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Stimulating the Growth and Development of Small and Medium Size Enterprises Through Financial Sector Policy Reform in Poland

by

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INTRODUCTION

PURPOSE

The purpose of this study is twofold. First, to identify the most immediate financial sector policy constraints which are limiting further development of the small and medium sized (SME) business sector in Poland. Second, to define a set of realistic and implementable recommendations which, if acted upon, will have a measurable impact in addressing these constraints over the next 12 months.

Effectively stimulating the growth and development of SMEs requires a multifaceted approach involving the interest and committment of both the public and private sectors. While further work is necessary within the banking and SME sectors themselves, this study focuses on financial sector policy reform as a critical component creating an environment conducive to the formation and more effective operation of SMEs. A direct result of this will be the development and utilization by financial institutions of a wider array of financial mechanisms and instruments more suited to SMEs.

The following analysis and series of policy recommendations are based in part on information contained in an earlier and broader GEMINI study on the financial and SME sectors in Poland.[1] This study was also greatly assisted by numerous discussions, meetings and conferences with leading Polish banks, financial sector advisors and bank training organizations.[2]

RATIONALE

A fundamental responsibility of any government is to create and maintain a solid legal foundation and regulatory framework which assures the stability of a democratic society, the effective functioning of the economy, and the successful operation of the financial markets. A free market will not thrive without stable economic policies, equitable tax systems, and a legal and regulatory environment conducive to private sector development. As such, the Government of Poland, as the institution responsible for the formation and implementation of public policy, is well-positioned to take the lead and act as the catalyst of reform.

Empirical observation and comparative analysis clearly indicate that further growth of the private sector in Poland is limited by a number of financial sector policy constraints. This includes constraints in the areas of law, regulation, taxation policy, access to information, and banking sector structural reform. The legal and regulatory environment impacting the banking sector is unclear, underdeveloped and inadequately defined in several key areas.[3] These limitations have impeded development of more effective

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1 The authors recommend those interested and active in this area to review the Study of the Financial Sector and SME Development in Poland, Volume One: Main Report, GEMINI Technical Report No. 68, February 1994.

2 On December 14, 1994 GEMINI co-hosted a round table discussion with the Warsaw Institute of Banking to review an earlier draft of this paper. See Bibliography for a list of participants.

3 In this report, "regulation" and "regulatory environment" refer to the executive orders issued by national institutions, specifically the Council of Ministers, Ministers, and the President of the National Bank of Poland.

financial institutions, alternative instruments and services, and in its most general sense, the bank-SME relationship. This is reflected by the limited access of SMEs to capital and greater risks to banks in lending to small business. The end result is that it is more costly for SMEs and banks to do business together.

While the largest source of funding for SMEs today is savings and other informal mechanisms, it is the premise of this paper that a more developed bank-SME relationship is a vital aspect of Poland's economic transition and necessary to allow the SME sector to reach its greatest potential. Although there is mounting evidence that foreign equity capital is becoming increasingly available and the capital market is expanding, it is unlikely that such sources of funds, with a few exceptions, will impact directly on small and medium size entrepreneurs. Furthermore, as the sector's needs exceed the inherent limits of informal borrowing, one can expect SMEs to turn to banking sector institutions as the primary source of finance for business expansion. In turn, these institutions will recognize that in a free market economy and with an appropriate supporting legal and regulatory environment, small- and medium-size entrepreneurs will evolve to constitute a major element of their portfolio as in western economies.

OBJECTIVES

- To identify and clarify selected financial sector policy constraints that currently inhibit the growth and expansion of SMEs.
- To underline the key role of policy in guiding and stimulating the growth of the banking sector as a fundamental element in the development of Poland's private sector.
- To propose a realistic and well-defined set of short term recommendations which, if acted upon, will have a measurable impact over the next 12 months.

THE GROWTH AND IMPORTANCE OF SMES IN THE POLISH ECONOMY

The transition to a free market economy in Poland has been both rapid and dramatic. The private sector's share of business activity has more than doubled since 1989, now contributing nearly 55% of GDP and employing approximately 60% of Polish workers (Table 1). This share of private sector economic activity is one of the highest in Central and Eastern Europe. In comparison with an EC average of 72%[4], it indicates remarkable progress, and is in many ways an exceptional model of post-Communist transformation.

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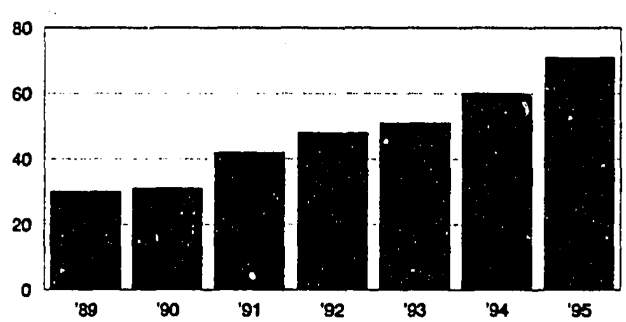
[4] "Small and Medium Sized Private Enterprises in the Transformation of the Polish Economy", paper by Piotr Dominiak and Franciszek Blawat, Technical University of Gdańsk, Faculty of Management and Economics, 1994.

It is also estimated that over 90% of the 2 million businesses currently registered in Poland are small and medium-sized enterprises (SMEs). This is seen as particularly important in light of Poland's slower pace of privatization as compared to her neighboring countries. Poland's ratio of 48 SMEs per 1000 inhabitants almost matches the overall European average[5] (see Appendix I), and SMEs are by far the leading source of new job creation. Often overshadowed but strategically important are microenterprises; about 90% of all SMEs in Poland can be classified as microenterprises, employing 10 people or less.

TABLE 1

POLAND'S PRIVATE SECTOR SHARE of GDP



Sources: '89-'92 Polish Central Statistical Office
Figures for '93, and '94 - '95 estimates by CS First Boston

However, signs of trouble have appeared. Despite annual GDP growth of 4% in each of the last two years, the reform initiative is being challenged by conflicting government policies, and the demands of moving from the initial economic burst to a more sustainable expansion. The rate of SME growth in numbers is expected to taper off as the country enters the next, more mature phase of economic reform, while the average SME is expected to grow larger.[6] Internal restructuring, and the internal transition to more systematic management styles has only just begun, placing a greater focus on issues such as cost control, quality, marketing and distribution, and demanding much more of the relatively inexperienced Polish manager.

Further private sector growth, especially SMEs,[7] is also restricted by a number of financial sector policy constraints. The focus of this report is that despite complexities in the surrounding environment including several macroeconomic obstacles to financial sector reform and the internal organizational challenges facing SMEs, policy constraints to SME sector development can and should be confronted now. Although many ministries and government institutions are affected by and are involved with policy reform, the majority of recommended actions contained in this report fall within the scope of the Ministry of Finance (MOF) and the National Bank of Poland (NBP).

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5 Ibid, p. 2. See Appendix I for additional statistics.

6 Ibid, p. 2

7 As over 90% of private businesses in Poland can be classified as small or medium size, the terms "private business sector" and "SMEs" are used synonymously throughout this paper.

THE CONTENTS OF THE REPORT

A summary follows this introduction. It summarizes both the key financial sector policy constraints limiting SME development as well as the recommended actions.

This is followed by a banking sector overview which focuses primarily on the key public sector institutions involved in banking sector development, their impact on the sector itself, and the issues of most importance under their jurisdiction.

The next section, Financial Sector Policy Constraints, describes in more detail the constraints which need to be addressed. This includes legal and regulatory barriers, constraints in the areas of taxation policy and access to information, and banking sector structural reform.

A short-term set of recommendations addressing the above mentioned policy constraints constitutes the final section of the report. The Action Plan is divided into the following areas: legal, regulatory, and fiscal policy reform, and direct credit mechanisms. Each section contains a brief summary of the constraints followed by a list of recommended actions.

SUMMARY

THE MAGNITUDE OF THE PROBLEM

A fundamental problem in the growth and diversification of Poland's economy is limited access to capital by SMEs. Short term credit is extremely expensive and difficult to access without excessive collateral security. It is estimated that almost 90% of Polish start-ups begin operations without any bank financing.[8] A recent survey of dynamic entrepreneurs in the Central European region shows the relatively minimal reliance in Poland on bank loans both at start-up and as a source of funds for future investment outlays (Table 2).[9]

TABLE 2 — FINANCING START-UP AND INVESTMENT

A survey* of 800 fast-growing companies in Central Europe shows that, except in the Czech and Slovak Republics, start-ups were financed largely by savings. In Poland, 60% of planned investments - the highest percentage in the region - will be financed by reinvested profits & savings, and only 26% by bank loans.

% Share of total financing	Czech	Hung.	POL	Slovak.	Slov.
START UP					
savings	28	57	60	31	81
bank loans	42	9	12	41	4
profits	14	7	10	17	6
private & company investment	4	16	4	3	3
other	12	11	14	8	6
PLANNED INVESTMENTS					
savings	1	14	11	2	8
bank loans	42	28	26	45	32
profits	37	27	48	41	43
private & company investment	9	11	3	6	4
other	11	20	12	6	13

*Source: *Central and East European Dynamic Entrepreneurs Database Survey, by the European Foundation for Entrepreneurship Research in co-operation with the European Venture Capital Association.*

8 "Poland Lets Small Business Go Begging", Central European Economic Review, p. 12, Autumn 1994, published by the Wall Street Journal.

9 See Appendix II for additional survey responses to financial issues.

Loan Guarantees and similar credit facilities, aimed primarily at small business and widely used in several forms in EC countries and around the world, operated in Poland up to the end of 1994 on a limited scale. Until recently, the national government has neither provided significant amounts of money nor established a clear regulatory framework allowing, or encouraging, the development of such financial instruments. Other banking services that typically facilitate commercial activity in advanced market economies are also under-developed, resulting in a fragmented and segmented banking sector. The liberal licensing policy of the early years of transition and the banks' subsequent imprudent lending practices has left many of these banks, and the sector as a whole, in a precarious financial position.

FINANCIAL SECTOR POLICY CONSTRAINTS

To a significant degree a number of laws, regulations and government policies have limited the financial sector's ability to respond to the needs of private business.

The expansion of credit activity to the private sector has been severely constrained by the absence of an efficient and effective collateral law. Poland's laws do not provide a systematic basis for collateralizing loans or registering liens or charges on a borrower's property. A collateral register for movables pledged as security does not exist. Additionally, there is no central mortgage register which would more easily determine if a real estate asset has been pledged as collateral. It is therefore extremely difficult to determine if prior claims have been registered or if a lender's rights have been threatened should a borrower sell collateral or use it to secure other loans.[10] In the case of movables it is practically impossible.

For almost 50 years bankruptcy proceedings were not undertaken in a free market context, which prevented the gradual evolution of bankruptcy practices and procedures. Presently, bankruptcy proceedings are slow, very costly and accommodate abuses. Current bankruptcy legislation makes difficult the active participation by non-government creditors, especially non-bank creditors. Permanent mechanisms and practical experience are necessary to ensure order of claimants' precedence, and protection of creditors' interests.

The depth and breadth of information sources in Poland are still limited and attitudes towards utilizing and exchanging information are considerably different in Poland than in Western countries. A barrier to the establishment and operation of reputable credit rating agencies is the section in the current Banking Law related to secrecy which does not allow banks to pass information to private agencies. This forces agencies to rely on information supplied largely by companies themselves, which is often incomplete and which cannot always be fully documented. An additional information barrier in Poland is the limited and inadequately enforced system of business registration.

Lack of clarity in the legal and regulatory environment may be limiting development of second-tier or "para-banking" financial institutions and instruments such as leasing[11] and loan guarantee funds for which SMEs are an important market. Included here is: (i) the lack of a specific legal category for non-

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10 A new collateral law, drafted with the assistance of the USAID-funded IRIS project, has cleared the Ministry of Justice and is currently being reviewed by other ministries.

