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KEY CHALLENGES OF FINANCIAL MARKET IN POLAND. MAIN TENDENCIES IN RETAIL, SME AND CORPORATE.

EXECUTIVE SUMMARY

This conference, organised by Economic Policy Institute from Sofia and the Institute for World Economics from Budapest is good opportunity to discuss main challenges of the financial sector in CEEE after integration to EU. I would like to briefly share the experience of the Polish financial sector in the process of its preparations to the EU membership and draw attention to the main tendencies which we observe currently in three market segments, namely: retail, SME's and corporate.

At the beginning let me point out four main issues related to the subject of this conference, as summarizing my paper.

Firstly, the CEEC accession to the EU has positively impacted further development of financial services sector and has triggered structural changes in all of its segments. Tendencies observed in Poland are characteristic for the whole Region due to comparable stages of transformation and banking sectors' penetration by foreign investors.

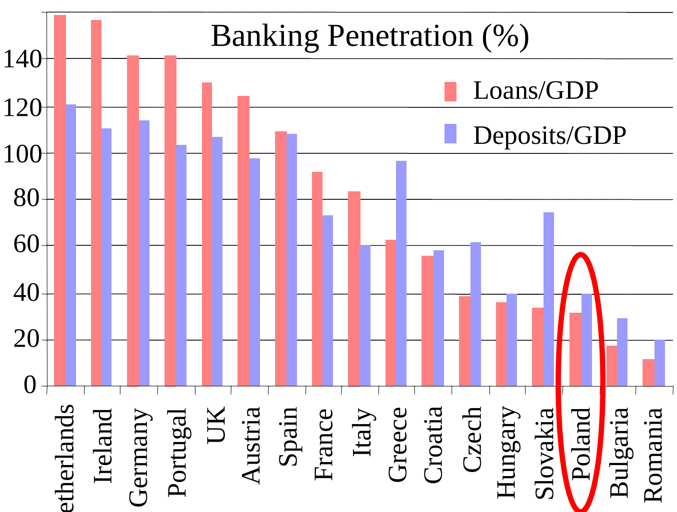
Secondly, banks were one of the first economic sectors to be privatised and restructured. For this reason in qualitative factors such as: product offer, distribution channels, technology domestic banks are competitive in the European Union however there is still a large gap in quantitative criteria.

Thirdly, the biggest growth potential lies in retail banking. Leading Polish banks focus on the same target client groups: affluent customers, middle class, SME and strategic products such as mortgage loans, mutual funds, credit cards, electronic banking. Retail segment will remain a main engine of banking growth for a long time.

And finally the on-going European integration affects financial market convergence which takes place within a legal concept laid out by the Financial Services Action Plan (FSAP). This will bring about a single EU capital market with the same rules for companies entering stock exchanges. Equity financing will gain in importance for corporations in a long run but in short-time financing, risk management, transaction settlements and electronic operations banking primacy will continue.

A qualitative leap in Polish banking within last 10 years

The good news is that in qualitative factors domestic banks are at a comparable level as their Western peers. What does it mean? I am thinking here of a business model, products innovation, technology, marketing approach and management system across the whole organization. Polish banks have become aware that the key success factors lie in sales starting from clients segmentation thru dedication of account managers, motivation and sellers' commitment. And in this respect Polish banks have gone thru a peaceful revolution. 10 years back banks applied only basic demographic segmentation. Now a so called behavioural segmentation is being developed. Earlier banks sold only commercial banking products now there is a mixed offer including investment banking products and bancassurance. 10 year back banks offered one or two products per one customer At now cross selling ratios of leading Polish banks is amounted 3,8 products per 1 current account. Earlier banks applied so called products approach in marketing management tools, now whole organisation is focus on clients, beginning from proper segmentation, trough packages of products, divisional structures of organisation in headquarter and network and finally proper management information system (MIS).



Source: EMEA Banks, Morgan Stanley, 18.10.2004

One of key success factors for building sales oriented approach is proper clients' segmentation which brings fruits in terms of profitability and additional business potential. Research of the Boston Consulting Group shows that segmentation helps account managers to capture additional banking business of almost 50% and helps increase profitability by 36%.

