow of funds to investment funds registered in Poland amounted to approximately PLN 18.5 billion, while the value of funds accumulated by households on bank accounts increased by PLN 11.0 billion. Individual unit-linked insurance, i.e. products similar to investment funds, were also very popular. The growth rate of gross written premium in the case of such insurance equalled approximately 40%. Pension funds also witnessed a significant inflow of contributions (PLN 14.4 billion).

The important increase in funds managed by collective investment institutions and insurance companies, together with the inflow of foreign capital, influenced the growth of demand for securities, in particular for stocks. A bull stock market encouraged companies to finance their operations through stock issues, as was the case in the previous year. In total, in 2004 and 2005 companies obtained PLN 24.9 billion via the stock market. However, due to the high profits of companies in 2005, the main source of investment financing were still own resources. The outstanding value of LCBs issued increased in those two years by PLN 3.6 billion, while the outstanding value of bank loans and credits dropped by PLN 0.8 billion.
It is difficult to say whether the gradual increase in importance of collective investment institutions and the rising interest of companies in the stock market are permanent or result from the simultaneous occurrence of the following factors: historically low interest rates, bull market on the stock exchange, significant inflow of capital to investment funds and open pension funds and, in the case of companies, a large surplus of liquid funds in the form of bank deposits. The figures from previous years may indicate, however, that the Polish financial system is gradually becoming market-oriented. Due to strong relations between companies and banks, one should, however, expect that the role of the banking sector in corporate financing will remain important in the future.

The most important developments in the Polish financial system in 2005 and events which may have a substantial impact on the development of sectors and financial markets in the future have been discussed below.

Regulations

Regulations in Poland. Since 2005 (as in the entire European Union), the obligation to apply International Accounting Standards / International Financial Reporting Standards (IAS/IFRS) to consolidated financial statements has been introduced. It is a complex task and Polish banks have been introducing IAS/IFRS on a gradual basis, therefore the comprehensive assessment of the impact of these developments on the results of the banking sector is not currently possible. Another important event was the adoption of new legislation related to the functioning of the capital market. The main purpose of introducing the new regulations, apart from the need to adjust to the EU regulations, was to facilitate raising capital through an issue of securities in a public offering.

Regulations in the European Union. In the context of Community law, initiatives aimed at improving the integration of the EU financial market were continued. The majority of them were carried out under the Financial Services Action Plan (FSAP), whose implementation deadline expired by the end of 2005. In December 2005, a White Paper was published, presenting the orientation of the future Community policy in the field of financial services for the years 2005–2010. One of the main Community legal acts whose text was approved in 2005 was the Capital Requirements Directive (CRD), aimed at introducing new rules for the determination of capital requirements for credit institutions and investment firms.

Infrastructure

Payment system. Two new euro payment systems were launched: SORBNET-EURO for large value payments and EuroELIXIR for retail payments. Therefore, a comprehensive infrastructure for settlements in euros was created, which at the same time integrated Poland with the European Union TARGET system.

WSE. Pursuant to the Act on the Trading in Financial Instruments, the regulated market obligation principle has been abandoned. The WSE and the Polish Agency for Enterprise Development launched Start information platform in order to support SME. Moreover, the WSE privatisation advisor was selected and the position of the WSE on privatisation scheme was presented.

National Depository for Securities (KDPW). Pursuant to the Act on the Trading in Financial Instruments, the deposit and settlement system operation was changed. The legal monopoly of the KDPW with respect to the settlement of transactions concluded on the regulated market and OTC
and definitions of settlement and clearing were included in the Polish legislation. Moreover, efforts were undertaken in order to identify all development possibilities of the KDPW.

**MTS-CeTO.** The first foreign investors acquired the status of market participants on the MTS Poland platform.

**Transaction systems.** E-MID launched an electronic transaction platform for interbank deposits denominated in PLN.

### Financial institutions

**Banks.** The banking sector assets to GDP ratio, as in previous years, showed an upward trend, reaching 60.7%. In 2005, the structure of bank assets changed significantly: for the first time, the value of household claims exceeded the value of corporate claims. This was mainly caused by the sustained growth of household loans, in particular housing and consumer credit for individuals. The increased importance of retail banking was directly related to the improved financial situation of households and to the lower than in previous years average interest rates on loans. In 2005, the downward trend of the value of corporate loans was halted. The share of companies in bank liabilities to the non-financial sector was still increasing. Company deposits became a more important source of banking sector fundraising, although the liabilities to households still prevailed in this respect. Banking sector efficiency rose. This was related to the improved quality of banks' lending portfolio and significant increase in the net financial result (by 28.9% with respect to 2004). Due to the cooperative banks' observance of the statutory obligation to achieve the minimum level of own resources, their further consolidation continued. The increase in their assets was also higher than in the previous year. A further significant drop in concentration of the entire banking sector was observed. Among all new Member States, only Poland recorded the sector concentration ratio much below the average EU-15 values.

**Credit unions.** In 2005, the number of branches and the number of credit union participants increased, accompanied by further reduction of the number of credit unions. Credit unions' asset value rose, but its growth rate was lower than in previous years. The growth rate of deposits and loans granted by these institutions also decreased. The net profit dropped by approximately 50% with respect to 2004 figures.

**Leasing.** The further development of the leasing sector measured by the value of assets leased occurred, yet the share of leasing in corporate financing remained low (approximately 1%). The importance of machinery and equipment in the structure of leased assets rose, however, vehicles still prevailed.

**Factoring.** Despite an increase in the value of invoices purchased (1.5% to GDP), the importance of factoring for the Polish economy was still insignificant.

**Credit agent and financial services brokers.** The importance of credit agent and financial services brokers in the financial system grew. Demand on the consumer finance market mainly focused on the mortgage loan segment. Instalment loans, very popular a few years ago, were gradually replaced with credit cards.

**Private equity/venture capital sector (PE/VC).** A rise in the value of private equity investments was accompanied by a drop in the value of acquired capital (the reverse trend occurred in 2004). Substantial changes in the business structure of PE/VC capital suppliers were observed, with a decrease in the share of pension funds and increase in the share of individuals. The largest rise in investment was observed in the consumer goods sector. Factors which may support the development of this sector are the launch of Start platform and the introduction of the Act on Certain Forms of Support for Innovative Activity.
Collective investment institutions (CII). In 2005, a strong rise (by 47%) in the value of assets of CII occurred (both for investment and pension funds). Due to a very large inflow of new funds to investment funds and to a bull stock market, the assets of investment funds increased. The rate of return for investment funds and low interest rates for bank deposits encouraged individual investors to allocate savings in investment funds. The growth of open pension funds’ assets was mainly caused by an inflow of new contributions from ZUS (Social Insurance Institution). The structure of the CII investment portfolio mainly featured Treasury bonds and stocks. The principle of minimum required rate of return encouraged pension funds to apply similar investment strategies.

Insurance companies. Insurance companies enjoyed the best financial results in their 15-year history. Gross written premium significantly increased in the life insurance segment, which mainly resulted from highly popular unit-linked insurance. For the same reason, for the second year in a row the share of assets where the investment risk is incurred by the insurance taker in the insurance companies’ investment portfolio increased. Due to the lower demand for non-life insurance, the growth rate of premiums in this segment was nearly twice as low as in 2004. Concentration in both segments fell.

Brokerage houses and offices. The number of entities conducting brokerage activities increased. The first foreign investment companies initiated their operations on the WSE and the first Polish brokerage entities were given a status of remote members of a foreign stock exchange. Good financial results of brokerage offices and houses were a result of revival on the primary market and good economic situation on the secondary market.

Financial markets

Money market

Compared to 2004, the value of traded Treasury bills dropped. However, the outstanding value of NBP bills soared. Commercial banks managed current liquidity mainly with the use of unsecured deposits. The FX swap market was the most liquid segment of the money market.

<table>
<thead>
<tr>
<th>Outstanding value of individual money market instruments as of year-end, 2002–2005 (PLN billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Instrument</td>
</tr>
<tr>
<td>Treasury bills</td>
</tr>
<tr>
<td>NBP bills</td>
</tr>
<tr>
<td>Short-term commercial bank debt securities (SBDS)</td>
</tr>
<tr>
<td>Short-term corporate bonds (SCB)</td>
</tr>
<tr>
<td>Unsecured deposits (interbank deposits)</td>
</tr>
<tr>
<td>Secured deposits (FX swap and conditional transactions)</td>
</tr>
</tbody>
</table>

1 It is not possible to determine the values of the banks’ positions in respect of fx swaps and conditional transactions on the basis of data from the bank reporting system.

Source: NBP.

Treasury bills. The outstanding value of Treasury bills issued dropped significantly, and their share in the State Treasury debt structure was, for the first time ever, lower than in the euro area. The Treasury bill market ceased to be the predominant segment of the short-term debt securities market. Turnover on the secondary market, where conditional transactions prevailed, decreased.

NBP bills. An important rise in the value of traded NBP bills was recorded, which resulted from the visible increase in excess liquidity of the banking system. From the beginning of 2005, the
maturity period of NBP bills was shortened to 7 days. This allowed the NBP to adjust the scale of operations to liquidity conditions in the banking sector in a more flexible way.

Short-term bank debt securities (SBDS). The role of SBDS as a bank fundraising instrument continued to fall. In the second half of 2005, banks abandoned the public issue of short-term bonds. The purchasers’ structure featured an increase in the share of households.

Short-term corporate bonds (SCB). The outstanding value of SCBs issued visibly dropped. Also, a decrease in the number of new issue programmes was observed. Companies held funds in the form of high-value bank deposits, which discouraged them from the use of short-term debt as a form of financing. The main legal basis for the issues was the Bonds Act. Among the purchasers of SCBs, the share of investment funds increased.

Interbank (unsecured) deposits. Market size, measured by the value of transactions, significantly grew. O/N deposits prevailed. The introduction of the POOLONIA (Polish Overnight Index Average) rate, being the average interest rate for O/N deposits weighted by transaction value, in January 2005 was an important event for market development. In subsequent months, POOLONIA became the standard reference rate for Overnight Index Swap (OIS) contracts.

FX swaps. In 2005, the upward trend for FX swap market liquidity continued. The increased liquidity resulted mainly from the higher activity of foreign banks (90% share in turnover on the domestic market), which used FX swaps for the financing of positions in Treasury bonds and for speculations on the PLN exchange rate.

Conditional transactions. Turnover on the domestic market for conditional transactions significantly increased, which mainly resulted from the increased value of secured deposits of the non-banking financial institutions, accumulated under BSB operations. Treasury bonds were, for the first time ever, the most often used collateral for conditional transactions, which resulted from, inter alia, the reduced number of Treasury bills held by banks.

Capital market

The size of the majority of capital market segments increased. The fastest growing segment of the capital market was a stock market. WSE capitalisation increased by 46%. The increase of the outstanding value of Treasury bonds mainly resulted from a drop in the value of issued Treasury bills. Good macroeconomic conditions, the bull market on the WSE and expectations of interest rate cuts in Poland contributed to a rise in the participation of non-residents on the Treasury bond and stock market. The remaining segments of the capital market remained underdeveloped.

Outstanding value of individual capital market instruments, 2002–2005 (PLN billion)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt securities</td>
<td>175.2</td>
<td>203.9</td>
<td>248.7</td>
<td>303.2</td>
</tr>
<tr>
<td>Marketable Treasury bonds</td>
<td>153.9</td>
<td>184.5</td>
<td>226.6</td>
<td>278.4</td>
</tr>
<tr>
<td>Long-term corporate bonds</td>
<td>4.5</td>
<td>5.3</td>
<td>7.3</td>
<td>8.9</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>2.2</td>
<td>2.7</td>
<td>3.0</td>
<td>3.3</td>
</tr>
<tr>
<td>Long-term commercial bank debt securities¹</td>
<td>1.4</td>
<td>2.8</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Mortgage bonds</td>
<td>0.2</td>
<td>0.8</td>
<td>1.0</td>
<td>1.8</td>
</tr>
<tr>
<td>NBP bonds</td>
<td>13.0</td>
<td>7.8</td>
<td>7.8</td>
<td>7.8</td>
</tr>
<tr>
<td>Equities – stock</td>
<td>110.6</td>
<td>167.7</td>
<td>291.7</td>
<td>424.9</td>
</tr>
</tbody>
</table>

Note: The outstanding value of individual capital market instruments for debt securities was measured by the outstanding value of those instruments, and for equities by capitalisation of domestic and foreign companies listed on the WSE.

¹ In comparison with the previous editions of the report, the data also cover, apart from the liabilities of Polish commercial banks resulting from the issue of own securities denominated in PLN, bonds denominated in foreign currencies, issued by mortgage banks, and European Investment Bank bonds.

Source: NBP calculations based on MF, NBP, WSE and Fitch Polska data.
Treasury bonds. The Treasury bond market was the largest and the most liquid segment of the debt securities market. The main debt instruments issued by the State Treasury were fixed-rate bonds. In 2005, the outstanding value of Treasury bonds issued on the domestic market increased by nearly 20%, while the turnover on the secondary market was over two times higher than in the previous year. The value of foreign investor involvement in the Treasury bond market increased, however, their share in the financing of the domestic debt of the State Treasury dropped.

Municipal bonds. The municipal bond market was one of the smallest segments of the debt securities market. The importance of bonds in the financing of the borrowing needs of local government units decreased, while the share of loans and credits grew. A barrier for the development of this segment was the low value of single issues.

Long-term bank debt securities (LBDS). Compared to the euro area, LBDS constitute an insignificant source of fundraising for banks. A rise in the value of long-term loans, in particular related to housing development, enhanced the banks’ interest in the issue of bonds denominated in foreign currencies on the overseas markets. This was one of the factors hampering the development of the domestic market. In 2005, banks ceased to issue bonds under public offering.

Long-term corporate bonds (LCB). A higher outstanding value of LCB issues and a rise in the number of issuers did not increase the importance of these instruments on the capital market. The share of leasing companies in the issuers’ structure increased. Private placements still predominated on the market.

Mortgage bonds. The outstanding value of mortgage bonds visibly rose, yet this segment was still an insignificant part of the Polish capital market. The reason for such a situation was the limited role of mortgage banks in the financing of the housing market. In 2005, banks were the largest group of investors on the market of mortgage bonds issued under private placement.

Stocks. Capitalisation of domestic companies listed on the WSE rose significantly to reach approximately 1/3 of GDP as of year-end. The WIG index rose by 33.7% to reach its historical high at the end of 2005. Stock turnover was also the highest in the WSE history, yet compared to stock market capitalisation, its value remained rather low. In 2005, stocks of 35 companies were introduced on the WSE, in the total amount of nearly PLN 7 billion. Stocks of ten companies were delisted. The RPW-CeTO stock market remained underdeveloped and its importance for the Polish financial system was negligible.

FX market

For a second year in a row, the value of FX transactions in Poland gradually decreased, accompanied by a visible increase in liquidity on the offshore market. The increasing volume of zloty exchange transactions in London resulted from the sustained large activity of hedge funds and from the growing interest in investments in assets denominated in PLN on the part of other financial institutions. The share of euros in the currency structure of turnover on the interbank market was still increasing. The zloty lost its basket nature. The main currency pair on the PLN market was EUR/PLN, and the strength of the Polish currency was reflected in the EUR against PLN exchange rate.

Derivatives market

The Polish market of OTC derivatives is much better developed than the stock market. The dominance of the OTC market is a result of the Polish bank-oriented financial system and of the large activity of foreign banks.

OTC derivatives. The liquidity in the most developed segments of the OTC interest rate derivatives market (FRA and IRS) visibly rose. The increase in the value of transactions may be attributed to the higher number of active participants and strong expectations of NBP interest rate cuts. The OIS market developed rapidly. The forward contracts market was the most liquid one among the segments of the OTC derivatives market. Forward transactions constituted the main
instrument used by companies for FX risk management. In 2005, the plunge of turnover value on the domestic FX options market was halted. Non-financial entities decided much more often to conclude CIRS contracts, mainly in order to reduce debt servicing costs. The market of credit derivatives was only in the initial stage of development.

**Stock exchange derivatives.** Turnover value on the futures market doubled with respect to the previous year. As in previous years, the largest segment of stock exchange derivatives market was the futures contract market on WIG20, accounting for over 90% of the turnover. Individual investors were the predominant group of investors. In 2005, the WSE featured two new instruments: bond options and stock options. On the WCE, turnover focused on the FX futures, yet this market should be considered small.
Introduction

The *Financial System Development in Poland 2005* is a new edition of the annual report describing changes that occurred in the financial system in a given year. The publication presents trends, barriers and probable scenarios of development of all financial institutions and financial markets operating in Poland, even if a given financial system segment is of little importance. Also analysed are changes in the infrastructure and regulations relating to the financial sector, as well as initiatives aimed at integration of the European financial market. According to the assumed methodology, developments which occurred in the financial system in 2006 have not been included in this report.

Chapter 1 presents the evolution of the size and structure of the Polish financial system, indicating a significant, persistent dominance of the banks over other financial institutions. Chapter 2 describes amendments to legal regulations relating to the financial sector, both at the national and at the European Union level. It also presents the analysis of the legislative process and the state of work of EU authorities on the selected legal acts, as well as the extent of their implementation by individual Member States. Chapter 3 describes the most important changes in the financial system infrastructure, including the participation of Polish settlement systems in the European system.

Chapter 4 presents a comprehensive analysis of the changes that occurred with regard to the individual financial institution groups in 2005. To the extent possible, the changes have been presented against the trends observed in other countries of the region and in the selected European Union Member States. Banks continue to dominate within the Polish financial system and, therefore, they are analysed first. Changes in commercial bank claims and liabilities as well as concentration and competition indicators for this sector have been described in detail. Subsequent sections analyse quasi-bank institutions and those which serve as intermediaries in the distribution of the banking products. The next sector analysed is that of collective investment institutions, i.e. investment and pension funds. As part of this analysis of financial institutions, the changes that occurred in the insurance sector as well as with regard to brokerage houses and offices have also been reviewed.

Chapter 5 analyses financial market developments. First, the evolution of the money market and its individual segments (Treasury bill, NBP bill, short-term corporate and bank debt securities as well as deposit transaction markets) has been presented. In the subsequent part of the chapter, the changes which occurred on the Polish capital market have been described. The development of the Treasury bond, municipal bond, NBP bond, mortgage bond as well as long-term bank and corporate debt securities markets have been analysed. A separate section has been dedicated to the stock market. Chapter 5 also presents changes occurring on the FX market and describes the evolution of the derivatives market in Poland, which has been divided into the stock exchange and OTC segments.
The financial system in Poland

1.1. Evolution of the size and structure of the financial system in Poland

Economic growth and low level of inflation in Poland in 2005 created favourable conditions for the development of financial system. Despite the fact that the Polish economy, just like other economies of Central and Eastern Europe, is still characterised by a relatively low level of financial intermediation, the trend towards the growing economic significance of the financial system was quite pronounced. In 2005, the value of financial system assets grew considerably, also in relation to GDP – by 7.7 pp, while a year ago by 2.7 pp (Table 1.1).

The year 2005 was characterised by the increase in assets value of all types of financial institutions (Table 1.2). The aggregate value of assets grew by 15%. The most rapid development was noted in the investment funds segment (increase in assets by 63.5%). In the case of investment funds and credit unions (Spółdzielcze Kasy Oszczędnościowo-Kredytowe – SKOK), the assets dynamics was higher than a year ago. In the remaining financial institutions a decrease in assets growth rate was observed as compared with 2004 (Table 1.3).

Table 1.1. Financial system assets as percentage of GDP in selected Central and Eastern European countries, 2002–2005

<table>
<thead>
<tr>
<th>Country</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>77.3</td>
<td>76.0</td>
<td>78.7</td>
<td>86.4</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>121.2</td>
<td>116.6</td>
<td>114.2</td>
<td>121.6</td>
</tr>
<tr>
<td>Hungary</td>
<td>84.1</td>
<td>95.9</td>
<td>103.2</td>
<td>117.7</td>
</tr>
</tbody>
</table>

Table 1.2. Assets of financial institutions in Poland, 1998–2005 (PLN billion)

<table>
<thead>
<tr>
<th>Type of Institution</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial and cooperative banks</td>
<td>318.7</td>
<td>363.4</td>
<td>428.5</td>
<td>469.7</td>
<td>466.5</td>
<td>489.0</td>
<td>538.5</td>
<td>587.0</td>
</tr>
<tr>
<td>Credit unions</td>
<td>0.6</td>
<td>0.9</td>
<td>1.2</td>
<td>1.8</td>
<td>2.5</td>
<td>3.4</td>
<td>4.2</td>
<td>5.3</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>20.7</td>
<td>28.9</td>
<td>37.9</td>
<td>47.2</td>
<td>57.6</td>
<td>65.7</td>
<td>77.9</td>
<td>89.6</td>
</tr>
<tr>
<td>Investment funds</td>
<td>1.8</td>
<td>3.2</td>
<td>7.1</td>
<td>12.1</td>
<td>22.8</td>
<td>33.2</td>
<td>37.5</td>
<td>61.3</td>
</tr>
<tr>
<td>Open pension funds</td>
<td>0.0</td>
<td>2.3</td>
<td>9.9</td>
<td>19.4</td>
<td>31.6</td>
<td>44.8</td>
<td>62.9</td>
<td>86.1</td>
</tr>
<tr>
<td>Brokerage entities</td>
<td>3.2</td>
<td>3.6</td>
<td>3.9</td>
<td>2.9</td>
<td>2.8</td>
<td>3.7</td>
<td>5.5</td>
<td>6.9</td>
</tr>
<tr>
<td>Total</td>
<td>345.0</td>
<td>402.3</td>
<td>488.5</td>
<td>553.1</td>
<td>583.8</td>
<td>639.8</td>
<td>726.2</td>
<td>836.2</td>
</tr>
</tbody>
</table>

The figures concerning GDP might differ slightly from those presented in the previous report. It is a result of the change in Eurostat GDP estimations for the particular Member States.

The level of financial intermediation is measured by the ratio of financial system assets to GDP. The ratio of the Polish financial system assets to GDP constitutes about 1/3 of average ratio in the euro zone countries.
The financial system in Poland

Table 1.3. Growth in assets of financial institutions, 2003–2005 (yoy, %)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial and cooperative banks</td>
<td>4.8</td>
<td>10.1</td>
<td>9.0</td>
</tr>
<tr>
<td>Credit unions</td>
<td>36.0</td>
<td>23.5</td>
<td>26.4</td>
</tr>
<tr>
<td>Insurance companies</td>
<td>14.1</td>
<td>18.6</td>
<td>15.0</td>
</tr>
<tr>
<td>Investment funds</td>
<td>45.6</td>
<td>13.0</td>
<td>63.5</td>
</tr>
<tr>
<td>Open pension funds</td>
<td>41.8</td>
<td>39.7</td>
<td>37.5</td>
</tr>
<tr>
<td>Brokerage entities</td>
<td>32.1</td>
<td>48.6</td>
<td>25.5</td>
</tr>
<tr>
<td>Total</td>
<td>9.6</td>
<td>13.5</td>
<td>15.1</td>
</tr>
</tbody>
</table>

Source: own calculations based on NBP, KNUiFE, KPWiG and IZFiA.

Table 1.4. Number of financial institutions in Poland, 1998–2005

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Commercial banks2</td>
<td>83</td>
<td>77</td>
<td>73</td>
<td>69</td>
<td>59</td>
<td>58</td>
<td>57</td>
<td>61</td>
</tr>
<tr>
<td>Cooperative banks</td>
<td>1189</td>
<td>781</td>
<td>680</td>
<td>642</td>
<td>605</td>
<td>600</td>
<td>596</td>
<td>588</td>
</tr>
<tr>
<td>Credit unions</td>
<td>220</td>
<td>228</td>
<td>146</td>
<td>144</td>
<td>120</td>
<td>109</td>
<td>83</td>
<td>75</td>
</tr>
<tr>
<td>Insurance companies3</td>
<td>54</td>
<td>56</td>
<td>67</td>
<td>71</td>
<td>72</td>
<td>76</td>
<td>69</td>
<td>68</td>
</tr>
<tr>
<td>Investment companies</td>
<td>15</td>
<td>17</td>
<td>21</td>
<td>19</td>
<td>19</td>
<td>17</td>
<td>20</td>
<td>23</td>
</tr>
<tr>
<td>Pension companies</td>
<td>0</td>
<td>21</td>
<td>21</td>
<td>17</td>
<td>16</td>
<td>16</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>Brokerage entities</td>
<td>46</td>
<td>48</td>
<td>49</td>
<td>42</td>
<td>38</td>
<td>36</td>
<td>40</td>
<td>42</td>
</tr>
</tbody>
</table>

1 The table contains the number of institutions the assets of which were taken into account in Table 1.2. It does not include foreign entities which can operate on the cross-border basis (without legal and organisational presence in Poland) and branches of foreign brokerage entities.
2 Banks which conduct operating activities. The number of commercial banks in 2000–2005 also includes credit institution branches. In 2004, there were three and in 2005 seven branches of credit institutions.
3 Entities which conduct operating activities. The number of insurance companies in 2000–2005 also covers the main branches of foreign insurance companies. In 2000, there was one, in 2001 and 2002 there were two, in 2003 there were three, while in 2004 and 2005 there was one main branch of a foreign insurance company operating in Poland.

Sources: NBP, KNUiFE, KPWiG and IZFiA.

In 2005, the number of the most important institutions in the Polish financial system – i.e. commercial banks – increased (four new branches of credit institutions were launched). Within the period concerned, 53 banks operated as joint-stock companies, one as a state-owned bank and seven as branches of credit institutions. The number of cooperative banks decreased by eight, the same occurred in the case of credit unions. There was also a slight decrease in the number of insurance companies, while the quantity of investment companies and brokerage entities increased. The data concerning the number of financial institutions operating in Poland are presented in Table 1.4.

In 2005, the Polish financial system was still largely dominated by the banking sector; however, the ratio of banking sector assets to total financial sector assets has been decreasing steadily. At the end of the analysed period, this ratio amounted to 70.2% (decrease by 4 pp as compared with the previous year). At the same time, the importance of non-banking financial institutions has been growing steadily. In 2005, the ratio of non-banking sector assets to total financial sector assets went up to 29.8% (for comparison – in 1998 it was 7.6%). The evolution of the structure of assets in the Polish financial system is presented in Figure 1.1, while the share of assets held by individual financial institutions within the Polish financial system in 2005 is shown in Figure 1.2.

The dominant role of the banking system and the relatively low level of financial intermediation were also typical of other countries in the region. Banking sector development levels in selected Central and Eastern European countries (Czech Republic, Hungary and Poland) compared with the euro zone are shown in Table 1.5.
Figure 1.1. Structure of assets of the Polish financial system, 1998–2005

Figure 1.2. Share of assets held by different financial institutions in the Polish financial system, 2005

Table 1.5. Banking sector development levels in Czech Republic, Hungary and Poland and in the euro zone, 2004–2005 (%)

<table>
<thead>
<tr>
<th>Country</th>
<th>Assets/GDP</th>
<th>Loans/GDP</th>
<th>Deposits/GDP</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>58.4</td>
<td>60.7</td>
<td>24.7</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>95.2</td>
<td>100.8</td>
<td>28.0</td>
</tr>
<tr>
<td>Hungary</td>
<td>73.0</td>
<td>80.6</td>
<td>35.3</td>
</tr>
<tr>
<td>Euro area</td>
<td>264</td>
<td>283.3</td>
<td>116</td>
</tr>
</tbody>
</table>

1 Credits and loans from the banking sector to the non-financial sector (domestic and foreign currency).
2 Deposits to the banking sector from the non-financial sector (domestic and foreign currency).

Sources: Poland, the Czech Republic and Hungary: calculations based on NCBs, Central Statistical Office and Eurostat data.

For the euro area: EU Banking Structures, European Central Bank, Frankfurt, October 2005, and Eurostat.
The capitalisation of stock and bond markets of Central and Eastern European countries was much lower than in the countries of the euro zone, despite a considerable increase in the stock prices over the last few years. In 2005, the Polish stock market managed to keep the position of the region’s largest capital market (both in terms of capitalisation and the number of listed companies). Similarly to the previous year, the number of companies listed on the Warsaw Stock Exchange (WSE) grew. In the Czech Republic and Hungary, the number of listed companies has been decreasing.

In 2005, similarly as in the previous year, the Polish stock market experienced the highest increase in capitalisation (expressed in euro). It rose by 52% (while the Czech market grew by 43%, and the Hungarian one increased by 33%). The increase in market capitalisation can be mainly attributed to a rise in stock prices, and additionally, in Poland and the Czech Republic, to the appreciation of their domestic currencies. Moreover, also public offerings of stocks contributed to the Polish market capitalisation. All three countries saw the increase in the capitalisation of the stock market as percentage of GDP. The basic indicators related to the degree of development of capital markets in these countries are presented in Table 1.6.

Table 1.6. Capital markets in 2004 and 2005, selected year-end figures

<table>
<thead>
<tr>
<th>Country</th>
<th>Stock market capitalisation1 (EUR billion)</th>
<th>Stock market capitalisation as % of GDP</th>
<th>Number of listed companies (including new ones)2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>52.5</td>
<td>79.9</td>
<td>23.2</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>21.7</td>
<td>31.1</td>
<td>23.9</td>
</tr>
<tr>
<td>Hungary</td>
<td>20.8</td>
<td>27.6</td>
<td>25.0</td>
</tr>
</tbody>
</table>

1 Capitalisation of domestic companies.
2 Includes domestic and foreign companies.
Sources: NBP calculations based on individual stock markets, Eurostat and FESE (number of listed companies) data.

1.2. Measures stimulating financial market development in Poland

On April 27, 2004, the Council of Ministers adopted the Warsaw City 2010 Agenda: Capital Market Development Strategy. Its objective is to create a strong regional capital market. The key goals of the Strategy include increasing capital market size, as well as improving its efficiency and security.

In 2005, specific tasks laid down in the Capital Market Development Strategy Implementation Schedule were implemented. The most important of them included:

– developing draft amendments to regulations in view of their simplification and compliance with the requirements laid down in the EU directives (Task 1): on October 24, 2005, the Act on Public Trading in Securities was replaced by three new legal acts: the Act on Public Offering, Conditions Governing the Introduction of Financial Instruments to Organised Stock market capitalisation1

3 In 2005, 35 companies debuted on the stock exchange, which gave the WSE the third place in Europe in terms of the number of debuting companies. The highest number of debuts was noted on the London Stock Exchange (626) and on the Oslo Stock Exchange (48).
4 The increase in capitalisation in domestic currency (domestic companies) amounted to: Poland – 43.9%, Czech Republic – 36.3%, Hungary – 36.4%.
6 The following institutions are responsible for the implementation of the Strategy: the Ministry of Finance, Ministry of the Treasury, Ministry of the Economy, Ministry of Education and Science, Ministry of Justice, as well as the Warsaw Stock Exchange, the Polish Securities and Exchange Commission, the National Bank of Poland, the Insurance and Pension Funds Supervisory Commission, National Depository for Securities and MTS-CeTO.
supporting development of investment services in the capital market (Task 2): the Act on Trading in Financial Instruments introduced many modifications with respect to conducting brokerage activities;

– increasing efficiency of the Securities and Exchange Commission (KPWiG) activities concerning prosecution of stock exchange offences (Task 3): the Act on Capital Market Supervision introduced amendments related to the scope of KPWiG’s authority in the field of the stock exchange offences prosecution;

– developing corporate governance mechanisms and the Principles of Good Practice (Task 6): the Warsaw Stock Exchange and MTS-CeTO introduced new amended and binding Principles of Good Practice in Listed Companies 2005 in January 2005 and February 2005, respectively;

– drawing up measures conducive to the increase in the level of municipal bonds issue in the alternative trading systems (ATS), on the Central Table of Offers (CeTO) or the Warsaw Stock Exchange, e.g. in order to absorb EU funds (Task 9): the Act on Trading in Financial Instruments allows to create the alternative trading systems (ATS) by entities conducting brokerage activities and companies running regulated markets;

– preparing measures supporting the development of private equity/venture capital (PE/VC) sector (Task 10): the Act on the National Capital Fund came into force in August 2005;10

– developing a youth educational programme as regards financial services market (Task 14): educational programmes were carried out by KPWiG, WSE and NBP;

– preparing measures aimed at stimulation of public-private partnership projects (Task 15): the Act on Public-Private Partnership came into force in October 2005;11

– preparing the WSE and the National Depository for Securities for privatisation or potential strategic alliance (Task 19): on March 29, 2005, the Minister of the Treasury appointed a consortium comprising McKinsey & Company Poland Sp. z o.o., CDM Pekao SA and Ernst & Young Audit Sp. z o.o. as a privatisation advisor; as a result, in June The Warsaw Stock Exchange joint stock company on the WSE privatisation options was presented; also, in June 2005 the National Depository for Securities issued Strategic Objectives of the National Depository for Securities by 2010.

The Warsaw City 2010 Agenda: Capital Market Development Strategy also specifies the levels of particular capital market indicators which are to be attained by 2010 (these indicators have been adopted as measures of implementation of the main Strategy objectives). Their values in the years 2003–2005 and objectives for 2010 are presented in Table 1.7.

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Table 1.7. Indicators adopted as measures of implementation of objectives laid down in Warsaw City 2010 Agenda: Capital Market Development Strategy in 2003–2005 and objectives for 2010

<table>
<thead>
<tr>
<th>Indicator Description</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>Objective for 2010</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock market capitalisation as percentage of GDP</td>
<td>16.6</td>
<td>23.2</td>
<td>31.9</td>
<td>The ratio of public stock market capitalisation to GDP should reach at least 50%.</td>
</tr>
<tr>
<td>Share of Polish market capitalisation in the EU-15 market capitalisation (%)</td>
<td>0.48</td>
<td>0.76</td>
<td>0.94</td>
<td>The additional objective is a constant increase in the share of Polish market capitalisation in the EU market capitalisation.</td>
</tr>
<tr>
<td>Value of corporate bond market as percentage of GDP</td>
<td>12.6</td>
<td>13.8</td>
<td>13.7</td>
<td>Domestic corporate bond market should attain the value of about PLN 90 billion.</td>
</tr>
<tr>
<td>Value of corporate bond market as percentage of GDP</td>
<td>1.5</td>
<td>1.5</td>
<td>1.42</td>
<td>Domestic corporate bond market should attain the value of at least 8% of GDP.</td>
</tr>
<tr>
<td>Volume of PE/VC funds investments (PLN million)</td>
<td>779</td>
<td>590</td>
<td>620</td>
<td>The value of assets invested by venture capital funds should attain the level of about PLN 2.8 billion.</td>
</tr>
<tr>
<td>Volume of PE/VC funds investment as percentage of GDP</td>
<td>0.093</td>
<td>0.064</td>
<td>0.064</td>
<td>The share of assets invested by venture capital funds in GDP should attain the level of at least 0.25%.</td>
</tr>
<tr>
<td>WSE turnover as percentage of WSE capitalisation</td>
<td>23.7</td>
<td>25.6</td>
<td>28.4</td>
<td>The share of the annual value of turnover on a particular market in market capitalisation should attain 70–90%.</td>
</tr>
</tbody>
</table>

1 Capitalisation of domestic companies (WSE).
2 Capitalisation of the EU-15 (the EU Member States before May 1, 2004) calculated for 12 European stock exchanges (11 national stock exchanges and Euronext embracing the markets in France, Belgium, Portugal and Holland). In 2005, capitalisation also covers the markets of Lithuania, Latvia and Estonia (the markets being participants of OMX alliance comprising the stock exchanges in Copenhagen, Stockholm, Helsinki, Riga, Tallinn and Vilnius).
3 The outstanding value of short- and long-term corporate bonds.
4 The share of session turnover (net) in stock market capitalisation (domestic companies).
5 Net turnover.

Sources: FESE, WSE, EVCA, Central Statistical Office.
The development of the financial system depends not only on economic conditions, but also on the regulations which constitute the basis of the activity of financial institutions. This chapter presents the most important amendments in Polish and Community law as measures taken in the European Union are aimed at setting major paths of amendments of the regulations regarding the financial system in Poland. Amendments introduced to the Polish law are prompted mainly by the necessity to adjust national law to the requirements of Community law. The EU Member States are obliged to achieve compatibility of national regulations with the requirements of EU law in order to create a single European financial market.

2.1. Changes of the regulations of the financial system in Poland

In 2005 many amendments were introduced to Polish financial services sector legislation. The most important amendments include:

- passing of the Act on Supplementary Supervision, 12
- passing of the Act on the so-called Prevention of Usury, 13
- amendments to a package of acts on insurance, 14
- amendments to the Act on Organization and Operation of Pension Funds, 15
- a new package of acts regulating the functioning of the capital market. 16

Furthermore, the International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) came into effect in Poland on 1 January 2005.

2.1.1. Regulations regarding the entire financial services sector

**Act on Supplementary Supervision**

Introduction of the Act on the Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in a financial conglomerate was intended mainly to adjust the Polish regulations to the provisions of the Community law. The Directive on the supplementary supervision introduced the uniform supervision principles over institutions in a financial conglomerate in the whole EU and ensured cooperation and exchange of information between the supervisory bodies overseeing entities of a financial conglomerate. The new regulations make it possible to include financial and operational data on the whole conglomerate in the supervisory analysis. The solutions supplement the existing regulations concerning supervision over individual sectors of the financial services market. The objective of supplementary supervision is to examine the financial situation of a conglomerate on the basis of the following parameters: capital adequacy and capital adequacy strategy, significant transactions within the group, level and concentration of risk in a conglomerate, risk of conflict between entities within a conglomerate, correctness of risk management, correctness and accuracy of internal controlling.

The new supplementary supervision regulations allow to entrust supervision over the conglomerate to a coordinator from the conglomerate’s leading entity’s Member State of origin. Introduction of the so-called supplementary supervision should contribute to enhancing the stability of financial institutions and financial security of the recipients of the services of entities comprising a financial conglomerate.

New regulations also strengthen cooperation and exchange of information between national supervisory institutions. The Act on Supplementary Supervision imposes an obligation upon the members of particular supervisory commissions to participate in annual meetings, whose aim is to: exchange information and coordinate supervisory activity within the so-called Coordination Committee for Financial Conglomerates.

2.1.2. Regulations regarding the banking services sector

**Act on so-called Prevention of Usury**

The Act on the so-called Prevention of Usury sets the maximum interest rate which can be charged on bank loans, trade credit and cash loans. Pursuant to the new regulations, the interest rate cannot exceed more than four times the lending credit rate of the NBP. Implementation of these regulations was not a result of the adjustment of the Polish regulations to the European law.

The new regulations limited the total value of all fees and commissions arising from a conclusion of a consumer loan agreement (excluding costs of credit insurance and security). The sum of all these fees cannot exceed 5% of the value of a consumer credit. Introduction of these amendments to the banking sector may primarily result in limiting the interest rate of loans associated with the use of credit cards.

The amendments introduced to the Act on the so-called Prevention of Usury also apply to the interest rate of non-Treasury bonds. The statutory limit of bond-related benefit which is strictly connected with the issuer’s creditworthiness rating, may negatively affect the attractiveness of this form of investment and make issue of the securities less profitable from the economic point of view (e.g. in the case of issuing the so-called junk bonds).

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18 Currently, no leading entity of a financial conglomerate operates in Poland. A list of countries, where the seats of leading entities are located, can be found in: Implementation of Directive 2002/87/EC – the Financial Conglomerates Directive. Identification of financial conglomerates, on the website: www.europa.eu.int.
International Financial Reporting Standards (IFRS)

Imposing the obligation to prepare consolidated financial statements according to the International Accounting Standards (IAS) and International Financial Reporting Standards (IFRS) (Box 2.1.1) was a vital amendment, which will have significant impact on the presentation and interpretation of banks’ financial statements. Standards are being implemented gradually, because it is an organizational and financial challenge to apply some regulations. Implementation of IAS/IFRS will change the way some elements of financial statements are shown and may also contribute to fluctuations of values of balance sheets and profit and loss reports. The most important change, as far as presentation and interpretation of the banks’ financial statements is concerned, is the valuation of amounts receivable using the amortised cost method. Due to a different method of valuation the balance sheet value of these assets will be adjusted for the value of discount calculated using an effective interest rate. Additionally, the structure of profit and loss report will also change. Part of income due to fees and commissions, charged when granting a loan, will be included under interest incomes.

It will be possible to fully assess the impact of the new regulation on the data regarding the banking sector will be possible only towards the end of 2006 when banks have completed implementation of the standards.

Box 2.1.1

INTERNATIONAL FINANCIAL REPORTING STANDARDS IN THE EU

Due to the dynamic growth of the financial markets in the EU and the stronger involvement of banks in derivatives transactions, exposures valuated using the historical cost method no longer reflect the actual risk of these transactions. Hence, in June 2002 the European Commission approved a Financial reporting strategy, according to which harmonisation of accounting principles within the EU became a fundamental condition of the integration of EU’s financial markets. The strategy is implemented, among others, through the 2002 Regulation of the European Parliament, on the application of the International Accounting Standards (IAS),1 which better reflect the risk. Since 2005 about 9 thousand companies listed on Europe’s stock exchanges have been required to prepare consolidated financial statements according to the standards worked out by the International Accounting Standards Board (IASB).2 IAS requirements apply to all the countries of the EU and to the European Economic Area (EEA). The standards are also applied by majority of enterprises in Switzerland.

In Poland, the obligation to apply the IAS was introduced by the amendment of the Accounting Act in August 2004.3 The obligation applies also to banks. Banks listed on a stock exchange and banks being parent undertakings in a capital group must prepare IAS-compliant consolidated financial statements. The aforementioned undertakings can choose to prepare stand alone financial statements according to the IAS.4 The banks submitting IAS-compliant reports are a

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1 According to Art. 2 of the Regulation No. 1606/2002 of the European Parliament and of the Council of 19 July 2002 on the application of international accounting standards, international accounting standards mean the International Accounting Standards (IAS), International Financial Reporting Standards (IFRS) and their interpretations, subsequent amendments to these standards and their interpretations, future standards and their interpretations prepared by or adopted by the International Accounting Standards Board (IASB).

2 International Accounting Standards Board (formerly International Accounting Standards Committee – IASC), with a seat in London, was formed in 1973 as a result of an agreement of institutions developing accounting standards in Australia, France, the Netherlands, Ireland, Japan, Canada, Mexico, United States and United Kingdom.


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20 Effective interest rate is the interest rate which discounts expected stream of future cash payments to the current net balance sheet value through the period up to the maturity date or to the moment of the next market valuation. It is an internal rate of return of an item of assets or a financial obligation for a given period. Setting the level of the interest rate includes all fees paid or received by a bank. (Ordinance of the Minister of Finance of 10 December 2001 on the special principles of bank accountability, Dz.U. of 2001, No. 149, item 1673).
substantial part of the Polish bank sector, as their share in the assets of the banking sector amounted to 68.8% as of the end of December 2005. Therefore, introduction of the IAS in Polish banks was an important factor which will change the hitherto economic interpretation of some balance sheet items.

If the fair value valuation method is used more widely as a result of IAS implementation, it may result in greater fluctuations of the items of banks’ profit and loss accounts. Changes in economic environment will be more rapidly reflected in financial statements. At the same time, financial statements prepared according to the IAS will better reflect the information needs of shareholders and prospective investors due to better risk identification. On the other hand, there are concerns over inaccurate valuation of the fair value of the instruments that are not traded in an active and liquid market, e.g. most of the bank loans earmarked for trading. For instance, in France the introduction of the IAS resulted in an increase in the balance sheet total of the banking sector.

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2.1.3. Regulations regarding non-banking financial institutions

**Insurance undertakings**

Amendments introduced to the Act on Insurance Activity were connected with the necessity to adjust Polish regulations to Community law. These regulations allow Polish insurance undertakings to conclude agreements on the transfer of insurance portfolio with a branch of an insurance company seated in another Member State. The amendments led to a decrease in the number of information obligations of life insurance undertakings towards their clients. Previous regulations imposed more information obligations on insurance undertakings than it was required by the European law.

The remaining amendments which did not result from the need to adjust regulations to the EU regulations included:

– adding debt collection and recourse to the list of insurance activities, which external entities can be commissioned to perform by insurance undertakings,

– expanding insurance undertakings’ scope of activity with mediation in concluding credit agreements, selling and repurchasing units of investment funds,

– improving consumer protection in life insurance,

– introducing an obligation to include the goods and services tax in the compensation for a motor damage if the entity entitled to the compensation produces an invoice and is not a VAT payer.

**Insurance intermediaries**

Amendments to the Act on Insurance Mediation were prompted by the necessity to adjust Polish regulations to Community law. EU regulations on insurance intermediation focus on increasing competition in a single market and improving consumer protection.

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5 As of the end of 2005, 17 domestic banks (7 of them are not listed on the Warsaw Stock Exchange) and 2 branches of credit institutions prepared their financial statements according to the IAS and the IFRS.

6 Fair value is the amount for which an asset could be exchanged or a liability settled, between knowledgeable, willing parties in an arm’s length transaction.

This is why a principle was introduced to the Polish law that insurance premium transferred to an intermediary shall be regarded as paid to an insurance undertaking. The other principle was the following: the transfer by an insurance undertaking to the intermediary of the amount due to the entitled person shall be legally effective only when the amount is received by the entitled person.

The remaining amendments to the Polish Act on Insurance Mediation adjusted to Community law included:

– stipulating precisely the principles of conducting business activity by insurance intermediaries from the Member State countries in Poland and the principles of carrying out business activity by Polish insurance intermediaries in these countries;

– increasing information obligations of insurance agents and insurance brokers.

Compulsory insurance

New regulations on compulsory insurance came into force on 1 January 2005. The changes concerned, i.a. excluding the responsibility of an insurance undertaking for damages caused intentionally by the insured or the persons he/she is responsible for.

A new amendment of the regulations on compulsory insurance was intended to stipulate precisely the existing regulations. The most significant changes concerned:

– introducing a new method of calculating the value of amount of cover,

– simplifying the calculation of the value of registry fee on general liability insurance agreements of motor vehicle owners,

– repealing the obligation to recalculate insurance premium if a buyer of a vehicle does not give a notice to terminate the insurance agreement,

– including the cost of an additional technical examination in the indemnity from a general liability insurance.

Making the law regulating the market of compulsory insurance more precise and coherent should help streamline the functioning of the market.

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25 Pursuant to Article 13 Para. 4a of the Act of 22 May 2003 on Insurance Mediation (Dz.U. of 2003, No. 124, item 1154, as amended) insurance agents are obliged to inform customers about:

– business name, under which agency activities are performed, and the address of its seat,

– entry in the insurance intermediaries register and how the entry in the register can be verified,

– held stocks or shares of an insurance undertaking entitling to at least 10% of voting rights at the general meeting of shareholders and, in the case of an insurance agent who is a legal person, about stocks or shares of the insurance agent held by an insurance undertaking, entitling to at least 10% of voting rights at the general meeting of shareholders.

26 Pursuant to Article 13 Para. 4a of the Act of 22 May 2003 on Insurance Mediation (Dz.U. of 2003, No. 124, item 1154, as amended) insurance agents are obliged to:

– inform the person seeking insurance protection about the company which carries out brokerage activity, its business address, registry of insurance intermediaries in which it is registered, and how this entry in the register can be verified, and, in case of insurance broker registered in a registry maintained by supervisory body, present to the insurance undertaking and the customer, at the first act and at every request, the permit to pursue brokerage activities;

– prior to concluding an insurance contract, provide advice in the written form, based on a comprehensive and reliable analysis of available offers of insurance, sufficient for the elaboration of recommendation of the most appropriate insurance contract and explain in writing grounds on which the recommendation is based;

– maintain confidential all the information obtained in relation with the performance of brokerage acts; the broker shall be bound by that obligation also after the termination of a contractual relationship with the customer;

– inform the person seeking insurance protection, at the first act, about held shares of an insurance undertaking entitling to at least 10% of voting rights at the general meeting of shareholders and, in case of a broker who is a legal person, about shares of the broker held by an insurance undertaking, entitling to at least 10% of voting rights at the general meeting of shareholders.

Pension funds and employees’ pension schemes

Changes in the organization and functioning of the employees’ pension schemes sector introduced in 2005 stemmed from the need to adjust the Polish regulations to the EU requirements. Foreign entities were allowed to manage the funds accumulated within employees’ pension schemes. Employees’ pension funds are now allowed to manage funds entrusted them by foreign employers who carry out employees’ pension schemes on the basis of Polish regulations.

Other significant changes in the organization and functioning of the pension funds sector, which do not stem from the need to adjust the Polish regulations to the EU law, include:

– repealing the provisions which made it possible to create type “B” Open Pension Funds, which were intended as a more secure method of investing pension savings in the period when the insured person has reached pre-retirement age,

– defining the obligations of the National Depository for Securities and pension companies as far as preparing financial statements of the Guarantee Fund is concerned,

– lowering the amount of arrears in payment, from which Open Pension Funds members should receive interest.

Investment funds

Amendments of tax regulations were of vital importance for the development of investment funds consisting of separate sub-funds (so called umbrella funds). The new amendments repeal the tax obligation for both natural and legal persons when funds are transferred from one subfund to another subfund (if both subfunds function within a single investment fund). This amendment should make investing capital in funds of this type more attractive.

2.1.4. Regulations regarding the capital market

The new amendments regulating the functioning of the capital market in Poland are a result of the ongoing changes in the EU, aimed at building a single capital market. The adoption of the Directive on the prospectus significantly affected the activity of both Polish and foreign issuers.

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29 Pursuant to Article 2 Para. 24 of the Act of 20 April 2004 on Occupational Pension Programs (Dz.U. of 2004, No. 116, item 1207, as amended) a foreign entity is an entity having seat in the territory of a Member State of the European Union, overseen by a supervisory body of this Member State. The business of a foreign entity, irrespective of its legal form, covers the accumulation and investing of money with the purpose of financing (pension) benefits to fund members upon their reaching the retirement age.
30 It applies to pension schemes which have the form of an employees’ pension scheme.
31 In Article 47 Para. 10i of the Act of 13 October 1998 on the Social Insurance System (Dz.U. of 1998, No. 137, item 887, as amended) the limit of the value of arrears in transfers of contributions to Open Pension Funds, from which interest is due, was lowered to PLN 2.
33 Pursuant to Article 17 Para. 1c of the Act of 26 July 1991 on Personal Income Tax (consolidated text Dz.U. of 2000, No. 14, item 176, as amended) the income due to redemption of units in a subfund of an investment fund (with separate subfunds) is not established if units of the subfund are exchanged for units of another subfund of the same investment fund.
34 According to Article 12 Para. 4 Subpara. 20 of the Act of 15 February on Corporate Income Tax (consolidated text Dz.U. of 2000, No. 54, item 654, as amended) income due to redemption of units of a subfund of an investment fund (with separate subfunds) is not included in the total income, if units of the subfund are exchanged for units of another subfund of the same investment fund.
According to the previous EU regulations, companies which wanted to raise capital in other countries were required to fulfil additional requirements set by regulators of those markets. Lack of a single definition of a public offering was yet another factor, which made it difficult to raise capital. The same issue could be considered a public offering in one Member State and a private offer in another Member State. To avoid such a situation, the requirements a public offering, preparation and approval of prospectuses were unified. The provisions the new Directive contains allow the issuing entities to offer securities in all Member States on the basis of a prospectus approved in one Member State.

Changes in the EU regulations concerning the capital market were also reflected in Polish law. The previous Act on Public Trading in Securities could not be used as a basis for adjusting Polish regulations to Community law, i.a. because of the terminology used in the Act. Definitions of “investment firm”, “foreign investment firm” and “public offering” were introduced.

The main purpose of adopting the new regulations, apart from the need to adjust to EU regulations, was to facilitate raising capital through an issue of securities in a public offering. This intention was reflected by the provisions concerning the contents of a prospectus and information memorandum. After the changes, there is now no definition of “significant” and “essential” agreements. It allows the issuer to decide on its own which of the concluded agreements are considered significant and should be disclosed. The requirements to provide the subscription price or sales price in a public offer prospectus and to conclude the agreement on investment after the beginning of sale are no longer present in the new regulations. The time limit for approving a prospectus was shortened (in comparison to previous regulations) to 10 working days. In order to make the Securities and Exchange Commission (Komisja Papierów Wartościowych i Giełd – KPWiG) function more efficiently, new regulations allow to entrust the Chairman of KPWiG with the authority to approve prospectuses.

Due to the introduction of the single passport principle to the Polish law, the procedure of admission to official listing was replaced by the procedure of prospectus approval or application for admission to trading in a regulated market. The number of foreign companies listed in the Warsaw Stock Exchange should continue to grow as a result of the application of the single European passport principle. The new solutions should not be very significant for smaller domestic capital companies.

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37 The Directive was transposed into the national legislation using the so called full harmonisation method. This is why a Member State cannot impose on issuers from other Member States additional requirements other than those listed in the Directive. The method was introduced to allow companies to solicit capital in other Member States without having to meet additional requirements set by regulating bodies of those countries.


40 The notion ‘investment firm’ means a brokerage house, a bank carrying out brokerage activities, a foreign investment firm conducting brokerage activities in the territory of the Republic of Poland, or any foreign legal person with a registered office in the territory of an OECD state or WTO member state, which conducts brokerage activities in the territory of the Republic of Poland.

41 The notion ‘foreign investment firm’ means a legal person or organizational unit without legal personality, having its registered office in the territory of another Member State, and if the laws of a given country do not require registration of offices – with a head office in the territory of another Member State, or a natural person resident in the territory of another Member State, which conducts brokerage activities in the territory of another Member State on the basis of a licence granted by a competent authority, as well as a foreign credit institution.

42 The notion of ‘public offering’ means making available in the territory of the Republic of Poland to at least 100 persons or to an unspecified addressee – which contains sufficient information on the securities to be offered and the terms and conditions of their acquisition, so enable an investor to decide to purchase these securities.

43 If approval of a prospectus concerns securities of an issuer, which has not so far issued securities in a public offering and if its securities are not admitted for trading in a regulated market, the time limit is 20 days.

44 Under the previous regulations a collegial resolution of the Polish Securities and Exchange Commission was necessary.
The principle that transactions in securities in public offering must be concluded in a regulated market (i.e. in the Warsaw Stock Exchange or MTS-CeTO) was also repealed. It is expected that the fees on transactions concluded in the Warsaw Stock Exchange will be consequently lowered. As the principle that transactions must be concluded in a regulated market has been repealed, investment firms may introduce alternative systems of trading in financial instruments.

The new regulations granted the status of a ‘qualified investor’ also to small and medium enterprises. This was intended to increase the attractiveness of issuing securities as a means for soliciting capital. Under the new regulations securities can be issued without having to prepare a prospectus, if the offer is directed to qualified investors or if the unit nominal value of securities exceeds EUR 50 thousand. The new legislation was introduced due to the guidelines included in the Prospectus Directive, concerning offers of this type. It is assumed that qualified investors and other entrepreneurs, who invest their funds in securities with unit nominal value of EUR 50 thousand, are capable to assess the security and profitability of investment without having the information provided in a prospectus.

It is also potentially very important for investment firms that they can now perform some activities through agents. Hence, the availability of brokerage services should increase. The next important change was the introduction of the possibility to perform a squeeze-out in public companies. It allows delisting a low liquidity company. In order to ensure more efficient protection of small shareholders, they were given the sell out right.

New regulations concerning transactions of qualified holdings were also introduced. On of the most important changes was the repealing of previous regulations concerning the need to obtain a permit of the Polish Securities and Exchange Commission in order to exceed the threshold of 25%, 33% and 50% of the total number of votes in a public company. However, the obligation to notify the Polish Securities and Exchange Commission of reaching or exceeding the threshold of 5%, 10%, 20%, 25%, 33%, 50% or 75% of the total number of votes in a public company was kept.

In order to increase the security of trading in the capital market the supervisory powers of the Chairman of the Polish Securities and Exchange Commission were expanded. The Chairman may now demand that a securities account be blocked, if suspicion arises that a crime was committed, connected with the use of non-public information or manipulation of a financial instrument. If the regulations are violated or if there is a justified suspicion of their violation regarding a public offering or applying for admission of securities to trading in a regulated market, the Polish Securities and Exchange Commission may also order to withhold a public offering or ban a public offering or admission of securities to trading. Moreover, criminal liability due to violating obligations concerning the so called qualified holdings was replaced by responsibility before administrative authorities. Manipulation of financial instruments may, in some cases, be prosecuted by the Polish Securities and Exchange Commission, using much simpler and faster administrative proceedings.

An obligation was introduced for agents of investment firms, commodity brokerage houses, banks and branches of credit institutions to provide the Polish Securities and Exchange Commission with information on suspicious transactions, which could be a manipulation or result from use of non-public information. The changes should result in enhancing the effectiveness of supervision and law enforcement in the capital market.

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45 Article 3 Para. 2 Subpara. a and d of the Directive 2003/71/EC of the European Parliament and the Council of 4 November 2003 on the prospectus to be published when securities are offered to the public or admitted to trading and amending Directive 2001/34/EC.


47 It may also demand that an account be blocked, where financial instruments which are not securities are registered, as well as a cash account which is used to service these accounts.
Expanding the list of legal forms in which brokerage activities can be carried out was an important change which did not stem from the need to adjust to Community law. New regulations make it possible to carry out brokerage activity in the form of a limited company and in the form of partnerships (however, they are allowed to perform only some activities\(^{48}\)). The new regulations should facilitate it for new entities to start brokerage activity.

**2.2. Measures of the European Union regarding the financial system**

As far as European law is concerned, initiatives to create a single financial market of the European Union continued in 2005. They were consistent with the aims of the Financial Services Action Plan (FSAP),\(^{49}\) whose deadline for completion passed on 31 December 2005.\(^{50}\)

**2.2.1. Financial Services Action Plan (FSAP)**

Within the framework of the adopted Financial Services Action Plan, 41\(^{51}\) out of 42 planned measures, concerning various segments of the financial market, were completed by the end of 2005. The only project that was not completed was the amendment of the 14th Company Law Directive on cross-border transfer of registered office.

Although the deadline for completion of the FSAP has expired, the program will be continued due to the fact that the adopted directives were not transposed into national legislation in the Member States. The deadlines for transposition of three directives (Directive on takeover bids,\(^{52}\) Transparency Directive\(^{53}\) and Directive on markets in financial instruments\(^{54}\) – 20 May 2006, 21 January 2007 and 31 January 2007,\(^{55}\) respectively) into national legislation in the Member States reach beyond the planned deadline of the project’s completion. According to the original plan, most actions carried out within the framework of the FSAP concerned securities markets and retail financial services. These areas were – when the FSAP was prepared – the least integrated areas of the single European financial market (Table 2.2.1).

Legislative acts constituted more than a half of the 42 measures contained in the FSAP. They included: 22 directives, 3 regulations and 1 decision (Box 2.2.1). The other measures were mainly non-binding communiqués and recommendations.

FSAP directives, dates of their adoption by the European Parliament and the Council of the European Union, as well as the transposition deadline are presented in Table 2.2.2.

\(^{48}\) According to Article 69 in connection with Article 95 of the Act of 29 July 2005 on the Trading in Financial Instruments (Dz.U. of 2005, No. 183, item 1538) these activities include:

- acceptance and transfer of orders to acquire or dispose of broker-traded financial instruments,
- investment advisory on broker-traded financial instruments, admitted to organised trading,
- advising companies on capital structure, corporate strategy and other matters related to such structure or strategy,
- advisory and other services relating to mergers, demergers and acquisitions of companies,
- investment advisory on matters concerning broker-traded financial instruments, except for financial instruments admitted to organised trading.

Limited joint-stock partnerships may also perform the following activities:

- management of portfolios including one or more broker-traded financial instruments,
- safekeeping of broker-traded financial instruments and registering changes in the holdings of such instruments,
- additional services related to standby underwriting and firm commitment underwriting.


\(^{50}\) Implementation of the FSAP was divided into two stages: 1) the deadline for adoption of the directives was set to 31 April 2004, 2) the deadline for transposition into the national legislation in the Member States was set to 31 December 2005. Including the Capital Requirements Directive (CRD); its text was agreed upon in 2005, but the document is to be officially adopted and published in 2006.


\(^{54}\) Institutions of the financial market are obliged to adjust to the new provisions by 1 November 2007.
Regulations of the financial system

Table 2.2.1. FSAP measures broken down by the area they concerned

<table>
<thead>
<tr>
<th>Areas included in the FSAP</th>
<th>Number of measures taken within the area</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retail Financial Services, Payments</td>
<td>8</td>
</tr>
<tr>
<td>Securities, Investment Funds</td>
<td>7</td>
</tr>
<tr>
<td>Company Law, Corporate Governance</td>
<td>7</td>
</tr>
<tr>
<td>Insurance, Occupational Pensions</td>
<td>6</td>
</tr>
<tr>
<td>Accounting, Auditing</td>
<td>6</td>
</tr>
<tr>
<td>Banking, Financial Conglomerates</td>
<td>3</td>
</tr>
<tr>
<td>Financial Markets Infrastructure</td>
<td>3</td>
</tr>
<tr>
<td>Insurance, Securities Markets</td>
<td>1</td>
</tr>
<tr>
<td>Taxation</td>
<td>1</td>
</tr>
</tbody>
</table>


Box 2.2.1

SECONDARY SOURCES OF THE COMMUNITY LAW

Regulations are legislative acts, whose scope of binding force is the broadest, compared with other legislative acts. They are addressed to all entities of Community Law: Member States, institutions, but also legal and natural persons. Regulations are obligatory in all their entirety and are directly applicable in all the Member States. They are an instrument for unifying the law in the whole Community. Regulations have priority over to national legislation.

Directives are legislative acts, addressed to the Member States (usually all of them). Member States may freely choose the means of achieving a particular result, defined in a given directive. It is, however, the duty of the Member States to fully and promptly implement the regulations included in directives into national legislation. Directives are an instrument for harmonisation of the legislation of Member States. They have priority over national legislation.

Decisions are legal acts, which apply to individual cases. They may be directed to the Member States, as well as at natural and legal persons. Decisions are fully binding on those to whom they are addressed. They are most often issued in order to apply treaty rules in specific cases. Decisions have priority over national law.

Recommendations and opinions are non-binding acts. They may be addressed to the Member States, other community institutions or natural and legal persons. They are used to express the position of a given institution as regards an area or a specific question.


In 2005 the European Commission focused on ensuring timely transposition of FSAP directives. Information concerning the rate of transposition of the FSAP directives was published two times a month. Figures 2.2.1 and 2.2.2 show the state of work on particular Directives in all the Member States as of 15 December 2005.

In 2005 the deadline for transposition into national legislation in the Member States of the following directives expired (transposition deadline is given in brackets):

- Directive amending the accounting rules in the 4th and 7th Company Law Directives56 (1 January 2005),

Table 2.2.2. Adoption dates of FSAP directives

<table>
<thead>
<tr>
<th>FSAP directive</th>
<th>Directive number</th>
<th>Adopting by the European Parliament and Council</th>
<th>Transposition deadline</th>
</tr>
</thead>
<tbody>
<tr>
<td>Directive amending the insurance directives and the Investment services Directive to permit information exchange with third countries</td>
<td>2000/64/EC</td>
<td>7 November 2000</td>
<td>17 November 2002</td>
</tr>
<tr>
<td>Directive on the reorganisation and winding up of credit institutions</td>
<td>2001/24/EC</td>
<td>4 April 2001</td>
<td>5 May 2004</td>
</tr>
<tr>
<td>Directives to allow fair value accounting</td>
<td>2001/97/EC</td>
<td>4 December 2001</td>
<td>15 June 2003</td>
</tr>
<tr>
<td>Two directives on UCITS¹</td>
<td>2001/107/EC</td>
<td>21 January 2002</td>
<td>13 August 2003</td>
</tr>
<tr>
<td>Two directives amending the solvency margin requirements in the insurance directives</td>
<td>2002/13/EC</td>
<td>5 March 2002</td>
<td>20 September 2003</td>
</tr>
</tbody>
</table>

¹ UCITS (Undertakings for Collective Investment In Transferable Securities) – are investment funds, whose units may be sold in the whole EU, if the association or investment firm that manages them is registered in one of the Member States. In Poland open investment funds fulfil the requirements of the Directive.


Source: prepared by the NBP on the basis of www.europa.eu.int.

– Directive on insurance mediation⁵⁷ (15 January 2005),
– Directive on the prospectus⁵⁸ (1 July 2005),

As of the end of 2005, Poland did not notify three directives to the European Commission: the Directive on takeover bids, the Directive on markets in financial instruments and the Transparency Directive. The deadlines for transposition of the above directives are set in 2006–2007 (Table 2.2.2).

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Figure 2.2.1. Rate of transposition of the FSAP directives in the Member States – view per directive


Figure 2.2.2. Rate of transposition of the FSAP directives in the Member States – view per Member States

### Table 2.2.3. Transposition of the EU Directives into Polish legislation

<table>
<thead>
<tr>
<th>EU Directive</th>
<th>Polish legal acts which include regulations of the respective EU directives</th>
</tr>
</thead>
</table>
2. Ordinance of the Council of Ministers of 16 October 2001 on current and periodical information to be made available by securities issuers  
3. Ordinance of the Minister of Finance of 10 December 2001 on the detailed principles of investment fund accounting  
4. Ordinance of the Minister of Finance of 12 December 2001 on the detailed principles of the drawing up of financial statements of affiliated entities by entities other than banks and insurance undertakings  
5. Ordinance of the Minister of Finance of 8 December 2003 on special principles of insurance undertakings accounting |
| Directive on insurance mediation | 1. Ordinance of the Prime minister of 11 June 2004 on the detailed scope of activity of the Minister of Finance  
2. Ordinance of the Minister of Finance of 4 December 2003 on the compulsory general liability insurance due to carrying out of agency activity  
3. Ordinance of the Minister of Finance of 4 December 2003 on the compulsory general liability insurance due to carrying out of brokerage activity  
4. Act of 22 May 2003 on Insurance Mediation  
5. Act of 22 May 2003 on Insurance and pension Supervision and on Insurance Ombudsman  
6. Act of 22 May 2003 on Insurance Activity  
7. Act of 20 April 2004 amending and repealing other acts following the Accession of the republic of poland to the European Union  
8. Act of 14 June 1960 the Code of Administrative Procedure  
2. Act of 29 July 2005 on the capital market Supervision  
4. Act of 27 May 2004 on Investment Funds  
5. Act of 22 May 2003 on Insurance Activity  
6. Act of 28 August 1997 on Organisation and Operation of Pension Funds  
7. Act of 27 May 2004 on Investment Funds  
8. Act of 20 April 2004 on Occupational Pension Programs  
9. Act of 1 July 2005 amending the Act on Organisation and operation of Pension Funds and other acts |

*Source: prepared by the NBP on the basis of www.europa.eu.int.*

### 2.2.2. Directives regarding the financial sector

Poland has been taking part in the decision-making process of the European Union since 1 May 2004. Polish representatives actively participate in every stage of this process. The EU law-making process as regards financial services is presented in Box 2.2.2.
Codecision procedure

1 By simple majority of votes – majority of votes (50%+1) of the Members of the European Parliament participating in the vote are necessary to make the decision. A quorum exists when at least one third of the Members (i.e. 245) are present.

2 Qualified majority of votes – three conditions must be met for a decision to be made: a) at least 232 out of 321 possible votes must be cast in favour; b) majority of Member States must be represented – i.e. at least 13 of 25 Member States; c) at least 62% of the population of the EU must be represented.

3 Unanimously – 25 out of 25 possible votes are necessary to make the decision.

4 By absolute majority of votes – at least 367 out of 732 possible votes (50%+1) are necessary to make the decision.

5 The deadlines of 3 months and 6 weeks can be postponed by 1 month and 2 weeks respectively.

6 If the opinion delivered by the Commission is negative, the Council may adopt the amendments of the EP unanimously.

7 Apart from the representatives of the EP and the Council, representatives of the Commission also participate in the Conciliatory Committee.

Source: prepared by the NBP on the basis of Article 251 of the Treaty establishing the European Community and A.A. Ambroziak, M. Mielecka, K. Ostrzygowska, I. Woicka (ed.): Proces decyzyjny w Unii Europejskiej. Przewodnik dla urzędnika administracji publicznej, Warszawa 2005, UKIE.

Box 2.2.2

Codecision procedure

THE EUROPEAN COMMISSION – LEGISLATIVE INITIATIVE

FIRST READING

EP – opinion

No amendments are proposed

Amendments are proposed

European Commission delivers an opinion

EU Council

No amendments are proposed

Amendments of the EP are approved

The draft is rejected or amendments are proposed

A COMMON POSITION IS ADOPTED

SECOND READING

The legal act is not adopted

The Commission delivers an opinion

The EP has 3 months to...

approve the common position or take no action

The EP proposes amendments

The Council has 3 months...

The EP approves the amendments of the EP

The EP has 3 months...

The legal act is adopted

The legal act is adopted

A CONCILIATION COMMITTEE IS CONVENED BY THE EP AND COUNCIL WITHIN 6 WEEKS

The legal act is not adopted

No common draft is prepared by the EP and the Council within 6 weeks

A common draft is prepared by the EP and the Council within 6 weeks

THIRD READING

The legal act is not adopted

reject the act

EP and the Council have 6 weeks to...

adopt the act

The legal act is adopted

1 By simple majority of votes – majority of votes (50%+1) of the Members of the European Parliament participating in the vote are necessary to make the decision. A quorum exists when at least one third of the Members (i.e. 245) are present.

2 Qualified majority of votes – three conditions must be met for a decision to be made: a) at least 232 out of 321 possible votes must be cast in favour; b) majority of Member States must be represented – i.e. at least 13 of 25 Member States; c) at least 62% of the population of the EU must be represented.

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EU LAW-MAKING PROCESS IN THE FIELD OF FINANCIAL SERVICES

Preparation of a draft legal act

The legislative initiative, i.e. the authority to prepare and propose drafts of legal acts, as regards creating legislation on financial services, belongs solely to the European Commission.

When preparing a draft legal act, the European Commission is advised by an expert group comprising representatives of the Member States, and also level 2 committees (EBC, ESC, EIOPC) and level 3 committees (CEBS, CESR, CEIOPS). Each committee includes representatives of all the Member States. Furthermore, the Internal Market and Services Directorate General (DG MARKT) organises public consultations, aimed at acquainting the European Commission with the positions of interested parties regarding the proposed legislation.

It is important to learn the positions of the Member States and interested parties as early as possible, because it allows to assess whether a given draft can be adopted in the later stages of the work in the European Parliament and in the Council and to seek possible compromises before the draft is officially published by the European Commission.

A formal draft of a legal act, together with its justification, then comes to the European Parliament and the Council. They adopt a draft Directive within the framework of the codecision procedure.

In 2005 the European Parliament and the Council adopted the following directive regarding the financial sector:

– Directive establishing a new organizational structure for financial services committees,60
– Directive on the capital adequacy of investment firms and credit institutions,61
– Directive relating to the taking up and pursuit of the business of credit institutions,62
– Third Directive on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing,63
– Fifth Motor Insurance Directive,64
– Reinsurance Directive,65
– Directive on cross-border mergers,66
– Directive on statutory audit of annual accounts and consolidated accounts.67

2.2.2.1. Directives regarding the entire financial services sector

New organizational structure of the committees

The European Commission presented a draft of the new organizational structure on 5 November 2003. The draft included a proposal for a Directive of the European Parliament and of the Council\(^{68}\) and six Commission Decisions\(^{69}\) concerning the creation of new committees and changing the status of the existing ones. The directive changing the organizational structure of financial services committees entered into force in April 2005.

The objective of the Directive was to streamline the decision-making process for financial services and to improve regulatory and supervisory cooperation. The Directive extended the organisational structure and the four-level Lamfalussy process, which has been used to the securities sector since 2002, to banking, insurance and investment funds (Table 2.2.4).\(^{70}\) Pursuant to the Directive, the existing Banking Advisory Committee (BAC) and the Insurance Committee (IC) were replaced by the European Banking Committee (EBC) and the European Insurance and Occupational Pensions Supervision Committee (EIOPC). The UCITS Contact Committee was dissolved and its functions were transferred to the European Securities Committee (ESC) and the Committee of European Securities Regulators (CESR).

The creation of four new committees – EBC, EIOPC, CEBS (Committee of European Banking Supervisors) and CEIOPS (Committee of European Insurance and Occupational Pension Supervisors) and the change of status of ESC and CESR was introduced pursuant to six separate Commission Decisions (footnote 61). The Decisions establishing EBC, EIOPC, ESC and CESR entered into force on the same day as the Directive changing the committee structure was adopted, whereas the CEBS and CEIOPS took up their duties on 1 January 2004 and 24 November 2003, respectively.

Table 2.2.4. New organisational structure and decision-making process for EU financial services sector

<table>
<thead>
<tr>
<th>Level</th>
<th>Banking</th>
<th>Securities</th>
<th>Insurance and Occupational Pensions</th>
</tr>
</thead>
<tbody>
<tr>
<td>Level 1</td>
<td>European Commission, EU Council, European Parliament</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Level 2</td>
<td>(Regulatory Committee)</td>
<td>European Banking Committee (EBC)</td>
<td>European Securities Committee (ESC)</td>
</tr>
<tr>
<td>Level 3</td>
<td>(Committee of Supervisors)</td>
<td>Committee of European Banking Supervisors (CEBS)</td>
<td>Committee of European Securities Regulators (CESR)</td>
</tr>
<tr>
<td>Level 4</td>
<td></td>
<td></td>
<td>European Commission, governments of the Member States, European Court of Justice</td>
</tr>
</tbody>
</table>

Source: prepared by the NBP on the basis of www.europa.eu.int.

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Level 2 committees (EBC, ESC, EIOPC) advise the European Commission on drafting level 1 legal acts and the financial sector policy. The committees, composed of high-level representatives of respective ministries of the Member States, are chaired by a representative of the Commission. Experts appointed by the ministries, chairpersons of respective level 3 committees and a representative of the European Central Bank can participate at meetings as observers. Poland’s official representative of the level 2 committees is the Minister of Finance. All the level 2 committees have a seat in Brussels.

The main role of the level 3 committees (CEBS, CESR, CEIOPS) is to provide advice to the European Commission, either at the Commission’s request or on their own initiative, as regards the preparation of proposals for level 1 legislative acts and drafts implementing measures (level 2) as well as ensuring timely transposition of the directives and convergence of the supervision practices in the Member States. Furthermore, level 3 committees are a forum for cooperation and information exchange between the institutions which supervise the financial markets. The committees are composed of high-level representatives of the respective institutions competent for the supervision of domestic markets in the Member States. The members of the committees elect chairpersons from among themselves. Poland is represented by members of the management board of the General Inspectorate of Banking Supervision (in the CEBS), the Polish Securities and Exchange Commission (in the CESR) and Insurance and Pension Funds Supervision Commission (in the CEIPOS). The committees have seats in London (CEBS), Paris (CESR) and Frankfurt (CEIPOS).

2.2.2.2. Directives regarding the banking services sector

Capital Requirements


The Capital Requirements Directive ensures consistent application of the New Capital Accord (prepared by the Basel Committee on Banking Supervision, the so-called Basel II) in the EU. Its objective is to change the principles of setting capital requirements for credit institutions and investment firms.\(^{74}\) The Directive introduces a more complex methodology which enables increased effectiveness of risk management among financial institutions.\(^{75}\)

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\(^{75}\) Pursuant to Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments the notion ‘investment firm’ means any legal person whose regular occupation or business is the provision of one or more investment services to third parties and/or the performance of one or more investment activities on a professional basis.

More in: chapter 4.1, Box 4.1.3.
Money laundering


The main objective of the Directive is to ensure coordinated implementation and application by the Member States of the Forty Recommendations76 of the Financial Action Task Force on Money Laundering (FATF), published in June 2003. Pursuant to the Directive an institution which services payments made in cash in excess of EUR 15 000 is obliged to verify the identity of the customer and the beneficial owner and report all suspicious transactions to the public authorities. The existing 1991 Directive expires with the entry into force of the new legal act.

2.2.2.3. Directives regarding non-banking financial institutions

Motor insurance

On 11 June 2005 the Directive relating to insurance against civil liability in respect of the use of motor vehicles was published. The Member States were obliged to transpose the Directive into their national legislation by 11 June 2007.

The objective of the Directive is to modernise legislation regulating the Community motor insurance system. The Directive is intended to help accident victims get and claim upon insurance and to ensure proper insurance protection for drivers. The new Directive introduces the minimum amount of insurance cover amount for personal injuries of EUR 1 million per victim or EUR 5 million per accident, regardless of the number of victims. A five year transition period was established in order to facilitate the adjustment to the new regulations. Moreover, the above amounts of cover will be adjusted to the European Index of Consumer Prices77 every five years. Furthermore, pursuant to the Directive damage done to pedestrians, cyclists and other road users will be covered by the compulsory insurance of the vehicle which participated in the accident. Due to the special importance of the motor insurance the work will be continued in order to enhance and consolidate the single insurance market.

Reinsurance

In December 2005 the Reinsurance Directive was published. The Member States have two years to transpose the Directive into their national legislation and in the case of rules relating to technical provisions the transposition deadline was postponed by a year.

The objective of the Directive is to cover reinsurance activity carried out in the EU by Community law. The reinsurance supervision rules, which have been functioning so far in the Member States, vary significantly. The directive introduces principles of taking up and conducting business by reinsurance undertakings which operate exclusively in the field of reinsurance activity and have a head office in a Member State or intend to establish it there. Under the directive, a reinsurance undertaking will be able to take up the business of reinsurance only after authorization by the competent authority of its home Member State has been granted. The directive defines the minimum requirements which have to be met in order to obtain such authorization.

The directive also addresses the question of reinsurance supervision in order to monitor the financial situation of reinsurance undertaking and enable the imposition of penalties. The reinsurance supervision authorities of the Member States are obliged to cooperate and to exchange information on a regular basis.

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76 An initial version of the Forty Recommendations was prepared in 1990 in order to prevent using the financial system for laundering of money from drug trafficking. In 1996 the first amendments were introduced, which addressed new sources of money laundering. After the document was reviewed in June 2003, a new version of the Forty Recommendations now addresses, apart from the question of money laundering, also the issue of financing of terrorist activity.

77 European Index of Consumer Prices (EICP) is an index of consumer prices prepared by Eurostat for the EU on the basis of the Harmonized Index of Consumer Prices (HICP) of every individual Member State.
2.2.2.4. Directives regarding the capital market

Cross-border mergers


The directive on cross-border mergers of limited liability companies is the first legal act adopted within the framework of Action Plan on Modernizing Company Law and Enhancing Corporate Governance in the European Union which was published in May 2003. The objective of the Directive is to facilitate cross-border mergers between various types of limited liability companies subject to the laws of different Member States. The regulations introduced in the Directive should create conditions favourable for creating economically stronger entities and help the merged enterprises to compete with big companies from outside the EU.

The directive applies to mergers of limited liability companies formed pursuant to the law of a Member State whose registered office, head office or principal places of business is located in the EU, provided at least two of them are governed by the laws of different Member States. The provisions of the Directive do not apply to UCITS and the Member States may decide not to apply the Directive for five years to cross-border mergers involving a cooperative society.

Employee participation is an important question regulated by the Directive. Pursuant to the Directive the company resulting from a cross-border merger is not obliged to introduce an employee participation system only if the system did not exist in any of the merging companies. In the remaining cases the company resulting from the merger is subject to the national law of the Member State where the registered office of company is located. If national legislation does not regulate the question of employee participation and at least one of the merging companies is operating under an employee participation system, the provisions of the Directive and of the Regulation on the European Company are to be applied.

Audit of annual accounts and consolidated account

On 16 March 2004 the European Commission presented the draft of a Directive on statutory audit of annual accounts and consolidated accounts. The new proposal of the Commission is intended to replace the Eighth Company Law Directive. The European Parliament adopted a draft of the new directive on 28 September 2005, but it also proposed its own amendments. After the amendments were adopted by the Commission, on 11 October 2005 the directive was approved by the Council. The directive is to be officially signed by the European Parliament and the Council and then published in 2006.

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78 Within the meaning of the directive ‘limited liability company’ is a company as referred to in article 1 of the first Corporate Law Directive (68/151/EEC) or a company with a share capital and having legal personality, possessing separate assets which alone serve to cover its debts. The company is subject to the national law governing it to conditions concerning guarantees such as are provided for by Directive 68/151/EEC for the protection of the interests of members and others. In Polish legal system this definition refers to both a limited liability company and a public limited company. In other legal systems the definition also includes other legal entities, e.g. limited joint stock partnerships.

79 The main objectives of the above plan include: strengthening shareholders’ rights, reinforcing protection of employees, creditors and other parties concluding transactions with companies, and increasing the efficiency and competitiveness of business. In order to achieve the above aims the Commission proposed measures, which are planned to be carried out in three stages: in the years 2003–2005, in the years 2006–2008 and after 2009.

80 Pursuant to Directive 2001/86/EC of 8 October 2001 supplementing the Statute for a European company with regard to the involvement of employees, the notion ‘participation’ means the influence of the body representative of the employees and/or the employees’ representatives in the affairs of a company by way of:
  – the right to elect or appoint some of the members of the company’s supervisory or administrative organ, or
  – the right to recommend and/or oppose the appointment of some or all of the members of the company’s supervisory or administrative organ.


The Directive on statutory audit of annual accounts and consolidated account is a reaction of the EU to financial reporting scandals, which took place in companies such as Parmalat (Italy) or Enron (USA). The objective of the directive is to rebuild investor confidence to financial statements of companies, as well as to restore the prestige of the profession of chartered auditor.

The new Eighth Directive obliges the Member States to organise an efficient public supervision system over chartered auditors and audit companies, as well as to create regulations ensuring an efficient information flow between a chartered auditor or audit company and the audited entity. The directive also introduces an obligation to apply international financial reporting standards during all audits of financial statements performed in the EU and an obligation to create audit committees in public interest entities.83

The Directive contains provisions defining the duties of chartered auditors and audit companies – rules of professional ethics, procedures concerning their appointment and dismissal, and unified requirements regarding independence from the audited entity. Furthermore, the directive announced the convening of an Audit Regulatory Committee, which will assist the Commission in establishing the implementing measures.

2.2.3. Green and White Papers regarding financial services

The idea of Green and White Papers and their role in the EU law making process are presented in Box 2.2.3.

Box 2.2.3

GREEN AND WHITE PAPERS IN THE EUROPEAN UNION

Green Papers published by the European Commission are documents intended to stimulate a debate and launch a process of consultation on a particular topic. They usually consist of a summary of the current legislation in a given area and the Commission’s proposals concerning possible legislative initiatives or other actions. They also often include questions directed to interested parties (institutions and individuals), who are thus encouraged to participate in consultations and discussions. According to some authors,1 Green Papers induce a public debate and encourage the society to participate in the law-making process. Consultations initiated by the publication of a Green Paper may be completed with a publication of a White Paper.

