REPORT ON THE CONDITION OF BANKS IN 2011

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MOST IMPORTANT OBSERVATIONS AND CONCLUSIONS

In 2011, the situation in the banking sector remained stable. The situation within the scope of capital base and liquidity was good, and at the same time the banks reported record financial results. The activity of the banking sector, measured by the rate of growth of balance sheet total, employment and sales network, remained moderate. A significant increase in lending to the enterprise sector, a certain slow down to the rate of lending to households as well as a slight increase to the rate of increase to the non-financial sector deposits were reported.

In some areas, unfavourable events have been observed, which may have a negative effect on the functioning of banks in forthcoming periods, and in particular:

- deterioration in the external banking sector environment;
- unfavourable structure of the housing loan portfolio and mounting problems associated with servicing of these loans;
- too high a share of foreign currency assets in some banks and foreign currency mismatch of assets and liabilities structure;
- excessive dependency of long term lending on short term deposits;
- limited effectiveness of the interbank market.

Some of these events are independent of the banks, however **most stem from the business model and should be subject to a fundamental change.**

- The current **situation regarding the capital base is good.**

  The value of own funds increased (from PLN 100.6 bn at the end of 2010 to PLN 110.9 bn at the end of 2011, i.e.: by 10.2 per cent). As of the end of 2011 all commercial banks complied with the minimum own fund requirement. Considering cooperative banks, the weakening of zloty caused 3 of them not to comply with the minimum own funds requirement, but the scale of the shortage was low.

  The solvency ratio in the banking sector **decreased** (from 13.8 per cent at the end of 2010 to **13.1 per cent** at the end of 2011), whereas the ratio at all banks was above the statutory minimum (8 per cent). The good capital situation is also affirmed by the fact that only a small number banks have a solvency ratio of below 12 per cent (15 commercial and 74 cooperative) and Tier 1 indicator of less than 9 per cent (5 commercial and 27 cooperative).

  Despite that fact, further capital base consolidation is recommended. This stems both from the level of risk accumulated on the balance sheets of banks, and from difficult external conditions, which may generate further disruptions in the operations of financial markets and influence the deterioration of the financial situation of some banks' customers. As a result **PFSA Chairperson issued individual recommendations to banks to limit the distribution of profits for 2011,** in order to further strengthen the capital base and the ability to withstand unexpected losses.

- The current **liquidity situation is good** (positive short term liquidity gap PLN 140.1 bn).

  Compliance with PFSA Resolution 386/2008 was satisfactory (the number of violations of the resolution was small and they typically concerned entities of marginal importance in the scale of the system).

An increase of the primary liquidity provision (by 6.4 per cent), supplementary liquidity provision (by 24.1 per cent) and stable foreign assets (by 12.0 per cent) were reported. The ratio of loans to deposits, which indirectly determines the scale of demand for funds from financial markets, after reaching a maximum at the turn of 2008 and 2009, remained relatively stable in recent years (oscillates between 107 - 114 per cent; at the end of 2011 amounted to 109.4 per cent).

The deterioration of mutual confidence among financial market participants and periodically occurring serious disruptions in the operations of financial markets are the primary obstacles in liquidity management. Thus, there is still a **need for steps aimed at strengthening the stability of sources of financing** and developing operational strategies that will take into account difficult external conditions.

An unfavourable situation persists on the domestic interbank market, marked by limited operational effectiveness. This manifests itself by low market turnover, low proportion of transactions with maturity of more than 1 day and low reciprocal credit limits, which were significantly reduced in 2008-2009 due to worries associated with the growing financial crisis (PFSA research showed that surveyed banks concluded 5213 transactions of total value equal to PLN 776.3 bn, out of which 91.5 per cent of the total number of transactions and 91.3 per cent of their total value constituted O/N transactions). Considering the current Polish banking sector situation **there are no justified reasons, for the market to function in a limited scope.** Therefore, restoration of mutual confidence is essential, which would contribute to, inter alia, extending higher reciprocal limits.

- **A significant net profit increase in the banking sector was reported** (from PLN 11.4 bn in 2010 to PLN 15.7 bn in 2011, i.e.: by 37.5 per cent), **stemming** predominantly **from an increase in net interest income and a reduction of the negative balance of write-downs and provisions.**

The primary factor for the increase in net interest income (by 13.1 per cent) was an increase in interest income obtained mainly due to an increase in the volume of loans and MPC increases to interest rates. On the cost side, it is worth noting the relatively low increase in interest paid to households. This resulted from the fact, that in the first half of 2011, banks strived to improve the net interest income at the cost of retail customers and only in June did they decide to make deposit interest rates more attractive (this was reflected in the increase of interest costs in the second half of the year, and particularly in the fourth quarter).

The decrease in the negative balance of write-downs and provisions (by 22.6 per cent) resulted from the decline in write-downs for consumer loans (-48.0 per cent), and, to a lesser extent, also from the decline in write-downs for loans to the enterprise sector (-30.8 per cent). On the other hand, a **further increase in write-downs for housing loans** (52.4 per cent) and IBNR was reported. Looking at the quarterly changes, Systematic decrease in write-downs on account of consumer loans and a simultaneous increase in write-downs on account of housing loans is evident (in the fourth quarter of 2011 write-downs on account of consumer loans were at their lowest level for 3 years and write-downs on account of housing loans were at their highest level ever)

Other items had little effect on improving banks' results. The relatively low growth rate of fees and commissions revenues (4 per cent) should be noted, which should be linked to, inter alia, decreasing rate of growth of lending to households, subdued activity on the capital markets as well as restricted ability for further increases in bank service fees. The rate of growth of costs was limited (5.0 per cent).

The positive tendencies were reflected in **an improvement to operational effectiveness measurements** (inter alia C/I reduction from 52.3 per cent in 2010 to 50.9 per cent in 2011 and ROE increased from 10.2 per cent to 12.8 per cent).

The banks financial plans indicate a stabilization of 2012 results at 2011 levels, whereas at a third of the banks a reduction of profits is expected.

- **The rate of growth of lending was moderate** (the total value of loans increased from PLN 787.5 bn, to PLN 911.3 bn i.e.: by 15.7 per cent, and upon eliminating the effect of changing exchange rates, the increase would be approximately PLN 89 bn i.e.: approximately **10.8 per cent**). The main areas of lending growth were loans to the enterprise sector, housing loans and loans to individual entrepreneurs and the budget sector.

In 2011 **a significant revival of lending to enterprises occurred** (value of loans increased by 20.4 per cent, and upon eliminating the effect of changing exchange rates by circa 16.8 per cent). It should be added that and upon eliminating the effect of changing exchange rates, **for the first time since the 90s, the growth of lending to enterprises exceeded the growth of lending to households**, which, in the current situation, should be considered favourable from the point of view of economic growth. The product structure of the increase should also be considered as favourable, i.e.: the i**ncrease in operating loans** (by 16.5 per cent) **and investment loans** (by 28.7 per cent), which on the one hand, indicates increased economic activity and on the other should be beneficial to the economic growth rate in forthcoming periods. Therefore, a scenario seems to play out, where the economic recovery begins to translate to increased demand for loans by enterprises, while the stabilisation of the loan portfolio quality begins to translate to increased supply by banks.

The primary danger to the growth of lending is the deterioration of the investment climate, economic downturns experienced by Poland's major trading partners and the expected reduction to the growth rate of the Polish economy. It may lead to another drop in demand for loans by enterprises, as well as more selective supply by banks.

A large increase in the nominal value of housing loans (19.2 per cent) was, to a large extent, caused by a weak zloty. Once the effect of exchange rate fluctuations is eliminated, the growth rate is similar to that in previous periods. **The clear dominance of zloty loans in the structure of new loans should be deemed favourable. However,** circa **20 per cent share of foreign currency loans in new loans is still too high** and entails a number of risks. The all time high proportion of loans with LTV exceeding 80 per cent in the structure of new loans (over 50 per cent of sales), excessively long repayment periods (25 year and longer loans constituted circa 70 per cent of new loans), further increases to the average value of new foreign currency loans (average value of foreign currency loans was twice that of zloty loans) should also be considered unfavourable.

In the second part of 2011, **a decrease in the growth rate of housing loans** was observed (adjusted by exchange rate fluctuations). This stemmed from a tightening of lending policies at some banks, changes to the "Rodzina na swoim" Programme (reduction of conversion factors) and a partial decrease in demand (fears regarding future financial situation, expected real property prices fall). In 2012 the factor causing a slow down in lending may be the entry into force of all the provisions of Recommendation S. A significant barrier to further market expansion are high real property prices, which limit their availability to average households.

The fall in the value of consumer loans (by 2.7 per cent) **are primarily the result of a sale of part of the loan portfolio and restrictions in lending by banks which incurred significant losses in this sector in previous years.**

The **slow down** observed in recent periods in terms of **consumer loans should be associated** with a number of factors. First and foremost this stems from **self-regulation by banks** which occurred due to a reduction in the quality of consumer loans and the necessity to create large write-downs (in 2008 the value of write-downs due to consumer loans amounted to PLN 3 bn and in 2009-2010 increased to circa PLN 7 bn per annum). At the same time, the **financial crisis** led to a certain change in the attitude of banks and their customers, which resulted in a reduction to supply and demand (similar to other eurozone countries). The **adoption of recommendation T** may also be a limiting factor. However, it should be pointed out that despite its adoption, some banks reported an evident increase in lending. Furthermore, it is difficult to consider most provisions of the said recommendation to be restrictive (the recommendation sets out a number of good practices, which should become a permanent element of responsible banking practices), and a number of banks reacted positively to the recommendation, indicating that it reduced negative competitive pressures. On the other hand, considering the short term character of consumer loans, certain amendments to some provisions of the recommendation should not be ruled out. **The gradual increase in competition from non-banking institutions** is limiting the growth of consumer loans. **A situation where banks or their parent entities conduct or intend to conduct activities of this type should be considered inappropriate** (this leads to a transfer of credit risk to a different location of the same capital group, increase of compliance and reputation risk, reduction of transparency and causes negative competitive pressures).

- **The total value of liabilities increased** (from PLN 1,043.4 bn to PLN 1 166.0 bn i.e.: by 11.8 per cent, and upon eliminating the effect of changing exchange rates by circa **8.5 per cent**).

Liabilities were dominated by the non-financial sector deposits (59.9 per cent) as well as deposits and loans received from the financial sector (22.9 per cent), followed by deposits of the budget sector and own issues. However, **significant differences are to be observed** amongst the banks **within the financing of operations structures, which stem from differences in their business models** (banks relying on non-financial sector deposits, banks which predominantly or to a very large extent depend on funds from the financial market or parent capital groups as well as banks using a mixture of the two to develop their business may be distinguished).

From the point of view of the country of origin of the funds, **domestic liabilities are dominant** (79.2 per cent), **however foreign funding plays a very significant role for some banks.**

- The value **of deposits from the non-financial sector increased** (from PLN 620.4 bn to PLN 698.5 bn i.e.: by 12.6 per cent, and upon eliminating the effect of changing exchange rates by circa **11.2 per cent**), which was caused by an increase in deposits by household (from PLN 422.4 bn to PLN 477.4 bn, i.e.: by **13.0 per cent**) and enterprises (from PLN 182.8 bn to PLN 205.9 bn, i.e.: by **12.6 per cent**). However most of this increase occurred in the fourth quarter of 2011. This phenomenon is partially cyclical, and partially stemmed from an improvement of the deposits offered by banks and a "collapse" on the capital market which resulted in a transfer of some funds to banks.

A high level of "tax free interest investments" should be considered unfavourable (as of the end of 2010, 10.1 m investments of this type were entrusted to banks, with a total value of **PLN 94.7 bn**), **and as such constituted a dominant part of liabilities at some banks.** Such products entail various types of risks, both at a level of individual banks as well as the entire sector in relation to which **the PFSA Chairperson recommended that banks withdraw all such "tax free interest" products from their offers.**

In the context of risk associated with deposits, the **increase** (as of 31 December 2010) **in the amount of BGF guaranteed funds to the equivalent of EUR 100,000** (adjusted to statutory EU requirements) should be pointed out. On the one hand, this represents a significant change **improving the safety of the banking system, but on the other it introduces a certain destabilisation factor.** This stems from the fact that some customers will invest in bank deposits offering the best terms without evaluating the risk profile of the bank (they will base their decisions only on the interest rates paid by the bank). These customers are aware that in the event of a "collapse" of the bank, their funds will be refunded immediately and in full up to an amount of EUR 100,000. The said changes **favour banks with an "aggressive" strategy** and to a large extent explain the significant success of some banks is securing deposits.

The very low proportion of deposits with maturity of more than 1 year (1.3 per cent) constitutes an unfavourable phenomenon in the deposits base structure.

- **Deposits and loans from the financial sector have increased** (from PLN 244.8 bn to PLN 266.7 bn, i.e.: by 8.9 per cent, upon eliminating the effect of exchange rate fluctuations by circa 1.0 per cent).

  The majority of the financial sector deposits and loans originated from foreign parent capital group entities.

- **The level of foreign funding remains relatively stable.**

  The value of liabilities with respect to foreign entities increased (from PLN 214.8 bn to PLN 242.4 bn, i.e.: by 12.8 per cent, upon eliminating the effect of exchange rate fluctuations by circa 2.8 per cent), whereas in the second part of 2011, in "real terms" (after adjusting for exchange rate changes), a reduction of these funds was reported. This stemmed primarily from transactions on the money market conducted by two branches of credit institutions and a partial change to the funding structure at two banks.

  The level of foreign funding measured by its share in the balance sheet total has been stable for a number of years (as of the end of 2011 this share amounts to **18.7 per cent** as compared to 18.5 per cent at the end of 2010).

  Most foreign funds originate from parent capital group entities (according to data, as at the end of 2011 the said funds amounted to **PLN 145.9 bn** not accounting for branches of credit institutions), which, on the one hand, increases the stability of these funds, but on the other, makes the banks more dependent on the parent company situation.

  The largest proportion of liabilities with respect to foreign entities occurred at small banks and branches of credit institutions under the control of foreign capital, where, in general, it exceeded 50 per cent. These funds also constituted a large proportion at some medium and large banks controlled by foreign investors, which in recent years developed lending in terms of housing loans (and to a lesser extent also consumer loans). And due to a lack of appropriate deposit base, these banks took advantage of foreign parent capital group funds.

  Fluctuations in the level of foreign funds stem primarily from changes in exchange rates and investment strategies implemented on the money market by some banks and branches of credit institutions. In particular, exchange rate fluctuations of 5-10 per cent may cause changes to the nominal values of these funds of PLN 10-20 bn. Similarly, fluctuations may stem from a build-up of transactions by active players on the money market.

  In the near future, **PFSA recommendations regarding restricting financing of households in foreign currencies as well as diversifying and extending sources of operational funding may act to limit foreign funding.** As a result, a decrease in the requirement for parent capital group funds should occur. **The PFSA intends for this to be a gradual process, which will not lead to disruptions in the functioning of the market nor to an increase in the cost of financing.**

- **Phenomena generating a number of risk types and which may constitute a source of potential threat are observed within the balance sheet structure. Particularly, the high share of foreign currency assets and excessive dependency of lending on short term deposits should be considered to be unfavourable.** A number of these phenomena are a natural element of banking and stem from the roles played by banks in the economy (i.e.: acting as links between entities seeking funds and entities with surplus funds, whereas the structure of supply and demand of funds varies and its the function of the bank to make the match), but most stem from the excessively expansive business models of some banks.

High proportion of foreign currency assets (as at the end of 2011 the total value of foreign currency assets amounted to PLN 363.1 bn and constituted **28.0 per cent of balance sheet total** as compared to PLN 290.1 bn and 26.3 per cent respectively as at the end of 2010) **stemmed primarily from the growth of foreign currency loans to households** (total value of foreign currency receivables form households amounted to PLN 212.7 bn and constituted 58.6 per cent of the total foreign currency receivables of banks) including primarily housing loans (PLN 196.6 bn; 54.1 per cent of foreign currency assets). High value of foreign currency loans to households results in is indicative of the scale of risk undertaken by banks and their customers and contributes to the increase in risk within the financial system. In particular it should be noted that **most households are not protected in any way against currency risk.**

The situation, where a number of large and medium banks, operating almost solely within the territory of Poland, **holds a high proportion of foreign currency assets** (in some cases exceeding 40 or 50 per cent), mainly as a result of foreign currency loans to households and only to a small extent due to foreign currency loans to enterprises **should be considered to be unfavourable.**

Banks balance sheet structure exhibits large disproportions in terms of maturity of assets and liabilities (as at the end of 2011 assets with terms to maturity of more than 1 year constituted 59.6 per cent of balance sheet total, whereas liabilities with an analogous term to maturity 13.0 per cent; even larger disproportions occurred considering terms of more than 5 years, where assets constituted 34.3 per cent of balance sheet total and liabilities only 5.3 per cent). **The fundamental reason for these disproportions is the growth of long term housing loans**, which are predominantly financed based on short term deposits of the non-financial sector and funds acquired from foreign parent entities (also, to a large extent, short term, but constantly renewed) and only to as small degree by long term liabilities.

The significant mismatch of terms to maturity is indicative of long term lending being based on short term deposits and contributes to an increase in liquidity risk. Therefore, **it is necessary for banks to increase the proportion of long term, stable sources of funding for lending**, inter alia, by making the long term deposits more attractive, building long term relationships with customers and issuing long term debt instruments. Shorter periods for which housing loans are granted would alleviate pressures in the balance sheet structure, as these are the dominant reason for the high level of mismatch (of both foreign currency and terms to maturity). This would also facilitate banks in issuing debt instruments based on portfolios of these loans, by reducing risk and simplifying the estimation of its scale.

Lack of appropriate long term sources of funding assumes additional significance in the context of CRD IV/CRR, which introduce a new measurement of liquidity, the so called NSFR, which aims to avoid excessive transformation of terms to maturity and ensure mid and long term liquidity.

- **The value of non-performing loans increased** (from PLN 61.8 bn as at the end of 2010 to PLN 66.8 bn as at the end of 2011, i.e.: by 8.0 per cent), **however the scale of the increase was less than in 2010** (PLN 5.0 bn as compared to PLN 10.9 bn). At the same time, as a result of increased activity within the entire loan portfolio, the **proportion** of these loans **decreased** (from 7.8 per cent to **7.3 per cent**). However it should be noted, that one-off events (sale of "bad credit" section of the portfolio, changes in accounting policies at some banks) influenced the decrease in the growth of non-performing loans.

The situation in the portfolio of loans to the financial and budget sector remained stable, and the quality of these portfolios was high.

The value of consumer non-performing loans in banks balance sheets stabilised (increase from PLN 23.2 bn to PLN 23.4 bn). However the low growth of non-performing loans was predominantly the result of "bad" receivables sales (PLN 2.6 bn) and writing-off these sections of the portfolio as provisions (PLN 0.8 bn). If it wasn't for these transactions, the growth of non-performing consumer loans would have been significantly higher (PLN 3.6 bn), however still lower than in 2010. As a consequence of the low growth of non-performing loans, a slow down to the increase of their share in the portfolio occurred. Although the said share did increase (from 17.3 per cent to 18.0 per cent), but this was a result of a fall in value of the said loans portfolio. However, forthcoming periods may bring a further increase in the share of these loans which stems, inter alia, from a high level of loans overdue by more than 30 days (increase from PLN 25.2 bn to PLN 26.1 bn) which exceeded the level of non-performing loans. On the other hand, the decrease in the level of loans overdue by less than 30 days (from PLN 9.1 bn to PLN 8.5 bn) may indicate a gradual easing of this negative pressure.

A decisive factor in the sector wide **increase to non-performing loans** observed in 2011 **was the increase in non-performing housing loans** (increase from PLN 4.9 bn to PLN 7.5 bn). Although the quality of these loans, measured by the proportion of non-performing loans was high (proportion increased from 1.8 per cent to 2.3 per cent), it should be remembered that the history of the majority of this portfolio is short and furthermore constitutes a high proportion in the balance sheets of many banks. **A significant deterioration in the repayments of these loans** has been reported, measured by an increase in payments overdue by more than 30 days (from PLN 5.7 bn to PLN 9.1 bn), whereas the increase in loans overdue by more than 30 days (PLN 3.4 bn) was higher than the increase in non-performing loans (PLN 2.5 bn), just as their share of the loan portfolio (2.9 per cent compared to 2.3 per cent). This will most probably exert negative pressure on the portfolio quality measured by the share of non-performing loans as well as financial performance of the banks in forthcoming periods. Furthermore, a **number of unfavourable events have been observed in this portfolio** (see below).

The quality of remaining loans to households deteriorated (an increase in non-performing loans from PLN 6.0 bn to PLN 7.7 bn; proportional increase from 8.1 per cent to 9.2 per cent), **which stemmed from an increase to non-performing loans extended to individual entrepreneurs** (mainly operating and investment).

The value non-performing loans to enterprises increased slightly (form PLN 27.2 bn to PLN 27.8 bn). An improvement to the financial situation of some enterprises was a contributing factor to the stabilisation of non-performing loans levels. The relatively low increase in non-performing loans was also a result of a change in the methods of classification of exposure with value impairment at one of the banks. As a consequence of non-performing loans level stabilisation and robust dynamics of lending to enterprises the **share** of non-performing loans **decreased** (from 12.4 per cent to **10.5 per cent).**

However, subsequent periods mat bring a deterioration of the loan portfolio quality, which stems from the slow down in the economic growth rate and deterioration of the job market expected in 2012-2013. Consequently, a deterioration in the financial situation of some borrowers which will exert negative pressure on the loan portfolio quality and performance of banks should be taken into account.

- **Despite the current high quality of housing loans portfolio** (however, a deterioration occurring at some banks), **a number of events which may have a detrimental effect on the future situation of banks are observed in the said portfolio.**

In 2011, **an increase in the number of borrowers having problems with servicing their housing loan liabilities** has been observed. PFSA research shows that at the end of 2011, banks' portfolios contained **31.6 thousand non-performing loans** and **39.3 thousand loans overdue by more than 30 days.**

The foreign currency structure of the loan portfolio dominated by foreign currency loans (in excess of 700 thousand loans with a value of nearly PLN 200 bn, constituting over 60% of the entire portfolio) **should be considered as unfavourable.** They generate various types of risk, both for customers as well as banks. In particular, they are due to exchange rate risk and the significant interest rate increases of foreign currency instruments expected in future. Furthermore, the issue of risk associated with funding of these loans, negative attitude by some participants of the financial market and rating agencies as well as their negative impact on the effectiveness of MPC should be borne in mind. At the same time, the high proportion of high denomination foreign currency loans in the portfolio (23.1 per cent of the portfolio value constituted foreign currency loans of more than PLN 500 thousand, which was a result of zloty weakening, but also indicates the scale of potential threats to banks and their customers) is an unfavourable phenomenon.

From the borrower's point of view the biggest danger arises from the possibility of unfavourable changes to the exchange rates occurring whilst they are forced into early termination of the loan agreement. In such a situation, they have to account for the possibility of incurring significant losses, which, for average income borrowers may endanger the stability of their households. From the bank's point of view, the risk associated with foreign currency loans, stems from the possibility of a significant deterioration in repayments of these loans during periods of weak zloty and economic downturn of the real property market. In such a situation, the foreign currency loan portfolio will generate losses, which may lead to a significant deterioration of the financial situation of banks whose business is dependant to a large extent on the quality of housing loans portfolio.

PFSA research disproves the view concerning the higher quality of foreign currency loans. As at the end of 2011, **the quality of foreign currency and zloty loans was similar,** and the higher share of non-performing loans in the zloty loan portfolio stemmed from the currency conversion of some non-performing foreign currency loans into zloty (post-adjustment, the share of non-performing loans in zloty loans was **2.45 per cent** and in foreign currency loans **2.27 per cent**). In this context it should be noted that **PFSA research contradicts the theory that foreign currency loans were extended to individuals on higher incomes** (in excess of 250 thousand loans were granted to borrowers whose net income did not exceed PLN 4 thousand and over 150 thousand to borrowers whose net income was in the region of PLN 4-6 thousand, which, considering the fact that these loans were often taken out by two borrowers, should be considered to be average values).

High average loan portfolio LTV should be considered as unfavourable. According to PFSA research, at the end of 2011 **the LTV value of the entire portfolio** of housing loans was about **81.6 per cent (zloty 63.8 per cent; foreign currency 94.7 per cent).** With regard to **252.9 thousand loans, total value PLN 103.1 bn, LTV exceeded 100%** (for 139.2 thousand loans, with a value of PLN 62.8 bn, LTV was more than 120%), whereas the majority of these loans were foreign currency loans. This means that **for loans constituting 33.1% of the value of the entire portfolio the real property value which constitutes the primary collateral for extended loans is lower than the value of extended loans.** Furthermore, the banks portfolios contained more than 250 thousand loans with LTV in the 80-100 per cent range.

Potentially the largest risk is associated with the portfolio of loans granted in 2007-2008, and in particular foreign currency loans. This stems from the fact that they were generated during a period of all time high real property prices and all time high zloty exchange rates against the major foreign currencies (in terms of foreign currency loans extended in the said period, **the current debt expressed in zlotys is, in many cases, more than 50% higher than at the time of borrowing).** Furthermore, a significant number of these loans were extended at high LTVs (frequently exceeding 100%) and at reduced lending standards (e.g.: underestimated living costs). **A high risk is also associated with loans granted in 2009-2011,** which stems from the still high proportion of foreign currency loans in total lending, high LTVs and real property prices. The rapid deterioration of 2009-2010 loans (3 per cent of 2009 loans overdue by more than 30 days as compared with 2.9 per cent of 2006 loans with a similar value of the loan portfolios) is of concern. This means that despite the experience gained by banks and customers in relation to the financial crisis, banks still engaged in overly liberal lending policies and borrowers accepted excessive risk. On the other hand, **the lowest risk is generated by the portfolio of loans extended up to the end of 2005** (despite the lowest current quality of this loan portfolio), which stems from the fact that they were for lower amounts, and additionally the significant rise in real property prices which occurred once they were granted resulted in a restriction of the scale of potential losses at the level of customers and banks (in the majority of cases the sale of real property should be sufficient to repay the liabilities with respect to a bank).

The **excessive product concentration** also poses a significant threat which stems from a high proportion of housing loans in the balance sheets of some banks (**in 2004 - 2011 the share of housing loans in the assets** of the banking sector **increased from 7 per cent to 24 per cent, and from 17 per cent to 41 per cent in the loans to the non-financial sector** whereas these ratios were significantly higher at some banks. Consequently these banks made their future financial condition dependent on the quality of the housing loan portfolio and the future situation on the real property market, and due to the high share of foreign currency loans, the situation on the foreign exchange market and the level of interest rates shaped by foreign monetary authorities will exert a strong influence.

Furthermore, the housing loans portfolio is associated with limited market liquidity, loans granted within the scope of the "Rodzina na swoim" programme (steep increase in the repayment rates after eight years), significant insurance concentration of these loans as well as unsatisfactory databases of the real property market.

The lending created by banks within the scope of housing loans entails a number of risks, not only for banks and their customers but also for the entire economy. With the indicated risks and negative phenomena in mind, a fundamental change to the current model for developing housing loans is essential.

Despite a moderate growth rate of the Polish economy (according to initial estimations, in 2011 GDP grew by 4.3 per cent as compared to 3.9 per cent in 2010), **an increase of risk occurred** in its external environment. This stems from, inter alia, growing debt crisis in some eurozone countries, deterioration of the outlook for the growth of the global economy (particularly the eurozone countries) and a significant deterioration in the confidence of the financial markets and investment climate Additionally, **a tightening of the fiscal policy aiming to deliver Poland from the path leading to an excessive deficit** is expected in 2012-2013.

As a result, we should bear in mind the possibility of a slowdown in the development of the Polish economy following a decline in external and internal demand as well as a decreasing tendency to invest on the part of enterprises and a reduction of expenditures by consumers. According to NBP forecasts included in March 2012 inflation and GDP projections, **the growth rate of the Polish economy will decrease to 3.0 per cent in 2012 and 2.3 per cent by 2013**, and an ensuing deterioration of the job market situation is expected.

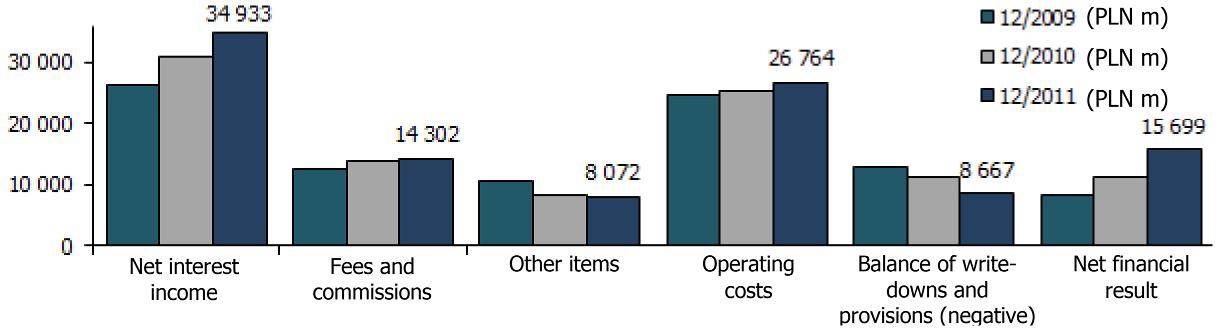
Accordingly, it should be considered that **despite a relatively good current situation, an increase in risk to the operations of banks in future periods has occurred.** The deteriorated confidence of the financial markets together with the expected decrease in the growth rate of the Polish economy and deterioration of the job market situation, carry a number of potential threats. In particular, banks should take into account possible difficulties with liquidity management and a deterioration in the financial situation of some borrowers which will exert negative pressure on their performance levels. Also, a restriction of the support from entities of parent capital groups and a transfer of reputation risk should not be ruled out.

Therefore, it is essential for banks to continually monitor potential threats and **carry on efforts aimed at ensuring an appropriate liquidity buffer, stable sources of funding and strengthen their capital position. The PFSA Chairperson's recommendations regarding 2011 profits distribution and the necessity for banks to acquire stable sources of funding stem from the above.**

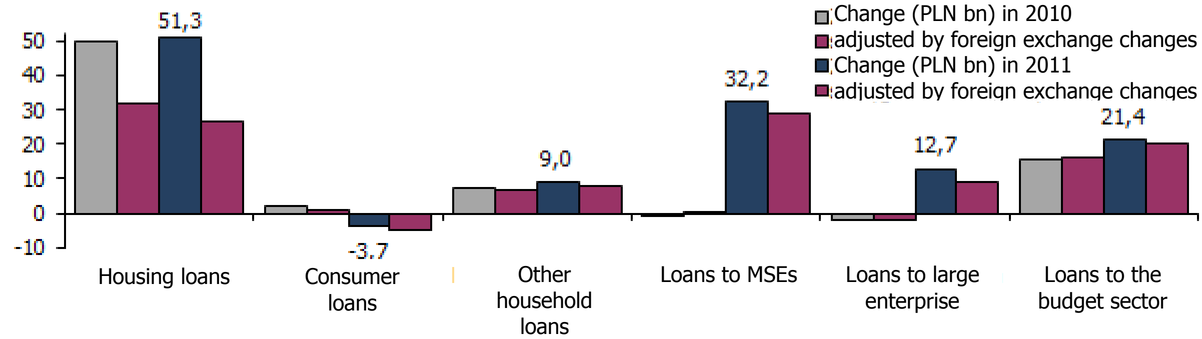
Selected data on the banking sector

	Value (PLN m, %)				Change by			
					12/2010		12/2009	
	12/2009	12/2010	09/2011	12/2011	PLN m	%	PLN m	%
EUR/PLN	4.1082	3.9603	4.4112	4.4168	0.4565	11.5 %	0.3086	7.5 %
CHF/PLN	2.7661	3.1639	3.6165	3.6333	0.4694	14.8 %	0.8672	31.4 %
USD/PLN	2.8503	2.9641	3.2574	3.4174	0.4533	15.3 %	0.5671	19.9 %
Balance-sheet total	1 057 376	1 159 358	1 279 983	1 295 039	135 681	11.7 %	237 663	22.5 %
Share of foreign currency mismatch	-6,1%	-5,9%	-5,8%	-6,0%	x	x	x	x
Selected profit and loss account items								
1/ Result of banking activity	49 607	53 083	42 351	57 308	x	x	7 701	15.5 %
- net interest income	26 376	30 899	25 641	34 933	x	x	8 557	32.4 %
- net fee and commission income	12 459	13 754	10 413	14 302	x	x	1 843	14.8 %
- other items	10 772	8 429	6 297	8 072	x	x	-2 700	-25.1 %
2/ Operating costs	24 815	25 477	19 594	26 764	x	x	1 949	7.9 %
3/ Provisions and write-downs (negative)	12 830	11 235	6 438	8 667	x	x	-4 164	-32.5 %
4/ Net financial profits	8 278	11 420	11 964	15 699	x	x	7 421	89.6 %
Selected balance sheet items								
1/ Assets								
- cash and receivables from central b	50 519	50 419	52 536	40 247	-10 171	-20.2 %	-10 272	-20.3 %
- claims on banks	60 272	68 472	82 106	71 844	3 372	4.9 %	11 572	19.2 %
- loans	686 997	753 641	845 328	874 782	121 140	16.1 %	187 785	27.3 %
- debt instruments and equities	199 837	231 193	232 174	243 376	12 183	5.3 %	43 538	21.8 %
2a/ Liabilities	954 066	1 043 378	1 154 946	1 165 985	122 607	11.8 %	211 918	22.2 %
- deposits and loans of the financial sector	216 756	244 831	269 429	266 734	21 904	8.9 %	49 979	23.1 %
- deposits of the non-financial sector	567 169	620 363	650 605	698 505	78 142	12.6 %	131 336	23.2 %
- households	387 681	422 360	453 143	477 373	55 013	13.0 %	89 691	23.1 %
- enterprises	165 126	182 781	181 636	205 867	23 086	12.6 %	40 742	24.7 %
- deposits of the budget sector	51 975	52 957	66 811	48 981	-3 976	-7.5 %	-2 994	-5.8 %
2b/ Shareholders' funds	103 309	115 980	125 037	129 054	13 074	11.3 %	25 745	24.9 %
Total loans (gross book value)	713 868	787 454	881 893	911 313	123 859	15.7 %	197 445	27.7 %
1/ Loans to the financial sector	24 585	25 534	25 989	25 748	214	0.8 %	1 164	4.7 %
2/ Loans to the non-financial sector	641 226	698 532	780 656	800 766	102 234	14.6 %	159 540	24.9 %
Households	416 413	475 425	526 035	532 022	56 597	11.9 %	115 609	27.8 %
- housing loans	217 762	267 508	311 889	318 774	51 266	19.2 %	101 011	46.4 %
- zloty	75 640	98 225	115 901	120 937	22 713	23.1 %	45 297	59.9 %
- foreign currency	142 123	169 283	195 988	197 837	28 553	16.9 %	55 714	39.2 %
- consumer loans	132 171	134 057	131 897	130 385	-3 673	-2.7 %	-1 787	-1.4 %
- other	66 479	73 860	82 248	82 864	9 003	12.2 %	16 384	24.6 %
Enterprises	222 080	219 688	250 781	264 548	44 860	20.4 %	42 468	19.1 %
SMES	127 222	126 999	152 350	159 160	32 161	25.3 %	31 938	25.1 %
- large enterprises	94 858	92 688	98 431	105 388	12 700	13.7 %	10 530	11.1 %
3/ Loans to the budget sector	48 057	63 387	75 248	84 798	21 411	33.8 %	36 742	76.5 %
Proportion of non-performing loans	7,1%	7,8%	7,5%	7,3%				
Total loans	6,0%	7,2%	7,3%	7,2%	x	x	x	x
Households	1,5%	1,8%	2,2%	2,3%	x	x	x	x
- housing loans	13,0%	17,3%	18,3%	18,0%	x	x	x	x
- consumer loans	6,7%	8,1%	9,1%	9,2%	x	x	x	x
- other	11,6%	12,4%	10,7%	10,5%	x	x	x	x
Enterprises	13,4%	14,6%	12,7%	12,6%	x	x	x	x
- SMES	9,2%	9,4%	7,7%	7,5%	x	x	x	x
- large enterprises					x	x	x	x
Proportion of overdue loans	7,3%	7,5%	7,7%	7,3%				
Non-financial sector overdue > 30 days	5,9%	6,2%	6,4%	6,0%	x	x	x	x
of which > 90 days	7,1%	7,8%	7,5%	7,3%	x	x	x	x
Capital adequacy								
Own funds	90 062	100 599	110 132	110 877	10 278	10.2 %	20 815	23.1 %
Total capital requirement	54 220	58 151	66 783	67 567	9 417	16.2 %	13 347	24.6 %
Surplus of own funds above requirement	35 842	42 448	43 350	43 309	861	2.0 %	7 467	20.8 %
Solvency ratio	13.3	13.8	13.2	13.1	x	x	x	x

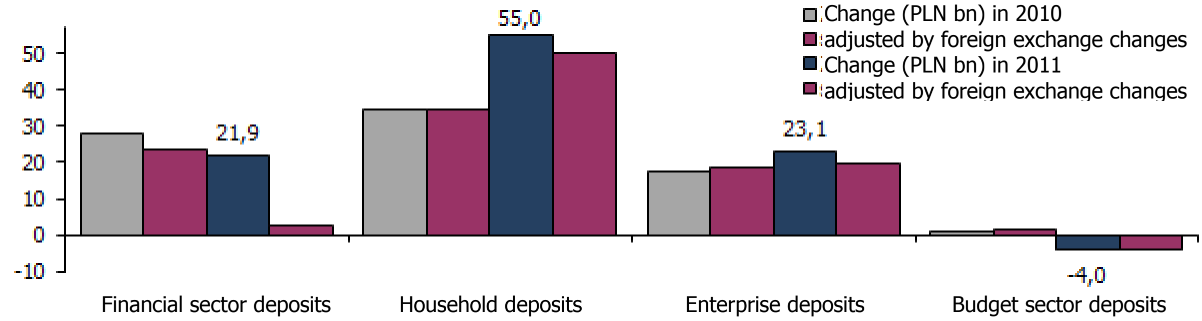
FACTORS AFFECTING FINANCIAL PROFITS



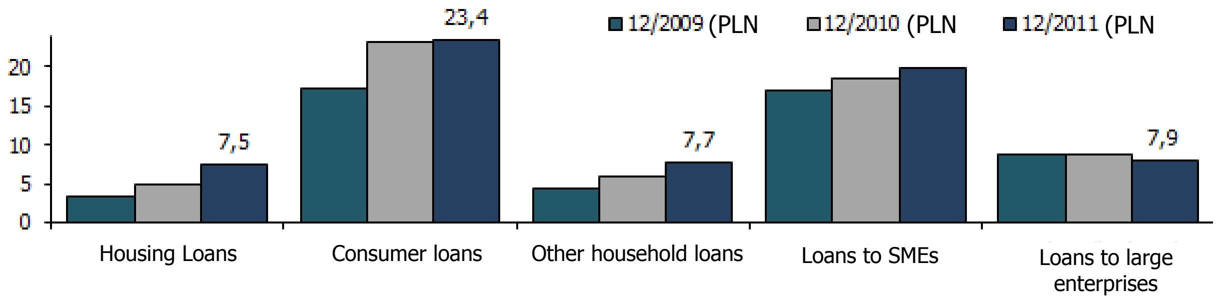
DIRECTIONS OF THE DEVELOPMENT OF NEW LOANS



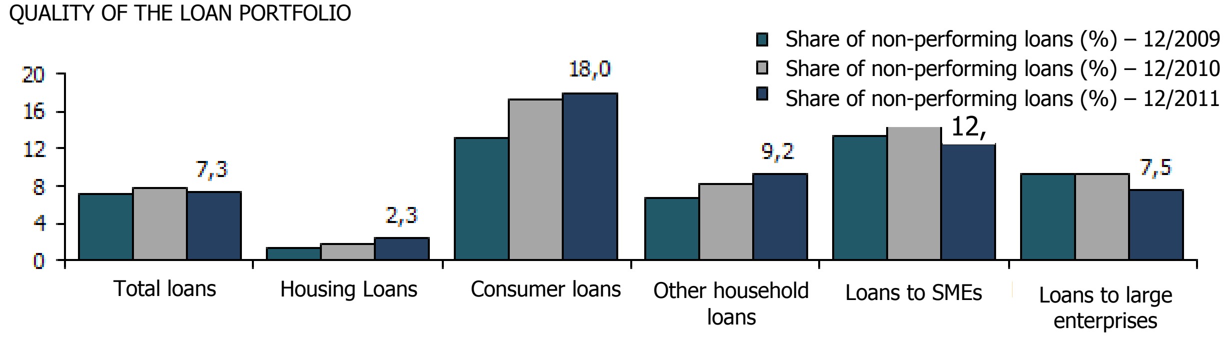
SOURCES OF FINANCING



STATE OF NON-PERFORMING LOANS



QUALITY OF THE LOAN PORTFOLIO



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1 THE ENVIRONMENT IN WHICH BANKS OPERATE[1]

1.1 Macroeconomic situation

In 2011, the economic growth rate remained moderate. According to initial estimations, the GDP grew by 4.3 per cent (as compared to 3.9 per cent in 2010). The following phenomena were also reported:

- **growth in industrial production** sold (of 7.5 per cent) in construction and assembly output (of 12.0 per cent) and a growth in retail sales (of 1.3 per cent);
- **growth in** foreign **trade** (exports increased by 15.3 per cent in zlotys, by 12.8 per cent in euros; imports – by 14.6 per cent and 12.1 per cent respectively);
- **improvement in the financial results of the enterprise** sector (net financial profits grew by 16.2 per cent to PLN 104.0 billion), slight decrease of the cost level index and increase in liquidity indices;

Chart 1.
Annual rate of growth in GDP (%)

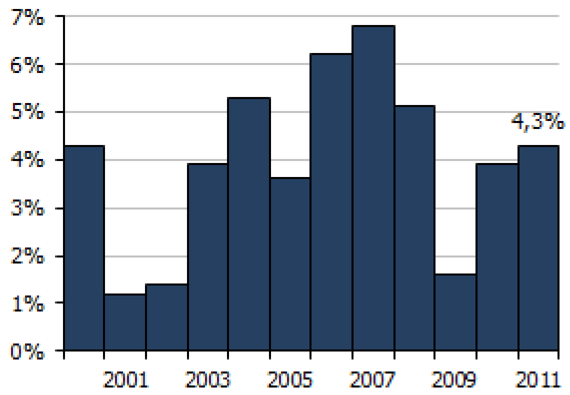


Chart 2.
Annual rate of growth in production and retail sales (%)

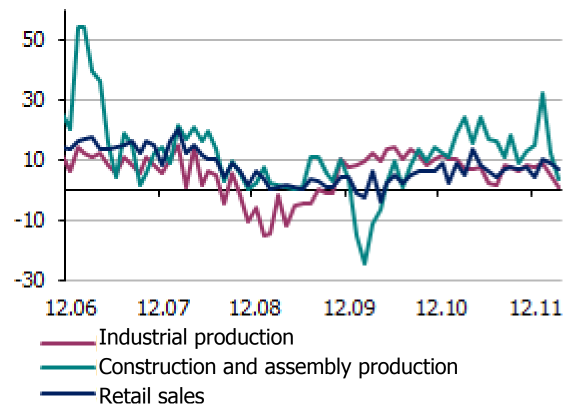


Chart 3.
Trade in PLN (PLN bn)

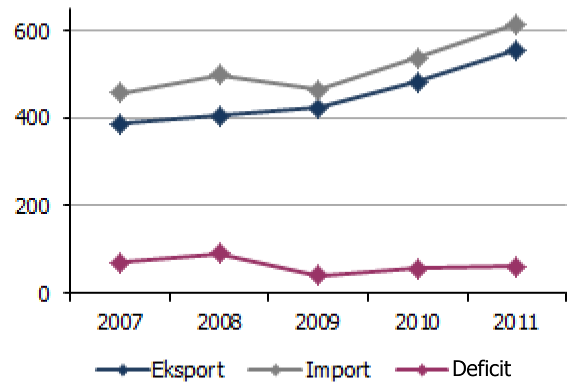
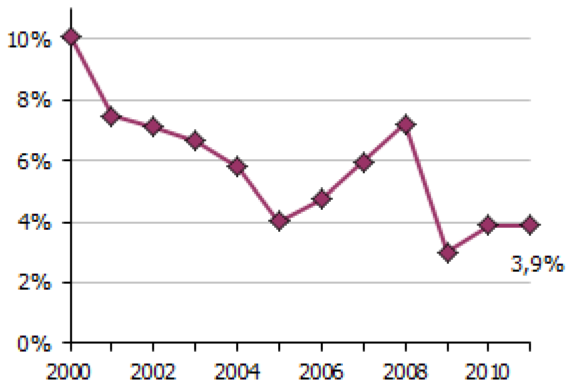


Chart 4.
Trade deficit / GDP (%)



[1] For more, see " Report on Poland's social and economic situation", Central Statistical Office; "Gross domestic product. Preliminary estimates", Central Statistical Office; "Foreign trading in global terms and by country", Central Statistical Office; "Financial performance of non-financial enterprises", Central Statistical Office; "Report on inflation", National Bank of Poland; "Message from the meeting of the Polish Monetary Council", National Bank of Poland; "Report on the stability of the financial system", National Bank of Poland; "National report on housing loans and real estate transaction prices", AMRON-SARFiN; "Monthly Bulletin", ECB.

Chart 5.
Unemployment rate (%)

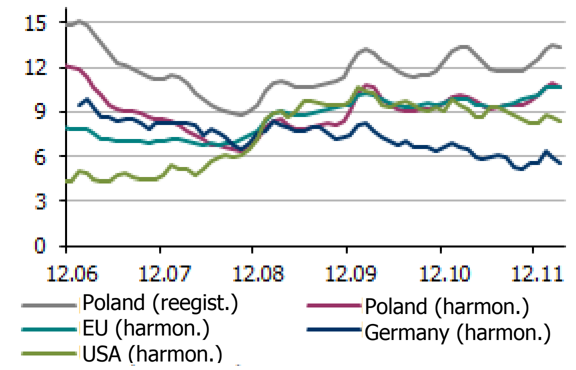


Chart 6.
Annual rate of growth in earnings and employment in the enterprise sector (%)

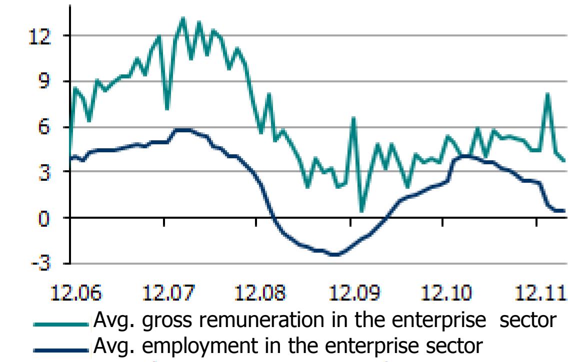


Chart 7.
Year-on-year increases in CPI and PPI (%)

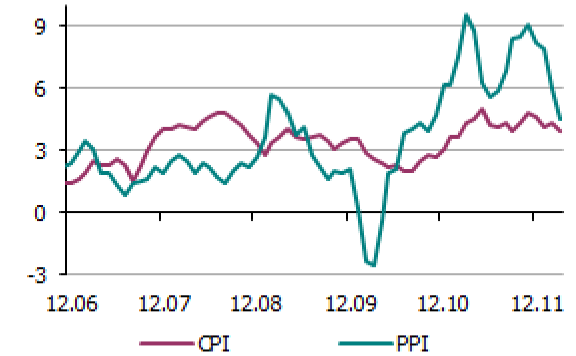


Chart 8.
Outlook and confidence indicators

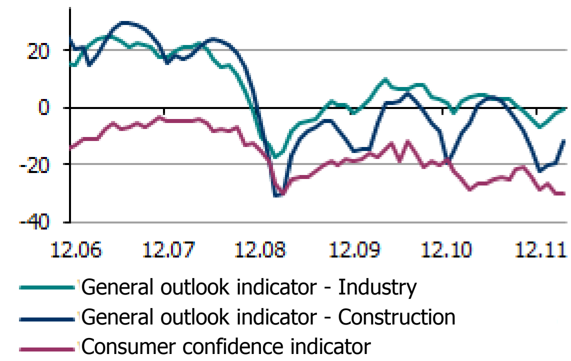


Chart 9.
Average price paid per sq. m of an apartment (PLN)

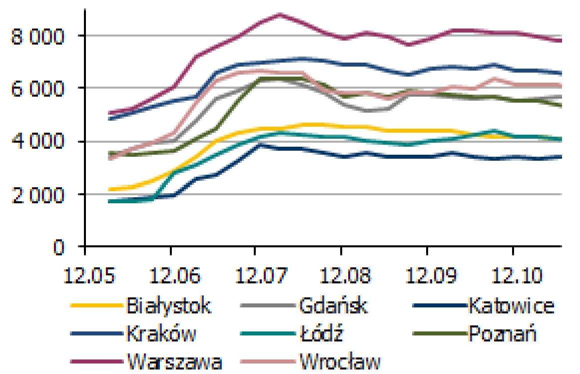


Chart 10
Change to av. price paid per sq. m. of an apart. - Q4 2011/Q4 2010 (%)

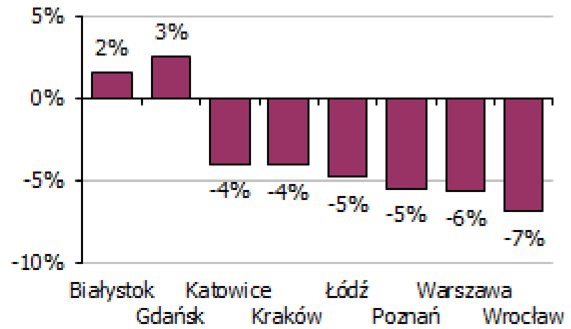


Chart 11
Financial results of the enterprise sector (PLN bn)

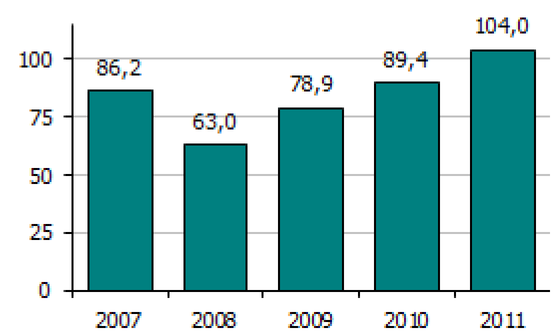
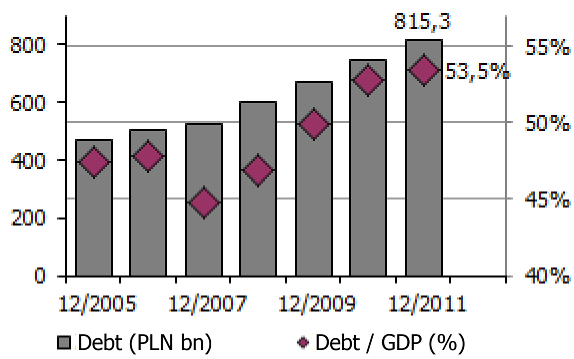


Chart 12
Public finance sector debt (PLN bn; %)



Source: Central Statistical Office, Ministry of Finance, Eurostat, AMRON SARFiN, own calculations

- **increase in employment** (by 3.2 per cent), however the rate of growth was subdued in the forthcoming months. Despite the increasing rate of growth of gross earnings in the enterprise sector (by 5.0 per cent) the buying power of gross earnings grew only slightly (by 0.9 per cent). Aside from seasonal fluctuations, the unemployment rate remained relatively stable and in recent periods, it was reported at a level approximately 2 per cent higher than before the crisis (reported at approximately 11-13 per cent; or 9-10% according to BAEL);
- **strong inflationary pressure was maintained,** which was related to increasing prices of raw materials, food and a VAT increase (the CPI grew from 3.1 per cent at the end of 2010 to 4.6 per cent at the end of 2011, while the PPI from 6.2 per cent to 8.2 per cent);
- **the low or negative position of indicators of** the overall outlook for industry and construction and of **consumer confidence**;
- **fall in house prices** (in the fourth quarter of 2011 average paid for prices on the major real property markets were on average 4 per cent -7 per cent lower than in the fourth quarter of 2010). A slight decrease in the number of housing units delivered was reported (by 3.5 per cent), however on the other hand an increase of the number of housing units the construction of which was begun (by 2.6 per cent) and of the number of building permissions (by 5.2%) occurred. At the same time, the development market reported the highest ever value of housing units available for sale, including housing units ready for delivery[2];
- **improvement in the current condition of the state budget** (the deficit amounted to PLN 25.1 bn compared to PLN 44.6 bn in the previous year; the level of realisation of the earnings planned for the entire year was higher, while the level of expenditure was lower than in 2010; tax proceeds increased by 9.3 per cent). On the other hands, there are concerns about the rapidly-growing public finance sector debt (debt of the public finance sector grew from PLN 747.9 bn at the end of 2010 to PLN 815.3 bn at the end of 2011, **however it was possible to stem the rate of growth of the ratio of public debt to GDP,** which according to initial estimations amounted to 53.3 per cent at the end of 2011 (as compared to 52.8 per cent in 2010).