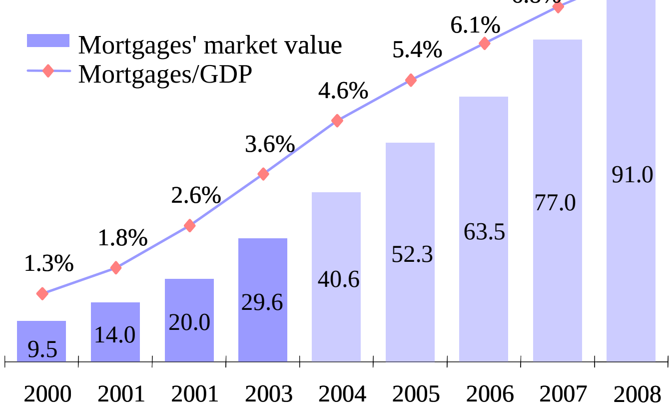
Within past 10 years we have observed a qualitative leap in Polish banking in terms of distribution, technology and credit risk management tools. Earliest branches operated with a separate IT system like "small , stand-alone banks" with up to 300 employees own accounting, balance sheet, profit and loss account. Now IT is fully centralized what facilitates on-line transactions with automatic settlement. At present outlets are mainly a point of product sales with front office only while back office systems are fully integrated with the core IT platform. Thanks new technology banks managed to improve productivity and reverse proportion between number of employees in back office and front office. 10 years back 65% of staff worked in back office while only 35% in front office. Now this proportion is reversed. During last 10 years banks change its attitude to network; from brick only (branches, sub branches, agencies) to "brick and clicks approach". Now 3,6 million of banking clients (24% of total customers) use internet and in this respect we are on comparable level as Western peers. Polish banks managed to adopt credit risk management tools to group of clients with centralisation whole process of risk management. Leading banks now are finalising the scoring system for retail and SME's.

Retail banking

Polish banks similarly to the banks from the whole Region have a large gap to catch up with the EU level. For example assets to GDP in Poland account for 65% and are 4 times lower than the EU average of 243%. The gap in loans is threefold (30% vs. 93%) and in deposits twofold (40% vs. 81%) but in strategic products, such as mortgages is almost 10 times smaller. The ratio of mortgages for private individuals to GDP in Poland accounts for below 5% vs. the EU average of 40%.

Only half of Poles possess own current accounts but almost all of the EU adults hold them in the banks. Almost half of banking clients in the EU use credit cards and other banking products while in Poland a penetration ratio is much lower. Polish banks have a big quantitative gap to western countries but also vis a vis a whole Region. In term of penetration ratios in loans and deposits, only two countries: Bulgaria and Romania are behind Poland.

Development of the size of housing loans for individuals

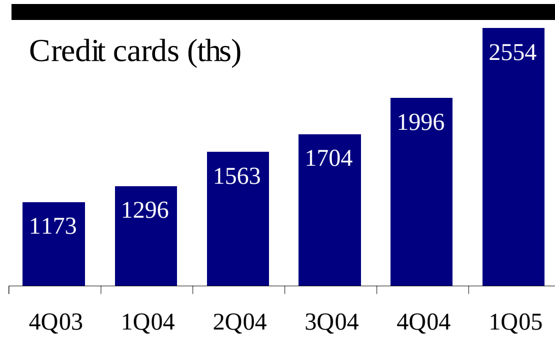


→ Average annual growth >30%
→ Mortgages/GDP: 1996 – 0.3%; 2004 - 5%; 2015 – 20%
→ Penetration ratio: 4% of households in 2004 to 18% in 2015e

Polish banks as well as other financial institutions pursue strategies of mature markets but at a much faster pace. Western European banks have developed for a long time in market environment while banks from the Region have undergone the transformation process for 10 to 15 years. A good example to illustrate fast development of Polish banks is leapfrogging from cash to cards society skipping a phase of checks. Looking at the main pillars of Polish retail banking in the past, at present and in the future, it is necessary to underline that:

- in the past, Polish banks did not have any strategy and clear focus on their groups of clients. Now leading universal banks focus on the same targets of retail clients: high net worth individuals, middle class as well as young and well educated people. A similar tendency will remain in the future. Banks want to concentrate on value added clients who are of a big potential for cross-selling,
- the fastest growth is in key retail products such as: mortgages, mutual funds and credit cards where Polish banks have the largest gap to their EU peers. For example ten years back the ratio of residential mortgages to GDP accounted for less than 0,3%, now it is almost 5% and we estimate that within next 10 years it will be 18%. Almost 17% of banking clients now use credit cards and according to our estimation within next 10 years almost 50% of banking clients will utilise this product. Now the ratio of mutual funds assets to GDP is 4,5%, what it is 10% share in retail savings and at the end of 2015 almost 30% of Poles savings will be allocated in mutual funds - it will be on the EU average level from 2004. In the mutual funds market we observe following tendencies; (i) higher market concentration (the share of 3 top players exceeds 55%, but the leader holds a market share of over 36%; (ii) growth of hybrid funds to the detriment of bond funds in the environment of interest rate cuts, (iii) stronger activity of Luxembourg funds and those from other countries addressing their product offer at high net worth individuals.

Credit cards (ths)



→ 70% average annualized growth rates
→ Credit cards constitute 12% of total cards (2008e –27%)
→ 5.2 card transactions per capita vs. 0.67 in 1999

Retail savings' structure

Financial instruments	Poland (2004)	Spain (2002)
Bank deposits	60%	46%
Securities	20%	16%
Investment funds	10%	30%
Life insurance	10%	8%

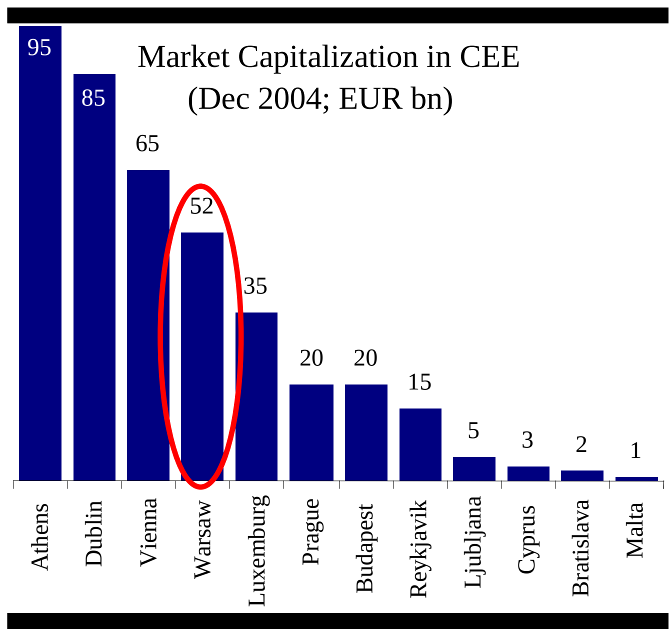
The good illustration of big growth potential in strategic retail products is annual growth rate during last 3 years in mortgages, which exceeded 30% and credit cards with a 70% average growth rates per year.

The most important competitive advantage in selling these strategic products are credit risk management tools implemented by banks and centralized data on clients' performance within the whole banking system. It helps banks to take quick and proper decisions and to be flexible on the very competitive market. A long time ago back in 1993 - Polish Banking Association started to build a central data office so called "Credit Information Bureau" collecting complex information on creditability of retail clients. Now this office is also in process of preparation to cover also the SMEs. As to the data on clients' standing Poland has been distinguished by the World Bank as a positive example not only among the CEEC but also in whole Europe.

Tendencies observed in Poland show that our country is heading more for the Anglo-Saxon model of financial sector. It is visible in fourth factors.