White Papers are documents published by the European Commission. Unlike the Green Papers, they include an official set of proposals for measures in a specific area. The measures can take the form of planned drafts of legal acts or non legislative documents (e.g. guidelines, recommendations). White Papers set EU priorities as regards a given issue, but also the means and stages of implementing them.

A list of all the Green and White Papers published by the Commission is available on the websites:

– http://ec.europa.eu-comm/off/green/index_en.htm (Green Papers),


Source: prepared by the NBP on the basis of A.A. Ambroziak, M. Mielecka, K. Ostrzygowska, I. Woicka (ed.): Proces decyzyjny w Unii Europejskiej. Przewodnik dla urzędnika administracji publicznej, Warszawa 2005, UKIE.
In 2005 the European Commission published:

– the Green Paper on Financial Services Policy 2005–2010,\(^{84}\)

– the White Paper on Financial Services Policy 2005–2010,\(^{85}\)

– the Green Paper on the enhancement of the EU framework for investment funds,\(^{86}\)

– the Green Paper on Mortgage Credit in the EU.\(^{87}\)

**Green Paper on Financial Services Policy 2005–2010**

Due to the nearing completion of the Financial Services Action Plan on 3 May 2005, the European Commission published a Green Paper on Financial Services Policy (2005–2010). The document deals mostly with the implementation of initiatives included in the FSAP and with cooperation with the Member States, and to lesser extent, addresses the question of proposing new laws. In the Green Paper, an outline of the main objectives of the financial services policy for the period 2005–2010 is presented, as well as the position of the Commission as regards the following issues:

– main directions of the future policy,

– transposition, enforcement and continuous evaluation of the European law,

– consolidation of financial services legislation in 2005–2010,

– new initiatives.

Proposals for actions were presented for all of the above areas. Their implementation is of crucial importance for the continued creation of an integrated financial market and consolidation of the progress achieved as a result of the implementation of the FSAP.

According to the Green Paper, the main directions of the European Commission’s policy in the area of financial services before 2010 are:

– consolidation of the existing legislation and proposing few new initiatives,

– ensuring an efficient transposition of the European regulations into national legislation and enforcing them more rigorously by supervisory authorities,

– regular ex-post evaluation whereby the Commission will monitor the practical application of the above regulations and their influence on the European financial sector.

Six priorities were proposed as regards applying and enforcing European law:

– compliance with the principles of openness and transparency of policy-making regarding financial services and the extensive use the consultation mechanism at all levels,

– simplification and consolidation of the existing financial services legislation (European and national),

– ensuring convergence of standards and practices of the supervisory authorities, while respecting the political accountability and existing institutional boundaries,

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\(^{86}\) COM(2005)314, Green Paper on the enhancement of the EU framework for investment funds.

\(^{87}\) COM(2005)327, Green Paper on Mortgage Credit in the EU.
– cooperation with the Member States in order to improve transposition and implement the EU regulations consistently,

– assessing if the existing directives and regulations are delivering the expected economic benefits and repealing measures which are assessed negatively,

– ensuring proper implementation and enforcement of the current regulations and initiating infringement procedures if needed.

As far as consolidation of financial regulations in 2005–2010 is concerned, the Green Paper emphasizes the necessity to complete initiatives which are still being negotiated in the European Parliament and the Council, and the main measures which are under preparation by the Commission. This concerns mostly: the proposal of a Directive on payment services, changes in the solvency regime of insurance undertakings (Solvency 2), and the possibility of presenting a proposal for a Directive on clearing and settlement. It was also considered not to propose any additional regulations concerning rating agencies and financial analysts, and implementing measures to the Directive on takeover bids. Furthermore, it was considered whether changes are needed to the Hague Convention. Moreover, support was expressed for further consolidation of supervision, and the need was emphasized to continue regulatory dialogue with the USA and China, deepen financial relations with other countries (Japan and China) and ensure the global competitiveness of the European financial sector.

The Green Paper identifies two areas where new legislative initiatives are planned, namely: investment funds and retail financial services. As regards investment funds, a document was announced which would present a complex overview of the UCITS legislation. Then, a Green Paper on the enhancement of the EU framework for investment funds will follow. In the area of retail financial services, further initiatives were considered, concerning mortgage credit, financial mediation, bank accounts, information requirements, and also the concept of the ‘26th regime’.


The White Paper on Financial Services Policy (2005–2010) was published on 5 December 2005. Contrary to the Green Paper, the document presents the final priorities of the Commission as regards financial services policy in 2005–2010. The measures presented in the White Paper do not differ substantially from the proposals included in the Green Paper. Pursuant to the White Paper, the final priorities of the Commission as regards financial services are:

– dynamic consolidation aimed at creating an integrated, open, global, competitive and economically efficient European financial market,

– removing barriers in order to ensure availability of financial services and free movement of capital in the whole EU at the lowest possible costs – while ensuring a high level of prudence and conduct of business regulations, resulting in a high level of financial stability,

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88 Currently the issues relating to rating agencies and financial analysts are regulated by the provisions of Directive on market manipulation (Directive 2003/6/EC), autoregulatory mechanisms like e.g. International Organization of Securities Commissions (IOSCO) and monitoring.


90 Multilateral convention of 13 December 2002 on the law applicable to certain rights in respect of securities held with an intermediary.

91 ‘26th regime’ is a proposal to create an additional legal regime, which would be binding in the whole EU, independently from 25 national regimes. Companies carrying out cross-border activity could decide to submit to this regime.
– implementation and regular assessment of the existing legislation and applying rigorously the better regulation agenda to new initiatives,

– enhancing supervisory cooperation and convergence in the EU, intensifying relations with other global financial markets and strengthening the global position of the EU in the financial markets.

The White Paper, in line with the position presented in the Green Paper, announces that initiatives in the following areas will be continued: retail banking (publication of a White Paper on mortgage credit, verification of the proposal of a Directive on consumer credit, proposal for a Directive on payment services), changes in the solvency regime of insurance undertakings (Solvency 2), and verification of the Banking Directive and Insurance Directives as regards qualifying shareholdings.\(^92\) The question whether to come forward with a proposal for a Directive on clearing and settlement is still open, while the concept of creating the ‘26th regime’ was dropped. Furthermore, work is planned to start on eliminating barriers in cross-border consolidation, the publication of a report evaluating the E-money Directive and on taking measures concerning deposit guarantee schemes. Pursuant to the Council’s request it was announced that a legal assessment of the Hague Convention would be made.

Compared to the Green Paper, the position of the Commission on the White Paper concerning the areas where new regulations should not be introduced (rating agencies, financial analysts, implementing measures to the Directive on takeover bids, capital requirements for regulated markets) did not change. The documents uphold the opinion that it is necessary to introduce new legislation concerning investment funds and retail financial services.

**Green Paper on the enhancement of the EU framework for investment funds**

On 12 July 2005 the Commission published a Green Paper on the enhancement of the EU framework for investment funds. The document was prepared within the review process of UCITS III\(^93\) Directives which concern coordination of regulations relating to undertakings for collective investments in transferable securities (UCITS). The analysis presented in the document was based on a report of asset management experts group,\(^94\) published in May 2004 and subsequent discussions with the Member States, members of the Committee of European Securities Regulators and market participants.

The Green Paper assesses the impact of regulations concerning the activity of investment funds, introduced by UCITS III Directives. The regulations allow UCITS funds authorised in one Member State to be offered throughout the EU. According to the view included in the Green Paper, there is no compelling case for fundamental legislative overhaul. However, many proposals were presented in the document, which aim at increasing the effectiveness of existing regulations, while ensuring a sufficient level of investor protection.

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The following priorities concerning investment funds were proposed in the Green Paper:

– eliminating the uncertainty concerning the recognition of funds, connected with the transition from UCITS I\(^{95}\) to UCITS III,\(^{96}\)

– simplifying the notification procedure for funds applying for a European passport,

– supporting implementation of Commission’s Recommendations concerning the use of derivatives and the simplified prospectus,

– explaining the definition of assets which can be purchased by UCITS.

Two areas of possible future initiatives were identified on the basis of the current legal framework: analysis of the way in which UCITS are offered, sold or promoted to individual investors and introduction of the management company passport. Nevertheless, there are concerns that if management companies can use the single passport, the supervision of the UCITS Funds’ sector will be weakened.

The Green Paper also addresses questions reaching beyond the existing legal framework. Long-term measures are considered, aimed at reducing costs and benefiting from economies of scale in the European funds sector (through cross-border mergers or fund pooling) and enhancing investor protection (through carrying out an analysis of risk types and risk controls). Research is expected to be undertaken on the influence of a common regulatory approach on the further development of the European market of alternative investments (private equity and hedge funds). Furthermore, a recast of the UCITS Directive along the lines of the Lamfalussy approach is planned.

The Green Paper also announces the creation of two expert groups on investment funds: Expert Group on Market Efficiency and Expert Group on Alternative Investment Funds.\(^{97}\)

Consultations on the questions raised in the Green Paper lasted until 15 November 2005. It is planned that the White Paper on the enhancement of the EU framework for investment funds will be published in 2006.

**Green Paper on Mortgage Credit in the EU**

On 19 July 2005 the European Commission published a Green Paper on Mortgage Credit in the EU. The document assesses whether it is justified for the Commission to take measures concerning the integration of mortgage credit markets in the EU. The consultation process started by the Commission is to identify solutions which will contribute to eliminating barriers in extending mortgage credit in the European Union.

European mortgage credit markets, despite some common trends, are quite varied, which limits competition between credit institutions from various countries. Product offer, borrower profiles, distribution methods, loan duration, home-ownership rates and funding mechanisms are very different. According to the Commission outsourced research, in the next several years the benefits for consumers of further integration of the European mortgage credit markets may include: lowering the cost of mortgage credit, improving product completeness in ancillary products, serving more borrowers, improving economies of scale due to integration with other financial services sectors and lowering credit risk.

\(^{96}\) UCITS III provisions expanded the scope of activity of UCITS management companies, information obligations connected with publishing an extract of the information prospectus and the contents of the passport of UCITS and the management company. The Member States were obliged to transpose the provisions of the new directives into their national legislation by 13 June 2004. The transition period for investment funds due to the change of Directive UCITS I to UCITS III expires on 13 February 2007. By virtue of the CESR guidelines the deadline was changed to 30 April 2006.  
\(^{97}\) The groups were created in December 2005.
According to the opinion of the Forum Group on Mortgage Credit, the Green Paper analyses four separate, but interrelated areas: consumer protection, legal issues, collateral and funding. The above areas were considered key to the integration and increased efficiency of the mortgage credit markets in the European Union.

As regards consumer protection, the Green Paper places special emphasis on information provision, which would enable the consumer to shop around and compare offers, as well as on compulsory advice provision in this respect. The document also addresses the question of early repayment. It is emphasized that if some degree of consistency was achieved in this area – especially on the imposition of fees – it would facilitate integration. The document also points to discrepancies over the calculation methods of Annual Percentage Rates and borrowing costs. Furthermore, some Member States have introduced legally enforceable caps on interest rates, often described as ‘anti-usury’, are aimed at preventing excessively high interest rates. The document also addresses the question of standardisation of credit contract terms (e.g. ‘the 26th regime’) and alternative means of redress (mediation or arbitration) in relation to traditional judicial redress mechanisms concerning mortgage credit.

As regards legal issues, the question of law applicable to contracts, including mortgage credit, was raised. The Green Paper also points at the various regimes for compilation of and access to credit-worthiness databases in the Member States. Ensuring cross-border access to databases was declared a priority. In the area of property valuation, due to the fact that there are several international valuation regimes, increasing their comparability was suggested. Moreover, the document emphasizes that initiatives were launched against national regulations concerning mortgage taxation which are not compatible with the EU law.

As regards mortgage collateral, the Green Paper addresses the question of a land register and Euromortgage. It was emphasized that understanding the contents and functioning of land registers, as well as easy access to such registers are crucial for cross-border activity. The idea to create a Euromortgage – an instrument which would secure loans on property and operate in all the Member States, facilitating the creation and transfer of mortgages – was also supported.

In the area of funding of mortgage credit, the emphasis was placed on questions connected with the pan-European funding mechanism. If such a mechanism was created, it could increase sources of funding and liquidity of the market and allow risk diversification. Furthermore, it was announced that a working group would be created to examine whether it is necessary to take measures concerning funding aspects (primary and secondary) of mortgage credit and to determine the character of these measures.

Consultations concerning the subjects raised in the Green Paper lasted until 30 November 2005. The White Paper on mortgage credit in the EU will be published in 2006.

2.2.4. Prospects of regulatory changes

According to the position presented in the White Paper on financial services policy 2005-2010, in the coming years an increased pressure from the Commission will be observed to transpose EU law into national legislation in the Member States and to apply EU law rather than to create new regulations. In Poland, this will imply the necessity to amend acts regulating the functioning of the financial sector in order to achieve full compliance with the requirements of Community law. The European Commission intends to launch new initiatives only in exceptional cases. Nevertheless, the projects, which are currently under work in the European Parliament and in the Council, must be finished. The main EU initiatives concerning financial services planned for 2006 and the most important potential changes in Polish law resulting from their implementation are presented in Table 2.2.5.
<table>
<thead>
<tr>
<th>Area</th>
<th>EU initiatives planned for 2006</th>
<th>The most important potential changes in Polish law resulting from implementation of EU initiatives</th>
</tr>
</thead>
<tbody>
<tr>
<td>Banking</td>
<td>Publication of the Capital Requirements Directive Work on the revision of article 16 of the Banking Directive (concerning qualifying shareholding)</td>
<td>Amending the Banking Law and the executive provisions Amending the Banking Law</td>
</tr>
<tr>
<td>Insurance</td>
<td>Work on the preparation of the Solvency 2 Directive</td>
<td>Amending the Act on Insurance Activity</td>
</tr>
<tr>
<td>Retail financial services</td>
<td>Publication of the White Paper on mortgage credit Work in the European Parliament and in the Council on adopting the proposal for a Directive on consumer credit</td>
<td>Amending the regulations concerning consumer protection Amending the Act on Consumer Credit</td>
</tr>
<tr>
<td>Investment funds</td>
<td>Publication of the White Paper on the enhancement of the single market framework for investment funds</td>
<td>Amending the Act on Investment Funds</td>
</tr>
<tr>
<td>Payment services</td>
<td>Work in the European Parliament and in the Council on adopting the proposal for a Regulation on information on the payer accompanying transfer of funds Work in the European Parliament and in the Council on adopting the Directive on payment services</td>
<td>The Regulation is directly applicable and hence does not require amending Polish law Amending the regulations concerning electronic payment instruments, the banking law, prevention of money laundering</td>
</tr>
<tr>
<td>Accounting</td>
<td>Work in the European Parliament and in the Council on adopting the proposal for a Directive amending the 4th and 7th Company Law Directive on the annual accounts and consolidated accounts of certain types of companies</td>
<td>Amending the Accounting Act</td>
</tr>
<tr>
<td>Auditing</td>
<td>Publication of the Directive on statutory audit of annual accounts and consolidated accounts</td>
<td>Amending the Accounting Act</td>
</tr>
</tbody>
</table>

Source: prepared by the NBP.
The infrastructure of the financial system includes several elements. An important role is played by the entities regulating and supervising the functioning of the financial system. The technical infrastructure consists of the institutions and systems that enable the execution of payments by the market participants, organise the trade in financial instruments and enable the settlement of the transactions. The systems ensuring the protection of the market participants and the institutions enhancing information transparency are important elements as well.

As in the previous edition of this study, this chapter presents only the most important changes concerning the financial market infrastructure in 2005 and the work in the field related to the integration of the European financial market. The description of individual entities, the systems of the financial market infrastructure and their functions can be found in the report entitled *Financial System Development in Poland 2002–2003*.

### 3.1. Regulatory and supervisory institutions

The institutions which regulate and supervise the operation of the financial system include the Ministry of Finance, the National Bank of Poland, the Commission for Banking Supervision (Komisja Nadzoru Bankowego – KNB), the Securities and Exchange Commission (Komisja Papierów Wartościowych i Giełd – KPWiG) and the Insurance and Pension Funds Supervisory Commission (Komisja Nadzoru Ubezpieczeń i Funduszy Emerytalnych – KNUne).

On 24 October 2005, three new legal acts regulating the functioning of the capital market entered into force: the Act on Trading in Financial Instruments, the Act on Public Offering, Conditions Governing the Introduction of Financial Instruments to Organised Trading, and Public Companies and the Act on Capital Market Supervision. The Acts changed among others the powers of the Securities and Exchange Commission in respect of the stock exchange crime prosecution, which may contribute to the increase in the safety of the stock exchange market functioning.

The Act on Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in Financial Conglomerate entered into force in June 2005. Pursuant to the Act, the Coordination Committee for Financial Conglomerates was established. It consists of the members of the Commission for Banking Supervision, the Securities and Exchange Commission and the Insurance and Pension Funds Supervisory Commission.

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102 Act of 15 April 2005 on Supplementary Supervision of Credit Institutions, Insurance Undertakings and Investment Firms in Financial Conglomerate (Dz.U. No. 83/2005, item 719).
3.2. Payment system

The most important change in the payment system in 2005 was the launch of two new euro payment systems: SORBNET-EURO for large-value payments and EuroELIXIR for retail payments. Therefore, a comprehensive infrastructure for settlements in euro was created which at the same time integrated Poland with the European Union payment system. Poland is the first new EU Member State which became a participant of the TARGET payment system.

3.2.1. Large value interbank settlements

The most important development with regard to large-value interbank settlements in 2005 was the start of the SORBNET-EURO system on 7 March 2005. It was the consequence of the SORBNET system development strategy adopted by the NBP Management Board in July 2003. It provided for the maintenance and development of the SORBNET system by the time of Poland’s entry to the euro area and the preparation of the SORBNET-EURO system on its basis for settlements of domestic and cross-border payments in euro.

The SORBNET-EURO system, similarly to the SORBNET system, is a real-time gross settlement system (RTGS). The system was connected to the pan-European TARGET system through the central bank of Italy and the Italian RTGS system called BIREL. The Bank of Italy is a correspondent bank – an intermediary between the SORBNET-EURO system and the TARGET system. It keeps the NBP’s settlement account for execution of all cross-border payment orders incoming to and outgoing from the SORBNET-EURO system.

The NBP participates in the TARGET system under the so-called option 4. It is the “full” option 4, i.e. an option which uses the intraday credit in euro. It means that the NBP has to meet the same requirements as those imposed on other central banks of the EU-15 countries remaining outside the euro area, apart from solutions related to the connection to the TARGET system via the Interlinking system. The structure of the TARGET system is presented in Diagram 3.1.

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104 Komunikat na temat decyzji Zarządu NBP w sprawie strategii rozwoju systemu SORBNET (Communication on the decision of the NBP Board on the SORBNET system development strategy), http://www.nbp.pl.
105 Orders are processed individually on a continuous basis throughout the operational day.
106 Trans-European Automated Real-time Gross settlement Express Transfer system. The TARGET system was launched in 1999 in order to settle operations within the framework of common monetary policy of the European System of Central Banks. The TARGET system allows for settlement of all types of payments in euro, both interbank and customer payments. Currently the TARGET system consists of 16 national RTGS systems (euro area countries, Denmark, Sweden, the United Kingdom and Poland) and the ECB payment mechanism. The individual RTGS systems are connected via the Interlinking system based on the SWIFT network (electronic bank communication system). In the domestic part of the Interlinking system each central bank (a participant of the TARGET system) holds correspondent accounts for the remaining central banks.
107 In November 2002 the ECB set forth five options of the connection of the EU acceding countries to the TARGET system, including two options of direct connection (option 1 and 2) and three options of indirect connection:
- option 1. – direct connection of the own RTGS system (in euro) to the TARGET system;
- option 2. – direct connection using a modified version of the RTGS system which already participates in the TARGET system;
- option 3. – connection by means of the accounts of the central bank and commercial banks held in one of the central banks from the euro area;
- option 4. – connection by means of the account of the central bank of the acceding country in a chosen central bank from the euro area;
- option 5. – connection by means of the accounts of the central bank and commercial banks held in a chosen commercial bank from the euro area.
108 In order to ensure settlement liquidity in the SORBNET-EURO system, the NBP provides banks with access to the intraday credit in euro. In order to do so, the NBP had to obtain funds from a commercial bank from the euro area to the amount compliant with the limit granted by the ECB (the NBP account with the Bank of Italy is credited with 350 million euro everyday).
The entities entitled to maintain accounts in the SORBNET-EURO system and submit payment orders to that system include:

- the NBP;
- domestic banks, branches of credit institutions and branches of foreign banks;
- the National Depository for Securities (Krajowy Depozyt Papierów Wartościowych – KDPW);
- the National Clearing House (Krajowa Izba Rozliczeniowa – KIR).

As compared to the correspondent banking (based on the network of bilateral relations between the banks), the main benefits of the new system include the shorter time of settlements in euro between the banks, lower settlement costs, higher level of security and automation of payments processing.

The NBP is the first participant of the TARGET system among the central banks of the countries which acceded to the European Union on 1 May 2004. It allowed Poland to join the EU payment system. By becoming a participant of the TARGET system Poland also fulfilled one of the necessary conditions for joining the euro area. In addition, participation in the TARGET system will in future facilitate the migration to the TARGET2 system.

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110 The participation in the TARGET system is mandatory for the euro area countries. However, pursuant to the decision of the ECB, the new Member States which have not adopted the single currency yet may participate in the system as well.
111 In 2002, the ECB decided about the reform of the TARGET system which had operated since January 1999. The reform assumes the building of a new version of the system i.e. TARGET2. Under the TARGET2 system arrangements all settlements from the domestic RTGS systems will be transferred to the Single Shared Platform. The objective of the TARGET2 system construction is to eliminate the weaknesses of the TARGET system: differentiated level of services for the system participants, difficulties experienced by the central banks in recovering the costs of the functioning of the domestic parts of the system, problems with the system modernisation and the difficulties with the inclusion of new countries in the system. The TARGET2 system is to be launched in the second half of 2007.
The participants of the SORBNET-EURO system as of the end of 2005 included the NBP, 36 banks, the National Depository of Securities and the National Clearing House. The turnover in the system increases systematically (Figure 3.1). The cross-border orders account for the majority of both the turnover (87% of turnover in the fourth quarter of 2005) and the number of orders (91% of all orders in the fourth quarter of 2005). The majority of cross-border orders received by means of the SORBNET-EURO system come from Italy, Germany and Spain (23.6%, 19.4% and 9.9%, respectively, in the fourth quarter of 2005). In terms of value, the orders from France and Germany prevail (52.8% and 17.1%, respectively, in the fourth quarter of 2005). The cross-border interbank payments constitute the majority in the structure of the turnover by main types of orders (Figure 3.2).

Figure 3.1. Monthly gross turnover in the SORBNET-EURO system in 2005

1. Excluding the value of intraday credit.

Source: NBP.

Figure 3.2. Structure of gross turnover in the SORBNET-EURO system by main types of operations in the fourth quarter of 2005 (average monthly percentage share)

Source: NBP.
At the end of 2005, the participants of the SORBNET system for settlement of payments in zloty included (apart from the NBP) 53 banks, the National Depository for Securities and the National Clearing House. Both the turnover in the system and the average monthly number of orders increased in 2005 (Figure 3.3).

Figure 3.3. Annual gross turnover and average monthly number of orders processed in the SORBNET system between 2002 and 2005

Source: NBP.

3.2.2. Retail payment systems

The most important event with regard to retail interbank settlements was the launch of the EuroELIXIR system by the National Clearing House on 7 March 2005. It is used for interbank retail settlements in euro. During the first months, the EuroELIXIR system functioned only for domestic settlements. The cross-border settlements became possible on 30 May 2005 when the NBP became a participant of the STEP2 and EURO1 system.112 The EuroELIXIR system allows to:

– settle domestic transactions in euro;

– transfer cross-border payments in euro to the STEP2 system;

– distribute cross-border payments received from the STEP2 system;

– settle other payments to or from the euro area between the participants, analogically to domestic settlements.113

The functioning of the EuroELIXIR system is possible thanks to the launch of the SORBNET-EURO system. The National Clearing House issues payment orders in the SORBNET-EURO system. They concern:

– mutual liabilities and receivables of banks resulting from the settlement of domestic retail payments in the EuroELIXIR system;

– cross-border euro payments routed via the EuroELIXIR system to the STEP2 system.


113 The last of the listed situations may take place when a bank from the euro area (bank A) wants to transfer a payment to a Polish bank (bank C), which is not its correspondent bank, by means of the correspondent banking. Bank A transfers the payment to its correspondent bank (bank B) which settles the payment with Bank C through the EuroELIXIR system.
The NBP plays the main role in the functioning of the EuroELIXIR system. It functions as:

– the settlement bank – to this end, the NBP uses the SORBNET-EURO system in which it holds current accounts of direct EuroELIXIR system participants; as the settlement bank the NBP is also the participant of the EURO1 system;

– intermediary in the transfer of orders to the STEP2 system – the NBP has a status of a direct participant of the STEP2 system and acts as the only entry point to the STEP2 system on the Polish market.\footnote{Thanks to the fact that the NBP is a point of entry to the STEP2 system, the participants of the EuroELIXIR system do not have to register as direct participants of the STEP2 system and pay the related fees.}

As regards the settlement of transactions between domestic participants, the EuroELIXIR system acts with no value limits. The settlement guarantee mechanism implemented in this system is identical to the one implemented in the ELIXIR system. The settlements are made on a net basis and the final settlement is carried out in the SORBNET-EURO system.

In the case of cross-border payments in the EuroELIXIR system there is a limit of 12 500 euro which from 1 January 2006 is to be increased to 50 000 euro (analogously to the change in the value of payment orders settled in the STEP2 system). In the settlements with the STEP2 system there is no multilateral compensation of liabilities and obligations of participants due to the sending and receipt of orders within the framework of separate clearing sessions. The orders are submitted to the STEP2 system by the National Clearing House on behalf of the NBP. The final settlement of cross-border orders is performed in the EURO1 system, through the NBP account at the Bank of Italy and the EBA Clearing (operator of STEP2 and EURO1 systems) account at the ECB.

The organisation of national and cross-border settlements by means of the EuroELIXIR system is presented in Diagram 3.2.

Diagram 3.2. Simplified diagram of settlements by means of the EuroELIXIR system

The advantages of the EuroELIXIR system, as compared to the correspondent banking, include the shorter settlement cycle, lower costs and benefits related to the netting of domestic orders.

At the end of 2005, the participants of the exchange of payment orders in the EuroELIXIR system included 34 banks (including the NBP). The value of the turnover in the EuroELIXIR system increased systematically (Figure 3.4). In the fourth quarter of 2005, the cross-border orders (outgoing and incoming) constituted 85.3% of the number of orders and 62.3% of their value. The cross-border orders were received from 28 countries. The majority of them come from Germany, the Netherlands, Belgium and Austria. The orders from those countries dominate also in terms of value (they accounted for 83% of the value of incoming cross-border orders in the fourth quarter of 2005).
In 2005, all interbank settlements in zloty, resulting from the customers’ orders and carried out through the National Clearing House, were executed in the ELIXIR system.\textsuperscript{115} At the end of 2005, direct participants of the exchange of payment orders in the ELIXIR system included 52 banks (including the NBP). The number of transactions settled through the National Clearing House increased by 11% in the analysed period as compared to 2004. The change was accompanied by a 4% growth of turnover. The average monthly turnover in the National Clearing House between 1999 and 2005 and the change in the share of the settlements in the SYBIR system in the turnover of the National Clearing House until 2004 are presented in Figure 3.5.

\textbf{Figure 3.5. Average monthly gross KIR turnover between 1999 and 2005 and the change in the share of the SYBIR system in the KIR turnover until 2004}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure3_5.png}
\caption{Average monthly gross KIR turnover between 1999 and 2005 and the change in the share of the SYBIR system in the KIR turnover until 2004}
\end{figure}

Note: The decrease in average monthly KIR turnover in 2003 resulted from the fact that from 1 January 2003 the large-value customers’ orders were directed directly to the SORBNET system. As from November 2004 (when the settlement guarantee mechanism was introduced to the ELIXIR system) the customers’ orders of any value may be directed to the ELIXIR system. The SYBIR system which handled the orders in the paper form operated until 30 June 2004.

Source: NBP.

\textsuperscript{115} The operation of the SYBIR system (traditional clearing house system used for the servicing of net interbank settlements in which the paper documents were used) came to an end on 30 June 2004.
The National Clearing House Strategic Plan for 2006–2010 was approved in September 2005. According to the document, the objective of the National Clearing House is to perform the role of the settlement services centre for banks from Central and Eastern Europe and to obtain a status of the pan-European automated clearing house (PE-ACH\(^{116}\)) in future.

Within the framework of the Strategic Plan implementation the National Clearing House intends to concentrate on:\(^{117}\)

- the development of interbank settlements in euro;
- the promotion of non-cash settlements in the economy;
- the development of settlement-related and supporting services;
- the participation in the standardisation process.

Within the framework of the services diversification strategy, the KIR intends to continue its activities concerning the optical reading and archiving in order to acquire customers in Poland and abroad. The certification services related to the public key infrastructure (the SZAFIR system) also play an important role in the KIR strategy.

Financial intermediation agencies

The Polish financial services market in 2005 saw a further increase in the scale of operations of the financial intermediation agencies which service mass payments.\(^{118}\)

The overwhelming majority (around 70%) of mass payments in Poland are made in cash. In the first half of 2005, Poles made 37.1 million cash payments a month, out of which 7.7% at the financial intermediation agencies. The share of individual entities in the mass cash payments market is presented in Figure 3.6.

Figure 3.6. The share of individual entities in the mass cash payments market in Poland in the first half of 2005 (structure of the number of payments)

![Figure 3.6](image)

Source: NBP.

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\(^{116}\) STEP2 is the first payment system which was granted the status of the pan-European automated clearing house by the European Payments Council (EPC).


\(^{118}\) The examples of the largest entities of this type include among others Dolnośląska Agencja Finansowa ELIXIR Sp. z o.o., Przedsiębiorstwo Prosspol Sp. z o.o. – Okienko kasowe and PIRF Sp. z o.o. – PF Mieszko.
The development of financial intermediation agencies is a result of among others the small use of banking services and poor computerisation of Polish society as well as the habit of making cash payments. The above factors have an impact on the rare use of the non-cash instruments offered by banks. On the other hand, the objective of Polish banks to promote non-cash operations with the simultaneous decrease of the attractiveness of the cash desk services (which are expensive for the banks) results in the increased interest in the services provided by the financial intermediation agencies.

The activities of the financial intermediation agencies are not supervised by any institution. The instances of bankruptcies and unreliability of some entities resulted in the attempt of self-regulation on the part of the mass payments market intermediaries. In April 2005 at the initiative of the six largest operators of cash point networks, the Commercial Chamber of Financial Enterprises (Izba Gospodarcza Przedsiębiorstw Finansowych – IGPF) was established. The IGPF tasks include the representation of economic interests of the enterprises grouped in the Chamber, supervision of the correct functioning of the financial intermediation agencies and the implementation of the standards of conduct which should be applied by the entities operating on the intermediation market.\(^\text{119}\) In November 2005, the Polish Economic Chamber of Financial Intermediaries was registered. It is the second and rival economic chamber for the IGPF which associates another group of financial intermediaries.

### 3.3. Financial instruments market infrastructure

The financial instruments market infrastructure consists of institutions that organise trading in financial instruments and the entities which settle the transactions. The following entities operate in Poland: the Warsaw Stock Exchange (WSE), markets organised by the MTS-CeTO company, Warsaw Commodity Exchange (WCE), the Securities Register (Rejestr Papierów Wartościowych – RPW, including the SKARBNET and SEBOP systems) servicing the Treasury bill and money market bill transactions, the National Depository for Securities system (Krajowy Depozyt Papierów Wartościowych – KDPW) servicing the market in Treasury bonds and financial instruments available on the markets organised by WSE and MTS-CeTO and the Clearing House of the Warsaw Commodity Exchange (Izba Rozliczeniowa Warszawskiej Giełdy Towarowej) which settles the forward transactions concluded on this exchange.

**Warsaw Stock Exchange**

The most important developments on the exchange market in 2005 included the resignation from the regulated market obligation principle as well as the selection of an advisor for the privatisation of the WSE and the presentation of the WSE position on privatisation options.

The regulated market obligation principle\(^\text{120}\) was abandoned pursuant to the Act on Trading in Financial Instruments. The possibility was introduced to conduct transactions outside the regulated market: to create alternative trading systems (ATS), to carry out the internal transactions with customers and to match the customers’ orders in the secondary trading by the entities conducting brokerage activities.

The Act defines the ATS as a multilateral system of trading in securities or monetary market instruments outside the regulated market.\(^\text{121}\) It has to ensure the concentration of demand and

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\(^{119}\) However, the signals about the exclusion of two operator networks from the members of the Commercial Chamber of Financial Enterprises in 2005 are a cause of concern.

\(^{120}\) Pursuant to Article 5 of the Act on Public Trading in Securities which was in force until October 2005 the securities admitted to public trading could have been traded on the regulated market exclusively.

\(^{121}\) The regulated market includes the stock exchange market, the over-the-counter market and the commodity market in financial instruments.
supply in a way which enables the conclusion of transactions between the participants of the system. An ATS may be organised by an investment company (brokerage house, bank conducting brokerage activities, foreign investment company or a foreign legal person conducting brokerage activities in Poland) or a company running a regulated market. Its bylaws have to be approved by the Securities and Exchange Commission.

The ATSs may be competition for exchange markets thanks to the lower transactional costs, longer sessions, offering access to numerous markets and ensuring a prompt execution of the transaction. The competition between the different trading platforms may in turn lead to the decentralisation of the trading and the lowering of liquidity on the regulated market. However, it seems that the matching of the customers’ orders by the entities conducting brokerage activities will be a more serious competition for the exchange market.

The activities related to the privatisation of the Warsaw Stock Exchange may be important for the further development of the Polish stock exchange market. On 29 March 2005, the Minister of the Treasury announced that the consortium consisting of McKinsey & Company Poland Sp. z o.o., Centralth Dom Maklerski Pekao SA and Ernst & Young Audit Sp. z o.o. was selected to be an advisor for the privatisation of the Warsaw Stock Exchange. Then, in June 2005 The Position of the Warsaw Stock Exchange joint stock company on the WSE privatisation options was presented. It contains three variants of the target shareholder structure of the Warsaw Stock Exchange, which assume that the main shareholder would be:

– a foreign strategic investor (with a majority or minority share);
– individual investors;
– domestic financial institutions.

The authorities of the WSE stated they had considered the combinations of the above variants. In their opinion, an alliance with a foreign partner which, similar to the Treasury, would have a minority share would be a favourable privatisation strategy. The share of the foreign strategic investor could be supplemented with a share of a Polish financial market institution, an institution representing an international financial investor (e.g. the European Bank for Reconstruction and Development – EBRD) and Polish individual investors. In addition, it was stated that the choice of a specific privatisation option also depends on the future model of the KDPW functioning and its relations with the WSE.

The Act on Trading in Financial Instruments changed the nomenclature of the stock exchange market. The division into official and unofficial market was abandoned. The official stock exchange listing market was distinguished within the stock exchange market and its requirements correspond to the official market. The WSE Supervisory Board passed the Rules of the Warsaw Stock Exchange to replace two sets of rules in force on the official and unofficial market. The detailed criteria for the admission to the main market (official stock exchange listing) are laid down by the Regulation of the Minister of Finance of 14 October 2005. The criteria for the admission of securities to trading on the parallel market are set forth by the Rules of the Warsaw Stock Exchange.

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122 The examples of the ATS operating on the European market include Posit, Trade Web, Instinet and CAST-OS.
125 The potential strategic investors for the WSE include: Deutsche Boerse, Euronext, London Stock Exchange, NASDAQ, NYSE, OMX and the holding which creates a regional alliance with the stock exchange in Vienna.
126 Resolution No. 1/1110 /2006 of the Supervisory Board of the Warsaw Stock Exchange.
127 Regulation of the Minister of Finance of 14 October 2005 on the determination of conditions that must be satisfied by the official stock exchange listing market and the issuers of securities admitted to trading in this market (Dz.U. No. 206/2005, item 1712).
The amended Principles of Good Practice in Listed Companies 2005 have been in force at the WSE since January 2005. The year 2005 was the third subsequent year in which the listed companies had the obligation to submit the declaration of the observance of these principles. All listed companies met this obligation. The number of companies which declared that they would not observe any rules decreased to 8 (3% of all companies listed on the WSE) from 17 in 2003.128

In December 2005, the Warsaw Stock Exchange and the Polish Agency for Enterprise Development (PAED) launched an Internet information platform START. It was created in order to support small and medium-sized enterprises by facilitating contact between the companies which look for capital (up to 15 million zloty) and qualified investors.129 The access to the system is possible for small and medium-sized companies. They may register on the START platform website and decide which investors will be able to see their data. The START system is not a transactional platform – the registration in the system allows the companies and investors only to establish contact.

**Markets organised by the MTS-CeTO company**

The most important change to the markets organised by the MTS-CeTO in 2005 was the obtaining of the status of the MTS Poland market participants by first foreign entities.

The following markets operate within the MTS-CeTO:

– the MTS Poland market, which is part of the Treasury Securities Dealer System;

– CeTO Securities Market (RPW CeTO, regulated OTC securities market), where stocks and corporate, municipal and Treasury bonds as well as mortgage bonds and investment certificates are traded.

At the end of 2005, there were 11 institutions with the member status on the RPW CeTO market (decrease by one as compared to 2004 and 2003) and one entity with the status of the participant130 (as in previous years). The number of participants of the MTS Poland market increased to 25 (from 18 in 2004). There were seven foreign entities among the participants. Two of them obtained the status of the Treasury Securities Dealer131 for 2006.

The amended Principles of Good Practice in Listed Companies 2005 have been in force on the RPW CeTO since February 2005.

**Warsaw Commodity Exchange**

In 2005, there were no significant changes to the functioning of the Warsaw Commodity Exchange at which currency futures contracts and options for those contracts as well as interest rate futures are traded.

**Securities Register**

In 2005, there were no significant changes to the functioning of the Securities Register. In 2004, 53 participants held Treasury bill deposit accounts with the Securities Register, while 47 banks and the Bank Guarantee Fund took part in money market bill trading. Table 3.1 presents the data concerning the number and value of Treasury bill and money market bill transactions processed by the Securities Register.

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129 Qualified investors may include financial institutions authorised to operate on financial markets, enterprises and individuals which meet the respective conditions.
130 The participants of the RPW CeTO market may trade in financial instruments only on their own account.
131 Treasury Securities Dealers (along with Bank Gospodarstwa Krajowego) are the only entities authorised to submit bids on the tenders of Treasury securities.
Table 3.1. Number and value of Treasury bill and money market bill transactions registered in the Securities Register in 2004 and 2005

<table>
<thead>
<tr>
<th></th>
<th>Number of transactions ('000)</th>
<th>Value of transactions (in PLN billion)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2004</td>
<td>2005</td>
</tr>
<tr>
<td>Treasury bills</td>
<td>107.1</td>
<td>74.3</td>
</tr>
<tr>
<td>Money market bills</td>
<td>2.5</td>
<td>4.3</td>
</tr>
</tbody>
</table>

1 The nominal value of transactions and their number include the primary market, the secondary market and redemption.

Source: NBP.

National Depository for Securities

The most important changes to the functioning of the National Depository for Securities in 2005 included the modification of the rules governing the functioning of the depository and settlement system, work on the establishing of potential directions of the National Depository for Securities development and the acceptance of the successive foreign issuers’ stocks to the National Depository for Securities.

The changes to the rules governing the functioning of the depository and settlement system were introduced by the Act on Trading in Financial Instruments. It has removed the legal monopoly of the National Depository for Securities for the clearing and settlement of transactions concluded on the regulated stock exchange and OTC market. The transactions concluded in alternative trading systems (ATS) may also be settled by an entity other than the National Depository for Securities.132 The EU Member States are obliged to ensure the freedom to choose the supplier of settlement services by the Directive on Markets in Financial Instruments (MiFID133). The MiFID should be transposed into the national legislation by the end of January 2007.134

In view of the consolidation of depository and settlement institutions, which is underway on the European market, and the adoption of the Capital Market Development Strategy – Agenda Warsaw City 2010 by the government in 2004, the work on the preparation of the development strategy for the National Depository for Securities was resumed. The document entitled the Strategic Objectives of the National Depository for Securities by 2010 which was published in June 2005 includes:

– intersystem harmonisation (preparation of procedures, regulations and standards which will make it possible to service cross-border transactions concerning a wide range of financial instruments);

– obtaining the actual ability of operational cooperation with a leading European depository and settlement system (the National Depository for Securities takes into account the operational cooperation in accordance with the principle of simultaneous payment and transfer of financial instruments – settlement on the delivery versus payment basis (DvP); the launch of the DvP connection was planned for the end of 2007);

– changes to the shareholders’ structure (the entities which may be the shareholders of the National Depository for Securities include the recipients of its services and a foreign investor; at the same time it was noted that a good moment for the change to the shareholders’ structure may be the beginning of the WSE ownership structure transformation);

132 At the same time, the Act indicates the National Depository for Securities as the only entity authorised to register dematerialised securities and other financial instruments which are not securities and which were admitted to trading on the regulated stock exchange market or the OTC market or introduced to alternative trading system.


134 The financial market institutions should adjust to the new provisions by 1 November 2007.
– the stabilisation of the financial model of the National Depository for Securities as a not-for-profit oriented organisation (according to this model the National Depository for Securities would not aim at maximising its profits but at ensuring the profitability for the company which would secure its ongoing functioning and the development of provided services);

– increase in quality and scope of provided services (modernisation of services, introduction of new services, changes to the IT system, membership in foreign clearing houses);

– obtaining the status of the Central Counterparty (CCP) which guarantees the settlement of transactions with its own capital (as it was already noted the decision to introduce this change should be made not earlier than at the moment when the transformations of the shareholders’ structure of the National Depository for Securities are completed but not later than by the end of 2006).

In 2005, the shares of two foreign issuers, namely, AmRest Holdings N.V. and SkyEurope Holding AG were accepted to the National Depository for Securities. The National Depository for Securities launched another intersystem link – Euroclear Bank opened a deposit account for the National Depository for Securities in April. It was related to the plans of the share issue of a foreign issuer.\textsuperscript{135} Euroclear is the fifth foreign depository and settlement institution (apart from OeKB, KLER, Clearstream Banking Luxemburg and CRESTCo) in which the National Depository for Securities has a deposit account.

In 2005, the direct participants of the National Depository for Securities included 62 entities\textsuperscript{136} (61 in 2004). The direct participants included 16 brokerage entities, 39 banks, 1 investment company, 3 other financial institutions and 3 foreign participants. In 2005, the number of issuers registered with the National Depository for Securities increased to 333 (308 at the end of 2004). The number of transactions settled in the National Depository for Securities increased to 7.36 million (from 5.57 million in 2004). The value of operations recorded in the National Depository for Securities also significantly increased, which resulted from the increase in turnover on the stock and Treasury bond market (Figure 3.7).

Figure 3.7. Value of operations recorded in the National Depository for Securities between 1999 and 2005

\begin{table}[h]
\centering
\begin{tabular}{|c|c|c|c|c|c|}
\hline
\hline
Value, PLN billion & 218.1 & 395.9 & 590.9 & 1,134.9 & 1,984.9 & 2,020.8 & 4,207.5 \\
\hline
\end{tabular}
\end{table}

Source: National Depository for Securities.

\textsuperscript{135} However, the share issue did not take place and therefore the connection with Euroclear was not active in 2005.

\textsuperscript{136} As of the end of the year. The participants of the National Depository for Securities include direct participants and issuers. Direct participants (unlike issuers) are entities authorised to maintain securities accounts, entities that do not maintain securities accounts but are authorised to perform brokerage activities, and other financial institutions which invest funds in the securities market on their own account.
In 2005, the definition of clearing and settlement was introduced to Polish law. Clearing was defined as the establishment of the amount of cash and non-cash benefits resulting from transactions contracted by the clearing parties. Settlement is the debiting or crediting of a depository account or the securities account held by the National Depository for Securities in connection with a transaction of sale or purchase of financial instruments as well as the debiting or crediting of the bank account indicated by a settlement party.

In 2005, work continued on the provision of the possibility to service dematerialised non-public debt securities in the National Depository for Securities system.

**Warsaw Commodity Exchange Clearing House**

In 2005, there were no significant changes to the functioning of the Warsaw Commodity Exchange Clearing House which is a separate organisational unit of the Warsaw Commodity Exchange and fulfils the functions related to the settlement of forward and future transactions concluded on this exchange. The clearing member may be a Warsaw Commodity Exchange shareholder authorised to participate in the clearing. As in the previous year, in 2005 there were two clearing members operating on the Warsaw Commodity Exchange.

**3.4. Market participant protection systems**

In 2005, there were no changes to the principles of the functioning of the Bank Guarantee Fund, capital market participant protection systems, the Insurance Guarantee Fund, the Pension Guarantee Fund and the Credit Unions’ Savings Protection Scheme.

**3.5. Institutions that enhance information transparency**

**Credit Information Bureau**

In 2005, the principles allowing to create not only negative but also positive history of the customers’ indebtedness by the Credit Information Bureau (Biuro Informacji Kredytowej – BIK) were laid down. The number of credit reports made available by the Bureau also increased.

The main activities of the Credit Information Bureau include the collection, processing and distribution of data regarding individual bank customers’ credit histories in the form of credit reports. The Bureau currently cooperates with 37 banks and the National Association of Credit Unions. The database of the Bureau contains information about 24.5 million credit accounts of almost 12.5 million people.

In April 2005, the amendment of the Banking Law was passed. It laid down the principles of processing the information which is bank secrecy and concerns individuals, after the expiry of the liabilities resulting from the agreement concluded with a bank or other institution authorised to grant loans. The Act solved the dispute which arose in 2004 between the Inspector General for the 

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137 The National Depository for Securities registers the securities on depository accounts or securities accounts. The National Depository for Securities keeps depository accounts for each participant (bank, entity conducting brokerage activities) which is authorised to hold the securities accounts. The National Depository for Securities keeps the securities accounts for the participants which are not authorised to hold securities accounts. The securities accounts kept by the National Depository for Securities may contain only the own securities of the participants for which the accounts are kept.


139 In accordance with statutory provisions, on 1 January 2005 the upper limit of funds covered by the mandatory system of National Depository for Securities compensations was increased to the zloty equivalent of 11,000 euro.

Protection of Personal Data (Generalny Inspektor Ochrony Danych Osobowych – GIODO) and the Bureau.  

After the amendment the information about the expired liabilities may be processed following the written consent of the person in question. The BIK will also be able to process the information about the expired liabilities without the consent of the person concerned (in this case the information cannot be processed longer than for 5 years from the expiry of the liabilities), provided that the following two conditions are met:

- the person concerned did not meet the obligation or the delay in the repayment exceeded 60 days;

- when the above situation occurred at least 30 days have passed from the notification of that person that the data will be processed without their consent.

The Act also introduced a 3-year period for the adjustment to its provisions.

The Credit Information Bureau will be able to process and disclose the information about the customers who repaid their debts i.e. to create a positive credit history. It will help banks to make decisions on granting loans and for the customers who timely fulfil their obligations it may mean the ability to obtain loans on more favourable conditions.

The number of credit reports made available by the Bureau has increased systematically (Figure 3.8), which demonstrated the growing demand for such services. In 2005, more reports (around 25% as compared to 15% a year before) were sold along with scoring, an additional element facilitating the estimation of risk incurred by the bank upon granting a loan. As from October 2005, the banks cooperating with the Bureau may also use the database of InfoMonitor Business Information Office. Furthermore, in 2005 the Bureau conducted work on the system of information about enterprises.

Figure 3.8. The number of credit reports made available by the BIK between 2001 and 2005

Source: Credit Information Bureau.

**Rating agencies**

The Fitch Polska S.A. rating agency continued its operations on the Polish market. In 2005, it assigned national ratings to two Polish cities and one voivodship and the international rating of the revenue bonds issue. At the end of 2005, 2 companies, 2 voivodships and 8 cities had a national rating granted by Fitch Polska and 5 companies (including one leasing company), 5 cities, 11 banks, one revenue bonds issue and the Republic of Poland had an international rating.

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142 Scoring is the evaluation of the customer, which shows the probability that the customer will repay the debt.
4. Financial institutions

4.1. Banks

Positive economic trends in 2005 created favourable conditions for the development of the banking sector in Poland. The development was reflected in both quantitative changes, i.e. increase of the sector’s assets to GDP ratio (60.7% in 2005, compared to 58.4% in 2004), as well as significant qualitative changes. The latter were connected with the introduction of new regulations, organisational and technical solutions, and, on the other hand, with increasing competition, particularly as regards household lending. At the same time, loan-portfolio quality of the banks improved considerably.

4.1.1. Evolution of the banking sector: size and structure

The banking sector in Poland still constitutes the main part of the financial sector. As of the end of 2005, the share of banks’ assets in the assets of the entire financial sector amounted to 70.2%. It translated into a decrease of 4 percentage points compared to 2004 and of 24.3 percentage points compared to 1996 and it was caused by more dynamic growth of non-banking financial institutions. In 2005 the growth rate of banking sector assets decreased slightly (9.1% compared to 10% in 2004), and in December the value of banking sector assets amounted to PLN 587 billion (Figure 4.1.1). The growth resulted in 89% from the growth of the commercial banks’ assets, particularly due to the growth of the value of housing loans to households (increase by 41%) and consumer loans (increase by 19%). It is worth noting that the growth of the value of cooperative banks’ assets was much higher than in the previous year (18.1% compared to 11.9% in 2004). Since 2001 cooperative banks’ assets have risen faster than assets of commercial banks. The share of cooperative banks’ assets in the assets of the entire banking sector increased in 2005 to 5.8% (Table 4.1.1), mainly due to the growth of claims on the financial sector. As of the end of 2005 the number of domestic commercial banks conducting operating activity amounted to 54 and was the same as one year ago (Table 4.1.1). There were, however, some changes on the list of banks operating in Poland:

– two banks, whose 100% of shares were owned by foreign capital, were transformed into branches of credit institutions;

– two other banks controlled by a foreign investor started to conduct operating activity in Poland.

Furthermore, in July 2005 one more bank was entered into the National Court Register.

143 Unless stated otherwise, data on the banking sector in 2005 were taken from the reporting database on 1 March 2006. Data for earlier years may be different from those presented in the previous edition, as they now include corrections sent in by the banks.

144 Assets of the banking sector do not include assets of banks which do not conduct operating activity and banks under liquidation.

145 Banking enterprise Bank Svenska Handelsbanken (Polska) SA was sold to Svenska Handelsbanken AB SA Oddzial w Polsce, and the remainder was transformed into a non-banking company; on 7 September 2005 the Commission for Banking Supervision issued a permit for Dresdner Bank AG to purchase the banking enterprise from Dresdner Bank Polska SA, and on 30 September 2005 the transaction was finalised.

146 Cetelem Bank SA, was entered into the register on 9 November 2004 (it started its operating activity on 1 January 2005) and RCI Bank Polska SA, was entered into the register on 26 November 2004 (it started its operating activity on 1 April 2005).

147 Dexia Kommunalkredit Bank Polska SA (under organisation).
Figure 4.1.1. Assets of the banking sector and their changes, 1996–2005

Table 4.1.1. Number of banks and ownership structure of the banking sector

Table 4.1.1. Number of banks and ownership structure of the banking sector

<table>
<thead>
<tr>
<th>Number of banks</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Commercial banks which conduct operating activity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>1.1. Domestic banks</td>
<td></td>
<td></td>
<td></td>
<td></td>
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<td></td>
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<tr>
<td>1.1.1. With majority public-sector ownership</td>
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<tr>
<td>1.1.2. With majority private-sector ownership</td>
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<td></td>
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<tr>
<td>1.2. Branches of credit institutions</td>
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<td></td>
<td></td>
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<td></td>
<td></td>
<td></td>
<td></td>
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<tr>
<td>2. Commercial banks conducting no operating activity</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>3. Cooperative banks</td>
<td>1.189</td>
<td>781</td>
<td>680</td>
<td>642</td>
<td>605</td>
<td>600</td>
<td>596</td>
<td>588</td>
</tr>
<tr>
<td>Banking sector (1+2+3)</td>
<td>1.272</td>
<td>858</td>
<td>754</td>
<td>713</td>
<td>667</td>
<td>660</td>
<td>659</td>
<td>657</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Share in total banking sector assets (%)</th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Banks conducting operating activity (including branches of credit institutions)</td>
<td></td>
<td></td>
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<tr>
<td>1.1. With majority public-sector ownership</td>
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<tr>
<td>1.2. With majority private-sector ownership</td>
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<td></td>
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<tr>
<td>1.2. Foreign equity (including branches of credit institutions)</td>
<td></td>
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<tr>
<td>2. Cooperative banks</td>
<td></td>
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</tr>
</tbody>
</table>

Source: NBP.
Since 1 May 2004 a definition of credit institution common for all European countries\textsuperscript{148} and the principle of mutual recognition of licenses to conduct banking activity (the so called single passport principle)\textsuperscript{149} have been in effect in Poland. Banks can operate on the basis of the single passport as a branch or directly within the framework of cross-border activity. As of the end of 2005, 7 entities conducted banking activity in Poland as branches of credit institutions, and 4 were in the stage of organisation.\textsuperscript{150} Among the seven branches operating in Poland 3 started to operate in 2004, and the other four in 2005. However, as the single passport principle has been in effect in Poland for only twenty months, it has not been a period long enough to fully assess its implications. Despite the fact that the number of credit institutions’ branches increased, their assets amounted to only 0.9% of the banking sector assets, just like in 2004. Growth of the asset value by 58% in comparison to the previous year indicated that foreign entities were interested in this form of activity, but on the other hand it was a result of low base. Reorganisation of the capital ties with headquarters seated outside the territory of Poland may result in a growth of competition in the banking services market\textsuperscript{151} in the future and therefore affect the profile, scope and prices of services provided by branches of credit institutions.

There were no major changes in the ownership structure of commercial banks. The privatisation processes continued and the share of the State Treasury decreased in the share capital of PKO Bank Polski SA (from 62.30% to 51.96%), and in the share capital of Bank Gospodarki Żywnościowej SA (from 49.48% to 43.5%) due to gradual transferring of shares to the employees. At the beginning of the year Rabobank Nederlanden BV purchased shares of BGŻ SA from cooperative banks.\textsuperscript{152} As of the end of December 2005, Polish capital had majority interest in 11 commercial banks (in 2003 – 13), including 4 controlled by the State Treasury (in 2004 – 5).\textsuperscript{153} Euro Bank SA\textsuperscript{154} and BGŻ SA\textsuperscript{155} were included for the first time in the group of private banks with majority foreign equity interest.

Asset share of banks with majority foreign equity interest in the assets of the entire sector has remained at almost unchanged level since 2000 (Table 4.1.1). In 2005 foreign investors controlled 43 domestic commercial banks whose share in the assets of the banking sector (including branches of credit institutions) amounted to 70.0%. Value of the assets of this banks’ group increased in comparison to the previous year by 12.9% (by 9.6% in 2004). Banks with majority foreign equity (including branches of credit institutions) held 66.7% of the deposits of non-financial customers in 2005 and extended 69.8% of the loans\textsuperscript{156} to non-financial customers. Their share in the assets of commercial banks in Poland was higher than in most of the EU-15 countries, but lower than in the remaining countries of the region, excluding Slovenia (Figure 4.1.2). Since 2001 the significance of foreign capital in the CEC-5 group has increased considerably, and its share in the assets grew on average by over 10 percentage points and reached 73.9% as of the end of 2005.


\textsuperscript{149} More on the single passport principle in: Rozwój systemu finansowego w Polsce w 2004 r. Warszawa 2005, NBP, p. 46.

\textsuperscript{150} French BNP Paribas SA Oddział w Polsce (operating since 30 January 2006), Greek EFG Eurobank Ergasias S.A. SA Oddział w Polsce (operating since 30 January 2006), Greek EFG Eurobank Ergasias S.A. SA Oddział w Polsce (operating since March 2006), as well as ABN AMRO Bank N.V. SA Oddział w Polsce and Calyon SA Oddział w Polsce were in the stage of organisation.

\textsuperscript{151} The branch uses capital base of the parent bank, and can reduce the costs of financing due using parent bank’s rating.

\textsuperscript{152} On 3 January 2005 the transaction of shares’ sale by cooperative banks to Rabobank Nederlanden was finalised; the bank’s share in the ownership structure rose from 14.04% to 35.32%. Majority of shares and votes (50.3%) in the General Shareholders Meeting belonged, as of the end of 2005, to foreign investors (Rabobank Nederlanden and EBRD).

\textsuperscript{153} In the State Treasury lost control over Bank Inicjatyw Społeczno-Ekonomicznych SA due to the fact that foreign investors took over control over the bank. Private banks with majority Polish equity interest included: Bank Współpracy Europejskiej SA, Wisłodni Bank Cukrownictwa SA, Getin Bank SA, INVEST-BANK SA, Gospodarz Bank Wielkopolski SA, Bank Polskiej Spółdzielczości SA and Mazowiecki Bank Regionalny SA.

\textsuperscript{154} Since 1 July 2005 majority of shares of Euro Bank SA has belonged to Société Générale SA.

\textsuperscript{155} As of the end of December 2003 69.7% of the shares of BGŻ were owned by the State Treasury, therefore the bank belonged to the group of banks with majority state equity interest. Since 3 January 2005, due to the finalisation of the sale of shares to Rabobank by cooperative banks, BGŻ has been classified in the group of banks with majority foreign equity interest.

\textsuperscript{156} Loans less earmarked reserves or depreciation and value correction charges.
Numerous research studies indicate that foreign direct investments in the banking sectors of Central and East-European countries contributed significantly to their development and stability. The presence of foreign banks in the countries with lower market entry barriers makes the domestic banks decrease their margins and contributes to rationalisation of financial mediation costs due to introduction of modern technologies and management practices. Thus, it creates favourable conditions for development of competition in the sector, and consequently more effective allocation of capital and improvement of the quality of services.\(^{157}\) Foreign direct investments can also contribute to improvement of financial systems’ stability. Firstly, foreign banks usually have more experience in extending loans, and thus have less doubtful receivables in their portfolios. Secondly, they are more resistant to negative shocks in the country\(^{158}\) due to their direct access to foreign funds.

The number of cooperative banks decreased in 2005. Just like in the previous years, this was due to mergers which resulted from the need to meet the statutory requirements concerning the minimum level of cooperative banks’ own funds, i.e. the equivalent of 500 thousand euros before the end of 2005.\(^{159}\)

The processes of employment restructuring continued until 2004, and together with computerisation of banking systems resulted in reduction of personnel, especially in the commercial banking sector (Figure 4.1.3). In 2005 the employment in the Polish banking sector increased\(^{160}\) and the downward trend which continued since 2000 was reversed. The main reasons of the employment growth in commercial banks were: expanding of the operating activity due to increasing demand for loans and other banking services from households and enterprises, as well as positive assessment of the prospects of banking services’ further development. These factors

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159 Cooperative banks are obliged to increase the sum of their own funds to above EUR 1 million before the end of 2010. Article 172, Para. 3, Subpara. 3 of the Banking Law of 29 August 1997 (consolidated text, Dz.U. of 2002, No.72, item 665).

160 The number of employees was calculated by converting the total employment into full time posts.
were additionally reinforced by the high economic growth rate and positive projections of economic growth, which increased demand for work in the entire economy. Employment growth was also observed in the cooperative banks sector.

Figure 4.1.3. Bank employees (excluding foreign field branches) in the years 1996–2005

The above trends were similar to the trends concerning the development of the bank branches network. In December 2005, 54 commercial banks operated in Poland through 3710 branches and 4614 other field branches, i.e. sub-branches and customer service offices (Figure 4.1.4). In 2004, the number of commercial banks decreased, and the number of their branches increased, while the number of other field branches decreased. In 2005, the situation was different: the number of domestic banks was stable, and the growth rate of the number of their branches was lower and amounted to only 0.2% (in 2004 – 18.8%). At the same time, the downward trend concerning the number of other field branches, including sub-branches, customer service offices and domestic representations, was halted, which resulted in an increase in 2005 by 0.3% (in 2004 there was a decrease by 23.1%). Ultimately, in 2005 the total number of bank branches increased slightly for the first time in 5 years.

It is worth noting that since 2003 banks have developed a network of partner branches, which carry out their activity on the basis of franchising agreements. In some banks partner branches replace closed down banks’ own branches, and in other banks a network of partner branches is built parallel with newly-opened bank branches.

Figure 4.1.4. Number of branches and domestic field branches of commercial banks in the years 1996–2005

Note: data for the year 2005 on the number of head offices and branches of credit institutions include 54 head offices and 7 branches of credit institutions, whereas the data for 2004 include 54 head offices and 3 branches of credit institutions.

Source: NBP.
4.1.2. Changes in the structure of bank assets and liabilities

Structure of assets

In 2005, just like in the previous years, claims on non-financial customers constituted the key item of the banking sector assets (Figure 4.1.5). The share of this group of claims (42.3%) rose slightly in comparison to 2004 (by 0.5 percentage points for commercial banks). However, it remained on a level similar to the average value of the ratio for CEC-5 countries. Growth of the share of commercial banks’ claims on non-financial customers in the structure of assets was mainly driven by the growth rate of the value of loans extended to households, which was higher than in the previous year (growth by 24.1% in 2005 and by 11.9% 2004). Changes of the exchange rate favourable for borrowers, also affected lending. In 2005, the value of loans to enterprises rose only moderately.

Securities were the second largest item in the commercial banks’ assets and their share grew by 1.5 percentage points, to 23.9% (Tables 4.1.2 and 4.1.3). Growth of the share of securities in the assets resulted from the growth of NBP money market bills’ purchases (increase by PLN 16.6 billion, change of the share in total assets from 1.1% to 4.0%), as well as from the growth of value of State Treasury bonds (increase by PLN 13.7 billion, translating into a change of share in the total assets from 12.8% to 14.3%). At the same time, due to smaller issue of Treasury bills, their share in the banks’ assets fell considerably (by more than 2 percentage points). The share of all Treasury securities in the banks’ total assets decreased by 0.6 percentage points.

| Table 4.1.2. Structure of commercial bank assets, 2002–2005 (%) |
|-----------------------------|---|---|---|---|
|                             | 2002 | 2003 | 2004 | 2005 |
| Cash and due from central bank | 4.7  | 4.0  | 3.8  | 3.1  |
| Claims on non-financial customers | 42.6 | 43.7 | 41.1 | 41.6 |
| Claims on financial corporations | 16.0 | 15.2 | 19.4 | 20.2 |
| Claims on general government | 3.2  | 4.1  | 3.9  | 3.5  |
| Share of securities in total assets, of which: | | | | |
| – Treasury bonds1 | 9.8  | 13.0 | 12.8 | 14.3 |
| – Treasury bills | 5.1  | 4.8  | 4.4  | 2.3  |
| – money market bills | 1.5  | 1.2  | 1.1  | 4.0  |
| Fixed assets | 4.8  | 4.5  | 4.0  | 3.5  |
| Other assets2 | 5.2  | 4.4  | 5.4  | 4.2  |

1 Except for debt conversion bonds.
2 Claims arising from securities purchased under repurchase agreements, and other assets.
Source: NBP.

| Table 4.1.3. Selected assets of commercial banks (PLN billion) |
|-----------------------------|---|---|---|---|
|                             | 2002 | 2003 | 2004 | 2005 |
| Claims on non-financial customers | 188.8 | 202.4 | 209.5 | 230.1 |
| Claims on financial corporations | 70.7  | 70.6 | 99.0  | 111.8 |
| Claims on general government | 14.2  | 19.1 | 19.9  | 19.5  |
| Securities | 103.9 | 111.5 | 114.3 | 132.2 |

Source: NBP.

Within the period concerned claims of commercial banks on the financial corporations still grew. Their share in total assets reached 20.2%. Nevertheless, this growth was smaller than in the

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161 Non-financial sector – entities, whose main activity is producing or trading goods or providing non-financial services, entities performing non-financial functions and natural persons (see Diagram 4.1.1).

162 In the CEC-5 group the highest share of claims on non-financial customers in total bank assets in 2005 was observed in Hungary and Slovenia (over 50%), whereas the lowest was observed in the Czech Republic and Slovakia – almost 30% (source: data provided by central banks of the Czech Republic, Hungary, Slovakia, Slovenia).

163 Due to the appreciation of zloty against euro and Swiss franc and low nominal interest rates loans in euros and francs were very popular (almost a half of the growth of household loans).
previous year (by 13.0% in 2005 and by 40.1% in 2004) due to smaller growth of the value of Polish banks’ investments abroad\textsuperscript{164} than in 2004.

Claims of commercial banks on general government\textsuperscript{165} decreased by 1.9% (to PLN 19.5 billion) in comparison to the end of 2004, and their share in the total assets decreased by 0.4 percentage points. Since 2001, the growth rate of claims on general government (mainly loans) decreased and, as of the end of 2005, it was negative. The reason for decreasing indebtedness of general government was mostly the drop in demand for loans and credits on its part.\textsuperscript{166} In the period from January to December 2005 the value of loans taken by central government institutions and social insurance funds decreased respectively by 19.4% and 5.2%. At the same time, the debts of local government institutions grew by 6.7% to PLN 10.6 billion.

In 2005 the changes in particular categories of cooperative banks’ assets mostly coincided with the changes taking place in the commercial banking sector. However, the asset structure of the two segments of the banking market was different (Figure 4.1.5 and Table 4.1.4). In both categories of banks the value of securities and claims on financial sector rose the fastest.

\textbf{Figure 4.1.5. Structure of the assets of commercial and cooperative banks in the years 2004–2005}

\textbf{Table 4.1.4. Selected assets of cooperative banks (PLN billion)}

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Claims on non-financial customers</td>
<td>12.6</td>
<td>14.7</td>
<td>16.6</td>
<td>18.3</td>
</tr>
<tr>
<td>Claims on financial corporations</td>
<td>7.1</td>
<td>6.3</td>
<td>7.6</td>
<td>10.4</td>
</tr>
<tr>
<td>Claims on general government</td>
<td>0.4</td>
<td>0.5</td>
<td>0.8</td>
<td>0.9</td>
</tr>
<tr>
<td>Securities</td>
<td>1.3</td>
<td>1.9</td>
<td>1.2</td>
<td>1.7</td>
</tr>
</tbody>
</table>

\textsuperscript{164} In 2005 the growth of Polish ‘other investments’ in the balance of payments in the form of deposits of Polish banks in foreign banks amounted to about PLN 2.6 billion (for comparison, in 2004 it was PLN 36.8 billion).

\textsuperscript{165} “General government” includes three subsectors: “central government,” “local authorities” and “social insurance funds.”

\textsuperscript{166} In the group of cooperative banks the value of claims on general government sector grew in 2005 (by 11%). The growth was caused by the fact that cooperative banks credited mostly investments of local authorities, which are subsequently partially financed from EU structural funds and the national budget.
Structure of liabilities

Liabilities to non-financial customers were still the main item of the structure of asset financing sources in the banking sector. Their growth in 2005 reflected the growth of total assets. The share of liabilities to non-financial customers in the liabilities of commercial banks remained almost unchanged, amounting to over 56% (Table 4.1.5), of which deposits constituted 97%. Just like in 2004, growth of deposits’ value in 2005 was mainly caused by the growth of the value of corporate deposits, but a growth of the value of households’ deposits was also noted (for the first time since 2002).

Liabilities to financial corporations were the second largest item of the liability structure of commercial banks (growth of 17.6%). As deposits constituted over 65% of this group of liabilities, the growth of these liabilities depended mostly on the changes of the value of financial corporations’ deposits (growth of over 28%). In the case of commercial banks, liabilities due to securities issued and outstanding and liabilities to general government grew much faster (respectively by 44.2% and 16.5%) than the value of total assets. Their share remained relatively low.

In 2005 liabilities to non-financial customers (mainly deposits), whose share in the structure amounted to about 75%, deposits of local government institutions and equity capital (Figure 4.1.6) were the main sources of financing for cooperative banks. The growth of non-financial customers’ deposits resulted from the growth of sole proprietors’ and individuals’ deposits, and – to a smaller extent – from the growth of individual farmers’ current deposits, the latter connected with direct payments from the Agency for Restructuring and Modernisation of Agriculture (ARiMR). The growing share of liabilities to the local government sector as an important financing source of cooperative banks’ operations proves that the role of cooperative bank as a local bank of the respective local government unit is becoming more and more established.

Table 4.1.5. Structure of commercial bank liabilities, 2002–2005 (%)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to central bank</td>
<td>0.6</td>
<td>0.5</td>
<td>0.4</td>
<td>0.5</td>
</tr>
<tr>
<td>Due to non-financial customers</td>
<td>60.5</td>
<td>59.7</td>
<td>56.7</td>
<td>56.4</td>
</tr>
<tr>
<td>Due to financial corporations</td>
<td>14.0</td>
<td>15.5</td>
<td>15.3</td>
<td>16.6</td>
</tr>
<tr>
<td>Due to general government</td>
<td>4.1</td>
<td>3.9</td>
<td>4.4</td>
<td>4.7</td>
</tr>
<tr>
<td>Securities issued and outstanding</td>
<td>1.1</td>
<td>1.1</td>
<td>1.3</td>
<td>1.7</td>
</tr>
<tr>
<td>Capital and subordinated debt</td>
<td>10.2</td>
<td>10.1</td>
<td>9.7</td>
<td>9.7</td>
</tr>
<tr>
<td>Other liabilities</td>
<td>9.6</td>
<td>9.1</td>
<td>12.1</td>
<td>10.7</td>
</tr>
</tbody>
</table>

Source: NBP.

Table 4.1.6. Selected liabilities of commercial banks, 2002–2005 (PLN billion)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Due to non-financial customers</td>
<td>268.1</td>
<td>276.7</td>
<td>288.8</td>
<td>311.9</td>
</tr>
<tr>
<td>Due to financial corporations</td>
<td>62.1</td>
<td>71.8</td>
<td>78.2</td>
<td>92.0</td>
</tr>
<tr>
<td>Due to general government</td>
<td>18.4</td>
<td>17.9</td>
<td>22.5</td>
<td>26.2</td>
</tr>
<tr>
<td>Securities issued and outstanding</td>
<td>3.7</td>
<td>5.2</td>
<td>6.5</td>
<td>9.4</td>
</tr>
<tr>
<td>Capital and subordinated debt</td>
<td>45.3</td>
<td>46.9</td>
<td>49.7</td>
<td>51.7</td>
</tr>
</tbody>
</table>

Source: NBP.

167 The growth of the share of liabilities to financial institutions in the total liabilities (by 1.3 percentage points) was caused mostly by the growth of the value of deposits from domestic banks (in the period between January and September 2005 by 45.7%). The value of foreign banks’ deposits decreased in the same period by 0.8%.

168 Debt level of commercial banks due to debt securities’ issues grew from 6.5 billion zloty in 2004 to 9.4 billion zloty in 2005, mostly as a result of the issuance performed by one of the foreign-controlled banks.

169 Deposits of the Ministry of Finance and the National Health Fund.

170 Deposits of local authorities in cooperative banks increased in 2005 by 26.6% in 2004 by 16.8%.

171 The growth rate of individual farmers’ deposits in cooperative banks was much lower in 2005 than in 2004 (more on the subject in the section on liabilities to non-financial customers).
4.1.3. Changes in the structure of claims and liabilities to non-financial customers

Non-financial customers\(^{172}\) have the biggest share in the assets and liabilities of the Polish banking system. This is why in the present subchapter – similar to the previous editions of this study – the focus was placed on non-financial customers.

Diagram 4.1.1. Division of the economy into sectors in NBP reporting – non-financial customers

<table>
<thead>
<tr>
<th>Enterprises</th>
<th>State-owned enterprises and companies</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Private enterprises and cooperatives</td>
</tr>
<tr>
<td>Households</td>
<td>Sole proprietors</td>
</tr>
<tr>
<td></td>
<td>Individuals</td>
</tr>
<tr>
<td></td>
<td>Individual farmers</td>
</tr>
<tr>
<td>Non-profit institutions providing services to households</td>
<td></td>
</tr>
</tbody>
</table>

Source: NBP.

\(^{172}\) As of the end of 2005 the share of claims on non-financial customers in the banking sector assets amounted to 42.3%, and the share of liabilities to non-financial customers in the sector’s liabilities amounted to 57.5%.
4.1.3.1. Claims on non-financial customers

The most important change in the structure of claims on non-financial customers in 2005 was the fact that the value of claims on households exceeded the value of claims on enterprises (Figure 4.1.7). This was due to the persistent high growth rate of loans to households in comparison to the moderate growth rate of loans to enterprises. Households became the main group of customers using bank financing. This phenomenon is not specific to Poland. The increasing importance of retail banking compared to corporate banking can be observed in other European countries and seems to be a lasting phenomenon. It does not apply solely to local markets. In the last two years there has been a dynamic development of retail banking on the international scale. Cross-border mergers and takeovers are more and more often a part of this process.173 Some research indicates that several pan-European retail banks will come into being before 2010, which means that the sector will consolidate in the next five years.174

Figure 4.1.7. Claims on non-financial customers, 2003–2005

![Chart showing claims on non-financial customers, 2003–2005](image)

Note: "Individuals" belong to "households" category.
Source: NBP.

Figure 4.1.8. Average weighted (nominal) interest rate of PLN loans to households and enterprises in Poland, 2002–2005

![Chart showing interest rates, 2002–2005](image)

Source: NBP.

173 In the present chapter the notion of cross-border mergers and takeovers is understood as transactions concluded by two or more banks, out of which at least one has its headquarters in the EU.
Apart from the structural factors present in Europe, the growing significance of retail banking in Poland is strongly connected with the improvement of households’ financial situation due to persistent favourable economic conditions and positive prospects for the forthcoming period. Furthermore, average interest rate of bank loans is much lower than several years ago, which is one of the basic factors of the households’ rising demand for loans (Figure 4.1.8).

As loans constituted majority of claims on non-financial customers (96.9% as of the end of 2005), further part of the present subchapter will be devoted to analysing this balance sheet item.

**Loans to non-financial customers**

In 2005 the growth rate of loans to non-financial customers was much higher than in 2004 (Table 4.1.8). The increase in loans to households was the highest (24.1%), whereas loans to enterprises grew at a moderate pace (3.4%). Selected categories of loans, which had the strongest growth rate in the period concerned, are analysed below.

There were no significant changes in the structure of loans to non-financial customers in comparison to 2004 (Figure 4.1.9).

**Loans to households**

The growth of loans to financial customers was mainly caused by the increase in loans to households, especially residential loans to individuals (which constituted 47.9% of the increase). Consumer loans, especially credit card lending, were the second largest item in the total growth of loans to non-financial customers. As of the end of 2005, the share of this type of loans in the loans to households was still low (3.1%). However, it is to be expected that credit card lending will increase in the nearest future and will often replace instalment loans. Consumer loan market in Poland is perceived as segment with high development potential. Due to strong competition in this market segment banks gradually ease requirements and lending criteria (loan margins are lowered, collateral criteria become less restrictive, loan maturities are prolonged, loan procedures are reduced, the waiting time for a credit decision is shortened). Consequently,

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**Table 4.1.8. Changes in selected categories of loans to non-financial customers, 2004–2005 (%)**

<table>
<thead>
<tr>
<th>Loan category</th>
<th>Enterprises</th>
<th>Households</th>
<th>Non-financial customers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Authorized overdraft</td>
<td>8.6</td>
<td>18.4</td>
<td>4.0</td>
</tr>
<tr>
<td>Investment loans</td>
<td>-10.5</td>
<td>5.3</td>
<td>8.4</td>
</tr>
<tr>
<td>Operational loans</td>
<td>-7.4</td>
<td>-7.3</td>
<td>-3.5</td>
</tr>
<tr>
<td>Real property loans, of which:</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– residential loans</td>
<td>13.7</td>
<td>10.5</td>
<td>21.2</td>
</tr>
<tr>
<td>Credit card lending</td>
<td>-15.5</td>
<td>4.9</td>
<td>21.1</td>
</tr>
<tr>
<td>Other loans and credits1</td>
<td>-5.7</td>
<td>-7.5</td>
<td>8.6</td>
</tr>
<tr>
<td>Total</td>
<td>-4.0</td>
<td>3.4</td>
<td>11.9</td>
</tr>
<tr>
<td>Mortgage-backed loans2</td>
<td>11.8</td>
<td>5.6</td>
<td>39.8</td>
</tr>
</tbody>
</table>

1 Including loans within installment sales systems. The category does not include discount loans, export loans, securities purchase loans, etc.
2 Among total loans. They do not add up with the remaining items.
3 The “households” category includes: individuals, sole proprietors and individual farmers.

Source: NBP.

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175 The category of customer loans taken by households included authorised overdrafts, credit card lending and other consumer loans and credits, especially loans within installment sale systems.


177 Consumer Loan in Europe: riding the wave, European Loan Research Institute, November 2005.
more customers can apply for loans of this type, which – combined with gradual improvement of the consumer confidence ratio\(^{178}\) – gives reasons to believe that the growth rate of consumer loans in Poland will still be fast in the nearest future. The observable change in the lifestyle of customers – i.e. the fact that the service timeline of durable devices becomes shorter – also affects the market. It is also worth noting that the trends concerning consumer and residential loans coincide (Figure 4.1.10).

**Figure 4.1.9. Structure of loans to non-financial customers, 2004–2005**

![Figure 4.1.9](image)

Growing demand for consumer loans is also a secondary result of the growth of residential loans, which brings additional demand for furnishings. In order to reduce the costs of financing consumer goods purchase, banks offered the so-called revolving mortgage loans to clients taking residential loans, which allows them to use an already paid part of the loan again to purchase furniture, a car, domestic appliances, or even to pay for a holiday trip. Taking into consideration the forecast growth of the residential loans, it is to be expected that residential loans will be an additional factor stimulating growth of the consumer loans.

Fast growth of the household debt due to consumer loans was characteristic for the entire European market. It is one of the fastest developing and most attractive (in terms of income) segment of the European financial services sector. This trend is expected to continue in the nearest future, which will be a result of both favourable macroeconomic prospects,\(^{179}\) and the

\(^{178}\) It is an indicator which presents both current and projected changes of individual consumption trends. Since January 2004, the consumer confidence among households has been analysed by the NBP together with the Central Statistical Office, by calculating the current (BWUK) and projected consumer confidence ratio (WWUK). BWUK is the average of balance assessments of the households’ financial situation changes, changes of the overall economic situation of the country and current performing of important purchases, and WWUK is the average of the balances of these assessments for the next 12 months.

improvement of customer attitudes in the EU. The regulations included in the Capital Requirements Directive, i.e. the possibility to reduce capital requirements of banks due to retail exposures by using preferential risk weight (75% instead of 100%), also favour this trend.

Figure 4.1.10. Secondary effect of residential loans to households’ growth – development of consumer loans

Note: the category ‘consumer loans’ includes authorised overdrafts, credit card lending and the remaining consumer loans, including loans financing instalment sales.
Source: NBP.

Loans to enterprises

Despite rising investment expenditure in 2005, no significant increase in demand for bank loans was observed in the corporate sector. Improvement of the financial situation of enterprises in 2005 did not bring significant changes in the structure of their financing sources in comparison to 2004. However, unlike in the previous year, the growth rate of loans was positive. Therefore, the downward trend of the value of loans extended to this category of borrowers was reversed in 2005.

It was observed that both enterprises in good financial situation and those belonging to the group of most indebted enterprises continued to repay their loans. The enterprises still most often used their own funds and short term liabilities to non-banking institutions to finance their operational activity. In 2005, enterprises did not report difficulties in obtaining a loan to be a significant limitation of the growth of their activity. The low growth rate of the value of loans to enterprises resulted from their good financial situation. Nevertheless, delayed disbursement of EU funds did not favour investments. As the expected investment boom becomes stronger, one can expect an acceleration of the growth rate of corporate debts, which will be additionally strengthened by strong competition between banks and by easing the criteria and requirements of extending loans.

Despite of the fact that the growth rate of loans to enterprises was still low in 2005, it is worth noting that the debts of enterprises rose fast within two categories of loans: credit card

181 Investment expenditure of enterprises in Poland (gross expenditure on fixed assets) in 2005 amounted to PLN 63.5 billion and was 7.3% higher than in 2004. Source: Wyniki finansowe podmiotów gospodarczych I-XII 2005. Warszawa 2005, GUS.
182 However, it is worth noting that the share of market financing in the corporate financing sources increases. More on this issue in Chapter 5.2.
184 Among 11 types of barriers reported by the enterprises the ratio calculated for the barrier “difficulties in obtaining a loan” in 2005 had the lowest value (calculated as arithmetic mean of the values of the ratio from particular quarters of 2005). More in: Wstępna informacja o kondycji sektora przedsiębiorstw ze szczególnym uwzględnieniem stanu koniunktury w IV kw. 2005. Warszawa 2005, NBP, p. 19 and 80. The publication is available at: www.nbp.pl.
lending and authorised overdrafts. Banks made their offers more attractive, introducing various credit cards for enterprises. They became a popular tool for managing short term deficits of cash and facilitated settling of transactions. Authorised overdraft was another type of enterprise loan, which became more popular in the last two years. The share of the growth of this loan type in the enterprises sector in the total growth of loans extended to non-financial customers in 2005 amounted to 13.1%. The main advantage of an overdraft facility is that it is not necessary to undergo formal procedures every time, and that it is cheaper than other types of loans. Apart from the above mentioned types of loans, investment loans also contributed to the growth of corporate sector’s debts in 2005. The growth rate of investment loans in 2005 amounted to 5.3% (in 2004 it was negative 10.5%).

As it was mentioned before, in 2005 the debts of households grew the fastest (Table 4.1.8). This is why the further part of the present subchapter will focus on credit services for this group of customers, and especially on analysing the development of residential loans market, the influence of exchange rate fluctuations on household lending growth and on describing the development of payment card market in Poland.

**Residential loans**

Residential loans were the fastest growing category of loans to non-financial customers in 2005. Their growth rate was much higher than in the previous year (12.4% in 2004 and 34.7% in 2005, Table 4.1.8). Consequently, their share in the structure of loans to non-financial customers grew for the following year (Figure 4.1.11).