Table No. 1. Poland as compared to EU countries in 2006-2011 (EUR bn, %)

	GDP EUR bn		GDP per capita (EU)=100		Debt pub. fin. sect. (% GDP)		Unemployment rate		S&P sovereign ratings		GDP rate of growth (%)						
	2006	2011	2006	2011	2006	2011	2006	2011	2006	2012	2007	2008	2009	2010	2011	2012p	2013p
EU	11 695	12 629	100	100			7.8	10.0			3.2	0.3	-4.3	2.0	1.5	0.0	1.3
Eurozone	8 565	9 414	109	108			8.0	10.6			3.0	0.4	-4.3	1.9	1.5	-0.3	1.0
Austria	259	301	126	126	62.3	72.2	4.4	4.1	AAA	AA+	3.7	1.4	-3.8	2.3	3.1	0.8	1.7
Belgium	319	368	118	119	88.0	98.2	7.9	7.1	AA+	AA	2.9	1.0	-2.8	2.2	1.9	0.0	1.2
Bulgaria	26	38	38	44	21.6	16.3	8.2	11.8	BBB+	BBB	6.4	6.2	-5.5	0.4	1.7	0.5	1.9
Cyprus	15	18	91	99	64.7	71.6	4.4	9.5	A	BB+	5.1	3.6	-1.9	1.1	0.5	-0.8	0.3
The Czech Republic	118	155	80	80	28.3	41.2	6.4	6.7	A-	AA-	5.7	3.1	-4.7	2.7	1.7	0.0	1.5
Denmark	219	240	124	127	32.1	46.5	3.9	7.8	AAA	AAA	1.6	-0.8	-5.8	1.3	1.0	1.1	1.4
Estonia	13	16	66	64	4.4	6.0	5.7	11.7	A	AA-	7.5	-3.7	-14.3	2.3	7.6	1.6	3.8
Finland	166	192	114	115	39.6	48.6	7.3	7.6	AAA	AAA	5.3	0.3	-8.4	3.7	2.9	0.8	1.6
France	1 798	1 997	108	108	64.0	86.0	8.8	9.9	AAA	AA+	2.3	-0.1	-3.1	1.7	1.7	0.5	1.3
Greece	209	215	92	90	107.3	165.3	8.7	21.0	A	CCC	3.0	-0.2	-3.3	-3.5	-6.9	-4.7	0.0
Spain	986	1 073	105	100	39.7	68.5	8.3	23.2	AAA	BBB+	3.5	0.9	-3.7	-0.1	0.7	-1.8	-0.3
The Netherlands	540	602	131	133	47.4	65.2	4.0	4.9	AAA	AAA	3.9	1.8	-3.5	1.7	1.2	-0.9	0.7
Ireland	178	156	146	128	24.5	108.2	4.3	14.7	AAA	BBB+	5.2	-3.0	-7.0	-0.4	0.7	0.5	1.9
Lithuania	24	31	56	57	17.9	38.5	4.9	14.3	A	BBB	9.8	2.9	-14.8	1.4	5.9	2.4	3.5
Luxembourg	34	43	270	271	6.7	18.2	4.6	5.1	AAA	AAA	6.6	0.8	-5.3	2.7	1.6	1.1	2.1
Latvia	16	20	51	51	10.7	42.6	6.2	14.6	A-	BBB-	9.6	-3.3	-17.7	-0.3	5.5	2.2	3.6
Malta	5	6	76	83	64.4	72.0	6.8	6.7	A	A-	4.3	4.1	-2.7	2.3	2.1	1.2	1.9
Germany	2 314	2 571	115	118	68.1	81.2	9.6	5.6	AAA	AAA	3.3	1.1	-5.1	3.7	3.0	0.7	1.7
Poland	272	370	52	63	47.7	56.3	11.9	10.0	BBB+	A-	6.8	5.1	1.6	3.9	4.3	2.7	2.6
Portugal	161	171	79	80	69.3	107.8	9.2	14.6	AA-	BB	2.4	0.0	-2.9	1.4	-1.6	-3.3	0.3
Romania	98	136	38	46	12.4	33.3	7.2	7.5	BBB-	BB+	6.3	7.3	-6.6	-1.6	2.5	1.4	2.9
Slovakia	45	69	63	74	30.5	43.3	12.0	14.1	A	A	10.5	5.8	-4.9	4.2	3.3	1.8	2.9
Slovenia	31	36	88	85	26.4	47.6	5.4	8.7	AA	A+	6.9	3.6	-8.0	1.4	-0.2	-1.4	0.7
Sweden	318	387	123	123	45.0	38.4	6.4	7.5	AAA	AAA	3.3	-0.6	-5.0	6.1	3.9	0.3	2.1
G. Britain	1 949	1 737	120	112	43.4	85.7	5.5	8.3	AAA	AAA	3.5	-1.1	-4.4	2.1	0.7	0.5	1.7
Hungary	90	101	63	65	65.9	80.6	7.5	11.0	BBB+	BB+	0.1	0.9	-6.8	1.3	1.7	-0.3	1.0
Italy	1 493	1 580	105	101	106.1	120.1	6.3	9.3	A+	BBB+	1.7	-1.2	-5.5	1.8	0.4	-1.4	0.4

Source: Eurostat, EC forecast (11 May 2012), Bloomberg, sovereign rating - long term debt in foreign currency (most recent 22 May 2012).

[2] According to REAS, in the fourth quarter of 2011, on the six markets analysed (Warsaw, Krakow, Łodz, Wroclaw, Tricity, Poznan), 48 thousand housing units were offered for sale, of which 10.5 thousand were ready for delivery - see "Rynek mieszkaniowy w Polsce" [Poland's housing market], REAS.

Chart 13
Cumulative real GDP growth in 2007-2011 (%)

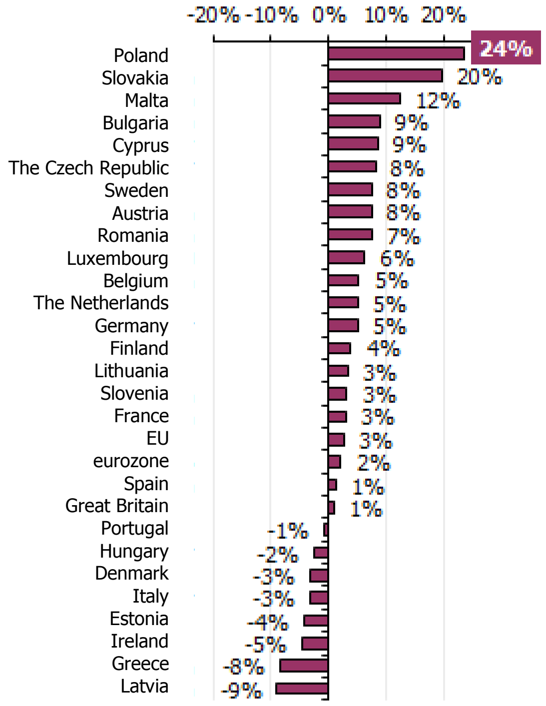
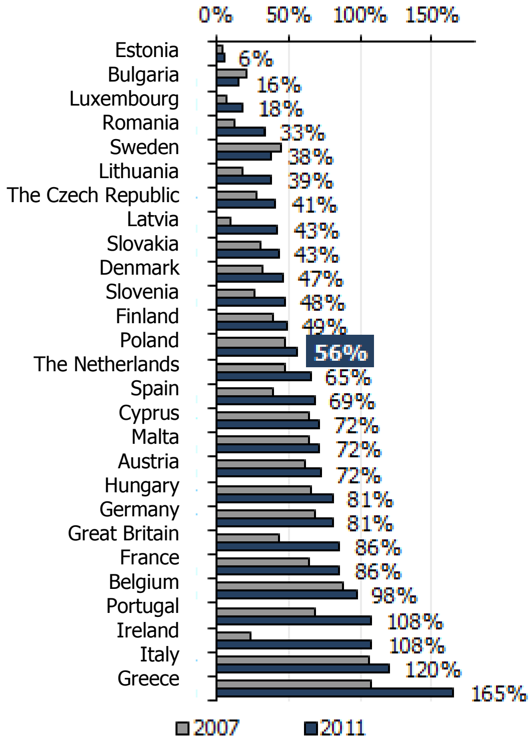


Chart 14
Public finance sector debt/GDP (%)



Source: Eurostat, own calculations

Despite the relatively good current situation, **the prospects for growth of the Polish economy in the coming periods have deteriorated.** This is a result of a global economic downturn, growing debt crisis in some eurozone countries as well as the tightening of the fiscal policy aiming to deliver Poland from the path leading to an excessive deficit expected in 2012-2013 (however this will improve Poland's creditworthiness). As a result, we should bear in mind the possibility of a slowdown in the development of the Polish economy following a partial decline in external and internal demand as well as a decreasing tendency to invest on the part of some enterprises and a reduction of expenditures by consumers.

According to NBP forecasts included in March 2012 inflation and GDP projections, the most probable scenario is one where **the growth rate of the Polish economy will decrease to 3.0 per cent in 2012** and 2.3 per cent by 2013 (the growth rate should pick up again by 2014). A deterioration of the job market situation is also expected.

Despite a deterioration in the outlook for growth, **the situation of the Polish economy is relatively good when compared to other EU countries.** This is evident in, inter alia, the highest economic growth rate in 2007-2011 out of all EU countries, a limited increase of the public finance sector debt to GDP ratio, as well as the relatively stable profitability of treasury securities and stable or improving ratings.

1.2 The situation in financial markets

In the first half of the 2011, the situation on global financial markets was relatively stable. The greatest influences on the confidence of market participants were the developments in the so-called peripheral eurozone countries, the influx of macroeconomic data from the USA, EU and China, the assessment of the effect of the earthquake in Japan and the developments in Arab countries. The influx of negative information tended to result in a temporary rise of risk aversion, which was reflected on the foreign exchange market, debt instrument market as well as the equity and commodity markets. Despite volatility and persisting uncertainty, this period marked the time of local all-time highs on equity and commodity markets, and reported a strengthening of emerging market currencies.

Chart 15
Central bank reference rates (%)

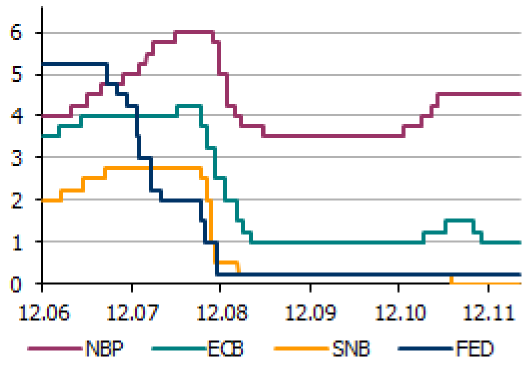


Chart 16
Money market rates (%)

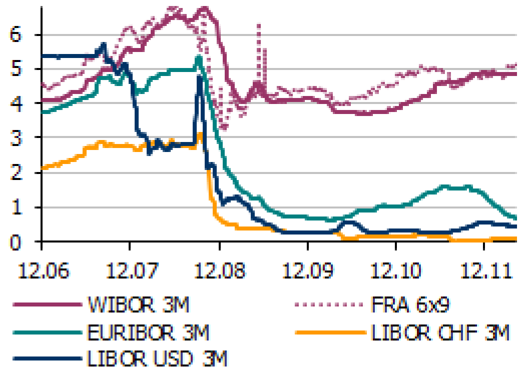


Chart 17
Average interest rates on loans and deposits in place (%)

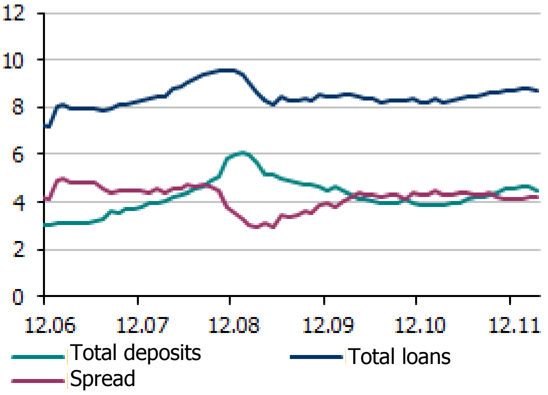


Chart 18
Average interest rates on new loans and deposits (%)

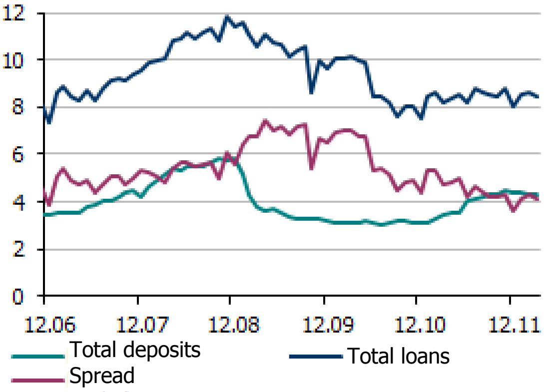


Chart 19
Major currencies' exchange rate against the zloty

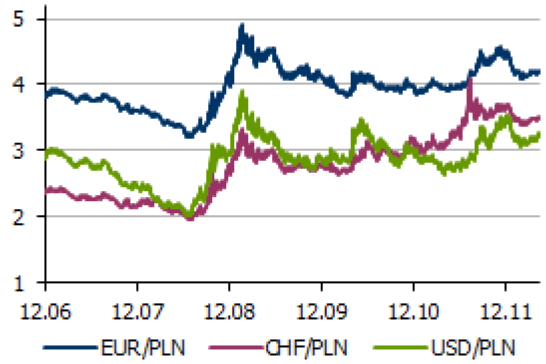


Chart 20
EUR exchange rate against major currencies

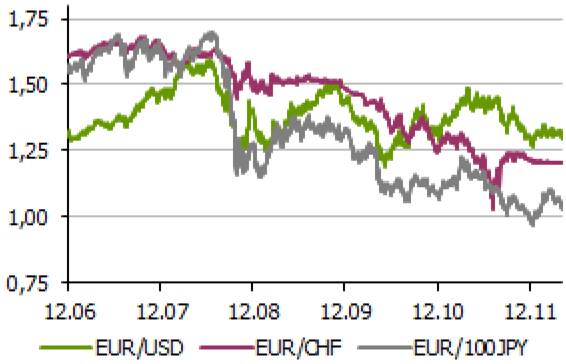


Chart 21
Yields on Polish treasury securities (%)

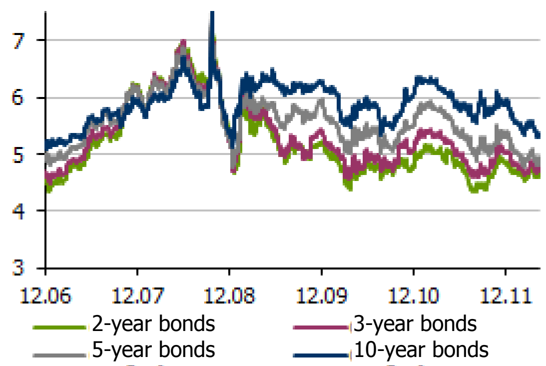


Chart 22
Yields on 10-year treasury bonds (%)

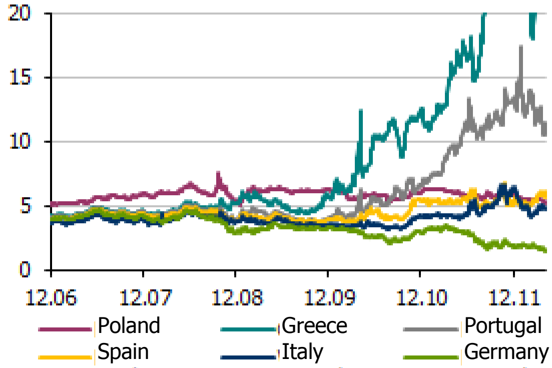


Chart 23
5-year credit default swap rates (basis points) - countries

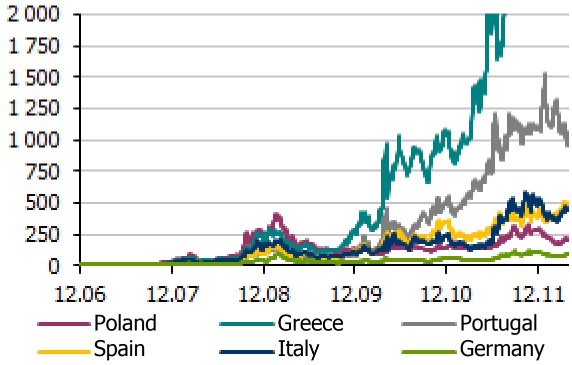


Chart 24
5-year credit default swap rates - subordinated debt (basis points) - banks

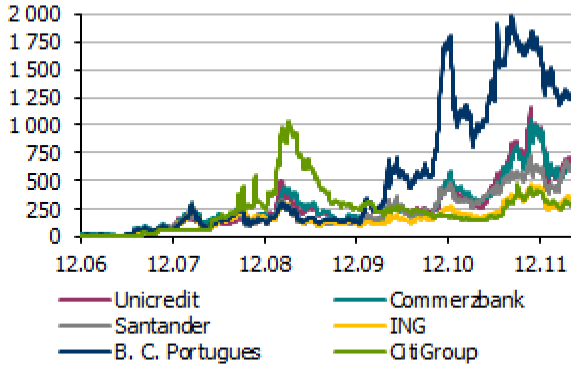


Chart 25
Change to index values (%, 31 December 2010=100%)

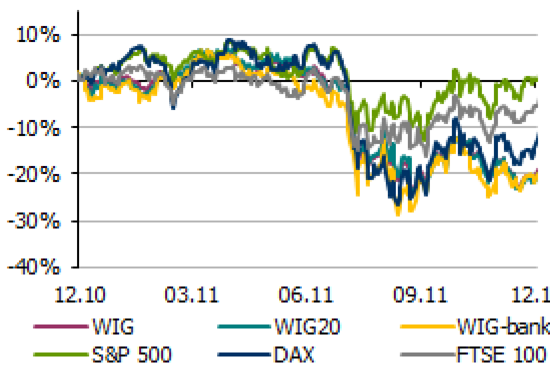


Chart 26
Change to raw material prices (%, 31 December 2010=100%)

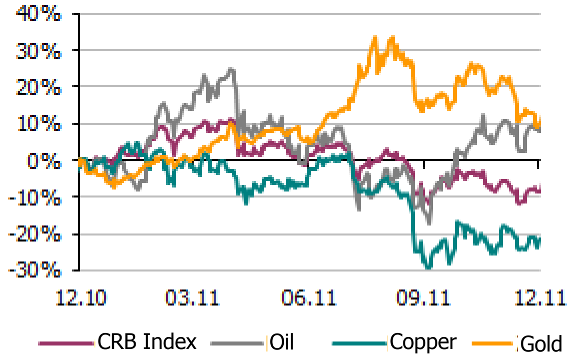


Chart 27
Market capitalisation of major banks (PLN bn)

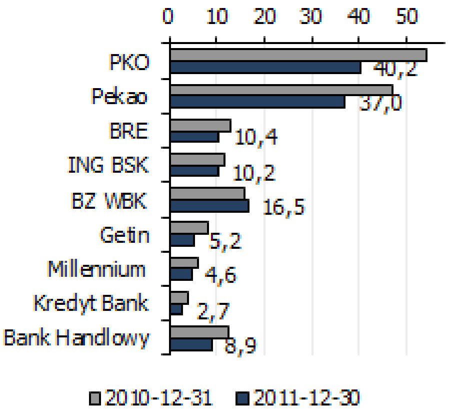
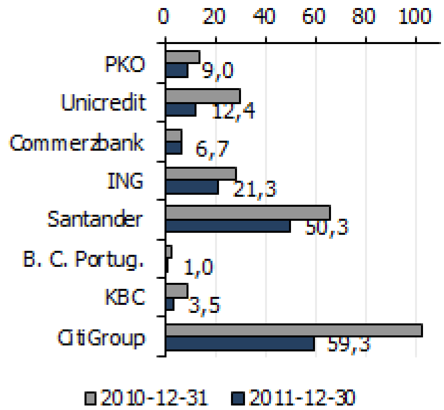


Chart 28
Market capitalisation of major banks' strategic investors (EUR bn)



Source: Bloomberg, NBP, own calculations

At the turn of the first and second half of the hear a significant deterioration of the global financial market confidence occurred. This resulted from the growing public finance crisis of certain eurozone countries and delays in the process of enactment by the US Congress of the higher debt limits for the USA, concerns about the financial standing of certain European banking groups together with indications of an economic deceleration in the EU and the USA, and a loss of confidence among enterprises and customers. The said process was intensified by a number of reductions to sovereign and financial institution ratings. While the rating agencies' decisions could be deemed reasonable, it should be noted that, during times of considerably lower confidence and anxiety on the market, these decisions contributed to deepening the crisis. Furthermore, as a rule, lowered ratings contribute to increased funding costs and selling of the securities issued by each affected entity (as a result of supervisory regulations or internal rules that prohibit investing into securities with a higher risk profile), which makes the entity's standing worse and may provide grounds for a further rating reduction. An important factor contributing to the crisis was media coverage, which excessively, emphasised the issue of actual or potential threats, which affected the attitudes of financial market participants, entrepreneurs and consumers. As a result, a number of entities chose to reduce their investments and spending, and financial markets experienced increasing pressure which helped deepen the crisis (e.g. some entities reduced their exposures to institutions subject to negative media speculation and banks reduced reciprocal limits).

A build-up of these negative phenomena resulted in very large markdowns on equity and commodity markets, selling of foreign currencies from emerging markets, increased profitability of treasury securities from some eurozone countries, reduction or loss of liquidity on the market for medium- or long-term unhedged financing, and increased costs of financing and CDS rates. The situation on the money market became more severe as a result of reduced exposure to Europe by US money market funds, which forced European banks to look for alternative sources of financing. Furthermore, deposits invested by banks in ECB accounts were reported to be growing rapidly, which indicated a decline of the confidence among banks.

From the banks point of view, the issue of the capacity to obtain or renew funding was of particular significance. At the same time the downturn of outlook on equity markets reduced the possibility of obtaining funding and caused the risk of a hostile takeover. The liquidity situation improved slightly after the major central banks intervened by agreeing to provide the necessary liquidity (in particular the ECB engaged in the so called LTRO programme, offering nearly EUR 500 bn in low interest long term loans to banks). Such activities should be treated as non-standard and temporary means.

On the domestic market, the following developments should be noted:

- tightening of the monetary policy by the Monetary Policy Council in response to the rapid growth of inflationary pressure (in January, April, May and June 2011 the reference rate was raised by 25 basis points and amounted to 4.50 per cent at the end of 2011)[3];
- **increased interest rates on the interbank market** (average WIBOR 3M rate increased from 3.8 per cent in December 2010 to 4.9 per cent in December 2011). At the same time, in the first half of 2011 quotes for FRA rates indicated expectations of a further rise in interest rates, whereas since August there has been a decrease, which should be associated with lowered expectations of the tightening of the monetary policy or even expectations of its easing (in December 2011, the average quotes for 6 x 9 FRA were at about 5.0 per cent);
- **increase in the interest rate on deposits and loans.** Interest rates on new deposit agreements grew from about 3.1 per cent in December 2010 to about 4.4 per cent in December 2011.[4], while interest rates on loan agreements grew from approximately 7.5 per cent to approximately 8.0 per cent[5].
- **lack of full efficiency of the interbank market**, as manifested in low reciprocal credit limits and banks' unwillingness to take risk (see below). As a result, in managing liquidity, banks used primarily overnight transactions, and the proportion of longer-term transactions was small (overnight transactions accounted for more than 90 per cent of all transactions, while in the pre-crisis period, these accounted for approximately 80 per cent of all transactions);
- increased profitability of treasury securities at the beginning of 2011, and then its subsequent decline which went on until September, when as a result of an escalation to disruptions on the financial markets it increased again (in December 2011 the average return on 2-; 3-; 5-; and 10 year treasury securities was 4.9 per cent; 5.1 per cent; 5.3 per cent; 5.9 per cent respectively and was similar to the levels reported in December 2010, which were 4.8 per cent; 5.1 per cent; 5.5 per cent; 6 per cent respectively);
- **further growth of foreign investors' involvement in purchases of Polish Treasury securities issued on the domestic market** (from PLN 128.3 bn at the end of 2010 to PLN 154.2 bn at the end of 2011, which means that those investors held nearly 30 per cent of the securities issued on the domestic market).The increased involvement of foreign investors certainly favours economic development, but also

[3] Furthermore, the PMC raised the lombard, deposit and rediscount rate (at the end of 2011, they were at 6.00 per cent, 3.00 per cent and 4.75 per cent, respectively).
[4] Deposits from households from 3.6 per cent to 4.7 per cent, and from enterprises – from 3.1 per cent to 4.3 per cent.
[5] Consumer loans – from 14.9 per cent to 15.2 per cent (annual percentage rate remained unchanged at 21.3 per cent), housing loans from 6.1 per cent to 7.0 per cent (annual percentage rate fro 6.6 per cent to 7.4 per cent), loans to enterprises from 5.9 per cent to 6.6 per cent.

increases systemic risk associated with the possibility of rapid withdrawal of a portion of capital (which could lead to greater treasury securities yields and a weaker zloty);

- relative stability of the zloty with respect to EUR and CHF in the first half of 2011 and a reported strengthening against the USD. However, due to an escalation of the crisis in the third quarter of 2011, **the zloty declined against the major currencies.** The situation only stabilised at the end of the year due to a slight improvement to investor confidence, BGK and NBP intervention and the SNB setting a minimum exchange rate for the CHF against the EUR (at a level of 1.2). However the zloty remained weak against the major currencies (at the end of 2011 NBP average exchange rates for 1 EUR, 1 CHF and 1 USD against the zloty were: 4.4168; 3.6333; 3.4174 respectively as compared to : 3.9603; 3.1639; 2.9641 at the end of 2010);
- continuation of increases in the equity market (until April), where indices reached their local highs, even though concerns were raised about the "increasingly selective nature of the increases" (the prices of most shares started to drop), as well as the very low liquidity of trading on some small and medium-sized enterprises.[6]. After reaching local highs, the indices begun to fall. In the second half of the year, **significant falls on the equities market occurred**, and large numbers of shares hit all-time lows (at the end of 2011, WIG, WIG 20, mWIG40, sWIG80 and WIG Bank indices were, respectively, higher by 20.8 per cent; 21.9 per cent; 22.5 per cent; 30.5 per cent; 21.7 per cent than those at the end of 2010).

The deteriorated confidence of the financial markets together with the expected decrease in the growth rate of the Polish economy and deterioration of the job market situation, carry a number of potential threats for banks. In particular, banks should take into account possible difficulties with liquidity management and a deterioration in the financial situation of some borrowers which may exert negative pressure on the loan portfolio quality and their performance levels. Also, a restriction of the support from entities of parent capital groups and a transfer of reputation risk should not be ruled out.

Accordingly, it should be considered that **despite a relatively good current situation, an increase in risk to the operations of banks in future periods has occurred. Therefore, it is essential for banks to** continually monitor potential threats and **carry on efforts aimed at ensuring an appropriate liquidity buffer, stable sources of funding and strengthen their capital position.** The PFSA Chairperson's recommendations regarding 2011 profits distribution and the necessity for banks to acquire stable sources of funding stem from the above.

On the other hand, **the crisis involves not only threats, but also opportunities.** If effective steps are taken to curb public debt growth and if the Polish economy proves to be resilient to crisis phenomena, Poland will have an opportunity to maximise capital inflow and investment in the medium- and long-term The crisis also presents an opportunity for some enterprises to accelerate their growth and acquire weaker competitors. In the long run, the current crisis may, therefore, provide an incentive to accelerate the rate of growth of the Polish economy.

[6] This latter phenomenon is probably also related to the very large number of companies that have entered the market in recent years and to the very fast development of the New Connect market. In regard to this, it appears necessary to think further about the strategy for development of the capital market, since the current situation may lead to negative consequences manifested, among other things, in declining interest on the part of small and medium-sized investors in capital market, the lack of trustworthy market valuation or manipulation of share prices. **The size of the market** (including the number of listed companies and the length of the trading session) **should be adjusted to match the scale of the entire economy**.

2 PRINCIPAL DIRECTIONS OF THE DEVELOPMENT OF THE BANKING SECTOR'S BUSINESS[7]

Due to the persistence of difficult external conditions and concerns as to the development of the economic situation, the **activity of the banking sector, measured by the rate of growth of balance sheet total, employment and sales network, remained moderate**. Lending increased slightly, however a significant revival of lending to the enterprise sector and a certain slow down to the rate of lending to households were reported. The rate of growth of the non-financial sector deposits slightly exceeded the 2010 figure, however this stemmed mainly from significant development of deposits towards the end of 2011. Levels of foreign funding remained relatively stable.

2.1 The structure of the banking sector and its role within the economy

In recent years, the banking sector structure has remained relatively stable

Chart 29
Number of commercial banks and credit inst. branches

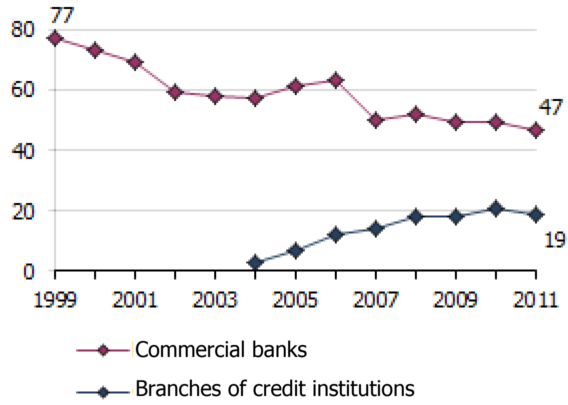
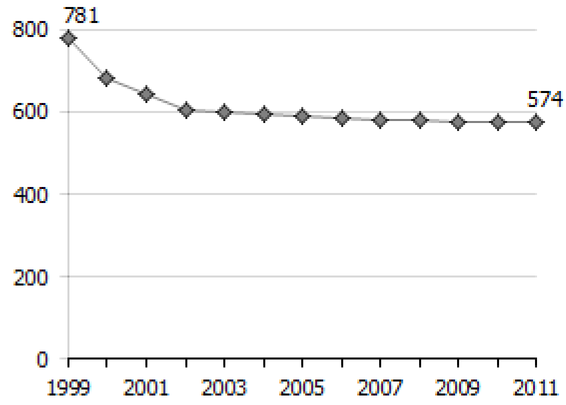


Chart 30
Number of cooperative banks



As at the end of 2011, **640 banks and credit institution branches were active operationally:**

- the number of commercial banks decreased from 49 at the end of 2010 to 47 at the end of 2011. This was a result of the takeover of AIG Bank Polska by Santander Consumer Bank, a merger of ING Bank Hipoteczny with ING Bank Śląski and Mazowiecki Bank Regionalny with Gospodarczy Bank Wielkopolski (SGB-Bank was created) as well as the transformation of a branch of EFG Eurobank Ergasias into a bank under the name of Polbank EFG operating as a joint stock company;
- the number of credit institution branches decreased from 21 to 19 (KBL European Private Bankers ceased operating, and a branch of EFG Eurobank Ergasias transformed into a bank);
- the number of cooperative banks decreased from 576 to 574. At the end of 2011 cooperative banks were affiliated in two structures: Bank Polskiej Spółdzielczości (366) and SGB-Bank (207). Krakowski Bank Spółdzielczy, which operated independently, was an exception.

[7] Note: The data presented in this material come from the data base as it stood on 6 February 2012 (and do not include subsequent corrections). The data and figures presented below come from the PFSA (unless otherwise indicated).

Chart 31
Employment (thousand people)

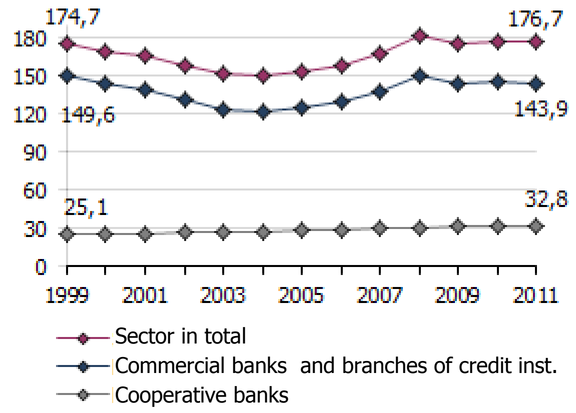
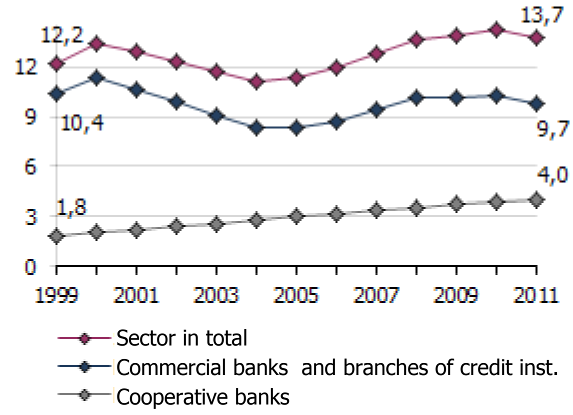


Chart 32
Number of branches and other sites (thousand)



In recent years, the level of employment and sales network remained relatively stable. However, in 2011 a slight **reduction in employment** was reported (by 0.2 thousand people) **and sales network** (by 0.5 thousand sites) which was a result of restructuring processes underway at some commercial banks. In terms of commercial banks, similar to the previous years, an increase in both employment and sales network was reported.

Chart 33
Ownership structure of the sector - share of assets (%)

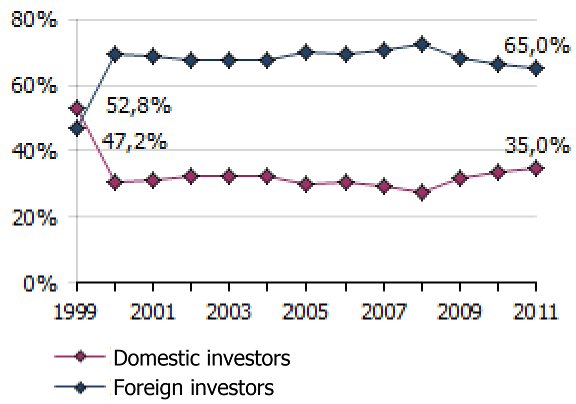
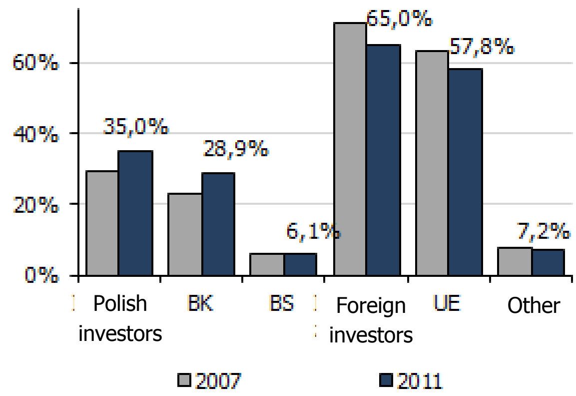


Chart 34
Share in assets by investor groups (%)[8]

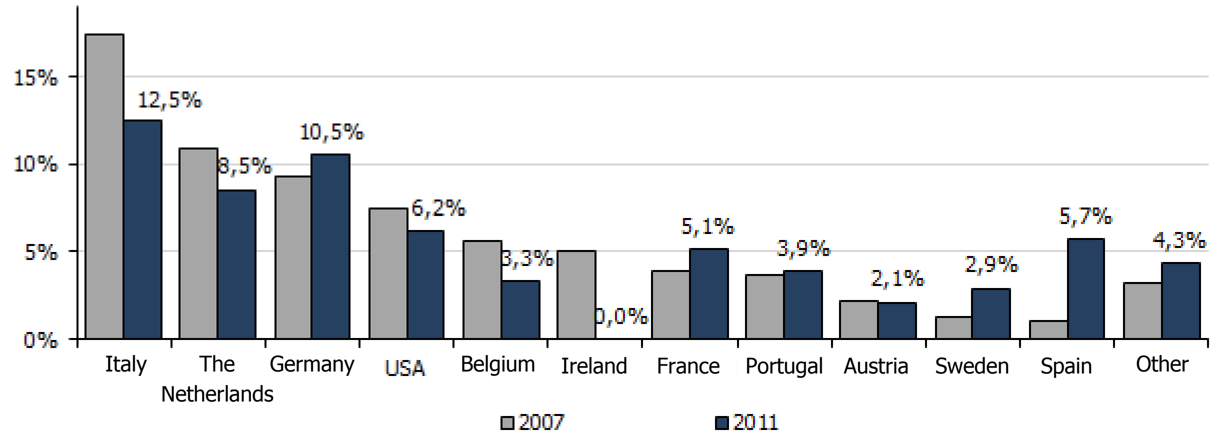


For the third year in a row, the banking sector ownership structure exhibits an **increase in banks controlled by domestic investors in the banking sector's assets.** On the other hand a deceleration in the rate of growth of the number of banks under foreign control has been reported, which should be attributed to the financial crisis and the deterioration in the financial standing of some strategic investors.

At the end of 2010, **domestic investors** controlled 10 commercial banks and all cooperative banks (The State Treasury controlled 4 commercial banks - PKO Bank Polski, Bank Gospodarstwa Krajowego, Bank Pocztowy and Bank Ochrony Środowiska). Their **market share** measured in assets increased from 33.8 per cent as at the end of 2010 to **35.0** per cent at the end of 2011).

[8] Polish investors - banks at which the majority holding (50% plus 1 vote) is in the hands of domestic investors. Two subgroups have been identified in this group: commercial banks (BK) and cooperative banks (BS). Foreign investors - banks at which the majority holding (50% plus 1 vote) is in the hands of foreign investors. Two subgroups have been identified in this group: banks and branches of EU countries credit institutions (UE) and entities, whose parent company is from outside of the EU (Other).

Chart 35
The change in the share of the sector's assets belonging to investors from given countries in 2007-2011 (%)



At the end of 2011, **foreign investors** controlled 37 commercial banks and all branches of credit institutions. Majority holdings were in the hands of investors from **18 countries,** whereas the dominant role was played by Italian investors (12.5 per cent of the sector's assets) followed by German (10.5 per cent), Dutch (8.5 per cent), American (6.2 per cent), Spanish (5.7 per cent) and French (5.1 per cent).

Chart 36
The share of major banks in the system's assets (%)

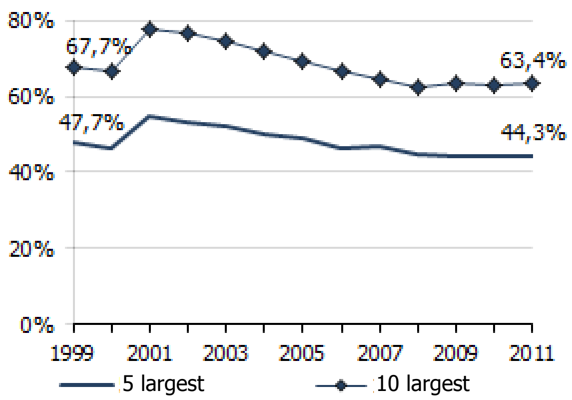
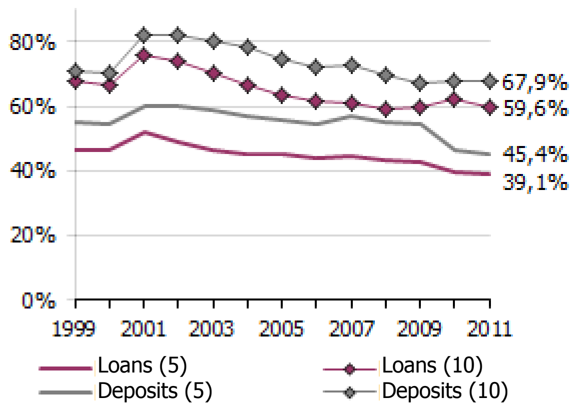


Chart 37
The share in the loans and deposits of the non-financial sector (%)



The level of concentration of the Polish banking sector has not changed significantly. 5 largest banks controlled **44.3 per cent** of the sector's assets (10 largest - 63.4 per cent).

The undisputed **leader was PKO BP** (balance sheet total at a level of PLN 190 bn) with Pekao (PLN 143 bn) as the runner and BRE (PLN 94 bn) in third place. These were followed by BGK, ING BSK, BZ WBK and Getin Noble (assets of over PLN 50 bn).

Assets of most (316) cooperative banks did not exceed PLN 100 m and only 19 showed a balance sheet total of more than PLN 500 m.

Chart 38
Financial system structure (%)

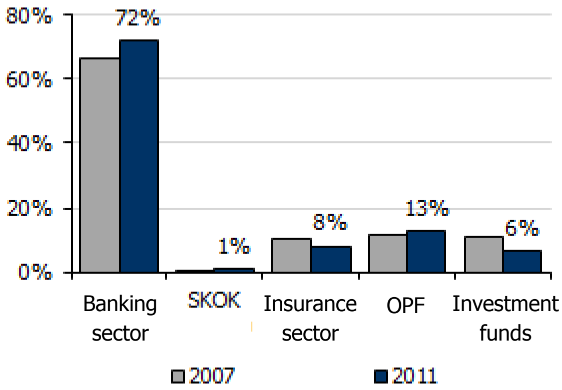


Chart 39
PKO BP in the backdrop of the financial system (PLN bn)

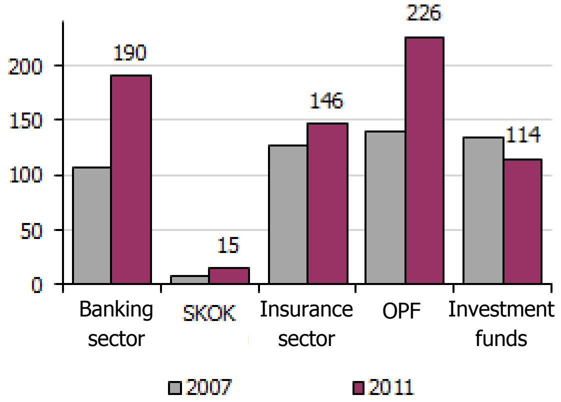


Chart 40
Share of banking sector's assets in GDP (%)

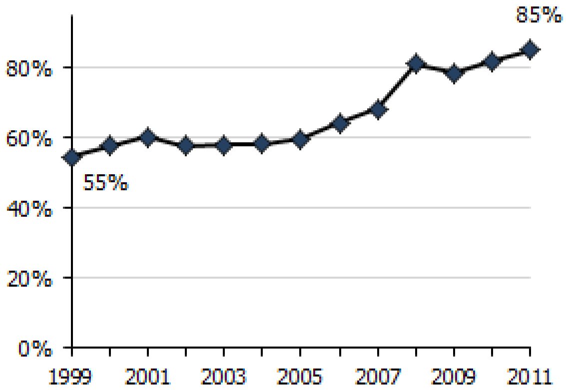


Chart 41
Share of loans and deposits in GDP (%)

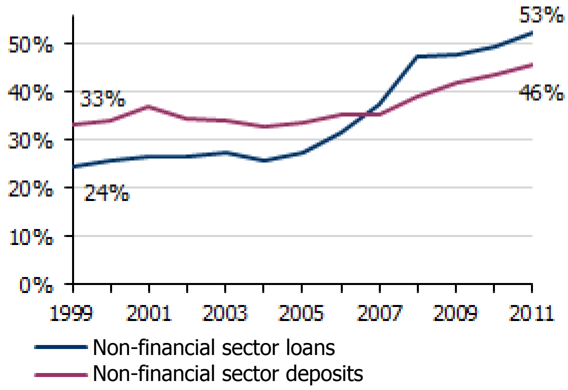


Chart 42
Share of loans to the non-financial sector in GDP (%)

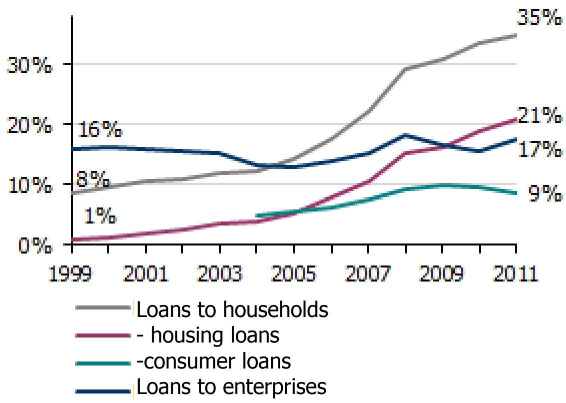
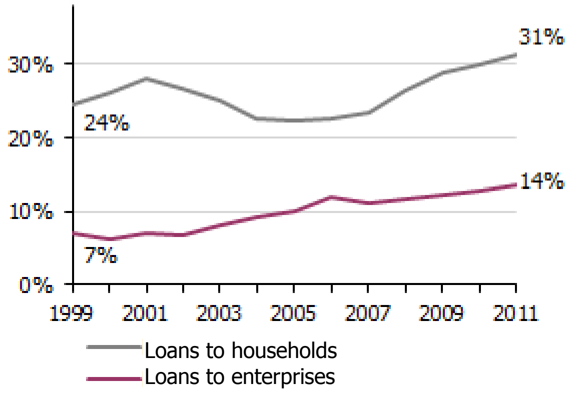


Chart 43
Share of deposits of the non-financial sector in GDP (%)



At the end of 2011, **the banking sector's assets constituted 72 per cent of the entire financial system** (without NBP), whereas PKO BP assets were comparable or exceeded the assets of the remaining financial system components. Therefore, **the stability of the banking system is of key significance for the stability of the entire financial system.**

In 2011 **the value of the banking sector assets as a proportion of GDP increased to** circa **85 per cent.** In the long term, attention is drawn by the systematic increase of the proportion of the value of household loans to the value of GDP (from circa 16 per cent in 1999 to circa 35 per cent in 2011), and in particular housing loans (from circa 1 per cent to circa 21 per cent) as well as household deposits (from circa 24 per cent to 31 per cent) and enterprise deposits (from circa 7 per cent to circa 14 per cent). On the other hand a long term stabilization of the share of loans to enterprises in GDP is observed (circa 15 per cent - 17 per cent).

2.2 Development of operations - main directions

In 2011 the banking sector reported an **increase to the balance sheet total** of PLN 135.7 bn (from PLN 1,159.4 bn at the end of 2010 to PLN 1,295.0 bn at the end of 2011), i.e. by **11.7 per cent** (9.6 per cent in 2010). **The growth in the scale of operations was driven mainly by an increase in lending** (the remaining items on the assets side showed little in a way of changes) funded primarily by an increase to the non-financial sector deposits, and to a lesser extent by an increase in liabilities with respect to the financial sector.

