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ABSTRACT

Poland's Emerging Financial System: Status and Prospects

by

Daniel Hogan, Elisabeth Rhyne, and David P. Dod

August 1993

This report is one of four country studies of financial sector reform in Bulgaria, Hungary, Poland, and Estonia. It was commissioned by USAID to assist the USG in planning programming in this sector. Each report examines the macrofinancial environment; the functions of central banks, including bank regulation and supervision; the future role of state banks, the development of banking services, capacity development in the banking system, and the role of donors. A synthesis report was also prepared to draw common findings and lessons from the four country studies.

This study finds that Poland has made significant progress in developing its financial system, noting in particular its emerging money markets, stock market, and monetary policy tools. It identifies several areas on which future efforts should focus, and outlines a brief agenda for action in the financial sector during the next few years. These include examining whether the implicit taxation imposed by various regulations is appropriate; developing a sound basis for private banks which combines work in regulatory policy oversight of the current consolidation process; developing an over-the-counter market; restructuring and privatizing the remaining specialized banks; and building the capacity for banks to become permanently established.

The report concludes with observations and recommendations for U.S. Government assistance.

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Poland's Emerging Financial System:

Status and Prospects

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SECTION ONE

RECENT ACCOMPLISHMENTS IN THE FINANCIAL SECTOR

Since the introduction of reforms toward a market-based economy in 1989, Poland has succeeded in implementing an economic transformation program that has led to broad-based changes in the enterprise and financial sectors. Among these changes are the creation of a multitiered banking system from the previous monobank system and the development of multiple methods through which state-owned enterprises (SOEs) are being privatized. Poland's reforms have created some notable positive gains, such as:

- Emergence from recession in 1992, with 2 percent growth in gross domestic product (GDP) — Poland was the first Central and Eastern European (CEE) country to enter post-reform recovery — and industrial production during the first quarter of 1993 up 6 percent from its 1992 level;

- A substantial decrease in the inflation rate, to 38 percent per year in April 1993, from 600 percent in 1989;

- An increase in private sector contribution to GDP, to approximately 45 percent of the total, up from 12 percent three years ago;

- Rapid reorientation of trade toward the West; and

- Privatization of 1,500 medium- and large-scale SOEs, representing about 20 percent of total and about 15 percent of industrial output.

In the financial sector, developments include:

- Substantial progress toward conversion of the nine former arms of the monobank into market-driven commercial banks;

- The creation of about 80 private banking institutions;

- Introduction of a stock exchange;

- Adoption of a new chart of accounts for the banking system, compatible with charts of the European Community (EC), with mandatory reporting requirements to the National Bank of Poland (NBP, or the central bank);

- The development of the money market, through the introduction of an interbank placements market, Treasury bills, and bonds;

- Improvements in the payments system, most recently including an interbank clearinghouse, which began operations in early 1993;

- Broadening of services available to consumers, including better payment services and the first introduction of ATM machines and credit cards; and

- The first privatization of state banks — most recently, the privatization in April 1993 of a major state-owned commercial bank, Wielkopolski Bank Kredytowy, whose public share issue was enthusiastically received by Polish buyers. Three banks are now traded on the Warsaw Stock Exchange (WSE).

The successes noted above have at the same time heightened awareness of systemic weaknesses within the Polish economy:

- The banking system is undercapitalized and suffers from a portfolio that contains as much as 15 percent of its assets in non-performing loans to SOEs. These problems require restructuring of many banks, both state and private.

- Credit is scarce within the banking system, particularly to small and medium-sized private entrepreneurs, who seem from their start-up and growth rates to have great potential for expansion. Overall bank lending has declined in real terms from 1991 to 1993, due in part to attractive, relatively risk-free alternatives for banks to place funds in government securities and the banks' lack of skills in credit analysis.

- The National Bank of Poland has developed good skills and authority to maintain effective control over monetary aggregates, but it seems to have weak legal and interministerial authority and a strong need for further training in prudential regulation and supervision such that, at present, effective supervision and enforcement are lacking.

- Some legislative measures to facilitate smoother functioning of the financial sector were not completed before dissolution of the party-splintered Parliament in May 1993. Still in draft or awaiting passage by a new Parliament are important pieces of legislation on banking law, collateral reform, and bankruptcy proceedings.

Broader economic problems make these financial issues more difficult to resolve:

- Some parts of the SOE sector, having lost major markets and having inherited overstaffing, fading technologies, and little appreciation for Western cost and financial controls, cannot become profitable and are nonviable under current state ownership arrangements;

- The fiscal deficit looms large. Although the government has committed to containing the deficit at 5 percent of GDP, its continued funding requirements will give the banking system little room to expand credit to efficient enterprises (except to the extent that banks cut back credit to inefficient, delinquent debtors).

- Unemployment, currently running at about 14 percent of the work force, is still a major threat, particularly in light of further rationalization at SOEs, and places reform efforts into a highly stressful political setting.

These developments provide the context for the initiation of the Financial Restructuring of Enterprises and Banks Program (FREB), a sweeping agenda for change in the financial sector being implemented during 1993 and 1994, with significant impact on the state-owned enterprise sector. The program gives the nine state-owned commercial banks (SOCBs) major responsibility for restructuring enterprises and resolving problem loans, under the supervision of the Ministry of Finance (MOF) acting in its role as "owner" of the banks on behalf of the Government of Poland (GOP).

This program, one of the most comprehensive in Central and Eastern Europe, is an integrated effort to solve the debt overhang of SOEs, resolve the ownership structure of SOEs (and the SOE's lack of effective corporate governance) through privatization, and recapitalize and prepare the banks for privatization. This will be done with the assistance of $450 million from the World Bank, about $1 billion from the Government of Poland, and donor funds reprogrammed from the unused zloty stabilization fund, including approximately $200 million in U.S. Government (USG) funds. The main legal elements of the FREB program were enacted in March 1993, and the accompanying World Bank loan was approved in May. The plan is well crafted to ensure positive incentives to all parties and should make a major contribution to Poland's economic transition, together with the other major reform agreements with which it is teamed (most notably the Enterprise Pact agreement on workers rights in privatization).

Presuming that the FREB effort will succeed, the next set of priorities for financial sector reform in Poland will need to include, among other things, three related issues: improvement of NBP's bank regulatory and supervisory capacity; establishment of a sound policy environment for private banks, including ensuring adequate capitalization; and whether and on what terms to introduce deposit insurance.

This report examines progress in financial sector reform in Poland through May 1993, the current condition of the system, and future plans and prospects for resolving existing shortcomings. With this background, the report also comments upon the role of donors in this process, focusing particularly on USG assistance. Finally, suggestions are made on areas where further USG assistance may be appropriate.

SECTION TWO

MACROECONOMIC POLICY AND THE CENTRAL BANK

Since 1991, all new net credit from Poland's banking system has been channeled toward financing the government deficit. Banks, on balance, therefore have not been able to allocate new credit to the enterprise sector. Although the situation has not been favorable for private enterprise in the short run, it does have important favorable aspects for building the soundness of the banking system:

- The average quality (liquidity and safety) of banks' assets has improved through expanding their portfolio of low-risk Treasury bills; and

- Banks have been able to avoid overstretching their current credit analysis skills — as a rapid build-up of new loans to enterprise borrowers would have required.

Partly because of this "crowding out" of enterprises by GOP, the interest rates on (zloty) bank loans in Poland seem very high to the borrowers, even though interest rates paid to depositors on bank time deposits are still 5 to 10 points below the rate of inflation. Some of the upward pressures on interest rates on bank loans can (and perhaps should) be reduced by policy measures available to Polish authorities — lower inflation, lower NBP reserve requirements on zloty deposits, and larger MOF allowances for tax deductions by banks to reflect losses on bad loans.

FISCAL AND MONETARY POLICY AND THE BANKING SYSTEM

Fiscal Performance

After a strong upsurge in government revenue (mainly taxes on inventory valuation profits) in 1990, the Government of Poland has suffered a series of fiscal deficits equal to 6, 7, and a projected 5 percent of GDP during 1991-1993. These recorded fiscal deficits exclude the large share of scheduled but unpaid external GOP interest obligations during this period that have been approved for debt cancellation (by Paris Club creditors) or have been left unpaid to other external creditors (London Club).

The fiscal deficit has placed a heavy burden on the local banking system, which has had to provide essentially all of the domestic financing of the deficits. As a result, banks found it necessary to reduce the outstanding real value of bank credit to enterprises and households during 1992 and early 1993. However, on the positive side:

- The fiscal deficit is fairly transparent — with the banks, in particular, no longer conducting significant quasi-fiscal expenditures in the form of new credit to delinquent SOE borrowers; and

- The deficit is being financed at market rates of interest, primarily through Treasury bill auctions since 1992 — to provide appropriate market signals for the wider market for bank credit.

Monetary Policy Performance

Despite unfavorably high fiscal deficits, the central bank has been able to maintain sufficient control over domestic credit since mid-1991, in order to:

- Continue the downward trend of inflation (see Table 1); and

- Avoid any serious erosion of Poland's foreign exchange reserves or abrupt depreciation of the currency — notwithstanding the serious political fragmentation and uncertain direction of economic policies that persisted for months after the autumn 1991 parliamentary elections.

In light of the ongoing deceleration of inflation for the last three years, the public's real demand for zloty deposits has been steadily increasing — although its holdings remain much smaller, in relation to GDP, than in the period before Poland's hyperinflation of 1989. From the end of 1991 to the end of 1992, zloty bank deposits held by households and enterprises rose by 65 percent — an increase for the year of about 10 percent in relation to GDP. The National Bank of Poland has made a rapid transition toward indirect, market-based tools of monetary control in recent years, assisted by frequent technical advice from the Bank of England. Direct NBP credit ceilings previously placed on the major commercial banks were discontinued by the NBP in January 1993. An interbank money market has been evolving since 1990 and auctions of Treasury bills began in May 1991. The volume of Treasury bills, the number of Treasury bill transactions on the secondary market (although still small in 1992), and the size of the interbank money market all increased dramatically in 1992.

Since January 1993, NBP has been conducting open market operations in Treasury bills through a network of 15 primary (bank) dealers — toward the goal of using open market operations, rather than rediscount credits, as the main tool of NBP for controlling the monetary base. Several foreign banks with market experience have been or will be included in the network of primary dealers. To facilitate hedging of exchange risks by exporters and importers, in 1993 NBP also introduced a set of regulations for foreign exchange forward transactions.

INFLATION, INTEREST RATES, AND ALLOCATION OF BANK CREDIT

Inflation Performance

During 1992, the annual rate of consumer price inflation in Poland stabilized at 40-45 percent — sharply lower than in 1989-1990 (see Table 1) but still much higher than in the neighboring Czech Republic and Hungary. Industrial producer price inflation has decelerated to only about 30 percent per year during 1992-1993 — reflecting improved productivity of industry and, because of an appreciating real exchange rate for the zloty, international price competition that has tended to repress zloty prices of tradable goods.

