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## FROM THE SCIENTIFIC COUNCIL

Ladies and Gentlemen,

We present you with the ninth edition of the 'Journal of Management and Financial Sciences'. We hope that these articles will present a contribution to the development of economic thought and contribute to a fuller understanding of the complex economic issues. We wish you pleasant reading.

*Janusz Ostaszewski,*  
Chairman of the Scientific Council and Dean of the Faculty

*Ryszard Bartkowiak,*  
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## **Post Crisis Corporate Governance Lessons. The case of the US investment banks**

### **Introduction<sup>1</sup>**

Corporate governance encompasses mechanisms and institutions which are aimed at providing for corporate efficiency. The corporate governance best practice delivers a set of commonly shared and globally recognised guidelines referring to the board work, the formation of specialised board committees (audit, remuneration, nomination, related party transaction), the structure of executive compensation, information policy and investor relations. Additionally, corporate governance recommendations deliver performance measures which are the fundament for the evaluation of a company's efficiency in meeting shareholder and stakeholder expectations and providing a benchmark for their competitors. The universality of corporate governance best practice allows for their adoption for listed companies, financial institutions as well as non-profit organisations.

The aim of this paper is to analyse the corporate governance shortcomings identified in the case of the US investment banks and show their divergence from the best practice norms. The paper is based on the case studies of three American investment banks, Bear Stearns, Lehman Brothers and Merrill Lynch which discuss their major corporate governance failures, resulting in the their collapses and contributing to the outbreak and course of the financial crisis and leading to a significant uncertainty on the stock market. The case study method offers a detailed description of the analysed field, area or issue taking into account different dimensions and features. It allows the study of individual cases and the relations between selected variables<sup>2</sup>. As shown in the paper the analysis of Bear Stearns, Lehman Brothers and Merrill Lynch depicts severe corporate governance inefficiencies although the scenarios of each of these investment banks proved to be different – Lehman Brothers collapsed filing for bankruptcy, Bear Stearns

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<sup>1</sup> The author would like to thank two anonymous referees for their valuable comments.

<sup>2</sup> Lisiecka K., Kostka-Bochenek A. (2009), Case study research jako metoda badań naukowych, "Przegląd Organizacji", Nr 12, s. 25–29.

was rescued in a takeover transaction by JP Morgan Chase and Merrill Lynch was taken over by the Bank of America, while the parent companies of the two latter banks were covered by the US bailout scheme known as the Troubled Asset Relief Plan (TARP). Although investment banks reveal their own specificity and may not – as opposed to the listed companies – be the prime receivers of the corporate governance recommendation in the first line, their impact (and hence stability and governance standards) upon the financial system and other market participants appears to remain crucial, particularly with respect to the course of the financial crisis. Moreover, before 2008, US investment banks operated largely in the form of public listed companies and not as financial holdings, this form assuring larger flexibility and liberalisation of operation<sup>3</sup>. Thus they needed and still need to adopt corporate governance. Finally, their control and monitoring practice as well as shortcomings have contributed to the understanding of corporate governance and performance.

This paper is organised as follows. The first section presents an outline of the investment banking sector taking into account its role in the outbreak and course of the financial crisis. The second section is devoted to the case studies of three investment banks, Bear Stearns, Lehman Brothers and Merrill Lynch, discussing their history and development up until the outbreak of the financial crisis in 2008. The main corporate governance shortcomings identified in these three investment banks referring to the board composition and work, structuring of the executive compensation as well as compliance with corporate governance best practice are presented in the third section. The final remarks and summary of the conducted analysis are delivered in the conclusion section.

## **1. The overview of the investment banking sector**

### **1.1. The origin and development of investment banking**

Investment banks have always been perceived as the elite of financial institutions known for their unique knowhow, service, quality, reputation and aggressive corporate culture. The origin of investment banks is related to the emergence of specialised services tailored for trade enterprises in the US as of 1688–1815<sup>4</sup>. The dynamic development of investment banking was also noted during the industrialisation period of the American economy 1850–1920 as well as after

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<sup>3</sup> Kansas D. (2009), *Guide of the end of Wall Street as we know it*, Collins Business, New York, pp. 90–91.

<sup>4</sup> Morrison A., Wilhelm W. (2007), *Investment banking: institutions, politics, and law*, Oxford University Press, pp. 97–120.

the introduction of the Glass-Steagall Act in 1932 which brought into effect the separation of commercial and investment banking. The investment banks in Europe originated from the universal banks which covered and still cover the wide range of banking services. There is no clear distinction between investment banks and investment banking as the term of investment bank refers to so called full service investment banks (Goldman Sachs, Morgan Stanley) as compared to the wider term of investment banking which comprises a set of services that may also be delivered, for instance, by universal banks or financial holding companies (HSBC, UBS, Deutsche Bank, BofA, JP Morgan Chase<sup>5</sup>. Additionally, investment banking services may be provided also by boutique investment banks (Grenhill, Sandler O'Neill). Interestingly, since 1999 when the Glass-Steagall Act was lifted and replaced by the Gramm-Leach Bliley Act, stating that investment banking services may be provided by various financial institutions and units formed within large corporations (e.g. British Petroleum).

Investment banking known also in the literature as corporate investment banking neither grants loans nor accepts deposits. Their prime role lies in assuring intermediary services within the financial system supporting the efficiency of capital allocation, transfer and creation<sup>6</sup>. Thus investment banking is to serve both companies searching for sources of external financing (as it optimises the cost of capital) and investors who provide capital for investment (as they provide a wide range of investment opportunities and access to financial instruments of various yields and risk levels)<sup>7</sup>. The determinants of investment banking development refer to the following issues<sup>8</sup>:

- Its ability to reduce, to a significant extent, the transaction costs typical of both the capital market and the market for corporate control (hostile takeovers, M&A) which is driven by the adoption of advanced technology ensuring compatibility between the preference schemes of the counterparties who enter into a transaction regarding the negotiation of financial contracts,
- Its superior ability to produce and manage information regarding the aspects in which the interests of the parties involved in a given negotiation normally diverge,

<sup>5</sup> Liaw K. (1999), *The business of investment banking. A comprehensive overview*, John Willey & Sons, London, pp. 14–24.

<sup>6</sup> Giovannini R., Caprizzi V., Chiesi G. (2010), *Investment banking services: Ownership structures, financial advisory and corporate governance models*, “International Journal of Business Administration”, Vol. 1, No. 1, pp. 49–63.

<sup>7</sup> Liaw K. (1999), *op. cit.*, pp. 14–22.

<sup>8</sup> Based on literature review in Giovannini R., Caprizzi V., Chiesi G. (2010), *op. cit.*, pp. 49–63; Morrison A., Wilhelm W. (2007), *op. cit.*, pp. 67–71; Liaw K. (1999), *op. cit.*, pp. 27–109.

- Its greater efficiency in collecting and processing information, but rather on that of the “certifying” effect, founded essentially on their own reputation to assure the validity of a given transaction,
- Its ability of introducing innovations in the form of new, advanced and complex financial instruments,
- Its ability to reduce information asymmetry due to the capabilities of information collecting and management which assures the crucial importance for the intermediary role and underwriting,
- Its ability to framework multi period firms-intermediary relationships.

Investment banking includes a wide range of services such as equity and debt underwriting, private equity, asset securitisation, financial engineering, investment management, repurchase agreements, clearing and settlement<sup>9</sup>. The breakdown of investment banking services is presented in Table 1.

**Table 1. Investment banking services**

Business areas	Products and services
Capital market	Primary Market operations: <ul style="list-style-type: none"> <li>– equity capital market services (issuing and placement, research, sponsorship, post listing support)</li> <li>– debt capital market services (issuing and placement, securitisation, research)</li> </ul> Secondary Market operations: <ul style="list-style-type: none"> <li>– equity capital market services (selling, dealing, brokerage, market making, asset management)</li> <li>– debt capital market services (selling, dealing, brokerage, market making, asset management)</li> </ul>
Corporate finance	<ul style="list-style-type: none"> <li>– ownership reallocation services (mergers and acquisition, LBOs/MBOs,</li> <li>– ownership structure reorganisation services (spin-offs, carve-outs, splits-ups, admission of new partners</li> <li>– company crisis restructuring services</li> <li>– financial advisory services</li> </ul>
Merchant Banking	<ul style="list-style-type: none"> <li>– equity holdings in companies in the start-up, early stage (venture capital)</li> <li>– equity holdings for growth or ownership base restructuring purposes (private equity)</li> </ul>
Project Finance (structured finance)	<ul style="list-style-type: none"> <li>– private investment initiatives (PFI)</li> <li>– mixed “public-private” partnerships (PPP)</li> </ul>

<sup>9</sup> Augar P. (2005), *The greed merchants. How the investment banks played the free market game*, Penguin Books, London, p. 33; Morrison A., Wilhelm W. (2007), *op. cit.*, pp. 22–34.

**continued Table 1**

Business areas	Products and services
Risk management	<ul style="list-style-type: none"> <li>- industrial risk management services</li> <li>- financial risk management services</li> <li>- advisory services for risk measurement and coverage</li> </ul>

Source: Capizzi V. (2006), Investment banking: un settore con elevatavarietà di operatori, prodotti, “Economia & Management”, Vol. 1, pp. 52–56 as quoted in Giovannini R., Caprizzi V., Chiesi G. (2010), Investment banking services: Ownership structures, financial advisory and corporate governance models, “International Journal of Business Administration”, Vol. 1, No. 1, p. 59.

Investment banking has developed significantly, mostly in Anglo-Saxon countries, as the size of the stock market and importance of equity financing has created a demand for specialised services and the intermediary role. The development in the US was led by the introduction of pension schemes, particularly the 401(k) scheme<sup>10</sup>, which adopted the deferred tax saving and pension plans<sup>11</sup>. The recent years have shown the significant development of investment banking in traditionally based on debt financing Europe as well<sup>12</sup>. The investment banking development is heavily rooted in the market liberalisation, consolidation in the banking sector, the emergence of advanced IT technologies and the increase of the stock market role within the global economy. The boom of investment banking which has been observed within the last 10 years has resulted from the quest for higher profits and financial instrument innovations, the increase in derivatives trade in particular.

## 1.2. The controversies of investment banking

Investment banks are often perceived as controversial institutions due to their aggressive strategies, lobbying practices and the size of generated profits. Studies reveal that the performance of investment banks measured by ROE remain at high levels or experience increase even in times of economic recession while other stock market participants face deterioration of their financial performances. For instance, although the return on investment of public listed companies dropped significantly in 1980 and 2004, investment banks enjoyed high margins of 16–17% before tax and a high ROE of 14–20%. Such good performance of investment banks is rooted in the financial products innovation and aggressive strategies of

<sup>10</sup> Augar P. (2005), *op. cit.*, p. 9.

<sup>11</sup> Plan 401(k) is solely sponsored by the employer. The employee decides about the size of the compensation dedicated and transfer to his or her pension account according to the regulation by the Internal Revenue Service (IRS). The employer may contribute to the pension scheme and is obliged to the funds management.

<sup>12</sup> Morrison A., Wilhelm W. (2007), *op. cit.*, pp. 13–24; Augar P. (2005), *op. cit.*, p. 37.

their employees driven by incentive compensation packages. The rate of return of investment banks over the period of 1980–2002 is presented in Table 2.

**Table 2. The rate of return of investment banks, 1980–2002 (%)**

Period	Nominal ROI	Interest rate	Risk premium	Inflation	ROI
1980–84	48	12	36	6	42
1985–9	22	8	14	4	18
1990–94	14	5	9	3	11
1995–99	21	5	16	2	19
2000–2002	19	4	15	2	17

Source: Augar P. (2005), *The greed merchants. How the investment banks played the free market game*, Penguin Books, London, p. 56.

The investment banks also earned much controversy in line with the increased disclosure of their remuneration packages perceived as a mechanism transferring the value from the real economy to the financial sectors. For instance the total return of investment in shares of the US public listed companies for the period of 1980–2000 accounted for 60 billion USD while the sum cashed by investment banks and other financial market intermediaries for their services (advisory, underwriting, management) was estimated at 120 billion USD. Additionally, the total compensation of investment bankers and brokers including stock options totalled 200 billion USD for the period of 1999–2000 only<sup>13</sup>. Moreover, investment banks comprising the sell side of the market accompanied by private equity and hedge funds are viewed as one of the main factors leading to the outbreak of the financial crisis starting with the subprime mortgage collapse and credit crunch. The investment banks aggressive policies and quest for high profitability has resulted in the financial market innovation and the adoption of complex financial instruments<sup>14</sup> such as RMBSs (residential mortgage backed securities), collateralised debt swaps (CDS) and collateralised debt obligations (CDO)<sup>15</sup> which have allowed the increase in the banks' portfolios security shifting

<sup>13</sup> The average compensation for associate at investment banks is estimated at 240.000–150.000 annually, while for the business school graduate the average pay accounts for 70.000 USD. The compensation of managing director is estimated at 3.2 million USD dropping to over 1 million USD in 2002 recession.

<sup>14</sup> The size of derivatives trade is enormous estimated at 124 trillion USD for interest rate derivatives, 3 trillion USD for credit derivatives and stock derivatives each – Augar P. (2005), *op. cit.*, pp. 150–160.

<sup>15</sup> International Labor Organization (2009), *Impact of the financial crisis on finance sector workers*, Geneva, GDFFCW/2009/1; Nawrot W. (2009), *Załamanie rynku papierów wartościowych na tle globalnego kryzysu finansowego, "e-Finanse"*, No. 3, p. 4.

the risk upon other market participants<sup>16</sup>. The surge in the derivatives trade brought about by investment banks and hedge funds has allowed for higher liquidity and at the same time increased the market volatility<sup>17</sup>.

## **2. Investment banks: case studies**

### **2.1. Bear Stearns**

Bear Stearns was founded as a brokerage house in 1923 in New York by Joseph Bear, Robert Stearns and Harold Mayer with an initial capital of 500.000 USD<sup>18</sup>. The bank managed to survive throughout the 1929 crisis and expanded nationally and globally, opening the Chicago branch in 1933 and its first overseas office in Amsterdam in 1955. Since 1985 the bank was listed on the NYSE. The firm growth led to the increase of services provided which covered corporate finance, mergers and acquisitions, assets management security and derivatives trading as well as clearing services provided for brokerage houses. The stock market services represented c.a. 80% of Bear Stearns revenues, with asset management estimated at nearly 10% and the global clearing services contributing c.a. 12% of the bank revenues. In 2006 Bear Stearns employed 15.500 employees controlling a capital of 66.7 billion USD with assets of 350 billion USD and was ranked the fifth largest global investment bank. In 2005–2007 Bear Stearns was classified as the Forbes “most respected companies worldwide” specialising in security trading.

The Bear Stearns collapse is heavily rooted in the bank’s excessive engagement in mortgage backed assets financed largely with the substantial leverage. According to the reports as of November 30, 2007 Bear Stearns’ involvement in credit derivatives was estimated at more than 13 trillion USD with futures and option totalling at 1.85 trillion USD. The 28 billion dollar assets of estimated value dropped to only 11 billion serving as collateral for the investment of 395 billion USD which gave a 35:1 leverage rate<sup>19</sup>. The investments in CDOs of Bear Stearns High-Grade Structured Credit Fund and Bear Stearns High Grade Structured Credit Enhanced Leveraged Fund adopting the leverage ratio of 35:1 and 100:1 respectively led to severe liquidity problems of Bear

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<sup>16</sup> Clarke T., Chanlat J.F. (2009), Introduction: A new order? The recurring crisis in Anglo-American corporate governance and the increasing impact on European economies and institutions, in: Clarke T., Chanlat J.F. (eds.), *European corporate governance. Readings and perspectives*, Routledge, London, pp. 1–42.

<sup>17</sup> Goldberg R. (2009), *The battle for Wall Street. Behind the lines in the struggle that pushed an industry into turmoil*, John Wiley & Sons, New York, pp. 4–14 and 138–152.

<sup>18</sup> Kansas D. (2009), *op. cit.*, pp. 60–61.

<sup>19</sup> Boyd R. (2008), *The last days of Bear Stearns*, [http://money.cnn.com/2008/03/28/magazines/fortune/boyd\\_bear.fortune/](http://money.cnn.com/2008/03/28/magazines/fortune/boyd_bear.fortune/)

Stearns in June 2007. In line with the distressed subprime mortgage payments the value of these two hedge funds estimated at 6 billion USD dropped to zero leading to a deterioration of financial performance and a downgrading of the bank from Standard & Poor's AA to A. The funds managing directors (Matthew Tannin and Ralph Cioffi) were sued with the charges of misrepresentation as the factual engagement in credit derivatives was not disclosed to shareholders. The poor bank performance and severe liquidity problems led to negative shareholder and business partners reactions who withdrew assets or suspended loans services and repo transactions. Neither the bank's efforts to restore market confidence nor the Federal Reserve Bank of New York's loan of 30 billion USD to provide liquidity were able to save Bear Stearns. On March 17 2008 the JP Morgan Chase takeover bid at 2 USD per share saved Bear Stearns legacy. The bid price which was increased to 10 USD per share a week later<sup>20</sup> making the total sum of 50 billion USD which remained a substantial discount to the pre-crisis share price level of 172–133 USD<sup>21</sup>. JP Morgan covered also the derivatives obligation of 13 trillion USD adding this to its 77 billion USD position while the US FED covered the toxic assets of 29 billion USD<sup>22</sup>. In January 2010 the name Bear Stearns was fully replaced by the JP Morgan brand.

## 2.2. Lehman Brothers

The origin of Lehman Brothers is dates back to 1844 when Henry Lehman, the son of Jewish German immigrants opened a multiproduct store in Montgomery known as "H. Lehman"<sup>23</sup>. Six years later, cooperating with two brothers, the store expanded into a cotton trade company as this commodity was used as clearing currency<sup>24</sup>. In 1858 the brothers started a New York branch, while in 1870 they were involved in building the cotton exchange<sup>25</sup>. Between the 19<sup>th</sup> and 20<sup>th</sup> centuries the company specialised in financing the retail companies (e.g. Sears) as well as the aviation and film industries. Similarly to Bear Stearns, Lehman Brothers successfully survived the 1929 crisis and significantly developed after

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<sup>20</sup> Sorkin A. (2008), JP Morgan pays \$2 a share for Bear Stearns, <http://www.nytimes.com/2008/03/17/business/17bear.html>

<sup>21</sup> Szybisty Z. (2008), Bear Stearns splajtował. Fed boi się kolejnych bankructw, <http://manageria.gazeta.pl/manageria/1,85811,5033659.html>

<sup>22</sup> JP Morgan took over also Bear Stearns Merchant Banking, Bear Growth Capital Partners, Bear Stearns Private Equity Ltd., renamed J.P. Morgan Private Equity, Bear Stearns Health Innoventures, Constellation Ventures.

<sup>23</sup> Lehman Brothers Holdings Inc., [http://topics.nytimes.com/top/news/business/companies/lehman\\_brothers\\_holdings\\_inc/index.html](http://topics.nytimes.com/top/news/business/companies/lehman_brothers_holdings_inc/index.html)

<sup>24</sup> Gadowski W. (2008), Lehman Brothers. Prawdziwa katastrofa w wirtualnym świecie, [http://wyborcza.pl/1,97559,5846722,Lehman\\_Brothers\\_Prawdziwa\\_katastrofa\\_w\\_wirtualnym.html](http://wyborcza.pl/1,97559,5846722,Lehman_Brothers_Prawdziwa_katastrofa_w_wirtualnym.html)

<sup>25</sup> History of Lehman Brothers, <http://www.library.hbs.edu/hc/lehman/history.html>

the II World War providing services for the largest US companies (Compaq, Ford Motor Company, Philip Morris, followed by Intel and IBM) and expanding globally. Lehman Brothers became also the official underwriter of US bonds. In 1984 the bank was merged with American Express which proved inefficient followed by the spin off ten years later. The last 13 years of Lehman Brothers showed the strong though isolated leadership of Richard Fuld resulting in further bank development, increased takeover activity and expansion into different service segments (e.g. bond fund – Lincoln Capital Fixed Income Management Company, investment fund – Neuberger Berman and Crossroads Group)<sup>26</sup>. The aggressive M&A policy boosted the share price by 150% over a period of three years. In 2005 Euromoney called Lehman Brothers “the best investment bank”.

Lehman Brothers successfully survived the doom period of the credit crunch and escaped the Bear Stearns scenario<sup>27</sup>, however in 2008 the bank was severely affected by the dramatic losses on the credit derivatives (CDO, CDS) and was forced to introduce substantial write offs in its balance sheet amounting to 2.8 billion USD in the third quarter of 2008 and began searching for an additional 6 billion USD capital<sup>28</sup>. In August 2008 Lehman announced its involvement in toxic assets estimated at 80 billion USD with the leverage ratio hitting 30:1. The long term investment known as NINJA accounted for nearly 564 billion USD and was financed by an interbank loan. The negative market reaction and increasing uncertainty affected the bank’s liquidity and drove the share price down lowering the market capitalisation of the then fourth US investment bank to 2.4 billion USD<sup>29</sup>. According to studies, despite the severe problems the bank could have been saved<sup>30</sup> as the UK Barclays Bank was ready to submit the takeover proposal while being supported by both the US and the UK governments. In light of the lack of any financial aid, after 158 years of history, on September 15, 2008 Lehman Brothers filed for bankruptcy (the file revealed 613 billion \$ debt versus 639 billion USD assets and a list of over 100,000 creditors including Citigroup and the Bank of New York Mellon) which started the downward trend on the stock market and was later declared as the official starting point of the outbreak of the financial crisis. During the bankruptcy proceedings Barclays Bank took

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<sup>26</sup> US bankruptcy Court Southern District of New York (2009), Lehman Brothers Holdings, Inc, Report of Anton Valukas, Examiner, Case No. 08-13555 (JMP), <http://www.nysb.uscourts.gov>

<sup>27</sup> Kansas D. (2009), *op. cit.*, p. 81.

<sup>28</sup> Lehman Brothers: three years of denial, <http://www.guardian.co.uk/commentisfree/cifamerica/2011/sep/12/lehmanbrothers-financial-crisis>

<sup>29</sup> Solving the Lehman insolvency, <http://www.guardian.co.uk/business/2010/sep/15/lehman-brothers-two-years-on>

<sup>30</sup> Upadek Lehman Brothers byl wypadkiem przy pracy?, [http://gospodarka.gazeta.pl/Gielda/1,85951,7034238,Upadek\\_Lehman\\_Brothers\\_byl\\_wypadkiemprzypracy\\_.html](http://gospodarka.gazeta.pl/Gielda/1,85951,7034238,Upadek_Lehman_Brothers_byl_wypadkiemprzypracy_.html)

over the American offices of Lehman Brothers, while the Asian and European branches were acquired by Nomura, the Japanese investment bank. As the analysis depicts the Lehman collapse was attributed to the fraud and misrepresentation of the factual leverage. The size of assets engaged in credit derivatives based on subprime mortgages was reported with the adoption of the so called repo 105 transaction. The repo 105 transactions which doubled between 2006 and 2008 amounted to 50 billion USD at the quarter end and were targeted at lowering the bank's leverage (lowering the assets to the equity ratio from 13.9 times to 12.1 times) for the reporting purposes<sup>31</sup>.

### 2.3. Merrill Lynch

Merrill Lynch started its operations on January 6, 1914 under the name of “Charles E. Merrill & Co.”, as founded by Charles Merrill. The name was changed into Merrill Lynch & Co. in 1915 when Edmund Lynch joined the company. The company succeeded in several investments (Pathe Exchange in 1921, Safeway in 1926) followed by significant restructuring four years later to spin off its retail brokerage business to E.A. Pierce & Co. in order to focus on investment banking<sup>32</sup>. However, due to the financial struggle of the smaller units the following years saw subsequent mergers to form Merrill Lynch, E. A. Pierce, and Cassatt in 1940. In 1952 the bank formed Merrill Lynch & Co. as a holding company and officially incorporated after nearly half a century as a partnership. In 1964 Merrill Lynch acquired C. J. Devine & Co the leading dealer in U.S. Government Securities which brought the leverage to establish money market products and government bond mutual fund products, responsible for much of the firm's growth in the 1970s and 1980s<sup>33</sup>. The bank became a publicly listed company in 1971. Over the years Merrill Lynch grew to be a prominent investment bank with the strength of its retail brokerage network which included more than 15,000 brokers and \$2.2 trillion in client assets in 2006 making it the world's largest brokerage<sup>34</sup>. However, as noted by G. Farrell “by the dawn of the 21st century, Merrill had begun to change. Instead of being a financial advisory business, which brought Wall Street to Main Street, it eventually morphed into a Wall Street investment bank, with management pursuing outsized profits in its sales and trading business.

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<sup>31</sup> Bris-May A. (2010), The Lehman Brothers case. A corporate governance failure, not a failure of financial markets, International Institute for Management Development, <http://www.imd.org/research/challenges/upload/TC039-10PDF.pdf>

<sup>32</sup> Farrell G. (2010), *Crash of the titans: Greed, hubris and the fall of Merrill Lynch and the near-collapse of Bank of America*, Crown Publishing Group, Random House, New York.

<sup>33</sup> Kansas D. (2009), *op. cit.*, pp. 84–85.

<sup>34</sup> Nestor Advisors (2009), *Governance in crisis: A comparative case study of six US investment banks*, NeAD Research Note 0109. London, pp. 5–6.

It was, of course, the reckless pursuit of profits in the fixed income markets that led to the firm's downfall"<sup>35</sup>.

Merrill Lynch was the world's largest underwriters for collateralised debt obligations (CDO) the majority of which were subprime mortgage backed securities (MBS). The excessive engagement in subprime MBS led to the dramatic announcement of a quarterly loss of 2.4 billion USD for the third quarter of 2007 and a writing off of 8.4 billion USD in assets. As for the period of 2006–2007 Merrill was the leading underwriter on CDO deals of 93 billion USD, while the total net loss for 2007 amounted to of 8.6 billion USD (following the reported profit of 2.1 billion USD for the second quarter of 2007)<sup>36</sup>. As the analysis reveals the sudden plunge was a result of wrong accounting practices since the bank did not report the actual values of its bad investments. Due to unethical accounting practices Merrill Lynch was forced to admit its internal control failures reporting quarterly losses of 9.83 billion USD in January 2008 and 1.97 billion USD losses in April 2008<sup>37</sup>. The leverage ratio was estimated at 30:1. On September 14, 2008 in order to rescue its legacy Merrill Lynch agreed to sell itself to the Bank of America for approximately \$50 billion<sup>38</sup>. Currently Merrill Lynch operates as the wealth management division of the Bank of America.

### **3. Corporate governance failures in investment banks**

The studies on the causes of the financial crisis point at various problems and inefficiencies which range from macroeconomic aspects, legal changes, inadequate quality of regulatory oversight to shortcomings of monitoring and control. Although poor corporate governance, particularly in the financial institutions, cannot be perceived as the exclusive cause of the financial crisis, its contribution remains unquestioned. The majority of the most severe inefficiencies relate to corporate governance shortcomings and poor practice opposing the commonly known and widely recognised guidelines<sup>39</sup>. Corporate governance definitions depend on the perspectives they derive from and they illustrate a wide range of approaches. In

<sup>35</sup> Farrell G. (2010), *op. cit.*

<sup>36</sup> Jo H., Durairaj V., Driscoll T., Enomoto A, Ku J. (2010), A tale of two bank mergers: A case study in corporate governance issues during acquisition, Academic and Business Research Institute (AABRI), <http://www.aabri.com/LV2010Manuscripts/LV10091.pdf>

<sup>37</sup> Internal control failure leads to \$500M loss understatement by Merrill Lynch, <http://www.corporatecomplianceinsights.com/internal-control-failure-merrill-lynch-500m-financial-restatement/>

<sup>38</sup> Sorkin A. (2008), Lehman files for bankruptcy; Merrill is sold, <http://www.nytimes.com/2008/09/15/business/15lehman.html?pagewanted=print>; Rhee R. (2010), Case study of the Bank of America and Merrill Lynch merger, University of Maryland School of Law, Working Paper no. 21, [www.ssrn.com/abstract=1579397](http://www.ssrn.com/abstract=1579397)

<sup>39</sup> Anderson R. & Associates (2010), Risk management and corporate governance, OECD.

general, corporate governance is viewed as a structure to monitor as well as to motivate executives to act in the interest of shareholders<sup>40</sup> and includes a set of control mechanisms such as boards (supervisory board or board of directors), the presence of majority shareholders, the position and role of a creditor, and broadly understood possibilities to discipline the managers by the market mechanisms, such as the stock market, market for corporate control (hostile takeovers), debt market (bonds), market for executives and business culture<sup>41</sup>. Corporate governance is defined as a “structure that is intended to make sure that the right questions get asked and that checks and balances are in place to make sure that the answers reflect what is best for the creation of long-term sustainable value”<sup>42</sup>. A similar definition perceives corporate governance as a “system by which organisations are directed and controlled and which specifies the distribution of rights and responsibilities among shareholders and managers and rules and procedures for making decisions on corporate affairs”<sup>43</sup>. The shareholder perspective rooted in the financial model of a corporation understands corporate governance as a mechanism assuring investors receive return on their investments<sup>44</sup> or as “a set of constraints that form the ex-post distribution of wealth”<sup>45</sup>. However, the growing complexity of business and the rising importance of concept such as corporate social responsibility and sustainable development emphasise the need to adopt a boarder perspective on corporate governance as the role of company and its board is not only to provide for value creation for the shareholder but also to assure for high social performance and incorporating the shareholders’ expectations into the company’s strategy and operation. Therefore, the perspective based on the social model of a corporation defines corporate governance as a structure to balance within the relations and interest fulfillment of various groups (Blair, 1999). As formulated in *Corporate Governance Principles* by the OECD (2004) “corporate governance involves a set of relationships between a company’s management, its board, its shareholders and other stakeholders. Corporate governance also provides the structure through which the objectives of the company are set, and the means of attaining those objectives and monitoring performance are determined”<sup>46</sup>. Although the literature review presents a wide range of corporate

<sup>40</sup> Wolf B. (1999), The effects of agency problems on the financial behavior, performance and efficiency of German industrial stock corporations, Peter Lang Europäischer Verlag der Wissenschaften.