Chart 44
Change to the sector's major assets in 2011 (PLN bn)

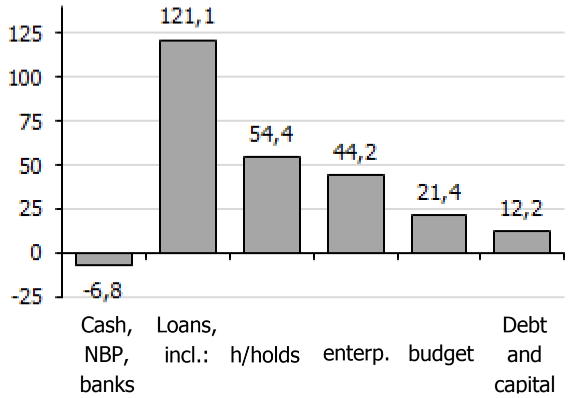


Chart 45
Change to the sector's major liabilities in 2011 (PLN bn)

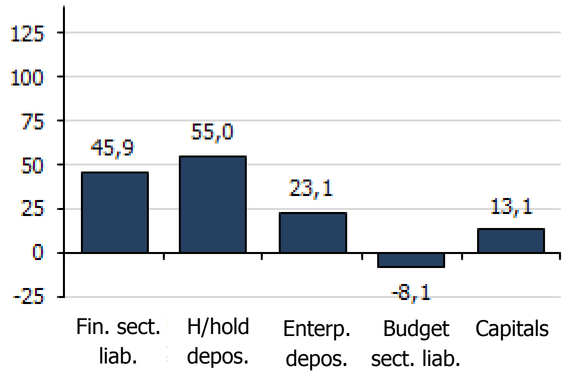


Chart 46
Balance-sheet total according to bank groups (PLN bn)

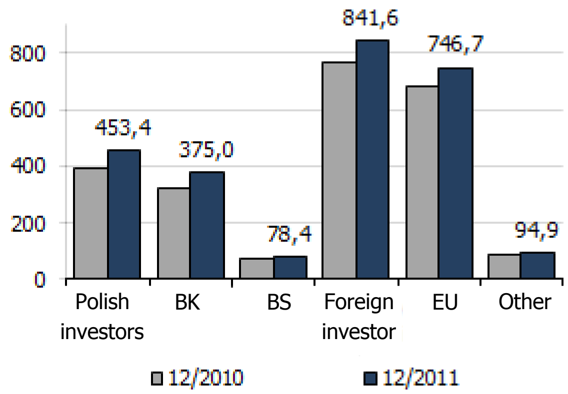
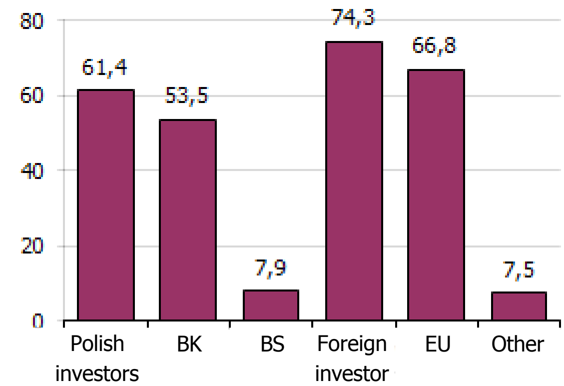


Chart 47
Change to the balance-sheet total according to bank groups (PLN bn)



In 2011 the **higher rate of growth at banks controlled by domestic investors** remained at levels reported over the recent years (increase to balance sheet total for these banks amounted to 15.7 per cent as compared to 9.7 per cent at banks controlled by foreign investors) which translated an increase to their share of the sector's assets. The lower growth dynamic at foreign investor controlled banks stemmed from the prevailing stagnation tendencies at a number of these institutions, which may be explained by a difficult financial position of some strategic investors and changes to their strategies. However, this group of banks is not homogenous and some reported a significant increase to the scale of their activities.

The relatively sharp balance sheet total rise was partially due to the weakening of zloty against major currencies, which translated into an increase in the nominal value of the foreign currency loan portfolio. Upon eliminating the effect of exchange rate fluctuations against the zloty[9] the balance sheet total increase would amount to circa PLN 94 bn, i.e.: circa **7.8 per cent** (in 2010 circa PLN 84 bn, i.e.: circa 7.5 per cent).

[9] **Growth rate adjusted for the impact of exchange rate fluctuations** was calculated at their level as it stood at the end of 2011. However, due to the limitations of the reporting system, the data presented in the material should be treated as estimates.

2.3 Lending and investment activity

In 2011, **the total value of loans** (as per gross balance sheet value) increased by PLN 123.9 bn, i.e. **15.7 per cent** (in the fourth quarter by PLN 29.4 bn; 3.3 per cent), whereas this increase was partially due to the weakening of the zloty. Upon eliminating the effect of exchange rate fluctuations against the zloty the increase would amount to circa PLN 89 bn, i.e.: circa **10.8 per cent** by which the increase in loans exceeded that in 2010 (circa PLN 55 bn, i.e.: circa 7.3 per cent).

Table No. 2. **Loan portfolio structure according to gross balance sheet values (PLN bn, %)**

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Total lending, of which:	653.6	713.9	787.5	881.9	911.3	27.7 %	15.7 %	3.3 %
1/ Financial sector	19.1	24.6	25.5	26.0	25.7	4.7 %	0.8 %	-0.9 %
2/ Non-financial sector	608.0	641.2	698.5	780.7	800.8	24.9 %	14.6 %	2.6 %
- households	372.4	416.4	475.4	526.0	532.0	27.8 %	11.9 %	1.1 %
- enterprises	233.3	222.1	219.7	250.8	264.5	19.1 %	20.4 %	5.5 %
- non-profit institutions	2.3	2.7	3.4	3.8	4.2	53.5 %	22.7 %	9.2 %
3/ Budget sector	26.5	48.1	63.4	75.2	84.8	76.5 %	33.8 %	12.7 %
Structure of loans by currency								
- zloty	433.1	488.2	534.7	584.0	604.5	23.8 %	13.0 %	3.5 %
- foreign currency	220.5	225.7	252.7	297.9	306.8	36.0 %	21.4 %	3.0 %

Chart 48
Loans to major customer groups (PLN bn)

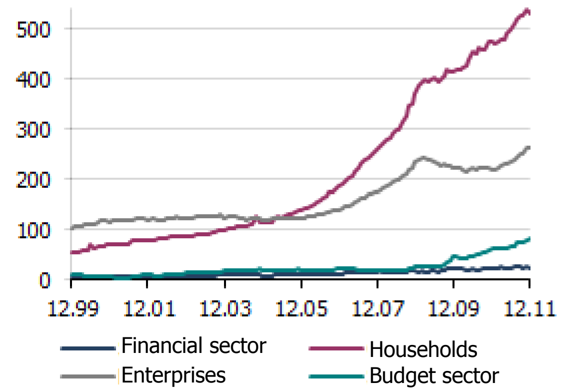


Chart 49
Loan portfolio structure (%)

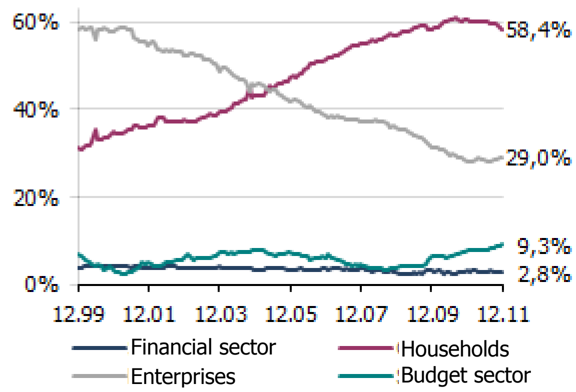


Chart 50
Change to the standing of loans to major customer groups (PLN bn)

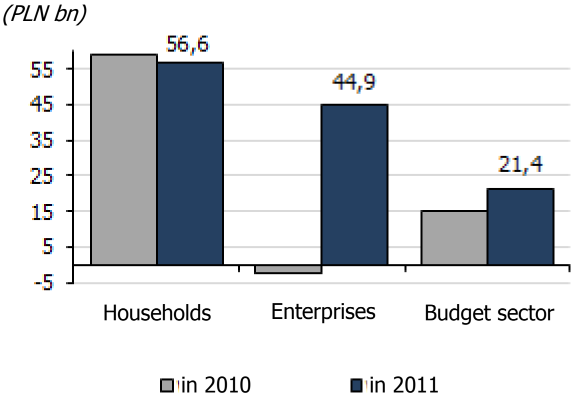
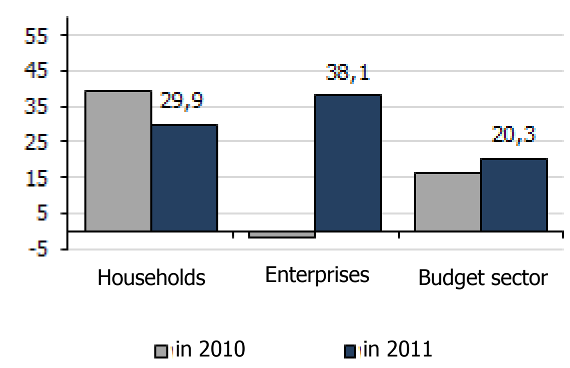


Chart 51
Change adjusted for exchange rates (PLN bn)



The growth to lending was primarily driven by increased financing of households, significant revival of lending to the enterprise sector and further growth of budget sector financing, whereas upon eliminating the effect of exchange rate fluctuations, the **increase in lending to enterprises** (nearly PLN 40 bn) **exceeded the growth of household lending** (circa PLN 30 bn), which was a first for a number of years.

Chart 52
Lending according to bank groups (PLN bn)

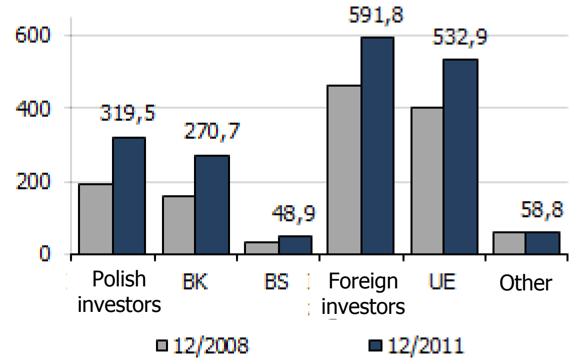


Chart 53
Share in loans according to bank groups (PLN bn)

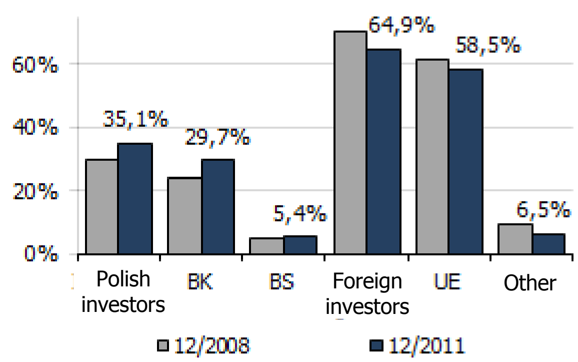


Chart 54
Change to lending in 2009-2011 (PLN bn)

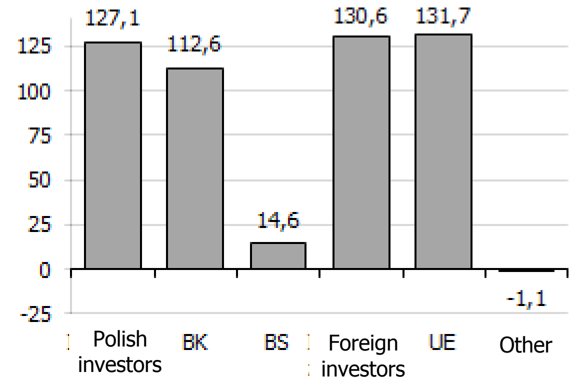
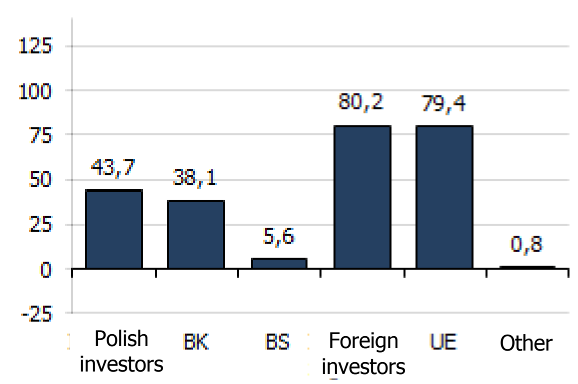


Chart 55
Change to lending in 2011 (PLN bn)



After the 2009-2010 slow down in lending, in 2011 an increase to the scale of financing was reported by foreign investor controlled banks (however part of the nominal increase was due to the weakening of the zloty). Nevertheless, some of them still reported a stagnation.

Table No. 3. **Structure of loans to households (PLN bn; %)**

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Total lending, of which:	372.4	416.4	475.4	526.0	532.0	27.8 %	11.9 %	1.1 %
1/ Housing loans	195.1	217.8	267.5	311.9	318.8	46.4 %	19.2 %	2.2 %
2/ Consumer loans	116.6	132.2	134.1	131.9	130.4	-1.4 %	-2.7 %	-1.1 %
3/ Other	60.7	66.5	73.9	82.2	82.9	24.6 %	12.2 %	0.7 %
Structure of loans by currency								
- zloty	220.4	259.0	290.8	313.1	317.5	22.6 %	9.2 %	1.4 %
- foreign currency	152.0	157.4	184.6	212.9	214.5	36.3 %	16.2 %	0.7 %

In 2011, the value of the portfolio of **loans to households** increased by PLN 56.6 bn, i.e. by **11.9 per cent** (in the fourth quarter by PLN 6.0 bn; 1.1 per cent), and upon eliminating the effect of exchange rate fluctuation, the increase would amount to approximately PLN 30 bn, and the rate of growth – approximately **6.0 per cent**. Credit growth resulted from **increased value of housing loans and loans to small enterprises**, while **the portfolio of consumer loans declined.**

Chart 56
Structure of loans to households (PLN bn)

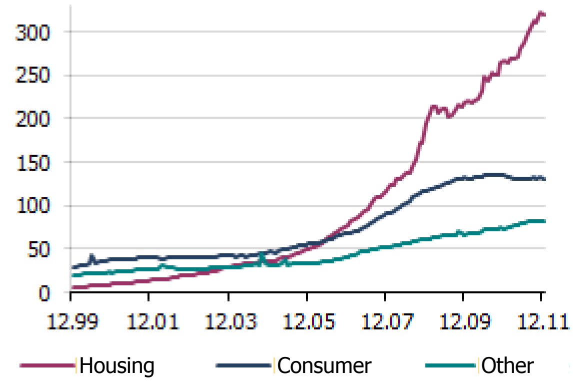


Chart 57
Structure of loans to households (PLN bn)

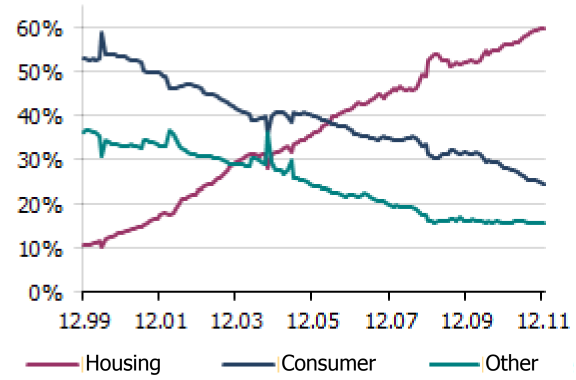


Chart 58
Annual rate of growth in loans to households (%)

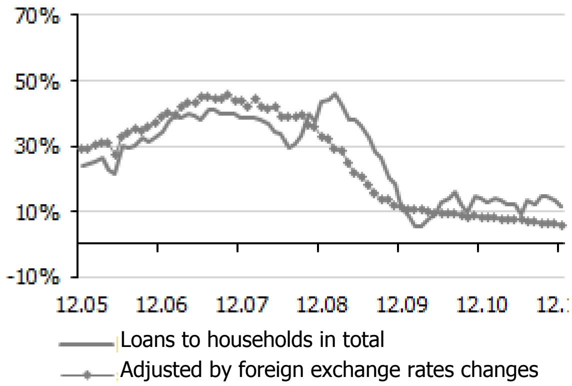


Chart 59
Annual rate of growth in housing loans (%)

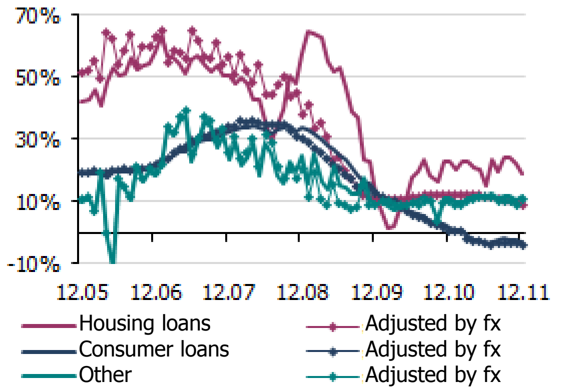


Chart 60
Change to the structure of loans to households (PLN bn)

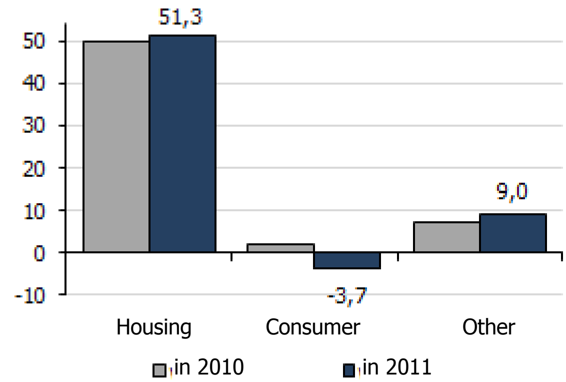


Chart 61
Change adjusted for exchange rates (PLN bn)

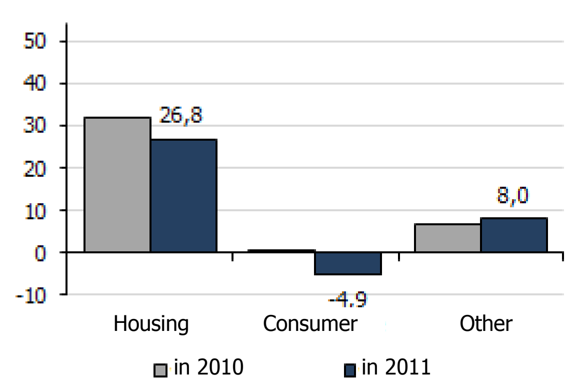


Chart 62
Rate of increase of lending to households in Poland and the eurozone (%)

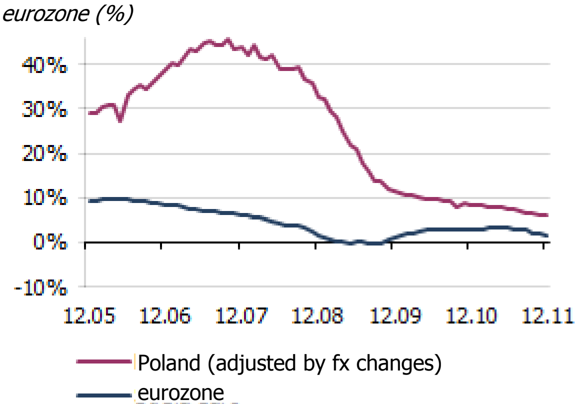
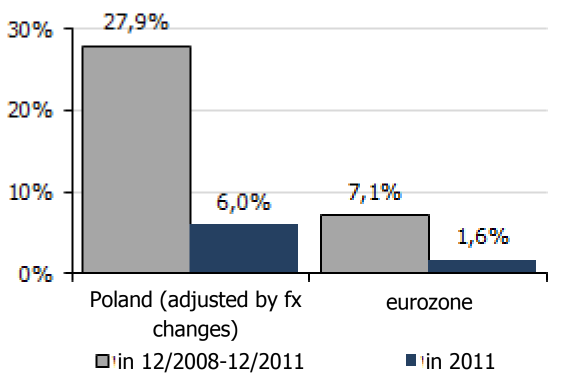


Chart 63
Change in 2011 r. and in 2005-2011 (%)



In observing the long term trends, the **decline** in lending to households is apparent (decrease to the housing loans growth rate, falling activity in terms of consumer loans, levelling out of the remaining loans). This is explained by the **statistical base** effect (base rate increase), **self-regulation by banks** due to the significant deterioration in the quality of consumer loans and a gradual deterioration of housing loans quality, **regulatory activities** (Recommendations S and T), as well as a **shift in the attitude of some households** resulting from the experiences of the financial crisis which led some households to reduce their bank debts.

The slow down in lending is also evident in the eurozone countries, which asserts the statement regarding reduced lending due to banks self-regulation and decreased demand from households.

Table No. 4. **Structure of housing loans (PLN bn; %)**

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Total housing loans, of which:	195.1	217.8	267.5	311.9	318.8	46.4 %	19.2 %	2.2 %
- zloty	59.1	75.6	98.2	115.9	120.9	59.9 %	23.1 %	4.3 %
- foreign currency	136.0	142.1	169.3	196.0	197.8	39.2 %	16.9 %	0.9 %
- EUR	2.6	7.6	19.7	29.4	31.9	321.8 %	61.5 %	8.5 %
- CHF	131.9	132.9	147.4	164.2	163.5	23.1 %	10.9 %	-0.4 %
- other currencies	1.5	1.7	2.1	2.4	2.4	44.8 %	13.2 %	1.9 %

Chart 64
Number of loan agreements at period end (thousand)

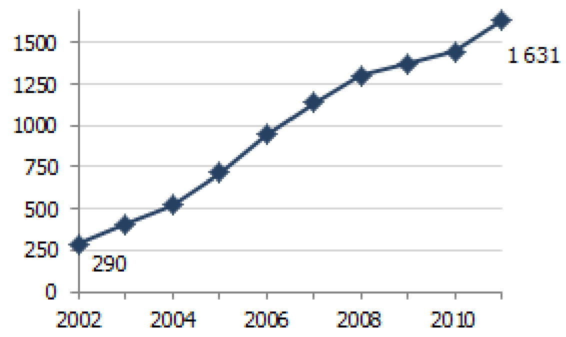


Chart 65
Role of housing loans in banks' balance sheets (%)

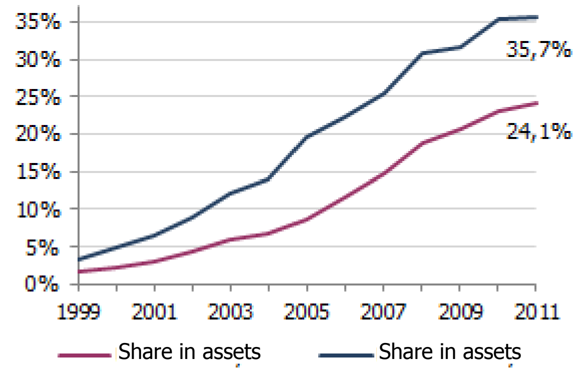


Chart 66
Currency structure of housing loans (PLN bn)

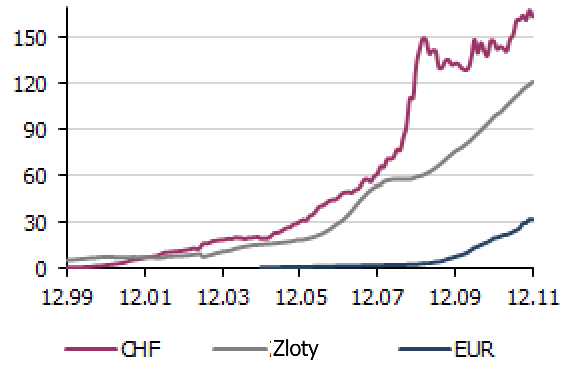
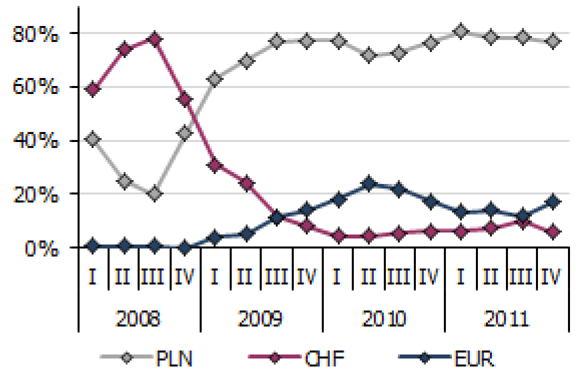


Chart 67
Structure of new housing loans (%)



Source: Polish Bank Association, AMRON-SARFiN, PFSA

In 2011, **the value of housing loans** (as per gross balance sheet value) **increased** by PLN 51.3 bn, i.e. **19.2 per cent** (in the fourth quarter by PLN 6.9 bn; 2.2 per cent), whereas this increase was to a large extent due to the weakening of the zloty against major currencies. Upon eliminating the effect of exchange rate fluctuation, the increase would amount to approximately PLN 27 bn, and the rate of growth – approximately **9.2 per cent**.

At the end of 2011, banks' portfolios contained in excess of 1.6 bn housing loans (as compared to 1.4 bn at the end of 2010).

Housing loans represented the dominant element of the loan portfolio and the sector's assets. As at the end of 2011, these constituted **37.5 per cent of total loans** (loans according to balance sheet value) and **24.4 per cent of balance sheet total** of the banking sector, whereas at banks which play key roles on the housing loan market this proportion was significantly higher (see chapt. IV)

The dominance of zloty loans in the structure of new loans should be deemed favourable (circa 80 per cent of new loan agreements in each quarter of 2011). Consequently, the value of zloty loans increased by PLN 22.7 bn, i.e. by 23.1 per cent, and the share of these loans in the portfolio of housing loans increased to 37.9 per cent (from 36.7 per cent at the end of 2010).

The favourable changes should be associated with the activities of banking supervision and an increase in currency risk awareness by customers and banks, which translated into a decreased demand for foreign currency loans and a tightening of procedures for granting loans by banks.

Chart 68
Number of loans granted as part of the RnS Programme (thousand)

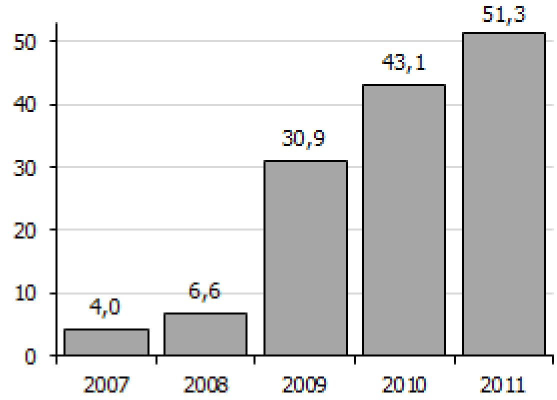
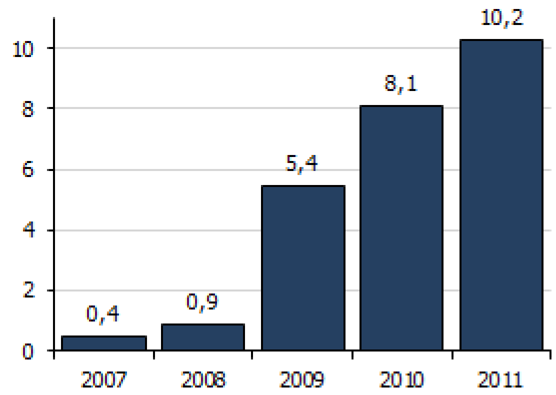


Chart 69
Value of loans granted as part of the RnS Programme (PLN bn))



Source: BGK

The "Rodzina na swoim" Programme was also a factor conducive to the growth of zloty loans, which, despite a number of objections as to its functioning and risks generated for the banking sector (stemming from the steep increase in repayment rates after 8 years), resulted in a growth of the zloty loans portfolio, as only such loans can be granted within the scope of this programme (in 2011 51.3 thousand loans amounting to a PLN 10 bn were granted as part of RnS Programme).

While the value of foreign currency loans increased by PLN 28.6 bn, i.e. 16.9 per cent, it was largely due to a weakening of the zloty. Upon eliminating the effect of exchange rate fluctuations, the increase of foreign currency loans would amount to approximately PLN 4 bn, i.e. 2.0 per cent. Despite the far reaching restrictions in foreign currency funding, **circa 20 per cent share in new loans is still too high.** Due to the risk generated by foreign currency loans, **they should be considered to be a niche product**, aimed at a very narrow group of customers, who are naturally protected against exchange rate risk (their income is in the currency of the loan). As at the end of 2011, the PFSA instigated one to one talks with banks in order to curb sales of foreign currency loans.

In 2011, **the foreign currency housing loan market was developed by medium and smaller banks.** Large banks (with a few exceptions), implemented a significant adjustment to their lending policy and most focused on zloty lending, and the granting of loans in EUR should most probably be associated with the currency conversion of come CHF loans to EUR.

Chart 70
Proportion of loans with an LTV>80% in new loans (%)

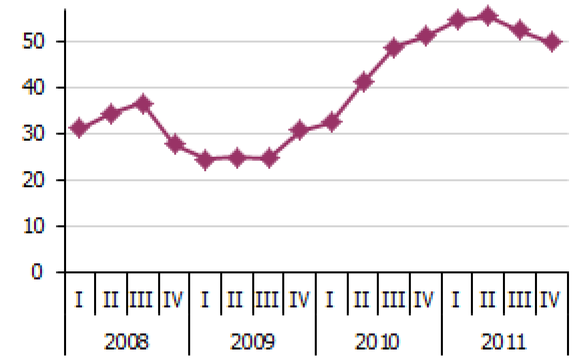
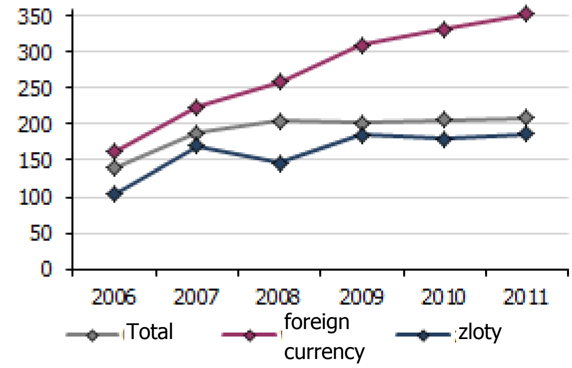


Chart 71
Average value of new loans (PLN thousand)



Source: Polish Bank Association, AMRON-SARFiN

Next to continuing foreign currency lending, the loosening of the key parameters describing the scale of risk assumed by banks and customers should also be considered as **unfavourable,** i.e.:

- **large share of loans with LTV of more than 80 per cent,** which amount to over 50 per cent of new loans;
- **excessive prolongation of the lending period** (loans granted for a term of more than 25 years accounted for nearly 70 per cent of all new loans in 2011);
- further **growth of the average value of new foreign currency loans.**

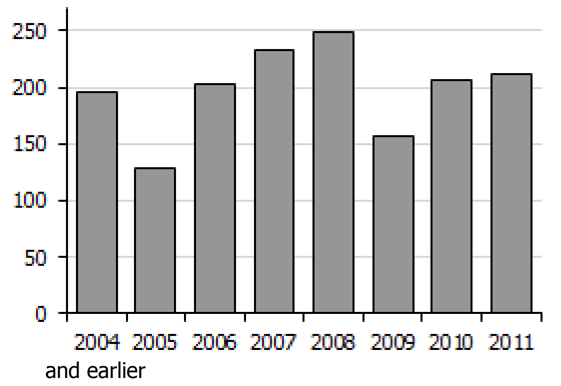
This causes increased risk for banks and their customer and limits the possibility of potential restructuring.

SURVEY RESULTS ON THE HOUSING LOAN PORTFOLIO [10]
PORTFOLIO STRUCTURE

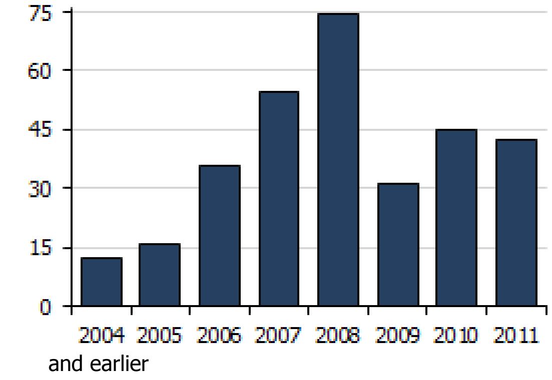
	Number of loans (thousand)						Gross book value (PLN bn)					
	Total	Zloty	Foreign currencies	CHF	EUR	other	Total	Zloty	Foreign currencies	CHF	EUR	other
Total	1 578.5	866.1	712.4	596.1	109.5	6.8	311.4	115.6	195.8	163.0	31.5	1.2
Loan amount:												
- up to PLN 100 thousand	595.9	414.5	181.4	152.7	24.3	4.3	28.1	18.2	9.9	8.8	1.0	0.1
- PLN 100-200 thousand	433.7	258.2	175.5	153.7	20.9	0.9	62.0	35.2	26.8	23.7	3.0	0.1
- PLN 200-300 thousand	242.3	115.0	127.3	105.2	21.6	0.5	59.2	26.7	32.5	27.0	5.4	0.1
- PLN 300-400 thousand	129.3	44.0	85.3	67.7	17.3	0.3	44.8	14.5	30.3	24.2	6.0	0.1
- PLN 400-500 thousand	70.0	16.5	53.6	43.2	10.2	0.2	31.4	7.1	24.3	19.7	4.5	0.1
- more than PLN 500 thousand	107.2	17.9	89.3	73.5	15.3	0.5	85.9	13.9	72.0	59.6	11.7	0.7
Term to maturity:												
- up to 10 years	271.7	196.1	75.5	63.1	10.7	1.7	16.7	10.6	6.1	5.2	0.9	0.1
- 10-20 years	435.6	250.9	184.7	156.8	25.3	2.6	60.3	26.7	33.6	29.2	4.2	0.2
- 20-25 years	242.6	103.8	138.8	126.0	11.8	1.1	57.1	16.3	40.7	37.7	2.9	0.2
- 25-30 years	502.2	265.3	236.9	186.6	49.4	1.0	132.3	49.8	82.6	63.6	18.5	0.5
- more than 30 years	126.5	50.1	76.4	63.6	12.4	0.4	45.0	12.3	32.7	27.4	5.1	0.3
Average LTV:												
- up to 70 %	923.9	585.0	339.0	285.5	48.3	5.1	110.5	59.3	51.2	43.3	7.6	0.3
- 70-80%	122.1	71.1	51.0	41.6	9.2	0.2	28.7	13.8	14.9	11.7	3.2	0.1
- 80-90%	120.1	69.4	50.7	38.6	11.9	0.2	31.0	14.1	16.9	12.3	4.5	0.1
- 90-100%	133.5	83.6	49.9	35.7	13.9	0.3	35.9	17.6	18.2	12.5	5.6	0.1
- 100-110%	71.8	27.1	44.6	30.8	13.5	0.3	24.3	6.7	17.6	11.8	5.7	0.1
- 110-120%	41.9	5.8	36.2	27.2	8.8	0.2	16.1	1.5	14.6	10.9	3.6	0.1
- 120-130%	29.4	1.8	27.6	26.1	1.4	0.1	11.9	0.5	11.4	10.7	0.6	0.1
- more than 130%	109.8	4.5	105.4	103.5	1.6	0.3	50.8	1.1	49.7	48.7	0.7	0.4

[10] Commercial banks and branches of credit institutions active on the housing loan market were included in the survey. The total amount of loans reported by banks was PLN 311.4 bn which constituted 97.7 per cent of all loans granted as per the FINREP system data.

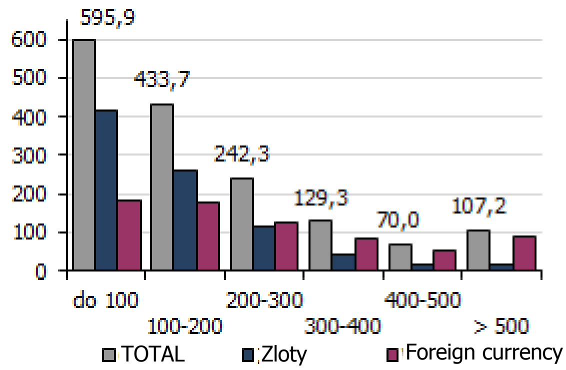
Number of loans by year of granting (thousand)



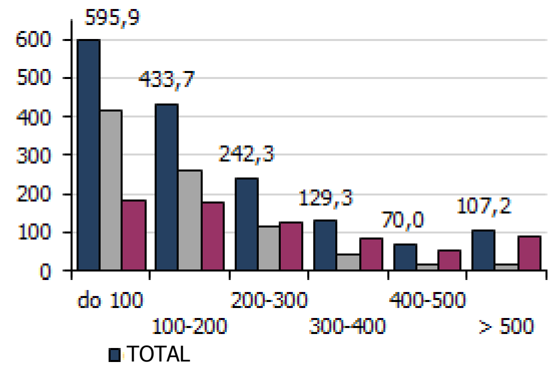
Value of loans by year of granting (thousand)



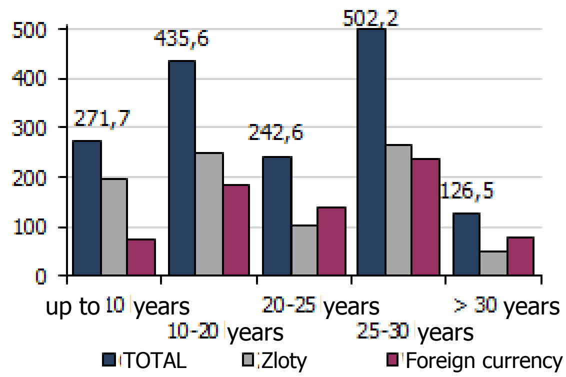
Number of loans by loan amount bands (thousand)



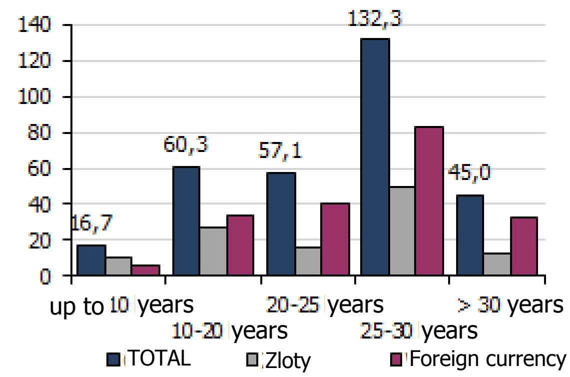
Value of loans (PLN bn) by loan amount bands (PLN thousand)



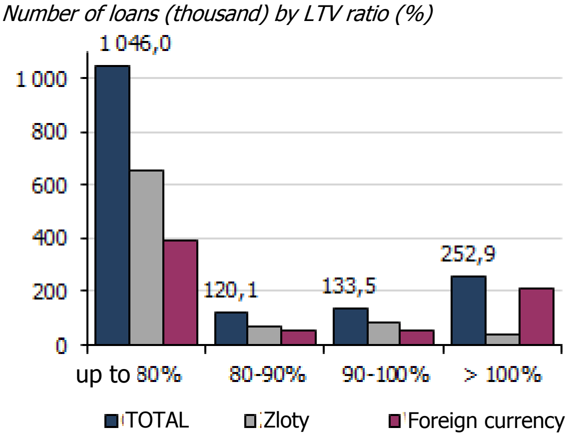
Number of loans (thousand) by term to maturity (years)



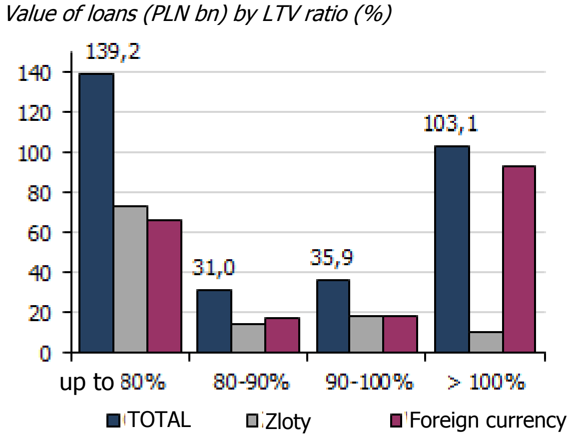
Value of loans (PLN bn) by term to maturity (years)



Number of loans (thousand) by LTV ratio (%)



Value of loans (PLN bn) by LTV ratio (%)



Overly expansive lending policy engaged in by banks has lead to an unfavourable loan portfolio structure. Based on PFSA survey results the following can be ascertained:

- the loan portfolio consisted of **252.9 thousand loans, total value PLN 103.1 bn, with LTV exceeding 100%** (for 139.2 thousand loans, with a value of PLN 62.8 bn, LTV was more than 120%). The majority of these loans were foreign currency loans (213.8 thousand loans, total value PLN 93.3 bn);
- the average value of foreign currency loans was double that of zloty loans (PLN 274.8 thousand against PLN 133.5 thousand). The high proportion of foreign currency loans of more than PLN 500 thousand is noteworthy (these constituted only 5.7 per cent of the total number of loans, but 23.1 per cent of their total value).

Such loan portfolio structure **constitutes a source of potential systemic risk** (see chapt. IV).

Chart 72
Quarterly change in housing loans (PLN bn)

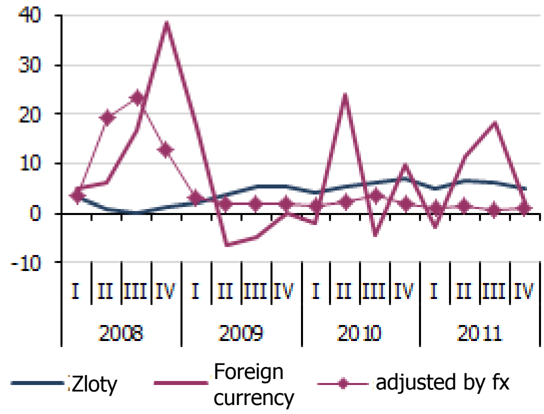
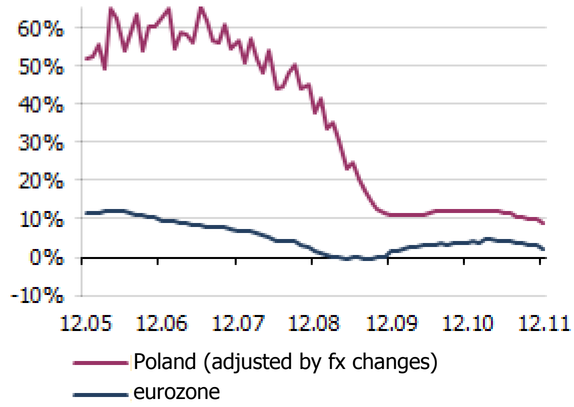


Chart 73
Rate of increase of household loans in Poland and the eurozone (%)



In the second part of 2011, **a certain decrease in the growth rate of housing loans** was observed (adjusted by exchange rate fluctuations). This should be associated with a tightening of lending policies at some banks, changes to the "Rodzina na Swoim" Programme (reduction of conversion factors) and a partial decrease in demand by potential borrowers reflecting fears regarding future financial situation (an effect of re-occuring symptoms of crisis) or disagreement with the current level of prices.

In 2012 the factor causing a slow down in lending may be the entry into force of all the provisions of Recommendation S (inter alia the recommendation to calculate creditworthiness based on a maximum term of 25 years) and self-regulatory activities by banks due to the gradually decreasing quality of these loans.

Chart 74
Average cost of development and selling price of 1 sq. m. of apartments in Warsaw (PLN)

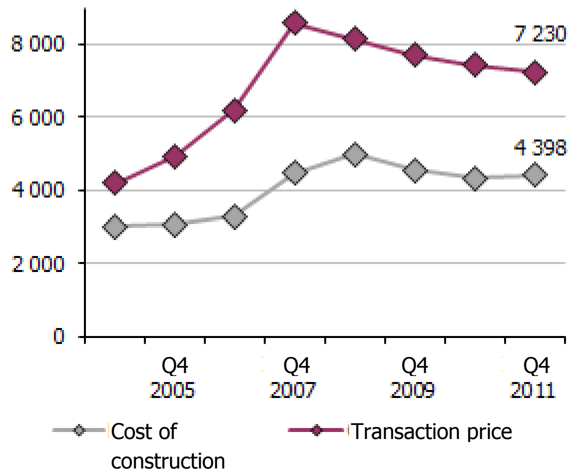


Chart 75
Average cost of development of 1 sq. m. of living space ion the entire country

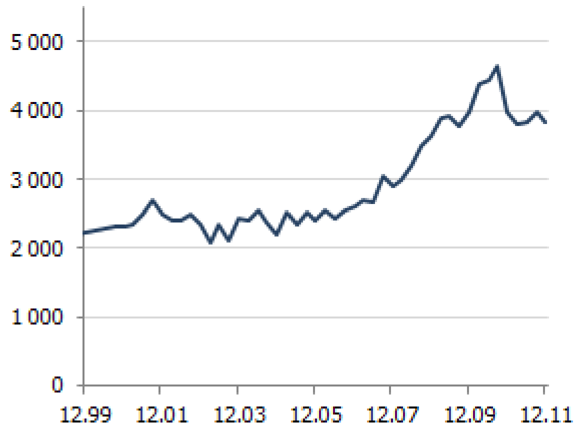


Chart 76
Developer's profit on 1 sq. m. of apartment in the largest Polish cities (PLN)

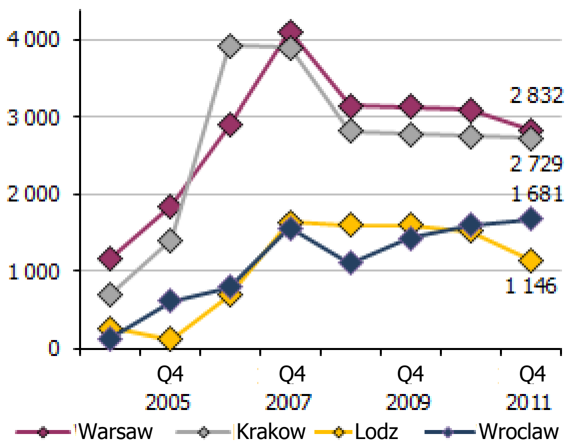
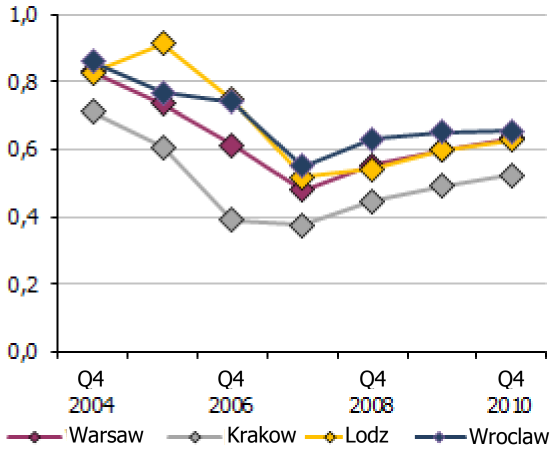


Chart 77
Affordability of 1 sq. m. of apartment[11] in the largest Polish cities



Source: "Information on real property prices and the situation on the residential and commercial real property market in Poland - fourth quarter of 2011" NBP; GUS; own calculations.

A significant obstacle to the development of the housing loans market **are high real property prices, which limit their availability to average households.** In this context it should be noted that the **rapid growth of housing loans in 2005-2008 together with a lack of matching supply and competition caused a rapid rise in real property prices which was justified only to a limited extent by increasing costs of production.** In particular, this process was stimulated by cheap and easily obtainable foreign currency loans, high LTVs at the time of granting a loan as well as long borrowing periods. Consequently, **prices begun to reflect the availability of loans and customers willingness to incur debt.**

The factor consolidating the unfavourable prices was the earlier RnS Programme formula, which employed too high conversion indices.

[11] Defined here as the ratio of average gross (monthly) income to the average selling price (developer's price) in a given market.