Firstly, this trend is reflected in the structure of retail savings' allocation by Poles where at the end of 2004 share of securities accounted for 20%, mutual funds - 10%, banking deposits - 60% and the rest of 10% is taken by life insurance. Ten years back almost 90% of retail savings was allocated in banking deposits. The share of securities in Poland at the end of 2004 was high in comparison with other EU countries for example it is comparable with the Spanish deposits structure in 2002.

Secondly, market capitalization in at the end of 2004 accounted for 50 bn Euro and its ratio to GDP in Poland is only 2.6 times lower than the EU average despite that the WSE opened up only 15 years ago while European mature markets have been growing for a very long time.



Thirdly, the share of individual domestic investors on the WSE is growing systematically and reached over 35% of the total turnover last year.

And finally pension reform which was finalized in 1999 has had a multiplying effect on the Polish capital market and is stabilizing local stock markets. Total assets of open pension funds have increased by almost PLN 10 bn yearly and equal almost PLN 70 bn now.

The question is how stable is this tendency in the Polish economy? In my opinion it depends mainly on growth potential of domestic capital market in the process of creation of Pan – European financial market. As long as the Polish floor attracts new issuers (both domestic and foreign) and offers high returns on investments, the WSE will keep impressive growth dynamics. Key challenge is the privatisation of the WSE in a way that ensures a proper shareholding structure, with a strategic partner from mature markets, who will be able and interested in development of the Polish capital market.

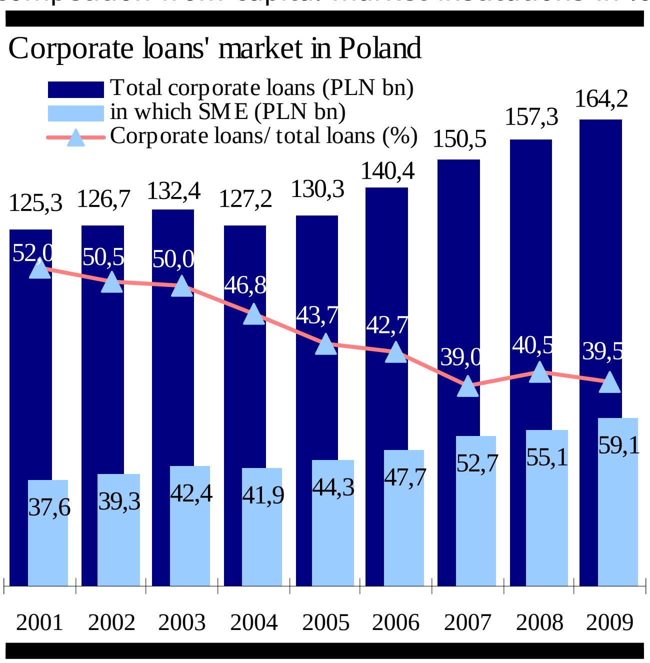
SME -SEGMENT

The Polish leading banks have changed their approach vis-à-vis SMEs. 10 years ago SMEs were not a target group for domestic banks for the following factors: (i) lack of creditability, (ii) no tools for credit risk management, (iii) changeable
and unpredictable financial standing. Now the largest Polish banks have announced that this segment is a key target group for their business strategies with such products as: payment cards, overdrafts, advisory related to the EU funds co-financing and internet access to current accounts.
What factors have decided on the change in banks' strategy to this segment?
There are three main factors: (i) growing importance this group of clients in Polish economy, (ii) passed exam by entrepreneurs after EU accession, (iii) visible improvement credit risk management tools in banking sector.

In Poland over 3,5 million clients belong to SME segment, who employed 7 million Poles and deliver almost 50% of the volume of GDP, have 50% share in export and 60% in import. Micro, small and medium sized enterprises play a central role in the European Union economy. There are a major source of entrepreneurial skills, innovation and employment. In the enlarged European Union of 25 countries, same 23 million SMEs provide around 75 million jobs and represent 99% of all enterprises.
The accession to EU accelerated development of SMEs mainly because of access to structural funds, aim to growing its competitiveness on European Union market.
The SME management in the Polish banks is developing towards a retail customers services model and is part of retail division. Apart from banks, it is also visible growing importance of of domestic capital market in financing this group of customers. 2004 was the best year for domestic capital market from the SME segment perspective for 2 reasons. On the one hand Poland noticed impressive growth in the number of new issuers on the WSE. 36 new offers happened in 2004 and 15 within the first 5 months of this year. On the other hand a decreased cost of public offer and high return on equity attracted new issuers as new investors. The best ROI was recorded in small companies and equalled 72.9% as compared with 36.3% for medium companies and 27.9% as a market average.