![Figure 4.1.11. Share of residential loans in the structure of loans to non-financial customers, 2003–2005](source: NBP)

The majority of borrowers were individuals whose share in the total growth of residential loans amounted to 95%. Macroeconomic situation, and especially stabilisation of the inflation level and persistent low interest rates, as well as improvement of the financial situation of households were important factors contributing to this growth. Moreover, rapidly growing real property prices in Poland and the expectations that the trend will continue made many households decide faster to buy their own apartments, but they also strengthened the trend to purchase real property for investment purposes. The trend was also present among foreign investors, who became more interested in purchasing real property in Poland. In order to retain their market share in a situation, when competition in the residential loans increased, the banks improved their distribution channels through cooperation with financial intermediaries and sweetened their offers. The offer of the banks was made more flexible through: extending the maturity of loans over 30 years, allowing for the loan to value ratio (LTV)\(^{186}\) to exceed 100%, easing the formal procedures and reducing the

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186 I.e. the relation of the loan value to the value of real property acting as a security of the loan.
waiting time for a credit decision. Consequently, the value of residential loans given to non-financial customers by the banking sector in 2005 increased by PLN 15.3 billion, and amounted to PLN 59.2 billion as of the end of the year. Residential loans accounted for 23% of loans to this sector (which translated into a growth of 3.6 percentage points compared to the end of 2004). Unlike in 2004, when a considerable growth of PLN loans was observed, foreign currency loans accounted for 77% of the residential loans growth in 2005. Consequently, the share of foreign currency residential loans in the structure of loans to non-financial customers increased (Table 4.1.9). Loans in CHF constituted majority (78%) of foreign currency loans. The share of loans in EUR amounted to about 17% and showed a falling trend.

Figure 4.1.12. Changes in foreign currency and PLN residential loans and total loans to non-financial customers, 2003–2005 (quarterly data)

Table 4.1.9. Currency structure of loans to non-financial customers, 2003–2005 (%)

<table>
<thead>
<tr>
<th></th>
<th>Residential loans</th>
<th>Total loans</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>in PLN</td>
<td>in foreign currencies</td>
</tr>
<tr>
<td>2003</td>
<td>74.0</td>
<td>53.0</td>
</tr>
<tr>
<td>2004</td>
<td>53.4</td>
<td>46.6</td>
</tr>
<tr>
<td>2005</td>
<td>45.5</td>
<td>54.5</td>
</tr>
</tbody>
</table>

Growth of residential loans to households was a reason of particular concern for the banking supervision. In 2005, work began on the so-called Recommendation S, which concerned good practises as regards loan exposure secured with a mortgage. The recommendation will enter into force in 2006 and will be the basis for proper identification and management of risk due to a portfolio of such exposures. The document is planned to be completed in the beginning of 2006, which is when consultations with the banks will commence. Introduction of new principles on extending foreign currency loans by Polish banks should not affect considerably the growth rate of the loans’ value, but it may bring changes to the structure of residential loans, i.e. it may contribute to a growth of the PLN loans’ share. Just like in the previous years, financing of housing will be constrained by a: limited supply of improved lands and lack of municipal area development plans. On the other hand, the age structure of Polish society and the fact that young people, born in the period of baby boom, are interested in buying apartments are factors which will sustain the current growth rate of residential loans. Demand for residential loans should continue also due to the favourable macroeconomic situation and improvement of the financial situation of households in
the nearest future. Rising demand may favour entry of new (especially foreign) developers to the Polish market.

Just like in the case of consumer loans, high growth rate of residential loans was also observed in other countries of Central and Eastern Europe (Figure 4.1.13). The growth rate of residential loans to households was particularly high (over 80%) in Bulgaria and in the Baltics. However, it contributed to emergence of external imbalance in the economy. It was characteristic of the countries in the region that the growth of loans was caused mostly by dynamic growth of foreign currency loans. Only in the Czech Republic, Lithuania and Slovakia this growth rate was small. On the other hand, very high growth rate of foreign currency loans in Slovenia resulted from very low base. It is worth noting that though the growth of residential loans to households in Poland was moderate in comparison to other countries of the region, the share of foreign currency loans in residential loans in Poland was high.

**Figure 4.1.13. Residential loans in selected countries of Central and Eastern Europe in 2005**

Note: Poland, Lithuania, Latvia and Estonia – data as of the end of December 2005, the remaining countries – data as of the end of September 2005, no data are available for Lithuania and Slovakia on the share of foreign currency loans in residential loans.
Relation of residential loans to GDP in the Czech Republic – data as of the end of 2004.
Source: Central banks.

**Influence of the exchange rates fluctuations on the growth rate of household loans**

As of the end of 2005, foreign currency loans accounted for 29% of the loans to households. It translated into a growth by 4.7 percentage points in comparison to 2004. The increase in the share of foreign currency loans resulted from the growth of household debts due to residential loans. Fluctuations of exchange rates in 2005 affected the value of loans less profoundly than in the previous years (Table 4.1.10). The total value of loans to households (calculated using constant exchange rates) grew in 2005 by 25.9% in comparison to the previous year, and by 24.1% (calculated using current exchange rates).

**Lending growth and development of the payment card market**

Acceleration of credit card lending to non-financial customers indicates that the lifestyle of the society is changing and that this form of payment is more often used in everyday transactions. In 2005, the total number of payment cards in Poland grew by 20.5% and amounted to 20.4 million (Figure 4.1.14). This means that on average every second citizen of Poland was the holder of a payment card (debit, credit or a charge card). The ratio is still very low in comparison to other
countries. Fast growth of credit cards number in Poland may, however, indicate that in the nearest future the difference between the ratios will be diminishing. Debit cards still constituted the majority of payment cards in 2005, but the share of credit cards increased regularly year by year. In 2000, their share in total number of issued payment cards amounted to only 3.3%, and in 2005 it was already 20.4%. This was mainly a result of the policy adopted by the banks, who reduced the fees for issuing and using credit cards (as well as temporarily suspended charging the interest rate – the so-called grace period), lowered the minimum income required of a future card holder, increased the non-price attractiveness of the offered cards (e.g. the possibility to customise the visual features of a credit card), and most importantly intensively promoted credit cards.

Table 4.1.10. Changes in loans to households in the years 2003–2005 (assuming constant and current exchange rate) (%)

<table>
<thead>
<tr>
<th></th>
<th>Assuming constant exchange rate</th>
<th>Assuming current exchange rate</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2003</td>
<td>2004</td>
</tr>
<tr>
<td>Authorised overdrafts</td>
<td>-2.6</td>
<td>4.1</td>
</tr>
<tr>
<td>Operational loans</td>
<td>-0.6</td>
<td>-2.4</td>
</tr>
<tr>
<td>Investment loans</td>
<td>6.6</td>
<td>9.8</td>
</tr>
<tr>
<td>Real property loans, of which:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>– residential loans</td>
<td>37.3</td>
<td>31.4</td>
</tr>
<tr>
<td>Credit card lending</td>
<td>35.7</td>
<td>31.6</td>
</tr>
<tr>
<td>Other loans and credits</td>
<td>-0.4</td>
<td>10.6</td>
</tr>
<tr>
<td>Mortgage-backed loans1</td>
<td>75.6</td>
<td>49.4</td>
</tr>
<tr>
<td>Total loans</td>
<td>9.6</td>
<td>16.0</td>
</tr>
</tbody>
</table>

1 Among total loans, they do not add up with the remaining items.

Notes:
1. The value of foreign currency loans expressed in PLN was converted into foreign currency according to the exchange rates of particular foreign currencies as of the end of 2003, 2004 and 2005, and the calculated foreign currency units were then converted into PLN using the constant exchange rate as of the end of 2003. EUR/PLN: 4.7170, USD/PLN: 3.7405, CHF/PLN: 3.0281.
2. The calculations were performed assuming that the structure of foreign currency loans to households did not change in the years 2003–2005 and that it was as follows: CHF – 78%, EUR – 17%, USD – 5%.

Source: NBP.

Figure 4.1.14. Number of payment cards in Poland and its growth rate, 2000–2005

187 In 2004 Poland was the last among the EU-25 countries as regards the number of payment cards per 1 inhabitant. The United Kingdom had the highest ratio (2.8), followed by the Netherlands, Luxembourg, Belgium (1.7). The average for EU-25 was 1.2. In the United States one citizen holds 5–8 payment cards. Source: NBP calculations on the basis of Eurostat data and Payment and Securities Settlement Systems in the European Union and in the Accessing Countries. Addendum Incorporating 2004 Data. Frankfurt March 2006 ECB. “Making advances.” The Economist January 14, 2006 vol. 378, No. 8460, www.cardweb.com, www.worldfactbook.com.
Debit cards accounted for the majority of transactions performed with payment cards, although the fastest growth in the number of transactions performed was observed in credit cards (Figure 4.1.15).

In 2005, the number of payment cards, transactions performed with payment cards and devices accepting electronic payment instruments increased. Average value of transaction with payment cards did not change significantly and amounted to PLN 244.4\(^{188}\) as of the end of 2005 (Figure 4.1.16). Some holders of payment cards still used them only in extraordinary situations, considered them as a token of prestige and preferred cash payments.

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\(^{188}\) Average value of cash withdrawal at an ATM amounted to PLN 302, and average value of a non-cash transaction with payment card amounted to PLN 127. See: Informacja o kartach płatniczych. IV kwartał 2005 r. Warszawa 2005, NBP, p. 1 and 7.
The above conclusions are also confirmed by the average value of operations at an ATM, which is much higher than the average value of transactions performed with a POS terminal (Figure 4.1.17). Thus, payment cards are often used to withdraw cash from ATMs, and not as a means of electronic payments. In order to better tailor functionalities of payment cards to the customers’ needs an agreement concerning the so-called cashpoint services was signed in 2005 between settlement agents, banks issuing credit cards and international payment organisations (Visa and MasterCard). Thanks to the cashpoint services, payment card holders will be able to withdraw cash in shops and services centres, mainly in groceries, petrol stations, pharmacies and drugstores (however, only under the condition that they first have bought something there). Owners of shops and service centres will be free to decide whether to offer cashpoint services. In Great Britain turnover of many shops increased due to offering these services.

In 2004, Poland was the seventh among EU-25 countries by the growth rate of the number of ATMs. In spite of significant growth, the number of ATMs per million inhabitants in Poland was still the lowest (Figure 4.1.18).

Figure 4.1.17. Average value of cash operations at ATMs and POS terminals, number of devices accepting card payment, 2004–2005

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>ATMs</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average value of transactions – ATM</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Number of POS terminals</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Average value of transactions – POS terminal</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: NBP.

Figure 4.1.18. Number of ATMs per million inhabitants in the European Union in 2004

Taking into consideration the improving financial situation of Polish households, the observed
evolution of the society’s lifestyle, promotion of payment cards by the banks, and increasing
functionality of cards, it is to be expected that Polish households will use payment cards more intensively.

4.1.3.2. Liabilities to non-financial customers

The trends shaping the structure of liabilities to non-financial customers observed since 2002
continued in 2005. It was most characteristic that the growth rate of liabilities to enterprises was
still much higher than the growth rate of liabilities to other categories of non-financial customers.
The value of liabilities to enterprises increased by 17% (in 2004 by 23.6%), whereas liabilities to
households increased only by 5.2% and liabilities to all non-financial customers increased by 8.8%
(in 2004 respectively: minus 1.4% and 4.8%). The value of liabilities to non-financial customers
reached PLN 337.4 billion as of the end of 2005 (Figure 4.1.19).

Due to the fact that this trend continued the share of enterprises in the structure of liabilities
to non-financial customers – contrary to changes in claims structure discussed above – increased
(Figure 4.1.20). This means that enterprises’ financial resources were becoming more important as
a source of banking sector financing.
Financial institutions

The fact that after the NBP interest rates decrease in 2005 average nominal interest on corporate deposits in banks dropped less than the interest on loans indicates that the banks noticed the importance of this source of financing. Moreover, the consistent decrease of the current producer price index (PPI), observed since mid 2004, resulted in an increase of the average real interest of corporate time deposits (it was positive for the first time since 3rd quarter of 2003); in first three quarters of 2005 PPI was higher than interest on household deposits.

Figure 4.1.21. Average weighted interest on PLN time deposits of households and enterprises in Poland, 2002–2005

Due to the fact that deposits constitute majority of the liabilities to non-financial customers (97.5% as of the end of 2005), further part of the present subchapter will focus solely on analysing this balance sheet item of the banking sector.

Deposits of non-financial customers

Financial resources of enterprises were the source of over 54% of the growth of non-financial customers’ deposits in 2005. Improvement of the financial situation of these entities resulted in a growth of their deposits in the banks (by 16.8%), which was accompanied by repayment of the loans, which had been taken earlier. A significant change was observed in household deposits. For the first time since the end of 2001 the value of deposits of this sector has increased (by 5.4%). The growth of household deposits was caused in 36% by the growth of deposits in cooperative banks, which largely reflected the transfer of direct payments from the EU. Almost 20% of the cooperative banks’ deposit base increase resulted from the rise in value of individual farmers current accounts. In 2005, banks and non-banking financial institutions competed more intensively to acquire the savings of non-financial customers. The growth of assets’ prices in the capital market resulted in an increase of the demand for capital market investments (e.g. the offer of investment funds). The competitive position of banks against non-banking institutions deteriorated, as non-banking institutions made their offers more attractive through introducing capital market products, which allowed obtaining higher interest than traditional bank deposits.

Currency structure of non-financial customers’ deposits remained relatively stable. However, growth of corporate foreign currency deposits (by 33.9%) was observed, which was connected with higher trade turnover with foreign countries. In the maturity structure of deposits in each group of non-financial customers the share of current deposits rose, while the share of time deposits decreased (Figure 4.1.22).

Figure 4.1.11. Changes in the non-financial customers' deposits, 2004–2005 (%)

<table>
<thead>
<tr>
<th></th>
<th>Enterprises</th>
<th>Households</th>
<th>Non-financial customers</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current deposits</td>
<td>26.1</td>
<td>23.3</td>
<td>2.7</td>
</tr>
<tr>
<td>Time deposits</td>
<td>22.5</td>
<td>9.3</td>
<td>-3.1</td>
</tr>
<tr>
<td>Deposits in PLN</td>
<td>23.6</td>
<td>13.2</td>
<td>1.6</td>
</tr>
<tr>
<td>Deposits in foreign currencies</td>
<td>28.4</td>
<td>33.9</td>
<td>-15.7</td>
</tr>
<tr>
<td>Total deposits</td>
<td>24.4</td>
<td>16.8</td>
<td>-1.5</td>
</tr>
</tbody>
</table>

Source: NBP.

Figure 4.1.22. Term and currency structure of non-financial customers’ deposits, 2004–2005

A. Term structure

<table>
<thead>
<tr>
<th></th>
<th>Enterprises</th>
<th>Households</th>
<th>Non-financial sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current deposits</td>
<td>46.4</td>
<td>43.4</td>
<td>71.4</td>
</tr>
<tr>
<td>Term deposits</td>
<td>53.6</td>
<td>56.6</td>
<td>28.6</td>
</tr>
</tbody>
</table>

B. Currency structure

<table>
<thead>
<tr>
<th></th>
<th>Enterprises</th>
<th>Households</th>
<th>Non-financial sector</th>
</tr>
</thead>
<tbody>
<tr>
<td>PLN deposits</td>
<td>82.4</td>
<td>79.8</td>
<td>84.8</td>
</tr>
<tr>
<td>Foreign currency deposits</td>
<td>17.6</td>
<td>20.2</td>
<td>15.2</td>
</tr>
</tbody>
</table>

Source: NBP.

Deposits were therefore to a lesser extent used as an instrument of savings and more often as an instrument of current liquidity management. This trend was reinforced by the gradual decrease of the difference between time and current deposits interest, both in the household and corporate segment (Figure 4.1.23).
4.1.4. Banking sector earnings and performance

In 2005, banks once again posted very good financial results. The growth rate of the banking sector’s financial results was not as high as it was in the previous year (in 2004 the growth amounted to over 204%), but both pre-tax and net earnings rose considerably, respectively by 40.0% and 28.9%.\footnote{It must be remembered that results of the banking sector for 2005 are not fully comparable with results from previous years due to the introduction of International Financial Reporting Standards. More on the subject in: Sytuacja finansowa banków w 2005 r. Synteza. Warszawa 2006, NBP, p. 14.} Improvement of the quality of loan portfolio, growth of its value as well as lower net charges to specific provisions were decisive in this respect. Consequently, considerable growth of income from household lending was observed in two areas: consumer loans and housing loans, and increase of the income from fees and commissions.

Improvement in the financial results of commercial banks accounted for over 98.5% of the growth of the banking sector aggregated net earnings, the remaining part of the growth was due to the increase of the cooperative bank earnings. In 2005 commercial bank pre-tax earnings reached PLN 10 449 million, which translated into a growth of 42.5% in comparison to 2004 (in 2004 a growth of 78.8% was observed). On the other hand, net earnings amounted to PLN 8 694...
Good results of commercial banks in 2005 resulted mainly from the growth of volume and value of the provided services. In particular, the following items increased: net interest and fee income, net FX gains, income from equities (mainly dividends).

In 2005, no profitability indicator in the banking sector deteriorated. (Table 4.1.13). In comparison to 2004, the quality of claims (the share of irregular claims fell by 3.8 percentage points to 11%) and capital profitability (growth by 3.2 percentage points to 20.8%) improved considerably. Net interest margin (NIM) decreased slightly by 0.02 percentage points. This trend began in 2004 and resulted from higher growth rate of assets than the growth rate of net interest income. The decrease of net interest margin could be connected with intensified competition between providers of banking services, particularly in housing and consumer loan markets. The mounting competition in the banking sector may be a stimulus for the banks to pay more attention to the effectiveness of their actions and quality of their services.

Table 4.1.13. Selected profitability and performance indicators of the banking sector, 2002–2005 (%)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets (ROA)1</td>
<td>0.5</td>
<td>0.5</td>
<td>1.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Return on Equity (ROE)2</td>
<td>5.8</td>
<td>5.8</td>
<td>17.2</td>
<td>20.8</td>
</tr>
<tr>
<td>Operating expense/assets</td>
<td>4.0</td>
<td>3.9</td>
<td>3.7</td>
<td>3.5</td>
</tr>
<tr>
<td>Net interest margin (NIM)4</td>
<td>3.4</td>
<td>3.2</td>
<td>3.3</td>
<td>3.3</td>
</tr>
<tr>
<td>Non-interest income/assets</td>
<td>2.9</td>
<td>2.4</td>
<td>2.4</td>
<td>2.3</td>
</tr>
<tr>
<td>Irregular claims/gross claims</td>
<td>21.1</td>
<td>21.2</td>
<td>14.9</td>
<td>11.0</td>
</tr>
</tbody>
</table>

1 ROA (Return on Assets) is the ratio of net earnings to average asset value.
2 ROE (Return on Equity) is the ratio of net earnings to average core capital.
3 General expense and amortisation.
4 NIM (Net Interest Margin) is the ratio of interest income less interest expense to asset value.
5 a. net fee income, earnings from equities and other variable-income financial instruments, net gains/losses on financial operations, net foreign exchange gains/losses.
6 In order to calculate this ratio the definition of irregular claims was applied, which is used in the banks using the Polish Accounting Standards. According to this definition, irregular claims include substandard, doubtful, and loss loans (since January 2004 new principles of classification of claims and of establishing earmarked reserves have been in effect). The value of claims on non-financial customers was used in the calculations. Banks using the IFRS report as irregular claims the claims, where it was objectively proven that they had lost value (according to IAS 39), and those which were acknowledged to have lost their value pursuant to the principles defined in IAS 39.
Source: NBP.

In 2005, the main source was the growth of interest income from non-financial customers (by 2,088 million zloty).
2005 was the second successive year when the share of irregular claims in the gross claims of commercial banks decreased significantly (by 10.7 percentage points in two years), reaching 11.5%. The most important factor contributing to the quality improvement of claims was the fact that the IAS 39-compliant principles of credit risk assessment were used by the banks applying the International Accounting Standards. In this group of banks a decrease of irregular claims by 19.6% was observed in comparison to 2004, whereas in the commercial banking sector as a whole the decrease amounted to 16.6%. Other factors, which contributed to the improvement of claims’ quality in 2005, were: better economic and financial situation of the borrowers, resulting from improvement of the business climate, better credit risk management, and the fact that some banks wrote off their lost claims to the off-balance sheet. In the commercial banks, just like in the entire sector, return on equity and on assets reached values respectively higher by 2.5 and 0.3 percentage points than in 2004 (Table 4.1.14).

When analysing changes with reference to 2004, it is evident that performance indicators’ developments in the cooperative banking sector were similar to those in the commercial banking sector (Table 4.1.15). In 2005, for the first time cooperative banks had worse results than commercial banks in terms of profitability measured by ROA and ROE (the indicators deteriorated respectively by 0.2 and 0.9 percentage points).\(^{192}\)

### Table 4.1.14. Selected profitability and performance indicators of the commercial banks, 2002–2005 (%)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets (ROA)</td>
<td>0.5</td>
<td>0.5</td>
<td>1.4</td>
<td>1.7</td>
</tr>
<tr>
<td>Return on Equity (ROE)</td>
<td>5.2</td>
<td>5.4</td>
<td>17.1</td>
<td>21.1</td>
</tr>
<tr>
<td>Operating expense/assets</td>
<td>3.8</td>
<td>3.7</td>
<td>3.4</td>
<td>3.3</td>
</tr>
<tr>
<td>Net interest margin (NIM)</td>
<td>3.3</td>
<td>3.1</td>
<td>3.2</td>
<td>3.1</td>
</tr>
<tr>
<td>Non-interest income/assets</td>
<td>2.8</td>
<td>2.4</td>
<td>2.4</td>
<td>2.3</td>
</tr>
<tr>
<td>Irregular claims/gross claims</td>
<td>22.0</td>
<td>22.2</td>
<td>15.5</td>
<td>11.5</td>
</tr>
</tbody>
</table>

Note: See explanation for Table 4.1.13.
Source: NBP.

### Table 4.1.15. Selected profitability and performance indicators of the cooperative banks, 2002–2005 (%)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Return on Assets (ROA)</td>
<td>1.6</td>
<td>1.2</td>
<td>1.8</td>
<td>1.6</td>
</tr>
<tr>
<td>Return on Equity (ROE)</td>
<td>18.2</td>
<td>12.2</td>
<td>18.3</td>
<td>17.4</td>
</tr>
<tr>
<td>Operating expense/assets</td>
<td>6.6</td>
<td>6.2</td>
<td>5.8</td>
<td>5.3</td>
</tr>
<tr>
<td>Net interest margin (NIM)</td>
<td>6.7</td>
<td>5.6</td>
<td>5.9</td>
<td>5.6</td>
</tr>
<tr>
<td>Non-interest income/assets</td>
<td>3.0</td>
<td>2.9</td>
<td>2.6</td>
<td>2.1</td>
</tr>
<tr>
<td>Irregular claims/gross claims</td>
<td>7.3</td>
<td>7.2</td>
<td>5.5</td>
<td>4.9</td>
</tr>
</tbody>
</table>

Note: See explanation for Table 4.1.13.
Source: NBP.

\(^{192}\) Higher profitability of cooperative banks in the previous years resulted from the fact that, unlike commercial banks, they concentrated on servicing local markets and were not considerably involved in financing of enterprises, which had debt repayment problems in the period of economic slowdown. This is why the recession did not affect cooperative banks to such a degree it affected commercial banks. In 2005, the involvement of cooperative banks in loans to enterprises grew by 19% and amounted about 20% of the total exposure to the non-financial sector.
Among CEC-5 countries, improvement of the both performance indicators was observed in Poland and in the Czech Republic, but in the Polish banking sector it was more pronounced (Figures 4.1.25 and 4.1.26). In the case of the remaining CEC-5 countries the trend concerning ROA was opposite to the trend concerning ROE. Generally, in the CEC-5 group the dynamics of changes of the profitability indicators slowed slightly in 2005, compared to the previous year.

Figure 4.1.25. Return on Assets (ROA) in the banking sectors of CEC-5 countries

Source: NBP, central banks of the Czech Republic, Hungary, Slovakia and Slovenia.

Figure 4.1.26. Return to Equity (ROE) in the banking sectors of CEC-5 countries

Source: NBP, central banks of the Czech Republic, Hungary, Slovakia and Slovenia.

Competing for bank customers in 2005, which was a clear-cut sign of the maturing of the banking services’ segment, can be best illustrated by historical series describing the net interest margin in the years 2000–2005 (Figure 4.1.27). The downward trend of the net interest margin may have contributed to the deterioration of ROA in Slovakia and Slovenia, and to the deterioration of ROE in Hungary. It is to be expected that this tendency will continue in the nearest future. The trend is a natural consequence of financial sector development and integration of the NMS markets with the markets of the EU-15 countries, where the value of NIM is much lower, as well as of the ongoing convergence of the interest rates.

193 In recent years profitability of banks in the EU-15 countries was lower than in the CEC-5 countries (the Czech Republic, Hungary, Poland, Slovakia and Slovenia). See: Banking Structures in the New EU Member States. Frankfurt January 2005 ECB, p. 24. The publication can be found on http://www.ecb.int/pub/pdf/other/bankingstructuresnewmemberstatesen.pdf.

194 In 2004, the value of net interest margin (arithmetic mean) in the EU-15 countries amounted to 1.41 and to 2.67 in the EU-10 countries. EU Banking Sector Stability. Frankfurt October 2005, ECB, p. 55–56. The publication can be found at: http://www.ecb.int/pub/pdf/other/eubankingsectorstability2005en.pdf.
4.1.5. Consolidation and concentration of the banking sector

Intensification of the M&A processes in the banking sector in Poland was taking place in the years 1999–2002. In the period 2003–2004 the consolidation slowed down considerably, which was due to the worldwide decline in the consolidation pace of big financial groups. It is possible that the trend among the banking sector entities, which was recently aimed at creating large international financial institutions offering full scope of services, will be replaced in the nearest future by paying more attention to distinct specialisation within the sector in one field of activity.195

Consolidation processes

In 2004, there were two takeovers in the Polish commercial banking sector,196 but due to the limited size of the participating entities, they, however, had no profound influence on the current situation of the banking sector; whereas in 2005 only the ownership structure of commercial banks changed.197 Neither a merger nor a takeover was observed. In 2005, six cooperative banks participated in mergers, and two cooperative banks were taken over as they fulfilled the statutory obligation to achieve the minimum level of own funds in the amount of 500 thousand euros.

Concentration

In 2005, the number of domestic commercial banks did not change. Nevertheless, concentration measured by the Herfindahl-Hirschman concentration index (HHI)198 for net assets, as well as CR5, CR10 and CR15 ratios199 continued to decrease (Figures 4.1.28 and 4.1.29).

The CR5 indicator for assets fell by 1.6 percentage points. The reason was slower growth rate of the assets of the five biggest banks (5.7%) – it was much slower than the average growth rate of the entire sector’s asset value (8.5%). Despite the fact that the growth rate of the remaining banks decreased by 3.6 percentage points in comparison to 2004, it remained higher than the growth rate of assets of the sectors’ five biggest entities (Figure 4.1.30). In 2005, the value of concentration indicators for loans and deposits also fell.

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196 On 27 December 2004 Bank Przemysłowy SA was taken over by Getin Bank SA and on 30 December 2000 GE Money Bank SA took over GE Bank Mieszkaniowy.
197 In July 2005, the agreement on purchase of 98.35% of shares of Euro Bank SA by the French group Société Générale was finalised and Atlas Vermögensverwaltung (a subsidiary of Commerzbank AG) purchased 100% of shares of BRE Bank Hipoteczny SA from BRE Bank SA (the transaction took place within one group), etc.
198 Herfindahl-Hirschman Index (HHI) for net assets is defined as the sum of squares of the shares of individual entities in the net assets of the sector. HHI indices for loans and deposits are calculated analogically. HHI can range from 0 to 1 and the higher its value, the higher market concentration.
199 CR5, CR10, CR15 are respectively the market shares of the 5, 10 and 15 biggest banks, e.g. in gross loans, assets, bank deposits, etc.
Figure 4.1.28. HHI and the number of entities in the commercial banking sector, 1999–2005

Source: NBP.

Figure 4.1.29. CR5, CR10, CR15 for net assets of the banking sector, 1999–2005

Source: NBP.

Figure 4.1.30. Asset breakdown of the commercial banking sector by counterparty, 2003–2005

Source: NBP.
The concentration level of the banking sector in Poland was lower than the average concentration level in the EU-25 banking sector (Figure 4.1.31). The CR5 indicator amounted to 49% and was the lowest in the CEC-5 group and in EU-10. At the same time – despite considerable differences in the history of banking development in Poland and in the EU-12 countries – concentration of the sector was not very different from that in the euro zone countries, and in some cases it was significantly lower. On the one hand, this reflected the fact that the banking systems in Europe differ in terms of maturity and – on the other hand – the size of particular national markets. If the EU-25 banking systems were put in order from the least concentrated to the most concentrated, then Poland would be the ninth, both in terms of CR5 and HHI. The remaining 16 countries of EU had more concentrated banking systems than Poland. In the report of the European Commission on retail banking in 2005 the Polish banking system is described, according to one of the measurements, as one with the lowest level of concentration in the entire European Union.

Figure 4.1.31. Concentration of the banking sectors in the EU-25 countries measured by the CR5 indicator for assets in 2004

In the years 2001–2004 significant differences in the levels of HHI were observed between CEC-5 and EU-15 countries (Figure 4.1.32). In the former, HHI showed a downward trend, whereas in the latter it rose slightly. One of the reasons that the trends in the CEC-5 countries are similar may be that there are capital links between their banking sectors through the same strategic investors. They diversified their portfolios, investing funds simultaneously in the entire region. Easier access of foreign investors to small or medium credit institutions than to entities of strategic importance could have been a reason for lowering of the concentration level in the CEC-5 countries. This in turn favoured increasing ability to absorb foreign direct investment by small and medium banks which were expanding their operations faster than the biggest banks. This is why the share of small and medium banks in the total assets grew, and therefore the concentration level of the entire sector decreased.

200 Measured both by HHI and the share of 5, 10 or 15 biggest banks in the sector’s assets (respectively CR5, CR10 and CR15).


202 The most active banks in Poland in this respect include: UniCredit Italiano, Citibank, ING, KBC, Commerzbank (see also: M. Gzyl: “Pięć banków rozdaje karty w regionie,” Rzeczpospolita No. 100/2006, 28 April 2006 r., p. B7).
4.1.6. Changes in the banks’ product offer

Offer for individual customers

In 2005 banks intensified their activity aimed at winning over as many new customers as possible. Loan market was the main field of competition. Banks promoted residential loans and made their offers of refinance and consolidation loans more attractive. This was intended to encourage the customers to give up the services of the competitive bank. To do so, banks were reducing loan instalment payment-related obligations.

Decreasing interest rates and the upward trend in prices on the capital market did not create favourable conditions for keeping financial surplus in bank accounts. Banks tried to make their deposit offer more attractive in order to reduce the amount of funds moved to other financial institutions. Banks tried to demonstrate the advantages of investing into deposits linked with investment funds and insurance policies. In some banks groups of advisors were organised, whose task was to help new customers go through the procedures necessary to switch to a new bank.

The value of banks’ expenses on promotion and advertising confirmed that the struggle for customers intensified. In 2005, banks and cooperating institutions’ expenditure on advertising increased by 30% in comparison to the previous year. Banks advertised more intensively personal accounts, investment products (mainly savings accounts), consumer and mortgage loans.

These marketing and promotion initiatives resulted from (but also caused) increased awareness and mobility of the banks’ customers. In 2005, two times more people changed their bank than in 2004, and every tenth new loan was used to pay old debts. The newly acquired customers were one of the main sources of the banks’ income growth.203

Changes to the loan offer

Mortgage loans – residential, consolidation and refinance – were the main field of the banks’ competition in the retail market. Banks eased the requirements and lending criteria.204 In 2005, i.a. commissions and fees due to granting and making a loan available, and interest rate were considerably lowered. It became a standard that no fees were charged for processing loan

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203 According to the research performed by Instytut Pentor. Source: M. Krześniak: ‘Banki konkurują a klienci migrują,’ Gazeta Prawna No. 211 (1576) of 8–30 October 2005 r., p. 10.

Financial institutions

applications. Some banks also gave up, within their core offer, charging commissions and fees for making a loan available. They also simplified the procedures and shortened the time for analysing the loan application to the minimum (which did not always imply making the funds available equally fast).

Residential loans were the fastest growing segment of the loan market. Its nearly 50% growth in 2005 resulted from both increased households’ demand for financing and from many promotion initiatives of the banks. The activity of brokers and financial consultants in the market was also important, as it made it easier for customers to compare and customize the offer to meet their individual possibilities and needs.

Banks became more flexible and more prone to negotiate. This new attitude to customers resulted in opening the market for groups of lower and irregular income, as well as in considerable lowering of margins. Margins of residential loans fell below 2 percentage points (and sometimes even below 1 percentage point), and there were loans in CHF available with interest rate below 2%. Employees of the banks’ loan departments helped the customers to go through additional procedures, and thus their cost was borne by the banks. It concerned e.g. establishment of a mortgage or valuation of real property. The customers were also attracted by: lack of fees for loan currency conversion, the possibility to repay the loan earlier without bearing any additional costs (which was usually possible after 2–3 years of the duration of a loan), grace period on interest payment (once a year for a month or on a one-off basis for several months).

The banks could offer refinance and consolidation loans due to market developments. Decreasing interest rates, improvement of the banks results and intensification of competition made the banks offer their customers better financing terms than at the start of the decade. Loans of this type gained in attractiveness, because they made it possible to cut monthly loan instalments and replace them with a single lower payment. The value of refinance loan could even exceed the value of the previous debt. The banks were willing to additionally cover majority of the costs and to deal with procedures necessary to help clients change the lender. However, the change of lender was not always advantageous for the client. In the case of foreign currency-denominated loans the necessity to convert a loan currency can make the operation less profitable. Imprecise tax regulations concerning tax reductions for housing purposes limit the possibility to change the lender.

Banks also promoted cash loans, usually within seasonal or occasional offers. The target groups of clients were mainly banks’ regular customers – holders of personal accounts and (or) reliable borrowers. It allowed the banks to limit the risk and procedures and to keep high interest rates simultaneously (15–20%). The relatively low costs of lending and high margins are the reason why these loans are always present in the banks’ offers.

Personal accounts and investment products

Competition in the retail services market intensifies every year. This is advantageous to the customers. Many diversified products make it possible to choose the offer best adjusted to the customers’ needs. In 2005, almost half of Polish citizens declared, that they had a banking account (9% even had two accounts), and 13% used an Internet account (in 2004 it was 5%).

Personal account is a strategic product for the banks. It binds the customers with the banks, it ensures that banks receive new funds regularly and it is a source of income (fees and commissions). Growing competition in the market affects the product offer of financial institutions in this area. Banks modified their personal account packages, taking into account i.a. wider availability of non-bank forms of investment and the necessity to reach new social groups. Many institutions offer e.g. special accounts for the youth and students – a more favourable (cheaper) offer, aimed at building long term relations with this group of customers.

205 According to the research performed by Instytut Pentor. Source: S. Koczot: “Konta bankowe pomagają pomnażać kapitał,” Gazeta Prawna No. 229 (1594) of 25–27 November 2005 r., p. 21
Striving to limit the costs and competition from Internet banks made most of the institutions introduce Internet access to their accounts and the possibility to perform many operations through this channel.

New customers could count on special, promotional terms and conditions when opening new accounts, e.g. they did not have to pay the fee for running the account or issuing a card. Holders of accounts could switch to a new bank more easily. The banks took into account the customers’ previous loan history, which gave them instant access to a loan limit with the same interest rate as the one for regular customers. Personal account packages were enhanced with additional services, including:

– the possibility to purchase units of investment funds (first of all investment funds from the same capital group as the bank),
– free insurance packages,
– Internet access to the account (often free of charge) with the possibility to perform operations cheaper than in a branch or via phone and to open deposits with higher interest rates,
– additional savings accounts carrying higher interest rates with the possibility to transfer funds between accounts without losing accrued interest,
– the possibility to open a sub-account for children.

Analysis of the banks’ fees and commissions Tables as regards retail services shows that banks clearly prefer to use the Internet as a channel of distribution and contact with the customers. Internet accounts are often free of charge and offer higher interest. Many operations can be performed through the Internet free of charge (some banks limit the number of such operations), and investing funds is more profitable (higher interest rates of deposits, no fees for purchase and redemption of investment funds units).

Due to the positive results of investment funds and their growing popularity in Poland as a form of investing savings the banks introduced capital market-linked products. This was also a response to withdrawal of funds from the banking system. Deposits linked to other forms of investment can be divided into two categories:

– investment deposits or deposits with a guaranteed rate of return – their interest consists of two parts: a minimum rate of return and a bonus, dependent on a given stock or commodity exchange index (capital or raw material) or a given exchange rate;
– dual deposits which combine a fixed term account and investment in a selected capital market fund or selected securities (e.g. Treasury bonds); half of the allocated sum remains in the account and the other half is invested according to the product’s profile.

Among traditional forms of investing, systematic savings programs (accounts) must be mentioned, which are often added to personal accounts. Interest increases as the amount of funds grows, and customer can use the funds at any time, withdrawing them or making transfers. However, some banks impose limits on the number of operations, which are free of charge and minimum amount of funds in the account. Interest rate is comparable with fixed interest rate deposits, however the accrued interest is not lost if the funds are withdrawn (within the limits).

Progressive (dynamic) deposits are yet another form of encouraging customers to keep the funds in bank accounts. As the duration of the deposit increases, the interest rate grows in comparison with the interest rate in the beginning of the deposit period.
Changes in the banks’ offer for enterprises

In 2005, banks devoted more attention to the offer for the enterprises sector due to the increasing share of this sector in the deposit base of banks and the risk of losing these customers due to their low demand for loans. This was particularly striking in the segment of small and medium companies.

The banks tried to make their offers more attractive, especially with products facilitating liquidity management, due to high share of investment projects financed from internal sources and lack of interest in taking loans. As the banks offered additional services within current accounts and allowed the enterprises to take loans to any purpose solely on the basis of an analysis the credit capacity in the moment when the account is being opened, the division of loans into investment, working capital and export loans was becoming less clear-cut. Banks often added additional packages of products to every opened account, like authorised overdraft or credit card lending and at the same time they increased loan limits. The costs of loans to enterprises were lower, because they could finance more of their needs using authorised overdraft due to the fact that there were no additional fees and procedures.

As far as the offer of deposits is concerned, apart from traditional deposits banks offered special settlement account to the enterprises, the so-called investment account, which offered the customers more attractive interest rate and the possibility to pay in and withdraw funds without losing the accrued interest.

Some banks also added to their offers electronic servicing of transactions and activities relating to documents through the Internet. Advanced computer systems allowed the enterprises to remotely access and manage the letter of loan and collection transactions on their every stage, i.e. from their preparation to their settlement. A specialist settlement service was also added to the offer, which allowed the enterprises, which issue many invoices to streamline the management of claims on contracting parties, and eliminate accounting errors in reports and statements. Moreover, the service allowed enterprises to automatically read in the data on the payments made into a financial-accounting system using a file received from a bank.

Banks often offered various types of payment cards for enterprises; their activity in this respect was directed not only at enterprises, but also at housing cooperatives. Products belonging to the broad category of e-banking also became more common. Access to a bank account, the possibility to transfer funds or to use an Internet calculator to verify credit capacity are standard services offered by the banks. On the other hand, it was a novelty that some banks used the possibilities created by the Act on Electronic Payment Instruments to make their offer for enterprises more attractive. E.g. local authorities could streamline paying various social benefits and reduce costs with a special payment card for the recipients. The respective allowance was transferred to the card every month, and the recipients could receive funds either in cash or non-cash.

In response to growing demand from enterprises for services within one capital group, the banks offered cash pooling services, which enables effective liquidity management on accounts run by a single bank for entities from one group. Cash pooling allows economic entities to take advantage of interest benefits, because banks sum up positive and negative balances of the accounts of entities from one group in one collective account (calculating the interest due is possible without transferring the funds between the accounts).206 In 2005, several banks introduced leasing and factoring services (available in their branches) to their offer. One bank offered the so-called recourse factoring, where it purchased corporate receivables and took over the risk due to possible insolvency of its contracting parties.

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206 There are three types of cash pooling: notional cash-pooling, zero-balancing cash pooling (the so-called real cash pooling) and near-zero-balancing cash pooling. Real transfer of cash does not take place in the case of notional cash-pooling (it is the so-called virtual consolidation). Interest is calculated for main account balance, and then transferred into particular subaccounts. More in: M. Dłubak: “Cash-pooling – zaawansowany instrument optymalizujący przepływy finansowe grupy kapitałowej,” Prawo Przedsiębiorcy No. 032/2006.
The fact that many banks built the so-called package offers was a sign that their offer for small and medium enterprises became more complex. Within a package, after opening an account in a given bank, an enterprise could use Internet banking, WAP services, text messaging and telephone banking, and a payment card was added to the package. Just like in the households segment, improving financial situation of enterprises resulted in easing criteria and requirements of extending loans. It was particularly noticeable in the case of entities from the small and medium enterprises sector.

**Internet banking services**

Due to the unique character of the banking sector, and especially due to the need to exchange information fast and efficiently and the need to have an open, unlimited contact with the customer, banks eagerly introduced technical innovation, particularly those based on the use of the Internet.

The results of Claessens’ research from 2001, concerning the use of electronic services’ distribution channels in the financial system, suggest that the electronic penetration of the financial system\(^{207}\) in developed countries will reach the level of 80% before 2010. The gap between developing and developed countries will decrease in the years 2001–2010 on average by 40–50 percentage points. The growth rate of e-finance and the starting point will depend mainly on the existing technical infrastructure and the market openness. Without doubt, the services will have considerable impact on the future shape of the financial system.\(^{208}\)

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**Figure 4.1.33. Share of accounts with Internet access in the total number of current accounts in 2004**

![Graph showing the share of accounts with Internet access in different countries in 2004.](image)

Source: Prepared by the NBP on the basis of: Blue Book: Payment and Securities Settlement Systems in the EU and in the acceding countries, Frankfurt, March 2006, ECB.

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\(^{207}\) Currently, there is no single measure regarding the level of financial services sector penetration by electronic systems. In this respect, authors of the mentioned research propose a synthetic indicator based on the following: percentage of the customers using Internet bank accounts, percentage of the broker transactions conducted via Internet, as well as the total number of POS terminals within a certain area or country. The indicator reaches values in the range of 1-100. See also: S. Claessens, T. Glaessner, D. Klingebiel, E-Finance in Emerging Markets: Is Leapfrogging Possible? World Bank, Financial Sector Discussion Paper, No. 7/2001, p. 11.

\(^{208}\) According to Claessens, the development of electronic finance will cause an increase in competition in the market, which will result in considerable fall of margins, etc. (See also: S. Claessens, T. Glaessner, D. Klingebiel: Electronic Finance: Reshaping the Financial Landscape Around the World. World Bank, Financial Sector Discussion Paper, No. 4/2000).
Judging by the statistics published in March 2006 by the ECB on the use of modern technologies in the settlement systems of the European banking sector, bank accounts with an Internet access option or Internet bank accounts became popular also in Poland (Figure 4.1.33).\(^{209}\) The level of e-finance penetration in Poland predicted by Claessens, 18% in 2005, is similar to the share of accounts with Internet access in the total number of current bank accounts (16%, just like in Malta, Italy and Portugal). As most of the Internet accounts in Poland were opened in the last several years (their share grew by 12 percentage points in the years 2001–2004, reaching 16%), it is justified to say that the growth rate of the Polish banking sector is relatively high in this respect, if compared to the selected European countries. Number of banks offering Internet services increased considerably in the last several years. In 1999, only 3 banks provided their services over the Internet, whereas in the end of 2005, just like a year before, there were 19 such banks. The offer is directed at both enterprises and individual customers. The growth rate of the number of customers using Internet accounts was high (Figure 4.1.34). In 2005, 52% growth of the number of people accessing their accounts over the Internet was observed in Poland. In 2004, the number of people accessing their bank accounts over the Internet amounted to about 5 million, and in 2005 there were 7.7 million of such users. The significance of e-banking is demonstrated by the fact that in the end of 2005 in one of the biggest Polish commercial banks 82% of transactions were performed electronically.\(^{210}\)

Internet banking is currently one of the fastest growing market segments. Direct benefits for the banks, especially for virtual banks, due to offering their products through electronic channels include:

- fast service,
- using one distribution channel for as many products as possible,
- no expenses of creating a network of branches, smaller dependence on the existing local infrastructure,
- no need to process paper documents,
- elimination of the threats due to forgeries of paper documents,
- lower costs of servicing an individual customer.\(^{211}\)

Figure 4.1.34. The number of enterprises and individual customers using Internet accounts

![Graph showing the number of enterprises and individual customers using Internet accounts from 1999 to 2005.](image)

Source: ZBP.

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\(^{209}\) Blue Book: *Payment and Securities Settlement Systems in the EU and in the acceding countries*. Frankfurt March 2006 ECB.


\(^{211}\) Services provided by the banks through unconventional distribution channels are on average 2–3 times cheaper than the same services distributed through a branch of a bank (see: *Komentarz do zarzutów stawianych sektorowi bankowemu na podstawie raportu pt. „Zagrożenia dla konsumentów na rynku bankowości detalicznej w Polsce*. 2003, p. 13, publication available at: [http://www.zbp.pl](http://www.zbp.pl).
The banks, which use the Internet to provide their services, gain competitive advantage over the entities, which use traditional methods. Both the banks, whose activity is based on traditional branches and who make it possible for customers to access their accounts over the Internet, and virtual banks, i.e. those which do not have traditional branches, often encounter developmental barriers. The most important problems and costs due to the use of the Internet in banking include:

– ensuring a proper protection system against cybercrime, as well as against operational risk due to servicing of accounts,

– limited personal contact of the customers with the bank, which will in the short term reveal the fears and customs established over the years in people who had so far used banking services only in their traditional form, and in the long term it may make it difficult to acquire new customers and contribute to their higher rotation between competing institutions, and consequently negatively affect the stability of the banks' financial situation,

– transferring of the costs borne by the banks due to traditional service of customers on the customers themselves, because the customers will have to buy suitable computer equipment and ensure themselves access to the Internet – it may be a barrier for less affluent customers,

– in the case of Poland, also low availability and high prices of Internet access services.

According to the results of a poll carried out in April 2004 among presidents of management boards of all the commercial banks and selected cooperative banks in Poland, 97% of the respondents perceived Internet banking as the most important method of contacting individual customers for the next several years. Despite the fact that the Internet became the second most important communication channel in terms of the number of users, it is also noticeable that the role of traditional access channels is maintained.

However, it is to be expected that Internet banking will become more and more popular in Poland, especially in the corporate sector. It will affect banking operations, as the value and structure of costs in banks will change, and their employment structure will evolve with the growing number of IT personnel.

4.1.7. Prospects

Similar to the entire European banking sector, 2005 was a favourable year for banks in Poland. They improved their financial results and increased lending – especially in the households sector. Due to the changing preferences of individual customers as regards investing savings, it seems that in the nearest future growth of lending will be one of the basic factors determining the situation in the retail banking sector in Poland. It is worth noting that gradual change of the role of banks as intermediaries between customers with savings and borrowers takes place in the entire European banking sector.

Polish banking sector grows faster than banking sectors in the other countries of the European Union. The ability of the domestic banking sector to adjust to the changing economic environment and the willingness to exploit the chances offered by this environment can be

212 More on the banks offering services over the Internet in: Rozwój systemu finansowego w Polsce w 2004 r. NBP, Warszawa, November 2005, p. 84–87.
214 65 percent of respondents regarded direct visits at the bank as one of the most important ways of contact between bank and the client. More on the results of the research in: M. M. Polasik: "Rozwój bankowości elektronicznej w Polsce – w świetle badań ankietowych," Bank i Kredyt No. 8/2005, p. 58.
216 Corporate lending also grew fast in EU countries.
observed in many areas. Due to the development of the financial system banks are often intermediaries providing services or offering products of other financial institutions (the development of bancassurance may be an example in this regard); banks do not, however, take over the risk due to given product or service. At the same time, the offer of banking services becomes broader, e.g. the banks participate in financing of leveraged buyout transactions.\textsuperscript{218} Banks are also interested in new markets, e.g. in the possibilities opened for Poland by trading the rights of to emit carbon dioxide. As over a thousand of Polish enterprises have the rights to emit about 239 million tons of carbon dioxide into the atmosphere annually, trading in securities in the form of emission rights may translate into a possibility to achieve additional profits for the banks.

In 2006, the act on the so-called prevention of usury\textsuperscript{219} will enter into force. It is intended to limit the maximum interest rate of a bank loan to the fourfold of Lombard rate. The act will not apply to the fastest growing banking segment in Poland – i.e. to residential loans, and therefore it will not affect its growth rate in the future.

In 2005, attempts were made by the banks to carry out securitisation transactions (Box 4.1.1). Due to the lack of appropriate regulations, high solvency ratios of the Polish banks and pertaining excess liquidity in the sector, it is difficult to predict further development of securitisation in Poland. According to some opinions, small banks can be interested in performing such transactions, because – unlike the biggest retail banks – their financing sources structure is different – it is less based on household deposits.\textsuperscript{220}

Box 4.1.1

**SECURITISATION**

The notion of securitisation

The securitisation is an alternative method of funding financial institution’s activity, using the asset side of its balance sheet – contrary to the traditional methods, which use only the liability side. Securitisation is the pooling of homogenous assets, which are then removed from the assets of the originator and used as collateral for liquid securities issued in the process.\textsuperscript{1} As a result, the risk burdening the asset portfolio is transferred from its previous owner to a different entity, e.g. a legally independent special purpose company, also referred to as Special Purpose Vehicle (SPV),\textsuperscript{2} and ultimately to the investors buying the issued securities. When the assets are transferred to the company they are divided into tranches. On the basis of the portfolio of assets designated for securitisation the company issues securities in packages with various risk profiles and various rates of return. The highest risk tranche (i.e. equity or mezzanine note) is subordinated to the other lower risk (higher rating) tranches. This means it in the first place covers potential losses due to lack of payment from the base assets’ portfolio. If the value of a loss exceeds the value of this tranche, the loss affects the next tranches, located higher in the subordination structure.\textsuperscript{3} Securitisation technique belongs to a broader group of structured finance.\textsuperscript{4}

\begin{flushright}

2 If the securitising entity issues investment certificates (instead of debt instruments) by a fund, often no special purpose company is created, because it is the owner of assets, which creates and services the fund, and cash flows due to the assets are synchronised with payments to certificate holders (see I. A. Raczkowska: Sekurytyzacja wierzytelności bankowych. Warszawa 2001, Wyd. KK, p. 18).


4 The category of structured finance comprises all non-standard financing methods, based not on the credit rating of the financed party, but on the value of the project to be carried out or on the value of particular assets. Structured finance is usually better suited to the needs of a debtor than traditional financing. The examples include: securitisation, convertible bonds, callable bonds (source: Structured Finance for Central and Eastern European Banks: The Way of the Future? seminar materials, Loan Comments, BACEE, Vienna, 15–16 November 2005).
\end{flushright}

\begin{flushleft}
218 I.e. a type of purchase, where some of the funds used to take over a company come from a bank loan.


220 P. Cyburt: Sekurytyzacja bankowych kredytów hipotecznych, w: Sekurytyzacja aktywów bankowych. Zeszyty BRE Bank – CASE, No. 82, Warszawa 2006 CASE.
\end{flushleft}
Most often it is the original owner of the underlying assets who initiates the process and transfers the ownership or the right to the cash flows generated by assets to the SPV. It also often services the assets until the securitisation is finished. The SPV issues debt securities backed with the assets, entering into a commitment towards their buyers (investors). Removing the assets from the balance sheet allows to reduce considerably the risk of the issuer’s bankruptcy. Revenues from the issuance are then transferred to the originator, and partially used to later repurchase of the securities from investors.

**Types of securitisation**

The following types of issued debt securities are distinguished, depending on the type of underlying assets:

- **MBS**, i.e. Mortgage-Backed Securities (including Residential MBS, based on liabilities of individuals, and Commercial MBS, based on commercial mortgages);
- **ABS**, i.e. Asset-Backed Securities, based on i.a. credit card and consumer financing receivables, future cash flows (e.g. trade and leasing receivables), assets of a designated part of the enterprise;
- **CDO**, i.e. Collateralized Debt Obligations (especially CLOs – Collateralized Loan Obligations and CBOs – Collateralized Bond Obligations).

**History of securitisation**

The history of securitisation dates back to 1970, when Government National Mortgage Association (GNMA) started to operate due to dynamic development of the housing market in the United States and to the need to find new sources of financing. The agency performed the first securitisation in the world, based on a portfolio of mortgage loans (MBS). First securities issued by Sperry Lease Finance Corporation based on assets other than mortgage loans appeared in 1985, also in the United States. This is how a new funding method emerged, which allowed to acquire funds not by using the liability side of balance sheet, but through assets. In Europe the first securitisations (MBS) were performed in 1987.

**Securitisation market**

Currently, Mortgage-Backed Securities (MBS) constitute a majority of the European securitisation market. They constitute 67% of the value of securitisation transactions performed in Europe (Figure 4.1.35). The second most popular type of securitisation instruments are Asset-Backed Securities (ABS), amounting to about 19% of the securitisation value.

![Figure 4.1.35. Securitisation market in Europe – its size and structure broken down by countries and types of securitisation instruments](image-url)

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5 Structured finance instruments appeared already in the 18th century in Denmark and in Germany as debentures (German: Pfandbrief).
CDOs, which are less popular in the Central and Eastern Europe, constitute almost 14% of the European market. Securitisation market in Europe grew by 31.1% annually (in the years 2004–2005) and is currently one of the fastest growing segments of the financial market.

As of the end of 2005 the total value of the Asset-Backed Securities market reached 319.6 billion euros and was 76.1 billion euros higher than one year earlier.7 In most countries in particular growth of the mortgage loan market contributed to the development of securitisation.

Since 1999 there have been numerous attempts to perform securitisation transactions in Poland. High liquidity of the Polish banking system, as well as the current regulations have not been favourable for development of securitisation in the form commonly seen in developed countries. A different model of funding emerged in the Polish market: it is based on sale of assets, as well as securitisation funds playing dominant role instead of the SPV.8

Decreasing participation of the European Bank for Reconstruction and Development (EBRD) in co-financing projects in Poland is the evidence that the banking sector in Poland has achieved high level of development. According to its strategy, the EBRD gradually withdraws from economically stable countries. On the other hand, increased interest of foreign commercial banks in the Polish market is noticeable. Since the Polish accession to the European Union to the end of 2005 credit institutions submitted 99 notifications to the Commission for Banking Supervision, informing about the intention to start cross-border activity in Poland and 11 notifications about the intention to start activity in the form of a branch of a credit institution.221

According to some experts, it is to be expected that the consolidation process in the European banking sector222 will again intensify in the nearest future. At the same time, geographical limits of banks’ activity in the world blur and the era of global banks begins,223 which seems to be confirmed by steady growth of the biggest banks’ share in the total value of banks’ assets in the world. In 2005, increased activity of banks was noticeable as regards cross-border mergers. Transactions of this type not only affect banking sectors of the merging banks’ countries of origin, but also affect banking sectors of the countries, in which the merging institutions play an important role as foreign investors. The planned merger of Bank BPH SA and Bank Pekao SA,

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8 See Box 4.5.3. in the chapter on investment funds.
resulting from the merger of the banks being their majority shareholders, was an example of such transaction.

In the last years the scope of cross-border mergers in Europe was rather limited. Apart from economic factors the reasons included: vast diversification of legal and cultural systems, and political decisions. The works initiated by the European Commission in order to verify article 16 (qualified holding of shares of a credit institution) of the Banking Directive prove that reducing the barriers blocking the development of international mergers in Europe is one of the Commission’s priorities. It was emphasised in the White Paper on financial services policy (2005–2010), published in 2005.

One should not expect the differences arising from historical development of banking systems in Europe to disappear in the process of European integration. In Poland, despite the gap concerning various quantity indicators (e.g. relation of loans to GDP), there has been a considerable quality development in the banking sector. Further development of the retail banking segment is to be expected in the next years. Competitive advantage will be more often based on non-financial factors, like high quality of the provided services, innovativeness and the ability to quickly adjust to the economic environment. The obligation for cooperative banks to increase their own funds to a level equal to or exceeding the equivalent of EUR 1 million before 31 December 2010 will be both a challenge and a factor affecting the concentration level of this sector.

The development of retail banking in Poland will be also influenced by the introduction of the Capital Requirements Directive (CRD) (Box 4.1.3). Regulations included in the directive will allow to reduce banks’ capital requirements due to retail exposures, and to classify specific loan portfolios towards small and medium enterprises in this group of exposures. Due to the implementation of the CRD banks will focus mainly on developing the risk management infrastructure, IT and reporting systems, as well as on training of the personnel and preparing internal procedures of risk management. The banks will bear considerable costs due to the implementation of the CRD.

**Box 4.1.3**

**NEW CAPITAL ADEQUACY METHODOLOGY AND ITS INFLUENCE ON THE BANKING SECTORS IN THE WORLD**

**Objective of the new regulations and the three-pillar approach**

The main reason for replacing the regulations included in Basel I (1988) with a more complex approach to risk envisaged in Basel II is the intention to reinforce and ensure stability and security of the international banking system. The new Basel accord was prepared on the basis of the previous accord from 1988 (e.g. the minimum solvency ratio was kept at 8%), but it addresses the recent changes in the banking sector in the last years (e.g. development of securitisation transactions). It is the most detailed document concerning regulatory capital calculation and risk management in the world. Due to a more versatile and detailed approach to the banking risk issues (especially credit and operational risk) and ensuring adequate capital for banks of various sizes and operating profiles, the New Capital Accord is to ensure that banks’ regulatory capital will coincide with the economic capital.

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1 Regulatory capital – the amount of the banks’ equity capital which must be designated according to domestic supervisory principles (the so-called Tier 1, 2 and 3 funds), which banks must keep at a level equal or higher than the minimum requirements in order to protect depositors and other creditors of the bank. Regulatory capital is used by banking supervision as one of the measures for assessing financial-economic situation of a bank.

2 Economic capital – the amount of capital, which should reflect the real economic risk of a given bank, i.e. cover the unexpected losses predicted by a bank over a certain period of time, therefore securing it against all types of risk identified in the bank’s activity.

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Financial institutions

will remain at a level similar to the current one, but it will be differently allocated between major risk components and particular groups of banks.

The structure of the New Capital Accord is characteristic – it is composed of three pillars, which complement one another. The first (minimum capital requirements) introduces considerable changes in credit risk and capital requirements due to operational risk (market risk issues didn’t change considerably). The new methodology allows banks to use their own, internal models of credit risk estimation. It is the so-called internal ratings-based approach (IRB), which is divided into foundation IRB (F-IRB) and advanced IRB (A-IRB). Banks, which will not choose the internal rankings-based approach (or will not be allowed by the banking supervision to use one), will use the standard methods. Similar to the previous regulations, it is based on combining strictly defined (given) risk weights with generally defined asset categories (in Basel II, in comparison to Basel I, new portfolios and risk weights were added). The internal ratings method is more risk sensitive than the standard method, but it is also more complicated. Similarly, in the case of operational risk management the banks will be able to use the advanced measurement approach (AMA). In the second pillar (supervisory review) the principles of control, transparency and responsibility of supervisory authorities were defined. The supervisory authorities are responsible for assessment of how effective the banks’ risk management is. The second pillar also includes guidelines for banks concerning keeping due diligence when assessing their capital adequacy. The objective of the third pillar (market discipline) is to improve informational transparency of the banks through introducing a set of information and reporting requirements, which will allow the market participants to assess a given institution.

**Implementation of the New Capital Accord – differences between the European Union and the United States**

Despite the fact that the recommendations of the Basel Committee on Banking Supervision (BCBS) are not binding, Basel I principles were commonly applied in the world. In the case of Basel II the process will be much more complicated and time consuming. However, in the EU – due to the fact that most of its provisions were introduced into the EU legal system through an amendment of the Directive 2000/12/EC and Directive 93/6/EEC – Basel II will be binding not only for banks, but also for investment firms.

The lawmaking process, aimed at transposing the provisions of the Capital Requirements Directive into the Polish law, can only commence after the official Polish version of the CRD is published in the Official Journal of the European Union, which will take place in 2006. Banks, which decided to use the standard methods, will start to calculate capital requirements pursuant to the CRD from 2007, and the advanced methods will enter into force from 2008.

In the United States, Basel II will be binding only for 10 banks, which operate internationally, and further 10-15 will be allowed to decide whether to apply it. In the United States work also started on the so called Basel I-A (ANPR – Advanced Notice of Proposed Rulemaking), which would apply to banks not being subject to the new Basel methodology (Basel II). The regulations are prepared due to the results of research performed within QIS-4 (quantitative impact study) in the American banks. They showed that Basel II would make it possible for the banks to reduce their regulatory capital (in some cases by over 40%). This would mean that banks still using Basel I (i.e. over 8 thousands of institutions) would be less competitive than those, which will introduce Basel II.

**Impact of the regulations on the development of banking systems**

Potential impact of Basel II on the banking systems of particular countries was analysed by the Basel Committee on Banking Supervision within QIS. Five such analyses were performed until the end of 2005 (the results of the last one will be published in 2006). QIS results were generally

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4 The first research was performed in 2001 (QIS 2 and QIS 2.5), and the next: QIS 3 in 2002, QIS 4 in 2004 and QIS 5 in 2005. 31 countries participated in the last research. The United States did not participate.
compliant with the predictions of the BCBS, because they confirmed that in banks operating internationally, which apply internal ratings-based approach, the level of regulatory capital will not change considerably. It will, however, decrease in small banks, which focus their activity in domestic markets. The research also showed that the impact of the new regulations will be differentiated, depending on the portfolio structure of a given bank. Assessment of the Basel II impact on the financing of small and medium enterprises is not unambiguous. For example, attributing more importance to financial indicators than quality factors (e.g. business plan assessment) when assessing credit capacity of an enterprise according to the IRB method may provoke fears that availability of capital for newly created enterprises, with no loan history, will deteriorate. On the other hand, qualifying strictly determined exposures towards small and medium enterprises in the group of retail claims, which according to Basel II have a preferential risk weight (75% instead of the previous weight of 100%), can contribute to increasing the attractiveness of this sector for banks.

According to many specialists, introducing the new capital adequacy methodology can be considered a revolution in the banking systems. It is emphasised that the benefits for banks arising from using advanced methods may be much bigger than the benefits from using the standard methods. However, applying the advanced methods requires vast expenses on IT systems improvement, creating databases necessary to build high quality risk management models, and training of personnel. According to some sources, the general cost of Basel II implementation in the years 2002–2006 (after taxation) for small European banks (with assets amounting to less than EUR 10 billion) will amount to, on average, EUR 30 to 60 million, for medium banks (with assets amounting to EUR 10 to 30 billion) will amount to EUR 60–70 million, and for large banks (with assets exceeding EUR 30 billion) will amount to EUR 80 to 150 million.

It is expected that due to better risk management methods in the banks the implementation of New Capital Accord will contribute to enhancing the stability of the European financial systems in the long term. Increasing the role of banking supervision in assessing the efficiency of the applied models, as well as changing information and reporting requirements, which will improve transparency of the market, should also contribute to the achievement of this objective.


It is worth noting that due to the introduction of the International Accounting Standards and the forthcoming date of the CRD implementation, the National Bank of Poland commenced works on a new system of bank reporting. It will be coherent with the system, which is currently being prepared by the Committee of European Banking Supervisors (CEBS), and it will apply to banks and investment firms. According to the CEBS guidelines, banks’ reporting for supervisory purposes will consist of two packages: FINREP – Financial Reporting Framework and COREP – Common Reporting Framework. Introducing uniform European bank reporting systems will be an important element of the EU banking systems’ harmonisation. It will allow to reduce the difficulties of supervising financial entities operating internationally, and most importantly it will improve information exchange between supervisory authorities from various European countries. Financial groups operating in several countries will be able to reduce costs borne due to fulfilling information requirements of particular supervisors, using one database and common reporting formats. Harmonisation of the bank reporting will also facilitate performing comparative analyses of the banking systems in the European Union.
4.2. Credit unions

Since 2005, credit unions (Spółdzielcze Kasy Oszczędnościowo-Kredytowe – SKOK) have been classified as monetary financial institutions in NBP reporting. Credit unions are non-bank institutions which can accept deposits from households. Their activity is not regulated by the Banking Act, thus they are not subject to banking supervision. Credit unions operate on a non profit basis pursuant to the Act on Credit Unions and the Cooperatives Act; they are overseen by the National Association of Credit Unions.

In other countries similar services are provided by credit unions. As of the end of 2004, a system of credit unions existed in 91 countries, and the number of credit unions amounted to 43,147 (Figure 4.2.1).

Figure 4.2.1. Number of credit unions in the world, 1998–2004

The most developed credit union system, both in terms of the number of credit unions (9,209) and the value of extended credits and accepted deposits, exists in the United States. In Europe, the most extensive system of unions (573) exists in the Great Britain. The share of Polish credit unions in the total value of extended credits, accepted deposits and also in the value of assets of credit unions in the world is much below 1%.

During the thirteen years of credit unions’ operations in Poland, both the number of their branches and members increased steadily. The number of credit unions has decreased in subsequent years as a result of consolidation (Figure 4.2.2). The main reason of this process was the fact that stronger credit unions took over smaller, ineffective, single-branch credit unions. According to the National Association of Credit Unions, mergers are initiated by the management of the credit unions which are being taken over and their members. Since 1992 (i.e. since the beginning of credit unions’ activity in Poland), no credit union has declared bankruptcy.

Sources and Notes:

228 The present subchapter is based on data from NBP, the National Association of Credit Unions and the World Council of Credit Unions.

229 The sector consists of: banks operating in Poland, branches of credit institutions, branches of foreign banks and credit unions. The change took place after the NBP Management Board had adopted Resolution No. 55/2004 on the procedure and detailed principles regarding the banks’ submission of the data necessary for establishing the monetary policy and conducting periodic assessments of the state’s monetary situation and the evaluation of the banks’ financial standing and the risk of the banking sector to the National Bank of Poland, amending Resolution No. 23/2003.


232 As at the end of 2004 credit unions in the United States constituted 21.3% of the total number of credit unions in the world, and their share in the value of extended credits amounted to about 80% (their share in the value of accepted deposits and the value of assets was very similar). Members of credit unions in the United States constituted 62.5% of the total number of credit unions members in the world.

233 I.e. 0.16% in deposits, 0.15% in credits and 0.14% in net assets.
As of the end of 2005, credit unions were present in 537 towns and cities, and their branches were concentrated mainly in the provinces of Silesia (300), Mazovia (154) and Lower Silesia (141).

Credit union assets still represented a small part of the financial sector. As of the end of 2005, credit unions assets amounted to 0.9% of bank sector assets, and 16.3% assets of cooperative banks, the main competitors of credit unions.

In the years 1998–2005, the value of loans extended and deposits accepted by credit unions increased steadily. Their growth rate, however, significantly decreased in the last years, which resulted from, among others, growing base (Figure 4.2.3).

As of the end of 2005, 67% of all credit and loans extended by credit unions were consumer credit and loans for households, and 9.2% were residential loans. Credit unions could extend credits and loans to their members for a period not longer than 3 years, and residential loans for a period not longer than 5 years. Funds which were not used to extend loans and credits could be invested by credit unions in: (1) bonds and other securities issued or guaranteed by the State Treasury or the NBP, (2) as deposits or shares in the National Association of Credit Unions, (3) as deposits in banks up to the limit guaranteed by the Bank Guarantee Fund (BFG), (4) in units of money market funds (articles 21 and 30 of the Act on Credit Unions of December 14, 1995 (Dz.U. No. 1/1996, item 2). As of the end of 2005, the share of debt securities in credit unions’ assets amounted to only 3.1%, and the share of units in money market funds amounted to only 2.4%.
The structure of credit unions’ deposits consisted mostly of deposits with original maturity up to one year, but the share of current deposits amounted to only 4.4%.

The growth rate both of assets and liabilities decreased, although credit unions offered more favourable interest rates on deposits and favourable loan terms than commercial banks.235

Unlike in the banking sector, in 2005, the net profit of credit unions fell by around 50% and amounted to 17.2 million zloty (34 million zloty in 2004). Consequently, the capital adequacy and efficiency ratios also deteriorated (Table 4.2.1). Nevertheless, the ratio of overdue loans improved (Table 4.2.2).

It is difficult to establish how credit unions will develop in the future. Taking into account the product offer of these institutions, it becomes clear that the offer evolves in the same direction as banks’ offer. Currently, credit unions not only offer deposits and loans but also mortgage loans, as well as debit and credit cards. Credit unions also act as intermediaries, selling investment fund participation units, insurance and offering individual pension accounts. However, due to their smaller capital base, the possibilities for credit unions to broaden their product offer are limited.

Figure 4.2.6. Changes in the value of deposits and loans in credit unions in comparison to commercial and cooperative banks, 2003–2005

Source: NBP, National Association of Credit Unions.

Table 4.2.1. Selected capital adequacy and performance indicators for credit unions, %

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005(^2)</th>
</tr>
</thead>
<tbody>
<tr>
<td>General capital adequacy ratio(^1)</td>
<td>8.00</td>
<td>8.44</td>
<td>8.65</td>
<td>8.18</td>
</tr>
<tr>
<td>Gross earnings/assets</td>
<td>0.48</td>
<td>0.43</td>
<td>0.84</td>
<td>0.35</td>
</tr>
<tr>
<td>Net earnings/assets</td>
<td>0.46</td>
<td>0.42</td>
<td>0.81</td>
<td>0.32</td>
</tr>
</tbody>
</table>

Note: The figures for credit unions cannot be compared to bank indicators.

1. The general capital adequacy ratio is defined as the ratio of total capital to assets.
2. Preliminary data.

Source: National Association of Credit Unions.

Table 4.2.2. Credit unions’ past due loans ratio, %

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005(^1)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Past due loans as a percentage of total loans</td>
<td>16.9</td>
<td>15.3</td>
<td>14.1</td>
<td>12.3(^1)</td>
</tr>
</tbody>
</table>

Note: The figures for credit unions cannot be compared to bank indicators.

1. Preliminary data.

Source: National Association of Credit Unions.
4.3. Non-banking institutions providing financial services

4.3.1. Leasing

In the developed countries leasing has been a widespread form of financing activity of enterprises for many years. In Poland, the use of leasing is limited. In 2005, the share of leasing in the structure of enterprise financing sources amounted to around 1%.

At year-end 2005, the value of leased assets in Europe amounted to 262.9 billion euro. Like in 2004, the highest value of assets was leased in Great Britain (55.8 billion euro), Germany (49.3 billion euro) and in Italy (44.2 billion euro). Most movables were leased in Great Britain (54.5 billion euro), Germany (42.6 billion euro), France (23.6 billion euro) and in Italy (22.2 billion euro), whereas most property was leased in Italy (47% of the total European property market amounted to 46.8 billion euro at year-end 2005), Germany and France.

Among the new Member States of the European Union most assets – apart from Poland (over 4 billion euro) – were leased in the Czech Republic (3.9 billion euro) and Hungary (4.7 billion euro).

Size and structure of the sector

In 2005, the foregoing trends in the ownership structure of leasing enterprises persisted. Companies which were bank subsidiaries prevailed, although their share decreased in favour of other entities (Figure 4.3.1). Foreign entities had a considerable share in the ownership of lessors providing to them with vast financing sources.

In 2005, like in previous years, the value of leased assets increased and amounted to 16.3 billion zloty (Figure 4.3.2). The upward trend holding for a few years reflects an increase in the importance of leasing among external forms of enterprises’ activity financing.


237 In the European countries industrial buildings constituted about 40% of the value of leased property. Office buildings were of lesser importance as far as property leasing is concerned. Source: Leasing Activity In Europe, www.leaseurope.org.


Like in previous years, financial leasing predominated, but an increase of demand for operating leasing was also observed. A slowdown in the leasing sector growth resulted from, among others, subsequent changes of the regulations concerning VAT and a decrease in sales in the automobile market (by about 26%), which resulted in a decrease in the growth rate of the leased cars’ value.

In 2005, there were no significant changes in the structure of leased assets. Leasing of means of road transport still accounted for the majority of leased assets, but its share diminished steadily (Table 4.3.1). The value of means of road transportation leased in 2005 amounted to 8.85 billion zloty, whereas in 2004 it amounted to 8.8 billion zloty. This trend can be favourable for the sector described above due to high sensitivity of this market segment to business changes. A greater diversification of the activity would contribute to the stability of the sector’s development.

In 2005, financing through leasing of assets belonging to the category of aircraft, ships and rail transport means increased considerably (by 125.8%, Table 4.3.1). As far as the means of road transportation are concerned, the value of leased passenger cars grew (by 93.1%), whereas the leasing of trucks decreased. In 2005, the value of leased trucks amounted to about 4.0 billion zloty, whereas in 2004 it amounted to 5.6 billion zloty (estimates of the Polish Association of Leasing Companies). In 2005, the leasing of computers and office equipment still remained low. This is not necessarily a proof of the limited popularity of leasing in that segment, because data on the use of the so-called producer leasing are unavailable. IT companies often lease computer equipment directly from the producers. In 2005, leasing of machinery and equipment grew fast (an increase of 49.5% in comparison to 2004). This confirms that the leasing market in Poland enters the stage of maturity.

In 2005, the value of leased property was still low and amounted to 15% of the value of leased assets. The reason may be that leasing of land and buildings requires much more complicated and costly procedures than purchasing movables through leasing. Furthermore, property is much more difficult to sell than e.g. a car if the lessee stops paying the leasing fees or when the leasing contract expires. Sale and lease back of property is used more and more often.

Figure 4.3.2. Value of leased assets, 1998–2005

Value of the leased assets – left-hand scale

Change of the value of leased assets – right-hand scale

Source: Polish Association of Leasing Companies.

Like in previous years, financial leasing predominated, but an increase of demand for operating leasing was also observed. A slowdown in the leasing sector growth resulted from, among others, subsequent changes of the regulations concerning VAT and a decrease in sales in the automobile market (by about 26%), which resulted in a decrease in the growth rate of the leased cars’ value.

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241 The share of road vehicles in the value of movables leased exceeded 60%; see: Wartość środków trwałych oddanych w leasing w okresie 1–4 Q 2005 r., www.leasing.org.pl.
244 Komentarz do informacji statystycznej nt. rynku leasingu za III kwartały 2005 r., www.leasing.org.pl.
246 Sale and lease back is a form of leasing in which an owner of a property sells it to a leasing company; in exchange for that the owner receives funds, and then leases the same property on the basis of an agreement concluded with the leasing company.
as well as leasing property under construction or even still in the planning phase. It is possible, because leasing contracts are concluded for very long periods of time (10, 20 years and longer).

**Figure 4.3.3. Value of movables leased, 1998–2005**

![Graph showing the value of movables leased from 1998 to 2005.](image)

**Table 4.3.1. Changes in the net value and structure of leased assets, 2002–2005 (%)**

<table>
<thead>
<tr>
<th>Year</th>
<th>Moveable leased</th>
<th>Machinery and equipment</th>
<th>Computers and office equipment</th>
<th>Rail, air and water transport means</th>
<th>Road transport</th>
<th>Property leased</th>
<th>Total movable and property leased</th>
</tr>
</thead>
<tbody>
<tr>
<td>2002</td>
<td>42.0</td>
<td>12.0</td>
<td>3.5</td>
<td>80.5</td>
<td>269.8</td>
<td>-57.5</td>
<td>21.7</td>
</tr>
<tr>
<td>2003</td>
<td>42.9</td>
<td>26.3</td>
<td>-20.9</td>
<td>53.2</td>
<td>13.2</td>
<td>11.5</td>
<td>40.7</td>
</tr>
<tr>
<td>2004</td>
<td>16.3</td>
<td>16.3</td>
<td>22.4</td>
<td>214.2</td>
<td>16.4</td>
<td>309.2</td>
<td>24.1</td>
</tr>
<tr>
<td>2005</td>
<td>12.5</td>
<td>49.5</td>
<td>8.3</td>
<td>125.8</td>
<td>-0.6</td>
<td>27.5</td>
<td>14.8</td>
</tr>
</tbody>
</table>

Table 4.3.1. Changes in the net value and structure of leased assets, 2002–2005 (%)

**Prospects**

Due to the expected business improvement, connected with greater investment growth, it is to be expected that the sector will continue to grow at a high rate. Access to EU funds will be favourable to further development of the leasing sector. Most of the funds are allocated for investments and development. The fact that by the end of October 2005 lessors gave approximately 1,400 letters of commitment concerning future financing (103 contracts were signed, amounting to 53.9 million zloty) under the Sectoral Operational Programme 'Improvement of the Competitiveness of Enterprises' proves that lessees widely used financing from the EU Structural Funds. The decision made on 8 December 2005 to exempt applications of entrepreneurs who had received a leasing commitment from another detailed financial analysis by the Polish Agency for Enterprise Development (Polska Agencja Rozwoju Przedsiębiorczości, PARP)248 is important for the future development of the leasing sector in Poland.

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247 Using this form of leasing increases liquidity of enterprises, makes it possible to include the income from leasing instalments in the costs and to reduce tax burden. Value of instalments can be adjusted to the possibilities of the entity, the nature of its activity (e.g. taking into account seasonal character of its activity) and changes in the business outlook. It is also a more flexible form of financing than bank mortgage loans and it can be always converted into a loan.

However, lack of transparent procedures in 2005 made it difficult for entrepreneurs to acquire funds from EU subsidies. The scarce value of the leased agricultural machines reflected the low level of EU funds absorption. In 2005, the share of agricultural machines in the leased assets amounted to 0.2%. It is to be expected that streamlining the procedures for granting subsidies to the agricultural sector will contribute to faster development of agricultural machines’ leasing in the coming years.

Self-government entities, which can use leasing to finance purchasing of fixed assets used for implementation of the so-called ‘own tasks’, did not use this mechanism as widely as possible. The reason might lie in the unfavourable regulations in this regard (the obligation to pay VAT on leasing instalments) and in the fact that this form of municipalities’ investment financing has only recently become available.

In June 2005, Polish Association of Leasing Companies and BIG Consulting started to cooperate. The main objective of this collaboration is to create a platform which would facilitate acquiring credit information on enterprises and natural persons by leasing enterprises. It should decrease the risk taken by the lessors.

“Long term vehicle hire” and car fleet management (CFM) are becoming increasingly popular. Smaller enterprises and natural persons also started to use them. Most of CFM enterprises in Poland start to specialise in servicing of a particular branch, e.g. communications, IT and pharmaceutical enterprises, foodstuffs industry and consulting companies. The importance of this market segment will grow in the future.

It is worth noting that lessors started to carry out securitisation transactions. The first securitisation of leasing assets in Poland was conducted by a leasing enterprise which securitised payments deriving from instalments concerning computer equipment leasing contracts for one of the banks. Securitisation may be an effective method of acquiring capital for development through an issue of securities by leasing companies.

4.3.2. Factoring

Factoring is a type of financial activity consisting in repurchasing receivables from enterprises, due to them on account of goods or services, connected with financing customers and providing additional services to their benefit. It is an extra benefit for the factorers that their receivables are actively monitored and managed by an external company, which improves the payment discipline of the contractors and shortens debt recovery time.

The development of factoring in Poland has been affected by such problems as failing to meet payment deadlines due to low financial discipline of domestic entrepreneurs (the problem concerns in particular the mining, metallurgy and healthcare industries), low efficiency of debt recovery through courts of law, increased competition among suppliers and increase in the public investment level (which is characterized by prolonged payment periods).


250 Based on information provided by BIG Consulting Sp. z o.o. The company offers services concerning, among others, consultancy and mediation as regards cooperation with Economic Information Bureaus (BIG). www.bigconsulting.pl.

251 “Long term vehicle hire” means that the entity which offers financing purchases a vehicle and is its owner, whereas another person or entity uses the vehicle.

252 Enterprises of this type offer services concerning organisational improvements of car fleet management, including selection of a suitable vehicle, overseeing the motor insurance schedule, comprehensive loss settlement, cash-free technical service or savings when buying fuel (car managers usually have ‘wholesale’ agreements with petrol stations networks). Moreover, a fleet of cars acquired via a car fleet management company is not included in the company’s assets. Based on: L. Wilkowicz: “Leasing. Branża czeka na impuls,” Parkiet, branch supplement, 15 December 2005, p. 1; M. Azembska: „Opięknówie aut,” Bank No. 12/2005, pp. 30–31.

253 “Co z tą sekurytyzacją?”, Nasz Rynek Kapitałowy No. 12 (180)/2005, p. 64.

Industry profile and performance

In 2005, factoring services were provided by both banks and 10 specialised enterprises (factors), registered in the Factoring Institutions Conference (Konferencja Instytucji Faktoringowych). The value of purchased invoices amounted to 14.2 billion zloty, and its share in the GDP (1.5%) remained low.\(^{255}\) This proves that the importance of factoring in Poland continues to be limited. For comparison, the ratio of the value of purchased invoices to GDP in the Czech Republic amounted to 2.9%, whereas in Hungary it amounted to 2.1%.\(^{256}\) The greatest number of invoices, like in the previous year, was purchased by one of bank subsidiaries.

In 2005, the global value of factoring services amounted to 1,016.5 billion euro, which represented an increase of 18.2% over the previous year. The value of purchased invoices in EU-25 countries came to 688.5 billion euro, i.e. 6.4% of the GDP. Europe remained the largest factoring services market in the world. Great Britain is the country with the strongest factoring traditions. 100 entities offer factoring services in this country, and the value of purchased invoices, as at the end of 2005, amounted to 237.2 billion euro. Factoring is also popular in Italy, where over 40 entities are active on the factoring market.

In 2005, in Poland factoring services were most often used by companies from foodstuffs (11.6%), energy (10.9%), general services (10.6%), metallurgy (7.7%), steel metallurgy (7.4%) and construction (4.9%) industries.\(^{257}\)

The so called "financial bridge" was introduced as an element of expanding the factoring product offer. The service enables the recipient of the goods to finance the current activity of the enterprise with liabilities to suppliers, while simultaneously granting them a secure and stable source of financing a trade credit. The suppliers receive funds to finance prolonged payment periods, because banks can buy their debt towards the recipient prior to the maturity date.

Prospects

Experiences of other countries may indicate that development prospects lay ahead of the Polish factoring market. Spain and Portugal can be considered examples in this respect. In Spain in 1998 factoring turnover amounted to 1.9% of GDP, whereas in 2004 came to 5.4%, while in Portugal it was, respectively, 5.3% and 10.4%.\(^{258}\)

Many barriers must be removed if Poland is to achieve a level of factoring services development comparable to the situation in these countries. Factoring still belongs to the group of relatively little known financial products. Insufficient knowledge in this respect still may be a barrier for further development of this market in Poland. The reason of relatively small popularity of factoring, if compared to its potential, may be also the fact that it is sometimes perceived as a tool for supporting enterprises in serious financial difficulties.

The development of factoring in Poland is still constrained by legal regulations. Lack of detailed regulations causes problems, even the definition of factoring and the question how to treat factoring settlements pose problems. The Goods and Services Tax Act\(^{259}\) does not contain unambiguous regulations concerning the taxation of factoring services with this tax. The Corporate Income Tax Act\(^{260}\) contains unfavourable regulations which do not allow to recognise losses incurred due to performing factoring services as tax-deductible expenses. Moreover, the Act on Prevention of Financial Circulation of Property Values Originating from Illegal or Undisclosed

\(^{255}\) NBP calculations based on GUS and FIC data. In Poland, factoring services are offered not only by factoring companies, but also by banks. Most of commercial banks that offer factoring services do not publicly announce the value of purchased liabilities. This is why it is impossible to objectively assess the level of development of the factoring market in Poland.
\(^{256}\) NBP calculations based on Eurostat and Factors Chain International data.
\(^{257}\) Data as at the end of September 2005, based on: Procentowy udział obrotów członków KIF w danej branży, KIF, Warszawa 2006, KIF.
\(^{258}\) Based on the data of Factors Chain International and The United Nations Statistics Division.
Sources and on Counteracting the Financing of Terrorism\textsuperscript{261} imposes new duties on factors with respect to information management systems. So far there has been no unambiguous opinion on whether the factors should apply the Act on Payment Dates in Commercial Transactions.\textsuperscript{262} It would protect creditors in business relations, giving them the right to demand legal interest as soon as on the 31\textsuperscript{st} day after the performance of a contract by the creditor, e.g. through delivery of the object of the contract.

Prohibition of claim assignment, used in the business relations by e.g. sales networks, in contracts with the suppliers, makes it impossible for this group of business entities to use factoring services.

Factoring services providers seek a possibility of further development through broadening the group of their services recipients. Self-government entities, to which the services of self-government factoring are directed, without doubt belong to this group.\textsuperscript{263}

\subsection*{4.3.3. Loan and financial brokers}

In 2005, two types of institutions were present on the financial brokerage market: loan brokers and financial brokers. Loan brokers cooperate with one bank and extend loans on its behalf, whereas financial brokers offer various financial products (not only bank products) and cooperate with several financial institutions. Apart from selling savings and credit products of various financial institutions, brokerage companies do also consultancy services.

In 2005, further growth could be observed on the credit intermediation market. The brokers have considerably developed the network of points of sale and cooperated more closely with the banks. The achieved results confirmed the growing role of the brokerage sector in the financial system. In 2005, 13 billion zloty worth loan agreements were signed owing to the brokers; in 1999 this value amounted to less than 5 billion zloty. It is estimated that banks extended half of the so-called quick loans owing to intermediaries. The sales of mortgage loans and credit cards through brokers also increased. The value of mortgage loans extended through this channel grew considerably in 2005, and its market share, according to estimations prepared by the sector, rose to about 15\% (from 7\% in the previous year).\textsuperscript{264} The Internet was an important factor in the process, as it was the main channel of contact with the clients for certain brokers and independent advisers.

\textit{Changes in the structure and profile of the sector}\textsuperscript{265}

Strong competition in the so-called consumer finance sector (Box 4.3.1) resulted in changes in the structure of the financial brokerage sector. Brokerage companies have developed sales networks, creating collaborating (partner) branches through franchising.

Most of major companies on the credit intermediation market continued to be owned by banks or bank groups (Table 4.3.2). Several brokers were included in banking structures. Enterprises independent from financial institutions constitute the majority of brokers, which enables them to cooperate with various banks, insurance companies or investment fund management companies.

\textit{Performance and the offer}

Changes in the sector structure did not affect its results. In 2005, owing to brokers, banks signed loan agreements amounting to 13.2 billion zloty, compared to 11.5 billion zloty in the previous year (Table 4.3.3). This translates into a growth of almost 15\% compared to 2004.

\textsuperscript{261} Act of 16 November 2000 on Prevention of Financial Circulation of Property Values Originating from Illegal or Undisclosed Sources and on Counteracting the Financing of Terrorism (Dz.U. No. 116/2000, item 1216, as amended).
\textsuperscript{262} Act of 12 June 2003 on Payment Dates in Commercial Transactions (Dz.U. No. 139/2003, item 1323).
\textsuperscript{264} Source: M. Krzęśnicks: „Na sukcesy banków zapracowali pośrednicy,” Gazeta Prawna No. 162 (1527), 22 August 2005, p. 9.
\textsuperscript{265} The chapter describes changes concerning solely financial and loan brokers, and not the entire consumer finance market in Poland. The banking sector was presented in Chapter 4.1.
CONSUMER FINANCE MARKET IN EUROPE

The term consumer finance should be understood as loan services and consultancy as regards investment and sale of investment products for individual clients, provided by banks, credit intermediation companies, lending companies and independent financial advisers. The offer of consumer finance companies includes the following types of credits:

1. Consumer credit:
   a) cash credit,
   b) revolving credit, including credit due to credit cards,
   c) instalment credit,
   d) car purchase credit,
   e) refinancing credit.

2. Credit for sole proprietor

3. Residential (mortgage) credit.

The institution representing consumer finance sector on the European market is EUROFINAS – The European Federation of Finance House Associations. The federation came into being in 1959 and associates 14 national associations, with 1,050 credit and financial institutions.

The Federation is the main source of information on the development and performance of regional consumer finance markets. It cooperates with the EU bodies during legislative works relating to the consumer credit market. It is an opinion-forming and lobbyist organization.

In 2004, EUROFINAS associated companies extended or acted as intermediaries in extending of 331 billion euro worth new credits; after the first two quarters of 2005 the value of these credits amounted to over 175 billion euro. For comparison, in the first two quarters of 2004 over 160 billion euro worth new credits were extended. Economic forecasts as at the end of 2005 indicate that European consumer finance market companies will extend credits amounting to over 363 billion euro.

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Table 4.3.2. Characteristic features of selected financial intermediaries and brokers

<table>
<thead>
<tr>
<th>Enterprise name (number of points of service)</th>
<th>Established in</th>
<th>Type of activity</th>
<th>Owner</th>
<th>Comments</th>
</tr>
</thead>
<tbody>
<tr>
<td>AIG Credit (49)</td>
<td>1992</td>
<td>Loan broker</td>
<td>AIG Consumer Finance Group</td>
<td>Established under the name of CLA; taken over by the AIG group in 1998.</td>
</tr>
<tr>
<td>Lukas (4942)</td>
<td>1993</td>
<td>Loan broker</td>
<td>Credit Agricole</td>
<td>Incorporated into Lukas Bank in September 2005.</td>
</tr>
<tr>
<td>Chrobry (900)</td>
<td>1994</td>
<td>Loan broker</td>
<td>GE Money Bank</td>
<td>Since 2005 incorporated into the banks as the Department of the Chrobry’s Agent Network Management.</td>
</tr>
<tr>
<td>Żagiel (200)</td>
<td>1995</td>
<td>Loan broker</td>
<td>Kredyt Bank</td>
<td>Taken over by Kredyt Bank in 2000.</td>
</tr>
</tbody>
</table>

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1 According to: B. Łęczynski, M. Penczar, E. Świątek and others: Biznes i ryzyko na rynku „consumer finance” w Polsce. Raport IBnGR sporządzony dla Konferencji Przedsiębiorstw Finansowych, Gdańsk, November 2005.

All points of service operate under a particular brand (i.e. client service points, own and partner branches, consultants’ and advisers’ offices, regional offices and authorised agencies).

Including the branches of Lukas Bank.


Table 4.3.3. Value and number of loan agreements signed by brokers, 2001–2005

<table>
<thead>
<tr>
<th></th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Value of the signed agreements (PLN billion)</td>
<td>9,482</td>
<td>9,319</td>
<td>8,902</td>
<td>11,558</td>
<td>13,207</td>
</tr>
<tr>
<td>Number of the signed agreements (thousand)</td>
<td>n/a</td>
<td>5,023</td>
<td>5,615</td>
<td>6,596</td>
<td>n/a</td>
</tr>
<tr>
<td>Number of reporting companies</td>
<td>16</td>
<td>14</td>
<td>9</td>
<td>12</td>
<td>11</td>
</tr>
</tbody>
</table>


Analysis of the situation in the sector is difficult due to poor quality of available data. Due to the changes in the sector structure, the analysed group is not uniform. According to the data obtained in 2004, the growth rate of the value of signed agreements was over twice higher than in 2005 (29.8% and 14.3% respectively). The analysis of the same group of brokers in 2004 and 2005 shows that the value of lending increased in the last year by over 50%.266

The new enterprises developed the fastest, some of them increasing the value of signed loan agreements even eight times. A high growth rate is strongly connected with activity profile and the low base effect. The share of selected entities in the credit intermediation market is presented in Figure 4.3.4.

The demand was concentrated in the mortgage loans segment. The share of intermediaries and brokers in the sales of mortgage loans is estimated at around 15%, including the share of Internet companies estimated at around 3%.267

1 All points of service operate under a particular brand (i.e. client service points, own and partner branches, consultants’ and advisers’ offices, regional offices and authorised agencies).

2 Including the branches of Lukas Bank.

266 LUKAS is not included in any of the two periods, and Cetelem (an enterprise incorporated into Cetelem Bank SA) and PTF (which was taken over by Santander group) are not included in the data for 2004. See: Table 4.3.2.

Instalment loans, very popular a few years ago, are now replaced with credit cards. In this sector, brokers are also very active and intensively cooperate with sales networks. Along with credit cards, new loyalty programs are introduced, offering bonus options (discounts, promotions) for regular customers. Credit card sales commission may become the main source of income for the intermediaries in a few years.268

**Organisation of the market**

Quality standards concerning the functioning of the sector are introduced by the organisation of the financial intermediaries in Poland – Financial Enterprises Conference (Konferencja Przedsiębiorstw Finansowych, KPF). Program Council of the Polish Quality Standards, set up in 2005, is to supervise the quality of trainings in order to award certificates to credit intermediation companies. Moreover, in 2005 the Code of Good Practices was adopted and the Ethics Commission started its activity.

In October 2005, the Financial Enterprises Conference established cooperation with EUROFINAS, its European counterpart, which associates industry representatives from the European Union countries. Participation in EUROFINAS grants access to information concerning legislative processes in the EU and rules of consumer finance market entities operating in other countries. From 2006 on, the Financial Enterprises Conference will become a full member of the EUROFINAS.

**Prospects**

The demand for the services of financial brokers and advisers is expected to continue to grow. Announcements of banks, which so far have not been active on the consumer finance market, stating that they will open loan offices confirm that the market has great potential and attracts attention.

Mortgage loans and credit cards sales will probably prevail on the retail services market. Industry representatives estimate that the value of signed loan agreements will grow by around 30% and the share of mortgage loans in the market will grow to approximately 25% (currently it

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268 The sources of income of financial brokers are commissions from the sales of banking products (including most importantly various types of loans). Some products are available only through the intermediaries (e.g. cash credit of one of the banks of the consumer finance segment).
is estimated to about 15%).\textsuperscript{269} It is to be expected that this share will continue to grow due to the fact that:

- customer expectations grow and their knowledge on personal finance improves,
- it is more and more difficult for the borrowers to analyse all the available offers,
- independent brokers have better position in negotiations with a bank than a single customer,
- in 2005, brokers were given the opportunity to act as intermediaries on behalf and on account of entities carrying out brokerage activity (as agents of investment companies).

Growth of the indebtedness of society and the trend to lower the costs of these debts will contribute to the development of consolidation loans and refinance loans, as they make it possible to replace all the monthly payments due to the credit taken earlier with one lower instalment.

Limitation of the interest rates on retail credits (the so-called Usury Act) should not considerably affect the activity of brokers. Most of the products offered by them are compliant with the requirements of the Act. The products may be adjusted by lowering the credit spread (which currently may even amount to 10 percentage points). Availability of loans for less wealthy people may be limited. Lenders will select customers more carefully, since it will be impossible to compensate the increased risk through increasing interest rates.

It is also possible that competition in the segment of higher income customers will increase. Companies which have so far acted as intermediaries, offering credits (with the highest interest rates) for everyone, will now try to build a position in a different segment of the market, where a more careful analysis of the customers’ creditworthiness is required. It will be necessary to invest in scoring systems, allowing to assess financial situation of the borrowers.

Brokers also intend to develop advisory services as regards investment and sales of investment products. They plan to introduce products for wealthy customers, thus entering a market segment which has so far been dominated by the banks. This is undoubtedly a result of growing competition and falling interest rates. It may result in commissions being decreased on the entire retail services market.

\textsuperscript{269} Optimistic forecasts predict even a 50% increase of the share in the next few years. Banks have already noted a considerable increase in credit sales, resulting from, among others, cooperation with the brokers. In some banks almost a half of loans are sold by brokers. Source: K. Orlik: „Czy oni pomogą bankom?”, Bank No. 12/2005–1/2006, p. 35; B. Chochołowski: \textit{Rekordowe wyniki pośredników finansowych www.money.pl}, 14 February 2006 r.; E. Wręcław: „Przybywa pośredników i klientów,” Rzeczpospolita No. 20/2006, 24 January 2006, p. B 7.
4.4. Private equity/venture capital sector

Size of the sector

Private equity/venture capital has been developing in Poland since the beginning of the nineties of the previous century. Even though it is characterised by a high volatility of annual capital raised, investments carried out and low investments to GDP ratio, within the last few years the sector has been systematically developing in terms of quality. Private equity funds were involved in more complex transactions (e.g. leveraged buyouts) than before (mainly enterprises’ financial restructuring) and were more active on the foreign markets, in particular in the former Socialist countries.

Changes observed in the private equity/venture capital (PE/VC) sector in 2005 were of different nature than the ones in the previous year. The increase in the value of private equity investments and – simultaneously – a decrease in the value of funds raised were noted (Table 4.4.1).

Table 4.4.1. Value of investments and funds raised by PE/VC funds in Poland, 2002–2005 (PLN million)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Investment value</td>
<td>529</td>
<td>779</td>
<td>590</td>
<td>620</td>
</tr>
<tr>
<td>Amount of funds raised</td>
<td>475</td>
<td>113</td>
<td>1,378</td>
<td>238</td>
</tr>
<tr>
<td>Number of enterprises financed</td>
<td>86</td>
<td>48</td>
<td>34</td>
<td>25</td>
</tr>
<tr>
<td>Number of enterprises in which funds completed their investment</td>
<td>30</td>
<td>60</td>
<td>41</td>
<td>29</td>
</tr>
<tr>
<td>PE/VC investments as percentage of GDP</td>
<td>0.069</td>
<td>0.098</td>
<td>0.063</td>
<td>0.064</td>
</tr>
</tbody>
</table>

1 The average 2004 NBP exchange rate has been used for calculations: EUR/PLN = 4.5340.
2 The average 2005 NBP exchange rate has been used for calculations: EUR/PLN = 4.0254.
3 I.e. the value of domestic funds investments in Poland, reduced by the value of their foreign investments and increased by investments of foreign funds in Poland.
4 I.e. the value of funds raised by private equity funds based in Poland.

A considerable decrease in the capital raised in 2005 can be mainly attributed to the fact that in 2004 the funds raised enough capital to finance investments scheduled for the next year. Additionally, significant fluctuations on the PE/VC market result from the high level of its concentration in Poland, which means that a single transaction may noticeably affect its development. Also the process of fundraising is worth paying attention to. Fundraising is often carried out outside Poland within the groups managing funds from abroad; however, the funds are allocated for investments in the region. Available statistical figures present information only on the amount of funds raised by the funds based in Poland.

In terms of the PE/VC to GDP ratio the Polish private equity sector still remained underdeveloped in comparison with other European countries. In 2005, the figure in twenty European countries amounted to 0.42% (an increase by approximately 0.09 p.p. compared with 2004 figure), while in Poland within the last few years it remained below 0.1% (0.064% in 2005) (Figure 4.4.1).

270 The meaning of venture capital is narrower than private equity. The terms private equity and private equity/venture capital (PE/VC) are used in this chapter interchangeably. Abbreviation PE/VC is used in order to emphasize that both private equity as well as venture capital sector were subject to analysis.

271 Concentration measured both by the value of investments and the amount of funds raised. For instance, in 2005 more than 90% of investments, in terms of their value, were carried out by one company managing private equity funds in Poland, which also recorded equally high share with regard to the amount of capital raised in 2004.

272 More about the specificity and the course of private equity funds investment process in: Rozwój systemu finansowego w Polsce w 2004 r. Warszawa NBP 2005, p. 95. In 2005, the value of Polish funds investments abroad dropped, the same occurred in the case of the foreign funds investments in Poland. Therefore, the increase in investments observed in 2005 may be attributed in full to the Polish PE/VC funds domestic investments.

273 The notion of European private equity sector, as used in this section, comprises 20 countries the statistical figures of which were available. The countries included in the statistics are the following: Austria, Belgium, Czech Republic, Denmark, Finland, France, Greece, Spain, Holland, Ireland, Germany, Norway, Poland, Portugal, Slovakia, Sweden, Switzerland, Hungary, Great Britain and Italy.
However, 2005 was a record year for the European private equity sector both with respect to the value of investments launched (27% increase in comparison with 2004) and the amount of funds raised (over 2.5-fold raise). For the first time since 2002, the value of resources raised by the funds has been higher than the value of investments initiated. Traditionally, a large part of capital raised by the European funds ended up in the portfolios of funds managed by the companies from Great Britain (64% of funds raised in Europe). France was ranked second (16%), while Germany third (4%).

Similarly as in previous years, with regard to the origin of the private equity/venture capital sources in Poland, foreign capital prevailed (94.3% of capital raised by the funds in 2005), in particular coming from the United States. However, the structure of investors providing PE/VC capital was subject to a significant change (Figure 4.4.2). It was a result of a considerable drop in the value of resources raised by the funds in 2005, which in turn caused a substantial shift in the structure of the capital sources (Table 4.4.1). While the share of pension funds fell from 52.9% in 2004 to zero in 2005, the share of private individuals grew from 0.2% to 50%. Nonetheless, a difference in the funds origin in the case of Polish and European private equity/venture capital sector still remained very prominent.
The largest private equity/venture capital funds’ providers in 2005 in Europe were pension funds (24.8%) and banks (17.6%). On average over 50% of capital raised annually by the European funds comes from domestic sources, however in some countries – similarly as in Poland – the share of foreign capital is very high, e.g. in the Czech Republic (100%), Hungary (approximately 80%), Sweden (78%) and Portugal (76%).

In 2005, no significant changes in a geographical structure of investments of the Polish companies managing private equity/venture capital funds were observable. Approximately 70% of investment value constituted the investments launched in Poland while the remaining 30% were those carried out in other European countries.

![Figure 4.4.3. Investments of private equity/venture capital funds based in Poland](image)

However, the breakdown of PE/VC investments by industry changed. 42.7% of the projects (in terms of their value) launched in 2005 were in the field of consumer goods (in 2004 it constituted merely 4%). An increase in investments was also observed in IT and production industries while the funds’ interest in telecommunications and media as well as financial services decreased. There was no involvement in the projects in the field of biotechnology. In Europe, consumer goods (27.6%), telecommunications and media (in total 15.4%) had the largest shares by value. As in previous years, the expected allocation of capital raised by the funds pertained to the projects at more advanced stages of development and out of high tech industry (58.5% of funds raised).

As opposed to the situation in the previous year, in 2005 the amount of divestments in Poland increased. In terms of value, trade sale ranked first (64.1%). Divestments by way of public offering were executed with regard to 9 enterprises (in 2004 only 5) which constituted 19% of the total divestment value in 2005. Three out of 9 companies carried out divestments by an initial public offering (Opoczno, Teta, Polish Energy Partners).

**Trends and prospects**

Private equity/venture capital sector is a relatively small segment of the capital market in Poland. Due to its specificity (length of investment process, susceptibility to changes – e.g. connected with tax system modifications or stock exchange economic climate) it is difficult to predict the trends in the sector in the short term (i.e. on a yearly basis). Nonetheless, a rapid development of private equity/venture capital in Europe within the recent period as well as better conditions for divestments due to WSE development allow us to conclude that the value of PE/VC investments in Poland will be growing in the coming years. The number of companies managing funds should not be subject to significant changes since their capital output ratio is adequate to the current size of the Polish market. Also the activity of such groups like Lewiatan Business Angels

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(set up in 2005 by the Polish Confederation of Private Employers) and PolBAN (operating since December 2003) which associate private investors with disposable capital for investments at earlier stages of development\textsuperscript{277} shall contribute to the market development in Poland. Additionally, the Sectoral Operational Programme ‘Increase of the Competitive Power of Enterprises for years 2004-2006’, co-financed from the European Regional Development Fund,\textsuperscript{278} established in Poland under the National Development Plan, provides for financial support for setting up seed capital funds (i.e. funds financing projects at their initial stages of development)\textsuperscript{279} until the end of 2006. Also the National Capital Fund (KFK), established on 1st July 2005,\textsuperscript{280} is to be co-financed from the EU resources. The objects of KFK activity comprise financial support for the venture capital funds. However, until the end of 2005 the Fund didn’t start to operate due to lack of relevant administrative ordinances.

In 2005, Polish private equity/venture capital funds were active both within the country and abroad (in particular in Romania, Czech Republic and Slovakia). Company buyout transactions were increasingly common (in 2005 one of the biggest leveraged buyout transactions in Central and Eastern Europe was executed), which also indicates that the level of market development improves. Therefore it may be stated that in Poland there is a clearly observable trend for investing in large enterprises. The reason for such a situation is that the rate of return realised by the funds on such investments is simply higher.\textsuperscript{281}

In 2005, there occurred two events which may have influence on the private equity sector in Poland. First of them was the launch of the Internet Information Platform (Start Platform)\textsuperscript{282} which allows the entrepreneurs looking for the sources of project financing to get in touch with potential investors (e.g. with PE/VC funds). This platform is a join undertaking of the Polish Agency for Enterprise Development and Warsaw Stock Exchange (WSE). It shall be noted that within such a short period of its activity more than 1/3 of private equity funds present on the Polish market declared their intent to join in (as Qualified Investors). At the moment it is still too early to assess the Platform’s effectiveness. However, it seems that it might also be a good platform for promotion of knowledge on the activities of private equity funds in Poland. The other event important for the development of private equity sector in Poland was the fact that in October 2005 the Act on Certain Forms of Support for Innovative Activity came into force.\textsuperscript{283} The Act provides for the possibility of taking out by the companies of the so-called ‘technological loan’ which is facilitated by the Bank Gospodarstwa Krajowego (BGK) under the Technological Loan Fund established there within.\textsuperscript{284} Moreover, the Act lays down a tax relief for the companies introducing new technologies as well as a possibility of establishing R&D units and deducting VAT on R&D services. Stimulation of the Polish economy innovation is crucial for the private equity sector development since Poland exhibits one of the lowest innovation rates in Europe.\textsuperscript{285} The increase in the number of newly established enterprises, providing innovative products and services, extends the range of investment possibilities for the private equity funds, and in turn contributes to possibility of realising higher profits.

In terms of the amount of capital raised by the funds, the year 2005 was record for the entire European private equity sector. It turned out that the funds specialising in the leveraged buyout transactions were particularly attractive for the investors since most of the capital raised ended up

\textsuperscript{277} To get more information on the subject, see: www.lba.pl, www.polban.pl. The total value of investments executed in 2005 in which PolBAN participated was over PLN 1 billion.

\textsuperscript{278} European Regional Development Fund.

\textsuperscript{279} To get more information on the subject, see: www.parp.gov.pl.


\textsuperscript{281} K. Wasilewska: Inwestycje na rozdrożu. Integracja Europejska, 1st November 2005 (the article available at www.psik.org).

\textsuperscript{282} Platform’s Internet site: https://start.info.pl.

\textsuperscript{283} The Act of July 29, 2005 on Certain Forms of Support for Innovative Activity (Dz.U. of 2005, No. 179, item 1484).

\textsuperscript{284} For the period 2005–2006 there has been PLN 150 million allocated for the fund. The resources allocated for the fund are to be specified each year in Budget Act and transferred to BGK through the Ministry of Economy.

\textsuperscript{285} It is calculated as a ratio of R&D expenditures to GDP as well as by the number of patent reports per 1 million of inhabitants.
in their portfolios. The above-mentioned fact as well as the increasing competition for investment capital between the private equity and hedge funds were the reason why some authorities supervising financial markets began to pay particular attention to banks exposure to private equity funds\textsuperscript{286} and a potential impact it may have on the domestic banking systems stability.\textsuperscript{287}


\textsuperscript{287} Financial Stability Review, No. 7, November 2005, Banque de France, p. 19, Box 2: Risks associated with the sharp increase in LBOs in Europe.
4.5. Collective investment institutions

The collective investment institutions (CII) include investment funds and pension funds. Unit-linked products have not been analysed in this chapter.

4.5.1. Investment funds

Size and growth of the sector

At the end of 2005, the net value of assets in investment funds (IF) amounted to 61.3 billion zloty (increase by 63.3%) (Figure 4.5.1). The increase resulted mainly from the inflow of new funds to the funds (approximately 18.5 billion zloty) and, to a lesser extent, from the change in the valuation of assets. The investors’ strong willingness to purchase units in investment funds resulted from the bull market on the Warsaw Stock Exchange (WSE) as well as from the wide product offer of Investment Fund Management Companies. The decrease in interest rates facilitated making profits from the increase in prices of debt securities which remained the most important item in the investment portfolio (Figure 4.5.4).

At the end of 2005, there were 23 investment fund management companies (increase by 3 entities). The ownership structure of new investment fund management companies was significantly different that the structure of the existing ones, i.e. the structure based on links with large capital groups. Two companies were established by domestic natural persons. It was possible owing to amendments to the Act on Investment Funds of 2004, which decreased the required initial capital of an investment fund management company from 3 million zloty to the equivalent of 125 thousand euro.

The Act on Investment Funds, which entered into force on 1 July 2004, was a stimulus for a greater diversification of the structure of the investment funds sector. The funds with the structure and types provided for in the new legislation began to operate as late as in 2005. From among 42 investment funds established under the license of the Polish Securities and Exchange Commission granted in 2005, 15 relied on new solutions proposed in the above-mentioned Act (Table 4.5.3). The number of closed-end investment funds began to grow dynamically, with 17 new funds established in 2005, including 4 securitisation funds (Box 4.5.2) and 3 real estate funds. Owing to

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288 Analizy Online data.
289 Units in collective investment undertakings include participation units and investment certificates.
290 Four entities began to operate but two investment fund management companies, namely Towarzystwo Funduszy Inwestycyjnych Kredyt Bank SA and Warta Towarzystwo Funduszy Inwestycyjnych SA, merged.
291 Article 49 para. 1 of the Act on Investment Funds of May 27, 2004 (Dz.U. No. 146/2004, item 1546, as amended).
the more flexible investment limits, the closed-end investment funds can use a greater number of financial instruments and create an investment portfolio adjusted to the customer’s needs through the issue of non-public certificates. From among 36 closed-end funds which obtained the authorisation of the Securities and Exchange Commission by the end of 2005, 11, including 8 newly created, declared to issue non-public investment certificates.

Box 4.5.1

CATEGORIES, TYPES AND STRUCTURES OF INVESTMENT FUNDS

The Act on Investment Funds of 2004 introduced a clear-cut division between the category, type and structure of an investment fund.

In Poland, investment funds may operate as open, specialised open and closed-end funds. They differ in respect of acceptable assets classes and investment limits, type of units in collective investment undertakings issued by the fund and governing bodies (board of investors, investors’ meeting).

The structure of an investment fund is expressed in its organisational structure, links between the individual elements of the fund (subfunds, affiliated funds) and in the method used to charge the investors with fees. The regulator introduced new fund structures within the three categories of investment funds:

– funds with various participation unit categories;
– funds with separate subfunds (umbrella funds);
– master-feeder (hub and spoke) funds.

Categories and structures of investment funds may overlap creating various configurations.

The type of investment fund depends on its investment policy. The regulator distinguished the following types of funds:

– ‘money market funds’;
– exchange traded funds;
– securitisation funds;
– private equity funds.

The Act prevents a free combination of various types and categories of funds. The above-mentioned funds are assigned with categories under which they may be created.

Table 4.5.1. Structures, types and categories of investment funds

<table>
<thead>
<tr>
<th>Structures and types of investment funds</th>
<th>Open investment fund</th>
<th>Specialised open investment fund</th>
<th>Closed-end investment fund</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fund with various participation units categories</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Umbrella fund</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Master fund</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Feeder fund</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>‘Money market fund’</td>
<td>Yes</td>
<td>No</td>
<td>No</td>
</tr>
<tr>
<td>Exchange traded fund</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
<tr>
<td>Private equity fund</td>
<td>No</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Securitisation fund</td>
<td>No</td>
<td>No</td>
<td>Yes</td>
</tr>
</tbody>
</table>

Note: Private equity fund may be a specialised open fund if it implements the investment policy of a closed-end fund. Source: B. Jawdosiuk, K. Radoś: Poradnik inwestora. Fundusze inwestycyjne. Warszawa 2004, KPWiG.

1 The freedom to combine various categories and structures is limited only in the case of funds with various categories of participation units which cannot be created as closed-end funds.

292 Specialised open investment funds also allow to reduce the range of buyers of the participation units through the appropriate provisions in the fund’s statutes.
The law imposes an obligation to register certain investment funds as closed-end funds. This refers to securitisation funds, exchange traded funds and private equity funds (Table 4.5.4). Due to the diversity of investment policies, closed-end funds were seldom created as equity funds, bond funds or mixed funds. Closed-end funds most often use non-standard investment portfolio structure.

The funds wishing to use the name of 'money market funds' were obliged either to transform their investment policy in compliance with the new legal requirements, or to change their name. Money market funds may invest their assets only in money market instruments and in deposits with maturity not longer than one year. The maximum average time (weighted by the value of deposits) to the maturity of the investment portfolio of a money market fund cannot be longer than 90 days. At the end of 2005, out of 25 funds investing on the money market only 6 used the name 'money market fund', including 3 newly created funds.

Some of the funds which began to operate in 2005 conducted similar investment policy to that of hedge funds. They vowed to post profits irrespective of the situation on the financial markets and declared that they will not follow benchmark. In addition, fund managers invested not only the customers’ resources but also their own funds as their remuneration depended on the achieved investment results.

Table 4.5.2. Number of investment funds in Poland, 2002–2005

<table>
<thead>
<tr>
<th>Type of Investment Fund</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open investment funds</td>
<td>85</td>
<td>91</td>
<td>107</td>
<td>134</td>
</tr>
<tr>
<td>Specialised open investment funds</td>
<td>23</td>
<td>24</td>
<td>24</td>
<td>20</td>
</tr>
<tr>
<td>Closed-end investment funds</td>
<td>16</td>
<td>22</td>
<td>23</td>
<td>36</td>
</tr>
<tr>
<td>Total</td>
<td>124</td>
<td>137</td>
<td>154</td>
<td>190</td>
</tr>
</tbody>
</table>

1 Data refer to the funds which obtained the consent of the Securities and Exchange Commission.
2 Data for 2002–2004 for the closed-end investment funds include closed-end funds, specialised closed-end funds and mixed funds.
Source: KPWiG.

Table 4.5.3. Number of investment funds established in 2005 according to new types and structures

<table>
<thead>
<tr>
<th>Structures of Investment Funds</th>
<th>Established in 2005</th>
<th>Types of Investment Funds</th>
<th>Established in 2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Funds with various participation unit categories</td>
<td>5</td>
<td>&quot;Money market funds&quot;</td>
<td>3</td>
</tr>
<tr>
<td>Umbrella funds</td>
<td>4</td>
<td>Exchange traded funds</td>
<td>0</td>
</tr>
<tr>
<td>Master funds</td>
<td>0</td>
<td>Securitisation funds</td>
<td>4</td>
</tr>
<tr>
<td>Feeder funds</td>
<td>0</td>
<td>Private equity funds</td>
<td>1</td>
</tr>
</tbody>
</table>
Source: KPWiG.

Although the customers of investment funds may include both natural and legal persons, the funds concentrated on individual customers. At the end of 2005, the savings of those customers amounted to approximately 82% of net assets of the funds. In 2004, the figure was lower by one percentage point. New resources deposited in the investment funds in 2005 came mainly from natural persons.

In 2005, the Act on Investment Funds was amended as a result of the adoption of three new acts which replaced the Act on Public Trading in Securities. The amendments to the Personal

293 The private equity fund may also be established as a specialised open investment fund but only when it implements investment policy of a closed-end fund.
294 Later in the text we use a broader definition of ‘money market funds’ as funds investing in money market instruments.
295 Analizy Online data.
Income Tax Act and the Corporate Income Tax Act removed the obligation to pay the capital gains tax in the case of redemption of participation units related to the conversion of units between the subfunds of the same investment fund.296 The lack of the specific tax issues related to umbrella funds was (until the amendment was introduced) perceived as a factor which limited the development of this part of the investment funds sector. However, according to the market participants, the existing legal regulations were not favourable for the transformation of funds into entities with separate subfunds.297 One of the explanations may be the fact that the participation units of the subfund could not differ in terms of the method of charging management fees despite the fact that they could differ in terms of contribution fees. It means that under the Act two fund structures, namely funds with separate subfunds and with different categories of participation units, cannot be fully merged.298

Table 4.5.4. Comparison of open investment funds (OIF), specialised open investment funds (SOIF) and closed-end investment funds (CIF)1

<table>
<thead>
<tr>
<th></th>
<th>OIF</th>
<th>SOIF</th>
<th>CIF</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Type of issued participation interest</strong></td>
<td>Participation units</td>
<td>Participation units</td>
<td>Public and non-public investment certificates</td>
</tr>
<tr>
<td>Investors</td>
<td>No limits</td>
<td>Possible limit on participation</td>
<td>No limits in the case of public certificates</td>
</tr>
<tr>
<td>Repurchase of units in collective investment undertakings</td>
<td>On demand, by the fund</td>
<td>Specified in the statutes</td>
<td>The fund may repurchase the certificates at the request of the participant or independently, the repurchase conditions are laid down in the statutes, in the case of public certificates – trading on the stock exchange</td>
</tr>
<tr>
<td>Valuation of assets</td>
<td>At least once in seven days</td>
<td>At least once in seven days</td>
<td>At least once in 3 months and seven days before the beginning of subscription for the certificates of another issue</td>
</tr>
<tr>
<td>Board of investors</td>
<td>No</td>
<td>Laid down in the statutes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

**Selected investment limits**

<table>
<thead>
<tr>
<th>Investment limits</th>
<th>OIF</th>
<th>SOIF</th>
<th>CIF</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short sale</td>
<td>No</td>
<td>Yes/No2</td>
<td>Yes</td>
</tr>
<tr>
<td>Borrowing of securities</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Granting of loans, guarantees</td>
<td>No</td>
<td>Yes/No2</td>
<td>50%</td>
</tr>
<tr>
<td>Taking loans</td>
<td>10%</td>
<td>Yes/No2</td>
<td>75%</td>
</tr>
<tr>
<td>Foreign currencies</td>
<td>No</td>
<td>Yes/No2</td>
<td>20% in a foreign currency of one country or in euro</td>
</tr>
<tr>
<td>Receivables</td>
<td>No</td>
<td>Yes/No2</td>
<td>Yes</td>
</tr>
<tr>
<td>Shares in limited companies</td>
<td>No</td>
<td>Yes/No2</td>
<td>Yes</td>
</tr>
<tr>
<td>Real estate, buildings and structures, sea vessels</td>
<td>No</td>
<td>Yes/No2</td>
<td>Yes</td>
</tr>
<tr>
<td>Securities or transferable property rights representing rights to precious metals</td>
<td>No</td>
<td>Yes/No2</td>
<td>Yes</td>
</tr>
</tbody>
</table>

1 The investment limits are stated as percentage of the fund’s assets.
2 Specialised open investment funds may apply rules and investment limits of closed-end funds provided that the participants of the fund consist only of legal persons, organisational units without the legal personality and natural persons who make a one-off payment of at least 40 thousand euro to the fund. Otherwise, the provisions on open investment funds are applied.


297 Article 162 of the Act on Investment Funds of May 27, 2004 (Dz.U. No. 146/2004, item 1546, as amended).

298 Funds with various participation unit categories may differentiate the method of collecting administration fees or fees which burden the assets of the fund.
At the end of 2005, 22 foreign investment funds could dispose of their units in Poland. The majority of notified entities had the form of umbrella funds. Having taken into account the number of all subfunds, it was established that the offer of foreign funds in Poland was wider than the offer of Polish ones. Polish funds did not undertake any measures aimed at the distribution of their participation units in other EU Member States. One of the factors which hampered sector development and decreased its ability to compete on the EU Member States markets included excessive capital requirements in respect of investment fund management companies, which were laid down in previous regulations in force. According to these provisions, investment fund management companies were obliged to maintain equity amounting to 25% of costs from the previous year. Following the amendment of the Act on Investment Funds, their equity cannot be lower than 25% of the difference between the total costs and the variable distribution costs. The new provision is compliant with the EU law, as stated in the Directive 93/6/EEC on the capital adequacy of investments firms and credit institutions, which stipulates that equity should be equivalent to one quarter of the preceding year's fixed overheads.\(^{299}\) Another reason for the lack of expansion of the Polish investment funds may be the fact that their foreign owners are already present on other markets.

At the end of 2005 the net assets of Polish investment funds accounted for 0.24% of the total assets of investment funds in Europe.\(^{300}\) The market share of the funds from three European countries, i.e. Luxembourg, France and Germany, exceeded 57%. The net assets of European funds increased by 22.8% and amounted to 6.6 trillion euro at the end of 2005.

In 2005, Poland recorded the largest growth of net assets of investment funds from among all countries associated in the European Fund and Asset Management Association (EFAMA). In terms of nominal values, Poland remained a leader among the countries from the region (Figure 4.5.2). As regards the investment funds assets measured as percentage of the GDP, Hungary remained the regional leader.

**Figure 4.5.2. Investment fund assets as percentage of GDP in Poland, Czech Republic and Hungary, 2004–2005**

\[\text{Figure 4.5.2. Investment fund assets as percentage of GDP in Poland, Czech Republic and Hungary, 2004–2005}\]

Concentration and competition

In 2005, the concentration of the sector measured by the market share of the three largest companies decreased. The downward trend has been maintained since 2003. The main reason behind the situation in 2005 was the fact that the growth of net assets managed by the leading company was lower than the growth of assets of the entire sector (Table 4.5.5). The Herfindahl-

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\(^{299}\) The only discrepancy between the Polish act and the EU directive results from the lack of the definition of the “preceding year’s fixed overheads” in Polish law. Parliament document No. 3318, www.sejm.gov.pl.

\(^{300}\) The calculations include the funds classified as UCITS (open funds in Poland) and non-UCITS (closed-end and specialised open funds in Poland). Data of the European Fund and Asset Management Association.
Hirschman index also confirms the decrease in the concentration of the investment fund management companies sector. The change resulted from a significant loss of the market share by the largest company (34.46% in 2004, 31.39% in 2005).

Table 4.5.5. Investment fund management company concentration indices, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>19</td>
<td>17</td>
<td>20</td>
<td>23</td>
</tr>
<tr>
<td>CR31 (%)</td>
<td>58.10</td>
<td>57.97</td>
<td>55.09</td>
<td>54.92</td>
</tr>
<tr>
<td>HHI2</td>
<td>0.1423</td>
<td>0.1494</td>
<td>0.1603</td>
<td>0.1469</td>
</tr>
</tbody>
</table>

1 Due to a relatively small number of entities in the sector, the CR3 indicator and not CR5 was applied. In CR3, the concentration of the sector is measured by the market share of the three largest companies, in terms of net assets of funds managed.

2 Herfindahl-Hirschman index.

Source: NBP calculations based on data of the Chamber of Fund and Asset Management.

The competition in the investment fund sector was intense. The distribution network of units was developed. Investment fund management companies broadened their product offer. The data of the Securities and Exchange Commission show that 92 entities could act as intermediaries in the sale and repurchase of units (mainly banks and brokerage houses) in 2005. The vast network of branches allowed them to distribute the units via banks and reach a wide range of customers, which is why the major inflows of resources in 2005 occurred in investment fund management companies with capital links with banks.

It may be stated that the emergence of investment fund management companies did not have a significant impact on the competition within the sector and the sector concentration. The non-public nature of offers and highly specialised investment activities of the funds managed by the new investment fund management companies resulted in a relatively low inflow of resources to those funds.

It seems that the funds’ increased investment possibilities and wider offer owing to the introduction of new types and structures of investment funds became an incentive for the offering of new products by the companies. However, there was no direct relationship between the number of funds created by individual investment fund management companies in 2005 and the inflow of funds to those companies.

**Asset structure**

In 2005, there was a significant change in the structure of the investment fund sector. The domestic bond funds, which had the largest share in the market in terms of the amount of managed assets, lost their leading position. The stable growth funds and balanced funds achieved a higher asset value than the bond funds. The hybrid funds, foreign equity funds and other funds reported a higher growth of the assets than the entire sector. The large growth of net assets of foreign equity funds and other funds resulted from the low base effect (Table 4.5.6).

Only the funds classified as stable growth funds and foreign equity funds had a positive balance of inflows and outflows each month. Non-classified funds and money market funds were stable with regard to the inflow of new resources. However, it must be remembered that the majority of the customers of money market funds are institutional investors who treat them as an alternative to bank deposits. The enterprises deposit their liquid resources which may be withdrawn from the fund at any time.

The funds investing in Polish equity were the most sensitive to price fluctuations on the financial markets. The uneven inflow of resources to equity funds reflected the uncertainty related to the changes in value of shares listed on the stock exchange. The outflow of capital from the Polish bond funds began in August 2005.
Table 4.5.6. Net assets of particular investment fund types, 2002–2005 (PLN billion)

<table>
<thead>
<tr>
<th>Fund type</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>Change 05/04 (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic equity</td>
<td>1.0</td>
<td>2.3</td>
<td>4.8</td>
<td>6.6</td>
<td>37.0</td>
</tr>
<tr>
<td>Domestic bond</td>
<td>15.4</td>
<td>13.5</td>
<td>8.1</td>
<td>10.7</td>
<td>32.4</td>
</tr>
<tr>
<td>Money market</td>
<td>4.2</td>
<td>5.4</td>
<td>5.1</td>
<td>8.1</td>
<td>57.3</td>
</tr>
<tr>
<td>Stable growth</td>
<td>0.5</td>
<td>5.0</td>
<td>7.1</td>
<td>14.8</td>
<td>108.6</td>
</tr>
<tr>
<td>Balanced</td>
<td>1.0</td>
<td>2.9</td>
<td>6.1</td>
<td>11.5</td>
<td>87.2</td>
</tr>
<tr>
<td>Foreign equity</td>
<td>0.1</td>
<td>0.1</td>
<td>0.3</td>
<td>0.8</td>
<td>179.9</td>
</tr>
<tr>
<td>Foreign bond</td>
<td>0.4</td>
<td>3.0</td>
<td>4.0</td>
<td>4.4</td>
<td>9.6</td>
</tr>
<tr>
<td>Other</td>
<td>0.4</td>
<td>0.6</td>
<td>2.0</td>
<td>4.5</td>
<td>125.5</td>
</tr>
<tr>
<td>Total</td>
<td>23.0</td>
<td>32.9</td>
<td>37.5</td>
<td>61.3</td>
<td>63.5</td>
</tr>
</tbody>
</table>

Note: Data for 2005 are preliminary data.
Sources: IZFiA, Analizy Online.

The generated rates of return were not a decisive criterion for the selection of the investment fund type by the investors. The investors optimized the risk-return trade-off by choosing mainly hybrid funds.

The analysis of assets by categories of investment funds shows that in 2005 the sector was dominated by open funds.\(^\text{302}\) Their market share measured by the net asset value exceeded 85%. The assets of closed-end funds increased rapidly and at the end of 2005 those funds managed the assets worth over 3 billion zloty.\(^\text{303}\) Specialised open investment funds recorded the lowest growth of assets and suffered a relative loss of importance (Table 4.5.7).

In 2005, significant changes to the structure of the funds’ investment portfolio took place. In the first half of the year, there was a significant increase in investments in the Polish Treasury bonds while the share of stocks and Treasury bills decreased. It resulted from a large inflow of resources to the domestic bond funds. In the second half of 2005, the share of stocks in the funds’ net assets increased as a result of the inflow of new resources to the funds which invest some of their assets in equity securities (Figure 4.5.4).

\(^{302}\) From among 23 European countries associated in the EFAMA, the non-UCITS funds exceed the ECITS funds only in Germany. The average share of the assets of the UCITS funds in the whole European funds market amounted to 79% at the end of September 2005.

\(^{303}\) Data of the Chamber of Fund and Asset Management.
Table 4.5.7. Net assets of individual types of investment funds, 2002–2005 (PLN billion)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open investment fund</td>
<td>18.3</td>
<td>27.2</td>
<td>30.7</td>
<td>53.0</td>
</tr>
<tr>
<td>Specialised open investment fund</td>
<td>2.5</td>
<td>4.5</td>
<td>5.1</td>
<td>5.2</td>
</tr>
<tr>
<td>Closed-end investment fund</td>
<td>1.4</td>
<td>1.8</td>
<td>1.1</td>
<td>3.1</td>
</tr>
<tr>
<td>Total</td>
<td>22.2</td>
<td>33.5</td>
<td>36.9</td>
<td>61.3</td>
</tr>
</tbody>
</table>

1 Data for 2002–2004 for closed-end investment funds include closed-end funds, specialised closed-end funds and mixed funds.

Note: Data for 2002–2004 come from the Central Statistical Office and concern the funds which had an obligation to prepare financial statements for a given year. Data for 2005 come from IZFiA.

Source: Central Statistical Office and IZFiA.

The structure of the Polish investment fund sector was different than the European model due to the higher share of hybrid funds and a much lesser share of equity funds (Figure 4.5.5). From among all countries associated in EFAMA Poland had the largest share of hybrid funds in the net assets of UCITS funds (45.8%). Another country with a significant share of hybrid funds was Italy where the share of assets invested in such funds amounted to 22.4%. Equity funds were the most popular in Great Britain (over 70% share in the UCITS funds market) and bond funds in Denmark (approximately 59%). Money market funds prevailed in Turkey (around 68% share in the market of UCITS funds).

Investment performance

In 2005, the value of participation units and investment certificates in the majority of the investment funds’ types increased. The only funds that suffered negative investment profitability due to the appreciation of the zloty against the euro were funds which invested their assets on European markets. The depreciation of the zloty against the US dollar had, however, a positive impact on the results of the bond funds which invested in securities in US dollars. Foreign equity funds have improved their performance as compared to 2004. The factor which had a significant impact on their rates of return was a good situation on the European stock exchanges since Polish funds bought mainly securities listed on those markets.

Figure 4.5.4. Structure of the investment funds’ portfolio, 2004–2005

Note: Data for 2005 refer to the figures at the end of June and December 2005.
Source: Central Statistical Office.

304 EFAMA data.
Financial institutions

FINANCIAL SYSTEM DEVELOPMENT IN POLAND 2005

Figure 4.5.5. Investment fund asset structure by type in selected countries and European average, 2005

Note: The „other” category may be overestimated due to the approximation of four other categories. Data in the “Europe” category includes the following countries: Austria, Belgium, Czech Republic, Denmark, Finland, France, Germany, Greece, Hungary, Italy, Liechtenstein, Luxembourg, Netherlands, Norway, Poland, Slovakia, Spain, Sweden, Switzerland, Turkey and Great Britain.
Source: EFAMA.

Table 4.5.8. Rates of return obtained by investment funds, 2002–2005 (%)

<table>
<thead>
<tr>
<th>Funds</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Domestic equity</td>
<td>1.1</td>
<td>35.0</td>
<td>23.8</td>
<td>22.9</td>
</tr>
<tr>
<td>Domestic bond</td>
<td>13.9</td>
<td>2.8</td>
<td>6.0</td>
<td>6.5</td>
</tr>
<tr>
<td>Money market</td>
<td>9.8</td>
<td>5.0</td>
<td>5.0</td>
<td>4.7</td>
</tr>
<tr>
<td>Stable growth</td>
<td>11.0</td>
<td>11.6</td>
<td>10.7</td>
<td>11.6</td>
</tr>
<tr>
<td>Balanced</td>
<td>4.3</td>
<td>17.9</td>
<td>14.4</td>
<td>18.1</td>
</tr>
<tr>
<td>Foreign equity</td>
<td>-27.9</td>
<td>23.7</td>
<td>-11.8</td>
<td>12.2</td>
</tr>
<tr>
<td>Foreign bond</td>
<td>5.2</td>
<td>10.5</td>
<td>-14.9</td>
<td>7.6†</td>
</tr>
<tr>
<td>Investment fund weighted-average</td>
<td>11.7</td>
<td>9.0</td>
<td>8.1</td>
<td>12.0</td>
</tr>
<tr>
<td>Annual average inflation (CPI)</td>
<td>1.9</td>
<td>0.8</td>
<td>3.5</td>
<td>2.1</td>
</tr>
</tbody>
</table>

† The rate of return is a weighted average of the rate of return of foreign bond funds in euro and US dollars.

Note: The rates of return for investment funds are stated as arithmetic averages for a given fund category. The weighted-average for investment funds does not include the unclassified fund group.

Sources: Analizy Online, Central Statistical Office, NBP.

Despite the fact that the rate of return on the WIG index in 2005 exceeded the 2004 level, it did not have any impact on the investment performance of the domestic equity funds. They were lower than in 2004, which could result from the fact that the largest inflow of assets to the equity funds was recorded in the last two months of the year, which is why the fund management entities could not fully benefit from the good condition on the stock exchange (Figure 4.5.6). Money market funds also recorded lower results than in 2004.

The investment performance of Polish funds in 2005 was worse than the results of the European funds. According to the estimates, the annual rate of return of the European equity funds amounted to 27% and totalled 12% for the whole sector of UCITS funds.305

Investment performance vs. risk level

In 2005, the investment activity of the funds was burdened with higher risk than in 2004. It concerned, in particular, the funds which invest some of their assets in shares listed on the Warsaw Stock Exchange. The significant volatility of stock exchange indices had an impact on the increase in risk. Only the entities which invested their assets abroad managed to achieve a higher rate of return in 2005 with a smaller standard deviation than in 2004. In the case of domestic equity funds and money market funds, the undertaking of additional risk did not result in the increase in

305 Data of EFAMA; no information about the rates of return of other categories of investment funds.
Financial institutions

profitability, contrary to expectations. Nevertheless, there was a strong positive linear correlation between the rate of return and the risk, as opposite to 2004 when the correlation was negative.\(^{306}\)

The efficiency of managing investment funds may also be evaluated on the basis of the Sharpe ratio.\(^{307}\) The highest profit to risk ratio was recorded by balanced funds (Figure 4.5.8).

**Figure 4.5.6. Rates of return of domestic equity funds vs. change in WIG, 1999–2005**

![Figure 4.5.6](image)

*Source: IZFA and WSE.*

**Figure 4.5.7. Rate of return to risk ratio in investment funds, 2004–2005**

![Figure 4.5.7](image)

*Notes:*
1. Abbreviations used in this Figure stand for the following: AKP – domestic equity funds, AKZ – foreign equity funds, PDP – Polish bond funds, PDZ – foreign bond funds, RP – money market funds, SW – stable growth funds, ZW – balanced funds.
2. The rate of return has been stated on a monthly basis, while risk has been expressed as the standard deviation for a given fund. 
*Source: NBP calculations based on Analizy Online data.*

**Figure 4.5.8. Sharpe ratio for individual types of investment funds**

![Figure 4.5.8](image)

*Note: Abbreviations used in this Figure stand for the following: AKP – domestic equity funds, AKZ – foreign equity funds, PDP – Polish bond funds, PDZ – foreign bond funds, RP – money market funds, SW – stable growth funds, ZW – balanced funds. 
*Source: NBP calculations.*

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\(^{306}\) The correlation was expressed as a Pearson correlation coefficient. However, it should be noted that the negative linear correlation was caused mainly by the data concerning foreign equity funds and foreign bond funds.

\(^{307}\) The Sharpe ratio is a measure of the efficiency of an investment understood as a risk-adjusted performance return. The indicator informs about the risk premium (expected rate of return above the risk-free interest rate) per unit of incurred risk (measured by the standard deviation). The higher the ratio, the more effective the investment.
New products offered

The year 2005 saw the largest number of new investment funds appearing on the market since 1999. Among the new funds introduced by the Act of 2004, the funds with various participation unit categories enjoyed the greatest popularity. Five such funds were established in 2005 although different fees were charged in the funds already before the relevant regulations were implemented. The essential feature of such funds is to award bonuses to participants who contribute large sums of money. Funds with various participation unit categories may operate only as open funds and specialised open funds.

Box 4.5.2

SECURITISATION FUNDS

Securitisation funds replace the Special Purpose Vehicles in the securitisation process.

Pursuant to the Act on Investment Funds of 2004, securitisation funds may be registered only in the form of closed-end funds. These funds are established as standardised or non-standardised. A standardised fund has a form of a fund with separate subfunds which allows it to differentiate the risk level in individual subfunds. A non-standardised fund cannot be an umbrella fund. Such a structure of a non-standardised fund increases the investment risk, which is why its offer may be addressed only to legal persons, organisational units without the legal personality and natural persons, on condition than the issue price of one certificate is an equivalent of at least 40 thousand euro. A standardised fund has to invest at least 75% of the assets of a subfund in one pool of receivables unless the statutes state otherwise. In the case of non-standardised funds, investments may concern various receivables.

Securitisation funds may prove to be helpful in the restructuring of banks’ loan portfolios. Tax benefits are favourable for the conclusion of agreements between banks and funds. Banks are entitled to include losses from the sale of receivables from loans, which constitute the difference between the amount obtained from the sale and the value of a given receivable, in the tax deductible expenses. Banks are not entitled to such benefits if a party of the securitisation transaction is a capital company.

If the securitisation of banks’ receivables is performed through a securitisation fund, the regulator imposes additional obligations of obtaining the consent of the debtor by the bank and the declaration of the debtor that it is subject to the debt collection for the benefit of the securitisation fund.1

In 2005, four non-standardised securitisation funds were established in Poland. In October 2005, the first agreement on the purchase of receivables from the bank was signed.2

Prospects

Following an insignificant growth of investment fund assets in 2004, there were no expectations of a rapid change in 2005. At the beginning of the year, there was no indication of a rapid increase in assets. The interest in funds increased in the second half of 2005 when a large inflow of new assets was recorded. It seems that the increase in assets will continue in the coming years, particularly in view of the fact that according to the WSE data only 1.4 million Poles invest via investment funds.

The decrease in the share of bank deposits in the households’ savings structure also shows that the savings are transferred from banks to the funds. At the same time the importance of the...

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1 The Banking Act of August 29, 1997, it refers to the agreements concluded after July 1, 2004 (consolidated text, Dz.U. No. 72/2002, item 665, as amended)
Financial institutions

...funds increases at the expense of individual investments, in particular in Treasury debt securities and bank bonds. It may be expected that the trend will continue in the coming years.

The analysis of the development of the Polish investment funds sector so far allows to expect that the popularity of more risky funds (hybrid and equity) will increase. The increase in assets of stable growth funds and balanced funds shows the growing interest of participants in the units related to a higher investment risk, which allow them to obtain higher rates of return. The importance of bond funds and money market funds decreased as a result of the drop in interest rates and high rates of return from investments in hybrid and equity funds.

There are great expectations, particularly on the part of the WSE, related to the establishment of exchange traded funds (ETF). Unfortunately, in 2005 no investment fund management company decided to engage in such an undertaking. An exchange trading fund could be established only as a closed-end fund issuing public investments certificates on a constant basis. Owing to such funds, the purchase of securities reflecting the structure of the whole index is cheaper than a direct investment in individual instruments. It seems that exchange traded funds may play an important role in the investment fund sector in future.

4.5.2. Pension funds

Size and growth of the sector

In 2005, open pension funds recorded a 37.5% increase in net assets. The assets managed by pension companies increased by 23.5 billion zloty as compared to 2004 and amounted to 86.1 million zloty (Figure 4.5.9). Such a large increase was determined by the contributions of 14 billion zloty provided by the Social Insurance Institution (Zakład Ubezpieczeń Społecznych – ZUS) and the increase of the price of assets by 10.3 billion zloty. The investment activity resulted in a 44% increase in net assets of pension funds. This factor increases systematically (30% in 2003, 40% in 2004) and if the good condition on the financial market is sustained, its impact may exceed the role of contributions transferred by the Social Insurance Institution.

The number of members of open pension funds decreased in 2005 to 11.72 million (from 11.98 million in 2004). The number of registered members decreased despite the inflow of over 600,000 new participants. It was the result of measures aimed at lowering the costs of the system operation and increasing its transparency. The measures included the verification of accounts and of the number of open pension funds’ members. Non-active accounts on which no contributions were made were liquidated and the correctness of the register of the funds’ members was verified. The reduction of the number of accounts resulting from the conclusion of two or more agreements by one person coincided with the deletion of those members who failed to meet the requirements of the Act in respect to obtaining membership in open pension funds.

The number of entities managing open pension funds did not change. From among 15 pension companies the ownership structure changed in one. Applications to take over the management of one pension fund were submitted and an agreement on conditional sale of one pension fund was concluded. The changes aimed at market consolidation depend on the consent of the Insurance and Pension Funds Supervisory Commission and may take place in 2006.

In 2005, Poland remained the regional leader in terms of assets managed by pension funds and of the assets as percentage of GDP. In Chile, where the oldest pension system with a mandatory...
capital pillar in the form of a fixed contribution operates, the value of assets was three times higher
than the value of assets of Polish pension funds (Figure 4.5.10).

**Figure 4.5.9. Size and changes in pension fund assets, 1999–2005**

![Graph showing changes in pension fund assets, 1999–2005.](image)

*Source: Insurance and Pension Funds Supervisory Commission.*

**Figure 4.5.10. Pension fund assets as percentage of GDP in selected countries, 2005**

![Graph showing pension fund assets as percentage of GDP.](image)

*Note: Data for Hungary, Mexico, Chile, and Poland include the second mandatory pension pillar, for Czech Republic they include the third voluntary pillar since there are no mandatory pension funds in this country.*

*Source: Data of the central banks of Czech Republic and Hungary, Eurostat and FIAP.*

**Concentration and competition**

In 2005, the concentration on the pension fund sector, measured both by the Herfindahl-Hirschman index and the share of the three largest companies in the market, decreased (Table 4.5.9). The decrease in the market share was reported in particular by the largest and three smallest entities in the sector. The position of middle-sized entities could have been strengthened by the lottery system\(^{313}\) which gives preference to funds with high rates of return and the share in the market not exceeding 10\%.\(^{314}\)

The obtained rate of return was not the most important factor which had an impact on the growth of net assets of the funds. The impact of acquisition activities was stronger. The growth of assets was correlated with the growth of the number of pension fund members (Figure 4.5.11).

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\(^{314}\) However, it should be noted that from among 600,000 new pension funds members, only around 120,000 were subject to lottery.
Table 4.5.9. Concentration indices of pension companies, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number</td>
<td>16</td>
<td>16</td>
<td>15</td>
<td>15</td>
</tr>
<tr>
<td>CR3 (%)</td>
<td>64.95</td>
<td>64.75</td>
<td>64.10</td>
<td>63.74</td>
</tr>
<tr>
<td>HHI</td>
<td>0.1650</td>
<td>0.1646</td>
<td>0.1616</td>
<td>0.1602</td>
</tr>
</tbody>
</table>

1 Due to a relatively small number of entities in the sector, the CR3 indicator and not CR5 was applied. In CR3, the concentration of the sector measured by the market share of the three largest companies in terms of net assets of the managed funds.
2 Herfindahl-Hirschman index.
Source: NBP calculations based on Insurance and Pension Funds Supervisory Commission data.

In 2005, the number of transfers of members between pension funds exceeded 320,000. The figure was equivalent to over a half of new members. It seems that funds could attach much importance to this form of acquiring new customers as an effective method to increase their share in the market since the funds’ assets increased not only by new contributions but also by the value of already collected capital of a newly acquired member.

Asset structure

In 2005, pension funds invested mainly in stocks and Treasury bonds (jointly over 90% of assets). The bond portfolio was dominated by the fixed-rate securities. When the Social Insurance Institution began to repay its obligations towards pension funds due to outstanding, non-transferred contributions, the number of floating bonds in the funds’ portfolio increased. The funds faced serious problems with disposing of such securities without losses and therefore the interest in such bonds was low.315

Apart from stocks and Treasury debt securities, the funds also invested their assets in deposits and bank securities. The value of those investments were characterised by a rather significant volatility throughout a year. It may be suspected that open pension funds decreased or increased their share in deposits depending on the situation on the stock market, thus achieving the desired level of liquidity.

Investments in municipal bonds were characterised by the largest growth of the funds’ assets (increase by around 2,400% in 2005\textsuperscript{316}). In addition, open pension funds invested in revenue bonds.

Within the foreign investment portfolio pension funds concentrated their attention mainly on stocks and non-Treasury debt securities. A large increase in the share of deposits in foreign currencies was recorded in 2005. They amounted to 24% of the funds’ foreign portfolio. At the end of 2005, the value of foreign investments of open pension funds amounted to around 1.5 billion euro.

The structure of the investment portfolio of pension funds depended on the investment limits and size and liquidity of the market of selected financial instruments. The widening of the catalogue of the pension funds’ deposits in recent years and the increasing of position limits did not lead to the increased diversification of the investment portfolio (Table 4.5.10). A very low interest in investing on other markets than stocks and Treasury bonds market resulted mainly from the fact that those markets were not much liquid due to their size and segmentation. In addition, investments in those markets would entail additional costs and could prove to be unprofitable for the managing entity since the level of overheads incurred upon the evaluation of the issue is, to a large extent, independent from its scale. The value of individual issues of non-Treasury debt securities in Poland is low, which in connection with the limit on concentration in securities of a single issue\textsuperscript{317} results in those overheads decreasing the attractiveness of the investment. The failure to use the whole limit for foreign investments entails additional costs charged to pension companies. They have to cover the excess of transaction costs of investments in foreign markets over their equivalents on the Polish market.

In 2005, the attempts were made to introduce significant changes to the set of instruments used in the investment policy of pension funds. On September 13, 2005 the Council of Ministers issued an Ordinance which allowed pension funds to invest in derivatives.\textsuperscript{318} The Ordinance, expected to enter into force on January 1, 2006, was repealed shortly before the end of 2005.\textsuperscript{319} Investments in derivatives were to include forward and futures transactions, options and swaps. The entry into force of the Ordinance was to coincide with the entry into force of the amended Ordinance on the determination of the maximum percentage of assets of an open pension fund that may be invested in individual investment categories as well as additional restrictions regarding the investment activities of pension funds. It would contain precise information on the limit of investments in derivatives, on parties to the transactions, valuation of instruments and underlying instruments. The gradual facilitation of pension funds’ investment in derivatives was to be reflected in the projected 5% position limit. The interest of the fund participants would be protected by an investment objective – derivatives could be used only as a security for the investment portfolio. In addition, investments in derivatives could not influence the increase in exposure to risk for a given category of investments. The regulator intended to introduce a ban on using the financial leverage on derivatives, which was expressed by the order to maintain the funds equivalent to the underlying instrument.

Pension funds expected the category of investments they can make to be extended with derivatives. The possibility to use derivatives by open pension funds would be a way to protect pension savings against unfavourable price fluctuations on the financial markets. Derivatives would allow to protect the stock part of the portfolio against price decreases on the stock exchange and to protect the bond part against interest rates increases. If, in view of the lack of the possibility to invest in derivatives and under unfavourable conditions on the financial markets, open pension funds expected the category of investments they can make to be extended with derivatives. The possibility to use derivatives by open pension funds would be a way to protect pension savings against unfavourable price fluctuations on the financial markets. Derivatives would allow to protect the stock part of the portfolio against price decreases on the stock exchange and to protect the bond part against interest rates increases. If, in view of the lack of the possibility to invest in derivatives and under unfavourable conditions on the financial markets, open pension

\textsuperscript{316} It was the low base effect.

\textsuperscript{317} Article 4 of the Ordinance of the Council of Ministers of 3 February 2005 on the determination of the maximum percentage of assets of an open pension fund that may be invested in individual investment categories as well as additional restrictions regarding the investment activities of pension funds (Dz.U. No. 32/2004, item 276, as amended).

\textsuperscript{318} Ordinance of 13 September 2005 on the investments of a pension fund (Dz.U. No. 186/2005, item 1549).

\textsuperscript{319} Ordinance of 20 December 2005 repealing the Ordinance on the investments of a pension fund (Dz.U. No. 260/2005, item 2180).
funds wanted to reduce their losses, they could only sell profit-making instruments, which may be difficult or even impossible with the decrease in liquidity and a significant value of the portfolio.

The use of derivatives may be related to certain risk, as any form of financial operations. However, it is worth noting that the appropriate risk measurement and diversification of investments lead to efficient use of various financial instruments. The risk management models are commonly applied by financial institutions. They allow these institutions to determine the acceptable level of risk and control it by the supervisory authorities. Derivatives contribute to the understanding of the essence of risk management and its assessment, while at the same time they make the financial system more resilient to potential shocks.320

The extension of pension funds’ investment opportunities with derivatives could also prove to be beneficial for the development of the derivatives market, especially of Treasury bond futures. These contracts are the first instrument on the WSE which allows it to manage the interest rate risk and thus they could become an interesting investment for the funds. The developed market in OTC derivatives would make it possible to efficiently use the discussed instruments.

Derivatives are often used in OECD countries to secure the investment portfolio of pension funds. The funds may also use derivatives for speculative purposes but it refers mainly to non-mandatory forms of savings. In some countries pension funds have the obligation to invest in derivatives in order to ensure the diversification of the investment portfolio (e.g. in Belgium). Derivatives are often acquired through investment funds and the position limits for those instruments fluctuate between 5% and 100%.

Table 4.5.10. Investment limits of pension funds vs. their use, 2005

<table>
<thead>
<tr>
<th>Financial instrument</th>
<th>Investment limit (%)</th>
<th>Use (%)</th>
<th>Value of a given category in the pension fund portfolio (PLN million)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Foreign investments</td>
<td>5</td>
<td>1.72</td>
<td>1,480.0</td>
</tr>
<tr>
<td>Dematerialised unsecured bonds issued by non-public companies</td>
<td>5</td>
<td>0.00</td>
<td>0.0</td>
</tr>
<tr>
<td>Stock, convertible bonds on a regulated OTC market</td>
<td>10</td>
<td>0.12</td>
<td>104.7</td>
</tr>
<tr>
<td>Secured bonds, other than dematerialised, issued by other entities than local government units</td>
<td>10</td>
<td>0.12</td>
<td>105.3</td>
</tr>
<tr>
<td>Unsecured bonds issued by public companies</td>
<td>10</td>
<td>0.09</td>
<td>77.6</td>
</tr>
<tr>
<td>Investment certificates</td>
<td>10</td>
<td>0.29</td>
<td>252.6</td>
</tr>
<tr>
<td>Depository receipts</td>
<td>10</td>
<td>0.00</td>
<td>0.0</td>
</tr>
<tr>
<td>Participation units</td>
<td>15</td>
<td>0.00</td>
<td>0.0</td>
</tr>
<tr>
<td>Deposits and bank securities in zloty</td>
<td>20</td>
<td>3.30</td>
<td>2,849.1</td>
</tr>
<tr>
<td>Revenue bonds</td>
<td>20</td>
<td>0.05</td>
<td>43.1</td>
</tr>
<tr>
<td>Local government authority bonds, other than dematerialised</td>
<td>20</td>
<td>0.00</td>
<td>0.0</td>
</tr>
<tr>
<td>Mortgage bonds</td>
<td>40</td>
<td>0.13</td>
<td>110.3</td>
</tr>
<tr>
<td>Local government authority bonds, dematerialised</td>
<td>40</td>
<td>0.03</td>
<td>29.2</td>
</tr>
<tr>
<td>Secured bonds, dematerialised, issued by other entities than local government units</td>
<td>40</td>
<td>0.01</td>
<td>5.5</td>
</tr>
<tr>
<td>Stocks, subscription rights, convertible bonds on a regulated stock exchange market</td>
<td>40</td>
<td>30.92</td>
<td>26,685.6</td>
</tr>
<tr>
<td>Treasury debt securities</td>
<td>no limit</td>
<td>61.45</td>
<td>53,040.9</td>
</tr>
</tbody>
</table>

Note: The data are presented as of December 31, 2005. Pursuant to the Act on Trading in Financial Instruments of July 29, 2005 (Dz.U. No. 183/2005, item 1538, as amended), dematerialized bonds are registered at the National Depository for Securities. Source: The Insurance and Pension Funds Supervisory Commission and the Ordinance of the Council of Ministers of 3 February 2004 on the determination of the maximum percentage of assets of an open pension fund that may be invested in individual investment categories as well as additional restrictions regarding the investment activities of pension funds (Dz.U. No. 175/2004, item 1814, as amended).

Investment performance

In 2005, the investment performance of pension funds with the highest and the lowest rates of return were only slightly different than in 2004. However, there was a positive change in the average weighted rate of return. It increased by almost 1 percentage point, which confirms that the largest participants of the sector posted better results than in 2004. This may be probably attributed to the increase in liquidity of the markets, facilitated more effective investment of large entities and an increase in stock exchange indices (WIG 20, WIG), which was higher than in 2004.

The minimum required rate of return and the average weighted rate of return were published twice in 2005. The two figures referred to the period of 36 months and were calculated with the use of the principle of reducing the share of the largest entities to 15%. All funds achieved the minimum required rate of return; the amounted to 20.74% in March and to 26.24% in September. Despite a large impact of funds with the highest value of managed assets on the average weighted rate of return, and thus the minimum required rate of return, the analysis of 3-year rates of return published in 2005 does not clearly show that the growth of the fund’s settlement unit depended on the size of the fund (Figure 4.5.12).

Table 4.5.11. Rates of return obtained by pension funds, 2002–2005 (%)

<table>
<thead>
<tr>
<th>Funds</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>The best open pension fund</td>
<td>17.4</td>
<td>16.8</td>
<td>16.7</td>
<td>16.4</td>
</tr>
<tr>
<td>The worst open pension funds</td>
<td>7.1</td>
<td>9.7</td>
<td>11.9</td>
<td>11.2</td>
</tr>
<tr>
<td>Pension fund-weighted average</td>
<td>13.6</td>
<td>10.9</td>
<td>14.0</td>
<td>15.0</td>
</tr>
<tr>
<td>Annual average inflation (CPI)</td>
<td>1.9</td>
<td>0.8</td>
<td>3.5</td>
<td>2.1</td>
</tr>
</tbody>
</table>

Note: The best and the worst open pension funds are the funds with the best and the worst investment performance in a given year, respectively.
Source: Insurance and Pension Funds Supervisory Commission, Central Statistical Office.

Figure 4.5.12. Relationship between net asset value and 36-month rates of return

Source: Insurance and Pension Funds Supervisory Commission.

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321 The reduction referred to only two entities.
322 The funds with assets of a relatively small value achieve the concentration limits of investments in the securities of one entity faster. They are characterised by a smaller discrepancy between the limits on the concentration of assets in the securities of one issuer and the limits concerning the share of fund’s investments in one issue. It is particularly important in the case of small issues.
Investment performance of open pension funds vs. risk level

The investments of pension funds in 2005 were characterised by a higher risk level and a similar difference between monthly rates of return as in 2004. However, the higher risk level resulted from the larger volatility of stock prices within the period, which automatically had an impact on the performance of pension funds. It may be stated that the funds continued to apply similar investment strategies (Figure 4.5.13).

The Sharpe ratio which presents the risk-adjusted return from an investment is useful from the point of view of the evaluation of management efficiency. The increase in investment risks of open pension funds was reflected in a significant decrease in the value of the Sharpe ratio, though it remained positive for all funds. Due to the similar investment portfolio structure, the higher volatility of stock exchange indices was visible in the decrease in the value of the analysed ratio for all funds. The management efficiency may be assessed on the basis of the difference between the value of the ratio in 2004 and 2005. The smaller the difference, the larger the stability of the investment policy in a given fund since in the changing conditions the Sharpe ratio fluctuated the least.

Figure 4.5.13. Open pension fund rate of return against risk, 2004–2005

Note: The rate of return has been stated on a monthly basis, while the risk has been expressed as the standard deviation for a given fund. Source: NBP calculations based on the Insurance and Pension Funds Supervisory Commission data.

Figure 4.5.14. Sharpe ratio for individual open pension funds, 2004–2005

Note: The end of 2004 saw a market consolidation which resulted in the decrease in the number of entities in the sector. Source: NBP calculations.
Prospects

The number of entities participating in the second pillar of the pension system may change in 2006 as a result of measures undertaken in 2005 which aimed at the consolidation of the open pension funds market. The probable changes in the sector’s structure would result from the takeover of management over one open pension fund and the sale of one pension company.

Due to the mandatory character of the pension system, the assets of pension funds will continue to increase systematically. It should not be disrupted by the transfer of accumulated pension capital to the institutions which pay out benefits. In 2035, the capital of the retiring persons will be twice higher than the value of contributions transferred to open pension funds.\(^{323}\) It does not mean, however, that the assets of open pension funds will decrease since they increase not only as a result of contributions’ payments but also owing to profits from investments.

The approaching date when the first pensions are to be paid out within the second pillar of the pension system requires a decision on completion of the pension reform.\(^{324}\) The arrangements in this regard should concern both the form of payouts and the institutions which will make the payments. It is also important that the market of pension benefit payouts will increase gradually and will exceed 1 billion zloty only after 5 years of operation when it covers only around 100,000 people.\(^{325}\) Opposite to open pension funds where the fund member bears the largest risk, the institutions paying out the benefits will be obliged to bear a significant part of the insurance and investment risk. The funds of pensioners, also during the decumulation stage, will be invested on financial markets and the total of pension payouts remains unknown since it depends on the form of the payout, life expectancy, etc.

It has not been decided yet to which institutions the pension capital from open pension funds will be transferred. There is a proposal to establish new specialised entities to pay out pension benefits as well as to use the already existing market structures. It is also essential to open a discussion on the competitive or non-competitive, i.e. multi- or one-entity, concept of the pension payout.

Although annuity is a traditional form of the payout of pension benefits, other forms of are also possible, as indicated by international experience in this regard. The division of products is based on three criteria: number of tranches, number of beneficiaries and the conditions under which benefits are paid out.\(^{326}\) Thus, one can to distinguish one-off payments, spouse pensions or annuities and many other structures. It seems that in view of the diversity of forms of benefits’ payout, the optimal situation – from the point of view of the pension system participants – would be to have the possibility to choose and thus adjust the method of payment to their individual needs.

4.5.3. Collective investment institutions and financial markets

In 2005, the collective investment institutions (CII) received over 30 billion zloty. The majority of the funds were invested on the Polish capital market.

The share of pension funds in both the capitalisation of listed companies and in free float decreased in 2005. As a result of the increase in price of owned participation securities, open pension funds’ position in stocks listed on the WSE increased by 32% although the value of the stocks sold in 2005 exceeded the value of purchased stocks by 936 million zloty.\(^{327}\) Thus, the funds also decreased the share of stocks listed on the WSE in the investment portfolio from 32.8% in

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\(^{323}\) Koszt wypłaty świadczeń z drugiego filara systemu emerytalnego. Warszawa 2005, KNUiFE, p. 11.
\(^{324}\) The first pensions from the second pillar of the pension system are to be paid in 2009.
\(^{325}\) 1 billion zloty is the estimated value of pension capital transferred by open pension funds to the paying institutions within the first 5 years of operation. Wypłata emerytur z II filara nowego systemu emerytalnego. Warszawa 2004, KNUiFE, p. 8.
\(^{327}\) Data of the Insurance and Investment Funds Supervisory Commission.
2004 to 31.4% in 2005. Excessive position in participation securities on the rapidly growing market could be a reason for exceeding the statutory limit by some funds, which would force these funds to sell off assets on unfavourable conditions.

Table 4.5.12. Collective investment institutions on Polish financial market, (%)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Open pension funds’ share in treasury bill and bond market</td>
<td>12.7</td>
<td>17.0</td>
</tr>
<tr>
<td>Open pension funds’ share in WSE free float</td>
<td>22.7</td>
<td>20.0</td>
</tr>
<tr>
<td>Open pension funds’ share in stock exchange capitalisation</td>
<td>9.4</td>
<td>8.6</td>
</tr>
<tr>
<td>Investment funds’ share in treasury bill and bond market</td>
<td>6.5</td>
<td>9.3</td>
</tr>
<tr>
<td>Investment funds’ share in WSE free float</td>
<td>9.7</td>
<td>11.7</td>
</tr>
<tr>
<td>Investment funds’ share in stock exchange capitalisation</td>
<td>4.0</td>
<td>5.1</td>
</tr>
</tbody>
</table>

1 Pension funds’ share includes stocks listed on the WSE primary market.
2 The stock exchange capitalisation includes only domestic companies. In addition, new rules governing the estimation of free float were used for the calculations. More on free float in Chapter 5.2.

Source: Insurance and Pension Funds Supervisory Commission, Ministry of Finance, WSE, Analizy Online.

At the end of 2005, the diversity of the share of stocks listed on regulated (domestic and foreign) markets in the investment portfolios of 15 pension funds amounted to 9 percentage points and their investment performance was not directly proportional to the share of stocks in the investment portfolio (Figure 4.5.15).

Open pension funds’ share in Treasury bills and bonds’ market significantly increased in 2005. The value of Treasury bills and bonds in the pension funds portfolio increased by 45%, with an around 9% increase in the State Treasury debt in the form of the Treasury debt securities. In 2005, pension funds invested mainly in Treasury bonds.

In 2005, the duration of wholesale Treasury bonds portfolio remained stable and fluctuated around 3 years. However, it is worth pointing out that within the first three quarters of 2005 the duration of pension funds’ portfolio was below the duration of investment funds portfolio. Only resident banks had the shorter average maturity period for their debt securities portfolios.

Figure 4.5.15. Share of stocks in the pension funds investment portfolio and the rate of return generated in 2005

Note: The share of stocks in the portfolio was presented as a difference between average monthly share of stocks listed on domestic and foreign regulated markets and the average share of stocks for the whole sector.
Source: NBP calculations based on insurance and Pension Funds Supervisory Commission data.
Due to a very large inflow of new resources to investment funds, they increased their share in the stock and Treasury securities market. The value of stocks listed on the WSE which are part of the investment funds’ portfolio increased by 81%, i.e. by around 7 billion zloty, out of which 2.8 billion zloty were newly acquired securities.\textsuperscript{328} The trend observed in the investment funds sector, opposite to the trend in the pension funds sector, resulted partly from the necessity to invest in stocks. A large part of investors’ resources was invested in hybrid funds which invest a large percentage of their assets in participation securities. Thus the share of stocks listed on the WSE in the net assets of investment funds exceeded 25% (around 23% in 2004).

The 57% increase in the value of Treasury securities in the portfolios of investment funds resulted in the increased share of investment funds in the market of such instruments. At the same time, their share in the whole investment portfolio of investment funds decreased.\textsuperscript{329}

In 2005, the investment possibilities of the CII on the primary stock market were lower than in 2004. The value of IPOs amounted to 6.98 billion zloty, which is slightly more than the half of the amount in 2004. The IPOs are important due to the continuous inflow of resources to pension funds. In addition, the purchase of the stock of new companies by pension funds increases the diversification of the funds’ investment portfolio and decreases the risk of reaching concentration limits.

4.5.4. Occupational Pension Programs and Individual Pension Accounts

The pension system reform implemented in 1999 made it possible to collect additional savings to be used after retirement. At the beginning only Occupational Pension Programs operated but since September 2004 there are also Individual Pension Accounts which jointly comprise the third pillar of the new pension system.

In 2005, there was a significant increase in the number of Occupational Pension Programs. At the end of 2005, there were 906 such schemes (342 in 2004). Such a rapid change resulted from new regulations which imposed an obligation to transform the group forms of collecting funds for pensions into Occupational Pension Programs by December 31, 2005 in order to maintain the right to deduct the expenditure incurred from the base of the social insurance contribution.\textsuperscript{330} From among 597 new programs registered in 2005, 461 were the transformations of the group insurance of employees into Occupational Pension Programs.\textsuperscript{331} At the end of 2005, the number of participants in Occupational Pension Programs amounted to 260,000 (129,000 in 2004) and the value of collected assets was 1,695.5 million zloty (919 million zloty in 2004).

The number of Individual Pension Accounts increased to 427,900 at the end of 2005. In 2005, the entities holding the IPA opened over 252,000 new accounts (increase by over 140%). However, a large increase in the number of new accounts was expected since 105,600 accounts were opened during 4 months of the IPA existence in 2004. As regards the number of opened IPA, the largest share belonged to insurance companies but, in terms of the number of accounts, the importance of banks increased the most (tripled) (Figure 4.5.16).

The value of assets collected in the IPA system in 2005 amounted to 690 million zloty (169 million zloty in 2004), out of which 44.5% were deposited in investment funds. The average balance of the IPA accounts has changed considerably. At the end of 2005, the value of the deposited funds exceeded 1,600 zloty, which represents an increase of almost 70% as compared to 2004 (account balance – 960 zloty). The largest growth of the average account balance was observed in insurance companies, which doubled the balance, and in brokerage entities.

In 2005, 1,628 transfer payments were made from Occupational Pension Programs to IPA and only one payment in the opposite direction. The greater popularity of IPA resulted from the fact

\textsuperscript{328} Analizy Online data.
\textsuperscript{329} Ministry of Finance data.
\textsuperscript{330} More on the subject in Chapter 2.2.
\textsuperscript{331} Data of the Insurance and Pension Funds Supervisory Commission and Dz.U. No. 116/2004, item 1207, as amended.
that the funds deposited there can be returned if any party decides to terminate the agreement and not when the scheme is deleted from the register as it is in the case of with Occupational Pension Programs. However, some restrictions were imposed on the mobility of funds within IPA in the form of the loss of benefits related to the exemption from the capital gains tax. In addition, if the transfer payment from the Occupational Pension Program was made prior to the reimbursement, then the amount subject to reimbursement is reduced by 30% of the total of basic contributions paid to the scheme.332

Restricted availability of the funds deposited with IPA, which results from the lack of the possibility to use them without losing the right to deductions before reaching the retirement age is a significant obstacle to this form of saving. The interest in IPA could increase, among others, through the increase in tax incentives.

Figure 4.5.16. Individual Pension Accounts opened with different institutions, 2004–2005

Source: Insurance and Pension Funds Supervisory Commission.