Table No. 5. Structure of consumer loans (PLN bn; %)

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Total consumer loans, of which:	116.6	132.2	134.1	131.9	130.4	-1.4 %	-2.7 %	-1.1 %
- credit cards	12.9	15.2	14.7	13.8	13.5	-10.8 %	-8.0 %	-2.2 %
- vehicle	8.3	7.9	7.7	7.1	6.8	-14.7 %	-12.4 %	-4.6 %
- instalment[12]	39.8	44.5	46.4	46.6	45.9	3.2 %	-0.9 %	-1.4 %
- other[13]	55.7	64.6	65.3	64.4	64.2	-0.6 %	-1.7 %	-0.3 %

Chart 78
Quarterly change in consumer loans outstanding (PLN bn)

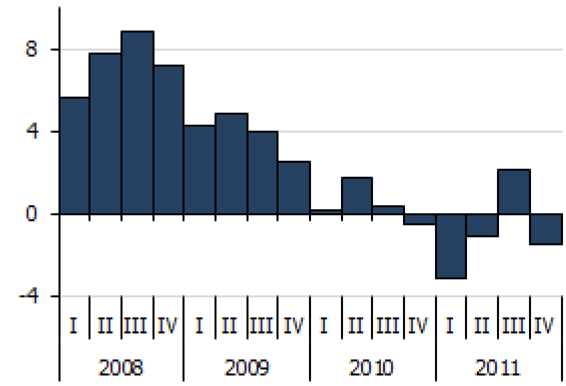


Chart 79
Change in loans outstanding by type (PLN bn)

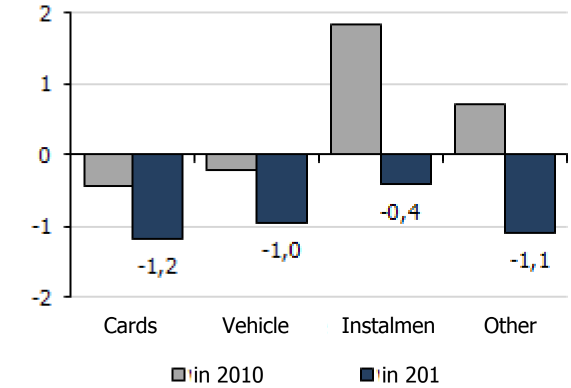


Chart 80
Rate of increase of consumer loans in Poland and the eurozone (%)

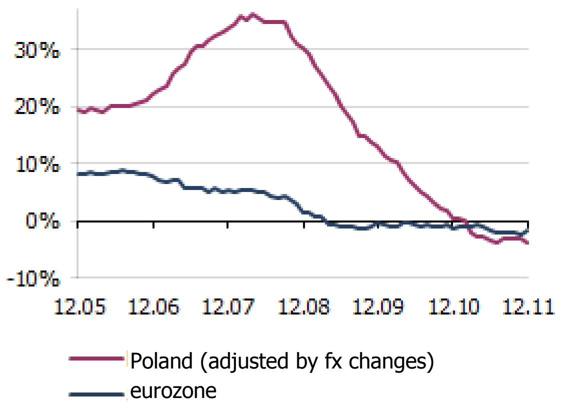


Chart 81
Change in loans outstanding in 2008-2011 and in 2011 (%)

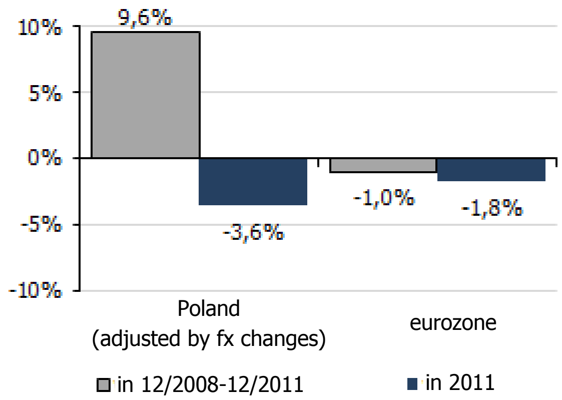


Chart 82
Performance of banks with a dominant consumer loan segment (PLN m)

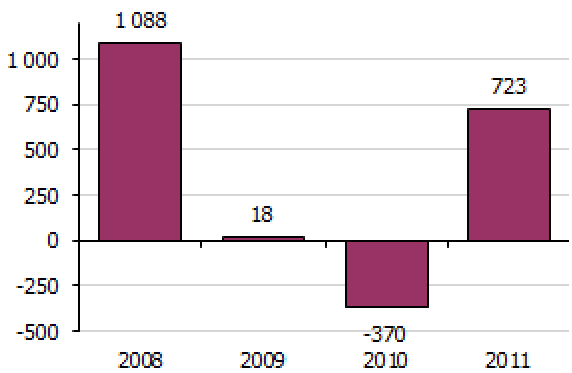
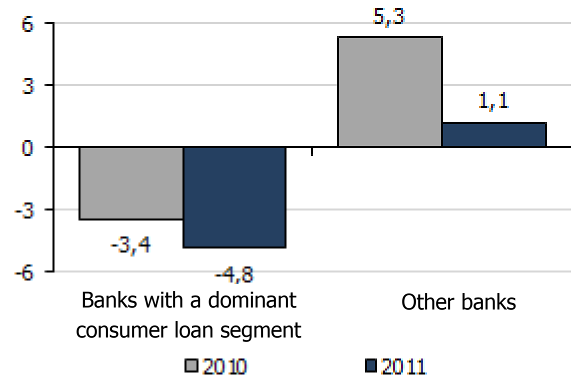


Chart 83
Change in consumer loans without accounting for the sale of a part of the portfolio (PLN bn)



[12] This category includes cash loans with a payment plan.
[13] This category includes overdrafts and cash loans repayable in a single payment.

In 2011, **the value of consumer loans decreased** by PLN 2.2 bn, i.e. by **2.7 per cent** (in the fourth quarter by PLN 1.5 bn; -1.1 per cent), and upon eliminating the effect of exchange rate fluctuation, approximately 3.6 per cent. However, it should be remembered that **one-off events** also influenced the change in the value of the portfolio. In particular banks **sold** consumer loan **portfolios** worth **PLN 2.6 bn**, as well as the PLN 0.8 bn worth of loans written-off to provisions (not appearing in balance sheets).

The reduction in lending primarily effected vehicle loans (-12.4 per cent; during the last two years -14.7 per cent) **and credit card debt** (-8.0 per cent; during the last two years -10.8 per cent). The reduction in lending in terms of other types of loans was significantly lower.

The reduction in the value of consumer loans reported in 2011**, stemmed from restrictions in lending by banks** which represent a significant share of the market for these loans and **which incurred significant losses in this sector in previous years. The reduction was further aggravated by the sale of a part of the loan portfolio.**

The significant **slow down in terms of consumer loans** as observed in recent periods (the growth peaked in mid 2008) **should be associated** with a number of coinciding factors:

- **self-regulation by banks** in an answer to the major deterioration of consumer loan quality and the associated need for large write-downs ;
- **adoption of Recommendation T** (this does not apply to all banks);
- **financial crisis which led to a certain change in the attitude of banks and their customers,** which resulted in a reduction to supply and demand (this may apply particularly to vehicle loans and larger instalment loans);
- **increase in competition from non-banking institutions;**
- **change in the strategy of some banks specialising in consumer finance,** whose owners are attempting to develop lending non-banking institutions (with the aim of bypassing the provisions of Recommendation T and restricting the influence of banking supervision);
- the growth of funding for small family firms, within which a blurring of the boundaries between loan usage for production and consumption may occur.

The rapid growth of lending in 2007-2009 often took place in a way of excessive easing of lending policy standards. As a result, the quality of consumer loans quickly deteriorated (the annual proportions of non-performing loans in 2008-2010 were 8 per cent, 13 per cent and 17 per cent respectively). This necessitated large write-downs leading to decreased profits or incurring losses by some banks (in 2008 the value of write-downs due to consumer loans amounted to PLN 3 bn and in 2009-2010 amounted to to circa PLN 7 bn per annum). **The increase to consumer loan write-downs was the primary reason for decreased financial performance of the sector in 2009-2010.** Consequently, **this led to self-regulation and tightening of the banks' lending policies.**

The adoption of recommendation T is also a limiting factor. However, it should be pointed out that **despite its adoption, some banks reported an evident increase in lending.** Furthermore **a number of banks reacted positively to the recommendation, indicating that it reduced negative competitive pressures.**

The increase in competition from non-banking institutions is limiting the growth of consumer loans (Cooperative savings and loan associations, lending firms) which should stiffen further in future. **A situation where banks or their parent entities conduct or intend to conduct activities of this type should be considered unfavourable.** This leads to a transfer of credit risk to a different location of the same capital group, increase of compliance and reputation risk, reduction of transparency and causes negative competitive pressures).

Table No. 6. Structure of other loans to households (PLN bn, %)

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Other loans to households, of which:	60.7	66.5	73.9	82.2	82.9	24.6 %	12.2 %	0.7 %
- operating	21.0	21.7	23.3	27.7	27.1	24.6 %	16.3 %	-2.1 %
- investment	21.2	22.7	25.1	27.8	28.8	26.6 %	14.6 %	3.5 %
- for real property	5.4	6.9	8.1	8.7	9.0	30.9 %	11.4 %	3.6 %
- other	13.2	15.1	17.4	18.0	18.0	19.0 %	3.5 %	-0.4 %

Chart 84
Structure of other loans to households (PLN bn)

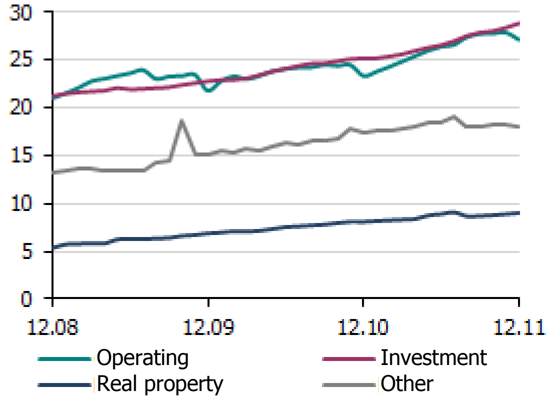
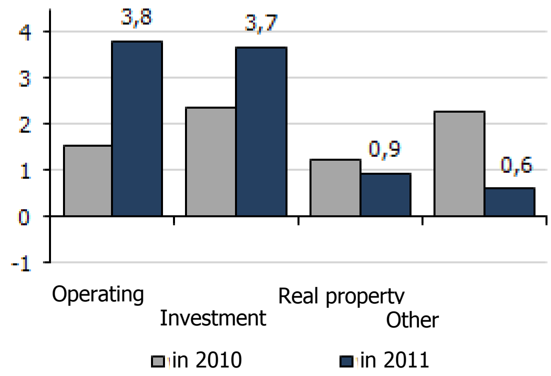


Chart 85
Change in loans outstanding by type (PLN bn)



The portfolio of **other loans to households,** which consists mainly of operating and investment loans for individual entrepreneurs and farmers, increased in 2011 by PLN 9.0 bn, i.e. **12.2 per cent** (in the fourth quarter by PLN 0.6 bn; 0.7 per cent). Lending was developed by most banks operating within this market.

The relatively high growth rate of these loans, particularly in terms of operating and investment loans should be favourable to the continuation of economic recovery.

Table No. 7. Structure of loans to enterprises (PLN bn; %)[14]

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Total lending, of which:	233.3	222.1	219.7	250.8	264.5	19.1 %	20.4 %	5.5 %
1/ SME	125.3	127.2	127.0	152.3	159.2	25.1 %	25.3 %	4.5 %
- operating	47.2	46.0	46.2	57.9	57.6	25.1 %	24.6 %	-0.5 %
- investment	32.2	34.1	35.2	42.8	47.5	39.1 %	35.1 %	10.9 %
- for real property	37.8	37.0	35.0	39.1	39.8	7.6 %	13.8 %	1.7 %
- other	8.0	10.0	10.6	12.5	14.3	41.9 %	34.1 %	14.2 %
2/ Large enterprises	108.0	94.9	92.7	98.4	105.4	11.1 %	13.7 %	7.1 %
- operating	59.2	48.4	44.2	48.9	47.8	-1.2 %	8.1 %	-2.3 %
- investment	33.2	30.3	30.1	32.7	36.5	20.3 %	21.3 %	11.5 %
- for real property	9.7	10.3	9.2	7.6	8.4	-18.4 %	-8.8 %	10.9 %
- other	6.0	5.8	9.2	9.2	12.7	117.1 %	38.5 %	37.8 %
Structure of loans by currency								
- zloty	173.2	163.8	165.1	183.8	192.9	17.7 %	16.8 %	4.9 %
- foreign currency	60.1	58.3	54.6	67.0	71.7	23.0 %	31.3 %	7.0 %

[14] Note: **The structure of the loan portfolio has been distorted** by a change to portfolio classification at one bank. In particular this effects the portfolio development and quality in the SME and large enterprises division. Therefore the description of these has been abandoned.

Chart 86
Loans to the enterprise sector (PLN bn)

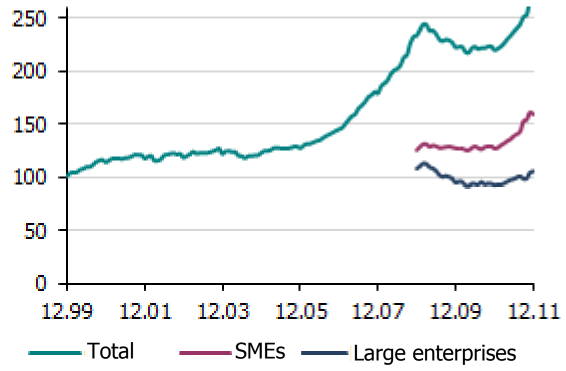


Chart 87
Annual growth rate for loans to enterprises (%)

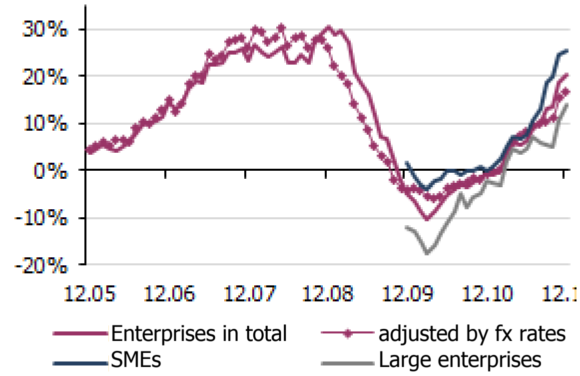


Chart 88
Change in loans outstanding (PLN bn)

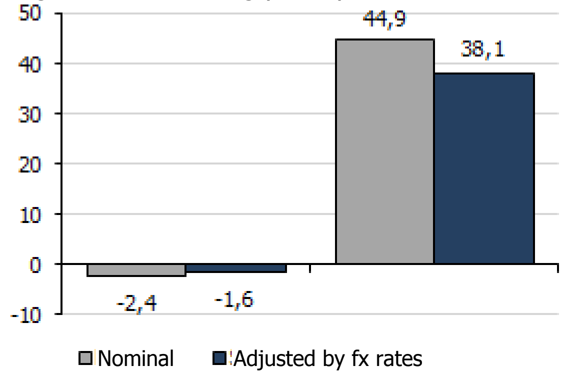


Chart 89
Proportion of loans for enterprises (%)

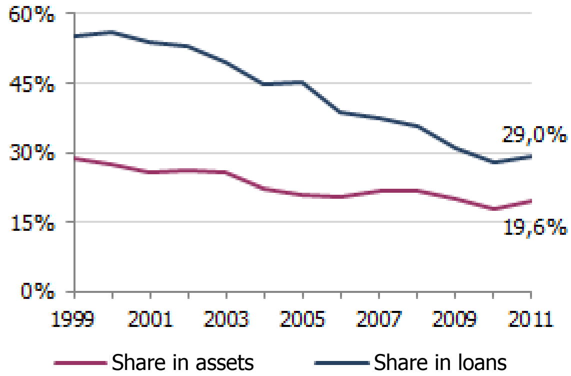


Chart 90
Loans structure by loan type (PLN bn)

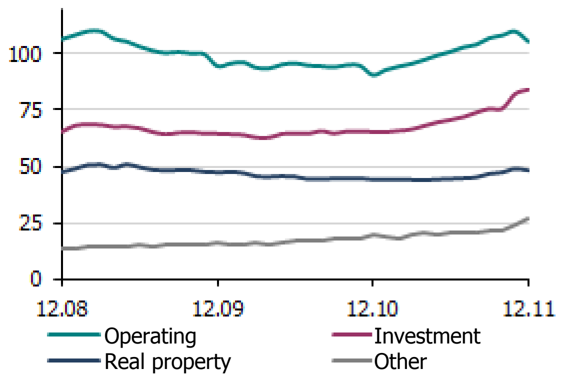
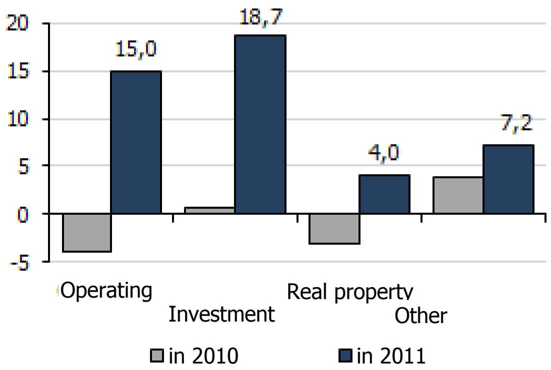


Chart 91
Change to loans structure by loan type (PLN bn)



In 2011 **a significant revival of lending to enterprises occurred.** The value of loans increased by PLN 44.9 bn, i.e.: **20.4 per cent**, and upon eliminating the effect of changing exchange rates by circa PLN 38 bn, i.e.: circa 16.8 per cent. However it should be pointed out, that despite the deteriorated investment confidence in the second half of 2011, in the fourth quarter the increase in lending amounted to PLN 13.8 bn, i.e.: 5.5 per cent (upon eliminating the effect of exchange rate fluctuation, the increase would amount to circa PLN 13 bn). In particular, attention should be directed towards **credit growth reported among large enterprises, which have been decreasing their debt to banks since 2009** (with the exception of the third quarter of 2010).

The product structure of the increase should also be considered as favourable, i.e.: the **increase in operating loans** (by 15.0 per cent) **and investment loans** (by 28.7 per cent), which on the one hand, indicates increased economic activity and on the other should be beneficial to the economic growth rate in forthcoming periods.

Therefore, a scenario seems to play out, **where the economic recovery begins to translate to increased demand for loans by enterprises, while the stabilisation of the credit portfolio quality begins to translate to increased supply by banks.**

In accordance with an earlier statement, and upon eliminating the effect of changing exchange rates, **for the first time since the 90s, the growth of lending to enterprises exceeded the growth of lending to households**, which, in the current situation, should be considered favourable from the point of view of economic growth.

The danger to the growth of lending in forthcoming periods may be the deterioration of the investment climate, economic downturns experienced by Poland's major trading partners and the expected reduction to the growth rate of the Polish economy. This may lead to another decrease in demand for loans by some enterprises, as well as more selective supply by banks. Additionally, it is difficult to predict the effects of a deteriorated financial standing of a number of construction enterprises on the banks' lending policies.

Table No. 8**. Structure of loans to the budget sector (PLN bn; %)**

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Total loans	26.5	48.1	63.4	75.2	84.8	76.5 %	33.8 %	12.7 %
Structure of loans by type of enterprise and product								
1/ Central government institutions	8.8	19.0	28.4	37.7	41.0	115.2 %	44.1 %	8.7 %
2/ Local government institutions	17.7	25.2	35.0	37.6	43.0	70.3 %	22.9 %	14.4 %
3/ Social insurance funds	0.0	3.8	0.0	0.0	0.8	-77.6 %	x	x
Structure of loans by currency								
- zloty	22.0	41.0	53.7	63.0	70.2	71.4 %	30.7 %	11.5 %
- foreign currency	4.5	7.1	9.7	12.3	14.6	105.6 %	50.6 %	18.9 %

Chart 92
Structure of loans to the budget sector (PLN bn)

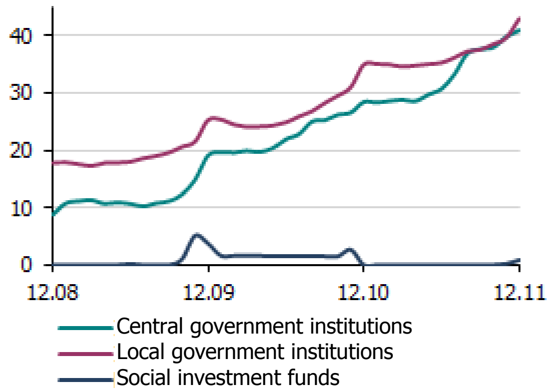
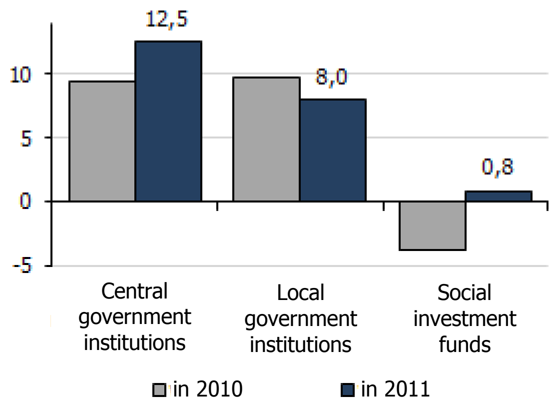


Chart 93
Change in loans outstanding (PLN bn)



In 2011, the value of **loans to the budget sector** increased by PLN 21.4 bn, i.e. by **33.8 per cent** (in the fourth quarter by PLN 9.6 bn; 12.7 per cent), with the value of loans to central government institutions increased by PLN 12.5 bn, i.e.: 44.1 per cent and to local government institutions by PLN 8.0 bn, i.e.: by 22.9 per cent.

The significant increase to the budget sector financing observed over in recent years, should be attributed to, inter alia, implemented infrastructure investments, which are undertaken with the use of EU aid funds and bank loans.

Table No. 9. Cash, central banks, financial sector, debt and equity (PLN bn; %)

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Cash and balances with central banks	39.6	50.5	50.4	52.5	40.2	-20.3 %	-20.2 %	-23.4 %
- cash	14.1	12.5	12.8	13.5	13.4	7.2 %	5.1 %	-0.4 %
- balances with central banks	25.5	38.0	37.7	39.1	26.8	-29.4 %	-28.7 %	-31.3 %
Claims on banks	92.3	60.3	68.5	82.1	71.8	19.2 %	4.9 %	-12.5 %
- domestic	51.2	38.0	44.4	52.5	41.4	8.8 %	-6.8 %	-21.2 %
- foreign	41.1	22.2	24.1	29.6	30.5	37.0 %	26.6 %	2.8 %
Structure of deposits by currency[15]								
- zloty	56.1	38.8	42.1	48.7	39.0	0.5 %	-7.4 %	-19.9 %
- foreign currency	36.1	21.5	26.4	33.4	32.9	53.0 %	24.7 %	-1.7 %
Portfolio of debt and equity instruments	174.9	199.8	231.2	232.2	243.4	21.8 %	5.3 %	4.8 %
1/ Debt securities	173.3	197.6	228.9	229.5	240.5	21.7 %	5.0 %	4.8 %
- central banks	18.5	41.0	74.6	87.6	93.4	127.9 %	25.1 %	6.6 %
- treasury	147.7	149.0	143.8	127.6	130.8	-12.2 %	-9.0 %	2.5 %
bills	36.4	30.5	15.5	9.0	6.6	-78.4 %	-57.6 %	-26.5 %
bonds	111.3	118.4	128.2	118.6	124.2	4.9 %	-3.2 %	4.7 %
- other	7.1	7.7	10.5	14.3	16.3	113.1 %	55.3 %	14.0 %
2/ Equity instruments	1.6	2.2	2.3	2.7	2.9	30.3 %	27.4 %	8.9 %

Chart 94
Selected categories of liquid assets (PLN bn)

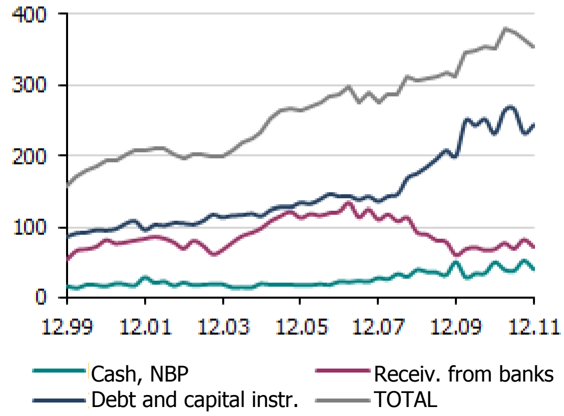


Chart 95
Proportion of the balance sheet total (%)

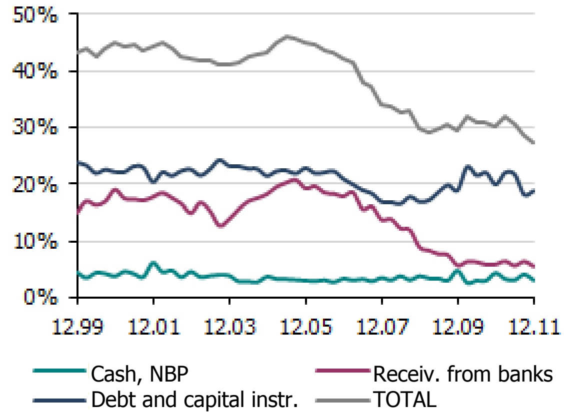


Chart 96
Changes in selected categories of assets (PLN bn)

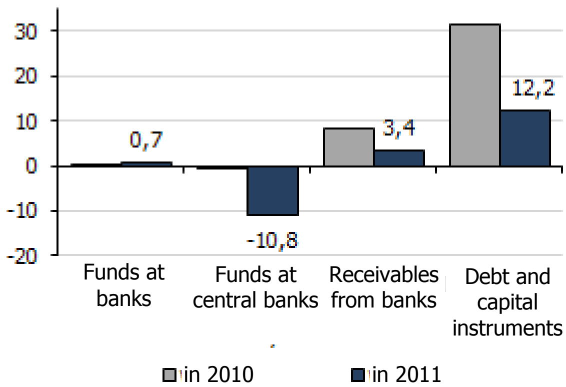
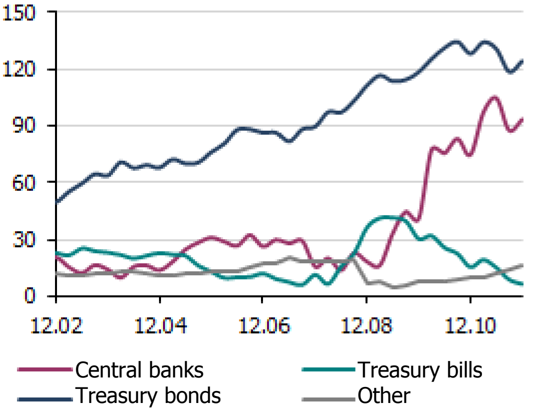


Chart 97
Structure of the debt security portfolio (PLN bn)



The total value of highest-liquidity assets (defined herein as the total of funds held in cash, central banks, receivables from banks as well as debt and equity instrument portfolio), at the end of 2011 amounted to PLN 355.5 bn and was **similar to the 2010 figure** (PLN 350.1 bn). However, throughout the year this figure was

[15] Due to the limitations of the reporting system, the value was estimated on the basis of the gross balance sheet value.

subject to fluctuations. The levelling out of the said amount, together with increased lending resulted in a further **decrease to the share of these funds in balance sheet totals** (from 30.2 per cent as at the end of 2010 to **27.4** per cent at the end of 2011).

Within the make up of the debt instrument portfolio, a further increase of NBP bills is noteworthy, which stems from further treasury bills emission reductions (a phenomenon observed in recent years caused by Ministry of Finance changes to the structure of obtained funds) and a reduction to the levels of treasury bonds.

2.4 Sources of financing

The structure of banks' sources of financing remains relatively stable. In 2011, the total value of liabilities increased by PLN 122.6 bn, i.e. by **11.8 per cent** (in the fourth quarter by PLN 11.0 bn; 1.0 per cent), and upon eliminating the effect of exchange rate fluctuation, the increase would amount to approximately PLN 91 bn, i.e.: approximately **8.5 per cent**.

Table No. 10 **Structure of operating funding sources (PLN bn; %)**

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Liabilities	947.2	954.1	1 043.4	1 154.9	1 166.0	22.2 %	11.8 %	1.0 %
Structure of liabilities:								
1/ Liabilities towards central banks	18.2	14.5	0.7	0.5	0.4	-97.5 %	-50.5 %	-20.3 %
2/ Liabilities towards the financial sector	316.0	269.4	316.4	375.1	362.2	34.4 %	14.5 %	-3.4 %
out of which deposits and loans	230.8	216.8	244.8	269.4	266.7	23.1 %	8.9 %	-1.0 %
3/ Liabilities towards the non-financial sector	516.6	579.4	631.9	664.9	712.7	23.0 %	12.8 %	7.2 %
out of which deposits	499.0	567.2	620.4	650.6	698.5	23.2 %	12.6 %	7.4 %
4/ Liabilities towards the budget sector	54.0	55.9	59.8	75.1	51.7	-7.6 %	-13.5 %	-31.2 %
out of which deposits	52.7	52.0	53.0	66.8	49.0	-5.8 %	-7.5 %	-26.7 %
5/ Other liabilities[16]	42.5	34.8	34.6	39.4	38.8	11.6 %	12.2 %	-1.5 %
Structure of liabilities by country[17]:								
1/ Domestic	736.9	769.8	828.6	908.2	923.6	20.0 %	11.5 %	1.7 %
2/ Foreign	210.3	184.2	214.8	246.7	242.4	31.6 %	12.8 %	-1.8 %
Supplementary information:								
1/ Liabilities towards the parent group	no data	no data	no data	no data	145.9	x	x	x
2/ Liabilities towards banks	238.1	196.5	227.7	264.6	249.1	26.8 %	9.4 %	-5.9 %
out of which deposits and loans	160.3	147.8	166.2	176.3	170.1	15.1 %	2.3 %	-3.5 %
3/ Liabilities arising from issue of securities	12.5	19.4	24.4	38.6	42.8	120.2 %	75.4 %	10.7 %
4/ Subordinated liabilities	7.6	8.9	9.7	10.4	10.1	13.6 %	3.8 %	-2.8 %
Capital	88.1	103.3	116.0	125.0	129.1	24.9 %	11.3 %	3.2 %

Liabilities were dominated by the non-financial sector deposits (at the end of 2011 constituting 59.9 per cent of total liabilities as compared to 59.5 per cent at the end of 2010) as well as deposits and loans received from the financial sector (22.9 per cent as compared to 23.5 per cent), followed by deposits of the budget sector and own issues.

From the point of view of country of origin of funds, domestic liabilities were dominant (amounting to 79.2 per cent at the end of 2011 as compared to 79.4 per cent at the end of 2010). However, foreign funding still represents a majority at some banks.

[16] Other liabilities include: financial liabilities on the account of transferring financial assets, collateral liabilities, provisions (main employee benefits and provisions for off-balance sheet liabilities), income tax payables, provision for general risk/IBNR, income in suspension and other liabilities.

[17] Within the scope of the "Other liabilities" item in the table, the reporting system does not differentiate between domestic and foreign Therefore the entire value attributed to this item is recognised under domestic, despite the fact that some of these liabilities are towards foreign entities.

Table 11. Deposits of the non-financial sector (PLN bn; %)

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Deposits of the non-financial sector, of which:	499.0	567.2	620.4	650.6	698.5	23.2 %	12.6 %	7.4 %
- households	336.9	387.7	422.4	453.1	477.4	23.1 %	13.0 %	5.3 %
- enterprises	148.0	165.1	182.8	181.6	205.9	24.7 %	12.6 %	13.3 %
- non-profit institutions	14.2	14.4	15.2	15.8	15.3	6.3 %	0.3 %	-3.6 %
Structure by currency								
- zloty	394.2	507.4	557.7	583.5	623.7	22.9 %	11.8 %	6.9 %
- foreign currency	104.9	59.7	62.7	67.1	74.8	25.2 %	19.4 %	11.5 %

Chart 98
Deposits of the non-financial sector (PLN bn)

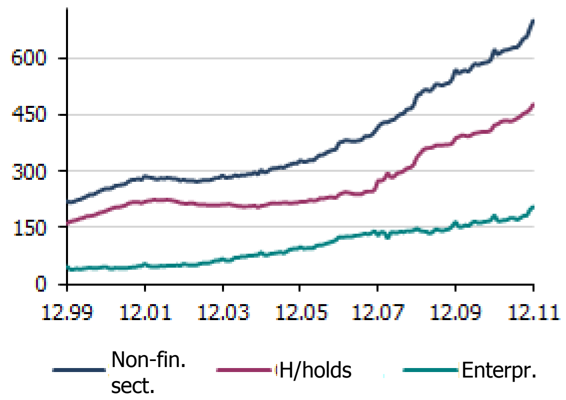


Chart 99
Proportion of deposits in balance sheet total (%)

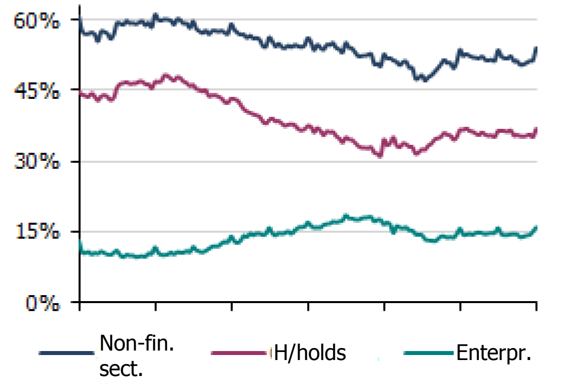


Chart 100.
Annual growth of deposits of the non-financial sector (%)

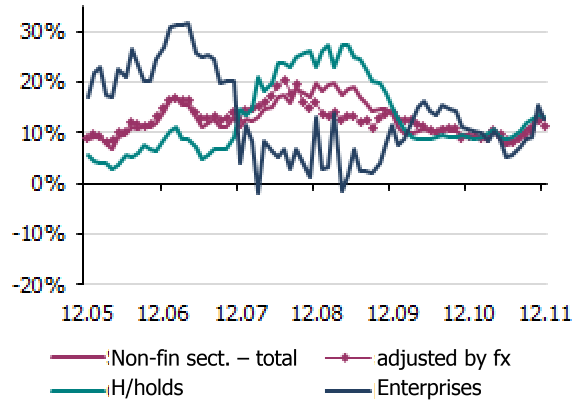


Chart 101.
Annual change in deposits (PLN bn)

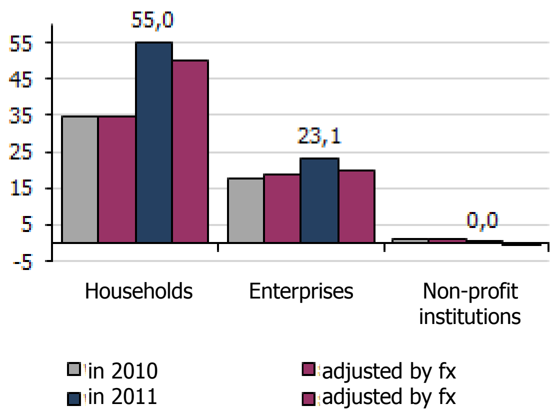


Chart 102.
Change to deposits according to bank groups (PLN bn)

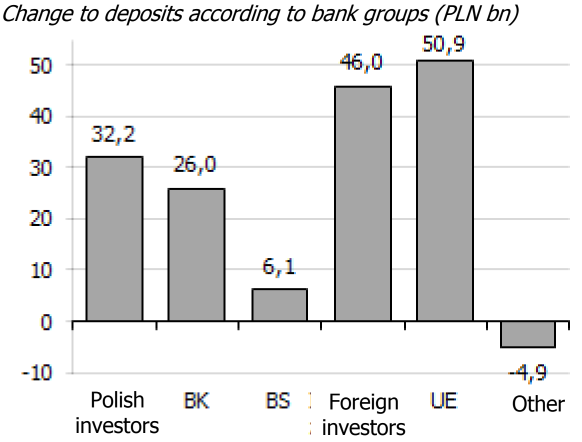
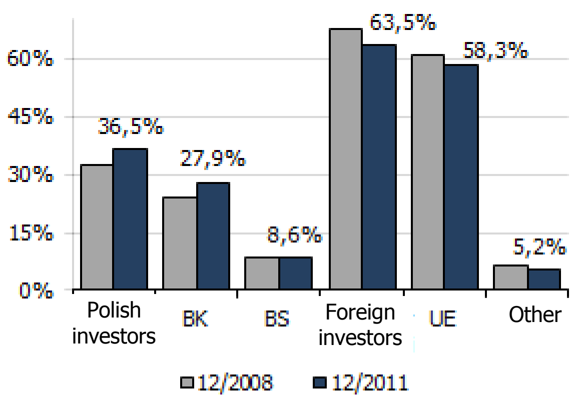


Chart 103.
Share in the deposits of the non-financial sector market (%)



In 2011, the value **non-financial sector deposits increased** by PLN 78.1 bn, i.e. by **12.6 per cent**, and upon eliminating the effect of exchange rate fluctuation, the increase would amount to approximately PLN 70 bn, i.e.: approximately **11.2 per cent**. The lion's share of the increase was observed in the fourth quarter of 2011. (PLN 47,9 bn), this phenomenon being partially cyclical, and partially stemming from an improvement of the deposits offered by banks in the second half of 2011 and major falls on the capital market which resulted in a transfer of some funds to banks.

The determining factor in the increase of deposits the non-financial sector was an **increase of household deposits**, the value of which grew by PLN 55.0 bn, i.e. 13.0 per cent [18] whereas the significant growth occurred in the second half of 2011, and particularly in the fourth quarter (increase of PLN 24.2 bn; 5.3 per cent). As already ascertained, this should be associated with increased interest on deposits and the capital market falls.

The value of **deposits from the enterprise sector** increased by PLN 23.1 bn, i.e. by 12.6 per cent[19], whereas up until September decreases were reported followed by a large increase in the fourth quarter (by PLN 24.2 bn; 13.3 per cent). The fall in the levels of deposits by from enterprises observed throughout most of the year, is partially a cyclical phenomenon (generally at the start of the year an "outflow" of enterprise deposits from the banking sector is observed), although last year this period of decline was evidently longer than in previous years. This should probably be associated with the prevailing growth of economic activity and the accompanying growth of investment levels. On the other hand, the large increase in the fourth quarter of 2011, can be explained by cyclical phenomena (in contract to the start of the year, the end of the year is usually witness to significant growth in deposits from enterprises) which were spurred on by the improvement to the financial standing of some enterprises and more attractive deposits offered by banks.

	TAX FREE INTEREST PRODUCTS	
	Investments	**Savings accounts**
Quantity	**10.1 m**	**1.8 m**
Value	**PLN 94.7 bn**	**PLN 11.3 bn**
Proportion in deposits of the non-financial sector	**13.5 %**	**1.6 %**

The high levels of "tax free interest investments" in the structure of deposits was an unfavourable phenomenon. According to PFSA research, as at the end of 2011, 10.1 m investments of this type were entrusted to banks, with a total value of PLN 94.7 bn, (over PLN 50 bn maturing by the end of March 2012 and only PLN 2 bn with maturity after 2012). Furthermore, there were 1.8 m tax free interest savings accounts held by banks accumulating PLN 11.3 bn funds.

Tax free interest products entail a number of risks, such as:

- compliance risk (creating products only in order to facilitate tax evasion for customers is legally and ethically dubious and is contrary to EBA recommendations),
- tax risk (the future position of tax authorities in terms of tax free interest investments may change and banks may be forced to pay the due taxes - an example of this risk is the shift in the position of inland revenue in terms of taxes due on employee medical benefits),
- reputation risk (bank, as a public trust organisation, should act in a manner inspiring confidence and trustworthiness and not giving rise to any doubts),
- liquidity risk (unstable, price sensitive deposit base),
- concentration risk (dependency of banks on deposits which may be withdrawn by customers at any moment),

[18] Upon eliminating the effect of exchange rate fluctuation, the increase would amount to approximately PLN 50 bn (18 per cent).
[19] Upon eliminating the effect of exchange rate fluctuation, the increase would amount to approximately PLN 20 bn (10.7).

- risk associated with negative pressure from competition (banks which did not offer products of this type were exposed to the risk of loosing some deposits or were "forced" to introduce products of this type).

Accordingly, the PFSA Chairperson pointed out some of the aforementioned risks to banks and **recommended the withdrawal of all "tax free interest" products.**

Chart 104.
Deposits structure of the non-financial sector (PLN bn)

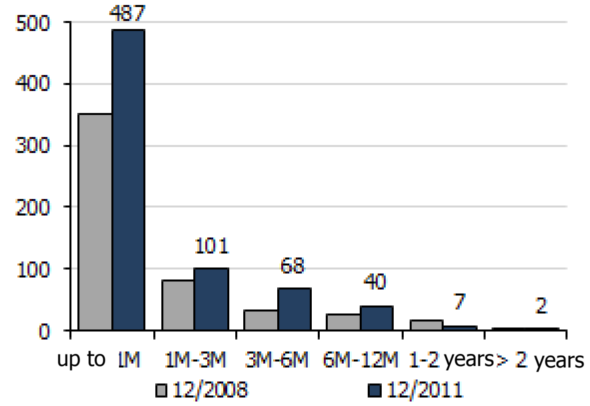
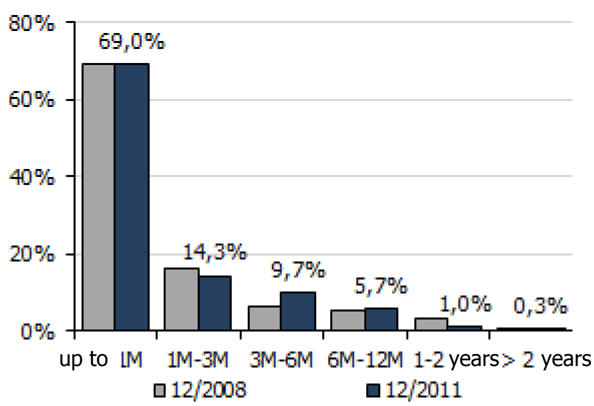


Chart 105.
Deposits structure of the non-financial sector (%)



The observed **marginal proportion of deposits with maturity of more than 1 year (1.3 per cent)** which together with a high proportion of long term loans causes an increase to liquidity risk constitutes an unfavourable phenomenon in the deposits base structure (see below).

In the context of risk associated with deposits, the issue of amendments to the Act on Banking Guarantee Fund by virtue of which, as of 31 December 201, **the amount of BGF guaranteed funds increased to the equivalent of EUR 100,000** and set the reduced timeframe for such refunds to 20 days should be pointed out. This resulted from the necessity to bring the Polish provisions in line with European Parliament and Council Directive 2009/14/EC which amended Directive 94/19/EC on deposit-guarantee schemes in terms of guaranteed amounts and payment timescales (EUR 100 000, 20 days). This was an exercise aimed at counteracting the financial crisis. On the one hand, this solution **improves the safety of the** banking **system, but** on the other **it entails a certain destabilisation factor.** This stems from the fact that some customers will invest in bank deposits offering the best terms without evaluating the risk profile of the bank (they will base their decisions only on the interest rates paid by the bank). These customers are aware that in the event of a "collapse" of the bank, their funds will be refunded immediately and in full up to an amount of EUR 100,000. The said changes **favour banks with an "aggressive" strategy** and to a large extent explain the significant success of some banks is securing deposits.

Table 12**. Deposits and loans of the financial sector (PLN bn; %)**

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Deposits and loans of the financial sector, of which:	230.8	216.8	244.8	269.4	266.7	23.1 %	8.9 %	-1.0 %
- domestic	80.2	67.1	74.8	80.7	78.2	16.4 %	4.5 %	-3.2 %
- foreign	150.6	149.6	170.1	188.7	188.6	26.1 %	10.9 %	-0.1 %
Structure by currency								
- zloty	113.1	104.1	104.9	106.2	104.9	0.7 %	0.0 %	-1.2 %
- foreign currency	117.6	112.6	139.9	163.3	161.8	43.7 %	15.7 %	-0.9 %

Chart 106.
Deposits and loans of the financial sector (PLN bn; %)

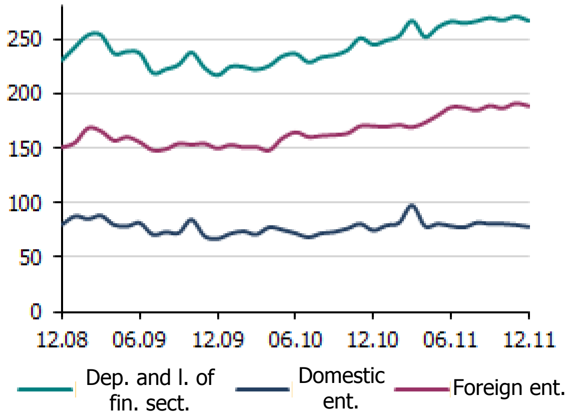


Chart 107.
Proportion of the balance sheet total (%)

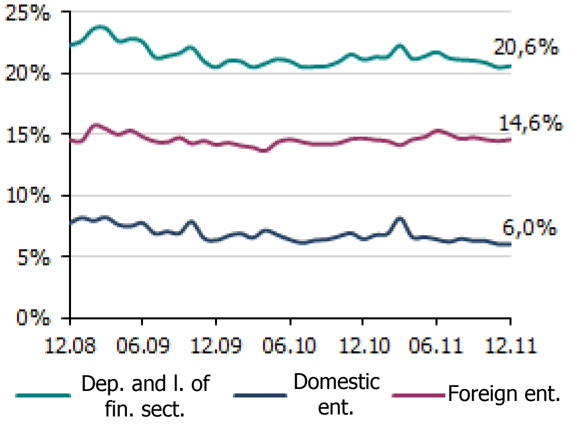


Chart 108.
Change in deposits and loans if the fin. sector (PLN bn)

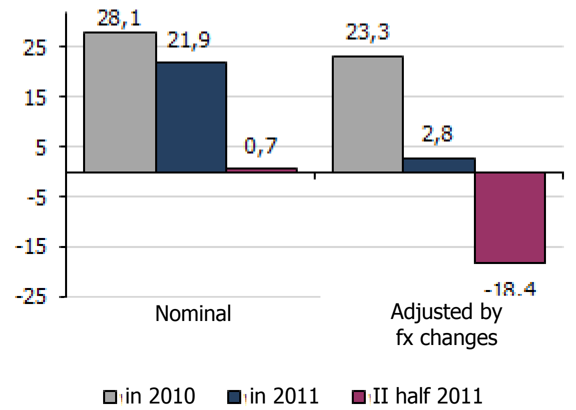
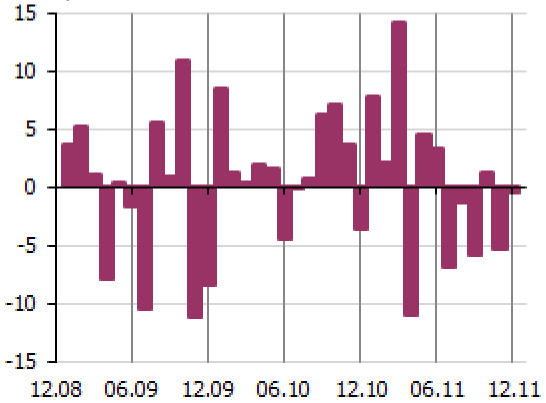


Chart 109.
Monthly fluctuations adjusted by exchange rate fluctuations (PLN bn)



The deposits and loans of the financial sector increased by PLN 21.9 bn, i.e. by **8.9 per cent** (in the fourth quarter by PLN 2.7 bn; -1.0 per cent), and upon eliminating the effect of exchange rate fluctuation, the increase would amount to approximately PLN 2,8 bn, i.e.: approximately **1.0 per cent**.

The decrease in deposits and loans of the financial sector in real terms (adjusted by exchange rate fluctuations) observed in the second half of 2011, stemmed from transactions on the money market conducted by two branches of credit institutions and a partial change to the funding structure at two banks.

Most loans and deposits from the financial sector originate from parent group entities, which, on the one hand, increases the stability of these funds, but on the other, makes the banks more dependent on the parent company situation (see below).

Table 13**. Deposits of the budget sector (PLN bn; %)**

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Deposits of the budget sector, of which:	52.7	52.0	53.0	66.8	49.0	-5.8 %	-7.5 %	-26.7 %
- central government institutions	20.6	24.8	28.3	42.6	26.1	5.2 %	-7.8 %	-38.6 %
- local government institutions	21.5	20.6	19.8	21.6	21.6	4.7 %	8.8 %	-0.1 %
- social insurance funds	10.7	6.5	4.8	2.7	1.3	-80.5 %	-73.4 %	-52.1 %

Chart 110.
Deposits of the budget sector[20] *(PLN bn)*

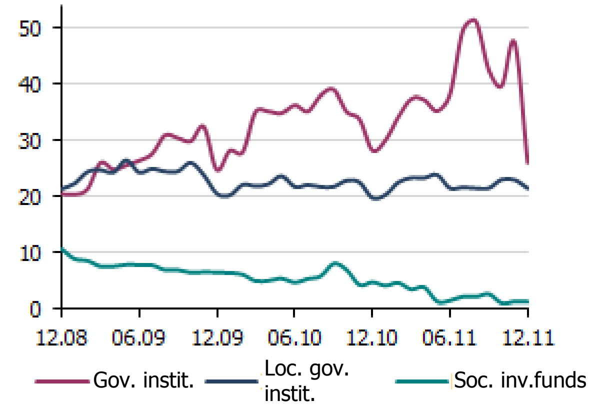
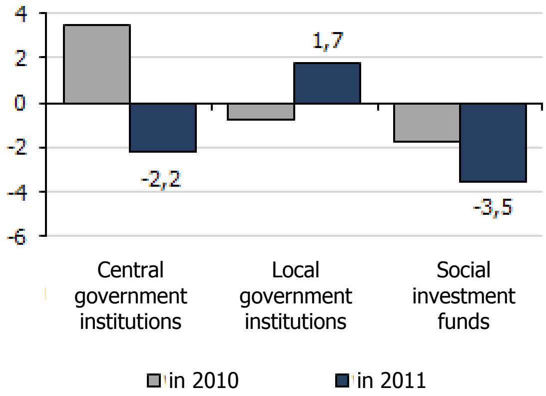


Chart 111.
Change in deposits (PLN bn)



In 2011, the value of **budget sector deposits decreased** by PLN 4.0 bn, i.e. by **7.5 per cent,** with the value of government institution deposits decreasing (by PLN 2.2 bn; -7.8 per cent), the value of local government institutions deposits increasing (by PLN 1,8 bn; 8.8 per cent) and the value of funds deposited by social insurance funds decreasing (by PLN 3.5 bn; -73.4 per cent).

The fall in the level of deposits by government institutions should be associated with the amendment to the act of public finances, which came into force on 1 May 2011.[21] As a result of which an outflow of budgetary funds from some banks occurred.

Chart 112.
Own issue and subordinated loans (PLN bn)

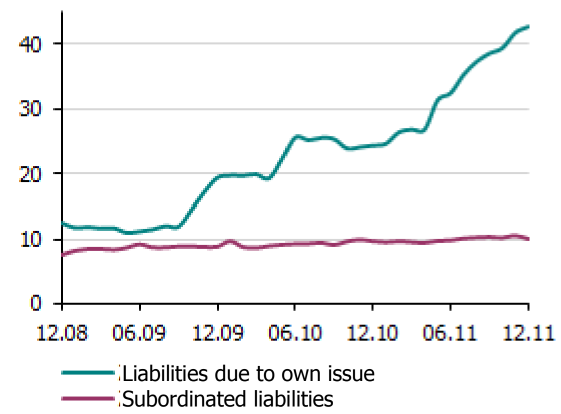
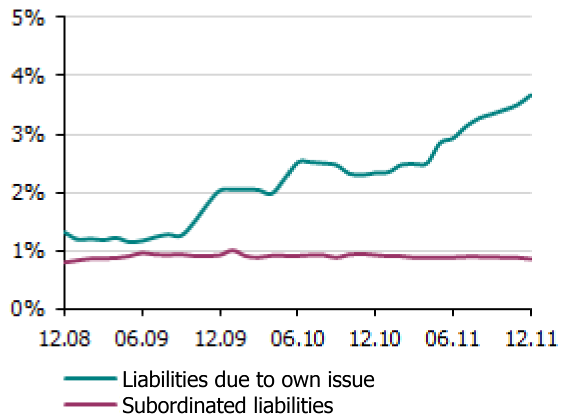


Chart 113.
Share in the liabilities of the banking sector (%)



A **significant increase in liabilities stemming from own issues of securities** was reported in 2011, with their value increasing by PLN 18.4 bn, i.e.: by **75.4 per cent** (from PLN 24.4 bn to PLN 42.8 bn). This was predominantly caused by issues carried out by two large banks.