<sup>41</sup> Allen F., Gale D. (2000), *Comparing Financial Systems*, the MIT Press, Cambridge, Massachusetts.

<sup>42</sup> Monks R., Minow N. (2004), *Corporate governance*, Blackwell Business.

<sup>43</sup> Ayuso S., Argandoña A. (2007), Responsible corporate governance. Towards a stakeholder boards of directors?, University of Navarra, “Working Paper”, No. 701, <http://www.iese.edu/research/pdfs/DI-0701-E.pdf>

<sup>44</sup> Shleifer, A., Vishny, R. (1997), A survey of corporate governance, “*Journal of Finance*”, 52: 737–783.

<sup>45</sup> Zingales L. (1997), *Corporate governance*, National Bureau of Economic Research, Chicago.

<sup>46</sup> OECD (2004), *Corporate governance principles*, <http://www.oecd.org/dataoecd/32/18/31557724.pdf>

governance theories and models, the shareholder approach and the principal-agent model appears to fit the best for the analysis of the investment banking sector.

The main corporate governance shortcomings depicted also in the case studies of the three analysed investment banks include<sup>47</sup>:

- The board practice – insufficient independence of board directors, their poor qualifications and inadequate board composition,
- Inefficient remuneration and alignment of incentive structures,
- Poor risk governance,
- Insufficient shareholder engagement.

### **Board practice**

Most of corporate governance studies point at the severe board failures as one of the crucial elements contributing to the collapse of the analysed investment banks. According to research the boards failed to fulfil their primary tasks of aligning the interests of the company with those of its shareholders and ensuring its objectivity for the evaluation and oversight of executive operations. The case studies of the distressed investment banks revealed several common characteristics of their boards which included:

- Combining the positions of chairman and CEO which led to the board agenda and decision process controlled fully by the CEO. The CEO dominated board lacked the required objectivity in its work. Additionally, the director appointment process proved also to be significantly influenced by the CEO which resulted in structural bias and affected the assessment as well as in the oversight over executives. For instance, Richard Fuld, the ‘over mighty’ CEO of Lehman Brothers exerted significant influence over the board work dominating its agenda and reducing the discussion and healthy debate<sup>48</sup>. The CEO tenure of the analysed banks remained significantly longer as compared to the survivors such as JP Morgan, Goldman Sachs and Morgan Stanley ranging from 4.6 for Merrill Lynch, 6.5 for Bear Stearns to 13.3 for Lehman Brothers<sup>49</sup>,

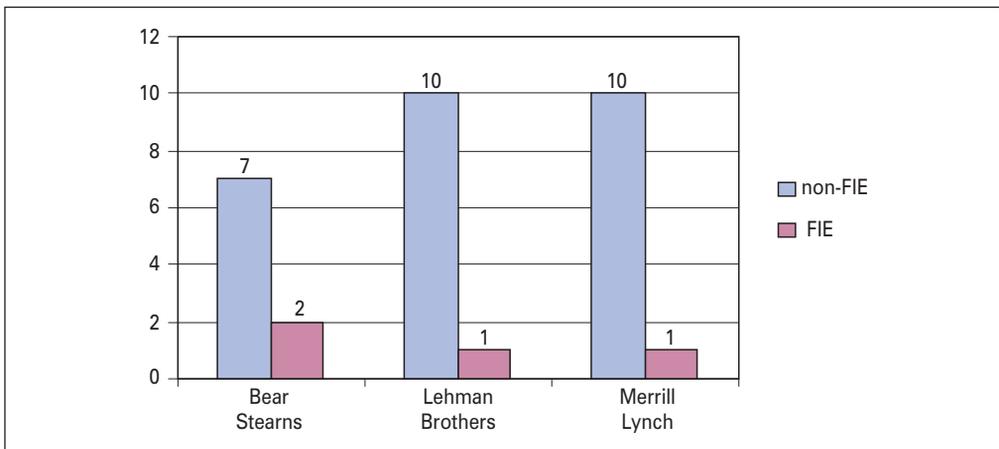
<sup>47</sup> Isaksson M. (2009), Corporate governance and the financial crisis: Questions and answers, OECD, [http://www.oecd.org/document/49/0,3343,en\\_2649\\_34813\\_43063537\\_1\\_1\\_1\\_1,00.html](http://www.oecd.org/document/49/0,3343,en_2649_34813_43063537_1_1_1_1,00.html); Kirkpatrick G. (2009), The corporate governance lessons from the financial crisis, OCED, <http://www.oecd.org/dataoecd/32/1/42229620.pdf>; Cheffins B. (2009), “Did corporate governance ‘fail’ during the 2008 stock market meltdown? The case of the S&P 500”, “The Business Lawyer”, Vol. 65, pp. 1–66.

<sup>48</sup> Arthur-Smith P. (2009), The five leadership lessons of Lehman Brothers’ demise, 21th Business Ideas, London School of Economics, <http://www.lse.lu/docs/FiveLeadershipLessonsOf%20Lehman-012509.pdf>

<sup>49</sup> Nestor Advisors (2009), *op. cit.*, p. 9.

- Inadequate composition of the board – the Nestor Advisors study cites the relatively small number of executives serving on the boards as a factor compounding the concentration of power in the CEO/chairman. Additionally, the “technical and institutional expertise may have been shallow, concentrated in the hands of a few, or lacking voice in boardroom dynamics”<sup>50</sup>. The directors lacked financial market updated knowledge and experience. The financial industry experts versus non-financial experts among non-executive directors in the three investment banks in 2007 is presented in Figure 1.

**Figure 1. The financial industry experts versus non-financial experts among non-executive directors in the three investment banks in 2007**



Source: Nestor Advisors (2009), “Governance in crisis: A comparative case study of six US investment banks”, NeAD Research Note 0109. London, p. 13.

As shown in Figure 1 the number of the financial industry experts as a percentage of non-executive directors accounted for 10–20% of the board composition for all three analysed banks<sup>51</sup>. Such boards might have had problems in understanding the increasing complexity of financial markets and new challenges related to derivatives. Moreover, on the Lehman Brothers while none of the directors performed executive function on major public corporations with all of them being into retirement within 12 years on average<sup>52</sup>. Interestingly, the average age of non-executive directors was higher in the case of the analysed banks (68 for Bear

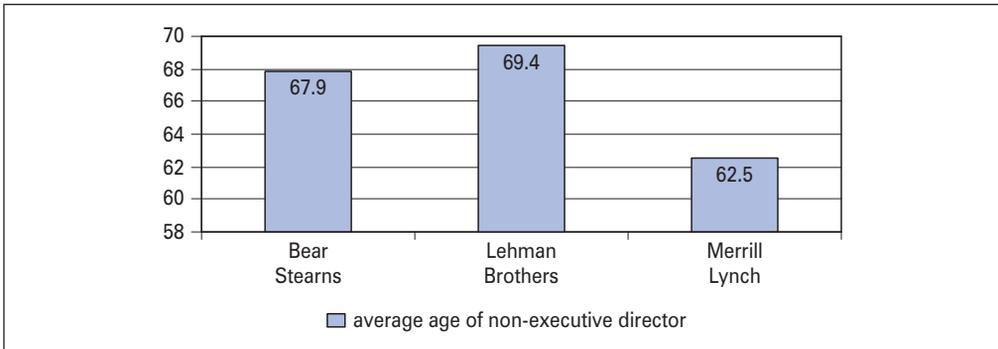
<sup>50</sup> Ard L., Berg A. (2010), Bank governance. Lessons from the financial crisis, Crisis Response – Public Policy for the private Sector, IFC, World Bank, May.

<sup>51</sup> Nestor Advisors (2009), *op. cit.*, p. 11.

<sup>52</sup> Larcker D., Tayan B. (2010), Lehman Brothers: Peeking under the board façade, Stanford Graduate School of Business, CGRP-03, [www.ssrn.com/abstract=1678044](http://www.ssrn.com/abstract=1678044)

Stearns, 69.5 for Lehman Brothers and 62.5 for Merrill Lynch) as compared with the survivors (60 for Morgan Stanley, 64 for Goldman Sachs and 60 for JP Morgan)<sup>53</sup>. Figure 2 presents the average age of non-executive directors in 2007.

**Figure 2. The average age of non-executive directors on the boards of the three investment banks in 2007**



Source: Nestor Advisors (2009), "Governance in crisis: A comparative case study of six US investment banks", NeAD Research Note 0109. London, p. 13.

- Inadequate independence of outside board directors – while many of the non-executive directors met the technical requirements for being considered independent, most of them had been serving on the board for a long time, from an average of 4 years at Merrill Lynch, 9 at Lehman Brothers to 10 at Bear Stearns. In all three cases the term of the CEO/chairman substantially exceeded that of the non-executive directors, indicating an imbalance of authority and potentially excessive sway over the appointment and turnover of board members. For instance on the Bear Stearns board four of the 13 directors were insiders and had performed this function for over two decades – James Cayne and Alan Greenberg (both since 1985), Alan Schwartz and Warren Spector (both since 1987). Moreover, most of the nine outside directors had been on the board for more than a decade including: Glickman (1985), Harrington and Nickell (both since 1993), Tese (1994), Novelty and Salerno (both since 2002) whereas only three directors had been on the board for less than five years<sup>54</sup>. Such board pattern led inevitably to networks and friendship affecting the objectivity of the directors.

<sup>53</sup> Nestor Advisors (2009), *op. cit.*, p. 13.

<sup>54</sup> Brown R. (2008), Bear Stearns, corporate governance and the capital markets: The role of the board (part 2), <http://www.theracetothetbottom.org/independent-directors/bear-stearns-corporate-governance-and-the-capital-markets-th.html>

**Executive compensation**

Executive compensation is viewed as one of the most important incentive mechanisms supporting the alignment of the interests of managers to those of shareholders traditionally and plays a crucial role in the corporate governance system. The main criticism of the analysed banks referred to the excessive level of remuneration backed with high bonuses and substantial severance packages to be awarded to senior executives (this problem is still visible in the nationalised British companies, as US TARP regulations included the renegotiation of the remuneration packages which banks covered). The corporate governance studies revealed executive compensation shortcomings with respect to not only the size but also to the structure and time line of the packages. The bonus culture in the financial sector, particularly amongst those involved in trading activities in investment banks, was perceived as a contribution to excessive risk-taking and short term orientation contributing to the outbreak of the financial crisis<sup>55</sup>. The example illustrating this executive pay pattern is delivered by the Lehman Brothers case. In 2007 Richard Fuld, the Lehman CEO, received \$34 million with his remuneration totaling \$450million over 10 years while the bank recorded losses of \$10 million with the share price falling by 95%. In 2006 only James Cayne, the CEO and Chairman, received compensation of \$33 million, of which \$17 million was a cash bonus and a year later he was awarded \$38 million while the bank went almost bankrupt and was taken over by JP Morgan. In both cases the significant proportion of the compensation was structured in the variable and short term component of bonus which amounted to 65%. Such pay pattern increased the motivation for boosting short term sales and profits shifting executive attention away from long term perspective. The remuneration practice is perceived as one of the strongest factors contributing to the corporate governance inefficiencies and public criticism as analyses depicted the lack of the alignment between the pay and corporate performance. Thus, it is difficult to find motivational functions in high bonuses paid to Lehman Brothers or Merrill Lynch managers leaving their jobs. Yet other evidence identified in the case studies of the analysed investment banks reveal a substantial differential in compensation levels between CEO pay versus the top four senior executive pay reaching the highest levels between 37% and 267% for Lehman Brothers (R. Fuld) and Merrill Lynch (S. O'Neal) between 2005 and 2007<sup>56</sup>. Interestingly however, the CEOs of the three distressed investment banks experienced large proportions of their personal wealth at risk exposure while owning banks shares. This should provide

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<sup>55</sup> House of Commons, Treasury Committee (2009), Banking Crisis: reforming corporate governance and pay in the City, Ninth Report of Session 2008–09.

<sup>56</sup> Nestor Advisors (2009), *op. cit.*, p. 18.

for the alignment with the interests of shareholders and lead to the enhancement of the company value<sup>57</sup>.

### **Risk governance and management**

The third heavily criticised area of corporate governance in the case of the analysed US investment banks which failed to provide for its oversight function was risk management and governance. The failure of risk governance is mostly tied to board level weaknesses<sup>58</sup> as the effective risk governance requires a well prepared board to form a risk management committee whose directors do possess experience and specialised knowledge in risk management and fully understand its role, needs and tasks. The study on corporate governance failures of the banks revealed however, that the board shortcomings in the process of risk governance related to the lack of understanding of their institution's risk profile and were unable to judge its appropriateness, for the following reasons<sup>59</sup>:

- the incomplete risk information and the lack of timely information transmitted to boards, leading to a false sense of security,
- a fundamental lack of expertise among non-executive directors,
- boards used by executives as a “group think” function rather than as a forum for vetting strategic risk issues,
- an overreliance on regulatory and compliance mechanisms to “catch” and report new or inappropriate sources of risk. This created a sort of “autopilot” risk mentality.

For instance, the Lehman Brothers management committee, which used to meet twice a year, was packed with directors in their 70s and 80s with no expertise in risk management and finance including a theatrical producer (Roger Berlind) and a former actress who was on the board for 18 years (Dina Merrill)<sup>60</sup>. Such a composition proved not to be very useful in the demanding market conditions. Similar flaws were noted in the case of Merrill Lynch and Bear Stearns whose risk management committee lacked finance experts<sup>61</sup>.

The second area of corporate governance inefficiencies with respect to risk management refers to the management level weaknesses as the study shows that senior management “failed to adopt and integrate the necessary systems to

<sup>57</sup> Nestor Advisors (2009), *op. cit.*, p. 19.

<sup>58</sup> Ard L., Berg A. (2010), *op. cit.*

<sup>59</sup> Ibidem; Ladipo D., Stilpon N. (2009), Bank boards and the financial crisis: A corporate governance study of the 25 largest European banks, Nestor Advisors, London.

<sup>60</sup> Gross D. (2010), Corporation killers, interview with J. Gillespie, Newsweek Magazine, <http://www.thedailybeast.com/newsweek/2010/02/02/corporation-killers.html>

<sup>61</sup> Nestor Advisors (2009), *op. cit.*, p. 16.

identify, manage, and report risk [as] the level and nature of aggregate risk arising in rapidly evolving balance sheets were not captured by systems and reports". These shortcomings led to inadequate pricing of business risk and reflection on return on risk which resulted in poor allocation of capital and liquidity problems<sup>62</sup>. As noted by Ard and Berg (2010) the main management level weaknesses lied in:

- in some cases risk measurement systems narrowly focused on readily identifiable or already recognised risks and did not conduct adequate surveillance for other, less obvious and higher-level risks<sup>63</sup>,
- risk management was generally confined to "silo" arrangements and therefore isolated along product and organisational lines<sup>64</sup>,
- risk management units lacked the visibility, stature, or independence to consolidate institution-wide risks and elevate concerns to a level sufficient to prompt a response from management and the board.

Interestingly, limitations are rooted in the one tier model particularly in the area of risk management<sup>65</sup>. The research by Brogi (2008) suggests that the two tier board is tailored to handle the risk governance and management better as it provides for its function to filter between ownership and management. Additionally, the study by Tandelilin, Kaaro, Mahadwartha and Supriyatna revealed that the crucial role of risk management, which is however tied to ownership structure that the relationships between corporate governance and risk management, and between corporate governance and bank performance are sensitive to the type of bank ownership<sup>66</sup>. As noted by the authors, ownership structure shows partial support as a key determinant of corporate governance<sup>67</sup>. The study also finds an interrelationship between risk management and bank performance. Risk management has a significant effect on bank performance and vice versa.

<sup>62</sup> Tobias A., Shin H. S. (2010), Liquidity and leverage, Federal Reserve Bank of New York Staff Reports, [http://www.newyorkfed.org/research/staff\\_reports/sr328.pdf](http://www.newyorkfed.org/research/staff_reports/sr328.pdf)

<sup>63</sup> U. K. Treasury (2009), A review of corporate governance in UK banks and other financial industry entities: Final recommendations (Walker Review), <http://www.hm-treasury.gov.uk>

<sup>64</sup> Senior Supervisors Group (2008), Observations on risk management practices during the recent market turbulence, <http://www.ny.frb.org>

<sup>65</sup> Brogi M. (2008), Regulation, corporate governance and risk management in banks and insurance companies, <http://www.actuaries.org/AFIR/Colloquia/Rome2/Brogi.pdf>

<sup>66</sup> Tandelilin E., Kaaro H., Mahadwartha P. A., Supriyatna (2007), Corporate governance, risk management and bank performance: Does type of ownership matter, "EADN Working Paper" No. 34.

<sup>67</sup> More precisely, foreign-owned banks have better implemented good corporate governance than have joint venture owned banks, state-owned banks, and private domestic-owned banks. Foreign-owned banks also incorporate significant relationship between corporate governance and risk management. Meanwhile, state owned banks underperform the other types of bank ownership in implementing good corporate governance.

### **Shareholder engagement**

The last area contributing to corporate governance failures in the analysed investment banks refers to the problem of insufficient shareholder engagement. Despite having a number of basic rights and obligations (such as the right to appoint directors, the right to make key corporate decisions, and the right to obtain information about the company, to participate in the decision making and prevent management from engaging in activities contrary to their interests) the dispersed shareholders, both individual and institutional prove to remain relatively passive in banks' governance and oversight leaving executives with significant discretion<sup>68</sup>. Investors are found to be confronted by substantial obstacles relating to the costs of their involvement (time, funds) as well as to the relatively poor efficiency of their activism. However, as it will be discussed in the next section several significant new regulations are targeting this problem.

## **4. Discussion**

The three analysed US investment banks – Lehman Brothers, Bear Stearns and Merrill Lynch lost their liquidity due to the extensive involvement in subprime mortgages financial instruments and revealed severe corporate governance failures<sup>69</sup>. The case studies depict potential areas of corporate governance inefficiencies providing valuable empirical material to formulate the essential guidelines of corporate governance practice. It is crucial to mention that the analysed US investment banks operated in the form of public listed companies and not as financial holdings and hence they were more interested in satisfying shareholder expectations for increasing share price and dividend payout, particularly since the regulatory and political environment supported by substantial lobbying activities<sup>70</sup> led to liberal conditions for the derivatives trade or hedge funds operation<sup>71</sup> which allowed increase in profitability. Additionally, the analysis of Lehman Brothers, Merrill Lynch and Bear Stearns mirrors the most problematic areas of oversight and monitoring of American listed companies. The corporate governance failures of investment banks which undoubtedly significantly contributed to the outbreak and the course of the financial crisis refers to the above presented aspects of executive compensation, board work, risk management and shareholder engagement. These corporate governance dimensions also lay

<sup>68</sup> Ard L., Berg A. (2010), *op. cit.*

<sup>69</sup> Posner R. (2010), *The crisis of capitalist democracy*, Harvard University Press, London.

<sup>70</sup> Johnson S., Kwak J. (2010), *13 Bankers. The Wall Street takeover and the next financial meltdown*, Panteon Books, New York.

<sup>71</sup> Lewis M. (2009), *The big short: Inside the doomsday machine*.

foundations for formulating some solutions which are expected to prevent the outbreaks of such crises in the future<sup>72</sup>. Hence, the presented case studies of Lehman Brothers, Merrill Lynch and Bear Stearns allow the formulation of the set of corporate governance recommendation as presented in Table 3.

**Table 3. Corporate governance guidelines – lessons from the investment banks' failures**

Area	General guidelines	Main directions
Board practice	<p>Balanced board structure with strong chairman leadership</p> <p>Strong independent director representation on board</p> <p>Increased transparency</p>	<p>Separation of CEO and Chairman functions, adopting the position of lead director where applicable</p> <p>Limitations for number of board terms/ years served on board</p> <p>Requirements with regards to directors commitment and trainings</p> <p>Board self-assessment reporting covering detailed criteria of work and performance conducted on the annual basis</p>
Executive compensation	<p>Adequate pay structure providing incentive mechanisms for executives while assuring for creation of long term sustainable shareholder value, eliminating the risk of short term orientation of executives and excessive risk activities</p>	<p>Pay</p> <ul style="list-style-type: none"> <li>• calculated on profits and by reference to other business goals</li> <li>• using a measure of risk-adjusted return to take proper account of a range of risks including liquidity risk</li> <li>• the fixed component of the remuneration package large enough to meet the essential financial commitments</li> <li>• an appropriate mix of cash and components designed to encourage corporate citizenship and alignment of interests between those of the employee and the firm (e.g. shares/ stock options)</li> <li>• a major proportion of the bonus element is deferred and a significant proportion of the deferred compensation is determined by a performance measure calculated on a moving average over a period of several years</li> </ul>

<sup>72</sup> House of Commons, Treasury Committee (2009), *op. cit.*

**continued Table 3**

<b>Area</b>	<b>General guidelines</b>	<b>Main directions</b>
Executive compensation		Bonus calculation <ul style="list-style-type: none"> <li>• risk or capital cost taken into account</li> <li>• performance to be assessed entirely on the results for the current financial year</li> <li>• adequate proportion of fixed component</li> <li>• bonuses not paid wholly in cash</li> <li>• deferral in the bonus element</li> </ul>
Risk management	Adequate composition of risk management committee  Risk management policies in place  Internal audit policies in place	Risk management committee directors with financial literacy, experience in the financial sector, having knowledge on current financial market trends and tendencies Better guidance for directors on implementing and assessing risk management and assurance frameworks  Risk management measurement and reporting  Internal audit procedures and reporting
Shareholder engagement	Increased participation in shareholder meetings, exercising rights  Increased shareholder engagement and involvement in structuring executive compensation	Adoption of IT techniques to enable GSM via Internet  Say on pay voting rule

Source: own compilation based on House of Commons (2009), Banking crisis: Reforming corporate governance and pay in the City”, London; SEC (2010), Wall Street Reform and Consumer Protection Act; Anderson R. & Associates (2010), “Risk management and corporate governance”, OECD; FRC (2010), “Implementation of the UK stewardship code”, London; U.K. Treasury. 2009, “A review of corporate governance in UK banks and other financial industry entities: Final recommendations” (Walker Review), <http://www.hm-treasury.gov.uk>

Despite the discussed possible solutions and suggested recommendations which are to guideline the companies in the area of monitoring, oversight and motivation to provide for a better alignment of the interests of senior management with the interests of their shareholders and to prevent (or at least ameliorate) the crisis, several studies indicate that the core of the problems remains

unsolved<sup>73</sup>. As noted by White (2011) “this corporate governance narrative is largely misguided and reflects an inadequate understanding of modern finance and financial theory” as the notions of limited liability assumes fulfilling the interests of diversified shareholders by encouraging senior managers to undertake greater risks than is in the interests of the corporation’s creditors (or regulators representing depositor creditors or the overall society). Hence, the investment bank strategy for fulfilling the interest of shareholder contradicts its regulatory constraints. Therefore, the suggested recommendation should provide for public policy improving the prudential regulation to restrain excessively risky activities than enhancing corporate governance, for restraining the systemically important financial institutions.

## Conclusion

The outbreak of the financial crisis which took place at the beginning of 2007 with the credit crunch and was followed by the sovereign debt of the majority of developed economies raises questions on the macroeconomic as well as systemic policies and rules and their enforcement. The long list of corporate governance shortcomings indicates the inefficiencies in a company’s control structure and motivating system. The case study approach appears to be helpful in understanding the complexity of the corporate governance failure as it allows for detailed description of individual companies and their specific problems. A great potential for the dynamics of corporate governance structure that triggered the financial crisis lies in the banking sector and the practices referring to board work and executive compensation of banks.

The paper discussed the collapses of three US investment banks – Lehman Brothers, Bear Stearns and Merrill Lynch from the perspective of their corporate governance failures. Although the presented case studies differ in terms of the course and the final results, they deliver consistent evidence with respect to control flaws. The corporate governance inefficiencies of the analysed banks which contributed to the outbreak and the course of the financial crisis refers to the crucial monitoring and incentive mechanisms of executive compensation, board work, risk management and shareholder engagement. The list of possible solutions and corporate governance guidelines although formulated and commonly recognised is supposed to improve the control and disclosure standards both in public listed

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<sup>73</sup> White L. (2011), Corporate governance and prudential regulation of banks: Is there any connection? in: Barth J., Lin Ch., Whilborg C., Research Handbook for Banking and Governance, [http://web-docs.stern.nyu.edu/old\\_web/economics/docs/workingpapers/2011/larry%20white%20wp2.pdf](http://web-docs.stern.nyu.edu/old_web/economics/docs/workingpapers/2011/larry%20white%20wp2.pdf)

companies and financial institutions. The impact of the recommendation on the quality of corporate governance and the performance of listed companies remains however an open question as it is heavily rooted in the factual adoption and practical enforcement.

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## **Methods of Increasing Bank Capital Effectiveness – part 3<sup>1</sup>**

### **1. Effective capital allocation**

The process of allocation may assume two forms<sup>2</sup>:

- passive allocation,
- active allocation.

The passive allocation is perceived as a process of assigning the available bank capital to particular activity areas (AA), connected with the evaluation of profitability of these AAs. However, without a built-in mechanism which would extort actions improving the profitability in certain areas (for example through the change in the amount of the allocated capital). In other words, the allocation in this form is connected, for example, with the mechanism of the AAs performance related bonuses. The calculated levels of profitability are only informative, not managerial. The active allocation includes a “built-in” mechanism extorting activities aimed at the improvement of the area profitability, and as a consequence, at the increase in the profitability on the scale of the whole bank. The process of allocation is connected with the evaluation of the AA profitability, and its results constitute the basis of assessment of the AA activity, and as a consequence the results determine, for example, the bonuses for the AA.

The introduction of the process of active allocation may not bring the expected effects in banks which possess capital surpluses (in such cases, it should be said that they are mismanaged institutions as they are not able to use the possessed capital resources).

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<sup>1</sup> This publication is a continuation of the article T. Cicirko: Methods of increasing bank capital effectiveness – part 1, “Journal of Management and Financial Sciences”, Volume II, SGH, October 2009.

<sup>2</sup> In practice, there is another form possible, between the passive and active allocation: the so-called semi-active allocation.

In the case of shortages of capital or its considerable limitation, one of the formulae shown below may be applied to calculate the profitability connected with the allocation of capital<sup>3</sup>:

Variant A

$$\frac{\textit{gross result}}{\textit{max[used capital; planned capital]}}$$

Variant B

$$\frac{\textit{gross result} - (\textit{surplus capital}^* \times \textit{penalty rate})}{\textit{used capital}}$$

\*) the capital surplus occurs when the used capital exceeds the planned capital,

Variant C

$$\frac{\textit{gross result} - (\textit{surplus capital}^* \times \textit{penalty rate})}{\textit{planned capital}}$$

The author considers variant C to be the most flexible formula. It combines the other presented variants A and B, which as a consequence allows for charging the AA with unused capital (denominator) and capital used in excess of plan (numerator).

This solution should discipline the AA to more accurately plan its demand for capital so that the amount of the planned capitals should be neither too low nor too high.

The bank capital management is closely connected with the bank effectiveness and risk management<sup>4</sup>. From this perspective, the introduction of the active capital allocation together with the implementation of the “double” discipline (variant C) should not reduce the planned profitability of capital, on the contrary it should improve it. However, the impact of the penalty rate on the bank profitability should be considered. The literature is silent on this point. The author’s self-designed research<sup>5</sup> in this area distinguishes three major cases:

- 1) “penalty” rate > the planned bank profitability rate,
- 2) “penalty” rate < the planned bank profitability rate,
- 3) “penalty” rate = the planned bank profitability rate.

<sup>3</sup> Cf. Ch. Matten, Zarządzanie kapitałem bankowym – alokacja kapitału i pomiar wyników (Bank capital management – capital allocation and result measurement), Dom Wydawniczy ABC, Warsaw 2000, p. 220.

<sup>4</sup> M. Iwanicz-Drozdowska, Zarządzanie finansowe bankiem (Bank financial management), PWE, Warsaw 2010, p. 212ff.

<sup>5</sup> T. Cicirko, Miary rentowności kapitałów w praktyce bankowej. Propozycje modyfikacji i zmian w modelach rentowności, Badania własne (Capital profitability measures. Modification proposals and changes in profitability models), SGH, 2009.

The research<sup>6</sup> conducted by the author indicates that the choice of the penalty rate has a considerable impact on the profitability achieved by the AA, and as a consequence the profitability of the whole organisation. For the AA, every use of capital in excess of plan, earning the yield at the level lower than the penalty interest, causes the decline in the profitability of both AA and the bank. If the capital is to allocated effectively, which as a consequence is to increase the effectiveness of the whole entity, it is necessary to introduce a solution making the penalty rate at least equal to the planned profitability of the whole bank (from the rational point of view, this rate should not be lower than the cost of the capital acquired by the bank). If the effectiveness of capital use is to be increased, it is necessary to “charge” the AAs whose planned profitability is lower than the bank’s, with the rate not lower than the planned profitability of the whole entity, whereas the AAs with a higher profitability than that planned for the whole bank, with the rate not lower than the planned profitability of the given AA. The AAs which want to avoid the decline in their planned profitability, should invest in an additional capital only in these activities which could earn the rate of return not lower than the planned profitability rate of the whole bank. In consequence, there would be an increase in the profitability of the AA as well as the whole bank.

It should be emphasised here that there is a particular significance attached to the bank structure perceived as the sum of individual activity areas with different profitability within the whole bank activity.

## **2. Reallocation capital model**

### **2.1. Introduction**

The extension of the effective capital allocation is the so-called reallocation, i.e. the conducting of another (additional) allocation of capital during the fiscal year.

The solution presented below in an innovative approach to the question of reallocation. The author suggests that the reallocation should be conducted when there are some activity areas (organisational units, business lines, departments etc.) possessing unused capital, and on the other hand some entities using capital in excess of the planned level. The capital reallocation, with certain conditions to be fulfilled (e.g. see the assumption for the model presented below), allows for the transfer of the unused capital to the areas suffering from its shortages. This solution reduces the growing capital base by the unused part. In other words, the

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<sup>6</sup> T. Cikirko, *Miary rentowności kapitałów w praktyce... (Capital profitability measures in practice...), op. cit.*

entity is not forced to raise the capital base by the excess amount (the sum of used capitals in excess of plan), only by the excess amount reduced by the unused sum. The application of reallocation brings the best effects when the capital limits are imposed on the bank or when the increase in the capital base is becoming difficult and costly (e.g. in the period of the present financial crisis). It is not necessary to reduce business in the activity areas exceeding the use of budgeted capital.

## 2.2. Reallocation model assumptions

During the year, or individual periods (quarters – Q) there is an AA (e.g. a department, a business line, an organisational line, a branch etc.) possessing the excess capital (i.e. an AA using less capital than assumed in the plan), and an AA indicating a shortage of capital (i.e. an AA using less capital than assumed in the plan).

The reallocation of the capital should be conducted after fulfilling jointly the following conditions:

- the AA which in a certain period indicated the use of capital below the planned amount accepts the reallocation, i.e. voluntary transfer of capital to another AA. It reduces the planned capital amount and at the same time the profitability indicator of the AA transferring the capital in on the rise,
- in a given period another AA indicated the use of capital in excess of the planned amount.

The capital reallocation is not conducted when the AA possesses unused capital and agrees to abandon it, but there are no AAs to have used the capital in excess of the budgeted level.

The transfer of capital between areas requires the determination of the order of activities on both parts. In the case of several AAs with unused capital, the author suggests three solutions:

- I. the capital is collected from the AAs in the following order: at first from the AA with the lowest planned ROC to the AA with the highest planned ROC,
- II. the capital is collected from the AAs in the following order: from the AA with the highest RoC to the AA with the lowest planned ROC,
- III. the capital is collected from the AAs in a proportionate way, i.e. in the way depending on the share of the shortage of the given AA in the total capital shortage.

The order of capital collection does not affect the profitability on the bank scale, it only determines the profitability of individual AAs. The choice of one

of the presented solutions depends on the preferences of the bank management in relation to the individual areas. The author considers the last solution to be the fairest.

The identical dilemma should be solved with reference to the order of AAs which receive the capital. In such a case, one of the aforementioned solutions may be used by analogy.

### 2.3. Practical aspects of the capital reallocation model

Selected numerical simulations illustrating the reallocation of capital are shown below.

The general assumptions of the simulations:

- AA annual result is evenly divided into quarters (result Q = 1/4 of annual result),
- a similar assumption refers to the level of used capital in the given quarter (used capital in the given Q = 1/4 of the annual capital),
- when there is one AA which shows a shortage and one with an excess, it is not important which capital allocation method is used (the order of collection and receipt).

#### Simulation 1<sup>7</sup>

(one AA indicates unused capital, one AA indicates a shortage)

Financial data<sup>8</sup>:

**Table 1.**

Plan Q	OD 1	OD2	OD3	OD4	BANK
Gross result	100	400	500	1000	2000
Capital (C)	1000	2000	2000	3000	8000
ROC	10.00%	20.00%	25.00%	33.33%	25.00%
Used Q					
Gross result	95	440	500	1000	2035
Capital (C)	800	2200	2000	3000	8000
Deviation from the capital plan (C)	-200	200	0	0	0
ROC implementation	11.88%	20.00%	25.00%	33.33%	25.63%
ROC* before reallocation	9.50%	19.50%	25.00%	33.33%	

ROC\* – profitability calculated according to variant C

<sup>7</sup> Own materials.

<sup>8</sup> ROC\* – profitability calculated according to variant C – see point 1 of the present study.

Table 2.

REALLOCATION of capital					
acc. to A	OD 1	OD2	OD3	OD4	BANK
Capital plan (C) after reallocation	800	2200	2000	3000	8000
Deviation from the capital plan (C)	0	0	0	0	0
ROC* after reallocation	11.88%	20.00%	25.00%	33.33%	25.63%

REALLOCATION of capital					
acc. to C	OD 1	OD2	OD3	OD4	BANK
Capital plan (C) after reallocation	800	2200	2000	3000	8000
Deviation from capital plan (C)	0	0	0	0	0
ROC* after reallocation	11.88%	20.00%	25.00%	33.33%	

ROC\* – profitability calculated according to variant C

In simulation 1 there is an assumption that AA 1 did not use 200 capital units, whereas AA 2 consumed 200 capital units in excess of plan. Calculating ROC based on the implementation data the following levels of profitability are obtained: in AA 1 ROC = 11.88% (10% above the planned value), in AA 2 ROC = 20% (the plan was implemented). However, the calculation of the profitability including the capital budget and the charge for exceeding it indicates that AA 1 showed the profitability of only 9.50%, and AA 2 19.50%. As a result of the conducted reallocation, there is a plan reduction by AA 1 (from 1000 to 800 units), which allows for the increase in ROC\* up to 11.88%. The reallocation also changes the AA 2 budget (from 2000 to 2200 units) and in this way the plan of capital use has not been exceeded and the penalty charge avoided – ROC\* grows from 19.50% up to 20.00% (the profitability plan is implemented). The transfer of capital from AA 1 to AA 2 (on mutual consent) confirms that AA 1 does not plan to consume the unused capital this year. This allows for the resignation from actions to increase the capital base by the excess amount by AA 2 in order to maintain the solvency ratio at the unchanged level. Thus, the bank does not incur any additional costs due to the increase in the capital base by 200 capital units.

The reallocation of capital in the case of on AA with a shortage and one AA with a capital surplus brings identical results for both solutions A and C.

**Simulation 2<sup>9</sup>**

(one AA shows unused capital, two AAs show a shortage)

Financial data<sup>10</sup>:

**Table 3.**

<b>Plan Q</b>	<b>OD 1</b>	<b>OD2</b>	<b>OD3</b>	<b>OD4</b>	<b>BANK</b>
Gross result	100	500	400	1000	2000
Capital (C)	1000	2000	2000	3000	8000
ROC	10.00%	25.00%	20.00%	33.33%	25.00%
<b>Used Q</b>					
Gross result	100	500	490	1175	2265
Capital (C)	800	2000	2100	3225	8125
Deviation from plan C	-200	0	100	225	125
ROC implementation	12.50%	25.00%	23.33%	36.43%	27.88%
ROC* before allocation	10.00%	25.00%	23.25%	36.67%	27.922%

**Table 4.**

<b>REALLOCATION of capital</b>					
<b>acc. to A</b>	<b>OD 1</b>	<b>OD2</b>	<b>OD3</b>	<b>OD4</b>	<b>BANK</b>
Capital plan (C) after reallocation	800	2000	2000	3200	8000
Deviation from plan C	0	0	100	25	125
ROC* after reallocation	12.50%	25.00%	23.25%	36.46%	27.92%

<b>REALLOCATION of capital</b>					
<b>acc. to C</b>	<b>OD 1</b>	<b>OD2</b>	<b>OD3</b>	<b>OD4</b>	<b>BANK</b>
Capital plan (C) after reallocation	800	2000	2089	3200	8089
Deviation from plan C	0	0	11	25	36
ROC* after reallocation	12.50%	25.00%	23.32%	36.46%	27.89%

There is an assumption made in the simulation 2 that AA 1 did not use 200 units of capital, whereas AA 3 consumed 100 units in excess of the plan, and AA 4 consumed 225 units in excess of the plan. Calculating ROC based on the implementation data the following levels of profitability were obtained: in the AA 1 ROC = 12.5%, in the AA 3 ROC = 23.33%, and in the AA 4 ROC = 36.43% (the plan was exceeded in every AA). However, the calculation

<sup>9</sup> Own materials.

<sup>10</sup> ROC\* – profitability calculated according to variant C – see point 1 of the present study.

of profitability including the capital budget as well as the excess charge indicates that AA 1 showed a profitability of 10.00%, and AA 3 and AA 4 23.5%, and 36.67% respectively. As a result of the reallocation, the plan of use is reduced by AA 1 (from 1,000 – 800, which allows for the increase of the ROC\* level to 12.50% (irrespective of the variant of reallocation: A or C). The reallocation also changes the AA 3 budget, but only in variant C (from 2000 to 2089 units); it raised the ROC\* up to 23.32%. In variant A of the reallocation, the ROC\* amounts to exactly the same as before the reallocation (the plan of capital use did not change). The transfer of capital from AA 1 to AA 4 (in both variants: A and C) does not change the profitability change: it is a result of the additional capital investment in the activity earning the return equal to the penalty rate.

The reallocation allows the bank not to undertake actions to increase the capital base by the excess amount of 325 capital units, only by 125. Thus, the bank incurs lower costs related to the increase in the capital base not reducing its profitability.

### Simulation 3<sup>11</sup>

(two AAs show unused capital, one shows a shortage)

Financial data<sup>12</sup>:

**Table 5.**

<b>Plan Q</b>	<b>OD 1</b>	<b>OD2</b>	<b>OD3</b>	<b>OD4</b>	<b>BANK</b>
Gross capital	100	500	400	1000	2000
Capital (C)	1000	2000	2000	2500	7500
ROC	10.00%	25.00%	20.00%	40.00%	26.67%
<b>Used Q</b>					
Gross capital	100	550	400	1000	2050
Capital (C)	800	2200	1900	2500	7400
Deviation from plan C	-200	200	-100	0	-100
ROC implementation	12.50%	25.00%	21.05%	40.00%	27.70%
ROC* before reallocation	10.00%	22.50%	20.00%	40.00%	

<sup>11</sup> Own materials.

<sup>12</sup> ROC\* – profitability calculated according to variant C – see point 1 of the present study.

**Table 6.**

<b>REALLOCATION of capital</b>					
<b>acc. to A</b>	<b>OD 1</b>	<b>OD2</b>	<b>OD3</b>	<b>OD4</b>	<b>BANK</b>
Capital plan (C) after reallocation	800	2200	2000	2500	7500
Deviation from plan C	0	0	-100	0	-100
ROC* after reallocation	12.50%	25.00%	20.00%	40.00%	

<b>REALLOCATION of capital</b>					
<b>acc. to C</b>	<b>OD 1</b>	<b>OD2</b>	<b>OD3</b>	<b>OD4</b>	<b>BANK</b>
Plan of capital (C) after reallocation	867	2200	1933	2500	7500
Deviation from plan C	-67	0	-33	0	-100
ROC* after reallocation	11.54%	25.00%	20.69%	40.00%	

Simulation 3 assumes that AA 1 did not use 200 and AA 3 100 capital units, and AA 2 consumed 200 capital unit in excess of plan. Calculating ROC based on the implementation data the following profitability levels are obtained: in AA 1 ROC = 12.5%, in AA 3 ROC = 21.05%, and in AA 2 ROC = 25.00% (the plan was implemented in AA 2, and exceeded in AA 1 and AA 3). However, the calculation of profitability including the capital budget and excess charge indicates the profitability of AA 1 at the level of 10.00%, and AA 2 and AA 4 22.50%, and 20.00% respectively. As a result of reallocation the plan of use is reduced by AA 1 from 1000 units to 800, which allows for the increase in ROC\* up to 12.50% (in variant A of reallocation), or from 1000 to 867 units earning profitability at the level of 11.54%. Reallocation also changes the budget of AA 3, but only in variant C (from 2000 to 1933 units) – ROC\* rose to 20.69%. In AA 2 in variant A and C of reallocation, ROC\* accounts for exactly the same: 25.00% and is by 2.50 percentage points higher than before the reallocation.

Simulation 4 assumes that AA 1 and AA 3 did not use 200 capital units each, and AA 2 consumed 200 and AA 4 150 capital unit in excess of the plan. Calculating ROC based on the implementation data the following profitability levels are obtained: in AA 1 ROC = 12.5%, in AA 3 ROC = 22.22%, and in AA 2 ROC = 25.00% and in AA 4 ROC = 33.33% (the plan was implemented in AA 2 and AA 4, and exceeded in AA 1 and AA 3). The calculation of profitability including the capital budget and excess charge indicates the profitability of AA 1 at the level of 10.00%, AA 2 – 22.50%, AA 3 – 20.00% and AA 4 – 32.78%. As a result of the reallocation of capital according to variant A the profitability of all AAs improves, with unused capital that could not be used to charge AA 3. The profitability after

reallocation is lower than the profitability based on implementation values but higher than ROC before the reallocation. The reallocation of capital according to variant C charges AA 1, 3 and 4 with the costs of unused capital, whereas the costs of its consumption in excess of plan charge AA 3.

### Simulation 4<sup>13</sup>

(two AAs show unused capital, two AAs show shortages)

**Table 7.**

<b>Plan Q</b>	<b>OD 1</b>	<b>OD2</b>	<b>OD3</b>	<b>OD4</b>	<b>BANK</b>
Gross result	100	500	400	1000	2000
Capital (C)	1000	2000	2000	3000	8000
ROC	10.00%	25.00%	20.00%	33.33%	25.00%
<b>Used Q</b>					
Gross result	100	550	400	1050	2100
Capital (C)	800	2200	1800	3150	7950
Deviation from plan C	-200	200	-200	150	-50
ROC implementation	12.50%	25.00%	22.22%	33.33%	26.42%
ROC* before reallocation	10.00%	22.50%	20.00%	32.78%	

**Table 8.**

<b>REALLOCATION of capital</b>					
<b>acc. to A</b>	<b>OD 1</b>	<b>OD2</b>	<b>OD3</b>	<b>OD4</b>	<b>BANK</b>
Capital plan (C) after reallocation	800	2200	1850	3150	8000
Deviation from plan C	0	0	-50	0	-50
ROC* after reallocation	12.50%	25.00%	21.62%	33.33%	
<b>REALLOCATION of capital</b>					
<b>acc. to C</b>	<b>OD 1</b>	<b>OD2</b>	<b>OD3</b>	<b>OD4</b>	<b>BANK</b>
Capital plan (C) after reallocation	825	2175	1825	3175	8000
Deviation from plan C	-25	25	-25	-25	-50
ROC* after reallocation	12.12%	24.71%	21.92%	32.55%	

To sum up the aforementioned simulations, it should be said that the reallocation positively affects the profitability of all the bank units, its scale depending on the capital re allocation variant used. The decision on the variant

<sup>13</sup> Own materials.

to be applied should be made by the bank management bearing in mind the preferences of all AAs. The advantage for the whole bank is obvious, i.e. it does not have to increase the capital base in order to maintain the solvency ratio at the required level.

Apart from all the advantages, the reallocation has some disadvantages as well. First of all, the periodical (quarterly) plan verification is to be mentioned. The author thinks that this task is too labour-consuming to be conducted four times a year as it is connected with the adjustment of financial plans. It should be remembered that every change has to be approved by the bank supervising bodies, i.e. the supervisory council. Furthermore, the plans are made by operational units, which may unfavourably affect the implementation of their operating activity (sales). The reallocation conducted in the middle of the year while updating the plans of the current fiscal year seems to be an optimal solution.

The general capital allocation principle, the active allocation in particular, is the assignment of such an amount of capital to the respective activity areas (organisational units) that the relation between the activity and the capital requirement is reflected in the most realistic way. This principle is fulfilled thanks to the capital allocation in the areas which through their activities and decisions are able to fully affect and manage the position generating the broadly perceived capital requirements (both RC and IC). Thus, capital should not be allocated to other AA lines which are not able to manage the position generating the capital requirements as the impact on the level of profitability is not possible.

With reference to the profitability calculation based on the allocated internal capital, it should be remembered that an AA cannot be expected to achieve the profitability equal to the bank expected profitability. Due to the fact that the whole capital covering all essential risks (IC) is not always allocated in the AA, it is necessary to rescale the required profitability ratio at particular levels so that the bank profitability could achieve the desired and expected level by the owners and investors. The respectively higher rates of return should be expected from AA. In other words, the bank profitability should be rescaled into the AA profitability, appropriately increasing it: capital in the denominator is higher than the sum of denominators of individual AAs.

The simulations in the last section concerning the innovative approach to increasing effectiveness of capitals used by banks are an element of the research conducted by the author on a broader scale. This study quotes only a selected element in order to indicate the directions of activity undertaken by banks in recent years. The indicated solutions may be used especially in the case of the imposition on the bank capital limits and restrictions as a result of the present financial crisis. The shift of the unused budgeted capital between AAs allows banks

to increase the capital base only by the difference between the excess amount and unused amount. This solution saves the capital, which in the author's opinion became a limited and costly product in the period of crisis.

The research questions asked at the beginning of this study have been verified and it may be certainly said that:

- the evaluation of the profitability of own capital based on RORC or ROIC may provide false information on the profitability of the entity's organisational units,
- the ROC evaluation model considering the effective allocation may become an element which effectively increases the use of corporate capital.

### **3. Effectiveness measurement integrated model**

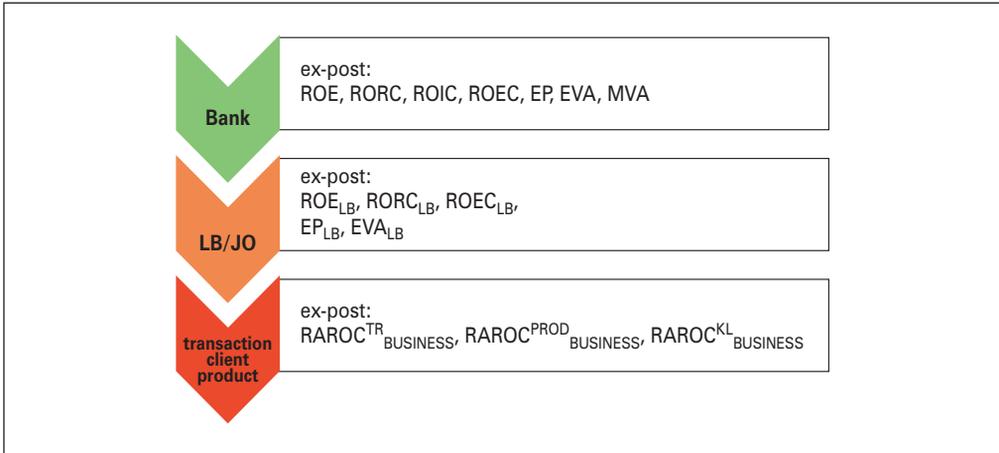
The effectiveness measurement integrated model should complement the bank capital management policy. The policy should be oriented at the optimisation of the rate of return on capital, which will allow for the creation of a stable base to increase the existing bank capital base in the following periods of operation. The implementation of this goal has to be conducted with the simultaneous control and retention of the solvency ratio at the level ensuring the appropriate capital adequacy.

The integrated model of effectiveness measurement should be multi-level and multi-tool. It is possible thanks to the implementation of the process of consumption measurement and capital effectiveness at every important organisational and structural level by means of appropriately selected tools. The model implementation should be used to introduce the specified responsibility for the generated effectiveness indicators. The proper instrument to be used is the application of the key performance indicators (KPI). The delegation of responsibility to the suitable staff for the amount of return on capitals calculated at different levels (from a transaction to the bank) improves the efficiency of capital management in the institution and disciplines the activity areas the effective use of capital.

The integrated model should also be a multi-phase tool assuming its permanent development to enable the application of more and more precise methods of effectiveness measurement with the simultaneous adjustment of tools to the current needs and technical possibilities of the bank. A three-stage model, graphically presented in Figure 1, may be proposed.

The model presented above imposes the duty of calculation of effectiveness measures based both on own, regulatory and internal capital or selected components

**Figure 1. Integrated effectiveness measurement model – overview drawing**



where:

ROE – own capital profitability,

RORC – regulatory capital profitability,

ROIC – internal capital profitability,

ROEC – economic capital profitability,

EP – economic profit,

EVA – economic value added,

MVA – economic value added,

LB – business line (activity segment),

JO – organisational unit (e.g. department or office),

$RAROC^{TR}_{BUSINESS}$ ,  $RAROC^{PROD}_{BUSINESS}$ ,  $RAROC^{KL}_{BUSINESS}$  – risk adjusted capital profitability calculated respectively at the level of transaction, product or client (the capital may be both regulatory and economic capital or individual components of these capitals).

Source: own material.

of these capitals. Depending on the level of model and measure, the calculation is made in an ex-post as well as ex-ante account. A detailed list of effectiveness measures at different levels of the model is presented in Table 9.

In the calculation of the profitability level (e.g. on transaction) the achieved result is compared with the capital most frequently covering the credit risk. The transition to a higher level of allocation (the client level) is the reason why in the denominator there may additionally appear e.g. the capital on account of market risk generated by the remaining client transactions. The achievement of the highest level of allocation (bank level) leads to the situation when in the denominator of the profitability ratio there is a cumulated capital to cover all risks to be covered by this type of capital. In the case of regulatory capital it

is the capital to cover credit, market and operating risk, whereas in the case of internal capital all risks identified by the bank are secured.

**Table 9. Effectiveness measurement integrated models measures**

Measurement level	Measurement tool	Capital (risks)	Time
Bank	ROC	Own capital Regulatory capital Internal capital	<i>ex-post</i>
	EP	Own capital	
	EVA	Own capital	
	MVA	Own capital	
Business line, organisational unit	ROC	Own capital Regulatory capital Economic capital	<i>ex-post</i>
	EP	Own capital	
	EVA	Own capital	
Client	$RAROC_{BUSINESS}$	Capital requirement for credit and market risk Economic capital to cover credit and market risk	<i>ex-post, ex-ante</i>
Product	$RAROC_{BUSINESS}$	Capital requirement for credit and market risk Economic capital to cover credit and market risk	<i>ex-post</i>
Transaction	$RAROC_{BUSINESS}$	Capital requirement for credit and market risk Economic capital to cover credit and market risk	<i>ex-post, ex-ante</i>

Source: own material.

This relation may be used in the process of price management (pricing), i.e. when determining the optimum level of prices for a given product, client, transaction etc.). Table 10 presents results, regulatory capitals at the level of the bank, business lines, products, clients and individual transactions.

**Table 10. Regulatory capital profitability calculated at different business levels**

		Bank														
		LB 1									LB 2					
		Total	Client 1			Total	Client 2			Client 3			Total	Prod. 1	Prod. 2	Prod. 3
			Amount	TR 1	TR 2		TR 3	TR 1	TR 2	TR 1	TR 2	TR 3				
Result	3000	1 150	690	120	270	300	400	190	210	60	60	1 850	500	600	750	
RC	12 900	4 660	2 850	350	1 070	1 430	1 660	1 100	560	150	150	8 240	2 550	2 570	3 120	
CR	9 800	3 900	2 300	200	900	1 200	1 500	1 000	500	100	100	5 900	1 850	1 950	2 100	
MR	2 000	-	-	-	-	-	-	-	-	-	-	2 000	600	500	900	
OR	1 100	760	550	150	170	230	160	100	60	50	50	340	100	120	120	
WNIP	2 000	767	460	80	180	200	267	127	140	40	40	1 233	333	400	500	
RORC (incl. wmp)	20.1%	21.2%	20.8%	27.9%	21.6%	18.4%	20.8%	15.5%	30.0%	31.6%	31.6%	19.5%	17.3%	20.2%	20.7%	
RORC	23.3%	24.7%	24.2%	34.3%	25.2%	21.0%	24.1%	17.3%	37.5%	40.0%	40.0%	22.5%	19.6%	23.3%	24.0%	
RORC CR	30.6%	29.5%	30.0%	60.0%	30.0%	25.0%	26.7%	19.0%	42.0%	60.0%	60.0%	31.4%	27.0%	30.8%	35.7%	
Difference: RORC (incl. wmp) - RORC CR	10.5%	-8.3%	-9.2%	-32.1%	-8.4%	-6.6%	-5.9%	-3.5%	-12.0%	-28.4%	-28.4%	-11.8%	-9.7%	-10.6%	-15.0%	
Difference: RORC (incl. wmp) - RORC	-3.1%	-3.5%	-3.4%	-6.4%	-3.6%	-2.6%	-3.3%	-3.3%	-7.5%	-8.4%	-8.4%	-2.9%	-2.3%	-3.1%	-3.3%	

Source: own material.

where:

- RORC CR = RORC<sub>EX-ANTE</sub> BUSINESS – profitability of transaction, client etc. based on the capital requirement for credit risk,
- RC – regulatory capital (total capital requirement),
- CR – capital requirement for credit risk,
- MR – capital requirement for market risk,
- OR – capital requirement for operating risk,
- WNIP – intangible assets.

Applying the integrated model of effectiveness measurement the regulatory capital profitability calculation (RORC) was made at the indicated levels. The return on regulatory capital on account of credit risk  $RORC_{CR}$  (on the capital requirement generated by the given transaction, product etc.) was also calculated. The link between the aforementioned profitability measures allows for the application of this causality in the decision making and planning process. If the return on regulatory capital of 20.1% at the bank level is to be achieved, with the expected (weighted) structure of sales, capital requirements, it should be assumed that the return on the transaction of client 3 calculated as  $RORC^{TR}_{EX-ANTE\ BUSINESS}$  has to amount at least 31.6%. By analogy, the return calculated on client 2 ( $RORC^{KL}_{EX-ANTE\ BUSINESS}$ ) has to amount to 20.8%, with the profitability of individual transactions at the level of 15.5% and 30.0% respectively. In other words, the seller may be imposed with the duty of generating a minimum return of client of every transaction, which is to guarantee the achievement of the expected rate of return at the bank level. In order to set a minimum return on client, transaction etc., In order to determine a minimum return on client, transaction etc., it is necessary to apply a scaling factor, i.e. the factor which determines the relation of profitability at the transactional level (based on the requirement for credit risk) with the profitability at the bank level (based on the total capital requirement). The scaling factor may be calculated in two ways for two different purposes, which is presented in the example below.

$$RORC^{TR}_{EX-ANTE\ BUSINESS} = RORC_{BANK} \times W^{Result}_{scaling} \times W^{RC}_{scaling}$$

where:

$RORC^{TR}_{EX-ANTE\ BUSINESS}$  – expected profitability of capital requirement for credit risk at the transactional level (*ex-ante*),

$RORC_{BANK}$  – profitability of regulatory capital at the bank level,

$W^{Result}_{scaling}$  – scaling factor based on result,

$W^{RC}_{scaling}$  – scaling factor based on regulatory capital,

$W_{TR}$  – result at the transactional level,

$W_{BANK}$  – result at the bank level,

$RC^{TR}_{CR}$  – regulatory capital on account of credit risk at the transactional level,

$RC_{BANK}$  – regulatory capital at the bank level.

Knowing the initial parameters, i.e. the expected result, budgeted regulatory capital (divided into individual components) and return on capital, it is possible to rescale the profitability from the bank level to the “business” profitability. This means that it is possible to determine the average weighted profitability to be obtained from every transaction, see Table 12.

**Example**

Table 11 includes the sales plan and results at the selected levels of the bank business structure.

**Table 11. Profitability of regulatory capital calculated for the bank, business line and clients**

	Bank			
	Total	LB 1		
		Amount	Client 1 Total	Client 2 Total
Result	1 190	1 190	690	500
RC	4 510	4 510	2 850	1 660
CR	3 800	3 800	2 300	1 500
MR	–	–	–	–
OR	710	710	550	160
WNIP	2 000	1 832	1 160	672
RORC (incl. wnip)	18.28%	18.76%	17.21%	21.44%

Source: own material.

Abbr. see Table 10.

**Table 12. Results, profitability at the transactional level**

	Transaction with client X
Result	690
RC	2 850
CR	2 300
MR	–
OR	550
RORC (with WNIP)	24.21%
RORC <sub>BANK</sub> = 26.39%	
RORC CR	?

Source: own material.

Symbols as in Table 10.

Assuming that in the future transactions will be concluded only with client X, the average weighted return on RC<sub>CR</sub> has to amount to 30% in order to achieve the RORC of 26.39% at the bank level.

On the basis of scaling indicators it is possible to effect re-scaling including the intangible assets in the calculations.

**Table 13. Profitability of regulatory capital calculated for the bank, business line and clients**

	Bank			
	Total	LB 1		
		Amount	Client 1 Total	Client 2 Total
Result	1 190	1 190	690	500
RC	4 510	4 510	2 850	1 660
CR	3 800	3 800	2 300	1 500
MR	–	–	–	–
OR	710	710	550	160
WNIP	2 000	1 832	1 160	672
RORC (incl. wnip)	18.28%	18.76%	17.21%	21.44%

Source: own material.  
Symbols as in Table 10.

Taking into consideration the deliberations in the area of profitability measurement at the lowest levels: in both ex-post and ex-ante account.

**Table 14. Profitability of regulatory capital calculated for the bank, business line and clients**

	Bank			
	Total	LB 1		
		Amount	Client 1 Total	Client 2 Total
Result	1 190	1 190	690	500
RC	4 510	4 510	2 850	1 660
CR	3 800	3 800	2 300	1 500
MR	–	–	–	–
OR	710	710	550	160
WNIP	2 000	1 832	1 160	672
RORC (incl. wnip)	18.28%	18.76%	17.21%	21.44%
<b>RORC</b>	<b>26.39%</b>	<b>26.39%</b>	<b>24.21%</b>	<b>30.12%</b>
RORC CR	31.32%	31.32%	30.00%	33.33%
<b>Difference: RORC (incl. wnip) – RORC CR</b>	<b>–13.04%</b>	<b>–12.55%</b>	<b>–12.79%</b>	<b>–11.89%</b>

Source: own material.  
Symbols as in Table 10.

#### **4. “Capital bank” concept**

An alternative solution to all the presented tools increasing the effectiveness of capital management is a complex and integrated mechanism based on the concept of the “capital bank.” This mechanism fulfils the bank requirement in the area of business decision making, being an element of the motivational system and constituting the basis for the used capital effectiveness measurement, simultaneously controlling the bank capital adequacy.

The concept of the “capital bank” is a system of internal calculations on the basis Capital Transfer Prices (CTP). Through the establishment of a special central unit to manage the bank capital, the mechanism is to ensure:

- expected level of the bank capital adequacy,
- effective and optimal use of the capital available in the bank by the business units,
- effectiveness measurement and analysis.

The idea of the CTP concept is close to the internal calculations based on fund transfer rates. However, in this case it is concerned with the capital issues related to the capital adequacy the bank wants to ensure. The object of calculation may be regulatory funds, regulatory capital, internal capital and own capital.

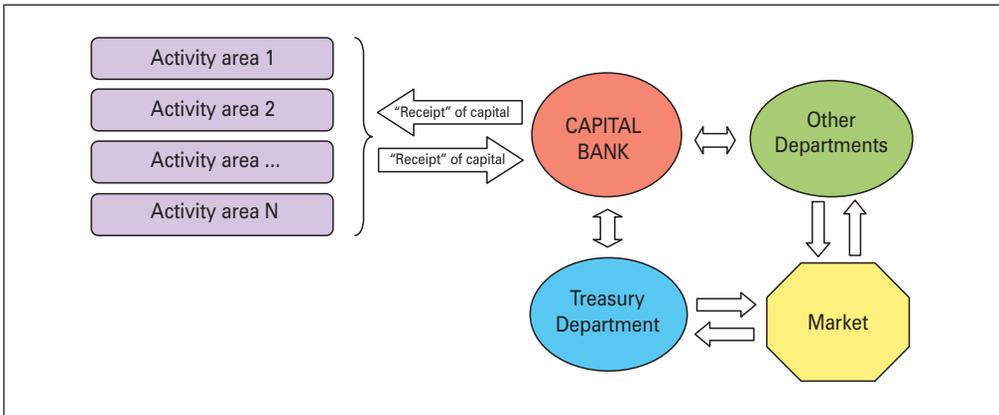
The basic assumption of the CTP concept is the creation of a bank central unit (department) which would combine the financial aspects (including capital planning, the allocation of capital, or used capital effectiveness measurement) and managerial (including bank activity management through capital management). This unit, called Capital Bank (Bank Kapitału – BK), would perform an advisory role in relation to the bank management and would recommend activities concerned with the maintenance of optimal structure of capitals and increasing the effectiveness of the available capital.

The BK’s main goal will be to supervise and control capital transfers between the internal units and external capital providers.

The process of internal settlements based on capital transfer rates is a cyclical activity including three stages:

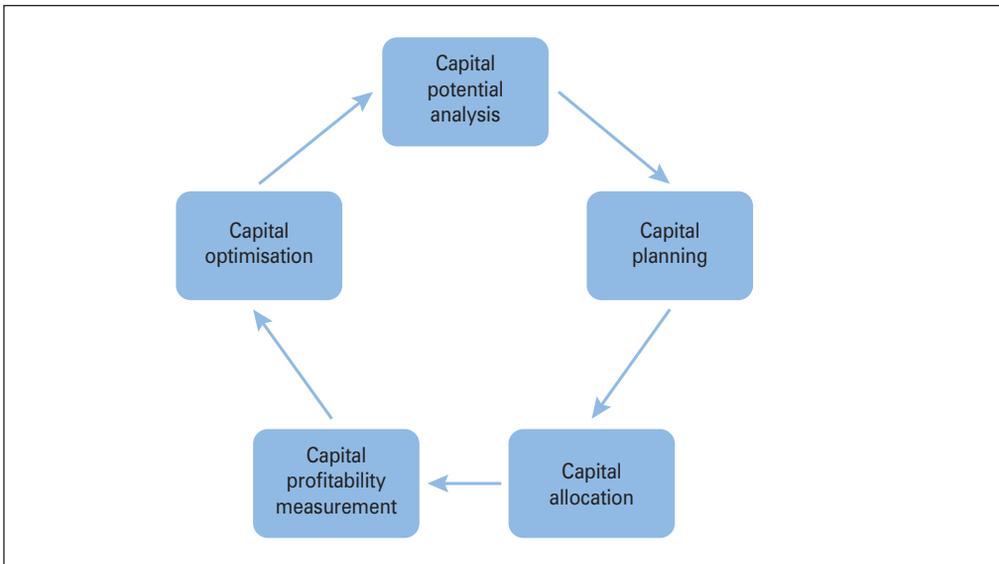
- 1) capital potential analysis,
- 2) capital planning,
- 3) capital allocation,
- 4) capital profitability measurement,
- 5) capital optimisation.

**Figure 2. The process of internal settlements based on capital transfer prices**



Source: own material.

**Figure 3. Stages of the internal calculation process**



Source: own material.

**Re: 1**

The analysis of the capital potential is conducted by the Capital Bank in cooperation with other bank units, in particular the Treasury Department and is aimed at:

- a) determination of the available capital level,
- b) potential extension of sources of own regulatory funds,

**Re: 2**

The process of capital planning is an element of an annual financial planning. Profit units plan business parameters such as the credit portfolio structure or the exposure amount that serve the purpose of calculation of the capital requirement value and internal capital. The planning process includes an element of negotiations between the sales units, the budgeting unit and the Capital Bank. The parties involved have to reconcile their interests, i.e. the feasibility of sales and their impact on the bank result with the maintenance of the proper level of capital security. The planning unit verifies sales values in relation to the market reality, follows the bank management's expectations of the result, and in cooperation with the BK guarantees planning of the required rate on return (for example ROE).

**Re: 3**

The financial plan accepted by the management is the basis for the allocation in profit units of the regulatory capital, internal capital, regulatory funds of bank own capital. The capital values will constitute basis for the implementation of the next stage, i.e. effectiveness measure. The allocation methods presented in this article are to be used at this stage.

**Re: 4**

The Capital Bank, i.e. a financial division unit, evaluates the effectiveness of the budgeted capital, analyses possible deviations from the plan, makes short-term capital forecasts including several scenarios, e.g. optimistic, realistic and the so-called black scenario, in other words, there is monitoring of the plan implementation and the level of capital adequacy (including the level of solvency ratio). The measurement of capital use effectiveness may be based on the tools described in this paper.

**Re: 5**

The capital optimisation is a stage oriented at the adjustment of regulatory funds to the capital demand on the one hand, and at the reallocation of capital in the need arises on the other.

At this stage there should also be some operating support for sales units conducted by the Capital Bank. This unit should substantively support the conclusion of transactions with high level of capital involvement so that the ultimate structure of the contract could generate a possibly lowest level of "risk appetite."

BK should analyse the calculation results of, for example, capital requirements in order to determine if, in the bank, they are not generated at a too high level as a result of no complete and updated transactional data in the information systems. The examples of the capital requirements calculations presented in section 3 prove that the lack of a single piece of information in the system or an incorrect entry (in particular in the area of security) may generate additional, unnecessary capital requirements.

It seems appropriate that the Capital Bank should apply the process of re-allocation for the purposes of capital management.

The implementation of tasks at different stages is laborious and requires the support of other organisational bodies of the bank. The Capital Management Committee is worth mentioning. It could be an ideal support for the BK activities and would be a proper link between the Capital bank and the bank management. It is suggested that the Committee chair should be performed by the management board member supervising the financial division (including the BK).

## 5. Summary and conclusions

Despite the work done by the Basel Committee on the model of evaluation of the bank capital adequacy for nearly 40 years, every new international crisis reveals weaknesses and shortcoming of the current regulations and risk management process. As a consequence, the crises bring changes in the adequacy standards in the form of more restrictive principles of the measurement and evaluation of bank capital adequacy.

The first essential question arising in such situations is the issue of capital adequacy measurement in the form of solvency ratio. Is the level of 8% proposed in the 1980's sufficient? If so, do the capital requirements at this level secure the bank against risk nowadays? The number of risks included in the solvency ratio in combination with the extension of the bank own funds may be regarded as the movement in the right direction. However, experts claim that the CAR construction is obsolete as the current risk borne by banks is more complex and incomparably larger than during the time Basel I<sup>14</sup> was created.

The implemented cautionary regulations are aimed at the stability of the financial market through the bank security. The modern bank system is not indifferent to crises and it may catalyse them itself. It should be emphasised that no regulations may become a panacea to create the security of banks. In this area, the most depends on the management and staff as well as owners of

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<sup>14</sup> B. E. Gup, *The New Basel Capital Accord: Is 8% adequate?*, Thomson, New York 2004.

these entities – their reason and prudence, honesty and sense of responsibility for the money entrusted by their trustful customers<sup>15</sup> to them. The application of the best models and techniques will not ensure a success in the area of risk management.

The excessive confidence in rating agencies, the internal models of risk level calculation with a limited period of historical data as well as the disregard of the model assumption by the specialists, and additionally the lack of understanding of these models by bank managers, as well as underestimating the counterparty risk with reference to derivative instruments caused tragic effects in the form of subprime crisis.

It may be stated that as long as bank institutions exist at a very high leverage level (e.g. the capital relation of Tier 1 to RWA) and create “empty” money, they will be exposed to essential risk and their capital will not be entirely adequate.

One may consider some alternative methods to replace the Basel solutions. Basel I treated the public debt as a financial instrument free of risk. After the crisis the governments of the emerging markets refused to repay their debts, for example in Russia in 1998. Basel II related the weight of risk to the state rating. The restrictive solutions within the capital area are criticised, it is true about Basel II as well as Basel III. The increased capital requirements for banks may in a very short time cause a lower availability of credit in the economy and reduce the effectiveness of banks measured through the return on capital ratio (ROE). However, in a longer run they should contribute to better stability of the world financial system.

A series of publications have proposed numerous solutions in order to reduce the undesired impact of capital effectiveness measures on the capital adequacy. They also present individual effectiveness measuring tools which may be applied separately or used to construct an integrated effectiveness measurement model. This paper presents a model and suggests solutions supported by numerous simulations which, with consideration for the IT limitations are the most adequate research tool.

The implementation of Basel II in Poland was to bring benefit to commercial banks, including a lower joint capital requirement, in particular, the credit risk requirement, which is essential and constitutes the majority within the regulatory capital, the effects were to be obtained primarily thanks to the application of the internal ratings. However, these methods when the economic situation deteriorates (recession or crisis) result in a higher requirement than the standard method.

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<sup>15</sup> M. Marcinkowska, *Standardy kapitałowe... (Capital standards...), op. cit., p. 525.*

This rule also refers to the internal capital whose major component is economic capital calculated on the basis of the VaR method. Taking into account the fact that the implementation of Basel II has not been fully completed – banks are intensively working at the moment to implement the advanced methods – and some new activities have been implemented to make new solutions come into effect. Basel III, which imposes more restrictive capital standards forces banks to strengthen the available capital in its “hardest” part, i.e. through the core capital.

The simulations presented in the last section of the publication are concerned with the innovative approach to increasing effectiveness of capitals used by banks, in particular in the case of limits and restrictions imposed on banks as an aftereffect of the present subprime crisis. The shift of the unused budgeted capital between business activity areas allows banks to increase the capital base only by the difference between the excess amount and unused amount. Such a solution saves the capital, which in the author’s opinion became a limited and costly product in the period of crisis.

It should be stated that it does not matter whether the profitability calculation is based on the regulatory or economic capital, some modifications can be introduced to the basic calculation formulae. They may also be applied in the situation of capital limitations. The modifications are aimed at the increase of effectiveness of the available capital base use.

The presented profitability calculation models, despite their advantages, have certain deficiencies. The author claims that variant C should be accompanied by the introduction of regulatory capital final states control combined, for example, with an additional result charge on account of the planned level excess. The tool constructed in such a way would be able to secure the bank goal, i.e. the appropriate rate of return on regulatory capital with a safe level of the capital solvency ratio and RC at the required (planned) level.

The example of the solution controlling the plan implementation may be based on the following mechanism:

$$\begin{array}{l} \text{Result charges} \\ \text{on account} \\ \text{of plan excess} \end{array} = \begin{array}{l} \text{Surplus of used capital} \\ \text{above the planned value} \end{array} \times \begin{array}{l} \text{Charge} \\ \text{rate} \end{array}$$

The surplus of capital used above the planned value is calculated as the difference between the value of the used and budgeted capital, however, for the correct functioning of this tool, the value of the surplus should have negative values. The tightening of the mechanism should be achieved by the selection of a considerably higher level of charge rate so as to effectively discourage the entity

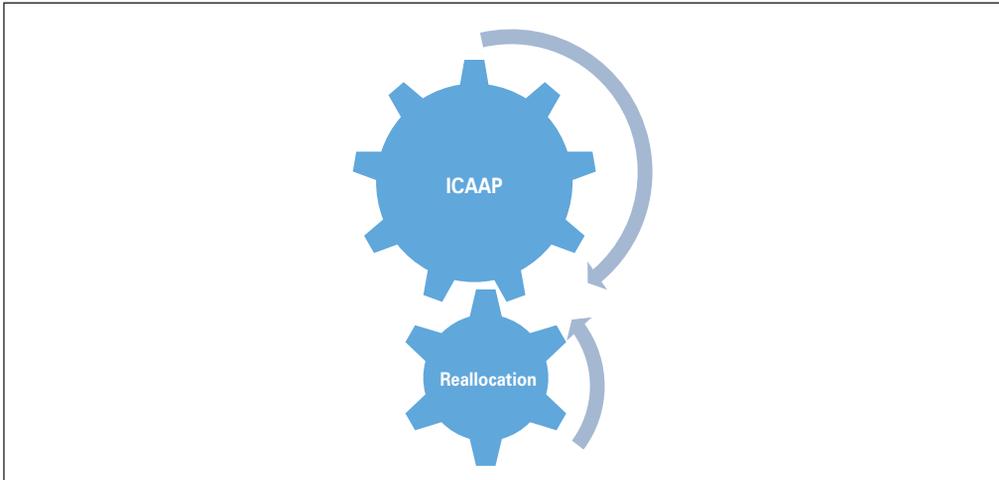
from exceeding the planned level of charge. The result charge on account of plan excess has to decisively decrease the result. The setting of the charge rate depends on individual factors existing in the bank and may be entirely different, e.g. in another bank the charge rate will be effective at the level equal to the profitability of the whole area, and in another it may be a multiple of the business area profitability rate.

It is worth saying that the implementation of such a tool depends on the planning data. If in a bank it is possible to plan capital intensity only on annual basis, the mechanism will work properly. It is necessary to have quarterly or monthly plans, according to the author the optimal period is a quarter. It allows banks to systematically follow and control capital, at the same time it does not require high outlays connected with monthly planning.

If within the bank, there are some organisational units that do not use capital with the capital shortages that trouble some other units, it is worth considering whether or not to implement the process of effective allocation of capital, i.e. the so-called re-allocation of capital. This process allows for the transfer of the unused capital from the units which planned the capital at a too high level to the units which have some possibilities of additional consumption of capital. The process of reallocation has to determine the principles of transferring the capital between units so that the bank profitability will not deteriorate. On the contrary, the relocation should increase its effective use. The presented author's self-designed model of reallocation satisfies all the aforementioned expectations.

Recapitulating the aforementioned deliberations, it should be said that the profitability control used in practice and based on the regulatory and internal capital does not secure the unit against the loss of capital adequacy and that the application of additional tools increases the security of capital adequacy stability and favourably affects the effectiveness of capital use.

The proposal of including, into the ICAAP process, the active reallocation of capitals as one of the sub-stages seems to be rational and efficient. The bank is obliged to implement the ICAAP process annually, nothing should stand in the way to modify one of its stages, i.e. the stage of capital allocation. The re-allocation would be a sub-stage implemented in a quarterly cycle and would allow for the current monitoring of the capital use and its effectiveness. At the same time, it would allow for the operational management of the capital, e.g. the advance information about the "gap" of the available capital possible to appear at the end of the calculation year. Both processes would constitute an integrated self-driven controlling and managerial mechanism, Figure 4.

**Figure 4. ICAAP process model modified by reallocation**

Source: own material.

The last proposed solution is the self-designed “capital bank” concept. On the basis of the presented deliberations with reference to this area it should be stated that the process of internal settlements based on capital transfer rates may become an important instrument to enhance the process of bank management. It allows for:

- assignment of minimum “cost” for the used capital to the areas of business activity,
- enacting the basis for setting price parameters of transactions and products,
- elimination of capital deficits and surpluses in different areas (units) as well as in the whole bank,
- determination of transactional, product or client profitability including their impact on the structure of their own funds (transfer processes set minimal profitability level of transactions, products etc.),
- evaluation of business decision making based on the share of different activity areas in the bank capital (equity, own funds of internal capital),
- bank capital management through a specialised central unit and advisory body in the form the Capital Committee.

The existing economic conditions favour the deliberations on the changes within the bank capital management processes through the implementation of the presented concepts or at least some selected elements.

Firstly, the effectiveness measurement integrated model should be introduced, which, at the selected levels of the organisational structure would ensure reliable information on the generated profitability, at the same time monitoring the adequacy level.

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## **Small Local Stores in Poland: Changes in the Retail Market and Consumer Preferences**

### **Introduction**

In recent years we may observe that the Polish retail market has undergone a major transformation. Dynamic changes in the structure of this market relate to the position which its particular segments occupy; the opinion especially concerns local stores. Several years ago it appeared that large chain stores (supermarkets and hypermarkets) would control 80–90% of the retail market, in particular the food market. Had the forecast changes taken place, small local stores would disappear, because, according to predictions, Polish consumers were to adapt their shopping habits to Western models. Therefore, there appeared new developments in the retail market as consumers were collectively doing shopping in supermarkets which started to emerge on the outskirts of large cities.

Also, in recent years we may observe the deterioration of the situation of small local stores. In 2005–2010 the number of such stores was decreasing considerably. The highest percentage of the liquidation of the stores is recorded among the smallest entities which employ up to 9 people<sup>1</sup>. Euromonitor International predicts that in 2013 their number will drop by 12% in comparison to 2009, and it will amount to 110.2 thousand. Most commonly, one of the chain stores is taking their place. However, the same organisation provides us with symptomatic information with regard to the situation of small grocery stores; namely, Euromonitor International forecasts that the turnover of these stores

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<sup>1</sup> T. Starzyk, W 2020 r. liczba sklepów w Polsce może spaść nawet o 40–60 tys. placówek, [www.portalspozywczy.pl/pliki/img45123](http://www.portalspozywczy.pl/pliki/img45123) [on-line] access 2.03.2011.

decline at a smaller pace, and within that period it would fall by only 1%, and in 2013 it will amount to approximately 64 billion zloty/PLN.

The multifaceted importance of the retail sector for the economy has been known and monitored in the European Union countries for many years due to their more than 4% share in the EU GDP and about 17 million employees working in the sector. The report of the European Commission aimed at monitoring the retail market recommends “a fair distribution of the internal market of retail services for 2020<sup>2</sup>”. Thus, the importance of continued monitoring of the problems appearing in the retail market, including food products market with 50% of the sales, is very significant<sup>3</sup>.

Identification of these problems concerned the situation of retail market of all forms of retail trade sales (traditional stores, electronic commerce, open markets), sizes (from small stores to hypermarkets), products (food, non-food, pharmaceutical) legal forms (independent stores, franchises, integrated groups), location (urban/rural, city centre/suburbs). In the context of the role of the small local stores, special attention has been paid to the accessibility (short distance) of stores providing goods which are essential for the elderly, the disabled, people who do not have a car, people living in sparsely populated areas<sup>4</sup>, and also to the problem of maintaining a number of jobs locally, to which the local stores contribute.

The situation in the retail trade has also been examined by Eurostat through the prism of the economic crisis. In the analysis of the European business in 2010<sup>5</sup> we could observe that retail trade, when compared to other types of economic activities, recorded a relatively small decline in activity which might be observed as a direct result of the crisis. As far as Poland is concerned, it is the effect of new developments within the structure of retail outlets, as well as changing attitudes of the owners of small stores and consumers' buying behaviour.

## Changes in the retail market

At this point we should note that small stores have not disappeared entirely from the market: they are incorporated in the structure of larger organisations

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<sup>2</sup> Report from the Commission to the European Parliament, the Council, the European Economic and Social Committee and the Committee of the Regions: Retail market monitoring report “Towards more efficient and fairer retail services in the internal market for 2020”, the European Commission, Brussels, KOM (2010) 355 final, [http://ec.europa.eu/internal\\_market/retail/docs/monitoring\\_report\\_pl.pdf](http://ec.europa.eu/internal_market/retail/docs/monitoring_report_pl.pdf) [on-line] access 5.07.2010.

<sup>3</sup> Euromonitor International 2007.

<sup>4</sup> Living Conditions in the EU, Eurostat News release no. 77/2009 of 28 May 2009.

<sup>5</sup> [http://epp.eurostat.ec.europa.eu/cache/ITY\\_OFFPUB/KS-ET-10-001/EN/KS-ET-10-001-EN.PDF](http://epp.eurostat.ec.europa.eu/cache/ITY_OFFPUB/KS-ET-10-001/EN/KS-ET-10-001-EN.PDF)

or franchise organisations. Therefore, not only the number of entities on the market have decreased. Simultaneously, as A. Faliński emphasised, the retail sale is a system where the price plays a key role. Small individual stores do not have a chance to compete against large chain stores<sup>6</sup>. According to the Nielsen report, on average, food in small stores is 20% more expensive than in hypermarkets or discount stores.

It is estimated that in Poland there are 330 shopping centres, out of which 18 are modern multifunctional objects. It is assumed that in 2011–2012 the number will increase and another 17 centres will be established. The boom in commercial investments is particularly noticeable in Silesia. As W. Woelfler of Immofinanz Group states, the growing affluence of Poles is what primarily affects the development of the retail trade, and the Poles, in contrast to the British, the German or the French, in recent years seem to spend more and more money in the shopping centres<sup>7</sup>.

Within the group of chain stores, we should pay particular attention to the discount shops. These stores offer a limited range of products at relatively low prices, and the interior of the store itself appears to be “cheap”; however, at present, we may observe greater and greater concern with regard to the interior design of the outlets. In such stores we may observe the goods still being placed in pallets or baskets. There are few branded goods and many products are own-brand goods, produced to fulfil the order placed by the chain store. It is estimated that from year to year the discount stores increase their revenue by more than 1/5. The largest retail shops in Poland are Żabka (2500 stores), Biedronka (more than 1650 stores) and Lidl (400 stores). In February 2010 GfK Polonia published a public opinion poll where the customers’ knowledge and preferences concerning chain stores were examined. According to the poll, Biedronka is visited by 80% of Polish clients, and the chain store is a leader in many other categories. Its advertising highlights fixed, low prices for basic foods, which is the guarantee of low-cost shopping. Biedronka, as the survey suggests, is the most deeply-rooted chain store as far as consumer knowledge is concerned. It remains the undisputed leader in terms of brand awareness<sup>8</sup>. In 2012 Biedronka’s owner plans to spend 1.6 billion euros for further development of the chain, which will result in the emergence of 850 new stores<sup>9</sup>.

<sup>6</sup> Ł. Czakowski, Sytuacja w handlu – Znikające sklepy, <http://www.detaldzisiaj.com.pl/article/sytuacja-w-handlu-znikajace-sklepy> [on-line] access 3.03.2011.

<sup>7</sup> Centra handlowe: rosną wymagania klientów, Handel-Net.pl. [on-line] access 17.12.2010.

<sup>8</sup> [http://www.biedronka.pl/o\\_nas/biedronka/kim\\_jestesmy/](http://www.biedronka.pl/o_nas/biedronka/kim_jestesmy/) [on-line] access 5.11.2011.

<sup>9</sup> “Gazeta Prawna” 4–6 November 2011, A4.

Lidl is Biedronka's competitor. As is emphasised in its advertising slogans – safety and consumer satisfaction are a priority. Recently, we may observe that special attention is being paid to the aspect of quality. A global company also attaches great value to social responsibility<sup>10</sup>. These are well-considered marketing activities that deliver desirable effects.

Tesco is a chain store which uses a strategy which is largely similar to those pursued by discount shops: they emphasise in their advertising slogans “discount prices at Tesco”, “buy cheap without giving up the quality”. The chain also stresses the attention paid to quality – “In *Tesco* a wide range of high quality products awaits you every day. Do the shopping with us and experience more comfort”. In 2010 the chain had more than 300 self-service stores, ranging from hypermarkets to small local stores, and in 2011 the chain intends to increase the number of stores significantly<sup>11</sup>.

Carrefour is introducing certain changes with regard to the strategy employed by the organisation: the corporation focuses on the rapid development of the “Carrefour Express” franchise stores<sup>12</sup>. The concept applies to locations both in urban and rural areas. Until the end of 2010, as M. Cieślakowska, director of PR and external communications of Carrefour Polska, claims within the chain approximately 80 stores of such types operate, and in 2011 and subsequent years Carrefour intends to open about 100 other such outlets yearly<sup>13</sup>.

Probably, small local stores tend to perceive the new developments as challenges or threats, which should induce the store owners to pay greater attention to the selection of their products, relations with customers, cooperating on equal terms with clients and surprising them with new ideas and new additional services.

The opportunity for small stores which presents itself is the tastes and habits of the Poles, to which the trade, large outlets in particular, need to adapt. When large stores began to emerge, Polish people started to be their frequent customers. However, the Western shopping model, for instance of the German, was not adopted by Poles in its entirety. At present, it emerges that fewer and fewer Poles do shopping in hypermarkets<sup>14</sup>. The outlets are usually situated on the

<sup>10</sup> [http://www.lidl.pl/cps/rde/xchg/lidl\\_pl/hs.xsl/index.htm](http://www.lidl.pl/cps/rde/xchg/lidl_pl/hs.xsl/index.htm) [on-line] access 5.11.2011.

<sup>11</sup> <http://www.tesco.pl/sklepy/>

<sup>12</sup> Franchise is a business method which involves licensing of trademarks and methods of doing business; it is a kind of cooperation between independent business entities. Franchisor allows the franchisee to use their know-how and brand name, and in return, collects payment from the franchisee who can use another firm's successful business model. Ref.: <http://franchising.pl/abc-franchizy>

<sup>13</sup> <http://www.carrefour.pl/page/pl/korporacyjny/wspolpraca/carrefour-franczyza/> [on-line], access

<sup>14</sup> Hypermarket is a store covering 8–12 thousand m<sup>2</sup>, offering a wide range of products, including food products, household goods, textiles, cosmetics, household appliances and audio/video devices.

outskirts of cities, and not every household, often living in blocks of flats without a lift, having relatively small refrigerators buy necessary goods on a weekly basis. Lower prices do not compensate for the relatively higher fuel prices, which, in turn, have an impact on prices. The Euromonitor International<sup>15</sup> research shows that the turnover of small stores in 2011, amounting to 15.7 billion euros, will be twice as much as the turnover of hypermarkets (7.8 billion euros).

### **The diagnosis of the situation of small stores located in the Mazovian province in the light of empirical research in 2011 – opinions of the owners and customers**

The research presented by Pentor titled *Polish Shopping Habits of 2010 (Zwyczaje zakupowe Polaków 2010)* shows that the Poles, despite the changes occurring in the retail trade, still tend to prefer small local stores. This is confirmed by *Shopper Trends 2010* analysis conducted by Nielsen: the Polish people most frequently, among the countries of Central and Eastern Europe, do shopping in small stores. It appears that the number of people using the services of large self-service stores has tended to decrease. 27% of consumers admit that they do their everyday shopping in local stores. It is an element of Polish culture which is not undergoing rapid changes; also there are other observable factors which come into play: habit, the aging population, the necessity of distribution of expenses due to the limited household budget. According to Pentor, the number of people who have used the services of small outlets in the last year has not changed, similar to the number of people who do their shopping only in hypermarkets<sup>16</sup>.

We may notice that clients are becoming more educated and selective, they take decisions after greater consideration and their choices are of a less and less impulsive nature. The clients pay attention not only to the products themselves but also to interior design, the appearance of staff, the general atmosphere of the place and politeness and friendliness of the staff working in particular outlets. These are the basic elements of marketing strategy. The owners of small stores cannot underestimate the market requirements, the changes taking place in the market, altering needs and expectations of customers; in addition, they need to be more and more sensitive to the issue of consumer rights. It is impossible to compete for customers, if we are unwilling to apply modern technology solutions,

<sup>15</sup> J. Solska, Nowa nadzwyczajna kariera sklepów osiedlowych, "Polityka" No. 38 of 10.08–16.08.2011, p. 36.

<sup>16</sup> [http://pl.nelsen.com/news/PressReleaseShopperTrends.op.cit.http://biznes.gazetaprawna.pl/artykuly/413097,kryzys\\_zmieni\\_l\\_zwyczaj\\_e\\_zakupowe\\_polacy\\_wybijera\\_ja\\_male\\_sklepy.html,2](http://pl.nelsen.com/news/PressReleaseShopperTrends.op.cit.http://biznes.gazetaprawna.pl/artykuly/413097,kryzys_zmieni_l_zwyczaj_e_zakupowe_polacy_wybijera_ja_male_sklepy.html,2) [on-line] access 10.03.2011.

modern forms of payment, or fail to observe our competitors' behaviour, their strengths and weaknesses, etc. Entering the niche markets and offering new additional services (added value) can be translated into a market success.

Meanwhile, as M. Wysocka of Target BPO claims, many owners of small stores hesitate to introduce terminals on the score of the lack of profitability. In the time of overwhelming electronic solutions, card payment is much faster and more convenient, and by offering this kind of payment the store owners meet their customers' expectations.

The situation where the seller or a store owner announces the introduction of a terminal and after a few months the situation does not change<sup>17</sup> is unacceptable.

In the research conducted by TNS OBOP<sup>18</sup>, 79% of respondents claimed that low prices are the basic criterion for selecting a particular store to do their shopping, and only every tenth Polish citizen claimed that they do not pay attention to prices when they buy food. In small local stores the most important factors are: the quality and freshness of the product, their locality, direct contact with a customer, individual approach and no queues. At this point we should also note that a considerably shorter distance from a producer to consumer is also of certain importance.

The authors designed a study commissioned by *Macro Cash and Carry* which aimed to find answers to the question relating to the situation of the owners of small grocery stores and the behaviour of the clients of those stores<sup>19</sup>.

The object of the study was to point to the qualities of small stores as well as their weaknesses. The study was conducted by ABR SESTA, a research company, in February 2011. The survey encompassed 68 owners of local stores and 660 clients of these stores, located in the area of 4 districts in Warsaw (Bemowo, Białołęka, Ursynów and Wawer, two on the left and right side of Warsaw), 4 adjacent towns (Ożarów Mazowiecki, Marki, Józefów and Piaseczno) and 4 satellite towns (Ostrołęka, Płock, Radom, Siedlce and Żyrardów). The idea for the selection based on the judgmental and quota sampling of districts and towns was based upon the identification of the similarities of consumer behaviour and opinions and owners of local stores in the aspect of four different (with regard to history and culture) local communities.

<sup>17</sup> [http://targetbpo.pl/pliki/TargetBPO\\_\(rajkr69d2tjrx51u\).doc](http://targetbpo.pl/pliki/TargetBPO_(rajkr69d2tjrx51u).doc).

<sup>18</sup> [portalspozywczy.pl](http://portalspozywczy.pl) 28.02.2011.

<sup>19</sup> The comprehensive description of the study and detailed findings are presented in the report prepared by the authors: Dąbrowska A., Słaby T., *Sytuacja małych sklepów w Polsce. Małe sklepy osiedlowe*. Report for Macro Cash and Carry, Warsaw February 2011.

The specialisation of local stores, which the surveyors visited, related to the most commonly encountered sales structure; namely, 69% constituted grocery stores and grocery and liquor stores; 31% convenience stores.

The diagnosis of the situation through the opinions of owners and clients of the shops aimed to identify the reasons for the deteriorating situation of local stores in Poland. An important research objective was the evaluation of the differentiation of the opinions of local shop owners and customers depending on the location of stores (Warsaw districts, adjacent and satellite towns) and also:

- identifying barriers faced by owners of small local stores;
- the evaluation of the store owners' initiatives to gain new clients;
- the assessment of support from authorities;
- characteristics of purchases in local stores;
- identification of motifs for the selection of local stores as a place to do shopping;
- analysis of the rationality of the shopping in small stores in housing estates;

and the answer to the question – is there an alternative to local stores?

In the context of the “struggle” for survival we identified the possibility of extending the activities of small stores, e.g. online shopping on the initiative of local store owners. E-shops attract more and more clients: saving time, the delivery of ordered and sorted products to customers' houses/flats are the qualities which encourage more and more people, especially young ones, to do e-shopping<sup>20</sup>. Piotr i Paweł ([e-piotripawel.pl](http://e-piotripawel.pl)), Bomi ([dodomku.pl](http://dodomku.pl) and [superasam24.pl](http://superasam24.pl)) or Alma ([Alma24.pl](http://Alma24.pl)) are just some of the proposals.

The opinions of owners concerning the functioning of their own local stores in 2010, in relation to 2009, were not very optimistic, but there has been no excessive pessimism. According to more than half of the respondents (55%) the situation has deteriorated, out of which 12% of the owners claimed that the situation has deteriorated considerably, and 31% believed that the situation has not changed. However, in early 2011 the greatest percentage of owners (47%) did not expect changes, 29% were afraid that the situation would deteriorate, and every tenth respondent expected a sharp deterioration. Only 13% of owners looked into the future with considerable optimism.

The analysis of the evaluations of the conditions of the local stores presented by their owners has been made through the prism of their concerns and relationships to their competition. When examining the structure of the

<sup>20</sup> Ref. A. Dąbrowska, M. Janoś-Kresło, A. Wódkowski, E-usługi a społeczeństwo informacyjne, Difin, Warsaw 2009 and A. Dąbrowska, M. Janoś-Kresło, Konsument na rynku e-usług w krajach Europy Środkowo-Wschodniej, Difin, Warsaw 2010.

responses concerning the impact of competition, the concerns outweigh other answers – 69% of owners were afraid of competition not only from similar stores, but mainly from large retail outlets. 26% of respondents assessed their situations in the context of the existing and potential competitors.

In the owners' opinions, buying in small local stores has many advantages. Among others we might mention: buying fresh food (99% of responses); establishing contact in the local community (96%). Some of them also see it as a chance to promote Polish goods.

The following information was important in the context of the evaluation of the activities of the store owners:

1. The owners frequently refused to give information concerning the average monthly turnover of their stores, and we may note that the number of refusals was higher in the Warsaw districts. On the scale of the entire examined population, 57% of the interviewees refused to give the answer concerning the average monthly turnover. Those who answered the question about the average monthly turnover in Warsaw and neighbouring towns determined the turnover in their stores within the limits of 31–50,000 zł/per month. The local stores located in satellite towns recorded much lower turnover (between 21–30,000 zloty/PLN/per month).
2. The structure of the responses related to the main clients doing shopping in the retail outlets. The fact that almost 90% of the owners, regardless of the location of the store, could not tell who the main customers of the store were, may suggest that the owners, who are often sellers, do not know their customers. The latter means that they do not establish relationships with them and they fail to build their customers loyalty. This may also indicate the lack of knowledge concerning their customer needs, which is necessary for designing the suitable product range.
3. The forecasts of the store owners in Warsaw and in satellite towns are rather optimistic, which frequently results in conservative approaches, and demotivates the owners to make greater effort with regard their activity; however, the interviewed owners are planning activities to increase the number of customers, mainly through promotions. The owners of the stores in Poland plan to expand their product range adapting to customer requirements. Only the owners of local stores in satellite towns (e.g. in Radom, Siedlce) look into the future with pessimism, and mostly (53.8%) do not plan to undertake any activities to attract new customers. Among the owners who plan such activities, 75% plan to gain new customers by offering special deals.

4. Opinions concerning the experienced or desired assistance from the local authorities did not vary with regard to the location of the store. The owners feel a complete lack of such support; they would like the authorities to constrain excessive competition from other local stores.

Analysing the attitudes of the owners of small stores it appears that they hope for the external activities which would affect their competition rather than focus on the undertaking of steps which would allow them to gain new customers and retain the existing ones. Their attitude was rather passive, to a large extent, demanding, irrelevant of the location of a store. A certain threat for the existence of the stores is the lack of involvement of the children of the sellers to follow in their footsteps: they do not want to work as hard as their parents. They prefer to lease the stores or to sell them. They do not wish to fight with expansive competition. However, some convenience stores<sup>21</sup>, for instance, Żabka, knowing the habits of Poles to buy in small local stores try to help these stores through the contracts signed with owners, offering the rent for ten years of the value equal to the profit which the owner has obtained so far<sup>22</sup>.

### **Preferences of customers for small local stores in the light of the findings of the study**

As already mentioned, the study aimed to identify the consumer profile and the behaviour of customers of small local stores. The profile of a consumer doing shopping in small local stores is characterised with the information presented in Table 1.

The majority of the respondents were women (69%), elderly persons aged over 65 (20%); in Warsaw young people aged 18–25 dominated (24%), in adjacent towns there were people aged between 26–35 (19%), with secondary education (46%), people with full-time employment (36%); in the case of satellite towns retired citizens and pensioners (37%), representatives of households consisting of two people (30%), with a monthly household net income of 2001–3000 or above 5000 zloty/PLN, and in Warsaw and in adjacent towns the income close to 5000 zloty/PLN dominated, and in the case of satellite towns the income was close to 2001–3000 zloty/PLN.

<sup>21</sup> Convenience store is a small store located in urban housing districts or in other convenient, frequently visited places, offering mainly goods satisfying everyday needs of residents.

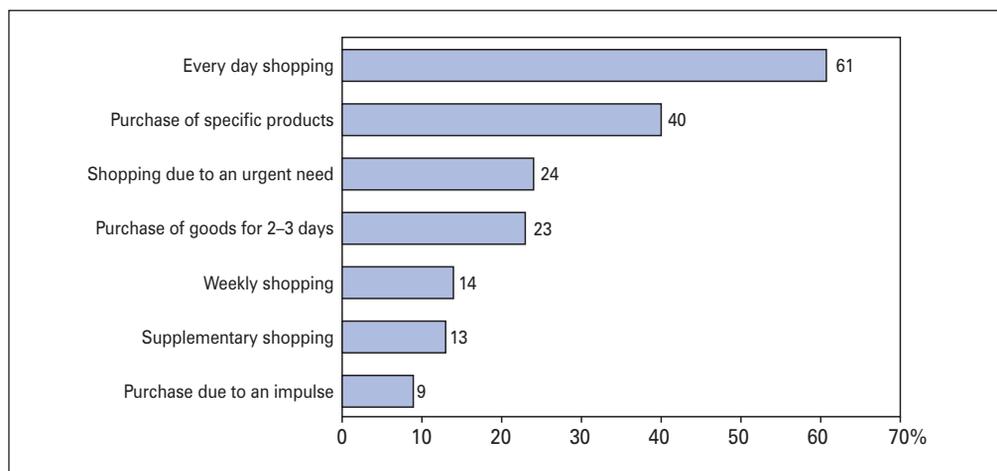
<sup>22</sup> A. Wroczyński, Akademia Rozwoju Systemów Sieciowych, "Gazeta Prawna", 4–6 November 2011, A.4.

**Table 1. The most common characteristics of the clients of small local stores**

Socio-economic characteristics	Warsaw	Adjacent towns	Satellite towns
Sexs	woman	woman	woman
Age	18–25 years	26–35 years	56+
Education	at least secondary	at least secondary	secondary
Employment status	Full-time employment, retired/pensioner, student	Full-time employment, retired/ pensioner, self-employed	Retired/pensioner, Full-time employment
Household size	2–4 people	2 people	2 people
Household income	over 5000 zloty/PLN	over 5000 zloty/PLN	2001–3000 zloty/PLN

Source: the authors' own research, February 2011.

Respondents in small local stores made small purchases (61% of responses) and bought specific products (40% of responses). Shopping on impulse is done in small local shops dominated in satellite towns. The responses of interviewees in the Warsaw districts pointed to complementary, weekly shopping, and making purchases of goods for 2–3 days was mentioned in adjacent towns – ref. Fig. 1.

**Figure 1. The types of purchases made in small local stores (N=660)**

Source: the authors' own research, February 2011.

The items which were most frequently bought in small local stores were bread and dairy products (80% of responses and above). The chain stores and convenience stores were seldom indicated in this case (up to 5% of responses).

Respondents visit discount stores mainly in order to buy water and soft drinks as well as household chemicals, cosmetics and personal care products (20% of responses). Super- and hypermarkets were the places where customers buy (more than 20% of responses): fats, coffee and tea, food concentrates, water and soft drinks, dry groceries, canned products, household chemicals, cosmetics and personal care products.

Thus, it appears that in small local stores the customers bought the products to satisfy their daily needs or those products which are most frequently bought / the items with a high rate of acquisition, (FMCG); however, greater diversification of the product range may be observed in towns outside Warsaw. Interviewees also frequently buy fruit and vegetables in those stores, which is confirmed by the specificity of small local stores. The “close to home” factor was the most important for products such as: stimulants, dry groceries, food concentrates, household chemicals, coffee and tea, fats, canned products, sweets and salty snacks, water and beverages; the percentage of responses range from 46% to 59%.

In the study the authors tried to identify the reasons why consumers make purchases in local shops. In the case of FMCG (bread, fruit and vegetables, meat, dairy products) the most important factor is the freshness of the products; the responses ranged from 64% to 82%. Therefore, the owner-retailer, who wishes to attract customers and compete against hypermarkets and discount stores has to create an offer which differentiates their store from competitive ones with regard to the quality and the freshness of products, in particular fruit, vegetables and meat – ref. Table 2.

Among the reasons for the lack of purchase of product kinds in local shops respondents mentioned: high price, limited product range, the lack of promotions, low quality of products, staleness, expired produce, lack of desirable items within the product range.

The selection of local stores as a place for doing shopping was conditioned by various factors – ref. Fig. 2.

Analysing the responses, taking into consideration the age of the interviewees, it was found that people aged up to 35 most frequently mentioned: “I buy only necessary things; I do not buy supplies, I spend less money; nice and friendly staff; fewer people; I don’t have a car or this way I support local trade”. Such responses point to the rationality of the shopping tendencies, supporting local producers, and a greater tendency to do shopping in other stores than small local stores.

People aged 36–55 years old mentioned: “a local store is close to my home, the products I buy there are fresh”. People aged 56+ most frequently emphasised such factors as: “shopping in small local stores takes little time, the shop assistant

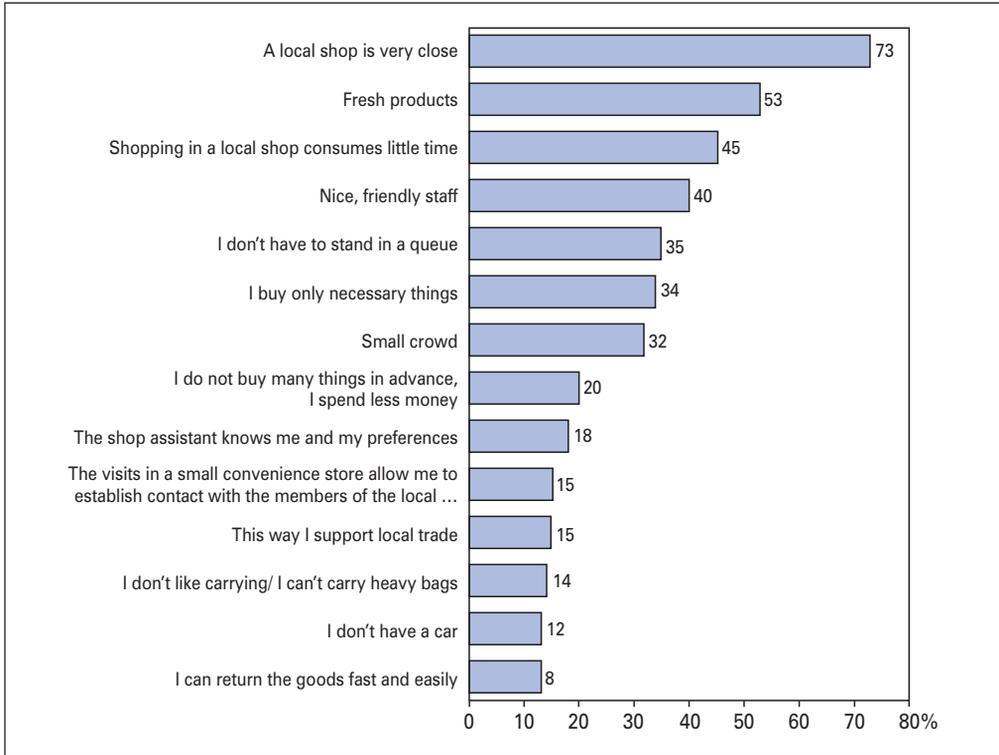
knows me and my tastes, I don't like carrying/I can't carry heavy shopping bags; visits to a small local store allow me to establish and maintain contact with other residents of the local community". The responses of elderly people show the importance of the relationship between clients and shop assistants and the tendency to save their efforts.

**Table 2. Reasons for shopping in local stores**

	freshness	close to home	price	the quality of products	Selection
Bread; N=565	82%	33%	11%	15%	5%
Fruit and vegetables; N=420	77%	35%	10%	26%	10%
Meat; N=391	75%	38%	9%	27%	15%
Dairy products; N=528	64%	38%	12%	18%	7%
Stimulants; N=338	4%	53%	30%	9%	25%
Dry groceries; N=300	24%	46%	23%	15%	8%
Food concentrates; N=331	21%	49%	22%	11%	9%
Household chemicals; N=170	2%	57%	21%	14%	24%
Tea and coffee; N=341	12%	48%	20%	20%	25%
Fats; N=344	31%	49%	20%	10%	12%
Canned products; N=245	15%	59%	19%	9%	10%
Sweets and salty snacks; N=370	17%	49%	19%	14%	25%
Water and beverages; N=331	11%	52%	20%	14%	23%

Source: the authors' own research.

The answer to the question concerning the issue which stores the respondents would choose if the small local stores they frequently visit should be closed down revealed interesting results. Nearly 60% would choose another small non-chain store, every fourth respondent pointed to a local chain store or a discount store, every fifth interviewee a super- or hypermarket, every eighth bazaars, street markets, and 7% mentioned specialist stores.

**Figure 2. The reasons for choosing local stores as a place to shop**

## Summary

Compared to other EU countries, Poland remains a leader with regard to the number of small local stores operating in the retail sector. In recent years their share was close to 50% of the market, but according to Euromonitor in 2014 their share would drop to about 32%. The decrease in the number of small stores is the result of the natural laws of the market. The Polish people are still guided by the criterion of price in their daily purchases. Specialisation is a chance for small outlets – says J. Kalinowski, a partner in KPMG, a consulting firm<sup>23</sup>.

In 2010, grocery retailers in Poland, another year in a row, developed at a lower rate than in previous years. In terms of the dynamics of the development the discount stores are still leaders in the sector: they strengthened their advantage and they appear to intensify their activities. Despite the continued decline in the importance of small grocery stores, which as the whole segment gives away their

<sup>23</sup> P. Mazurkiewicz, Kłęska małych sklepów, na rynku coraz gorzej, <http://www.rp.pl/arttykul/590077.html>

market share to modern distribution channels, small chain stores are developing rapidly. The latter particularly concerns the outlets operating in the segment of convenience stores and the stores functioning on the basis of franchising<sup>24</sup>.

We observe many changes in the environment in which small grocery stores operate; the new developments influence the conditions of their functioning and they also enforce certain changes in the strategies of behaviour in the market.

Among the changes we may list<sup>25</sup>:

- dynamic changes of the consumer needs, preferences and behaviour – following the example of Western models, recently consumer ethnocentrism, supporting local, organic produce gain in importance,
- increasing complexity of markets, suppliers and competitors – the increase in the number of intermediaries, increasing concentration and integration with regard to production and trade,
- extending the range and the intensity and competitiveness – increasing diversity of companies (sector participants), changes in the nature of competition,
- dynamic changes in information and communication technology – the need to innovate.

We observe the growing popularity of the already existing chain stores which outperform small stores not only with regard to low prices, properly designed selection, but also more and more frequently the good quality of products.

In the light of the findings, the owners of small stores on housing estates were not very optimistic. Conservative and pessimistic moods dominate in their attitudes. More than 70% of respondents notice the obstacles in conducting trading activity – the proximity of competitive entities. The concentration of small local stores is not without significance.

Just over half of the surveyed store owners plan to undertake the activities aimed at increasing the number of clients (despite the awareness of real threats), mainly by organising various promotions and reducing margins. We may advance a thesis that such behaviour was and still is fairly typical for most owners of small stores on housing estates in Poland.

Generally, the location, product range and the quality of the service influence the development of a small retail outlet. As E. Maleszyk<sup>26</sup> observes, convenient location – next to the competitive advantage resulting from cost leadership of

<sup>24</sup> <http://www.poradnikhandlowca.com.pl/aktualnosci/PMR--Do-2013-roku-rynek-spozywczy-w-Polsce-wzrosnie-o-blisko-40-mld-zl,6319,strona9.html> [on-line], access 15.03.2011.

<sup>25</sup> Handel wewnętrzny w Polsce. Funkcjonowanie małych firm handlowych (Domestic Trade in Poland. Functioning of Small Trading Companies), IBRKK, Warsaw 2010, p. 53.

<sup>26</sup> Handel wewnętrzny w Polsce..., *op. cit.*, p. 76.

chain stores – is the biggest contributor to the eradication of small companies. It is most commonly associated with low level of professionalism, limited material and capital resources, as well as the scarcity of marketing and managerial experience of owners, and as a consequence – the lack of strategies for the development of small retail companies.

The association of small stores within a chain and groups creates a possibility of the joint negotiation of prices – by forming a purchasing group the retailers increase the volume of the purchasing contract, which, in turn, allows for negotiations with suppliers. An individual owner of a small local store usually has little chance of negotiating, for instance, rent or prices. However, a willingness to cooperate is necessary. The dynamic development of the franchise is evidence for the importance of a recognisable brand and a consistent, high standard of services, and the requirements of the chain store guarantee the above mentioned qualities. Joining the chain is a chance for the owners of small stores; however, an offer of access to know-how and the logo of an external company is connected with considerable costs. For those who do not want or cannot bear such expense, it is important that they create a good business plan, implement marketing strategies and effectively manage a business.

The lack of effective price negotiations of small store owners and suppliers often results in higher prices which the client has to pay for the purchased products. The purchases in small stores are still the most expensive ones.

As the study indicated, clients mainly visit small stores in order to make small purchases – daily or supplementary shopping. Small stores are valued mainly due to the small distance from the place of residence and the availability of fresh products. The awareness of social and economic effects of the specific consumer behaviour i.e. making a decision to shop in small local shops is of slightly smaller importance.

Therefore, an opportunity to increase turnover in small local stores and building consumer loyalty is possible owing to the owners' care to provide high quality and fresh FMCG products which customers need to replace in their household on a regular basis. Care must also be taken with the speed and quality of service.

The results of the study pointed to the fact that small local stores would like to receive support from the local authorities within their city or district. Such a need is recognised by most owners of local stores, as well as the clients of these stores. The desired support mentioned by the interviewees is of preferably financial or organisational nature; it could also be provided in the form of favourable legislation. The development of small local stores requires the assimilation of modern solutions (e.g. e-money payments), the introduction of additional services

(even if they are not so popular) which would attract the clients' attention and convince them that they are an object of concern for the store owner. Interviews, observations and customer relations based on cooperation and understanding might be used to recognise and evaluate the feasibility of a particular idea. In the Polish retail market we may observe many examples where a small store in an urban or rural area may be seen as an example to follow.

In the nearest future, as it is estimated, a new trend dominating the Polish retail market is likely to emerge: smaller and smaller stores, closer to the customer's home will concentrate their efforts on reducing prices. The winners in this competition will be those companies who are able to effectively respond to the challenges connected with organising the supply chain. Also, we cannot forget the last aspect – the challenge of proper price management. Improving processes and the implementation of appropriate price and margin optimisation technology will grow in importance together with the degree of consolidation in the Polish market<sup>27</sup>. The last “novelty” in the retail trade market is an idea of creating small shopping centres (small shopping arcades), where you may find a cafe, florist, chemist, butcher's, grocery store, greengrocer, pharmacy and a large parking lot. However, the project called “Czerwona Torebka” which is designed to save small merchants<sup>28</sup>, has a powerful enemy, i.e. in order to obtain an official building permit you need to wait nearly a year, while building may last only two months.

In conclusion, in the light of the changes taking place in the market as well as the findings of the study, the owners of small grocery stores or convenience stores need to face many obstacles that threaten their existence as well as the challenges which allow them to create a modern facility with a well-considered product range, attractive interior design, promotions and polite and efficient staff that can attract customers. The latter is confirmed by the comments of owners and children of store owners, who joined the family business supporting them with their knowledge e.g. with regard to marketing, law or merchandising, during a seminar organised at this year's POLAGRA in Poznań.

Thus, we may predict that the opinions regarding the general liquidation of small stores turned out to be premature. The consolidation of small retail businesses is progressing in different ways. For instance, Żabka proposes joining the franchise without depriving the store owners of the ownership rights. Still, we

<sup>27</sup> Deloitte, Delikatesy i supermarkety muszą postawić na nowe rozwiązania, <http://www.dlahandlu.pl/handel-nowoczesny/raporty/deloitte-delikatesy-i-supermarkety-musza-postawic-na-nowe-rozwiazania,12794.html> [on-line] access 10.03.2011.

<sup>28</sup> P. Mączyński, L. Kostrzewski, Wielki sen o małych galeriach handlowych, “Gazeta Wyborcza, Gospodarka”, 5–6 November 2011, p. 11.

may observe Polish people need local stores (their number in Poland is estimated to be half of all 90,000 grocery stores). Trade in Poland reveals its complex nature, which surprised large foreign chain stores. Polish trade, in particular the food sector, is dispersed, and the factors which are conducive to the fact that customers still buy goods in small local stores are: on the one hand, supporting local producers, on the other, economic conditionings such as less and less affluent wallets of the majority of Poles.

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## The Economic Impact of Cultural Institutions on the Local Economy

### Introduction

This study presents the findings of the project “Identification of directions and scale of economic and social impact of cultural institutions on the region on the example of Koziolok Matolek European Fable Centre in Pacanow”<sup>1</sup> financed within the framework of the programme called Culture Observatory in the year 2011. The project’s objective was to identify directions and the scale of impact of cultural institutions on the region (municipality, *gmina*, and province, *voivodeship*) on the example of the European Fable Centre in Pacanow (hereinafter referred to as EFC). The research hypothesis to be verified in the project is an assumption of the three-stage impact of institutions on the socio-economic system through:

1. primary economic impact measured with direct impacts generated by tourism generated by the EFC within the municipality,
2. indirect effects measured with growth of the level of socio-economic development of the municipality triggered by the EFC,
3. secondary economic impact estimated with an indicator that will be constructed on the basis of the model of the Keynesian multiplier.

The research project comprised the implementation of empirical field research with the use of questionnaire forms (distributed both in hard-copy and electronic form) and in-depth personal interviews. The factors deciding the choice of venue of the research project accomplishment were, in particular:

- The unique nature of the phenomenon – the EFC is a unique in the country institution exploiting the fictional character for the purpose of the socio-economic activation of the region; it is worthwhile saying that in Europe there are only few such projects exploiting the potential of

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<sup>1</sup> Detailed information and full text of the research report are available in the following URL <http://www.obserwatoriumkultury.pl/art.pl,2011,104809.html> (Polish language).

fiction in creating concrete and measurable economic effects (i.e. Euro Disneyland, Asterix Park).

- The EFC socio-economic environment – the municipality of Pacanow, being a place that to the majority of Poles is associated with Koziolak Matolek (Dimwit the Billy Goat), has, at the same time, its second face, which means high unemployment, low level of enterprise, prevalence in the employment structure of the public sector and agriculture. Owing to these fact, it will be possible to diagnose the effects not disturbed by the impact of other projects.
- The strong position of the EFC on the market for cultural services of the Swietokrzyskie Voivodeship – the EFC is one of the major facilities on the culture map in the Swietokrzyskie Voivodeship.
- An active policy of the EFC as regards stimulation of region development – the EFC activities are not limited to provision of the basic cultural offer; the EFC ambition is to play the role of a centre stimulating the region's socio-economic activation.

The above-presented factors induced the research team to undertake an attempt to describe the directions and strength of the EFC impact on the region's economy. The project was carried out in the territory of the Municipality of Pacanow (District, *powiat*, Busko, Swietokrzyskie Voivodeship).

## 1. Information on the socio-economic situation of the Municipality of Pacanow



The municipality of Pacanow is a fragment of two physiographical and geographical units. The northern upland part is situated within the Nida Trough (*Niecka Nidzianska*) of the Lesser Poland Upland area, whereas the southern one, lowland, in the area of the Sandomierz Basin, is in 70% of the municipality area a Vistula River flood-land terrace. The geological structure of the municipality is diversified. There are here loesses, the Vistula's alluvia, water and glacial, sandy and gravel and clayey deposits, used as construction raw material. It is located on the fringes of the south-eastern part of the Swietokrzyskie Voivodeship and neighbours through its southern border, located on the Vistula River, with the Malopolskie (Lesser Poland) Voivodeship. Following the administrative reform of Poland carried out on 1.01.1999 the Municipality of Pacanow appeared in the territory of the restored District of Busko Zdroj. In the provincial administrative system, the Municipality borders with the following administrative units:

- from the District of Busko: in the west, with the Municipality of Solec Zdroj; in the north-west, with the Municipality of Stopnica;
- from the District of Staszow: in the east, with the Municipalities of Olesnica and Lubnice;
- from the District of Dabrowa Tarnowska: in the south, with the Municipalities of Szczucin and Medrzechow.

The Municipality of Pacanow occupies an area of 124 km<sup>2</sup> which accounts for approx. 1.2% of the area of the entire Swietokrzyskie Voivodeship. The distance from the municipal locality of Pacanow to the seat of the provincial authorities, Kielce, amounts to approx. 70 km. The total length of borders of the municipality amounts to 58 km, of which 15 km account for the natural border on the Vistula River. The Municipality of Pacanow is comprised of 28 village authorities, i.e.; Biechow, Biskupice, Chrzanow, Grabowica, Karsy Dolne, Karsy Duze, Karsy Male, Kepa Lubawska, Komorow, Kolko Zabieckie, Ksiaznice, Niegoslawice, Oblekon, Pacanow, Podwale, Rataje Karskie, Slupskie, Slupia, Trzebica, Wola Biechowska, Wojcza, Wojeczka, Zborowek, Zborowek Nowy, Zolcza Ugory, Zabiec, Kwasow, and Sroczkow.<sup>2</sup>

The amount of the municipality's budget in the last three years was subject to some fluctuations, for which, no doubt, there are responsible economic commotions evoked by the financial crisis in 2009. Tables 1 and 2 present the structure of the municipal budgetary revenues and expenditures, together with the dynamics of their growth.

In the period in question, the amount of revenues grew in 2010 against 2008 by 15.59% and, compared to 2009, by 22.04%. It is worthwhile paying attention to section 756 where there are registered municipality's revenues on account of taxes being paid. In the above amount in 2010 the following sources prevailed: "Municipalities' shares in taxes constituting the state's budget revenues" accounting for 42.35% and "Proceeds from agricultural tax, forestry tax, inheritance and gift tax, tax on civil law transactions as well as local taxes and fees from natural persons" accounting for 39.96% of total proceeds. Assuming the stimulating impact of the European Fable Centre on the municipal economy, revenues within the framework of these items should increase in the years 2010 (the year of the commencement of its activities by the European Fable Centre) and subsequent. An obvious inhibitor of growth will be in the case of this item, an overall macroeconomic situation in Poland. Analysing the dynamics of changes of this item of the municipal budget, one may notice that in 2010, against 2009, the revenues slightly decreased – they fell by 0.83%.

<sup>2</sup> Strategia rozwoju gminy Pacanow, Pacanow 2004; the document is accessible on-line under the address: <http://bip.pacanow.pl/> (date of downloading 17.10.2010).

Table 1. Pacanow Municipality's budget revenues in 2008–2009

Municipal budget section	% of total annual revenues			Dynamics (%)	
	in 2008	in 2009	in 2010	2010 vis-à-vis 2008	2010 vis-à-vis 2009
Section 010	1.99	2.23	1.96	113.41	106.94
Section 020	0.01	0.01	0.01	132.08	91.52
Section 600	0.59	1.14	6.32	1 231.00	677.34
Section 700	0.99	1.14	1.93	225.68	207.09
Section 710	0.01	0.01	0.00	19.00	19.00
Section 750	0.85	0.35	0.58	78.57	203.13
Section 751	0.01	0.08	0.23	4 533.25	351.72
Section 754	0.01	0.00	2.18	33 209.25	No data
Section 756	15.56	15.76	12.81	95.19	99.17
Section 758	39.67	48.33	37.72	109.90	95.24
Section 801	0.75	6.10	9.74	1 505.08	194.97
Section 852	13.24	15.34	22.87	199.61	181.91
Section 853	0.00	0.32	0.26	No data	97.85
Section 854	0.75	0.83	0.72	110.46	105.20
Section 900	0.00	0.08	0.06	No data	89.88

Continued Table 1

Municipal budget section	% of total annual revenues			Dynamics (%)	
	in 2008	in 2009	in 2010	2010 vis-à-vis 2008	2010 vis-à-vis 2009
Section 921 Culture and national heritage protection	25.58	4.53	0.07	0.31	1.84
Section 926 Physical education and sports	0.00	3.75	2.57	No data	83.60
Total revenue (PLN)	21 124 087.55	20 007 248.65	24 416 484.12	115.59	122.04

Source: authors' own calculations based on the report on municipal budget execution for 2008, 2009, 2010; documents are available on-line under the address: <http://bip.pacanow.pl/> (date of downloading: 17.11.2011).

Table 2. Budgetary spending of the Municipality of Pacanow in 2008–2009

Municipal budget section	% of total annual expenditures			% of total annual revenues	
	in 2008	in 2008	in 2008	2010 vis-à-vis 2008	2010 vis-à-vis 2009
Section 010 Agriculture and hunting	5.11	3.06	5.41	127.94	260.31
Section 400 Electricity, gas and water production and supply	0.17	0.00	0.00		
Section 600 Transport and communications	2.56	8.46	6.94	328.10	120.82
Section 700 Housing	0.75	1.25	0.46	74.27	54.37
Section 710 Service activities	0.08	0.13	0.08	108.34	83.06
Section 720 Information technology	0.00	0.00	0.01		

Section 750	Public administration	9.65	11.08	11.19	140.32	148.68
Section 751	Offices of the supreme bodies of state authority, control and law protection and judiciary	0.01	0.08	0.19	4 533.25	351.72
Section 754	Public security and fire safety	0.59	0.82	2.65	543.49	478.22
Section 756	Proceeds from local taxes and fees and shares in income tax	0.29	0.31	0.20	84.23	94.99
Section 757	Public debt service	0.26	1.87	1.01	467.63	79.72
Section 801	Education	24.31	44.58	40.93	203.77	135.22
Section 851	Healthcare	0.43	0.52	0.32	91.28	91.62
Section 852	Public aid	13.09	18.19	21.68	200.33	175.56
Section 853	Other social policy's tasks	0.00	0.33	0.22		97.85
Section 854	Educational care	1.52	2.34	2.02	161.00	127.10
Section 900	Public utilities and environment protection	2.32	3.07	2.72	142.12	130.52
Section 921	Culture and national heritage protection	36.82	3.61	3.76	12.36	153.49
Section 926	Physical education and sports	2.05	0.31	0.21	12.39	100.00
Total expenditures (PLN)		23 597 541.54	19 387 757.12	28 552 160.04	121.00	147.27

Source: authors' own calculations based on reports on municipality's budget execution for 2008, 2009, 2010; documents are available on-line under the address: <http://bip.pacanow.pl/> (date of downloading: 17.11.2011).

In the statement of the municipal budgetary expenditures, one may notice that the year 2010 was closed by the municipality with a deficit of 4,135,675.92 PLN which accounts for 16.92% of the municipality's revenues. In the structure of expenditures, the highest level of appropriations is connected with financing the municipality's tasks in the areas of education (40.93% of expenditures in 2010), public aid (21.68%) and public administration (11.19%). There is a noticeable strong growth of spending on public aid what is, undoubtedly, connected with an aggravating macroeconomic situation. In 2009–2011, the number of people registered as unemployed slightly declined, from 270 at the end of 2009 to 260 people in mid-2011.

**Table 3. Unemployment in the territory of the Municipality of Pacanow**

State as of	31.12.2009	31.12.2010	30.06.2011
Unemployment figures in Municipality Pacanow	270	273	260
of which the selected groups of jobless people:			
Women	129	137	132
benefit eligibility	24	24	21
dismissed for reasons on the part of the workplace	2	3	7
staying without a job for more than 12 months	69	60	68
at the mobility age of 18–44	221	228	207

Source: statistics of the District Labour Office in Busko Zdroj; data are available on-line under the address: [www.pupbusko.pl](http://www.pupbusko.pl) (date of downloading: 17.11.2011).

There is a noticeable high number of jobless people of the mobility age, i.e. 18–44, which, however, slightly decreased in the period in question. The high unemployment rate and surplus of people at the mobility age may be conducive to the inhabitants' earning migration. The structure of entities of the national economy by individual types of activity grew slightly in the period in question.

**Table 4. Entities registered in the REGON base (the Municipality of Pacanow)**

The Municipality of Pacanow	2009	2010	2010/2009
Total	318	323	101.57
of which:			
agriculture, forestry, hunting and fishing	8	10	125.00
industry and construction	32	32	100.00
Services	224	225	100.45

Source: authors' own calculations based on the Local Data Bank of the Central Statistical Office; data are available on-line under the address: [www.stat.gov.pl](http://www.stat.gov.pl) (date of downloading: 17.11.2011).

An analysis of the detailed description of entities registered in the REGON base shows a decline in the number of natural persons carrying out business activity which may result from the economic crisis. In the structure of entities, one may notice a slight growth of activities in the area of accommodation and catering, which may issue from growing entrepreneurs' expectations towards tourism, as well as the minimal increase of the number of NGOs.

**Table 5. Characteristics of entities registered in the REGON base (the Municipality of Pacanow)**

Description		Number of entities		
		31.12.2008	31.12.2009	31.12.2010
Commercial partnerships		7	8	8
Civil law partnerships		13	11	11
Cooperatives		3	3	3
Foundations, associations and social organisations		19	19	20
Natural persons carrying out business activity	Total	265	254	257
	of which: manufacturing	35	30	no data
	of which: construction	53	50	no data
	of which: trade; repair of motor vehicles	114	109	no data
	of which: accommodation and catering	7	9	no data
	of which: transportation and storage	20	18	no data
	of which: financial and insurance activities	5	3	no data
	of which: professional, scientific and technical activities	12	8	no data

Source: Statistical Yearbook of the Swietokrzyskie Voivodeship, Statistical Office in Kielce; the document is available on-line under the address: [www.stat.gov.pl/kielce](http://www.stat.gov.pl/kielce) (date of downloading: 17.11.2011).

In 2011, in the territory of the Municipality of Pacanow, the following changes took place among the entities of the national economy<sup>3</sup>:

- 21 new entities were registered,
- 3 agro tourist enterprises were registered,
- 15 entities were deleted from the business activity records,

<sup>3</sup> Based on the interview conducted at the office of the Municipality of Pacanow on 24.10.2011.

- the prevailing domains of business activity in the territory of the Municipality of Pacanow are: construction and repair services, trade, catering services and motor vehicle repair.

## 2. The Koziolak Matolek European Fable Centre in Pacanow

The genesis of the idea to set up the European Fable Centre needs to be looked for in the Festival of Children's Arts organised in 2003 in the Municipality of Pacanow. During his stay on 22 March 2003 in Pacanow, the then Minister of Culture, Mr Waldemar Dabrowski, presented the vision of the celebration of the 70<sup>th</sup> anniversary of Koziolak Matolek's 'birth' in the course of his meeting with representatives of the Marshall Office, Voivodeship Administration, Council of the Municipality and key stakeholders. In the first edition of the festival, organised in 2003, some 20 thousand participants took part. During the first day of the festival, the Minister of Culture declared Pacanow the Capital of the European Fable. Starting from the second edition of the festival, there were deliberations to construct a building, being a European Fable Centre. Pursuant to the Resolution of the Council of the Municipality of Pacanow of 30 August 2005<sup>4</sup>, the hitherto Municipal Culture Centre was transformed into the Koziolak Matolek European Fable Centre in Pacanow and it received consent to raise funds for financing the investment project. The application for a grant was lodged in 2005 within the framework of Priority 3 "Protection of the European Cultural Heritage" in the contest announced within the Norwegian Financial Mechanism and the Financial Mechanism of the European Economic Area. The assigned grant amounted to 2,669,802 euros<sup>5</sup>.

The Koziolak Matolek European Fable Centre (hereinafter EFC) is a cultural institution that has been functioning at a new seat since 4 March 2010. It employs 27 workers and cooperates with some 30 volunteers. The number of guests visiting the EFC amounted to<sup>6</sup>:

- as of 31/12/2010: 43 315 people,
- as of 31/10/2011: 48 117 people.

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<sup>4</sup> Resolution No XXXV/186/05 of the Council of the Municipality of Pacanow of 30 August 2005. Based on the Public Information Bulletin of the Koziolak Matolek European Fable Centre in Pacanow; available on-line under the address: [www.bip.pacanow.eu](http://www.bip.pacanow.eu) (date of downloading 17.11.2011).

<sup>5</sup> Based on the information of European Fund Department of the Ministry of Culture and National Heritage, website: [www.eog.mkidn.gov.pl](http://www.eog.mkidn.gov.pl) (date of downloading 17.11.2011).

<sup>6</sup> Based on the information on sale of tickets of the Koziolak Matolek European Fable Centre in Pacanow.



- payroll and supplementary payroll remunerations: to 866,597.25 PLN,
- social insurance and other benefits: to 151,596.05 PLN,
- purchase of outsourcing: to 1,276,421.84 PLN,
- consumption of materials and energy: to 507,136.45 PLN,
- taxes and fees: to 13,317.92 PLN.

Based on the analysis of the lines of expenditures covering 41% of the amount of expenditures incurred by the EFC in 2010 on outsourcing, purchase of materials and energy, it is estimated that 35.28% of expenditures were paid to contractors having their seat or branch office (invoice issuer's postcode) in the territory of the Swietokrzyskie Voivodeship<sup>9</sup>. The geographical distribution of net expenditures (excl. VAT) of the EFC by district is presented in Figure 1.

### 3. Directions of the cultural institution impact on the region

The issues of ways serving an analysis of economic impact must be considered in three dimensions:

- **Primary economic impact (PEI)**, which takes into account expenses incurred by visitors and direct revenues generated by cultural institutions (e.g. ticket sales revenues, sponsoring revenues); they are directly connected with the functioning of a given institution and with activities carried out in the surveyed territory or in its direct vicinity (among other things, activities of units managing the cultural institution, commercial and service companies carrying out their activities related to the institution, public institutions, e.g. the police, units of local transport, etc.); in practice, the direct impact is relatively the most easy to capture and measure. Direct effects are measured most often with the level of created revenues, number of jobs, level of direct taxes and, sometimes – it is possible – with the level of value added tax.
- **Indirect effects**, which take into account the effects felt by economic units and the local community indirectly involved in servicing the institution and people benefitting thereof; indirect effects are connected with the functioning of the chain of supplies of goods and services for the activity taken into consideration while estimating the direct effects (e.g. supplies of utility services, fuels, materials, etc., transport, construction and other services, important to the activity carried out in connection with the

<sup>9</sup> It is necessary to pay attention to the that the Koziolok Matolek European Fable Centre in Pacanow as an institution of the sector of public finance is obliged to apply the procedures of public procurement in the selection of suppliers which means, among other things, the need to maintain competitiveness in supplier selection.

cultural institution and in its direct environment; also financial, insurance services and, possibly, medical services, etc.). It needs to be emphasised that indirect effects occur also owing to expenses incurred by visitors at the destination place (tourists, one-day visitors in connection with the travel made by them and stay in the territory where the cultural institution operates. These are, first of all, activities carried out by accommodation facilities, catering outlets, other tourist attractions, which are used by visitors, as well as other units providing services to this group).

- **Secondary economic impact (SEI)**, which takes into account a further growth of expenditures evoked by growth of incomes in the region (e.g. wages and salaries), issuing from activities carried out by the cultural institution<sup>10</sup>. They occur owing to expenditures (consumption and investment) incurred by employees on the activity taken into account when estimating direct and indirect effects. Estimating the level of induced effects, there are taken into account further, occurring after one another phases of expenditures; one should also remember that the underlying activity is that carried out by the cultural institutions, being, to say so, an impulse to further economic actions. The stage of determining the level of induced effects is connected with the need to estimate economic multipliers requiring an analysis of input-output multipliers<sup>11</sup>.

Examining a broader multiplier impact within the region, the authors assume that there exists correlation between local business units, and the multiplier impact is all the greater the more the local tourist industry is integrated with other fields of the economy in the region and the less it makes use of the activities of external units. Therefore, the volume of the multiplier depends on the volume and structure of the local economy, which is subjected to examination. In the subject literature it is emphasised that urbanised regions, large towns and cities are usually characterised by a higher level of the multiplier, small towns and rural areas – by a lower<sup>12</sup>. In rural areas, we deal with definitely greater

<sup>10</sup> Cf. also Baker Associates: Economic Impact of Glastonbury Festivals 2007. Mendip District Council. Shepton Mallet 2007.

<sup>11</sup> For example, the research carried out in 2009 in Spain show that the multiplier estimated for the celebration of the Holy Week in Seville amounted to 2.14; the average multiplier for the region (Andalusia) amounts to 1.51; these estimates mean that every euro spent in relation to the celebration of the Holy Week yielded 2.14 euros, of which 63 cents 'leaked' beyond the region. The research also allowed the estimation that the aggregate economic effect of that event was 1.22% of Seville's GDP and 0.7% of GDP of the whole province. Cf. J. L. Martin Navarro, A. Garcia Sanchez, M. L. Palma Martos, The Economic Impact of Spring Feast in Seville.

<sup>12</sup> For example, when analysing impact of the Glastonbury Festivals 2007 authors of the project cited the multipliers applied in other surveys of this type, showing their differentiation depending on the region's size. And so, the example of the festival in Edinburgh shows that the multiplier for

'leakages' of money, and it is proper to emphasise that the lesser leakages, the greater the multiplier effects. International surveys show additionally that the multipliers, computed for activities of the tourist nature, are higher than for other types of activity<sup>13</sup>.

In the research so far carried out, it is also emphasised that the multiplier effects are disturbed when, related to a given activity, the region is not able to ensure the basic production factors (skilled employees, potential to investment implementation, capital, food). The chain of indirect effects ends (or significantly limits itself), as a rule, in the two cases: when the high propensity to save arrests a further money spending by those people or economic entities, to which there flew in direct expenses connected with the institution/event in question and when demand cannot be met by producers from a given area, and the stream of money 'leaks' beyond the region. Then producers of a given area are not able to deliver the necessary goods and services and suppliers will seek them at producers from outside the region. Taking this into account, one should remember that many a time the visitor spends money on the products manufactured by faraway economic units (related to Pacanow, such a threat is, for example, the purchase of souvenirs, toys, which are manufactured in other regions). This will cause outflow of money from a given region and transfer of the multiplier effect beyond its territory – "losses" will take place of the multiplier effect in a given territory and transfer thereof to other areas, many a time geographically very distant. A reason for such 'losses' may also be taxes, the above-mentioned savings and, on the scale of the whole country, imports of goods and services. There takes place the need to 'import' the production factors (labour, capital, and production capacities) from outside the region; there takes place an outflow of revenues from tourism and profits are exported beyond the region<sup>14</sup>.

The analysis of the impact of the event or cultural institution on the economy refers also to its impact on changes in the level and structure of employment. There is estimated a similar multiplier, which is often a subject of controversies and diversified, sometimes erroneous and too many simplified interpretations. The simplified approach assumes that economic units directly or indirectly affected by the cultural institution in question (e.g. catering outlets or accommodation facilities) fully make use of the employed workers and they

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the city itself was formed within the limits of 1.38–1.69 (depending on the surveyed sector of the economy: accommodation, catering, etc.), while for entire Scotland – already at the level of 1.53–1.94. Cf.: Baker Associates: *Economic Impact of Glastonbury Festivals 2007...*, *op. cit.*, p. 14.

<sup>13</sup> *Ibid.*, p. 14.

<sup>14</sup> Cf. also A. Konieczna-Domańska, *Gospodarka turystyczna Zagadnienia wybrane*, Wydawnictwo KANON, Warsaw 2007.

do not have any labour reserves that may be used in connection with starting or expanding activities of the cultural institution; therefore, they must fully hire new staff, setting up for them new workplaces. However, employers are not always forced to employ new personnel. Often, responding to an increased demand, they make use of the possessed labour reserves, employ the previous personnel in increased working time, hire additional employees on a part-time basis or for a short time-period, adjusted, for example, to the seasonal intensity of movement. Additionally, one must remember that many jobs may be taken by people from outside the region (then there takes place a 'leakage' of revenues and jobs beyond the region. These dangers relate to a lower extent to cultural institutions with a continuous, yearlong nature of their activity, where there is the need to employ permanent personnel. Surveying the problem of employment, one must, therefore, also take into account the fact from where (from what distance from the place, in which the cultural institution operates) the hired employees arrive, hence, what the scope of its impact is.

The analysis of the subject literature and the so far carried out projects enables not only insight into the adopted methodological solutions but it also delivers interesting research findings<sup>15</sup>. Due to the specificity of the cultural events in question as well as different features of the socio-economic environment, those findings are often incomparable; nevertheless, it is worthwhile presenting some of them and to show what – in result of that research – the coefficients of the multiplier effects have been estimated.

**Table 6. Statement of multiplier effect coefficients for the region**

Even/Region	Multiplier	Source
Holy Week celebration/Seville	2.14	J. L. Martin Navarro, A. Garcia Sanchez, M. L. Palma Martos
Festival/Glastonbury	1.38–1.69	Baker Associates
Festival/Grahamstown National Arts	2.56–3.16	M. Saayman, R. Rossouw
London/The Royal Centre Theatre	1.5	D. Shellard
London/West End Theatre	1.5	T. Travers

Source: authors' own elaboration.

The analysis of the level of multipliers estimated for individual events and cultural institutions proves that they have an individualised nature and are quite differentiated, depending on:

<sup>15</sup> Cf. e.g. A. Gelan, Local economic impact. The British Open. Annals of Tourism Research, 2003, Vol. 30, No. 2, pp. 406–425.

- type of event/cultural institution,
- event duration,
- type of business activity, to which they relate (hotel industry, transport, catering, etc.); multipliers are higher related to those types of activity, in relations to which they are used, to a greater degree, products and services produced in the region; for example, multipliers for catering are, as a rule, higher because they are used, to a greater degree, local agricultural products and local labour force,
- degree of urbanisation of the region, to which they relate.

It is worth referring here to the surveys carried out by A. Gelan and to pay attention to their complexity. Carrying out an economic analysis of the impact of a great event on the local economy, the authors took into consideration not only revenues but also the financial contribution made by local institutions of the public sector from the region in question (e.g. to the improvement of infrastructure, training of the personnel employed as well as to event promotion); it is also important to take into account the co-financing on the part of central institutions (the central budget, institutions from outside the region). Because the authors were interested only in new streams of money supporting the local economy in relation to the event in question, they did not consider the sums spent by the local authorities, assuming that they would be left in the region anyway, though perhaps they would support another local civic initiative. What's more, in the analysis of the economic effects of the event, they did not forget to deduct the value of goods imported from outside the region. It is proper to remind people here that in surveys related to a small region, the share of goods imported from outside its territory will be more significant than those related to a bigger region.

As regards the methodological conclusions from the survey, the authors paid attention to the fact that neither knowledge of the number of visitors nor awareness of the level of expenditures guarantees a fair assessment of the impact of an event on the local economy. The most important is the share of expenditures assigned for local products and services: the larger it is, the more beneficial is the impact of the cultural institution or cultural event on the region's economy. It also concerns retail purchases: the more local sellers are involved in servicing tourists/visitors arriving in connection with the surveyed institution/event, to the bigger degree the charged margins are left in the region. This also relates to the whole chain of suppliers. Striving to achieve as good an effect as possible, one should, therefore, undertake actions that will encourage incurring expenses on accommodation and purchases of additional services in the region, and not outside it, and also to engage sub-suppliers of those products and services. The

greater their share, the larger margin is left in the region and the greater real economic impact of the event on the region. A similar conclusion may be made in relation to the effects of the multiplier's impact: the more subsequent expenses are related to products and services within the region the greater is its importance for the local community. Hence, one may draw a more general conclusion, not necessarily complying with common expectations and conventional opinions: small regions, with a low level of development, including typically rural regions, are not able to derive adequately great and expected economic benefits from cultural and sport events or cultural institutions if they are not able to encourage visitors to buy local products. Realisation of this fact should trigger initiatives aimed at raising the quality of local products and services, indirectly accompanying cultural institutions and not only directly connected with them.

One of the more interesting findings of the recently carried out research is estimation, on the example of the Glastonbury Festival 2007, of the economic impact of the festival both on the region in a narrower and broader sense, therefore, not only on the locality where it is organised but also on the whole Mendip region as well as on the half-million city of Bristol located 50 km away<sup>16</sup>. Estimations were made with the use of several complementary research tools; however, to do so, there were necessary values of the multipliers computed in the Scottish Tourism Multiplier Study (STMS).

Detailed results were also provided by the project implemented in South Africa, on the example of the Grahamstown National Arts Festival<sup>17</sup>. Examining the festival participants' (*festinos*) expenses and using the *social accounting matrix* (SAM), the authors managed to estimate not only the direct, indirect and induced effects related to the entire project but also to break down their estimations to a number of types of business activity: trade, hotel industry and catering, transport and services related to communication, financial services, industry and other. Making use of the multipliers relating to employment, the number of new jobs was also estimated, also divided into the selected types of activities. As A. Gelan, the authors of the South African surveys emphasise that:

- a) higher multipliers relate to urban areas, lower to rural (due to the greater opportunity to spend money within the territory),
- b) multipliers are diversified depending on the type of activity (higher where products and services produced in the region are used to a greater degree, for example, multipliers for catering are, as a rule, higher because to

<sup>16</sup> Baker Associates: Economic impact of Glastonbury Festivals 2007..., *op. cit.*

<sup>17</sup> M. Saayman, R. Rossouw, The significance of festivals to regional economies: measuring the economic value of the Grahamstown National Arts Festival in South Africa, "Tourism Economics", 2011, 17 (3), p. 603 and subseq.

a greater degree, local agricultural products and local labour force are used),

- c) an attempt to increase the multiplier requires the intensification of local production connected with the cultural institution and with servicing visitors as well as the extension of the tourist offer, adding other attractions that will encourage visitors to stay longer.

The overview of research carried out recently allows pointing out the following potential elements of the socio-economic impact of the event/cultural institution on the region:

- change of the structure of local and/or regional economy,
- stimulation to activity the local industrial production connected with the object of the cultural institution's activity, supplies to the tourist industry, souvenir industry,
- development of tourism, change of its structure, season extension,
- volume and structure of employment,
- density and quality of the transport network, use of means of transportation,
- change of the site's investment attractiveness, change of land value.

## **4. Primary economic impact**

### **4.1. Analysis of expenses incurred by visitors**

The initial assumption of the project was to examine two streams of travellers arriving in Pacanow: tourists (i.e. people who stop in a given territory for at least one night, hence, they use the local lodging facilities) and 'short-term visitors', sometimes also called 'excursionists' or 'hikers' who do not stay overnight in a given territory. The division of the stream of travellers into these two groups is, from the economic point of view, difficult to overestimate due to quite different dimension of their impact on the local economy and different types of infrastructure that is indispensable for their attendance. In relation to the movement of travellers we deal with in Pacanow, this assumption appeared to be unrealisable due to the overwhelming advantage of short-term (one-day) visits, the insignificant importance of tourism (with lodging) and the lack of possibilities to reach – in reasonable time and with reasonable cost – the satisfactory group of respondents staying for the night. Therefore, the analysis is based on surveys of one-day movement, and where it is necessary for further estimations – supported with data from Polish nation-wide surveys.

For the overwhelming majority of respondents, the EFC was the main purpose of travel (55.8%), who had chosen intentionally and specially, or it was one

of the attractions visited during their stay nearby (25%). In the survey, individual tourists prevail (from 1 to 4 persons); these data can hardly be considered as well as reflecting the structure of movement, particularly if to take into account that a significant group of visitors to Pacanow is constituted of organised excursions of children and youth.

**Table 7. Structure of visitors by the main purpose of travel**

Main purpose of travel	Share (%)
Visit to the EFC as the main purpose of travel	55.8
Visit to the EFC additionally to travelling in Poland	17.3
The EFC as one of the attractions visited during a stay nearby	25.0
Participant of the event organised by the EFC	1.9

Source: authors' own calculations based on a survey launched in Pacanow.

**Table 8. Average expenses incurred by visitors**

	Tourists	Short-term visitors
Share of this group in the population of respondents (in %)		83.10
Expenses incurred prior to travel (PLN/person)	75.0	53.3
of which (in %):		
• transport	100.0	69.2
Expenses incurred in Pacanow (PLN/person)	317.0	52.0
of which (in %):		
• lodging	22.1	0.0
• board	50.5	23.8
• transport (fuel, tickets)	11.0	12.6
• recreational, entertaining services	10.1	31.4
• souvenirs	6.3	14.0
• other purchases	0.0	12.8
• other expenses	0.0	5.4

Source: authors' own calculations based on a survey launched in Pacanow.

Discussing the structure of expenses, it is worthwhile looking closer at the sums assigned to board, recreational and cultural services as well as to purchases. The interviewed short-term visitors almost 83.3% of their board expenses assigned to catering services (restaurants, bars, and canteens), 16.4% to the purchase of foods and soft beverages and the remaining 0.3% to cigarettes and alcoholic beverages. Among the expenses on recreational and entertainment

services, almost the whole sums were assigned to the purchase of tickets to the EFC; as far as purchases of souvenirs are concerned, more than 80% assigned to various figures of Koziolok Matolek. Analysing the structure of expenses, it is also worthwhile paying attention to a relatively greater share of sums destined to other purchases and other expenses. The former should include expenses related to various purchases made additionally to the travel; the latter – for example, expenses incurred in the nearby children’s playground. In the surveyed sample, short-term visitors accounted for 83.10% of all respondents. Comparing the above information with the amounts estimated by the Institute of Tourism in 2010, expenses of Polish tourists were estimated in short-term travel (up to 5 days) at 63 PLN/day of stay.

## 4.2. Cultural institution expenditures

The expenditures of the EFC were estimated on the basis of analysed financial statements for the year 2010<sup>18</sup>. In the structure of expenditures, those amounts that were appropriated by the finances of business entities and households were singled out; they account in aggregate for 2,815,068.51 PLN<sup>19</sup>.

## 4.3. The estimation of the volume of the primary economic impact

For the purposes of estimation of volume of the primary economic impact, the following values were adopted:

- The number of individuals who visited the EFC in 2010 = 43,315 people,
- The number of individuals who visited the EFC in the period from 1.01.2011 to 31.10.2011 = 48,117 people,
- Per cent of visitors staying in Pacanow longer than 1 day and night = 16.90%,
- Per cent of short-time (one-day) visitors = 83.10%,
- Average time-period of stay of short-term visitors = 2.90 days,
- Average level of expenses incurred by short-term visitors = 52.0 PLN/per-day,
- Average level of expenses connected with tourists’ stay in Pacanow in the period longer than one day = 317 PLN/person,
- Cultural institution expenditures = 2,815,068.51 PLN.

<sup>18</sup> For details, see Chapter 2.2.2. of the present study.

<sup>19</sup> The amount covers the following expenditure items: payroll and non-payroll remunerations: 866,597.25 PLN, social insurance and other benefits: 151,596.05 PLN, outsourcing: 1,276,421.84 PLN, consumption of materials and energy: 507,136.45 PLN, taxes and fees: 13,317.92 PLN.

The value of direct effects is shown in the below-presented formula:

$$PEI = E_E + E_V^{20} \quad (1.)$$

where:

$$E_V = E_{STV} + E_{LTV}^{21} \quad (2.)$$

Expenses incurred by short-term visitors can be computed with the use of the following product:

$$E_{STV} = AE_{ST} \times VR_{ST} \times V^{22} \quad (3.)$$

Expenses incurred by tourists staying longer than one day can be calculated with the use of the following product:

$$E_{LTV} = AE_{LT} \times VR_{LT} \times AVP_{LT} \times V^{23} \quad (4.)$$

Based on the above-presented data, we can compute expenses incurred by tourists in connection with their stay in Pacanow in 2010 and 2011 as follows:

Variable	2010	2011	Total
$E_{LTV}$	2 320 514.50	2 577 772.04	4 898 286.54
$E_{STV}$	1 871 727.78	2 079 231.80	3 950 959.58
$E_V$	4 192 242.28	4 657 003.85	8 849 246.12
$E_E$	2 815 068.51	No data	2 815 068.51
$PEI$	7 007 310.79	4 657 003.85	11 664 314.63

Source: authors' own calculations based on a survey launched in Pacanow.

## 5. Indirect effects

The surveys carried out in 2011 among residents allow the statement that, in general, opinions on the impact of the European Fable Centre on the region are unexpectedly positive, mature and optimistic. All groups of stakeholders perceive not only an increase of tourism in the town (score +7.3) but also a very positive impact of the EFC on Pacanow's recognisability (+7.3), its aesthetic appearance (+6) and, in consequence, good exploitation of the cultural institution, which

<sup>20</sup> Sum of expenditures of the cultural institution and visitors' expenses.

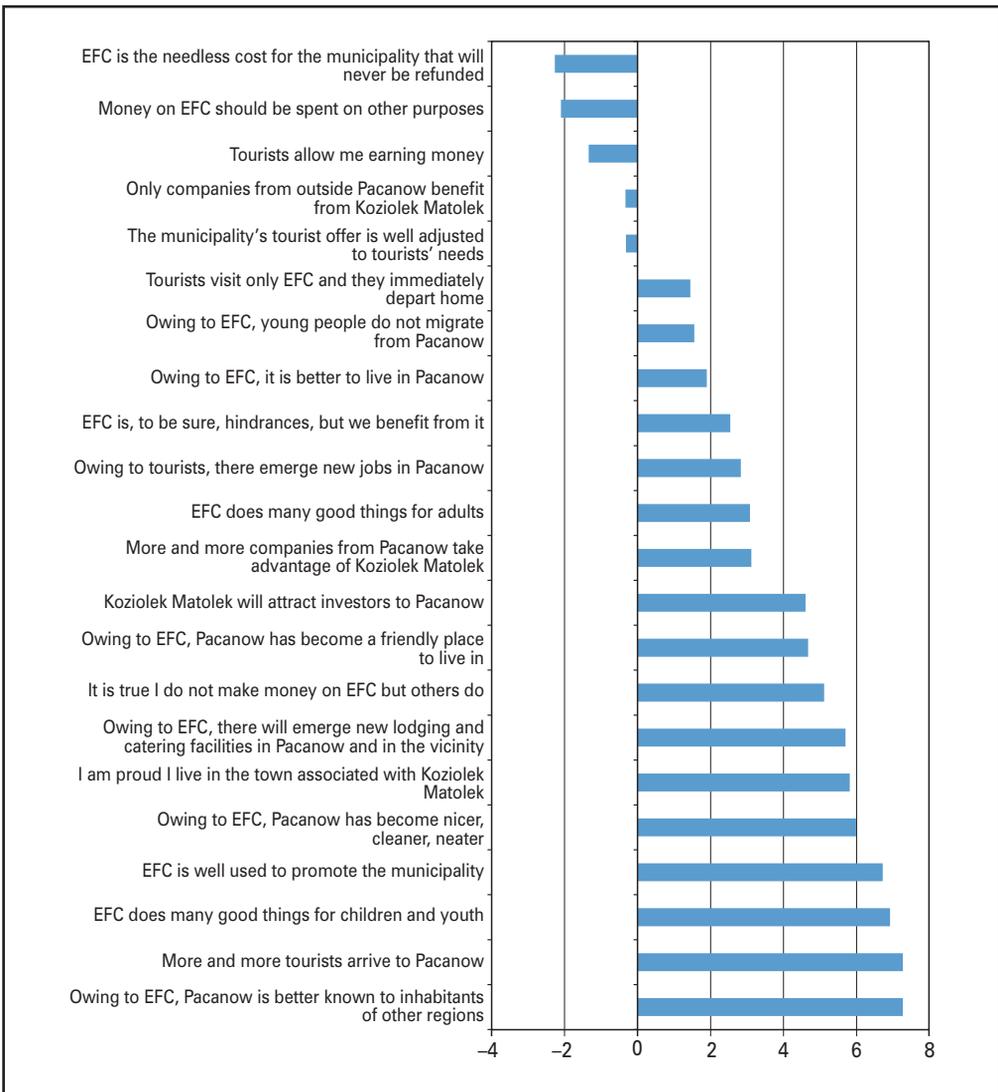
<sup>21</sup> Sum of expenses of short-term visitors (STV) and long-term visitors (LTV).

<sup>22</sup> Product of average daily expenses incurred by short-term visitors, per cent of short-term visitors, and volume of tourist movement connected with the cultural institution.

<sup>23</sup> Product of average daily expenses incurred by long-term visitors (staying longer than one day), average duration of stay, per cent of long-term visitors, volume of tourist movement connected with the cultural institution.

the EFC is, for the promotion of the town (+7.3). In result, such a perception of the role of the EFC affects the growth of the level of local patriotism; this is evidenced just by the fact that all the surveyed groups of inhabitants identify themselves to a great degree with the statement *I am proud I live in the town associated with Koziolak Matolek* (cf. Fig. 2).

**Figure 2. Residents’ opinions on the socio-economic impact of the EFC in Pacanow: respondents as a whole (the scale of scores: -10 +10)**



Source: authors’ own calculations based on a survey launched in Pacanow.

To a great degree, the respondents perceive both general positive social effects (the *EFC does many good things for children and youth* – score +6.9, *Pacanow becomes a more and more friendly place to live in* – score +4.7, *now, it is better to live in the town*) and the concrete economic dimension. The latter is not always, to be sure, so unanimous and so positive, nevertheless, the respondents clearly see and appreciate the opportunity to obtain additional material benefits in connection with the EFC (however, attention is attracted to the fact that they rather perceive the opportunity to earn money by others, not by themselves!), emergence of new workplaces and, in the future, chances to attract to Pacanow new investment, particularly in the tourist industry (thanks to *the EFC, there will emerge new lodging and catering facilities in Pacanow and in the vicinity* – score +5.7 points).

It is worth paying attention to the perception of the phenomena, which may be, from the inhabitants' point of view, potentially controversial, is not either negative to such a degree, which one might expect. Taking into account the medium scores, the respondents rather do not agree with the statement that *only companies from outside Pacanow benefit from Koziolak Matolek* (score –0.3), they do not think that *money from the EFC should be spent on other purposes* (–2.1) and most of them do not think that *the EFC is a needless cost for the municipality that will never be refunded* (–2.3).

The presented above evaluation of the socio-economic impact of the EFC on the region is of the averaged nature, covering all the respondents. Though it is very important, as it covers the whole community of the town, it is also proper to analyse how the EFC is received by individual groups of citizens, using in a different degree the EFC and involved to a different degree in its functioning.

## 6. The secondary economical impact

The level of the secondary economical impact can be computed as a product of the sum of direct effects and the multiplier; assuming different values of the multiplier it is possible to estimate the level of the induced effects (cf. Table 9).

The value of the multiplier can also be estimated based on the Keynesian multiplier that assumes the form:

$$k = \frac{1}{1 - MPC(1 - t)}^{24} \quad (5.)$$

where:

$$MPC = \frac{\Delta C}{\Delta Y}^{25} \quad (6.)$$

<sup>24</sup> *MPC* – Marginal Propensity to Consume, *t* – effective tax rate.

<sup>25</sup>  $\Delta C$  – increase in consumption (of consumer expenses),  $\Delta Y$  – increase of income.

**Table 9. Estimation of the induced effects (in PLN)**

Variable	2010	2011	Total
PEI	7 007 310.79	4 657 003.85	11 664 314.63
Multiplier			
Holy Week celebration/Seville			2.140
Festival/Glastonbury			1.535
Festival/Grahamstown National Arts			2.860
London/The Royal Centre Theatre			1.50
London/West End Theatre			1.50
Induced effects (SEI)			
C 1	14 995 645.08	9 965 988.23	24 961 633.310
C 2	10 756 222.05	7 148 500.90	17 904 722.960
C 3	20 040 908.85	13 319 031.00	33 359 939.840
C 4	10 510 966.18	6 985 505.77	17 496 471.950
C 5	10 510 966.18	6 985 505.77	17 496 471.950
Average induced effects <sup>a)</sup>	13 362 941.67	8 880 906.33	22 243 848.000

<sup>a)</sup> The arithmetic mean of induced effects for multipliers C1 – C5.

Source: authors' own calculations based on a survey launched in Pacanow.

The application of the Keynesian multiplier in the above formula requires making some important assumptions<sup>26</sup>; they include, in particular: (1) the assumption of stability of prices and wages in the situation of the incomplete use of production factors; (2) the assumption that there is a possible functioning of the economy whose real production is lower than the potential one; (3) the assumption of the existence, with the present level of wages and prices, of unused production capacities; (4) the assumption that the factors limiting production are on the demand side, and (5) the assumption of a closed economy, i.e. that growth of demand will not be subsidised by the growth of imports.

## Conclusions

1. Summing up the results of the surveys related to the socio-economic impact of the cultural institution, which the EFC is, on the economy of the Municipality of Pacanow, first of all, it needs to be emphasised

<sup>26</sup> In more details on the assumptions of Keynesian multiplier and methodology of estimation thereof, see, inter alia, *Ekonomia*, Paul A. Samuelson, William D. Nordhaus (transl. by Michal Rusinski, Zofia Wolinska) Wydawnictwo Naukowe PWN, Warsaw 2007.

that the positive effects of ‘investing’ in culture are of a long-term nature and they seldom appear immediately upon the incurrence of expenses; hence, they are more difficult to be perceived and appraised. There is the need of time that respective social groups and individual members of the local community could find the way for making use of the opportunities provided for them personally by the EFC. What is more, decisions on initiating and then co-financing cultural institutions happen to be controversial for local communities; then, there appear opinions that, may be, money should be spent on other, sometimes more urgent purposes and that it is a needless cost for the region, which will never be returned. These controversies stem from the logical necessity to make a choice as regards the allocation of the available resources and, moreover, from differentiated preferences and visions with respect to regional development, sometimes also from the lack of faith as to the possibility of transforming current sacrifices into a long-term development.

2. Respondents perceive not only external changes (renovated facades, decorations) but also investment projects serving the common good (new pavements, sewage, roads), development of private enterprise (new shops, bars, restaurants), opportunities to attract investment, provision of such conditions to life and work that will prospectively be conducive to a stronger identification of the youth with a ‘small fatherland’ and to stay in Pacanow.
3. The surveys among residents showed also certain diversification of opinions inside that community. It is important that for most opinion-forming individuals, with potentially the greatest impact on decisions as regards the further development of the EFC, there is a characteristic certain optimism as to the potential and future impact of the EFC (*Koziolok Matolek will attract investors to Pacanow; more and more companies from Pacanow take advantage of Koziolok Matolek; owing to tourists, new jobs in Pacanow emerge; it is true I do not make money on the EFC but others do*). There is, between the respondents, for example, quite a significant polarity as to the issue who, first of all, takes advantage of Koziolok Matolek: inhabitants of the municipality or businesses from outside Pacanow. There exists a little surprising fact that entrepreneurs, i.e. the group which is (should be?) an intermediate major beneficiary of the EFC development, evaluate the economic impact, the opportunity to earn money and the chances for the potential development of the town very much non-uniformly, often sceptically. Entrepreneurs, more

often that the respondent body, think that tourists spend too little time staying outside the EFC (*tourists visit only the EFC and they immediately depart*), they also less optimistically assess the way of taking advantage of the EFC to promote the municipality.

4. This sceptical attitude of entrepreneurs should become an impulse to courageous actions that will allow for increasing tourism, extending stays in Pacanow, creating the opportunities for the growth of expenses incurred by visitors and, in effect, ensuring a broader commitment of the local business. This requires:
  - a. significantly better information and promotion,
  - b. extension of the tourist offer by way of determined promotion and inclusion of other attractive sites (for instance, St Martin Basilica, nearby monuments, products of popular culture, natural attractions), creation of new tourist products exploiting local attractions (mini heritage park?), tracing and marking out the tourist, bike trail, etc.,
  - c. undertaking the production of a wider assortment of souvenirs exploiting the symbols of Pacanow and Koziolok Matolek.
5. The research has confirmed the hypothesis, often put forward in the literature, that neither awareness of the number of visitors nor awareness of the level of expenses guarantees a fair evaluation of the impact of an event on the local economy. **The most important is the share of expenses assigned to local products and services: the higher it is the more beneficial impact of the cultural institution, cultural event on the region's economy.** Achievement as a good effect as possible on the region requires undertaking actions that will encourage incurring expenses that are left in the region and not leaking outside (this also concerns the sub-suppliers of products and services). The greater the share is the bigger margin is left in the region and the greater is the real economic impact of an event on the region. In **small, typically rural regions, deriving adequately high and expected economic benefits from cultural, sport events or cultural institutions will be very much doubtful if they are not able to encourage the visitors to buy local products.** This threat concerns Pacanow, too. It is important that the awareness of this fact is high among the residents. This should encourage the undertaking of actions and to trigger initiatives aimed at raising the quality of local products and services, indirectly accompanying the cultural institution, bought by visitors, so to say, 'on the occasion' of their stay at the EFC.

6. It must be explicitly emphasised that the extension of the EFC activity and a greater share of the inhabitants in potential benefits requires employment of a relevant level of social capital, human and financial. The occurrence of a certain minimum of these types of capital (understood as resources, know-how, citizens' entrepreneurial attitudes, local self-governmental entities, NGOs, network of relations, leadership but also the willingness to carry out social cooperation and a certain level of optimism) provides opportunities for social mobilisation, collective enterprise and – in consequence – an increased supply of goods and services delivered to visitors.

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## **Consumer Lease Development in Poland. Legal Determinants**

### **Introduction**

Lease as a source of financing has been applied in Poland for over 20 years. Thanks to the application of this instrument a dozen per cent of all investments are financed in the Polish economy<sup>1</sup>. While it is legitimate to state that lease is a relatively common tool applied by Polish entrepreneurs within their business activities, its application on the part of the Polish consumers is marginal with reference to the total lease services market. It is in contrast to the European leasing market, where the consumer lease is estimated to finance on the average about 30% of the vehicle financing market, and the value of this segment of the market accounts for over 200 billion euros<sup>2</sup>.

The aim of the present article is to present the legal determinants concerning the consumer lease, with a particular interest in the 2011 changes in legal regulations on the lease agreements taxation, with reference to physical persons not involved in business activity. Furthermore, the author intends to indicate, based on the prior analysis of legal regulations, the prospects for development of the consumer lease in Poland.

### **1. Consumer lease and civil law**

In 2000 the lease agreement was introduced into the Polish Civil Code as the third agreement on the payable use of things. Unlike the UNIDROIT convention of May 1988 on international financial lease, the Polish civil and legal regulations

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<sup>1</sup> According to the data of the Polish Leasing Association in 2007 the share of leasing in the financing of all investments amounted to 17% to fall to 15.2% in 2008 and 10.9% in 2009 following the economic slowdown caused by the global financial crisis. In 2010 there was another rise in the share of leasing in financing of investment. It is estimated that in 2010 this share amounted to 12.6% and 13.1% in 2011. Source: data of the Polish Leasing Association. <http://www.leasing.org.pl/pl/statystyki/2011> [access: 25.02.2012].

<sup>2</sup> A. Bobrowicz, Kto skorzysta na leasingu konsumenckim (Who will benefit from consumer leasing), <http://miesiecznikdealer.pl> [access: 4.02.2012].

allow for the application of lease as a form of financing in corporate business turnover, and an alternative way, to the consumer credit, of the financing of goods by people not involved in any business activity. According to art. 709<sup>1</sup> of the Civil Code:

*The lease agreement obliges the lessor, to the extent of the conducted business, to acquire an object from the vendor designated under the terms of this agreement, and give this object the lessee to use, or use and benefit from for a fixed period, and the lessee shall pay to the lessor, in agreed instalments the amount at least equal to the price or compensation for the purchase of the object by the lessor.*

According to the Polish civil and legal regulations the lessor in the lease agreement may be exclusively an entrepreneur doing lease business “to the extent of the conducted enterprise,” whereas the lessee may be every physical or legal person possessing a legal capacity to act. The analysis of the regulations included in the Civil Code explicitly indicates that the lessee may be both an entrepreneur, who would require a technological line or a given property within the conducted business as well as a physical person not involved in any business activity, who intends to use the object of the lease agreement within their households. Thus, in the light of the Polish civil law for 11 years, i.e. since the introduction of the regulations on the lease agreement into the Civil Code there have been no obstacles in the way of the development of consumer lease. In the author’s opinion, the lease agreement regulated within the civil law contributes to a fair balance of rights and commitments of both parties to the lease agreement (their content had been interpreted in a different way by the participants of the Polish leasing market before it was introduced into the Civil Code). It refers, first of all, to the regulation of rights and commitments of the parties in the area of effects of a loss of the object of lease, the responsibility of the lessor for its defects as well as the effects of default on lease instalments by the lessee. Taking the above into consideration, it should be stated that the civil and legal regulations that came into effect more than a decade ago definitely do not create any barriers to the consumer lease development in Poland.

## **2. Consumer lease and tax law**

### **2.1. Consumer lease tax in the income tax regulations**

Whereas the civil and legal regulations did not hinder the development of consumer lease in Poland, the tax regulations passed in 2001 were created mainly

in favour of the people involved in business activity entitled to depreciation write-offs. The legislator created two variants of the taxation of parties to the lease agreement, the second variant could be applied only when according to the agreement, the depreciation write-offs are made by the lessee. Taking into account that a consumer as a rule cannot apply depreciation write-offs, this variant could not be used within the consumer lease agreements. In this connection, when the lessee did not do business activity, there was a necessity of concluding agreements in the so-called 1st lease agreement taxation variant. This variant assumes that the leased object for the purpose of income tax is depreciated by the lessor, and the whole lease instalment (principal and interest part) is treated as his profit in view of the regulations of the taxation law. In turn, the lessee as a physical person could not qualify for the incurred costs as tax deductible revenue costs. Furthermore, there was an serious problem connected with the premature termination of the agreement, as the customer could not buy the object at the amount resulting from the settlement of the contract, but at the market value. Additionally, a lease agreement had to be concluded for the period of at least 40% of the normative time of depreciation. All the aforementioned limitations led to the situation in which consumer lease transactions up to 2011 had been marginal in relation to the whole lease services market in Poland.

The Act of 25 March 2011 on the limitation of administrative barriers for citizens and entrepreneurs<sup>3</sup> introduced, for example, changes in the area of consumer lease transaction taxation. The regulations of the law, which came into effect on 1 July 2011, on income tax of legal persons determine the tax rules in relation to the lease agreement parties, including the agreements concluded by a physical person not involved in any business activity. In the case of the so-called first variant (the object of lease, for the purposes of income tax, is depreciated by the lessor), the regulations in force since 1 July 2011 state that:

1. "The charges determined in the lease agreement incurred by the lessee within the basic lease period on account of the use of fixed as well as intangible assets are treated as the income of the lessor and respectively, in the case mentioned in point 1, the tax deductible revenue cost of the lessee, with reservation in section 2 and 3, if:
  - 1) a lease agreement, in the case when the lessee is not the person mentioned in point 2, was concluded for a fixed time, amounting to at least 40% of the normative period of depreciation, if the objects of lease are movables or intangible assets subject to depreciation,

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<sup>3</sup> Act of 25 March 2011 on the limitation of administrative barriers for citizens and entrepreneurs, "Journal of Laws" 2011, No. 106, item 622.

or was concluded for the period of at least 10 years, if the object of lease is real estate liable to depreciation;

- 2) a lease agreement, when the lessee is a physical person not involved in business, was concluded for a fixed time;
- 3) the amount of charges within the lease agreement, mentioned in point 1 and 2, reduced by the due tax on goods and services, corresponds to at least the initial value of fixed or intangible assets.”

Thus, according to the new regulations, a consumer lease agreement may be concluded for any time, but it has to be defined, and the amount of charges together with the possibly determined price at which the ownership is to be transferred, has to correspond to at least the initial value of the object of lease. With reference to the value of the purchase option, in the case of consumer lease, it cannot be lower than the so-called hypothetical net value (the initial value of a fixed asset reduced by the sum of depreciation write-offs calculated by means of the degressive method with coefficient 3)<sup>4</sup>.

**In the case of the so-called first variant of taxation of consumer lease agreement parties (the object of lease, for the purposes of income tax, is depreciated by the lessor) the consequences concerning the income tax are as follows:**

- during the basic lease period for the lessor:
  - the lease fee (the principal part and additional fee) is all regarded as profit,
  - the object of lease is depreciated by the lessor, whose depreciation write-offs as a whole are treated as tax deductible revenue cost (with the exception of cars, where there is a limit of 20,000 euros),
- during the basic lease period for the lessee (consumer): the concluded agreement does not result in any tax effects.
- after the expiry of the basic lease period:
  - the lessor is obliged to transfer the ownership of the object of lease to the lessee if the terms of the agreement are fulfilled and the lessee is willing to make use of this option provided for in the agreement;
  - the price of the ownership transfer may considerably differ from market prices, but it cannot be lower than the so-called hypothetical net value.

On the other hand, the second variant of the taxation of parties to the lease agreement states that the lessor’s incomes and respectively lessee’s tax deductible

<sup>4</sup> With reference to intangible assets the net mortgage value is calculated as the initial value reduced by the depreciation write-offs with 3 times shorter depreciation periods.

revenue costs cannot include fees on account of the repayment of initial value of fixed or intangible assets if the following terms are fulfilled:

- 1) lease agreement is concluded for a fixed time;
- 2) the amount of agreed fees in the lease agreement, reduced by the due tax on goods and services corresponds to at least the initial value of fixed or intangible assets;
- 3) the agreement includes the provision that in the basic lease period:
  - a) the depreciation write-offs are made by the lessee if not mentioned in b or
  - b) the lessor resigns from depreciation write-offs if the lessee is not involved in business activity.

Thus, according to the regulations in force until 1 July 2011, the application of the second variant of the taxation of parties to the lease agreement is also possible in the situation when the lessee is a physical person not doing business activity: in such a situation the lessor has to resign from the depreciation write-offs. Analogous to the case when the lessee is a business entity, also in the case of consumer lease fulfilling the conditions of the second taxation variant, the transfer of ownership after the expiry of the lease agreement may be made at any price.

**In the case of a consumer lease agreement which fulfils the aforementioned terms, the income tax consequences are as follows:**

- during the basic lease period, only the additional fee, which is a part of the lease fee, is treated as the lessor's income,
- during the basic lease period for the lessee the concluded agreement has no tax effects,
- after the expiry of the basic lease period:
  - the lessor is obliged to transfer the ownership to the lessee provided the agreement terms have been fulfilled and the lessee is willing to make use of this option provided for in the agreement;
  - the transfer of ownership may be made at any price, also considerably different from the market prices and hypothetical net value.

In conclusion, it should be stated that the new regulations clearly determine the principles of taxation of the parties to the lease agreement, also when the lessee is not a business entity. It should also be emphasised that the new regulations do not introduce any tax incentives (e.g. in the form of tax deductions) for consumers who would like to make use of the new form of financing.

## 2.2. Consumer lease tax in regulations on tax on goods and services

The profitability of consumer lease depends to a large extent on the tax on goods and services (VAT) levied on these transactions. Since 1 May 2004 lease agreements, depending on their provisions, are treated as the delivery of goods or rendering of services.

In order to treat a lease agreement as the delivery of goods, the agreement has to fulfil jointly three terms:

- it should be concluded for a fixed time,
- depreciation write-offs for the purpose of income tax should be made by the lessee unless land is the object of lease,
- the agreement should stipulate that as a consequence of the events resulting from this agreement, the ownership will be transferred to the lessee.

According to the interpretation of the Finance Minister the last of the aforementioned conditions is fulfilled if the lessee is entitled to purchase the object of lease after the expiry of the basic lease period, for which the agreement was concluded (the so-called purchase option of the object of lease).

However, if the lease agreement is not eligible for qualification as delivery of goods, then on the basis of the VAT law, it is treated as a service. Analysing the aforementioned conditions it should be stated that a consumer lease agreement as a rule will be treated as services (with the exception of the lease of land). The consequences of the assumed solutions are as follows:

- the VAT of 23% will be calculated successively on all the lease instalments (with the exception of land lease, when it is necessary to calculate the VAT in advance on all payments resulting from the concluded agreement),
- the lessor will calculate the lease fees on net prices, also in the case of a car lease. According to the regulations of the law on tax on goods and services, a full VAT deduction on account of a car purchase irrespective of its kind, favours the taxpayers whose activity is:
  - re-sales of these cars or
  - renting these cars on the basis of a rental or lease agreement or other agreements of similar character, if these cars are intended to be used exclusively for these purposes for the period of at least six months.

The acceptance of the solution that with reference to the majority of objects of consumer lease, the VAT will be calculated successively on individual instalments should be assessed as a favourable solution. A consumer unlike an entrepreneur cannot deduct the VAT and the necessity for one-time payment of

the whole VAT “in advance” would question the legitimacy of concluding such transactions. It should also be noted that VAT is levied on both the principal and interest part of the lease instalment. In the case of land lease, the necessity for one-time payment by the consumers of the whole VAT seems to be a factor which will decisively discourage them from entering into this kind of transaction.

### **3. Consumer leasing and consumer credit law**

The prospects for development of consumer leasing in Poland may depend on whether or not the transactions will have to fulfil the requirements determined by the law on consumer credit. Since 18 December 2011 a new law on consumer credit has been in force in Poland<sup>5</sup>. These regulations implement directive 2008/48/WE of the European Parliament and Council of 23 April 2008 on consumer credit agreements. Unfortunately, while the regulations of the directive are explicit enough, the implementation of the domestic legal order may arouse certain doubt<sup>6</sup>. According to art. 2, section 2d of Directive 2008/48/WE its regulations are not applied to the rental or leasing agreements unless the agreement itself or any separate agreement provides for the obligation of the purchase of the object of lease. It is assumed that such an obligation exists if the creditor unilaterally decides so. On the other hand, according to art. 4 section 2 point 2 of the law on consumer credit, its regulations are not applied to lease agreements when the agreement does not provide for the transfer of ownership of the object of lease to the consumer. At the same time art. 4 of the law on consumer credit states that “the law is applied to rental and lease agreements if separate agreements derived from this agreement provide for the transfer of ownership of the object of these agreements at the debtor’s request<sup>7</sup>”. While this regulation does not arouse any doubt and is compliant with the Directive of the European Parliament and Council, the interpretation of art. 4 section 1 point 2 of the law on consumer credit is not so definite. The interpretation of this regulation should give an answer to the question who should be obliged to transfer the ownership of the object of lease so that the agreement would be compliant with the law on consumer credit. The results of the interpretations lead to a fairly definite conclusion:

<sup>5</sup> Act of 12 May 2011 on consumer credit, “Journal of Laws” 2011, No. 126, item 715.

<sup>6</sup> D. Bucior, „Nowa ustawa o kredycie konsumenckim a umowa leasingu” (New law on consumer credit and the lease agreement), <http://www.lawblog.pl/2011/07/31/nowa-ustawa-o-kredycie-konsumenckim-a-umowy-leasingu/> [access 25.02.2012].

<sup>7</sup> Act of 12 May 2011 on consumer credit, “Journal of Laws” 2011, No. 126, item 715. “Journal of Laws” 2011, No. 126, item 715.

it is the lessor who should be responsible for it<sup>8</sup>. It seems to be contradictory to the idea of the Directive – the application of the requirement included in it with regard to consumer credit should take effect only when it is the lessee not the lessor that is responsible to buy the object of lease. Nevertheless, both the theory and practice of the operation of the lease market services in Poland it appears that the so-called option to purchase an object on lease is the lessee's right, which may be taken advantage of or not. All the more anxiety is aroused by the aforementioned regulation of art. 4 section 1 point 2 of the new law on consumer credit. The author suggests its content should be changed as soon as possible so as make it compliant with all other Community regulations and at the same time remove all doubts whether the consumer lease agreements should be subject to the provisions included in the law on consumer credit or not.

#### **4. Prospects for the consumer credit development in Poland**

Assessing the prospects of consumer leasing development in Poland, one should consider the experience of West European countries. Apparently, a car is a typical object of consumer lease. It is obvious as the lease of this kind of object bears a relatively low risk for the lessors. The changes in the Polish law presented in the first section of the article do not introduce any tax preferences for lessees/consumers. The motor vehicle age structure in Poland shown in Figure 1 poses a question whether or not certain minimal formal fiscal stimuli should be created to encourage consumers to buy new vehicles or to use them for example on the basis of the consumer lease agreement.

Obviously, there is an open question of the preferences with reference to all new cars, or, at least initially, for example only to cars of relatively low fume emissions, i.e. hybrid or electric cars. The international experiences show that different kinds of incentives with regard to “ecological cars” are applied not only by rich West European countries but also, for example, Romania which is a less wealthy country than Poland. In that country hybrid and electric cars are exempted from the charge on pollution within the current registration tax, and with regard to electric cars it is possible to obtain a 20% refund of the vehicle price (max. 3,700 euros)<sup>9</sup>. Unfortunately, in Poland cars, including those with low fume emissions, are all the time treated as fixed assets that instead of having been given tax privileges by the legislator are troubled with restrictions.

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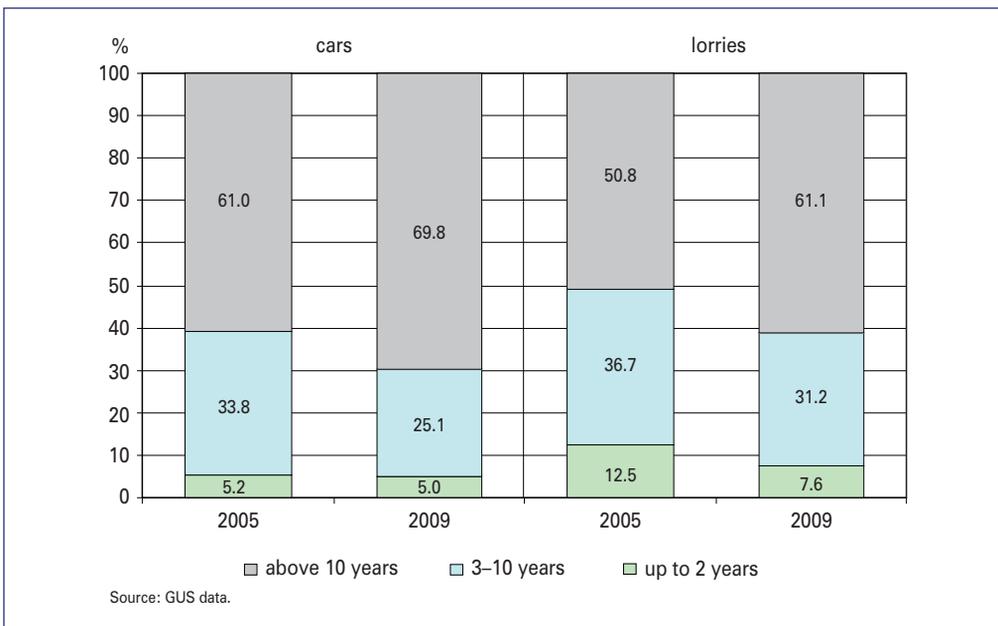
<sup>8</sup> D. Bucior, *op. cit.*

<sup>9</sup> M. Pogroszewska, *Auta na prąd bez zachęt podatkowych* (Electric cars without tax incentives), “Rzeczpospolita” of 4 November 2011.

An example to be quoted is the regulation which states that in the case of a vehicle used by a business entity, the amount of tax due is 60% of the calculated rent (instalment) or other payment resulting from the concluded agreement, documented with the invoice or the prohibition of the amount of the reduction or refund of the difference of the tax due with reference to engine fuel, diesel or gas used to power cars purchased by the taxpayer. Taking into account the fact that the change in the age structure of motor vehicles in Poland may bring not only measurable social effects but also the so-called multiplying effects within the automotive sector, contributing to the general economic growth of the country, it is well justified to undertake the activities aiming at:

- the lifting of tax restrictions with reference to car using business entities,
- the introduction of at least minimal tax incentives for the consumers who would make use of cars within the so-called consumer lease.

**Figure 1. Motor vehicle age structure in Poland in 2005 and 2009**



Source: J. Krzak, Ograniczanie emisyjności pojazdów w transporcie drogowym. Pojazdy hybrydowe i elektryczne w Polsce – perspektywy i bariery rozwoju (Restrictions on vehicle emissions in road transport. Hybrid and electric vehicles in Poland: Prospects and development barriers), in: *Polityka klimatyczna (Climate policy)*, ed. M. Sobolewski, "Studia BAS", No. 1/2012.

## Summary

Since the moment of introduction into the Polish Civil Code in 2000 of the regulations on lease agreement there are no obstacles to the development of the so-called consumer lease. Unfortunately, the tax regulations in force until 30 June 2011 were not in favour of this form of financing among physical persons not involved in business activity. The changes in the tax regulations made in 2011 with reference to consumer leasing should be given a moderately positive assessment. Admittedly, they do not create any tax incentives for consumers, but the transparent tax principles of this kind of transactions may be a stimulus to encourage some physical persons to make use of this kind of financing. Among potential customers there may be persons doing the so-called professions, employed on the basis of civil legal agreements (contract agreement or contract for a specific task), who are not able to document in the bank the appropriate level of income. The author estimates that the necessary condition to make the consumer lease play an important role in the financing of consumer goods (especially with reference to a car as a typical object of lease) is the creation of at least minimal tax incentives and the removal of tax doubts in relation to the dilemma whether the consumer lease agreements are subject to the law on consumer credit.

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## **The Taxation of Free Employee Benefits in the light of Personal Income Tax**

### **Introduction**

For years employee (fringe) benefits have been an element of the employers' policy to motivate employees. It appears that people expect their employers not only to remunerate them for their work but also to take non-financial care of them. This care is usually reflected in the form of fringe benefits. Employers find these benefits to be an efficient tool to reward and motivate staff, which allows them to improve team loyalty and effectiveness as well as to attract the best workers.

There is not a closed catalogue of such benefits. These most frequently applied by employers include refunding costs related to the Internet, foreign language lessons, vocational improvement training, gift coupons, medical care, cinema or theatre tickets, swimming pool or fitness class admissions. From the perspective of human resource management, undoubtedly the proper selection of employee benefits is important. The difficulty connected with the non-wage motivation is that the individual solutions should be applied to different people in order to make people well motivated and involved and as a consequence to be able to achieve the business goals set by the organisation.

Non-wage compensations may be viewed from not only the point of view of management but also from the perspective of the tax duty. To tax or not to tax? This is a question asked by numerous employers, who remunerate their staff in this form. The notion is a crucial issue for the employer to define when deciding whether or not to charge tax on employee benefits.

### **1. The notion of free employee benefits on the basis of the tax law**

In the Polish tax law there is no legal definition of employee benefits. Taxation acts are confined to the determination of the principles of evaluation of the specific groups of benefits. This fact is not an obstacle to the legal and tax specification of the content of this notion, referring to the relevant judicature, the achievement of the doctrine and even the everyday understanding of this word.

In the light of the dictionary entry of “free”, it means the one not paid for<sup>1</sup>. On the other hand, benefit is a duty to perform something of transfer something in somebody else’s favour and also what is performed or transferred<sup>2</sup>. “To receive” means to become a recipient, to obtain something as a gift or in return for something<sup>3</sup>. Taking into consideration the above definition, it should be assumed that a free employee benefit may be considered exclusively as an activity in favour of the **material gain** of only one party.

Similarly, the notion of fringe benefits is defined within the judicature. The verdict of the Supreme Appeal Court of 30 December 1998<sup>4</sup> stated that *the notion of fringe benefit should be understood as any economic or legal phenomena whose result is a profit at the expense of another entity*. A similar opinion was expressed in the adjudication of 24 June 1998, according to which *a fringe benefit is an object of commitment in which a material gain is to be received by only one party*<sup>5</sup>. In turn, the judgement of the Regional Administrative Court in Gdansk passed on 29 October 1999 indicates that *fringe benefits should refer to all legal and business occurrences within the activities of legal persons which result in free, i.e. not connected with costs or another form of equivalent, the material gain to this person, having a definite financial dimension*<sup>6</sup>.

Administrative courts are of the opinion that it is possible to speak about free benefits only when as a result of the transfer there is a material gain on the part of the recipient, who, at the same time, is not obliged to provide any mutual benefit.

Translating the definition mentioned above into the area of income tax it may be said in a simple way that free benefits in favour of an employee occur when the employee receives something free of charge from the employer which results in a material gain on the part of the employee of a definite financial dimension.

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<sup>1</sup> Słownik języka polskiego PWN (The dictionary of the Polish language), [www.sjp.pwn.pl](http://www.sjp.pwn.pl), Internet resources as of 10.03.2012.

<sup>2</sup> Ibid.

<sup>3</sup> Ibid.

<sup>4</sup> Wyrok NSA z 30 grudnia 1998 r., sygn. akt SA/Sz 105/98.

<sup>5</sup> The Regional Administrative Court Judgement in Krakow of 24 June 1998, file ref. no. I SA/Kr 1277/97.

<sup>6</sup> The Regional Administrative Court Judgement in Gdansk of 29 October 1999, file ref. no. I SA/Gd 1290/98.

## 2. Free employee benefits as the employee's income

In the Act on personal income tax (referred to as: pit), though there are no definitions of the notion of free fringe benefits, there is a method of evaluating them as a taxable income. According to Art. 11 section 1 of pit, *incomes (...) are the money and monetary values received or placed at the disposal of the taxpayer or the value of the received benefits in kind and other free benefits*<sup>7</sup>. The method of evaluation of the received benefits in kind and other free benefits is included in Art. 12 section 2 and 3 of pit, i.e. in the regulations which define incomes from employment and related relationships. This means that benefits of this kind obtained by the employee are taxed according to the tax scale. The employer is also obliged to charge the social insurance premiums on this account.

The issue of taxing fringe benefits within the income tax is beyond discussion if certain tax exemptions are provided in this area. For example, the Labour Code (LC) imposes the duty on the employer to guarantee the employees numerous free benefits. This group includes the employer's duty to guarantee within the situation determined by the law:

- preventive meals as well as drinks for people working in especially hard working conditions<sup>8</sup>,
- means of individual protection<sup>9</sup>,
- protective clothes and shoes<sup>10</sup>,
- prophylactic examinations<sup>11</sup>.

These benefits are exempt from tax on the basis of Art. 21 sect. 10–11 of the Act on personal income tax. There are also other non-wage benefits subject to the exemption. For example, the exemption refers to the value of material and money gains which do not exceed the annual value in the fiscal year of the total value of 380 zlotys transferred by employers from the funds of the Inner Company Social Benefit Funds (CSBF), except for bills, vouchers and others allowing them to exchange them for goods and services<sup>12</sup>. There is no doubt about the principle of providing benefits from the CSBF: they should be treated as income from the employment relationship, so the benefits exceeding the aforementioned threshold are employee's income. Even though Art. 21 does not identify a definite benefit provided by the employer in favour of the employee, is this the former that is

<sup>7</sup> The Act of 26 July 1991r on personal income tax ("Journal of Laws" No. 257, item 1725).

<sup>8</sup> Art. 232 Act of 24 June 1974. (Labour Code: uniform text, "Journal of Laws" of 16 May Dz. U. of 16 February 1998, No. 21, item. 94 with later amendments).

<sup>9</sup> Art. 237<sup>6</sup> LC.

<sup>10</sup> Art. 237<sup>7</sup> LC.

<sup>11</sup> Art. 229 LC.

<sup>12</sup> Art. 21 sect. 1, point 67 PIT.

always obliged to charge the advanced tax? The answer to this question is not uniform and definite as it requires an analysis of the notion itself of employee benefits and the notion of income tax. In this context it is crucial to determine whether the employee has obtained a material gain and in which proportion it is to the business goals of the company, i.e. if it does serve only the individual needs of the employee and whether the free benefit income was really received by the taxpayer and if it is possible to ascribe a real value to this income<sup>13</sup>.

There is no doubt that, if the employees make a profit from free receipts from the employer, they should pay tax due on it. Such an opinion is expressed not only by tax authorities but also by the courts. Other examples of benefits levied with tax within personal income tax are: a company car used by employees for private purposes<sup>14</sup>, medical insurance bought by the employer in favour of an employee and the employee's family<sup>15</sup> or eventually a company telephone used for private purposes<sup>16</sup>. These examples raise no doubts as to the receipt of benefit by the employee or its value. It is possible to ascribe a definite value to an individual employee, for example, on the basis of the insurance premium value: the so-called mileage reimbursement rate in the case of a company car for private use or eventually on the basis of telecommunications billings.

Thus, the question arises if it is possible to tax such benefits that do not fulfil the two conditions mentioned above, i.e. it has not been really received and the actually received income on account on this benefit cannot be ascribed to the employee. The latter has become a central axis of the dispute within the doctrine and judicature over the taxation of free employee benefits. This dispute focused primarily on two types of benefits: medical subscriptions and lately on integration events.

### 3. Tax on medical subscription

The medical subscription is a specific service, offered by the service providers on the market of medical services, consisting in medical treatment provided within the agreed scope to the patients eligible for the service in return for a periodically made payment of the agreed amount.

<sup>13</sup> A. Taudul, *Opodatkowanie niektórych świadczeń pracowniczych – problemy praktyczne* (Tax on certain employee benefits. Practical approach), "Przegląd Podatkowy", No. 4/2008.

<sup>14</sup> Interpretacja Dyrektora Izby Skarbowej w Warszawie z dnia 12 maja 2010 r. (Interpretation of the Director of the Treasury Office, Warsaw, file ref. no. IPPB2/415-105/10-3/MK).

<sup>15</sup> Supreme Administration Court Judgement of 30 July 2009, also: Interpretation of the Finance Minister of 23 November 2010, file ref. no. DD3/033/122/CRS/10/PK-620.

<sup>16</sup> A. Taudul, *Opodatkowanie niektórych świadczeń pracowniczych...* (Tax on certain employee benefits...), *op. cit.*

The employed in Poland are subject to compulsory medical insurance and on this account they have access to medical care financed by public funds. The scope of this care is defined by the Act of 27 August 2004 on publicly funded medical care benefits<sup>17</sup>. Due to the limited access and the deteriorating quality of the public medical services, private medical care is becoming an alternative. The employer is often the one to finance this care paying for the medical subscription with his own funds. The scope depends on the agreement made by the parties connected with payment made by the employer. The payment is as a rule made for all the employees irrespective of how often and in which scope they will make use of the medical care. The legal grounds for providing medical services within the subscription are a civil contract concluded between the parties (the employer and the company rendering medical services).

From the taxation perspective it is essential to determine whether or not in the case of medical subscription we deal with a free benefit and if we do, what is it? And eventually, how to define the taxable income on this account?

There is no doubt that the free medical care funded by the employer in favour of the employees signifies free benefit. The employee makes material gains of a definite financial dimension. If not for this benefit, the employee would have to invest his/her own funds to see a doctor, have an examination etc. The dispute over the judicature did not refer to the very existence of a free benefit but the method of assessing the income related to it. For example, in August 2008 the Regional Administrative Court<sup>18</sup> in Warsaw stated that the benefit in the form of medical subscription is not taxed due to the fact that the employer does not know how much the employee benefited: the scope of medical services is included in the medical confidentiality and the protection of personal data. Therefore, the employer cannot acquire any information about the medical services the employee made use of. The statement of 2009 made by the Regional Administrative Court in Białystok<sup>19</sup> says: in the case of free benefits tax may be levied only on the profit actually obtained, *real, not only possible to obtain (the value of the obtained benefit, and not the opportunity to benefit)*. However, the employee whose medical care is financed by the employer acquires only the information that the employer guarantees free medical service which he/she may make use of but does not have to. In the case the employee does not use the medical care provided by the employer,

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<sup>17</sup> Act of 27 August 2004 on publicly funded health care benefits financed ("Journal of Laws" No. 210, item 2135).

<sup>18</sup> Judgement of the Regional Administrative Court in Warsaw of 20 August 2008, file ref. no. III SA/Wa 625/08.

<sup>19</sup> The Regional Administrative Court Judgement in Białystok of 17 February 2009, file ref. no. SA/Bk 1/09.

*it cannot be claimed that he/she obtains a material benefit or free benefit of any kind. If the value of medical services cannot be attributed to the benefits obtained by one definite employee, for example, when the lump-sum subscription is to be paid by the employer for the whole groups of people irrespective of the actual use of medical services by the employee, it is hardly possible to determine the income acquired by a definite employee on account of the employer's financing of medical services. It is impossible to establish whether or not the employee obtained the benefit and what its value is.*

There are also different stances adopted by courts on the issue of profit in the case of medical subscription. For example the judgement of 29 September 2008 of the Regional Administrative Court in Warsaw<sup>20</sup> which stated that the value of medical subscription is the employee's income even if they do not use it. According to the court the employer who provides the employee with the opportunity to make use of medical services gives them the benefit in kind, and this is a profit resulting from the employment relationship. Thus, it is not important if the employee made the actual use of this opportunity. An unfavourable stance for the employee was also presented by the Regional Administrative Court in Wrocław in the judgement of 4 July 2008<sup>21</sup>.

The uniform judiciary became the reason for the Supreme Administrative Court (NSA) to deal with the problem. It stated in the judgement of 24 May 2010<sup>22</sup> that the purchase of medical subscription by the employer is an income of free benefit. It is not important to what extent the employee used the medical services within the subscriptions. According to the NSA judges it is indisputable that the employee obtains property gains in the form of an opportunity to use certain medical services. Thus, the income appears at the moment when a medical centre is obliged to be ready to provide them with services. This moment may be placing the employee on the list of those eligible or giving him/her the patient's ID card.<sup>23</sup> According to the court, the income does not depend on the actual use of medical services by the employee. Justifying its stance, the court referred to the similarity of the medical subscription and insurance contract concluded by the employer in favour of the employee, according to the court in both cases the benefit is to provide the employee with a particular insurance protection. Accepting this kind of reasoning, the employee would achieve a measurable financial gain

<sup>20</sup> The Regional Administrative Court Judgement in Warsaw of 29 September 2008, file ref. no. III SA/Wa 1356/08.

<sup>21</sup> The Regional Administrative Court Judgement in Wrocław of 4 July 2008, file ref. no. SA/Wr 383/08.

<sup>22</sup> Resolution of seven judges of the NSA judges of 24 May 2010, file ref. no. II FPS 1/10.

<sup>23</sup> Ibid.

corresponding to the market value of the offered packages already at the moment of paying the premium by the employer.

The problem of the evaluation of subscriptions was not included in the question sent to the extended panel due to which the court could avoid referring to the most controversial issue, i.e. the evaluation of the benefit obtained by the employee. Therefore, it was legitimate to issue another resolution. This time the Supreme Administrative Court made it in an extended 30-member panel. In the light of the resolution of 24 October 2011<sup>24</sup> *the price of the package of medical services bought by the employer is a reference point for the estimation of the value of benefit obtained by the eligible individuals. The division of this price into all belonging to the set of entitled individuals may result in the value of free benefit per entitled individual as it is made according to, i.e. with reference to the package purchase price, in compliance with Art.12 section 3 in connection with Art.11 section 2a point 2 of pit. The value of the benefit mentioned in the referred legal regulations is not the benefit purchase price itself but the value is determined according to purchase prices which means: with reference to these prices. In this area, the value of free benefit may be determined as the equivalent of the part of the purchase price per the entitled individual, i.e. "according to the purchase price," within the idea of the aforementioned formulation Art. 11 section 2a point 2 of pit. If the employer transferred the money of the value of the package per the entitled individual to the employee, and he/she bought additional medical services, the amount would no doubt constitute free benefit in compliance with Art. 12 section 1 of pit.*

The court claims that it is insignificant to what extent the employee made use of the medical subscription because the opportunity itself to use the offered services becomes his/her income. It is significant, though, whether or not he/she agreed to accept such a benefit. As stated by the adjudication panel *the taxpayer – employee – third entitled person in the package – may accept or refuse to use the agreement providing benefit in their favour. The employer does not have to obtain the employee's consent to include them into the purchased medical care package but on the other hand the employee is not mandatorily obliged to accept the benefits and may refuse to make use of them. The right to refuse the implementation of benefit resulting from the agreement of providing benefit in favour of the third party is important from the tax perspective as its implementation causes a legal interpretation of taxable income. The employer does not oblige a taxpayer to accept any free benefit, including the acceptance of free benefit regarded as income resulting from the employment relationship according*

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<sup>24</sup> NSA Financial Chamber Resolution of 24 October 2011 file ref. no. II FPS 7/10.

*to Art. 12 section 1 of pit. For this reason, the expression of the employee's will with reference to the refusal to use the right providing and guaranteeing medical care services resulting from the medical package purchased by the employer will no doubt give rise to the conclusion that the taxpayer did not accept the aforementioned benefit. The refusal to accept the employee benefit in the form of package use may occur before making use of medical services included in the package, for example during the settlement of the first, after being included in the package, personal income advanced tax payment, when the taxpayer can calculate the tax and actual benefits and charges on account of the decision within the discussed area.*

The aforementioned NSA stance was assessed by the doctrine as controversial. After all, the resolution was supported only by 22 judges from the 30-member panel. The stance contrary to the one expressed by the resolution was reflected in the separate statement made by eight judges who raised the issue that *the opportunity itself to use by the employee a package of medical services whose value is not tax free is not an income on account of obtaining free benefit and is not subject to be levied with this tax although it has material value*<sup>25</sup>. According to the judges disapproving of the resolution, also according to numerous tax experts, the opportunity itself to use the medical services package cannot be regarded as income from free benefits because it is not compliant with the definition of free benefits income. In the light of the language interpretation the use in Art. 11 of pit the term "obtained" with reference to benefits in kind and other free benefits excludes in its very idea the possibility of regarding the income from "placing at the disposal", reserved entirely for money and monetary values. Thus, it is even more difficult to speak about an income from the "opportunity to use." This opinion is shared by some tax advisors who point to the fact that the court definition of free benefits does not result from the act of law on income tax, and the scope of taxation should result directly from the act of law. It was also observed within the doctrine that the method of calculation of an employee's statistical income is non-applicable in certain situations, in particular when the lump sum is paid by the employer quarterly refers to equal forms of subscriptions (basic, extended etc.)<sup>26</sup>. In such a situation some employees will have inflated income while others will pay tax on a considerably lower income.

These arguments are certainly legitimate, however, it should be borne in mind that medical subscriptions are similar to medical insurance whose idea does not differ at all from the former and therefore both situations should have the same tax effect according to the tax law.

<sup>25</sup> Ibid.

<sup>26</sup> P. Molik, NSA każe pobierać PIT od pakietów medycznych (NSA requires a PIT levy on medical packages), "Gazeta Prawna" of 25 October 2011.

## 4. Taxation of integration events

The next employee benefit provided by employers in favour of employees arousing a lot of controversy within the tax environment is that of integration events. Integration events are organised for a definite purpose, namely the integration of the team so that it could be more effective, achieve better business results and as a consequence generate higher company profits.

From the tax perspective the employee's share in such an event is considered in the context of free benefits. The problem reappeared after the resolution on medical subscription was made. There is a clear tendency, on the part of both tax institutions and judicature, to use the aforementioned adjudication in order to justify the extension of the tax levy to include all the situations in which the employee obtains an opportunity to voluntarily use non-wage benefits provided by the employer for all the staff from the corporate circulating funds, irrespective of the actual use of this opportunity by the entitled employee.

The tax authorities claim that the employee generates income on account of the participation or even an opportunity to participate in such a meeting. According to the tax authorities (...) *It should be underlined that the amount of employee's income connected with the participation in a sport and recreational event is not affected by the level of use of particular attractions planned for the participants as the price paid by the employer for the organisation did not depend on the level of "consumption" of these attractions by the employees. In other words, from the taxation point of view it is not significant what and how much the employee ate and drank or whether the employee made use and if so in which scope of the attractions prepared for the event*<sup>27</sup>.

Different opinions can be found in the administrative courts' adjudications. The example to be quoted is the Supreme Court Judgement of 11 January 2011<sup>28</sup>, in which the adjudicating panel did not agree with the opinion that the lump sum formula of determining costs of integration event organisation incurred by the employer does not allow for the determination of income of individual employees.

At the end of last year the NSA approach changed radically. In the judgement of 2 December 2011<sup>29</sup>, the adjudicating panel stated that *the lump sum formula of the event costs settlement which makes the price paid by the employer independent of the number of employees participating in the company event as well as the services individual employees made use of, is not an obstacle to determine the individual income of every employee. The court stated that the financial benefit*

<sup>27</sup> Individual interpretation of 14 September 2011, file ref. no. IPTPB2/415-405/11-2/ASZ.

<sup>28</sup> NSA judgement of 11 January 2011, file ref. no. II FSK 1531/09.

<sup>29</sup> NSA judgement of 2 December 2011, file ref. no. II FSK 1017/10.

*provided by the employer is the opportunity itself to use these services and not its implementation.* The Supreme Administrative Court expressed a similar opinion in the judgement of 17 January 2012<sup>30</sup>.

At the moment it is difficult to speak about a uniform approach to the taxation of staff participation in the integration events. Nevertheless, if the judicature in the area is still in the present state, it certainly will not be deprived of controversy, primarily with reference to the perception of the participation in such an event as a financial benefit of the employee. While in the case of medical subscriptions the financial benefit, although difficult to measure, is existent, in the case of the participation in the integration event it is difficult to measure or to even to point to. A simple analogy cannot be applied to all non-monetary benefits provided in favour of employees by the employer. There is a different character of medical care and company meeting. Integration meetings are organised for business purposes. Their immediate goal is to integrate employees, which in turn is to affect positively the company results. From this perspective, the consideration of financial benefit in the aspect income generation is a wrong assumption because in numerous cases the participation in such a meeting is a duty rather than a pleasure for the employee. The employee, has to, although may not be willing to, take part in such a meeting as this determines his/her career and prospects in the company. Furthermore, an analogous question to the one posed before may be asked again, whether the employees would invest their own money if the employer did not organise such a meeting. The answer to this question is not obvious at all... and benefits reaped due to this seem virtual.

## Conclusions

The taxation of free employee benefits has aroused a lot of controversy for years. The tax authorities have always attentively watched this kind of benefits due to the potential possibilities of avoiding tax payment. It is more difficult to estimate and identify this kind of remuneration in comparison with money remuneration.

On the other hand fringe benefits have become an effective way to motivate staff. The employees have also benefited from this form of pay. The lack of detailed regulations in this area did not make employers treat them as a taxable component of remuneration. The uncertainty about the tax on such benefits grew due to the inconsistent adjudication line of the administrative courts. In particular, this problem hit the medical subscriptions hard with reference to which opposite judgements were passed within a month. At the same time, a pro-fiscal strategy of the tax authorities was to be observed on the basis of a broad interpretation of fringe benefits.

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<sup>30</sup> NSA judgement of 17 January 2012, file ref. no. II FSK 2740/11.

The complexity of this situation was noticed by the Supreme Administrative Court, which dispelled the taxpayers' doubts passing two resolutions on medical subscriptions. Although the judgement was assessed as controversial, it dispelled the entrepreneurs' uncertainty. Admittedly, they are responsible for the appropriate calculation and collection of tax on account of the paid remuneration.

However, it should be borne in mind that the NSA resolutions on medical subscriptions did not refer to all possible fringe benefits to be found within the reality of business practice. Unfortunately, neither the tax authorities nor courts seem to notice this fact extending the tax effects resulting from these resolutions to any benefits, whether or not a given benefit may be regarded as a free benefit according to the definition quoted at the beginning of this article. This causes an excessive fiscalism, which theoretically could be shown by the tax authorities but on no account should it be manifested by the administrative courts.

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4. Individual interpretation of 14 September 2011, file ref. no. IPTPB2/415-405/11-2/ASZ.

# Summary

Maria Aluchna

## **Post Crisis Corporate Governance Lessons. The case of the US investment banks**

The paper analyzes the corporate governance shortcomings identified as the divergence from best practice. It is based on the case studies of three American investment banks Bear Stearns, Lehman Brothers and Merrill Lynch discussing their major corporate governance failures which resulted in their collapses contributing to the outbreak and course of the financial crisis and leading to significant uncertainty on the stock market. The analysis of Bear Stearns, Lehman Brothers and Merrill Lynch depicts severe corporate governance inefficiencies although the scenarios of each of these investment banks proved to be different – Lehman Brothers collapsed filling for bankruptcy, Bear Stearns was rescued in a takeover transaction by JP Morgan Chase and Merrill Lynch was taken over by Bank of America, while the parent companies of two latter banks being covered by the US bailout scheme known as Toxic Asset Relief Plan (TARP). The identified main corporate governance shortcomings refer to the board composition and work, structuring of the executive compensation as well as risk management. The empirical material allows for the formulation of main corporate governance guidelines.

Tomasz Cicirko

## **Methods of Increasing Bank Capital Effectiveness – part 3**

The present study is a continuation of author's deliberations on the area of commercial bank capital management. The deliberations are presented in three closely related sections. Part 1<sup>1</sup> is devoted to the presentation of the idea and classification of bank capital. Part 2 refers to the modern effectiveness measures based on bank capitals. Part 3 is devoted to the practical aspects of the issues discussed before and includes the summary of the three sections of the publication. The author presents the process of capital effective allocation (capital re-allocation). This process allows for the elimination of the phenomenon of not using the excess of allocated capital by some bank units and increase the effectiveness of used capitals, in particular in the case of imposition of limits and restrictions on the bank. The study also indicates the solution of including the active reallocation of capital in the ICAAP process. The publication is crowned with the author's self-designed "capital bank" concept: the solution fulfils the bank expectations in the area of making business decisions and enters the modern motivational system. The solution may constitute the basis for the used capital effectiveness measurement and control the bank capital adequacy at the same time. The "capital bank" concept is a system of internal settlements based on capital transfer prices (CTP).

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<sup>1</sup> See: T. Cicirko, Methods of increasing bank capital effectiveness – part 1, "Journal of Management and Financial Sciences", Volume II, SGH, October 2009.

Anna Dąbrowska, Teresa Słaby

### **Small Local Stores in Poland: Changes in the Retail Market and Consumer Preferences**

Recently, changes in the Polish retail trade have been taking place. The number of small local stores is decreasing. The authors conducted research in association with Macro Cash and Carry in February 2011 among 68 owners of small local stores located in 4 districts of Warsaw, 4 adjacent towns and 4 satellite towns. The results of this research show the tough competition between the small local store owners and super- and hypermarket chains. The chance for the further existence of small stores is to join the convenience store chains or franchising. Individual operation is possible only through providing high quality and freshness of products as well as price cutting. Polish customers tend to shop less at the supermarkets as they prefer small local stores, which gives the store owners an opportunity for further existence on the retail market.

Rafał Kasprzak, Teresa Skalska

### **The Economic Impact of Cultural Institutions on the Local Economy**

The paper presents the findings of the project “Identification of directions and scale of economic and social impact of cultural institutions on the region on the example of Koziółek Matolek European Fable Centre in Pacanów” financed within the framework of a programme called Culture Observatory in the year 2011. The project’s objective was to identify the directions and scale of impact of cultural institutions on the region (municipality, *gmina*, and province, *województwo*) on the example of the European Fable Centre in Pacanów (hereinafter referred to as EFC). The research hypothesis to be verified in the project is an assumption of the three-stage impact of institutions on the socio-economic system through:

1. primary economic impact measured with direct impacts generated by tourism generated by the EFC within the municipality,
2. indirect effects measured with the growth of the level of socio-economic development of the municipality triggered by the EFC,
3. secondary economic impact estimated with an indicator that will be constructed on the basis of a model of the Keynesian multiplier.

Piotr Russel

### **Consumer Lease Development in Poland. Legal Determinants**

Lease transactions have been concluded in Poland for over 20 years. The lease market has developed primarily in the segment of investment goods used within the conducted business activity. In comparison with the European lease market, the lease transactions whose lessees are consumers are all the time marginal in relation to the whole lease market. The article is aimed at the synthetic presentation of legal determinants related to the consumer lease, with particular attention to the regulations of 2001 changing the principles of taxing lease agreements in which the lessee is a physical person not conducting business activities.

Joanna Szlęzak-Matusiewicz

### **The Taxation of Free Employee Benefits in the light of Personal Income Tax**

For years employee (fringe) benefits have been an element of the employers' policy to motivate employees. There is not a closed catalogue of such benefits. These most frequently applied by employers include refunding costs related to the Internet, foreign language lessons, vocational improvement training, gift coupons, medical care, cinema or theatre tickets, swimming pool or fitness class admissions. From the perspective of human resource management, undoubtedly the proper selection of employee benefits is important. Non-wage compensations may be viewed from not only from the point of view of management but also from the perspective of the tax duty. Taxing employee benefits has been arousing a lot of controversy for years. The lack of detailed regulations in this area did not make employers treat them as a taxable component of remuneration. The uncertainty about the tax on such benefits grew due to the inconsistent adjudication line of the administrative courts. In particular, this problem hit hard the medical subscriptions with reference to which opposite judgements were passed by courts within a month. At the same time, a pro-fiscal strategy of the tax authorities was to be observed on the basis of a broad interpretation of fringe benefits. The article is aimed at the presentations of the court judicature and the doctrine with regard to the issue of taxation of employee benefits most frequently applied in the business practice.