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332 These contributions are transferred to the Social Insurance Institution and are recorded at the individual account of the insured. The Act on Occupational Pension Programs of April 20, 2004 (Dz.U. No. 116/2004, item 1207, as amended).
4.6. Insurance companies

4.6.1. Size and structure of the insurance sector

Insurance companies

In 2005, no substantial changes were observed with regard to the structure of the Polish insurance market. There were 67 insurance companies conducting business activity, out of which 32 belong to sector I (life insurance sector) and 35 to sector II (personal and property insurance sector, hereinafter referred to as non-life insurance sector). One of the domestic entities of sector II ceased to pursue insurance business.

Table 4.6.1. Insurance companies conducting activity on the territory of Poland, 2000–2005

<table>
<thead>
<tr>
<th></th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Insurance companies</td>
<td>66</td>
<td>69</td>
<td>70</td>
<td>73</td>
<td>68</td>
<td>67</td>
</tr>
<tr>
<td>Sector I – life</td>
<td>32</td>
<td>35</td>
<td>35</td>
<td>35</td>
<td>32</td>
<td>32</td>
</tr>
<tr>
<td>insurance companies</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Sector II – non-life</td>
<td>34</td>
<td>34</td>
<td>35</td>
<td>38</td>
<td>36</td>
<td>35</td>
</tr>
<tr>
<td>insurance companies</td>
<td>1</td>
<td>2</td>
<td>2</td>
<td>3</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Chief branches</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>Sector I – chief</td>
<td>1</td>
<td>1</td>
<td>1</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>branches of life</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>insurance companies</td>
<td>0</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>1</td>
</tr>
<tr>
<td>Sector II – chief</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>branches of non-life</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>insurance companies</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: Insurance and Pension Funds Supervisory Commission.

In 2005, there was one chief branch of a foreign insurance company operating in the Polish insurance sector. It offered non-life insurance contracts and as the entity having been under the authority of the Insurance and Pension Funds Supervisory Commission it was included in the aggregate balance of the insurance sector. There were also branches of insurance companies from the EU Member States which operated on the Polish market; however, they do not fall under the authority of the Polish insurance supervision. Since 1 st May 2004, i.e. the date of Poland’s accession to the EU, insurance companies from the EU Member States have the right to carry out business operations in Poland without the requirement of obtaining a license issued by the Insurance and Pension Funds Supervisory Commission (as they operate under the single passport) and they are not obliged to submit quarterly and annual reports to the Commission.

The insurance supervisory authority decided to withdraw one license to conduct insurance activities. There were also three insurance companies in bankruptcy (two life insurance companies and one non-life insurance company).

The sector is dominated by the institutions operating as joint-stock companies (58 companies). Only 9 companies were established in the form of mutual insurance societies. In terms of ownership structure, similarly as in the previous period, private sector prevails with a predominance of foreign capital (Table 4.6.2).

Ownership structure of insurance companies

The ownership structure of insurance companies is well illustrated by the shares of particular groups of investors in subscribed capital. In 2005, the subscribed capital amounted to 4.7 billion zloty. The said capital in the sector of life insurance increased by 4.9% due to the adjustments of subscribed capitals of several companies having less significant share in the market. At the same time, the subscribed capital of non-life insurance sector companies grew by 1.4% mainly as a result of an increase in the subscribed capital of small and medium-sized insurance companies.

In 2005, there were no significant changes with regard to the ownership structure of insurance companies. Foreign entities prevailed on the Polish market. Their share in the subscribed capital of both life and non-life insurance sector companies remained at the same level and came to 76.2%. Only very few insurance companies were controlled by domestic shareholders. Public sector and domestic banks still had a relatively low share in subscribed capitals, which amounted to over 4% (Figure 4.6.1). The State Treasury was a major shareholder of PZU (and indirectly controlled also PZU Życie) and Export Credit Insurance Corporation (KUKE) as well.

### Table 4.6.2. Insurance companies conducting activity on the Polish market in 2005

<table>
<thead>
<tr>
<th>Insurance companies</th>
<th>Capital</th>
<th>Ownership sector</th>
<th>Legal status</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Predominant domestic capital</td>
<td>Predominant foreign capital</td>
<td>Private</td>
</tr>
<tr>
<td>Sector I – Life insurance companies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Companies in operation</td>
<td>32</td>
<td>7</td>
<td>25</td>
</tr>
<tr>
<td>Companies holding licenses</td>
<td>34</td>
<td>7</td>
<td>27</td>
</tr>
<tr>
<td>Sector II – Non-life insurance companies</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Companies in operation</td>
<td>35</td>
<td>14</td>
<td>21</td>
</tr>
<tr>
<td>Companies holding licenses</td>
<td>36</td>
<td>14</td>
<td>22</td>
</tr>
<tr>
<td>Chief branches</td>
<td>1</td>
<td>0</td>
<td>1</td>
</tr>
</tbody>
</table>

Source: Insurance and Pension Funds Supervisory Commission.

### Figure 4.6.1. Subscribed capital structure by investor groups in 2005

![Subscribed capital structure by investor groups in 2005](image)

Source: Insurance and Pension Funds Supervisory Commission.

However, the amount of subscribed capital is not crucial for the determination of the amount of gross written premium. Insurance companies having relatively low equity may record high premium as the provisions of law oblige the insurance entities to retain adequate equity for covering guarantee capital and the maintenance of required solvency margins. The said amounts are determined in proportion to the premium, claims, scale and type of insurance activities. That is why the share of insurance companies with predominant foreign capital in gross written premiums was lower than in the case of subscribed capital and came to 48% (inclusive of both insurance sectors).

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334 Data of the Insurance and Pension Funds Supervisory Commission.

335 In sector I gross written premium is a value of premiums payable in a reporting period, while in sector II it is a value of premiums payable for the whole insurance period. The amounts of premiums and indicators concerning particular groups of insurance products pertain to direct insurance activities. Ordinance of the Minister of Finance of 8 December 2003 on special accounting principles for insurance undertakings, (Dz.U. of 2003, No. 218, item 2144, as amended).
Concentration and competition within the sector

In 2005, a level of concentration fell down in both sectors of insurance services. The Herfindahl-Hirschman Index (HHI) for the premiums in the sector of life insurance was 0.20 while in non-life sector it came to 0.27.

The share of five biggest life insurers in the premiums decreased compared to the previous period from 77% to 73% and the share of three biggest life insurance companies declined from 65% to approximately 60% (Figure 4.6.2).

In terms of premiums, PZU Życie still holds the leading position, however, its share in the Polish insurance market dropped from 43% to 40%. The company manages to keep its dominating status on the market thanks to group insurance services which account for approximately 89% of its portfolio.

Small and medium-sized insurance companies grew in significance. The increase of their share in the market was recorded mainly owing to different capital life insurance products which form an alternative to other forms of saving.

In 2005, the share of the biggest non-life insurers did not decrease substantially in comparison with the figures recorded in the previous year. The share of five biggest entities amounted to 77% while the share of three biggest non-life insurers was 67%. PZU retained its leading market position, nevertheless, its share measured by insurer’s share of premiums went down to 49% (Figure 4.6.3).

For many years PZU Group has been a dominating entity on the Polish insurance market. In view of the current level of concentration its status seems safe. Both companies pursue their marketing policy through the network of employees and agents as well as sales of well-tested products on the Polish market. Insurance companies competing with the market leader adopted the strategy of copying its moves or capturing new market segments. In the case of life insurance services, unit-linked insurance became a very attractive product in the segment.

In order to improve their position on the market small and medium-sized insurance companies respond to customer needs more rapidly and flexibly by offering niche insurance products designed for specific target groups. Taking such steps results in a growing share of smaller entities in the insurance market. The process is slow but creates favourable conditions for product innovativeness.
Premium amount in Poland compared to other European countries

In 2005, disproportions between the European countries regarding the amount of premium (measured by insurance penetration$^{336}$ and density rates$^{337}$) were apparent, both in the whole industry as well as in the particular insurance sectors. In 2005, the average insurance penetration came to 7.8%.

The highest insurance penetration, amounting to 12.5%, was recorded on the British market where life insurance products are predominant. In the countries where the insurance markets exhibit lower level of development, non-life insurance sector products prevail (Figure 4.6.4).

Polish insurance market is numbered, both in terms of premium amount per capita and the ratio of premium to GDP, among less developed ones. In the period concerned, the upward trend in premiums dynamic was observable. Similarly as in the countries having better developed financial markets, the significance of life insurance in Poland is growing.

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$^{336}$ Insurance penetration rate is a quotient of premium amount and GDP.

$^{337}$ Insurance density rate corresponds to per capita premiums amount.
The amount of premium per capita shows the highest level in Switzerland, while among the EU countries the highest amount is recorded in Great Britain. In 2005, in Switzerland gross written premium per capita came to USD 5,558 and was considerably higher than the European average (USD 1,514). In Poland, gross written premium per capita was USD 245 (Figure 4.6.5).

**Figure 4.6.5. Insurance density in selected European countries in 2005**

NBP own calculations on the basis of World insurance in 2005.

**Gross written premium amount in Poland**

In 2005, the upward trend in gross written premium amount which was observable in the previous periods, continued. In 2005, in comparison to the previous year the premiums went up from 27.6 billion zloty to 31 billion zloty (Figure 4.6.6).

In 2005, the annual gross written premium amount growth rate for the whole insurance sector amounted to approximately 12%. The premiums in life insurance sector (sector I) were characterised by higher dynamic and their growth rate exceeded 20%. The rate of growth recorded in the branch of non-life insurance products (section II) was slower and it came to just a bit over 5% (Figure 4.6.7). The reasons for such situation may be sought, on the one hand, in the development tendencies in the field of life insurances and, on the other, in a declining tendency to contract non-life insurance agreements.

**Figure 4.6.6. Gross written premium amount, 2002–2005**

Source: Insurance and Pension Funds Supervisory Commission.
In 2005, premium growth rate in the life insurance sector reached the highest level in the last five years. Crucial factor which contributed to the said increase was the popularity of life unit-linked insurance products (classified among the products of group 3). Growth of life insurance premiums (counted among the products of group 3) as well as accident protection and sickness insurance premiums (group 5) noted a slight decrease. In 2005, premium growth rate in both these groups amounted to 12.4% and 10.3% respectively (Figure 4.6.8).

There were some dynamic changes observed in the insurance segment connected with the Employee Pension Programmes – EPP. In 2005, the EPP premiums amount was sevenfold higher than in the previous year; however, its share in the market was relatively low and did not exceed the level of 1.5%. Thus, one cannot expect that, given the current legal regulations, the said type of insurance will play an important role in the system of pension insurance. Also dowry insurances (group 2) seem to be of little importance for the development of this sector as their share accounted for just a bit over 1%.

In 2005, the amount of premiums of unit-linked insurance increased substantially. It may be reasonably expected that the share of such type of insurance products in the market will grow systematically provided that good economic climate on the capital market will not substantially deteriorate and no other alternative forms of savings will appear.

338 It was a result of compulsory transformations of group employee agreements into the Employee Pension Programmes EPP).
In 2005, the rate of development of non-life insurance sector was relatively slow compared with the previous year and the rate of growth observed in the sector of life insurance products. The premium growth rate was lower than in 2004 and amounted to 5.4%. Figure 4.6.9 presents premium growth rate of selected types of non-life insurance products.

In 2005, premiums in many groups and types of insurance products essential for the sector exhibited wide diversity in terms of their dynamics. The premium growth rate was most significant in the segment of Motor Third Party Liability Insurances (Land Vehicles). This obligatory type of insurance has the lion’s share in the whole sector, that is why the segment’s development is crucial for the whole non-life insurance sector. In 2005, the premiums amount growth rate for the segment of motor third party liability insurance (Land Vehicles) amounted to 11.6%. Thanks to good marketing results recorded in the said group of insurance products the whole sector of non-life insurance showed the increase in the gross written premiums amount in 2005, even though the premiums in the segment of land vehicles “casco” insurance decreased by 1.4%.

**Figure 4.6.9. Premium growth rate in selected non-life insurance groups, 2002–2005**

![Graph showing premium growth rate in selected non-life insurance groups from 2002 to 2005](image)

**Premium structure**

Pursuant to the law provisions currently in force, there are five groups of life insurance products:

- life insurance (group 1),
- dowry insurance (group 2),
- unit-linked insurance (group 3),
- endowment insurance (group 4),
- accident protection and sickness insurance (group 5).

Insurance products of group 1 (traditional life insurances) still prevailed and their share in premiums amounted to approximately 50%. Unit-linked insurance products ranked second among other types of life insurance. They combine both protection and savings at the same time. Funds coming from premiums are collected in the form of capital investment fund. In 2005, these insurance products accounted for 36.9% of insurance portfolio while their share, measured by the amount of premium, has been systematically growing.
Another type of insurance having considerable share in the portfolio are accident protection and sickness insurance agreements, numbered among the insurance products of group 5. This type of insurance cannot be offered as an independent life insurance product but only as insurance against some additional type of risk which accompanies other four basic types of insurance products. In 2005, the share of the said types of risk in the portfolio was approximately 16.5%. It is significant inasmuch as, opposed to the other types of insurance policies, the premium does not include the element of savings characteristic for life and endowment insurances as well as unit-linked products. It proves the fact that the customers show much interest in protection against the effects of accidents and sickness (Figure 4.6.10).

Dowry (group 2) and endowment insurance (group 4) only complemented the offer of insurance companies and did not have any significant share in the structure of gross written premiums.

Pursuant to the currently binding law provisions, non-life insurance products are classified by 18 specific groups. Insurance products included in particular groups vary both in terms of the scope of protection provided and the amount of premium.

Similarly as it in the previous years, the sector of non-life insurance is dominated by the following types of insurance products:

- accident insurance (group 1),
- casco insurance of land vehicles (group 3),
- insurance against fire and natural forces (group 8),
- insurance against other damage or loss of property (group 9),
- motor third party liability insurance (land vehicles) (group 10),
- general third party liability insurance.

Motor third party liability insurance (land vehicles) (group 3) and third party liability insurance resulting from the ownership of land motor vehicles (group 10) constituted two main groups of insurance products having the largest share in gross written premium amount. In 2005, their share amounted to approximately 28% and 36% respectively. Premiums under motor third party liability and accident and theft insurance accounted in total for almost 2/3 of aggregate non-life insurance premiums.

The second group of products of vital importance for the sector are insurance products referred to as third party fire and theft insurance. Insurance policies of such type are classified as the products of groups 8 and 9, connected with each other with respect to the subject of protection. The share of these insurance products in the non-life insurance sector in 2005, measured by gross written premiums amount came to 11% and 7% respectively. In total, the insurance products classified in this category accounted for 18% of the market (Figure 4.6.11).
Other types of insurance products were of little significance and their share in the structure of gross premiums amounted to 8.1%.

**Figure 4.6.11. Structure of premiums in non-life insurance sector at the end of 2005**

![Pie chart showing the structure of premiums in non-life insurance sector at the end of 2005.](image)

Source: Insurance and Pension Funds Supervisory Commission.

### 4.6.2. Insurance companies assets

In 2005, assets of insurance companies reached the amount of 89.6 billion zloty as opposed to the amount of 77.9 billion zloty recorded in the previous year. The assets of life insurers constituted approximately 60% of the whole sector’s assets and amounted to 53.5 billion zloty while in the case of non-life insurers it was 36.1 billion zloty (Figure 4.6.12).

Dynamics of assets movements in the whole sector was similar to the one observed in the previous year. The assets of life insurers were growing faster than the assets of non-life insurance companies (Figure 4.6.13). In total, the rate of assets growth in both sectors in 2005 was lower than in the previous year and came to approximately 16.7%.

The structure of balance sheet and assets of life insurance companies was different from that of non-life insurers. When it comes to life insurers the position of utmost importance was taken by investments (investments of insurance companies) which accounted for nearly 2/3 of their balance sheet total and investments where the insurance taker incurs risk connected therewith, constituting over 1/3 of balance sheet total. The remaining items of balance sheet assets were less important and in aggregate did not go beyond several percent of balance sheet total (Figure 4.6.14).

**Figure 4.6.12. Assets of insurance sector, 2002–2005**

![Bar chart showing assets of insurance sector, 2002–2005.](image)

Source: Insurance and Pension Funds Supervisory Commission.
Within the two last years the amount of net assets\textsuperscript{339} allocated for covering of liabilities under life insurance contracts where the investment risk is incurred by the insurance takers grew considerably. The said type of insurance includes also unit-linked insurance products. A visible increase in this item of balance sheet is a result of customers’ large interest in such a type of insurance products which are often deemed as an alternative to other forms of investing on the capital market.

Investments of life insurance companies excluding unit-linked insurance exhibit less dynamic growth. It may be attributed to the fact that the investments entail both insurance products of purely protective nature as well as the ones of protective and savings character where the premium is designed for the payments of claims resulting from an insurance occurrence. Some part of premiums is allocated for covering liabilities under claims which are usually paid at the end of insurance period.

Investments allotted for, in the major part, covering current and future liabilities arising under insurance contracts transacted prevail in the structure of assets of non-life insurers. In 2005, such investments constituted approximately 85% of their balance sheet total (Figure 4.6.15).

\textsuperscript{339} Net assets of life insurance where the investment risk is incurred by the insurance takers are the assets allocated for covering liabilities to customers. The Accounting Act of 29 September 1994 (Dz.U. of 2002, No. 76, item 694, as amended) and the Act of 22 May 2003 on Insurance Activity (Dz.U. of 2003, No. 124, item 1151, as amended).
Despite the fact that the premiums in both insurance sectors are comparable, the amount of assets and investments of non-life insurance companies is much lower than in the case of life insurers. The reason for such situation is the fact that the premiums collected by non-life insurers are allocated for covering insurance risk. Non-life insurance products are of such nature that their premiums do not include the element of savings characteristic for life insurances.

Non-life insurers establish technical provisions covered by matching assets. They are designed mainly to cover liabilities under insurance events which had occurred, however, the claims related thereto were not paid as well as to cover liabilities under insurance contracts transacted where the reporting period does not correspond with the period of responsibility specified in the insurance contract.

Figure 4.6.15. Structure of assets of non-life insurance companies, 2002–2005

Another important item of the balance sheet of non-life insurers includes also receivables which comprise, *inter alia*, receivables from insurance takers, intermediaries, reinsurers and subordinate entities. The share of the said assets item in the balance sheet is approximately 9% while the aggregate share of nonperforming assets in the balance sheet total of non-life insurance companies accounts for around 15%.

**Investment portfolio structure**

Insurance companies remained conservative in their investment policies on the Polish market in 2005. In 2005, investments structure was similar to the one shaped in the previous periods. High share of debt securities with fixed return rate was maintained and amounted to 71%. Stock, shares and securities with floating rate of return (without taking into consideration investments on the insurance takers account and at their own risk) constituted 10% of overall investments value.

Due to a growing interest in life unit-linked products (group 3) value of investments connected with such type of insurance is continuously increasing. That is why the structure of investments of life insurers undergoes changes (Figure 4.16.16).

Structure of investments of non-life insurance companies was similar to the one observed last year. In 2005, debt securities formed an important part of their portfolio with the share of 61% (it decreased slightly compared with the previous period). Share of investments in subordinate entities and in real property was 16.5% and 2.4% respectively. Stocks, shares and securities with floating rate of return, like in the pervious year, accounted for a bit over 10% of non-life insurers investments. In 2005, the share of loans granted went up to 5.6%. There were granted mainly to domestic entities and amounted in total to 1.7 billion zloty (Figure 4.6.17).

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340 Reporting period is a period with respect to which the quarterly or annual financial statements are drawn up.
4.6.3. Insurance sector financial results

In 2005, financial standing of life as well as non-life insurance companies was best within the last 15 years. Their aggregate financial result amounted to 5.2 billion zloty. Such good performance may be attributed to the fact that both sectors recorded faster growth of earnings and the amount of their income was higher than the costs incurred (Figure 4.6.18). At the same time, they also managed to keep the operating costs at the same level as in the previous year. Net financial result of life insurers increased by over 60%, while in the case of non-life insurance companies their net result grew by over 100% in comparison to 2004 (Figure 4.6.19).

The items which influenced the most life insurance companies revenues were earned premiums, net of reinsurance\textsuperscript{341} and investment income, out of which over 1/3 constituted earnings from unit-linked insurance products. On the other hand, the most important entries in equity and liabilities were paid claims and changes in technical provisions as well as operating costs. Another

\textsuperscript{341} Earned premiums, net of reinsurance, is a written premium, net of reinsurance within a reporting period, less of provision for unearned premiums at the end of reporting period and increased by provision for unearned premiums at the beginning of reporting period, net of reinsurance, Ordinance of the Minister of Finance of 8 December 2003 on special accounting principles for insurance undertakings, (Dz.U. of 2003, No. 218, item 2144, as amended).
item classified as costs and characteristic for life insurance sector was the entry concerning changes in other technical provisions, i.e. provisions for life assurance policies. The said provisions are established with respect to liabilities consisting in payments of claims at the end of insurance period coming from the premiums. That is the reason why the companies have to establish compulsory provisions, the changes in which are recognised as costs (Figure 4.6.20).

The structure of revenues and expenses of non-life insurance companies is similar to the one of life insurers, except for expenses related to changes in provisions for life assurance policies. In the non-life insurance sector such provisions are established for covering liabilities under pension benefits payments (most often linked to third party liability insurance) and their amount is much lower than in the case of life insurance.

Figure 4.6.18. Revenues and costs of insurance industry by sectors, 2002–2005

Source: Insurance and Pension Funds Supervisory Commission.

Figure 4.6.19. Net earnings of insurance companies and rate of their growth, 2002–2005

Source: Insurance and Pension Funds Supervisory Commission.
4.6.4. Selected ratios and indicators of insurance activities

Basic indicators which enable to monitor the insurance market and constitute the evidence of the sector’s expansion possibilities are: gross claims ratio and corresponding claims ratio net of reinsurance\(^342\) as well as operating ratio often referred to as combined ratio\(^343\). Within the last five years the downward trend in non-life sector indicators was observed, which is evidence of the improvement of insurance sector performance. Higher level of claims ratio, net of reinsurance (having taken into account the share of reinsurers) compared with gross claims ratio indicates the role of reinsurance in this sector. Higher claims ratio confirms the need to incur additional costs for securing insurance portfolio. Beginning from 2002 there was an observable decrease in gross claims ratio and claims ratio, net of reinsurance. The said tendency reflects the improvement of revenues to costs ratio connected with the insurance process and the upturn of insurance activity financial results (Figure 4.6.22).

\(^{342}\) Claims ratio (net of reinsurance) is a ratio of claims (net of reinsurance) having taken into account changes in provisions for outstanding claims (net of reinsurance) to earned premium (net of reinsurance).

\(^{343}\) Combined ratio (net of reinsurance) is a ratio of claims, having taken into account changes in provisions for outstanding claims and costs of operating activities plus other expenses (net of reinsurance) to earned premium (net of reinsurance).
Figure 4.6.22. Selected ratios and indicators of non-life insurance sector, 2002–2005

Source: Insurance and Pension Funds Supervisory Commission.

Combined ratio serves as a measure of operating results which takes into account expenses related thereto. Situation when the ratio is higher than 100% indicates losses on insurance activities. On the other hand, decrease in the said ratio proves the improvement on the non-life insurance market, which in turn has positive influence on the improvement of financial results.

With respect to life insurance companies a modified claims ratio is a better measure of earnings than the above-mentioned claims ratio. The said ratio differs in that the earned premium includes also income from investments while the claims cover also changes in provisions for life assurance policies. Such modified claims ratio in the sector of life insurance was running at about the same level as in the sector of non-life insurance.

4.6.5. Reinsurance

The share of reinsurers in the risk of insurance companies is measured by premiums retention ratio\textsuperscript{344} and claims retention ratio.\textsuperscript{345} The higher the said indicators, the high indicators show the lower reinsurers share. Most often these are foreign entities who serve as reinsurers of Polish insurance companies.

The share of reinsurers in the life insurance sector remained low and the premiums retention ratio in 2005 exceeded 98%. It may be attributed to the fact that, with regard to life insurance, there are applied reinsurance programmes corresponding with specific needs in this field and the level of risk connected with a single insurance occurrence is relatively low. Additionally, there is no reinsurance protection provided with regard to many insurance products due to large risk dispersion and relatively low insurance amount or low sum at risk.

In 2005, the premiums retention ratio in the sector of non-life insurance products amounted to 84.8% and increased by approximately 2.3 percentage points compared with the analogous period of the previous year. The increase of the said ratio reflects a decrease in the ratio of reinsurance premiums to gross written premiums (Figure 4.6.23).

The increase of retention ratios in the sector of non-life insurance was caused by the reduction of reinsurance protection scope and reconstruction of reinsurance programmes applied by insurance companies. Changes in reinsurance programmes concerned in particular limitation of the role of proportional reinsurance in favour of non-proportional reinsurance,\textsuperscript{346} as well as an

\textsuperscript{344} Premiums retention ratio is a quotient of premiums, net of reinsurance, and gross premiums amount.

\textsuperscript{345} Claims retention ratio is a ratio of claims (net of reinsurance) to gross claims.

\textsuperscript{346} The nature of proportional reinsurance is that both the insurance company and reinsurer take the same percent share of premiums and claims. In case of non-proportional reinsurance the share of reinsurer is determined in proportion to the scope of risk borne. More on the issue in: R.L. Carter: Reinsurance. Guy Carpenter & Company, 2000.
increase in net risk of insurance companies. The reasons for the said phenomenon may be both the increase in equity of insurance companies and optimization of reinsurance programmes.

In 2005, the claims retention ratio (connected with premiums retention ratio) continued at the similar level as in the previous year and amounted to 85.5%. The said ratio was a bit higher than the premiums retention ratio which proves that reinsurers, having paid relatively less claims as percentage of premiums, realized mark-ups for reinsurance protection granted.

Figure 4.6.23. Premiums and claims retention ratios in non-life insurance companies, 2002–2005

![Premiums and claims retention ratios in non-life insurance companies, 2002–2005](chart.png)

Source: Insurance and Pension Funds Supervisory Commission.

**4.6.6. Product offer**

Product offer of life insurers in 2005 was dominated, just as it used to be in the pervious years, by two types of insurance products: group life insurance and individual unit-linked insurance. The above-mentioned insurance products combine the scope of protection classified pursuant to the binding legislation respectively in group 1 and group 5 as well as group 3 and group 5 (Figure 4.6.24).

Group life insurance products still had the greatest share in the insurance portfolio. These agreements are most often concluded in the form of group investment employee life insurance policies where the employer is the insurance taker. Product offers are also supplemented with a possibility of concluding agreements by other legal or natural persons. Their typical scope of protection covers the risk of death of the insured and co-insured, included in group 1, casualty, costs of medical treatment and other types of risk classified in group 5.

Group insurance products were one of most common forms of insurance protection and their share in life insurance market amounted to nearly 50%. Despite the fact that other more inventive products appear and constitute strong competition to group insurance, such form of insurance protection is well established in both the employers and employees and it still forms a fundamental part of the Polish life insurance market. The offer of such insurance products was also supplemented with some options making it possible to contribute additional savings premiums (as a group or individually). However, the premiums allotted for savings purposes and paid under the products of group insurance remain relatively low. In the recent period, insurance companies extended the range of their insurance offers and included therein also protection against some additional types of risk. The most significant types of risk such products are designed to cover are: risk related to hospital and dental treatment, treatment in an outpatient’s clinic and risk of critical illnesses. Such offer is intended to meet the customers’ expectations with regard to health care and it seems that it will win a permanent place on the market.
Individual life unit-linked insurance ranked second in terms of the product’s significance on the market of life insurance. It has been nearly 10 years since the said products started to be offered on the Polish market and their market share has been systematically growing. The range of products in this segment is very wide; however, basically they all provide insurance protection combined with savings. Depending on the insurance company’s strategy, customers’ needs and expectations, the proportion of these elements may differ from product to product. One of possible solutions is to limit the protection to the level of necessary minimum whereby the major part of premium (net of costs) can be allocated for a capital investment fund. The product of such construction is very close, in terms of its function, to the offer of investment funds.

Another large group of insurance products the influence of which on the dynamics of life insurance premiums is considerable constitutes the segment of individual life insurance – included in group 1 of the sector. Substantial share of such products in the market was achieved thanks to, inter alia, introduction of short-term life insurance products which became an alternative to short-term investments. It is possible under the current legislative solutions according to which insurance claims (understood as payouts of a certain amount payable at the end of insurance period) are not taxable. Thanks to such regulations short-term endowment policies with a single premium, most often designed for one year, enjoy growing popularity. Endowments are policies in which the customer, having contributed the single premium at the beginning of insurance period, receives the claim payout at the end thereof. Should the policy holder die during the agreement period, the amount is to be paid out to the beneficiaries. As the claim paid out by an insurance company is free from tax, the policy can be an alternative to fixed bank deposits.

The life insurance for borrowers is an important product group for the financial sector. It provides life and health protection for debtors over the repayment period. It is also possible to extend the insurance protection over the other borrower. This agreement is a long-term insurance product. Insurance agreements are usually concluded for the loan period while their value depends on the amount of indebtedness appearing from the plan of loan redemption. In most of the cases the loan granting bank is appointed as insurance beneficiary. Should there occur the insured event, insurance company pays out claims corresponding with (or at least equivalent to) the outstanding loan principal and interest. Such type of insurance is deemed as additional loan security in case of borrower’s death, nonetheless, it is not designed to protect against the borrower’s insolvency risk arising in connection with some other circumstances. Insurance agreements offered by different companies may provide for various scope of detailed protection. Typical insurance protection can cover also some additional kinds of protected risks, such as for instance, risk of critical illnesses or incapacitation for work as a result of injury or disease.
Non-life insurance products offered by insurance companies most often combine different types of protected risk classified in various insurance groups.

Motor vehicle insurance prevails on the Polish non-life insurance market. This product may combine three types of risk within a single insurance agreement. In terms of premiums amount the most significant group comprises accident and theft insurance, third party liability, casualty and assistance insurance policies. The share of these products remains large even though there is a noticeable decrease in premiums under accident and theft insurance agreements. This type of insurance (group 3) is voluntary unlike the third party liability insurance which is compulsory in Poland. It is estimated that less than 1/4 of passenger cars are protected with accident and theft insurance while the said figure is even lower in case of other land motor vehicles (lorries, tractors, motorcycles and others). The most important types of risk possible to be protected include theft and damage risk (connected with road traffic, stopping and parking). In order to lower the costs arising in connection with the vehicle insurance (lower the premiums) the owners of vehicles decide to limit the scope of risk to be protected (for instance customers give up insurance protection against vehicle’s theft) or abandon the idea of taking out accident and theft insurance.

The second group of products of essential importance for non-life insurance sector are insurance products referred to as third party fire and theft insurance agreements. Both types of products are aimed at the same insurance subject matter. Diversified product offer is targeted at big commercial companies, medium-sized and small entrepreneurs as well as individual customers. This group covers mainly insurance protection against fire and natural forces as well as other accidents. Depending on the target group the products differ and can include additionally third party liability insurance, insurance against financial loss or others.

General third party liability insurance was offered as an independent insurance or in the form of insurance packages. We may distinguish here two fundamental groups of products: voluntary and compulsory insurance products. Despite the fact that the Act on Compulsory Insurance has entered into force and there has been introduced the requirement of having professional indemnity insurance policy in case of particular professions, the share of these policies is still of marginal significance.

On the other hand, insurance products of major importance for the financial system are credit and financial guarantee insurance agreements, referred to as financial insurance or financial product. Their share in the market remained low; however, the premium dynamics in the group is high. Most common type of such insurance is credit insurance which provides insurance protection covering the period until the entry in the Land and Mortgage Register becomes valid (the so-called ‘bridge’ insurance). Unlike the credit insurance products offered by the life insurance sector, this type of policy guarantees protection against general insolvency and is taken out for a short term. The same group of financial products embraces also insurance products regarding different kinds of closed-end loans (e.g. export or trade loans), guarantees (e.g. concerning custom duties) and insurance against other types of financial risks.

Moreover, insurance companies address their offer to banks, giving possibility of insuring the borrower's own contribution. Such product is referred to as credit enhancements insurance (covering the outstanding amount of borrower's own contribution). In such agreements in most of the cases a bank is appointed as beneficiary. The amount of claims (indemnity) is usually limited with respect to the amount of indebtedness under loan and determined as a ratio thereof.

Recently non-life insurance companies (similarly as in the sector of life insurance) pay more attention to health insurance products. They continued drawing up offers and conducting marketing activities. However, until appropriate statutory measures are adopted in the field, no increase in the market share of such insurance products should be expected.

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347 Ubezpieczenia komunikacyjne po przystąpieniu do UE. Warszawa 2005, KNUIFE.
4.6.7. Distribution channels

Insurance agents and brokers as well as direct insurance sales\(^{349}\) remained the main channels of distribution. Among them the leaders of life insurance sector were insurance agents involved in selling of both individual and group insurance policies. More than a half of premiums amount comes from the agreements concluded though the agency of such entities. Individual agents represent the most numerous group and their share measured by gross written premium exceeded 1/4 of premiums in the sector. Legal entities ranked second (14.7% of premiums amount), followed by banks acting as insurance agents (14.4%). Bank distribution channels share in the sales of life insurance products increased in comparison with the previous year and its role has been continuously growing. Insurance brokers are of lesser importance in the sector of life insurance and their share as distribution channel accounts for 4.2%.

Direct sales by the employees of insurance companies play an important role in the sector of life insurance. More than 1/3 of premiums amount was acquired by such distribution channel. It results from the fact that group insurance agreements concluded and handled by the employees of insurance companies account for the major share in the life insurance market. In this segment the biggest life insurer on the Polish market which managed to work out and establish standards of selling and handling group insurance products enjoys a dominating position.

In the sector of non-life insurance distribution channels of major significance were: sale by agents (44% share in the market), direct sales (24% share in the market) and sales by insurance brokers (16%). The role of banks as distribution channels for non-life insurance products is relatively insignificant and their share did not go beyond 0.6%.

New IT technologies, considered as distribution channels, do not play an important role in sales of insurance products and their share in the market accounts for merely a fraction of gross written premium percentage.

4.6.8. Prospects

The year 2005 was exceptionally successful for the whole insurance sector. Gross written premiums as well as financial results were record in the last 15 years of the market history, established by the Act on Insurance Activity of\(^{350}\) 1990. Basic technical indicators also show that the financial standing of insurance companies has been systematically improving.

The process of ownership transformations slowed down; nonetheless, it has not been completed yet. Within the coming years we might expect mergers of companies owned by the capital groups and buy-outs of minority shareholders in companies where foreign capital prevails. At the moment, it is difficult to predict how the ownership transformation processes of PZU and PZU Życie will proceed.

In Poland, gross written premium per capita remains several times lower than the European average and is considerably lower than in the countries where the financial markets are highly developed. Gross written premium in the sector of life insurance came to the same level as in non-life insurance sector, which in turn indicates that the market's development moves in the same direction as in other EU countries. Forecasts concerning premiums assume faster growth in the sector of life insurance than in the field of in non-life insurance. The said process it to be particularly visible with respect to assets. The amount of investments of life insurers is already higher than these of non-life insurance companies and this trend is to strengthen in the future, resulting in growing predominance of life insurance sector in this respect.

\(^{349}\) Rocznik ubezpieczeń i funduszy emerytalnych 2004. Warszawa 2005, KNUIFE.

\(^{350}\) On 28 July 1990 the Act on Insurance Activity entered into force (then repeatedly amended). The Act took into account most of EU Directives and introduced considerable reforms on the market. Most important among them were: demonopolisation of Polish insurance market, precise determination of general principles of establishing and conducting business activity in the sector of non-life insurance as well as distinguishing life insurance from other insurance products, which had a strong influence on the proper functioning of insurance companies and their finance management.
Competition on the insurance market as well as making use of foreign investors experience helped extend the product offer and lower prices for insurance protection provided.

Within the following years the sector of life insurance will remain dominated by group life insurance products and different types of unit-linked insurance which are typical for the Polish market.

The unquestioned leader of non-life insurance products are, and probably will be, vehicle insurance, insurance against fire and natural forces and third party liability insurance.

Great hopes are placed in financial insurance products, in particular these connected with mortgage loans. Market participants expect that development of this segment of products may positively influence enhancement of the whole financial sector development.

Despite optimistic forecasts the market of health insurance is growing very slowly and it would be unreasonable to expect that, considering legislative solutions in force, there is going to come a turning point in this field.
4.7. Entities conducting brokerage activities

In 2005, there were three types of institutions on the Polish market, which conducted brokerage activities (investment companies): brokerage houses, banks conducting brokerage activities (brokerage offices and banks’ organisational units) and foreign investment companies. Brokerage houses are independent entities which operate under organisational requirements provided for in the Polish Commercial Companies Code. Brokerage offices are financially and organisationally separate banks’ units while the banks’ organisational units mean the sections within the bank’s structure which are involved exclusively in taking and transferring orders to purchase or sell financial instruments. Foreign investment companies operate on the Polish market under licenses granted by the competent home country supervisory authorities, after having informed the Securities and Exchange Commission of their intention to launch investment activities in Poland.

4.7.1. Evolution of the size and structure of the sector

In 2005, the tendency for increase in the number of firms conducting brokerage activities continued. It was a result of the Warsaw Stock Exchange (WSE) bull market. The number of brokerage houses and banks conducting brokerage activities rose to 4252 (compared to 40 in 2004). Additionally, 5 new foreign investment companies commenced activity on the Polish stock exchange market.

Stock market constitutes the largest segment of WSE market. In 2005, the share of five largest brokerage entities in this segment turnover slightly grew. CRS index amounted to 63.9%, compared with 62% in 2004. However, the concentration level did not go beyond the figure recorded in 2003 (64.2%), which proves its stabilisation. In 2005, there were no major changes among entities with the highest share in stock exchange turnover. The shares of the largest brokerage entities in WSE stock turnover in 2004 and 2005 are presented in Figure 4.7.1.

Figure 4.7.1. Share of the largest brokerage entities in WSE stock turnover

![Figure 4.7.1](image.png)

Source: WSE.

In 2005, no changes occurred with regard to the leaders of most of stock exchange market segments. DM BH managed to maintain its position in the stock market while DM BOŚ remained the leader of the futures market. When it comes to the options market, the share of DI BRE Banku decreased by 8 percentage points against some smaller entities. The only change in the position of

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351 Some of the brokerage houses are bank subsidiaries which operate within the same capital group.
352 Including 33 brokerage houses and 9 banks conducting brokerage activities (5 brokerage offices and 4 banks’ organisational units).
a leader occurred in the bond market where BDM PKO BP (increase in turnover by 9 percentage points) displaced CDM Pekao (decrease by 5 percentage points). The entities with the highest share in stock exchange turnover in 2005 are presented in Table 4.7.1.

### Table 4.7.1. The entities with the highest share in stock exchange turnover, 2005 (percentage of market share, trading volume in PLN million and in quantitative terms)

<table>
<thead>
<tr>
<th>Stock market</th>
<th>Bond market</th>
<th>Futures market</th>
<th>Options market</th>
</tr>
</thead>
<tbody>
<tr>
<td>DM BH</td>
<td>BDM PKO BP</td>
<td>DM BOS</td>
<td>DB BRE Banku</td>
</tr>
<tr>
<td>19.52%</td>
<td>37.62%</td>
<td>19.94%</td>
<td>31.83%</td>
</tr>
<tr>
<td>PLN 35,356.27</td>
<td>PLN 1,903.22</td>
<td>2,145,305 contracts</td>
<td>1,161,979 contracts</td>
</tr>
<tr>
<td>million</td>
<td>million</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Source: WSE.

In 2005, first foreign investment companies launched operating activities on the WSE (Table 4.7.2). Four of them operated as remote members of the Warsaw Stock Exchange, while one pursued business through the establishment of a branch. However, their share in stock exchange turnover was insignificant. Only KBC Securities managed to rank among the first ten entities with the highest share in stock exchange turnover (although the result may be attributable to the fact that it has taken over IDM Kredyt Banku).

In 2005, also the first Polish brokerage entities were granted a status of remote member of a foreign stock exchange. Since August, DB Securities has been conducting activities on the stock market of the Budapest Stock Exchange (BSE) whereas CDM Pekao commenced operations on the same market in October. The said entities ranked 23rd and 25th respectively among the members of BSE (total number of members being 37), recording a 0.16% and 0.03% share in stock exchange turnover. Remote membership in a foreign stock exchange (like in the case of foreign investment companies operating on the Polish market) allows the brokerage entities to gain access to the stock exchange trading system without establishing a physical presence in a particular country or the need to use intermediation services of local brokerage entities, which would result in generating some additional costs.

Table 4.7.2. Share of foreign investment companies in stock exchange turnover, 2005 (percentage of market share, trading volume in PLN million and in quantitative terms)

<table>
<thead>
<tr>
<th>Stock market</th>
<th>Bond market</th>
<th>Futures market</th>
<th>Option market</th>
</tr>
</thead>
<tbody>
<tr>
<td>KBC securities SA</td>
<td>3.23%</td>
<td>2.78%</td>
<td>3.08%</td>
</tr>
<tr>
<td>Branch in Poland</td>
<td>58,595.33 million</td>
<td>58,595.33 million</td>
<td>330,831 contracts</td>
</tr>
<tr>
<td>Belgium</td>
<td>0.11%</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Wood&amp; Company</td>
<td>208.02 million</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Financial services a.s.</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>0.01%</td>
<td>18.45 million</td>
<td>–</td>
</tr>
<tr>
<td>Concorde Securities Ltd</td>
<td>0.00%</td>
<td>5.97 million</td>
<td>–</td>
</tr>
<tr>
<td>Hungary</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Fischer Partners</td>
<td>0.00%</td>
<td>0.32 million</td>
<td>–</td>
</tr>
<tr>
<td>Fondkommission AB</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Sweden</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
<tr>
<td>Credit Suisse securities (Europe) Ltd</td>
<td>0.00%</td>
<td>0.32 million</td>
<td>–</td>
</tr>
<tr>
<td>Great Britain</td>
<td>–</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

In 2005, three other foreign investment companies were granted a status of remote member of the Warsaw Stock Exchange, however, they conducted no operating activities.

Source: WSE.

353 Remote membership gives foreign investment companies a possibility of direct access to the WSE system without the need to establish a physical presence in Poland or to use local intermediaries.
4.7.2. Financial results

Good financial standing of brokerage offices and houses, similarly as in 2004, was a result of upswing on the primary market and good economic climate on the secondary market. The pre-tax financial results of brokerage entities in 2005 amounted to 712.4 million zloty and were higher by 37% than figures recorded in 2004 (519 million zloty). The good financial standing of brokerage offices and houses is also confirmed by the value of pre-tax return on revenue (Figure 4.7.2) and the increase in the number of institutions which managed to generate profit from their activities. In 2005, there were 31 firms which posted profit and 10 firms which recorded loss (in 2004, it was 29 and 8 firms, respectively).

Figure 4.7.2. Brokerage offices and houses’ pre-tax return on revenue, 1999–2005

Note: Pre-tax return on revenue is calculated as the ratio of pre-tax profit/loss to total revenue.
Source: Central Statistical Office.

In comparison with the year 2004, brokerage firms achieved a higher income from transactions in securities on the secondary market, which was a result of higher WSE turnover and an increase in stock indices. Income from intermediation in investment funds’ units increased, although the rate of such growth was slower than in 2004. Additionally, income from intermediation in the sale of securities on the primary market slightly decreased.

4.7.3. Brokerage services market

In 2005, the situation on the stock exchange market was favourable. 35 companies were floated on the WSE, while, compared to 2004, session stock market turnover grew by 60%. The public share offerings of the highest value (2.9 billion zloty) were underwritten by BDM PKO BP (it offered shares of PGNiG). DI BRE Banku and CA IB Securities offered shares the value of which amounted to 1.2 billion zloty and 1.1 billion zloty, respectively.

In 2005, as in previous years, the value of funds in securities accounts held by customers of brokerage offices and houses increased; at the same time, the number of investment accounts also grew (Table 4.7.3).

In 2005, the distribution of brokerage activities via the Internet continued to develop. The number of Internet accounts kept by brokerage offices and houses grew considerably (it went up to approximately 121,000 while in 2004 it was about 74,000). DM BZ WBK continues to maintain the largest number of Internet accounts (over 21,000). In the first half of 2005, the average share of Internet accounts in the total number of accounts held with brokerage houses and offices came to 10%, which is more by 4 percentage points than in the corresponding period of the previous year. In the second half of 2005, over 50% of orders were placed via the Internet (Figure 4.7.3).

The analysis of the financial standing of brokerage offices and houses was carried out on the basis of data pertaining to 41 firms.
In 2004, the banks whose structure did not include brokerage offices were enabled to offer brokerage services through their organisational units.\textsuperscript{355} It may be expected that in response to the customers’ needs an upward trend towards the integration of banking and brokerage services will continue. In 2004, one bank took advantage of offering brokerage services at the bank counter while in 2005 three other banks decided to make the same move. In 2005, yet another bank provided its customers with access to the brokerage services through their bank accounts.

Since January 2005, the \textit{Code of Good Practice of Brokerage Houses}\textsuperscript{356} has been in force. It specifies, \textit{inter alia}, the scope of information required to be disclosed to customers and the principles concerning avoiding conflict of interest. So far 19 entities\textsuperscript{357} – members of the Chamber of Brokerage Houses (\textit{Izba Domów Maklerskich, IDM}), the organisation associating entities which conduct brokerage activities – have undertaken to observe the provisions of the Code. In 2005, the Chamber adopted also the \textit{Standard for Assessment of Adequacy of a Brokerage Service to the Individual Customer’s Situation}. The said regulations may contribute to the improvement of quality and security of customer service.

4.7.4. Prospects

In 2005, the number of notifications about the intention to engage in brokerage activities in Poland submitted by foreign entities more than doubled.\textsuperscript{358} However, only five entities actually conducted operating activities on the WSE. Also in 2005, two credit institutions which are entitled to

\begin{table}[h]
\centering
\caption{Number of securities accounts and investors’ registers and value of funds held therein, 2002–2005}
\begin{tabular}{|l|c|c|c|c|}
\hline
\hline
Number of securities accounts and investors’ registers maintained by brokerage offices and houses (in thousand, as at year-end) & 1,251.1 & 1,176.6 & 1,535.5 & 1,651.4 \\
\hline
Value of funds in securities accounts and investors’ registers held by brokerage offices and houses (PLN million) & 29,153.5 & 33,747.6 & 64,994.2 & 77,819.5 \\
\hline
\end{tabular}
\end{table}

Note: Investors’ registers constitute the accounts of non-public market.
Source: Central Statistical Office.

\textsuperscript{1} Options have been listed on the WSE since September 2003.
Source: WSE.
conduct investment activities within the territory of Poland informed that they had commenced operating activities. Additionally the Czech Internet brokerage company FIO continued its operations on the Polish market. The National Bank of Poland has no information about any other entities which might have started to provide services in Poland on the cross-border basis. Nonetheless, one may assume that the notification about the intention to engage in brokerage activity in Poland is rather a result of long-term development strategies of foreign entities; therefore it is not tantamount to an immediate start of operating activity. Thus, it may be expected that new foreign companies will appear on the Polish market in the coming years, although the increase in their number will be gradual.

In October 2005, the Act on Trading in Financial Instruments entered into force. The Act introduces many modifications with respect to conducting brokerage activities. Brokerage houses were enabled, inter alia, to operate as limited companies (full range of brokerage services) or as partnerships (limited range of brokerage services). Another modification is the lifting of the capital requirement with regard to the entities conducting limited brokerage activity (receipt and transmission of orders or investment advisory services), provided that they have concluded liability insurance contracts. The said amendments may facilitate commencement of business operations for new entities in the future.

The Act on Trading in Financial Instruments also contains other amendments aimed at adjusting Polish regulations to Community law. One of them is a possibility to conduct transactions outside the regulated market, which means that brokerage entities are allowed to carry out direct transactions with customers, match customers’ orders in the secondary trading and to create alternative trading systems (ATS). The possibility to carry out direct transactions enables the entities providing brokerage services to effect the purchase or sale orders of securities (admitted to organised trading) through concluding purchase agreements with the ordering party on their own account. On the other hand, matching the orders by a brokerage entity consists in taking the actions aimed at carrying out a transaction between an ordering party and other customer of the same brokerage entity. From the customers’ viewpoint, this may imply lower costs of orders’ execution as in such case they bear no additional costs related to transactions on the regulated market.

Furthermore, the Act introduced an institution of an investment company agent who is authorised to act as intermediary on behalf and on account of an entity carrying out brokerage activities within the scope of business activities of such an entity. The agent is empowered to conclude agreements with the customers, promote services offered by the investment company, act as an advisor in the issues connected with the company’s services, and accept the buy and sell orders of financial instruments. In December 2005, two first entities: Bank Millennium SA and Xelion. Doradczy Finansowi Sp. z o.o., were entered into the register of investment companies’ agents. It may be expected that investment companies will take advantage of making their services more available owing to agents’ services, as they have not had any possibility to use direct methods in competing for customers so far.

However, even though certain modifications have been introduced, the economic climate on the stock market remains a crucial factor contributing to the development of the market of brokerage services. Furthermore, the role of the Internet brokerage services distribution channel is expected to continue to increase in the coming years. It also seems that the customers’ interest in the integrated banking and brokerage services will increase (access to the brokerage services at the bank counter and possibility of investing through bank accounts).

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360 Prior to the introduction of the said modifications brokerage houses could operate solely as joint-stock companies.
361 Thereby Polish regulations were brought into line with Directive on markets in financial instruments (MiFID). The MiFID should be transposed into national legislations by the end of January 2007. However, the financial market institutions should adjust to the new provisions by November 1, 2007.
362 Pursuant to Article 5 of the Act on Public Trading in Securities which was in force until October 2005, the securities admitted to public trading could have been traded solely on the regulated market. Pursuant to the Act, the regulated market included: official stock markets, unofficial stock markets and unofficial OTC markets (Article 90 of the Act).
363 The following entities can become agents of an investment company: natural person, legal person or an entity without legal personality.
5
Financial markets

5.1. Money market

5.1.1. Evolution of the money market size and structure

Compared to 2004, the outstanding value of the Treasury bills issued on the money market decreased significantly. It resulted among others from the improvement of the budget situation and the policy of the issuer which aimed at decreasing the refinancing risk and the interest rate risk. The outstanding value of short-term debt securities issued by commercial banks and enterprises slightly decreased. However, the outstanding value of the NBP bills issued increased in 2005 (Table 5.1.1). FX swaps remained the most liquid investment instruments; they were most commonly used by non-residents to finance their investments in Treasury bonds and speculate on the zloty exchange rate. Commercial banks managed their current liquidity position mainly on the unsecured deposit market. The conditional transaction market was developing slowly.

Table 5.1.1. Outstanding value of individual money market instruments as of year-end, 2001–2005 (PLN billion)

<table>
<thead>
<tr>
<th>Instrument</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Treasury bills</td>
<td>35.2</td>
<td>42.0</td>
<td>48.1</td>
<td>46.9</td>
<td>24.4</td>
</tr>
<tr>
<td>NBP bills</td>
<td>14.3</td>
<td>7.3</td>
<td>6.0</td>
<td>5.7</td>
<td>23.0</td>
</tr>
<tr>
<td>Short-term commercial bank debt securities</td>
<td>1.8</td>
<td>2.8</td>
<td>3.5</td>
<td>2.7</td>
<td>2.6</td>
</tr>
<tr>
<td>Short-term corporate bonds</td>
<td>n/d</td>
<td>8.0</td>
<td>7.3</td>
<td>6.5</td>
<td>4.8</td>
</tr>
<tr>
<td>Unsecured deposits (interbank deposits)</td>
<td>25.0</td>
<td>23.5</td>
<td>22.3</td>
<td>25.1</td>
<td>29.2</td>
</tr>
<tr>
<td>Secured deposits (FX swap and conditional transactions)(^1)</td>
<td>n/d</td>
<td>n/d</td>
<td>n/d</td>
<td>n/d</td>
<td>n/d</td>
</tr>
</tbody>
</table>

1 It is not possible to determine the values of banks’ positions due to FX swaps and conditional transactions on the basis of data from the bank reporting system.
Source: NBP data.

5.1.2. Marketable short-term debt securities market

5.1.2.1. Treasury bills

Market size

The downward trend in the financing of the State Treasury debt with Treasury bills was maintained in 2005. The amount outstanding of the issued Treasury bills amounted to 24.4 billion zloty at the end of 2005 and was by 48% lower than at the end of 2004. It was the lowest level of the State Treasury debt arising from the Treasury bills issued since 2001.

From August 2004 the amount outstanding of the Treasury bills issued has decreased relatively systematically month to month.
The reduction in the amount outstanding of Treasury bills was the result of the improved liquidity of the central budget and the decisions on the public debt management. The budget deficit in 2005 amounted to 28.4 billion zloty and was 31.5% lower than in 2004. It was also lower by 19% than the deficit planned for 2005.

The decreasing importance of Treasury bills in financing the borrowing needs of the central budget was also the result of the strategy adopted by the Ministry of Finance. The public finance sector debt management strategy prepared each year by the Ministry of Finance assumed the reduction of the domestic currency refinancing risk.

The additional short-term factors which influenced the decrease in the amount of Treasury bills issued included:

– use of funds accumulated in previous years; average level of the central budget liquidity reserve held with the NBP and BGK decreased by over a half, from 15.4 billion zloty in 2004 to 6.0 billion zloty in 2005;

– accumulation of maturities of Treasury bonds with maturities of up to one year; the share of such bonds in the total Treasury securities amounted to 13.2% at the end of 2004 and 18.9% at the end of 2005.
A significant decrease in the value of Treasury bills issued resulted in the share of the short-term securities issue in the whole domestic Treasury securities market achieving the average level of debt securities markets of the euro area countries. The share of Treasury bills in the Treasury securities at the end of 2005 amounted to 7.8% in Poland and to 8.3% in the euro area countries.

**Primary market**

From 1 January 2003 Treasury bills are sold on the primary market within the Primary Dealers System. The rules governing the system operation are set forth by the regulations on performing the function of the Primary Dealer, which are prepared each year by the Ministry of Finance. In 2005, two foreign financial institutions were for the first time chosen to be Primary Dealers in the competition for performing the function of the Primary Dealer in 2006. As in 2004, also in 2005 eleven Primary Dealers and BGK had the right to purchase Treasury securities on the wholesale primary market.\(^\text{364}\)

The gross Treasury bills issued decreased from 48.7 billion zloty in 2004 to 26.9 billion zloty in 2005. In 2003 and 2004, the issues of Treasury bills in the first and second half of the year were almost evenly distributed while the value of Treasury bills issued in the second half of 2005 amounted to only 29.3% of the bills issued in the whole year.

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\(^{364}\) In 2004, twelve Primary Dealers were selected but one of them was excluded during the year.
As in previous years, the value of purchase bids significantly exceeded the supply of Treasury bills. In 2005, the demand to supply ratio amounted to 3.08 (in 2004, the analogical ratio was 2.70).

As in previous years, also in 2005 mainly 52-week bills were issued. An important change to the structure of Treasury bills issued was the lack of 26-week bills issue. The tendency to abandon the use of this instrument has been visible in the issuing policy of the Ministry of Finance for several years. The improvement in the budget situation resulted in the lower concentration of the securities maturity and thus no need for the issue of 26-week bills.

**Secondary market**

Treasury bills are traded on the OTC market (99.4% of the total turnover) and on the electronic MTS Poland platform (0.6% of the total turnover). One of the reasons behind such a high concentration of trade in Treasury bills on the non-regulated market was the fact that the market was dominated by conditional transactions (repo and sell-buy-back). Conditional transactions amounted to 90% of total transactions. Since 2002 the share of conditional transactions has fluctuated between 88% and 93%. The fact that only banks could conduct transactions on the MTS Poland market limited the possibilities of the electronic market development. However, as compared to the interbank OTC market, the turnover on the MTS Poland market was also small and amounted to 6%.

Organisational and ownership changes which occurred in the electronic platform in 2004 contributed to the increase in its importance. The turnover on MTS Poland increased by 15% in 2005 as compared to the previous year.

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Average daily gross turnover in Treasury bills amounted to 9.7 billion zloty in 2005 and was 30.3% lower than in the previous year. The main reason for the drop in the turnover in Treasury bills in 2005 was the decrease in the value of the outstanding securities. The drop in turnover was accompanied by a slight deterioration in the Treasury bills liquidity resulting from its correlation with the market size. The liquidity ratio decreased from 5.86% in 2004 to 5.79% in 2005.366

Transactions between banks and non-banking customers constituted 88.6% of all transactions in 2005. Transactions between banks amounted to 9.9%, between banks and foreign customers to 0.1% and other transactions stood for 1.4% of the total. Such a high share of transactions between banks and non-banking customers shows that the majority of the Treasury bills purchased by banks on the primary market were resold. As a result, domestic non-banking investors were the largest group of investors. At the end of 2005, they owned 58.9% of the Treasury bills issued (57.9% at the end of the previous year). However, there was no single dominant group of investors among the domestic bank investors. The banks had 40% and foreign investors 1.1% of the Treasury bills issued.

The increase in the number of domestic non-banking investors among the buyers of Treasury bills resulted from the yields on money market instruments. The yield on Treasury bills was higher than the yield on bank deposits. It resulted in the situation where the purchase of Treasury bills was beneficial for enterprises and households without the access to interbank deposit market.367

**Figure 5.1.6. Monthly turnover in Treasury bills in Poland, 2002–2005**

Source: NBP.

**Figure 5.1.7. Investors on the Treasury bill market, 1998–2005**

Source: NBP.

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366 The liquidity ratio is measured as a ratio of average monthly gross turnover to average amount outstanding of bills issued in subsequent months. Since conditional transactions are counted as two single transactions, the changes in the value of these transactions have a significant impact on the liquidity level.

367 Individual buyers may purchase Treasury bills in banks. The required minimum value of the transaction of the Treasury bills purchase is usually 50,000 zloty.
Prospects

In 2005, the decrease in the share of Treasury bills in the Treasury securities issued was stronger than it had resulted from the previous trend. Since a significant decrease in the Treasury bills issued resulted, inter alia, from one-off factors (use of the money surplus from previous years by the Ministry of Finance, relatively high value of Treasury bonds with maturities of up to one year), the decrease in the Treasury bills issued may slow down in 2006. The Public Finance Sector Debt Management Strategy prepared each year by the Ministry of Finance provides for the reduction of the State Treasury debt from the Treasury bills issued to 6.3% of the domestic debt in 2008.\footnote{Strategia zarządzania długiem sektora finansów publicznych w latach 2006-08, Warszawa, September 2005, Ministry of Finance, p. 31.}

The stabilisation of the budget situation will determine whether the share of the Treasury bills in the State Treasury debt financing will be established at the level recorded in the euro area. The potential increase in uncertainty or the deterioration of the financial situation of the State will contribute to the increase in Treasury bills issued.

5.1.2.2. NBP bills

The issue of money market bills is the main open market operation performed by the NBP on the domestic money market. The value of each money market bills issue depends on the forecasted scale of excess liquidity in the domestic banking system. The central bank uses this instrument to absorb the excess liquidity and control the level of short-term interest rates on the interbank deposit market.

Market size

In 2005, the excess liquidity of the banking system, as measured by the balance of money market bills issued and outstanding, significantly increased (by 11.4 billion zloty on an annual average basis as compared to 2004). The most important reason for the increase in the scale of excess liquidity of the banking sector was the net purchase of foreign currencies by the NBP. The central bank was servicing the EU funds by buying large amounts of foreign currencies transferred to Poland by the European Commission. The second important factor which influenced the increase in money market bills issuance was the decrease in the balance of the State budget time deposits with the central bank. It should be remembered that in 2004 the liquid funds on the money market were largely absorbed by the Ministry of Finance, which held a very high level of zloty deposits with the NBP. The extended possibilities of distributing the central government liquidity reserve in the banking sector and the introduction of limits on State budget time deposits with the NBP as from 1 January 2005 (Box 5.1.1) significantly decreased the share of the Ministry of Finance in the...
absorption of liquid funds on the interbank market. The average amount of the Ministry of Finance time deposits held with the NBP in 2005 was 5 billion zloty and was by 7.2 billion zloty lower than in 2004. The increase in the excess operational liquidity in the second half of 2005 was also influenced by the payment of the NBP profit to the State budget and the further redistribution of those funds by the government. The liquidity was reduced only by the increase in reserve money. Taking into account the above-mentioned factors, the central bank gradually increased the value of money market bills offered on weekly auctions. The balance of NBP bills issued and outstanding amounted to 23 billion zloty at the end of December 2005 and was by 17.26 billion zloty higher than in the previous year (Figure 5.1.9).

Box 5.1.1

CHANGES TO THE CENTRAL GOVERNMENT DEPOSIT SYSTEM

In 2004, the Ministry of Finance and the NBP undertook measures aimed at transferring central budget deposits outside the central bank. In May, the Ministry of Finance signed an agreement with Bank Gospodarstwa Krajowego (BGK) on accepting the State budget time deposits in zloty. Pursuant to the agreement, the BGK deposited the funds on the interbank market by contracting buy-sell-back transactions collateralised with Treasury bills with the banks performing the function of Primary Dealers. In December 2004, the Ministry of Finance and the NBP signed a new framework agreement on the central government time deposits with the central bank. The agreement introduced the limits on time deposits of the State budget with the NBP as from the beginning of 2005. According to the arrangement, the level of maximum daily value of deposits was gradually reduced (from 10 billion zloty at the beginning of the year to 6 billion zloty at the end of 2005). Due to the above-mentioned constraints on the allocation of temporary budget surpluses with the central bank, the Ministry of Finance extended the possibilities of depositing the funds on the interbank market. From 21 January 2005, the Treasury bonds may be used as collateral for the deposits in conditional transactions. At the end of July 2005, the scope of the State budget liquidity management instruments was extended by unsecured deposits placed through BGK with the banks having the status of Primary Dealers. The average level of funds deposited by the Ministry of Finance with the banking sector amounted to 934 million zloty in 2005.

The changes introduced to the Ministry of Finance time deposits system allowed to improve the liquidity forecasts made by the central bank and, as a consequence, decreased the volatility of short-term interest rates on the interbank money market.


Figure 5.1.9. NBP bills issued and outstanding, 2002–2005 (as of month-end)

Source: NBP Securities Register.
From the beginning of 2005, the maturity of NBP bills was shortened to 7 days.\(^{369}\) The change allowed the NBP to adjust in a more flexible way the scale of its operations to the liquidity situation in the banking sector. In addition, commercial banks could determine their needs easier and more precisely within a week’s perspective. The direct impact of the NBP on the level of one-week interbank deposits contributed to the reduction of fluctuations of short-term interest rates on the interbank deposit market (Figure 5.1.10). In 2005, the average deviation of the SW WIBOR rate from the reference rate amounted to 9.15 basis points and was by 8.6 points lower than the average deviation of 2W WIBOR rate in 2004, when the NBP issued bonds with a 14-day maturity. The shortening of the main open market operations’ maturities adjusted the operational instruments of the NBP monetary policy to the Eurosystem standard modified in 2004.\(^{370}\) The money market bills were issued regularly once a week, each Friday.\(^{371}\) The auction participants included 13 banks with the Primary Dealer status\(^{372}\) and, pursuant to statutory provisions, the Bank Guarantee Fund.\(^{373}\) However, it was announced that from 2006 all banks operating in Poland which meet the technical requirements related to performing the open market operations would be able to participate in the main NBP open market operations.\(^{374}\) The Primary Dealers system will be maintained in order to select the partners for fine-tuning operations.

![Figure 5.1.10. Deviation of WIBOR rates from the NBP reference rate, 2003–2005](image)

**Primary market**

As in previous years, in 2005 the demand for money market bills from commercial banks exceeded the supply. In absolute terms, the surplus of demand over supply was significantly higher in 2005 than in the previous year (by 6.5 billion zloty on average). However, overbidding measured as the ratio of demand to supply at an auction was lower and more stable than in 2004 (Figure 5.1.11).

The shortening of the maturity time of the open market operations and the reduction of the volatility of the Ministry of Finance time deposits allowed to decrease the fluctuations of short-

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\(^{370}\) Since March 2004 the maturity time of the ECB main open market operations has amounted to 7 days. More about the instruments of the ECB monetary policy in: *Monetary policy implementation in the euro area*, Frankfurt 2005, ECB.

\(^{371}\) When Friday was an official holiday, the auction was held on Thursday.

\(^{372}\) These were the most active banks in the money and OTC interest rate derivatives markets. The banks were selected based on the uniform Dealer Activity Index criteria prepared by the NBP.


\(^{374}\) The requirements include direct participation in the SORBNET payment system and the NBP Securities Register and having the ELBON application which facilitates electronic submission of orders to the NBP.
term interest rates and limited the overbidding. These activities contributed to the improvement of the liquidity forecasts prepared by the NBP and commercial banks, which allowed them to plan their demand for liquidity-absorbing operations. From the beginning of 2006, the scope of information on the banking system liquidity, to be made available by the central bank, will be extended. The NBP will publish information about the average value of banks’ current accounts on the day preceding the reserve requirement period as well as the projection of average balances of those accounts for the following week (time of the absorbing operation) once a week, on the day of the money market bills’ auction, in the Reuters information service. Publication of this information should improve the accuracy of the liquidity forecasts made by commercial banks and increase the rationality of their decisions concerning the value of bids placed at the auction, which in turn will contribute to the stabilisation of short-term interest rates on the interbank money market.

**Figure 5.1.11. Overbidding on the NBP bills market, 2003–2005**

Secondary market

Secondary trading in money market bills took place on the non-regulated interbank market. The value of transactions on the secondary market increased significantly in 2005 (Figure 5.1.12) as a result of the increased value of issues and thus the amount of outstanding money market bills. However, due to the shortening of the open market operations’ maturity to 7 days, the money market bill market was characterised by low liquidity. It is demonstrated by the number of concluded transactions (the average daily number of transactions was still lower than 10). A large part of the operations were transactions where the Primary Dealers resold the purchased bills to other banks shortly after the auction. Due to a very short maturity period, money market bills were seldom used as collateral in repo transactions. The share of conditional transactions in total net turnover in money market bills decreased by a few percentage points compared to previous years and amounted to slightly less than 2%. It did not, however, limit the development of conditional transactions market since the Treasury bonds were more often used as collateral for those operations.

Prospects

The excess liquidity of the banking system in 2006 should be similar to the one recorded in 2005. In the coming years, the scale of excess liquidity will depend on the following factors: net foreign exchange sales/purchases by the NBP in respect of servicing EU funds and Poland’s foreign debt, changes to the amount of notes and coins in circulation and the amount of Ministry of Finance deposits with the NBP. The value of the State budget deposits held with the central bank

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375 This is the ratio of the nominal value of repo transactions to the total net value of money market bill transactions. Estimates based on reports submitted by a group of banks, the Money Market Dealers, to the NBP.

should further decrease, which will have an impact on the increase in excess liquidity. The implementation of these plans will make it possible to significantly reduce the fluctuations of one of the most important independent factors which affect the scale of operational excess liquidity in the banking sector and, as a result, to reduce the fluctuations of short-term interest rates owing to the increased accuracy of liquidity forecasts prepared by the NBP and commercial banks.

Figure 5.1.12. Secondary market for NBP bills, monthly net turnover, 2002–2005

The liquidity situation in the domestic banking system will change completely only after Poland’s accession to the euro area. Banks operating in Poland will then become the element of the European banking system. The structural liquidity shortage on the euro area money market will result in the fast absorption of the excess funds in Poland by banks from other countries. The NBP will cease issuing money market bills and will carry out refinancing operations within the framework of the Eurosystem monetary policy.

5.1.2.3. Short-term commercial bank debt securities

Size and structure of the market

Short-term bank debt securities (SBDS) include bonds and bank securities with the original maturities up to one year, issued by commercial banks.

The outstanding value of SBDS on the domestic market amounted to 2.6 billion zloty at the end of 2005. The nominal value decreased by 3.3% as compared to the previous year. The share of short-term securities in the total bank debt securities also decreased. It was a continuation of a downward trend which started in 2002.

Table 5.1.3. Short-term commercial bank liabilities related to debt securities issued, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Short-term commercial bank liabilities related to debt securities issued (PLN billion)</td>
<td>2.8</td>
<td>3.5</td>
<td>2.7</td>
<td>2.6</td>
</tr>
<tr>
<td>Share of short-term securities in bank liabilities related to debt securities issued (%)</td>
<td>89.6</td>
<td>69.2</td>
<td>60.3</td>
<td>49.4</td>
</tr>
</tbody>
</table>

Source: NBP.

At the end of 2005, the share of SBDS in bank liabilities related to debt securities issued was still high as compared with developed capital markets, despite decreasing trend. In the euro area countries this share amounted to 11.7%. At the same time, the share of SBDS in total banks
Financial markets

liabilities amounted to 1.9% in the euro area while in Poland the figure was 0.5%, mainly due to a different liquidity situation.

In 2005, commercial banks significantly increased the value of bonds issued through private placements, which became the main type of SBDS. SBDS are issued first of all as discount securities.

At the end of 2005, the securities issued for up to 3 months amounted to over a half of the banks’ liabilities related to SBDS. Bonds issued through private placements predominated since the issue of short-term bonds for up to 1 year on public market was unprofitable. Public offerings were characterised by higher costs while the liquidity of SBDS issued in this market is as low as the liquidity of the securities offered under private placements. Therefore, such securities were less profitable for investors.

Table 5.1.4. SBDS structure by debt instruments (% as of year-end)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Bonds issued through private placements</td>
<td>32.3</td>
<td>56.9</td>
</tr>
<tr>
<td>Bonds issued through public offerings</td>
<td>18.0</td>
<td>4.6</td>
</tr>
<tr>
<td>Bank securities</td>
<td>49.7</td>
<td>38.5</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: NBP.

Table 5.1.5. Maturity structure of short-term bank debt securities with the original maturities of up to one year, 2002–2005 (%)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Up to 1 month</td>
<td>7.5</td>
<td>5.2</td>
<td>12.2</td>
<td>18.7</td>
</tr>
<tr>
<td>From 1 month up to 3 months</td>
<td>19.3</td>
<td>13.4</td>
<td>41.7</td>
<td>50.3</td>
</tr>
<tr>
<td>From 3 months up to 6 months</td>
<td>6.7</td>
<td>16.0</td>
<td>14.5</td>
<td>17.1</td>
</tr>
<tr>
<td>From 6 months up to 1 year</td>
<td>66.5</td>
<td>65.3</td>
<td>31.6</td>
<td>13.9</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: NBP.

Primary market

The reason for the lower value of SBDS issued and the change of their structure in 2004 and 2005 was the fact that banks ceased offering one-year bonds in public offerings. The structure of those bonds allowed to use the exemption from the income tax on paid disposal of securities admitted to public trading and purchased before 31 December 2003. Following the expiry of this income tax exemption on 1 January 2004, the further issue of ‘anti-tax’ bonds was not justified. After 2004, only Bank BPH continued to issue one-year public bonds on a regular basis but began to reduce their number and ceased issuing these debt securities from August 2005.

The main reason for abandoning the issue of public bonds was a relatively high cost of acquiring the money along with low interest of these securities for investors on the primary market, since banks had to incur the costs related to the introduction and maintenance of bonds on the public market. Moreover, due to a relatively low price interest of one-year bonds issued through public offerings, the issues were only partly subscribed, which increased the unit issue costs. In 2005, one-year bonds worth 490 million zloty were issued through public offerings, out of which bonds worth 90.3 million zloty were registered at the National Depository for Securities. It means that the supply of the bonds was over five times larger than the demand. The lack of demand for one-year bonds issued through public offerings resulted in the average sales of a single issue amounting to 18.4 million zloty while the planned sales were 122.5 million zloty. The average value of publicly offered issues amounted to 47.6 million zloty in 2005.

Source: NBP, ECB.
The interest in the purchase of SBDS by households and entities from the category of ‘other financial intermediaries’ increased in 2005. Despite a relatively low interest of bank bonds as compared to other securities (e.g. Treasury bills), the investors who purchased them could obtain higher income than when depositing money with the bank. In 2005, the interest on bank deposits declared for the period of up to one year amounted on average to 2.7% for enterprises and 3.7% for households. In addition, the enterprises, households and other investors which temporarily had available funds could sell the bank bonds on the secondary market in the case of increased demand for money. In the case of smaller investors, the limited possibilities of purchasing other debt instruments also played a significant role. For example, the purchase of Treasury bills required the investment of at least 50,000 zloty.

**Secondary market**

SBDS sold through public issues are traded in regulated secondary markets. The changes which took place in 2004 and made it possible for, among others, the National Depository for Securities to hold a bank securities deposit, did not contribute to the creation of a regulated market in which various issuers’ securities could be traded. At the end of 2005, no bank securities were registered with the National Depository for Securities.

Table 5.1.6. Yield on one-year bonds issued through public offerings and of Treasury bills sold on the primary market, 2005

<table>
<thead>
<tr>
<th>Month of issue</th>
<th>Yield on bank bonds (%)</th>
<th>Subscription fee (PLN) maximum</th>
<th>Subscription fee (PLN) minimum</th>
<th>Yield on Treasury bills (%) without the subscription fee and costs of Treasury bills purchase</th>
<th>Difference between the yield on bank bonds and Treasury bills including the average subscription fee and costs of Treasury bills purchase1</th>
</tr>
</thead>
<tbody>
<tr>
<td>January</td>
<td>6.75</td>
<td>1.19</td>
<td>0.79</td>
<td>6.25</td>
<td>0.50</td>
</tr>
<tr>
<td>March</td>
<td>6.00</td>
<td>1.09</td>
<td>0.69</td>
<td>5.56</td>
<td>0.44</td>
</tr>
<tr>
<td>April</td>
<td>5.00</td>
<td>0.49</td>
<td>0.00</td>
<td>5.37</td>
<td>-0.37</td>
</tr>
<tr>
<td>July</td>
<td>4.40</td>
<td>0.39</td>
<td>0.09</td>
<td>4.29</td>
<td>0.11</td>
</tr>
</tbody>
</table>

1 The costs of Treasury bills purchase by non-financial investors were assumed to be 0.4% percentage point. The purchase of Treasury bills by investors which are not Primary Dealers results in costs amounting to 0.2–0.5 percentage points. While offering the purchase of Treasury bills to individual customers, banks set forth a minimum transaction value (usually 50,000 zloty). The higher the purchase value, the lower the margin and subscription fee.

Source: NBP study based on issue letters for bonds issued through public offerings in 2005.

**Table 5.1.7. Structure of SBDS buyers, 2004–2005**

<table>
<thead>
<tr>
<th>Category of buyers</th>
<th>Share in the total value of SBDS (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2004</td>
</tr>
<tr>
<td>Enterprises</td>
<td>69.3</td>
</tr>
<tr>
<td>Other financial intermediaries</td>
<td>9.6</td>
</tr>
<tr>
<td>of which: investment funds</td>
<td>–</td>
</tr>
<tr>
<td>Households</td>
<td>2.3</td>
</tr>
<tr>
<td>Monetary financial institutions</td>
<td>9.0</td>
</tr>
<tr>
<td>Other entities</td>
<td>9.8</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: NBP calculations based on information obtained from the banks which are Primary Dealers or money market dealers serving as depositaries.
The bonds issued by commercial banks are traded on the Warsaw Stock Exchange and the RPW CeTO market. In 2005, the one-year bond turnover is concentrated on the WSE, since the public bonds issued by the largest issuer, i.e. Bank BPH, were traded on this market. The market was characterised by a very low liquidity. The annual value of one-year bank bond turnover on the WSE amounted to 7.5 million zloty. In the second half of 2005, the turnover decreased due to a lower number of bond issues outstanding. This was the period in which several issues had to be redeemed and there were no new issues.

**Prospects**

In the coming years, the importance of SBDS is likely to decrease. The growing demand for long-term loans (due to, among others, the increasing importance of housing loans) will increase the banks’ demand for money for longer periods. The aim of the SBDS issues will be mainly to finance short-term needs of the banks. In 2006, banks will probably concentrate on the sale of securities through private placements. The importance of bond issues through public offerings will continue to diminish due to a relatively high cost of acquiring financing through such issues. The interest of such securities for investors is also low.

5.1.2.4. Short-term corporate bonds

**Market size**

In 2005, the preceding trends were maintained which means that the short-term corporate bond (SCB) segment in Poland has still diminished. Its share in the non-Treasury debt securities market decreased to 19.7% while in 2002 it was still 41.8%.\(^{379}\) The total outstanding value of the SCB issued decreased by 26.2% within a year (from 6.5 billion zloty in December 2004 to 4.8 billion zloty in December 2005). The number of issuers of the SCB dropped as well (Table 5.1.8).

In 2005, the corporations increasingly preferred to obtain the funds on the market for the period longer than one year. As a result the share of SCB in the total outstanding value of debt securities issued decreased from 47% at the end of December 2004 to 35% at the end of December 2005. This trend was particularly strong in the second half of the year.

\(^{378}\) The SCB market includes debt securities issued in Poland by corporations, other financial intermediaries (excluding investment funds) and financial auxiliaries.

The term corporations denotes all institutional units recognised as legal entities which are market producers and whose principal activity is the production of non-financial goods and services.

Other financial intermediaries are financial institutions whose main activity is financial intermediation through incurring liabilities in forms other than currency, deposits and/or close substitutes for deposits from institutional units other than financial institutions, e.g. leasing and factoring companies.

Financial auxiliaries are financial institutions which are not engaged in financial intermediation on their own behalf but only contribute to the creation of conditions for such intermediation, e.g. asset management companies, investment fund management companies and pension fund management companies.

\(^{379}\) NBP data submitted by banks – Primary Dealers and (or) money market dealers serving as depositaries.
The favourable financial results of enterprises which had been maintained in Poland for several years influenced the decrease in the demand for debt financing. Since the companies had a large amount of available funds, they financed their business activities largely from own funds^380 and deposited the surplus in the banks (at the end of December 2004 the value of corporate deposits amounted to 4.9 billion zloty and at the end of December 2005 it was 99.2 billion zloty). The external financing sources included mainly bank loans (119 billion zloty at the end of December 2005) which still prevailed among foreign sources of capital (Figure 5.1.15). SCBs were seldom used as a source of financing short-term needs of enterprises^381 although the costs of financing through short-term securities issues decreased in the analysed period (Figure 5.1.16).

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Table 5.1.8. Outstanding value of SCBs issued, 2002–2005 (end of December)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding value (PLN billion)</td>
<td>7.99</td>
<td>7.34</td>
<td>6.5</td>
<td>4.8</td>
</tr>
<tr>
<td>SCB issuers</td>
<td>272</td>
<td>232</td>
<td>193</td>
<td>184</td>
</tr>
</tbody>
</table>

Source: NBP data submitted by banks – Primary Dealers and (or) money market dealers serving as depositaries, Fitch Polska.

Figure 5.1.14. Corporate debt securities structure, 2004-2005

Source: NBP study based on data submitted by banks – Primary Dealers and (or) money market dealers serving as depositaries.

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It seems that the decrease in the use of the SCB as a source of financing results also from the still small demand for those instruments on the part of institutional investors.

The share of SCB in the corporate financing is low in the countries with stable economic conditions where enterprises finance their investments from, among others, issues of debt securities with long maturities. As in previous years, also in 2005 the long-term debt securities prevailed in the corporate securities issued in the euro area (Figure 5.1.17). The SCB market development slowed down in favour of securities with longer maturities. Compared to 2004, the size of the SCB market diminished (96.0 billion euro in 2005, 97.1 billion euro in 2004).382

Figure 5.1.17. Outstanding value of short-term and long-term debt securities issued by non-financial corporations in the euro area

Note:
1. Non-financial corporations include businesses and non-monetary financial corporations, i.e. other financial intermediaries, financial auxiliaries, insurance companies and pension funds.
2. Data apply only to issues by euro area residents.

The French market, whose value increased by almost 4 billion euro, remained the largest SCB market in the euro area. As regards the total outstanding value at the end of December 2005, it accounted for over 40% of the whole euro area market. The share of the Polish SCB market in the European market amounted to only 1.3% (Figure 5.1.18). Compared to 2004, the outstanding value of SCBs issued decreased, inter alia, in Germany and Spain.

**Primary market**

In 2005, no changes to the SCB issuers’ structure took place. As in 2004, the leasing companies were the most active SCB issuers among other financial intermediaries (Figure 5.1.19). It was related to the increased value of leased assets in Poland and the growing demand of lessors for external financing. The main legal basis for the issues in 2005 was the Bonds Act (91% issues by outstanding value at the end of 2005 as compared to 78.6% at the end of 2004), which indicates the tendency to consolidate the legal basis.383 The share of the issues on the basis of the Bill of Exchange Act amounted to 7.8% and on the Civil Code to just 1.2%. As in previous years, the issues were offered through private placements.

Rating still did not play an important role on the Polish SCB market. Despite being aware of the benefits from having the rating, the majority of issuers did not see the need to obtain it.384

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384 It is confirmed by the results of the NBP research carried out in 2004. See: A. Graż, P. Sobolewski (ed.): Wybrane determinanty rozwoju rynku akcji i korporacyjnych instrumentów dłużnych w Polsce. Wyniki badania ankietowego, Warszawa 2005, NBP.
The number of new SCB issuance programmes continued to decline. In 2005, 17 programmes were organised (19 in 2004). The SCB issued under the existing programmes prevailed, while the new issuance programmes did not have a significant impact on the size of the market due to their low value. In 2005, the amounts of individual SCB issues ranged from 0.1 million zloty to 320 million zloty. The average value of the issue amounted to 19 million zloty. The largest new issuance programmes were initiated for the following companies: Polkomtel (1 billion zloty), International Paper Kwidzyn (400 million zloty) and Echo Investment (300 million zloty). The programme for Sitech, which in 2004 was increased to 2 billion zloty, remained the largest issuance programme. The nominal value of a single instrument in 2005 ranged from 10,000 zloty to 1 million zloty.

In 2005, the maturity structure of SCBs was dominated by the instruments with maturities of up to 3 months. The majority of SCB issues (around 99%) were unsecured.

At the end of 2005, 16 banks were involved in the organisation of issues. The number of arrangers decreased by 2 as compared to 2004. The concentration among issuing agents observed for many years was present also in 2005 (5 banks accounted for 75.67% of SCB issues conducted, as measured by outstanding value).

Secondary market

The liquidity of the secondary SCB market remained low. There were no qualitative changes on the secondary market in 2005 which would improve its organisation and eliminate the existing obstacles to SCB market development. The secondary market was still strongly segmented, since due to the lack of a common clearing house the individual SCB issuing agents organised their own trading markets.

Investors

As in previous years, enterprises and banks dominated in the structure of SCB buyers. The reason for this was the character of the SCB issues which were addressed directly to the entities chosen by the issuing agent or issuer. The interest of investment funds and insurance companies in the SCB issues was still too small, though a tendency of the increase of their participation in the structure of SCB purchasers was being observed. It is these entities which determine the pace of development of the SCB market on the developed markets.