Despite the large increase, own issue funds constituted only 3.7 per cent of all banking system liabilities, however the role of this funding source at some banks was significant.

[20] The major decline observed in the fourth quarter (- PLN 17.8 bn; -26.7 per cent) is characteristic for this period.
[21] Pursuant to the NHF Act, all executive agencies and other state-owned legal entities (with the exception of enterprises, research institutes, banks and commercial law companies) are required to invest free cash in zlotys in the form of deposits with the Minister of Finance (this obligation does not apply to funds derived from budgetary subsidies).

The value subordinated liabilities increased by PLN 0.4 bn, i.e.: **by 3.8 per cent** (from PLN 9.7 bn to PLN 10.1 bn). This is predominantly caused by an increase to the value of these liabilities due to a weaker zloty.

Subordinated liabilities constituted a marginal source of banks funding, representing 0.9 per cent of all liabilities.

Table 14. **Capital of the banking sector (PLN bn, %)**

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Total capital, of which:	88.1	103.3	116.0	125.0	129.1	24.9 %	11.3 %	3.2 %
- share capital	16.1	21.1	23.0	24.2	24.6	16.5 %	7.0 %	1.7 %
- supplementary capital	38.1	46.9	51.0	56.0	56.1	19.7 %	10.0 %	0.1 %
- reserve capital	10.9	18.4	21.4	22.8	22.8	23.8 %	6.4 %	-0.2 %
- general risk fund	8.4	7.5	8.0	8.4	8.4	11.1 %	3.9 %	0.0 %
- revaluation reserve	0.3	0.5	1.0	1.4	1.3	146.9 %	36.9 %	-3.2 %
- current year's profit (loss)	13.6	8.3	11.4	12.0	15.7	89.6 %	37.5 %	31.2 %
- other items	0.8	0.6	0.2	0.3	0.2	-65.2 %	11.4 %	-30.0 %

Chart 114.
Major categories of funds (PLN bn)

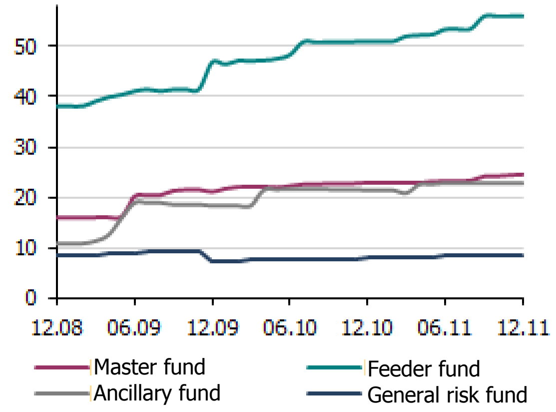
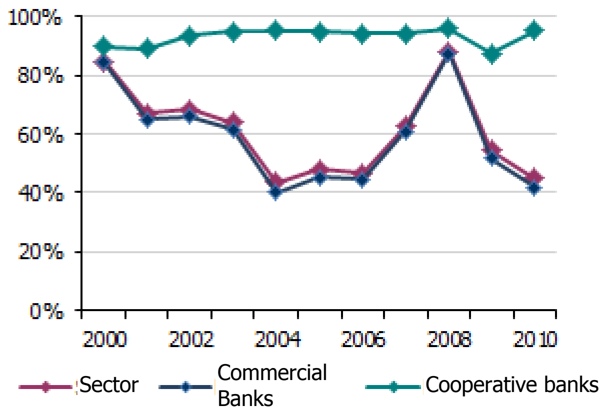


Chart 115.
Distribution of profits – proportion of retained profits (%)



Capital (funds) of the banking sector increased by PLN 13.1 bn, i.e. **11.3 per cent**. The increase in capital was due to capital formation from this year's funds and the transformation of Polbank EFG from a branch to a bank operating as a joint stock company.

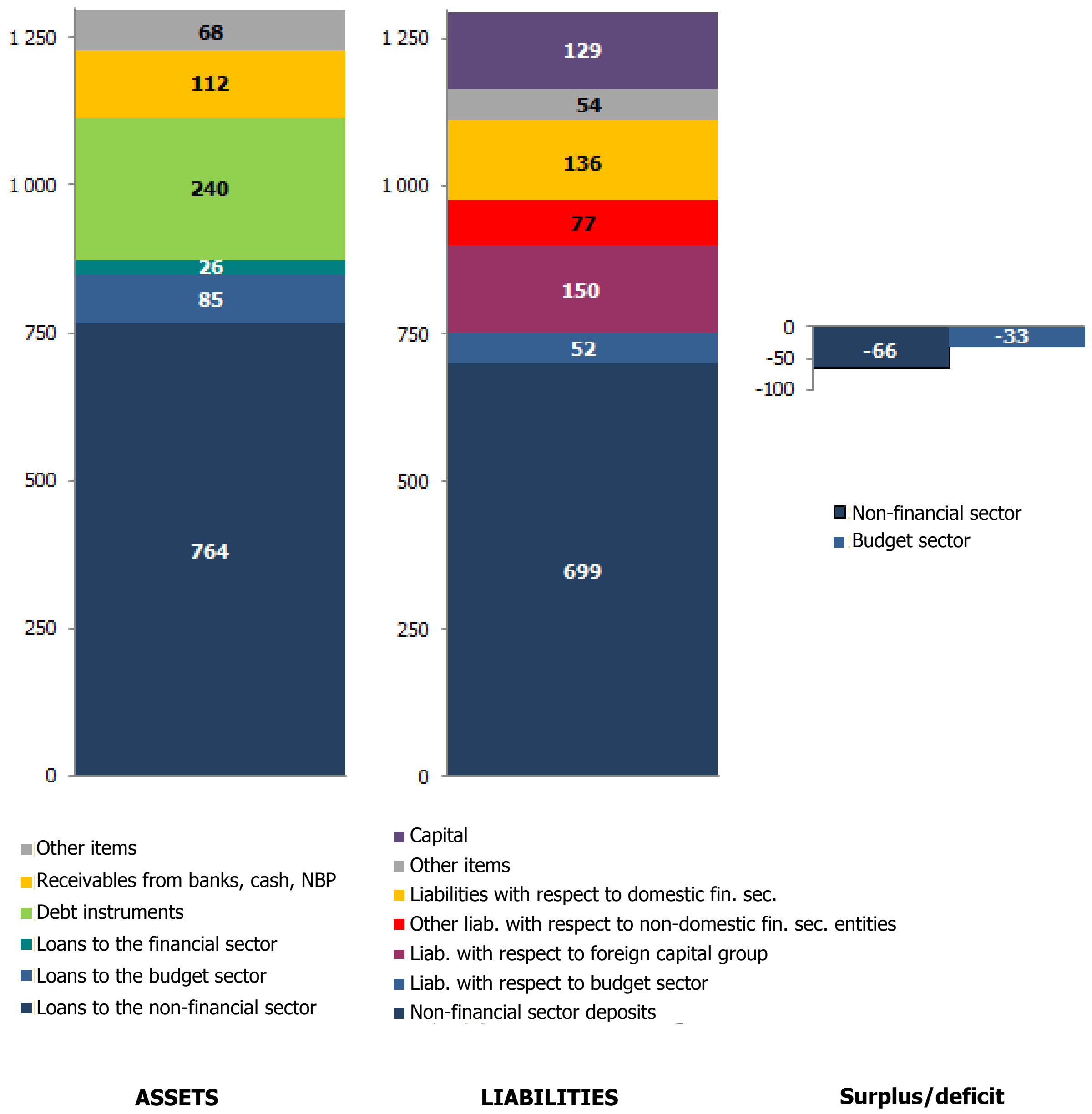
In 2011, **banks allocated approximately 45 per cent of the profits generated in 2010** towards capital increases (with 54 per cent in 2010 and 88 per cent in the record year of 2009). It is also important to emphasise the differences in profit distribution between commercial and cooperative banks. In the case of commercial banks, approximately 42 per cent of the 2010 profits remained with banks while the remainder was disbursed to shareholders, whereas in the case of cooperative banks 94 per cent of profits remained with banks, which is usual for this group of banks.

An account of the aforementioned difficult external conditions experienced by banks, as well as the aggregated but not realised risk, the issue of maintaining high capital levels by banks is of particular significance. For this reason the **PFSA Chairperson decided to introduce recommendations with regard to distribution of profits for 2011,** in order to further strengthen the capital base and the ability to withstand unexpected losses.

2.5 Models for funding banks operations, foreign funding issue

The primary source for financing banks' operations are deposits of the non-financial sector, which at the end of 2011 constituted 53.9 per cent of the balance sheet total. These are followed by liabilities with respect to **foreign entities operating within parent capital groups (11.5 per cent** of the balance sheet total), entities of the domestic financial sector (10.5 per cent), foreign financial sector entities (5.9 per cent), budget sector (4.0 per cent), other liabilities (4.1 per cent) and capital (10.0 per cent).

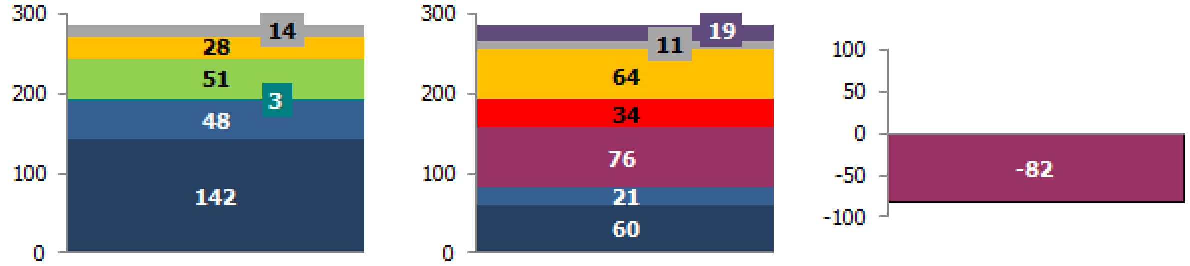
STRUCTURE OF OPERATING FUNDING SOURCES FOR THE BANKING SECTOR (PLN bn; %) AS AT 31 DEC 2011



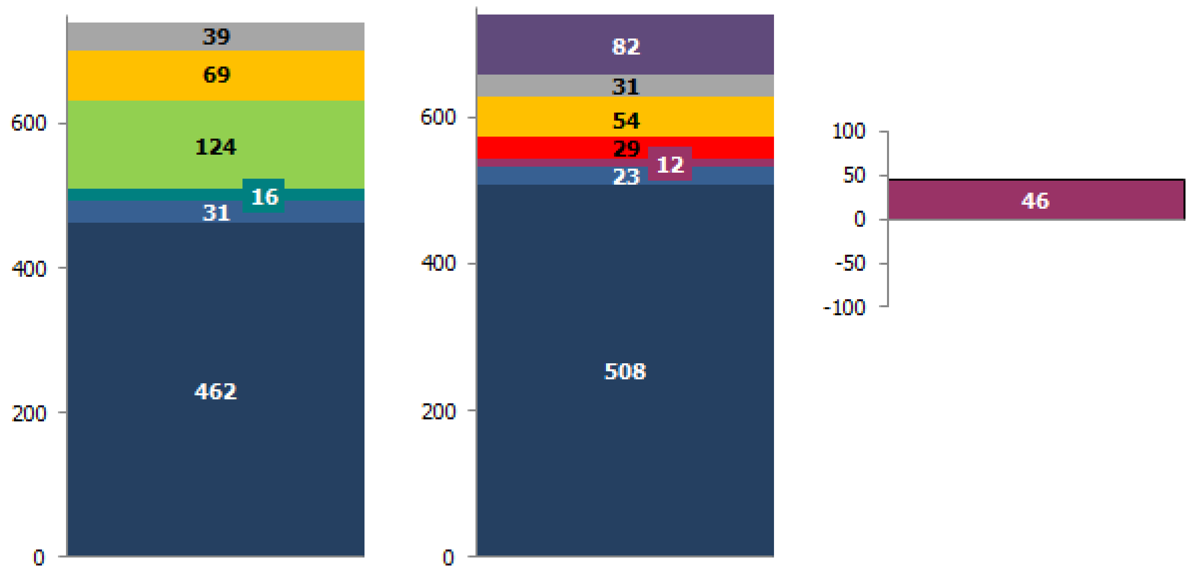
However, significant differences are to be observed amongst individual banks within the structures for financing operations, which stem from differences in their business models.

STRUCTURE OF BANKS' OPERATING FUNDING SOURCES ACCORDING TO BUSINESS MODEL
(PLN bn; %)
AS AT 31 DEC 2011

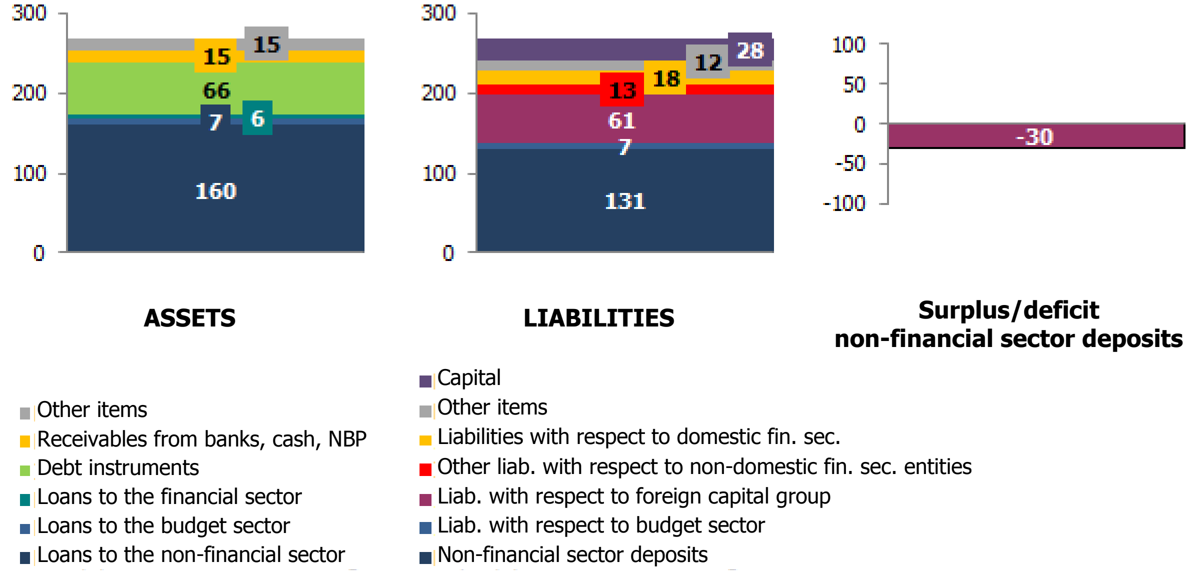
Banks whose activity is based on funds acquired from the financial sector - 22.1 per cent of the sector's assets



Banks whose activity is based on funds acquired from the non-financial sector - 57.1 per cent of the sector's assets



Banks engaging in mixed strategies - 20.8 per cent of the sector's assets



Considering the structure of funding three groups of banks are identified:

- banks whose activity is based on funds acquired from the financial sector;
- banks whose activity is based on funds acquired from the non-financial sector;
- banks with mixed funding strategies;

Banks whose activity is based on funds acquired from the financial sector

This group consists of 36 banks and branches of credit institutions - which at the end of 2011 held **22.1 per cent** of the sector's **assets, 18.6 per cent of loans** to the non-financial sector and **8.6% of deposits** from the non-financial sector. These banks reported the **highest shortage of deposits from the non-financial sector in relation to generated lending (-PLN 82.2 bn).**

However this group is certainly not homogenous and within its ranks a number of subgroups may be identified: credit institution branches, small banks controlled by foreign investors, mortgage banks, medium banks controlled by foreign investors, associating banks, cooperative banks and BGK.

These banks exhibit the **highest degree of dependency on foreign funding.** At the end of 2011, the total value of funds for this group originating from foreign financial sector entities amounted to PLN 110.6 bn (48.9 per cent of total foreign funds) and constituted 38.7 per cent of the balance sheet total. **PLN 76.1 bn** out of the above amount **can be attributed to funds received from foreign capital groups (50.9 per cent of the total amount of funds received from parent capital groups).**

However the scale of foreign funding is determined by a few banks. The high levels of foreign funding at these banks stems predominantly from the growth of foreign currency housing loans, which were financed based on funds from parent capital groups. An additional factor generating foreign funds requirements, particularly for credit institution branches is **activity on the money market** (NBP bills and treasury securities transactions, interbank market transactions) as well as the growth of lending to enterprises.

The source of this funding should be considered relatively stable. This results from a strong capital standing of strategic investors and their plans to develop operations in Poland. **However, a gradual decrease of its scale should not be ruled out, which stems from PFSA recommendations aiming to limit financing households in foreign currencies and decrease the degree to which banks depend on funds from the group.** Consequently, the requirements of these banks for foreign funding should be subject to a gradual decrease.

The reduction in foreign funding may also be due to slow down in lending caused by a fall in demand, or curtailed transactions on the money or capital markets.

Banks whose activity is based on funds acquired from the non-financial sector

This group consists of 18 commercial banks and cooperative banks which at the end of 2011 held **57.1 per cent** of the sector's **assets, 60.4 per cent of loans** to the non-financial sector and **72.7% of deposits** from the non-financial sector. These banks reported a **surplus of deposits from the non-financial sector in relation to generated lending (PLN 46.1 bn).**

This group exhibits **slight/marginal foreign funding**, which constitutes 5.6 per cent of balance sheet total for this group (**PLN 12.4 bn of funds originate from foreign capital groups** and PLN 29.1 bn of other funds originate from financial sector foreign entities).

Significant funding from parent capital group entities applies to only three banks. **The level of this funding can be considered to be relatively stable,** however, similar to the previous group, a gradual reduction of its scale may be expected due to PFSA recommendations.

Banks with mixed funding strategies

This group consists of 12 commercial banks which at the end of 2011 held **20.8 per cent** of the sector's **assets, 21.0 per cent of loans** to the non-financial sector and **18.7% of deposits** from the non-financial sector. These banks reported a **shortage of deposits from the non-financial sector in relation to generated lending (PLN 29.6 bn).**

Most banks in this group are, to a large extent, dependant on foreign funding. At the end of 2011, the value of funds for this group originating from foreign financial sector entities amounted to PLN 74.0 bn (32.7 per cent of total foreign funds) and constituted 27.5 per cent of the balance sheet total for banks in this group. **PLN 61.0 bn** out of the above amount **can be attributed to funds received from foreign capital groups (40.8 per cent of the total amount of funds received from parent capital groups).**

The high levels of foreign funding in this group stem predominantly from the growth of foreign currency housing loans, (and also consumer loans, albeit to a lesser extent) which were financed based on funds from parent capital groups. An additional factor generating foreign funds requirements, is **activity on the money market** as well as lending to enterprises.

Considering the financial standing and plans of strategic investors in relation to the Polish market, the level of this funding may be considered as stable. However, similar to other groups, a gradual decrease of its scale should be expected due to recommended supervision (reduction to financing households in foreign currencies and decreasing the degree to which banks depend on funds from the group).

To sum up the analysis above, **three models for financing operations can be identified in the Polish banking sector.** The first, relying on funds obtained from the financial sector (keeping in mind the non homogeneity of this group), the second relying on funding operations based on deposits from the non-financial sector and third, being an intermediate model, where a significant role is played by funds obtained from the financial sector as well as deposits from the non-financial sector.

Attention is drawn to the fact that considering the first and third groups, **foreign funding is significant, which primarily originates from entities of the parent capital group.** However, it should be pointed out, **that the level of the said funding is relatively stable, and the observed fluctuations, to a large extent, stem from changes in exchange rates as well as transactions conducted on the money markets.**

Chart 116.
Receivables and liabilities with respect to foreign entities (PLN bn)

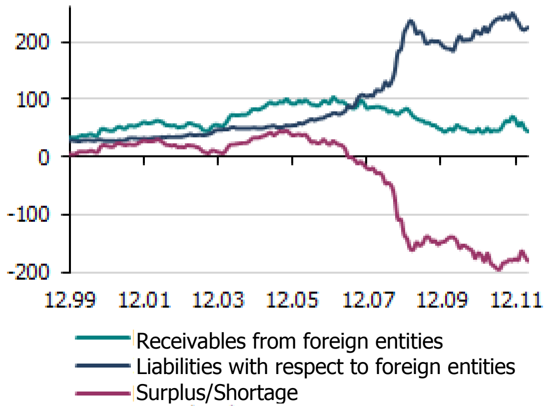
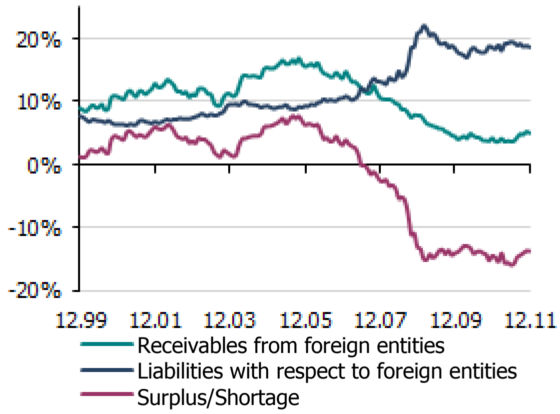


Chart 117.
Proportion of the balance sheet total (%)



At the end of 2011, **the value of liabilities towards foreign entities amounted to PLN 242.4 bn, which represents an increase** of PLN 27.5 bn (in November a record level of these funds was reported - PLN 250 bn), i.e.: of **12.8 per cent** as compared to the end of 2010, However, a significant proportion of this increase is attributed to the weakening of zloty. Upon eliminating the effect of exchange rate fluctuations, the increase would amount to approximately PLN 7 bn, i.e. **2.8 per cent**. The decrease in funds from foreign entities in real terms (adjusted by exchange rate fluctuations) reported in the second half of 2011 (by circa PLN 16 bn), which as has already been noted, stemmed from transactions on the money market conducted by two branches of credit institutions and a partial change to the funding structure at two banks.

The level of foreign funding remains relatively stable (as of the end of 2011 their share in balance sheet total amounts to **18.7 per cent** as compared to 18.5 per cent at the end of 2010), **whereas the scale of financing differed significantly amongst individual banks.**

The largest proportion of liabilities with respect to foreign entities occurred at small banks and branches of credit institutions under the control of foreign capital, where, in general, it exceeded 50 per cent, which was due to the strategies of these entities (reliance on funding from parent banks). These funds also constituted a large proportion at a few medium and large banks controlled by foreign investors, which in recent years developed lending in terms of housing loans (and to a lesser extent also consumer loans). And due to a lack of appropriate deposit base, (at all of these banks, the ration of loans/deposits exceeded 100 per cent, and at some even 200 per cent) these banks took advantage of foreign parent capital group funds. According to date provided to the PFSA by the banks, **the value of funds from parent entities** at the end of 2011 amounted to **PLN 145.9 bn** (the research did not take into account branches of credit institutions, where a significant proportion of financing originated from the "parent" bank). PLN 34.8 bn out of the above amount was payable in more than 3 tears, PLN 38.2 bn was payable in 1 to 3 years and the remaining had a term to maturity of less that one year (however these funds are regularly renewed).

To sum up, it can be ascertained, **that the level of foreign funding remains relatively stable and the observed fluctuations stem primarily from changes in exchange rates and investment strategies** implemented on the money market by some banks and branches of credit institutions. In particular, exchange rate fluctuations of 5-10 per cent may cause changes to the nominal values of these funds of PLN 10-20 bn. Similarly, fluctuations may stem from a build-up of transactions by active players on the money market.

In the near future, **PFSA recommendations regarding restricting financing of households in foreign currencies as well as diversifying and extending sources of operational funding may act to limit foreign funding.** As a result, a decrease in the requirement for parent capital group funds should occur. **The PFSA intends for this to be a gradual process, which will not lead to disruptions in the functioning of the market nor to an increase in the cost of financing.**

2.6 Balance sheet foreign currency structure, assets and liabilities terms to maturity structure

Phenomena generating a number of risk types and which may constitute a source of potential threat are observed within the balance sheet structure. Some of these phenomena are natural to the banks' operations and stem from their role in the economy (inter alia to be a go between for entities seeking funds and entities with surplus funds, whereas the structure of supply and demand of funds varies and its the function of the bank to make the match). However, part of the negative observations stem from excessively aggressive business models employed by some banks.

BALANCE SHEET FOREIGN CURRENCY STRUCTURE OF THE BANKING SECTOR (PLN bn) AS AT 31 DEC 2011

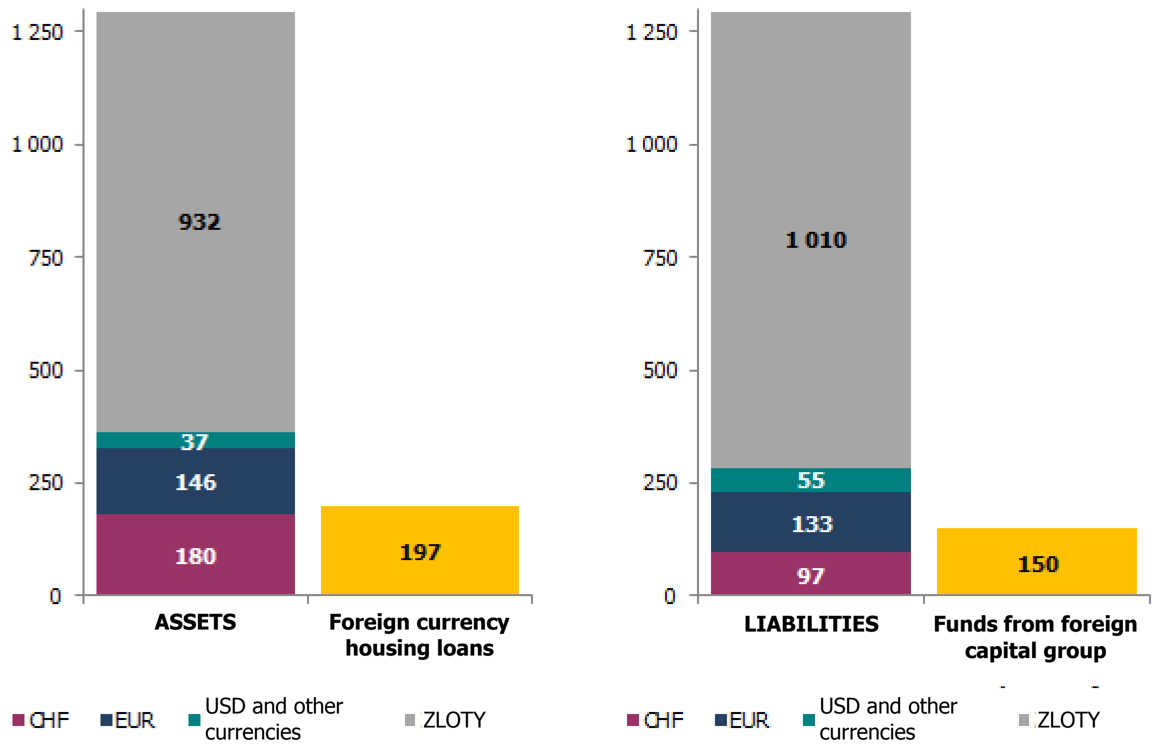


Chart 118.
Foreign currency assets and liabilities (PLN bn)

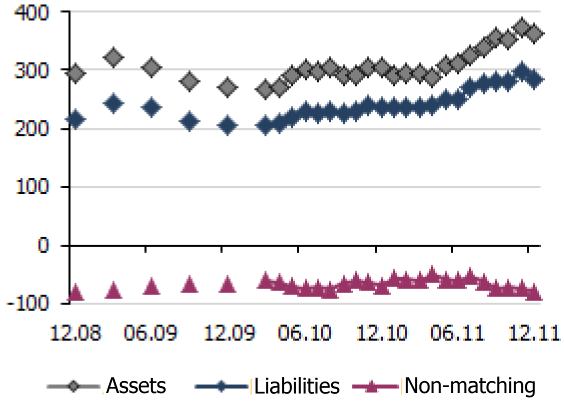
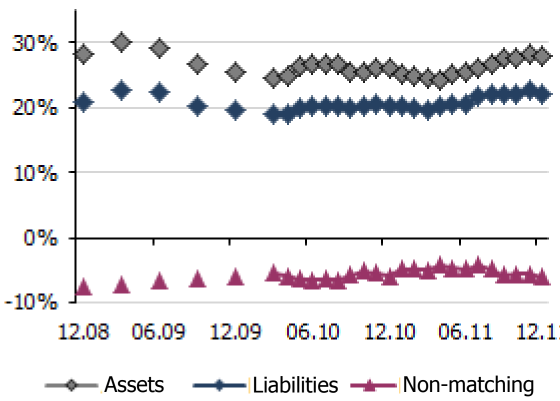


Chart 119.
Share in assets (%)



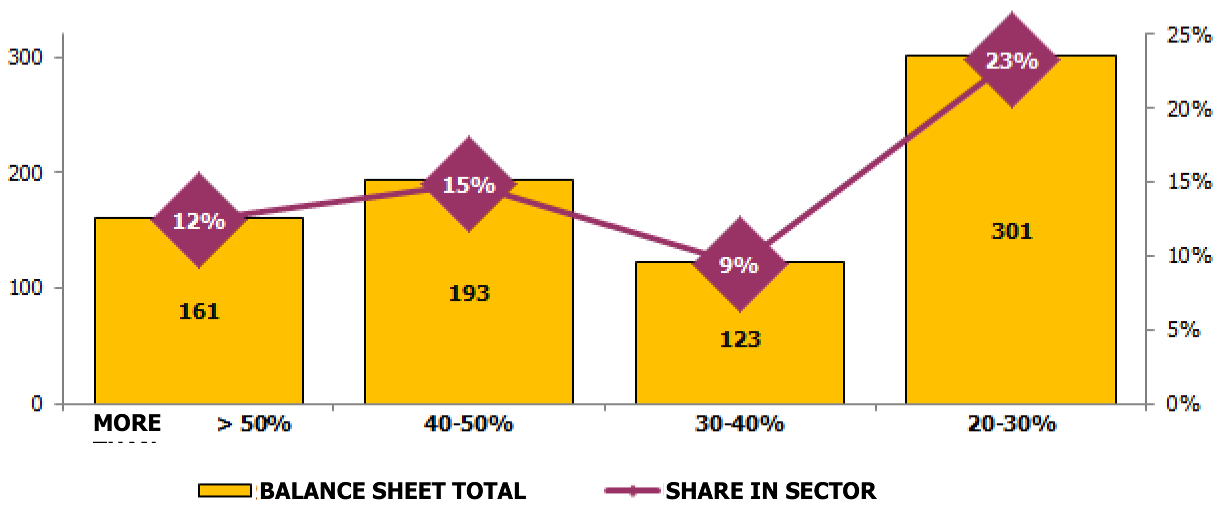
At the end of 2011, the value of **foreign currency assets** amounted to PLN 363.1 bn and constituted **28.0 per cent of balance sheet total** (as compared to 26.3 per cent at the end of 2010). The value of **foreign currency liabilities** amounted to PLN 285.0 bn and constituted **22.0 per cent of balance sheet total** (as compared to 20.4 per cent at the end of 2010). In 2011, the growth of foreign currency items (assets by PLN 58.7 bn, i.e.: by 19.7 per cent; liabilities by PLN 48.5 bn, i.e.: 20.5 per cent) was primarily caused by a weak zloty.

CHF denominated assets constituted 13.9 per cent of the balance sheet total, EUR 11.2 per cent and other foreign currencies 2.9 per cent. In the structure of liabilities this share was: 7.5 per cent; 10.2 per cent and 4.3 per cent, respectively.

High share of foreign currency assets predominantly stems from the growth of foreign currency housing loans (mainly in CHF), whose balance sheet value at the end of 2011 was PLN 196.6 bn and constituted 54.1 per cent of these assets. **The total value of foreign currency receivables form households** amounted to PLN 212.7 bn and **constituted 58.6 per cent of all foreign currency receivables due to banks, whereas** receivables from **enterprises** amounted to PLN 70.0 bn and constituted **19.7 per cent.**

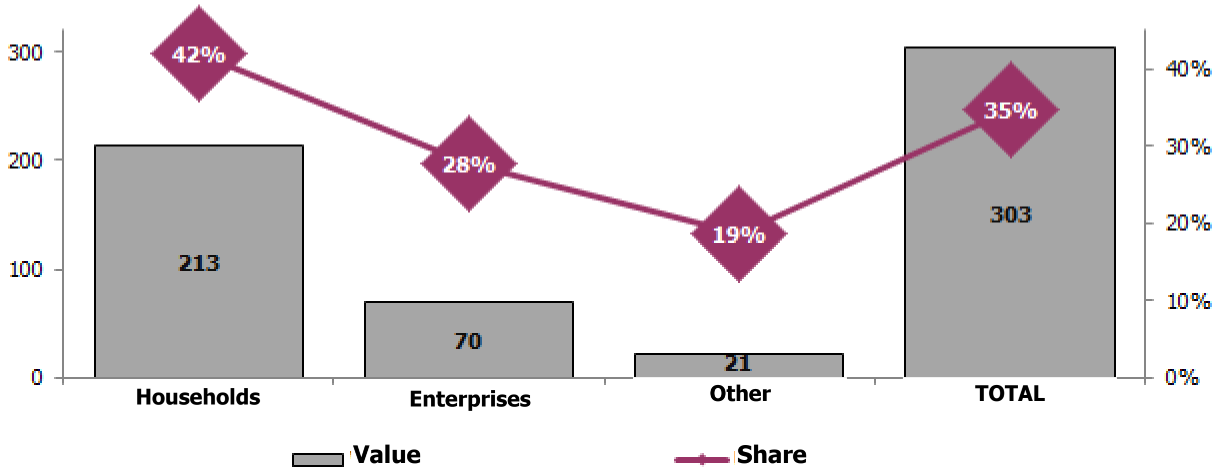
High value of foreign currency loans extended to households is indicative of the scale of risk undertaken by banks and their customers and contributes to the increase in risk within the financial system. In particular it should be noted that **most households are not protected in any way against currency risk** (a very small group of customers receiving regular income in foreign currencies can be considered to be protected). Although, banks are able to protect the flows of current financial streams against exchange rate and interest rates risk by entering into derivative transactions, their ability to hedge against customer insolvencies due to a deterioration in their financial situations resulting from unfavourable changes to exchange rates and interest rates is limited.

BANKS WITH FOREIGN CURRENCY ASSETS EXCEEDING 20 PER CENT OF BALANCE SHEET TOTAL (PLN bn; %) AS AT 31 DEC 2011



The situation, **where a significant number of large and medium banks,** operating almost solely within the territory of Poland, **hold a high proportion of foreign currency assets** which, as has already been ascertained, is mainly a result of growth of foreign currency loans to households and only to a small extent due to foreign currency loans to enterprises (enterprises are often protected against exchange rate risks due to regular foreign currency revenues ensured by business activity conducted with their foreign partners or entering into hedge transactions) **should be considered to be unfavourable.**

LOANS WITH INTEREST RATES
DEPENDANT ON FOREIGN MONETARY AUTHORITIES DECISIONS
AS AT 31 DEC 2011 (PLN bn, %)



The high proportion of foreign currency loans not only indicates the scale of the risk accepted by banks and their customers, **but also limits the ability of MPC and NBP to influence the price of money.** At the end of 2011, **the interest rates for 35 per cent of all loans** (42 per cent for loans to households and 62 per cent for housing loans) **was dependent on the decisions of foreign monetary authorities**.

Chart 120.
Currency mismatch of assets and liabilities (PLN bn)

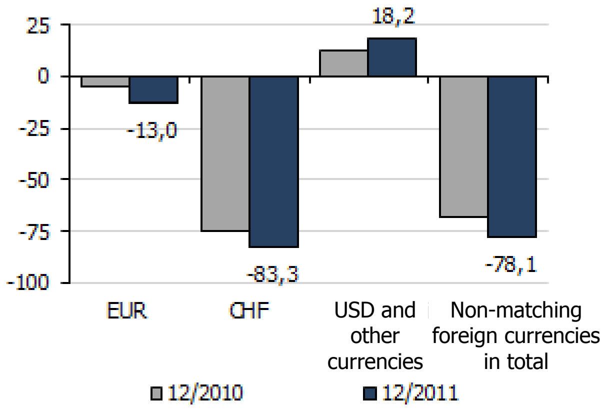
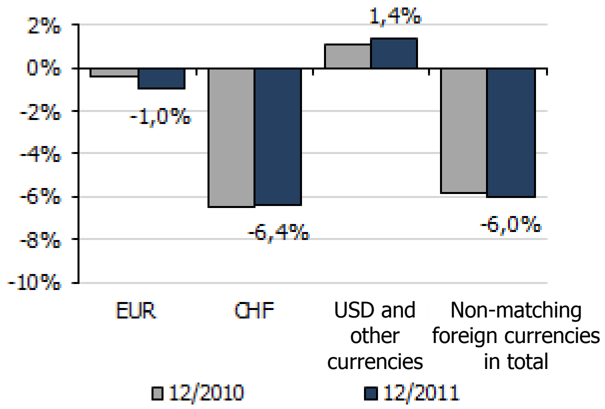


Chart 121.
Share of mismatches in total assets (%)

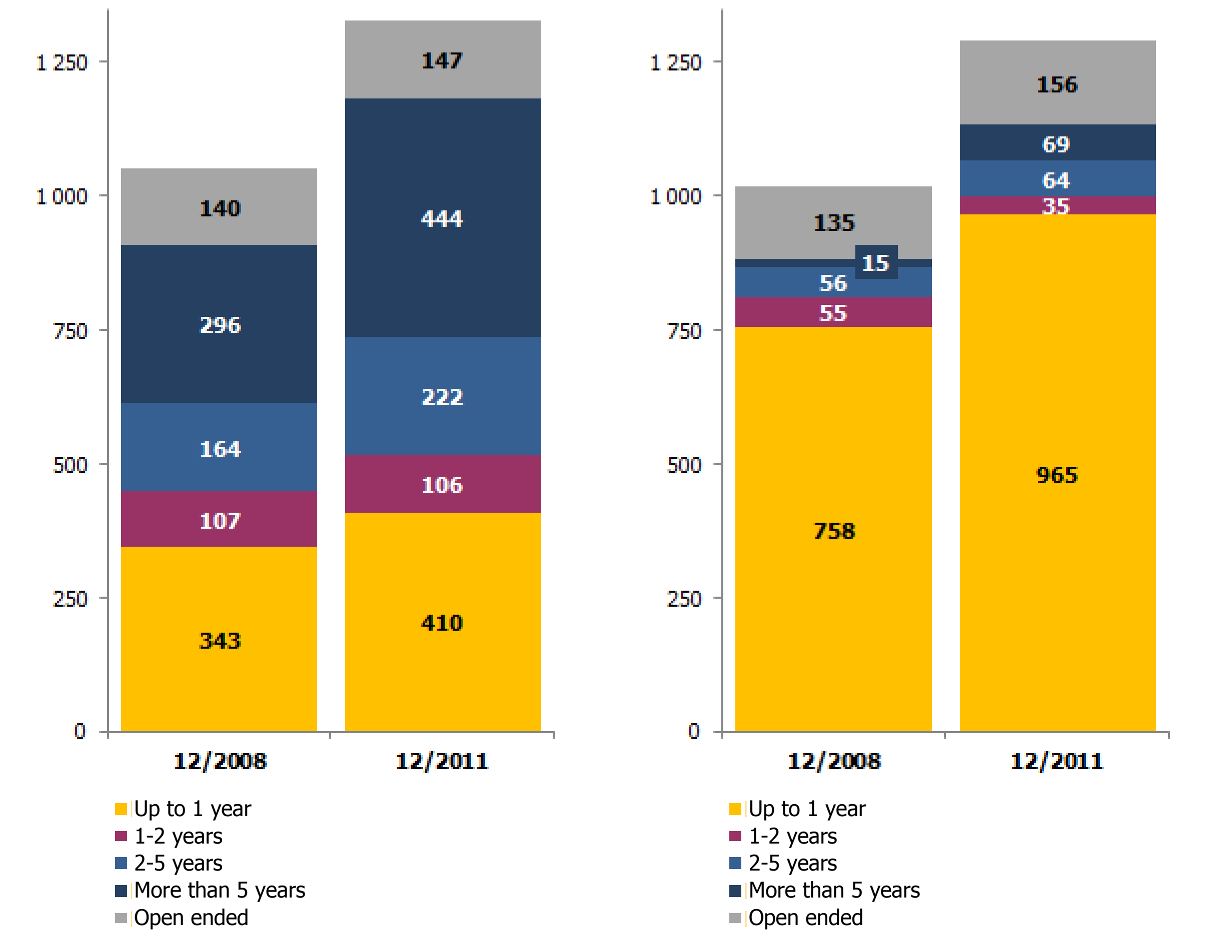


Due to a weakening of zloty relative to major currencies, **foreign currency mismatch.**[22] **of the balance sheet structure in terms of figures deteriorated** and at the end of 2011 amounted to **PLN 78.1 bn** (as compared to PLN 67.9 bn at the end of 2010) **However its share in the balance sheet total remained stable** (increased from 5.9 per cent as at the end of 2010 to **6.0** per cent at the end of 2011). The mismatch **predominantly applied to CHF** (-PLN 83.3 bn; -6.4 per cent of balance sheet total), and to a lesser degree EUR (-PLN 13.0 bn; -1.0 per cent of balance sheet total) and was due to the fact that not all banks extending loans in these foreign currencies had access to funding in the currency of the loan (in order to finance lending they relied on swap transactions). With regard to other foreign currencies, banks reported a surplus (PLN 18.2 bn; 1.4 per cent).

The currency mismatch is primarily a result of the activities of a few banks, which, in recent periods, conducted extensive activities in the area of foreign currency housing loans, without having sources financing in the currency of the loan.

[22] Defined as the difference between foreign-currency liabilities and foreign-currency assets.

STRUCTURE OF THE SECTOR'S BALANCE SHEET TERMS TO MATURITY (PLN bn)



ASSETS **LIABILITIES**

Chart 122.
Assets and liabilities 1-5 years and > 5 years (PLN bn)

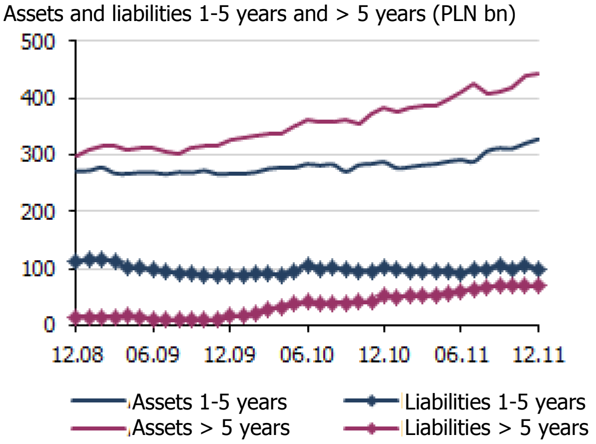
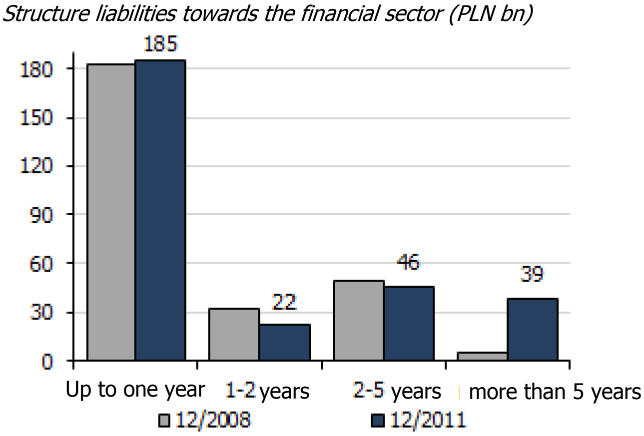


Chart 123.
Structure liabilities towards the financial sector (PLN bn)



The structure of banks' balance sheet exhibits significant disproportions with regards terms to maturity of assets and liabilities. In particular, at the end of 2011 assets with terms to maturity of more than 1 year constituted 59.6 per cent, whereas liabilities with an analogous term to maturity 13.0 per cent. Even larger disproportions occurred considering terms of more than 5 years, where assets constituted 34.3 per cent of balance sheet total and liabilities only 5.4 per cent, **and 19.7 per cent of assets and only 1.4 per cent of liabilities with terms to maturity of over 10 years[23].**

As already ascertained, the mismatch, to a large extent, stems from the role played by banks in the economy. **The primary reason for significant disproportions is the rapid growth of long term housing loans, which are financed based on short term deposits and funds acquired from foreign parent entities (to a large extent, short term) and only to a slight degree by long term liabilities.**

Such development strategy engaged in by banks may be explained by:

- relatively low costs of obtaining deposits from the non-financial sector (particularly current deposits);
- easy access to foreign funding in the period preceding the collapse of the investment bank Lehman Brothers;
- unwillingness of banks to obtain long term financing, stemming from, inter alia, necessary broader informational requirements towards potential investors;
- insufficient appreciation of the liquidity risk issue stemming from implemented funding strategies.

The primary risk associated with excessive mismatch of assets and liabilities terms to maturity is liquidity risk. In particular, banks have to account for the possibility of an increase in the scale of deposit withdrawals as a result of disruptions on the financial markets, deterioration in the evaluation of a given institution, significant improvement to deposits offered by competitors or alternative investment vehicles. Then it could transpire, that the scale of generated inflows will not be sufficient to downset the increased outflows and at the same time the bank will not hold sufficient liquid assets available for immediate sale (due to a high proportion of long term loans). In such a situation, the bank will be forced to rapidly and significantly improve the deposits it offers (cost increase) or will have to obtain significant funding from the market or central bank. This in turn may translate into a materialisation of reputation risk with all its negative consequences.

Lack of appropriate long term sources of funding assumes additional significance in the context of CRD IV/CRR, which introduce a new measurement of liquidity, the so called NSFR (stable funding indicator).

$$\text{NSFR} = \frac{\text{Value of available stable funding}}{\text{Required level of stable funding}} > 100\ \%$$

In terms of calculating the available value of stable funding, weights (0-100 per cent) are assigned to individual liabilities items, reflecting the proportion which will be available in more than 1 year. In the denominator, weights (0-100 per cent) are also assigned to individual asset items, according to the general rule, where the less liquid the given item, the larger its weight (the denominator increases).

[23] In an analysis of the terms to maturity structure of the balance sheet limitations of the reporting system should be borne in mind, and in particular :

- items without a "defined term to maturity", which include assets and liabilities without a set term as well as payables for which the agreed payment date has passed (inter alia, cash, fixed assets, intangible assets, capital investments, own capital, assets/liabilities due to income tax, provisions);
- the reported data pertains to nominal values, by which the total according to nominal values will not be the same at the balance sheet total. However, the scale of this distortion is small. The value of assets is exaggerated by 2.6 per cent as compared to their balance sheet values (predominantly the distortion stems from write-downs/provisions) and for liabilities understated by 0.4 per cent.

However this limitations do not influence the nature of the views and conclusions formulated herein.

The primary aim of this measure **is to avoid excessive transformation of terms to maturity and ensure mid and long term liquidity.** According to plans, the new liquidity standard is to enter into force in 2018.

Considering the new regulations, in 2011 the PFSA conducted a survey (using data correct on 30 June) with the aim of determining the effects of expected regulatory changes on the standings of individual banks. 44 banks were included in the survey. The average value of NSFR for the surveyed banks was 107 per cent, with 11 banks not achieving the required minimum (shortage of stable sources of funding amounted to circa PLN 35 bn). However, increasing the volume of financing in the long term (more than one year) or acquiring larger amounts of deposits from the non-financial sector would cause an increase of the NSFR indicator to the required minimum.

Considering the aforementioned risks as well as the forthcoming regulatory requirements, **banks should increase the proportion of long term, stable sources of funding**, **by,** inter alia, by making the long term deposits more attractive and **issuing long term debt instruments** (based on high quality, homogenous housing loan portfolios).

State aid is also necessary in supporting the development of the debt instruments market, as well as creating mechanisms stimulating long term savings, inter alia, by offering tax incentives.

2.7 Off-balance sheet transactions

In 2011 and **increase in the scale of off-balance sheet transactions** was reported, which, on the one hand, was due to an increase in lending, and on the other, to the developments on the financial markets.

The value of granted liabilities concerning financing increased to **PLN 200.5 bn** (by 21.4 per cent). Most of the liabilities (nearly 78,4 per cent) were liabilities towards non—financial sector entities, which resulted mainly from the awarded credit lines (PLN 143.1 bn). **The value of the guarantees granted** by banks rose to **PLN 50.6 bn**, (by 4.1 per cent), of which most (78,9 per cent) were guarantees granted to non-financial sector entities (of which PLN 12.7 bn as security for the repayment of loans).

On the other hand, banks held liabilities concerning financing, received from other entities, in the amount of PLN 68.0 bn (of which PLN 58.8 bn represented liabilities granted by financial sector entities) and guarantees granted by other entities in the amount of PLN 95.6 bn (of which PLN 67.1 bn were granted by non-financial sector entities).

Chart 124.
Interest rate transactions (PLN bn)

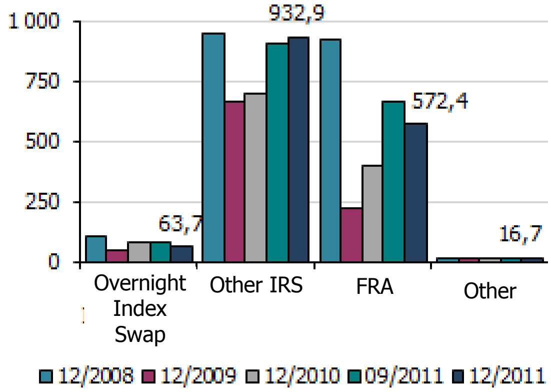


Chart 125.
Transaction scale vs. interest rate volatility (PLN bn; %)

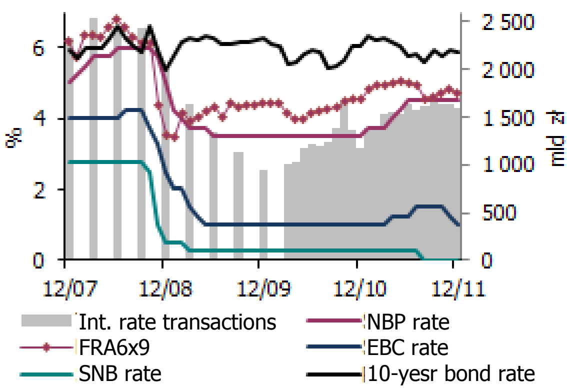


Chart 126.
Foreign currency transactions (PLN bn)

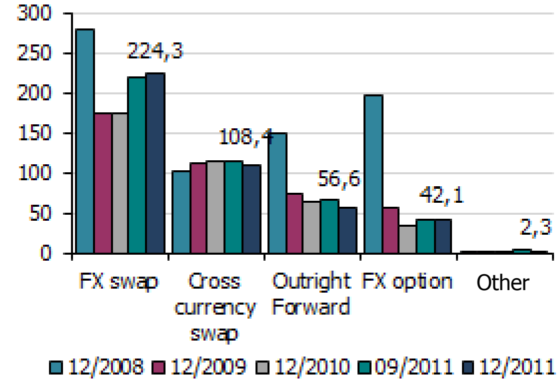
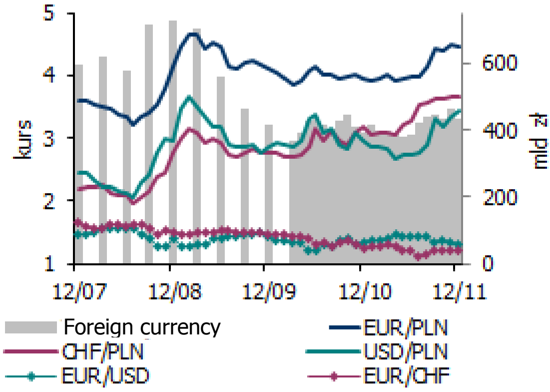


Chart 127.
Transaction scale vs. exchange rate volatility (PLN bn; PLN)



At the end of 2011, the **nominal value of concluded derivatives transactions** amounted to PLN 2 024.0 bn which represented an increase of 28.2 per cent on 2010. Open positions in derivatives were reported by 47 banks, **with 5 banks holding nearly 70 per cent of the transactions concluded** (by nominal value), and 10 banks holding more than 90 per cent.

The increase in the value of open positions, as observed in 2011, resulted primarily from **the increase in the volume of IRS transactions and FRA transactions, which was due to banks' expectation of interest rate increases** (tightening of the monetary policy by the MPC). As a result, banks strived to protect themselves against interest rate risk (primarily from potential losses in the event of Treasury bond price decreases), and developed investment strategies concerning speculation and arbitrage.

In the first half of 2011, the value of open positions on the FX derivative market remained similar to that as at the end of the 2010 .This was related to the relative stability of exchange rate, and therefore, stabilisation of demand among enterprises for hedging against exchange rate risk. The changes in banks' management of the risk concerning the portfolio of foreign currency housing loans, as observed in recent periods, contributed to the stability of the open positions. On the one hand, some banks were able to secure long-term funding in foreign currency (typically, from their parent group companies). On the other hand, banks increasingly used long-term CIRS transactions, rather than rolling over short-term fx swaps. However, in the third quarter of 2011, an **increase of open positions on the FX derivative market was reported,** which was due to significant weakening of the zloty and consequently increased demand from customers for hedging against exchange rate risk.

It should be noted that derivative instruments in bank portfolios are **above all instruments traded on the OTC market,** which, on the one hand, stems from the better development of the OTC market and, on the other hand, better adjustment of transaction terms to investors' needs.[24].

In the product structure, the majority were interest rate derivatives (mainly in zlotys), whose nominal value at the end 2011 represented more than 78,3 per cent of the value of all open positions in derivatives. Among those, the most important instruments were IRS instruments (46.1 per cent of all open positions in all derivatives), FRA (28.3 per cent) and OIS (3.1 per cent), with the FRA market being the most developed.[25]. 21,4 per cent of all open positions were in **FX derivatives**, the most important of which being FX swaps (11.1 per cent), CIRS (5.4 per cent) and outright forwards (2.8 per cent). Other types of derivatives were negligible.

[24] For more information about the derivative instrument market, see various editions of "Rozwój systemu finansowego w Polsce" [Development of Poland's financial system], NBP.
[25] The higher nominal value of IRS transactions compared to FRA transactions stems from the fact that IRS transactions are often concluded for a term of several years, as a result of which they are off the balance sheet for longer periods of time.

The structure was dominated by transactions concluded amongst the banks themselves, which at the end of 2011 constituted 92.7 per cent of the volume off all concluded transactions. The proportion of transactions concluded with other financial sector institutions was very low (1,7 per cent), which was due, among other things, to the limited interest in that market from investment funds and the absence of appropriate executive legislation, which would enable pension funds to protect themselves from unfavourable changes of the prices of Treasury bonds held. The share of transactions with non-financial sector entities was also minor (5,0 per cent). However, it is important to distinguish transactions in interest rate-linked instruments, where the proportion of non-financial entities was marginal (2,0 per cent of interest rate transactions), and FX derivative transactions, where that proportion was considerable (15,3 per cent of FX transactions). It must also be noted that an important reason behind the decline in the activity of the non-financial sector on the market for FX derivatives were the 2008-2009 experiences in options trading, which lowered the demand of enterprises for these products. Furthermore, the amendment of Recommendations A and I forced banks to improve, among other things, the process of notifying customers of the risk inherent in transactions, strengthening the standards of documenting derivative transactions, as well as the preference of offering simple products to customers.

In the area of **country of origin**, it is worth emphasising **the high proportion of transactions concluded with foreign entities** (at the end of 2011, they represented 55.6 per cent of all open positions), which is related to their high proportion in IRS (not OIS), FRA, fx swap and CIRS transactions.

3 THE BANKING SECTOR'S FINANCIAL RESULTS

In 2011, a significant **increase in net profit of the banking sector** was reported. The main source of the **improvement was the higher interest result and lower negative balance of write-downs and provisions.**

Table 15**. Selected items from the profit and loss account of the banking sector (PLN m; %)**

	Financial results in I-XII				Change 2011/2012		Financial result in the last four quarters			
	2008	2009	2010	2011	PLN m	%	Q1 2011	Q2 2011	Q3 2011	Q4 2011
Profits on banking activities	48 412	49 607	53 083	57 308	4 225	8.0 %	13 688	14 393	14 270	14 957
- net interest income	28 012	26 376	30 899	34 933	4 034	13.1 %	8 175	8 652	8 815	9 292
- net fee and commission income	11 439	12 459	13 754	14 302	548	4.0 %	3 401	3 577	3 435	3 890
- other items	8 961	10 772	8 429	8 072	-357	-4.2 %	2 112	2 164	2 021	1 775
Operating costs	24 713	24 815	25 477	26 764	1 286	5.0 %	6 390	6 774	6 429	7 170
Depreciation	2 335	2 544	2 534	2 590	56	2.2 %	623	631	601	735
Provisions and write-downs (negative)	5 511	12 830	11 235	8 667	-2 568	-22.9 %	2 114	2 178	2 147	2 228
NET FINANCIAL PROFIT OR LOSS	13 556	8 278	11 420	15 699	4 279	37.5 %	3 783	4 007	4 174	3 735

Chart 128.
Profits on banking activities (PLN m)

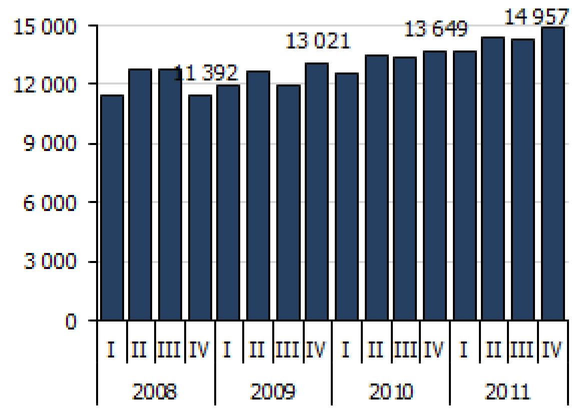


Chart 129.
Operating costs (PLN m)

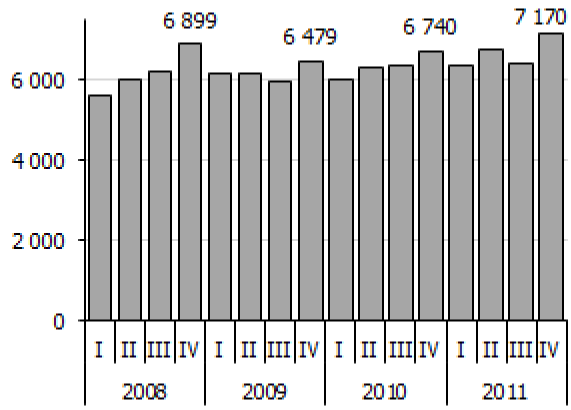


Chart 130.
Negative balance of write-downs/provisions (PLN m)

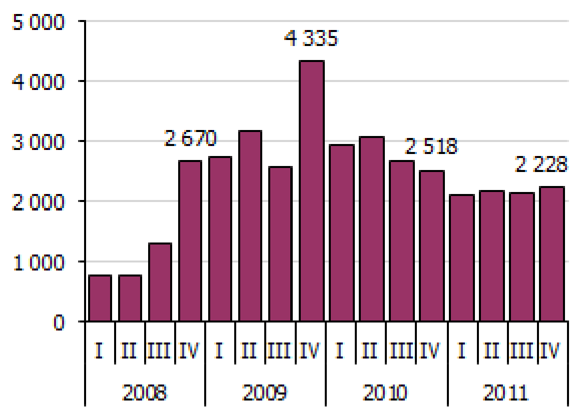
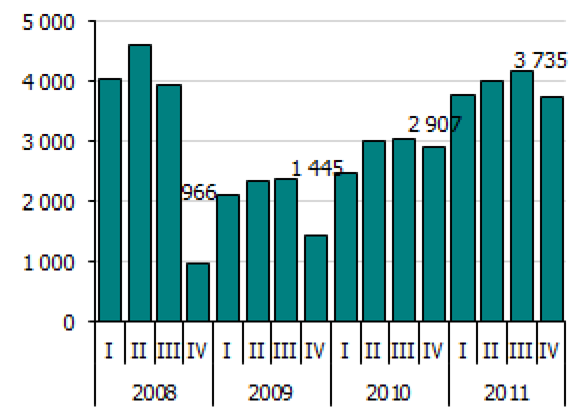


Chart 131.
Net financial profit or loss (PLN m)



The net financial profit of the banking sector was **PLN 15.7 bn**, which denotes its growth compared to the corresponding period of 2010 by PLN 4.3 bn, i.e. by **37.5 per cent,** whereas:

- **results were improved for 500 entities holding 89.5 per cent of the** sector's **assets**;

- **the positive results by banks which reported significant losses in 2011** is worthy of attention;
- **financial results of cooperative banks improved by slightly less then across the entire sector** (increase by 25.2 per cent from PLN 736 m to PLN 921 m), whereas 461 banks reported improvements in results (with 83.9 per cent of this group's assets under their control) and at 113 the results were poorer;
- at the end of 2011 , six commercial banks, eight branches of credit institutions and one cooperative bank reported net losses for a total amount of PLN 520 m, with their joint share in the sector's assets of 2.9 per cent. This, however, signifies an improvement against 2010, when the total amount of losses was PLN 1 265 m, and losses were reported by 20 entities holding 8.2 per cent of the sector's assets.

Chart 132.
Financial result In 2010-2011 according to bank groups (PLN m)

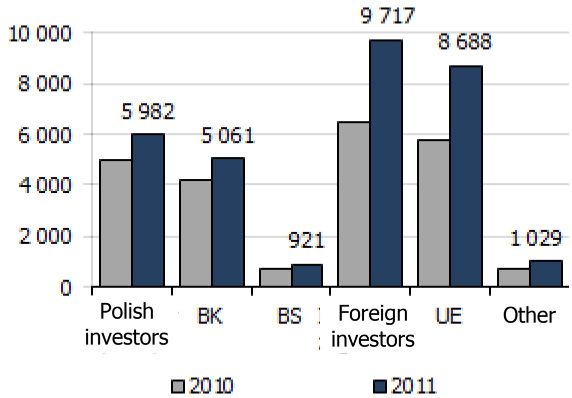


Chart 133.
Change to financial results (PLN m)

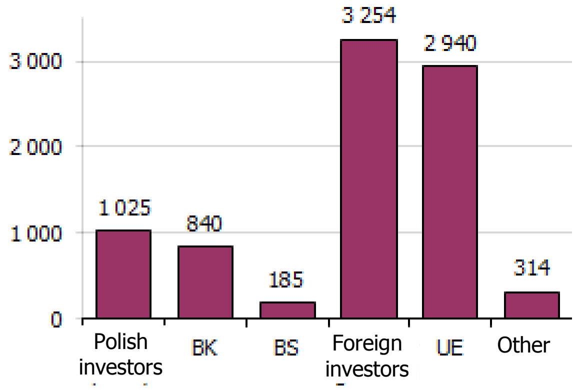


Chart 134.
Net profit in 1999-2011 according to bank groups (PLN m)

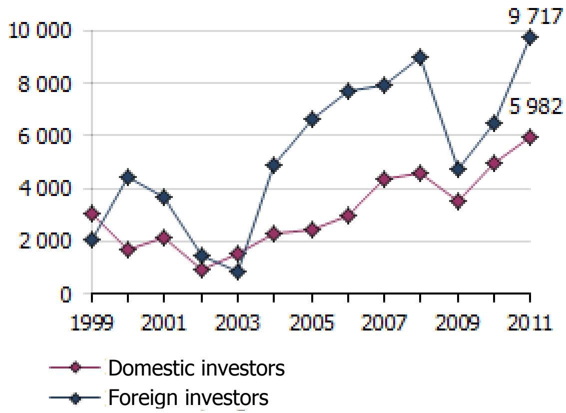
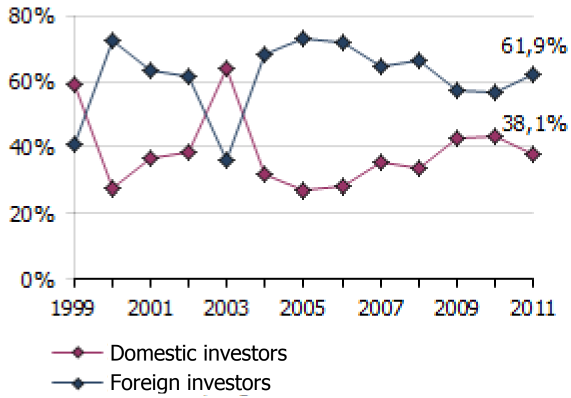


Chart 135.
Share in the sector's results (%)



Considering individual bank groups, the significant improvement to the financial results at banks under the control of foreign investors should be pointed out. However, this was due to a significant deterioration of the performance of these banks in 2009-2010 (in 2008 the net result for this group amounted to PLN 9.0 bn and then in 2009 fell to PLN 4.7 bn)[26]. Consequently the share of the banking sector's profits generated by this group increased to 61.9 per cent (from 56.6 per cent), however it was still below that their share in the sector's assets.

[26] For banks controlled by domestic investors the profits fell only in 2009 (from PLN 4.5 bn in 2008 to PLN 3.5 bn in 2009).

Table 16. Net interest income of the banking sector (PLN m; %)

	Financial results in I-XII				Change 2011/2012		Financial result in the last four quarters			
	2008	2009	2010	2011	PLN m	%	Q1 2011	Q2 2011	Q3 2011	Q4 2011
INCOME	58 094	55 585	57 268	64 749	7 482	13.1 %	14 949	15 917	16 150	17 734
1/ Financial sector	8 372	5 538	5 450	7 216	1 766	32.4 %	1 557	1 716	1 842	2 102
2/ Non-financial sector	41 406	41 075	41 770	45 591	3 821	9.1 %	10 643	11 191	11 251	12 506
Households	27 079	29 114	30 059	31 707	1 648	5.5 %	7 598	7 931	7 591	8 588
Consumer loans	14 101	16 358	17 006	15 959	-1 047	-6.2 %	4 042	3 980	3 726	4 211
Housing loans	8 266	7 560	8 133	10 075	1 942	23.9 %	2 247	2 529	2 520	2 780
- zloty	4 418	4 356	5 258	6 545	1 286	24.5 %	1 478	1 659	1 551	1 857
- foreign currency	3 847	3 205	2 875	3 530	656	22.8 %	769	870	969	922
Other loans	4 712	5 195	4 920	5 673	753	15.3 %	1 308	1 423	1 344	1 597
Enterprises	14 125	11 743	11 441	13 564	2 123	18.6 %	2 977	3 187	3 575	3 826
Non-profit institutions	202	218	270	319	50	18.5 %	69	73	86	92
3/ Budget sector	1 835	1 793	2 066	2 769	703	34.0 %	597	650	724	798
4/ Debt securities	6 481	7 179	7 982	9 174	1 192	14.9 %	2 151	2 360	2 333	2 329
COSTS	30 082	29 209	26 368	29 816	3 448	13.1 %	6 774	7 265	7 335	8 442
1/ Financial sector	11 392	8 926	7 056	8 340	1 284	18.2 %	1 833	2 109	2 111	2 287
2/ Non-financial sector	16 116	18 206	17 221	19 226	2 005	11.6 %	4 444	4 575	4 588	5 618
Households	9 856	13 534	12 634	13 321	687	5.4 %	3 207	3 212	3 037	3 865
Enterprises	5 847	4 259	4 225	5 522	1 297	30.7 %	1 152	1 275	1 450	1 645
Non-profit institutions	413	414	361	383	22	6.0 %	85	88	101	108
3/ Budget sector	2 574	2 077	2 092	2 250	158	7.6 %	497	581	636	537

Chart 136.
Interest income and expense (PLN m)

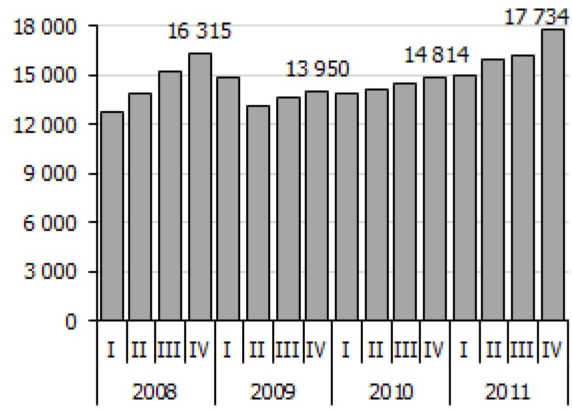


Chart 137.
Selected interest income and expense (PLN m)

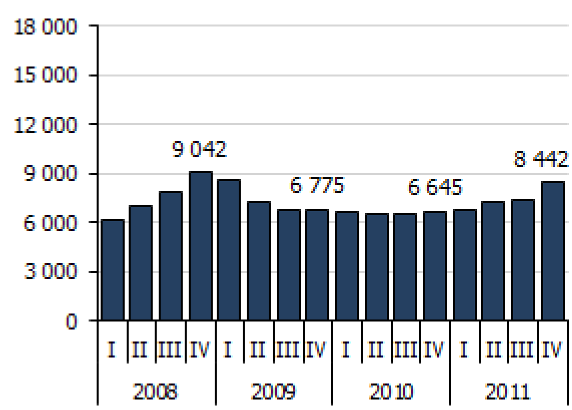


Chart 138.
Selected interest income (PLN m)

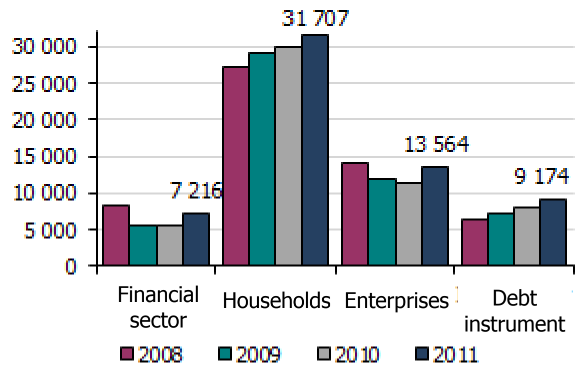
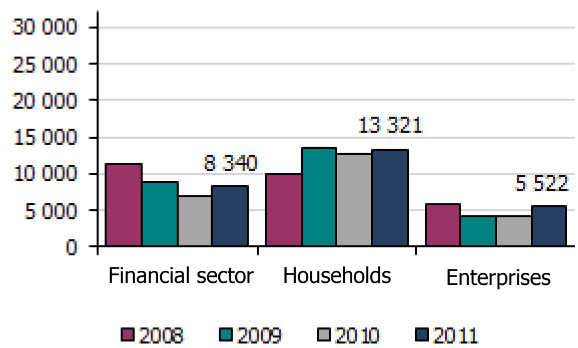


Chart 139.
Selected interest expense (PLN m)



Net interest income increased by 13.1% (by PLN 4,034 m). The main factor contributing to this improvement was the significant increase in interest income (PLN by 7,482 m), helped by increased loan volumes and the interest rate increases dictated by MPC. The interest expenses increase was significantly lower (PLN 4 034 m). However it should be added that the rate of growth of interest expenses in the second half of 2011 picked up, which was partly due to an increase in the deposit base and party due to an increase in deposit interest. Consequently, throughout the year the rate of growth of interest expenses matched the rate of growth of inters income and amounted to 13.1 per cent.

The increase in interest income resulted primarily from an increase in income on loans to the non-financial sector (by PLN 3,821 m; 9.1 per cent), and, to a lesser extent, on income from the financial sector (by PLN 1 766 m; 32.4 per cent), debt securities (by PLN 1 192 m; 14.9 per cent), and also on loans to the budget sector (by PLN 703 m; 34.0 per cent). However, **the loss of income on consumer loans** (by PLN 1 047 m; -6.2 per cent) should be pointed out, which was set off by a p**ronounced increase of income on housing loans** (by PLN 1 942 m; 23.9 per cent) and **on loans to enterprises** (by PLN 2 123 m; 18.6 per cent). The decline in interest income on consumer loans was caused by a decrease in their volume and an increase in impaired and overdue loans, which did not generate income or did so irregularly.

On the cost side, it is worth noting the relatively low increase in interest paid to households (by PLN 687 m; 5.4 per cent) whereas costs paid for the benefit of the financial sector and enterprises increased significantly. This resulted from the fact, that in the first half of 2011, banks strived to improve the net interest income at the cost of retail customers and only in 2011 did they decide to make deposit interest rates more attractive.

Other items of the banks' performance had little effect on improving banks' results. **The results on account of fees and commissions increased** (by PLN 548 m; **4 per cent**), and the **remaining results** of banks' operations **decreased** (by PLN 357 m; **-4.2 per cent**) which should be linked to, inter alia, decreasing rate of growth of lending to households, subdued activity on the capital markets as well as restricted ability for further increases in bank service fees.

The rate of cost growth was moderate (increase by PLN 1,286 m; **5.0 per cent**), with the rate of growth of employee costs (3.7 per cent) was slightly lower than the increase in general and administrative expenses (5.7 per cent). Costs of depreciation increased slightly (2.2 per cent).

Table 17**. Balance of write-downs/provisions (PLN m; %)**

	Financial results in I-XII				Change 2011/2012		Financial result in the last four quarters			
	2008	2009	2010	2011	PLN m	%	Q1 2011	Q2 2011	Q3 2011	Q4 2011
Balance of write-downs and provisions, of which:	-5 511	-12 830	-11 235	-8 667	2 568	-22.9 %	-2 114	-2 178	-2 147	-2 228
1/ Write-downs in respect of financial assets	-4 275	-11 556	-10 545	-7 437	3 109	-29.5 %	-1 749	-1 898	-1 709	-2 081
Households	-3 420	-8 807	-9 004	-6 355	2 649	-29.4 %	-1 720	-1 575	-1 523	-1 537
Consumer loans	-3 047	-7 108	-7 017	-3 646	3 371	-48.0 %	-1 157	-945	-898	-647
- credit cards	-342	-888	-937	-286	651	-69.5 %	-126	-68	-53	-38
- vehicle	-93	-191	-195	-149	46	-23.6 %	-64	-14	-49	-21
- instalment	-760	-2 467	-2 036	-1 273	763	-37.5 %	-385	-401	-256	-230
- other	-1 852	-3 563	-3 849	-1 938	1 911	-49.6 %	-581	-461	-539	-357
Housing loans	-247	-562	-867	-1 321	-454	52.4 %	-258	-292	-332	-439
Other loans	-125	-1 137	-1 120	-1 389	-268	24.0 %	-305	-339	-293	-452
Enterprises	-702	-2 681	-1 524	-1 055	470	-30.8 %	-41	-306	-182	-525
- SME	-358	-842	-955	-518	437	-45.7 %	47	-224	122	-463
- large enterprises	-344	-1 839	-569	-536	33	-5.8 %	-88	-82	-304	-62
Other entities	-153	-68	-17	-27	-9	53.7 %	12	-17	-3	-19
2/ Other items										
Provisions	-398	-524	-769	-665	104	-13.5 %	-154	-151	-226	-134
- write-downs in respect of non-financial assets	-153	-210	-87	-108	-21	23.8 %	-9	-27	-49	-23
- IBNR/general risk provision	-685	-541	166	-457	-623	-375	-203	-101	-164	10

Chart 140.
Write-downs in respect of financial assets (PLN m)

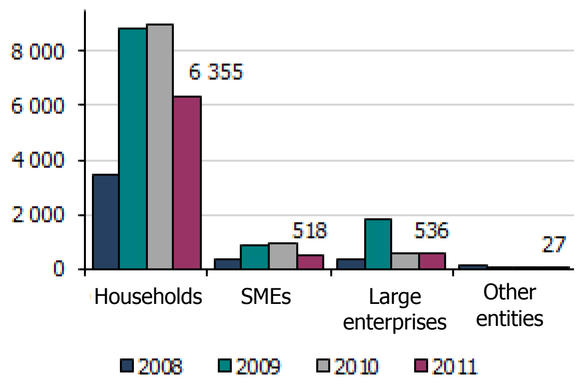
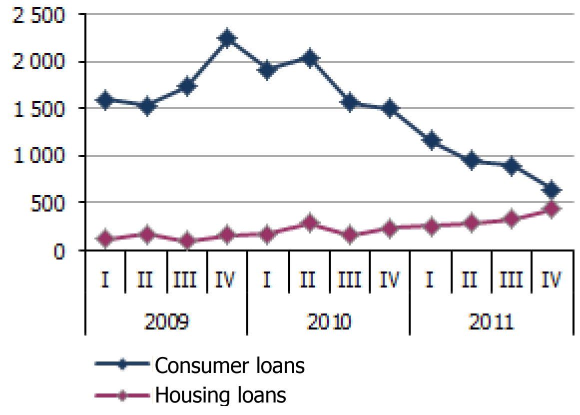


Chart 141.
Write-downs in respect of consumer and housing loans (PLN m)



The second factor contributing to the market improvement of banks' financial performance (other than increased net interest income) was a decrease of PLN 739 m, i.e. **22.9 per cent of the negative balance of write-downs and provisions**.[27]. However, it should be added, that **cooperative banks reported an increase to the negative balance of write-downs** (from PLN 173 m to PLN 270 m, i.e.: by 19.7 per cent).

Improvement in this regard stemmed primarily from a **decrease in write-downs of consumer loans** (by PLN 3 371 m; -48.0 per cent), which concerned all major products (single repayment loans by PLN 1 911 m, instalment loans by PLN 763 m, credit cards by PLN 651 m and vehicle loans by PLN 46 m). To a lesser extent, the improvement in write-downs was influenced by a decrease in write-downs of loans to the enterprise sector (by PLN 470 m; -30.8 per cent).

The increase of a negative balance of provisions was influenced by i**ncreased write-downs of housing loans** (by PLN 454 m; **52.4 per cent**), other loans to households (by PLN 268 m; 24.0 per cent), as well as increased write-downs of IBNR/general risk provisions (by PLN 623 m).

Looking at the changes in the levels of write-downs, systematic decrease in write-downs on account of consumer loans and a simultaneous increase in write-downs on account of housing loans is evident (in the fourth quarter of 2011 write-downs on account of consumer loans amounted to PLN 647 m and were at their lowest level for 3 years and write-downs on account of housing loans increased to PLN 439 m and were at their highest level ever).

The phenomena observed in the last quarters appear to indicate that most banks experienced a breakthrough in the acceleration of unfavourable phenomena. However, due to the expected deterioration of the investment climate and fears of a down turn on the job market, t**he issue of the continuation of favourable tendencies in coming periods remains open.**

[27] Taking into account an adjustment to data due to the change to the operating format of Polbank EFG, the scale of reduction to the negative write-downs balance would be smaller.

Table 18. **Selected measures of efficiency of the banking sector (PLN m; %; PLN thousand)**

	Banking sector			including: commercial banks			including: cooperative banks		
	2009	2010	2011	2009	2010	2011	2009	2010	2011
Net financial result	8 278	11 420	15 699	7 620	10 833	14 458	686	736	921
Banks reporting losses									
- number of banks reporting losses	16	20	15	9	7	6	x	2	1
- share in the sector's assets	7.9 %	8.2 %	2.9 %	5.4 %	5.6 %	2.7 %	x	0.0 %	0.0 %
- total value of losses	-1 716	-1 265	-520	-1 225	-648	-435	x	-15	-1
ROA - Net result / average assets	0.81	1.03	1.28	0.83	1.10	1.32	1.18	1.12	1.24
ROE - Net result / average basic funds	8.37	10.21	12.78	8.22	10.19	12.98	10.54	10.46	11.88
C/I - Costs / incomes	54.21	52.26	50.85	52.87	50.61	49.21	71.62	69.31	66.64
Banking performance / average assets	4.83	4.78	4.66	4.82	4.80	4.71	5.86	5.71	5.74
- net interest income / average assets	2.57	2.79	2.84	2.50	2.76	2.85	4.15	4.14	4.30
- net non-interest income / average assets	2.26	2.00	1.82	2.32	2.03	1.86	1.72	1.58	1.44
Bank's operating costs / average assets	2.41	2.30	2.18	2.34	2.22	2.12	3.96	3.72	3.60
- employee / average assets	1.30	1.29	1.20	1.23	1.22	1.13	2.86	2.66	2.53
- general management / average assets	1.11	1.01	0.98	1.11	1.00	0.98	1.11	1.06	1.07
Bank's operating costs / banking performance results	49.97	47.98	46.71	48.61	46.20	44.99	67.63	65.07	62.74
Bank's operating costs / net interest income	93.97	82.42	76.62	93.71	80.22	74.37	95.62	89.88	83.66
Bank's operating costs / net non-interest income	106.72	114.82	119.64	100.98	108.96	113.87	230.98	235.76	250.82
Balance of write-downs/provisions / average assets	1.14	1.04	0.63	1.16	1.06	0.66	0.15	0.27	0.30
Assets per employee (PLN m)	6.07	6.59	7.33	6.85	7.46	8.40	1.90	2.21	2.42
Employee costs per employee (PLN thousand)	76.98	81.13	83.22	82.22	86.61	89.92	51.23	54.70	57.84
Gross profit per employee (PLN thousand)	69.96	88.78	114.07	78.37	101.81	133.53	26.75	30.01	36.02

Chart 142.
ROA - Net result / average assets (%)

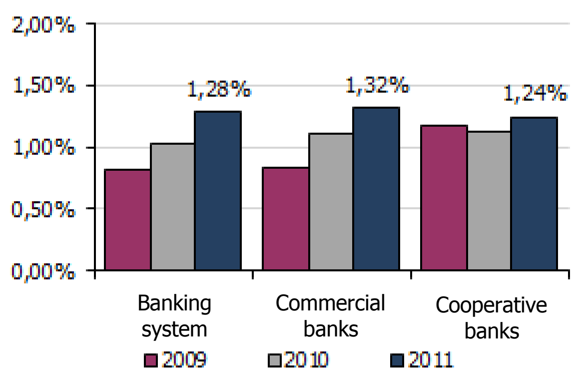


Chart 143.
ROE - Net result / average basic funds (%)

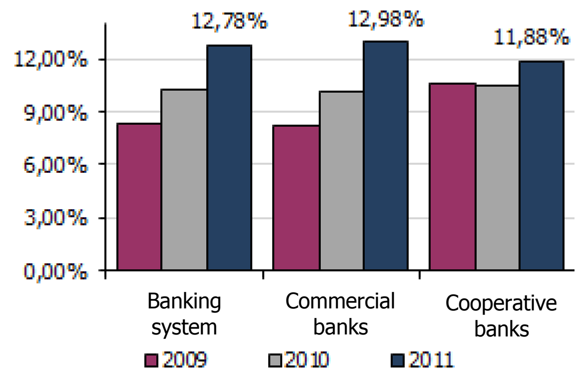


Chart 144.
C/I - Costs / incomes (%)

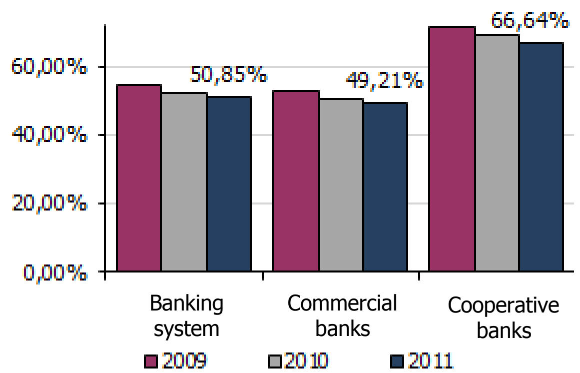
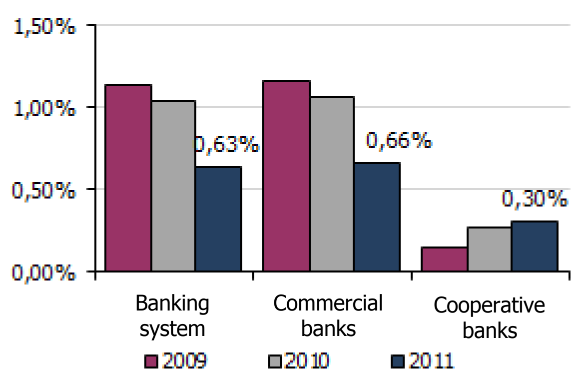


Chart 145.
Balance of write-downs/provisions / average assets (%)



The positive tendencies translate into an **improvement in most efficiency measures for banks' operations.** In particular in 2011 as compared to 2010 the following occurred:

- slight increase in interest margins from 2.79 per cent to 2.84 per cent;
- decrease in the operating costs indicator (C/I) from 52.26 per cent to 50.85 per cent and the share of operating costs in average assets (from 2.30 per cent to 2.18 per cent) and the profits generated on banking activity (from 47.98 per cent to 46.71 per cent);
- decrease in the negative balance of write-downs/provisions in average assets from 1.04 per cent to 0.63 per cent;
- ROA increase from 1.03 per cent to 1.28 per cent, and ROE from 10.21 per cent to 12.78 per cent.

The improvement to operational efficiency indicators occurred for both commercial and cooperative banks. For cooperative banks, it is worth noting, the systematic improvement to the C/I indicator, however on the other hand a slight deterioration (increase) in the share of the balance of write-downs/provisions in average assets was reported.

Based on **2012** financial plans, **it is viable to expect a stabilisation of net results at 2011 levels.** However, the fact that one third of surveyed banks expect a deterioration in results should be emphasised.

4 MAIN AREAS OF RISK AND CAPITAL ADEQUACY

4.1 Liquidity

The current **situation of banks in regard to liquidity can be considered satisfactory,** but a few banks experienced events that required the intervention of supervision authorities.

Table 19**. Number of banks and branches of credit institutions not meeting at end month the standards of Resolution 386/2008**

	01/10	02/10	03/10	04/10	05/10	06/10	07/10	08/10	09/10	10/10	11/10	12/10
Commercial banks	-	1	-	1	-	-	-	-	-	-	-	-
Branches of credit institutions	-	-	-	-	-	-	-	1	-	-	1	1
Cooperative banks	5	6	7	7	5	10	6	6	6	4	4	3
Total share in the sector's assets (%)	0.2 %	0.7 %	0.2 %	0.7 %	0.1 %	0.2 %	0.1 %	0.2 %	0.2 %	0.1 %	0.1 %	0.1 %
	01/11	02/11	03/11	04/11	05/11	06/11	07/11	08/11	09/11	10/11	11/11	12/11
Commercial banks	-	-	-	-	-	-	-	-	-	-	-	-
Branches of credit institutions	-	-	-	1	1	1	1	-	-	-	-	-
Cooperative banks	3	1	1	2	-	3	2	-	5	5	2	2
Total share in the sector's assets (%)	0.0 %	0.0 %	0.0 %	2.1 %	2.1 %	2.1 %	2.1 %	-	0.1 %	0.0 %	0.0 %	0.1 %

Chart 146.
Selected assets[28] *(PLN bn)*

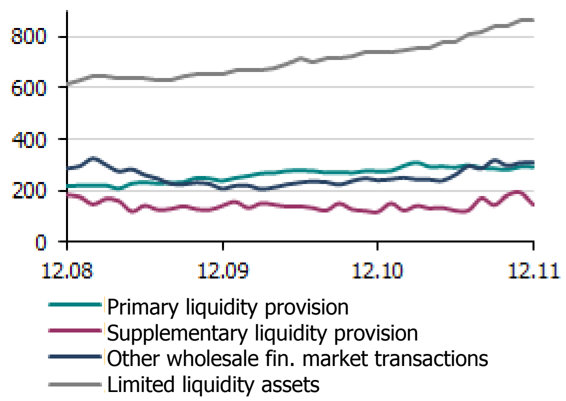


Chart 147.
Change (PLN bn)

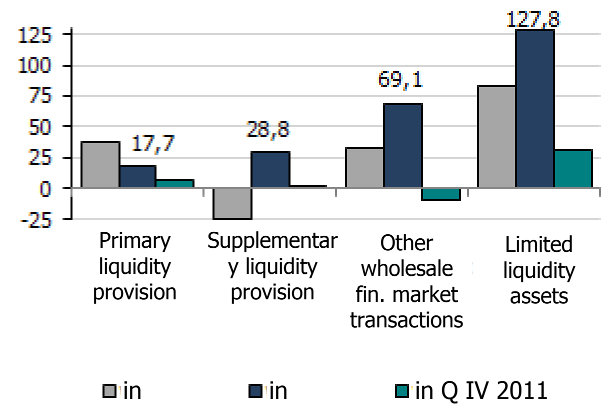


Chart 148.
Selected liabilities[29] *(PLN bn)*

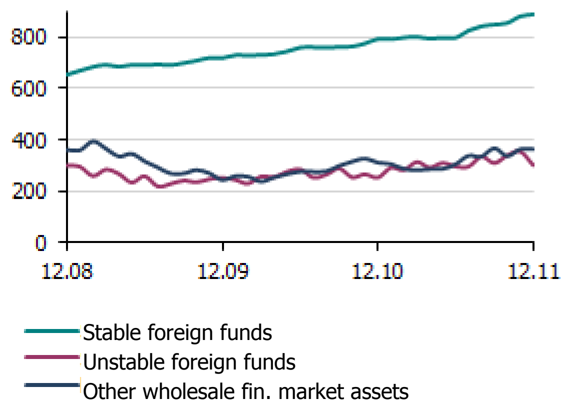
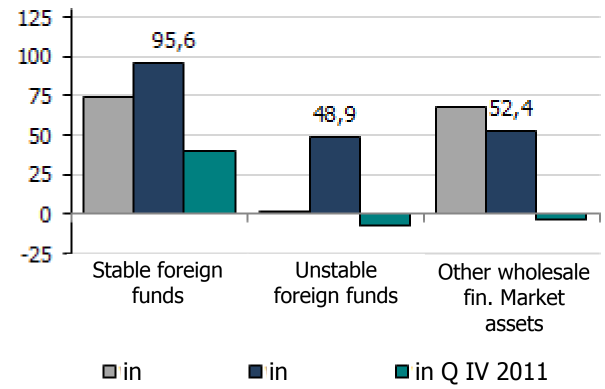


Chart 149.
Change (PLN bn)



[28] Definitions – see PFSA resolution 386/2008 concerning the determination of liquidity standards binding upon banks.
[29] Ibid.

Chart 150.
Loans and deposits of the non-financial sector (PLN bn)

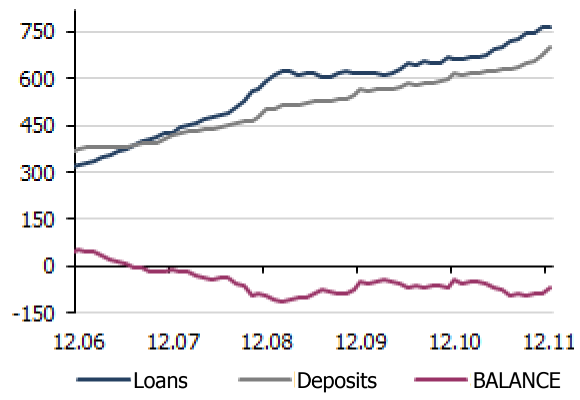
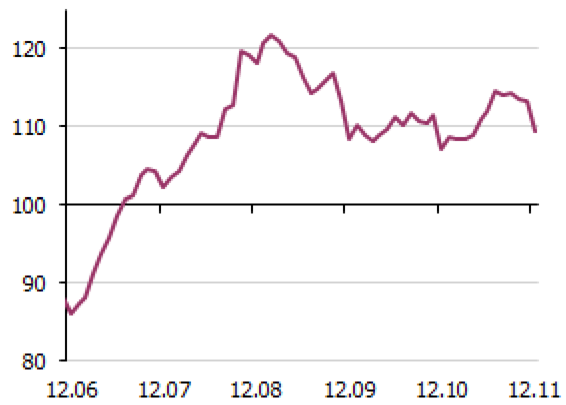


Chart 151.
Relationship of loans to non-financial sector deposits (%)



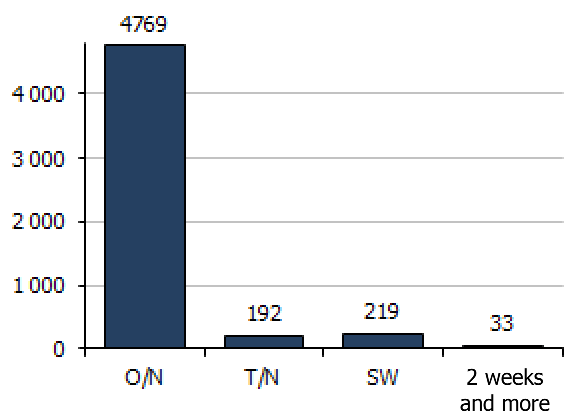
The current liquidity situation was good:

- **compliance** with the provisions of **PFSA Resolution 386/2008** of concerning the determination of liquidity standards binding upon banks may be **deemed to have been satisfactory**. The number of violations of the resolution was small and they typically concerned entities of marginal importance in the scale of the system;
- 2011 saw an **increase in the primary liquidity reserve** of 6.4 per cent (from PLN 276.2 bn at the end of 2010 to PLN 293.9 bn at the end of 2011) and the supplementary liquidity reserve of 24.1 per cent (from PLN 119.6 bn to PLN 148.5 bn). At the same time there was an increase of 12.0 per cent in the level of stable foreign funds (from PLN 794.1 bn to PLN 889.8);
- **the ratio of loans to deposits,** which determines the scale of demand for funds from financial markets, after reaching a maximum at the turn of 2008 and 2009, remained relatively stable oscillating between 107 - 114 per cent (at the end of 2011 amounted to 109.4 per cent as compared to 107.2 per cent at the end of 2010).

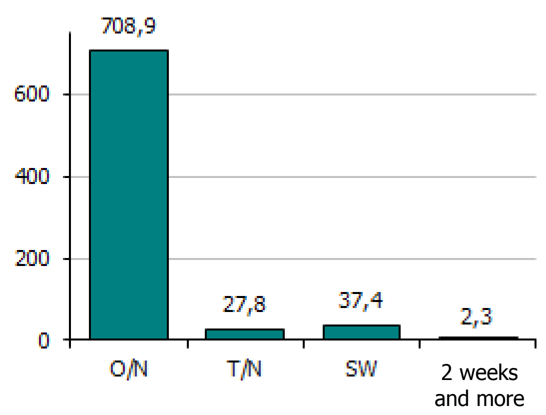
The primary difficulty in managing liquidity is the reported decline in mutual confidence among financial market participants, which is a derivative the global financial crisis, intensifying debt crisis of some eurozone countries, deterioration of outlook for global economic growth and lowered ratings for certain countries and financial institutions. In light of the above, banks have to account for the possibility of major periodic disruptions in the functioning of financial markets and should strive to improve the stability of funding sources and to establish strategies, which will be adjusted to the difficult conditions.

SELECTED RESULTS OF PFSA RESEARCH ON THE INTERBANK MARKET SITUATION[30]

The number of transactions concluded in 2001, according to duration

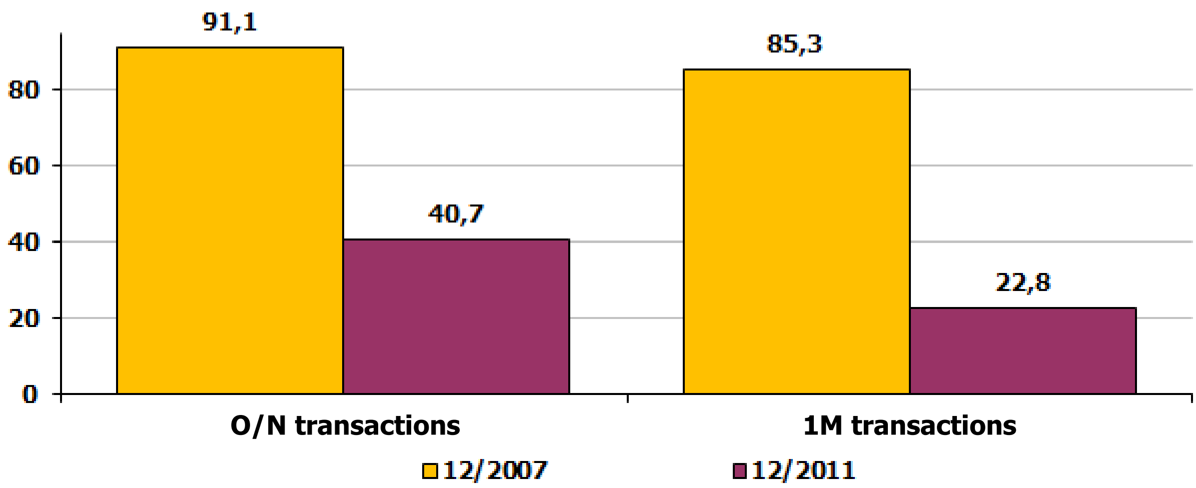


Value of concluded transactions in 2011 (PLN bn)



[30] PFSA survey of 15 banks, the major market players.

Reciprocal limits for O/N and 1M transactions between banks (PLN bn)



An unfavourable situation persists on the domestic interbank market, marked by limited operational effectiveness. This manifests itself by low market turnover, low proportion of transactions with maturity of more than 1 day and low mutual credit limits, which were significantly reduced in 2008-2009 due to worries associated with the growing financial crisis (PFSA research showed that banks concluded 5213 transactions of total value equal to PLN 776.3 bn, out of which 91.5 per cent of the total number of transactions and 91.3 per cent of their total value constituted O/N transactions).

Considering the current Polish banking sector situation **there are no justified reasons, for the market to function in a limited scope.** Therefore, restoration of mutual confidence is essential, which would contribute to, inter alia, extending higher reciprocal limits.

4.2 Credit risk

In the first half of 2011, a stabilisation or improvement to the loan portfolio quality (with the exception of housing loans) was observed. However in the second half of the year, unfavourable events were reported in some areas.

Table 20**. Loans confirmed as impaired (non-performing) and their share in the portfolio (PLN bn; %)**

	Value (PLN bn)					Share in portfolio (%)				
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2008	12/2009	12/2010	09/2011	12/2011
Non-performing loans in total, of which:	30.7	50.9	61.8	65.9	66.8	4.7 %	7.1 %	7.8 %	7.5 %	7.3 %
1/ Financial sector	0.4	0.2	0.2	0.2	0.1	2.0 %	0.6 %	0.7 %	0.6 %	0.5 %
2/ Non-financial sector	30.0	50.7	61.4	65.5	66.4	4.9 %	7.9 %	8.8 %	8.4 %	8.3 %
- households	14.8	24.9	34.1	38.6	38.5	4.0 %	6.0 %	7.2 %	7.3 %	7.2 %
- enterprises	15.2	25.7	27.2	26.8	27.8	6.5 %	11.6 %	12.4 %	10.7 %	10.5 %
- non-profit institutions	0.1	0.0	0.1	0.0	0.0	2.9 %	1.5 %	2.0 %	0.7 %	1.0 %
3/ Budget sector	0.3	0.1	0.2	0.2	0.3	0.9 %	0.2 %	0.3 %	0.3 %	0.3 %
3/ Budget sector	0.3	0.1	0.2	0.2	0.3	0.9 %	0.2 %	0.3 %	0.3 %	0.3 %

In 2011 the **value of non-performing loans portfolio increased** by **PLN 5.0 bn**, i.e. 8.0 per cent with most of the increase occurring in the third quarter (PLN 3.7 bn). Despite that fact, the **share** of these loans in the portfolio **decreased** to **7.3 per cent** as at the end of 2011 which was caused by a more rapid growth of the entire loans portfolio.

One-off events played a significant role in the observed changes. The sale or writing-off to provisions of parts of the loan portfolio and a change in the classification of receivables as well as accounting standards changes in terms of loan portfolios at two banks (affecting PLN 3.5 bn consumer loans and PLN 0.9 bn loans to enterprises) aided the decrease in non-performing loans and overdue loans. On the other hand a change to loan portfolio classification methods at one bank had the opposite effect.