11 "Leasing: Room for Growth - and Confusion", Warsaw Voice, p. B7, February 5, 1995, highlights the advantages of this method of financing as well as the related legal and tax issues which need to be addressed.

profit institutions in Poland, which has resulted in the absence of one specific form of legal/organizational structure more suited to loan guarantee activity; (ii) the requirement under the Polish Banking Code that all lending institutions possess a banking license from the National Bank of Poland; and (iii) confusing terminology within the Banking Law and the Civil Code which has led to an unclear legal definition of and distinction between banking and non-banking activity.[12]

Another area needing further review is the current policy on foreign and domestic bank licensing. In most market economies, a greater level of foreign bank competition and a more developed network of specialized domestic banks typically leads to a wider array of financial instruments and in-bank services available to the private sector.

The use of tax policy as an element of fiscal policy to encourage investment and business development in Poland has been limited. In addition to the negative effects of the growing "gray" economy, fiscal policy also directly affects the banking sector. Tax deductibility of loan loss reserves in the Polish banking system is still significantly limited, the classification procedure is somewhat inflexible and interpretation of the definition of "doubtful loans" is considered restrictive. All of these factors reduce the financial incentive for banks to consider greater levels of investment lending.

Privatization of state-owned banks is a critical element of the banking sector's structural reform and of the country's economic transition because of the current dominance of state-owned banks. Consolidation of the sector, in part hampered by the slow pace of privatization, will require revision in banking law, taxation law, and the commercial code. Consolidation should be a market-driven initiative with a legal framework in place to support its implementation. Universality and specialization are other key strategic choices in banking sector structural reform.

Finally, macroeconomic issues continue to challenge public policy and financial sector reform. A high rate of inflation has been a major constraint to credit availability. Interest rates remain high as a Central Bank tool to control inflation but they also tend to discourage borrowing by prudent entrepreneurs. Although the Central Bank periodically reduces the discount rate, these reductions are not automatically followed by similar reductions by the banks as the latter view wider interest rate spreads as an opportunity to increase profits to meet more stringent capital requirements and solvency ratios as well as and to offset the opportunity cost of high non-interest bearing reserve requirements.

INTERNAL BANKING SECTOR CONSTRAINTS

This report also touches upon certain key internal issues related to the banking sector's growth and development, which, while not policy-related, nevertheless affect the ability of banks to work more effectively with SMEs.[13] This includes the need to develop lending policies and internal procedures focused more on SMEs, and to invest more heavily in training. A number of foreign bank experts have pointed to the lack of SME lending skills utilized in Polish banks. This set of unique skills - business planning and cash flow analysis, less emphasis on collateral and more on intuition and good judgment - have, to this point, been difficult concepts for the Polish banking community to embrace.

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[12] The Polish Foundations Forum is leading an initiative to create a suitable law for non-profit institutions in Poland.

[13] Appendix VI summarizes selected issues internal to the banking sector.

Compounding the difficulties for the banking system in working with SMEs are the inherent risks of SMEs themselves, the higher costs commonly associated with lending to small business, and the evolution of the private sector in Poland now facing internal and operational challenges associated with a maturing economy. This also includes elements of deeply-rooted business behavior based less on economics and more on history and culture. It includes significant private sector skepticism about the importance of business planning, its reluctancy to divulge and share information in an economy operating in many ways along informal guidelines, and a pronounced divergence in business attitudes towards observing the law.

In summary, financial sector policy reform therefore becomes an extremely difficult, delicate and complex task, taking place in a country where the national government has yet to adopt a comprehensive policy in support of the SME sector.[14]

RECOMMENDATIONS FOR FINANCIAL SECTOR REFORM

It is in the interests of effecting practical change and to sustain the momentum of economic reform developed over the last four years that the most pressing of financial sector policy limitations related to SME development have been highlighted. The report concludes with a selected number of reforms seen as realistic and implementable, and which - if acted upon, will have a measurable impact over the next 12 months.

The primary objectives of the recommendations are as follows:

- To increase SME access to capital
- To reduce the risks to banks of lending to SMEs
- To lower the costs to SMEs and financial institutions in doing business together

Based upon secondary source research, empirical evidence and numerous interviews with public and private sector representatives active in and committed to the development of the SME sector, the following subject areas have been selected as the basis for reform:

Legal Reform:

- Passage of a new collateral law which will establish a systematic basis for collateralizing loans and registering mortgages and liens;
- Reform of bankruptcy law to expedite, simplify and clarify the bankruptcy process;
- Improvement in access to and utilization of information through revision of the section in the Banking Law related to secrecy which severely limits banks from supplying

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[14] Initiated by the Ministry of Industry and Trade (MIT), GEMINI is assisting in the preparation of Poland's first independent SME policy. Drafted in January 1995, it is currently being reviewed by MIT before being presented to the Government for adoption.

information needed for the development of reliable credit rating and risk assessment agencies; development of a more complete and effective system of business registration which should include greater monitoring and stronger enforcement of required financial information from private business entities;

- Revision of the Banking Law and elimination of conflicts between the Banking Law and the Civil Code to more clearly distinguish between banking and non-banking activities, and to more clearly define acceptable vehicles of credit and financial intermediation activity;

- Creation of a separate legal category for non-profit institutions and second-tier financial institutions;

- Legal clarity to allow more progress in consolidating the banking sector by revising the Banking Act, Taxation Law and the Commercial Code to provide a consistent definition of bank holding entities and their operating and financial guidelines.

Regulatory Reform:

- Clarification of the regulatory environment under which second-tier financial institutions and various financial instruments such as loan guarantee funds are allowed to operate and develop;

- Clear policies supporting the selective licensing of foreign banks and adequately capitalized domestic banks (including specialized), in order to introduce greater competition into the banking sector.

Fiscal Policy Reform in the Banking Sector:

- An increased incentive for banks in granting long term investment credit, by; (i) making it easier to write off problem loans on the income statement which would reduce the taxability of the reserves which banks must create for such loans; (ii) allowing for a prudent level of unallocated loan loss reserves to be made available to Polish banks; and (iii) liberalization of the interpretation of the "Doubtful Loans" reserve requirements.

Direct Credit Mechanisms to Assist SMEs:

- Creation of a working group of active organizations and committed individuals to develop and implement an overall strategy supporting the more effective utilization of loan guarantee funds and other financial instruments aimed at SMEs;

- more direct support at the national and regional levels, and from international donors, for SME financial instruments as potential catalysts for SME lending, including support for needed training.

Although some of the constraints and recommendations contained herein are linked to a business's scale and scope, most are equally, or nearly equally, applicable to both small and big business.

Consequently, we urge the reader to consider and appreciate the broader implications of this study within the context of Poland's private sector development.

To conclude, there is much at stake in achieving financial sector reform. Poland is again becoming internationally recognized as a financially credible and solvent country, as witnessed by (i) the September 1994 signing of an agreement with the London Club on restructuring its debt; (ii) the positive view of Poland taken by the IMF; (iii) continued and increasing cooperation with international institutions; and (iv) its imminent debut on international financial markets through the first issue of Eurobonds.[15] Financial sector policy reform and private sector development will be significant factors in determining whether Poland gains membership in the European Union and quite possibly the difference between Poland becoming a model or a warning to neighboring countries who have only just started on the path to reform.

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15 "Poland's Financial Credibility Grows", Trybuna No. 229, September 30, 1994 p. 1

BANKING SECTOR OVERVIEW

INTRODUCTION

In order to better understand the scope of financial sector policy constraints limiting the growth and development of SMEs, and to better appreciate the need for focused reforms to reduce these constraints, it is necessary to review the main aspects of the Polish banking system. Polish banks are key implementing institutions which in the future are expected to be the main source of credit to SMEs. The following section will briefly describe and review current issues facing the leading institutional players within the banking sector.

The commercial banking system in Poland remains the primary source of financial intermediation in the transition to a market economy. The sector numbers approximately 100 banks, including former branches of the National Bank of Poland (NBP) converted into joint-stock companies of which many are owned by the State Treasury, foreign and domestic private commercial banks, and State-owned specialized banks.[16] These institutions are governed and supervised by the NBP, Poland's central bank. In addition there are over 1600 cooperative banks which are regulated by cooperative law, and supervised by the NBP.

In spite of the progress achieved since 1989 the transition of the banking sector, like that of other sectors, is as yet incomplete. To broaden financial services and to provide competition for the nine former NBP branches, over 90 private banks were licensed over the past five years. Inadequate capital requirements and imprudent lending practices have left many of these banks in a precarious financial position. As a result, the banking sector remains fragmented, with new private banks accounting for only 10% of banking sector assets and 18% of deposits by the end of 1993. Treasury-owned and State-owned specialized banks continue to dominate the sector (Table 3) with virtually no full-fledged nationwide branch banking systems in operation. The strong segmentation of the banking system, both sectorally and geographically, hinders the efficiency of financial markets, reduces the ability of financial intermediaries to diversify their portfolios and spread risks, and limits the more complete financial system infrastructure necessary to more effectively serve the needs of the private sector.

THE PUBLIC SECTOR

Key Players - National Bank of Poland, Ministry of Finance

The National Bank of Poland (NBP) and the Ministry of Finance (MOF) have the most direct influence on financial sector development in Poland. Throughout the socialist period the NBP, under the supervision of the MOF, conducted limited commercial banking operations as required by central planning. With passage of the 1989 Banking Act the NBP officially divested itself of its commercial banking activities to become Poland's Central Bank. In doing so, its nine branches were converted into "commercialized"

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16 There are four "specialized" banks wholly owned by the Government whose primary activities include savings accounts, foreign exchange activities, agricultural lending, and mortgage lending. "Treasury owned" banks refer to six of the former nine branches of the NBP which were converted into joint-stock companies with the Treasury holding all or a majority of the shares. Three other former NBP branches have been privatized with the Treasury holding a minority position.

private banks owned by the Treasury. Three of these banks have since been privatized, with the Treasury retaining a minority position in each.

TABLE 3 — THE POLISH BANKING SYSTEM (billions of U.S. dollars)

	Total deposits				Nongovernment credit			
	Amount		Percent of total		Amount		Percent of total	
	end -92	end -93	end -92	end -93	end -92	end -93	end -92	end -93
Specialized banks	11.04	12.13	53.2	54.0	6.81	6.92	43.1	43.3
Commercial banks (ex-NBP)	6.08	6.33	29.3	28.2	5.45	5.04	34.5	31.6
Nonprivatized	4.49	4.45	21.6	20.2	4.31	3.94	27.2	24.6
Privatized	1.59	1.79	7.7	8.0	1.14	1.11	7.2	6.9
Other private banks	1.93	2.30	9.3	10.2	2.21	2.83	14.0	17.7
Cooperative banks	1.70	1.72	8.2	7.7	1.35	1.19	8.5	7.5
Total banking system	**20.76**	**22.48**	**100**	**100**	**15.81**	**15.99**	**100**	**100**

Source: NBP

Significant progress has been made since 1989 by the NBP to establish its independence as the regulatory institution for the banking sector and chief policy maker on monetary issues. Nevertheless, the Ministry of Finance, as de facto owner of six former branches of the NBP, has the potential to influence lending and investment policy for a substantial portion of total banking sector assets. This is in addition to the former NBP branches' capacity as a source of funding to meet the budget deficit.

Public Sector Competition for Funds

Financial sector liquidity for short-term and investment credit is an essential ingredient for private sector growth in a market economy. Statistics indicate that Poland's financial system is liquid. It is rather a question of how banks and other financial intermediaries choose to allocate available funds. Substantial loan losses and other pressures on profitability make many bankers reluctant to pursue aggressive loan policies focusing on SMEs in what they perceive to be a high-risk market. As a result, they are turning to more conservative alternative investments such as government Treasury Bills and bonds which, despite declining returns in 1994, are essentially risk-free and incur little or no transaction costs. While total domestic credit rose in real terms in 1993, most of this increase is due to significant growth in credit to government. The Government of Poland (GOP) absorbed nearly 60% of the increase in credit in 1993 to fund the central budget deficit.[17] The banking system, including the Central Bank, is the primary source of government borrowing. Draining these financial institutions of resources that might otherwise be allocated to further development of the private sector has resulted in a decrease in total credit to the

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[17] Poland: Growth With Equity Policies for the 1990s, The World Bank, Report No. 13039-POL, September, 1994.

business sector (private businesses and SOEs combined) in real terms in 1993 (Table 4). In fact, total credit to private enterprise, while growing in real terms in each of the last two years, is not keeping pace with the increase in government borrowings which now are almost twice as large. The total planned level of commercial bank lending in 1994 was not reached.[18] Should these trends continue, the banking system will play a decreasing role in economic development.

TABLE 4 **POLAND - DOMESTIC CREDIT (Trillions of Polish Zloty)**

	1990	1991 1/	1991 2/	1992	1993
Net Domestic Credit	109.1	245.7	279.4	438.9	632.2
(real % change)	0.3	66.0	88.8	19.5	6.4
General Government	-9.2	54.0	**92.7**	**190.0**	**300.3**
(Change as % of total)	...	...	...	30.6	9.7
Non Government	118.2	191.8	186.8	248.9	332.0
(real % change)	31.3	19.5	16.4	1.4	-1.5
SOE	101.0	145.6	103.8	117.7	142.5
(real % change)	...	6.2	...	-13.7	-10.6
Private Enterprises	11.3	36.5	**75.8**	**119.2**	**166.8**
(real % change)	...	137.7	...	19.6	3.4
Households	5.9	9.7	7.2	12.0	22.6
(real % change)	84.2	21.5	-9.9	27.2	38.8

1/ former NBP methodology
2/ recent NBP methodology
Sources: NBP, World Bank calculations

Structural Reform

With regard to the State- and Treasury-owned banks, the government has directed considerable resources to increasing the banks' capital and has passed legislation that should encourage the banks to resolve the problem of non-performing loans. The private banks, however, do not have the same financial support as the State- and Treasury-owned banks. The NBP has injected financial resources into several private banks and others were established with minimum capitalization and will undoubtedly be forced into liquidation or merger with stronger institutions. The Central Bank's current reluctance to license new foreign and domestic banks has been an attempt to encourage foreign investment in existing domestic financial institutions. The question is whether the risks associated with a more liberal licensing policy would be more than offset by the benefits of greater sectoral competition achieved through the presence of foreign banks as well as specialized domestic banks offerring a specific range of products and services. Denial of bank licenses may slow the pace of competition and ultimately the upgrading of domestic bank services.

[18] "Keeping Distance", Gazeta Bankowa, December 17, 1994, p.1

The Law on Financial Restructuring of Enterprises and Banks (EBRP) was introduced in an attempt to resolve problems related to debt restructuring. This law has helped to restore financial discipline in the system and contributed to commercial banks' and Treasury-owned banks' development of risk assessment skills. About one third of the enterprises which accounted for the majority of bad loans have entered into conciliatory agreements with their creditors.

Despite debt reductions and capital injections achieved through the EBRP, however, new statistics indicate the problem of bad debt in the banking system continues. In October 1994, the total amount of outstanding loans for enterprises and households was 386 trillion (old) zlotys[19] from which more than 106 trillion (old) zlotys or 27% were considered irregular and 66 trillion (old) zlotys or 17% were considered unrecoverable.[20]

Progress in restructuring this debt is a necessary prerequisite to more rapid banking sector privatization and ultimately, development of more flexible lending policies. Bank privatization has proceeded very slowly, beset in part by controversy surrounding the most recent privatization in late 1993, and remains a concern given the significant share of privatized banks still held by the State Treasury. Privatization - or the lack of it - and the different organizational structures in the current banking system is impeding progress in consolidation of the industry and has highlighted several inconsistencies within the law.

Consolidation is a prominent trend in the industry; both the President of the NBP and the Minister of Finance have urged many banks to consider merging. The real purpose of consolidation is not to save individual banks in immediate financial difficulty, but, through operational synergy, to enlarge the range of products and services offered, to enhance the quality of service, and to lower operating costs. Consolidation should be a market-driven process which will allow Polish banks to compete more effectively with international banks and to be better able to diversify risk and deepen their asset mix. This requires clarity and consistency in the legal and regulatory environment.[21]

While a number of potential mergers/consolidations have been recently proposed involving, at one point or another, nearly all major Polish banks, the fact remains that none of these proposals has yet taken effect. Some of the more notable constraints are as follows: (i) both the Banking Law and the Commercial Code do not specifically define the concept of holding entities nor specify the appropriate form(s) in which consolidation can occur, within the banking sector or in the larger financial sector framework; (ii) the lack of legal clarity among the wide range of nonbank financial institutions which could potentially become involved as partners; (iii) Taxation Law does not allow financial statement consolidation of holding companies for tax purposes. Additionally, the deductibility of taxes paid on dividends is considered restrictive especially for the pure holding company; (iv) there is concern that the time-consuming requirements of consolidation as presented in existing proposals, namely the need to effectively fuse internal operations, strategic plans and management mentality, require deeper analysis. Finally, concern has been expressed that, in the short term at least, a more consolidated banking sector will not lead to a reduction in barriers to capital currently being faced by SMEs, and may in fact accentuate it to the extent that larger banks will focus on larger customers.

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19 The Polish currency, the zloty, was redenominated as of January 1, 1995. All monetary values used in this study are based on the old denomination, currently about 23,500 zloty to the U.S. dollar.

20 "Bad Debts are Growing", Rzeczpospolita, December 8, 1994.

21 See Appendix IV, Legal Constraints to Banking Sector Consolidation.

The NBP and the MOF are responding jointly to these challenges with new proposals, including changes to the Banking Law to further clarify the definition of bank consolidation, and the terms of operation of bank capital groups.

While there is a growing consensus that the Polish banking system can probably accommodate elements of both universal banking and specialization, opinion is again divided. The NBP President has acknowledged a universal banking system as imperative if Poland is to move closer to, and ultimately become a member of the EC. However, other observers doubt whether this model is particularly suitable to Poland given concerns over inadequate capital and undue concentration of power, and have suggested in its place a system of adequately capitalized specialized banks focused on different market segments.

The banking sector is dealing with some fundamental structural choices. What is most critical is that the ultimate path or paths followed lead to greater stability and efficiency, an increase in confidence from the general population, and a clearly defined and supportive legal regulatory framework. The absence of these elements, in the meantime, makes banking sector expansion, diversification and public acceptance more difficult.

COMMERCIAL BANKS

Financial Performance

While certain individual banks have generated impressive profits, the combined financial condition of the State-owned specialized banks, Treasury-owned commercial banks, and a number of private banks licensed since 1989 remains precarious, in part a result of deteriorating loan portfolios and under-capitalization.

Major issues facing the Polish banking system today include the magnitude of the banks' non-performing loan portfolios, the need to provide reserves for those loans, and the resulting impact on the weaker institutions' profitability. It is estimated that approximately 27% of State banks' loans are non-performing; this includes an estimated 60% of credit granted to large, mostly state-owned enterprises.[22]

The financial performance of the banking sector as a whole has declined. Average gross profitability, despite very large lending spreads, declined from 18.9% in 1992 to 6.7% in 1993, while net profit for the banking system as a whole fell to -1.15%[23]. A total of 24 banks, mostly private, recorded losses for 1993. Eighteen banks did not reach the required 8% solvency rate and nearly half of the total reserves set aside in the system to cover doubtful loans were in the form of State Treasury restructuring bonds made available to nine banks. The proportion of loans classified as non-recoverable rose from 42% (of all non-performing loans) in 1992 to 56% in 1993. Substantial resources have already been allocated

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22 Statistics in this section of the study were obtained from a report entitled "Banks 1993", by the Education and Banking Research Fund, commissioned by the Union of Polish Banks.

23 Parliament amended the Corporate Income Tax Act in May 1994 to provide banks with somewhat more flexibility in writing off non-performing loans as a tax deductible expense and therefore reducing the tax burden of reserves set aide for non-performing loans. These changes should have a positive impact on the financial performance of the banking system.

to restoring solvency in the financial system, with more needed. A recent injection by the NBP of four trillion zloty into banks on the verge of bankruptcy underlines the general concern.

Overall profitability continued to decline into the first half of 1994. However, a breakdown of aggregate statistics reveal sharp differences. While system profitability as a whole was again negative, 60 of the 86 commercial banks recorded a profit, with the 9 banks emerging from the NBP recording the highest profits (the gross profit to cost ratio in four of them exceeded 35%).[24]

Still, it is estimated that profitability will stay depressed in the near term. Internal inefficiencies continue to be a major problem, as it is estimated that unit operating costs in Polish banks are several times higher than in Western banks. In addition, competition from mutual funds, government securities and other sources will likely force banks to (i) keep deposit rates relatively high in order to attract funds, even as inflation falls, thus squeezing margins further, and (ii) rely on income from treasury, money market and capital market operations to offset the net losses from more traditional lending activity.

Asset Deployment

Concern for financial stability and the need to meet increased capital and reserve requirements has prompted bankers to avoid higher risk and to seek alternative investments for maximum risk-free profitability. Banks have been investing in high-yielding government bonds, increasing such investments by 35% in real terms over the last two years (including a 200% real increase in the nine commercialized banks and an 800% increase in the private banks), and expanding their highly profitable foreign exchange operations.[25]

Financial market operations in the past year should lead to interesting asset-deployment dynamics for the coming 12 months. Banks financed an increasing share of the deficit in 1994 and are expected to finance an even larger share in 1995 as the NBP continues to reduce its own deficit-financing commitment. However, a reduction in the return on government securities can also be observed in 1994; the 1-year Tbill rate fell from 38% to 26% with the yield curve virtually flattening (Table 5), while the average loan rate was 34% in the 14 largest Polish banks.[26]

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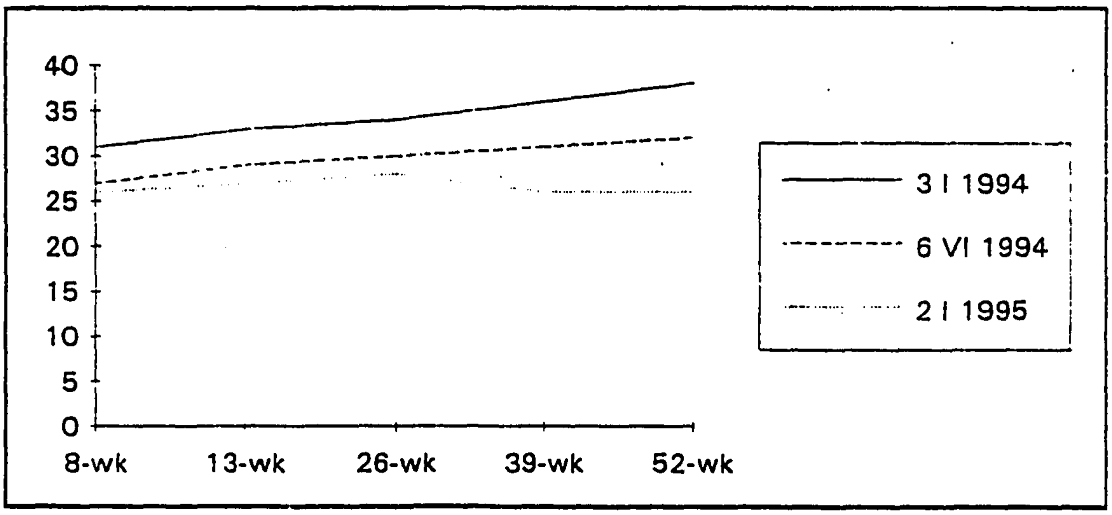
24 From a survey conducted by the General Inspectorate of Banking Supervision of the National Bank of Poland.

25 Poland: Growth with Equity Policies for the 1990s, op. cit., p. 79.

26 "Bad Debts are Growing", op. cit.

TABLE 5 YIELD CURVE ON GOVERNMENT TREASURY BILLS (%)



Source: "Keeping Distance", Gazeta Bankowa, December 17, 1994, p. 1

A number of technical, operational, and behavioural changes in addition to financial sector policy reform are required in order for Polish banks to diversify their asset portfolios and more effectively lend to the SME sector. While this paper addresses relevant financial policy constraints which need to be overcome, more work needs to be done in areas such as bank training, lending policy development, loan analysis, and the utilization of technology.

SMEs IN POLAND

The Definition

In Poland over 90% of private sector enterprises employ less than 10 people and more accurately qualify as microenterprises (Table 6). A sales level below a certain minimum requires different reporting procedures for tax purposes, which differentiates the micro firm from the SME defined as employing between 10-100 people. Polish banks readily acknowledge the attractiveness of the market segment composed of established medium-sized firms with a track record as opposed to the small, undocumented start-up. However both types of firms are routinely grouped in the same category. Providing a conclusive and practical definition and/or segmentation of the SME sector in Poland has proved elusive, complicating the task of all players including SME organizations, government, donor groups, and commercial banks.

TABLE 6	Growth of Poland's Small Private Sector Firms (in thousands)							
Type of Firm	**'89**	**'90**	**'91**	**'92**	**'93**	**'94***	**'95***	**'96***
Sole proprietor	0	1,083	1,349	1,631	1,784	1,973	2,034	2,136
Limited Liability	12	33	48	58	65	78	94	112
Joint Venture	0.4	2	5	10	14	16	19	21
TOTAL	12	1,118	1,402	1,699	1,863	2,067	2,147	2,269

** Estimates*
Source: 1989-1993, Polish Central Statistical Office, 1994-1996, Pexim Co., Ltd.

The Inherent Riskiness of SME Lending

Small business is relatively unattractive to banks for a number of reasons, the result of which makes SME loan analysis and monitoring more costly. SMEs usually experience a higher overall business failure rate; they often lack the assets necessary for collateralizing loans and the skills necessary to complete credit applications and business plans; and it is often more difficult to document SME company history. This does not mean that banks are uninterested in lending to SMEs or that SMEs are naturally unprofitable. SME lending is simply not a high priority for most banks, especially when the SME sector itself is new and often undocumented, and where risk-free returns have been very attractive. A recent study classifies only 1% of all SMEs in Poland as acceptable credit risks of banks based on the criteria of liquidity, profitability and efficiency.[27] A profit margin of 10%, often used as the minimum acceptable rate in an international context, has been achieved by only 25% of Polish enterprises.[28]

The decline in total bank credit in the Polish economy over the last four years is therefore not surprising. The reality is that in Poland, most SME loan applications currently are not bankable; most SMEs are not candidates for asset-based lending and an antiquated collateral law disqualifies a huge portion of SMEs from the start.

What is also evident is a major difference in perception between banks and SMEs. According to banks, most or all SME loans are extremely risky; according to SMEs, banks are not doing enough to identify promising lending opportunities and/or marketing themselves to the private sector. Existing financial sector policy constraints are contributing directly to this misleading and counterproductive debate.

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[27] "Keeping Distance", op. cit.

[28] "Sad Balance: Report on the Situation of Banks in 1993", Nowa Europa, September 23-25, 1994.

OTHER ELEMENTS

The Cooperative Banking Sector

Cooperative banks have the potential to be a significant source of funding for the SME sector in rural areas, particularly in the field of micro-lending. As a result of poor management and inadequate regulation and supervision, coop banks are currently facing severe financial problems. They account for the largest number of potential bankruptcies in the system (over 700). The focal point of the crisis is the BGZ Central Cooperative bank itself. Its recapitalization needs are estimated to exceed those of the commercialized banks as required under the Law on Financial Restructuring by over two-to-one. The portfolio of BGZ has deteriorated sharply, raising questions about management, credit policies based on loans granted to struggling agricultural enterprises, and vulnerability to political influence. While recent legislation was passed to restructure both the coop banks and the BGZ (including a substantial injection of bonds into the BGZ), concern has been expressed over the decision to recapitalize both the central coop bank and its individual members at the same time, and the still-to-be-resolved issue of how to reform the BGZ to avoid such a massive capital injection in the future.[29]

The problems of the BGZ have perhaps overshadowed efforts by the independent cooperative banking sector to restructure and improve the quality of their loan portfolios. As part of the recent reform of the cooperative banking sector, coop banks had to choose whether to operate independently or within the national (BGZ) system. Over the past few months, two independent regional networks have emerged, with the total number of member coop banks exceeding several hundred. Criteria for joining these independent regional banking networks have become more stringent including an increase in the level of capitalization required. There are many specific examples of independent cooperatives lending to SMEs who view this activity as an integral component of economic development in the local community.

Credit Unions

Credit unions are developing in parallel fashion with the financial sector in Poland. Their primary focus is to provide members with consumer loans and to a lesser degree, microenterprise loans. The growing number of these institutions creates potential funding opportunities for small and micro-entrepreneurs. To date the Foundation for Polish Credit Unions has registered over 100 credit unions, opened a licensed Credit Union School, established four Regional Training Centers, published a series of training manuals and education films, and initiated an overseas internship training program. Credit unions exist primarily in factories with membership drawn mostly from the workforce. It is estimated that approximately 80% were started by Solidarity activists but maintain no official relationship with the trade union.

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[29] On September 9, 1994 the BGZ was converted into a joint-stock company and is expected to receive restructuring bonds worth 12 trillion zloty but will require and additional 20 trillion zloty to achieve the required 8% solvency ratio. The president of BGZ stated that the bank will seek foreign aid to make up the short-fall.

Today, they have an estimated 50,000 members who have deposited 300 billion zlotys. About 230 billion zlotys has been loaned out, mostly for consumer purchases and cash-flow emergencies.[30] Although other small loan programs exist in Poland, only credit unions are legally empowered to take in deposits and lend money without requiring a bank charter. To guarantee repayment, most credit unions rely on peer pressure, the knowledge and experience of members of the loan committee, and sometimes on co-signing agreements.

Financial Intermediation

Financial intermediation is in the early stages of development. There are few institutions which issue and provide a secondary market for capital market instruments. Although the Polish Development Bank engages in secondary market activities, it has indicated that the volume of trade is low because the brokerage houses are still unfamiliar with the mechanics of capital market instruments. Swaps, forwards and asset backed securities are still conceptual and require a more developed institutional capacity. The market for fixed-income securities remains limited and is dominated by Treasury issues. Still small by international standards, the Warsaw Stock Exchange now lists more than fifty companies, but many are recently privatized, formerly State-owned enterprises; initial public offerings (IPO) for privately held firms have not truly tested the market's appetite for traditional private sector equity securities. An insufficient number of foreign and domestic institutional investors is another significant limitation.

New sources of equity capital for private sector investment are just now entering the market, but venture capital needed by start-up Polish entrepreneurs continues to be scarce. Pension funds and insurance companies do not yet play a meaningful role as a source of capital for private sector development. The level of foreign investment in Poland, although increasing, does not compare favorably with investment in other Central European economies. While Warsaw's stock exchange flourished in 1993 and attracted considerable attention from international investors, its performance in 1994 fell sharply and the exchange still faces a number of operational shortcomings.

International Donors

International donors have introduced significant capital into the financial system in the form of grants, loans, technical assistance and training. Much of this has been directed to financial and banking sector reform and SME development. A number of recent multilateral initiatives call for direct equity support for companies either undergoing privatization or significant restructuring.

However, the lines of credit made available to the SME sector have remained largely unutilized, the most notable exception being the Polish-American Enterprise Fund's "Windows" Program which has loaned over US$ 60 million to the SME sector.[31] The reasons for under-utilization vary. The commercial banks, who typically act as on-lenders to small business, have shown little interest in participating in these programs, citing as their main concerns complicated and lengthy application procedures, long delays in the approval process, and the potential problems of cross currency lending.

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30 "Marx Meets the Market", Warsaw Business Journal, March 3-9, 1995, pp. 1,4.

31 For further information on the "Windows" Program please contact the Polish-American Enterprise Fund at ul. Towarowa 25, 00-869 Warszawa.

Although the World Bank has recently streamlined and simplified its loan application and approval process, it would appear that banks prefer to invest their local currency funds in government securities rather than lend to business enterprises and are unlikely to access foreign lines of credit for lending purposes without specific incentives.

SUMMARY

The banking sector in Poland is not, in its present stage, contributing as much to economic development as it can, nor is it meeting the short- and long-term needs of the private sector, particularly small- and medium-size enterprises. Key regulatory and legal constraints in the policy environment make action imperative on a number of fronts.

In this chapter we have identified the key players in the banking sector and briefly described some of the more immediate issues they are currently facing. In order to develop and implement a focused approach to financial policy reform to stimulate the development of SMEs, it is vitally important to understand the individual needs and constraints faced by these institutions.

Improving the SME-bank relationship can be achieved only by reducing the costs and risks for each side in doing business together and changing some of the basic perceptions that inhibit this relationship's development.

FINANCIAL SECTOR POLICY CONSTRAINTS

In this chapter, the most urgent financial policy constraints affecting SME development are described in greater detail. As previously stated, this is not meant to be a comprehensive list of all policy-related changes affecting the sector. Rather it is a much narrower but deeper investigation into selected policy constraints which should, and indeed can, be addressed in the immediate future.

LEGAL ISSUES

Many of the current laws and regulations governing Poland's economy are either outdated or non-market oriented, and open to wide interpretation. In such an environment the effects of an inefficient legal environment on the conduct of business and on free-market growth can be time-consuming and costly. Of particular importance to the banking and SME sectors are the laws governing collateral, bankruptcy and access to information.

Collateral Law

The expansion of credit activity to the private sector has been severely constrained by the absence of an efficient and effective collateral law. This is perhaps the single most important requirement for breaking the impasse in bank lending to enterprises.

Presently, Poland's laws do not provide a systematic basis for collateralizing loans or registering liens or charges on a borrower's property. Firstly, a collateral register for movables pledged as security does not exist. Secondly, the claims of secured creditors are ranked low in priority according to Article 1025 of the Civil Procedures Code which establishes the order for satisfying claims on a debtor. Execution costs, alimony, remuneration, work-related compensation for health and disability, and taxes are placed ahead of the claims of secured creditors. Banks, even if unsecured, have priority over non-bank creditors.

In addition, executing a lien is currently a lengthy, expensive, and often uncertain process. Collection procedures are administered by court-appointed bailiffs as opposed to private specialists in other countries. Property title records, particularly real estate, are not clear because of unresolved issues related to reprivatization and the process of transferring state property to local governments and enterprises. There is also no ability to place a floating lien that covers an entire company's operations to allow at least some of the going concern to be salvaged.

The Union of Polish Banks (UPB) has expressed strong support for the creation of a central lien agency and the Ministry of Justice has proposed legislation on this issue which calls for integrating the 19 or so current registries into one grand system. Since a lien provides information on the pledged collateral but not on the status of the loan itself, the UPB has also developed a cooperative information exchange agency where banks can determine if potential borrowers have outstanding loans with other institutions and whether they are behind in their repayment.

Furthermore, there is no central mortgage register to determine if a real estate asset has been pledged as collateral. (Real estate mortgages are registered in the regional court having jurisdiction over the area in which the property is located.) It can easily take over six months for a mortgage to be registered, providing the unscrupulous borrower the opportunity to mortgage the same property several times.

It is therefore extremely difficult to determine if prior claims have been registered or if a lender's rights have been threatened should a borrower sell collateral or use it to secure other loans. In the case of movables it is practically impossible.

An additional barrier is the right of the Taxation Office, in obtaining a pledge of assets against tax liabilities, to establish a mortgage without entering it into the mortgage register, as well as establishing a lien on movables which, according to Article 1025 of the Civil Procedures Code, ranks ahead of normal creditors. This makes it even more difficult for other lenders to rely on pledged collateral given the existence of these so-called "secret tax liens" which are a source of considerable uncertainty in the existing asset-based lending process in Poland.

Reform continues but has taken considerable time. The GOP is currently considering the passage of a new collateral law to resolve these constraints.[32] The new collateral proposal has cleared the Justice Ministry and is currently being reviewed by other ministries. The proposal has been very well received by selected members of the donor community. Passage of this bill is not expected before late 1995 at the earliest. In the meantime, additional work is needed in determining the financial and technical requirements of establishing a central registry, as well as providing training to financial institutions to understand how the new proposal will function.

Badly needed reform of collateral law and its ancillary procedures would create a more favorable lending environment for banks by reducing the legal impediments to secured bank lending, and therefore the perceived risk of SME lending. The banks will be able to lower their collateral requirements, thus benefitting the borrower who cannot now meet the banks' current demands for excessive collateral.

Bankruptcy Law

The laws governing bankruptcy, while not contemporary, are nevertheless fundamentally sound, according to the European Insolvency Practitioners Association (London). However, for almost 50 years bankruptcy proceedings were not undertaken in a free market context, which prevented the gradual evolution of bankruptcy practices and procedures. Currently, the legal system is being severely challenged to manage the volume and complexity of cases coming before the courts, related not only to bankruptcy but in most other areas of the law as well.

Bankruptcy proceedings are extremely slow and accommodate abuses. A key problem with current bankruptcy legislation is that it makes difficult the active participation in these proceedings by non-government creditors, especially non-bank creditors, because priority is given to substantial outstanding fees before the claimant is paid. The result is that most creditors, where possible, attempt to find settlement mechanisms different from bankruptcy procedures, knowing that in case of bankruptcy they will likely not receive any proceeds. Additional problems include the lack of experienced judges, under-staffing and low salary levels of court officials, fraudulent dissipation of assets prior to filing, and immense social pressures

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[32] "Collateral Law in Poland: Is It Coming?" by Ronald A. Dwight, Director, IRIS-Poland Project, AmCham Legal Briefs. The new collateral law proposal is an initiative of the USAID-funded IRIS project.

against the bankruptcy of many State-owned enterprises. The result is that it can take two years or longer to settle claims.

It must be acknowledged that a financial system does not want to rely on bankruptcy proceedings themselves as the defining characteristic in its relationship with small business. Funds collected from a bankruptcy rarely approach the initial value of the loan, and, given the nature of SMEs, the collection rate on small business loans is usually extremely low. However, bankruptcy protection and its efficient proceedings are necessary in commercial lending and finance. Bankruptcy is a last resort to reclaim funds. Thus, an enterprise's capacity to secure loan capital is affected not only by a lender's perception of risk but also by the risk related to repayment in the event of bankruptcy or default. This issue takes on added importance as bankruptcies are increasingly being used in Poland as a tactical maneuver to avoid repayment of bank debt.[33]

Progress has been made by allowing bank-led proceedings to restructure debt, ownership, and operations of State-owned enterprises. However, this measure is applicable for a limited time only. Permanent mechanisms and practical experience are necessary to ensure order of claimants' precedence, and protection of creditors' interests. In addition, bankruptcy proceedings should be structured not only to balance the rights of borrowers and creditors but also to administer and settle such matters expeditiously and cost-effectively.

Bank Secrecy Law and the Scope of and Access to Information

Sources of Information

Sources of business and economic information in Poland are limited and attitudes towards the sharing and exchange of information are sharply different in Poland than in other Western countries.

The enterprises defined by the Central Statistical Office (GUS) as small and medium are periodically examined (once a year) on the basis of a randomly selected sample. A questionnaire is sent to these firms by mail but the response rate is not high.

The whole system of business registration in Poland is flawed and the result is that information is extremely difficult to obtain on substantial segments of the Polish private sector. In addition to the problems associated with the absence of a collateral register and with an uncentralized and nonautomated mortgage registry, it is estimated that 60-70% of private companies registered under the commercial code do not provide the court registry with the required annual balance sheet. Furthermore, penalties for non-compliance are nominal.

At the local level, noncommercial entities must register their businesses with the Gmina. This includes individual proprietorships and partnerships, which account for a large percentage of small or micro business. Here too, the quantity and quality of information is insufficient for banks to evaluate credit

33 Parliament has recently enacted a new law on business offenses which introduces prison-term penalties and stiff fines for borrowers found guilty of "tactical bankruptcy". The Law on Protection of Economic Activity, which came into force on January 1, 1995, penalizes those who transfer assets to a newly established company in an attempt to avoid repayment to creditors. However there are still a number of ways in which to fraudulently dissipate assets.

risk. For example, information is not available on an enterprise's property, sales, taxes and liabilities. Again, only a small administrative penalty is charged for non-compliance.

Finally, Polish courts have the ability to make accessible to the public their verdicts on the wide range of economic and financially-related cases over which they preside. While this information exists, it is not proactively disseminated nor convenient to access at the courthouse.

Credit Rating and Risk Assessment Services

In more developed financial systems, bankers have access to a wider variety of financial information concerning potential customers, and both banks and customers have a better understanding of and appreciation for the value of having access to such data. This financial information gives the lender the tools necessary to perform educated risk assessments of potential customers. In turn, having a positive financial evaluation based on such information comprises a well-recognized element of a business's financial credibility.

These are the primary roles of credit rating agencies. These institutions perform the task of collecting economic data from a variety of sources including overall economic trends and industry and regional analyses, in order to generate economic profiles of individual firms. This information is utilized by public and private organizations, including financial institutions, in the evaluation of a particular company. Banks are both an important source for and beneficiary of information from such agencies.

In Western countries, there are also associations which assimilate information from statistical centers and make it available to financial institutions. This includes a wide range of sector- and region-specific demographic and socio-economic data.

Currently there are a total of six business intelligence centers in Poland:

- InfoData (incorporated 1990),
- Ibia Industrial-Commercial Information Office (incorporated 1989),
- InfoCredit (incorporated 1990),
- Intercredit (incorporated 1992),
- Creditreform (incorporated 1992) and
- Dun & Bradstreet (representative office).

While these companies supply general business information they are not credit rating services; nor do they provide industry or regional comparatives for companies to gauge themselves within the market. The company Creditreform has had many more inquiries from Western firms than Polish firms. Companies like InfoCredit have data on about 100,000 firms (detailed information on about 5,000). Creditreform has extensive information on about 30,000. A typical commercial report prepared by Intercredit Warszawa includes incorporation date, legal status, capital, shareholders, owners, business activity, sales, liabilities, fixed assets, financial performance and investment projects.

The absence of more fully developed information and credit rating services in Poland and the reluctance of businesses and banks to more fully rely on existing services, results in Polish bankers utilizing alternative information sources to a greater degree. These alternative sources include personal contacts with other financial institutions, which, without even considering the confidentiality issue, is in itself an inefficient and unreliable method of credit checking. Without the assurance that their lending decisions are based on reliable statistics, bankers will remain cautious about lending to riskier loan proposals.

Legal Barriers to Accessing Information

Provisions in the current Banking Law relating to secrecy are a constraint to the establishment of reputable credit rating agencies. Through enforcement of a number of laws and regulations, the concept of secrecy affects a wide variety of players and institutions including the state at the highest level, the public sector workplace, and the banking sector. Article 48 in the current Banking Law does not allow banks to provide information to private agencies. This section in the law permits banks to reveal client information only to the clients, the clients' authorized financial auditors, and to the courts in the case of penal or treasury proceedings.

Banks may share information with each other about outstanding loans, turnover, and account balances to the extent that this information is needed for issuing loans and/or guarantees. However even this information is limited in scope. Many banks have acknowledged that sharing of information in the industry itself needs to be greatly expanded. In addition, most Polish banks do not routinely monitor the degree of credit commitment to particular sectors of the economy or regularly assess the total amount of loans given to inter-linked clients, and therefore understandably find it difficult to assess the credit-worthiness of other banks in which they place deposits.[34] Failure to follow these procedures significantly increases risk in dealing with both borrowing clients and other banks.

Our research has indicated that Polish banks are willing to share information on a wider scale. What is needed is a supportive legal and regulatory framework and an efficient mechanism to justify banks' investing the time and money to utilize such services. An enabling framework supporting a more diverse flow and exchange of information would also increase the willingness of SMEs themselves to provide information to credit rating agencies. A greater acknowledgement by SMEs of the benefits to be gained by providing this information, and of the important role of such agencies as a formal element in business evaluation, would add value and credibility to the entire SME lending process.

Banking Law

Aside from efforts to establish an effective set of prudential regulations dealing with issues such as exposure risk, equity holdings, and interbank lending, a major priority is to clearly define the different classes of financial institutions authorized in Poland under the Law. The banking code does not distinguish between commercial banks and so-called "second-tier" or "para-banking" financial institutions which in many countries play a significant role in servicing SMEs.

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[34] Review of the Status of the Polish Capital Markets, March 1994. Financial Services Ltd. page 35.

The Banking Act of 1989 requires continuous review, clarification, and revision as the size and scope of the banking and financial sector evolve. It is the widely-shared opinion that the Banking Law does not reflect adequately the current needs of the banking sector. An important element in the debate on banking sector consolidation is the lack of regulations governing the operations of capital groups and bank holding companies. The Accounting Act includes a definition of a holding or "dominating" entity but the Banking Act and the Commercial Code do not.

The new Banking Law proposed by the NBP, which has yet to be approved, includes a more specific definition of a bank holding entity which should help to overcome these legal inconsistencies. Also included in the NBP proposal is an entire chapter focusing on the definition and operating guidelines of bank capital groups in the consolidation stage. These Central Bank proposals relating to bank consolidation and the creation of bank capital groups are being developed through consultation with the Union of Polish Banks and large individual banks.

REGULATORY ISSUES

Parallel to legal reform and of immediate importance is the need to clarify the regulatory framework allowing for more widespread development of new classes of financial institutions stimulating SME access to finance. These include cooperative savings institutions, credit unions, and second-tier or para-banking financial institutions. These are the more likely institutions to design, develop and implement alternative financial instruments such as loan guarantee funds.

Loan Guarantee Funds as an Instrument of Second-Tier Financial Institutions in Poland

Loan Guarantee Funds are created to encourage financial institutions to lend to small businesses with viable projects and good prospects of success, but which are unable to provide adequate collateral or lack a financial track record. Such funds would appear to play a very useful role in Poland to stimulate small business lending. SMEs would benefit through a reduction in the collateral barrier and therefore greater access to capital, as well as through the opportunity to develop a banking relationship. For banks, lending risk would be reduced while experience in lending to SMEs would be gained. Evidence in Poland also suggests that many banks would allocate more credit to private business if there were other institutions willing to share the risk.

Loan guarantee funds operate in many European, Western and developing countries in various forms. The U.S., German and French examples have each resulted in the granting of several billion dollars worth of loans and guarantees, benefitting tens of thousands of small firms, and act as important catalysts in stimulating small business credit. Experience suggests that, with a realistic fee structure, good cooperation between the Fund and participating banks, a focus on long-term financial sustainability, sound credit decision-making, and a reasonably leveraged ratio of guarantee activity to fund capital, such programs can act as important sources of capital for both start-ups and ongoing entities.

In Poland, despite political consensus since 1989 that SMEs need financial support, the Government has done little to facilitate development of direct financial assistance to SMEs. This includes support for a national re-guarantee fund, which is a critical component of loan guarantee funds operating in many countries. The first initiative at the national level to be undertaken is the recent announcement of the program to be implemented through Bank Gospodarstwa Krajowego (BGK). This program will guarantee up to 60% of a loan issued to firms which employ up to 250 persons and which earn an annual profit not greater than the equivalent of 20 million ECU. The program is to be financed by the state budget in the amount of 200 billion zlotys, which is by far the largest single initiative of its kind to be introduced in Poland. However, concern has been expressed that this program focuses largely on export-oriented firms and is not aimed at the majority of small businesses.

Not only have many international credit lines aimed at Polish small business been underutilized, but the proportion of donor resources allocated specifically to loan guarantee activity has been minimal. Most of the loan guarantee funds which do exist operate primarily at the regional or local level and are funded largely by selective international donor agencies. These funds show little evidence of standard operating procedures and are in many instances commencing operations with limited initial capital. The structure of several funds have not been designed for full cost recovery and long-term financial sustainability. Results to date have been inconclusive. A joint working group composed of practitioners, government representatives, international donors, and SME activists could be an effective way to pool resources and help establish SME financial instruments which are appropriate and applicable in Poland's economic and social context.[35]

Regulatory and legal uncertainties may be limiting development of guarantee funds in Poland, both in number and scope.[36] These constraints include: (i) the lack of a specific legal category for non-profit institutions in Poland, which has resulted in the lack of one specific form of legal/organizational structure more suited to loan guarantee activity; and (ii) the requirement under the Polish Banking Law that all lending institutions (including those specializing in loan guarantee activities) must possess a banking license from the NBP. Existing guarantee funds are operating largely through Regional and Local Development Agencies which do not accept deposits and do not have banking licenses.

The NBP has been reluctant to issue licenses to such organizations and has not clearly specified at what point the activities of existing programs may be subject to more intense scrutiny and/or be considered in violation of the Banking Law. The NBP has so far issued only one specialized lending license to an SME financial institution, the Polish American Enterprise Fund in 1990.

Further, the NBP is empowered to set specific regulations for second-tier financial institutions but it has thus far not done so. Article 11 in Chapter 2 of the Polish Banking Law defines the range of activities to be carried out by Polish banks. Article 111 also allows companies established under the Commercial Code (limited liability or joint stock companies) to undertake certain banking activities with the specific permission of the NBP and the MOF. Part 3 of this article permits the President of the NBP, in agreement with the Ministry of Finance, to establish the regulations governing the banking-related activities of such organizations. To date, these regulations have not yet been established.

Representatives of loan guarantee funds in Poland, as well as Polish legal experts, argue that many commercial firms issue loans and guarantees as part of their normal business operations defined under the civil code (using the term "poręczenie" and not "gwarancje"), and as such are legal and do not require NBP approval. This allows non-banking institutions not specializing in lending activities to issue loans and

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[35] On January 19, 1995 a meeting was held in Warsaw, organized by the Cooperation Fund, to explore interest in creating such a working group. The title of the meeting was "Financial Instruments in Support of Small and Medium Sized Enterprises".

[36] Much of the material in this section of the study is based on "Local Guarantee Funds and SME Promotion in Poland", by Anthony Levitas, Resources Development Foundation, Warsaw, 1994. A second source of useful information is Lokalne Fundusz Gwarancyjne, eds. Anthony Levitas and Grażyna Gęsicką, Warsaw, 1994.

guarantees under the above referenced name and classification. It is on this basis that most existing programs are operating, and in which international donor assistance has been committed.

The current Banking Law does not define precisely what is banking activity and what is not. Article 11 includes both the term "poręczenie" and "gwarancje" to describe bank guarantees (see Appendix III for an English translation of Article 11). However, the term "poręczenie" is also included as an activity under the Civil Code. It is not clear, therefore, which law ultimately regulates loan guarantee activity, and the degree to which current activity may be considered illegal if undertaken by institutions not having a banking license or for whom Article 11 in the Banking Law does not make an exception (such as a Foundation).

The new Banking Law proposed by the NBP tries to resolve this confusion by delineating more strictly between banking activity and non-banking activity. In the section of the new Law defining the range of activities of banks, it has eliminated the word "poręczenie", which is now defined as a banking activity only if a bank chooses to carry it out.[37]

As the NBP does not actively encourage lending activity falling outside the scope of the banking system, it is difficult to gauge, therefore, how the NBP will react to either the development of a large number of small SME guarantee programs or programs that begin to generate larger volumes of guarantees. As a result of this lack of definition and support, existing programs may be encouraged to remain small, and pursue low volume, low-fee strategies which, unfortunately, will not lead to financial self-sufficiency.

Loan guarantee funds can play an especially important and practical role in this phase of economic maturation in Poland, and serve as an ongoing source of financial support for small business. The national government and international donors need to look more deeply into this type of direct financial assistance as well as clarify the legal and regulatory environment permitting its development. It is also critical that current initiatives are implemented professionally in order to build a credible base of activity from which greater government, private sector and community commitment will follow.

Foreign and Domestic Bank Licensing

Only in late 1994 did the NBP, after a three-year hiatus, again begin issuing banking licenses to foreign banking institutions albeit on a very limited scale. The competitive position of the foreign banks is undoubtedly a factor in this hesitation. Until recently the NBP has opted for greater foreign expertise in existing Polish financial institutions by encouraging strategic investment in the more troubled banks. If this strategy does not work, domestic banks that are unable to challenge the foreign banks will lose an increasing amount of their most profitable business.

The NBP has not issued domestic banking licenses for a considerable period of time either. The role of specialized domestic banks providing a range of products and services to specific segments of the private sector needs to be further explored, particularly as the private sector itself is expanding and diversifying. Easy to lose sight of amidst the debate over consolidation and universality, such domestic

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[37] Appendix III compares the section in the current Banking Law and the proposed new law which defines the range of banking activities. In order to clearly understand the difference between the existing law and the new proposal, relevant changes in wording have been italicized.

financial institutions, if adequately capitalized, could justify the increasingly expressed opinion that the Polish banking system can accommodate elements of both universality and specialization.

Despite the understandable political sensitivity related to foreign involvement in the banking sector, the authors believe it is imperative that the NBP revise and clarify its policy on foreign bank licensing to give the larger financial community a clearer picture about the future of banking sector structural reform.

Bank Supervisory Capacity of the NBP

The powers of the NBP are perceived by many as too narrow, preventing the Central Bank from carrying out effective supervision of all banking institutions, and timely liquidation and bankruptcy as necessary.[38]

Although much progress has been made, the absence of clear authority to supervise the banking sector, particularly the State-owned banks, limits the Central Bank's capacity to act independently in setting and implementing monetary policy. At the present time Parliament can reject the NBP's money supply recommendations, a key mechanism for controlling inflation and interest rates.

An area of immediate concern is the NBP's ability to deal with, and ultimately resolve, bank failure situations. The NBP established criteria for assessing bad and doubtful debts and gave banks until the end of March 1994 to achieve the necessary level of reserves. Most banks did not meet this level including 60-70% of the cooperative banks.

The Law on Financial Restructuring of Enterprises and Banks has allowed banks to take a direct role in the restructuring of enterprises. They have been given new legal powers to initiate conciliation procedures in order to solve the joint problem of enterprise and bank bad debt. The key question is whether banks will want to expand their lending to riskier SMEs at a time when they must deal with existing borrowers, many of whom, despite reaching conciliation agreements, will ultimately fail, not to mention recent statistics that the overall level of bad or doubtful loans within the sector is again rising.

To some extent a universal banking system is emerging in Poland with banks offering a wide variety of financial products and taking an active part in the management and restructuring of client businesses. However, the adjustment of Polish banks to the wider range of demands placed on them (and the risks which may emerge as a result of banks' holding greater equity stakes in companies) will need close monitoring, a further challenge to the supervisory capabilities of the NBP.

FISCAL POLICY

The use of tax policy as an instrument to encourage investment and business development in Poland has been limited. A contributing factor has been the MOF's need to maximize revenue for budgetary purposes with the result that Poland now has the highest average tariff levels in Central Europe (Table 7).

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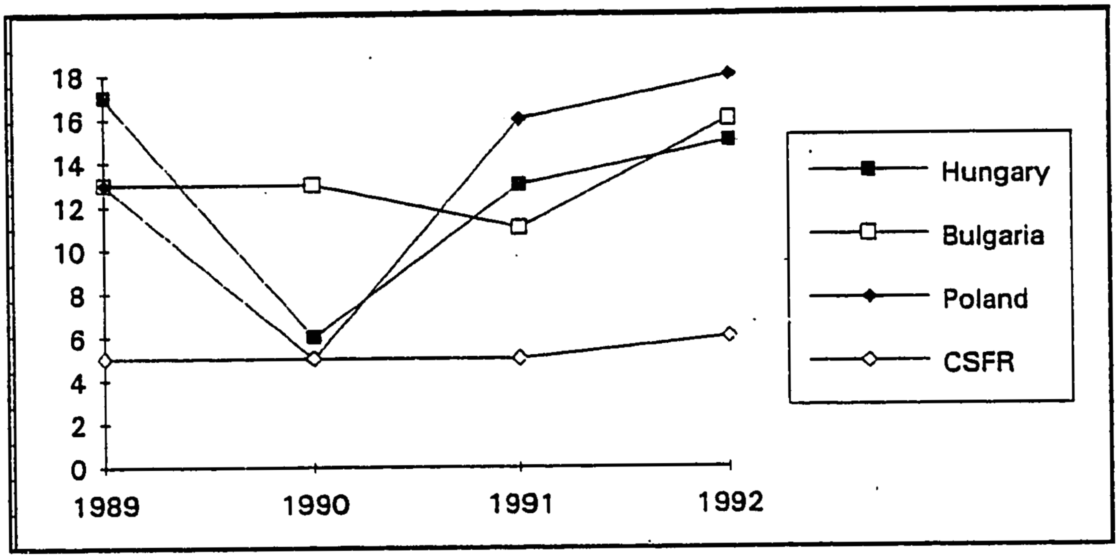
[38] The dilemma of the NBP in the bankruptcy and liquidation of failing private banks is demonstrated by the recent collapse of Megabank in Warsaw. Although there is no legal obligation for the Government to protect depositors in such failures, the NBP has decided that it will guarantee all personal deposits.

TABLE 7: AVERAGE TARIFF LEVELS IN SELECTED COUNTRIES (%)



Source: EBRD Transition Report, October, 1994

What is needed is a long-term strategy and the development of a tax policy designed to create investment, stimulate economic growth, and ultimately, increase tax revenues. A result of the current policy is, because of limited access to capital, most SME investment is financed with retained earnings. However, this limited mechanism is further inhibited by high tax levels on accumulated retained earnings. The only alternative for SME investment is therefore investment credit which is very difficult to access in today's environment.

Constraints and Reforms in the Banking Sector

Passage of amendments to the Corporate Income Tax Act in May 1994 allows banks somewhat wider latitude in deducting loan write-offs on their income statements. Previously, only a small portion of the banks' accounting adjustments for write-offs and provisions against doubtful or uncollectible loans were recognized by the MOF as valid for tax purposes. Specifically, tax deductions for non-performing loans were allowable only when documents announcing bankruptcy or liquidation proved that borrowers were no longer capable of repaying their debt, or when bailiff documents were issued which confirmed the lost credit. The reserves placed against these non-performing loans were not eligible for tax deductions until the loan was actually written-off [39]. The new 1994 law makes it possible to write off debts based on the issuance of a broader set of court documents (issued either as part of the court bankruptcy procedure, the bailiff procedure, and/or the conciliatory agreement procedure) which either confirm, or establish strong probability of, a debt's unrecoverability.

[39] See Polish Tax Law, section Income Tax of Legal Persons. 15 February 1992. Dziennik Ustaw Nr. 21 as amended 1993.

Despite this progress, however, important constraints remain:

- Tax deductibility of loan loss reserves in Poland is still greatly restricted as a significant portion of the provisioning required for lesser quality loans cannot be deducted as a business expense on the Income Statement.

1. The reserve for loan losses is created and divided into three parts as follows:

    - a minimum of 20% of loans considered "below standard"
    - a minimum of 50% of loans considered "doubtful"
    - 100% of loans considered "lost" or unrecoverable

    The basis for tax deductibility of the component of reserve for problem loans classified as "lost" continues to be document-driven, which is regarded as a complicated, time-consuming and costly process. Furthermore, the first two parts of the reserve ("below standard" and "doubtful") are not deductible at all, which means that the banks are effectively paying tax on these non-deductible reserves at the current tax rate of 40%. In the consolidated balance sheet of Polish banks, over 40% of the total reserve is classified as either "below standard" or "doubtful". Coupled with the difficulties in writing off loans classified as "lost", this suggests that banks are paying taxes on a substantial part of the total outstanding loan loss reserve.

2. The classification procedure for loan loss reserves is somewhat inflexible. In addition to being able to deduct the portion of allocated reserves classified as "lost" (if it can be proven that these loans are unrecoverable), banks may create a tax-deductible "unallocated" risk fund to cover loan losses, but only up to a maximum of 1% of the average amount of unpaid credits and loans outstanding at the end of each quarter of the accounting year. In comparison with the banking sectors of other countries, this percentage is viewed as low. A prudent level of unallocated reserves has therefore not been made available to Polish banks to set aside as a tax-deductible allowance for doubtful loans.

    The process of creating "allocated" reserves tends to be more complicated, is more difficult to change, and, given the specific limits which have been established for each category, can be restrictive. Creating unallocated reserves is perceived as less rigid and can be a reasonably accurate reflection of the quality of a bank's loan portfolio.

3. The interpretation of the definition of "doubtful loans" is considered restrictive. Provisioning in the amount of at least 50% must be made for all loans classified as doubtful, which, according to the NBP definition, includes "obligations of debtors whose economic and financial situation has deteriorated significantly". Interpretation of this definition tends to include both unforeseeable losses and calculated losses, the latter of which may reflect a deliberate and economically viable strategy of accepting losses in a

given period of time. A financial strategy deliberately projecting a short term loss can often be an element of a business's long term investment strategy.[40]

The Union of Polish Banks and other groups maintain that this strict interpretation of the definition of doubtful loans, plus the fact that all such provisions are taxable, is reducing the incentive for banks to make long term investment loans.

OTHER PUBLIC POLICY ISSUES

Privatization

From a peak of about 8,500 state-owned enterprises (SOEs) in 1989, there are still over 5,000 remaining, the majority of which are SMEs. The contribution of SOEs to sales and to employment exceeds 40% in a number of sectors and they are still dominant in heavy industry. The relatively poor performance of SOEs (mostly due to losses in large firms) is a drain on the economy and the national budget: while employing between 15-20% of the industrial labor force, they have accounted for about 45% of total losses in the economy during the last two years.[41]

The privatization of individual companies has slowed in the past 18 months due to conflicting public signals regarding the role of privatization in the economy. A decision was made not to proceed with presentation of the proposed law under the Enterprise Pact in relation to compulsory enterprise transformation. The Mass Privatization Program, which will help develop the capital markets and provide new avenues for financial intermediation, was delayed for three years and is only now being implemented, and on a smaller scale than originally anticipated.

The GOP is also emphasizing the commercialization of SOEs. This process is normally considered to be a first step towards privatization but there is some concern that the final step in many cases may never take place, particularly as there will be no time limit for privatization after commercialization. By converting SOEs into joint stock companies subject to the commercial code, commercialization does have the advantage of avoiding the need for a worker's council and such companies will no longer be subject to the excessive wage tax[42] and will presumably be run on free market principles. Nevertheless the GOP, via the Treasury, will retain ownership of these companies and make the decision as to when and how to privatize, subjecting the process to political intervention.

Implementation of the government's privatization strategy will have a significant effect on the financial sector. First, new private sector companies will seek equity investment and bank financing as part of restructuring programs. Second, finalization and passage of a Reprivatization Law will help clarify and thus stabilize ownership rights of property.

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40 "Companies with Foreign Shareholding Need Stable Environment", Zycie Gospodarcze No. 51, December 18, 1994, p. 17

41 Poland: Growth with Equity Policies for the 1990s, op. cit.

42 The Excessive Wage Tax is a tax imposed on SOEs that grant wage increases in excess of Government guidelines.

Privatization of Polish Banks

Privatization of State-owned banks is an important element of the sector's structural reform and of the country's economic transition because of the current dominance of the State-owned banking sector. Independent banks are more likely to allocate capital more efficiently than those controlled by the government, similarly the overall level of political involvement in the financial sector will be reduced as banks' independence will not be compromised by the State Treasury's ownership of shares. The potential involvement of a foreign strategic investor, best achieved in a private banking system, brings know-how and market experience. The acceleration of the privatization process through the Mass Privatization Program will put pressure on the financial markets to the extent that a state-controlled banking sector may be less effective in providing needed finance for large numbers of enterprises undergoing post-privatization restructuring.

Foreign Investment

Foreign investment not only contributes significant capital to the financial sector but also provides numerous indirect benefits to SMEs. By bringing needed technology and skills, foreign investment establishes new standards of quality and performance and places the same high demands on suppliers. Often smaller companies provide supporting products or services to larger ventures. This can have important trickle-down economic effects.

Limited domestic savings and investment capital make it necessary for Poland to seek foreign investment as a financial vehicle for further economic development. Although the pace of foreign investment has increased in the last two years, total investment lags behind that of several other former socialist countries, notably Hungary and the Czech Republic. To date Poland has attracted only 7% of all foreign investment in the Central European region.[43] Although there are listed over 16,000 companies with foreign capital involvement, only 1.5% have invested more than $1 million. The top 220 foreign investors in Poland have been responsible for 70% of all foreign capital invested in Poland over the last four years.[44]

Reasons for this situation, according to foreign investors, include an inconsistent and unstable legal framework, constantly changing customs regulations, high taxes and constraints on the acquisition of real estate by foreign entities.[45] Other barriers include restrictions on borrowing from foreign lenders and on foreigners placing time deposits with Polish banks.

Successful debt reduction negotiations recently concluded with the London Club of creditors should help to increase and diversify the flow of foreign investment to Poland. A recent review of investment in Poland points to the next wave focusing on post-privatization acquisitions. Much of this activity could center around the SME sector.

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43 European Bank for Reconstruction and Development (EBRD): Transition Report, October 1994.

44 Fundamental Facts, Figures and Regulations, State Foreign Investment Agency (PAIZ), 1994.

45 Nowa Europa No. 193, October 5, 1994, p. 3

The "Gray" Economy

Although beyond the scope of this study, another important issue needing further attention and analysis is the continuing growth of the "gray" economy, estimated to comprise between 20%-30% of GDP (with illegal incomes alone comprising over 8% of GDP[46]). This indicates that the tax system requires additional reform and stronger enforcement. Much of this activity is the result of tax avoidance by entrepreneurs who believe current taxes (including VAT, social insurance, customs and duty, corporate and individual) are extremely burdensome. A liberalization of current tax requirements would benefit the GOP through greater tax revenues from businesses that, in a changed tax environment, may be encouraged to legalize their operations.[47]

Losses resulting from illegal economic activity are believed to total 340 trillion zloty ($15 billion USD) per year. It is believed that legally registered businesses moonlighting by smuggling and stating lower-than-real sales and incomes and forging invoices account for as much as 70% of total illegal turnover. Other activities include unreported sales by unregistered businesses and individuals and transactions between the private and public sector. Related tax offenses include inaccurate tax reporting, failure to report a taxable business, failure to keep records for tax purposes, and failure to meet tax liabilities. In 1993 tax officers inspected the financial records of nearly 150,000 private businesses to discover that nearly 40% of these firms failed to comply with binding regulations and standards. Establishing economically and personally interconnected companies benefitting from tax exemptions is common, as is manipulation of VAT refunds. Real losses from border and customs offenses alone are estimated at more than $5 billion.[48]

Institutions forecasting economic trends believe that the Polish gray economy will grow at a rate of about 10-15% per year, with foregone revenue for the budget exceeding the combined budgets of several key ministries including health, education and social welfare.

The loss of tax receipts, the resulting lower budget revenue, and the distortions introduced into social spending policies that frequently result in financing people with hidden incomes are all related to this on-going dilemma. Gray market activities also represent a significant competitive advantage to unregistered entrepreneurs, damaging the efficiency of registered SMEs, and deforming the image of real economic progress.

The gray economy is connected with an enormous range of laws and regulations. It is a reflection of attitudes and behaviors towards the government's policies perceived as constraints to private business development. The magnitude of the gray market is also a result of the difficulties associated with managing the rapid burst of economic growth in Poland over the last few years.

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46 Study carried out by Gdańsk Market Economy Studies Institute, 1994.

47 For more detail see "Taxation in View of Small and Medium Enterprises Development". Working Paper. Sygma Co.Ltd. Wroclaw 1994. Pages 95-6.

48 "Black Business: A Second Poland", Wprost No. 45, November 6, 1994, p.16.

Macroeconomic Issues

As with the gray economy, macroeconomic reform and the control and alteration of macroeconomic indicators are beyond the scope of this study. However, we have decided to review briefly selected aspects of the macroeconomic framework, as they are vital elements in the country's economic transition; the most notable being deficit spending, inflation, and interest rates.

While inflation has continued to decline from 600% in 1989 to about 30% in 1994 (with a forecast of under 20% for 1995) and the threat of hyper-inflation seems to have disappeared, it has been a major reason for the lack of long-term credit. The inherently greater difficulties of making progress down a descending inflation path will make 1995 a pivotal year for this macroeconomic indicator. Upward pressure on interest rates continues as a tool to control inflation but also reflects the NBP's high, non-interest bearing reserve requirements for zloty deposits (and low reserve requirements for foreign currency deposits).

Recent trends point toward gradual change; the level of required reserves on zloty demand deposits has declined from 23% to 19% in the past year, while banks have been given more flexibility to settle their reserve positions (on an average monthly basis, rather than a daily basis, as before). These factors should put downward pressure on interest rates and reduce the opportunity cost of holding mandatory reserves. The NBP's policy of gradually reducing the crawling peg devaluation rate of the zloty to maintain at least the real value of the domestic currency should help discourage the shift towards dollar-denominated bank deposits.

Parliament has passed an ambitious economic development program, A Strategy for Poland, calling for reduced government spending and a commitment to lowering inflation to under 10% by 1997. The government's strategy will rely on domestic investment and exports to stimulate growth. This in turn raises the critical issue of savings mobilization, being advocated by the government in a number of ways in an environment where attitudes towards saving remain inconsistent and fragile.

SUMMARY

In this chapter we have presented the reader with a selection of laws and regulations which detrimentally affect SME development. Some require minor amendment or modernization (Bankruptcy Law and the law related to real estate collateral), some need to be more completely overhauled given changing economic structures (Banking Law, including the sections relating to secrecy), while other laws need to be created (Collateral Law dealing with the lien registry).

We have also reviewed certain regulatory limitations affecting the development of second-tier financial institutions, the degree of competition in the banking sector as well as fiscal policies directly inhibiting the banks themselves.

Some of these constraints are being addressed currently by the relevant public sector institutions. The authors argue that these reform efforts must be continued and eventually expanded to include the other key issues described in this section of the report.

SHORT-TERM ACTION PLAN

INTRODUCTION

This section addresses the most immediate policy constraints to further developing the relationship between the banking sector and small business. Although many ministries and government institutions have a stake in and are involved with policy reform, the majority of recommended actions contained in this report fall within the scope of the MOF and the NBP. In several cases the issue to be resolved involves both legal and regulatory reform. Given that regulation is typically based upon the legal code, we have included, where unclear, such issues under legal reform.

- The issue:

  One of the key elements inhibiting the restructuring and further growth of the rapidly developing private sector, particularly SMEs, is the fact that their short- and long-term credit and investment requirements are not being met by financial institutions. Although a multitude of social, economic and political reasons can be cited, one of the prime reasons for this is the lack of a clear, concise and consistent government and NBP policy framework encouraging greater access to funds by SMEs, and at the same time reducing the inherent risk factor for all parties.

- Primary objectives to be achieved:

  - To increase SME access to capital
  - To reduce the risks to banks of lending to SMEs
  - To lower the costs to SMEs and financial institutions in doing business together

- Action to be taken:

  - Implementation of recommendations focusing on reforms having a measurable impact over the next 12 months and which directly address the objectives stated above.

RECOMMENDATIONS

Legal Reform

Although the reform process is well underway there remain significant legal impediments to full development of an open economy financial system as well as a number of legal barriers to SME lending. These include the absence of a Collateral Law, major deficiencies in Bankruptcy Law, restrictive laws relating to bank secrecy, and a lack of clarity and consistency between the Banking Law and other legislation.

Recommended Action

1. Enactment of a new collateral law to establish a systematic basis for collateralizing loans or registering mortgages and liens. Specific elements:

    - Create a central registry to determine collateral status of a pledged asset
    - Clarify real estate property title records
    - Enable creditors to place a floating lien that covers an entire company's operations
    - Reassess the order of claimant priority more in favor of secured creditors and unsecured banks
    - Expedite and simplify the lien execution process

2. Enactment of a new bankruptcy law to:

    - Expedite and simplify the bankruptcy process
    - Establish permanent mechanisms to ensure order of claimants' precedence and protection of creditors' interests
    - Encourage active participation of non-bank creditors
    - Establish penalties for borrowers found guilty of fraudulent dissipation of assets resulting in bankruptcy to avoid repayment of debt
    - Clarify the role of court-appointed trustees in the bankruptcy process

3. Improve and expand access to and utilization of information:

    - Revise and modernize the Banking Law related to secrecy, specifically by expanding Article 48 in the existing Banking Law to allow banks to provide a wider range of information to a greater number of organizations. This will encourage the creation of credit rating and risk assessment agencies and the development of a wider and more credible information base to be shared between financial and other institutions.

- Develop a more complete and effective system of business registration to include greater monitoring and stronger enforcement of financial information required from private business entities.

- Require Polish courts to make more accessible to the public their verdicts on the wide range of economic and financially-related cases over which they preside.

4. Continuous review of the Banking Law to ensure that it is amended in accordance with the evolving financial sector. This includes:

- Revise current legislation to provide the framework for the creation of new financial institutions, including second-tier or "para-banking" financial institutions, including cooperative savings institutions.

- Change the Banking Law and eliminate conflicts between the Banking Law and the Civil Code to:

  — More clearly define and distinguish between banking and non-banking activities. Revise Article 11 of the current Banking Law which presently uses both the terms "poręczenie" and "gwarancji" to classify bank guarantees as a banking activity, in order to eliminate conflict with the civil code in which the term "poręczenie" is also found.

  — More clearly define acceptable vehicles of credit and financial intermediation activity.

- Amend, revise and modernize the Banking Law, Taxation Law and Commercial Code to allow for consolidation of the banking sector by providing a precise and consistent definition of bank holding entities, the conditions under which they may be established, and their operating guidelines.

5. Create a separate legal category for, and clear definition of, non-profit institutions.

Regulatory Reform

An unclear regulatory environment is limiting the growth, development and acceptance of second-tier financial institutions, which typically are the implementors of SME-related financial instruments such as loan guarantee funds. The current NBP tendency to withhold approval of foreign bank licensing applications to establish operations in Poland, designed to encourage strategic foreign investment in existing Polish banks, is limiting competition in the sector. There has also been no new licensing of specialized domestic banks which could deepen the sector by providing specific products and services to private business.

Recommended Action

1. Clarify the regulatory environment under which second-tier financial institutions are allowed to operate, and SME financial instruments can be introduced. Establish specific regulations referred to in Article 111 of the existing Banking Law (see Appendix III) governing the functioning of such institutions.

2. Establish the institutional framework for new non-bank financial institutions and to supervise their activities.

3. Amend the bank licensing policy to encourage the selective licensing of foreign banks and adequately capitalized domestic banks (including specialized), in order to introduce greater competition into the banking sector.

Fiscal Policy Reform in the Banking Sector

The current level of taxes is clearly a constraint to the growth and expansion of small business. The large and expanding unofficial Polish economy is also limiting the orderly and systematic development of the private sector. However, in keeping with the format of this study, concerns relating to social security and the level of corporate income tax, while justified, are beyond the scope of the paper.

Taxation policy is reducing the incentive for banks to increase long term investment lending because the tax deductibility of loan loss reserves in the Polish banking system is significantly limited and the classification procedure for this provisioning is somewhat inflexible. The restrictive interpretation of the definition of "doubtful loans" adds to this disincentive.

Recommended Action

1. Increase the tax deductibility of reserves which banks must set aside for loans classified as "below standard" and "doubtful" and make easier the ability of banks to write off reserves allocated for loans classified as "lost".

2. Allow for a prudent level of unallocated loan loss reserves to be made available to Polish banks.

3. Liberalize the interpretation of the definition of reserve requirements for "doubtful loans" to include only unforeseeable losses and not calculated or planned losses.

Direct Credit Mechanisms to Assist SMEs

Despite significant donor resources allocated to Poland over the last few years, support from the national government and from international donors for loan guarantee funds and other appropriate financial mechanisms for small business has been limited. The full range of such institutions and financial instruments has not been fully analyzed. Current programs in operation are not standardized, are often funded with limited capital, and are not universally aimed at long-term financial self-sufficiency.

Recommended Action

1. Create a working group of active organizations and committed individuals to develop and implement an overall strategy to more effectively utilize loan guarantee funds and other financial instruments aimed at SMEs in Poland.

2. Improve the coordination between and amongst governmental units and international donors in implementing loan guarantee programs, including adequate support for training of public officials, implementing institutions and banks.

CONCLUSION

Although some of the constraints and recommendations contained herein are linked to a business's scale and scope, most are equally, or nearly equally, applicable to both small and big business. Consequently, we urge the reader to consider and appreciate the broader implications of this study in the context of Poland's private sector development.

Effectively stimulating the growth and development of SMEs requires a multifaceted approach involving the interest and committment of both the public and private sectors. This study has focused on financial sector policy reform as one of several components creating an environment conducive to the formation and operation of SMEs. Additional reform is needed within the banking and SME sectors themselves. The statistics clearly indicate the rapid growth of the private sector and the immediate need for increased access to affordable capital. As such, we have not and indeed can not, prioritize or propose a specific sequence in addressing the issues. Most important is an awareness and understanding of the barriers limiting the growth and expansion of SMEs as a key "engine" of economic growth and for all institutions active in this arena to coordinate, collaborate and take concrete steps forward in resolving these constraints. In this light, the Government of Poland, in adopting a policy for small and medium-sized enterprises, is well-positioned to take the lead and act as the catalyst of reform.

The authors hope this study has been useful in clarifying the need and identifying realistic solutions for selected SME-related financial sector policy reforms. A short term focus for this study was selected due to ever changing market dynamics both within Poland and internationally. Consequently, further research, analysis and adjustment, on a regular basis, is recommended in order to continually upgrade and maintain the competitiveness of Polish SMEs at levels allowing them to compete in foreign markets, and especially in the rapidly emerging market of a united Europe.

Finally, the authors would like to thank a number of institutions, without whose assistance this study would have been impossible to complete. This includes a number of individuals from the Ministry of Industry and Trade, the Ministry of Finance, the National Bank of Poland, the United States Agency for International Development (USAID), the Cooperation Fund, Coopers and Lybrand, Agricultural Cooperative Development International (ACDI), the Union of Polish Banks, the Warsaw Institute of Banking and several Polish and international banks.

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LIST OF PERSONS INTERVIEWED

Władysław Kulczycki, Ph.D.	Advisor to the President, General Inspectorate of Banking Supervision National Bank of Poland
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The following individuals participated in a round table discussion held on December 14, 1994 at the Warsaw Institute of Banking to comment on an initial draft of this report:

Name	Position and Institution
Tom Brennan	Advisor Treasury/Bank Handlowy
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Wiesław Sendek	Director, Credit Department

	BISE	
Witold Sowilski	Director, Credit Department Kredyt Bank
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APPENDIX I

GROWTH AND DEVELOPMENT OF SMEs IN POLAND

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GROWTH AND DEVELOPMENT OF SMEs IN POLAND

A. Number of Private Firms in Poland (1982 - 1994)

YEAR	NUMBER OF PRIVATE FIRMS
1982	392,268
1983	438,224
1985	481,724
1986	500,230
1987	530,457
1988	572,451
1989	857,430
	1,201,933
1991	1,493,701
1992	1,733,127
1993	1,943,561
1994 (30.06)	2,036,254

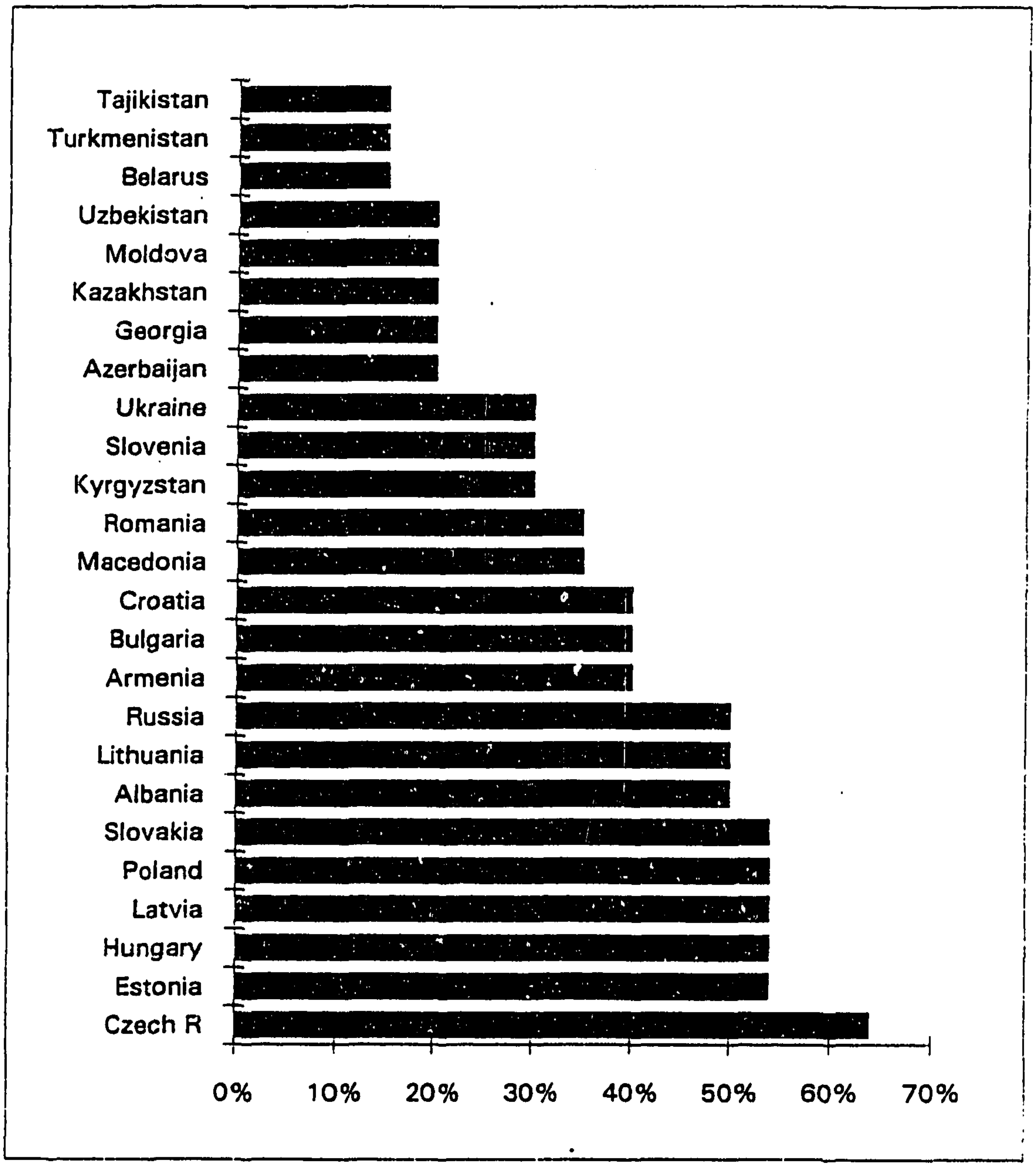
Source: GUS [1992, 1993, 1994]. Piasecki, Rogut [1993].

B. SMEs Per 1000 Inhabitants and Share of SMEs in Total Employment

COUNTRY	Number of SMEs/1000 inhabitants	The share of SMEs in total employment (%%)
Belgium	49	60-71
Denmark	33	72-80
France	35	60-71
Greece	69	81-90
Spain	53	81-90
Netherlands	28	72-80
Ireland	35	72-80
Germany	37	60-71
Portugal	59	81-90
Great Britain	46	60-71
Italy	68	81-91
European Communities - average	**49**	**72**
Poland (1993)	**48**	**50**

Source: The European [1994]; