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Polish financial sector in the transformation period: foreign direct investments*

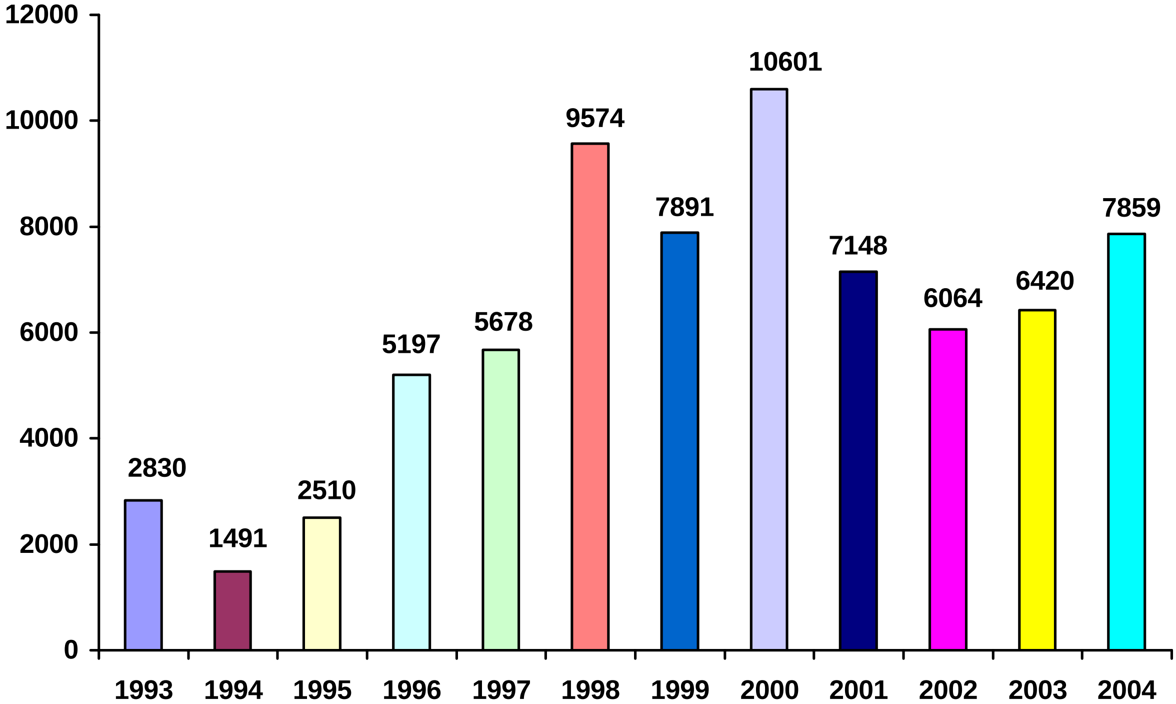
Foreign direct investments in the financial sector

Foreign direct investments in Polish transformation

Foreign direct investments (FDI) play both a fundamental and instrumental role in the transformation process. This was at least the truth with regard to the post-Soviet Central and East European economies including Poland. It provided necessary capital, know-how, new markets and market conduct spirit, characteristic for the market economy.

Cumulative total value of FDI in Poland (FDI stock) reached by the end of 2004 was at the level of 84,5 billion USD. The size of annual inflows varied reaching its maximum in the year 2000 and stabilizing thereafter at the level of ca 6-7 billion USD annually (see Fig 5).

Fig 5 Inflow of FDI into Poland (in millions USD)



Source: PAIIZ

* Paper presented at the International Conference on Transformation and Development, University of Washington, Seattle, 2006.

Over 50% of the inflow in recent years are greenfield initiatives of which share is clearly climbing at the expense of acquisitions and especially privatisation deals of which share in 2004 fell to only 17% of the total. This would mean that the period characterized by merely change of ownership (privatisation) has been replaced by the period characterized by new investments.

Foreign-owned corporations play today an important role in the Polish economy. In 2003 their overall capital investments totalled 46 billion zloties which constituted over 41% of the total capital outlays in the national economy. They were responsible at the same time for over 75% of the capital outlays in the manufacturing industry[1]. Foreign-owned companies generated in 2003 around 54,5% of Polish export and over 61% of the country's imports. They employed in total in 2003 over 1 million people.

The largest share of FDI stock belongs to the EU-15 based companies which are in control of about 74% of its total value by 2004[2]. They are followed by US-based investors and thereafter by international institutions, EBRD in particular which invested in Poland by 2004 over 4 billion USD. In sum, Poland attracted by 2004 investors from 35 countries and representing over 1100 companies. It is interesting to note that traditional directions of origin of foreign investors were in the course of 2005 supplemented by large investment projects implemented by Indians (steel industry) and Ukrainians (motor industry). It could indicate the beginning of a new era in this respect.

As far as EU-15 based investors are concerned a clear leadership position belongs to French companies (Telecom, Michelin, Carrefour, Casino, Auchan, Lafarge, Saint Gobain) which invested over 16 billion USD. They are followed by Dutch (United Pan – Europe Communications, ING Group, BP, Heineken) with FDI stock of over 10 billion USD /see table 12/.

Out of 80,6 billion USD invested in Poland by 2004 over 41,4% were allocated to the manufacturing industry. The leading role in this regard belongs to the investments in transport equipment (ca 21% of the total manufacturing industry investments), mainly motor industry, food processing, drinks and tobacco (ca 21% of the total manufacturing), building materials industry (ca 13%) and electric and optical equipment (ca 10%)[3]. Investments in the manufacturing industry were followed by the financial sector which attracted by the end of 2004 ca 19 billion USD which represents 23,4% of the total FDI stock in Poland. Biggest investors in this area include:

- European Bank for Reconstruction and Development (4 billion USD),
- KBC Bank (1,7 billion USD),
- Hypo und Vereinsbank (1,3 billion USD),
- Citigroup (1,3 billion USD).

Table 12. FDI stock in Poland in 2004 by country of origin [a)]

Country of origin	million USD	% of total	number of investors
France	16 026,1	19,9	101
Netherlands	11 154,2	13,8	126
USA	10 163,7	12,6	118
Germany	10 149,5	12,6	258
International	4 648,7	5,8	14
United Kingdom	4 337,2	5,4	56
Italy	4 089,3	5,1	67
Sweden	3 715,2	4,6	60
Belgium	2 902,6	3,6	27
Denmark	2 096,2	2,6	50
Total	80 649,8	100,0	1101

[a)]covering only investment projects with the value exceeding 1 million USD

Source: MGiP

[1] Bezpośrednie inwestycje zagraniczne w Polsce według stanu na koniec 2004 roku, MGiP, Warszawa 2005 p. 6
[2] Bezpośrednie inwestycje zagraniczne ... op. cit. p. 18
[3] Bezpośrednie inwestycje zagraniczne ... op. cit. 27

The third most important area of FDI is trade (ca 12% of FDI stock) followed by transport and communication (9,7%). Details are provided in Fig. 6.

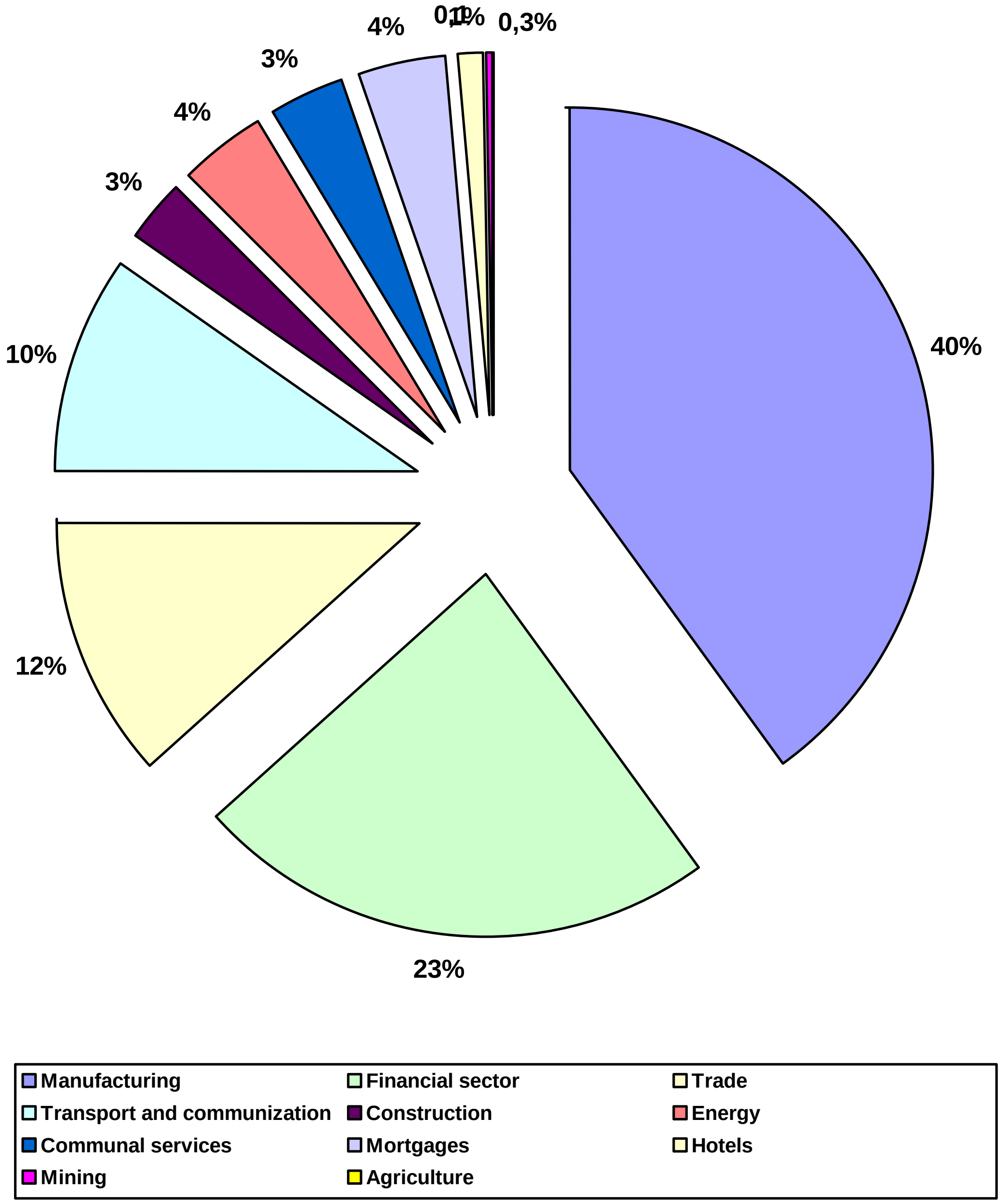


Fig 6. Sectoral structure of FDI stock in Poland (end 2004)

Source: PAIIZ

The role of foreign direct investments in the financial sector

As indicated before, the financial sector attracted roughly a quarter of FDI allocated to Poland. There are no official figures on the sectoral distribution of the said investments however one could make some estimations on the basis of the share capital owned. According to the available information, its value for the above three segments of the financial sector reached by the end of 2004 11,353 million zloties. Out of this amount, of which 7086 million zloties were accounted for in the banks, 3352 million zloties were recorded in insurance and 1097 million zloties were recorded in the pension industry.

Table 13. Foreign direct investments in the Polish financial sector 2004 (%)

	Banking sector		Insurance [a)]		Pension Funds	
	Capital	Assets	Capital	Assets	Capital	Assets
Total foreign investors	63,0	67,6	72,1	42,1	71,3	76,7
Germany	11,5	18,9	27,8	7,6	12,4	7,0
Italy	1,8	11,3	1,9	0,2	0,9	1,1
Austria	3,6	11,3	1,9	2,5	9,5	3,4
Belgium	10,6	5,1	1,0	4,4	-	-
Netherlands	5,7	7,9	4,2	5,0	5,5	26,3
Finland	-	-	5,8	0,2	13,8	3,6
France	2,2	2,4	1,2	0,3	0,5	0,7
UK	1,4	0,1	4,5	11,6	9,2	22,2
EU-15 total	51,3	58,6	65,1	33,6	60,4	65,2
US	9,0	8,6	7,7	8,5	6,2	9,0

[a)] only direct foreign ownership

Source: NBP, KNUiFE

Hence it means that by now 60% of the invested capital was attracted by the banking sector, 29% by the insurance industry and the remaining 11% by the pension industry.

Assessing this structure from the point of view of the existing structure of the view of the Polish financial sector assets, we should note clear under-representation of the banking sector investments in the share capital. As indicated before, banks are in control of over 74% of the country's financial assets, by 14% points more than its level in the foreign owned capital. At the same time one should underline a clear over-representation of the insurance industry-related investments as in 2004 this industry represented only 10,8% of the total financial assets of the country, whereas its share in foreign owned capital in the financial sector accounted for nearly 30% of the total. To put it in a different perspective: the capital/ asset productivity measured by a relation of share capital to the assets controlled (capital related "price" of the assets) in the banking sector was around two cents for one dollar of assets (7086 mln PLN to 363.713 mln PLN) whereas in the insurance industry it was ca 10,5 cents for one dollar of assets (3352 mln PLN to 32.705 mln PLN). In the case of the pension funds relevant figures are the same as in the banking sector.

An immediate question comes to mind regarding the reasons for such differences: are they industry-specific and simply reflect a higher capital/output ratio in the insurance industry? Or may be there are some other forces in operation? To what extent may this result from the two different paths of the foreign capital penetration in the said industries: acquisitions of the existing State-owned stakes in the case of the banking industry versus greenfield projects in the insurance industry? And if this is the case, why then are pension fund-related investments as productive as in banking whereas they were completely greenfield projects? One possible explanation is that in the case of the insurance industry foreign investors were forced to compete against the market dominating and powerful PZU Group whereas in the case of the pension sector the whole industry has been set up from scratch. Thus the existing difference may simply represent the cost of PZU. These hypotheses require certainly much more empirical research before any final conclusion is made.

As far as the geographical structure of investments is concerned, the EU-15 clearly dominate the scene, controlling roughly over 50% of the financial assets of the country. Among EU-15 countries the leading position is occupied by Germany, followed by the Netherlands, Belgium and Austria. An astonishingly low share is recorded except for Germany by other large EU-15 countries: Italy, France and the United Kingdom. France, topping the list of foreign investors in Poland, is far behind the leaders in the financial sector. From outside of the EU-15, substantial share belongs to the investors from the United States. It is worth noting that eight EU-15 countries and the US account for nearly 100% of the invested foreign capital. The inner circle thus is very limited.

Foreign investments in the financial sector have been accomplished via two different strategic routes: privatization projects in the case of the banking industry and greenfield projects in the case of the insurance and pension industries. In a sense then in the first case it was the State who decided on the deals whereas in the second case it was the market, with the notable exception of PZU.

The State sold in 2000 to Dutch-based Eureko 30% of its shares for 700 million Euro, estimating the overall value of the company at around 10 billion PLN. Four years later Towers Perrin, a leading international expert on the insurance industry, valued the company at a level of about twice as much. Cumulated net income of the company in 2000-2004 reached the level of ca 6,8 billion PLN and 2,5 billion more is expected in 2005. Nearly the same amount as the estimated value of the company in the year 2000. Hence there is a widely held belief that the company was seriously undervalued in the course of the privatization project and the whole transaction was mismanaged in economic terms.

As mentioned before, foreign banks have acquired a dominant position via participation in the privatization of the State-owned banks from 1993 to 2000. During the first phase between 1993-1997 the concept of gradual privatization based on minority participation of foreign banking institutions was applied. In 1998-2000 the abrupt change of the policy took place and the bulk of the remaining major State-owned banks was sold to majority foreign shareholders[4].

Until 2004 no new privatization-led transaction was recorded. In 2004 however in the wake of rehabilitation of a major State owned-bank, the Bank for Food Economy (BGŻ), 50,3% of the shares have been acquired by Rabobank (NL) and EBRD. Thus the overall number of majority State-owned banks decreased since then to four (PKO BP, BGK, Bank Pocztowy and BOŚ).

When analysing various characteristics of foreign direct investments in the Polish financial sector it should be underlined that an overwhelming majority of the investors have come from large international capital groups. The Polish market therefore represents only as a rule a small part of their overall operations.

Assessment of the role foreign direct investments in the financial and in particularly the banking sector remains a highly debated issue in Poland[5]. It also attracts international attention[6]. There are both arguments in favour, which support the use of FDI and others – against, which discourage.

On the positive side it is first of all underlined that FDI broadens the capital base of the financial industry and banking sector in particular. It is of utmost importance in view of the fragility of the financial system, to permit poorer countries to set up sound and well-capitalized institutions. It may also in parallel provide a resolution via takeovers for troubled financial institutions.

FDI may additionally positively affect transfer of financial know-how and bring about increased operational efficiency via enhanced corporate standards, quality of risk management and improved market offerings. Foreign investors may also contribute to the upgrading of prudential and compliance standards.

- All these positive effects were recorded in Poland to varying degrees.
- There are however also some risks of adverse impact. They include inter alia
  - the danger of crowding out local financial institutions by more efficient foreign ones,
  - the danger of abuse of market position and inadequate market offering which is of particular concern in the case of heavily concentrated industry,
  - the danger of inadequate civic spirit and the sense of social responsibility[7],

[4] Farnox M., Lanteri M., Schmidt J. – Foreign direct investment in the Polish financial sector, Case study prepared for the CGFS Working Group on Financial Sector FDI, June 2004 p. 3
[5] Poznański K. – Wielki przekręt. Klęska polskich reform, Towarzystwo Wydawnicze i Literackie, Warszawa 2000, Szelągowska A. – Kapitał zagraniczny w polskich bankach, Poltext, Warszawa 2004, Jaworski W. (red) Banki w Polsce. Wyzwania i tendencje rozwojowe, Poltext, Warszawa, 2001
[6] See for example Poret P. – Making FDI and financial sector policies mutually supportive, OECD Global Forum on International Investment, Mexico City, 26-27 November 2001
[7] Poret P. – Making FDI ... op cit. p 4

- Their appearance becomes a real danger only under the circumstances of high foreign capital dependency.

As far as Poland is concerned these hypothetical side effects have not until now been empirically proven though it seems that both policymakers and the people have become more alert end sensitive with regard to the high penetration level by foreign investors of the country's financial system[8] . In a recent article in "Gazeta Bankowa" for example – a leading representative of the new governing coalition in Poland – critically reports about the high dividends level of leading foreign-owned banks which paid out in 2004 alone over 2,5 billion zloties (ca 800 million USD) representing ca 80% of the profits due, thus decreasing their own investment base. Particularly regrettabe is the dividend policy of Citibank which transmits abroad in recent years over 90% of its profits. The author concludes by saying that foreign shareholders apparently indicate their unwillingness for long-term market and product development and their preference for "juicing the lemon" [9] .

[8] evidence includes the long lasting conflict between Eureko and the State Treasury over PZU
[9] Skrzypek S. – Zmierzch dywidendy, Gazeta Bankowa, 21-27/11/2005 p. 15 see also Farnox Metal ... op cit pp 10-18.