Chart 152.
Non-performing loans (PLN bn)

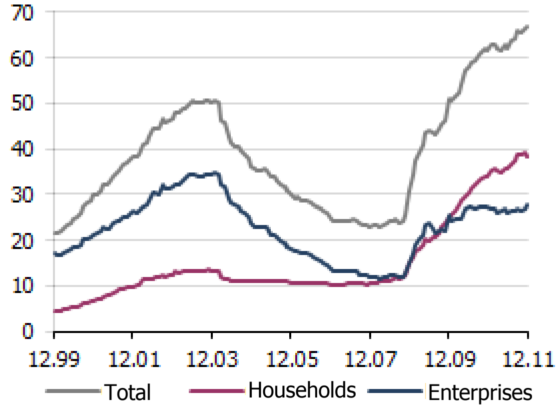
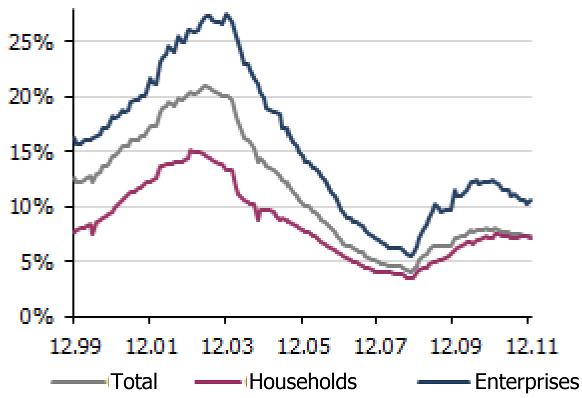


Chart 153.
Proportion of non-performing loans in portfolio (%)



The increase of non-performing loans occurred predominantly within the scope of loans granted to households, and to a significantly lesser extent within the scope of loans to enterprises. The situation in the portfolio of loans to the financial and budget sector remained stable, and the quality of these portfolios was high.

Table 21**. Non-performing loans to households and their share of the portfolio (PLN bn; %)**

	Value (PLN bn)					Share in portfolio (%)				
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2008	12/2009	12/2010	09/2011	12/2011
Non-performing loans in total, of which:	14.8	24.9	34.1	38.6	38.5	4.0 %	6.0 %	7.2 %	7.3 %	7.2 %
1/ Consumer loans	9.1	17.2	23.2	24.2	23.4	7.8 %	13.0 %	17.3 %	18.3 %	18.0 %
2/ Housing loans	2.1	3.2	4.9	6.9	7.5	1.1 %	1.5 %	1.8 %	2.2 %	2.3 %
3/ Other	3.6	4.5	6.0	7.5	7.7	6.0 %	6.7 %	8.1 %	9.1 %	9.2 %

Chart 154.
Non-performing loans to households by type (PLN bn)

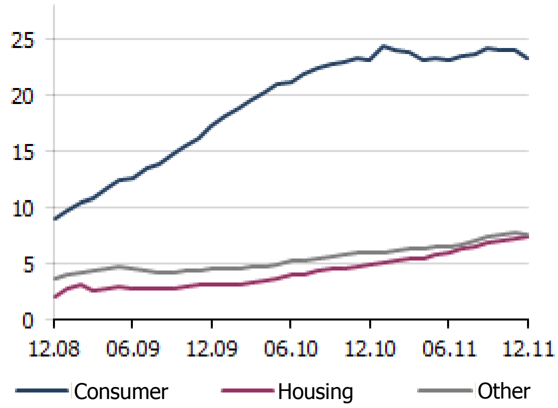
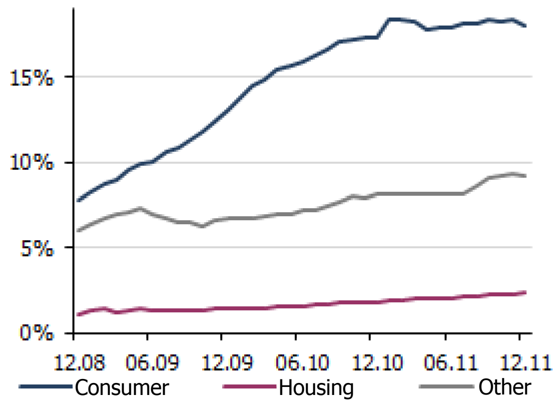


Chart 155.
Share in portfolio (%)



In 2011, **the value of non-performing loans to households increased by PLN 4.4 bn** i.e.: by 13.0 per cent but due to a similar dynamic of of the value of the entire loan portfolio, **the share of non-performing loans** remained at levels as at the end of 2010, and at the end of 2011 amounted to **7.2 per cent.** The growth of non-performing loans **was predominantly due to an increase in the value of non-performing housing** loans, and to a lesser degree also to operating and investment loans granted to individual entrepreneurs.

Table 22. **Consumer loans confirmed as impaired (PLN bn; %)**

	Value (PLN bn)					Share in portfolio (%)				
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2008	12/2009	12/2010	09/2011	12/2011
Non-performing loans in total, of which:	9.1	17.2	23.2	24.2	23.4	7.8 %	13.0 %	17.3 %	18.3 %	18.0 %
- credit cards	0.9	1.9	2.7	2.7	2.5	7.4 %	12.6 %	18.1 %	19.2 %	18.7 %
- vehicle	0.6	0.8	1.0	1.1	1.0	7.8 %	10.2 %	12.7 %	15.4 %	15.4 %
- instalment	2.9	6.0	7.3	7.8	7.3	7.3 %	13.6 %	15.7 %	16.7 %	15.9 %
- other	4.6	8.5	12.3	12.6	12.5	8.2 %	13.1 %	18.8 %	19.6 %	19.5 %

Chart 156.
Non-performing consumer loans (PLN bn)

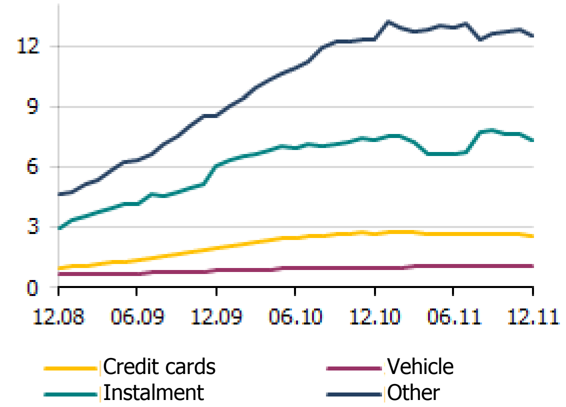


Chart 157.
Share in portfolio (%)

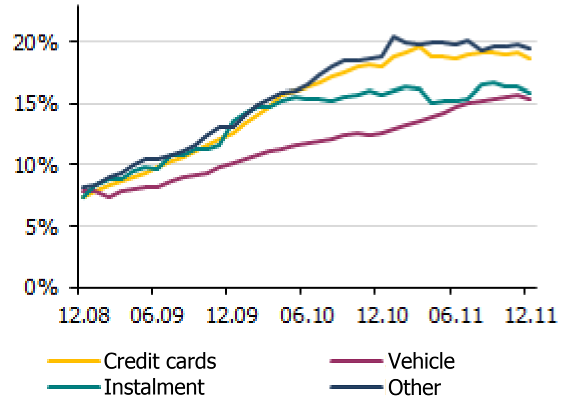


Chart 158.
Quality of consumer loans (PLN bn)

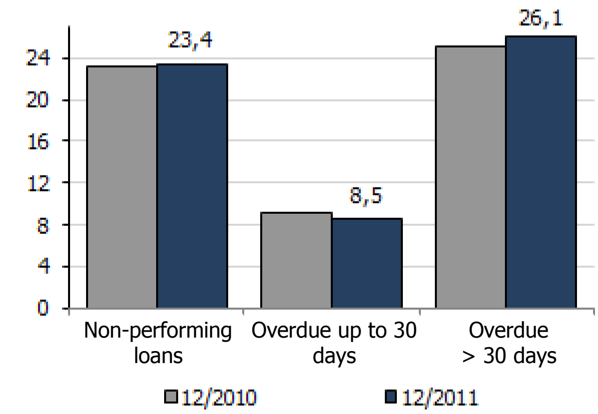
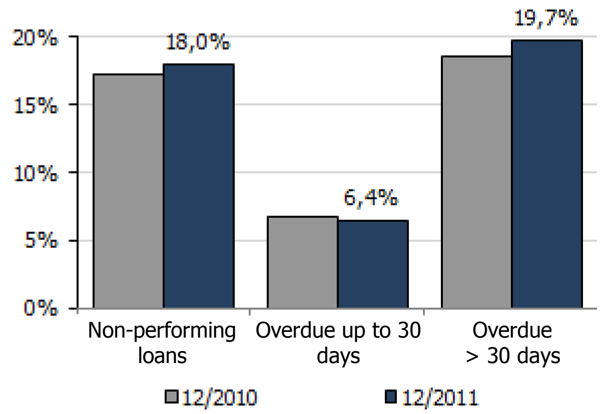


Chart 159.
Quality of consumer loans - share in portfolio (%)



The value of non-performing consumer loans remained at a level similar to that as of the end of 2010 (increase of PLN 0.2 bn) **However this was due to the sale and writing-off to losses parts of the portfolio of these loans** (as already ascertained, these transactions related to a portfolio of loans with a total value of PLN 3.4 bn). **If it wasn't for these transactions, the growth of non-performing loans would have been significantly higher** (PLN 3.6 bn).

At the end of 2011, the **share of non-performing loans increased to 18.3 per cent** (from 17.3 per cent t the end of 2010) which was caused by a decrease in the value of the entire consumer loan portfolio.

The value of loans overdue by up to 30 days decreased slightly (from PLN 9.1 bn as at the end of 2010 to PLN 8.5 bn as at the end of 2011), while loans overdue by **more than 30 days increased** (from PLN 25.2 bn as at the end of 2010 to PLN 26.1 bn as at the end of 2011). The fact that the value of loans overdue by more than 30 days was higher by PLN 2.7 bn that loans confirmed as impaired is noteworthy, and **will most probably exert negative pressure on the portfolio quality measured by the share of non-performing loans as well as financial performance of the banks in forthcoming periods.**

Table 23. **Hosing loans confirmed as impaired (PLN bn; %)**

	Value (PLN bn)					Share in portfolio (%)				
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2008	12/2009	12/2010	09/2011	12/2011
Non-performing loans in total, of which:	2.1	3.2	4.9	6.9	7.5	1.1 %	1.5 %	1.8 %	2.2 %	2.3 %
- zloty	1.0	1.7	2.8	3.8	4.3	1.7 %	2.3 %	2.8 %	3.3 %	3.5 %
- foreign currency	1.1	1.5	2.1	3.1	3.2	0.8 %	1.1 %	1.3 %	1.6 %	1.6 %

Chart 160.
Non-performing housing loans (PLN bn)

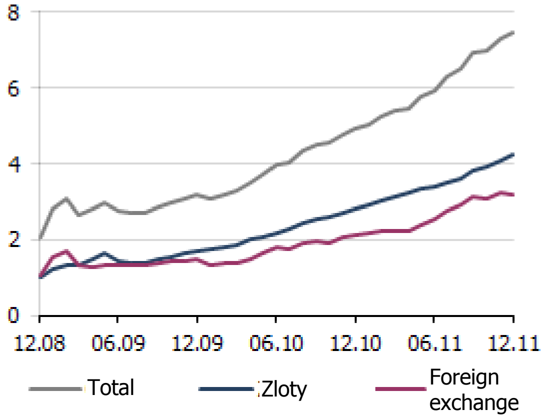


Chart 161.
Share in portfolio (%)

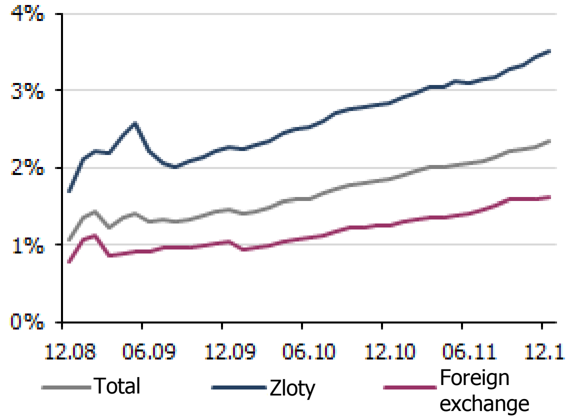


Chart 162.
Housing loans - non-performing and overdue (PLN bn)

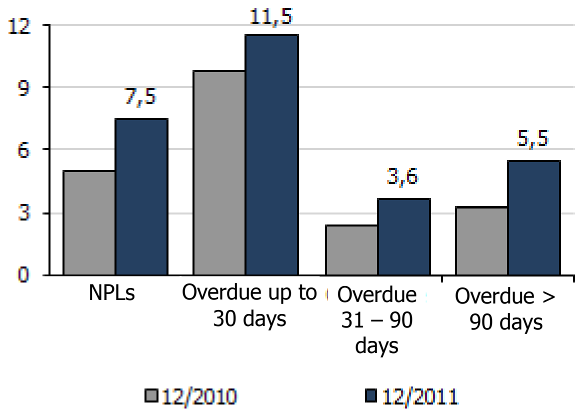
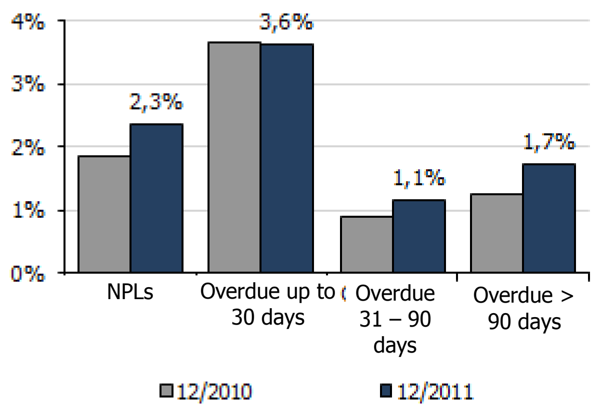


Chart 163.
Housing loans - non-performing and overdue - share (%)



The growth in non-performing housing loans which increased by PLN 2.5 bn, i.e.: by 51.2 per cent (in the fourth quarter by PLN 0.5 bn; 7.8 per cent) **was decisive** for the sector wide **increase in non-performing loans** observed in 2011. As a result of the considerable increase in non-performing housing loans, there was a deterioration of the quality of these loans, which manifested itself in an **increase in the proportion of non-performing loans** from 1.8 per cent at the end of 2010 **to 2.3 per cent** at the end of 2011. Based on the PFSA survey results, it is possible to state, that as at the end of 2011 there were **31.6 thousand non-performing loans.**

A deterioration in loan repayments was also reported. The value of loans overdue by up to 30 days increased from PLN 9.8 bn as at the end of 2010 to PLN 11.5 bn as at the end of 2011, while loans **overdue by**

more than 30 days increased from PLN 5.7 bn to **PLN 9.1 bn**. Based on the PFSA survey results, it is possible to state, that as at the end of 2011 there were **39.3 thousand loans overdue by more than 30 days.**

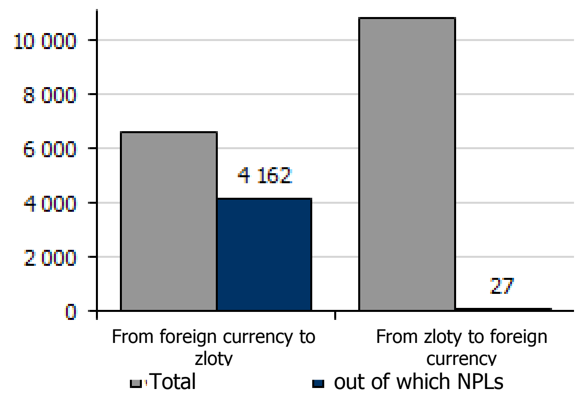
The **increase in loans overdue by more than 30 days** (PLN 3.4 bn) **was higher than the increase in non-performing loans** (PLN 2.5 bn), **just as their share of the credit portfolio (2.9 per cent compared to 2.3 per cent**) is noteworthy. **This will most probably exert negative pressure on the portfolio quality measured by the share of non-performing loans as well as financial performance of the banks in forthcoming periods.**

The value of non-performing **zloty** loans increased to PLN 4.3 bn (increase of PLN 1.5 bn; 52.4 per cent), and their share in the portfolio these loans increased to 3.5 per cent (from 2.8 per cent). The value of non-performing **foreign currency** loans increased to PLN 3.2 bn (increase of PLN 1.1 bn; 49.6 per cent), and their share in the portfolio these loans increased to 1.6 per cent (from 1.3 per cent). In interpreting the data concerning the quality of housing loans by type of currency, one must consider **distortions resulting from converting loans**, as well as the **higher percentage of early repayment of zloty loans.** These two factors are causing an "understating of quality" of zloty loan portfolio and an "exaggerating of quality" of foreign currency loan portfolio.

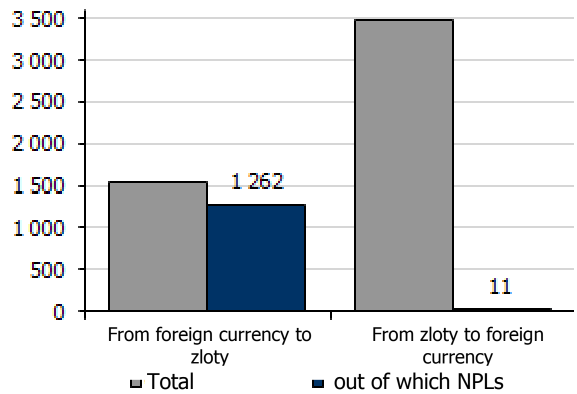
SURVEY RESULTS ON THE HOUSING LOAN PORTFOLIO
LOAN CURRENCY CONVERSION

	Year loan granted								Total
	before 2005	2005	2006	2007	2008	2009	2010	2011	
1/ Foreign currency converted to zloty									
- number of loans	2 588	746	659	727	1 095	231	271	260	6 577
of which non-performing	600	585	556	678	1 006	220	266	251	4 162
- value of loans (PLN m)	264	127	168	346	525	44	32	35	1 543
of which non-performing (PLN m)	74	107	148	329	499	42	31	33	1 262
2/ Zloty converted to foreign currency									
- number of loans	1 201	491	1 783	4 973	859	419	868	214	10 808
of which non-performing	0	2	5	16	3	0	1	0	27
- value of loans (PLN m)	159	93	510	1 854	361	171	267	58	3 473
of which non-performing (PLN m)	0	1	2	6	2	0	0	0	11

Number of converted loans (pieces)



Value of converted loans (PLN m)



The results of the PFSA survey indicate that **by the end of 2011, banks converted into zlotys 6,6 thousand foreign currency loans** for a total value of **PLN 1 543 m,** of which **4,2 thousand** loans for a total value of **PLN 1 262 m** were **non-performing loans**. Furthermore, banks converted from zlotys into foreign currency 10,8 thousand loans for a total value of PLN 3 473 m, of which only 27 loans for a total value of PLN 11 m were non-performing loans.

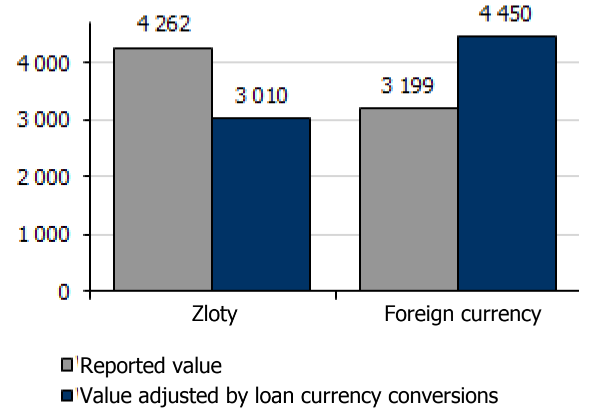
Most non-performing foreign currency loans converted into zloty loans were granted in 2007-3008 (1.7 thousand loans for a total value of PLN 828 m). This proves the thesis that during the peak of the real property boom banks engaged in overly liberal lending policies.

Considering the results of the surveys, it is possible to make an adjustment to the reported data and determine the actual quality of the loan portfolio, due to the currency in which they were extended (without accounting fro the issue of early repayments). To that end, loans which were initially granted in foreign currencies (both those "performing" and "non-performing") should be subtracted from the zloty loan portfolio, and loans which were initially granted in zloty (both those "performing" and "non-performing") and are currently reported in the foreign currency portfolio should be added. An analogous adjustment should be made to the foreign currency loan portfolio.

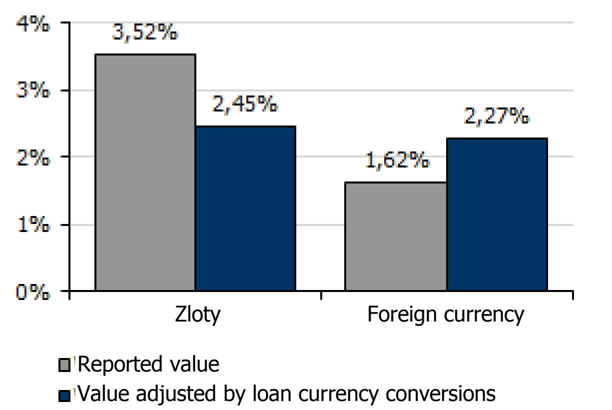
ADJUSTED QUALITY OF HOUSING LOANS BY LOAN CURRENCY

ZLOTY LOANS	
1/ Reported data	
- total loans	120 937
- out of which non-performing loans	4 262
- proportion of non-performing loans	**3.52 %**
2/ ADJUSTMENT to reported data	
Increments on the account of zloty loans converted to foreign currency loans	
- total loans	3 473
- out of which non-performing loans	11
Decrements on the account of foreign currency loans converted to zloty loans	
- total loans	-1 543
- out of which non-performing loans	-1 262
3/ ADJUSTED DATA	
- total loans	122 867
- out of which non-performing loans	3 010
- proportion of non-performing loans	**2.45 %**
FOREIGN CURRENCY LOANS	
1/ Reported data	
- total loans	197 837
- out of which non-performing loans	3 199
- proportion of non-performing loans	**1.62 %**
2/ ADJUSTMENT to reported data	
Increments on the account of foreign currency loans converted to zloty loans	
- total loans	1 543
- out of which non-performing loans	1 262
Decrements on the account of zloty loans converted to foreign currency loans	
- total loans	-3 473
- out of which non-performing loans	-11
3/ ADJUSTED DATA	
- total loans	195 907
- out of which non-performing loans	4 450
- proportion of non-performing loans	**2.27 %**

Value of non-performing housing loans at the end of 2011 (PLN bn)



Percentage of non-performing housing loans at the end of 2011 (%)

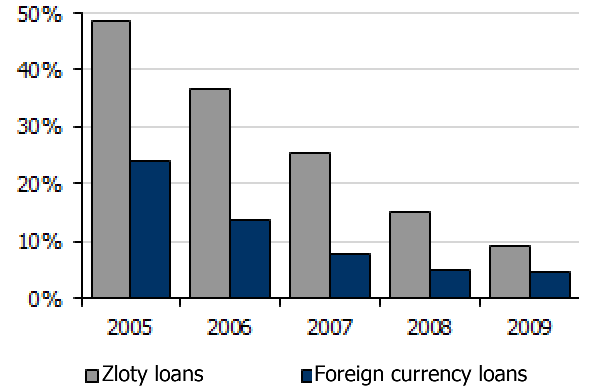


After adjusting for currency conversions, it may be stated that at the end of 2011, the total value of non-performing loans originally granted in zloty was PLN 3.0 bn, and the actual **proportion of non-performing loans in the portfolio of zloty loans was 2.45 per cent.** In the case of foreign currency loans, the total value of non-performing loans was PLN 4.5 bn, and the **proportion of non-performing loans was 2.27 per cent.**

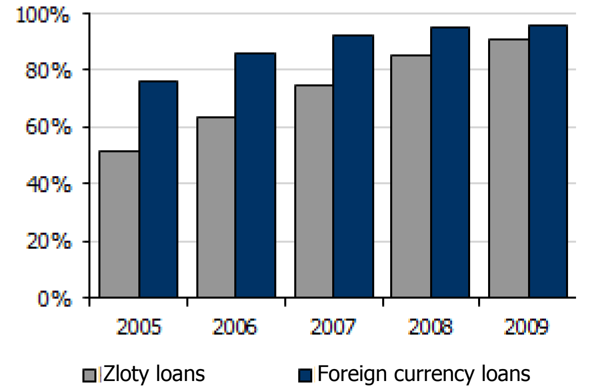
EARLY REPAYMENTS OF HOUSING LOANS BY CURRENCY

	Share of repaid housing loans in loans granted in 2005-2009				
	2005	2006	2007	2008	2009
Zloty loans	48.7 %	36.8 %	25.4 %	15.0 %	9.3 %
Foreign currency loans	23.9 %	13.7 %	7.6 %	5.0 %	4.5 %

Repaid loans by year of granting (%)



Loans outstanding by year of granting (%)



Source: BIK (data correct as on 06/2011)

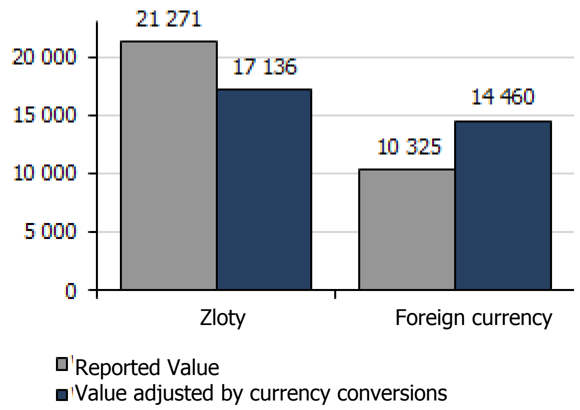
An additional factor distorting the view of the actual quality of the loan portfolio with respect to currency type **is the issue of early repayment of loans, as a result of which some good loans disappear from the loan pool** (assuming a lack of inflow of new loans the quality of outstanding loans deteriorated as the share of non-performing loans is increasing).

According to BIK data, it may be concluded that **zloty loans are repaid early significantly more frequently than foreign currency loans.** As a consequence, this phenomenon indirectly contributes to the decrease in value of the outstanding zloty loan portfolio. If these loans were still maintained, they would be reported as correct, by which the share of non-performing loans would decrease.

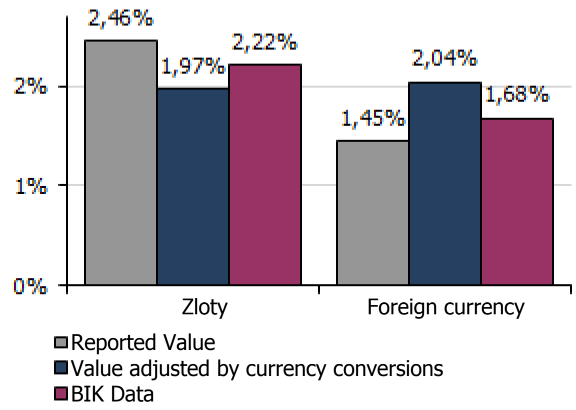
The increased early repayment rate of zloty loans stems from, inter alia, **lower average value of loan agreements and a lack of negative effects of exchange rate fluctuations on the scale of debt** (the weakening of zloty caused an increase in debt for borrowers holding foreign currency debts, making it impossible or unprofitable to repay the loan early - see below)

It should be noted, that a situation is possible, where loan repayment is due to a customer switching banks (because of better terms) or a "bad" loan is subject to early repayment (agreement termination). Nevertheless, it does not seem for this to eliminate the phenomenon of a higher rate of early zloty loan repayments and its effect on the zloty loan portfolio quality.

Non-performing housing loans - quantity (pieces) - 12/2011



Share of non-performing housing loans - quantity (%) - 12/2011



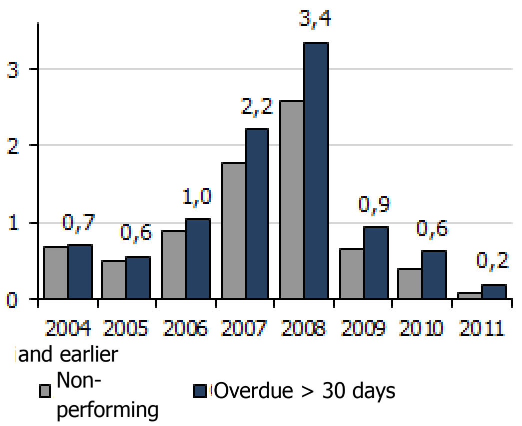
Here a reference should be made to the **differences in the evaluation of housing loans portfolio quality** which are present **between** data published by **PFSA and BIK.** Firstly this stems from a different approach BIK data is based on a quantitive approach (the ratio of the total number of non-performing loans to total number of loans), and not on value terms, which is key from the point of view of risk inherent in banks' portfolios. Secondly, the reason for the difference is the definition of non-performing loans, which, according to BIK is based on repayments being overdue by more than 90 days. Thirdly, the differences stem from the database range (BIK sample is slightly larger). Finally, BOK data does not take into account the issue of loan currency conversions.

Adopting the quantitive approach, PFSA and BIK data on quality of loans are similar. However, after applying the adjustment associated with loan currency conversions, it turns out that the **quality of zloty loans is better** that the quality of foreign currency loans. Thus it should be stated, that in light of PFSA data, the stipulations presented in BIK reports regarding the superior quality of foreign currency loans are unjustified.

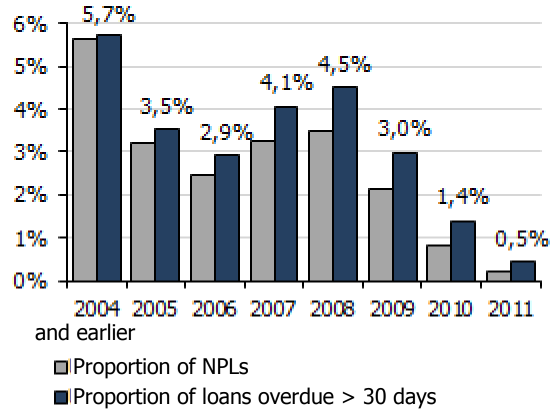
To sum up, quality of zloty and foreign currency housing loans is comparable. If the higher early repayment rate of zloty loans was accounted for (or adopt the "quantitive" approach), then based on PFSA data, then, as at the end of 2011, the quality of zloty loans was superior to foreign currency loans.

SURVEY RESULTS ON THE HOUSING LOAN PORTFOLIO
QUALITY OF LOANS BY YEAR OF GRANTING

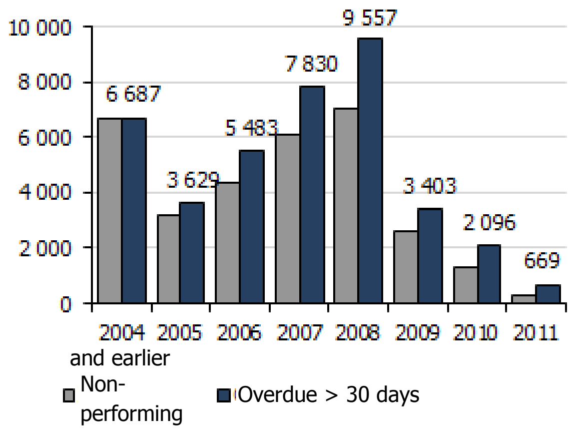
NPLs and overdue > 30 days by year of granting (PLN bn)



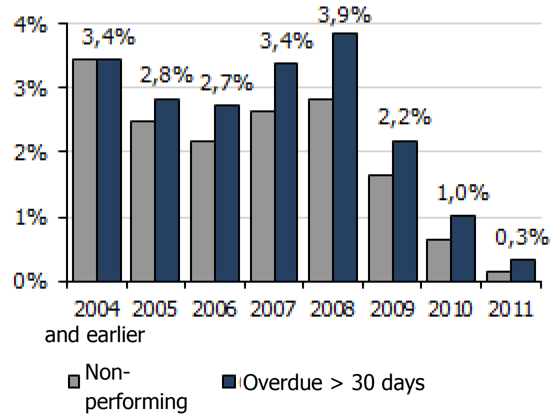
Proportion in given year (%)



Number of NPLs and overdue > 30 days by year of granting (PLN bn)



Proportion in given year (%) - 12/2011



Based on PFSA survey results, **the lowest quality is represented by loans granted in 2007-2008,** which is exhibited not only by the most number and highest value of non-performing and overdue loans (which is partially due to the record lending in those years) but also the highest proportion of non-performing and overdue loans. The share of **non-performing** loans in loans granted in 2007 and 2008 is **3.3 per cent and 3.5 per cent** respectively, and of loans **overdue by more than 30 days 4.1 per cent and 4.5 per cent.** Admittedly the quality of loans extended prior to 2005 is lower, but this stems from the "maturing" process of this portfolio, as well as the high quantity of loans repaid early. The low quality of 2007-2008 loans is proof to the statement that the highest credit risk is inherent in those two years which stems from, on the one hand, all time high real property prices in that period, and on the other, from overly expansive development of lending, which in many instances breached the rules of fair evaluation of creditworthiness, as well as understating maintenance costs. It should be added, that in the said period, some average income customers decided on foreign currency loans under the influence of incorrect analyses on the outlook for the real property market and zloty exchange rates developments. Furthermore, **some customers decided in favour of foreign currency loans, as in such manner they were deemed to have better creditworthiness** (due to low interest rates in CHF), **permitting them to purchase apartments which ware rapidly becoming more expensive** (for zloty loans they would not have sufficient creditworthiness to be able to obtain a loan to purchase such apartments).

The **rapid deterioration of 2009-2010 loans** (share of non-performing loans in 2009 loans is 2.9 per cent, loans overdue by more than 30 days is 3.0 per cent) as compared with 2.5 (2.9) per cent for 2006 loans with a similar value of the credit portfolio is also an unfavourable phenomenon. This means that despite the experience gained by banks and customers in relation to the financial crisis, banks engaged in overly liberal lending policies and borrowers accepted excessive risk.

Despite a relatively high current quality of housing loan portfolio, this portfolio generates a number of types of risk. In particular the following should be remembered:

- **high share of foreign currency loans;**
- **high average LTV values of loan portfolio, high average foreign currency loan amount and long loan periods;**
- **database restrictions may aid trustworthy real property valuations;**
- **excessive product concentration;**
- **steep increase of loan repayment rates as part of the "RnS" Programme** (after eight years);
- **restricted liquidity of trading on the real property market** which poses questions regarding the real value of collateral held by banks in a situation where they need to be realised on a large scale;
- **high concentration of loan insurance system;**
- **no data on the number of customers whose liabilities under loans are fulfilled through incurring other obligations or discontinuing their discharge** (e.g. rent payments).

Foreign currency loans generate a number of risks, both for customers and banks and in particular **the risk of significant debt increase** expressed in zloty associated with the possibility of a weakening of the zloty and the risk of a significant increase in the costs of servicing the debt due to foreign currency instrument interest rate increases from their all time lows.

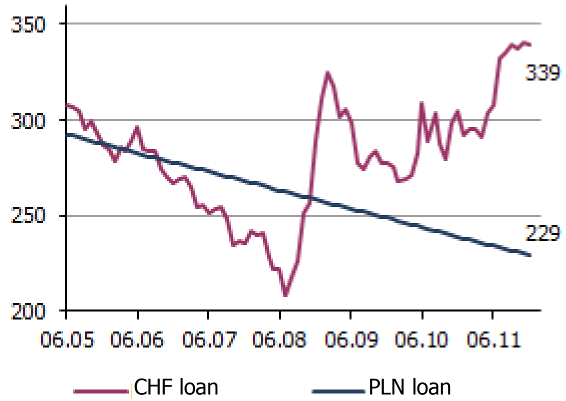
So far, only the exchange rate risk materialised, which was, to a large extent, neutralised by a reduction to interest rates by the SNB and ECB to their all time lows. Once the current financial crisis is overcome, a strengthening of the zloty may be expected and consequently an improvement to the financial situation of customers whose debts are in foreign currencies. However, such may also be expected to result in increases to interest rates (CHF, EUR) which will act to increase the costs of servicing the debts by customers who have foreign currency loans. Furthermore, a situation where despite overcoming the crisis in the eurozone, the zloty will remain relatively weak against major currencies (e.g.: a deterioration in the macroeconomic situation of the Polish economy) can not be ruled out. If CHF ands EUR interest rates were to increase with the zloty remaining weak against major currencies, the possibility of a significant deterioration in repayments of some foreign currency loans should be taken into account.

The biggest risk is associated with foreign currency loans extended in 2007-2009, which were generated under the conditions of all time low real property prices and the zloty in a record strong position against major currencies. As a result of the decline of the zloty, with regard to these loans, the zloty debt level increased dramatically, in many cases by more than 50 per cent. Consequently most borrowers from that period are forced to keep the foreign currency loan, as otherwise they would incur a loss further multiplied by the fall in real property prices (for many households this would present a real threat to their stable functioning). This means that despite lower repayment rates the current **situation of these borrowers is in fact less favourable than that of borrowers who decided to take out zloty loans.** Additionally, (as already ascertained), in that period many borrowers decided in favour of a foreign currency loan as this translated into better creditworthiness for them. These customers should be considered to belong to a high risk group, as particularly sensitive to changes in exchange and interest rates. It should be remembered that in the said period loans were granted under conditions of excessive easing of lending standards and low margins.

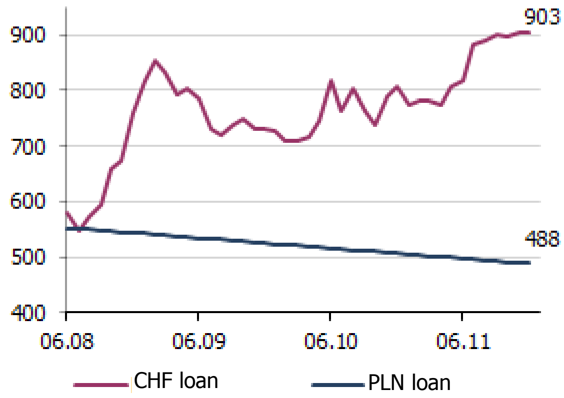
From the borrower's point of view the biggest danger associated with foreign currency loans **arises from the possibility of unfavourable changes to the exchange rates occurring whilst they are forced into early termination of the loan agreement** (e.g.: due to a reduction or loss of income or a difficult family situation). In such a situation, **the borrowers have to account for the possibility of incurring significant losses, which, for average income borrowers may endanger the stability of their households.** In extreme situations, where a significant weakening of the zloty coincides with a downturn on the real property market, a situation may arise, where despite the sale of an apartment and assigning the entire funds from the sale to loan repayment, the outstanding debt value expressed in zloty may exceed the value at the time of taking the loan out.

BORROWERS' FINANCIAL SITUATION SIMULATION BY LOAN CURRENCY FOR 12/2011

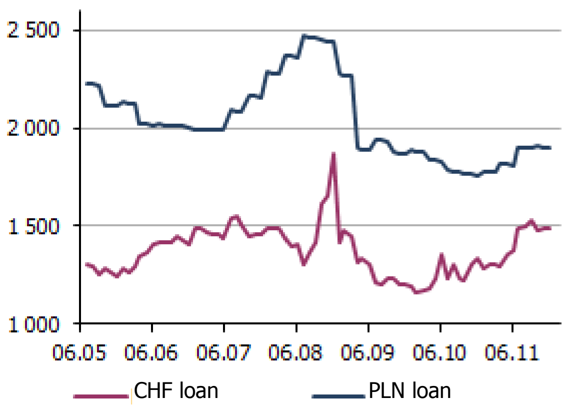
Debt level (PLN thousand) – loan of June 2005



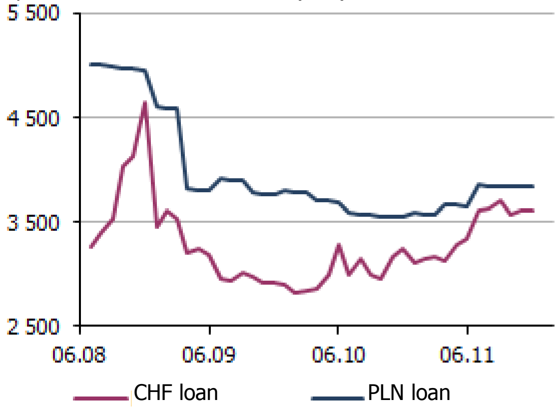
Debt level (PLN thousand) – loan of June 2008



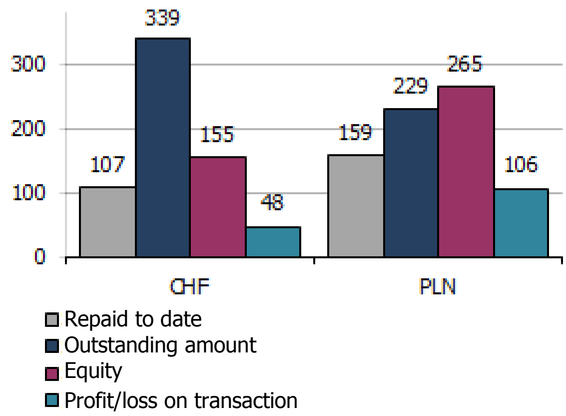
Capital-interest instalment level (PLN) – loan of June 2005



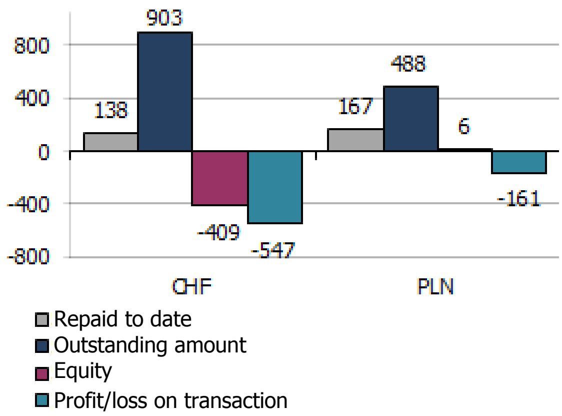
Capital-interest instalment level (PLN) – loan of June 2008



Loan termination 31 December 2011 (PLN thousand)
– loan of June 2005



Loan termination 31 December 2011 (PLN thousand)
– loan of June 2008



Assumptions

- Loan taken out for the purchase of a flat with a floor area of 65 sq. m., 30 year repayment period, LTV 100%, diminishing instalments repayment plan (for simplicity of calculations), 3-monthly variable rate, spread for foreign currency loans 2% for purchase rate and 3% for sale rate;
- The value of loan corresponds to the real property price at the time of purchasing - for a June 2005 loan this was circa PLN 293 thousand (price of 1 sq. m. of a flat in Warsaw circa PLN 4500), and for a June 2008 loan circa PLN 553 thousand (price of 1 sq. m. of a flat in Warsaw circa PLN 8500);
- The selling price of a flat according to average prices in fourth quarter 2011 circa PLN 494 thousand (price of 1 sq. m. of a flat in Warsaw circa PLN 7600).

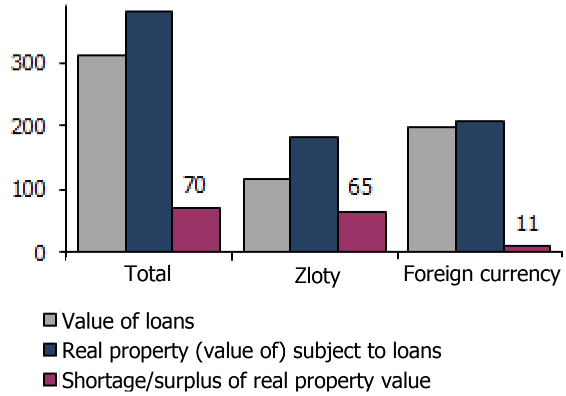
The negative equity arrived at after the sale of a flat **in the event of a 2008 foreign currency loan** means**, that despite selling the flat and using the entire funds obtained from its sale to repay the foreign currency loan, the customer will still be in debt with respect to the bank** (in the example PLN 409 thousand, i.e.: over 70 per cent of the initial value).

From the bank's point of view, the risk associated with foreign currency loans, stems from the possibility of a significant deterioration in repayments of these loans during periods of weak zloty and economic downturn of the real property market. The financing issue is an additional element of risk (not all banks with significant foreign currency loan portfolios have secured stable sources for financing thereof) and **the negative attitude towards foreign currency loans to households by** analysts and **rating agencies,** which may be reflected in a reduction to ratings for individual banks. High share of foreign currency loans in the sector's assets **makes it more difficult to conduct monetary policy and influence the price of money in the economy.** Additionally, wide ranging practice of extending **low interest foreign currency loans was one of the factors attributed** to the steep rise in real property prices in 2005-2007, and by the same to **a reduction in the availability of flats for average income households.**

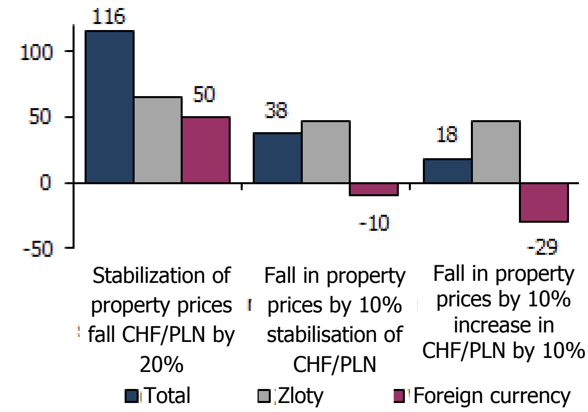
Considering all those factors, it should be stated that **foreign currency loans should be withdrawn from banks standard offers. They should constitute a niche product aimed at customers who are naturally protected against exchange rate risk** by receiving their income in the currency of the loan or a very narrow group of wealthiest customers who are able to soak up the unfavourable changes to exchange and interest rates over long periods of time.

SURVEY RESULTS ON THE HOUSING LOAN PORTFOLIO
AVERAGE PORTFOLIO LTV:

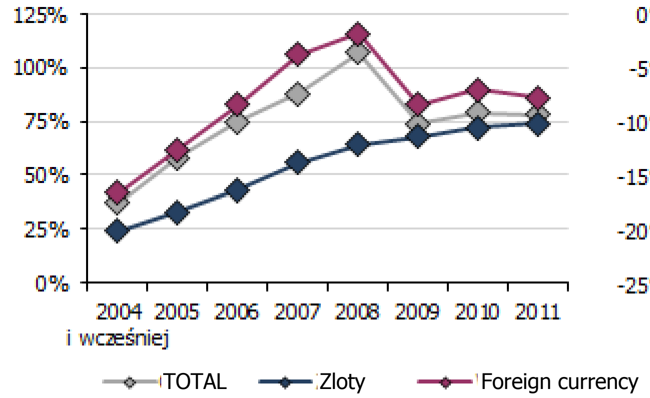
Housing loan portfolio parameters



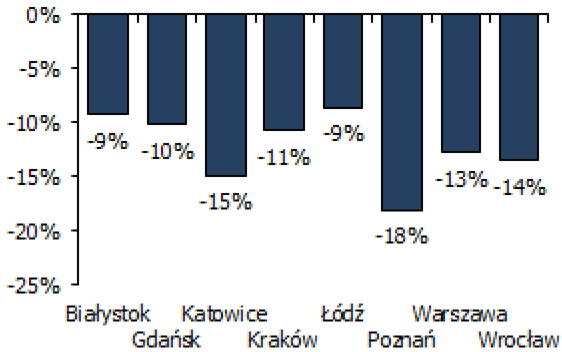
Simulation of changes to collateral value surplus/shortage[31] in relation to exchange rate and real property prices changes (PLN bn)



LTV by year and type of loan



Fall in house prices since bull market peak[32] %



Source: PFSA, AMRON-SARFiN, own calculations

[31] In order to simplify and better reflect the phenomenon, it was assumed that all foreign currency loans are extended in CHF and collateral is in the form of the real property being the subject of the loan.
[32] Some developers experienced a fall in prices of as much as a few dozen per cent.

Risk generated by the housing loan portfolio also stems from its unfavourable LTV structure. At the end of 2011:

- **average LTV value of the entire portfolio of housing loans was circa 81.6 per cent** whereas for **zloty** loans **63.8 per cent** and **foreign currency** loans circa **94.7 per cent;**
- the banks' portfolios consisted of **252.9 thousand loans, total value PLN 103.1 bn, with LTV exceeding 100 per cent** (for 139.2 thousand loans, with a value of PLN 62.8 bn, LTV was more than 120 per cent). **The majority of these loans were foreign currency loans** (213.8 thousand loans, total value PLN 93.3 bn);
- the banks' portfolios consisted of **253.6 thousand loans, total value PLN 66.8 bn, with LTV between 80 and 100 per cent** (for 133.5 thousand loans, with a value of PLN 35.9 bn, LTV was more than 90 per cent).

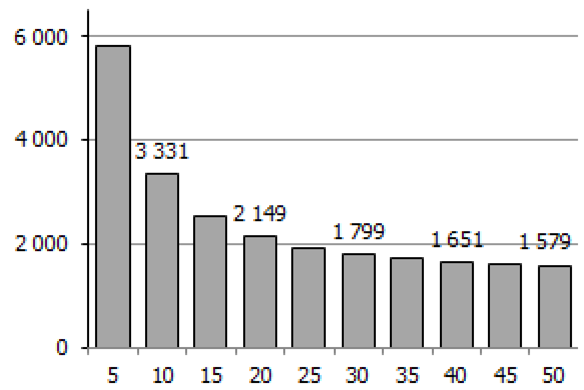
This means that for 16.0% of loans which constitute 33.1% of the value of the entire loan portfolio the real property values which constitute the primary collateral for extended loans was lower than the value of extended loans In the event of a material deterioration of the quality of that loan portfolio and the need by banks to enforce collaterals on a large scale (by selling housing units or loan portfolios, given the inability to effectively enforce other collaterals), some customers and banks could incur significant losses which would be multiplied by the associated additional fall in real property prices.

INSTALMENT LEVELS SIMULATION
ACCORDING TO INTEREST RATES AND REPAYMENT PERIODS

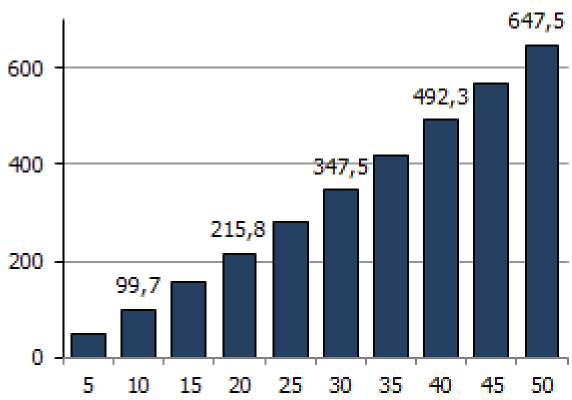
	Instalment amounts according to interest rates and repayment period							Total interest accumulated according to interest rates and repayment period						
	2%	3%	4%	5%	6%	7%	8%	2%	3%	4%	5%	6%	7%	8%
5 years	5 258	5 391	5 525	5 661	5 800	5 940	6 083	15 500	23 436	31 497	39 682	47 990	56 422	64 975
10 years	2 760	2 897	3 037	3 182	3 331	3 483	3 640	31 248	47 619	64 482	81 836	99 674	117 991	136 779
15 years	1 931	2 072	2 219	2 372	2 532	2 696	2 867	47 495	72 914	99 431	127 029	155 683	185 367	216 052
20 years	1 518	1 664	1 818	1 980	2 149	2 326	2 509	64 236	99 310	136 306	175 168	215 830	258 215	302 237
25 years	1 272	1 423	1 584	1 754	1 933	2 120	2 315	81 469	126 790	175 053	226 131	279 871	336 101	394 635
30 years	1 109	1 265	1 432	1 610	1 799	1 996	2 201	99 189	155 332	215 609	279 767	347 515	418 527	492 466
35 years	994	1 155	1 328	1 514	1 711	1 917	2 131	117 391	184 911	257 896	335 906	418 439	504 959	594 929
40 years	908	1 074	1 254	1 447	1 651	1 864	2 086	136 069	215 498	301 831	394 363	492 308	594 861	701 249
45 years	843	1 013	1 199	1 398	1 609	1 829	2 057	155 216	247 059	347 322	454 943	568 781	687 715	810 714
50 years	791	966	1 157	1 362	1 579	1 805	2 038	174 823	279 559	394 273	517 450	647 529	783 039	922 694

Assumptions 1/ PLN 300 000 loan 2/ Equal instalments

Instalments according to crediting period (PLN)



Interest accumulated according to crediting period (PLN)



Assumptions 1/ PLN 300 000 loan 2/ Equal instalments 3/ 6 per cent interest rate

In the context of long repayment periods commonly used by bank, it should be stated that, inter alia:

- **excessively long repayment periods are not in the interest of banks' customers.** Reduction in instalments achieved by applying long repayment periods (over 20-25 years) is slight, but a large increase to the total interest occurs.

  Extending the repayment period only makes sense with very low interest rates (this explains the high demand for low interest 30-40 year foreign currency loans). However, in borrowing for long repayment periods, it can not be assumed that interest rates will always stay at such low levels;
- there is a concern, **that some loans extended for long periods have been granted to customers whose financial situation excluded them from loans** for shorter periods due to a low creditworthiness. This means that these customers should be considered to belong to a high risk group.
- **excessively long repayment periods also increases the customer's exposure** (and indirectly the bank's) **to interest rate risk,** as the sensitivity of monthly instalments to interest rate changes increases;
- excessively long repayment periods are the fundamental reason for significant distortions in the structure of dates to maturity in banks' balance sheets;
- **excessively long repayment periods increases the difficulty in estimating the scale of risks associated with the loan and may constitute a barrier for the development of the debt instrument market based on mortgaged receivables.**

Another risk associated with the housing loan portfolio is the **risk of excessive product concentration** at banks with a dominant position on the housing loan market.

Chart 164.
Proportion of housing loans in the balance sheet total (%)

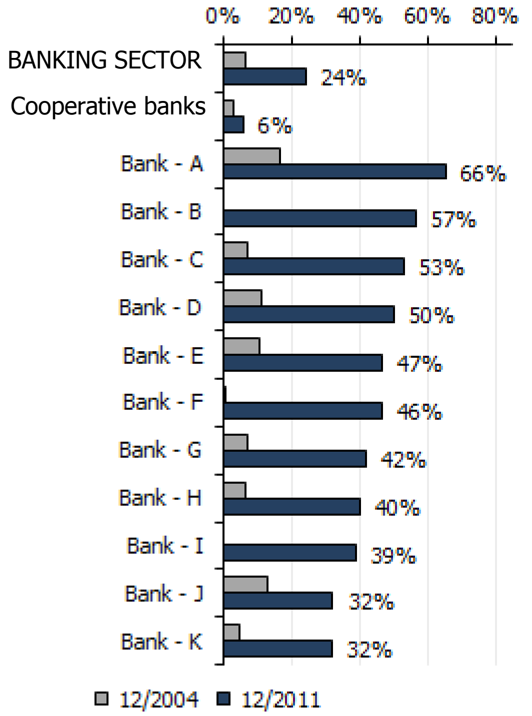
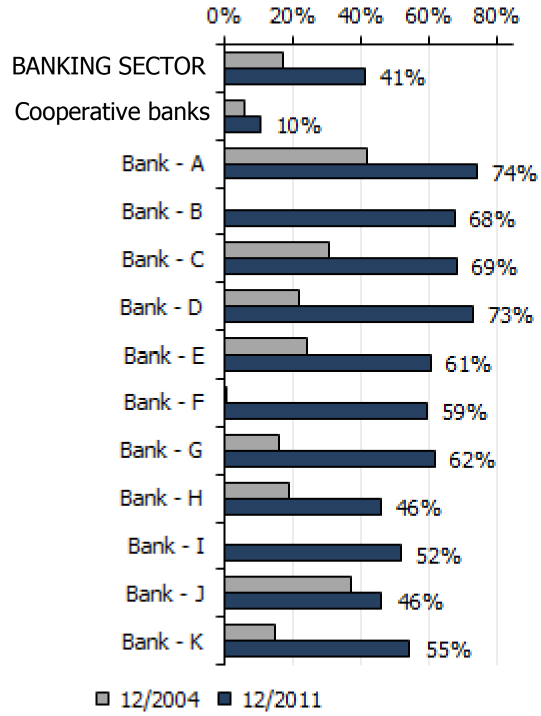


Chart 165.
Share of housing loans in loans to the non-financial sector (%)



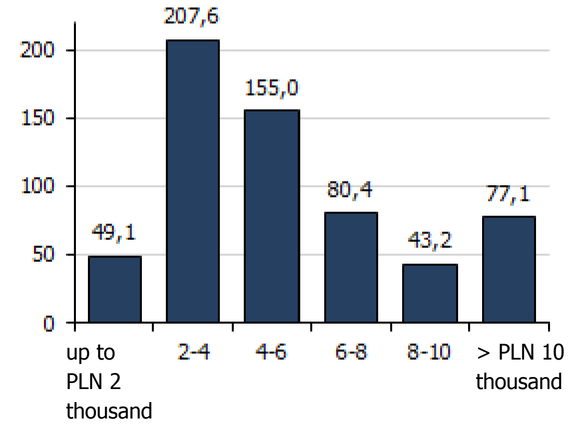
In observing the changes which took place between the end of 2004 (i.e.: at the threshold of the real property market and housing loan market boom) and the end of 2011, it may be ascertained that in this period **a significant increase of the share of housing loans in the banking sector's assets occurred** (from 7 per cent at the end of 2004 to **24 per cent** at the end of 2011) and in loans to the non financial sector (from 17 per cent to **41 per cent**). The changes at banks occupying key positions on the market for these loans were even more pronounced. Many experienced an **increase in the proportion from a few to a few dozen per cent** thus a significant change to their business model can be said to have taken place.

The changes which occurred in 2004-2011 entail defined consequences and generate various risks. In particular **many banks made their future financial condition dependent to a large degree on the quality of the housing loan portfolio and the future situation on the real property market.** At the same time due to the high share of foreign currency loans, **the situation on the foreign currency market and the level of interest rates shaped by foreign monetary authorities** (mainly SNB and ECB) **will exert a strong influence on the quality of the portfolio of these loans**.

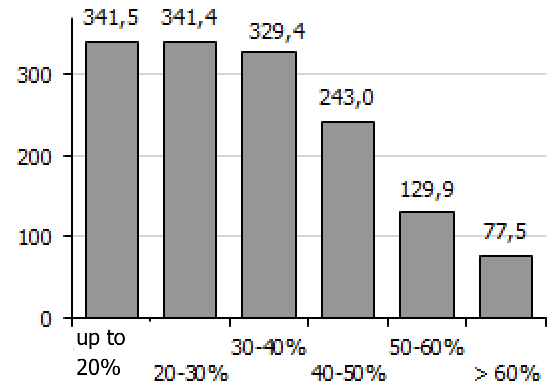
SURVEY RESULTS ON THE HOUSING LOAN PORTFOLIO BORROWERS' INCOME SITUATION[33]

	Number of loans (pieces)				Value of loans (PLN m)			
	Total	Share	PLN	Foreign currencies	Total	Share	PLN	Foreign currencies
Estimated net income of borrowers at the end of 2011:								
TOTAL including:	1 442 932	100.0 %	830 529	612 403	291 264	100.0 %	112 686	178 578
up to PLN 2 thousand	123 103	8.5 %	74 028	49 075	10 025	3.4 %	4 397	5 628
PLN 2-4 thousand	564 027	39.1 %	356 417	207 610	71 942	24.7 %	34 461	37 481
PLN 4-6 thousand	364 293	25.2 %	209 305	154 988	72 321	24.8 %	30 243	42 077
PLN 6-8 thousand	165 771	11.5 %	85 378	80 394	43 452	14.9 %	15 341	28 111
PLN 8-10 thousand	82 061	5.7 %	38 831	43 230	26 135	9.0 %	8 071	18 063
> PLN 10 thousand	143 677	10.0 %	66 570	77 107	67 390	23.1 %	20 172	47 218
Estimated DTI level (net income/instalment amount)								
TOTAL including:	1 462 659	100.0 %	831 177	631 482	293 454	100.0 %	112 716	180 738
up to 20 %	341 547	23.4 %	182 251	159 297	48 698	16.6 %	15 908	32 790
20-30%	341 354	23.3 %	182 003	159 351	62 748	21.4 %	19 924	42 824
30-40%	329 369	22.5 %	191 047	138 322	67 792	23.1 %	25 772	42 020
40-50%	242 983	16.6 %	153 005	89 978	53 721	18.3 %	24 737	28 984
50-60%	129 871	8.9 %	79 907	49 964	33 839	11.5 %	15 217	18 621
> 60 %	77 535	5.3 %	42 964	34 571	26 656	9.1 %	11 159	15 497

Foreign currency borrowers' income situation (thousand pieces)



Distribution of the burden of instalments on income (thousand pieces)



According to estimates at the end of 2011 **for nearly 15 per cent of borrowers, the instalments exceeded 50 per cent of their net income** (the value of their debt amounted to circa 20 per cent of the loan portfolio), **which should be considered to be too high a burden** (additionally over 15 per cent of borrowers were burdened with instalments of circa 40-50 per cent of their net income). Admittedly some of these loans may have been granted to high earners, but even for them, such significant instalment burden should be considered risky in the long term.

[33] Note: As some banks filed to provide information or provided incomplete information, the number and value of loans do not correspond to those presented earlier.

The large number of foreign currency loans extended to individuals whose income situation should be considered to be average, which is contrary to the thesis on the high incomes for foreign currency borrowers (over 250 thousand loans have been granted to borrowers whose net income did not exceed PLN 4 thousand; furthermore 150 thousand borrowers were in the PLN 4-6 thousand range) is also noteworthy. Thus it can be ascertained that **foreign currency loans were, to a large extent, granted to average income individuals.** In this context the similar populations of high earning zloty and foreign currency borrowers should be pointed out. This means, that a significant part of the wealthiest customers decided in favour of zloty and not foreign currency loans.

BANKS' LENDING POLICY AND REGULATORY REQUIREMENTS IN EU COUNTRIES

	Source: "HOUSING FINANCE IN THE EURO AREA" ECB 2009				Source: "Global Financial Stability Report" April 2011, IMF			Notes
	Typical repayment period	Average DTI	Additional capital requirements	Typical LTV for first time buyers	Typical repayment period	Dominant interest rate type	Maximum LTV	
Austria	30			84	25-30	fixed	80	2008 - ban on extending foreign currency loans
Belgium	20			80	20	fixed	100	
Cyprus	20-25			80				max LTV 80%
Denmark					30		80	max LTV 80%; max 30/35 years
Finland	20-25		LTV > 70	81				2010 - max LTV 90%; creditworthiness calculation max 25 years
France	19			91	15-20	fixed	100	
Greece	15-20	16.9 (2007)	LTV > 75	73				
Spain	30	20.7 (2005)	LTV > 80	72	30	flexible	100	
The Netherlands	30	18.6 (2007)		101	30	fixed	125	
Ireland	31-35		LTV > 75	83	21-35	flexible	100+	
Luxembourg	20 or more			87				
Malta	30-40			63				
Germany	25-30	17.7 (2003)		70	20-30	fixed	80	
Norway								2010 - max LTV 90%
Portugal	30-40	14.0 (2006)	LTV > 75	71	25-35	flexible	90	
Slovenia	20 or more			65				
Sweden					30	flexible	80-95	2010 - max LTV 85%
G. Brittan [34]					25	flexible	110	
Hungary								2010 - max LTV 75%
Italy	22	16.6 (2006)	LTV > 80	65	20		80	

Source: ECB, IMF, information published by supervisory authorities in given countries.

[34] Following the crisis banks in G. Britain underwent drastic self-regulation which particularly impacted on LTV (acc. to Council of Mortgage Lenders first time buyers currently borrow circa 80 per cent of real property value). There is also an ongoing discussion on establishing LTV, DTI and maximum lending period limits.

In the context of lending policies engaged in by Polish banks, it should be pointed out that they are more lenient than the norms applied in most European countries.

To sum up the above deliberations it should be ascertained, that **despite the relatively high quality of housing loans, this portfolio exhibits a number of unfavourable phenomena** (in particular mounting problems associated with debt servicing at an ever more increasing number of borrowers, unfavourable portfolio structure due to the loan currency and LTV, unsatisfactory sources of funding). Additionally the limited efficiency of monetary policy instruments due to the high proportion of foreign currency loans and the necessity to develop long term sources of funding which rely on, inter alia, mortgage loans (reflecting the experiences of the "subprime crisis" one of the fundamental prerequisites of success for the development of this market is generating high quality housing loans entailing an easy to estimate risk) should be borne in mind. **Accordingly, a fundamental change to the current model for developing housing loans is essential.**

Table 24**. Non-performing loans to the enterprise sector and their share in the portfolio (PLN bn; %)** [35]

	Value (PLN bn)					Share in portfolio (%)				
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2008	12/2009	12/2010	09/2011	12/2011
Non-performing loans in total, of which:	15.2	25.7	27.2	26.8	27.8	6.5 %	11.6 %	12.4 %	10.7 %	10.5 %
1/ SME	9.3	17.0	18.5	19.3	20.0	7.5 %	13.4 %	14.6 %	12.7 %	12.6 %
- operating	4.0	5.9	5.9	6.4	6.4	8.5 %	12.8 %	12.8 %	11.1 %	11.1 %
- investment	1.9	4.0	4.6	4.0	4.3	5.9 %	11.7 %	13.0 %	9.3 %	9.1 %
-real property	2.7	5.9	6.5	6.9	7.4	7.2 %	16.0 %	18.6 %	17.8 %	18.6 %
- other	0.7	1.2	1.6	1.9	1.9	9.2 %	11.6 %	14.8 %	15.4 %	13.3 %
2/ Large enterprises	5.8	8.7	8.7	7.6	7.9	5.4 %	9.2 %	9.4 %	7.7 %	7.5 %
- operating	3.2	4.6	4.1	3.7	3.5	5.4 %	9.5 %	9.2 %	7.6 %	7.3 %
- investment	1.8	2.3	2.6	2.2	2.6	5.5 %	7.6 %	8.6 %	6.6 %	7.2 %
-real property	0.3	0.5	0.7	0.5	0.5	3.5 %	4.9 %	8.0 %	6.2 %	6.5 %
- other	0.5	1.3	1.3	1.2	1.2	7.6 %	22.6 %	14.4 %	13.3 %	9.3 %

Chart 166.
Non-performing loans to the enterprise sector (PLN bn)

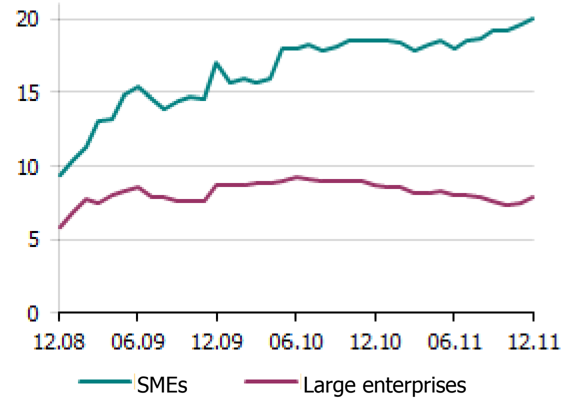
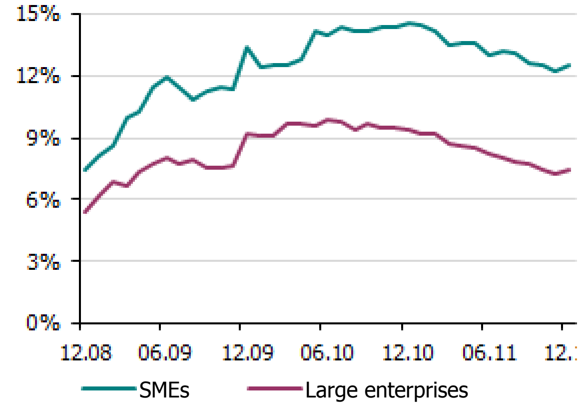


Chart 167.
Change in non-performing loans to enterprises (PLN bn)



In 2011 the value of non-performing loans to enterprises increased by **PLN 0.6 bn**, i.e. 2.3 per cent with most of the increase occurring in the fourth quarter of 2011 (PLN 1.0 bn). An improvement to the financial situation of some enterprises was a contributing factor to the stabilisation of non-performing loans levels. The relatively low increase in non-performing loans was also a result of a change in the methods of classification of exposure with value impairment at one of the banks. As a consequence of non-performing loans level stabilisation and robust dynamics of lending to enterprises the **share** of non-performing loans **decreased** (from 12.4 per cent to **10.5 per cent).**

[35] Note: As previously indicated, the changes to non-performing loans to SMEs and large enterprises have been distorted by a change to portfolio classification at one bank. Therefore the description of these has been abandoned.

There are concerns regarding a deterioration of the quality of loans to enterprises due to the expected reduction to the growth rate of the economy. Additionally, in connection with the recently publicised problems experienced by come construction enterprises specialising in, inter alia, construction of roads and motorways, there are concerns regarding quality deterioration of the portfolio of loans granted to these entities.

4.3 Capital adequacy

The current capital base situation of the banking sector may be considered good.

Table 25**. Capital adequacy (PLN bn; %)**

	Value (PLN bn)					Change up to (%)		
	12/2008	12/2009	12/2010	09/2011	12/2011	12/2009	12/2010	09/2011
Own funds for calculation of CAR	76.9	90.1	100.6	110.1	110.9	23.1 %	10.2 %	0.7 %
Own funds account:								
1/ Own funds (primary)	73.7	86.4	98.2	106.2	106.6	23.4 %	8.5 %	0.3 %
2 / Own funds (supplementary)	8.5	9.9	11.4	12.8	13.0	30.9 %	13.8 %	1.6 %
3/ Reductions in funds for calculation of CAR	-5.8	-6.5	-9.3	-9.1	-9.0	37.8 %	-3.1 %	-0.8 %
- primary	-4.2	-5.2	-7.7	-7.5	-7.4	42.2 %	-3.6 %	-0.7 %
- supplementary	-1.6	-1.3	-1.6	-1.6	-1.6	20.4 %	-0.2 %	-1.0 %
4/ Short term capital	0.4	0.3	0.3	0.2	0.3	11.7 %	20.1 %	48.3 %
Total capital requirement, of which:	55.6	54.2	58.2	66.8	67.6	24.6 %	16.2 %	1.2 %
- credit risk	48.6	47.3	50.9	59.2	59.7	26.3 %	17.4 %	0.9 %
- operating risk	5.7	6.0	6.1	6.3	6.4	6.5 %	4.6 %	0.6 %
- general interest rate risk	0.7	0.6	0.5	0.6	0.6	1.3 %	14.1 %	1.4 %
- price risk	0.4	0.3	0.5	0.5	0.4	44.0 %	-11.8 %	-11.5 %
- settlement risk - deliveries	0.0	0.0	0.0	0.0	0.0	-6.5 %	-5.6 %	-0.1 %
- other and transitional capital requirements	0.2	0.1	0.2	0.2	0.5	619.2 %	150.1 %	164.5 %
Surplus/deficit of own funds	21.2	35.8	42.4	43.3	43.3	20.8 %	2.0 %	-0.1 %
Solvency ratio	11.2	13.3	13.8	13.2	13.1	x	x	x

Chart 168.
Own funds and total capital requirement (PLN bn)

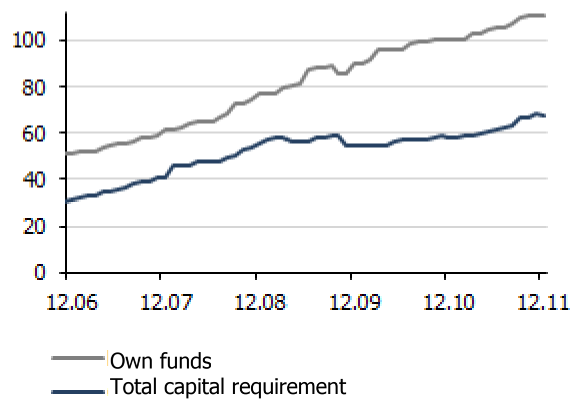
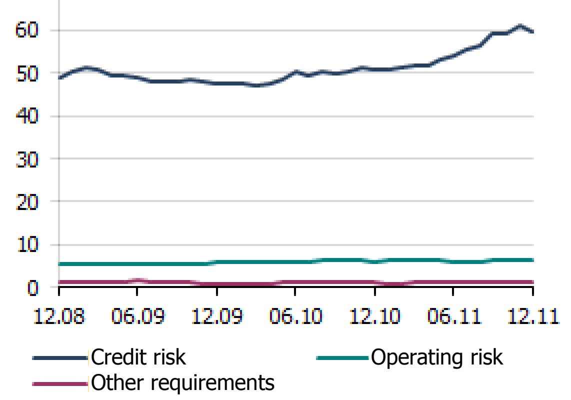


Chart 169.
Structure of total capital requirement (PLN bn)



In 2011, the total **value of own funds** of the domestic banking sector **increased** by PLN 10.3 bn, i.e. 10.2 per cent.

As of the end of 2011 all commercial banks complied with the minimum own fund requirement of EUR 5 m. Considering cooperative banks, the weakening of zloty caused 3 of them not to comply with the minimum own funds requirement of EUR 1 m , but the scale of the shortages was slight. It should be added that fund levels at cooperative banks may be considered to be resistant to the effects of the possible further weakening of the zloty (hypothetically assuming that EUR 1 = PLN 5, then only 25 banks would have to obtain additional capital - at one of the banks the shortage would exceed PLN 1.5 m, at 4 it would be in the PLN 500-900 thousand range, at 17 in PLN 100-500 thousand and at 3 it would be less than PLN 100 thousand).

Chart 170.
Surplus of own funds over total requirement (PLN bn)

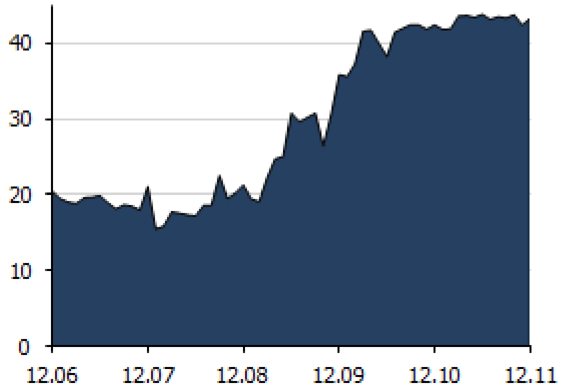


Chart 171.
CAR – solvency ratio (%)

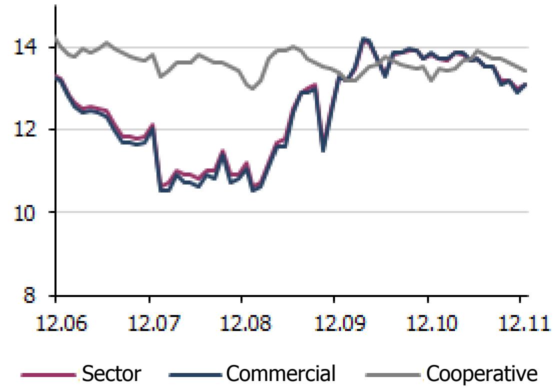


Chart 172.
Distribution of commercial banks by CAR – December 2011

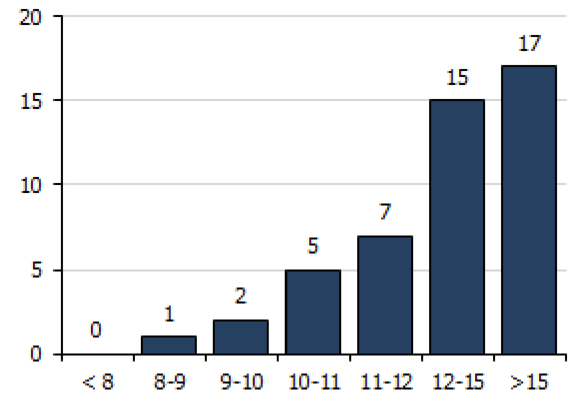
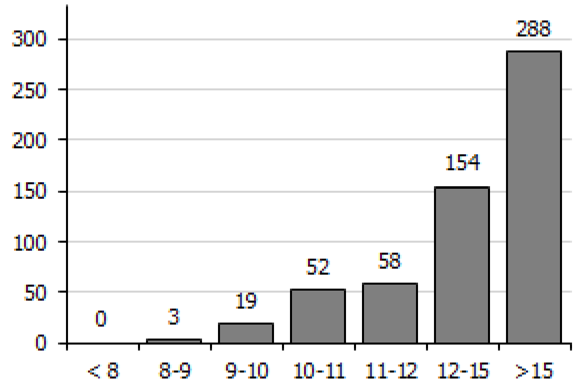


Chart 173.
Distribution of cooperative banks by CAR – December 2011



In 2011, the **value of total capital requirement increased** by PLN 9.4 bn, i.e. **16.2 per cent** (to PLN 67.6 bn). The primary reason for this increase was the credit risk requirement increase of PLN 8.9 bn (to PLN 59.7 bn) due to increased lending and a weaker zloty, resulting in an increase to zloty values of foreign currency loans (and by the same an increase to the capital requirement). The value of requirement on the account of operating risk increased by PLN 0.3 bn (to PLN 6.4 bn) and requirements on the account of other risks by just under PLN 0.3 bn (to PLN 1.5 bn).

Despite an increase to the total capital requirement, **the surplus of own funds over total capital requirement increased slightly** (from PLN 42.4 bn as at the end of 2010 to PLN 43.3 bn as at the en of 2011) which was due to a greater increase in own funds in quantitative terms.

The solvency ratio in the banking sector **decreased** (from 13.8 per cent at the end of 2010 **to 13.1 per cent** at the end of 2011, **whereas the ratio at all banks was above the statutory minimum (8 per cent).**

At the individual bank level, the following must be emphasised:

- **a good capital position for most of the largest banks** (balance sheet total > PLN 10 bn). At the end of 2011, solvency ratio of less than 10 per cent only observed at 3 banks, at 11 reported in the 10-12 per cent range and at remaining it exceeded 12 per cent. At the same time at only 5 banks in this group the Tier 1 ratio was less than 9 per cent;
- **good capital position of the remaining commercial banks.** At all banks the solvency ratio exceeded 10 per cent with all but one at over 12 per cent. At the same time at all banks in this group the Tier 1 ratio was less than 9 per cent;
- **good capital situation of most cooperative banks.** Out of 575 banks only 24 experienced a decline in own funds, with only 4 experiencing a reduction in the 10-20 per cent range. The remaining experienced an increase in funds, and at 254 of more than 10 per cent. At the end of 2011, only 22 banks had a solvency ratio of less than 10 per cent, 110 – in 10 to 12 per cent range and the remaining were above 12 per cent. At the same time the Tier 1 ration was below 9 per cent at only 27 cooperative banks.

Despite the good current situation**, further capital base consolidation is recommended.** This stems both from the level of risk accumulated on the balance sheets of banks, and from difficult external conditions, which may generate further pronounced disruptions in the operations of financial markets and influence the deterioration of the financial situation of some banks' borrowers. As a result **PFSA Chairperson issued individual recommendations to banks to limit distribution of profits for 2011,** in order to further strengthen the capital base and the ability to withstand unexpected losses.

LOAN PORTFOLIO BREAKDOWN - PFSA METHODOLOGY

Financial sector (excluding banks and branches of credit institutions)

Non-financial sector

- Enterprises
    - SMEs
        - Operating
        - Investment
        - For property
        - Other loans and receivables
    - Large enterprises
        - Operating
        - Investment
        - For property
        - Other loans and receivables
- Households
    - Housing
        - Zloty
        - Foreign currency
    - Consumer
        - Credit cards
        - Vehicle
        - Instalment
        - Other
    - Other
        - Operating
        - Investment
        - For property
        - Other loans and receivables
- Non-profit institutions acting for the benefit of households

Government and local government institution sector

- Central government institutions
- Local government institutions
- Social insurance funds

Operating loans - loans for the financing of the ongoing business of a firm or farm, i.e., for example, for payment of obligations to suppliers and payment of salaries and running costs. In this category the following should also be shown: discount and export loans together with overdrafts (excluding overdrafts for private persons).

Investment loans - loans to finance the borrower's new production or servicing capacity, or to increase existing capacity, and other endeavours whose nature is that of joint and accompanying investment extended for the financing of endeavours aimed at: restoring, modernising and increasing fixed assets, with the exception of vehicle loans and real property loans (these are shown separately). Where a loan is granted in support for a variety of purposes (e.g. purchase of land, construction of industrial plant and purchase of machinery and equipment) classification of the loan should be based on the purpose that predominates in the amount of the loan.

Housing loans – it is conventionally accepted that these are loans granted to households for: the acquisition, construction, reconstruction, extension or development of a house or of a dwelling that constitutes a separate real property, and adaptation of non-residential premises (or buildings) for housing purposes, the acquisition of co-operative rights to a dwelling or the right of separate ownership of a unit in a housing cooperative, repairs to a house or a dwelling as referred to above, the acquisition of a building plot or part of one for the construction of a detached house or of an apartment building which contains, or is to contain, a dwelling, and other objectives relating to meeting housing needs, particularly coverage of the costs of participation in the cost of construction of dwellings by a social housing association.

Real property loans - other housing loans (granted to entities other than households), commercial real property loans and loans for other real property.

Consumer loans - loans granted to private persons for purposes unrelated to business or the running of a farm. These loans include:

- loans on a **credit card account** - the use of funds up to the credit limit set by the bank when the credit card was issued without any restriction on the purpose for which the loan was granted and independently of the method of repayment;
- **vehicle** loans;
- **instalment** loans - loans repayable in instalments (usually over between one and three years) and intended for the purchase of consumer goods (e.g. white goods) or the financing of the current needs of households (e.g. holiday and vacation loans). This category also includes balloon loans.**This category does not include car loans and loans that are repaid by a single payment;**
- **other** - loans that are repaid by a **single payment**. They also include **overdrafts on current accounts** for households that are not connected to business or the running of a farm.

Other loans and receivables - other loans (not included in the groups named above) and other receivables.

BREAKDOWN OF THE ECONOMY BY SECTOR[36]

Financial sector

- Monetary financial institutions
    - Central banks
        - NBP
        - Central banks - foreign
    - Other monetary financial institutions
        - Banks and branches of credit institutions
        - Other monetary financial institutions
            - Cooperative savings and loan associations (SKOK)
            - Money Market Funds
- Other financial sector institutions
    - Insurance institutions
    - Pension funds
    - Other financial intermediaries
        - Investment funds (excluding money market funds)
        - Other financial intermediaries (excluding investment funds)
    - Ancillary financial institutions
    - International financial organisations (only those that are non-domestic)

Non-financial sector

- Enterprises
    - SMEs
    - Large enterprises
- Households
    - Individual entrepreneurs
    - Private individuals
    - Individual farmers
- Non-profit institutions acting for the benefit of households

Government and local government institution sector

- Central government institutions
- Local government institutions
- Social insurance funds

[36] The material presented is a slightly modified extract from the " Supplementary instructions on the FINREP package", NBP

FINANCIAL SECTOR - entities whose principal activity is financial intermediation, i.e.: the acquisition of financial assets and simultaneous incurring of liabilities on their own account as a result of carrying out market financial transactions, together with individuals providing services that are ancillary to financial intermediation.

Central banks – the Polish National Bank - operating under the Act on the Polish National Bank of 29 August 1997 (Journal of Laws 2005 No. 1 item 2 as amended). **Central banks** - **foreign** – the institution in the country of a non-resident that serves the functions of monetary authority, whose main activity is the issuance of national currency and the safekeeping of all or part of the state's foreign exchange reserves. The central bank may also perform other functions such as controlling the size of the money supply and of credit in the economy, conducting exchange rate policy, financial servicing of the government sector, supervision of the banking system, holding and refinancing banks' reserves, and organisation of financial settlements. Some of these functions may be performed by other institutions. This category also includes the European Central Bank.

Other monetary financial institutions - financial institutions whose business is to receive deposits and/or close substitutes for deposits from entities other than monetary financial institutions and to grant loans and/or invest in securities for their own account. For countries within the European Union, these institutions are classified according to an updated list, which is published in the Internet on the NBP's website (www.nbp.pl) and on the European Central Bank's website (www.ecb.int). For other countries, it is assumed that other monetary financial institutions means banks (other than the central bank).

Banks (excluding banks that are bankrupt, in liquidation or being established) - a unit created and operating under the Banking Law Act of 29 August 1997 (Journal of Laws No. 140, item 939 as later amended), or, in the case of cooperative banks, under the Cooperative Law Act of 16 September 1982 (Journal of Laws of 1995 No. 54, item 288 as later amended), or in the case of associating banks under the Act on the Functioning of Cooperative Banks, their Association and Associating Banks of 28 December 2000 (Journal of Laws No. 119, item 1252 as later amended), or in the case of mortgage banks under the Act on Mortgage Bonds and Mortgage Banks of 29 August 1997 (Journal of Laws No. 140, item 940 as later amended).

Branches of credit institutions - organisational units of a credit institution that perform in its name and on its behalf all or some of the activities covered by the permit issued to that credit institution, with all organisational units of a credit institution that have these features and are established within the territory of Poland being considered to be a single branch.

Cooperative Savings and Credit Associations [Spółdzielcze Kasy Oszczędnościowo-Kredytowe, SKOK] - units created and operating under the Act on Cooperative Savings and Credit Institutions of 14 December 1995 Journal of Laws of 4 January 1996, No. 1, item 2 as amended).

Money market funds - funds established under the Act on Investment Funds of 27 May 2004 (Journal of Laws 2004 No. 146 item 1546).

Insurance institutions - institutions offering insurance products and pursuing their own objectives and tasks through an insurance enterprise, operating in the form of a joint-stock company or as a mutual insurance company, operating under the Law on Insurance Activities of 22 May 2003 (Journal of Laws No. 124, item 1151 as later amended). The concept of insurance institution does not cover entities that operate in the area of social insurance (the ZUS Social Insurance Institution, the KRUS Agricultural Social Insurance Fund, the NFZ National Health Fund or the FP Labour Fund) or the entities that supervise insurance institutions and pension funds (the Polish Financial Supervisory Authority), which are counted as belonging to the government and local government institutions sector.

Pension funds - institutions the subject of whose business is collecting moneys and investing them with a view to making payment to members of the funds after they reach retirement age, acting under the Act on Organisation and Operation of Pension Funds of 28 August 1997 (Journal of Laws 2004 No. 159, item 1667 as later amended).

Other financial intermediaries - financial institutions whose primary activity is financial intermediation carried out by incurring liabilities in forms other than cash, deposits and/or substitutes for deposits in institutional entities other than monetary financial institutions.

Investment funds (excluding money market funds) - legal persons, as defined in the Act on Investment Funds of 27 May 2004 (Journal of Laws 146/04 item 1546), whose sole business consists in investing moneys, raised by public, or in circumstances specified in the act by private, invitations to acquire participation units or investment certificates, in securities, money market instruments and other property rights defined in that act. This category also includes National Investment Funds.

Other financial intermediaries (excluding investment funds) - financial institutions whose primary activity is financial intermediation carried out by incurring liabilities in forms other than cash, deposits and/or substitutes for deposits in institutional entities other than monetary financial institutions. This sub-sector includes, inter alia: financial leasing enterprises (enterprises that provide operating lease services be shown in the non-financial sector under enterprises), factoring enterprises, brokerage houses, institutions of the Private Equity/ Venture Capital type, firms established for the purpose of asset securitization, and banks that are bankrupt, in liquidation or being established.

Auxiliary financial institutions - financial institutions that do not conduct financial intermediation on their own behalf, but only contribute to creating the conditions for such intermediation. This sub-sector includes, among others: brokers, insurance and pension agents and consultants, investment advisors, foreign exchange bureaux, stock exchanges, commodity exchanges, institutions that form the infrastructure for the functioning of financial markets such as settlement chambers and centres (e.g. Polcard), security depositories (e.g. Krajowy Depozyt Papierów Wartościowych SA [the National Depository for Securities], guarantee institutions (e.g. the Bank Guarantee Fund), financial funds and foundations (including: the Cooperation Fund), investment fund companies, pension fund companies, institutions dealing with instalment sales, asset management companies, the Polish Bank Association, the National Association of Savings and Credit Unions and representative offices of foreign banks.

International financial organisations - financial institutions engaged in multilateral cooperation and extension of assistance to member states or third countries, e.g. the International Monetary Fund, the International Bank for Reconstruction and Development (the World Bank), the Bank for International Settlements (BIS) and the European Bank for Reconstruction and Development (EBRD). Also included here are international financial institutions in the meaning given to that term by Article 4 paragraph 3 of the Banking Law Act of 29 August 1997 (Journal of Laws 2002 No. 72, item 665 as amended).

NON-FINANCIAL SECTOR - entities whose principal activity is the production and trading of goods or the provision of non-financial services (including operating leases), entities performing non-financial functions and natural persons. The non-financial sector **includes enterprises, households and non-profit institutions.**

Enterprises - all entities whose principal activity is production or trading in non-financial goods or services. This group also includes natural persons engaged in business activities on their own account unless the number of people working in a business was more than nine at the end of the financial year last completed.

Small and medium-sized enterprises (SMEs) - entities in which the number of people working at the end of the fiscal year last completed was less than 250 and natural persons conducting business on their own account if the number of people working in a business was more than nine but fewer than 250 at the end of the fiscal year last completed. This category also includes micro-enterprises (enterprises, in which no more than nine people were working at the end of the financial year last completed). Natural persons conducting economic activity on their own account in which no more than nine people were working at the end of the fiscal year last completed are classified as individual entrepreneurs (households).

Large enterprises - entities in which the number of people working at the end of the fiscal year last completed was at least 250 and natural persons conducting business on their own account if the number of people working at the end of the fiscal year last completed was at least 250

Households - individuals or groups of individuals who are consumers and/or a person or group of persons who are producers of market goods and non-financial services intended solely for their own needs.

Individual entrepreneurs - natural persons engaged in business on their own account, to whom the reporting bank provides services related to their activities, where the number working in the business was at the end of the fiscal year last completed no more than nine (e.g. members of the professions, if they meet these conditions). Loans granted to persons engaged in business that are intended to fund consumption needs or to meet their needs for housing should be reported as loans to private persons. Similarly, deposits for these people if they are established separately for private purposes should be shown as the deposits of private persons. Non-public health facilities and non-public schools run by natural persons should also be included here if the number of people working in the business was no more than nine at the end of the financial year last completed.

Private persons – natural persons, with the exception of those engaged in business or in agricultural activities (i.e. categorised as individual entrepreneurs or as individual farmers). This category also includes: employee assistance and loan funds run by workplaces, school savings banks and parents councils operating in schools, kindergartens and other facilities.

Individual farmers – natural persons whose main source of income is agricultural production and whose business is not registered in the form of enterprises, companies, partnerships, cooperatives or producer groups. Loans granted to individual farmers that are intended to fund consumption needs or to meet their needs for housing should be reported as loans to private persons. Similarly, if deposits for these people are established separately for private purposes they should be shown as the deposits of private persons.

Non-profit institutions acting for the benefit of households - non-profit institutions which are separate legal entities and act to benefit households whose primary income, apart from that obtained from occasional sales, is voluntary contributions in cash or in kind from households, government and local government grants and income derived from ownership rights. This sub-sector includes, among others: trade unions, professional and scientific associations and societies, consumer associations, political parties, churches and religious organisations, volunteer fire departments, funds and foundations acting fro the benefit of households, social clubs, cultural, recreation and sports clubs, housing commonholds, non-public health care facilities and non-public schools if these are maintained by churches and religious associations, foundations serving households, trade unions, professional self-governing bodies and associations and other entities classified as non-profit institutions, charitable institutions, and humanitarian aid organisations financed by voluntary transfers in cash or in kind from other institutional entities.

GOVERNMENT AND LOCAL GOVERNMENT INSTITUTIONS SECTOR- the government and local government sector includes public authorities and organisational entities that are subordinate to them, state legal persons and other state organisational entities that are not covered by the National Court Register, whose activities are financed in whole or predominantly from public funds, except state enterprises, state banks, and state-owned commercial companies.

Central government institutions - all the ministries and other central institutions whose area of competence normally extends to a country’s entire economic territory with the exception of the management of social insurance funds. This subsector includes central authorities of government administration and entities subordinate to them whose activities are financed to a specified extent from the state budget.

Local government institutions - local government bodies (municipal, county and provincial) and organisational entities subordinate them to whose activities are financed from the budget of local government entities, with the exception of regional branches of social insurance funds. The area of competence of local government institutions covers only local parts of a country's economic territory.

Social insurance funds – these include all central and local institutional units whose principal activity is to provide social benefits provided that they meet both of the following criteria: by law or on the basis of relevant regulations specified population groups are required to participate in the plan (e.g. a pension plan) or to pay premiums and the government is responsible for management of the institution in terms of setting or confirming the amount of premiums and benefits. This sub-sector includes: The Social Insurance Institution and the Agricultural Social Insurance Fund and the funds managed by them (the Social Insurance Fund, the Demographic Reserve Fund, the Contribution Fund, the Prevention and Rehabilitation Fund, the Pension and Disability Benefit Fund, the Administration Fund, the Incentive Fund, the Reserve Fund and the Labour Fund), the National Health Fund and the latter’s provincial branches.

GLOSSARY OF SELECTED TERMS[37]

Nominal value of financial instruments - the amount of receivables, liabilities or off-balance sheet liabilities or the value of a security denoting the amount of capital (together with accrued interest) at the reporting date that a debtor is contractually obliged to pay to a creditor. In the case of debt securities such as bonds and bills of exchange, this amount denotes the sum that will be payable at maturity (together with accrued interest). In the case of shares, nominal value is the value shown in the statutes and entered into the court registry.

Carrying value - the value consistent with valuation at the balance sheet date, i.e.:

- financial assets are measured at: amortised cost calculated using the effective rate interest less any write-downs made for impairment or provisions created intentionally or at fair value and in the case of financial assets classified as available for sale fair value should be reduced by any write-downs for impairment or at cost less any write-downs for impairment,
- shares in subsidiaries are valued at the purchase price taking account of any write-down for impairment or in accordance with IAS 39,
- shares in other entities: banks preparing financial statements in accordance with IAS make valuations in accordance with IAS 39, while banks preparing financial statements in accordance with PAS value financial fixed assets at purchase price taking account of any write-down for impairment,
- financial liabilities are measured at: fair value or at amortised cost using the effective interest rate
- tangible fixed assets are valued at: purchase price or production cost less accumulated depreciation or at post-revaluation amount corresponding to fair value less accumulated depreciation and any write-downs for impairment,
- investment properties are valued: at fair value or at cost less accumulated depreciation and any write-downs for impairment,
- intangible assets are measured at: purchase price or production cost less accumulated depreciation and any write-downs for impairment or at post-revaluation amount corresponding to fair value less accumulated depreciation and any write-downs for impairment,
- fixed assets classified as held for sale are valued at the lower of carrying amount and fair value less costs of sale (IFRS 5)
- stocks are valued at purchase price or production cost or at net obtainable realisable value, depending on which is the lower amount.

Net carrying value - the carrying value.

Gross carrying value – carrying amount without deduction for accumulated depreciation and any write-down for impairment/specific provisions created.

Net assets - assets of the entity less liabilities, corresponding to the value of own funds.

Portfolio A - other receivables from the portfolio of financial assets valued at fair value through the profit and loss account and financial assets held for trading.

Portfolio B - other receivables from the portfolio of financial assets available for sale and investments held to maturity and the entire portfolio of loans and other claims.

[37] The material presented is a slightly modified extract from the "Instrukcja uzupełniająca do pakietu FINREP" [”Supplementary instructions on the FINREP package"], NBP

Unimpaired receivables (for banks using IAS) – financial assets without confirmed loss of value. Receivables subject to incurred but not reported write-downs should be shown in the "without loss of value" columns. Receivables without loss of value **for banks using PAS** - credit exposures categorised as normal and under observation.

Impaired receivables (for banks using IAS) – financial assets objective evidence of the loss of value of which has been confirmed as referred to in § 59 of IAS 39 and recognised as impaired assets, in accordance with the principles of IAS 39. Receivables with loss of value (**for banks using PAS**) – credit exposures classified as threatened.

Gross carrying amount of exposure no loss of value of which has been confirmed - banks applying PAS show these as normal and under observation, while banks applying IAS show exposures as unimpaired and as those for which indications of loss of value have appeared but write-downs have not been made. **Gross carrying amount of exposure with recognised loss of value** - banks applying PAS show threatened loans, while banks applying IAS should show impaired exposures for which a write-down has been made for loss of value.

Revaluation write-downs for assets that are valued individually - banks applying PAS show the creation of specific provisions for credit exposures with the exception of specific provisions created for exposures arising from loans and retail loans classified as "normal", while banks applying IAS show the value of write-downs made for loss of value on individual exposures. **Revaluation write-downs for financial assets that are valued as a portfolio** - banks applying PAS show the creation of specific provisions for credit exposures arising from loans and retail loans classified as "normal", while banks applying IAS show the value of write-downs made for credit exposures the loss of value of which has been assessed jointly.

Write-down for loss of value/specific provision is the amount by which the carrying amount of an asset exceeds its recoverable amount. **Recoverable value** – corresponds to the fair value less costs of sale or the value in use of an asset or cash-generating unit, depending on which is the higher (IAS 36.6) or the present value of estimated future cash flows discounted using the effective interest rate (IAS 39.63).

Initial term (to maturity) - the period for which a contract was concluded with a customer. The contractual period is also the period amended by an annex that is an integral part of the contract. In the case of deposits this will be the period for which the deposits have been declared to have been lodged in the bank. With respect to loans the initial term is the period for which the loan was extended taking into account the date set for repayment of the last instalment, while in the case of securities it is the period from the date of issue until the maturity or redemption of the securities. For deposits where the date of deposit of funds is other than the date of conclusion of the contract (e.g, interbank T/N and S/W deposits) the maturity date is counted from the date of deposit (i.e. of rebooking from off-balance sheet to the bank balance sheet) until the date of repayment of the funds.

Term to maturity - the period remaining between the reporting date to the date specified in the contract for payment of receivables, this being for receivables payable in one payment the date specified in the contract for payment of the entire debt and for receivables payable in instalments the date specified in the contract for payment of individual instalments.

Term to maturity - the period remaining between the reporting date and the date specified in the contract for payment of obligations.

Term of bank's commitment - the year in which the bank's receivable arose.

Non-delinquent receivable – a receivable paid in accordance with the schedule specified in the contract for the repayment of receivables, i.e. no delays have occurred in payment of capital or interest.

Overdue receivables – receivables for which payment of interest or principal amounts have not been made on the dates specified in the contract. By overdue period should be understood the period from the date due for payment (the specified date for payment of an instalment, interest or the entire amount) to the balance sheet date. The length of the overdue period for receivables repaid in instalments should be taken to mean the period from the date on which the earliest instalment was due if delayed payment has occurred.

Unserviced receivables - consist of claims in the case of which a payment has not been made for more than three months after the contractual date (calculated from the date of payment specified in the contract to the reporting date). For unserviced claims all amounts due must be shown, even if the delay in payment relates to particular instalments of principal or payments of interest. Under unserviced receivables should also be shown those on which a delay (of more than three months) has affected only interest payments while payments of principal have been made on time.

Deposits - a bank's liabilities arising from the funds deposited in customers' accounts, with the exception of liabilities arising from cash collateral taken.

Sight deposits - funds deposited in entities' current accounts in a reporting institution which may be payable on demand.

Time deposits - funds deposited with a reporting institution for a specified term.

Deposits redeemable at notice - funds deposited in a reporting institution without a specific maturity date which cannot be withdrawn without prior notice to the reporting institution of intention to withdraw all or part of the deposit. The notice period is specified in the contract. Withdrawal of the deposit without prior notice is impossible or causes the loss of a substantial part or all of the interest due.

Blocked deposits - funds deposited in a reporting institution which the depositor cannot dispose of freely because of their use for specified purposes, inter alia for the settlement of letters of credit or as security for risk borne by the reporting institution in relation, for example, to a loan granted or to credit card transactions. If it is possible to determine an initial term for raising the blockage, the deposit should be allocated to the appropriate group of time deposits. Inability to determine such a term leads to allocation of the deposit to the "blocked deposits" category.

Loans on the liability side - the obligations of a reporting institution relating to loans it has received. This category excludes liabilities related to securities issued. The category excludes obligations on account of issued securities.

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