TABLE 1

INFLATION AND INTEREST RATES (1989-1993)
(percent per annum)

Financial Indicator	1989	1990	1991	1992	April 1993
Consumer price increase (from year earlier)	640	249	70	44	38
Interest rates (zl) on sources of funds					
Refinance credits from NBP	140	55	40	38	35
Demand deposits quoted at SOCBs	21	15	9	6	
Three-month time deposits*		50	34	35	
Interest rates (zl) on loans and investments					
One-year low-risk loans, quoted at SOCBs			46	46	
Risky credits				58	
Overdue debt			90	80	

*Median of quoted rates. No data available on actual average rates

Sources: National Bank of Poland, monthly *Information Bulletin*

Interest Rates

Since the commercialization of the main state-owned commercial banks in 1991, there has been a relatively wide spread between deposit and lending rates at the commercial banks. For zloty-denominated deposits from and loans to enterprises, the size of that spread often may be as much as 20 or 30 percentage points — and much wider for delinquent debts. Four factors seem to contribute to the spread between bank deposit and lending rates of interest:

- High direct and indirect taxation of banks' activities as intermediaries — reflecting both adverse Ministry of Finance tax treatment of banks' income and the high NBP reserve requirements;

- Obligatory directed credits that the government determines the banks should supply (at rates below market rates of interest) to housing, central investment facilities, and agriculture;

- A realistic assessment of the credit risk on loans to enterprises in an economy where collateral laws are flawed, financial records of borrowers are limited, high business risk is endemic, and credit reference services and the ability of the banks' staffs to do good credit analysis of their customers are inadequate; and

- A possible lack of adequate competition among banks in various regional markets (the importance of which might be tested by a study of deposit rates and costs of bank credit in Warsaw versus other, more remote markets).

Allocation of Bank Credit

Owing to the expanded needs for financing the government deficit in 1991 and 1992, net bank credit to the nonfinancial sector declined in real terms in both years, and a further small decline is projected for 1993. Officials indicate that the contraction of real credit for the nonfinancial sector during 1992 was significantly greater for SOEs than for private enterprises (although statistics are not maintained by borrower ownership category to verify this). The number of SOEs delinquent on outstanding loans and considered uncreditworthy by their banks rose from 2,880 at the end of 1991 to about 4,500 in mid-1992, but then remained around that level during the second half of 1992.

Most bank loans to the nonfinancial sector — including almost all recent lending to industrial SOEs — is made at "arm's-length" (non-preferential) terms by the banks. However, at the end of 1992, about 30 percent of the banks' outstanding credit to the nonfinancial sector could be classified as directed credit, distributed among:

- Housing credits of zl 40.7 trillion;
- Central investment credits of zl 22.7 trillion; and
- Agricultural credits of zl 12.4 trillion.

Total directed credits are thus zl 75.8 trillion.

Interest rates on these credits are partly subsidized by the government, but the total remuneration received by the banks is low — for example, greater than the NBP refinancing rate but lower than the normal interest rate that banks charge on low-risk short-term business loans. The size of directed bank credit appears to be declining as a portion of total credit to the nonfinancial sector — from a 32.0 percent share at the end of 1991 to a 30.5 percent share at the end of 1992, and to 26.7 percent at the end of June 1993.

TABLE 2

BANK CREDIT TO NONFINANCIAL AND GOVERNMENT SECTORS

Domestic Bank Credit, by Sector	1989	1990	1991	1992	1993 (projected)
Stock of Outstanding Credit (in trillions of zloty, end of period):					
Credit to nonfinancial sector	33	118	194	249	311
Net credit to general government			106*	190	262
Balance of other items			-81	-155	
Change in Net Bank Credit (nominal percent increase):					
To nonfinancial sector		263	64	26	27
To general government				79	40
Real Change in Net Bank Credit (percent increase, consumer price index-deflated):				58	
To nonfinancial sector		6	-4	-13	-3
To general government				24	6

*Adjusted upward by zl 18.3 trillion to exclude the impact of an MOF refinancing operation with the Bank Handlowy in December 1992

Sources: National Bank of Poland, monthly *Information Bulletin*, NBP and World Bank estimates

Taxation of Financial Institutions and Instruments — Explicit and Implicit

Direct taxation of interest and other investment income in Poland is fairly moderate — which is broadly appropriate in recognition of the high inflation premium contained in zloty interest rates.[1] However, Polish tax law treats investment income among individuals, enterprises, and banks substantially differently:

[1] For high-inflation countries, the rationale for not taxing nominal interest income at the high rates applied to wage incomes is to avoid pressuring citizens (and enterprises) into socially wasteful efforts to minimize liquidity holdings and overmanage their cash balances.

- For individuals, interest income on bank deposits received in zlotys or foreign currency has been free from any income tax (as set out in the annual budgetary laws for 1992 and 1993) since the introduction of Poland's personal income tax at the beginning of 1992.[2]

- For enterprises, nominal interest income is grossed up with other income and taxed at the 40 percent rate for corporate income tax. (Thus, for example, taking representative figures from the end of 1992, an enterprise receiving a 30 percent interest rate on three-month time deposits would have received a negative post-tax nominal interest rate compared with respective consumer and producer price inflation rates of 44 and 32 percent for the year ending in December 1992.) As a result, enterprises have a substantial tax inducement to hold liquid assets in forms that yield capital gains (for example, inventories) or through nominees (namely individuals) whose interest is not subject to income tax.

- Conversely, enterprises are allowed to deduct interest paid on bank loans. That would seem to give enterprises an incentive to borrow zlotys — where the high rate of zloty inflation would give them large tax deductions. However, frequent comments from Polish enterprises indicating a desire to borrow foreign currency rather than zloty loans suggests that zloty borrowing in order to inflate tax deductions for interest payments is not a prevalent strategy.

- Banks' net income is nominally taxed at the 40 percent rate, but (in the opinion of the banks and NBP) only a small portion of the banks' appropriate accounting adjustments for write-offs and provisions against doubtful or uncollectible loans are recognized by MOF as valid for tax purposes. Thus, the effective rate of taxation of banks' true profits may be much higher than 40 percent — imposing a cost that banks must pass along to borrowers through increased loan rates of interest.

Tax considerations currently make foreign exchange deposits extremely attractive to individuals in Poland: the interest is untaxed and the bank bears no NBP reserve requirement because there is currently no legal basis for imposing reserve requirements against foreign exchange-denominated deposits. In fact, $6.3 billion — or 45 percent of all deposits held by individuals in Polish banks — are in foreign currency accounts.

Reserve requirements against zloty deposits impose a substantial implicit tax on Polish banks' deposit-based lending or investment activities. Reserves required to be held at the NBP bear no interest, and the required ratios are extremely high in comparison with reserve requirements against deposits in other countries; since August 1992, the NBP-required reserve ratios in Poland have been 23 percent on demand deposits (down from 30 percent in 1991) and 10 percent on time deposits. To a bank with the option to invest in Treasury bills at about 30 percent, these NBP reserve requirements imply a 3 percent (time deposit) to 7 percent (demand deposit) wedge between deposit and loan rates of interest.

Actions to remedy three of the current anomalies in Poland's tax treatments of interest income seem to be mainly within the National Bank of Poland's sphere of influence:

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[2] However, according to a new regulation in mid-1993, interest income on zloty Treasury Bills by individuals is taxable (at a 20 to 40 percent rate) as income. Income on stock dividends is also taxable — in that case, at a 20 percent rate.

- Further reductions in the level of reserve requirements — which the NBP appears to be planning, now that it has more flexibility to use open market operations and other improved monetary control instruments;

- Specific NBP guidelines for provisioning against bad loans — required to be fully in force for all banks by the end of 1993. Some version of NBP guidelines on provisioning could provide, in time, a basis for standardized tax allowances against doubtful loans and, thus, could lead to somewhat lighter taxation of banks' net interest income;[3] and

- A new National Bank of Poland law, recently in preparation by a parliamentary commission, that would seem to allow the future introduction of reserve requirements against foreign exchange deposits. By imposing a non-zero reserve requirement on foreign currency deposits and reducing the reserve requirement on zloty deposits, NBP could induce banks to price deposits to make it more attractive for individuals to shift more of their deposits into zloty accounts that would be more easily available to finance domestic credit needs of the Polish economy.

For its part, the remedies to financial distortions that the Ministry of Finance tax authorities can provide would include:

- Reducing the differences in tax treatment of interest income between enterprises and individuals; and

- Allowing banks to deduct from taxable income loan losses that are reasonable, given historical experience, or that are recognized by the auditors and NBP bank regulators (for example, partial write-downs on restructured loans through conciliation procedures that are expected to be widely used during 1994) — even if they are not yet certified by a court liquidator.

FOREIGN EXCHANGE POLICIES AND EXCHANGE CONTROLS

Controls over Convertibility

Whatever the possible merits are for management of the zloty exchange rate, controls on convertibility of the zloty seem to be hampering the development of efficient foreign trade financing for Polish enterprises (see Annex A) and an efficient money market. In addition, the controls impose red tape and complications on the normal management of business risks by banks and resident enterprises that act as traders or cross-border investors. For example, under current foreign exchange controls, the possible hedging by traders of their import financing requirements is limited to situations where an underlying invoice already exists, while banks simply are not permitted to use forward exchange markets as a means of balancing the currency exposure in their current asset and liability positions between zlotys and foreign exchange.

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[3] However, officials interviewed at Polish commercial banks and at NBP expressed skepticism that Ministry of Finance tax authorities could be persuaded to accept from banks any evidence of loan losses other than a final court decree of insolvency and uncollectibility.

Currently, Poland's foreign exchange controls require enterprises to convert foreign exchange earnings from exports into zlotys immediately at a licensed foreign exchange bank or NBP. Such controls are difficult to enforce in most countries, and current controls in Poland have presumably led to substantial accumulation of offshore foreign currency accounts by enterprises, use of personal foreign currency accounts at Polish banks (as custodians for enterprise funds), use of currency rather than bank transfers to settle export (and hence also import) transactions, and other evasions of the exchange regulations.

Polish authorities have not yet indicated when they plan to complete the transition to full external convertibility of the zloty — which would allow Polish enterprises to hold and deal in foreign currency instruments freely. One could argue that the remaining restrictions on foreign exchange operations may no longer be having a significant effect in restraining capital outflows by residents, as was presumably the original intent of the limits on free external convertibility. In particular, the differentials between exchange rates in the official and the free exchange house markets have been very narrow — less than 2 percent — during the past 18 months.

For 1993, GOP policy plans include:

- Liberalizing access to foreign trade financing; and
- Implementing detailed regulations to allow formation of a forward exchange market to give traders access to forward cover.

To prepare for freer enterprise access to foreign exchange instruments and markets, it would be logical for NBP and MOF to deal in advance with the asymmetries in tax treatment of individuals and enterprises noted above. Otherwise, there may be a tendency of enterprises to shift substantially from their current, heavily taxed zloty deposits and loans into lightly taxed dollar deposits and loans.

Exchange Rate Management

Since October 1991, the National Bank of Poland has followed a crawling peg policy for determining the exchange value of the zloty in the interbank market. Except for a one-time devaluation of 12 percent in February 1992, the crawling peg has resulted in approximately a 20 percent annual rate of depreciation of the zloty against Poland's main trading partners.

Because of the much wider gap (over 35 percent per annum in 1992) between inflation in Poland and in its main trading partners, the current exchange rate policy is leading to real appreciation of the zloty and possible loss of competitiveness for Polish exporters. However, World Bank and IMF analysts believe that there is evidence from 1991-1992 that Polish firms are rapidly improving their factor productivity — such that some continuing real appreciation of the zloty during 1993 may be consistent with stable competitiveness of Polish companies in international trade.

REGULATION AND SUPERVISION OF BANKS

The National Bank of Poland has succeeded in slowing monetary growth and inflation further since 1991, but it (like other central banks in Eastern Europe) has had less rapid success in building a strong and reliable system of bank regulation and supervision. Apart from internal challenges of developing skills and procedures for bank supervision, NBP also faces the following:

- NBP does not in practice have full supervisory authority over the main portion of the financial system, the state banks (which hold 84 percent of banking system assets). The Ministry of Finance, exercising the ownership function for the state, retains major decision-making power.

- There is strong political opposition against closure or restriction of licensed operations by many of the cooperative banks that are in an unsound condition (cooperative banks account for 6 percent of total banking system assets).

- Among the many private banks licensed since 1989, where NBP does have clear authority, several problem institutions have absorbed much of the staff time available for supervision.

- The legal framework for banking is still under development, as Poland still relies on the initial 1989 Banking Act, with subsequent regulations promulgated through decrees and amendments. Thus, supervisors must attempt to apply a rapidly evolving set of standards.

In any setting, the training of effective bank supervisors takes several years, even in circumstances where the operational tasks of supervisors have already been well defined. Nevertheless, NBP has been making progress on a wide variety of fronts.

Supervisory Functions

Bank supervisory functions are domiciled within NBP in the General Inspectorate of Banking Supervision and are organized into four divisions: the Analysis Division, the Supervisory Policy Division, the Legal Division, and Problem Banks. In addition to their named functions, three divisions are each responsible for a different aspect of supervisory functions, as follows:

- Analysis Division — banking supervision of regional inspection teams;

- Supervisory Policy Division — banking supervision by on-site teams, accounting policy, and training;

- Legal Division — banking supervision by on-sight teams, and oversight of supervision for cooperative banks.

Chart of Accounts

One of NBP's recent achievements, with the support of the Banque de France, was the preparation and implementation of a chart of accounts for banks that conforms to European standards. The charts include not only the set of accounts, but also reporting requirements on loan quality, solvency, credit exposure, credit concentrations, and large depositors. Emerging areas of bank services, such as foreign exchange exposures, leasing, and government securities portfolios, require further investigation and incorporation into the set of accounts.

Classification of Non-Performing Loans

In November 1992, NBP promulgated provisioning rules for doubtful loans based on the standard classifications of Substandard, Doubtful, and Loss, with 20, 50, and 100 percent provisioning requirements, respectively. The classifications are based on the number of days a bank obligation is past due and do not, at present, appear to be based upon credit analysis or determination of reasonable expectations for reimbursement. NBP will need to deepen the classification definitions from the current automatic categorization based on days past due to incorporate normal credit standards, possible work-out scenarios, and repayment plans. At that point, these standards will have a more educative benefit for the banking system.

On-Site Versus Off-Site Supervision

A debate at the Inspectorate continues regarding on-site versus off-site supervision, with the Inspectorate, at present, undecided on which method of supervision it should adopt for its primary supervisory functions. The on-site supervisory methods favored by the United States are not nearly as prevalent in Europe. France, England, and Germany rely largely on off-site reporting and outside auditors to provide verifiable and auditable information to respective central banks for review. NBP requires assistance from several sources, in the form of a policy dialogue to help decide underlying principles that will prevail in Polish bank supervision, before a clear course of action for the Inspectorate can be determined. The general question underlying this on-site/off-site decision is whether NBP intends to rely primarily on its own direct enforcement or instead on the full disclosure of information so that depositors and other creditors can make their own informed decisions. In the meantime, work is progressing, funded by USG, on an on-site inspection manual. NBP looks to this manual and accompanying training as a centerpiece of its capacity development. This work is discussed in Section Four.

Supervision of Cooperative Banks

There are approximately 1,600 cooperative banks in Poland, accounting for 6 percent of total bank assets and providing the agricultural sector with deposit and farm loans services. They are small credit-union banks, with average total assets of zl 2 billion per location, serviced by an average staff of seven. Many are thought to be insolvent, threatening an insignificant percentage of the banking system but carrying political and budgetary consequences because depositors enjoy a government guarantee and farmers depend on the institutions for seasonal crop advances. The cooperative bank system is being regionalized — that is, brought under the control of four regional financial institutions, including the Bank for Food Economy. These four institutions will be responsible for aggregating payment and remittance services and will be the recipients of off-site supervisory reporting requirements.

However, this system is yet to be established. For the moment, the Inspectorate is responsible for the monitoring of the cooperative banks — including on-site supervision, establishment of reporting procedures, solvency testing, and promulgation of reporting requirements. These duties place an enormous management burden on the Inspectorate, given the number of institutions. Large numbers of supervisory visits are taking place. NBP must find a way to reduce the burden on itself, by streamlining supervision of these banks or divesting responsibility to other institutions. Until it does, the cooperative banks will divert scarce management resources, hampering the development of supervisory capacity.

Deposit Insurance

The advisability of instituting deposit insurance and the specific characteristics of the possible system (for example, full or partial coverage, uniform or differentiated premium rates) remains a topic of considerable debate. Two issues in particular need to be considered:

- Will the playing field for public and private institutions be more or less level with or without deposit insurance?
- Is prudential regulation and supervision fully adequate to avoid moral hazard — that is, excessively risky behavior induced by deposit insurance coverage?

The introduction of deposit insurance has been under study for some time, but a specific plan has not yet emerged.

EQUITIES MARKETS AND MASS PRIVATIZATION

In Poland, as in other Eastern European countries under study, there is great interest in developing equities markets, particularly given the dependence of current privatization plans on effective means for raising and trading equity. Currently, the stock market has little quantitative significance in the economy: tradable equities are held by a small fraction of the population, and the total market value of the 16 firms listed on the Warsaw Stock Exchange in early May 1993 appears to be about zl 7 trillion, or only 0.5 percent of GDP. Since May 1992, the Ministry of Finance has also issued some zl 5 trillion of one- and three-year Treasury bonds at floating rates of interest that are now traded (in minimum blocks of about $6,000 equivalent) on the Stock Exchange.

The Polish Mass Privatization Program (MPP), enacted by Parliament in April 1993, will substantially broaden ownership of equities and the need for equity trading among the general public. Under this program, up to 600 medium and large-sized SOEs (financially viable companies with annual sales of not less than $5 million per year) will be privatized into widely held companies. As a group, the 600 SOEs to be included in the MPP have a book value of about zl 150 trillion ($8 billion). The MPP will involve distribution of most of the equity of each company to National Investment Funds (NIFs, 60 percent of the total) and to employees of the enterprises (15 percent).

Approximately 20 NIFs — each of which will constitute a closed-end mutual fund and will have its own Western-Polish investment management company — will be established and their shares listed on the Warsaw Stock Exchange by 1994. About five of the NIFs will be founded for the benefit of several million government employees and pensioners who will receive free share certificates (to compensate for past inflation). The other NIFs will be founded for the benefit of all adult citizens who choose to purchase Universal Share Certificates for an amount up to 10 percent of the monthly wage. With the NIFs listed on the stock exchange, both of these groups will have a fairly broad market on which to dispose of or trade such shares.

However, most of the underlying 600 companies will not be eligible for listing on WSE. In particular, the requirements for companies to be listed on the Warsaw Stock Exchange are sufficiently stringent to preclude WSE listings for most of the newly privatized companies that will emerge during 1993-1994 under the MPP or through debt-equity swaps to be initiated through the enterprise and bank restructuring program. Accordingly, the tens of thousands of company employees of MPP enterprises who receive direct bearer shares in their companies during the fall of 1993 will need some informal or organized (for example, over-the-counter) market for trading of their shares.

Rules and facilities for an over-the-counter market do not yet exist in Poland, and in view of the unprofitability of Polish brokerage firms at present, it is doubtful whether an efficient over-the-counter market can quickly emerge without some type of official direction or sponsorship. In developing such a market, it is important to ensure that officially sanctioned trading is accompanied by adequate disclosure requirements to protect investors.

Poland's legal and regulatory infrastructure for the stock market seems to be rather highly developed (for example, defining clearly the property rights of shareholders and requiring a three-year financial history and extensive disclosure of information). The capacity of the Securities Commission for investigation and enforcement of sanctions against misconduct is untested.

SECTION THREE

THE DEVELOPMENT OF BANKS

THE RECENT EVOLUTION AND THE CURRENT STATUS OF BANKS

Poland began its transformation from a monobank system in 1989 with the creation of nine state-owned commercial banks that took over the commercial operations of the monobank, the National Bank of Poland. NBP began to function as a central bank under the Law on the Central Bank, while a separate Banking Act governed the state-owned commercial banks and also laid out the rules for entry of new private banks. In addition, four large specialized banks remain from the pre-reform period: Bank Handlowy (foreign trade); PKO SA (foreign currency); the Bank for Food Economy (agriculture and cooperative banks); and PKO-BP (savings and home mortgages).

The nine commercial banks are each centered on a major city or region, with branches throughout Poland. Thus, there is a regional focus but some geographic competition. These banks began life with a large (perhaps too large) amount of physical and human resources: each bank has 40 to 70 branches and 3,000 to 5,000 employees. These nine banks, together with the four state-owned specialized banks, continue to dominate the financial system, with 84 percent of total banking sector assets in early 1993.

Early on, the Government of Poland expressed its intent to prepare these banks for eventual privatization, and it set up a governance structure to foster the needed transformation of what were then still essentially agents of the central plan into modern, market-driven banks. The banks were commercialized — that is, they were organized as joint stock companies, fully owned by the Ministry of Finance. The Ministry, in turn, created a supervisory board for each bank as the main governing body. These boards represent the Ministry's interests as shareholder but allow for the Ministry to be removed from decision making on most matters. According to the World Bank (which encouraged MOF toward this model of bank governance), the system has worked well: "The Ministry of Finance has exercised its ownership function in a very effective way vis-a-vis the SOCBs, achieving a delicate balance between increased SOCB autonomy and accountability, and active shareholder's guidance on key strategic issues."[4] The twinning arrangements described in Section Four were an attempt to speed transformation of these institutions through massive infusions of foreign technical expertise.

Private banks entered the market rapidly during 1990 and 1992, benefiting from rather liberal rules governing establishment of banks, including a low minimum capital requirement that was further eroded by the near-hyperinflation of 1990. The nearly 80 private banks that now exist are a diverse group. A number of these banks were begun with participation by state-owned (and in some cases private) enterprises that envisioned them as sources of credit for the main shareholders. Others involve foreign ownership, as joint ventures, subsidiaries, or branches of foreign banks. However, most of these banks are owned by private entrepreneurs and investors, many of whom have little prior experience in banking. Several of these banks were quietly restructured by NBP after becoming insolvent. Taken together, the private banks now hold only 10 percent of total banking sector assets, a share that has been increasing steadily, though slowly, from a level of zero in 1989.

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[4] World Bank, p. 12.

Some of the private banks are privatized former state-owned banks. The first bank privatization was completed in the summer of 1992, with the sale of a 47.5 percent stake in Bank Roswoju Eksportu, the export development bank, to the public. This bank was listed on the Warsaw Stock Exchange in October 1992. A second bank, the Bank of Inicjatyw Gospodarczych (BIG) or Bank for Economic Initiatives, started by a group of SOEs, also went public in 1992. In April 1993, shares were floated for Wielkopolski Bank Kredytowy of Poznan. Katowice-based Bank Slaski, the largest commercial bank, is slated to be privatized in late 1993. There appears to be a healthy appetite for bank stocks among the investor public, as the Wielkopolski Bank offering was many times oversubscribed. In addition, the more than 1,600 cooperative banks that serve rural areas and are grouped under the umbrella of the Bank for Food Economy hold 6 percent of total banking sector assets.

THE PLAN FOR FINANCIAL RESTRUCTURING OF ENTERPRISES AND BANKS

The centerpiece of financial sector reform in Poland in 1993 is the plan to involve the banks in restructuring state-owned enterprises with delinquent debts and, in the process, improve the portfolios of the nine commercial banks, recapitalize them, and prepare them for privatization. This plan is an attempt to clarify the recoverable part of banks' bad loans to SOEs that emerged among the state-owned banks in 1990 and 1991 and, at the same time, improve the process for liquidating, restructuring, or privatizing some of the weaker of the large SOEs.

The Emergence of the Bad Debt Problem

When the nine commercial banks were broken off from NBP, they were assigned portfolios of existing customer relationships to SOEs, a role that traditionally included fulfilling all of a company's transaction and credit needs. The portfolios transferred at the time of the split had not been developed on the basis of the creditworthiness of the borrowers; the concept of creditworthiness itself had been meaningless in a setting where loans were based on the requirements of the central plan. After the split, the nine banks continued to lend to the SOEs, having little experience in how to evaluate risk or seek other customers. At the time of the split, most of the SOEs seemed to be functioning profitably. The shocks of the 1990 and 1991 reforms (price reform, reductions in state subsidies, the opening of the economy to Western trade, and the collapse of the CMEA market) initially created windfall inventory profits for most SOEs. However, the downturn in real sales in 1991 changed the environment drastically, causing many SOEs to increase debts and to become unable to continue servicing debt. The banks tended to react to these developments by continuing to lend, rolling over credits, and in many cases capitalizing unpaid interest. Thus, the bad debts in current portfolios are largely the result of loans made during 1990 and 1991. Debts from prior years are a smaller part of the problem, as their value was eroded by the period of high inflation.

Although the bad loan problem developed after the main banking reform in 1989, it is, in effect, an artifact of the attempt to extricate the state from its identity with the economy. Knowledgeable GOP officials contend that most of the loans were made after the banks had been put on notice that they were to operate as market-oriented commercial organizations, but it is also clear that the banks had not yet been able to reorient themselves. Centrally planned directives had ended, but customer relationships and traditional patterns of operating could not be changed quickly, leaving a strategic vacuum at banks just at the time when SOE performance worsened.

In addition, there were conflicting incentives within the government as owner of both SOEs and the banks. As state subsidies ended, SOEs (presumably with the backing of their GOP owners) turned to the state banks as alternate sources of finance, requests that were difficult for those banks, despite their nominal commercialization, to deny. Both the short-term financial interests of the state as SOE owners and some of the short-term political needs of GOP (to avoid mass layoffs) militated against fully commercial operations by the banks, even as the long-run interest of the state and government clearly required creation of a market-based financial system. Moreover, in its role as owner of the banks and guarantor of their deposits, the state had and has an interest in bank solvency. This set of conflicting incentives demonstrates that a halfway house of commercialized but state-owned banks is not a satisfactory foundation for financial system development, behavioral directives notwithstanding.[5]

Despite the political constraints, the Ministry of Finance directed SOCBs to impose substantial credit discipline over delinquent SOE borrowers in 1991-1992. Independent supervisory boards installed at the SOCBs in 1991 facilitate independent credit judgment and may hasten commercialization of the banks' policies. SOCBs were also warned and discouraged, effective January 1992, against extending credits to uncreditworthy state enterprises. In that connection, a blacklist of approximately 2,000 delinquent SOE borrowers was established by the SOCBs (to substitute for the type of credit information system on borrowers not yet developed in Poland).

The crucial question at this point is whether government can intervene in a way that convincingly provides a foundation for future independent operation of the bank and enterprise sectors on market principles, without creating expectations of further bail-outs. Such a foundation is a necessary prelude to privatization of the banks. The current plan appears to have a good chance of succeeding in this task, as discussed below.

The Severity of the Problem

While it is difficult to be precise about the extent of bad SOE loans among the Polish banks, some indications of the magnitude of the problem are possible, as shown in Table 3. At the end of 1991, non-performing loans reported by the nine commercial banks totalled zl 19.5 trillion. If this total is divided by total loans outstanding six months later (July 1, 1992) it is estimated that 12 percent of all loans were non-performing. This figure is certain to underestimate the amount of such loans — first, because the time periods are not directly comparable, and, second, because banks continue to have a strong incentive to under-report their problem loans, as discussed elsewhere in this report. The World Bank estimates the total debt of SOEs to all banks as equivalent to US$ 7.5 billion (September 1992), and further reports mid-1991 audit results that showed bad debts at an average of 40 percent of total loans (which is equivalent to US$ 3 billion). The picture varies widely from bank to bank, however. Several banks, such as Wielkopolski Bank Kredytowy and Bank Zachodni, have reduced their exposure by shifting out of loans into Treasury securities and other low-risk assets, so that loans are only a small portion of total assets. Although large, the bad loan problem appears to be somewhat smaller in relation to total bank assets in Poland than in some of Poland's neighbors.

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[5] Banks have begun to implement tougher attitudes toward SOEs more recently, particularly as FREB began to take shape. When it became clear that eligibility for recapitalization would be assessed on the basis of audits that had already taken place (so that future mistakes would not be covered in the bail-out), the incentive structure shifted decisively in favor of commercial behavior by banks.

TABLE 3

SELECTED INDICATORS FOR THE NINE STATE-OWNED COMMERCIAL BANKS
(in billions of zlotys)

Bank	Total Loans	Non-Perf. Loans*	Total Assets	Capital	Loans/ Assets	Capital/ Assets	Non-Performing Loans as Percentage of:		
							Loans	Assets	Capital
Pomorski Bank Kredytowy	7,927	1,349	13,774	1,498	57.6	10.9	17.0	9.8	90.1
Bank Depozytowo-Kredytowy	n/a	1,102	46,120	1,258	n/a	2.7	n/a	2.4	87.6
Bank Zachodni	5,737	979	107,980	1,328	5.3	1.2	17.1	0.9	73.7
Powszechny Bank Gospodarczy	13,468	681	22,099	917	60.9	4.1	5.1	3.1	74.3
Bank Przemyslowo - Handlowy	13,237	741	31,091	1,712	42.6	5.5	5.6	2.4	43.3
Wielkopolski Bank Kredytowy	7,352	1,100	108,021	1,418	6.8	1.3	15.0	1.0	77.6
Bank Slaski	10,741	987	26,815	2,587	40.1	9.6	9.2	3.7	38.2
Powszechny Bank Kredytowy	12,089	969	25,971	1,683	46.5	6.5	8.0	3.7	57.6
Bank Gdanski	6,550	1,578	17,294	1,426	37.9	8.2	24.1	9.1	110.7
AGGREGATE	77,101	9,486	399,165	13,827	19.3	3.5	12.3	2.4	68.6

*Non-performing loans as of December 31, 1991. All other figures as of July 1, 1992.

Source: *Central European*, February 1993

Nevertheless, the bad loan problem threatens to erode the capital of the nine banks, many of which already have capital-to-asset ratios below 5 percent. Even the highly conservative estimate given above shows bad loans in the SOCBs as ranging to from 38 percent to 111 percent of capital.

The Bad Loan Problem as an Aspect of SOE Policy

From the perspective of the government as a whole, the bad loan problem of the banks is but one facet of the broader problem of how to force operational changes or liquidations of unprofitable SOEs. (These are SOEs that will not be touched by mass privatization.) Thus, the FREB plan is considered one of the important elements of Poland's overall privatization policy.

As owner, tax collector, and (through banks) creditor, the state has an interest in maximizing the value of the enterprises in financial difficulty. It must find a way to represent those interests in the face of differing short-run interests on the part of management and workers. Potential candidates for leading the process of restructuring and liquidation of unprofitable SOEs might include government ministries; a specially created organization, such as Germany's Treuhandanstalt; the courts, through bankruptcy proceedings; and banks. The selection from these choices is driven by considerations of incentives, organizational competence, and technical expertise. In Poland, the banks easily emerged as the most viable candidate: they have already made significant progress in building capacity, due in part to the receipt of extensive technical assistance; they have the beginnings of the development of the relevant specialized skills and a long-term interest in obtaining such skills; and their interests in maximizing the value of the debtor firms are reasonably congruent with those of the government. The courts, by contrast, have barely begun to develop a capacity to handle bankruptcy cases.

After selecting the banks as the agents of restructuring, the challenge facing the government is to create a system that relies on the banks and at the same time helps them maintain or improve solvency and prepare to be privatized themselves. A final consideration is the politically sensitive issue of the fate of the workers, many of whom will be facing unemployment and whose outlook on the appropriate future of the enterprises is likely to differ substantially from that of the banks.

Features of the Plan

According to the plan as agreed between the Government of Poland and the World Bank, and as passed by the Sejm in the Law on Financial Restructuring of Enterprises and Banks, selected state-owned commercial banks will be eligible for recapitalization provided they take several steps to restructure their loan portfolios by December 1993. These steps include creating a loan work-out department (this was required in 1992 and has already been done), identifying non-performing loans, and carrying out a plan acceptable to the Ministry of Finance for restructuring the portfolio of the loans.

The main tool that banks will have for portfolio restructuring is a newly expanded out-of-court settlement process known as Conciliation Proceedings, in which debtors submit plans for banks to restructure the debt, ownership, and operations of the debtor company. The process gives greater authority to the banks than they would have under a court-run bankruptcy, but also requires greater involvement of banks in corporate governance. In the process, banks will play the roles of advisor, work-out manager, enterprise restructurer, credit and equity provider, and privatization advocate. Conciliation includes creation of detailed plans covering specific timetables, staffing patterns, marketing plans, and capital requirements. In many cases, it will lead to negotiated debt write-downs and liquidations of some SOE assets. As an alternative, debt-to-equity conversion is available at the initiative of creditors holding at least 30 percent of an SOE's debt, and this element of the plan promises to involve banks in enterprise ownership and governance for years to come. The conciliation process is available for any bank to use, but only the state commercial banks will be eligible for recapitalization.

Each bank will receive recapitalization only after it develops an acceptable plan for the whole problem portfolio and takes specified actions to implement it, including placing each problem debtor into liquidation or conciliation by March 1994. Recapitalization will take place through the issuance of long-term government bonds by the Ministry of Finance. Interest and principal payments on those bonds will come from the Polish Bank Recapitalization Fund (containing donor money reprogrammed from the unused currency stabilization fund of 1989, GOP budget funds, and the new World Bank loan). The total available to banks through this fund is US$ 1.5 billion. The World Bank's $450 million Enterprise and Financial Sector Adjustment Loan will be disbursed in three tranches, through mid-1994.

The success of the plan depends in large part on the ability of the banks to develop strong loan work-out departments. Accordingly, donor-funded technical assistance is being planned to support those units. The EBRD is also planning to use this process as a vehicle for making investments in viable SOEs. Through a program known as Stabilization, Restructuring, and Privatization, EBRD is in the early stages of planning to establish joint venture holding companies with each bank, into which banks will place the debts of companies that could be successfully restructured. The holding companies would have EBRD and other debt, equity, and technical assistance resources to draw on in transforming enterprises.

Finally, to deal with the political ramifications of enterprise restructuring, the government has negotiated the Enterprise Pact with representatives of labor and enterprises. Among other things, the pact requires labor to give up some claims on involvement in the privatization process in return for a specified share of ownership and representation on the supervisory board of the privatized enterprise. The government has also established a separate process with transparent budget subsidies to deal with the several most politically or socially difficult enterprises (for example, large enterprises located in places that offer few alternative sources of employment).

Conclusions Regarding the Plan

At the start of its implementation, the financial restructuring plan appears to be sound and to have well-crafted incentives. The government has made it clear that banks will not have a second chance for assistance with bad loans and, thus, that they already have the warning they need to revise their lending policies. The amount of funding available for recapitalization appears to be sufficient, when weighed against current estimates of the prospective losses that banks will incur; however, some observers question whether these estimates are accurate. The recapitalization itself is being done in a way that does not distort incentives, either for banks to make bad loans now (eligibility will be calculated from portfolio status at the end of 1991) or for banks to be lax on recovery (as they keep any recoveries they make). Finally, the process also appears to be generally supportive of the restructuring of enterprises that the banks believe can be made profitable -- rather than their quick liquidation.

To the extent that the plan paves the way for banks to be privatized, potential benefits are apparent among already privatizing banks. The prospect of bank privatization appears to energize institutions. Banks facing privatization and banks that have recently completed privatization appear to be the most likely to develop successful work-out solutions for problem loans; they have been aggressive about expanding services and networks and have developed a client-oriented, relationship-based strategy on the provision of credit to enterprises. The initial privatization candidates have curtailed their lending to the SOE sector.

THE STATUS OF OTHER BANKS

Restructuring is also needed among private banks in Poland. Although they number more than 80, as noted earlier, these banks hold only about 10 percent of total banking assets. Many of the banks are undercapitalized; some, perhaps many, are said to be technically insolvent. The current condition of private banks results in part from policy decisions made at the time of the Banking Act of 1989. The policy established at that time combined easy entry for private banks with competitive disadvantages compared with state banks. Minimum capital requirements were set quite low and further eroded by inflation, banks were not prohibited from lending to owners, and supervision capacity was not adequate to monitor risk taking. On the other hand, until recently private banks had disadvantages in comparison with state banks in loan collection (private banks had to enforce collateral through the courts, while state banks could by-pass the courts), a lack of deposit insurance, and an absence of the kind of massive technical assistance that public sector banks have received. One positive aspect of this policy mix is that the absence of deposit insurance discouraged depositors from placing funds in banks that were not demonstrably sound. On the other hand, the policy has resulted in slower growth of private banks and the proliferation of banks that have very low capital. In addition, the emergence of portfolio quality problems among some private banks poses a risk of runs and sharp tiering in cost of deposit funds at other (uninsured) private banks. In short, private banks were allowed to enter the market, but were not given the foundation needed to become strong.

It is clear that consolidation is needed among the private banks, in some cases simply because of low capitalization and in other cases because of insolvency. This process will be driven by the increase in minimum capitalization to about $6 million, coupled with Basle standard capital adequacy requirements, both scheduled to take effect at the end of 1993. Anticipating the changes, mergers are already beginning to take place.

An example of this process, and of ways consolidation may contribute to financial reform in the future, can be seen in the merger of the Lodzki Bank Rozwoju (LBR) into Bank Inicjatyw Gospodarczych (BIG). The merger is the first in the banking sector since the 1989 reforms. BIG will pay just under $2 million for a new issue of LBR shares, giving it 96 percent of the stock and 99 percent of voting rights, saving LBR from bankruptcy. LBR was in receivership, controlled by NBP, which attempted several recovery programs for the bank. BIG plans to raise an additional $15 million of capital for LBR in the first six months of restructuring. The merger, subject to the approval of the NBP, requires a new business plan, with emphasis on the work-out capacity of BIG and the application of BIG's loan portfolio management skills to LBR's troubled assets. Additionally, BIG must prove that it is capable of maintaining and upgrading the range of services offered by LBR.

NBP will find its way in this and other bank consolidations difficult to navigate. NBP must oversee a consolidation process that leaves the private banking sector stronger, and yet there is great reluctance to close any banks without reimbursement of depositors. The prevailing attitude among Polish bankers and policy makers appears to be overriding fear of triggering a banking sector panic and thus long-term destruction of the confidence of the public in the banking system. The alternative is for NBP to bail out several failed banks quietly (as it has done in the past). This would preserve stability in the short run, but at the cost of sending the message that the government implicitly backs all parts of the banking system, creating a serious moral hazard problem.

Although the private banks as a group face serious problems, it might also be noted that some of the private banks are showing signs of influencing the evolution of the financial system by innovating and improving services, thus driving the other banks to improve in order to remain competitive. The ability of private banks to perform this competitive function is one of the main reasons for the government to work to place them on a sounder policy footing.

THE DEVELOPMENT OF SERVICES TO BUSINESS

Banks in Poland have made significant strides in providing services to private businesses, but they still face impediments. Much of the improvement has been on the transactions support side, where competition has been great. The following changes all contribute to improvements in transaction services: improvements in the domestic payments system, including the introduction of the interbank clearinghouse in early 1993; investments by each bank in computer and telecommunications technology; restructuring of relationships between branches; development of a service orientation among bank staff; and development of links to foreign banks (for example, correspondent relationships and joining SWIFT). Although there are still problems and an uneven quality of services across banks, progress in 1992-1993 has been dramatic.

The picture is less sanguine on the lending side. Data are not available on loans to private enterprise (figures are provided only for the combination of SOEs and private enterprise). However, indications are that banks are not rapidly expanding the volume of their lending to private business. The most important reasons for this are these:

- The crowding out of private credit by government borrowing;
- The difficulty among many banks in extricating themselves from poorly performing SOE loans that tie up their assets; and
- High real interest rates that discourage businesses from borrowing.

That lack of effective loan demand is an issue is evident from the fact that banks report excess liquidity and say that the recent decline in yields on Treasury bills has not led them to switch into lending. Other reasons for low levels of lending include the still inadequate legal framework for secured transactions, the lack of an effective credit rating service, high actual business risk, and a shortage of staff trained in credit analysis. On a more positive note, there are indications that banks are developing a wider array of credit products for private businesses, such as overdrafts, slightly longer term lending, and leasing.

An analysis of credit and documentation for international trade was conducted by A.I.D. in October 1992. An updated presentation of that analysis is attached to this report as Annex A.

THE DEVELOPMENT OF RETAIL BANKING

In contrast with some other CEE countries, retail banking in Poland appears to be set for development without further major changes in banking structures. The beginnings of competition in retail banking were created by the entry of the nine state-owned commercial banks, ending the monopoly positions of the two specialized state banks (PKO BP, the domestic currency savings bank, and PKO SA, the retail foreign currency bank). The nine commercial banks have been able to attract household deposits at favorable interest rates partly by virtue of the full state guarantee on deposits they can offer. Since the creation of these banks, the share of household deposits in zlotys in PKO BP has fallen from nearly 100 percent to 40 percent. Without the benefit of the guarantee, private banks claim to find it expensive to raise deposits from the public, and only a handful are pursuing such business.

Banks are introducing new services for individuals at a rapid pace, although most of the innovative services remain the exception rather than widely applied practice. Consumer services being introduced include credit and debit cards, ATMs, checking, a wider range of deposit instruments, hire purchase lending (on automobiles and other durables), personal lines of credit, and private banking services for wealthy clients. While consumer lending is beginning, it is still insignificant by volume, accounting for less than 2 percent of total banking sector assets. The quality of retail transactions services has already improved as a result of improvements in payments systems and in bank telecommunications and the recent introduction of the interbank clearinghouse, and it should improve further in the coming years.

While commercial banks have been moving into retail business, the traditional retail banks have begun to transform themselves into universal banks (one may question whether this is generally the best strategy for savings banks in CEE countries, whose strengths are in such different lines of business). PKO BP has begun to develop international and corporate lines of business and, with the exception of its continued emphasis on mortgage lending, has begun to invest its funds in much the same array of assets as other banks.[6] While there is still significant market segmentation resulting from the legacy of the old system, it is already clear that competitive forces are erasing the boundaries and that, over the next few years, service range and quality will improve and financial intermediation will increase.

Two tasks remain to complete the groundwork for retail banking:

- Reaching a decision about whether and in what form to introduce deposit insurance; and

- Privatizing PKO BP and PKO SA.

Banks and the press assert that Polish depositors are extremely sensitive to the existence of the state guarantee. The absence of the state guarantee is seen as one of the greatest hindrances to the growth of private banks. If deposit insurance is introduced, it should provide the same level of guarantee to all participants. If, as is anticipated, deposit insurance does not cover 100 percent of all deposits, state banks would have to give up their current full guarantee, and they are highly reluctant to do so. It remains to be seen how this issue will be resolved. There are no plans to privatize PKO BP or PKO SA in the near future, although improvements in governance and capital are planned at PKO BP, which will place it on a more independent, commercial basis.

THE ENTERPRISE CREDIT CORPORATION

The Polish American Enterprise Fund established the Enterprise Credit Corporation (ECC) for the dual purposes of making loans to small enterprises in an environment in which virtually no one made such loans and helping the main Polish banks to develop their staff capability in small business lending. According to many observers, the program has been the most successful of several such efforts in Poland (and perhaps in the region) — efforts that include lines of credit for small and medium enterprise through

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[6] PKO BP's role in mortgage finance raises several issues that are beyond the scope of this paper and will not be discussed here.

the Polish Development Bank and the Bank for Social and Economic Initiatives, a government-owned lending mechanism for small enterprise. The success of the Enterprise Credit Corporation is measured by its ability to make a relatively large number of loans in comparison with other mechanisms aimed at small business (approaching 2,000), and to maintain a low percentage (now 3 percent) of problem loans.

The ECC works through 13 windows it has arranged at 10 Polish banks (all state-owned). At these windows, staff from the bank, who have been trained in credit analysis by ECC, accept and analyze detailed loan applications from prospective borrowers. If the application is acceptable to the bank, it moves on to ECC staff, who review the business plan, investigate the documentation, and recommend it for acceptance to ECC's credit committee. ECC provides U.S. dollar loans, in amounts up to $75,000, at a current interest rate of 11 percent for loan terms up to three years. All the funds belong to ECC, but banks share the credit risk equally with ECC and receive one-quarter of interest receipts plus a half percent fee for their risk and expenses, in addition to payments of $150 per window staff per month. Loans are not disbursed to borrowers but instead are paid directly to suppliers on the basis of invoices. Since it began in 1991, ECC has disbursed $33 million; it has an outstanding portfolio of $20 million. Its funding comes completely from an interest-free investment of $28 million from the Polish American Enterprise Fund, which is in turn funded by a grant from the U.S. budget.

There appears to be general agreement that ECC is a competent organization that has succeeded in implementing a workable lending methodology, training both its own staff and staff at banks and demonstrating that it is possible to make good loans to small business in Poland. The current issues surrounding ECC lie not with operational questions, but with policies, and with whether ECC is a model that should be replicated in other countries.

One issue concerns the provision of dollar loans. This has alternately been a windfall and a risk for borrowers. During its first months, demand for ECC loans was very high because it was known that the zloty-to-dollar conversion rate was being held relatively constant, although inflation and interest rates for the two currencies differed greatly. Thus, it was very profitable for borrowers to borrow in dollars at the then-operative rate of 12 percent and to invest in zlotys at deposit rates of 35 percent. ECC attempted to reduce use of their loans for currency arbitrage by disbursing only on the basis of invoices.

The exchange rate situation today no longer presents such advantages for borrowing in dollars. Dollar borrowing is now recognized to be more risky for most Polish businesses, although the zloty continues to depreciate at a much lower rate than the differential between zloty and dollar interest rates. ECC is therefore focusing on exporters and selected businesses that are able to increase prices apace with inflation, leaving aside a large proportion of business sectors. However, the underlying question remains whether dollar-denominated lending is appropriate for ECC's clientele.

Another issue concerns the evolving relationship to banks. According to ECC staff, banks were initially interested in working with ECC because it brought them new customers, particularly at a time when banks faced low NBP-imposed credit ceilings (before open market operations were introduced). Now banks can make the loans themselves, and ECC is becoming something of a competitor to the banks in which its windows operate. Because it has chosen to lend through the state-owned banks, ECC has been dealing with banks that have strong deposit bases. At present, most of these banks are overliquid in both zloty and foreign currency. In one respect, this shift is exactly what ought to happen in a program that works through banks. To the extent that ECC has helped banks begin making such loans (by developing customer relationships and by training staff), it can be considered highly successful.

On the other hand, the future of ECC is now uncertain. ECC staff would like to convert the organization into a financial institution in its own right, independent from the banks and eventually able to offer a range of client services, including zloty loans and full-service transaction support. This would presumably also involve mobilizing deposits and sourcing funds commercially. ECC points out that the potential market for small business lending in Poland is enormous, particularly when compared with existing services, and that there is room for great expansion. ECC staff argue that an organization such as ECC, which has developed professional competence, should evolve into a bank with a strong small business orientation. Such a move would make a shift away from the concept of ECC as an internal catalyst for learning among banks.

In considering replication of ECC in other countries, one would not normally plot a path that involves working as a catalyst for banks for the first few years, then turning toward creation of an independent financial institution. However, it may be a sensible path.

A final issue with regard to ECC is its use of no-cost capital for lending. ECC optimistically claims that it would be able to operate its program on the basis of a 4 percent spread, which would permit it to handle a 7 percent cost of capital and still lend to borrowers at what it considers a competitive rate of 11 percent. Other estimates of administrative costs of ECC, based on ECC's historical costs, are substantially higher than 4 percent. Although a start-up subsidy in the form of Enterprise Fund investment in ECC may have been appropriate for a pilot effort to lend to small business in Poland, particularly during the early stages of reform, it would appear that the setting and the organization have now matured to the point where ECC should be placed on a fully commercial basis, including paying market rates for its funding.

SECTION FOUR

CAPACITY BUILDING AND DONOR ACTIVITIES

FUTURE AREAS OF FOCUS IN THE POLISH FINANCIAL SYSTEM

Poland has made significant progress in developing its financial system. Its emerging money markets, the stock market, and monetary policy tools are among the many important accomplishments it can already claim. The FREB plan has great potential for coping with the most important challenge facing the financial system and setting the stage for bank privatization. The coming year will be a crucial testing period.

The tasks involved in creating a modern financial system in Poland are far from complete, however, and this report has identified several areas on which future efforts should focus. The following paragraph outlines a brief agenda for action in the financial sector during the next few years.

At NBP, work remains to be done in developing the capacity of NBP to implement a sound regulatory framework and to supervise the banking sector. For example, it would be beneficial to examine whether the implicit taxation imposed by various regulations is appropriate. At the same time, important tasks facing NBP include developing a sound basis for private banks in Poland, which combines work in regulatory policy with oversight of the current consolidation process. The condition and future role of the private banks is one of the least-studied aspects of the financial sector. Part of the process of establishing the framework for private banks includes resolving questions about whether deposit insurance should be introduced, and under what terms. In capital markets the next significant task (as perceived by numerous GOP officials) may be development of an over-the-counter market. Another set of tasks includes the restructuring and eventual privatization of the remaining specialized banks, with the cooperative banks and the Bank for Food Economy being the most urgent targets of reform. Finally, as discussed below, there is a continuing need for training and technical assistance to be made available to banks and for internal and external training capacity to become permanently established.

The most important measures of success in financial sector development will be increasing confidence in the banking system, leading to a deeper deposit base, and increasing credit extension to private enterprises. Progress in these areas cannot be rushed. The quickest path toward the expansion of assets and private sector credit is pursuit of the current agenda, pursuit of the additional tasks outlined above, and simultaneous progress by GOP in reducing the macroeconomic uncertainties and financial burden on the financial sector caused by inflation and government borrowing requirements.

The text that follows discusses how donors are now participating and can participate most appropriately in these tasks.

DONOR INVOLVEMENT IN THE RESTRUCTURING PLAN

The plan for Financial Restructuring of Enterprises and Banks is a joint creation of Poland's Ministry of Finance and the World Bank. These two entities cooperated closely to design the main features of the plan. An important process followed to broaden the base of support. Inside Poland, this process involved bringing NBP on board and leading the plan through the Council of Ministers and the Sejm. Outside Poland, the other donors (including USG) became involved through development of a range of technical and advisory supports for the plan and the banks and through donor decisions in autumn 1992 to reprogram the zloty stabilization fund for use in bank recapitalization. The donors most closely involved in providing technical (and some financial) support are EC PHARE, EBRD, and the British Know-How Fund.

The FREB program is a second generation activity for the World Bank, which established its close connection to the Government of Poland's financial sector reforms during its 1991 Financial Institutions Development Loan, through which the nine commercial banks received diagnostic assistance and then twinning partners. These steps laid the groundwork for the current program. In addition to the creation of the bank recapitalization fund, a range of other donor activities will support the FREB:

- Technical assistance to work-out departments of the commercial banks. As many as four long-term advisors may join the staff of each of the loan work-out departments, supplied by EC Phare, the British Know-How Fund, and other donors that express an interest. EC PHARE has made a commitment to fill out any spaces in the matrix of advisor positions that are not supplied by other donors.

- EBRD is in the early stages of negotiating the Stabilization, Restructuring, and Privatization program, through which it would enter into joint ventures with each bank to create holding companies. Each holding company would take on approximately 15 of the potentially viable SOEs in the bank's problem loan portfolio. EBRD financial resources would supplement those of the bank to help revitalize these companies. EC PHARE will also cooperate in this program, supplying technical assistance as well as some capital.

- The World Bank loan contains detailed conditionality relating to development of NBP's bank supervision capacity. Donor-supplied advisors (including some from USG), whose tasks and placement are being coordinated by the World Bank, will assist NBP to meet these conditions. Because of its close involvement with FREB and negotiation of the accompanying loan, the World Bank staff has essentially taken over from the initial IMF-led diagnostic missions in providing strategic guidance on NBP's bank supervision system.

BANK TRAINING

In addition to supporting FREB, the other main area of donor activity in the financial sector is banker training. The need for training of bank staff in Poland is enormous and will continue to be so for some time. The current number of bank employees in Poland approaches 100,000 (although there may be fewer, not more, in the future, as efficiency improves). In the short run, the needs are great to expose bank staff to training opportunities wherever they may be found, and in particular, to maximize exchange with the West. This is happening now through myriad vehicles, both private and public. In the longer run, bank training institutions and mature in-house bank training programs will take over the training function. The development of those institutions is a current priority.

Three bank training institutes are being established in Poland. The first, the Katowice banking school, began two years ago, under the auspices of the National Bank of Poland, with considerable assistance from the European donors, particularly EC PHARE. It is now opening a branch in Warsaw.

The second is the Warsaw School of Banking, a project of the Polish Bankers A ›ciation. This school officially opened in early 1993, and courses are being offered on an ad hoc is. The school is renovating a training facility on the outskirts of Warsaw and expects to open the facility in late 1993. USG has supplied the school a training advisor who is helping to design the school along the lines of the American Institute of Banking (for example, maximizing the use of practicing bankers as instructors). The Warsaw Banking School is also supported by the European donors. A third school is being developed in Gdansk with separate affiliation.

The range of curriculum needs for bank training include large-scale needs in credit analysis at basic and advanced levels; specialized training aimed at management in areas such as strategic planning, asset and liability management, and the like; and specialized training aimed at staff, such as training in international letter of credit procedures. It is expected that the larger banks will develop their own training programs to teach basic procedures, so that the bank training schools are likely to provide basic training for smaller banks and more specialized training for the full range of banks.

One aspect of skills transfer that deserves special comment is the twinning process set up by the World Bank, through which the state-owned commercial banks were paired with Western European banks that became in essence technical partners to the Polish banks. These arrangements have the advantage of integrating skills development with organizational transformation, a potentially efficient way to bring about the kind of transfer of knowledge and practice that needs to occur. While the twinning arrangements are not uniformly praised, the negative comments concern the execution of some of the contracts (for example, high costs, or selection of unmotivated Western partners) rather than the concept itself. In the cases where the relationship has worked well, twinning is thought to have made important contributions to improved operations.

OBSERVATIONS ON USG ACTIVITIES

As of May 1993, the USG was assisting financial sector reform in Poland through the following activities:

- Placement by the U.S. Treasury of advisors in government and banks. Long-term advisors are or have been working in the following financial sector areas: the Ministry of Finance (on FREB, external debt negotiations with the London Club, and issuance of government securities), NBP (on bank supervision), Bank Handlowy (general advisory services); and the state-owned commercial bank based in Lodz (general advisory services). The advisors have generally been well-selected, competent people, who have made positive contributions on the basis of their technical and interpersonal skills.

- The Enterprise Credit Corporation and related activities of the Polish American Enterprise Fund. The Enterprise Fund has also invested in Polish banks, including major ownership of the First American Bank of Krakow and a small stake in Wielkopolski Bank Kredytowy.

- A variety of short-term activities arranged by the Financial Services Volunteer Corps and focusing on capital market development, together with a half-time long-term advisor to the Ministry of Privatization on the mass privatization program. In addition, an A.I.D. contractor, KPMG, has provided an advisor to the Ministry of Privatization.

- A U.S. Treasury initiative in 1992 to assist the FREB program and recapitalization and privatization of the nine SOCBs by rallying other donors so that most of the zloty stabilization fund of 1989 could be reprogrammed for the bank recapitalization fund.

- A contract through which KPMG is working with NBP to develop an on-site inspection manual for bank supervision. This manual and its accompanying training are expected to be a centerpiece in implementing NBP's on-site inspection program. In addition, the contract provides for advice on strategic planning for bank supervision.

- Provision by Treasury through a contract with KPMG of a long-term advisor to the Warsaw Banking School, together with short-term availability of instructors.

- A long-term U.S. Securities and Exchange Commission advisor to the Polish Securities Commission (on stock exchange development).

- The Institutional Reform and the Informal Sector (IRIS) Project, a legal reform effort focused on improving the law and practice governing secured transactions for lending.

The most notable feature of this cluster of activities is its diversity. It covers a wide range of topics, from training in credit analysis to the operation of the securities market. It also uses a wide array of delivery mechanisms: individual advisors, technical assistance contracts, a cash transfer, and direct investment (by Polish-American Enterprise Fund). The array of activities that constitute the USG program is a collection of separate actions, each having its own origin, both in terms of the sponsoring USG body and in terms of the circumstances in Poland leading to the selection of the particular activity. A guiding strategy is not evident.

Having characterized the U.S. activities as a cluster of actions rather than a strategy or program, it is important to raise the issue of whether such a targets-of-opportunity approach is the most fruitful way to organize future USG assistance to the Polish financial sector. The case in favor of this approach involves the observation that the organizing principle need not lie at the level of American assistance to the Polish financial sector, but at two other levels. On the U.S. side, there is the establishment of vehicles that are essentially on call for providing assistance: the Treasury advisors program, the bank training program, A.I.D. Bureau for Europe's privatization contracts, A.I.D. Bureau for Private Enterprise's Financial Sector Volunteer Corps and IRIS contracts, and the Polish-American Enterprise Fund. In most of these cases, the organizing principle cuts across several countries. On the Polish side, there is an ongoing financial sector reform effort, guided by GOP. The American activity selection process would then, it is hoped, result from matching on-call resources with the needs generated by the Polish process.

Although there is an important element of truth in this rationale, a stronger case can be made in favor of greater attention to strategy at the level of USG assistance to the Polish financial sector (that is, at the program level). One of the notable features of Polish financial sector reform has been its focus around major plans, such as FREB. These plans have been developed through close working relationships, first, between GOP and the World Bank and, second, between the group of other donors that have taken a leading role in assisting the sector (the World Bank, EBRD, EC PHARE, and the Know-How Fund). The United States has taken complementary action in two areas — for example, in reprogramming the stabilization fund monies and its coordination with the World Bank on NBP supervision. However, the USG has not been a full partner with the donor group, and thus, for example, missed an opportunity to contribute to the massive technical assistance for work-out departments that represent the greatest need of the nine SOCBs during 1993-1994.

The United States has acted instead primarily as a supplier of expertise. This role was appropriate during the early stages when the setting was highly fluid and GOP had not yet developed its own experience in working with donor organizations. When it reacts to disparate requests from different ministries and departments, USG risks committing resources to areas where its base of institutional knowledge may be too shallow to adequately assess the wisdom of the particular proposed assistance. For example, some interagency voices involved in the USG assistance strategy for Poland strongly promoted during mid-1992 a request from a GOP source to help Poland expand export credit insurance through a governmental agency. That assistance proposal was nearly adopted — until an assessment requested by the State Department's Office of Eastern European Affairs and A.I.D.'s Bureau for Europe led to the conclusion that it was unwise for USG to go fishing in these (previously) unfamiliar waters.[7]

By concentrating on supplying resources, rather than on jointly defining a program, USG has underestimated the value of gaining a thorough agreement between donor and recipient on the ways assistance will be used to further the recipient's plans. The lack of such an understanding has reduced the effectiveness of several of the activities. Finally, the sourcing of activities from several USG agencies and contracts has meant missed opportunities for synergy between closely related activities. For example, the Treasury advisor to NBP on bank supervision and the A.I.D. contract for KPMG to produce an on-site manual might have been more effective if linked together in a common program and negotiated as a package with NBP.

RECOMMENDATIONS FOR SPECIFIC USG ACTIVITIES

Bank Regulation and Supervision

A range of related issues confronts the National Bank of Poland, including improving bank supervision (in line with World Bank conditionality), defining and implementing bank regulations and legislation, presiding over the consolidation of private banks and the restructuring of the cooperative banks, and introducing (or deciding not to introduce) deposit insurance. These issues suggest a series of interrelated tasks that could be bundled into a larger project, with the general purpose of building a sound regulatory and supervisory environment for the banking sector. As discussed above, most of the assistance NBP has received, while high in quality, has approached each task separately. NBP's own progress has been uneven, with rapid progress on some fronts and lack of progress on others. In the bank supervision area, the strategic planning concept of the KPMG activity might be used to assist the kind of joint planning and advisory process that has characterized the donor relationship to the FREB program, to help NBP develop, articulate, and implement its plans for the shape of the financial system to come. In addition to matters of bank supervision, Section Two of this report notes several specific regulatory areas where policy analysis and dialogue might be useful (for example, implicit taxation of reserve requirements). The task of building a coherent policy framework becomes more relevant now because of the imminent emergence of the state-owned banks from their transformation process and into private hands and because of the impending consolidation process among private banks. USG, beginning with dialogue at the highest levels of NBP, should investigate whether U.S. support around this constellation of issues would make sense.

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[7] As implied by the discussion in Annex A, the main flaw in the export credit insurance scheme seemed to be that exporter demand was declining for such insurance from the sole local non-subsidized commercial provider, WARTA.

Capital Markets Development

The Securities Commission and the Warsaw Stock Exchange are operating smoothly, thanks in part to USG assistance, and they do not appear to need additional assistance at this time. However, there are other needs in capital markets development that USG might consider. These activities might be considered a continuation of the targets-of-opportunity approach. They are recommended in part because U.S. expertise in this area is highly regarded and would likely be received well by Polish counterparts. Specific capital markets areas identified include the following:

- Over-the-counter Market Development. Plans are beginning for an over-the-counter market as a support to the mass privatization program that will result in holdings of securities in individual enterprises by large numbers of citizens, particularly workers. An over-the-counter market is intended to enable those holders to realize the value of their shares (and to maintain political support for mass privatization). Any assistance in developing such a market should involve not only development of the trading mechanism, but also analysis of the appropriate regulatory framework for such a market, with a focus on information disclosure requirements and protection against insider trading.

- Response to financial sector innovations. The government (NBP and MOF) will need to be able to respond in regulation to the introduction by the private sector of more sophisticated financial products. It is clear that such products (for example, derivatives) will be introduced, and GOP currently lacks skills and a framework for assessing their merit in a way that protects and supports market participants.

- The United States has been slated to provide assistance in developing the public offering for the fourth state-owned bank, planned for 1994. Work on this offering should begin in late 1993. This is an important, discrete activity for which Treasury has authorized funds; responsibility has been delegated to the GOP Ministry of Finance.

Continuing Existing Activities

This report does not attempt to evaluate individual activities, as its scope did not allow for detailed investigation of the progress each is making. A brief review reveals that some of these activities are working well, whereas others need revision. In general, the team can affirm that the United States should continue to support its current array of activities to their logical conclusions. In particular, efforts to support development of bank training capacity should clearly continue to be a part of the USG program over the next few years.

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ANNEX A

FINANCIAL SECTOR EVALUATION

TABLE A-1

ASSESSMENT OF EXPORT FINANCING AND RELATED SERVICES IN POLAND

Function or Service Area	Availability and Quality of Service	Prognosis or Need for Remedial Measures
1. Export Documentation and Financing		
A. Standard L/C financing of exports by Polish bank: - review exporter's documents; - advise (or confirm) documentary L/C of importer's bank; - cable amendments or extensions;	Main export finance banks (Handlowy, 90% market share in 1991, 65% in 1992; BRE) have been swamped 1990-92 by a multitude of new customers and types of transactions--as smaller private firms have emerged and as SOEs have deconsolidated and bypassed sector FTOs. Errors and delays in export document processing have been frequent due (i) exporter inexperience, (ii) weak skills and procedures at new local banks, and (iii), at Handlowy and old SOEs, high turnover of trained personnel.	Training in export documentation and financing is needed; this should be done at the banks which, in turn will train their customers. Training continues at Bank Handlowy (for internal staff only); NBP and technical schools also previously offered such training. Citibank, Warsaw has provided several 1-to 2-week, gratis L/C training courses for other banks' staff--simultaneous translation, bilingual handouts, no text. Training plans of Warsaw and Katowice bank training institutes in this area not yet assessed by Evaluation Team. It would be useful to translate L/C self-study training book and manuals (5 1" books) from English to Polish.
- pay out letter of credit to exporter. B. Other methods of Financing:	SOEs have very weak international sales and marketing efforts, aggravated by staff and budget cuts in these areas. Many small exporters have had no prior experience with L/Cs and have been vulnerable to armed robberies of satchels of currency or to fraud by Western customers.	Foreign banks that have entered Poland are highly skilled in trade finance and seem to be expanding rapidly (from a small base), with high profitability. Most local private banks (except IFC-sponsored IBP) seem to lack skill, potential in export finance.
1. Use of guarantee (wechsel), where exporter mails documents directly to importer. 2. Documentary collection 3. Open account financing	Charges for foreign exchange funds transfers are very high and credit to exporter's account is often delayed for up to 10 days (2-5 weeks in early 1992), owing to: slow internal management, banks' addiction to float for low-cost funds, limited access to SWIFT outside Warsaw HQs, and poor clearing service by NBP.	Rapid expansion of HQ SWIFT access, new regional branches of Handlowy (now 24) and Export Development Bank, first interbank clearinghouse (4/93), and competition from foreign banks (who offer same-day transfer of funds) have been rapidly reducing delays in transfers for most customers and lower fees for funds transfer at all Handlowys and HQs of regionals. However, other factors (layered management, error-prone processing; and, outside Warsaw, delays due to slower development of telecom links, limited computerization, and lack of competition between the 9 regional banks and the foreign trade banks to force reduction of the float may cause persistent problems of delayed transfers to customers of regional banks for a couple of years.

TABLE A-1, Continued

Function or Service Area	Availability and Quality of Service	Prognosis or Need for Remedial Measures
II. Other Export Related Financing		
A. Pre-export financing for Polish exporters 1. From local banks	Not available from most banks except against cash collateral or mortgages. However, foreign currency receivables from exports are preferred to domestic collateral--which is generally unreliable (see IV.B, below). Some foreign banks and Handlowy will lend to prime customers on basis of credit analysis. Since 4/92 some banks have been forced to freeze/reduce outstanding loans to many medium/large customers--as NBP abruptly lowered customer loan ceilings to 15% of bank's capital, with no allowance for transfer of risk to a guarantor. Import L/Cs are charged as 100% risk versus 20% in U.S. Law allows discretion for NBP President waiver to as high as 50% of bank capital, which has led to a flood of requests for waivers.	Current banking law should be revised at time of next general update so as to standardize loan limits along EC model and to remove the statutory broad NBP discretion over loan ceilings (customer ceiling of 25 percent of bank capital?). In the interim, NBP could set objective standards for waivers (for best-rated banks) or for partial or full deduction (as in U.S. bank-regulatory practice) for loans that are subject to secure, third-party guarantees.
- zloty loans - foreign currency	Exporters have little demand for <u>zloty</u> credit because of perceived high cost. Demand for <u>dollar</u> credit at 12-20% p.a. would probably be substantial, but use of f.x. proceeds to repay such loans appear to be technically in conflict with f.x. regulation regarding surrender of export proceeds to a "foreign exchange bank".	NBP has recently (8/92) ruled in favor of allowing dollar loans by one foreign bank as a legitimate form of pre-payment for exports, with proceeds used to repay loan. As other banks develop familiarity with this system, they should be able to expand dollar lending to exporters.
2. From customers abroad	Some firms (e.g., shipyards) have been able to obtain substantial advances (progress payments to 60-70 percent of value from fleet owners), but such arrangements may require the producer to offer steep price concessions to the foreign customer.	Most Polish banks are too conservative to lend against export purchase orders. When problem of legal insecurity of liens is solved (see IV.B), availability of loans against goods in process should improve. Banks have finished debt workout w/Szczecin shipyard, can resume limited lending (but not Gdansk or Gdynia).
B. Post-export financing for foreign customer		
1. Short-term	Generally not available. No system exists (e.g., bankers'acceptances) to permit exporters to get bank financing for deferred payment (e.g., 6-month extension in credit-competition with a Far East supplier.)	Demand for nonsubsidized post-export <u>financing</u> from Poland by commercially sound foreign customers is likely to be low [even if supply emerges] so long as <u>real</u> interest rates on loans in Poland continue to be significantly higher than in financial markets abroad.
2. Medium/long-term	Not available.	

TABLE A-1, Continued

Function or Service Area	Availability and Quality of Service	Prognosis or Need for Remedial Measures
III. Export Credit Insurance		
A. Commercial risk insurance and reinsurance 1. to Western cos. 2. to CEE, CIS cos.	Insurance against commercial risk is currently available from WARTA (with risk retention of 10-40%). Demand for this line of insurance ($800,000 in annual premiums) has declined about one-third in dollar terms 1990-92. WARTA has been pressuring clients to take total turnover coverage in order to stem further loss of premium income. 75% of WARTA's commercial risk is reinsured w/private Western insurers--to avert risk of heavy losses such as WARTA incurred for a few years before 1986. Reinsurers will accept CSFR, Hungary risk but not other CIS, CEEs where no acceptable bankruptcy law is present.	Most interviewees (exporters, banks, WARTA, AMPLICO) foresaw little customer interest in stand-alone commercial risk insurance on export credits, possibly a higher level of interest in such insurance for domestic credits (pending reform of collateral system). Domestic credit insurance against commercial risks might help to alleviate either current hesitancy of banks to make loans against inventory or working capital or the regulatory loan ceilings.
B. Political risk insurance	Insurance against political risk was done for account of GOP (not WARTA), 1985-91, led to heavy MOF losses suffered on political risk insurance in Iraq and sub-Sahara. GOP committee suspended authorizations for such policies by WARTA or KUKE, 6/91. WARTA thinks there would be significant client interest in political-cum-commercial risk insurance for CEE markets and that customers might be willing to pay the high premiums (e.g., 10% for short-term Polish risk charged by Hermes, Gerlings). KUKE management contemplates offering political+commercial credit risk insurance of $300 million per year--with emphasis on CSFR, Hungary, Ukraine, and Kaliningrad. MoF is preparing a law (10/92) that would permit KUKE (or WARTA?) to resume offering political plus commercial export credit risk insurance. A new committee composed of MoF, MoFER, and _____ would set guidelines (premiums, country limits) and act on specific large transactions. The draft law would also permit direct loans to export customers (by KUKE?), but no such operations planned for near term.	Proposed new MoF political risk insurance program must pass two hurdles: (i) approval by MoF of budget support for the implicit subsidy and exposure to potentially significant future losses (opinion is divided within MoF); (ii) approval by IMF and some biltaeral donors to allow use of accrued interest on PSF to finance an initial $63 million budget allocation to this program. WARTA and KUKE are potential competitors to provide political risk coverage, and, in WARTA's view, the market may not be big enough to support two separate vendors. WARTA sees export-credit insurance as a side-line that should be offered as part of total insurance service to its clients. KUKE (dormant since mid-1991) was founded on the view that export credit insurance should be the business of a specialized company. Initial country risk classifications by KUKE would probably be borrowed from Dun & Bradstreet Intl (4 risk classes). KUKE and MoF appear to have avoided any recommendation yet about the exact parameters (e.g., degree of subsidy, maximum maturity, country limits, off-cover countries) that would govern KUKE's export credit insurance operations.

TABLE A-1, Continued

Function or Service Area	Availability and Quality of Service	Prognosis or Need for Remedial Measures
IV. Other Infrastructure Related to Foreign Trade Financing		
A. Bonded warehouses	Very limited in Warsaw area; many more will be needed if/when revision of commercial code enables greatly increased lending against inventories as collateral. In the interim, some banks avoid use of liens by taking ownership of goods in storage, then reselling to the customer.	Phase-out of internal EC border controls and many customs warehouses as of 1/93 may facilitate rapid shift of experienced bonded warehouse management to Poland in 1993-94.
B. Uniform Commercial Code - center to register liens - concept of and system for transfer of liens	Scandals over multiple pledging of collateral have raised general awareness of the importance of a central registry of liens. NBP, Justice, and Union of Polish Banks are close to agreement on procedures, location and management of a national registry for Poland.	Registry expected to be in operation by late spring 1993 w/modem access for all banks. Possibly to be modelled on the Finnish system (including, in time, a central registry of unique corporate names and trademarks). USAID contractor Ron Dwight (KPMG/IRIS) is providing technical assistance.
C. Credit rating services within Poland	An embryonic black list has been established among Polish banks. No Dun & Bradstreet-type credit reporting service. No central registry of corporate names.	Are there legal impediments to establishing a more comprehensive credit-history-reporting service? [Check with Tomas Stawecki (IRIS).]

NOTE: Views attributed to organizations in this outline reflect comments of individuals (or interpretations thereof) and may not reflect the views or conclusions of the organization.

ANNEX B

CONSOLIDATED BALANCE SHEETS OF THE BANKING SECTOR

TABLE B-1

CONSOLIDATED BALANCE SHEET OF THE BANKING SECTOR: ASSETS
(in trillions of zlotys)

ITEMS	12/91	3/92	6/92	9/92	12/92
Foreign receivables	58.1	72.2	81.0	94.5	104.9
Cash in vaults	12.1	11.9	13.3	13.5	17.3
Deposits at NBP	35.5	34.6	33.7	34.1	41.2
Interbank loans	15.7	17.4	18.7	20.7	26.1
Loans to government	14.4	12.6	15.3	20.4	26.6
Loans to enterprises	186.3	200.5	211.6	220.6	231.4
Loans to households	7.1	7.6	8.5	9.9	11.9
Treasury bills	13.2	23.9	32.5	46.0	50.8
Treasury bonds	46.9	57.8	55.5	57.5	43.1
Other securities	8.7	7.9	7.5	7.5	7.8
Other assets	53.7	57.2	59.5	77.9	90.1
Total assets	451.7	503.6	537.1	602.6	651.2

Source: *Narodowy Polski Information Bulletin*

TABLE B-2

CONSOLIDATED BALANCE SHEET OF THE BANKING SECTOR: LIABILITIES
(in trillions of zlotys)

ITEMS	12/91	3/92	6/92	9/92	12/92
Foreign liabilities	17.3	21.6	23.1	29.3	30.2
Loans from NBP	72.5	77.5	76.7	78.7	48.0
Interbank deposits	17.7	19.7	21.0	24.3	31.7
Loans to government	18.7	18.9	21.0	22.0	39.1
Demand deposits in zloty	51.1	49.6	53.0	57.4	71.0
of which from enterprise	46.9	44.9	47.6	51.1	63.8
of which from household	4.2	4.7	5.4	6.3	7.2
Savings deposits	6.3	6.8	7.4	8.1	9.5
Time deposits, zloty	82.4	102.7	117.7	134.1	150.1
of which from enterprise	24.3	30.7	37.3	43.0	45.0
of which from household	58.1	72.1	80.5	91.0	105.1
Demand deposits in foreign currency	19.2	21.8	21.9	23.0	25.9
of which from enterprise	2.1	2.4	2.2	1.2	1.3
of which from household	17.2	19.3	19.7	21.7	24.6
Time deposits, f/c	38.1	47.6	50.0	56.0	64.9
of which from enterprise	1.1	1.2	1.4	2.4	2.2
of which from household	37.0	46.3	48.7	53.7	62.7
Other liability and equity	128.3	137.7	145.3	169.6	180.6
Total liabilities	451.6	503.9	537.1	602.5	651.0
Note: Total enterprise deposits	74.4	79.2	88.5	97.7	112.3
Total household deposits	122.8	149.2	161.7	180.8	209.1
Total foreign currency deposits	57.3	69.4	71.9	79.0	90.8
Total zloty deposits	139.8	159.1	178.1	199.6	230.6
CPI Index (dec 91 = 100)	100.0	111.6	122.4	134.1	144.3
Liabilities/CPI Index	4.5	4.5	4.4	4.5	4.5
Household deposits/CPI Ind	1.2	1.3	1.3	1.3	1.4
Enterprise loans/CPI Ind	1.9	1.8	1.7	1.6	1.6

TABLE B-3

POLISH BANKING SECTOR: DISTRIBUTION OF ASSETS AND LIABILITIES
(percentage of total)

ITEMS	12/91	3/92	6/92	9/92	12/92
ASSETS Foreign liabilities	12.9	14.3	15.1	15.7	16.1
Cash in vaults	2.7	2.4	2.5	2.2	2.7
Deposits at NBP	7.9	6.9	6.3	5.7	6.3
Interbank loans	3.5	3.5	3.5	3.4	4.0
Loans to government	3.2	2.5	2.8	3.4	4.1
Loans to enterprises	41.2	39.8	39.4	36.6	35.5
Loans to households	1.6	1.5	1.6	1.6	1.8
Treasury bills	2.9	4.7	6.1	7.6	7.8
Treasury bonds	10.4	11.5	10.3	9.5	6.6
Other securities	1.9	1.6	1.4	1.2	1.2
Other assets	11.9	11.4	11.1	12.9	13.8
Total assets	100	100	100	100	100
LIABILITIES Foreign liabilities	3.8	4.3	4.3	4.9	4.6
Loans from NBP	16.1	15.4	14.3	13.1	7.4
Interbank deposits	3.9	3.9	3.9	4.0	4.9
Loans to government	4.1	3.8	3.9	3.7	6.0
Demand deposits (zloty)	11.3	9.8	9.9	9.5	10.9
of which from enterprise	10.4	8.9	8.9	8.5	9.8
of which from households	0.9	0.9	1.0	1.0	1.1
Savings deposits	1.4	1.3	1.4	1.3	1.5
Time deposits (zloty)	18.2	20.4	21.9	22.3	23.1
of which from enterprise	5.4	6.1	6.9	7.1	6.9
of which from households	12.9	14.3	15.0	15.1	16.1
Demand deposits (foreign currency)	4.3	4.3	4.1	3.8	4.0
of which from enterprise	0.5	0.5	0.4	0.2	0.2

Table B-3, Continued

ITEMS	12/91	3/92	6/92	9/92	12/92
of which from households	3.8	3.8	3.7	3.6	3.8
Time deposits (foreign currency)	8.4	9.4	9.3	9.3	10.0
of which from enterprise	0.2	0.2	0.3	0.4	0.3
of which from households	8.2	9.2	9.1	8.9	9.6
Other liability and equity	28.4	27.3	27.1	28.1	27.7
Total liabilities	100	100	100	100	100
Notes: Total enterprise deposit	16.5	15.7	16.5	16.2	17.3
Total household deposits	27.2	29.6	30.1	30.0	32.1
Total foreign currency deposits	12.7	13.8	13.4	13.1	13.9
Total zloty deposits	31.0	31.6	33.2	33.1	35.4
of enterprise deposits, percentage in foreign currency	4.3	4.5	4.1	3.7	3.1
of household deposits, percentage in foreign currenct	44.1	44.0	42.3	41.7	41.8

ANNEX C

PERSONS INTERVIEWED

PERSONS INTERVIEWED

Mrs. Barbara Baranska
Foreign Relations
Polish Bank Association

Mr. Branko P. Belusic
Controller
Enterprise Investors

Mr. Dale Blickenstaff
KPMG Resident Advisor
Warsaw School of Banking

Mr. Thomas J. Brennan
Advisor
Bank Handlowy

Dr. Piotr Cyburt
Director, Loan Workout Department
Powszechny Bank Kredytowy S.A. w Warszawie

Mr. Michael H. Davenport
Second Secretary
British Embassy

Mr. Ron Dwight
IRIS-Poland Project

Ms. Malgorzata Dusza
Director, Correspondent Banking
Powszechna Kasa Oszczednosci — Bank Panstwowy (PKO-BP)

Mr. Pawel Graniewski
General Counsel, Mass Privatization Department
Ministry of Privatization

Prof. Antoni Kantecki
Secretary General
Banking Education and Research Foundation

Mr. Henryk Klimczak
Deputy Director, Economic Department
Bank Handlowy

Mr. Robert Konski
Advisor to the Minister of Finance

Ms. Irena Koszada
Advisor, Loan Workout Department
Bank Handlowy

Mr. Andrej Krzeminski
Manager, Financial Institutions
BIG Bank

Mr. Marek Kulczycki
President
Enterprise Credit Corporation

Mr. Wojciech Kwasniak
Deputy Director, Bank Supervision Department
National Bank of Poland

Mr. Wojciech Lipka
Adviser to the Chairman
Polish Bank Association

Mr. Waldemar Maj
Director
Foundation for the Development of the Financial Sector
EC PHARE

Ms. Alicja K. Malecka
President
Pioneer First Polish Trust Company

Mr. John A. McDowell
International Economist
U.S. Treasury

Mr. George Metcalfe
Chief of Party
GEMINI-Poland

Ms. Jolanta Muller
Deputy Director, Loan Workout Department
Bank Handlowy

Mr. Edward L. Nolan
Policy Economics Group
KPMG Peat Marwick

Mr. Jacek Osinski
Monetary and Credit Policy Department
National Bank of Poland

Mr. Krzysztof Pietraszkiewicz
Managing Director
Polish Bank Association

Mr. Stefan Preker
Vice President Finance
Enterprise Investors

Mr. Dariusz Pronczuk
Business Analyst
Enterprise Investors

Mr. Witold Radwanski
Deputy Resident Representative
European Bank for Reconstruction and Development

Mr. Antoni Repa
Supervising Project Manager, Mass Privatization Department
Ministry of Privatization

Mr. Mario Reyes-Vidal
Senior Operations Officer
The World Bank

Mr. Piotr Rymaszewski
Advisor, Banking Division
Ministry of Finance

Mr. Edmund J. Saunders
Advisor to the President
National Bank of Poland

Mr. Andrzej Scislowski
Director
KPMG Reviconsult Ltd.

Mr. David Scott
Senior Financial Sector Specialist
The World Bank

Ms. Ewa Sleszynska-Charewicz
Director, Bank Supervision Department
National Bank of Poland

Mr. Robert D. Strahota
U.S. Securities and Exchange Commission
Senior Advisor

Mr. Peter M. Swiderski
Regional Director
Financial Services Volunteer Corps

Ms. Anna Trzecinska
Monetary Programming Division Manager
Monetary and Credit Policy Department
National Bank of Poland

Mr. Mariusz Wieckowski
Head of Banking Division
Ministry of Finance

Mr. James Wojtasiewicz
Second Secretary
United States Embassy

Mr. Zenon Zebracki
Advisor to the President
National Bank of Poland