CORPORATE

In the corporate segment we are witnessing same new tendencies. The first one is the increased competition from capital market institutions in long-term financing. This will be more and more visible along with the implementation of Financial Services Action Plan. The second tendency is a decreasing share of loans for corporate customers in the total loan portfolio to below 40% in next five years. Thirdly, domestic loans are being replaced by foreign debt. The indebtedness of Polish companies abroad reached almost 40 bn EUR, that is over 30% more than the domestic debt. And finally, banks are selling wide range of products from money and capital market for this segment (foreign exchange and interest Swap’s, derivative & structured instrument).



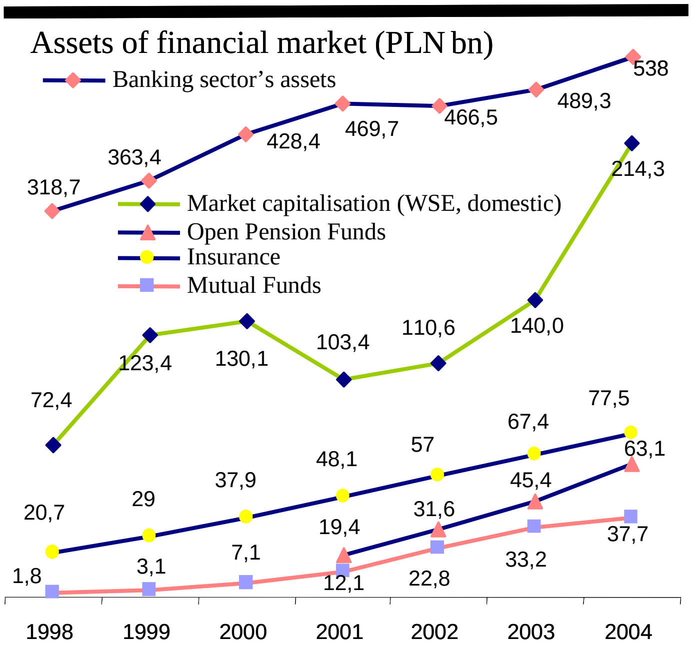
This segment has remained the most competitive for Polish banks since early 90 – ties due to foreign banks, who assist their clients and help them expand business activities in this Region. Drop of margins in corporate loans can serve here as a good example. In blue chips financing interest spreads are even lower than the average EU level. On the other hand, Polish banks have recorded impressive growth in electronic banking and transaction settlement for this group of clients, as a consequence of their growing exports and imports after the EU accession.

EU MEMBERSHIP HAS ACCELERATED THE DEVELOPMENT OF FINANCIAL MARKET IN POLAND AND HAS ATTRACTED NEW FOREIGN PLAYERS

The performance of financial market after first year of participation in the European Union improved, thanks to a positive influence on macroeconomic recovery and excellent performance of Polish companies. The GDP growth of by 5.3% last year was one of the highest since 1997 due to hefty upturns in exports by 30%, investments - by 5.1% and private demand by 4.5%.

The fastest growth was visible on the capital market, where local companies' capitalization on the WSE rose by 53%. This tendency is visible also in this year. For example on 22 June of 2005, the total market capitalization is equal to PLN 336 bn (together with foreign issuers) and PLN 230 bn. That means that 32% of the Warsaw exchange market capitalization comes from foreign companies such as: IVAX, MOL, BA-CA, Borsodchem, BMP AG – a German venture capital.

Assets of pension funds grew last year by 40%, insurance sector by 15%, investment funds by 13% and banking assets by 10%. Despite a very strong growth of assets in other financial segments- banks remain a main player with 2/3 share in total assets in finacial sector (excluding WSE). The second and third places in financial assets belong to insurance (10,7%) and pension funds (8,7%)

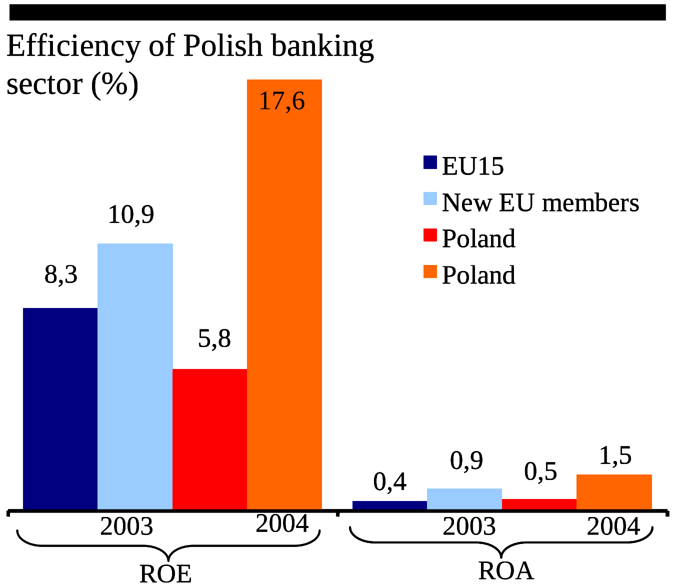


Source: STFI, KNUiFE, NBP, GPW

Single "European Passport" helps dismantling of barriers for foreign financial services providers. We are observing growing competition from the EU credit and financial institutions. 70 foreign banks expressed their interest in cross border activities. New entrants of mutual funds and insurance institutions as well as 6 EU brokerage offices are willing to become a cross-border WSE member.

During 2004 net profit of the Polish banking sector tripled, reaching the all-time high of PLN 7.3 bn. This improved efficiency ratios: ROE grew up to 17.6%, ROA to 1.5% and C/I ratio down to 56%.

In 2003 our average financial performance was three times lower with ROE of 5.8% and ROA – 0.5%. Last year proved that the effect of scale in the banking sector played a positive role in terms of earnings' generation. The share of 5 biggest Polish banks in total banking assets accounted for 53% whereas in net profit - 65%. Apart from macroeconomic factors both the reduced corporate tax rate (from 27% to 19%) and the liberalization of loans' classification rules had a positive influence on banks' earnings in 2004. Despite improving the quality of assets, share of non performing loans is still high and at the end of 2004 accounted for 14,6%.



For several years in the banking sector we have been observing a slowdown in retail deposits due to attractiveness of investment funds while retail loans have been growing systematically. In my opinion this mismatch between annual growth rates of loans and may hamper internal financing. Banks will be obliged to finance more often their business via capital market instruments and the EU accession is facilitating this type of financing. Why? Because of: (i) the improvement of their creditability by rating agencies after the EU accession what brought cheaper cost of finance, (ii) growing importance of public listed banks on local stock exchanges.

Concluding this paper I would like to underline follows tendencies on financial market in Poland after EU accession.

Firstly, domestic financial market institutions have a big growth potential although their dynamics will be different across market segments;

Secondly, the future looks promising for retail segment however banks should enhance sales-oriented corporate culture and concentrate more on cross-selling and value added clients. The key success factor in retail banking is customers' oriented approach across the whole organization.

Thirdly, importance of SMEs segment for domestic banks will be more and more visible because it is the main target group in face of globalisation and liberalization processes. Banks changed their role vis-à-vis this segment and are becoming "advisers" especially in the EU-funds co-financing. For this group of clients the most important is the improvement of credit risk management as well as the product packages adopted to life cycle of clients.

And the fourth conclusion is that the key challenges for corporate are: the development of comprehensive product offer combining banking and capital market instruments such as structured finance and cross-selling as well as the improvement of banks' competitiveness in effective financial risk management, as a very important offer for corporate.

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