# REPORT ON ACTIVITIES OF BANK HANDLOWY W WARSZAWIE SA IN THE FIRST HALF OF 2005

SEPTEMBER 2005

# TABLE OF CONTENTS

# I. The Polish economy in the first half of 2005

## 1. Main macroeconomic trends

After the significant acceleration of the pace of economic growth in 2004, the first half of 2005 saw a clear slowdown of economic activity. The scale of the economic slump in the first quarter of 2005 proved to be higher than initially expected and the rate of growth of Gross Domestic Product (GDP) fell to 2.1% in the first quarter of 2005, from 4.0% year-on-year in the fourth quarter of 2004.

Export still remained the main driver of growth in the economy in the first quarter of 2005 and despite the disadvantageous conditions in the financial market (PLN continued its appreciative trend in January and February), its contribution to GDP increased to 0.9% in the second quarter versus 0.7% in the first quarter of 2005.

On the other hand, the investment growth rate proved to be disappointing, as it was only 1.0% year-on-year in the first quarter of 2005, as compared with the increase by 7.4% in the last 3 months of 2004. After elimination of seasonal fluctuations, gross expenditure on fixed assets fell by 0.4% and this has been the first fall since the beginning of 2003.
A slowdown was noted also in the case of consumption demand which was lower than in the fourth quarter, and attained only 1.7% year-on-year. Nevertheless, taking into account the effect of the high reference base associated with consumption demand acceleration before Poland's accession to the UE, this result may be considered relatively good.

Economic growth contributed to a gradual increase in the demand for labor. In June 2005 average employment in the enterprise sector increased by 0.3% month-on-month and was 1.6% higher than one year earlier. At the same time, a reduction in the registered unemployment rate to 18.1% in June 2005 from 19% in December 2004 was noted. The increase in employment was associated with a slight improvement in wages. Within 6 months of 2005, wages in the enterprise sector nominally increased by 2.6%, although they dropped by 0.3% in real terms.

The strong appreciation of zloty, the slight improvement on the labor market and the low level of internal demand contributed to the dampening of inflatiory pressure. In June 2005, the annual inflation rate dropped below the lower inflation target, to the level of 1.4% year-on-year, from 4.4% year-on-year in December 2004.

In addition the low level of the Producer Price Index (PPI) confirms the lack of price pressure. As compared with the previous year, the prices of industrial output were lower by 0.5% in the first half of 2005. Thus, PPI deflation on an annual basis was noted for the first time since December 2001. Similarly as in the case of the Consumer Price Index (CPI), the effect of the high reference basis contributed to the drop in the annual PPI, resulting for example from high crude oil price rises in the corresponding period of 2004. We expect that the producer price growth rate will be maintained at a low level in the nearest months, and it will be slightly accelerated in the fourth quarter of 2005, after the high base effect expires.

Despite the economic slowdown, the State Budget remains under control. After the first half of 2005, the budget deficit amounting to PLN 18.5 billion attained 52.9% of the annual plan. As a result, the progress of budged execution was lower than planned by the Ministry of Finance at the beginning of 2005 – in accordance with this schedule, the deficit should attain 62.8% of the annual plan after the first six months. A marked growth tendency of corporate income taxes was maintained, which was partially due to the relatively good financial standing of the Polish enterprises. The net income in the first half of 2005 amounted to 49.5% of the plan (against 48.4% in the corresponding period of 2004), while the expenditure was covered in 50% (47.2% of that in the preceding year).

## 2. Money markets and FX markets

In the first half of 2005, the Monetary Policy Committee (MPC) lowered interest rates on three counts, each time by 50 basis points. The stance in monetary policy was also changed three times. The first change from the restrictive to mild stance preceded the first reduction. At the second reduction, the stance was changed to neutral to cool down market expectations with respect to any further rate cuts. At its June meeting, MPC returned to its mild stance to give a signal that further loosening of the monetary policy was possible in the situation of dropping inflation.

The reason for such a significant lowering in money costs by the central bank was a very low GDP growth in the first quarter of 2005 and the disappointing economic results in the second quarter of 2005 (in particular, weaker industrial production and retail sales as well as the low growth of wages). The capacity for interest rate reduction was ensured also by the decreasing inflation which attained the level equal to the NBP target in June 2005.

In the bond market, the first half of 2005 was marked by decreasing rates of return. The lower-than-expected economic growth rate and lowering inflation raised investors hopes for aggressive cuts of interest rates. The market was also supported for a long time by the situation in base markets. Real euphoria took place before the last MPC meeting which was manifested by the growth in prices of domestic securities to historically high levels. Also the June statements of the MPC members who declared their readiness to reduce further credit costs in the situation of the lack of signs of any clear economic revival were not without importance. The forecasts indicating the drop in inflation to the level of 1.5% in the second half of 2005 made this scenario more credible and gave an impulse for further purchasing.

In January and February 2005, the zloty continued its appreciating trend initiated in the previous year. Nevertheless, publications of the opinion polls indicating the defeat of the European Constitution in the French referendum as well as the lack of possibility of widening the Eurozone by new Member States if the Treaty is rejected caused an increase in concerns about the future of the European Union. As a result, a wave of zloty disposal started in mid-March 2005, which lasted to the beginning of May when European Commission representatives managed to calm down the market by ensuring that the work on the development of the European Constitution would not be discontinued even when the referendum in France was unsuccessful. Over that time, the zloty lost over 11% against euro and almost 15% against dollar, which due to the same grounds appreciated against euro. May and June were once again zloty's months, as the currency managed to appreciate by 7% with respect to euro, supported by the inflow of foreign capital to the domestic debt market. Nevertheless, the zloty still lost with respect to the dollar, which was associated with the global strengthening of the dollar.

## 3. Capital market

In the first half of 2005, the indices of the stock market of the Warsaw stock exchang continued their growth. The main stock exchange index, WIG, amounted to 28,332 points at the end of June 2005, representing the growth of 6.4%. The index of the largest and most liquid companies, WIG20, increased in the first half of the 2005 by 4.4%.

The base market index, WIG, having attained the record value on 25 February 2005 at a level of 28,547, then entered a phase of correction for 2,5-months, which carried down WIG to the level of 25,617 points. From mid-May 2005, another growth phase commenced, which brought the main market index WIG to new historic peak heights.

One of the more important events in the equity market in the first half of 2005 was the June debut of the Lotos Group on the Warsaw stock exchange. At the end of 2004, the number of listed companies stood at 230, and increased in the first half of 2005 by 14. Total market capitalization (taking into account foreign entities) increased from PLN 291.7 billion as of the end of 2004, to PLN 337.6 billion at the end of June 2005, and the market capitalization growth by 15.7% results mainly from debuts of new companies on the stock exchange.

Table 1. Stock market indices as of the end of the period, 2004 – first half of 2005

| Index | 30-June-05 | 31-Dec-04 | Change on year beginning (%) |
|---|---|---|---|
| WIG | 28,332 | 26,636 | 6.37 |
| WIG-PL | 27,983 | 26,540 | 5.43 |
| WIG20 | 2,047 | 1,961 | 4.42 |
| MIDWIG | 1,769 | 1,730 | 2.25 |
| TECHWIG | 625 | 666 | -6.13 |
| WIRR | 4,367 | 4,739 | -7.84 |
| NFI | 93 | 98 | -5.36 |
| Sector sub-indices | | | |
| Banking | 38,334 | 35,454 | 8.12 |
| Construction | 21,574 | 19,015 | 13.46 |
| IT | 10,365 | 12,997 | -20.25 |
| Media | 30,601 | NA | NA |
| Foodstuffs | 23,079 | 23,762 | -2.87 |
| Telecommunications | 10,613 | 10,243 | 3.61 |

*Source: WGPW, Dom Maklerski Banku Handlowego SA*

Increased index levels were positively correlated with the activity of investors in the equity market. Turnover on the equity market increased by 47% from PLN 50.3 billon in the first half of 2004 to PLN 74.0 billion in the first half of 2005, continuing its growth trend established in 2003.

The turnover value in the bond market dropped by 15.7% to PLN 2.29 billion as of the end of June 2005 as compared with PLN 2.72 billion in the first half of 2004. In the second quarter of 2005, the value of bond turnover amounted to PLN 1.2 billion and was higher by 5.1% than in the first quarter of 2005.

Index growth and the continuing bullish equity market had a positive impact on investors' activity in the market of futures contracts. In the first half of 2005, investors' activity in the market of futures contracts was higher by 6.8% than in the corresponding period of 2004. The number of concluded futures transactions increased from 4.14 million to 4.42 million.

Meanwhile, the market of options developed very dynamically. The number of option transactions in the first half of 2005 was more than twofold higher than in the corresponding period of 2004. After two quarters of 2005, option transaction turnover volume amounted to 140,500, whereas in the first half of 2004 the number of transactions stood at 66,500.

Table 2. Equity and bond turnover, and derivative transaction volumes on WSE as of the end of the period, first half of 2004 - first half of 2005

| | 1st half of 2004 | 1st half of 2005 | Change 1st half of 05/1st half of 04 (%) |
|---|---|---|---|
| Equity (PLN million) | 50,328 | 73,969 | 46.97 |
| Bonds (PLN million) | 2,717 | 2,289 | -15.73 |
| Futures (volume) | 4,139,922 | 4,421,766 | 6.81 |

| | | | |
|---|---|---|---|
| Options (volume) | 66,532 | 140,502 | 111.18 |
| Number of brokers | 21 | 26 | 23.81 |

*Source: WGPW, Dom Maklerski Banku Handlowego S.A.*

### 4. Banking sector

The banking sector's net financial result for the first half of 2005 was PLN 4.36 billion and was by 17% higher than in the first half of 2004. The growth in the profitability of the sector resulted above all from the increase in the result on banking activity, which in the first half of 2005 was higher by more than PLN 0.4 billion as compared with the corresponding period of 2004 and the decrease in costs of banking activity by PLN 0.3 billion. In the first quarter of 2005, a reduction in net charges to provisions and negative revaluation in the revaluation reserve by PLN 0.3 billion as compared with the corresponding period of 2004 was also noted.
The growth in the sector's result on banking activity in the first half of 2005 was attributable to an increase in income on shareholdings, other securities and other financial instruments with variable income, the result on financial operations, and the result on foreign exchange operations. On the other hand fees and commissions dropped significantly as compared with the first half of 2004. In the first half of 2005, the percentage growth in interest income was more than twice higher than the percentage growth in interest income in the corresponding period of 2004. In nominal values, interest income increased slightly more than interest expense, due to which net interest income remained practically at the same level as the first half of 2004.

In the first half of 2005, the growth of loans to individual customers amounted to around 20% year-on-year. The downward trend of individual customers' deposits was reversed (growth by 3% year-on-year). This was mainly due to the increasing competition for deposits. As of the end of the first half of 2005, The portfolio of loans offered to economic entities increased as compared with the end of the first half of 2004 by ca. 1%. Meanwhile, the situation in the market for corporate deposits improved significantly and was reflected by an increase by 15% in the corresponding period.

## II. Selected balance sheet data and financial results of Bank Handlowy w Warszawie SA

### 1. Summarized financial data of Bank Handlowy w Warszawie SA

| PLN million | 2004 | The first half of 2005 |
|---|---|---|

| | | |
|---|---|---|
| Balance sheet total | 33,809.1 | 34,757.0 |
| Equity* | 5,693.5 | 4,649.2 |
| Loans** | 9,057.3 | 9,673.1 |
| Deposits** | 16,853.1 | 16,271.0 |
| Net profit | 448.5 | 281.5 |
| Earnings per share or convertible bond (in PLN) | 3.43 | 2.15 |
| Dividend per share or convertible bond (in PLN) | 11.97 | ----- |
| Dividend payout ratio | 99.99% | ----- |
| Capital adequacy ratio | 18.5% | 12.7% |

** Excluding net profit for the current period.*

*** Dues and payables from the non-financial and public sector.*

## 2. Financial results of the Bank in the first half of 2005

### 2.1 Profit and loss account

The net profit of the Bank in the first half of 2005 was PLN 281.5 million and was by PLN 42.3 million, i.e. 17.7 % higher than in the corresponding period of the previous year. The following were among the factors which primarily contributed to the increase in the net profit of the Bank: increase in operating income by PLN 139.9 million, i.e. 14.3%, mainly owing to the increase in net interest income. At the same time there was an increase in the Bank's general expenses by PLN 55.8 million, i.e. 9.1%.

**Selected Profit and Loss Account items**

| | First six months | | Change | |
|---|---|---|---|---|
| **In PLN thousand** | **2005** | **2004** | **in PLN thousand** | **%** |
| Net interest income | 513,241 | 452,986 | 60,255 | 13.3% |
| Net fee and commission income | 264,939 | 270,474 | (5,535) | (2.0%) |

| In PLN thousand | First six months 2005 | First six months 2004 | Change in PLN thousand | Change % |
|---|---|---|---|---|
| Profit on financial assets and liabilities held for trading | 11,154 | (27,755) | 38,909 | (140.2%) |
| Realized profit on financial assets and liabilities other than valued at fair value | 102,861 | 21 | 102,840 | 489,714.3% |
| Foreign exchange profit | 202,379 | 242,934 | (40,555) | 16.7% |
| **Operating income** | **1,121,929** | **981,991** | **139,938** | **14.3%** |
| General expenses | (669,740) | (613,939) | (55,801) | (9.1%) |
| Net impairment loses | 11,140 | 4,002 | 7,138 | 178.4% |
| **Profit before tax** | **360,828** | **289,991** | **70,837** | **24.4%** |
| **Corporate income tax** | **(79,362)** | **(50,840)** | **(28,522)** | **56.1%** |
| **Net profit** | **281,466** | **239,151** | **42,315** | **17.7%** |

### *2.1.1 Operating income*

The following factors contributed in particular to the growth in operating income by PLN 139.9 million, i.e. 14.3%, as compared with the corresponding period of the previous year:

- increase in net interest income by PLN 60.3 million (13.3%), mainly as a result of obtaining a good net interest income on term deposits in the interbank market,
- increase in realized profit on financial assets and liabilities due to the higher gain on debt securities in the trading portfolio – Treasury bonds by PLN 102.9 million as compared with PLN 21 million in the corresponding period of the previous year,
- decrease in net profit on foreign exchange by over PLN 40.6 million (16.7%) mainly as a result of losses on currency derivative instruments.

### 2.1.2 *Expenses*

**EXPENSES**

| in PLN thousand | First six months 2005 | First six months 2004 | Change in PLN thousand | Change % |
|---|---|---|---|---|
| Salaries | 254,643 | 222,475 | 32,168 | 14.5% |
| Social security and other benefits | 81,974 | 83,901 | (1,927) | (2.3%) |
| **Total personnel expenses** | **336,617** | **306,376** | **30,241** | **9.9%** |
| Administrative expenses | 326,753 | 299,370 | 27,383 | 9.1% |
| Taxes and fees | 4,519 | 4,217 | 302 | 7.2% |
| Contributions and payments to the Bank Guarantee Fund | 1,851 | 3,976 | (2,125) | (53.5%) |
| **Total general expenses** | **669,740** | **613,939** | **55,801** | **9.1%** |
| Depreciation | 69,637 | 72,252 | (2,615) | (3.6%) |
| **Total expenses** | **739,377** | **686,191** | **53,186** | **7.8%** |

In 2005, the Bank continued to pursue restructuring activities with the aim to improve the institution's efficiency and increase its profitability by lowering the costs of operation. Nevertheless, in the first half of 2005, the costs of operation of the Bank and general expenses as compared with the corresponding period of the previous year increased by more than 9%. The increase in expenses resulted mainly from an increase in the provisions for future pension benefit expenses and benefits for the years of service, higher salaries expenses associated mainly with the increase in employment in the consumer banking segment and advertising and marketing as well as advisory service expenses, which are higher in 2005. Another important factor affecting the level of expenses was the opening of 13 new branches of CitiFinancial.

In July 2005, the Bank announced an employment restructuring plan. More information on the conditions of layoffs is presented in the section discussing the events after the balance sheet date in the part concerning the Bank's Financial Statements.

### *2.1.3 Provisioning charges and financial assets revaluation*

**Specific provisions**

| in PLN thousand | First six months 2005 |
|---|---|
| Specific provisions for incurred but not reported (IBNR) losses | 18,900 |
| Specific provisions for off-balance sheet receivables and liabilities | 1,120 |
| accounted for individually | 97,771 |
| accounted for portfolio | (96,651) |
| Impairment of financial assets available for sale | (4,558) |
| Other | (4,322) |
| **Net impairment losses** | **11,140** |

As a result of the implementation of the International Accounting Standards (IAS) by the Bank, the rules of calculation of impairment write-downs were changed. Because this change was introduced prospectively in accordance with IFRS 1.36 A, the Bank did not present any data comparable with the corresponding period of the previous year. As of 1 January 2005, the opening balance was restated, taking into account the new methodology of creation of provisions and the difference between the provisions calculated in accordance with Polish Accounting Standards as of the end of 2004, together with the general reserve and total interest in suspense, and the provisions consistent with IAS and was recognized under equity as "profit for previous years".

The impact of the provision for incurred but not reported losses and provisions accounted for collectively and individually, amounted to a net credit of PLN 20 million which confirms the stabilization of loan portfolio.

### *2.1.4 Ratio analysis*

The ratio of return on assets, reflecting the ratio of net profit to the balance sheet total, has slightly increased. The higher value of ROE mainly results from the reduction of the Bank's equity by PLN 1,044.2 million (i.e. by 18.3%).

**PROFITABILITY AND COST EFFICIENCY RATIOS OF BANK**

| in PLN thousand | First six months 2005 | 2004 |
|---|---|---|
| Return on owners' equity (ROE)* | 7.6% | 7.3% |
| Return on assets (ROA)** | 1.4% | 1.3% |
| Net interest margin (NIM)*** | 3.1% | 2.6% |
| Earnings per 1 share or convertible bond (EPS), in PLN | 2.15 | 1.83 |
| Cost/Income**** | 67.8% | 71.1% |

* *Net profit divided by average equity and retained earnings (including current period's net profit) calculated on a monthly basis; annualized ratio*

** *Net profit divided by average assets calculated on a monthly basis; annualized ratio*

**** Net interest income divided by average assets calculated on a monthly basis; annualized ratio*

*****  Relation of the sum of general administrative expenses and depreciation to the sum of other operating income and expense*

## 2.2 Balance Sheet

As of 30 June 2005, the Bank's balance sheet total amounted to PLN 34,757.0 million and was higher by 2.8% than at the end of 2004.

**Selected balance sheet items**

| In PLN thousand | As of 30/06/2005 | As of 31/12/2004 | Change in PLN thousand | Change % |
|---|---|---|---|---|
| Cash, operations with the Central Bank | 814,452 | 841,114 | (26,662) | (3.2%) |
| Financial assets held for trading | 7,209,711 | 5,316,962 | 1,892,749 | 35.6% |
| Financial assets available for sale | 5,112,453 | 6,091,194 | (978,741) | (16.1%) |
| Equity investments | 323,563 | 332,511 | (8,948) | (2.7%) |
| Loans and other receivables | 18,885,977 | 18,498,769 | 387,208 | 2.1% |
| including from the non-financial sector | 9,673,149 | 9,057,286 | 615,863 | 6.8% |
| *Total assets* | *34,756,965* | *33,809,131* | *947,834* | *2.8%* |
| Financial liabilities held for trading | 4,368,480 | 4,194,290 | 174,190 | 4.2% |
| including derivative instruments | 4,368,480 | 3,926,173 | 442,307 | 11.3% |
| Financial liabilities accounted for at depreciated cost | 22,455,280 | 21,974,328 | 480,952 | 2.2% |
| including deposits | 21,592,090 | 20,667,770 | 924,320 | 4.5% |
| Financial liabilities from transfer of financial assets | 552,792 | - | 552,792 | - |
| *Total liabilities* | *29,826,285* | *27,667,147* | *2,159,138* | *7.8%* |

### *2.2.1 Assets*

Despite a substantial decline in the loan portfolio as a result of the prudent lending policy pursued by the Bank, it still remains the largest component of the Bank's assets. In the first half of 2005, the increase of loan receivables from the non-financial sector by PLN 615.9 million (i.e. 6.8%) is related to prospective introduction of changes to accounting for "Cash Pooling" accounts, in accordance with International Accounting Standards. The description of this product and its balance sheet treatment are presented in Note 30 of the Bank's Financial Statements. Taking into account the value of net balances amounting to PLN 751.2 million as of 31 December 2004, net credit exposure to non-financial entities decreased by PLN 135.3 million in comparison to the end of 2004.

Receivables due from the financial sector (including banks) were maintained at a level similar to 31 December 2004, and amounted to PLN 8,956.8 million (growth by 3.2%) as of 30 June 2005.

The debt securities portfolio remains the second largest item of assets.

Its very high level (mainly with respect to the Treasury bond portfolio) is due to the efforts to leverage the positive trends in the market of these instruments and by the necessity to invest some of the equity released in the previous years from the reduced loan portfolio.

**Debt securities portfolio**

| in PLN thousand | As of 30/06/2005 | As of 31/12/2004 | Change in PLN thousand | Change % |
|---|---|---|---|---|
| Treasury bonds | 5,364,770 | 6,263,335 | (898,565) | (14.3%) |
| NBP bonds | 378,474 | 384,287 | (5,813) | (1.5%) |
| Treasury bills | 74,013 | 303,770 | (229,757) | (75.6%) |
| Certificates of deposit and bonds issued by banks | 120,080 | 160,727 | (40,647) | (25.3%) |
| Issued by other financial institutions | 598 | - | 598 | ----- |
| Issued by non-financial sector | 149,501 | 190,914 | (41,413) | (21.7%) |
| NBP money market bills | 1,902,250 | - | 1,902,250 | ----- |
| **T O T A L** | **7,989,686** | **7,303,033** | **686,653** | **9.4%** |

### *2.2.2 Liabilities and equity*

The first six months of 2005 did not bring any significant changes in the structure of liabilities and equity of the Bank in 2004, which to a large extent resulted from the stability of the deposit base.

The main source of financing the Bank's assets continued to be from liabilities due to the non-financial sector. In comparison with the end of 2004, this item fell by PLN 582.1 million (i.e. 3.5%), nevertheless this reduction was partly offset by the increase in liabilities due to the financial sector, by PLN 1,506.4 million, i.e. by almost 39.5%.

Liabilities due to banks, which represent the majority of liabilities due to the financial sector, increased in the period from PLN 1,570.3 million to PLN 2,832.9 million, i.e. by PLN 1,262.6 million (i.e. 80.4%). In the course of the first six months of 2005, these liabilities were maintained at a lower level than receivables due from banks, which indicated the existence of excess liquidity in the Bank.

An important item on both sides of the Bank's balance sheet is the significant share of unrealized profits/losses on derivative operations which reflects the scale of off-balance sheet purchase/sale operations carried out by the Bank. The balance sheet valuation of these instruments is presented in "Financial assets/liabilities in the trading portfolio".

A new item of the Balance Sheet is financial liabilities from transfer of financial assets which amounted to PLN 552.8 million as of the end of June 2005. Until International Accounting Standards were introduced, this item was offset in total by the receivables from the entities in the same group as the entities from which the Bank had the liability. Currently, these items are presented in the Balance Sheet on a gross basis, consistent with the new standards. (see the Note 30 of the Bank's Financial Statements).

## *2.3 Equity and capital adequacy*

As compared with 2004, the equity of the Bank decreased by PLN 1,044.2 million (i.e. by 18.3%). This was mainly a result of:

- Dividend payable of PLN 1,149.8 from the profit of previous years transferred from capital surplus and reserve capital, pursuant to the Resolution No. 8 of the Ordinary Meeting of Shareholders of the Bank of 21 June 2005. The remaining part of the dividend payable, of PLN 414.2 million, originating from profit for 2004, has not been taken into account in the calculation of the Bank's own equity
- Implementation of International Financial Reporting Standards mainly with respect to the calculation of revaluation write-downs. The increase in equity by PLN 61.7 million resulted from the difference arising from the change in the accounting standards,
- Increase in the revaluation fund by PLN 11.9 million, caused by an increase in the value of revaluation of debt securities available-for-sale.

**EQUITY**

| | As of | | Change | |
|---|---|---|---|---|
| in PLN thousand | **30/06/2005** | **31/12/2004** | **in PLN thousand** | **%** |
| Authorized capital | 522,638 | 522,638 | - | 0.0% |
| Capital surplus | 2,944,585 | 3,044,585 | (100,000) | (3.3%) |
| Reserve capital | 711,977 | 1,726,562 | (1,014,585) | (58.8%) |
| Revaluation capital | 31,572 | 19,650 | 11,922 | 60.7% |
| General risk fund | 390,000 | 390,000 | - | 0.0% |
| Profit (loss) from previous years | 48,442 | (9,973) | 58,415 | 585.7% |
| **Total equity** | **4,649,214** | **5,693,462** | **(1,044,248)** | **(18.3%)** |
| Core capital | 4,569,200 | 5,683,785 | (1,114,585) | (19.6%) |
| Supplementary capital | 31,572 | 19,650 | 11,922 | 60.7% |
| Profit (loss) from previous years | 48,442 | (9,973) | 58,415 | 585.7% |

The level of capital was sufficient to guarantee financial security to the institution and the deposits it accepts.

As of 30 June 2005, the capital adequacy ratio was 12.66% and was by 5.83 percentage points lower than at the end of 2004. The decrease in the ratio was mainly due to:

- reduction in the Bank's equity by PLN 1,054 million
- increase in the capital requirement resulting from the excess of the exposure concentration limit and limit of high exposures by almost PLN 200 million (the increase concerned the entities of Citigroup).

**CAPITAL ADEQUACY RATIO**

| Stan as of, in PLN thousand | **30/06/2005** | **31/12/2004** |
|---|---|---|
| **Balance sheet value of capital funds** | **4,649,214** | **5,693,462** |
| - goodwill | 1,693,060 | 1,683,273 |
| - other intangible fixed assets | 1,248,521 | 1,243,645 |
| - investments in subordinated entities | 78,769 | 65,933 |
| - financial assets revaluation reserve fund | 365,770 | 373,695 |

| | | |
|---|---|---|
| **Eligible capital** | **2,956,154** | **4,010,189** |
| **Risk-weighted off-balance sheet assets and contingent liabilities (bank portfolio)** | **14,630,113** | **15,458,685** |
| **Total capital requirement, of which:** | **1,868,683** | **1,735,363** |
| - capital requirement for credit risk | 1,170,409 | 1,236,695 |
| - capital requirement due to the excess of credit concentration limit | 398,177 | 198,697 |
| - total capital requirement for market risks | 197,486 | 197,763 |
| - other capital requirements | 102,611 | 102,208 |
| **Capital Adequacy Ratio** | **12.66%** | **18.49%** |

# III. Activities of Bank Handlowy w Warszawie SA in the first half of 2005

## *1. Lending and other risk exposures*

### *1.1 Lending*

The Bank's lending policy is based on active portfolio management and precisely specified target markets, designed to facilitate exposure and credit risk analysis within the framework of a given industry of the customer. In addition, individual borrowers are continuously monitored so that signs of deterioration in creditworthiness can be detected promptly and appropriate corrective steps can be taken. Active credit policy has resulted in significant reduction of credit exposure to customers and industries which recently faced financial difficulties (e.g. shipyard, building and heavy industries).

**Lending to non-bank customers (gross)***

| | As of | | Change | |
|---|---|---|---|---|
| in PLN thousand | **30/06/2005** | **31/12/2004** | **in PLN thousand** | **%** |
| Loans in PLN | 10 258 102 | 9 606 292 | 651 810 | 6.8% |
| Loans in foreign currency | 2 417 847 | 2 164 590 | 253 257 | 11.7% |
| **Total** | **12 675 949** | **11 770 882** | **905 067** | **7.7%** |
| Loans to non-financial sector | 11 458 324 | 10 652 846 | 805 478 | 7.6% |
| Loans to financial sector | 1 217 559 | 1 116 759 | 100 800 | 9.0% |
| Loans to public sector | 66 | 1 277 | (1 211) | (94.8%) |
| **Total** | **12 675 949** | **11 770 882** | **905 067** | **7.7%** |
| Non-financial corporates | 9 165 960 | 8 697 683 | 468 277 | 5.4% |
| Non-bank financial entities | 1 217 559 | 1 116 759 | 100 800 | 9.0% |
| Individuals | 2 280 537 | 1 946 151 | 334 386 | 17.2% |
| Other non-financial entities | 11 827 | 9 013 | 2 814 | 31.2% |
| Public entities | 66 | 1 276 | (1 210) | (94.8%) |
| **Total** | **12 675 949** | **11 770 882** | **905 067** | **7.7%** |
| Other receivables | 6 486 | 3 506 | 2 980 | 85.0% |
| **Total** | **12 682 435** | **11 774 388** | **908 047** | **7.7%** |

**) Excluding accrued interest*

As of 30 June 2005, the gross credit exposure to the non-financial sector amounted to PLN 12,675.9 million, representing an increase by 7.7% as compared with 31 December 2004. The largest part of the non-financial sector credit portfolio, which is loans to non-financial corporates (72.3%) showed in the first six months an increase by 5.4%, the main driver of which was the new accounting treatment of overdraft receivables in "Cash pooling" product (Additional Note 30 to Financial Report). As of the end of June 2005, loans to individuals grew in comparison with the end of 2004 by 17.2% and amounted to PLN 2.280.5 billion.

As of 30 June 2005, mainly due to depreciation of the zloty versus the dollar, the currency structure changed slightly as compared with the end of 2004. The share of foreign currency loans, which in December 2004 was 18%, increased to 19% in June 2005. It must be stressed that the Bank grants foreign currency loans to customers who have foreign currency cash flows or to those who, in the Bank's opinion, are able to predict or absorb the currency risk without significant deterioration of their financial position.

A substantial part of the Bank's credit exposure to non-bank financial institutions was attributable to the Bank's Capital Group entities. As of 30 June 2005, the largest credit exposure amounting to PLN 461.5 million, was the funding granted to the Bank's subsidiary, Handlowy-Leasing S.A. Lending to the Bank's subsidiaries is granted on an arm's length basis.

The Bank monitors the concentration of its exposure on a regular basis, seeking to avoid a situation where the portfolio is dependent on a limited group of customers. As of the end of June 2005, as a result of reduction in the Bank's equity, the Bank's portfolio of exposure to non-bank entities included an exposure exceeding the exposure concentration limits laid down by the law. This exposure related to financing of a leasing company owned by the Bank (Customer 1), and the permissible limit was exceeded by PLN 35.3 million. There were steps undertaken which decreased the exposure below the legal limits.

**Exposure concentration – non-bank customers**

| in PLN thousand | Total exposure | Balance sheet exposure * | Off-balance sheet exposure |
|---|---|---|---|
| Customer 1 | 617,457 | 461,476 | 155,981 |
| Customer 2 | 459,979 | 248,889 | 211,090 |
| Customer 3 | 411,989 | 258,097 | 153,892 |
| Customer 4 | 400,000 | 400,000 | 0 |
| Customer 5 | 274,801 | 128,619 | 146,182 |
| Customer 6 | 261,352 | 228,217 | 33,135 |
| Customer 7 | 229,510 | 25 | 229,485 |
| Customer 8 | 220,688 | 130,957 | 89,731 |
| Customer 9 | 199,562 | 156,057 | 43,505 |
| Customer 10 | 185,504 | 70,877 | 114,627 |
| **Total 10** | **3,260,842** | **2,083,214** | **1,177,628** |

*) Does not include exposures due to held shares and other securities. Principal amounts for individual entities, excluding exposures to entities related to a given customer.

## *1.2 Quality of loan portfolio*

Pursuant to the Resolution of the Extraordinary Meeting of the Bank's Shareholders, with the effect from 1 January 2005, the Bank presents its stand alone financial statements in accordance with International Accounting Standards (IAS), International Financial Reporting Standards (IFRS), and related interpretations issued in the form of Regulations of the European Commission. The change in the standards, mainly the adoption of IAS 39, resulted in a new method of classification of the amounts due to the Bank and calculation of provisions for the risk related to crediting operations.

Currently, all receivables of the Bank are attributed to two portfolios depending on the existing risk of impairment of the receivables: the portfolio of receivables not at risk of impairment and the portfolio of receivables at risk of impairment. Depending on the materiality of the receivables, the portfolio at risk of impairment is then divided into receivables accounted for individually or collectively.

As of the end of June 2005, the share of loans at risk of impairment was 21.8% of the total portfolio and was lower as compared with the restated opening balance as of 1 January 2005 by 0.3%. The fall involved the customer portfolio accounted for individually and was related to the repayment of receivables in this customer group. The portfolio of customers accounted for collectively increased by 13.6% in the first half of 2005, explained by the reclassification of customers from the portfolio of receivables at risk of impairment.

**Loans to non-financial sector (gross) by the quality of exposure**

| | As of | | | |
|---|---|---|---|---|
| w tys. zł | 30/06/2005 | | 31/12/2004 | |
| | Thousand PLN | Share in % | Thousand PLN | Share in % |
| **Loans to non-banking sector (gross)** | | | | |
| Not at risk of impairment | 10 544 892 | 78.2% | 9 572 611 | 76.6% |
| At risk of impairment | 2 941 698 | 21.8% | 2 931 784 | 23.4% |
| accounted for individually | 2 203 253 | 16.3% | 2 281 926 | 18.2% |
| accounted for collectively (portfolio method) | 738 445 | 5.5% | 649 858 | 5.2% |
| **Total non-banking sector (gross)** | **13 486 590** | **100.0%** | **12 504 395** | **100.0%** |

Currently, provisions for receivables reflect the actual impairment of the portfolio, taking into account the discounted forecast of cash flows associated with the repayment of receivables. Moreover, the provisions are estimated for each receivable irrespective of their portfolio attribution and for probable but as yet unidentified losses.

As of 30 June 2005, the impairment of the portfolio was PLN 1,915.8 million, PLN 68.6 million of which was attributable to receivables not at risk of impairment. In the first half of 2005, the provisions increased by 0.1% with the concurrent increase in exposure, including accrued interest, by 2.1%. The increase in provisions was mainly related to the portfolio at risk of impairment accounted for collectively, including receivables reclassified from the group with the lower risk characteristics to the group with the higher risk characteristics. Classification to the specific group of receivables within the framework of the collective approach is the determinant for the level of the ratio used for the calculation of provisions.

**Impairment of non-bank loan portfolio**

| | As of |
|---|---|
| In thousand PLN | 30/06/2005 |
| Impairment due to incurred but not reported (IBNR) losses | 68 581 |
| Impairment of receivables | 1 847 171 |
| accounted for individually | 1 415 611 |
| accounted for collectively | 431 560 |
| **Total impairment** | **1 915 752** |
| | |
| Impairment due to incurred but not reported (IBNR) losses | 14.2% |
| Impairment of receivables | 62.8% |

### 1.3 Off-balance sheet exposures

As of 30 June 2005, off-balance sheet exposure amounted to PLN 10,224 million, representing a decrease by 7.1% as compared with 31 December 2004. The largest change related to committed loans which represented 75.8% of off-balance sheet assets, which decreased by more than PLN 607 million (7.3%). Forward placements were reduced by PLN 121 million to zero. Moreover, a fall in letters of credit issued by PLN 60 million (37%) was noted. The fluctuation on undrawn credit lines resulted both from the adjustment of credit lines required by customers as well from the use of the limits granted to customers by them.

**Off-balance sheet exposures**

| | As of | | Change | |
|---|---|---|---|---|
| in PLN thousand | **30/06/2005** | **31/12/2004** | **in PLN thousand** | **%** |
| Guarantees | 2 347 536 | 2 351 306 | (3 770) | (0.2%) |
| Letters of credit issued | 106 605 | 168 073 | (61 468) | (36.6%) |
| Third-part confirmed letters of credit | 23 760 | 17 108 | 6 652 | 38.9% |
| Committed loans | 7 746 422 | 8 353 740 | (607 318) | (7.3%) |
| Forward placements | 0 | 121 359 | (121 359) | (100.0%) |
| **Total** | **10 224 323** | **11 011 586** | **(787 263)** | **(7.1%)** |
| Provisions for off-balance sheet liabilities | 37 846 | 39 352 | (1 506) | (3.8%) |
| Provision coverage index | 0.37% | 0.36% | | |

## 2. External funding

As of 30 June 2005, the total value of external funding of the Bank was PLN 22,399.6 million and was higher by PLN 482.3 million (2.2%) than at the end of 2004. Liabilities due to the financial sector were the highest contributors to the Bank's external funding, which increased by PLN 1,506.4 million (39.5%), and in particular bank deposits which increased by PLN 1,031 million as compared with the end of 2004. At the same time, the Bank noted a drop in the balance of funds entrusted to it by non-financial institutions, the liabilities of which amounted to PLN 15,781,1 million as of 30 June 2005 and fell as compared with 31 December 2004 by PLN 541 million (3.3%). This fall resulted from two phenomena: a drop in time deposits, both from individuals as well as from corporates, as well as the higher balance of liabilities on current accounts.

**External funding*)**

| in PLN thousand | As of 30/06/2005 | 31/12/2004 | Change in PLN thousand | % |
|---|---|---|---|---|
| **Due to the Central Bank** | **355** | **718** | **(363)** | **(50.6%)** |
| **Due to financial sector** | **5 321 076** | **3 814 669** | **1 506 407** | **39.5%** |
| Funds on current accounts, including: | 1 196 032 | 721 487 | 474 545 | 65.8% |
| *- funds on current accounts of banks and other monetary financial institutions* | *1 194 215* | *720 855* | *473 360* | *65.7%* |
| Deposits, including | 4 125 044 | 3 093 182 | 1 031 862 | 33.4% |
| *- deposits of banks and other monetary financial institutions* | *1 638 702* | *849 460* | *789 242* | *92.9%* |
| **Due to non-financial sector** | **15 781 105** | **16 322 099** | **(540 994)** | **(3.3%)** |
| Funds on current accounts, including | 4 675 892 | 3 977 474 | 698 418 | 17.6% |
| *- corporate customers* | *2 570 832* | *2 284 398* | *286 434* | *12.5%* |
| *- individuals* | *1 587 092* | *1 324 039* | *263 053* | *19.9%* |
| Deposits, including | 11 105 213 | 12 344 625 | (1 239 412) | (10.0%) |
| *- corporate customers* | *7 153 135* | *7 833 795* | *(680 660)* | *(8.7%)* |
| *- individuals* | *3 487 092* | *4 032 425* | *(545 333)* | *(13.5%)* |
| **Due to public sector** | **489 909** | **531 002** | **(41 093)** | **(7.7%)** |
| Funds on current accounts | 154 471 | 148 729 | 5 742 | 3.9% |
| Deposits | 335 438 | 382 273 | (46 835) | (12.3%) |
| **Other liabilities** | **744 192** | **840 477** | **(96 285)** | **(11.5%)** |
| **Sell-Buy-Backs** | **63 008** | **408 361** | **(345 353)** | **(84.6%)** |
| **Total external funding** | **22,399,645** | **21,917,326** | **482,319** | **2.2%** |

**)Without interest accrued*

As to the changes in external funding, among the segments of non-banking customers the highest drop as of 30 June 2005 as compared with 31 December 2004, was noted by the Bank in the group of individual customers, by PLN 300.2 million (5.5%). This results from the intensified competition of the alternative offers of capital market investments in the context of falling interest rates, expansion of investment funds and a buoyant stock market.

The source of the decrease of PLN 218.1 million (2.0%) noted in non-financial entities' deposits as of 30 June 2005 as compared with 31 December 2004 were mainly time deposits, which were partially moved to current accounts. The main reason was the above-mentioned decreasing trend of interest rates.

**Liabilities to non-bank customers**

| in PLN thousand | As of 30/06/2005 | As of 31/12/2004 | Change in PLN thousand | Change % |
|---|---|---|---|---|
| Liabilities towards: | | | | |
| Individuals | 5,189,642 | 5,489,847 | (300,205) | (5.5%) |
| Non-financial economic entities | 10,531,645 | 10,749,745 | (218,100) | (2.0%) |
| Non-profit institutions | 459,755 | 424,038 | 35,717 | 8.4% |
| Non-bank financial institutions | 2,490,909 | 2,247,722 | 243,187 | 10.8% |
| Public sector | 490,123 | 531,212 | (41,089) | (7.7%) |
| Suspense account liabilities | 77,810 | 48,543 | | |
| **Total** | **19,239,884** | **19,491,107** | **(251,223)** | **(1.3%)** |
| PLN | 14,236,557 | 14,529,334 | (292,777) | (2.0%) |
| Foreign currency | 5,003,327 | 4,961,773 | 41,554 | 0.8% |
| **Total** | **19,239,884** | **19,491,107** | **(251,223)** | **(1.3%)** |

## 3. Corporate and Investment Banking Segment

### 3.1 Transaction Banking

The Bank has a rich, comprehensive and modern product offer related to financial and transactional servicing of enterprises. Apart from providing traditional services such as current accounts, domestic and foreign transfers, deposits, and overdrafts, the Bank also provides customers with more sophisticated transactional banking products, particularly in the area of electronic and Internet banking. Development of such activities is facilitated by access to world-class Citigroup technological resources.

#### *3.1.1 Transaction servicing*

The modern and rich transactional banking offer is the result of continuous efforts to provide services which meet the needs of the Bank's customers in the most effective manner. Economic growth and new business ideas of our customers stimulate the implementation of new practical solutions.

An important element of the Bank's offer is clients' cash management. The Bank offers a number of solutions, starting from the standard account operation products as well as cash and cashless transaction servicing, through e-banking and servicing of mass payments, to advanced solutions of consolidated accounts for the management of liquidity between various units of the customer and servicing of receivables with the use of advanced solutions based on the SpeedCollect platform.

As a result of efforts aimed at reducing the amount of paper orders executed in the Bank, the solution named ZetaFax, i.e. the "electronic form for manual transfer" was developed. The basic objective of the introduction of this solution is to increase the number of orders processed electronically as well as to limit customers' errors and mistakes by the introduction of tools verifying the information filled in by the customer in the money transfer instruction.

The Bank introduced into its offer the solution which makes it possible to settle mass payments (for all types of bills, e.g. for gas, phone, electricity, rent, etc.) at Payment Servicing Points operated by third persons, for the benefit of creditors who have not entered into separate agreements with the Bank.

In the first quarter of 2005, the Bank implemented the Working Capital Management project during which almost 100 customer analyses, taking into account the nature of the customers' business as well as the customers' size and development stage, were completed. The analyses made were used for preparation of individualized offers which were to contribute to funds management optimization.

Another important element of receivables management is Direct Debit. One of the Bank's initiatives with respect to this product was cooperation within the framework of the Coalition for Direct Debit and conducting the pan-Polish campaign promoting the Direct Debit. At the same time, the Bank actively solicits new customers. Its most prominent successes include entering into cooperation with Cyfra+ and Wielkopolska Spółka Gazownictwa Sp z o.o. which joined the group of entities offering to their customers a convenient method of paying their bills through the Bank's Direct Debit.

In the first half of 2005, the Bank noted a further dynamic development of the bill payment product "Unikasa". A number of new agency outlets were put into operation, both within the framework of the network of current customers as well as through the acquisition of new regional issuers.

Moreover, a decision was made to change the product branding. The existing branding, in orange color tones, was replaced by green. The purpose was "brand refreshing" and to increase product awareness in the context of its active promotion throughout Poland. The color change allowed differentiating our solution from the competition.

Moreover, the Bank launched a hotline for the Unikasa product, facilitating access to information to individual and corporate customers (issuers and agents). At the same time, the Bank can more efficiently monitor the complaints lodged and more rapidly explain the issues reported to it.

In the first half of 2005, the Bank also commenced work on improving the quality and functionally extend the range of the currently offered cash products. The new approach to the management of these products and the use of the available information technologies will result in an improvement of quality of the products offered and extension of the existing product offer. The purpose is also to significantly automate reporting and record processing whilst maintaining process security.

The cash management products for customers include credit cards, payment cards, and prepaid cards issued by the Bank. They are a convenient tool for paying for business expenses by the customer's employees. Searching for new uses for the existing products, in the first half of 2005, the Bank introduced an innovative method of use of the VISA Electron cards for withdrawal of social benefits in cash. The new prepaid card type is designed for the distribution of funds from allowances and scholarship funds.

At the beginning of 2005, the Bank introduced the Automatic Banker for customers who use corporate cards. This service makes it possible to obtain an automatic phone access to card information. The introduction of the Automatic Banker is a significant facilitation for the users of corporate cards.

At the same time, the Bank continues active solicitation of customers using Citibank Business Debit Cards whose number increased in the first six months of 2005 by 18%, and the number of cards issued increased by 26%.

In order to satisfy customers needs, at the beginning of 2005 the European Union Unit was established, where the special package "Europe of Enterprises" was prepared, within the framework of which customers requesting support from EU funds may use a customer friendly credit program. The offer is addressed to all enterprises and local government units which would like to use the development opportunity offered by the European Union and the possibility to compete in international markets. Apart from the credit program, the Unit prepared a number of products increasing the efficiency of trade financing and making it possible to effectively settle and manage the funds obtained from subsidies.

Within the framework of EU programs, the Bank entered into a Cooperation Agreement with Bank Gospodarstwa Krajowego and the Polish Agency for Enterprise Development (PARP) which enabled significant extension of the Program offer.

In addition, the European Union entered into cooperation with many consulting firms which will help customers of the Bank prepare documentation necessary for filing a request for subsidies and to provide step by step guidance through the complicated funds acquisition process. The consulting firms provide services to our customers upon preferential terms.

To improve the flow of information on the EU programs, a dedicated Hotline was established and marketing activities presenting the Bank's offer were commenced (press articles, a www page, conferences, etc.).

Within the framework of development of the "Italian Desk" office project supporting the Bank and its Italian partner at financing of trade of Polish and Italian contractors, launched in 2004, implementation of a new solution entitled "Borderless Banking" was commenced, consisting in active cooperation at the sale of the Bank's products by other financial institutions. The proposed model of cooperation aims at providing joint benefits for the Bank and cooperating financial institutions through product range enlargement, cost optimization, and increase in the bank activity coverage.

### *3.1.2 Trade Finance products*

The key task of the Bank as a leading institution in the field of trade service and finance was continuation of implementation of new solutions as well as the development of electronic service platforms. The exceptional feature of the offer was the introduction of innovative structuring of solutions to meet the specific needs of customers and the creation of an option for more extensive service of applications filed with the Bank via electronic data transmission means.

Traditionally, the main products enjoying the highest popularity among the Bank's customers were guarantees and letters of credit issued by the Bank, servicing of documentary collection and discounting of receivables documented by promissory notes and invoices (factoring).

To ensure the competitiveness of the Bank's offer in trade finance, new products were introduced – funding invoice-documented trade receivables in the domestic market on the basis of the insurance polity of Credit Export Insurance Corporation (Korporacja Ubezpieczeń Kredytów Eksportowych Spółka Akcyjna ) and letters of credit “covered upfront”.

Moreover, in addition to new products the extension of the variants available in the existing Bank’s offer is important. For example, the Bank commenced the issuance of guarantees required within the framework of the European Union program, PHARE and World Bank. The option of generating reports which will help customers monitor the inflows and conduct so-called “soft” debt collection was introduced. Furthermore, the Bank put into operation an option of electronic submittal of applications for opening import letters of credits, applications for guarantees, and payment orders for import collection.

In the area of transaction servicing, the catalogue of significant transactions should include a number of performance bonds issued by the Bank, where the amount of a single instrument exceeded PLN 5 million. Also a number of customs guarantees whose single value exceeded PLN 10 million should be considered important.

An important achievement of the Bank in the first half of 2005 was the implementation of the program for funding the suppliers of one of the largest network of hypermarkets in Poland for the total amount of PLN 8 million. The amount of funding granted within the framework of the invoice discounting programs (without programs based on the policy of Korporacja Ubezpieczeń Kredytów Eksportowych S.A. - KUKE SA) totaled an equivalent of USD 197 million in the first half of 2005.

#### *3.1.3 Custody services*

The Bank conducts custody services on the basis of the Polish legal regulations and consistently with the international standards of custody services offered to investors and brokers operating in international security markets. Owing to that, the Bank meets the requirements of the greatest and most demanding corporate customers.

The Bank is the leading depositary bank in Poland. It offers custody services to foreign institutional investors and depositary services to domestic financial institutions, in particular pension funds, investment funds and insurance capital funds.

The Bank holds securities accounts, settles securities transactions, handles dividend and interest payments, portfolio valuation, individual reports, and arranges for customer representation at general meetings of shareholders of listed companies. It also maintains registers of foreign securities, which also involves intermediation in the settlement of transactions for domestic customers on foreign markets.

As of 30 June 2005, the Bank operated 8,274 securities accounts. The Bank was a depositary for the following open-ended pension funds: Commercial Union OFE BPH CU WBK, AIG OFE, SAMPO OFE , OFE Pocztylion, Pekao OFE, Generali OFE, ING Nationale Nederlanden Polska OFE. The Bank was also a depositary for the following investment funds: BZ WBK AIB TFI S.A., SEB TFI S.A, PIONEER PEKAO TFI S.A.

### *3.2 Other Capital Markets and Banking*

### *3.2.1 Corporate Bank*

Corporate and Investment Bank provides comprehensive services for more than 140 major customers whose demands exceed the basic product range and require advice in the area of financial engineering. Separate departments provide for coordination of the treasury and financial management products available and prepare offers that embrace lending, debt equity financing, mergers and acquisitions.

The Bank actively supports the development of the largest enterprises in Poland, granting funds on its own as well as arranging or participating in syndicates, and also arranging the acquisition of funds from the capital market. The major transactions completed in the first half of 2005 included:

- Entering into an agreement on a 5-year syndicated facility for one of the retail sale networks in Poland, for EUR 106 million. The Bank's share in the transaction amounts to EUR 30 million. In the transaction, the Bank acts as the authorized principal arranger and syndication agent;
- Entering into an agreement on a 5-year syndicated facility for a leading Polish telecommunication service provider for EUR 900 million. The Bank's share in the transaction amounts to EUR 50 million. The Bank acts as the authorized principal arranger and syndication agent. The Agreement was signed in the second quarter 2005;
- Entering into an agreement on a 2-year syndicated facility for the key entity in the railway transport market, for EUR 130 million. The Bank's share in the transaction was at a level of EUR 15 million. In the transaction, the Bank acted as the authorized principal arranger and syndication agent. The transaction is attributable to the second quarter of 2005;
- Signing a contract of mandate for organization of the revenue bond issuance program for a water supply and sewerage collection company with the indebtedness limit of up to PLN 400 million. Within the framework of the program, the Bank acts as the co-arranger for the transaction;
- Signing bond issue program agreements for a telecom operator for PLN 1 billion. Within the framework of the transaction, the Bank acts as the arranger, dealer and payment agent as well as the depositary. The agreements were signed in June 2005 for 5 years;
- Signing a contract of mandate for organization of the medium-term bond issuance program for the amount of PLN 250 million, for a food industry company. The Bank acts as the transaction arranger and dealer. The transaction is applicable to the second quarter of 2005.

Furthermore, the Bank signed an agreement on advisory services related to debt restructuring for a customer in the fuel and power sector.

As of 30 June 2005, the Bank had a leading share in the market of issuance of short-term debt securities at a level of 23% and serviced 26 debt security issuance program.

### *3.2.2 Commercial Bank*

The Commercial Bank services small and medium-sized enterprises, offering to them local access to the Bank's products and services. The customer service model encompasses a network of conveniently located bank outlets and banking consultants who coordinate the relationship between customers and the Bank. Additionally, the Bank offers modern e-banking solutions providing to the customers rapid and convenient access to a number of solutions.

The offering for small and medium-sized enterprises includes the whole spectrum of solutions, from the Bank's standard products to advanced solutions tailored to the individual customers' needs, including arrangement of funding from the capital market, liquidity management and market risk management.

The key to the success of the Bank's cooperation with the customers in the small and medium-sized enterprises segment is delivery of possibly the most comprehensive offer of solutions, enabling the customers to use both a local approach and global resources of the Bank's expertise.

In the first half of 2005, the structure of the solutions offered was maintained, with a significant advantage in cash management and trade finance products. Apart from the standard products of foreign exchange and money markets, the customers' interest in the offer of derivative instruments, which effectively assist in competition through risk management in the context of significant fluctuations of foreign exchange rates and interest rates, has been systematically increasing.

#### *3.2.3 Treasury*

The Bank continued the activity in financial markets both for the customers' account as well for its own account. In addition to simple foreign exchange products and intermediation in trade in the money and capital market instruments, the Bank offers to its customers comprehensive solutions in foreign exchange and interest rate risk management, adjusting these solutions to the needs of the entity serviced.

In the first half of 2005, the Bank strengthened its position in the derivative instruments market. In particular, option instruments enjoyed high demand. The Bank also noted good results in the sale of Market Linked Deposit (MLD). Additional functionalities of the MLD product introduced in the first quarter of 2005 contributed to these result.

Owing to the growth in the customer base, the first half of 2005 was another period of strong commitment to intermediation in trade in the secondary market of debt securities, and the Bank noted historically high turnover volumes. The fluctuations in the secondary market also contributed to the Bank's high share in foreign exchange transactions in the interbank market.

## *4. Consumer Banking Sector*

### *4.1 Credit Cards*

The first half of 2005 was yet another period of intensifying competition in the credit card market. The Bank, owing to active sales and continuously upgraded offer, maintained its leading position. As of 30 June 2005, the portfolio of credit cards serviced attained the number of 550,000, which represents 8.5% growth compared with the corresponding period of the previous year.

In the first quarter of 2005, the Bank attained the best acquisition results in its history, mainly owing to the substantial demand for the Citibank Visa Silver and MasterCard Silver credit cards.

In the second quarter of 2005, the Bank significantly changed the Citibank Credit Card offer. A new and the most prestigious of cards offered by Citibank Handlowy was launched in the Polish market – the Citibank Platinum (VISA and MC) Credit Card, providing its holder with many additional services and privileges and the highest credit limit of available. Target market criteria were also modified for other credit cards.

Apart from the launch of the new Platinum card, another event important for cards was lowering of the interest rate on credit cards, owing to which the offer became more competitive. The interest on the Silver card was established at a level of 25.80%, and the interest on the Gold card was established at a level of 23.88%, for Platinum – 21.84%. The new interest rate is applicable to transactions made after 20 June 2005. The existing balance may be spread by the customer over 24 months with the credit cost of 14.99%.

The second quarter of 2005 was also a record for the sale of the Komfort Installment Plans. Moreover, the newly implemented product Cash Transfer from the Citibank Credit Card with the option of repayment within the framework of the Komfort Installment Plan proved to be a success.

## 4.2 Consumer Banking

### 4.2.1 Retail loans

The consumer loan market displays a high and sustained pace of growth. The Bank, wanting to exploit the market opportunities, enhanced its acquisition processes supported by an advertising campaign in the media and promotional actions, along with widening the target customer market. In the first half of 2005, the Bank attained the highest net income on the sale of the Citibank Loan to date, granting almost twice as many loans as in the corresponding period of 2004. As to mortgage loans, the Bank continued cooperation with GE Money Bank and Nykredit Bank Hipoteczny S.A.

### 4.2.2 Investment products

The drop in interest rates contributed to the increase in the attractiveness of alternative saving forms with the use of capital market instruments. Also the competition for customers' savings is getting fiercer. The key to the success is the diversified and steadily adjusted product offer.

In the first quarter of 2005, the Bank introduced the Capital Accumulation System (SAK) with the Union Investment TFI funds for sale. It is yet another systematic saving plan in the Bank's offer. SAK makes it possible to invest in the bond funds, a balanced fund and three equity funds.

In March 2005, the Bank launched the sale of foreign funds – open investment funds registered in Luxembourg – through the CitiGold branch network. Three types of funds managed by the Citigroup Asset Management Ltd. (CAM) are available within the offer: Citi FCP, CitiMoney FCP and CitiSicav. The offer includes in total 51 subfunds available in EUR, USD and GBP, belonging to the above three fund types.

Additionally, within the framework of foreign funds, it is worth mentioning the option to invest into the so-called fund of funds (CitiChoice Multi-Manager). The newly introduced European regulations make it possible for the first time for investment funds in the EU to invest their funds directly into other funds – on the same terms as those in force for investments in shares or bonds. CAM is one of the first financial institutions which takes advantage of these new legal solutions. Through the access to the funds of funds offered by CAM, the Bank's customers can invest in the best available funds and to manage them as a single investment portfolio.

In the first half of 2005, 19 subscriptions for Market Linked Deposits and 14 subscriptions for Structured Bonds took place. In June, a Structured Bond transaction was made for the first time in pounds sterling.

In the first half of 2005, the Bank organized numerous seminars devoted to investment products for existing and potential customers of the Bank.

In parallel with the development of investment products, the Bank models the offer of deposit products, in particular the modern deposits accessible via the Internet - T-deposits. In the first half of 2005, the existing wide range of terms was supplemented by another one – the 3-week deposit.

Moreover, the Bank conducted numerous promotional campaigns to acquire deposit and account customers among the customers using other products such as credit cards.

### *4.2.3 Insurance products*

In addition to investment products, the Bank's offer includes insurance products which combine the features of an insurance policy and a deposit product, which enjoy great interest among the customers. An example are investment programs with life insurance, the savings program with life insurance "Plus", or the guarantee policy in which the customer participates in the benefits resulting from investing part of the premium into the State Treasury bonds, offered by the Bank. Another product of this type is the "Hospitalization Profit" life insurance launched in February 2005. This insurance is designed for Citibank credit card holders and their spouses who hold the supplementary card.

### *4.2.4 Bank Accounts*

Wealthy and middle-segment customers remain the main target group for personal accounts in the CitiGold, CitiOne and CitiKonto offer. It should be mentioned that in March 2005 the CitiGold account received for the second time the title of the best offer on the ranking list of the Rzeczpospolita daily. The ranking list applied to the offer for wealthy persons and emphasized the prestige and convenience of the CitiGold offer. The features which contributed to the Bank obtaining the best scores for the CitiGold offer were modern banking products and personalized approach to the demanding customer.

As of the end of the first half 2005, the Consumer Banking segment operated 403,000 current accounts, as compared with 345,500 at the beginning of the year.

### *4.2.5 Electronic distribution channels*

The wide product offer is associated with the use and development of state-of-the-art distribution channels.

The number of Citibank Online users as of the end of the first half of 2005 exceeded 282,000, and thus increased by 54% as compared with the corresponding period of the previous year. The number of transactions initiated via Citibank Online constituted more than ¾ of the total number of transactions of the Consumer Banking segment. Activation of this distribution channel is supported by the appropriate pricing policy and special offers such as the T-Deposit with an attractive interest rate available exclusively via the Internet.

The Bank also actively promotes the Online Statement service, registering a stable increase in the number of its users, and thus generating substantial savings. As of the end of the first half 2005, 8% of account holders used this service. The number of CitiGSM customers notified on their balance by an SMS message as of the end of the first half 2005 increased by 34% as compared with the corresponding period of the previous year.

Since January 2005, Customer Relationship Management (CRM) has been operating in the Consumer Banking segment. The CRM system is used in all branches. The main objective of implementation of the System is to support and manage marketing campaigns in the Bank and modern support for sales. The launch of the CRM System also made it possible to implement a uniform customer service approach irrespective of the place of the customer's contact with the Bank.

### *4.3 SME Banking: CitiBusiness*

In the first half of 2005, CitiBusiness continued the sale of products and services in the form of product packages. After the balance-sheet date, the Bank decided to conduct a restructuring of the business model for existing CitiBusiness customers – small and medium-sized enterprises whose sales revenue does not exceed PLN 8 million.

## *5. CitiFinancial*

The strategic goal of CitiFinancial is to become the fastest-growing and the most profitable enterprise on the Polish market of consumer loans; the goal is pursued by establishing and maintaining strong customer relations, where, as the key element, the top priority is given to customers' needs, with a simultaneous focus on profitability of products and customers. The main principle is a personalized approach to every customer, with a view of building a long-standing relationship, beneficial for both parties.

The target market of CitiFinancial is 15.5 million private individuals, more than 7 million households. This is a significant market where the access is guaranteed through the Bank's credit offering. First and foremost, CitiFinancial focuses on customers who have not found a product range adjusted to their needs at traditional banks. Most of them are customers with medium or lower monthly incomes who appreciate the accessibility of the Bank's outlets. Therefore the Bank develops dynamically its network of branch offices located at shopping centers and in the vicinity of housing estates. As of 30 June 2005, the Bank operated 52 branch offices, which corresponds to an increase by 13 bank offices in the first half of 2005.

CitiFinancial product offering includes consumer loans (secured and unsecured) and sales of insurance products. Granted loans constitute an important element for starting cooperation and offering other products from the offer which Bank plans to develop and adjust to the customers' needs.

The group of products described in the above, developed and sold under the brand name of CitiFinancial, is characterized by a strong, more than nine-fold sales growth dynamics – a proof that the implemented market penetration model is right.

## *6. Branch network*

In the first half of 2005, the Bank continued the development and reorganization of its branch network, aiming at optimization of the operating cost and accessibility to retail and corporate customers. In the first half of 2005, the Bank's network increased by 18 branches, mainly owing to the enlargement of the CitiFinancial network. The total number of the Bank's branches as of the end of the first half of 2005 was 185, which consisted of:

1. 42 branches and sub-branches of the Corporate Bank, 27 of which services consumer banking customers.
2. 91 branches of the Consumer Bank, including 1 Investment Center, 12 branches dedicated to CitiGold Wealth Management customers and 10 Consumer Bank branches services Corporate Bank customers.
3. 52 branches of CitiFinancial situated in shopping malls and near housing estates.

Both Corporate Bank as well as Consumer Bank branches can service CitiBusiness customers.

Owing to the diversity of its solutions, the above structure is to ensure the optimal access to services for all existing and future customers of the Bank.

## 7. Changes in IT

The objective of IT development is to provide optimal processes while ensuring data security and continuity, and implementation of new solutions reflecting technological progress, product needs and the Bank's regulatory environment.

The following solutions influenced the development of a leading-edge product range, improvement of its quality and efficiency, and reduction of its cost:

- Implementation of the new version of the Goniec client software containing the extensions required by the regulatory authorities.
- Completion of the process of implementation of the 'Interactive Voice Response' system for the Card Products Management Unit.
- Implementation of distribution of the report on ZUS payment details.
- Installation of telecom and IT infrastructure in new branches of CitiFinancial.
- In transaction services, implementation of the new Customer Relationship Management (CRM) type application to automate the management of customer relationships, control of execution of the anti-money laundering policy (AML), aggregation and presentation of the financial and operational data.
- Extending the functionality of the CitiGateway application servicing zloty settlements, in connection with the introduction of new rules for payments to Tax Offices.
- Implementation of the phone call recording system servicing the Collections Department in the Consumer Bank.

Moreover, a number of efficiency improvements and functionality extensions were performed with respect to the systems used by the Consumer Bank.

In order to reduce the expenses, the Bank uses state-of-the-art technological achievements, implementing the idea of an digital office. The implementation of the Digital Office initiative was completed. Certain internal processes were adjusted to the "paperless" work processes, which made it possible to substantially reduce the costs of materials used. Additionally, the electronic platform for filing and accepting leave applications (eUrlopy) was implemented within the framework of implementation of concept.

Additionally, the Bank takes care to optimize the fulfillment of regulatory duties. The effective interest methodology (EIM) for loans, deposits, securities and documentary operations was implemented consistently with the accounting standards in force.

## 8. Brokerage

### 8.1 Secondary Market

The Bank operates on the capital market through its wholly owned brokerage subsidiary Dom Maklerski Banku Handlowego S.A. ("DMBH"). DMBH was established on 1 April 2001 as a result of the transfer of all assets of Centrum Operacji Kapitałowych Banku Handlowego (Capital Markets Centre) to Citibrokerage S.A., which as of that day changed its name to that used currently.

The bullish trend of the securities market in the first half of 2005 was a consequence of, among other factors, an improvement in investment attitudes in the Central and Eastern Europe region, especially in May and June 2005. There has also been a sustained interest of foreign investors in the Polish capital market, with particular focus on participation in investments ion the Warsaw Stock Exchange DMBH made extensive use of the bullish trend, and – having a very strong sales and transaction analysis and management team, specialized in servicing of large institutional customers whose assets are kept at trustee banks. DMBH retained the leader position on the equity market, increasing its share in the total turnover generated by all brokerage houses on this market from 17.6% ( June 2004) to 21.6% ( June 2005).

### 8.2 Primary Market

DMBH conducted the stock exchange flotation of Opoczno S.A., worth PLN 455.6 million, which represented 10.09% of the value of debuts organized in the first half of 2005 on the Warsaw Stock Exchange.

### 8.3 DMBH as Market Maker

DMBH commenced its independent operations on the Warsaw Stock Exchange in 1994, firstly as a Stock Exchange Member – Specialist, and subsequently as a Market Maker. Since the beginning of the futures market on the WSE, DMBH has acted as a Market Maker in the area of futures contracts for the WIG 20 index. Furthermore, DMBH is also a Market Organizer on the Central Table of Offers (CTO), whose operating principles are similar to those of a Market Maker.

Both Market Makers and Organizers are responsible for placing and maintaining put and call offers of fixed value on the order cards of individual companies. This provides investors with a guarantee of order execution. It is especially important for companies with low liquidity.

As of the end of the first half of 2005, DM BH acted as Market Maker for 44 company shares, i.e. 18.03% of all shares listed on the WSE, one convertible bond and futures contracts for the WIG20 index. It is noteworthy that among companies managed by Market Makers, there were three foreign companies quoted at the same time on their parent markets.

As Market Organizer on the CTO, DMBH performed tasks for the USD CitiBonds investment certificate of the Mixed Investment Fund.

With respect to the value of transactions managed by DMBH as the Market Maker, DMBH was among the top brokerage houses. The share in this market segment in the first half of 2005 reached 20.23% (in Q1- 20.9%, in Q2- 19.45%) of the total turnover managed by all brokerage houses acting as Market Makers for the equity market.

## 9. Leasing

The Bank conducts leasing operation via its two subsidiary companies: Handlowy-Leasing S.A. and Citileasing Sp. z o.o. In the first half of 2005, the companies continued their operations in the segment of transactions of medium and higher value (so-called middle/big-ticket lease) as well as in the area of vendor financing. A special emphasis was put on the offer directed to the Bank's customers, but customers were also actively acquired through contacts with the dealer network.

The range of products offered by the company includes operating leases, financial leases and sale and lease back. The product range was enlarged and the lease of the following fixed assets was added to the programs of financing means of road transport and typographic machines (printing and bookbinding machines and pre-press equipment) serviced to date:

- forklifts,
- plastic processing machines (injection presses, extruders, blow molding machines and accessories),
- machine tools (for machining, plastic working and unconventional working together with their accessories).

In April 2005, the electronic "Egeria" system was successfully implemented. Currently its is the most modern system for the service of lease transactions in the market. It is a fully integrated and comprehensive system. Many activities conducted in the first half of 2005 will have positive effects only in the second half of the year. They include:

- intensified acquisition within the framework of new product programs,
- launching phone sale and conducting direct mailing campaigns targeted on the potential customers for the new programs,
- putting into operation the www.handlowyleasing.pl page together with the electronic lease form where the first enquiries were received
- defining the rules of cooperation and commencement of cooperation with professional consulting forms – the aim of these actions is to facilitate to our customers their servicing in the process of obtaining EU subsidies.

## 10. Asset management

As of 30 June 2005, the value of assets under management of Handlowy Zarządzanie Aktywami S.A. (HanZA) was PLN 3,337.4 million, a growth by over 115% as compared with the end of the first half of 2004, when HanZA managed assets at a level of PLN 1,551.68 million, while the pace of growth of assets in the first half of 2005 was almost 37% versus the increase of 14% in the corresponding period of 2004.

As of the end of June 2005, the assets of individual customers totaled PLN 1,230.1 million, with the majority share of the assets of CitiFunds belonging to Towarzystwo Funduszy Inwestycyjnych Banku Handlowego S.A. and managed by HanZA – PLN 1,022.2 million. The value of institutional customers' assets was over PLN 2,107 million, where PLN 662.5 million were assets of CitiFunds and the remaining assets originated predominantly from insurance companies and other financial institutions.

The increase in the HanZA assets in the period between January and June 2005 resulted mainly from the systematic inflow of new assets from the existing corporate customers as well as from the high popularity of CitiFunds, mainly among individual customers who increased the assets by almost 75%.

In the first six months of 2005, the portfolios managed by HanZA generated results close to the benchmark ones. The highest rate of return in the equity market in the first half of 2005 was generated by the portfolios with the balanced strategy, investing on average half of their assets in shares quoted on the Warsaw Stock Exchange and the second half in debt securities – 9.84%. On the other hand, the portfolio of debt securities which are the product most often chosen by institutional customers, had a return rate of 6.34%, which is definitely a very good result as compared with the benchmark at a level of 5.25%.

## *11. Investment Funds management*

As of 30 June 2005, the value of assets of the funds managed by Towarzystwo Funduszy Inwestycyjnych Banku Handlowego S.A. (TFI BH) was PLN 1,684.7 million, as compared with the assets of PLN 1,046.1 million as of the end of the corresponding period of 2004.

The fund with highest volume of assets proved to be CitiBalanced Central European Open-Ended Investment Fund (CŚFIO), whose assets increased very dynamically throughout the whole first half of 2005 (by more than 93%) and totaled over PLN 447 million as of the end of the period (versus only slightly more than PLN 121 million as of the end of the first half of 2004). It should also be noted that almost 100% of the assets of this fund are assets originating from natural persons which proves the huge popularity of the investment strategy of this fund changed in September 2004, consisting in widening the spectrum of investment options by the equity markets of the Central European countries, among Polish individual investors. Despite the lapse of 10 months from the change in the investment strategy, it is still the most popular fund in the TFI BH offer, at the same time noting one of the best results in the past period among all balanced-strategy funds present in the Polish market.

Despite such a spectacular increase in its assets, the CitiBalanced Central European FIO was not the most dynamically growing fund in the TFI BH offer – a similar percentage asset growth (almost 94%) was noted in the first half of 2005 by CitiBonds Open-Ended Investment Fund, and the highest growth of almost 120% was noted by CitiMoney Open-Ended Investment Fund. Nevertheless, in the case of the latter fund, a high variability of its asset volume exists, due to the characteristics of such a fund type which is designed to a large extent to the investors who want to obtain a return on their investment within a short time.

The second largest fund as of the end of June 2005 proved to be the CitiSenior Specialized Open-Ended Investment Fund (SFIO) – the value of its assets increased in the first half of 2005 by over 46% and totaled almost PLN 368.4 million as of 30 June 2005. This fund systematically obtains very high asset growths. The growth attained in the corresponding period of 2004 (above 41%) was hardly different from the growth noted in the first half of 2005. Nevertheless, in this case almost 60% of the assets are corporate customers' assets, belonging mainly to the institutions for which TFI BH operates Employee Pension Programs, but it should be emphasized that the increase in the assets held by individual customers of this fund has been increasing from each subsequent period to another.

It should be emphasized that almost 50% of all assets invested in all CitiFunds was invested in two mixed-strategy TFI BH funds (balanced and stable) as of the end of June 2005, which indicates the sustained popularity of the investment strategies based both on the equity market as well as on the debt security market.

Despite numerous market fluctuations, all open-ended funds managed by TFI BH generated profits to their investors in the first half of 2005. The highest result was obtained by CitiBalanced Central European FIO – 8.09% - which gave to this fund a very high position in combination with the competition. CitiBonds FIO brought to its investors a return at a level of 5.41%, CitiSenior SFIO – 4.64%, CitiEquity FIO – 1.50%, CitiLiquidity SFIO – 2.97%, CitiMoney FIO – 2.91% and PKP Employee Ownership Fund SFIO – 4.88%.

## 12. Special purpose investment companies

Apart from strategic commitments – including Dom Maklerski Banku Handlowego S.A., Towarzystwo Funduszy Inwestycyjnych Banku Handlowego S.A., Handlowy Zarządzanie Aktywami S.A., Handlowy Leasing S.A., Citileasing Sp. z o. o., Handlowy Heller S.A., in the first half of 2005 the Bank performed capital operations through three special purpose investment companies whose activity was financed by the Bank with returnable contributions to their equity capital, subordinated loans, and also from financial profits of the companies.

Apart from strategic companies, the Bank's commitments portfolio belongs to the restructured portfolio – it contains capital exposures without the predetermined rate of return, which were earmarked by the Bank for the sale at the appropriate moment.

## 13. Other Information about the Bank

### 13.1 Rating

The Bank has a full rating from the international rating agency Moody's Investors Service.

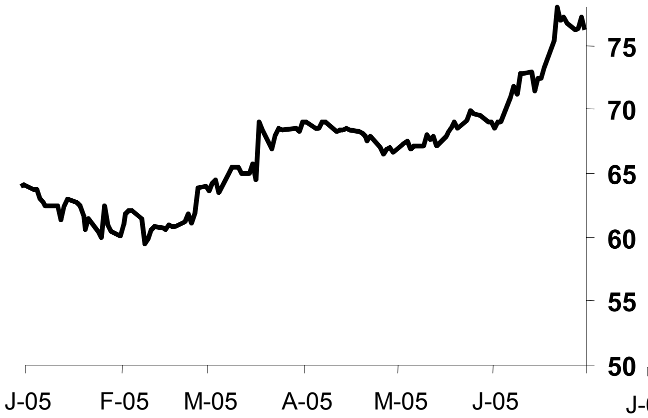
Since January 2003 Moody's has maintained A2 rating for long-term deposits (investment grade, 6th on the 21 point rating scale) and Prime-1 for short-term deposits (1st on the 4 point rating scale). The Bank ratings are at the highest level available for entities domiciled in Poland.

Additionally, on October 31, 2004, the agency notified the Bank of a change in outlook of the financial strength rating, now at D+ level, from stable to positive, which was justified with the Bank's leading market position in the area of credit cards, corporate and investment banking, capital market competencies, as well as cash & trade services and the initiated expansion on the Consumer Banking mass-market under the CitiFinancial brand.

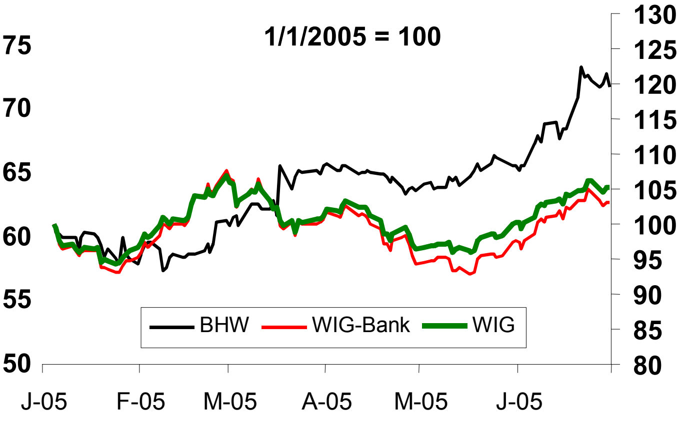
### 13.2 The Bank's stock performance on the Warsaw Stock Exchange

In the first half of 2005, the Bank's share price on the Warsaw Stock Exchange (WSE) increased from PLN 64.10 (31 December 2004) to PLN 76.20 (30 June 2005), i.e. by 18.9%. For comparison, the WIG-BANKI banking sector index in the same period grew much less, i.e. by only 8.1%, and the main exchange index, WIG, grew by 6.4%.

**Quotations of BHW Stocks, PLN**




**Quotations of BHW Stocks & Indices**




### *13.3 Awards and honors*

Awards and honors granted to the Bank in the first half of 2005

- **Citibank Handlowy** was honored with the title of the **Patron of the Year 2005** of the National Philharmonic Concert Hall in Warsaw
- **Citibank Handlowy** was awarded the **Superbrands Polska** title

**Citibank Handlowy was ranked third on the "the Dream Employer" ranking list** of the financial sector prepared by the Student Consulting Scientific Circle of the Warsaw School of Economics (SGH) in cooperation with SMG/KRC Millward Brown Company and the editing board of Rzeczpospolita.

- **The CitiGold account was ranked first on the ranking list of Rzeczpospolita** in the category of the personal account for wealthy and demanding individuals.
- **The Citibank Handlowy credit card** was recognized as the **safest card** on the ranking list of **Rzeczpospolita**
- Promotional emblem **Bank Friendly to Entrepreneurs** for Citibank Handlowy for the year 2004
- **Dom Maklerski Banku Handlowego S.A.** received **an award of the President of the Management Board of the Warsaw Stock Exchange** for the largest share in stock trade in 2004.

### *13.4 Sponsoring activity and cultural patronage*

- Strategic sponsor **of the photo exposition "One passion, two visions" of David Michael Kennedy and Tomek Niewiadomski** in June 2005 in Fabryka Trzciny in Warsaw.
- The Bank sponsored the **charity concert of the Beethoven Academy Orchestra** celebrating the Child's Day on 4 June 2005 in Cracow **for the benefit of the orphanage in Cholpon Ata in Kirgisia**
- The Bank was a sponsor of the **Al Di Meola Group's** concert within the framework of the **Wrocław Non Stop Citibank Handlowy** festival in June 2005
- The Bank was a sponsor of the **"Days of the Sea"** organized by the Szczecin Town Gmina in June 2005
- The Bank was a sponsor of **"Gorzów Days"** organized by the Municipal Culture Center in Gorzów Wielkopolski in June 2005.
- In April 2005, the Bank was a sponsor of the extraordinary concert of the **Academy of St. Martin-in-the-Fields** in the National Philharmonics Concert Hall in Warsaw.

# IV. Major risk factors relating to the operations of Bank Handlowy w Warszawie SA

## 1. Major risk factors related to Bank Handlowy's environment

### 1.1 Economy

According to the forecasts developed by the Bank, economic growth will accelerate in the second half of 2005, to which the gradual revival of domestic demand will contribute. GDP growth in 2005 will be lower than in 2004 and will amount to 3.3%, versus 5.4% one year earlier. The positive growth tendencies will also continue in 2006.

The expected increasing appetite for investments, stimulated by an exceptionally low level of interest rates, will contribute to the accelerated growth of the national demand. Moreover, the initiation of new projects co-funded by the European Union by businesses and local governments will contribute to the growth in investment expenditure.

The growth in employment and the acceleration of growth in real wages will contribute in the third and fourth quarters to the accelerated growth in consumption. As a result, the consumption growth in 2005 will attain the level of 2.4%, versus 3.4% in 2004. A marked increase in consumption demand will be noted only at the beginning of 2006, due to the planned positive revaluation of pensions.

The main source of threats for the scenario of domestic demand increase is the political insecurity relating to the direction and shape of economic policy of the government formed after the parliamentary elections. The program of the new government will indicate for investors the pace and scale of increasing the restrictiveness of the fiscal policy in subsequent years. Due to the necessity of meeting the Maastricht criteria – including the fiscal criteria– changes in the public finance sector deficit will be the determinant for the potential date of Poland's accession to the Economic and Monetary Union. The lack of strategy of the Polish route to the eurozone may reduce the willingness of some investors to commence new investment projects in Poland.

According to the Bank's forecasts, the uncertainty as to the condition of the public finances in 2006 and 2007 will be maintained also after the parliamentary elections, which will inhibit the appreciative trend of the zloty. Nevertheless, it cannot be excluded that if the new government introduces a public finance reform, the growth in the value of the Polish currency will become one of the factors putting at risk the Polish enterprises' competitiveness in the world markets. The potential inhibition of the export growth would negatively affect the profits made by exporters, reducing the customers' willingness to use the services offered by the Bank.

Strong appreciation of the zloty would increase the anxiety of the monetary authorities connected with the possibility of economic growth and deep reduction of the inflation rate in 2006. It cannot be ruled out that in such a case the Monetary Policy Council would decide to loosen the monetary policy further, which would lead to a reduction in interest rates to the lowest ever levels.

The economic condition in Poland may be strongly affected by external factors – changes in crude oil prices and fluctuations in the markets of countries which are the main trade partners of Poland. The dynamic growth in crude oil prices in the first three quarters of 2005 did not fully translate in inflation rate changes or in the pace of economic growth. However, if the crude oil price rise trend were sustained in the subsequent months of 2005 and 2006, the risk of a violent acceleration of inflation and weakening of economic growth would significantly increase.

### 1.2 *Regulatory risk*

Any changes in economic policies or in the legal system could have a considerable effect on the Bank's financial condition. In terms of banking sector regulation, a particularly important role is played by statute law, and by the secondary provisions issued by the Minister of Finance, resolutions of the Management Board of the NBP, ordinances issued by the President of the NBP, and also resolutions of the Commission for Banking Supervision ("KNB").

In terms of the regulations mentioned above, those of key significance include:

- permissible concentration of credit exposure limits (Banking Act),
- ceiling on equity investments, measured in relation to the capital base (Banking Act),
- liquidity and credit risk standards (resolutions of the Commission for Banking Supervision),
- calculation and maintenance of mandatory reserves (NBP, Banking Act, and resolutions of the Commission for Banking Supervision and of the NBP Management Board),
- taxation and similar charges.

### 1.3 *Competition within the banking sector*

Competition between banks in different segments of the Polish banking market seems to be strong. We expect that companies will increasingly utilize financial alternatives to bank loans, such as issuance of short-term debt securities, bonds and equity or lease finance. It is very likely that due to growth in foreign investment in the banking sector, as well as creation of the single European market of financial services, an increase in competition will be observed particularly in such segments as foreign exchange operations, foreign trade settlement and investment banking. Poland is in sharp focus of international financial institutions planning to include the country in their cross-border businesses. Despite, however, of the large number of entities, which have announced their intention to start doing business in Poland, no significant changes in the banking sector structure are to be expected. Indeed, institutions for which Poland is an interesting and attractive market have been active here for a number of years. As a result, the offering of banks operating in Poland is often similar to that of the UE banks. The competition will take place mainly in the area of service quality, especially the speed and efficiency of customer service. Further consolidation processes in the sector could possibly relax the competition. The significance of electronic access channels to customer accounts will also grow.

The Bank is well prepared to compete in the European environment. Nevertheless, the growing level of competition within the banking sector may have an adverse effect on the Bank's financial performance.

## ***2. Major risk factors connected with Bank Handlowy w Warszawie SA and its operations***

### *2.1 Liquidity risk*

As a typical feature of the banking activity, maturity mismatches between loans and the funding deposits are also experienced at the Bank. They may give rise to potential problems for current liquidity, were there to be a build-up of large payments to customers. The management of the Bank's assets and liabilities, including the regulation and control of liquidity risk, is the responsibility of the Assets and Liabilities Committee whose strategy is implemented by the

Treasury Department. The Bank's deposit base is stable and diversified. Furthermore, the Bank has good access to interbank funding and adequate capital. The level of liquidity risk is thus low.

## 2.2 *Foreign exchange risk*

The Bank performs foreign exchange operations both on behalf of its customers and for its own account, and holds open foreign exchange positions within established limits. The material positions of the interest rate risk are opened by the Bank in three basic currencies, i.e. in PLN, USD and EUR. Furthermore, periodically the Bank opens significant positions in currencies of the Central and Eastern Europe countries (Czech Republic, Slovakia, Hungary). The management of foreign exchange risk is the responsibility of the Treasury Department which assumes the risk within the framework of the procedures and limits established by the Assets and Liabilities Management Committee, controlled independently by the Market Risk Department. The foreign exchange risk is mitigated with the use of position sensitivity limits for each currency allowed for trade, the value at risk limit, and the precautionary threshold of the maximum monthly loss. The limit of value at risk arising from open foreign exchange position is established at a level below 1% of the Bank's equity. The foreign exchange risk assumed currently is moderate, and the level of potential risk determined by the size of position limits may be defined as moderately high. Therefore, the Bank bears foreign exchange risk and it is not certain that future movements in exchange rates will not have an adverse effect on the Bank's financial standing.

## 2.3 *Interest rate risk*

The Bank manages interest rate risk broken down by trading and banking books. The trading books include debt securities in the trading portfolio and derivative transactions (interest rate swaps - IRS, forward rate agreements - FRA, futures, the interest element of the forward foreign exchange transactions). The trading portfolio is valued each day at market prices and all changes in the value of this portfolio resulting from changes in the market interest rates are reflected directly in the profit and loss account. The interest result in the Bank's operations within the banking book including all asset and liability items not included in the trading book is calculated on the basis of amortized cost (accrued interest, attributed discount/premium), and the result of valuation of securities available for sale adjusts the value of the Bank's equity.

In the trading book, the Bank assumes the interest rate risk to realize gains on short-term changes in the level and curve shapes of interest rates and relations between interest rates for various securities (profitability of bonds as compared with the rates of interest rate swap transactions). The material positions of the interest rate risk are opened by the Bank in three basic currencies, i.e. in PLN, USD and EUR. The interest rate risk of the trading book is mitigated with the use of position sensitivity limits for each currency allowed for trade, precautionary thresholds for the interest rate positions in individual time intervals, the value at risk (VaR) limit, and the precautionary threshold of maximum monthly loss. The limit of value at risk (VaR) arising from open interest rate position is established at a level below 1% of the Bank's equity. The management of the interest rate risk in the trading book is the responsibility of the Treasury Department which assumes the risk within the framework of the procedures and limits established by the Assets and Liabilities Management Committee, controlled independently by the Market Risk Department. The interest rate risk assumed currently by the Bank in the trading book is moderate, and the level of potential risk determined by the size of position limits may be defined as moderately high. Therefore, it is not sure that the future movements in interest rates will not have an adverse effect on the Bank's financial standing.

As is the case with other Polish banks, in the banking book the Bank is exposed to a time mismatch risk regarding the interest rate changes on its assets and the underlying liabilities. The interest rate risk can arise where it proves impossible to offset the fall in income caused by lower rates of interest on loans granted and purchased securities available for sale through a corresponding reduction in the rates of interest paid to depositors. Similarly, this risk also applies to situations where a rise in deposit rate charged to the depositors cannot be offset by a corresponding rise in lending rates or investments of the funds obtained into the debt securities portfolios. The interest rate risk of the banking book is mitigated with the use of limits of potential fall in the interest margin over one as well as five and six years, at the assumption of a change in the interest rate curve by 100 basis points for each of the currencies in which the Bank opens the material risk positions. Furthermore, the Bank uses precautionary thresholds for total return on the portfolio (the accrual-based interest gain or loss is adjusted by the gain or loss realized on the sale of debt securities and change in the economic valuation of the total banking book in the specific time interval) and separate sensitivity limits and alarm thresholds of unrealized loss on the portfolio of debt securities available for sale. The management of the interest rate risk in the banking book is the responsibility of the Treasury Department which assumes the risk within the framework of the procedures and limits established by the Assets and Liabilities Management Committee, controlled independently by the Market Risk Department. The interest rate risk assumed currently by the Bank in the banking book, determined by the size of limits applied by the Bank, may be considered high. It is not sure that the future movements in interest rates will not have an adverse effect on the Bank's financial standing. The current interest rate risk level is moderate.

### 2.4 *Credit risk*

Lending and guarantee business is inherently linked with the risk of payment delinquency (in terms of both loan principal and interest), and also with the risk that the asset represented by an outstanding loan or granted guarantee will prove impossible to recover. The Bank monitors its risk assets on an ongoing basis, and establishes all the requisite specific provisions against loans classified as irregular. The Bank's Management Board considers the current loan-loss provisions as adequate. In connection with the possibility of changes in the external environment that could have a negative impact on the financial situation of the Bank's customers, there is no certainty that in the future the need to provision adequately against the existing asset portfolio will not have an adverse effect on the Bank's financial condition, or that the provisions and collateral in place will prove sufficient to absorb the losses possibly arising on lending activity.

### 2.5 *Equity investment risk*

Equity investments can be divided into two categories: strategic and restructuring. The strategic portfolio includes the Bank's shares in financial institutions of a strategic significance to the Bank due to its operations. The restructuring investment exposure arises from debt to equity conversion. The investments are executed directly by the Bank or indirectly via the Bank's wholly-owned special purpose investment vehicles. As of the end of the first half of 2005, the value of net equity investments including subordinated loans and convertible bonds for the Bank's investment companies amounted to PLN 323.5 million as compared with PLN 332.5 million as of the end of 2004. For some equity investments, their pricing is based on the assumption of finding a strategic investor for the company, in which the Bank holds shares. Therefore, a continuous high level of foreign investment may be crucial to the valuation of such investments. Moreover, due to a number of macroeconomic effects, the situation on equity markets and other factors having an impact on activities of the companies in which the Bank is a shareholder, the selling price of owned shares may turn out to be lower than expected, or even lower than their value in the Bank's books, which may have a negative impact on the Bank's share prices. The Bank has already created substantial provisions related to its equity investments and hence the risk level connected with a further drop in the value of the Bank's investment portfolio is low.

### 2.6 *Operating risk*

The Bank defines its operating risk as a risk arising from inadequate or unreliable internal processes or systems, or from people's errors or external events.

For several years, the Bank has managed its operating risk using a variety of tools and techniques (principally self assessment process and also through techniques such as checklists, limits, contingency planning) which are applicable also to the Bank's subsidiaries. Following the publication of the Basel Committee's recommendations and of Recommendation M issued by the Bank Supervisory Committee, the BHW Management Board intensified qualitative and quantitative measurements of the operating risk.

The basic rules of management and the roles and responsibilities at various levels of the Bank's management are regulated in the "Operating Risk Management Policy". In the Bank, the Committee for Business Risk, Control and Compliance is responsible for the ongoing monitoring of operating risk. Audit and review exceptions, operating events and indices related to operating risk are the subject of regular reports presented to the Committee. At the same time, the quality of the operating risk management process (including the self-assessment process) in individual organizational units of the Bank are subject to control and assessment by internal audit.

The overall level of operating risk is assessed as average, typical for the scale of business of the Bank.

### 2.7 *Contributions to the Bank Guarantee Fund*

Pursuant to the Act on the Bank Guarantee Fund, the Bank is included in a mandatory deposit protection scheme for personal deposits. The Banks included in this scheme are required to make specific contributions to the Fund.

Due to a general deterioration within the banking sector, or a bankruptcy or financial distress of one of the participating institutions, the Bank and other participants in the Bank Guarantee Fund may be required to make large payments to the Fund, in proportion to the sums held within the individual deposit protection funds established for given institutions. This could adversely affect the Bank's earnings.

# V. Prospects for the business development of Bank Handlowy w Warszawie SA

## *1. General objectives of the Bank's development*

The Bank's objective is to systematically increase the shareholder value by ensuring an appropriate return on equity and increasing the Bank's share in key market segments. In the coming years, the Bank's intention will be to continue active acquisition of new customers from all market segments.

Over the next few years, the Bank aims for a double-digit market share, as measured by its share in the net income from banking activity generated by the banking sector. In the first half of 2005, this share amounted to 7.3%. The market share increase is to be attained by maintaining the

Bank's leading position in corporate banking and services for the high net worth individuals and through development of consumer banking. Business areas with a high growth potential, e.g. services for large and medium-sized domestic enterprises (Commercial Banking Sector) and loans to private individuals (CitiFinancial), will be significantly developed.

The Bank will also place a special emphasis on its cost management policy. In the first half of 2005, the Bank's share of general expenses of the banking sector was 8.6% as compared with 8.1% in the first half of 2004. In the coming years, the Bank will focus on a strict cost discipline, so as to ensure a sustainable cost/income ratio below 2.0. The Bank's share in the net financial result of the banking sector in the first half of 2005 was 5.2% as compared to 3.2% in the first half of 2004.

One of the Bank's priorities for the coming years is further development of the Regional Processing Center in Olsztyn, which provides settlement services for the Bank and for foreign banks within Citigroup.

### *1.1 Corporate banking*

The Bank is a corporate banking leader in Poland. As of the end of the first half of 2005, its share of the corporate lending (private and state-owned companies and cooperatives) market stood at 6.8% as compared with 8.7% as of the end of the first half of 2004, whereas the share in the corporate deposits market amounted to 11.4% as compared with 13.6% as of the end of the first half of 2004. The Bank's share of the corporate debt origination market, measured by indebtedness size, was 23.0% as of the end of the first half of 2005 as compared with 16.4% as of the end of the first half of 2004.

In 2005 the Bank operates on the basis of a newly implemented, more effective model for servicing corporate customers. As a consequence of introducing the new Customer Coverage Model, the product offering for large and medium-size enterprises was expanded. The largest customers of the Bank customers are provided with a fully customized service.

The Bank's potential corporate banking customer base includes all companies operating in Poland, except for those belonging to sectors permanently excluded from the Bank's target market due to the general Bank policy or included on restricted lists as a result of sanctions imposed either by international organizations or the US government.

The Bank's position is particularly strong in servicing international corporations and the largest Polish companies. Moreover, it is the foremost institution in handling money market and foreign exchange transactions. The Bank's goal is to retain its present market share in these areas. In developing relationships with the largest customers, the Bank has the significant advantage of being part of Citigroup. The Bank is in a position to offer to these customers unique services that blend its own knowledge of the domestic business environment with the international experience and global reach of Citigroup.

The majority of the Bank's revenues will be generated by cash management, trade service and treasury products. The solutions and innovations in these product groups will be the key factors determining the competitive advantage of the Bank, in particular in cooperation with the most demanding international and leading domestic companies. The Bank will also aim to use the possibilities of selling these products to the large and medium-sized domestic enterprises segment to a much greater extent.

### *1.2 Consumer banking*

The Bank considers that services for customers of the consumer banking sector provide the highest growth potential in the medium term.

As of the end of the first half of 2005, the Bank's share in total lending to private individuals totaled 2.4%, as compared with 2.1% as of the end of the first half of 2004, whereas the market share in deposits as of the end of the first half of 2005 was 2.5% as compared with 3.0% as of the end of the first half of 2004.

The Bank is primarily interested in acquiring customers with medium and high income, living in cities with over 100,000 inhabitants. The Bank's product offering is tailored to suit the needs and expectations of this customer profile.

It is of key importance for the Bank to maintain the strong position in credit cards – the market in which Citigroup is the world leader. New card types as well as loyalty-building programs will be offered. The target group of customers to whom the Bank will offer its cards will be expanded.

The Bank has a very strong position in the high net worth customer segment. What sets us apart from the field is that these customers are offered worldwide services.

In the first half of 2005, the Bank gradually strengthened its position in this market segment thanks to the *CitiGold Wealth Management* service. The key highlight of the wealth management service is the savings and investment plan comprising investment, insurance and banking products. The products available in the Wealth Management package include current accounts, term deposits, investment deposits and dual-currency deposits, investment funds, treasury bills, domestic and international bonds, brokerage services, credit facilities, credit cards and insurance products. Customer funds are managed in personalized investment portfolios based on the customers' individual needs and preferences. Poland is the first European country where Citigroup introduced its *CitiGold Wealth Management* service.

Furthermore, the Bank is expanding its offering to medium-income customers holding *CitiOne* or *CitiKonto* accounts. In addition to developing traditional deposit services and increasing transactional functionality of the accounts, special emphasis will be placed on extending investment and insurance offering. Along with the increasing customers' demand for new methods of placing their savings, the Bank will systematically expand its investment fund offering.

The Bank also continues granting cash loans to low-income customers. This activity is treated as a separate business and is conducted under the brand of CitiFinancial, a Citigroup division specialized in lending to private individuals. The Bank expects a dynamic growth in this area.

### *1.3 Distribution network*

The Bank operates in the market using two brands - citibank handlowy for the distribution of consumer banking and corporate and investment banking, and citi financial for the CitiFinancial distribution channels. The Bank's priority is to build brand awareness among the current and future target customers for the given business segment.

The Bank's customer service is based on the network of outlets, banking consultants, third party direct sales agents and remotely operated distribution channels such as Internet banking, call Center, IVR (interactive automatic telephone service) and multi-functional ATMs.

Streamlining of the branch network through optimization of available space, closure of least profitable outlets, and integration of corporate and consumer sector branch offices is currently underway. In the case of corporate and investment banking customers and *CitiGold* customers, the mainstay of the distribution network are bank consultants. The dynamic enlargement of the CitiFinancial network will be continued.

The use of the Bank's distribution network takes into account plans of increasing the scope of activities in consumer banking and achieving synergies with the corporate bank. In the coming years, the Bank will aim to minimize operational activities in branches and completely transform them into service centers. The priority is to increase functionality and availability of remote distribution channels and to further enhance the qualifications of banking consultants, in particular those handling large entities that demand more sophisticated financial products. In the case of consumer banking substantial emphasis will be placed on further growth of Internet usage (Citibank Online). As a target, the Internet is to become the basic source of conducting transactions for private individuals.

High functionality and high quality of access to the customer phone service center through CitiPhone call centers for private individuals and the CitiService/Customer Service Department telephone centers for large and medium-sized enterprises will be maintained.

### 2. Synergies

Wide-ranging experience and diverse operations provide the Bank with strong competitive leverage and allow it to offer customers comprehensive solutions by taking advantage of the opportunities afforded by synergies between corporate and consumer banking, between banking services, asset management and brokerage services, and also between banking products and insurance, etc.

Packages of deposit and loan products are offered to the staff of the largest corporate customers. A typical package includes personal current accounts (e.g. CitiKonto) together with payroll support facilities, credit cards, mortgage loans and cash advances. In addition to pricing incentives, the Bank is prepared to conduct financial educational seminars for their employees.

The Bank will also continue to sell corporate products to its consumer customers from the CitiGold sector. Specialized treasury products, brokerage services and asset management facilities in particular will be offered. All groups of consumer customers will further be offered investment products, in particular participation units in investment funds.

### 3. The community

The Bank aspires to be a model corporation in Poland, with a strong sense of social responsibility. The Bank actively supports various cultural, educational and philanthropic activities – both at the national level and in local communities, especially through the Kronenberg Foundation. Moreover, the will Bank actively participate in the dialogue between the state authorities and the business sector about regulations that influence the climate and conditions of conducting business activity in Poland.

## VI. Good Practices in Public Companies

### 1. Corporate Governance Rules

In accordance with the statement of the Bank Management Board adopted in the resolution of 19 May 2005 and contained in the ongoing report no. 22/2005 of 6 June 2005, the Bank follows the corporate governance rules defined in the “Good Practices in Public Companies 2005”

The statement received a positive opinion of the Bank Supervisory Board expressed in its resolution of 24 May 2005, and then accepted by the Resolution No. 11 of the Ordinary General Meeting of the Bank Shareholders held on 21 June 2005.

### 2. Accuracy and fairness of the statements presented

To the best knowledge of the Bank Management Board, the semi-annual financial data and the comparative data presented in the "Semi-annual Financial Statements of Bank Handlowy w Warszawie SA 2005" were prepared consistently with the accounting standards in force and reflect the accurate, true and fair view of assets and financial position as well as the financial profit or loss of Bank Handlowy w Warszawie SA. The Semi-annual Management Board Report contained in this document contains a true picture of the development, achievements and situation (together with the description of the basic risks) of Bank Handlowy w Warszawie SA in the first half of 2005.

### 3. Selection of the entity authorized to examine financial statements

The entity authorized to examine financial statements, reviewing the semi-annual financial statements of Bank Handlowy w Warszawie SA, was selected consistently with the legal regulations. This entity along with the registered auditor met the conditions necessary for issuing an impartial and independent report on the review, consistently with the respective regulations of the Polish law.

Signatures of all Management Board Members

| | | | |
|---|---|---|---|
| 26.09.2005 | Sławomir Sikora | President of Management Board | |
| Date | Name | Position / function | Signature |
| 26.09.2005 | Philip Vincent King | Vice- President of Management Board | |
| Date | Name | Position / function | Signature |
| 26.09.2005 | Reza Ghaffari | Vice- President of Management Board | |
| Date | Name | Position / function | Signature |
| 26.09.2005 | Lidia Jabłonowska-Luba | Member of Management Board | |
| Date | Name | Position / function | Signature |
| 26.09.2005 | Michał H. Mrożek | Member of Management Board | |
| Date | Name | Position / function | Signature |