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Prospects

Taking into account the trends from previous years and the financial results of enterprises, further decline in the companies’ SCB issues should be expected. Even if the improvement of the financial standing of enterprises will lead to the rise of both investments and the demand for financing, the latter is expected to be satisfied by the issues of the long-term debt securities.

Some increase in demand on the part of institutional investors may become an incentive to the development of the SCB market in the coming years.

5.1.3. Deposit transaction market

Deposit transactions are used for current financial liquidity management by enabling market participants to invest temporary surpluses or to borrow funds. Taking into account the transaction credit risk, unsecured interbank deposits, as well as deposits collateralised by foreign currency (FX swaps) and by securities (conditional operations – repos and sell-buy-backs) can be distinguished.

The most important participants of the deposit transaction market are banks which lend available funds to one another on a daily basis. Large-value transactions with maturities ranging from one day to one year are concluded on the interbank market. The structure of the interbank deposit transaction market in Poland was considerably different from the structure of this market in the euro area (Figure 5.1.24). Conditional transactions, mostly repos, were the main instrument of liquidity management at banks on the euro area money market. The tri-party repos\(^{388}\) have become increasingly popular, especially among short-term operations (O/N, S/N, T/N).\(^{389}\) In such repo transactions, cash and securities are exchanged through a third party, i.e. an agent, which improves the efficiency of the settlement of operations and reduces the operational barriers and credit risk.\(^{390}\) As regards the unsecured deposit market in the euro area, banks were the most active in the one-day deposit segment. These operations are a kind of supplement for deposits in conditional transactions where the loans with maturity periods from T/N to one month prevailed.\(^{391}\) FX swaps were the most seldom used deposit instrument for banks in the euro area.

In Poland, the participants of the interbank market rarely used conditional transactions to manage their liquidity. Although the share of such transactions in deposit operations of banks has been gradually increasing, the growth rate of the conditional transactions market remains relatively low. Another collateralised deposit instrument, i.e. FX swap, was used mainly in operations with non-residents. Foreign banks readily borrowed zlotys in short-term T/N and O/N swaps while domestic banks hedged their foreign currency liquidity position in this way. Banks used mainly unsecured deposits for short-term financing in zlotys. For smaller banks, unsecured deposits were sometimes the only liquidity management instrument.

Unlike repos and FX swaps, classic deposits which dominate on the domestic interbank money market do not require any collateral but at the same time are burdened with much higher risk and, to a larger extent, charge the credit limits which banks impose on one another.\(^{392}\) Due to low credit limits imposed on small banks by other market participants, such banks have limited


\(^{389}\) This is the form of denoting the maturity periods of interbank deposits. Standard maturity dates: one-day – O/N, T/N, S/N, one week – SW, two weeks – 2W, three weeks – 3W, one month – 1M, two months – 2M, three months – 3M, six months – 6M, nine months – 9M and one year 1Y. All deposits except for O/N and T/N begin on the second working day after the conclusion of the transaction. O/N (overnight) deposit begins on the day of the conclusion of the transaction and matures on the following working day, T/N (tomorrow next) is a deposit which begins on the first working day following the day of the conclusion of the transaction and matures on the following working day.

\(^{390}\) The agent is responsible for the efficient settlement of the transactions, daily valuation of securities and maintaining the collateral of appropriate value. The function of an agent is most often performed by the custodian bank or the central depository for securities.


\(^{392}\) The charge on the credit limit arising from conditional transactions and FX swaps amounts up to 10% of the nominal value of the transaction while for a classic interbank deposit it amounts to 100% of nominal value.
financing possibilities on the interbank deposit market and must often rely on switch transactions\(^{393}\) where conclusion depends on a third party. In such a situation it would be much easier to obtain funds on the conditional transaction market. The development of the interbank repo market in Poland would bring the structure of the domestic money market closer to the one of the euro area and facilitate the full integration of both markets after the adoption of the common currency.

Figure 5.1.24. Deposit transactions structure on the interbank market in Poland and in the euro area, 2003–2005

![Figure 5.1.24](image)

Note: Net turnover on the deposit transaction market is equal to the nominal value of unsecured deposits, conditional transactions and FX swaps denominated in zloty and euro and concluded between banks – Polish and euro area residents.

5.1.3.1. Unsecured deposits

Unsecured interbank deposits are the simplest and most common of liquidity management instruments used by banks operating in Poland. On the interbank deposit market, funds are continuously transferred from banks with temporary surpluses to banks with liquidity shortages. Liquidity needs of the bank which result from the necessity to maintain an average level of the reserve requirement, as well as from its operations in different segments of the financial market (i.a. granting loans, activity on the securities market, foreign exchange transactions), are satisfied on the interbank deposit market on a daily basis. To this end, one-day O/N transactions are most often used since both the liquidity situation of the banking system and the demand of individual entities for funds change each day.

Market size

The unsecured interbank deposit market belongs to the most developed segments of the domestic financial market. In 2005, after an insignificant decrease in liquidity, the average daily net turnover on the interbank deposit market increased by 12% as compared to 2004 and amounted to PLN 8.2 billion (Figure 5.1.25). The increased activity on the market is also confirmed by data on the banks’ outstanding interbank deposits. Their value was significantly higher than in previous years and amounted to PLN 29.2 billion at the end of December.

As in the euro area, banks were most active in the segment of transactions with a maturity period of up to one week. The maturity structure of turnovers was dominated by one-day operations which provide banks with the possibility of flexible liquidity management and effective use of credit limits imposed on them by other market participants. In 2005, O/N deposits accounted for around 80% of net turnover in Poland and around 70% of net turnover in the euro area.\(^{394}\)

\(^{393}\) Switch is a transaction concluded between two banks via a third bank. Such transactions are used in a situation when the bank, which is going to submit its deposit, has used the credit limit imposed on its transaction partner but still disposals of a free limit for the intermediary bank, and the intermediary bank has a free limit for the bank which wants to obtain the money.

concentration of turnovers in the short-term transaction segment is confirmed by the structure of the banks' debt arising from interbank loans classified by original maturity period (Figure 5.1.27). At the end of December 2005, deposits for up to one week accounted for almost half of the outstanding debt. The share of deposits with the original maturity period of over 3 months was still low and amounted to 20%.

**Figure 5.1.25. Monthly net turnover on the interbank deposit market, 2002–2005**

![Figure 5.1.25](image)

Source: NBP.

**Figure 5.1.26. Interbank deposits outstanding at the end of quarters, 2002–2005**

![Figure 5.1.26](image)

Source: NBP.

**Figure 5.1.27. Maturity structure of interbank deposits outstanding at the end of 2005**

![Figure 5.1.27](image)

Note: The maturity intervals are left half-open. The interval labelled as "<1W" covers all deposits with maturities of up to one week (including O/N, T/N and S/N).

Source: NBP.
**Money market rates**

In 2005, the spread between the rates at which banks wished to lend funds to other banks (WIBOR) and accept deposits (WIBID) did not change. The spread quoted ranged from 10–20 basis points for deposits with maturities of at least one month to 15–25 basis points for one-day transactions. The wider spread for deposits with short maturity periods resulted from the higher sensitivity of short-term interest rates to changes in the banking system liquidity.

In line with the specificity of this market, the O/N rate fluctuated the most (Figure 5.1.28), which resulted from ongoing changes of independent factors as well as from differences in the assessment of the liquidity situation between the central bank and commercial banks. In 2005, there were no liquidity disruptions similar to those in spring of 2004. Therefore, the average deviation of the O/N WIBOR rate from the NBP reference rate was lower by as many as 18 basis points and amounted to 22 basis points. Shortening of maturities of the main open market operations contributed to the decrease in fluctuations of SW WIBOR and 2W WIBOR rates. The interest on deposits with maturity of one month and more was the most stable since it is determined mainly by the market expectations of the market participants in respect of the future interest rates’ level.

The introduction of the POLONIA (Polish Overnight Index Average) rate, the equivalent of EONIA rate in the euro area, on 24 January 2005 was an important event for the financial market development in Poland. The Polish Bank Dealers Association ACI Polska, which organises the POLONIA rate fixing in cooperation with the NBP, published the fixing rules. According to the rules, the NBP is responsible for the calculation of the POLONIA rate. The POLONIA rate is calculated as the average interest rate of O/N interbank deposits weighted by their amounts. Basis for this account are transactions concluded between the fixing participants and settled by 4.30 p.m., about which the NBP received the same information. In 2005, the participants of the POLONIA rate fixing included 13 banks operating in Poland which participated in the fixing of WIBID and WIBOR reference rates. They were required to submit to the central bank the information about the amounts, interest rates and counterparties of all unsecured O/N transactions concluded with other fixing participants. The rate was published each working day at 5 p.m. in the Reuters information service (NBPS website).

Figure 5.1.28. WIBOR and NBP deposit, reference and lombard rates, 2003–2005

![Graph showing WIBOR and NBP rates](image)

Source: Reuters.

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396 Detailed rules for the POLONIA rate calculation are presented in Regulamin fixingu stawki referencyjnej „POLONIA”, Warsaw 2005, Polish Bank Dealers Association ACI Polska.
The POLONIA rate fixing is carried out on the basis of a representative sample and reflects the true cost of raising funds on the domestic money market more accurately than the O/N WIBOR rate. It is confirmed by the fact that in December 2005 the value of deposits which created the basis for the POLONIA rate calculation accounted for around 50% of the total value of all unsecured O/N interbank deposits on the domestic market. The value of transactions, about which both parties submitted consistent information to the NBP, amounted to 98.5% of the value of all reported O/N deposits. The introduction of a more transparent rate for O/N deposits was important for the development of the derivatives market. POLONIA quickly became the standard reference rate for Overnight Index Swap (OIS) contracts on the Polish money market. Higher reliability of the new reference rate should contribute to the increased interest in OIS contracts among non-residents. In 2005, POLONIA fluctuated around the middle of the band set by the fixing of O/N WIBID and O/N WIBOR reference rates. Deviation of the POLONIA rate fixing from the middle of the band amounted usually to less than 10 basis points while the average deviation from the NBP reference rate was 26 basis points (Figure 5.1.29).

Figure 5.1.29. POLONIA rate and its fluctuations in respect of O/N WIBID and O/N WIBOR rates and the reference rate in 2005

Management of funds on bank current accounts with the NBP

As in previous years, banks maintained a small surplus of their average funds on the current accounts with the central bank as compared to the minimum reserve requirement (Figure 5.1.30). The average positive deviation of the amount of funds on accounts held with the NBP from the reserve requirement amounted to PLN 28 million (0.24% of the reserve requirement). Efficient management of current account funds was possible thanks to the use of the NBP deposit and credit operations at day’s end, as well as daily publication (in the Reuters service, on the NBPM website) of information about the reserve requirement and about the balance of commercial banks’ funds held on the central bank account one day before. In 2005, there were five cases of banks failing to meet the obligation to maintain the minimum reserve requirement.

The funds held by banks on their current accounts with the central bank are used to make large-value payments in the SORBNET system. The gradual increase of the ratio of turnover on the banks’ settlement accounts to their average balance, which had been observed since the fourth quarter of 2003, was maintained in 2005. In December 2005, the level of the reserve requirement was higher by almost 1 billion zloty as compared to December 2004, but the average daily turnover increased by over 20 billion zloty within the same period. Such a large increase in turnover resulted from increased value of flows related to interbank customer orders,\(^\text{397}\) which are a consequence of

\(^{397}\) Foreign banks make payments in zlotys through the correspondent banks which are the participants of the domestic payment system. All transactions of non-residents concluded on the market of zloty-denominated instruments are thus settled in the SORBNET system.
both dynamic development of the zloty offshore market and high activity of non-residents on the FX swap and Treasury bonds markets.

Figure 5.1.30. Deviation of the reserve holdings held on current accounts with the NBP from the required reserves, 2002–2005

![Graph showing deviation of reserve holdings from required reserves]

Source: NBP.

Figure 5.1.31. Turnover on banks’ current accounts with the NBP and the ratio of this turnover to the average amount of funds held on these accounts, 2003–2005

![Graph showing turnover on current accounts]

Source: NBP.

Executing payment orders of such a large value would be impossible without the use of an intraday credit facility. Thus, the NBP granted an intraday credit facility to the SORBNET system participants in exchange for the transfer of ownership title to Treasury securities. Within the analysed period, banks more frequently used this instrument, which facilitated the settlement of payments. In 2005, the average daily value of intraday credit taken out by banks was higher by 1.8 billion zloty as compared to 2004 and amounted to 7.35 billion zloty.

**Market infrastructure**

Unsecured interbank deposit transactions were concluded using voice brokers and the Reuters Direct electronic communication system as well as by phone. A very small number of banks used the Delta Dealing System. The frequent use of voice brokers, as compared to other instruments, resulted from the anonymity and considerable flexibility of such a method of communication between the market participants, including the possibility to find switch transaction partners.
The establishment of an electronic transactional platform was an important change to the infrastructure of the unsecured interbank deposits market. Following long preparations and consultations with the banking sector, in July 2005 the e-MID company launched an electronic platform enabling the conclusion of transactions in zlotys on the interbank deposits market. Each participant of this transactional system has a permanent view on rates and total value of transactions concluded in individual market segments. The electronic market of deposits in zlotys is not an anonymous market as the name of the bank which entered the quotations to the system is given next to the quotations. It allows the dealers to choose the offers of those contracting parties for which the bank has not used the credit limits yet. However, some market participants see the lack of anonymity as a drawback. Greater transparency reduces the asymmetry of information, which in turn reduces the possibility of posting additional profits by individual entities. The participants of the market included around 30 banks (both domestic and foreign). Average daily net turnover between July and December 2005 amounted to 143 million zloty, i.e. around 2% of the average daily value of unsecured interbank deposit transactions concluded in Poland. O/N transactions prevailed.

Another important change to the money market infrastructure in Poland was the launch of the SORBNET-EURO payment system. The new system facilitated faster and safer settlement of large-value cross-border payments in euros. In order to ensure efficient settlements, the NBP introduced an intraday credit facility in euros collateralised with Treasury bonds, for which the fixing takes place on the MTS-CeTO platform. However, both the new system and the intraday credit facility were seldom used in 2005. Banks settled the transactions denominated in euros mainly through the correspondent banks which were most often their dominant entities.

**Prospects**

The Polish money market should evolve towards the model functioning in the euro area, where conditional transactions are the main liquidity management instruments in banks and unsecured deposits play a less significant role. The factor which will have an impact on the development of the interbank deposits market is the transformation of some domestic banks into branches of foreign credit institutions (e.g. BNP Paribas, Calyon Bank). The functioning as a branch of a credit institution may eliminate one of the obstacles to the development of the unsecured deposits market, i.e. low credit limits imposed by banks on each other. A branch of a foreign credit institution uses the capital of its parent institution, which makes it possible to grant it higher limits for market and credit risk. On the other hand, with the centralisation of competences in risk management at the level of banking groups, the autonomy of such entities and their activity in various segments of the financial markets may be limited. In the coming years, an increase in operations with non-residents should be expected. The functioning of the e-MID platform will allow foreign banks to more actively participate in the interbank zloty deposits market. The launch of the large-value payment system in euros should contribute to the gradual growth of the activity of domestic entities on the euro-denominated instruments market, even prior to the adoption of the common currency.

**5.1.3.2. Secured deposits**

The analysis of the secured deposit transactions market will be divided into two parts – FX swaps (deposits collateralised by foreign currency) and conditional transactions – repos and sell-buy-backs/buy-sell-backs (deposits collateralised by securities).

**5.1.3.2.1. FX swaps**

An FX swap is a combination of two opposite foreign exchange transactions which are settled on different dates. Thus it consists of two secured deposit transactions. The sale of a foreign currency in the initial exchange (the short leg) and its obligatory repurchase in the final exchange (the long leg) make it possible to obtain zlotys for a specific period.
Market size

The złoty FX swaps market is the largest among the markets of the region. The average daily turnover on the złoty FX swap market (domestic and offshore segments together) amounted to around PLN 18.8 billion (i.e. around USD 5.8 billion) in 2005, of which 30% were operations between non-residents. In 2005, the domestic FX swap market developed further. The average daily net turnover on the interbank FX swap market in Poland increased by PLN 0.8 billion (6.5%) as compared to 2004 and amounted to PLN 13.6 billion398 (Figure 5.1.32). According to banks operating in London, the increase in turnover on the offshore market was similar (the average daily value of the transactions amounted to around USD 1.6 billion, i.e. around PLN 5.2 billion). It means the further dynamic growth of its liquidity, which has been increasing since the market emerged. Transactions with non-residents accounted for over 90% of net turnover on the domestic market. Banks operating in London were the most active among non-residents.

The higher turnover on the FX swap market resulted mainly from the increased activity of foreign banks. The stable macroeconomic situation and further appreciation of the złoty favoured the market’s growing activity. The long-term and strong appreciation trend collapsed in March but by July the złoty began to strengthen again (Figure 5.3.2). Under such circumstances, non-residents used FX swaps to speculate on the złoty exchange rate. As in 2004, banks and hedge funds, which expected the złoty to strengthen, took positions on the forward market, concluding simultaneously spot and FX swap transactions.399

Figure 5.1.32. Monthly turnover on the interbank FX swap market in Poland, 2002–2005

![Graph showing monthly turnover on the interbank FX swap market in Poland, 2002–2005](image)

Note: Net turnover – monthly nominal value of transactions adjusted for double-counting. The figures presented include only the transactions where the złoty was one of the currencies involved.

Source: NBP data submitted by banks – Primary Dealers and/or money market dealers and candidates for these functions.

2005 saw a significant inflow of foreign capital to the majority of the so-called emerging markets.400 The low inflation rate, decreasing bonds yields and the expectations of the decrease in interest rates encouraged foreign investors to invest in Polish securities. In the first half of the year, foreign financial institutions willingly invested in Polish Treasury bonds. The inflow of capital was halted in autumn as a result of the increased political risk. At the end of December 2005, the investments of non-residents on the Treasury bond market amounted to PLN 68.7 billion and were around 10.5% (PLN 6.7 billion) higher than in December 2004.401 The information obtained from the market participants suggests that part of this growth of investments was financed by złotys

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398 This is the average daily nominal value of FX swaps adjusted for double-counting. Only the złoty leg of the initial or final exchange is taken into account.
401 Data of the National Depository for Securities.
acquired on the FX swap market. A strategy of financing the position in bonds, which was very popular especially among banks, was to roll-over the zloty loans in the T/N FX swap transactions every day. This strategy largely contributed to the increased turnover on the FX swap market. Some institutional investors acquired zlotys on the offshore market by concluding and then rolling-over the transactions with longer terms, i.e. 1M and 3M FX swaps which were used to finance the investments in Polish bonds and to take forward positions on the zloty market.

An additional factor behind the increase in turnover on the FX swap market was the significant increase in amounts outstanding and activity of foreign banks on the market of interest derivatives in zlotys. The growth of turnover on the FRA market could contribute to the improvement of liquidity in the FX swap segment. FX swaps enable dealers to hedge the interest rate risk which occurs as a result of the FRA transaction.

The activity on the customer market was still limited. The average daily value of transactions concluded by banks operating in Poland with non-banking entities amounted to around PLN 250 million in 2005. The limited interest of non-financial entities in this instrument resulted from the fact that such institutions mainly use forwards to hedge against the FX risk. Natural risk mitigation techniques and FX option strategies were also popular methods for reducing the foreign exchange risk.402

**Market structure**

In 2005, the currency composition of turnover on the domestic FX swap market did not change considerably. USD/PLN deals still dominated on the interbank market and accounted for 98% of the zloty exchange transactions. The share of EUR/PLN pair was less than 2%. Such a currency structure resulted from the standard existing on the global FX market. Even in the situation of a decreasing difference between the money market rates in the United States and Poland (which occurred in 2005), foreign banks traditionally used US dollars in FX swaps. It does not mean, however, that investments in Polish bonds were refinanced in US dollars. Investors usually borrowed low interest currencies, such as yen and euro,403 on the interbank market. Then they exchanged the borrowed funds for US dollars and only then obtained zlotys in USD/PLN FX swaps. The EUR/USD and USD/JPY markets belong to the world’s most liquid FX markets. Therefore, the cost of an additional operation, i.e. the exchange of the refinancing currency to USD, is very low.404 It should be expected that even in the conditions of a negative disparity between the interest rates in Poland and the United States, the share of USD/PLN operations in the FX swap market will not decrease considerably.

USD/PLN operations accounted for 72% of the turnover on the customer market. The lower share of the USD/PLN pair in the currency compositions of operations with non-banking entities indicates that some of the transactions in this segment were used to hedge financial flows from the real sector in which euro payments prevail.

The maturity structure of turnover on the FX swap market confirms the popularity of financing positions in Treasury securities by rolling-over one-day FX swaps. Transactions with maturities of 7 days or less accounted for almost 93% of turnover on the domestic market (Figure 5.1.33). T/N and O/N swaps dominated. According to market participants’ estimations, the share of such transactions in total turnover amounted to around 75–85%. The widespread use of T/N swaps resulted from the flexibility of matching financial flows in the case of withdrawal from investments in securities and from the standard of settlement spot interbank transactions on the second business day. Transactions with maturities exceeding one month accounted for around 5% of turnover and were primarily used for speculation on interest rate and exchange rate movements.

403 In 2005, low interest rates in the Czech Republic encouraged some investors to treat the Czech koruna as the refinancing currency. The borrowing of Czech koruna was used to finance positions in securities of other emerging markets.
404 The spread between the bid and offer rate in transactions on the EUR/USD and USD/JPY spot markets amounts to just 1–3 basis points.
Financial markets

and for hedging FX positions resulting from forward transactions with non-banking entities. Such a maturity structure of the turnover on the FX swap market is also characteristic for other currencies of our region. In Hungary, the FX swaps with maturities of up to 1 week accounted for 84% of the turnover. The slightly lower share of those transactions (as compared to Poland) resulted from the lower liquidity of the Hungarian FRA market. If the FRA market is poorly developed, then FX swaps with maturities longer than 7 days are more frequently used for speculation on interest rate changes.405

Figure 5.1.33. Maturity structure of turnover on the FX swap market in Poland, 2005

![Maturity structure of turnover on the FX swap market in Poland, 2005](image)

Note: The maturity intervals closed on the right.
Source: NBP data submitted by banks which are Primary Dealers and/or money market dealers and candidates for dealers.

Market participants and infrastructure

The domestic interbank FX swap market was considerably concentrated. The share of the five most active banks in net turnover amounted to around 70%. Interbank transactions were executed in the Reuters Dealing Direct 3000 system and via voice brokers. The standard value of FX swap transactions with maturities up to 1 week amounted to between USD 25 and 200 million. For swaps with a longer maturity the ticket size seldom exceeded USD 50 million.

Prospects

Until Poland enters the euro area, the FX swap market will remain the most liquid segment of the domestic money market. Foreign banks will remain the important and very active participants of FX swap market. Even the negative disparity between the interest rates in Poland and the United States will not cause changes in the currency structure of FX swaps involving zlotys. The further development of the FX swap market and the value of the transactions will primarily depend on non-residents’ interest in investments in zloty-denominated instruments. The inflow of capital to the domestic financial market will be determined by both local and global factors.

The increase of interest rates in the USA and the euro area in the coming years could reduce the growth of capital inflow to the emerging markets. However, in the situation of global excess liquidity and observed diversification of investment portfolios the investments of global financial institutions on those markets should remain high. The stable macroeconomic environment in Poland will encourage non-residents to maintain and purchase zloty-denominated securities. The position of foreign entities in Treasury bonds should increase slightly. Potential expectations of changes in the official NBP interest rates in 2006 will additionally favour the speculation on the derivatives market. Such investment strategies will definitely use FX swaps, which should increase the FX swap market liquidity. The development of the FX swap market will also be stimulated by the operations of hedge funds which are still very active on the emerging markets. The higher volatility on the global markets and uncertainty concerning the future political situation and fiscal policy in Poland could, however, contribute to the decrease in turnover.

5.1.3.2.2. Conditional transactions

Two types of conditional transactions collateralised by debt securities are concluded on the Polish money market: repos and sell-buy-back/buy-sell-back (SBB/BSB) transactions. As a result of the collateral used in such transactions, the credit exposure to the counterparty is much lower than in traditional interbank deposits. The credit risk in conditional transactions does not arise from the counterparty’s creditworthiness but solely from the volatility of the prices of securities used as collateral. The risk of a significant decrease in the collateral value on the domestic conditional transactions market is low since it is dominated by the short-term operations collateralised with Treasury securities.

Another important type of risk related to repo transactions is the legal risk. Market participants do not always use appropriate documentation describing in detail the legal relationship in a conditional transaction. It creates the risk that the legal nature of this financial instrument may be changed, which in turn may result in inefficiency of the collateral.406

<table>
<thead>
<tr>
<th>Legal documentation</th>
<th>Repo</th>
<th>SBB/BSB</th>
</tr>
</thead>
<tbody>
<tr>
<td>A framework agreement modelled on Recommendation on the conclusion of REPO and BUY/SELL BACK transactions on the Polish financial market, the Polish equivalent of Global Master Repurchase Agreement</td>
<td>A framework agreement modelled on Recommendation on the conclusion of REPO and BUY/SELL BACK transactions on the Polish financial market</td>
<td>A significant part of transactions is concluded on the basis of two agreements: on purchase and sale of securities, i.e. undocumented sell/buy back</td>
</tr>
<tr>
<td>Bilateral agreements</td>
<td>YES – for all transactions concluded pursuant to the framework agreement</td>
<td>YES</td>
</tr>
<tr>
<td>Temporarily transfer of ownership in securities</td>
<td>For other transactions – see below</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Registration of collateral in securities depositories</th>
<th>Repo</th>
<th>SBB/BSB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Three types of repo transactions are distinguished in both securities depositories (National Depository for Securities and Securities Register): (1) transfer of securities and their registration on the account of the buyer, i.e. the party which deposits funds (a standard in interbank transactions); (2) transfer of securities and their registration on the account of the buyer, but the securities are blocked on the account (popular for customer transactions); (3) no transfer of securities, they are only blocked on the account of the seller (used only in transactions with non-banking entities).</td>
<td>Transfer of securities and their registration on the account of the buyer</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Accounting</th>
<th>Repo</th>
<th>SBB/BSB</th>
</tr>
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<tbody>
<tr>
<td>The party obtaining funds reports in its balance sheet the securities which it has transferred as collateral for the time of the duration of transaction.</td>
<td>The party obtaining funds reports in its balance sheet the securities which it has transferred as collateral (it does not apply to undocumented SBB/BSB).</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Payments of proceeds—coupons</th>
<th>Repo</th>
<th>SBB/BSB</th>
</tr>
</thead>
<tbody>
<tr>
<td>The temporary owner transfers the proceeds on the day of their receipt to the entity which undertook to repurchase the securities.</td>
<td>They are kept by the party which deposits the funds. The obtained proceeds are included in the repurchase price (dirty price).</td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Reserve requirement on transactions with non-banking entities</th>
<th>Repo</th>
<th>SBB/BSB</th>
</tr>
</thead>
<tbody>
<tr>
<td>Reserve requirement is zero from mid 2004²</td>
<td>Exempt from reserve requirement</td>
<td></td>
</tr>
</tbody>
</table>

The existence of two types of conditional transactions is the result of the historical conditions which influenced the development of the financial market in Poland. There were significant differences between the repo and SBB/BSB transactions before 2004. Different rules governing the reserve requirement and the recording of those instruments in accounting books, as well as imprecise regulations on the scope of investments of non-banking financial institutions resulted in a significantly more developed and liquid market of SBB/BSB transactions in Poland. Currently the two types of conditional transactions have almost identical economic nature. Different legal documentation in numerous institutions on the basis of which dealers conclude the transactions and the differences in the transfer of proceeds and recording of collateral in securities depositories cause the two types of transactions to be treated as distinct (Table 5.1.9).

Market size

In 2005, the activity on the domestic conditional transactions market significantly intensified (Figure 5.1.34). The average daily net turnover in the SBB/BSB segment exceeded PLN 5.6 billion (an increase of 17% as compared to 2004). The statistics on market liquidity point to the first results of the introduction in mid 2004 of the zero rate of the reserve requirement on funds obtained in repo transactions with non-banking entities. The value of repo transactions concluded in 2005 was higher by over 150% than in 2004 and the decrease in activity on the interbank market was accompanied by a significant increase in the value of transactions with non-banking entities. However, the domestic repo market with a daily turnover of PLN 0.45 billion was still poorly developed. Repo transactions accounted for only 7.5% of all conditional transactions concluded in Poland.

SBB/BSB transactions dominated (a 94% share) the turnover on the interbank market on which there had never been any constraints related to the reserve requirement. Securities-driven deals accounted for a significant part of the transactions between banks. In order to obtain the specific securities to close a short position on other transactions, the majority of market participants...

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1 There are doubts concerning the legal nature of such transactions. According to some lawyers such transactions might not be recognised as repos since there is no transfer of the ownership in securities. The party which borrows the funds is obliged only to transfer the collateral to the account of the counterparty and to transfer the ownership if it goes bankrupt.

2 Resolution No. 1/2004 of the Monetary Policy Council on banks’ reserve requirements and the rate at which required reserves are remunerated (Dz.Urz. NBP of 2004, No. 2, item 2).
used SBB/BSB transactions, which have a less complicated structure. Repo transactions were used mainly as a liquidity management instrument. In addition, Bank Gospodarstwa Krajowego, through which the Ministry of Finance deposits funds on the money market, conducted almost exclusively BSB transactions with banks – Primary Dealers. Such a structure of conditional transactions distinguished the Polish money market from the developed financial market where traditional repo transactions prevailed.408

**Figure 5.1.34. Monthly turnover in SBB/BSB and repo segments, 2002–2005**

![Graph showing monthly turnover in SBB/BSB and repo segments, 2002–2005](image)

Source: NBP calculations based on NBP Securities Register and National Depository for Securities data as well as reports submitted by banks – Primary Dealers and/or money market dealers and candidates for dealers.

**Figure 5.1.35. Monthly net turnover on the interbank and customer conditional transactions market, 2002–2005**

![Graph showing monthly net turnover on the interbank and customer conditional transactions market, 2002–2005](image)

Source: NBP calculations based on NBP Securities Register and National Depository for Securities data as well as reports submitted by banks – Primary Dealers and/or money market dealers and candidates for dealers.

**Market participants**

The Polish money market was still dominated by transactions with domestic non-banking institutions (Figure 5.1.35). Few banks were active participants of the interbank market. In 2005, the average daily value of transactions between banks increased by 48% as compared to 2004 and amounted to PLN 1.29 billion. It accounted for around 20% of total turnover on the market of deposit transactions collateralised with securities. In the euro area countries the interbank market is much more developed.409

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In 2005, after a year of stagnation, activity in the segment of transactions with non-banking entities intensified considerably. A significant, 35% increase in liquidity on the customer market resulted from a high activity of non-banking financial institutions. Insurance companies and pension funds, but first of all, investment funds deposited their temporary surpluses of funds by concluding short-term conditional transactions. The average daily value of transactions with those institutions increased by almost PLN 1 billion in 2005 and amounted to around PLN 3.5 billion, out of which the transactions of investment funds amounted to over 30%. Deposits in the form of conditional transactions had two advantages: they were collateralised and more profitable. The higher profitability of those deposits resulted from legal regulations. The banks that accepted funds in repo and BSB transactions did not have to incur costs in the form of the reserve requirement and therefore they could offer slightly higher interest. Non-banking financial institutions preferred BSB/SBB transactions since the lack of a uniform definition of a repo transaction in the legislation and imprecise regulations concerning the catalogue of instruments in which those institutions may invest left many doubts concerning the use of traditional repo transactions.

The domestic conditional transactions market is characterised by a very small activity of non-residents. Transactions with foreign banks were concluded very seldom and accounted for less than 1% of the registered turnover. However, it is worth noting that the repo transactions collateralised with securities issued in Poland were concluded also outside the domestic market – among non-residents. Several large London banks used short-term repo transactions to close short positions on Treasury bonds. The information obtained from the offshore market participants shows that several transactions of a standard value of PLN 10 or 25 million were concluded weekly.

**Market structure**

In 2005, very important changes in the structure of repo and SBB/BSB collaterals occurred (Figure 5.1.36). Transactions collateralised with Treasury bonds, which are a standard on the developed markets, prevailed for the first time. A significant increase of the share of Treasury bonds was accompanied by a decrease in the use of Treasury bills. The share of other assets in the collateral structure was low. Banks sporadically concluded transactions secured against NBP bills and non-Treasury debt securities.

The described changes to the collateral structure were forced by market development and a decrease in the number of Treasury bills owned by banks. It was visible already in 2004 that the Treasury bill portfolios held by the majority of banks were too small to collateralise the transactions with the central bank – intraday credit, lombard facilities and conditional transactions. In addition, pursuant to the provisions of the concluded Credit Support Agreements, some banks used those securities as collateral for the settlement of other transactions concluded on the interbank market. In 2005, the Ministry of Finance gradually limited Treasury bill issues, which in turn resulted in a decrease in the value of bills held by domestic banks (from PLN 14.5 billion at the end of December 2004 to PLN 6.5 billion at the end of December 2005). In addition, the demand for collateralised deposits increased significantly, mainly on the part of non-banking financial institutions. It was related to the increased value of conditional transactions in which the banks accepting the funds transferred or blocked the Treasury securities they owned. In such a situation, the factors which had so far discouraged banks from using Treasury bonds in conditional transactions became irrelevant and the instrument became the most often used collateral.

The maturity structure of conditional transactions did not change considerably as compared to 2004. The share of transactions with maturities of up to 7 days in the total turnover amounted to approximately 90%. One-day transactions (O/N, T/N and S/N) accounted for over half of this share. Collateralised deposits with initial maturity of over one month were concluded infrequently and accounted for less than 5% of the transactions. Such a maturity structure confirms that the

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411 The figures provided are estimates since SBB/BSB transactions are treated as two separate transactions in depository systems and therefore it is difficult to obtain complete, coherent data on the maturity structure of conditional transactions.
Polish conditional transactions market is dominated by short-term deposit transactions. Transactions with maturities exceeding one week, which may be used in arbitrage strategies and for speculation on interest rate changes, are relatively seldom. The majority of banks treated conditional transactions as a financial instrument which supplemented their offer of deposit products for non-banking financial institutions and enterprises. Both banks and collective investment institutions rarely used the repo and SBB/BSB transactions for speculations on changes of the yield curve and the optimization of costs of maintaining portfolios of Treasury bonds. The said applications of repo transactions are characteristic for mature money markets.

### Market infrastructure

Most repos and SBBs/BSBs were concluded on the unregulated OTC market via the Reuters conversion system terminals, voice brokers or by phone. Interbank conditional transactions collateralised by Treasury securities could also be concluded using the MTS Poland platform. The average daily value of transactions collateralised with Treasury bonds which were concluded on the electronic platform in 2005 amounted to PLN 115 million, i.e. 9% of the net turnover on the interbank conditional transactions market. However, no transaction collateralised with Treasury bills was concluded on the MTS-CeTO market in the analysed period. In 2006, non-banking entities will probably also be able to agree on the terms of conditional transactions on the electronic market since MTS-CeTO announced the launch of a new segment of trading in Treasury securities, i.e. a platform for non-banking financial institutions (the so-called B2C market).

### Market segmentation

The presented characteristics of the domestic conditional transactions market, mainly its segmentation and domination of short-term SBB/BSB transactions used only as substitutes to deposits, show that the market was still in the initial stage of development. The diversity of the types of repo and SBB transactions may in future hinder the further development of the conditional transactions market. The segmentation of the market, in particular of its customer segment, results from the lack of a uniform and widely accepted legal documentation for repos and SBB/BSBs and the lack of coherence of definitions used by different market participants.

Repo and SBB/BSB transactions are not consistently regulated in Polish legislation. Regulations concerning the functioning of specific financial institutions treat those transactions differently. There is no framework agreement for repo and SBB/BSB transactions, which would be widely accepted in the whole financial system. Currently there is a model legal documentation for interbank transactions which sets forth the basic principles of the conclusion and settlement of repo
transactions. The documentation also includes an appendix defining the standard of BSB/SBB transactions. However, according to information provided by market participants, few banks signed bilateral framework agreements modelled on the recommendation. There is no model documentation on the customer market, which results in market fragmentation and a large number of undocumented sell-buy back transactions (SBB/BSB transactions treated by law as two outright transactions – two independent agreements on purchase and sale of securities). The creation of commonly accepted legal documentation could contribute to the harmonisation of the recording of repo transactions in the securities depositories. Currently, as a result of the market participants’ demand there are three forms of the repo recording both in the National Depository for Securities and the Securities Register (Table 5.1.9).

Moreover, the provisions on the catalogue of instruments in which specific non-banking financial institutions may invest do not define clearly whether it is legal to make deposits in repo transactions and limit the possibilities of the conditional sale of securities in the portfolios of these institutions. As a result, most non-banking financial institutions conclude only BSB transactions whose objective is to deposit available funds.

Additional factors which influence the liquidity of the interbank conditional transactions market include: the existing tax and accounting duality and insufficient portfolios of Treasury securities held by some banks. According to the accounting standards in force, the party disposing of securities in repo transactions and documented SBB/BSB transactions still declares those securities in its assets. Therefore, the earnings from the sale of assets are not posted. The tax law treats this issue differently. According to the tax regulations, earnings are posted when the ownership title is transferred. Therefore, the party ‘selling’ the securities in the initial exchange of the SBB/BSB and repo transactions (with the reservation described in note 1 to Table 5.1.9) is obliged to pay the tax at source, which decreases the profitability of repo and SBB/BSB transactions.

Some banks with the liquidity shortage do not use conditional transactions, due to excessively low portfolios of Treasury securities. At the end of 2005, the distribution of Treasury bonds in banks’ portfolios was more similar to the even distribution than at the end of 2004 (Figure 5.1.37). However, the distribution of those securities was still uneven with the five largest banks holding over 60% of the value of Treasury bonds in the assets of the domestic banking system. A further five banks held another 20% in their portfolios. It seems that the increase in owned financial instruments which could be collateral for conditional transactions should contribute to the increase in the number of active participants of the interbank market.

The development of the conditional transactions market in Poland could contribute to the establishment of a liquid market of futures contracts for Polish bonds. On the developed money markets, repo transactions are a method for obtaining bonds which must be supplied on the day of the settlement of forward contracts. However, the futures market in Treasury bonds which was created on the WSE is characterised by a low volume of turnover and it seems that there will not be a significant increase in its liquidity within the coming years.

Prospects

The turnover on the conditional transactions market, and in particular in the SBB/BSB segment, should increase systematically in the coming years. The development of the customer market will be supported by the expected increase in the value of assets managed by investment and pension funds. It seems that transactions with maturities of several days will continue to dominate and Treasury bonds will be the basic type of collateral. The development of the conditional transactions market could contribute to the improvement of liquidity of other segments of the Polish financial market, i.e. the market of Treasury bills and bonds.\footnote{Main features of the repo market in the euro area. ECB Monthly Bulletin, October 2002, pp. 55–68.}

The dynamic growth of the value of transactions and the increased share of transactions with maturities longer than 7 days are not possible unless market segmentation is eliminated. The regulations and standards which exist in Western European countries should be taken into account while changing the legal and tax regulations and creating the framework agreements. It will encourage foreign banks which are important investors on the Polish bonds market to participate in the domestic repo market. The development of the interbank repo market would be enhanced by the increase in the number of its active participants, which will occur provided that more banks will be legally and organisationally prepared to conclude conditional transactions.

The development of the interbank repo market with an active participation of non-residents will facilitate a smooth integration of the domestic money market with the euro area market. Domestic banks will be able to adjust to the functioning in the conditions which will occur after Poland adopts the single currency. Liquidity management on the market whose participants include numerous banks from different countries will be much easier thanks to the use of repo transactions.
5.2. Capital market

5.2.1. Evolution of the capital market: size and structure

In 2005, the Treasury bond market and the stock market remained the most important segments of the Polish capital market. The remaining segments were still much less significant. The stock market was the fastest developing segment of the capital market in 2005 – WSE capitalisation grew by 46%.

Table 5.2.1. Size of individual capital market segments, 2002–2005 (PLN billion)

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Debt securities</td>
<td>175.2</td>
<td>203.9</td>
<td>248.7</td>
<td>303.2</td>
</tr>
<tr>
<td>Marketable Treasury bonds</td>
<td>153.9</td>
<td>184.5</td>
<td>226.6</td>
<td>278.4</td>
</tr>
<tr>
<td>Long-term corporate bonds</td>
<td>4.5</td>
<td>5.3</td>
<td>7.3</td>
<td>8.9</td>
</tr>
<tr>
<td>Municipal bonds</td>
<td>2.2</td>
<td>2.7</td>
<td>3.0</td>
<td>3.3</td>
</tr>
<tr>
<td>Long-term commercial bank debt securities</td>
<td>1.4</td>
<td>2.8</td>
<td>3.0</td>
<td>3.0</td>
</tr>
<tr>
<td>Mortgage bonds</td>
<td>0.2</td>
<td>0.8</td>
<td>1.0</td>
<td>1.8</td>
</tr>
<tr>
<td>NBP bonds</td>
<td>13.0</td>
<td>7.8</td>
<td>7.8</td>
<td>7.8</td>
</tr>
<tr>
<td>Equities–stocks</td>
<td>110.6</td>
<td>167.7</td>
<td>291.7</td>
<td>424.9</td>
</tr>
</tbody>
</table>

Note: size of individual capital market segments for debt securities was measured by the outstanding value of those instruments and for equities, by capitalisation of domestic and foreign companies listed on the WSE.

1 In comparison with the previous editions of the report, the data also cover, apart from the liabilities of Polish commercial banks resulting from the issue of own securities denominated in PLN, bonds denominated in foreign currencies, issued by mortgage banks, and European Investment Bank bonds.

Source: NBP own study on the basis of MF, NBP, WSE and Fitch Polska data.

5.2.2. Marketable long-term debt securities market

5.2.2.1. Treasury bonds

Market size and structure

The Treasury bond market is the most important segment of the Polish debt securities market. The share of marketable Treasury bonds in the entire (short-term and long-term) debt securities market equalled 77.8% as of the end of 2005. In the euro area countries, this share is not so large. The share of Treasury bonds in the entire euro area debt securities market equalled 41.9% as of the end of 2005, and in the long-term securities market it amounted to 45.9%. The main reason for the predominance of Polish Treasury bonds is the low level of development of non-government debt securities. In Poland, the value of long-term debt securities issued by banks was lower by 93.2% than the value of Treasury bonds, while in the euro area it was merely 24.4%. The Polish Treasury bond market was the largest among those of the countries that acceded to the EU in 2004. The value of traded Treasury bonds in Poland equalled EUR 74.6 billion, as compared to the two subsequent largest markets of the new Member States: EUR 30.2 billion (Hungary) and EUR 19.5 billion (Czech Republic). The Polish market was also larger than certain euro area markets.

In 2005, the outstanding value of marketable Treasury bonds, similarly to the previous years, grew faster than public debt. In comparison with the previous year, public debt as of the end of 2005 increased by 9.3%, domestic debt by 8.2% and outstanding value of marketable Treasury bonds by 22.9%.

The higher growth rate of the outstanding value of marketable bonds in 2005 resulted from the following factors:

– decrease in importance of Treasury bills issues for the financing of the State budget borrowing needs;

416 The data apply to securities denominated in EUR.
417 Applicable to bonds denominated in EUR, issued by the euro area countries.
– redemption of non-marketable bonds, which lowered the outstanding value of non-marketable bonds from PLN 4.3 billion as of the end of 2004 to PLN 0.6 billion as of the end of 2005 (the Ministry of Finance conducted e.g. early redemption of restructuring bonds and bonds in order to increase BGZ’s own capital\textsuperscript{419});

– drop in the Ministry of Finance issue of savings bonds; outstanding value of these instruments was lower by 4.8% than in 2004; decreasing of amount outstanding of the savings bonds resulted from changes in the household preferences with respect to the savings structure; lowering of debt securities’ yield resulted in the increased interest of households in other forms of savings, e.g. investments in participation units of investment fund.

By 2003, high growth rate of the Treasury bond market development mainly resulted from the increase in the supply of fixed-rate bonds. Between 2004 and 2005, the outstanding value of inflation-indexed bonds and floating-rate bonds grew fastest. Dynamic development of these market segments resulted from the low base. Inflation-indexed and floating-rate bonds constituted 1.6% and 11.1% of the value of the traded Treasury bonds respectively as of the end of 2005. Increase in the value of those instruments resulted from the issue policy implemented by the Ministry of Finance and from the important demand from the part of investors.

Table 5.2.2. Amounts outstanding long-term Treasury securities in euro area countries and in selected Central European countries, 2005 (EUR billion, as of year-end)

<table>
<thead>
<tr>
<th>Country</th>
<th>Debt resulting from the issue of the Treasury bonds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Italy</td>
<td>1,035.0</td>
</tr>
<tr>
<td>Germany</td>
<td>835.8</td>
</tr>
<tr>
<td>France</td>
<td>832.7</td>
</tr>
<tr>
<td>Spain</td>
<td>275.6</td>
</tr>
<tr>
<td>Belgium</td>
<td>227.7</td>
</tr>
<tr>
<td>Holland</td>
<td>201.0</td>
</tr>
<tr>
<td>Greece</td>
<td>173.7</td>
</tr>
<tr>
<td>Austria</td>
<td>116.2</td>
</tr>
<tr>
<td>Poland</td>
<td>74.6</td>
</tr>
<tr>
<td>Portugal</td>
<td>69.2</td>
</tr>
<tr>
<td>Finland</td>
<td>48.6</td>
</tr>
<tr>
<td>Ireland</td>
<td>31.3</td>
</tr>
<tr>
<td>Hungary</td>
<td>30.2</td>
</tr>
<tr>
<td>Czech Republic</td>
<td>19.5</td>
</tr>
</tbody>
</table>

Source: For the euro area countries, Eurostat, for the remaining countries, NBP calculations.

Figure 5.2.1. Household savings invested in Treasury bonds in 2005

Source: MF, NBP.

\textsuperscript{419} Restructuring bonds were issued in the years 1993–1994 in four series and transferred to ten banks in order to increase their equity and reserves. In 1996, two series of bonds for BGZ were issued.
Eased fears of adverse developments in the State’s financial situation in 2005 allowed the issuer to prolong the duration of domestic Treasury bonds. Duration has been gradually increasing since the beginning of 2004.

Despite the prolongation of average maturity of TS, it was still shorter than in the EU-15. Average maturity of marketable TS in 2005 equalled 3.4 years in Poland, 4.4 years in Finland, 6.2 years in Holland, 6.3 years in Italy, 6.4 years in Germany, 6.6 years in Spain and 12.4 years in the United Kingdom.420

**Marketable fixed-rate bonds**

Fixed-rate bonds had the largest share in the financing of the State budget borrowing needs. As of the end of 2005, they constituted 86.8% of the outstanding value of marketable bonds (88.7% in 2004). As in previous years, also in 2005 2-, 5-, 10-, and 20-year wholesale bonds constituted the main traded instruments.

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**Table 5.2.3. Government debt structure and growth rate, 2004–2005 (as of year-end, PLN billion)**

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Government debt</strong></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>I. Domestic government debt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1. Outstanding value of TS</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.1. Treasury bills</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.2. Treasury bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.2.1. Marketable bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– fixed-rate bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– floating-rate bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– inflation-indexed bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.2.2. Saving bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>1.2.3. Non-marketable bonds</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
<th>Change (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>402.9</td>
<td>440.2</td>
<td></td>
<td>9.3</td>
</tr>
<tr>
<td>291.7</td>
<td>315.5</td>
<td></td>
<td>8.2</td>
</tr>
<tr>
<td>286.9</td>
<td>312.0</td>
<td></td>
<td>8.7</td>
</tr>
<tr>
<td>46.9</td>
<td>24.4</td>
<td></td>
<td>-48.0</td>
</tr>
<tr>
<td>240.0</td>
<td>287.6</td>
<td></td>
<td>19.8</td>
</tr>
<tr>
<td>226.6</td>
<td>278.4</td>
<td></td>
<td>22.9</td>
</tr>
<tr>
<td>201.0</td>
<td>241.8</td>
<td></td>
<td>20.3</td>
</tr>
<tr>
<td>23.0</td>
<td>2.6</td>
<td></td>
<td>-90.4</td>
</tr>
<tr>
<td>9.1</td>
<td>8.6</td>
<td></td>
<td>-5.5</td>
</tr>
<tr>
<td>4.3</td>
<td>0.6</td>
<td></td>
<td>-87.0</td>
</tr>
</tbody>
</table>

**Figure 5.2.2. Structure of the outstanding value Treasury bonds, 2002–2005**

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Figure 5.2.3. Average maturity and duration of Treasury bonds issued on the domestic market, 2003–2005

Source: MF.

Table 5.2.4. Structure of the outstanding value of the marketable fixed-rate bonds, 2003–2005

<table>
<thead>
<tr>
<th>Bond value (PLN billion)</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-year zero-coupon bonds</td>
<td>52.4</td>
<td>52.9</td>
<td>57.1</td>
<td>31.0</td>
<td>26.3</td>
<td>23.6</td>
</tr>
<tr>
<td>Bonds with maturities of up to 5 years</td>
<td>81.1</td>
<td>70.8</td>
<td>86.7</td>
<td>48.0</td>
<td>35.2</td>
<td>35.9</td>
</tr>
<tr>
<td>10-year bonds</td>
<td>26.3</td>
<td>68.7</td>
<td>85.7</td>
<td>15.6</td>
<td>34.2</td>
<td>35.4</td>
</tr>
<tr>
<td>20-year bonds</td>
<td>1.5</td>
<td>3.4</td>
<td>6.4</td>
<td>0.9</td>
<td>1.7</td>
<td>2.7</td>
</tr>
<tr>
<td>Retail bonds</td>
<td>2.1</td>
<td>2.6</td>
<td>3.2</td>
<td>1.2</td>
<td>1.3</td>
<td>1.3</td>
</tr>
<tr>
<td>Other bonds(^1)</td>
<td>5.6</td>
<td>2.6</td>
<td>2.6</td>
<td>3.3</td>
<td>1.3</td>
<td>1.1</td>
</tr>
<tr>
<td>Total</td>
<td>169.0</td>
<td>201.0</td>
<td>241.7</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

\(^1\) Conversion bonds.
Source: MF.

The issue policy of MF aimed at gradual prolongation of the duration of bonds through the reduction of the share of bonds with shortest maturities and the increase in value of bonds with longer maturities. The longer was the maturity, the higher was the growth rate of the value of issue of individual wholesale bonds.

**Marketable floating-rate bonds**

In 2005, as in the previous year, the marketable floating-rate bond market developed faster than the fixed-rate bond market. The high rate of growth mainly resulted from the low base and an increase in the outstanding value of 7-year bonds. Such an important rise in the value of these bonds also resulted from strong demand for those instruments. 2005 did not face, however, the issue of 3-year wholesale bonds.

Table 5.2.5. Structure of the outstanding value of the marketable floating-rate bonds, 2003–2005

<table>
<thead>
<tr>
<th>Bond value (PLN billion)</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>3-year retail bonds</td>
<td>5.3</td>
<td>3.4</td>
<td>3.5</td>
<td>34.1</td>
<td>14.8</td>
<td>10.9</td>
</tr>
<tr>
<td>3-year wholesale bonds</td>
<td>–</td>
<td>6.7</td>
<td>6.7</td>
<td>–</td>
<td>29.2</td>
<td>21.1</td>
</tr>
<tr>
<td>7-year wholesale bonds</td>
<td>–</td>
<td>1.1</td>
<td>9.1</td>
<td>–</td>
<td>4.9</td>
<td>28.4</td>
</tr>
<tr>
<td>10-year wholesale bonds</td>
<td>10.2</td>
<td>11</td>
<td>11.9</td>
<td>65.9</td>
<td>47.9</td>
<td>37.3</td>
</tr>
<tr>
<td>Private placements</td>
<td>–</td>
<td>0.8</td>
<td>0.8</td>
<td>–</td>
<td>3.2</td>
<td>2.3</td>
</tr>
<tr>
<td>Total</td>
<td>15.5</td>
<td>23.0</td>
<td>31.9</td>
<td>100.0</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: NBP calculations on the basis of MF data.
The basis for determining the coupons of such bonds were 6M WIBOR rate for 7- and 3-year retail bonds and 3M WIBOR rate for 3-year wholesale bonds. Moreover, 3-year retail bonds issued in the previous years were also traded, with the coupon calculated on the basis of the yield on 13-week Treasury bills.

**Marketable inflation-indexed bonds**

The inflation-indexed bond market was the fastest developing segment of the Treasury securities market. In 2005, the value of those bonds in circulation increased by 76.8%. By the end of 2005, the value of bonds sold equalled PLN 4.7. Such high rate of growth can be attributed e.g. to the following factors:

- relatively low output base; this instrument was introduced in 2004 and as of the end of that year, inflation-indexed bonds constituted merely 1.1% of all issued bonds;
- Ministry of Finance issue strategy, based on the prolongation of the maturity of the issued securities; the original maturity of inflation-indexed bonds equals 12 years;
- large demand for such securities, in particular from the part of foreign investors.

The adopted construction of inflation-indexed bonds allows the retention of the real investment value and an annual 3% interest yield. The face value of inflation-indexed bonds is variable and subject to indexation according to the coefficient calculated by the MF on the basis of the cumulative monthly Consumer Price Index.421

**Savings bonds**

In 2005, private investors’ portfolios included, apart from the 10-year retirement bonds, also 2-year fixed-rate bonds and 4-year inflation-indexed bonds. Savings bonds, which can be purchased solely by individuals, are an alternative form of household saving. Their interest rates were higher than that of bank deposits. The average interest rate of 2-year bank deposits in 2005 amounted to 3.9%, of 2-year fixed-rate bonds – 4.8%, of 4-year inflation-indexed bonds – 5.2%, while of 10-year retirement bonds – 5.5%. Despite the more advantageous interest rates of savings bonds as compared with bank deposits, the outstanding value of savings bonds issues dropped at the end of 2005 by 4.8% as compared with the previous year. Only the value of 10-year retirement bonds was over two times higher. Retirement bonds are inflation-indexed bonds. The interest rate for a given interest period is calculated based on the 12-month Consumer Price Index growth rate, increased by a specific margin.

Such significant increase in the value of the issued retirement bonds mainly resulted from the low output base. The demand for those instruments results from their role in the Individual Pension Accounts system. Brokerage entities that keep IPA offer e.g. investment in 10-year retirement bonds. An investor, who chose such investment, purchases these securities for the subsequent contributions. This solution enhances the value of the issued bonds.

Savings bonds are not traded on the secondary market. They are stored in the Bond Purchaser Register maintained by the issuing agent (since 2003 – PKO BP SA).

**Table 5.2.6. Structure of the outstanding value savings bonds, 2004–2005 (as of year-end)**

<table>
<thead>
<tr>
<th>Shares of savings bonds (%)</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>2-year fixed-rate bonds</td>
<td>90.0</td>
<td>92.0</td>
</tr>
<tr>
<td>4-year inflation-indexed</td>
<td>9.4</td>
<td>6.5</td>
</tr>
<tr>
<td>10-year pension bonds</td>
<td>0.6</td>
<td>1.5</td>
</tr>
<tr>
<td>Total</td>
<td>100.0</td>
<td>100.0</td>
</tr>
</tbody>
</table>

Source: MF

---

Primary market

In 2005, the organisation of the primary market did not change. However, the document entitled ‘Strategia zarządzania długiem sektora finansów publicznych w latach 2006–08’ (Public Finance Sector Debt Management Strategy in the years 2006-2008) developed by the Ministry of Finance in September 2005 assumed important organisational modifications in the coming years, related to the separation of debt management from the Ministry of Finance structure and to the establishment of a separate agency for that purpose. Public debt management carried out by a separate agency has been a solution adopted by 14 European Union Member States, including 11 EU-15 countries. New Member States that have adopted this model feature Latvia, Hungary and Slovakia.

The form of issue is diverse and depends on the type of Treasury bonds sold. Marketable wholesale bonds are sold at auctions organised for Primary Dealers. Private placement is a complementary form of sales of valuable issues, although in 2005 the Ministry of Finance did not apply this solution. The sales of marketable retail bonds and savings bonds were limited to PKO BP branches.

In 2005, the Ministry of Finance issued bonds with total value amounting to PLN 95.7 billion, of which PLN 89.7 billion corresponded to the issued wholesale bonds. The value of sold bonds was higher by 2.0% compared to 2004 figures.

Figure 5.2.4. Treasury bond issue, gross

![Graph showing Treasury bond issue, gross](image)

Source: NBP calculations on the basis of NBP and MF data.

In 2005, the main factor constraining the domestic issues of treasury bonds was an increase in the issues of bonds for foreign markets. At the end of 2005, the outstanding value of foreign issues (excluding Brady bonds) amounted nearly to PLN 80 billion, which was higher by PLN 35 billion than as of the end of 2004. The gross value of issue in Poland grew slower than the domestic debt of the State Treasury, since redemptions of TS were lower than in 2004. The value of bonds redeemed in 2005 equalled PLN 47 billion, as compared to PLN 52 billion in 2004. The value of Treasury bonds issued decreased in particular in the second half of 2005, which resulted from the improved budget situation. The value of sold wholesale bonds amounted to PLN 51.6 billion in the first half of year and PLN 38.1 billion in the second half of 2005.

As in the previous years, the main form of sales of wholesale bonds on the primary market was auction sales. The MF sold 80.8% of bonds issued in 2005 at auctions (with total value of PLN 72.5 billion). The Ministry of Finance also used switching auctions. They allow redemption of bonds without employing cash. In 2005, securities with total value of PLN 15.9 billion were sold at

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422 The LTS system is described in Chapter 5.1.2.1.
423 Including non-competitive auctions.
switching auctions (compared to PLN 20.3 billion in 2004). Bonds with longer maturities were mainly offered for sale. In terms of type, 10-year bonds were most popular (PLN 7.8 billion), followed by 5-year bonds (PLN 4.3 billion) and 7-year floating-rate bonds (PLN 2.9 billion). Apart from selling Treasury bonds at auctions and switching auctions, the Ministry of Finance provided the Open Pension Funds with bonds with total value equalling PLN 1.4 billion under the operation of taking over ZUS debt.

Between 2001 and 2003, the average value of wholesale bonds offer at a single auction grew gradually (in 2001, it was PLN 1.0 billion, in 2002 – PLN 1.8 billion, and in 2003 – PLN 2.2 billion). In 2004 and 2005, the average value of the offer was maintained at a similar level and amounted to approximately PLN 2 billion. Although the volume of offers at individual auctions did not grow, 2005 saw a further increase in the average value of a single bond in circulation to the level of PLN 13.1 billion (compared with PLN 10.3 billion in 2004). A rise in the value of individual issues with simultaneous stability of the volume of individual offers at auctions resulted from the issue policy limiting the number of bond issues. Single issues were gradually sold at auctions. Public Finance Sector Debt Management Strategy in the years 2005–2007 assumes that the minimum value of medium- and long-term fixed-rate bond issue should equal EUR 5 billion. In 2004, this requirement was met by two issues, followed by four issues in 2005.

Changes in the structure of State Treasury debt, involving the increased share of inflation-indexed and floating-interest wholesale bonds, resulted from high demand for those instruments. The demand for fixed-rate wholesale bonds was relatively lower.

Figure 5.2.5. Largest issues of Treasury bonds, 2002–2005 (as of year-end)

Table 5.2.7. Demand for wholesale bonds at auctions, 2005

<table>
<thead>
<tr>
<th>Type of bond</th>
<th>Purchase offer value (PLN million)</th>
<th>Sales value (PLN million)</th>
<th>Surplus of purchase offers over sales value (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>7-year floating rate bonds</td>
<td>16,975</td>
<td>5,040</td>
<td>336.8</td>
</tr>
<tr>
<td>12-year inflation-indexed bonds</td>
<td>6,858</td>
<td>1,952</td>
<td>351.3</td>
</tr>
<tr>
<td>2-year zero-coupon bonds</td>
<td>75,452</td>
<td>28,320</td>
<td>266.4</td>
</tr>
<tr>
<td>5-year fixed-rate bonds</td>
<td>67,088</td>
<td>25,310</td>
<td>265.1</td>
</tr>
<tr>
<td>20-year fixed-rate bonds</td>
<td>5,495</td>
<td>2,600</td>
<td>211.3</td>
</tr>
<tr>
<td>10-year fixed-rate bonds</td>
<td>13,448</td>
<td>9,289</td>
<td>144.8</td>
</tr>
</tbody>
</table>

Note: Data concerning 10-year fixed-rate bonds include DS1110 bonds, the issue of which was re-opened in November 2005. Source: NBP calculations on the basis of MF data.

424 The data apply to fixed-rate wholesale bonds.
425 This amount is at the same time the minimum level required for the introduction of bonds denominated in EUR to quotations on the EuroMTS platform.
While at wholesale auctions the demand largely exceeded the supply, in the case of retail bonds, both marketable and savings, the situation was reversed. In 2005, the total sales of such bonds were lower by 13.4% than in the previous year. Out of a PLN 15.8 billion worth offer, 37.8% was sold. The main reason for such little interest in savings bonds was an increased interest in the investment funds.

Bonds that faced the lowest demand despite a relatively profitable interest rate were 10-year retirement bonds. Only 6.5% of the offered securities were actually sold. The low demand for such bonds resulted, *inter alia*, from an insufficiently attractive system of savings accumulation under Individual Pension Accounts (IPA), as well as from rigid rules for investment in IPA.426

**Secondary market**

The years 2000-2003 were characterised by a very high growth rate of Treasury bond turnover.427 On average, the turnover grew by 86.4% per annum. In 2004, however, this trend was halted. The registered turnover was 2.2% lower as compared to 2003 figures. 2005 saw another high growth rate of Treasury bond turnover – 115% compared to the previous year. Average daily turnover on the Treasury bond market in 2005 equalled PLN 29.6 billion (PLN 14.1 billion in 2004).

The turnover growth began in the second half of 2004 and continued throughout 2005. An important factor of this growth, apart from the developing market, was the rising value of conditional transactions resulting from the activity of non-banking financial institutions. The share of SBB (sell-buy-back) transactions on the unregulated market increased from 30.1% in 2004 to 43.9% in 2005. The share of repo transactions also grew from 0.4% to 5.0% respectively. Consequently, the value of conditional transactions grew by 244% in 2005, while the share of outright transactions by 58%. A rise in value of bond-backed SBB and repo transactions resulted from the change in the structure of collaterals for conditional transactions. As compared to previous years, in 2005 the collaterals less often included Treasury bills, replaced by more popular bonds.

One of the important factors of turnover growth was also the lowering from the second half of 2004 of marketable interest rates, which contributed to the rise in bond prices. Anticipation of lower interest rates enhances investors’ activity, in particular in the case of investors with shorter investment horizon.

**Figure 5.2.6. Annual turnover in the Treasury bond secondary market, 1998–2005**

![Annual turnover in the Treasury bond secondary market, 1998–2005](image)

Note: Gross-basis turnover calculated for outright and conditional transactions concluded both on the stock exchange and OTC.

Source: NBP and National Depository for Securities.

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426 In certain brokerage entities, retirement bonds can be purchased under individual pension accounts solely by those investors who declare to invest only in this type of instruments.

427 Turnover refers to gross turnover, unless otherwise indicated.
The faster growth of turnover than of outstanding value of Treasury bonds enhanced market liquidity. Liquidity growth mainly resulted from the growth of the volume of conditional transactions. Liquidity ratio\textsuperscript{428} in 2005 equalled 2.46 (1.39 in 2004). Other factors that enhanced liquidity included pricing trends on the Treasury bond market. In 2004, when the annual average yield of Treasury bonds was increasing, the liquidity of those securities dropped. The liquidity ratio, measured after the exclusion of conditional transactions, equalled 0.97 in 2004, as compared to 1.26 in 2005.

\section*{Figure 5.2.7. Monthly turnover and yield of Treasury bonds in the secondary market, 2003–2005}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure5.2.7}
\caption{Monthly turnover value – left-hand scale. 5-year benchmarking bond yield – right-hand scale.}
\end{figure}

Note: Including the unregulated market, stock exchange and electronic platform.
Source: NBP and National Depository for Securities.

\section*{Table 5.2.8. Treasury bond yield vs. liquidity ratio, 2003–2005}

<table>
<thead>
<tr>
<th>Year</th>
<th>Treasury bond liquidity ratio</th>
<th>Average yield of 5-year benchmarking\textsuperscript{1} Treasury bonds (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2003</td>
<td>1.67</td>
<td>5.63</td>
</tr>
<tr>
<td>2004</td>
<td>1.39</td>
<td>7.12</td>
</tr>
<tr>
<td>2005</td>
<td>2.46</td>
<td>5.21</td>
</tr>
</tbody>
</table>

\textsuperscript{1} Issues of 5-year bonds constitute the largest share of the market.
Source: NBP calculations based on NBP and National Depository for Securities data.

\section*{Figure 5.2.8. Quarterly Treasury bond market liquidity ratio, 1998–2005}

\begin{figure}[h]
\centering
\includegraphics[width=\textwidth]{figure5.2.8}
\caption{Quarterly Treasury bond market liquidity ratio, 1998–2005}
\end{figure}

Source: NBP calculations based on National Depository for Securities and Ministry of Finance data.

\textsuperscript{428} Liquidity is measured as the ratio of the average monthly turnover of Treasury bonds to the average amount of bonds held by investors at the end of individual months.
Financial markets

Table 5.2.9. Individual markets’ share in total turnover on the Treasury bond market, 1998–2005 (%)

<table>
<thead>
<tr>
<th>Year</th>
<th>Unregulated market</th>
<th>WSE</th>
<th>MTS Poland(^1)</th>
<th>Transaction conducted within the framework of NBP open market operations</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>92.5</td>
<td>66.4</td>
<td>1.1</td>
<td>–</td>
</tr>
<tr>
<td>1999</td>
<td>95.6</td>
<td>4.2</td>
<td>0.2</td>
<td>–</td>
</tr>
<tr>
<td>2000</td>
<td>97.6</td>
<td>1.8</td>
<td>0.1</td>
<td>0.5</td>
</tr>
<tr>
<td>2001</td>
<td>98.0</td>
<td>0.6</td>
<td>0.0</td>
<td>1.4</td>
</tr>
<tr>
<td>2002</td>
<td>94.2</td>
<td>0.2</td>
<td>5.0</td>
<td>0.6</td>
</tr>
<tr>
<td>2003</td>
<td>94.1</td>
<td>0.4</td>
<td>5.4</td>
<td>0.1</td>
</tr>
<tr>
<td>2004</td>
<td>96.3</td>
<td>0.2</td>
<td>3.1</td>
<td>–</td>
</tr>
<tr>
<td>2005</td>
<td>95.7</td>
<td>0.1</td>
<td>4.2</td>
<td>–</td>
</tr>
</tbody>
</table>

\(^1\) By November 2004, TS Electronic Platform. In parallel to MTS Poland, also RPW CeTO market operates on MTS-CeTO. However, Treasury bond transactions on this market are rarely concluded.

Source: NBP calculations based on National Depository for Securities data.

Treasury bonds were traded on three markets: the unregulated market, the MTS Poland (electronic platform) and on the Warsaw Stock Exchange. Transactions on the MTS Poland could be concluded solely by banks. In Poland, as in the majority of European Union countries, the unregulated (OTC) market predominates.

2005 was the first full year of operation of the MTS Poland electronic platform. Transformation of the Electronic TS Market into the MTS Poland electronic platform in November 2004 enhanced the growth rate of this market. Bond turnover nearly tripled. However, the share of the platform in Treasury bond turnover increased by mere 1.1 pp. (from 3.1% in 2004 to 4.2% in 2005).

In 2005, non-residents gained direct access to the MTS Poland market. As of year-end, the market featured 25 participants, of which 7 foreign.\(^{429}\) In 2004, the electronic platform counted 18 participants. Primary Dealers and candidates for dealers are obliged to quote and conclude transactions on the MTS Poland platform. One of the criteria for the approval of new Primary Dealers is the assessment of activity on the electronic platform. MTS Poland participants are either:

– market-makers, providing their own TS purchase and sales offers with specified minimum quotation unit and spread, not exceeding the value set forth in the regulations, or

– market-takers, solely accepting the whole or the part of the market-makers’ offer.

Every day information TS quotations are set as a point of reference for the entire debt securities market (e.g. for the valuation of Open Pension Funds’ portfolios).

It seems that banks’ activity on the MTS Poland platform largely depends on the acquisition of the Primary Dealer’s status. After each completed competition, the activity of electronic platform participants dropped.\(^{430}\) Therefore, the creation of the MTS Poland platform did not eliminate the phenomenon of seasonal drop in turnover in the last quarter of the year. In 2005, annual average turnover volatility on the MTS Poland, measured as a quotient of standard deviation and average turnover, equalled 46.2% (35.2% in 2004, 52.9% in 2003). Monthly turnover volatility on the MTS Poland was 2.5 times higher than on the unregulated market. Turnover volatility ratio for the unregulated market in 2005 equalled 18.1%.\(^{431}\)

\(^{429}\) Data as of year-end.

\(^{430}\) In accordance to the regulations for Primary Dealers (Regulamin pełnienia funkcji Dealera Skarbowych Papierów Wartościowych) of October 19, 2004, the competition for Primary Dealers in 2006 began on December 1, 2004 and ended on September 30, 2005. The turnover on the MTS Poland market was one of the selection criteria.

\(^{431}\) Turnover on the unregulated market excludes conditional transactions.
Investors

Domestic investors predominate on the Treasury bond market. At the end of 2005, their market share equalled 76.1%, which means a rise by 2.4 pp. as compared to 2004 figures. As in previous years, banks were major purchasers of Treasury bonds, but their share was gradually decreasing.

Pension funds were a category of investors which rapidly increased their share in the Treasury bond market between 2002 and 2005. Investment funds also expanded their market share in 2005. In both cases, it resulted from an inflow of new funds to those institutions.

Although in 2005 the value of non-residents' portfolio increased by PLN 6.7 billion (i.e. by 10.6%), for the first time since 1999 their market share has fallen. Non-residents' portfolio structure in 2005 was not monogenic. By August 2005, the Treasury bond market faced an inflow of foreign capital (in August 2005, the value of non-residents’ portfolio was the highest, amounting to PLN 73.8 billion), while from September 2005 non-residents began to reduce their share.

The reason for the falling interest of foreign investors in the Treasury bond market was the uncertainty as to the development of political situation in Poland. The lowering of the share of foreign investors in this market was also triggered by the exogenous factor. In 2005, interest rates...
rose in United States, which, together with a drop in interest rates in Poland, resulted in decreasing attractiveness of the Polish market. In December 2004, the average yield on 10-year Treasury bonds in the United States equalled 4.22%, to reach 4.47% in December 2005. In Poland, the average yield on 10-year bonds fell from 6.02% in December 2004 to 5.17 in December 2005.

Table 5.2.10. Foreign investors on the bond market, 1999–2005 (as of year-end)

<table>
<thead>
<tr>
<th>Year</th>
<th>Amount of Treasury bonds held by foreign investors (PLN billion)</th>
<th>Foreign investors’ share in domestic bond market (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1999</td>
<td>6.6</td>
<td>9.4</td>
</tr>
<tr>
<td>2000</td>
<td>15.7</td>
<td>12.7</td>
</tr>
<tr>
<td>2001</td>
<td>19.9</td>
<td>16.1</td>
</tr>
<tr>
<td>2002</td>
<td>30.3</td>
<td>19.7</td>
</tr>
<tr>
<td>2003</td>
<td>40.3</td>
<td>21.9</td>
</tr>
<tr>
<td>2004</td>
<td>62.0</td>
<td>26.3</td>
</tr>
<tr>
<td>2005</td>
<td>68.7</td>
<td>23.9</td>
</tr>
</tbody>
</table>

Source: MF.

**Prospects**

Further development of Treasury securities market will depend on the borrowing needs of the central budget, public debt management policy, as well as on inflation processes and the situation on the international financial markets. Poland’s market will remain the largest market among countries that acceded to the European Union in May 2004.

The increase in the value of domestic issues, provided that it does not involve substantial deterioration of Treasury debt-to-GDP ratio, and the increase in the value of single issues should improve bond market liquidity. The factor which may affect market liquidity can be a significant rise in yield on the bond market. The rising interest of domestic investment funds and pension funds in the Treasury bond market will stabilise the development of this market, since these institutions mainly apply long-term investment strategies.

Due to the fact that the gap between the interest rates of Polish bonds and the interest rates of bonds on the largest markets narrowed, one should not expect a dynamic rise in interest in Polish bonds from the part of foreign investors. However, the Polish market remains attractive for this category of investors. Interest of foreign banks in the function of Primary Dealers or in the participation in the electronic platform supports this opinion.

No substantial changes should occur in the share of individual market segments in the Treasury bond turnover in the coming years. One can expect that the main market for bond trading will remain the unregulated OTC market; however, the development of MTS Poland will probably reduce its domination.

5.2.2.2. Corporate bonds

**Market size**

The high growth rate of the development of long-term corporate bond (LCB) market, observable since 2004, remained high also in 2005. Outstanding value of LCBs increased by PLN 1.6 billion to PLN 8.9 billion. Also, the number of issuers rose (Table 5.2.11). In 2005, the trend which began in the second half of 2004 and was characterised by a gradual drop in the outstanding value of SCBs and rise in the outstanding value of LCBs will be maintained (Figure 5.2.11). Companies had a surplus of liquid assets, which affected their willingness to issue SCBs.

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432 LCB market covers bonds issued in Poland by companies, other financial intermediaries (excluding investment funds) and financial auxiliaries.

433 Fitch Polska data. To date, the NBP presented solely the development of the non-public market in its analyses. From this edition, the entire LCB market will be analysed, both private placements and public offers. Table 5.2.12 includes verified data on the value of debt of the entire LCB market in the years 2002–2005. The outstanding value of non-public LCB issues as of year-end 2005 amounted to approximately PLN 8.1 billion.
The value of LCB issues rose, since these securities are mainly used for investment financing. The share of LCBs in the entire market of non-governmental debt securities in Poland equalled approximately 36%. Despite these positive changes, the LCB market cannot be considered well-developed.

The largest LCB market is in the United States. In the European Union, the best developed LCB markets are in the Holland, France, Spain and Italy. The size of the Polish market is similar to the Czech LCB market.

Table 5.2.11. Outstanding value of LCBs issued and number of issuers, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Outstanding value (PLN billion)</td>
<td>4.53</td>
<td>5.29</td>
<td>7.26</td>
<td>8.92</td>
</tr>
<tr>
<td>Number of issuers</td>
<td>53</td>
<td>59</td>
<td>69</td>
<td>82</td>
</tr>
</tbody>
</table>

Source: NBP data submitted by banks – Primary Dealers and/or money market dealers and candidates for dealers, Fitch Polska.

Figure 5.2.11. Outstanding value of LCBs and SCBs issued as of quarter-end, 2004-2005

Figure 5.2.12. Outstanding value of corporate bonds issued in the selected EU-25 countries, 2004–2005

Note: Corresponding ESA 95 sector code: corporate entities include non-financial entities and non-monetary financial institutions comprise insurance companies, pension funds, auxiliary financial institutions and other financial intermediation institutions.

In the last years, the euro area faced lower ratio of bank loans granted to non-financial institutions to GDP (41.8% in 2003, 37.6% in 2004, 31.6% in 2005) and a rise in the importance of the issue of debt securities measured as a percentage of GDP (7.2% in 2003, 10% in 2004, 11.8% in 2005).\textsuperscript{434} Similar trends were observable on the Polish market with respect to bank loans for the non-financial sector (14.8% of GDP in 2003, 13.1% of GDP in 2004, 12.1% of GDP in 2005) and to debt securities (0.6% of GDP in 2003, 0.8% of GDP in 2004, 0.9% of GDP in 2005).

In Poland, LCBs are issued as public offers and private placements. In 2005, private placements still predominated, constituting approximately 90% of the value of the entire LCB market. The outstanding value of LCBs under public offer amounted to PLN 855 billion as of the end of 2005.\textsuperscript{435} Therefore in the further part of this section we have focused on private placement issues.

**Primary market**

The major issuers of LCBs offered under private placement were companies. Their share in the issuers’ structure lowered with respect to 2004 (from 93.7% as of the end of 2004 to 89.7% as of the end of 2005).

In 2005, the importance of other financial intermediaries increased, mainly of leasing companies (in 2005, this share stood at 10% as compared to 6% in 2004), which resulted from the development of this sector in Poland in previous years and from seeking the sources of financing.

The majority of LCBs were bonds. The outstanding value of convertible bonds as of the end of 2005 amounted to approximately PLN 540 million.\textsuperscript{436} In November 2005, revenue bonds were issued (Box 5.2.2). Their issuer was the Municipal Water Supply and Sewage System PLC in Bydgoszcz (Miejskie Wodociągi i Kanalizacja w Bydgoszczy Sp. z o.o.). The issuance programme value amounted to PLN 600 million and by the end of 2005, PLN 100 million worth of securities were introduced into trading. Their maturity was set at 2024.

![Figure 5.2.13. Structure of private LCBs issuers (as of year-end)](image)

Source: NBP study on the basis of data submitted by banks – Primary Dealers and/or money market dealers serving as depositaries.


Box 5.2.2

REVENUE BONDS

Revenue bonds are debt securities issued in order to obtain funds for the financing of investments, the revenue of which will be allocated to the repayment of the outstanding amounts resulting from the issue of these bonds. The revenue bonds are secured with specified and separated property of the issuer and the issuer is responsible for the liabilities resulting from the bonds, yet solely to the extent where they do not exceed the value of security and revenue from the investment financed from funds obtained from the issue. This is derogation from the principle applicable to all other types of bonds, where the issuer is responsible for the liabilities resulting from the bonds with all his property. According to Polish law, the issuers of revenue bonds may include local government units and companies that meet specific requirements. Bonds with such structure are an alternative source of financing of infrastructural investments.


LCBs are issued under issuance programmes. The largest programme, in terms of limit volume, was the private placement programme organised for Autostrada Wielkopolska. The limit of this programme amounted to PLN 3.2 billion. At the same time, bonds issued (in 2001) under this programme remained the instruments with the longest ever original maturity, i.e. 36 years. Among public issues, the programme organised for BZ WBK Finance & Leasing remained the largest, with a PLN 2 billion worth limit.

Bonds denominated in PLN predominated on the LCB market. As of the end of 2005, issues in foreign currencies constituted an insignificant percentage, i.e. 1.4% of the total value of all issues (7.7% as of the end of 2004).

At the end of 2005, the majority of LCBs issued under private placement was unsecured – only approximately 20% of the value of the issued bonds was secured with mortgage or other assets (Figure 5.2.14).

Figure 5.2.14. Structure of private LCBs security (as of year-end)

<table>
<thead>
<tr>
<th></th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Unsecured debt securities</td>
<td>81.7%</td>
<td>80.2%</td>
</tr>
<tr>
<td>Debt securities backed with other assets</td>
<td>16.6%</td>
<td>11.2%</td>
</tr>
<tr>
<td>Debt securities backed with financial assets</td>
<td>1.7%</td>
<td>0.1%</td>
</tr>
<tr>
<td>Mortgage-backed debt securities</td>
<td>8.5%</td>
<td>11.2%</td>
</tr>
</tbody>
</table>

Source: NBP study on the basis of data submitted by banks – Primary Dealers and/or money market dealers serving as depositaries.

437 Based on the data submitted by banks – Primary Dealers and/or money market dealers serving as depositaries.
439 Pursuant to Article 5 of the Bonds Act (Dz.U. No. 120/2001, item 1300, as amended), a bond should contain information about the scope and form of security or about the lack thereof.
As in the previous year, also in 2005 only a few banks specialised in conducting LCB issues. The five banks that arranged around 78% of issues were Deutsche Bank Polska, BRE Bank, Bank BPH, PKO BP and ING Bank Śląski. Issuers of private placements were mainly brokerage companies.

In well-developed countries, rating plays an important role on the debt securities market. Polish legislation and regulations do not require ratings, thus the importance of ratings on the LCB market, similarly to the SCB market, is marginal.

Secondary market

As in previous years, the LCB turnover in 2005 took place mainly on the unregulated market. Transactions were usually settled by banks arranging the issues. The NBP has no information about the LCB turnover on the secondary market. Only data on trading in corporate bonds on the MTS-CeTO regulated OTC market were available. The annual turnover on this market amounted to PLN 209.2 million. In 2005, bonds issued by five companies (four in 2004) were traded on MTS-CeTO.440

Investors

Corporate bonds issued under private placement were mainly held by domestic investors, i.e. banks and companies. The share of this category of entities in the LCB purchasers' structure exceeded 60% at the end of 2005 and was lower by 7 percentage points as compared to 2004 figures (Figure 5.2.15). The third group of investors were investment funds, the share of which equalled 16.2% (rise by 2.6 pp. compared to 2004).

Prospects

The LCB market in Poland develops fast, yet it still constitutes a small segment of the capital market. Leasing companies may have important impact on the growth of the supply of these instruments. Their importance as LCB issuers increases with every year. In the coming years, they may seek possibilities of the financing of e.g. real estate leasing, which remains on the low level of development. Moreover, due to the growth of competition, companies may more intensively search for alternative sources of financing in order to reduce operating costs. Good prospects of the Polish economy in the coming years, in particular the increase in company investments, can contribute to the development of the domestic LCB market. Companies announce the continuation of already implemented investments and the initiation of new investments in 2006.441

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440 Based on information submitted by the MTS-CeTO.
441 More information in: Wstępna informacja o kondycji sektora przedsiębiorstw ze szczególnym uwzględnieniem koniunktury w I kw. 2006 r., Warszawa 2006, NBP.
Other LCB development stimuli discussed in the previous edition of the study appear to remain valid. Mergers and acquisitions undoubtedly play an important role, since the issue of corporate bonds may be one of the ways of obtaining capital for the financing of M&A.\textsuperscript{442} 2005 saw a rapid development of M&A market in the world and in Poland,\textsuperscript{443} yet the role of debt securities issues in the financing of M&A transactions in Poland is still insignificant.

Barriers for the development of LCB market include e.g. low liquidity of the secondary market, low level of interest in these instruments on the part of institutional investors, lack of centralised deposit and settlement system and relatively little knowledge about this market.\textsuperscript{444} The development of the domestic LCB market in Poland may be also triggered by the fact that numerous large foreign-owned companies intensively absorb the funds provided by parent companies. As of the end of 2004, the value of loans granted to Polish companies by their foreign owners equalled PLN 65.1 billion, while at the end of 2005 it amounted to PLN 72.6 billion.

Another factor limiting the development of LCB market in Poland may be the companies’ preferential treatment of bond issues on foreign markets. In the previous years, the value of foreign issues of corporate bonds exceeded the value of corporate bonds issues on the domestic market.

\textbf{Box 5.2.3}

\textbf{FOREIGN BOND ISSUES}

The international markets allow the acquisition of much larger capital than the local banking system or domestic issues. Bonds placed on foreign markets may be either foreign bonds or Eurobonds. Foreign bonds are denominated in the currency of the country where they are sold and are subject to this country’s jurisdiction (e.g. \textit{Yankee bonds, samurai bonds, matador bonds or bulldog bonds}). Eurobonds are sold outside the country of the currency in which they are denominated and they may be even issued simultaneously in a number of countries. The issue of Eurobonds is usually subject to the British or New York state jurisdiction.\textsuperscript{1}

Bonds issued on foreign markets have usually maturities not exceeding 25 years, but the most popular are those with maturities from 3 to 10 years. Foreign bond issues are conducted by entities with strong market position and high creditworthiness.

The issues involve the participation of consortia (syndicates) of the recognised international banks. The main participants of the consortia are the management group, the distribution group and the underwriters.

In 2005, the foreign market allowed Polish non-financial entities to obtain funds amounting to over PLN 11 billion (over PLN 14 billion in 2004).\textsuperscript{2}


\textsuperscript{2} NBP data.


\textsuperscript{443} 2005 was a record year in by the number and value of M&A. The total number of global M&A within 11 months of 2005 equalled 24,806 and amounted to USD 2,059 billion, which was a rise by 19%. In the corresponding period in 2004, 20,888 transactions were concluded with total value of USD 1,736 billion. In 2005, the highest value of transactions in the last ten years was observed in the Eastern and Central Eastern European countries, amounting to USD 87,738 million (against mere USD 44,767 million in 2004). In Poland, the highest number of transactions in the region was concluded in 2005 (USD 9,412 million, which accounted for approximately 25% of the total value of Eastern and Central European M&A). KPMG Forum – O krok przed konkurencją, Warszawa, January 2006, KPMG, pp. 20–27.

\textsuperscript{444} More information in: A. Gąt, P. Sobolewski (ed.): \textit{Wybrane determinanty rozwoju rynku akcji i korporacyjnych instrumentów dłużnych w Polsce. Wyniki badania ankietaowego}, Warszawa 2005, NBP.
Poland’s adoption of the European single currency may be a landmark for the development of LCB market. The euro area witnessed a dynamic development of LCB market in previous years. The development was triggered mainly by the introduction of the single currency and elimination of FX risk, which contributed e.g. to the reduction of issue costs and expansion of investor base.\(^{445}\) Since 1999, the outstanding value of bonds in the EU increased from approximately EUR 645 billion to approximately EUR 1,300 billion in 2005.

### 5.2.2.3. Municipal bonds

According to the Bonds Act, municipal bonds may be issued by municipalities, poviats, voivodships, the capital city of Warsaw and by associations of territorial units.\(^{446}\) The main issuers of municipal bonds are cities with poviat status. Bonds issued by these entities constituted 59.4% of total municipal bonds issued as of the end of 2005. The share of the remaining groups of local government units (LGUs) in this market is much lower.

#### Table 5.2.12. Structure of municipal bonds’ issuers and the share of debt securities issued in local government units’ liabilities, as of year-end, 2005 (%)

<table>
<thead>
<tr>
<th>Issuer Type</th>
<th>Share in the amount of municipal bonds</th>
<th>Outstanding bond issues in total liabilities</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cities with poviat status</td>
<td>59.4%</td>
<td>18.7%</td>
</tr>
<tr>
<td>Municipalities</td>
<td>26.4%</td>
<td>10.8%</td>
</tr>
<tr>
<td>Poviats</td>
<td>10.7%</td>
<td>19.3%</td>
</tr>
<tr>
<td>Voivodships</td>
<td>3.5%</td>
<td>13.2%</td>
</tr>
<tr>
<td>Total</td>
<td>100.0%</td>
<td>15.5%</td>
</tr>
</tbody>
</table>

Source: Ministry of Finance.

The structure of issuers of municipal bonds is determined by two major factors:

– the scale of possibility to undertake liabilities;

– preferences in the financing of LGU borrowing needs; the entities that financed their operations through the issue of municipal bonds to the least extent were municipalities; outstanding value of debt securities constituted 10.8% of municipality liabilities as of the end of 2005, while the average LGU rate equalled 15.5%.

The LGUs mainly issue bonds with maturities exceeding one year.\(^{447}\) The average maturity was 5.5 year. Bonds issued by voivodships had the longest maturities (7.2 year), which was related to the larger scale of investments. The issue was aimed at obtaining funds for investments financing in such fields as roads, environmental protection, education or bus fleet.\(^{448}\)

#### Market size

The municipal bond market is one of the smallest segments of the debt securities market. In 2005, its share in the entire debt securities market amounted to 0.9%. In the European Union, municipal bonds also constitute a small segment of the debt securities market. The share of the other government sector\(^{449}\) in the debt securities market in the euro area as of the end of 2005 equalled 2.9%. The largest share of this sector was observed in Germany (7.5%) and Spain (3.9%).

In 2005, the growth rate of the amount outstanding of municipal bonds decreased. The growth rate of the outstanding value of municipal bonds issued by LGUs in 2005 amounted to

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\(^{446}\) The Bonds Act of June 29, 1995 (consolidated text, Dz.U. No. 120/2001, item 1300, as amended).

\(^{447}\) Short-term bonds constituted 2.2% of total municipal bonds issued as of the end of 2005.

\(^{448}\) The research by Invest Consulting shows that the said fields absorb approximately 76% of funds obtained from the issue of municipal bonds.

\(^{449}\) “Other government” covers local authorities and state social insurance institutions.
4.7%. In 2001, it amounted to 75.1%, in 2002 – 42.1%, in 2003 – 18.3%, and in 2004 – 11.2%. The growth rate of the outstanding value of debt securities issued by LGUs was lower than the growth rate of the domestic outstanding value of debt securities issued by the Treasury. Consequently, the share of LGUs in the structure of bonds issued by general government sector decreased, from 1.2% in 2004 to 1.0% in 2005.

**Figure 5.2.16. Outstanding value of debt securities issued by local government units, 1999–2005**

The low value of individual issues is an obstacle to the development of the municipal bond market. The average value of a bond issue as of the end of 2005 equalled PLN 2.1 million. Such a low issue amount results in the fact that the issue of bonds does not imply substantial advantages in comparison with credit taken into account high fixed costs. Therefore, loans and credits were the main borrowing instruments of LGUs (outstanding value of 83.3% as of the end of 2005).

Between 2000 and 2004, the share of debt securities in the structure of LGU liabilities was increasing but in 2005 it dropped. The share of debt securities in the structure of domestic liabilities of LGUs amounted to 15.5%, compared to 16.4% as of the end of 2004.

Another factor affecting the growth rate of the value of municipal bonds issued was the LGU interest in foreign credits. The outstanding value of foreign long-term loans and credits taken by LGUs amounted to PLN 2.3 billion as of the end of 2005. Compared to the end of 2004, the increase in foreign loans and credits equalled 63.5%, while total liabilities of LGUs increased by 10.9%.

**Figure 5.2.17. Share of outstanding value of securities issued in the domestic debt of local government units, 2000–2005**

Source: Ministry of Finance.

Source: NBP calculations on the basis of Ministry of Finance data.
Primary market

In 2005, no significant changes occurred with regard to the organisation of the primary market of municipal bonds. Small issues predominated on this market. The average value of bond issue under private placement in 2005 amounted to PLN 1.1 million. Due to the small amounts of individual issues, municipal bond issues were mainly traded on non-public market, just as in previous years. As of year-end 2005, bonds issued by private placement accounted for approximately 85% of all municipal bonds.

No issues of municipal revenue bonds were conducted to date.\(^{450}\) Such bonds are popular in the United States. They constitute approximately 50% of all municipal bonds. The reason for the lack of revenue bonds was the fact that their issue requires much more specialised knowledge than in the case of standard bonds. Revenue bonds are redeemed from revenues generated by investments financed by those bonds. This requires e.g. detailed feasibility study, property separation, specification of revenue generated from this property and specification of the parts and types of this revenue intended for liability coverage, as well as the establishment of a special account intended for the accumulation of funds for the repayment of liabilities. LGUs, in particular the small ones, may encounter problems with meeting the requirements related to the issue of revenue bonds and may be forced to seek external assistance, which increases the costs of issue.

Bonds under public offers covered approximately 15% of municipal bonds issued in 2005 and were placed at the RPW CeTO market. As in 2004, there were traded issues placed by three cities (Ostrów Wielkopolski, Poznań and Rybnik). The value of bonds issued under public offer increased from PLN 396.5 million as of the end of 2004 to PLN 490.5 million as of the end of 2005 and the number of registered issues grew from seven to eight. Since placing issues on the regulated market involves higher costs, the amounts of public issues were much higher than those of private placements. The average value of bond issues under public offers amounted to PLN 61.3 million.

LGUs incurred additional costs when introducing bonds on the regulated market. These costs covered e.g. charges:

- of issuing agent for the placement of a bond on the regulated market (on average, 0.25-0.45% of the value of issue),\(^{451}\)
- of the Polish Securities and Exchange Commission for the entry in the securities register, amounting to 0.06% of the value of issue (not exceeding EUR 25,000),
- for the National Depository for Securities: for the acceptance of a bond – 0.01% of the value of issue (between PLN 2,000 and PLN 150,000), for the issuer’s participation in the KDPW – PLN 6,000 per annum, for the payments of coupons and redemption – 0.075% of the value of paid amounts (between PLN 5,000 and PLN 15,000),\(^{452}\)
- for MTS-CeTO – arranger of the market on which the municipal bonds were listed: for the placement of a bond, 0.0075% of the value of issue and PLN 250 per each planned year of the execution of rights resulting from debt securities from a given issue (not less than PLN 1,500 in total),\(^{453}\)
- related to the potential rating; Polish legislation does not require rating; as of year-end 2005, ten LGUs had long-term domestic rating.\(^{454}\)

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\(^{450}\) Apart from the local government units, municipal bonds may be issued by companies where at least 50% of stocks is held by a LGU or by a company carrying out the tasks, or providing services, of public utility (Article 23a. of the Bonds Act).


\(^{452}\) The presented data constitute a simplified excerpt from the KDPW scale of charges.

\(^{453}\) According to MTS-CeTO scale of charges. The presented data constitute a simplified excerpt from the CeTO scale of charges.

Despite the higher costs incurred by the issuer, public issue may be profitable. The requirement is an adequate volume of issue. The increase in the costs of issue may be compensated by a lower premium paid by LGUs to the purchasers of bonds due to the greater transparency and lower liquidity risk. Considering the issuer’s responsibility to inform the purchasers about the state of their finances, the purchaser of municipal bonds has more information about the issuer than the purchaser of bonds issued under private placement.

Municipal bond issues are arranged by banks, mainly those with large branch networks. Approximately two thirds of the arranged issues are handled by two banks: PKO BP SA and Bank Pekao SA. Their responsibilities include, among other things, assistance in the preparation and placing of issues, and in the case of the non-public market, also maintaining bond deposits, settlements related to bond sales and redemption as well as interest payouts. Arranger banks may also underwrite issues.

Municipal bonds were mainly purchased by domestic investors, of which banks constituted the majority. As of year-end 2005, banks held approximately 3/4 of the outstanding value of municipal bonds.

Secondary market

Public municipal bonds are traded on the RPW CeTO regulated off-exchange market. In 2005, turnover on the regulated market amounted to PLN 8.6 million, compared to PLN 195.4 million in 2004. In 2003, municipal bond turnover equalled solely to PLN 1 million. The low value of single issues compared to Treasury bonds and the high proportion of floating rate bonds result in the fact that municipal bonds are not purchased by short- and medium-term investors.

The NBP has no information about the turnover on the OTC market.

Prospects

Strong fragmentation and predominance of low-amount issues are the main factors hampering further development of the municipal bond market. This is an obstacle to the small and large investors’ access to the market and prevents application of efficient investment strategies. One of the proposed solutions for enhancing the attractiveness of issues is the grouping of issuers and

Figure 5.2.18. Municipal bond issue arrangers – share in the municipal bond market, 2005

Uczestnicy niebankowi zwiększają obrotu papierami skarbowymi. Rozmowa z Prezesem Zarządu MTS-CeTO, „Parkiet” of February 27, 2006.

Municipal bonds are usually floating-rate bonds and such bonds have lower liquidity than fixed-rate bonds.
issuing bonds by associations of territorial units.\textsuperscript{457} Joint bond issues allow reduction of investment risk and enhancement of investment liquidity. In such situation, the issuers incur lower costs related to lower risk and liquidity premiums.\textsuperscript{458} Larger issues of municipal bonds would also allow greater participation in the public market. This would make such issues more popular with the investors.

The fact that Poland, being a European Union Member State, absorbs EU structural funds is a factor which may significantly contribute to the development of the municipal bond market. EU funds are mainly addressed at LGUs (e.g. European Regional Development Fund). The need to cofinance the investments implemented by LGUs with the use of EU funds will force the LGUs to seek additional sources of financing, e.g. from the issue of bonds.

The issue of municipal bonds as an instrument of incurring debt by LGUs is subject to limitations resulting from the Act on Public Finance of 30 June 2005.\textsuperscript{459} The Act specifies the maximum amounts of LGU debt:

- total amount of debt cannot exceed 60% of the LGU’s revenue in a given year,
- total amount of instalments repaid in a given year cannot exceed 15% of revenue planned for that year.

In 2005, the total amount of LGU debt equalled 20.4% of their revenue. Thus, limitations of LGU debt should not substantially hamper the development of the municipal bond market, although they may constitute a restriction of issue for certain LGUs.

\textbf{5.2.2.4. Long-term commercial bank debt securities}

Long-term bank debt securities (LBDS) are securities issued by commercial banks with maturities of at least one year.\textsuperscript{460} LBDS are issued as bank bonds and bank securities.

\textbf{Market size}

In 2005, LBDS offered on the Polish market amounted to PLN 3.0 billion.\textsuperscript{461} This includes the outstanding value of securities issued by Polish commercial banks (0.9 billion zloty), European Investment Bank bonds (1.77 billion zloty) and mortgage bank bonds in foreign currencies (356 million zloty).

In the euro area, debt securities issued by domestic banks are an important source of fundraising. They constitute the second segment, after the Treasury securities segment, of the debt securities market. As of year-end 2005, they accounted for approximately 35% of the total debt securities market in the euro area.\textsuperscript{462} In Poland, LBDS issued by domestic banks account for 0.4% of the entire domestic long-term debt securities market. Also with respect to the share in commercial banks’ liabilities, debt securities issues in Poland constitute a rather insignificant source of fundraising. In the euro area as of year-end 2005, the share of the outstanding value of debt securities issued by banks in their liabilities equalled 16.3%, compared to 1.6% in Poland.\textsuperscript{463} The reason for such gap was mainly the difference in liquidity of the banking sector in Poland and in the euro area.

In the years 2004–2005, the structure of factors triggering the development of bank debt securities market substantially changed. Until the end of 2003, development of bank debt securities market was enhanced by issues in domestic currency, mainly public offers of the ‘anti-tax bonds’.  

\begin{thebibliography}{9}
\bibitem{Brzeski} Such solutions are applied e.g. in Switzerland. J.A. Batten, T.A. Fetherston, P.G. Szilagyi: \textit{European fixed income market}, England, 2004, John Wiley & Sons, Ltd., p. 423.
\bibitem{PublicFinance} Dz.U. No. 249/2005, item 2104, as amended.
\bibitem{Mortgage} Mortgage bonds are discussed in a separate section.
\bibitem{Indication} Unless indicated otherwise, in the case of the outstanding value of debt securities issued by banks, the data refer to year-end figures.
\bibitem{Secure} This ratio includes both secured and unsecured securities. In the euro area, the secured securities form is an important part of LBDS. Their share is estimated at 40–50%. Even excluding secured securities, acquisition of funds by banks through the issue of debt securities is of greater importance in the euro area than in Poland.
\bibitem{ECB} Calculated for the euro area on the basis of ECB \textit{Monthly Bulletin}, March 2006, for Poland on the basis of NBP data.
\end{thebibliography}
The levy of a tax on all capital revenues resulted in the abandoning of further issues of these bonds. This process was reflected by the structure of bank bonds. Since 2004, the share of securities under public offers decreased.

In 2005, banks more often decided to conduct foreign issues in foreign currencies, which resulted from the development of the portfolio of mortgage loans in foreign currencies. Bonds in foreign currencies could not have been sold on the domestic market due to the lack of demand from the part of non-bank financial institutions. This resulted in a dynamic increase in the value of bonds in foreign currencies placed on the foreign markets.

Figure 5.2.19. Outstanding value of LBDS in domestic currency issued by domestic commercial banks

As of year-end 2004, the outstanding value of foreign currency issues by commercial banks amounted to PLN 2.36 billion (increase by 143.9% compared to the previous year), to reach PLN 4.52 billion as of year-end 2005 (increase by 91.3%). Liabilities in foreign currencies already account for nearly a half of total outstanding value of debt securities issued by banks.

Primary market

In 2005, domestic banks did not offer LBDS through public issues. However, foreign bonds of Citibank N.A. in USD were publicly offered on the WSE in October 2005.

Public placements in 2005 amounted to PLN 388 million. The LBDS and SBDS primary market were similarly organised.

Secondary market

Bonds issued by commercial banks may be traded both on the regulated and on the unregulated market. The regulated markets were RPW CeTO and the WSE. In 2005, as in the previous year, bonds issued by four domestic banks were registered with RPW CeTO and bonds issued by one domestic bank, with the WSE. The value of public bank bonds in trading amounted as of year-end 2005 PLN 123 million. Gross turnover in these bonds amounted to PLN 1.1 billion, of which 99.7% was the turnover on the RPW CeTO. The high share of RPW CeTO in the total turnover on the regulated secondary market resulted from the 2005 redemption of the “anti-tax bonds”. Turnover for bonds maturing in 2005 constituted 99.5% of total turnover of bank bonds.

465 BPH was the main issuer of bonds in foreign currencies. This bank issues eurobonds for the London market.
466 No trading in these bonds was observed in 2005.
on RPW CeTO (the value of long-term bonds on this market equalled PLN 620 million as of year-end 2004, compared to PLN 90 million as of year-end 2005).467

European Investment Bank bonds were also traded on the secondary market. Turnover in those bonds amounted to PLN 423.9 million, while an important part of turnover covered OTC transactions (96.6%).

Bank bonds have low liquidity. This results from the low value of single issues, as well as from the lack of bonds with long maturities.468 The largest issue of bank bonds, with maturity falling beyond 2005, equalled PLN 62 million, while the value of the largest issues of Treasury bonds amounted nearly to PLN 30 billion.

The NBP has no information about the LBDS turnover on the unregulated market.

Investors

Public bank bond issues have been targeted mainly at individuals. Private placements, on the other hand, have been targeted at institutions.

Table 5.2.13. Currency structure of the outstanding value of bonds issued by banks, 1998–2005 (as of year-end)

<table>
<thead>
<tr>
<th>Year</th>
<th>Share of foreign-currency bonds in the value of LBDS issued (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>46.5</td>
</tr>
<tr>
<td>1999</td>
<td>5.9</td>
</tr>
<tr>
<td>2000</td>
<td>27.8</td>
</tr>
<tr>
<td>2001</td>
<td>32.1</td>
</tr>
<tr>
<td>2002</td>
<td>22.7</td>
</tr>
<tr>
<td>2003</td>
<td>18.6</td>
</tr>
<tr>
<td>2004</td>
<td>36.6</td>
</tr>
<tr>
<td>2005</td>
<td>43.3</td>
</tr>
</tbody>
</table>

Table 5.2.13. Currency structure of the outstanding value of bonds issued by banks, 1998–2005 (as of year-end)
Prospects

The role of the issue of debt securities as a source of fundraising by Polish commercial banks is marginal. The main reason is the excess liquidity of the banking system. However, changes in the structure of household savings, involving the decreasing share of bank deposits and the increasing share of investment funds, will force the banks to seek new sources of fundraising. This may be achieved e.g. through the issue of LBDS. This trend may be supported by an increasing importance of mortgage loans, which are of their very nature long-term loans. This process will contribute to the change in the LBDS structure: the importance of LBDS will increase, while that of SBDS will decrease.

5.2.2.5. Mortgage bonds

In Poland, mortgage bonds can be issued solely by mortgage banks469 carrying out activity in accordance with the Act on Mortgage Bonds and Mortgage Banks.470 The structure of this group has not changed since 2002.471 However, the outstanding value of mortgage bonds issued systematically rose, to reach PLN 1,762.79 million as of year-end 2005 (Figure 5.2.20). The value of new mortgage bond issues amounted to PLN 882.61 million. Although the outstanding value increased in 2005 by 73.6%, the importance of mortgage bonds, both in terms of Polish banking sector development and capital market development, remained small.

Two issuers entities prevailed at mortgage bonds primary market, with 97.6% share in the total value of issue. The largest number of issues (14 out of total 23) was conducted by BRE Bank Hipoteczny. In 2005, this bank conducted two issues of mortgage bonds with the total value of PLN 110 million (in terms of the outstanding value of issues, this bank’s market share accounted for 51.8% as of year-end 2005). In the same year, larger issues were conducted by BPH Bank Hipoteczny (PLN 600 million). This increased its share in the outstanding value of issues from 15.3% in 2004 to 45.8% in 2005. These issues were mainly denominated in PLN, which resulted in the increase of the share of these instruments in the total outstanding value.

Figure 5.2.20. Outstanding value of mortgage bond issued by mortgage banks in Poland, 2002–2005

Source: NBP.

469 In certain European countries, mortgage bonds may also be issued by universal banks.
471 In 2005, four mortgage banks were operating. Only the names of two of them changed. BRE Bank Hipoteczny SA by the end of 2004 operated under the name Rheinhyp BRE Bank Hipoteczny SA, and HypoVereinsbank Bank Hipoteczny SA on November 25, 2004 changed its name to BPH Bank Hipoteczny SA. The remaining two were Śląski Bank Hipoteczny SA and Nykredit Bank Hipoteczny SA.
Table 5.2.14. Mortgage bond issues in Poland

<table>
<thead>
<tr>
<th>Bank name</th>
<th>Issue date</th>
<th>Maturity</th>
<th>Issue amount (millions)</th>
<th>Issue currency</th>
</tr>
</thead>
<tbody>
<tr>
<td>BRE Bank Hipoteczny SA</td>
<td>28.06.2000</td>
<td>5-year</td>
<td>5</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>14.09.2001</td>
<td>3-year</td>
<td>10</td>
<td>USD</td>
</tr>
<tr>
<td></td>
<td>14.09.2001</td>
<td>3-year</td>
<td>5</td>
<td>EUR</td>
</tr>
<tr>
<td></td>
<td>20.11.2001</td>
<td>4-year</td>
<td>10</td>
<td>USD</td>
</tr>
<tr>
<td></td>
<td>20.05.2002</td>
<td>6-year</td>
<td>10</td>
<td>USD</td>
</tr>
<tr>
<td></td>
<td>20.05.2002</td>
<td>7-year</td>
<td>10</td>
<td>EUR</td>
</tr>
<tr>
<td></td>
<td>29.07.2002</td>
<td>4-year</td>
<td>50</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>10.04.2003¹</td>
<td>5-year</td>
<td>200</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>20.05.2003</td>
<td>6-year</td>
<td>20</td>
<td>EUR</td>
</tr>
<tr>
<td></td>
<td>23.10.2003¹</td>
<td>5-year</td>
<td>200</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>20.05.2004</td>
<td>5-year</td>
<td>25</td>
<td>EUR</td>
</tr>
<tr>
<td></td>
<td>20.05.2004</td>
<td>5-year</td>
<td>25</td>
<td>USD</td>
</tr>
<tr>
<td></td>
<td>14.04.2005¹</td>
<td>5-year</td>
<td>100</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>21.11.2005</td>
<td>5-year</td>
<td>10</td>
<td>USD</td>
</tr>
<tr>
<td></td>
<td>29.12.2000</td>
<td>10-year</td>
<td>3.63</td>
<td>EUR</td>
</tr>
<tr>
<td></td>
<td>29.04.2002</td>
<td>5-year</td>
<td>22</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>16.05.2002</td>
<td>5-year</td>
<td>8</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>16.05.2002</td>
<td>5-year</td>
<td>10</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>2.06.2005¹</td>
<td>7-year</td>
<td>200</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>18.08.2005</td>
<td>3-year</td>
<td>150</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>21.11.2005¹</td>
<td>5-year</td>
<td>400</td>
<td>PLN</td>
</tr>
<tr>
<td></td>
<td>24.01.2003</td>
<td>4-year</td>
<td>3</td>
<td>EUR</td>
</tr>
<tr>
<td></td>
<td>29.11.2004</td>
<td>3-year</td>
<td>30</td>
<td>PLN</td>
</tr>
</tbody>
</table>

¹ Public issues.
Source: NBP.

Table 5.2.14 presents the basic data related to the private and public issues of mortgage bonds in Poland. In the 6-year history of this market, mortgage bonds were issued mainly under private placements.

Secondary trading in mortgage bonds can take place both on the public and non-public markets. Public trading is organised by MTS-CeTO. The function of arrangers, paying agents, dealers and depositaries of non-public mortgage bonds is usually vested in parent banks of mortgage banks. In 2005, five issues of mortgage bonds were listed on the MTS-CeTO, i.e. three more than in 2004. Unlike 2004, 2005 did not face any trading in mortgage bonds on this market.

In 2005, the share of banks in the structure of purchasers of mortgage bond issued under private placement increased, which made them yet again the main investor on the market (Figure 5.2.21). The share of international financial institutions decreased from 45.4% in 2004 to 27.6% in 2005 and the share of investment funds in the purchasers’ structure slightly dropped to reach 4.8% as of year-end. The share of non-bank financial institutions remains small. However, one should keep in mind that consequently to the small value of mortgage bonds issued in Poland, substantial changes in the investors’ structure may result from a low base.

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472 The NBP has no information about the turnover on the non-public market.
473 The value of turnover in mortgage bonds in 2004 was higher by 107% than in 2003 and amounted to PLN 122 million.
474 MTS-CeTO does not publish information on the purchasers’ structure on the public market. The analysis of the investors’ structure presented in this chapter refers solely to the non-public market.
475 The following institutional investors may invest in mortgage bonds:
   - insurance companies – up to 10% of the amount of technical provisions (the Insurance Activity Act of May 22, 2003, Dz.U. No. 124/2003, item 1151, as amended),
   - open investment funds – up to 80% of fund assets, but not more than 25% of assets in mortgage bonds issued by a single mortgage bank (the Act on Investment Funds of May 27, 2004, Dz.U. No. 146/2004, item 1546),
   - closed investment funds – no more than 25% of assets in mortgage bonds issued by a single mortgage bank, open pension funds – up to 40% of assets, but not more than 15% in mortgage bonds not admitted to public trading (Ordinance of the Council of Ministers on the determination of the maximum percentage of assets on an open pension fund that may be invested in individual investment categories as well as additional restrictions regarding the investment activities of pension funds of February 3, 2004, Dz.U. No. 32/2004, item 276).
Figure 5.2.21. Investors on the mortgage bond market (private placement, as of year-end)

Prospects

The mortgage bond market remained a small part of Polish capital market and the use of mortgage bonds was not as common as in other European countries. This market has been operating for six years. Its structure and growth rate was mainly determined by universal banks belonging to the same banking groups as mortgage banks. Decision on the selection of a specific mortgage loan refinancing strategy is often made at the group level, and universal banks, prevailing over mortgage banks with respect to the value of granted mortgage loans, were very influential in this respect.

The issues of mortgage bonds in Poland were often accompanied by oversubscription. This may indicate that there is large demand for secure long-term securities. It seems that the currently observed gradual outflow of deposits from the banking sector to other financial institutions (in particular investment funds) and the maintained high growth rate of mortgage loans will probably lead to changes in the structure of the sources of bank financing in the nearest future in Poland. Poland will probably not achieve the identical share of mortgage banks in mortgage loan financing as Hungary. Hungarian mortgage banks finance over 60% of mortgage loans (mainly housing loans) of the entire banking sector with mortgage bonds. European experiences show that despite the complementary use of different instruments based on mortgage assets, such as MBS (mortgage-backed securities), the main complementary instrument for the client deposit financing are mortgage loans. Due to the Polish legislation in force (mortgage bonds can be issued solely by mortgage banks), implementation of this scenario in Poland is impossible.

The share of deposits in the financing of mortgage loans in the European Union systematically decreases (60% in 2005). However, the importance of securitisation increase, since certain countries allow the use of ABS (asset-backed securities) as the security of the issue of mortgage bonds.

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476 Introduction of favourable tax regulations in Hungary resulted in a concentration of a large part of housing loans in mortgage loans, which allowed them to acquire capital on foreign markets.

477 Mortgage bonds are classified as covered bonds, i.e. securities backed by mortgage or government guarantees.


479 More on securitisation in Box 4.1.1.
mortgage bonds. In other countries, mortgage bonds may serve as a security of ABS issue.\textsuperscript{480} Wider use of covered bonds will be also supported by the CRD, which introduces preferential conditions for the financing of mortgage liabilities with mortgage bonds without rating.

Certain signals suggest that Polish mortgage banks seek market niches where their competitive position against commercial banks would be stronger. Such niche could be e.g. the financing and refinancing of investments in real estate implemented by local government units (LGUs). Considering Poland’s accession to the European Union and greater availability of financing under regional and structural funds, one may expect an increase in LGU debt. This may be used by mortgage banks which focus on the corporate lending and on the financing of commercial real estate. Owing to the use of public mortgage bonds in project finance\textsuperscript{481} and to the establishment of a SPV for that purpose, LGUs are not limited by debt limitations resulting from the Act on Public Finance.\textsuperscript{482} However, no public mortgage bonds have been issued on the Polish market to date.\textsuperscript{483} One may expect that in the nearest future the growth rate of the development of mortgage bond market will remain unchanged.

\subsection*{5.2.2.6. NBP bonds}

No changes in the outstanding value of bonds issued by the NBP occurred in 2005.\textsuperscript{484} NBP bonds issued for banks in 2002 with total value of PLN 7.82 billion were traded in 2005.

Transactions in NBP bonds are seldom concluded and result from conditional transactions. The value of NBP bond turnover amounted to PLN 4.5 billion in 2005. The 2004 turnover amounted to PLN 1.7 billion.

\subsection*{5.2.3. Marketable equities market}

Apart from stocks, the marketable equities market included allotment certificates, subscription rights and priority rights.

\subsubsection*{5.2.3.1. WSE stock market}

\textbf{WSE capitalisation}

In 2005, the value of stocks of companies listed on the WSE, and thus the stock market size, was influenced by changes in stock prices, new listing, delisting and new issues of stocks of already listed companies.

The upward trend from spring 2003 continued. Capitalisation of domestic companies grew by 44\% to reach PLN 308.4 billion in 2005. Including foreign companies, market capitalisation equalled PLN 424.9 billion and grew by 46\% in 2004. WIG index rose by 33.7\%, reaching an all-time high of 36,068.56 points on December 27. Investments in the largest companies listed on the WSE brought the highest returns – the WIG20 index rose by 35.4\%,. The parallel market WIRR index rose by 15.4\%, which was slower increase compared to 2004 figures (73\%). Higher growth rate of the value of large companies mainly resulted from the boom on the commodities’ markets (high oil and copper prices) and from good financial results of banks.\textsuperscript{485} The rise in WIG20 index also


\textsuperscript{481} It is the most often applied method of the financing of LGU real estate. More about project finance: K. Brzozowska: \textit{Finansowanie inwestycji infrastrukturalnych przez kapitał prywatny na zasadach Project Finance}, Warszawa 2005, CeDeWu.

\textsuperscript{482} The Public Finance Act of June 30, 2005 (Dz.U. No 249/2005, item 2104).

\textsuperscript{483} Pursuant to the Act on Mortgage Bonds and Mortgage Banks of August 29, 1997 (Dz.U. No. 99/2003, item 919), mortgage banks may issue two types of mortgage bonds: of mortgage and public nature. The former are backed by mortgage and the basis for the issue of the latter is the outstanding value of loans for the public sector, granted by mortgage bank.


\textsuperscript{485} On December 30, 2005, WIG20 index included ten companies from the fuel, copper and banking sector. They constituted 70.2\% of the value of this index, compared to seven companies with 61\% share in WIG20 the year before. The number of banks included in WIG20 remained unchanged (five), but their share in the index decreased from 43.2\% as of year-end 2004 to 33.5\% as of year-end 2005.
resulted from the demand for stocks of companies included in this index from the part of foreign investors, who prefer investments in large, more liquid companies. Although the main WSE indices rose significantly yoy, 2005 faced two corrections, the first one in March and April (WIG20 plunged by 11.2%), the second one in October (WIG20 dropped by 7.1%). The autumn adjustment mainly resulted from the increased investment risk due to the uncertainty caused by political situation related to the parliamentary and presidential elections.

Figure 5.2.22. WIG and WIG20 market indices, 2003–2005

Source: WSE.

The maintenance of favourable market conditions was supported by the improved economic situation in Poland, which was reflected in the increased profits of companies. Moreover, the accession to the EU enhanced confidence in the Polish market. Continued low interest rates on the world markets and large capital availability contributed to the increased capital inflow on the WSE and on the other regional markets, resulting in further rise in stock prices.

In 2005, the number of IPOs amounted to 35, which was only one less than in the previous year. However, the total value of IPOs, including public sales of stocks by stockholders and new issues, was lower by nearly 47% than in 2004 and amounted to PLN 6.98 billion. The large value of IPOs in 2004 was greatly influenced by the PKO BP offer (PLN 7.89 billion) accounting for 60% of the total value of 2004 offers. The majority of newly listed companies in 2005 were private-owned (28 companies). The State Treasury introduced stocks of seven entities. In terms of the value of offers, the State Treasury was again the largest seller, offering stocks worth PLN 4.9 billion (PLN 2.08 billion in the case of private offers). The value of new stock issues under IPO amounted to PLN 5.25 billion and was nearly 3.5 times higher than in 2004 (PLN 1.52 billion). This resulted from the manner of privatisation of state-owned companies. State-owned companies entered the market mainly through new stock issues (the total of PLN 4.35 billion). Such policy allowed the partial privatisation of companies and maintenance of control over those companies by the MST, while companies could acquire capital necessary for further development. IPOs of private owned companies were largely the manner of investment exit (the value of new issues amounted to PLN 903 million).

486 According to the NBP data as of the end of November 2005, companies included in WIG20 index accounted for 71.2% of the foreign investors’ portfolio, while MIDWIG companies accounted for 18.6%.

487 According to the data of the European Fund and Asset Management Association, in 2004 the inflow of funds to the European UCITS amounted to EUR 203 billion. In 2005, the inflow was even higher and amounted to EUR 378 billion.

488 The main stock market indices in Prague (PX 50) and in Budapest (BUX) increased by 42.7% and 41% respectively. This shows e.g. the large demand for the stocks of companies listed on the stock exchanges in our region. Foreign capital was inflowing on the WSE throughout most of 2005. Foreign capital outflow was observed in February and April, as well as in October, November and December.

489 Companies may enter the stock market through the issue of new stocks, selling old stocks or offering stock packages including both new and old issues. Structure of the offer is important for the company’s additional capitalisation. Funds accumulated as a result of sales of the new issue remain with the company and usually serve as a source of investment financing, while the sales of old stocks is a method for the investment exit and does not generate cash for the company.
In 2005, two foreign companies debuted on the WSE and offered shares worth 493.7 million. This implied a drop by 50% in the number of offers and by 76.9% in terms of value, compared to the previous year. Therefore, the number of foreign companies on the Polish stock exchange increased to seven and their total capitalisation as of year-end 2005 amounted to PLN 116.5 billion (rise by 50.5%).

In terms of the number of IPOs, the WSE was rated the third stock exchange in Europe after LSE and Oslo Børs (Figure 5.2.24), and in terms of the value of IPOs, the WSE was rated the seventh. This implied a relatively low average value of the newly listed companies (PLN 199.5 million).

The main reason for the maintenance of a large number of newly listed companies in 2005 was the boom in the market and the large demand from the part of investors, which is implied by substantial reductions of orders during IPOs. High valuations of the listed companies in a situation where the costs of introducing new companies were fixed rendered the stock issue on the

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490 In 2004, four new foreign companies were listed on the WSE (BorsodChem, IVAX, bmp AG, MOL), with total offer value of PLN 2.14 billion. In the case of MOL, the dual-listing was applied. MOL is listed on the WSE and on the Budapest SE simultaneously.

491 The highest order reduction rate was observed in the case of Zelmer offer in the tranche for individual investors and amounted to 98.7%.
WSE one of the cheapest sources of fundraising. This enhanced the interest of companies in entering the stock market.

The value of new issues in 2005 amounted to PLN 13.2 billion and was the highest in the WSE history. In 2004 and 2005, companies acquired nearly PLN 25 billion through the stock exchange. Considering the lower outstanding value of bank credits taken by companies in those years, this implied a change in the preferences of companies as to the sources of financing of their operations.492

According to WSE data 493, the average cost (median) of the conducting of IPO on the WSE in the years 2004–2005 accounted for 5.29% of the offer value and the cost of fundraising through subsequent issues was even lower.

Due to a large number of IPOs in 2005, the number of companies listed on the WSE increased to 255. 242 companies (including 14 NFIs) were listed on the primary market, while 13 were listed on the parallel market. In 2005, due to the acquisitions by other companies and bankruptcies, 10 companies were delisted.

Figure 5.2.25. New stock issues on the WSE, 1998–2005

![Graph showing new stock issues on the WSE, 1998–2005](Source: National Depository for Securities.)

Table 5.2.15. WSE stock market statistics, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Exchange capitalisation, year-end (PLN million)1</td>
<td>110.565</td>
<td>167.717</td>
<td>291.697</td>
<td>424.900</td>
</tr>
<tr>
<td>– of which domestic companies</td>
<td>110.565</td>
<td>140.002</td>
<td>214.313</td>
<td>308.418</td>
</tr>
<tr>
<td>Number of listed companies</td>
<td>216</td>
<td>203</td>
<td>230</td>
<td>255</td>
</tr>
<tr>
<td>Number of newly listed companies</td>
<td>5</td>
<td>6</td>
<td>36</td>
<td>35</td>
</tr>
<tr>
<td>Number of delisted companies</td>
<td>19</td>
<td>19</td>
<td>9</td>
<td>10</td>
</tr>
<tr>
<td>Free float/capitalisation of domestic companies</td>
<td>34.4%</td>
<td>43.6%</td>
<td>41.4%</td>
<td>43.1%</td>
</tr>
<tr>
<td>WIG index</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– year minimum</td>
<td>12.582.4</td>
<td>13.502.7</td>
<td>21.299.4</td>
<td>25.206.5</td>
</tr>
<tr>
<td>– year maximum</td>
<td>16.311.6</td>
<td>22.033.8</td>
<td>26.636.2</td>
<td>36.068.6</td>
</tr>
<tr>
<td>Return on index (%)</td>
<td>3.2</td>
<td>44.9</td>
<td>27.9</td>
<td>33.7</td>
</tr>
<tr>
<td>Investment accounts at year-end (thousands)</td>
<td>1.016</td>
<td>947</td>
<td>851</td>
<td>853</td>
</tr>
<tr>
<td>Capitalisation as a proportion of GDP (%)</td>
<td>14.34</td>
<td>20.84</td>
<td>32.99</td>
<td>43.91</td>
</tr>
</tbody>
</table>

1 Capitalisation calculated for all companies listed on the WSE (both domestic and foreign).

Source: WSE.

492 In 2004, the outstanding value of bank loans for companies decreased by PLN 4.8 billion compared to 2003, to increase by PLN 4 billion in 2005.

Turnover

Gross turnover in stock trading in 2005 compared to 2004 figures increased by 61% and amounted to PLN 191.1 billion, which was an all-time record. The average value of turnover during one trading day rose by 63.7% to reach PLN 761.3 million. Such a rise resulted from the rise in stock prices, higher number of listed companies and the bullish market which encouraged the investors to increase the share of stocks in their portfolios. Turnover value-to-capitalisation ratio, which measures market liquidity, equalled 62% and was higher by nearly seven percentage points than in the previous year (Table 5.2.17).

Although the situation much improved in 2005, the WSE had lower liquidity than other stock exchanges in the region. Turnover value in Prague equalled EUR 35.96 billion, i.e. 112% of stock market capitalisation, in Budapest the figures showed EUR 19.42 billion and 70% respectively, while in Warsaw – EUR 24.1 billion and 30% respectively. Low level of WSE turnover resulted from the fact that a large part of company stocks were held by strategic investors and long-term institutional investors, who often apply the buy&hold strategy.

Table 5.2.16. Number of companies listed on individual WSE markets, 2000–2005

<table>
<thead>
<tr>
<th>Market type</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Primary</td>
<td>121 + 14 NH</td>
<td>123 + 14 NH</td>
<td>118 + 14 NH</td>
<td>112 + 14 NH</td>
<td>201 + 14 NH</td>
<td>228 + 14 NH</td>
</tr>
<tr>
<td>Parallel</td>
<td>67</td>
<td>61</td>
<td>57</td>
<td>54</td>
<td>115</td>
<td>13</td>
</tr>
<tr>
<td>Free</td>
<td>23</td>
<td>32</td>
<td>27</td>
<td>23</td>
<td>–</td>
<td>–</td>
</tr>
</tbody>
</table>

Source: WSE.

Table 5.2.17. Stock turnover on the WSE, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Stock market turnover (PLN million)</td>
<td>63,662</td>
<td>79,774</td>
<td>118,518</td>
<td>191,095</td>
</tr>
<tr>
<td>– trading day average (PLN million)</td>
<td>255.7</td>
<td>317.8</td>
<td>464.8</td>
<td>761.3</td>
</tr>
<tr>
<td>Stock turnover value as a proportion of the capitalisation of domestic companies (%)</td>
<td>57.6</td>
<td>57.0</td>
<td>55.3</td>
<td>62.0</td>
</tr>
<tr>
<td>Turnover ratio (%)(^1)</td>
<td>22.9</td>
<td>29.2</td>
<td>32.3</td>
<td>25.9</td>
</tr>
<tr>
<td>Transactions per session</td>
<td>11,358</td>
<td>12,228</td>
<td>15,467</td>
<td>19,277</td>
</tr>
</tbody>
</table>

\(^1\) Turnover ratio for stocks is the ratio of the number of stocks traded to the average number of stocks in trading and introduced into trading during the analysed period.

Note: The difference between turnover ratio based on turnover value (62% in 2005) and turnover ratio based on the number of stocks sold (25.9%) results from the fact that in 2005 stocks with higher unit prices prevailed.

Source: WSE.

Figure 5.2.26. Monthly stock turnover on the WSE, 2002–2005

Note: Turnover value calculated as a sum of daily gross turnover in a given month.
Source: WSE.
The majority of the traded stocks were those of the largest companies included in the WIG20 index. Over the half of the WSE turnover (52%) were transactions involving the stocks of five companies. In comparison with other countries in the region, the situation on the Polish market was much better in this respect. For instance, in Prague and Budapest this ratio exceeded 80%. The high ratio for the above stock exchanges results from a low number of listed companies (39 and 44 companies respectively). In comparison with the developed markets (e.g. Deutsche Börse 33.7%, Borsa Italiana 43.8%), concentration of the WSE turnover is higher. It should be noted, however, that the number of companies listed in those markets is higher (764 and 282 respectively). It can be expected that the increase in the number of listed companies will be accompanied by a systematic decrease in the turnover concentration ratio for the Polish stock market.

The ratio of free float to stock market capitalisation rose slightly to reach 43.1% as of year-end 2005. Since 2000 we can observe an upward trend with respect to this ratio. It is a positive factor, since it implies an increase in liquidity of the entire stock market, which decreases transaction-related costs (narrower spreads).496

<table>
<thead>
<tr>
<th>No.</th>
<th>Company</th>
<th>Turnover (PLN million)</th>
<th>Share in WSE turnover (%)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>PKN Orlen</td>
<td>28,335.4</td>
<td>14.8</td>
</tr>
<tr>
<td>2</td>
<td>TP SA</td>
<td>25,933.3</td>
<td>13.6</td>
</tr>
<tr>
<td>3</td>
<td>PKO BP</td>
<td>16,177.5</td>
<td>8.5</td>
</tr>
<tr>
<td>4</td>
<td>KGHM</td>
<td>14,431.0</td>
<td>7.6</td>
</tr>
<tr>
<td>5</td>
<td>Pekao</td>
<td>14,392.8</td>
<td>7.5</td>
</tr>
<tr>
<td>6</td>
<td>BPN</td>
<td>6,519.5</td>
<td>3.4</td>
</tr>
<tr>
<td>7</td>
<td>Lotos</td>
<td>4,584.4</td>
<td>2.4</td>
</tr>
<tr>
<td>8</td>
<td>Netia</td>
<td>4,578.9</td>
<td>2.4</td>
</tr>
<tr>
<td>9</td>
<td>Agora</td>
<td>3,994.1</td>
<td>2.1</td>
</tr>
<tr>
<td>10</td>
<td>Prokom</td>
<td>3,141.7</td>
<td>1.6</td>
</tr>
<tr>
<td></td>
<td>Total</td>
<td>122,088.6</td>
<td>63.9</td>
</tr>
</tbody>
</table>

Source: WSE.

Figure 5.2.27. Free float on the WSE, 1998–2005

Free float – left-hand scale
Free float to WSE stock capitalisation – right-hand scale

Note: Capitalisation refers to capitalisation of domestic companies.
Source: WSE.

494 Turnover concentration ratio depends on both the number of companies listed on a given market and the difference in their sizes. The market where stocks of companies of similar size are listed will have lower concentration ratio than the market with identical number of companies of diverse sizes.

495 The free float is the number of company stocks registered in the National Court Register, excluding:
- stocks held by one stockholder or a group of interrelated stockholders, which form at least 5% of all company stocks issued;
- stocks held by the State Treasury;
- own stocks of a company, intended for redemption.
Free float stocks are always stocks controlled by investment funds and pension funds, asset management companies and stocks covered by depositary receipts. For foreign companies, of which the stocks are listed on the WSE, free float is a median of the number of stocks deposited with the KDPW, calculated on every trading day in the last three months.

496 The spread is a difference between the best purchase offer and the best sales offer of a given financial instrument.
Participants

WSE data show that the main group of investors on the stock market were foreign investors, who at the end of 2005 had 38.6% of share in market capitalisation (Figure 5.2.28). According to the data gathered by the NBP for the statistics related to the international investment position of Poland, the participation of foreign investors on the Polish stock market was higher, to reach 49.4% at the end of 2005 (Figure 5.2.29). The difference between the NBP and WSE data results from the fact that the WSE data are based on the annual reports of companies constituting approximately 90% of the market in terms of capitalisation. Moreover, these data include solely investors controlling over 5% of stocks of a given company. NBP statistics include all foreign investors. The second important group of investors were pension funds and investment funds, as well as asset management institutions. The value of stocks held by those entities constituted over 20% of the entire market capitalisation. Individual investors were also important, controlling stocks accounting for nearly 17% of the WSE capitalisation.

In 2005, foreign investors increased their share in stock market turnover by 8 pp., to reach 41% (Figure 5.2.30). Such a change was caused by a higher capital inflow to Poland due to the better prospects for the rise in company listings than in the developed countries. Increased share in turnover of foreign investors contributed to a 31% rise in the average transaction value, amounting to PLN 19,277.

Figure 5.2.28. Investors on the Polish stock market, 2005 (share in capitalisation of domestic companies)

![Figure 5.2.28. Investors on the Polish stock market, 2005 (share in capitalisation of domestic companies)](image)

Source: WSE.

Figure 5.2.29. Value of stocks admitted to public trading in foreign investors’ portfolios to WSE capitalisation, 2002–2005

![Figure 5.2.29. Value of stocks admitted to public trading in foreign investors’ portfolios to WSE capitalisation, 2002–2005](image)

Source: NBP calculations based on NBP and WSE data.

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497 Data gathered by the NBP in order to calculate Poland’s investment position included solely foreign investors.

498 The larger share of foreign investors in stock market companies capitalisation (49.4%) than in the turnover (41%) results from the fact that part of stocks is held by strategic foreign investors who do not trade in them.
In 2005, the share of individual investors in the WSE stock turnover dropped (from 35% to 26%), which was probably related to a large increase in the institutional investors’ stock portfolio (mainly investment funds) and to the fact that individuals more often than in the previous years acted through the intermediary of investment funds. Consequently, in 2005 the value of stocks held by investment funds rose by 81% (amounting to PLN 15.6 billion).

Prospects

In 2005, the Polish stock market maintained its position among the Central and Eastern European markets. Its dominant role is reflected by basic indicators describing market size, i.e. capitalisation, the number of listed companies, as well as the number and value of newly listed companies. The importance of the stock exchanges in the economies of the countries in the region, measured as the ratio of capitalisation to GDP, is similar. In terms of turnover value, Central and Eastern European stock exchanges are also comparable.

The lower liquidity of the WSE compared to other exchanges in the region, as well as to Western European stock exchanges, such as the Dublin and Vienna stock exchanges, largely results from the lower average capitalisation of companies listed on the WSE.

The importance of the capital market as a source of corporate financing gradually increases, given the high number of newly listed companies on the WSE and the announcements of new IPOs. Considering the fact that the cost of fundraising through stock issue on the WSE is comparable to the cost of a bank credit, one can expect new IPOs on the market in the nearest future. However, one should keep in mind that the role of the stock exchange as a source of companies’ fundraising depends on the situation on the market.

As in previous years, one can expect both Polish and foreign IPOs. The important factor encouraging foreign firms to enter the Polish capital market may be the attractive costs of fundraising compared to other European markets. The single passport principle, which facilitates the introduction of stocks of EU companies to trading on the markets of all Member States, is also important. Participation of new foreign companies would be undoubtedly favourable for the WSE, since not only would it contribute to the increase in stock market capitalisation, but also would result in the increase in turnover, which would lead to the improved market liquidity. New issues would also be favourable for the open pension funds, which results from the systematic inflow of contributions and their investment on the stock exchange.

499 The value of funds on the individual investors’ accounts in brokerage houses and offices as of year-end 2005 equalled PLN 25.8 billion, which was 36.5% higher than as of year-end 2004. Considering the rapid growth of stock exchange indices in this period and a dynamic increase in the assets of investment funds, slower increase in bank deposits of individuals, this shows a shift in the preferences with respect to investment of savings from investment accounts and bank deposits to investment funds.
Table 5.2.19. Selected European stock exchange indicators, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
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<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Athens</td>
<td>338</td>
<td>340</td>
<td>321</td>
<td>304</td>
<td>Athens</td>
<td>37.2</td>
<td>40.8</td>
<td>38.2</td>
<td>42.4</td>
</tr>
<tr>
<td>Milan</td>
<td>295</td>
<td>279</td>
<td>278</td>
<td>282</td>
<td>Milan</td>
<td>146.2</td>
<td>148.0</td>
<td>133.1</td>
<td>155.2</td>
</tr>
<tr>
<td>Budapest</td>
<td>48</td>
<td>49</td>
<td>46</td>
<td>44</td>
<td>Budapest</td>
<td>50.0</td>
<td>54.4</td>
<td>50.5</td>
<td>70.4</td>
</tr>
<tr>
<td>Frankfurt</td>
<td>934</td>
<td>866</td>
<td>819</td>
<td>764</td>
<td>Frankfurt</td>
<td>194.3</td>
<td>133.1</td>
<td>140.8</td>
<td>149.3</td>
</tr>
<tr>
<td>Euronext</td>
<td>1,114</td>
<td>1,047</td>
<td>999</td>
<td>966</td>
<td>Euronext</td>
<td>141.1</td>
<td>103.3</td>
<td>110.7</td>
<td>102.2</td>
</tr>
<tr>
<td>Dublin</td>
<td>77</td>
<td>66</td>
<td>65</td>
<td>66</td>
<td>Dublin</td>
<td>61.0</td>
<td>57.6</td>
<td>43.3</td>
<td>54.6</td>
</tr>
<tr>
<td>London</td>
<td>2,424</td>
<td>2,692</td>
<td>2,437</td>
<td>3,091</td>
<td>London</td>
<td>247.5</td>
<td>165.0</td>
<td>200.3</td>
<td>176.8</td>
</tr>
<tr>
<td>Prague</td>
<td>45</td>
<td>38</td>
<td>55</td>
<td>39</td>
<td>Prague</td>
<td>60.2</td>
<td>61.0</td>
<td>69.5</td>
<td>112.2</td>
</tr>
<tr>
<td>Warsaw</td>
<td>202</td>
<td>189</td>
<td>230</td>
<td>255</td>
<td>Warsaw</td>
<td>30.6</td>
<td>30.1</td>
<td>25.2</td>
<td>30.4</td>
</tr>
<tr>
<td>Vienna</td>
<td>129</td>
<td>125</td>
<td>120</td>
<td>111</td>
<td>Vienna</td>
<td>19.9</td>
<td>21.9</td>
<td>30.0</td>
<td>35.0</td>
</tr>
</tbody>
</table>

In 2004 and 2005, the State Treasury was the largest entity creating the supply of stocks on the primary market. Declarations submitted by the Treasury at the end of 2005 do not allow a simple assessment of the future trends in the privatisation of State-owned companies through the WSE. Thus, the problem of the acquisition of new private issuers by the stock exchange, both domestic and foreign, is considered crucial.

5.2.3.2. CeTO Securities Market

**Market size**

CeTO Securities Market (RPW CeTO) was the second market trading in company stocks after the WSE. The nature of companies listed on this platform did not change. They included small and medium enterprises. In 2005, the number of listed companies remained unchanged (no new company was listed and no company was delisted).

Unlike the situation on the WSE, market situation on the RPW CeTO was weak. The value of ITO index\(^500\) in 2005 increased by 6.2%, although throughout most of the analysed period the downward trend prevailed. Market capitalisation rose by 9.1% to reach PLN 378.8 million, mainly through the increase in the last quarter of 2005.

In 2005, the share of package transactions in total turnover on the RPW CeTO equalled 71%. This was an important change compared to 2004, when package transactions constituted solely 26% of turnover. The large share of package transactions in the RPW CeTO mainly resulted from low turnover value, thus a few larger transactions substantially contributed to the change in this

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\(^{500}\) The ITO index is the Central Table of Offers (CeTO) stock index.
Financial markets

Gross turnover in stocks on the RPW CeTO (the sum of package and individual transactions) amounted to PLN 73.7 million, which meant a 29% rise with respect to the previous year. In 2005, the value of individual transactions on the RPW CeTO dropped by 49.8% to PLN 21.2 million, which resulted in the drop in market liquidity. The size of turnover remained small and average daily turnover amounted to approximately PLN 85,000. The average number of transactions per session decreased to nine (from fifteen in 2004).

Figure 5.2.31. RPW CeTO capitalisation, 1998–2005

Table 5.2.20. RPW CeTO main market indicators, 1998–2005

<table>
<thead>
<tr>
<th>Year</th>
<th>Number of listed companies</th>
<th>Capitalisation (PLN million)</th>
<th>ITO index (points)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1998</td>
<td>25</td>
<td>375.2</td>
<td>11,500</td>
</tr>
<tr>
<td>1999</td>
<td>24</td>
<td>322.6</td>
<td>15,549</td>
</tr>
<tr>
<td>2000</td>
<td>21</td>
<td>275.3</td>
<td>15,254</td>
</tr>
<tr>
<td>2001</td>
<td></td>
<td>192.8</td>
<td>9,115</td>
</tr>
<tr>
<td>2002</td>
<td></td>
<td>203.7</td>
<td>9,776</td>
</tr>
<tr>
<td>2003</td>
<td></td>
<td>335.4</td>
<td>9,704</td>
</tr>
<tr>
<td>2004</td>
<td></td>
<td>344.3</td>
<td>9,457</td>
</tr>
<tr>
<td>2005</td>
<td></td>
<td>378.8</td>
<td>10,047</td>
</tr>
</tbody>
</table>

Prospects

In the last years, RPW CeTO faced a tendency to systematic decrease in the basic indicators of market development (number of listed companies, turnover value, number of transactions per trading day). This mainly resulted from the competition of the WSE. Many companies treated their listing on the RPW CeTO as a way of gaining access to the capital market without the rigours of the WSE. In 2004, 40 package transactions were concluded with the total value of PLN 14.8 million, while in 2005 the figures showed 24 transactions with the total value of PLN 52.5 million.
RPW CeTO as a transitional period, preparing them for the debut on the WSE. According to the previous assumptions, the planned advantage of the RPW CeTO was lower costs of listing on the public market compared to those of the WSE. These incentives were not, however, sufficiently attractive for companies, which chose the WSE when considering fund raising through public issue of stocks. It seems that, in the last years, RPW CeTO has been transforming into the debt securities market (municipal bonds, corporate bonds, Treasury bonds and mortgage bonds), which has been reflected in the higher value of turnover with respect to these instruments. It can be assumed that in the coming years the importance of the stock market on this platform will systematically decrease in favour of the debt securities market.

Table 5.2.21. Stock turnover on the RPW CeTO, 1998–2002

<table>
<thead>
<tr>
<th></th>
<th>1998</th>
<th>1999</th>
<th>2000</th>
<th>2001</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>1. Total turnover (PLN million)</td>
<td>208.1</td>
<td>325.9</td>
<td>436.2</td>
<td>103.1</td>
<td>97.3</td>
<td>63.2</td>
<td>57.1</td>
<td>73.7</td>
</tr>
<tr>
<td>– excluding package transactions</td>
<td>121.1</td>
<td>168.4</td>
<td>241.1</td>
<td>40.2</td>
<td>18.3</td>
<td>17.3</td>
<td>42.3</td>
<td>21.2</td>
</tr>
<tr>
<td>– average daily turnover</td>
<td>0.48</td>
<td>0.67</td>
<td>0.96</td>
<td>0.16</td>
<td>0.07</td>
<td>0.07</td>
<td>0.17</td>
<td>0.09</td>
</tr>
<tr>
<td>2. Average number of transactions per trading day</td>
<td>48</td>
<td>75</td>
<td>93</td>
<td>17</td>
<td>9</td>
<td>8</td>
<td>15</td>
<td>9</td>
</tr>
</tbody>
</table>

Source: MTS-CeTO.

5.2.3.3. Other equities – allotment certificates, subscription rights and priority rights

In 2005, the gross turnover value for allotment certificates, subscription rights and priority rights equalled PLN 6.1 billion, which was over five times higher than in the previous year. The turnover value of these instruments was closely related to the situation on the primary market. Since 2003, turnover in these instruments has been systematically increasing, which was caused by a rising value of new stock issues of companies both already listed and newly listed on the WSE. Moreover, many investors purchased financial instruments under IPO for speculative purposes. This resulted from the bull market on the WSE implying large demand for these instruments from the part of investors, and consequently a large oversubscription. Investors often sold these instruments already during the first sessions, which allowed their further trading on the stock exchange.

Figure 5.2.33. Gross turnover of allotment certificates, subscription rights and priority rights, 1998–2005

Source: WSE.

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502 Allotment certificate is a security entitling to the new issue of stocks of a public company. Certificates can be traded on a stock exchange already a few days after the allocation of stocks and before their registration in the court register. ACs substantially solve the problem of long awaiting of the quotation since the moment of subscription under public offering. Subscription right is a security giving the current company’s shareholders the right to buy newly issued shares before other investors. These instruments allow current company’s stockholders to maintain the current level of participation in the company. Priority right is a security entitling the holder to purchase stocks of a given company at the price specified in advance and at the specific moment.


503 In 2005, during 25 IPOs allotment certificates were allocated to investors.
5.3. Spot FX market

The changes that occurred in 2005 on the zloty spot market were a continuation of the phenomena which had been observed in the preceding years. The value of FX transactions in Poland was still gradually decreasing but at the same time the offshore market liquidity was significantly increasing. The increasing volume of zloty exchange transactions on the London market resulted from significant hedge fund activity and a growing interest, also among other financial institutions, in investments in assets denominated in zlotys. In 2005, the share of the euro in the currency structure of turnover on the interbank market continued to rise. The zloty completely lost its basket nature. The dominant currency pair on the zloty market was EUR/PLN and the exchange rate of the euro against the zloty was the best indicator of the strength of the zloty. In 2005, the Ministry of Finance was exchanging foreign currencies obtained from the issue of Eurobonds on the spot market.

Market size

The zloty market was the biggest and the most liquid among the markets of currencies in our region. In the fourth quarter of 2005, the average daily value of zloty exchange transactions on the domestic market (deals where at least one party is a resident) was over twice as high as the value of the transactions on the Czech koruna market (Table 5.3.1). The vast majority of transactions in Poland were conducted on the interbank market. The transactions between banks and non-banking entities constituted little over 15% of the net turnover. In 2005, the activity on the domestic interbank market was still slowly decreasing (Figure 5.3.1). The average daily net turnover fell by around 3% as compared with 2004 and amounted to PLN 3 billion. It resulted from the handling by London-based banks of higher and higher flows arising from customer orders and from transferring the speculative activity of the banks outside Poland. The process of risk centralisation in European group banks, which has been observed for a few years, was connected with the transfer of competences to manage the FX position from certain banks in Poland to their parent companies.

It was still non-residents who were very active participants of the domestic interbank market, as transactions with foreign banks constituted over 70% of the turnover. The liquidity on the customer market also decreased during the period in question. In spite of a further increase in foreign trade turnover, the average daily value of transactions on the customer market was lower as compared with 2004 and amounted to PLN 0.55 billion.

Table 5.3.1. Average daily net turnover on the zloty, Czech koruna and forint spot FX markets in the fourth quarter of 2005, USD million

<table>
<thead>
<tr>
<th></th>
<th>Zloty</th>
<th>Czech koruna</th>
<th>Forint</th>
</tr>
</thead>
<tbody>
<tr>
<td>Total turnover, of which:</td>
<td>1,108</td>
<td>505</td>
<td>855</td>
</tr>
<tr>
<td>– EUR/domestic currency transactions</td>
<td>880</td>
<td>447</td>
<td>657</td>
</tr>
<tr>
<td>– USD/domestic currency transactions</td>
<td>161</td>
<td>45</td>
<td>118</td>
</tr>
</tbody>
</table>

Note: Data for the Czech koruna on the basis of transactions registered in October 2005.
Source: Data from the Czech National Bank, National Bank of Hungary, National Bank of Poland.

The decrease in liquidity on the domestic market was accompanied by a dynamic increase in activity on the offshore market, which started in the second half of 2004. The information received from market participants indicates that the value of transactions concluded between non-residents increased by around 25% in 2005. This is confirmed by a further growth in the value of customer orders in the SORBNET system. In the fourth quarter of 2005, the value of payments made on behalf of foreign banks was higher by 22% than the value of such payments registered in the same period of 2004.

In 2004, exports and imports of goods and services denominated in euros increased by 20.4% and 17.7%, respectively. In 2005, they amounted to 17.0% and 12.8%, respectively.
period in 2004. On the basis of this information and data from the BIS survey,\textsuperscript{505} the average daily turnover on the zloty offshore market in the last quarter of 2005 could be estimated at over PLN 3.6 billion (USD 1.1 billion). In 2005, the total average daily value of zloty exchange transactions thus amounted to PLN 6.2–7.2 billion (USD 1.9–2.2 billion).

Figure 5.3.1. Monthly turnover on the domestic interbank zloty market, 2002–2005

A significant increase in the zloty market liquidity was also observed by its participants. Bank dealers claim that in 2005 they did not have problems with closing the FX positions resulting from large customer orders amounting to several dozen million zlotys.\textsuperscript{506} As a result of the increase in turnover, the zloty exchange rate was less sensitive to short-term speculative capital flows. The size of the zloty market corresponds to Poland’s economic potential. Comparing the relationship of the net turnover on the zloty market to Polish GDP in nominal values with similar relations for developing countries proves that the zloty market is relatively well developed.\textsuperscript{507}

The dynamic increase in turnover on the offshore market resulted from both global and local factors. Due to global excess liquidity and the search for higher yields, non-banking institutions were interested in investing in the emerging markets. A stable macroeconomic situation and expectations of interest rates cuts as well as growing indices at the WSE encouraged foreign investors to invest in assets denominated in zlotys. Orders from foreign institutional investors affected the FX positions of market makers, which in turn increased turnover on the interbank zloty market. Moreover, the lack of a strong trend on the zloty market in 2005 encouraged bank dealers to short-term speculation. After two months of weakening in April and May (Figure 5.3.2) the zloty was gradually strengthening. This upward trend was, however, disrupted twice because of short-term depreciation of our currency: in July and at the end of October and beginning of November. The autumn zloty depreciation was related to the political situation. Foreign investors, unsure of the future economic policy after the collapse of the coalition negotiations, reduced their investments in Polish securities and were selling the zloty.

In recent years, hedge funds were a very active group of investors on FX markets of developing countries. This was partially due to the fact that the value of funds managed by these institutions grew dynamically (between 1998 and 2005 at the average rate of 30% per year)\textsuperscript{508} and


\textsuperscript{506} A large customer order, e.g. amounting to EUR 50 million on the zloty market, affects a FX dealer’s position considerably. In order to maintain his previous position, which reflects his expectations concerning exchange rate movements, the dealer concludes appropriate transactions on the interbank market. He usually conducts several trades on lower amounts with several banks of, e.g. EUR 5 million each. Subsequently, each bank tries to balance its position and concludes more transactions with other banks. This behaviour is described in literature as ‘passing on a hot potato’.

\textsuperscript{507} C. Csávás, S. Erhart: Are Hungarian financial markets liquid enough? The theory and practice of FX and government securities market liquidity, Budapest 2005, Magyar Nemzeti bank, pp. 30–35.

they had to search for higher rates of return for their assets. Hedge funds perceived currencies as an investment assets alternative to securities, which sometimes enabled them to achieve higher returns and diversify their portfolios. Compared with traditional institutional investors, hedge funds often changed their FX positions. Popular strategies employed by hedge funds on the emerging FX markets included carry trade\textsuperscript{509} which used interest rate differential, as well as positive feedback trading.\textsuperscript{510} Furthermore, hedge funds often used leverage, which in investments on the FX market consisted in taking large positions in FX options. Therefore, the impact of hedge funds on financial markets, both on changes in exchange rate and liquidity, was much higher than it would result from the value of the capital managed by these institutions.

The information obtained from FX dealers indicates that in 2005, hedge funds were still very active participants on the zloty market. The strong trend towards the zloty appreciation, which continued until the end of February (Figure 5.3.2), and the interest rates in Poland which were at that time relatively high, encouraged hedge funds to employ the carry trades on the zloty market. In the following months, these institutions still took large positions in the Polish currency and strengthened short-term appreciation and depreciation trends by applying positive feedback trading. Moreover, hedge funds were willingly buying FX options for zloty exchange rate. FX option dealers indicate that in 2005, it was common to take large positions in barrier options, which are more sensitive to exchange rate movements and which could result in greater volatility and higher flows on the spot market in comparison with vanilla options. The activity of hedge funds on the FX option market additionally increased the liquidity of the zloty market. London-based banks, which sold such options, hedged their FX positions dynamically using so-called delta hedging i.e. currency sale or purchase on the spot market. Due to the high value of single transactions, hedge funds dealt almost exclusively with foreign banks, mainly London-based banks. Because of a very conservative policy concerning the open FX position and low credit limits, most of the banks operating in Poland could not be the counterparty of these institutions. This explains the deepening zloty market segmentation which consists in a dynamic increase in turnover on the offshore market and a gradual decrease in liquidity in Poland.

**Market structure**

The mentioned increase in turnover did not contribute to the decrease in the difference between bid and offer rates quoted on the interbank market. The standard spread for the main currency pair on the zloty market EUR/PLN ranged from 10 to 20 basis points and even reached 30


\textsuperscript{510} Positive feedback trading or momentum trading is the investment strategy employed by short-term investors. It consists in buying the currency when its value increases and selling it when its value decreases.
basis points during periods of significant volatility of the zloty exchange rate. The effective spread, which illustrates market liquidity in a much better way, was considerably lower. The difference between real bid and offer rates, on which transactions were concluded, usually amounted to 6 basis points.

The euro against the domestic currency (Table 5.3.1), similarly to the Czech Republic and Hungary, was the dominant foreign exchange relationship in the currency composition on the zloty market. In 2005, the share of the euro in the currency composition of turnover on the interbank market continued to rise. In the fourth quarter, EUR/PLN deals accounted for almost 85% of the value of transactions in which zloty was exchanged for foreign currencies. The share of the USD/PLN pair, which in the second quarter of 2004 still prevailed in the currency composition, decreased at the end of 2005 to around 10% (Figure 5.3.3). It resulted from the transfer of activity to the EUR/PLN market. Other banks acting as market makers found that in connection with Poland’s future adoption of the euro, EUR/PLN transactions should be the main operations on the zloty market. In 2005, all banks already quoted the zloty against the euro, and considered the USD/PLN rate as a resultant exchange rate, i.e. one dependent on the EUR/USD rate. It happened because the zloty completely had lost its basket nature. In the first half of 2005, the share of the euro in the basket ensuring minimum variance of daily returns amounted to 100% (Figure 5.3.4). In the middle of June, this share dropped by several percentage points mainly as a result of changes in trends on the EUR/USD market, but then increased again and remained on the level of around 90% for the rest of the year.

The fact that the zloty lost its basket nature meant that it was not a basket exchange rate but a nominal EUR/PLN rate that reflected the strength of the zloty in the best possible way. This is confirmed by the EUR/PLN and USD/PLN historical volatilities as well as by the correlations between those exchange rates and the EUR/USD rate. The EUR/PLN rate was more volatile than the USD/PLN until the middle of 2003. The end of Poland’s EU entry negotiations and the positive outcome of the country’s EU accession referendum contributed to changes in the structure of historical volatilities on the zloty market. In 2005, EUR/PLN volatility was already considerably lower than that of the USD/PLN (Figure 5.3.5). The high USD/PLN volatility resulted from the fact that it was, as in other countries in our region, a resultant exchange rate calculated from the euro rate against the domestic currency and the EUR/USD rate. It means that the USD/PLN exchange rate depended on both local factors, which were represented in changes of the EUR/PLN rate and on trends on the most liquid segment of the FX market, i.e. EUR/USD one. The fact that the USD/PLN rate was highly dependent on changes on the EUR/USD market is confirmed by a high correlation between those rates (Figure 5.3.6). In 2005, the euro exchange rate against the zloty was less dependent on EUR/USD rate movements than between 2002 and 2004. A low correlation coefficient proves that

511 With regard to the zloty exchange rate, basis points (called “pips” by FX dealers) are equal to one-hundredths of 1 grosz.
in 2005 EUR/PLN was a main currency pair and that the exchange rate of the euro against the zloty yielded very accurate information about the appreciation or depreciation of the latter.

Figure 5.3.4. Share of the euro in the zloty basket ensuring minimum variance of daily returns, 2003–2005

Source: NBP, Reuters.

Figure 5.3.5. USD/PLN, EUR/PLN and EUR/USD three-month historical volatilities, 2003–2005

Note: Three-month historical volatility is the standard deviation of the distribution of daily returns observed over 66 trading days.
Source: NBP, Reuters.

Figure 5.3.6 Three-month rolling correlations of USD/PLN and EUR/PLN rates with the EUR/USD rate, 2003–2005

Note: Absolute correlation coefficient values for daily returns observed over 66 trading days have been presented in this Figure. The correlations of EUR/PLN and USD/PLN rates vis-à-vis the EUR/USD exchange rate are positive and negative, respectively. An absolute correlation coefficient value close to 1 signifies a strong relationship between exchange rate movements, while a value close to zero signifies a very weak relationship.
Source: NBP.
In 2005, there were no significant changes in the currency structure of turnover on the customer market. EUR/PLN transactions continued to prevail but their share was lower in comparison to the interbank market and accounted for 57% of turnover. USD/PLN transactions amounted to 32% of turnover and deals in which zloty was exchanged for other currencies accounted for 11%. The prevalence of EUR/PLN transactions resulted from the close connection between the Polish and the EU economy. The share of transactions involving USD and other currencies, which was higher than that on the interbank market, reflected the currency structure of Poland’s foreign trade. In 2005, the share of foreign currencies in payments arising from exports and imports of goods amounted to: 70% and 60% – EUR, 19% and 27% – USD and 11% and 13% – other foreign currencies, respectively.512

Transactions in which foreign currencies were exchanged for other foreign currencies were also concluded on the domestic FX market. EUR/USD operations clearly prevailed among them (almost 80%). In 2005, the average daily turnover in the EUR/USD segment amounted to PLN 1.7 billion and was lower by 20% in comparison with 2004. It resulted from the decrease in value of transactions concluded on the interbank market, which was in turn connected with the fact that the zloty lost its basket nature. Bank dealers opening FX positions in the zloty on EUR/PLN market no longer had to conclude EUR/USD transactions in order to convert part of their exposures to the US dollar and thus become independent from EUR/USD exchange rate fluctuations. EUR/USD operations were, on the other hand, used to take positions in synthetic forwards. USD/PLN operations dominated on the FX swap market, while EUR/PLN transactions prevailed on the spot market. Therefore, the simultaneous conclusion of spot and FX swap transactions was sometimes accompanied by the EUR/USD deal which enabled neutralisation of the flows arising from the short leg of FX swap.

**Market participants and infrastructure**

The zloty market in Poland showed significant concentration. The value of transactions concluded by the five most active banks amounted to around 65% of turnover on the domestic market. The Czech and Hungarian markets exhibit similar concentration. The share of the five most active banks in total net turnover on the domestic Czech koruna and forint markets amounted to 70% and almost 60%, respectively.513 As already mentioned, foreign banks and hedge funds were very important zloty market participants, which generated significant order flows. According to the opinion of the zloty market participants, the most active foreign banks were Deutsche Bank, Citigroup, UBS, HSBC and JP Morgan.514

In 2005, a new important participant on the zloty market appeared, namely the Ministry of Finance, which exchanged currencies obtained from the issue of eurobonds. In the whole year of 2005, the Ministry of Finance bought PLN 7.3 billion. These transactions had an impact on the zloty exchange rate. First of all, large zloty buy orders may cause its appreciation. Publicly available information indicates that in December, the Ministry of Finance sold foreign currencies worth PLN 1.6 billion, which means that at that time the average daily value of the order amounted to EUR 20 million (around PLN 80 million). Research on the zloty market microstructure515 suggests that in 2002, the orders of the net sale of EUR 10 million in exchange for the zloty caused the zloty to strengthen by 0.055%, which corresponds to a change in EUR/PLN rate by around 20 basis points.516 Secondly, the information alone that the Ministry of Finances buys the zloty aroused expectations on the zloty strengthening and consequently led to its appreciation. This was particularly visible during the last months of 2005. Other market participants, expecting the Ministry of Finance order flows to cause the appreciation of the zloty, also bought the zloty in order to sell it later at a more favourable exchange rate.

512 NBP data on the basis of payments for goods registered in the banking system.
516 It seems, however, that due to a significant increase in turnover on the zloty market in the last two years, the change in the exchange rate resulting from such order flow would have been lower.
Banks concluded transactions on the zloty market mainly via an electronic broking system that automatically matches buy and sell orders, i.e. Reuters Spot Matching. The value of zloty transactions conducted using this system increased by a few percentage points in comparison with 2004 and accounted for around 50% of turnover on the interbank market. The share of the Reuters Spot Matching system in the turnover breakdown by execution method increased at the cost of an increasingly lower value of transactions concluded in the conversational system, i.e. Reuters Dealing Direct. Nevertheless, almost half of all transactions were still executed via traditional conversational system or voice brokers. Occasionally, dealers agreed transaction terms by phone. The fact that it is becoming increasingly common to use matching systems is a positive phenomenon. The use of such systems changes dealers’ behaviour, allows the straight through confirmation and settlement of transactions and, above all, increases price transparency on the zloty market (Table 5.3.2). In the future, interbank transactions should be more frequently concluded in matching systems. There have been announcements that by early 2006, it will be possible to execute zloty transactions on the Electronic Broking Services platform.\footnote{Besides Reuters Spot Matching, EBS is another electronic trading system for interbank transactions which automatically matches buy and sell orders. This system has so far handled major currency pairs (such as EUR/USD, EUR/CHF, USD/CHF, EUR/JPY, USD/JPY) while exchange transactions of developing country currencies have been exclusively concluded in the Reuters Spot Matching.}

### Table 5.3.2. Execution methods of FX transactions on the interbank zloty market

<table>
<thead>
<tr>
<th>Execution methods of FX transactions</th>
<th>Quoting party – non-aggressive</th>
<th>Party initiating transaction – aggressive</th>
<th>Price transparency</th>
</tr>
</thead>
<tbody>
<tr>
<td>Direct – using phone and the Reuters Direct conversational system</td>
<td>Displays its quotes upon other banks’ request (market making).</td>
<td>Concludes transactions at rates offered by other banks.</td>
<td>Low – terms of transactions know only to counterparties.</td>
</tr>
<tr>
<td>Indirect – using the services of a voice broker and Reuters Spot Matching system</td>
<td>Shows its offers (limit orders) to brokers or enters them into the matching system.</td>
<td>Concludes transactions at the best rates presented by voice brokers and in the matching system (market orders).</td>
<td>Higher – transaction rates and directions (buy or sell by the aggressor) are known to all banks.</td>
</tr>
</tbody>
</table>


Customer transactions can also be executed via electronic trading systems. Financial institutions, particularly hedge funds, used these systems willingly. The most popular trading platforms for zloty transactions were, among others, Deutsche Bank’s Autobahn and FXall organised by a consortium of banks active on the FX market.

The standard transaction amounts on the interbank zloty market did not change in 2005 and amounted to 3 and 5 million euros for trades concluded in the conversational system and 1 and 3 million euros for trades executed via Reuters Spot Matching. However in the matching system the value of a single deal more frequently exceeded 1 million euros.

**Prospects**

In the coming years, a further slow decrease in turnover on the domestic interbank market should be expected. It will mainly result from the increase in activity of foreign banks on the offshore market. It is, however, hard to define the effects of the transformation of some banks operating in Poland into branches of credit institution. The risk taken by credit institution branches may be bigger than so far, as possible losses could be covered by considerably higher capital of the parent company. Higher capital will allow increasing not only market exposure but also credit limits imposed by counterparties. Therefore, this process may contribute to the increase in the value of speculative transactions which ensure, to the greatest degree, the liquidity on the FX market. On
the other hand, such transformations may be accompanied by the centralisation of FX position management. This will, in turn, limit the independence of banks operating as branches and cause the transfer of their activity on the FX market to parent institutions. In 2006, the value of zloty exchange transactions between non-residents is still expected to grow. There will be favourable conditions for this increase, including a good macroeconomic situation in Poland, continuously growing interest of financial institutions in investing in assets of developing countries and the activity of hedge funds which remains high.

Until Poland’s adoption of the euro, the EUR/PLN will be the main foreign exchange relationship on the domestic FX market. The share of the euro in the basket ensuring minimum variance of daily returns in the long term will amount to 100%. This means that the euro exchange rate against the zloty will reflect the strength of the Polish currency in the best possible way. It seems that the share of the EUR/PLN pair in the currency composition of turnover on the interbank market will increase by a few percentage points and remain at the level of 85%.

Significant changes on the FX market will take place after Poland has joined the euro area. Then, the value of transactions on this market will be significantly reduced, even by half. The dominant currency pair will be the EUR/USD. However, due to risk centralisation and transformation of some domestic banks into branches of credit institutions, it seems that the euro exchange transactions on the interbank market will constitute only one part of today’s operations involving the zloty. Lack of FX risk in the majority of foreign trades (payments in euro prevail in exports and imports) will limit demand for foreign exchange transactions from non-financial customers. Moreover, large financial institutions and enterprises wishing to hedge the flows in US dollar may come to the conclusion that it will be easier to conduct transactions directly with large foreign banks which offer a wide variety of financial products and probably lower margins. In this case, banks operating in Poland may reduce their activity and operate only as intermediaries in transactions between small and medium-sized customers and their parent banks.
5.4. Derivatives market

Financial derivatives are traded both on the stock exchange and over-the-counter markets. The stock exchange market, where interest rate and equity-linked derivatives\textsuperscript{518} are main subject of trade, is better developed on most of global markets. The advantage of the stock exchange market over OTC results from centralisation of trade and functioning of clearing houses, which contribute to reduction of credit risk borne by the parties to the transactions and enable more entities to participate in operations. The activity on the OTC market is mainly focused on transactions involving FX derivatives.

5.4.1. Evolution of the derivatives market: size and structure

In the Polish financial system the structure of the derivatives market is much different from the one mentioned above – i.e. the Polish OTC market is much more developed. The average daily turnover recorded on the OTC market in the period 2004–2005 was significantly higher than that of derivatives traded on the WSE (Table 5.4.1). The dominance of the OTC market was a result of the Polish bank-oriented financial system. Banks, i.e. the institutions with the largest assets in the Polish financial system, served the role of market makers on the OTC market. The considerable activity of foreign banks had a substantial impact on the turnover in this market. These banks are still almost absent from the WSE. It were the speculative interbank transactions which to a large extent were crucial for the liquidity of this market. Additionally, Polish companies that manage their financial risk more frequently chose derivatives offered by banks than the ones traded on stock exchanges. Factors behind their preferences included, inter alia, long-term relationships between banks and enterprises, higher flexibility of OTC derivatives and higher market liquidity, which affected the cost of the hedging instrument used.

In 2005, there was an observable increase in liquidity of interest rate derivatives traded on the OTC market. This increase may be attributed to several factors. Firstly, a new group of Polish banks joined the group of active participants of the interest rate derivatives market. Secondly, strong expectations concerning NBP interest rates cuts also contributed to the increase in the volume of speculative transactions, in particular on the FRA market. Another factor which played a part in the turnover growth on the OTC market was the rapid development of the Overnight Index Swap market. The most liquid segment of the market of transactions with FX risk exposure which exhibited the highest liquidity was the market of forward contracts where the operations with non-banking sector entities prevailed.

Table 5.4.1. Average daily net turnover on the domestic derivatives market, 2003–2005 (PLN million)

<table>
<thead>
<tr>
<th></th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>OTC market</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Interest rate derivatives</td>
<td>3,979.1</td>
<td>4,178.3</td>
<td>6,240.7</td>
</tr>
<tr>
<td>FX derivatives</td>
<td>1,403.2</td>
<td>1,312.0</td>
<td>1,518.7</td>
</tr>
<tr>
<td>Stock exchange market</td>
<td>236.0</td>
<td>251.5</td>
<td>498.6</td>
</tr>
<tr>
<td>Interest rate derivatives</td>
<td>0.0</td>
<td>0.0</td>
<td>15.0</td>
</tr>
<tr>
<td>FX derivatives</td>
<td>1.0</td>
<td>0.5</td>
<td>0.8</td>
</tr>
<tr>
<td>Stock market derivatives</td>
<td>235.0</td>
<td>251.0</td>
<td>482.8</td>
</tr>
<tr>
<td>– of which WIG20 futures</td>
<td>226.4</td>
<td>239.6</td>
<td>448.8</td>
</tr>
</tbody>
</table>

Note: OTC market turnover calculated according to nominal value; stock exchange market turnover calculated on the basis of settlement amounts. The stock exchange market includes solely instruments listed on the WSE. ’FX derivatives’ category for the OTC market does not include FX swaps.
Source: NBP own calculations on the basis of NBP and WSE data.

Within the period concerned a substantial increase in the turnover was noted on the WSE derivatives market. The bull market which continued throughout 2005 contributed to the increase in the value of transactions performed on the WSE derivatives market by as much as 98%. As in

previous years, WIG 20 futures contracts enjoyed great popularity with investors. Trading in such instruments accounted for over 90% of the total turnover on the derivatives market. In 2005, there appeared new derivatives on the WSE: i.e. bond futures and stock options. Due to a short period of being listed on the WSE both segments were poorly developed. At the end of the year, warrants were withdrawn from trade on the WSE as the investors’ interest in them was insignificant.

5.4.2. OTC derivatives

The OTC market plays a very important role in the Polish financial system, since it enables financial institutions and enterprises to manage their FX and interest rate risks in an effective manner. Due to the decentralised nature of this market, banks are major underwriters and participants therein. The analysis of domestic banks’ gross positions by nominal values of derivatives shows that, just as in previous years, the interest rate derivatives segment was the most developed, while banks focused their activities on instruments denominated in zlotys (Table 5.4.2).

Table 5.4.2. Gross positions of domestic banks on the OTC derivatives market, end of 2005 (by nominal value of instruments, PLN billion)

<table>
<thead>
<tr>
<th></th>
<th>Zloty1</th>
<th>Other currencies</th>
</tr>
</thead>
<tbody>
<tr>
<td>FX derivatives</td>
<td>100.05</td>
<td>Not available</td>
</tr>
<tr>
<td>Forwards</td>
<td>48.25</td>
<td>Not available</td>
</tr>
<tr>
<td>CIRS</td>
<td>23.20</td>
<td>Not available</td>
</tr>
<tr>
<td>Option</td>
<td>28.60</td>
<td>Not available</td>
</tr>
<tr>
<td>Interest rate derivatives</td>
<td>1,095.68</td>
<td>82.65</td>
</tr>
<tr>
<td>FRA</td>
<td>620.31</td>
<td>21.70</td>
</tr>
<tr>
<td>IRS</td>
<td>456.66</td>
<td>59.68</td>
</tr>
<tr>
<td>Options</td>
<td>1.51</td>
<td>1.25</td>
</tr>
<tr>
<td>Bond forwards</td>
<td>0.20</td>
<td>0.02</td>
</tr>
<tr>
<td>Other instruments of similar nature (e.g. OIS)</td>
<td>16.92</td>
<td>0.00</td>
</tr>
<tr>
<td>Equity-linked market derivatives</td>
<td>1.21</td>
<td></td>
</tr>
<tr>
<td>Credit derivatives</td>
<td>0.13</td>
<td></td>
</tr>
</tbody>
</table>

1 For FX derivatives, the nominal value of derivatives transactions regarding zloty exchange rates against foreign currencies has been presented.

Source: NBP.

FRA and IRS contract markets remained the largest segments of the OTC derivatives market in Poland. The said contracts were mainly concluded on interbank market. The markets of other interest rate derivatives – bond forwards and options – were much less developed. A decrease in banks’ involvement in forward transactions was a result of the possibility of trading in T-bonds futures on the WSE. Domestic banks did not maintain portfolios of options and only a few offered them to non-banking customers. Options transactions were entered into only occasionally.

On the other hand in 2005 a significant development of the Overnight Index Swap market took place. The said fact is proved by banks’ positions of OIS transactions, which account for a predominant element of category ‘Other instruments of similar nature’ presented in the Table 5.4.2.

The forward contracts market was the most liquid among the segments of the OTC derivatives market. Such transactions were in most cases concluded by entities of the non-banking sector. FX forwards remained the derivatives that were used most frequently by companies as hedging instruments to manage FX and interest rate risks. In 2005 a downward trend on the market of FX options with respect to turnover was stopped. Entities of the non-financial sector decided much more often, in comparison with previous years, to conclude CIRS contracts. Such contracts were used mainly to reduce the costs arising in connection with servicing debt under the issue of bonds denominated in zlotys.

Trading in instruments which value depends on stock prices was concentrated on the stock exchange market. The limited involvement of banks in the OTC derivatives market derivatives
resulted from the closing of the exposure caused by the sale of structured deposits including foreign stock exchange index options to private banking customers.

In 2005 in the off balance sheet positions of banks there appeared credit derivatives - i.e. credit default swaps. The nominal value of such transactions confirms that the credit derivatives market has not developed in Poland yet. At the beginning of 2005 there were introduced major changes in the field of legislative measures applicable to this market. As of the beginning of January 2005, a Resolution of the Commission for Banking Supervision came into force, allowing banks to use credit derivatives in order to release their regulatory capital.\footnote{Resolution No. 4/2004 of the Commission for Banking Supervision on the scope and detailed procedures for determining capital requirements against particular risks, the scope of application of statistical methods and the preconditions for obtaining approval for their application, the manner and detailed procedures for calculating a bank’s risk-based capital ratio, the scope and manner of giving consideration to a bank’s operations within a corporate group in calculating capital requirements and the risk-based capital ratio, and the specification of additional items of bank balance sheets included together with the capital base in calculating capital adequacy, together with the scope and method of determining such items and the conditions for doing so.} Additionally on 7 January, the Management Board of the Polish Bank Association adopted a Recommendation on the conclusion of credit derivatives on the Polish interbank market. The said document covers definitions of basic credit derivatives and specifies the standards for the market of derivatives involving exposure to receivables. However, it seems that in order to ensure further development of the market, it is necessary to introduce legislative amendments regarding investments by non-banking financial institutions which would allow them to acquire credit derivatives and to popularize valuations based on rating.

\subsection*{5.4.2.1. Interest rate derivatives}

\subsubsection*{Market size}

The year 2005 was a period of rapid development for the OTC interest rate derivatives market. Poland managed to strengthen its position as the largest OTC interest rate derivatives market in Central and Eastern Europe.\footnote{More in: Financial System Development in Poland 2004, Warsaw 2005, NBP, p. 211.} Within the period concerned domestic banks considerably increased their off balance sheet positions of interest rate derivatives denominated in zlotys. After a decrease observed in 2004 the market of FRA contracts, measured by the value of off balance sheet positions arising from the contracts entered into (a total of nominal value of purchased and sold contracts), recovered and increased in 2005. In 2005 the value of involvement of the domestic banking system on the FRA market grew by as much as 123\% (to PLN 620 billion), whereas as the end of 2004 the amount of gross positions was lower by over 40\% in comparison with the end of 2003 (Figure 3.4.1). It seems that after the reduction of positions due to losses incurred in the Q4 of 2003 banks decided to take considerable positions in interest rate derivatives, in particular FRA. Stable economic situation, as well as strong expectations concerning interest rates cuts by the NBP created favourable conditions for such steps.

In 2005 the involvement of the domestic banking system in IRS contracts increased – the nominal value of such contracts included in banks' portfolios grew by 45\%, amounting to PLN 457 billion (Figure 5.4.2). However, it should be noted that banks' involvement is not the most reliable measure for comparing the markets of FRA and IRS contracts. Since a primary term of some of IRS contracts is longer than one year, such transactions, in contrast with FRA contracts, are recognized in banks' accounts even for several years. Analysing data concerning off balance sheet positions it is worth noting that the share of transactions concluded with non-residents was lower than in the pervious years (approximately 40\% and 55\% for FRA and IRS contracts respectively).

Substantial growth of the domestic OTC interest rate derivatives market is evidenced by a considerable increase in turnover (by approximately 45\%), both in the segment of FRA and IRS contracts. In 2005 the average daily net turnover on one of the most liquid segments of the Polish financial market – i.e. FRA market – amounted to PLN 4.9 billion, while in 2004 it was PLN 3.4 billion (Figure 5.4.3). On the IRS market, the average daily net turnover grew from PLN 0.83 billion to PLN 1.20 billion (Figure 5.4.4).
Figure 5.4.1. FRA market size, 2002–2005

Note: Gross nominal value of FRA (sold and purchased) in domestic banks’ portfolios as at the end of June and December.
Source: NBP.

Figure 5.4.2. IRS market size, 2002–2005

Note: Gross nominal value of IRS (sold and purchased) in domestic banks’ portfolios as at the end of June and December.
Source: NBP.

Figure 5.4.3. Average monthly net turnover on the FRA market, 2002–2005

Note: Data adjusted for double-counting with respect to transactions between resident banks.
Source: NBP data submitted by banks – Primary Dealers and/or money market dealers and candidates for dealers.
The 2005 trends for the increase in liquidity of FRA and IRS markets had several common causes. Firstly, compared with 2004, the number of active participants in both markets grew considerably. Several domestic banks which before 2005 concluded occasional transactions in interest rate derivatives, mainly to hedge their positions in debt securities, increased their involvement in such contracts. The said banks use more commonly interest rate derivatives, in particular FRA and 1Y IRS vs. 3M WIBOR contracts for speculations on the yield curve within the time horizon of up to one year. As a result the value of transactions concluded increased. The increase in the share of contracts entered into by residents in total turnover shows that the activity of domestic banks also increased. In 2005 transactions with non-residents averaged out at about 51% of net turnover on the domestic FRA market (a dozen or so percentage points less than it used to be in 2004). The analogous indicator for the IRS market did not exceed 60%. Secondly, decreasing interest rates and expectations concerning further cuts by the NBP encouraged to take speculative positions. It is also evidenced by the fact that the increasing turnover on the FRA market was recorded in the months when there were strong expectations regarding interest rates cuts by the Monetary Policy Council (RPP). Moreover, in the circumstances of lowering inflation, decreasing T-bonds yield and zloty appreciation against the euro, also non-residents decided to be more active on the market. Compared with 2004, the nominal value of transactions with foreign banks increased by over 15%.

FRA and IRS contracts denominated in zlotys were also traded outside Poland, on the London market. However, the NBP has no data pertaining to the value of transactions concluded between non-residents. It may be expected that foreign banks (inter alia, UBS, HSBC, Deutsche Bank, JP Morgan, Barclays Bank and Royal Bank of Scotland), similarly as in previous years, concentrated their activity mainly on the market of interest rate swaps. Based on information acquired from market participants it may be estimated that on 2005 the value of IRS transactions on the offshore market grew considerably and was close to the turnover recorded on the domestic market.

A new instrument on the Polish market – the Overnight Index Swap – introduced in 2004 extended the offer of available derivatives by an instrument involving short-term interest rates. In 2005 the OIS market exhibited substantial growth. After a period of organizational preparations and drawing up procedures for risk management connected with such an instrument, a new group of banks decided to join the market participants. In the second half of 2005 there were 7 domestic and several foreign banks active on the OIS market. The average daily net turnover amounted to about 250 PLN million. Dynamic development of the OIS market and the increase in the number of participants resulted from the following factors: relatively high O/N rates, diversified...
transaction settlements as well as flexibility and variety of applications of this instrument for managing the interest rate risk. The OIS contracts allow banks to, *inter alia*:

- hedge against the changes in the costs of raising funds on the money market (guarantee of a fixed level of refinancing costs related to positions in Treasury securities and maintaining required reserves),

- eliminate risk arising in connection with imperfect adjustment of instruments generating positive and negative cash flows (reduction of so called "basis risk"),

- speculate on the increase or decrease of interest rates in so called "short" end of the yield curve, of maturity of up to 3 months; such derivative may be very useful in the speculations on the changes in short-term interest rates since FRA 1x2 and 2x3 contracts show little liquidity,

- adopt the strategy of carry trade (sale of OIS) without involving liquid assets in the circumstances where the yield curve exhibits positive slope,

- carry out arbitrage between the rates quoted on the OIS market and other markets which entail interest rates – i.e. FRA, repo, FX swap; in the future it is expected to contribute to the improvement of effectiveness and better integration of all mentioned markets.

The option market remained the least developed OTC interest rate derivatives segment. In 2005 transactions in options were concluded only occasionally and their average monthly turnover did not exceed the amount of PLN 50 thousand. They covered exclusively option contracts concluded with non-banking customers and back-to-back hedges with foreign banks. There was no domestic bank which managed the portfolio of interest rate options as it would be unprofitable due to low market liquidity and considerable outlays connected with operational preparation and risk monitoring.

**Market structure**

As in previous years, transactions, where the 1M, 3M and 6M WIBOR served as standard reference rates, were concluded on the FRA market. In 2005 the transactions with maturity of up to one year were most common, although several banks quoted rates for contracts with maturity exceeding one year (12x15, 12x18, 18x24). Similarly as in previous years, market liquidity was concentrated in the following segments: 1x4, 3x6, 6x9, 9x12, 1x7 and 3x9. Standard FRA nominal values amounted to PLN 100 million; however, there were also transactions concluded having higher nominal value ranging from PLN 200 to 300 million. The spreads between the bid and offer rates were usually 5 basis points and were slightly higher with respect to large sizes (large size transactions).

In 2005 the increased significance of 1Y IRS contracts in the maturity structure of turnover on the interest rate swap market continued. The share of transactions with one-year maturities went up to 47%. 3M WIBOR served as a standard reference rate for 1Y IRS transactions; however there were also some transactions where 1M WIBOR was used as a reference rate for floating interest amount calculation. Concentration of activity on 1Y IRS transactions was connected with the limitation of the T-bonds issues. Taking into account the reduced possibilities of investing in such instruments, banks took positions in interest rate swap transactions to ensure specific interest rates on deposits with a one-year horizon. Foreign investors who took long positions in zlotys also often took advantage of 1Y IRS contracts, mainly in order to guarantee an annual return on investment. Moreover, concluding 1Y IRS contract based on 3M WIBOR is a much easier and more effective way of taking off balance sheet positions in interest rate derivatives (measured by BPV).

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523 Form of notation for the FRA contracts on the interbank market. The first number denotes the date of the rate spread settlement while the difference in the numbers gives the information on the reference rate. For example FRA 2x3 denotes the 1M WIBOR contract which will be settled in two months.


525 The BPV (basis point value) is a fundamental measure used in interest rate instrument portfolio management which corresponds to he change in the value of an instrument (portfolio) caused by a shift of one basis point in the yield curve.
with one-year horizon than three FRA transactions of adequate parameters. The increase in the value of transactions with maturity of up to one year caused a decrease in the share of remaining contract categories. The segment of transactions with maturity exceeding 5 years still exhibited low liquidity, which was mainly a result of low credit limits imposed by domestic banks themselves. When it occurred that banks operating in Poland concluded transactions with 5-year horizon or longer, they also used break clauses,\(^{526}\) reducing the risk and burden of credit limits.

In contracts concluded with non-residents, the use of switch transactions was popular. In such dealings the entity dominating in the domestic bank (parent bank) served as an intermediary between a London-based bank and the domestic bank. Domestic banks determined the contract conditions, while foreign banks which are their actual owners acted as formal contractors of London-based banks as their capital and credit lines for third parties. Standard values of IRS contracts ranged from PLN 50 to 100 million, although there also occurred transactions with a nominal value of PLN 250 and 500 million. The spread between the fixed rates at which banks wished to pay and be paid interest rates was at the level between 5 and 7 basis points.

**Figure 5.4.5. IRS contracts maturity structure, 2004–2005**

<table>
<thead>
<tr>
<th>Year</th>
<th>&lt;1Y</th>
<th>1–2Y</th>
<th>2–3Y</th>
<th>3–5Y</th>
<th>&gt;5Y</th>
</tr>
</thead>
<tbody>
<tr>
<td>2004</td>
<td>(41%)</td>
<td>(33%)</td>
<td>(10%)</td>
<td>(10%)</td>
<td>(6%)</td>
</tr>
<tr>
<td>2005</td>
<td>(47%)</td>
<td>(25%)</td>
<td>(8%)</td>
<td>(14%)</td>
<td>(6%)</td>
</tr>
</tbody>
</table>

Note: Maturity structure by original maturities, contract maturity bands are closed on the right.
Source: NBP data submitted by banks – Primary Dealers and/or money market dealers and candidates for dealers.

In January 2005 a new rate fixing for interbank O/N deposits – i.e. the POLONIA rate was introduced on the Polish market. In February 2005 the Polish Bank Dealers Association ACI Poland (Polskie Stowarzyszenie Dealerów Bankowych ACI Polska) issued a recommendation concerning OIS transactions settled on the basis of POLONIA rate.\(^{527}\) Since in comparison with O/N WIBOR, the POLONIA rate proved to be more representative and reliable,\(^{528}\) it became a standard reference rate for the OIS contracts denominated in zlotys. In 4. quarter of 2005 approximately 90% of all OIS transactions were settled with the use of the POLONIA reference rate. Standard values of transactions with original maturity of up to one month ranged from PLN 50 to 100 billion, while the spread quoted was about 5 basis points. Seven-day transactions, namely the ones with maturity corresponding to the NBP open market operations, prevailed in the maturity structure of OIS contracts. It means that banks often used such transactions in order to make the cost of financing their positions in debt securities independent from short-term changes in liquidity in the banking sector which appear between the dates of open market operations.

**Market participants**

The participants of the OTC interest rate derivatives market were almost exclusively banks. As it has already been mentioned, a considerable share in turnover on the FRA and swaps (IRS and to lesser extent OIS) was generated by non-residents – mainly London-based banks which held large

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526 Such clause allows banks to settle the transaction earlier (contract’s termination) where the credit exposure on the counterparty arising under the transaction (counterparty’s loss) exceeds a predetermined amount.

527 Transakcja swapa odsetkowego opartego na indeksie POLONIA (OIS), recommendation available at www.acipolska.pl.

528 More in Chapter 5.1.2.
portfolios of Polish Treasury bonds. Similarly as in 2004, the interbank FRA and IRS markets showed significant concentration. Transactions concluded by the five most active domestic banks accounted for 70% of net turnover recorded in Poland. Due to the limited number of participants, concentration of turnover on the domestic OIS market was even much more significant. In the second half of 2005 contracts of three most active domestic banks constituted approximately 75% of total value of transactions.

Transactions with non-banking entities were rare on the OTC interest rate derivatives market. Most of them constituted interest rate swaps, however, the value of transactions concluded with non-banking entities accounted merely for several percent of turnover on the domestic IRS market. As in the previous years, non-banking financial institutions showed little activity on the interest rate derivatives market. In 2005 no amendments to legislative regulations concerning open pension funds (OFE) were introduced, even though they were announced in 2004 and much expected. The said modifications were to enable such institutions to use derivatives as a means of hedging their investment risk. It means that the second largest group of investors on the Polish market of Treasury bonds (banks rank first) have no possibility of hedging against the decrease in the value of their debt securities portfolio, resulting from the increase in long-term interest rates. The fact that they cannot take advantage of derivatives limits the development of the Polish financial market and in some situations it may even pose a considerable threat to the amount of future pensioners’ savings.

Amortising and drawdown swaps enjoyed continuous popularity with corporate customers. The parameters of such transactions were shaped on individual basis and differed from the interbank market standards. The number of potential customers from the non-financial sector was much limited due to rigorous credit requirements and an increasingly common obligation to submit a security deposit. The limited interest in interest rate derivatives among Polish enterprises resulted from the fact that they seldom managed interest rate risk, although most of them were exposed to this type of risk. Moreover, in the opinion of entrepreneurs, the cost of using derivatives was too high, while the effectiveness of such hedging raised doubts.

**Prospects**

In the coming years the OTC interest rate derivatives market should be expected to continue to develop. As most large commercial banks in Poland have already become active participants of the FRA and IRS market, it seems that the liquidity of these markets will not see such dynamic growth as in 2005. The factor which will still affect the liquidity and maturity structure of the IRS market in Poland will be a low level of credit limits imposed by other domestic and foreign financial institutions for banks operating in Poland. The influence of the said factor will be lessened in comparison with the previous years due to, *inter alia*, transforming of some of domestic banks into branches of credit institutions and using switch transactions. Nonetheless, it seems that the value of interbank turnover on the FRA and IRS market will be dependent mainly on the expectations concerning changes in interest rates which are key stimulation for the increase in speculative transactions. One should not expect the growth of demand for FRA and IRS transactions by non-financial entities.

It seems that in the coming years in the situation where inflation is low and stable Polish enterprises will use derivatives for managing their interest rate risk very rarely. The involvement of non-banking financial institutions will probably remain low as the potential participants of the IRS market – i.e. open pension funds (OFE) – will not have the possibility of limiting investment risk by means of investments in derivatives. It also means that the emergence of the bond futures market on the WSE in 2005 will not rather pose a threat to the IRS market. The development of the bond futures market does not seem very probable without the participation of pension funds.

On the other hand, though, it may be expected that the Overnight Index Swap market will grow rapidly. New domestic, as well as foreign banks will join the group of market participants. It should cause an increase in turnover, also in the market segment of transactions with longer

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529 Open pension funds became the second largest group of investors on the domestic Treasury bond market in August 2005.
horizons (one, three and six-month contracts). Such operations will be used for speculative transactions in changes of interest rates of the central bank. The rapid development of the OIS market in the euro area within the last few years, as well as a variety of possible applications of such contracts allow us to forecast that also in Poland OIS will become one of the most liquid instruments of the OTC derivatives market. The market of interest rate options will remain one of the least developed segments of the domestic financial market. Options will be treated purely as an instrument for expanding the banks’ offers addressed to non-financial customers and due to high costs of operational preparation and management of such instruments portfolio, they will not be a subject of trade on the interbank market.

Considerable changes on the domestic OTC derivatives market will be linked to Poland’s entry to the euro area. Adopting the common currency by Poland, as well as consolidation and centralisation of risk management in banking sector will entail a reduction in the value of interbank transactions. Most domestic banks which at present perform the function of market makers will be much less active. The said banks will merely play the role of market users and they will provide services for non-banking customers, selling products tailored to their individual needs.

5.4.2.2. FX derivatives

Market size

In 2005 the market for zloty derivatives remained the biggest and most developed among the markets for other currencies in Central and Eastern Europe. The predominance of transactions between non-residents, mainly London-based banks, was a characteristic feature of the zloty market, forint and Czech koruna forwards and options. The NBP has no data concerning the value of turnover on the offshore FX derivatives market in 2005. However, based on information acquired from market participants it may be assumed that the average daily turnover was higher than in 2004 and for the forward market amounted to approximately PLN 1.1 billion, while for the option market to PLN 0.45 billion. In a further part of this document there is an analysis of the size and structure of the domestic zloty derivatives market, that is the market covering transactions where domestic banks act as at least one of the parties thereto.

In 2005 the liquidity of OTC FX derivatives increased considerably. As in previous years the forward segment accounted for a major part of the market. In 2005 the value of daily turnover on the zloty forward market went up to PLN 0.98 billion (from PLN 0.92 billion in 2004). The said increase was a result of activity intensification on the customer market. The larger number of transactions hedging enterprises against unfavourable changes in foreign exchange rates was probably a result of the breakdown of a strong trend towards zloty appreciation which occurred at the beginning of March 2005 and the increase in the amount of payments denominated in foreign currencies, which may be attributed to the growth in the volume of export and import of goods and services. The average daily turnover on the interbank market decreased in the period concerned by about 8% and amounted to PLN 0.145 billion, including transactions with foreign banks which accounted for 90 % of all contracts concluded (Figure 5.4.6). It means that the share of transactions with non-banking customers grew – their value was 5.5 times higher than the value of forward contracts concluded between banks. Such a substantial difference in liquidity between the two mentioned segments of the zloty forward market stems from the fact that forward contracts are basic instruments used by enterprises to manage their FX risk. However, banks rather prefer synthetic forward contracts which are combinations of transactions concluded on more liquid markets – spot and FX swap markets.

On the domestic FX options market, unlike on the forward market, interbank transactions prevailed. The average daily turnover on the interbank zloty options market was higher by 23% than in the previous year and amounted to PLN 0.36 billion in 2005 (Figure 5.4.7). At the same time the average daily turnover on the customer zloty options market was PLN 0.125 billion and were higher by PLN 0.035 billion (38%) compared with 2004. The above-mentioned situation contributed to the increase in turnover on the interbank market, since most of banks which offered FX options served as intermediaries – they closed positions arising from the conclusion of an option transaction with a customer by concluding an opposite transaction with their parent company or another foreign bank. Higher volatility and adjustments on the zloty market (Figures 5.3.2 and 5.3.5) stimulated speculative transactions of banks and the enterprises’ demand for option strategies which would hedge their future cash flows. The above-mentioned increase in turnover did not mean, however, that the trends observable in Poland in 2004 – i.e. the transfer of non-residents activities to the offshore market and marginalization of transactions concluded between domestic banks – were stopped. The daily value of transactions entered into on the interbank market in 2005 was lower by 25% (PLN 0.13 billion) in comparison with the value of transactions recorded in 2003. The situation on the domestic FX option market depended strongly on movements of foreign banks as since 2003 the share of transactions with non-residents exceeded 90% and was gradually increasing (in 2005 it was 96%). The lower level of activity on the domestic market in comparison with the period 2002–2003 and, as reported by market participants, the dynamic increase in turnover on the offshore market were a result of, inter alia, the fact that the nominal values of particular option strategies were too high for banks operating in Poland, that is why they acted increasingly seldom as foreign banks’ counterparties. The strategies with nominal values of EUR (USD) 50 and 100 million, which are commonly traded on the London market, would considerably affect the structure of option portfolio while the risk which they generate would constitute an excessive burden for domestic banks’ capital.

Similarly as in other countries of Central and Eastern Europe, the CIRS market remained the least developed segment of the domestic OTC FX derivatives market in Poland. However, it should be mentioned that compared with previous years, the value of CIRS transactions concluded between banks substantially increased. In 2005 the average daily net turnover on the interbank market in Poland increased by approximately PLN 40 million to approximately PLN 55 million (Figure 5.4.8). One of the factors which contributed to the said increase were transactions with high nominal values concluded by banks in order to hedge their exposure arising from the mismatch between the structure of loans granted and deposits received. CIRS transactions with foreign banks prevailed –

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532 Figure presented include the nominal value of each option comprised in the strategy offered.
they accounted for about 95% share in turnover. The most common type of contracts traded on the interbank market was basic swaps where the payments in both currencies are calculated on the basis of floating interest rates. Transactions with non-banking customers were still occasional. The average daily net turnover on the customer market amounted to PLN 8 million in 2005.

**Figure 5.4.7. Average monthly turnover on the zloty FX option market by nominal value, by quarters, 2002–2005**

Note: According to the Bank for International Settlements standard, the figures presented include the nominal value of each option comprised in the strategies.

Source: NBP data submitted by banks – Primary Dealers and/or money market dealers and candidates for dealers.

**Figure 5.4.8. Average monthly turnover on the CIRS market (foreign currency/PLN), by quarters, 2002–2005**

Source: NBP data submitted by banks – Primary Dealers and/or money market dealers and candidates for dealers.

**Market structure**

The currency structure of turnover on the zloty FX forward market did not change compared with 2004. EUR/PLN transactions prevailed – they accounted for approximately 66% of the contract value both on the customer and interbank market. USD/PLN transactions constituted about 30% of turnover. The dominance of EUR/PLN segment resulted from the currency structure of payments for the sale of goods and services. Non-banking entities used various types of forward contracts to hedge their future cash flows. Apart from traditional forward transactions, enterprises increasingly took advantage of forward options and par forwards which were available in the offers of almost
all banks selling derivatives. The structure of these products makes the value of flows in foreign currency independent from changes in foreign exchange rates.533

European style options, where exercise is only allowed on the expiration date, were a subject of trade on the domestic interbank FX options market. The American style and exotic options were sold to non-banking customers. Market makers of the interbank sector published usually quotes for option strategies (most often straddle, butterfly and risk reversal)534 with maturities of up to one year (1W, 1M, 2M, 3M, 6M, 1Y). Option transactions with longer maturities were entered into only occasionally.535 In 2005 the maturity structure of turnover did not undergo significant changes (Figure 5.4.9). Transactions with the shortest maturities prevailed. Compared with 2004, EUR/PLN options were traded more frequently. In 2004 the share of EUR/PLN options in the currency structure of transactions involving the zloty accounted for approximately 64% (in 2004 it was 55%). Transactions in the segment USD/PLN constituted 35%. Typical values of transactions on the interbank market in Poland were EUR or USD 10 and 25 million. Spread, measured by the implied volatility, for the ATM option strategy involving the EUR/PLN and USD/PLN exchange rates was about 0.5 percentage point.

Figure 5.4.9. Maturity structure of turnover on the zloty FX option market, 2004–2005

Note: Maturity structure by original maturities; contract maturity ranges are closed on the right.
Source: NBP data submitted by banks – Primary Dealers and/or money market dealers and candidates for dealers.

It is also worth mentioning that in 2005 there was an observed increase in the activity in the barrier option segment on the London zloty option market. Hedge funds exhibited considerable interest in this product (Box 5.4.1). Based on the information obtained from market participants it may be estimated that the value of average monthly transactions in barrier options amounted to approximately PLN 2 billion.536 The development of this segment of the offshore FX options bears some consequences on the situation on the zloty market. Taking considerable positions in barrier options by non-residents may contribute to the increase in the liquidity of plain vanilla options and affect the zloty exchange rate as well as enhance its volatility.

The increase in turnover on the interbank CIRS market was accompanied by changes in their maturity structure. Compared with 2004 the share of transactions with horizons of up to two years decreased substantially and in 2005 their amount accounted for 33% of turnover (Figure 5.4.10). At the same time the proportion of transactions with maturities exceeding five years increased. It was possible since, as in case of IRS contracts, switch transactions were increasingly common on the interbank market. Regarding transactions with non-banking entities, security deposits and break clauses were employed, aimed at the reduction of credit risk. Transactions involving EUR and USD prevailed in turnover on the interbank market. The currency structure of CIRS contracts on the customer market was more diversified. Apart from EUR/PLN and USD/PLN CIRS also contracts involving...
CHF and JPY enjoyed growing popularity. CIRS contracts were not used exclusively for hedging against FX and interest rate risks. Polish enterprises which preferred debt instruments denominated in Polish zlotys used CIRS transactions also in order to reduce the costs connected with debt servicing.

**Box 5.4.1**

**BARRIER OPTIONS AND THEIR INFLUENCE ON THE ZLOTY EXCHANGE RATE VOLATILITY**

Barrier options belong to the group of exotic options. This kind of product is a conditional one as its value depends on the exchange rate throughout the entire life of an option and not only on its expiration date. Barrier options differ from plain vanilla ones in the element which is included in this product and referred to as a ‘barrier’. A predetermined level of exchange rate constitutes the barrier which, if exceeded within the life of an option, results in its becoming null and void before the expiration date (knock-out option) or its activation (knock-in option). A knock-in option starts as inactive and cannot be exercised if within its life the exchange rate does not exceed the level predetermined at the moment of concluding the transaction (knock-in barrier). After the option activates, it becomes a plain vanilla option (the purchaser can exercise the option on the date of its expiration, provided that its intrinsic value is positive). Purchaser has the right to exercise a knock-out option exclusively when on or before the date of expiration the exchange rate did not exceed the level predetermined as the contract’s barrier. If over the life of an option the exchange rate exceeds the barrier level, the option deactivates and becomes null and void (the purchaser loses all rights under the transaction).¹

In 2005 there was an observed increase in the activity in the zloty and other currencies of Central and Eastern Europe barrier option segment on the offshore market. Hedge funds showed considerable interest in barrier options, in particular knock-out ones. Having taken advantage of financial leverage and susceptibility to the changes in exchange rates which are characteristic for this kind of products (they pay less premium than the plain vanilla options), the funds speculated on the zloty exchange rate. London-based banks, which were very active on the zloty market, acted as option writers and they often concluded large-size transactions (in terms of their nominal values).

Such banks usually hedged against the risk arising in connection with the sale of such products. In order to do so they used two types of strategies: concluded suitable transactions on the plain vanilla option market (so called static replication) and performed regular transactions on the spot market (delta hedging). In the event where a knock-out call option is offered (involving buying euros for Polish zlotys) and knock-out barrier is below the spot EUR/PLN rate the former of the above-mentioned strategies consists in the sale of short-term put options involving euros with the exercise rate close to the predetermined barrier level. It results in the increase in turnover on the plain vanilla market, although where the market is shallow it may cause the decrease in the price of such options – i.e. a drop in implied volatility.² Should the zloty exchange rate be close to the specified barrier level, delta hedging requires that the zlotys be sold in exchange for euros on the spot market. The value of such transactions has to be higher than a nominal option value.³ In the situation where the barrier level is exceeded and barrier option becomes null and void, its writer has to offset the position taken in the spot market – i.e. buy zlotys.⁴ Such large size quick transactions, related to hedging positions in barrier options, may result in changes in the zloty exchange rate and contribute to the increase in its volatility.

³ It is so as the value of position taken on the spot market is directly connected with delta and, considering the situation when the exchange rate is close to the predetermined barrier level, the absolute value of delta for the barrier option concerned is higher than 1.
Market participants

The OTC derivatives market included domestic and foreign banks as well as non-financial entities. Non-banking financial institutions were absent from this market due to the lack of a need to hedge against FX risk. Open pension funds could not take advantage of derivatives, moreover, taking into account the limit of investments on foreign markets which was not fully utilized, their FX exposure was insignificant. Non-residents – i.e. London-based banks – played an important role in all interbank transactions (over 90% share in turnover). The activity of foreign entities created liquidity of the option and CIRS markets, while transactions concluded by non-banking entities (enterprises) were crucial for the size of the forward market. It was the result of hedging by enterprises against risk of changes in the zloty exchange rates, as most frequently they used various types of forward transactions to this end. Due to a simple structure, flexibility and availability in the banks’ offers, more than one third of Polish enterprises hedging their FX exposure uses the said transactions. Additionally, as it appears from NBP research, only 8% of companies managing their FX risk use FX options regularly, while 1.5% – CIRS contracts.\footnote{More in: Financial System Development in Poland 2004, Warsaw 2005, NBP, pp. 225–227.} Besides enterprises, the second group of active participants in the forward market were private banking customers who speculated on the zloty exchange rate using non-deliverable forwards (NDF).

In 2005 there were only a few banks managing portfolios of FX options, which performed regular transactions in such instruments. In almost all transactions non-residents were parties to the contracts concluded on the interbank market. Most domestic banks owned by foreign companies were only intermediaries in the FX option market – their exposures under sale of option strategy to non-banking entity were instantly offset by back-to-back hedging. Enterprises showed interest in complex strategies and exotic options paying less premium (lower purchase price) and premium payment profile tailored to their individual needs.

Only a few banks concluded CIRS contracts on a fairly regular basis, of which some were used as hedging transactions. A limited number of speculative transactions and high requirements regarding counterparties’ creditworthiness continued to limit market liquidity.

Prospects

In the coming years no significant changes in the size and structure of the OTC FX derivatives market are expected. Retaining the legislative solutions concerning investment limits imposed on open pension funds will also result in a decrease in demand for such instrument by financial institutions. The domestic forward market will still be dominated by customer transactions and the volume of turnover thereon will be dependent on the number of hedging transactions concluded by enterprises. This in turn will be influenced by: the volatility of the zloty exchange rate and dynamics of trade with foreign parties. Activity on the interbank market will remain low as domestic banks will continue to prefer synthetic forward contracts (combinations of spot and FX swap

\begin{figure}
\centering
\includegraphics[width=\textwidth]{maturity_structure_turnover_cirs_2004-2005}
\caption{Maturity structure of turnover on the CIRS market, 2004–2005}
\end{figure}

\begin{itemize}
\item Note: maturity structure by original maturities; contract maturity ranges are closed on the right.
\item Source: NBP data submitted by banks – Primary Dealers and/or money market dealers and candidates for dealers.
\end{itemize}
transactions). In the coming years one should not expect any considerable development of the FX option market in Poland. Further increase in foreign banks’ activity on the offshore market and centralisation of risk management in banking groups will contribute to the limitation in the domestic market liquidity. The amount of domestic banks’ capital and related low credit limits will prevent the emergence of a liquid interbank CIRS market.

Substantial changes in the domestic FX derivatives market may be expected only after Poland’s entry to the euro area. The adoption of the common currency will most probably result in a decrease in turnover on both the interbank and customer market. Due to a geographical structure of Polish trade, a considerable part of payments for services and goods will no more generate FX risk. This will mean a substantial decrease in demand for forward contracts and option strategies by enterprises. The adoption of the euro may, inter alia, entail the liquidation of option portfolios by some banks. Option and CIRS contracts portfolios denominated in EUR will be managed from abroad by parent banks, whereas domestic banks will only act as intermediaries in the sale of FX derivatives.

5.4.3. Stock exchange derivatives

Financial derivatives are traded on the Warsaw Stock Exchange (WSE) and the Warsaw Commodity Exchange (WCE). In 2005 the WSE introduced to trading bond futures and stock options while the range of products offered by the WCE remained unchanged. Apart from the above, the following products were traded on the WSE: stock index futures, FX futures, single stock futures, MiniWIG20 index participation units, warrants and stock index options. The WCE offered FX futures, interest rate futures as well as options on FX futures contracts.

In 2005, the stock index futures remained a dominant segment of the regulated derivatives market on the WSE. Their share in the total number of contracts sold on the WSE futures market was 91.4% (2.8 pp less than in 2004) while their turnover rose by 83.1%. Stock index options were the second largest segment with regard to the share of turnover (4.4%). Compared to 2004, the turnover in this segment was 308.1% higher. Also the turnover on the FX futures market increased (by 54.4% compared to 2004). The number of MiniWIG20 index participation units sold and turnover decreased by 59.3% and 49% respectively, which was a continuation of the downward trend initiated in 2003. Moreover, turnover with respect to warrants also dropped (by 76%) and due to the decrease in the investors’ interest, they were withdrawn from trading at the end of 2005.

Within the period concerned on the WCE, as in the previous years, investors were mostly interested in FX futures, particularly in USD/PLN, EUR/PLN and EUR/USD exchange rates. Low transaction volume was recorded in short-term interest rate futures and Treasury bonds futures (238 and 38 contracts transacted respectively throughout the whole of 2005) and all the said transactions were carried out in the first half of 2005.

Since the beginning of trading in derivatives on the WSE, individual investors formed the major group of market participants. According to surveys conducted by the WSE, the share of individual investors in turnover on the futures and options markets in 2005 accounted for 75%. In contrast to the WSE, on the WCE a major group of investors constituted enterprises which hedged against the FX risk.

In the coming years, turnover on the stock exchange derivatives market will tend to concentrate on the WSE. Similarly as in previous years individual investors will remain the basic group of participants, however, their predominance will diminish in favour of non-banking financial institutions and foreign investors.

\[538\] A WSE questionnaire survey called Investors on the stock exchange markets addressed to the brokerage offices and houses which are the WSE members. Results available at www.gpw.pl.
5.4.3.1. Interest rate derivatives

Interest rate futures were traded on the WSE and the WCE. The WCE offer included contracts based on short-term (1M WIBOR and 3M WIBOR) as well as long-term (2-, 5- and 10-year Treasury bonds) interest rates. In February 2005 the WSE introduced to trading bond futures. These instruments are quoted in the continuous trading system from 9 a.m. to 4.20 p.m. There is no post-auction trading carried out. Underlying instruments are fixed-rate Treasury bonds. The value of issue cannot be less than PLN 5 billion, while the date of redemption has to be fixed within the obligatory time limit: not shorter than two years and nine months but not longer than five years and six months following the date of contract execution. Contract executions consist in the delivery of bonds upon the conditions determined by the National Depository for Securities (KDPW). At the moment of the introduction of bond futures to trading on the WSE there appeared a new group of stock exchange members, i.e. banks. At the end of 2005 there were five market makers on the bond futures contracts market: CDM Pekao, Bank Pekao, Bank BPH, ING Bank Śląski and PKO BP.

Bond futures contracts were admitted to trading to accommodate open pension funds which invest a considerable part of their assets (about 2/3) in the Treasury bonds, whereby they are exposed to interest rate risk. Within the period concerned this market segment recorded a lower rate of development than expected due to the lack of regulations allowing open pension funds to invest in derivatives. In 2005 the transaction volume in bond futures was 32.4 thousand contracts, the turnover amounted to PLN 6.6 billion, while the number of open positions as of the end of 2005 equalled 58.

Figure 5.4.11. Treasury bond futures traded on the WSE in 2005

![Graph showing treasury bond futures traded on the WSE in 2005](source: WSE)

Despite the fact that the interest rate futures market on the WCE has a seven-year history, its liquidity remains limited. In 2005, both the number of contracts sold (except for 3M WIBOR futures) and the number of open positions decreased (Tables 5.4.3 and 5.4.4).

Interest rate futures are one of the most popular financial derivatives on developed markets. They enjoy considerable interest especially among institutional investors who invest a substantial part of their assets in debt instruments. Enterprises, which finance their operations mainly through bank loans, are the second most important group of purchasers of such contracts. Transactions in interest rate futures enable them to hedge against interest rate risk. Taking developed European markets as an example, it may be expected in Poland that the bond futures market has also potential for development. Domestic institutional investors (open pension funds, insurance companies and investment funds) invest a large part of their assets in Treasury securities and therefore their investment portfolios exhibit considerable exposure to interest rate risk. It may indicate that there is a substantial potential demand for such kind of instruments. Regrettably, due to legislative solutions in force, in the near future open pension funds will not be allowed to hedge their investment portfolios with derivatives. At present the only domestic institutional investors

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admitted to trade on this market are investment funds and insurance companies. However, until now they have not showed considerable interest in the said instruments. Regarding insurance companies, a probable reason for such situation was that they are subject to the same supervision principles as open pension funds and the same authority – The Commission for Insurance and Pension Funds Supervision (KNUIFE), which monitors and supervises their activities. The cause for insignificant activity of investment funds on the market may be similar, as the Securities and Exchange Commission (KPWiG) paid special attention to risk related to particular investments instead of the entire portfolio risk as it is practised in case of banks (risk based approach). Both for open pension funds as well as investment funds the stock exchange is a perfect market to carry out transactions in derivatives as it guarantees transparency.

Table 5.4.3. Gross annual number of interest rate futures sold on the WCE 2002–2005

<table>
<thead>
<tr>
<th>Instrument</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>WIBOR 1M futures</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>WIBOR 3M futures</td>
<td>51</td>
<td>53</td>
<td>70</td>
<td>238</td>
</tr>
<tr>
<td>2-year bond futures</td>
<td>9</td>
<td>44</td>
<td>11</td>
<td>10</td>
</tr>
<tr>
<td>5-year bond futures</td>
<td>49</td>
<td>161</td>
<td>89</td>
<td>12</td>
</tr>
<tr>
<td>10-year bond futures</td>
<td>42</td>
<td>70</td>
<td>23</td>
<td>3</td>
</tr>
</tbody>
</table>

Source: WCE.

Table 5.4.4. Open positions in interest rate futures on the WCE 2002–2005 (as of the end of the period)

<table>
<thead>
<tr>
<th>Instrument</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>WIBOR 1M futures</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>0</td>
</tr>
<tr>
<td>WIBOR 3M futures</td>
<td>0</td>
<td>38</td>
<td>18</td>
<td>0</td>
</tr>
<tr>
<td>2-year bond futures</td>
<td>1</td>
<td>1</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>5-year bond futures</td>
<td>12</td>
<td>15</td>
<td>2</td>
<td>0</td>
</tr>
<tr>
<td>10-year bond futures</td>
<td>5</td>
<td>4</td>
<td>1</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: WCE.

Enterprises could become a significant investor group in this market segment. Unfortunately they prefer instruments offered by banks (IRS and CIRS contracts) to stock exchange derivatives due to their higher liquidity. Also foreign institutional investors, who together with our domestic institutional investors form the group of most active participants on the Polish Treasury bonds market, should be interested in bonds futures. The said market segment should start to develop provided that both foreign and domestic investors will be active thereon, ensuring high liquidity, similarly as in the case of the OTC market.

5.4.3.2. FX derivatives

FX derivatives are traded on the WSE and WCE. Investors’ activity was concentrated on the WCE where they concluded three times more transactions than on the WSE. In 2005, neither exchange introduced new FX futures into trading. EUR/PLN and USD/PLN futures were traded on the WSE while EUR/PLN, USD/PLN, CHF/PLN, EUR/USD, EUR/HUF and EUR/CZK futures were traded on the WCE.

On the WSE investors’ interest in FX futures grew considerably. The number of contracts sold increased by 79.9% while the turnover went up by 54.4% (Figure 5.4.12). Investors were mostly interested in USD/PLN futures contracts (turnover increased by 106%, amounting to PLN 328 million). The downward trend initiated in 2004 continued and the interest in EUR/PLN futures contracts dropped further by 18.6%. Aggregate turnover in FX derivatives increased by 54.4%, amounting to PLN 420 million. The change in the turnover structure was a result of the USD appreciation against PLN and higher volatility of the USD/PLN than EUR/PLN exchange rate.
Figure 5.4.12. FX futures on the WSE, 2002–2005

Source: WSE.

The situation on the WCE was different. The upward trend present since 2002 was reversed and the volume in FX derivatives in 2005 dropped by 28.4% compared with 2004 (Figure 5.4.13). On the other hand, the number of open positions as of the end of the year increased by 32.6%. As in previous years, USD/PLN, EUR/PLN and EUR/USD futures were the most popular FX futures (Table 5.4.5). The number of contracts sold increased for USD/PLN and CHF/PLN futures whereas the number of open positions grew in case of USD/PLN, EUR/PLN and USD/EUR future contracts. With respect to the market segment comprising USD/CHF, GBP/USD and GBP/PLN futures exclusively, the number of contracts sold was insignificant and throughout the whole year it amounted to 12, 6 and 40 contracts respectively. In 2005, as in the previous year no transactions were carried out in the Czech koruna and Hungarian forint FX futures segment. The increase of interest in USD/PLN futures was a result of, similarly as on the WSE, higher volatility of the USD/PLN exchange rate than recorded in the previous year.

The FX futures market still remained underdeveloped. Taking into account the increase in the foreign trade volume as well as adjournment of the date of Poland’s entry to the euro area turnover on the FX futures market should increase.541 Better knowledge on the possibilities of hedging against FX risk is also expected to contribute to the growth of turnover in such instruments. Nonetheless, at the moment the major barrier which hinders the market development is competition from more liquid OTC instruments offered by banks.

Figure 5.4.13. FX futures on the WCE, 2002–2005

Source: WCE.

541 At the end of 2005 Poland was the only country among the new EU Member States which did not give a declaration on the date of entry to the euro area. The countries of the euro zone are Poland’s main trade counterparties. Their share both in Polish import and export in 2005 accounted for 51.3% and 58.5% respectively.
Table 5.4.5. Annual turnover (number of contracts sold) and open positions in FX futures on the WCE, 2002–2005

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>USD/PLN exchange rate</td>
<td>2,596</td>
<td>10</td>
<td>3,500</td>
<td>88</td>
<td>4,486</td>
<td>258</td>
<td>9,543</td>
<td>376</td>
</tr>
<tr>
<td>EUR/PLN exchange rate</td>
<td>866</td>
<td>86</td>
<td>4,464</td>
<td>70</td>
<td>9,597</td>
<td>186</td>
<td>6,164</td>
<td>235</td>
</tr>
<tr>
<td>USD/EUR exchange rate</td>
<td>937</td>
<td>21</td>
<td>11,000</td>
<td>113</td>
<td>12,848</td>
<td>67</td>
<td>3,168</td>
<td>76</td>
</tr>
<tr>
<td>CHF/PLN exchange rate</td>
<td>2,677</td>
<td>52</td>
<td>615</td>
<td>2</td>
<td>74</td>
<td>22</td>
<td>390</td>
<td>20</td>
</tr>
</tbody>
</table>

A – number of contracts sold
B – open positions as at year-end
Source: WCE.

5.4.3.3. Stock index and stock derivatives

Stock index futures

In 2005, as in previous years, WIG20, TechWIG and MIDWIG stock index futures contracts were traded on the WSE. WIG20 futures continued their domination on the market. In 2005, their share in the total number of stock index futures contracts sold was 99.8% (versus 99.1% in 2004). In 2005 the number of WIG20 futures contracts sold throughout the entire year increased by 48% compared to 2004 (Figure 5.4.14). Thanks to the bull market, turnover rose by 84.4% (Table 5.4.6).

In 2005, the migration of investors from the spot market to the WIG20 futures market continued. The reason for the change in the individual investors’ investment direction was the threat of a break in further increase in stock prices, which might have affected the profits possible to gain on the spot market. The ratio of WIG20 futures turnover to the turnover of stocks in the WIG20 index (liquidity ratio) increased slightly, reaching 170.4% (Table 5.4.8). At the end of 2007 there were 7 brokerage entities (versus 8 in 2004) which acted as market makers on the WIG20 futures market and ensured adequate liquidity.

Figure 5.4.14. WIG20 futures traded on the WSE, 2002–2005

Source: WSE.
MIDWIG futures have been traded on the WSE since February 2002. In 2005 the number of contracts sold decreased ten-fold while the turnover nine-fold (Figure 5.4.15). The MIDWIG futures liquidity ratio also decreased, having recorded only 0.2% (versus 5.8% in 2004) which was the lowest level of the instrument's quotations in history. Limited investors' interest in MIDWIG futures resulted in lower liquidity of such contracts (no market maker) and higher return rate from investments in the stocks of large companies included in WIG20 index.

Investors' interest in TechWIG futures contracts (Figure 5.4.16) remained at a similar level as recorded in 2004. A slight increase in turnover and a decrease in the number of contracts sold may be attributed to the rise in stock prices of high-tech companies. The liquidity ratio for TechWIG futures remained low and in 2005 amounted to 0.3% (versus 0.4% in 2004). The causes for stagnation in this market segment are the same as defined with respect to the MIDWIG futures.

In 2005, WIG20 futures contracts were ranked eighth among equity index futures contracts quoted on the European exchanges in terms of trading volume (ninth in 2004) while with respect to turnover they took sixth place (twelfth place in 2004). WIG20 futures are the most liquid instrument traded on the WSE, which is a reason for low spreads.544 The high liquidity of these

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544 In 2005, spread for WIG20 futures was 6 basis points, whereas the average spread for the stocks in the companies included in this index was 51.5 basis points. Spreads for TechWIG and MIDWIG futures were 74 and 110 basis points respectively.
Instruments (low transaction-related costs) may contribute to the further increase in turnover on this market in the future. Taking into account the upward trend on the WSE when it comes to stock prices, the turnover will probably grow faster than the number of contracts sold. Another factor which may also contribute to the increase in volume in the said segment is the growth of the domestic institutional investors’ involvement.\textsuperscript{545} A strong impetus which might stimulate the market’s development would be allowing open pension funds to invest in derivatives. The growth of the stock index futures market may also be inspired by foreign investors thanks to easier access to the Polish market (larger number of foreign members of the WSE). At the end of 2005 the said group accounted for merely 5% share in the WIG20 future market turnover. Better prospects for the increase in stock prices in comparison to the developed markets (relatively low stock prices) may lead to the growth of interest in the Polish market by this group of investors. However, it should be noted that the bull market, which started on the WSE in spring 2003, may trigger anxiety as to a possible reversal in the upward trend in prices on the Polish stock market.

Figure 5.4.15. MIDWIG futures traded on the WSE, 2002–2005

Source: WSE.

Figure 5.4.16. TechWIG futures traded on the WSE, 2002–2005

Source: WSE.

On stock exchanges in developed countries, the main stock index futures contracts account for as much as 90% of total turnover in stock index contracts. Analysing the development of such instruments on the WSE to date it may be assumed that the same regularity is also observable with regard to the Polish market. Nevertheless, one should also remember that in the MIDWIG and TechWIG future segments, there were no market makers which could have ensured their liquidity.

\textsuperscript{545} In 2005, the share of this group of investors in futures turnover accounted for 20%, out of which 3/4 was generated by the market makers.
In the coming years, as before, WIG20 futures are expected to prevail on the stock index future market, whereas the significance of the remaining stock index contracts will most probably diminish gradually.

Table 5.4.9 Major stock index futures in Europe – annual number of contracts sold, 2002–2005 (in million)

<table>
<thead>
<tr>
<th>Underlying instrument</th>
<th>Stock exchange</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>DJ EURO STOXX50</td>
<td>Eurex</td>
<td>86.4</td>
<td>116.0</td>
<td>121.6</td>
<td>140.0</td>
</tr>
<tr>
<td>DAX30</td>
<td>Eurex</td>
<td>20.0</td>
<td>27.1</td>
<td>29.2</td>
<td>32.7</td>
</tr>
<tr>
<td>CAC40</td>
<td>Euronext Paris</td>
<td>26.4</td>
<td>29.3</td>
<td>24.1</td>
<td>25.0</td>
</tr>
<tr>
<td>FTSE100</td>
<td>Euronext LIFFE</td>
<td>17.2</td>
<td>20.3</td>
<td>20.8</td>
<td>21.5</td>
</tr>
<tr>
<td>OMX</td>
<td>OM</td>
<td>12.5</td>
<td>14.6</td>
<td>16.5</td>
<td>19.7</td>
</tr>
<tr>
<td>SMI</td>
<td>Eurex</td>
<td>7.0</td>
<td>9.0</td>
<td>8.1</td>
<td>8.6</td>
</tr>
<tr>
<td>AEX</td>
<td>Euronext Amsterdam</td>
<td>4.2</td>
<td>5.2</td>
<td>5.7</td>
<td>7.4</td>
</tr>
<tr>
<td>WIG20</td>
<td>WSE</td>
<td>3.1</td>
<td>4.1</td>
<td>3.5</td>
<td>5.2</td>
</tr>
<tr>
<td>IBEX35</td>
<td>MEFF</td>
<td>3.9</td>
<td>3.5</td>
<td>4.4</td>
<td>4.9</td>
</tr>
<tr>
<td>MIB30</td>
<td>IDEM</td>
<td>4.9</td>
<td>4.3</td>
<td>3.3</td>
<td>3.6</td>
</tr>
</tbody>
</table>

Source: Eurex, Euronext, WSE, IDEM, MEFF and OM.

Stock futures contracts

In 2005, stock futures contracts in the following companies were traded on the WSE: Agora, Bank Millennium, Bank Pekao, Bank BPH, BRE Bank, BZ WBK, KGHM, PKN Orlen, PKO BP, Prokom and TP SA.

Since the time when single stock futures were introduced, investors’ interest has grown steadily (except for 2004). In 2005 the number of contracts sold grew almost two-fold and turnover increased by 162% (Figure 5.4.17 and Table 5.4.10). The turnover in this market segment reached the highest level in the history of these instruments trading. The liquidity ratio for stock futures exceeded the record level and reached 4.6% (versus 3.1% in 2004). The increase of interest in such contracts in 2005 may be attributed to the upward trend which was noted with respect to the prices of particular companies’ stocks which in turn encouraged investors to take positions in the said contracts. Higher investors’ activity in this market segment resulted in the drop in spread by 31 basis points on average (down to 53 basis points). As the end of 2005 there were six brokerage entities performing the role of market makers. Compared to the previous year the number of market makers did not undergo any changes.

Figure 5.4.17. Stock futures traded on the WSE, 2002–2005

Source: WSE.

546 Prices of stocks in the companies on which future contracts are concluded increased in 2005 by 48% on average (arithmetic average) while the median was 48.2%.

547 Market makers on the stock future market included: ING Securities, CDM Pekao, DM BOS, Beskidzki DM, CA IB Securities and IDM.
Table 5.4.10. Basic statistical data concerning the stock futures market on the WSE, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Number of transactions</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– total</td>
<td>67,509</td>
<td>67,099</td>
<td>63,296</td>
<td>132,229</td>
</tr>
<tr>
<td>– session average</td>
<td>271</td>
<td>267</td>
<td>248</td>
<td>521</td>
</tr>
<tr>
<td>Number of contracts sold</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– total</td>
<td>92,097</td>
<td>93,055</td>
<td>87,888</td>
<td>172,828</td>
</tr>
<tr>
<td>– session average</td>
<td>370</td>
<td>371</td>
<td>345</td>
<td>689</td>
</tr>
<tr>
<td>Turnover (PLN million)</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>– total</td>
<td>1,332</td>
<td>1,758</td>
<td>2,085</td>
<td>5,468</td>
</tr>
<tr>
<td>– session average</td>
<td>5.3</td>
<td>7.0</td>
<td>8.2</td>
<td>21.8</td>
</tr>
<tr>
<td>Open positions as at year-end</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(PLN million)</td>
<td>1,291</td>
<td>1,972</td>
<td>2,268</td>
<td>2,928</td>
</tr>
<tr>
<td>Number of open positions as at year-end</td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>(PLN million)</td>
<td>9</td>
<td>19</td>
<td>29</td>
<td>63</td>
</tr>
<tr>
<td>Spread (basis points)</td>
<td>116</td>
<td>103</td>
<td>84</td>
<td>53</td>
</tr>
</tbody>
</table>

Source: WSE.

Table 5.4.11. Turnover (number of contracts sold) of stock futures in Europe

<table>
<thead>
<tr>
<th>Stock exchange</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>MEFF (Madrid)</td>
<td>12,645,186</td>
<td>12,492,568</td>
<td>12,054,799</td>
<td>18,813,689</td>
</tr>
<tr>
<td>Euronext LIFFE (London)</td>
<td>3,935,121</td>
<td>6,349,198</td>
<td>12,929,406</td>
<td>12,158,889</td>
</tr>
<tr>
<td>Euronext (total)</td>
<td>7,570,175</td>
<td>7,004,235</td>
<td>13,491,781</td>
<td>12,158,093</td>
</tr>
<tr>
<td>IDEM</td>
<td>59,868</td>
<td>468,083</td>
<td>1,734,256</td>
<td>5,987,674</td>
</tr>
<tr>
<td>OMX (Stockholm)</td>
<td>1,290,181</td>
<td>1,242,890</td>
<td>1,881,919</td>
<td>5,659,823</td>
</tr>
<tr>
<td>BSE (Budapest)</td>
<td>452,638</td>
<td>618,261</td>
<td>706,386</td>
<td>740,396</td>
</tr>
<tr>
<td>WSE</td>
<td>92,097</td>
<td>93,055</td>
<td>87,888</td>
<td>172,828</td>
</tr>
</tbody>
</table>

Source: WSE, Euronext, IDEM, BSE, MEFF and OM.

In 2005 – as in 2004 – the WSE ranked seventh among European stock exchanges in terms of stock futures’ trading volume. On developed European markets such instruments enjoy popularity (Table 5.4.11) and it may be assumed that also on the Polish market they will be increasingly popular with investors. It is evidenced by the growth in market liquidity, which in turn results in lowering transaction-related costs. It is difficult to estimate what might be the influence of the introduction of stock options into trading (it took place at the end of 2005) on the stock futures market as investors may treat them as a substitute of stock futures. Nonetheless it seems that both segments will develop parallel to each other.

Warrants

Warrants were traded on the WSE until 16 December 2005. Two types of such instruments were traded: European and American.\(^{548}\) Compared to 2004, the number of issuers did not change (BRE Bank and Beskidzki Dom Maklerski–BDM). Call and put warrants for several dozen of the most liquid company stocks as well as for WIG20 futures were traded.

In 2005, the value of warrant trading fell by 74.8%, which was a continuation of the trend that began in 2004. As a result, the average session turnover also decreased (Table 5.4.12). In connection with the decrease in investors’ interest in this type of instruments, high costs of market activity and the introduction of company stock options by the WSE, the issuers decided to stop selling warrants. The main group of investors on this market were individuals.

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\(^{548}\) European warrants may only be exercised on the expiry date, which is set in advance by the issuer. American warrants, on the other hand, may be exercised on any date up to and including the expiry date.
Prospects

Warrants are popular financial instruments on some of the developed financial markets (MEFF, Eurex). In Poland, however, this segment has failed to develop. In 2005, as in previous years, the trading of stock index options, which provided, to a certain degree, an alternative to warrants, was an additional factor hampering the development of the latter. Due to the introduction of new instruments that were similar to warrants in nature (i.e. stock options), the two issuers of warrants (BRE Bank and Beskidzki Dom Maklerski–BDM) ceased to offer them. Although the WSE declares its readiness to list warrants, one should not expect that they will be traded on the Warsaw Stock Exchange in the coming years.

Stock index options

WIG20 index options were first traded on the WSE in September 2003. From the beginning, investors’ interest has been rising steadily (Figure 5.4.19). In 2005, the options market volume increased by 217.5% and amounted to 259 thousand options. The turnover was higher by 308.1% while the number of open positions at the end of the year increased by 34.7% and amounted to 6,432. The liquidity ratio was 8.6%, which means that it rose by almost 5 pp in comparison with the previous year. This ratio is, however, very low compared to the liquidity ratio of WIG20 futures (170.4%) but a very short history of this market segment should be taken into account.

In 2005, there was only one market maker (BRE Bank). The predominance of individual domestic investors on the WIG20 options market slightly decreased. Their share in the options market volume fell from 76% to 74%. Institutional domestic investors exhibited greater interest (an increase in volume share from 20% to 25%). On the other hand, foreign investors’ interest dropped (from 4% to 1%).

A high volume of West European stock index options may point to the development potential of the WSE option market as well (Table 5.4.13). In 2005, the volume of stock index options recorded the most dynamic growth among all derivatives. It resulted, among others, from a clear upward trend with regard to indices and a low comparision basis. Another factor that had a positive

Table 5.4.12. Basic indicators concerning warrant trading on the WSE, 2002–2005

<table>
<thead>
<tr>
<th></th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>Transactions per session</td>
<td>14</td>
<td>22</td>
<td>15</td>
<td>7</td>
</tr>
<tr>
<td>Total turnover (PLN million)</td>
<td>8,5</td>
<td>15,5</td>
<td>11,5</td>
<td>2,9</td>
</tr>
<tr>
<td>Average session turnover (PLN thousand)</td>
<td>34,1</td>
<td>61,7</td>
<td>44,9</td>
<td>11,9</td>
</tr>
</tbody>
</table>

Figure 5.4.18. Warrant turnover structure, 2002–2005

Prospects

Warrants are popular financial instruments on some of the developed financial markets (MEFF, Eurex). In Poland, however, this segment has failed to develop. In 2005, as in previous years, the trading of stock index options, which provided, to a certain degree, an alternative to warrants, was an additional factor hampering the development of the latter. Due to the introduction of new instruments that were similar to warrants in nature (i.e. stock options), the two issuers of warrants (BRE Bank and Beskidzki Dom Maklerski–BDM) ceased to offer them. Although the WSE declares its readiness to list warrants, one should not expect that they will be traded on the Warsaw Stock Exchange in the coming years.

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A high volume of West European stock index options may point to the development potential of the WSE option market as well (Table 5.4.13). In 2005, the volume of stock index options recorded the most dynamic growth among all derivatives. It resulted, among others, from a clear upward trend with regard to indices and a low comparision basis. Another factor that had a positive

549 MEFF is the futures and options Spanish official market (in Spanish: Mercad Oficial de Opciones y Futuros) while Eurex is the world’s second largest derivatives exchange based on turnover, managed by Deutsche Börse AG | SWX Swiss Exchange.
impact on the increase in volume in this market segment included promotional and educational measures for investors organised by the WSE. A negative phenomenon relates to the fact that the share of foreign investors in turnover dropped significantly as they preferred futures contracts, which were cheaper than options. The WSE held talks with brokerage houses and offices in order to attract new entities which would be interested to act as market makers on the WIG20 options market. These measures were aimed at increasing market liquidity and accordingly raising its attractiveness for investors. It can be assumed that if the trend on the stock market is clear, investors will prefer futures contracts, as these allow them to achieve the intended profits at a lower price for the financial instrument.

Figure 5.4.19. WIG20 index options traded on the WSE, 2003–2005

Figure 5.4.20. Investor structure on the WIG20\(^1\) option market, 2003–2005

Stock options

In October 2005, the WSE introduced to trading stock options of five companies (KGHM, Bank Pekao, PKN Orlen, Prokom and TP SA). At the end of 2005, 122 series of stock options were traded. Annual volume amounted to 4,372 and the number of open positions at the end of the year was 413.
At the end of 2005, it was one market maker (BRE Bank). With regard to trading of these instruments, limits on price fluctuations are set. The limits are calculated once a quarter and equal 5% of the average price from the last 20 closing prices of the underlying instrument from the preceding quarter. In the case of KGHM, PKN Orlen and TPSA, one option accounts for 500 stocks while in the case of Pekao and Prokom, one option equals 100 stocks. The option expiry date falls on the last Friday of the two closest months from the cycle of March, June, September and December. Transactions are settled in zlotys.

On world markets, stock options were treated with considerable interest by investors. The turnover in these instruments is higher than that of stock futures and index options. Since stock options were first traded on the WSE, interest in them has been increasing. At present, both the WSE and the market maker concentrate on the building liquidity and promoting this new instrument among investors and undertaking educational measures. What could constitute a problem for the more advanced investors is a limited offer of stock options (a small number of series and companies for which the options are issued) preventing them from employing complex investment strategies. This problem should, however, gradually disappear with the development of the market. The low liquidity which this segment has so far exhibited and which resulted from a short history of the market, did not encourage investors to invest in these instruments either. As in case of other derivatives, one should expect that the main group of participants on the market of company stock options will be individual investors. Because of financial leverage, these instruments enable to achieve high profits with the investment of a relatively low capital. The advantage of stock options over futures relates to the fact that the loss resulting from a wrong anticipation of price movements of the underlying instrument is limited to the premium paid while it is unlimited in the case of futures contracts. A chance of dynamic development of this market segment could lie in halting the strong upward trend in stock prices on the WSE. If the uncertainty with regard to the direction of changes in stock prices increases, investors may prefer stock options to futures contracts.

**MiniWIG20 index participation units**

In 2005, as in previous years, the transaction volume of MiniWIG20 index participation units decreased significantly (Figure 5.4.21). It reached the lowest level since they were first traded, that is 18,580 units (a decrease by 49% in comparison with 2004). The drop in volume was accompanied by a decrease in turnover from PLN 15.6 million in 2004 to PLN 8 million in 2005 (by 53.9%). At the end of 2005, the number of open positions amounted to 6,692, which meant a decrease by 29% in comparison with 2004. In 2005, as in previous years, three companies (DM BOS, BDM, DM BH) performed the function of market makers.

### Table 5.4.13. Options on major stock indices in Europe, 2002–2005 (in PLN million)

<table>
<thead>
<tr>
<th>Underlying instrument</th>
<th>Exchange</th>
<th>2002</th>
<th>2003</th>
<th>2004</th>
<th>2005</th>
</tr>
</thead>
<tbody>
<tr>
<td>EUR STOXX50</td>
<td>Eurex</td>
<td>39.5</td>
<td>61.8</td>
<td>71.4</td>
<td>90.8</td>
</tr>
<tr>
<td>CAC40</td>
<td>Euronext</td>
<td>84.3</td>
<td>73.7</td>
<td>63.2</td>
<td>59.1</td>
</tr>
<tr>
<td>DAX30</td>
<td>Eurex</td>
<td>44.0</td>
<td>41.5</td>
<td>42.2</td>
<td>53.6</td>
</tr>
<tr>
<td>AEX</td>
<td>Euronext Amsterdam</td>
<td>9.1</td>
<td>14.1</td>
<td>17.1</td>
<td>19.8</td>
</tr>
<tr>
<td>FTSE100</td>
<td>Euronext LIFFE</td>
<td>13.3</td>
<td>14.6</td>
<td>17.9</td>
<td>14.5</td>
</tr>
<tr>
<td>OMX</td>
<td>OM</td>
<td>4.9</td>
<td>6.4</td>
<td>8.9</td>
<td>12.2</td>
</tr>
<tr>
<td>IBEX35</td>
<td>MEFF</td>
<td>5.4</td>
<td>3.0</td>
<td>2.9</td>
<td>4.4</td>
</tr>
<tr>
<td>SMII</td>
<td>Eurex</td>
<td>4.2</td>
<td>3.0</td>
<td>3.6</td>
<td>4.1</td>
</tr>
<tr>
<td>MIB30</td>
<td>IDEM</td>
<td>2.6</td>
<td>2.5</td>
<td>2.2</td>
<td>2.6</td>
</tr>
<tr>
<td>WIG20</td>
<td>WSE</td>
<td>–</td>
<td>0.02</td>
<td>0.08</td>
<td>0.25</td>
</tr>
</tbody>
</table>

Source: WSE, Eurex, Euronext, MEFF, IDEM, OM.
MiniWIG20 index participation units failed to become popular among investors. This can result, among others, from the bull market which makes investors actively manage their portfolios rather than follow movements in stock indices. Another factor that could weaken the interest in this instrument is its structure, i.e. it does not give investors the right to be paid dividends. In the situation of increasing company profits, which is reflected in high dividends, MiniWIG20 index participation units become an investment goal which is less attractive than direct investment in WIG20 stocks. Another factor that has a negative impact on the development of this market segment is the strong upward trend in stock prices, as the result of which investors wishing to increase the profit margin, invest their funds in WIG20 futures. It seems that in the coming years this market segment will remain underdeveloped and its significance will gradually decrease.
# Abbreviations Used in This Report

<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>ABS</td>
<td>Asset-Backed Securities</td>
</tr>
<tr>
<td>AIM</td>
<td>Alternative Investment Market</td>
</tr>
<tr>
<td>A-IRB</td>
<td>advanced internal ratings-based approach</td>
</tr>
<tr>
<td>ARiMR</td>
<td>Agency for Restructuring and Modernisation of Agriculture (Agencja Restrukturyzacji i Modernizacji Rolnictwa)</td>
</tr>
<tr>
<td>ATMF</td>
<td>at the money forward</td>
</tr>
<tr>
<td>ATS</td>
<td>alternative trading system</td>
</tr>
<tr>
<td>BCBS</td>
<td>Basel Committee on Banking Supervision</td>
</tr>
<tr>
<td>BGK</td>
<td>Bank Gospodarstwa Krajowego</td>
</tr>
<tr>
<td>BIG</td>
<td>Economic Information Bureau (Biuro Informacji Gospodarczej)</td>
</tr>
<tr>
<td>BIK</td>
<td>Credit Information Bureau (Biuro Informacji Kredytowej)</td>
</tr>
<tr>
<td>BIS</td>
<td>Bank for International Settlements</td>
</tr>
<tr>
<td>BPV</td>
<td>basis point value</td>
</tr>
<tr>
<td>BSB</td>
<td>buy-sell-back</td>
</tr>
<tr>
<td>BWUK</td>
<td>current consumer confidence ratio (bieżący wskaźnik ufności konsumenckiej)</td>
</tr>
<tr>
<td>CCP</td>
<td>Central Counterparty</td>
</tr>
<tr>
<td>CEBS</td>
<td>Committee of European Banking Supervisors</td>
</tr>
<tr>
<td>CEC</td>
<td>Central European Countries</td>
</tr>
<tr>
<td>CEIOPS</td>
<td>Committee of European Insurance and Occupational Pension Supervisors</td>
</tr>
<tr>
<td>CESR</td>
<td>Committee of European Securities Regulators</td>
</tr>
<tr>
<td>CeTo</td>
<td>Central Table of Offers (Centralna Tabela Ofert)</td>
</tr>
<tr>
<td>CIF</td>
<td>closed-end investment fund</td>
</tr>
<tr>
<td>CII</td>
<td>collective investment institutions</td>
</tr>
<tr>
<td>CIRS</td>
<td>currency interest rate swap</td>
</tr>
<tr>
<td>COREP</td>
<td>Common Reporting Framework</td>
</tr>
<tr>
<td>CPI</td>
<td>Consumer Price Index</td>
</tr>
<tr>
<td>CRD</td>
<td>Capital Requirements Directive</td>
</tr>
<tr>
<td>DG MARKT</td>
<td>Internal Market and Services Directorate General</td>
</tr>
<tr>
<td>DvP</td>
<td>Delivery versus Payment</td>
</tr>
<tr>
<td>Dz. U.</td>
<td>Journal of Laws (Dziennik Ustaw)</td>
</tr>
<tr>
<td>Dz. Urz. NBP</td>
<td>Official Journal of the National Bank of Poland (Dziennik Urzędowy Narodowego Banku Polskiego)</td>
</tr>
<tr>
<td>EBA</td>
<td>Euro Banking Association</td>
</tr>
<tr>
<td>EBC</td>
<td>European Banking Committee</td>
</tr>
<tr>
<td>EBRD</td>
<td>European Bank for Reconstruction and Development</td>
</tr>
<tr>
<td>EBS</td>
<td>Electronic Broking Services</td>
</tr>
<tr>
<td>EC</td>
<td>European Commission</td>
</tr>
<tr>
<td>EC</td>
<td>European Community</td>
</tr>
<tr>
<td>ECB</td>
<td>European Central Bank</td>
</tr>
<tr>
<td>EEA</td>
<td>European Economic Area</td>
</tr>
<tr>
<td>EEC</td>
<td>European Economic Community</td>
</tr>
<tr>
<td>EFAMA</td>
<td>European Fund and Asset Management Association</td>
</tr>
<tr>
<td>EIB</td>
<td>European Investment Bank</td>
</tr>
<tr>
<td>EICP</td>
<td>European Index of Consumer Prices</td>
</tr>
<tr>
<td>EIOPC</td>
<td>European Insurance and Occupational Pensions Supervision Committee</td>
</tr>
<tr>
<td>EONIA</td>
<td>Euro Overnight Index Average</td>
</tr>
<tr>
<td>EP</td>
<td>European Parliament</td>
</tr>
<tr>
<td>EPC</td>
<td>European Payments Council</td>
</tr>
<tr>
<td>EPP</td>
<td>Employee Pension Programmes</td>
</tr>
<tr>
<td>ESC</td>
<td>European Securities Committee</td>
</tr>
</tbody>
</table>
Abbreviations used in this report

ETF Exchange Traded Funds
EU European Union
EU-10 the 10 countries which acceded to the European Union on May 1, 2004
EU-15 the 15 countries which were European Union member states before May 1, 2004
EU-25 the 25 countries which have been European Union member states since May 1, 2004
EUROFINAS European Federation of Finance House Associations
EVCA European Private Equity and Venture Capital Association
FATF Financial Action Task Force on Money Laundering
FED Federal Reserve System
FESE Federation of European Securities Exchanges
FIAP Federación Internacional de Administradoras de Fondos de Pensiones
FINREP Financial Reporting Framework
F-IRB foundation internal ratings-based approach
FRA forward rate agreement
FSAP Financial Services Action Plan
GDP Gross Domestic Product
GIODO Inspector General for the Protection of Personal Data
(Generalny Inspektor Ochrony Danych Osobowych)
GNMA Government National Mortgage Association
GUS Central Statistical Office (Główny Urząd Statystyczny)
HICP Harmonized Index of Consumer Prices
IAS International Accounting Standards
IASB International Accounting Standards Board
IBngR Gdańsk Institute for Market Economics
(IInstytut Badań nad Gospodarką Rynkową)
IDM Chamber of Brokerage Houses (Izba Domów Maklerskich)
IF investment fund
IFRS International Financial Reporting Standards
IGPF Commercial Chamber of Financial Enterprises
(Izba Gospodarcza Przedsiębiorstw Finansowych)
IMF International Monetary Fund
IOSCO International Organization of Securities Commissions
IPA Individual Pension Account
IPO Initial Public Offering
IRB internal ratings-based approach
IRS interest rate swap
ITO RPW-CeTO stock market index
IZFiA Chamber of Fund and Asset Management
(Izba Zarządzających Funduszami i Aktywami)
KDPW National Depository for Securities
(Krajowy Depozyt Papierów Wartościowych)
KFK National Capital Fund
(Krajowy Fundusz Kapitałowy)
KIF Factoring Institutions Conference
(Konferencja Instytucji Faktoringowych)
KIR National Clearing House
(Krajowa Izba Rozliczeniowa)
KNB Commission for Banking Supervision
(Komisja Nadzoru Bankowego)
KNUiFE Insurance and Pension Funds Supervisory Commission
(Komisja Nadzoru Ubezpieczeń i Funduszy Emerytalnych)
KPF Financial Enterprises Conference
(Konferencja Przedsiębiorstw Finansowych)
<table>
<thead>
<tr>
<th>Abbreviation</th>
<th>Description</th>
</tr>
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<tbody>
<tr>
<td>KPWIG</td>
<td>Securities and Exchange Commission</td>
</tr>
<tr>
<td>KUKE</td>
<td>Export Credit Insurance Corporation</td>
</tr>
<tr>
<td>LBDS</td>
<td>long-term bank debt securities</td>
</tr>
<tr>
<td>LCB</td>
<td>long-term corporate bonds</td>
</tr>
<tr>
<td>LGU</td>
<td>local government units</td>
</tr>
<tr>
<td>M&amp;A</td>
<td>mergers and acquisitions</td>
</tr>
<tr>
<td>MBS</td>
<td>mortgage backed securities</td>
</tr>
<tr>
<td>MF</td>
<td>Ministry of Finance</td>
</tr>
<tr>
<td>MIDWIG</td>
<td>index of medium-sized companies listed on the WSE main market</td>
</tr>
<tr>
<td>MiFID</td>
<td>Markets in Financial Instruments Directive</td>
</tr>
<tr>
<td>NBP</td>
<td>National Bank of Poland</td>
</tr>
<tr>
<td>NCA</td>
<td>New Capital Accord</td>
</tr>
<tr>
<td>NDF</td>
<td>non-deliverable forward</td>
</tr>
<tr>
<td>NFI</td>
<td>National Investment Fund</td>
</tr>
<tr>
<td>NIM</td>
<td>Net Interest Margin</td>
</tr>
<tr>
<td>O/N</td>
<td>overnight</td>
</tr>
<tr>
<td>OECD</td>
<td>Organisation for Economic Co-operation and Development</td>
</tr>
<tr>
<td>OTE</td>
<td>open pension fund</td>
</tr>
<tr>
<td>OPE</td>
<td>open investment fund</td>
</tr>
<tr>
<td>OIS</td>
<td>Overnight Index Swap</td>
</tr>
<tr>
<td>OTC</td>
<td>over-the-counter</td>
</tr>
<tr>
<td>PARP</td>
<td>Polish Agency for Enterprise Development</td>
</tr>
<tr>
<td>PE/VC</td>
<td>private equity/venture capital</td>
</tr>
<tr>
<td>POLOONIA</td>
<td>Polish Overnight Index Average</td>
</tr>
<tr>
<td>POS</td>
<td>Point of Sale</td>
</tr>
<tr>
<td>PPEA</td>
<td>Polish Private Equity Association</td>
</tr>
<tr>
<td>PPI</td>
<td>Producer Price Index</td>
</tr>
<tr>
<td>ROA</td>
<td>Return on Assets</td>
</tr>
<tr>
<td>ROE</td>
<td>Return on Equity</td>
</tr>
<tr>
<td>RPP</td>
<td>Monetary Policy Council</td>
</tr>
<tr>
<td>RPW CeTO</td>
<td>CeTO Securities Market</td>
</tr>
<tr>
<td>RPW</td>
<td>Securities Register</td>
</tr>
<tr>
<td>RTGS</td>
<td>Real Time Gross Settlement</td>
</tr>
<tr>
<td>S/N</td>
<td>spot next</td>
</tr>
<tr>
<td>SBB</td>
<td>sell-buy-back</td>
</tr>
<tr>
<td>SBDS</td>
<td>short-term bank debt securities</td>
</tr>
<tr>
<td>SCB</td>
<td>short-term corporate bonds</td>
</tr>
<tr>
<td>SE</td>
<td>Societas Europaea</td>
</tr>
<tr>
<td>SKOK</td>
<td>credit union</td>
</tr>
<tr>
<td>SME</td>
<td>small and medium-sized enterprises</td>
</tr>
<tr>
<td>SOIF</td>
<td>specialised open investment fund</td>
</tr>
<tr>
<td>SPV</td>
<td>Special Purpose Vehicle</td>
</tr>
<tr>
<td>SW</td>
<td>spot week</td>
</tr>
<tr>
<td>SWIFT</td>
<td>Society for Worldwide Interbank Financial Telecommunication</td>
</tr>
<tr>
<td>T/N</td>
<td>tomorrow next</td>
</tr>
<tr>
<td>Abbreviation</td>
<td>Description</td>
</tr>
<tr>
<td>--------------</td>
<td>-------------</td>
</tr>
<tr>
<td>TARGET</td>
<td>Trans-European Automated Real-time Gross settlement Express Transfer system</td>
</tr>
<tr>
<td>TechWIG</td>
<td>index of companies listed on the WSE which belong to the High-Tech Segment</td>
</tr>
<tr>
<td>TUnŻ</td>
<td>life insurance company (Towarzystwo Ubezpieczeń na Życie)</td>
</tr>
<tr>
<td>UCITS</td>
<td>Undertakings for Collective Investment In Transferable Securities</td>
</tr>
<tr>
<td>UKIE</td>
<td>Office of the Committee for European Integration (Urząd Komitetu Integracji Europejskiej)</td>
</tr>
<tr>
<td>WCE</td>
<td>Warsaw Commodity Exchange</td>
</tr>
<tr>
<td>WIBID</td>
<td>Warsaw Interbank Bid Rate</td>
</tr>
<tr>
<td>WIBOR</td>
<td>Warsaw Interbank Offered Rate</td>
</tr>
<tr>
<td>WIG</td>
<td>Warsaw Stock Exchange Index (Warszawski Indeks Giełdowy)</td>
</tr>
<tr>
<td>WIG20</td>
<td>index of the 20 largest companies listed on the WSE main market</td>
</tr>
<tr>
<td>WIRR</td>
<td>Warsaw Index of the Parallel Market (Warszawski Indeks Rynku Równoległego)</td>
</tr>
<tr>
<td>WSE</td>
<td>Warsaw Stock Exchange</td>
</tr>
<tr>
<td>WWUK</td>
<td>projected consumer confidence ratio (wyprzedzający wskaźnik ufności konsumenckiej)</td>
</tr>
<tr>
<td>ZPL</td>
<td>Polish Association of Leasing Companies (Związek Przedsiębiorstw Leasingowych)</td>
</tr>
<tr>
<td>ZUS</td>
<td>Social Insurance Institution (Zakład Ubezpieczeń Społecznych)</td>
</tr>
<tr>
<td>1M</td>
<td>one month</td>
</tr>
<tr>
<td>1Y</td>
<td>one year</td>
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</tbody>
</table>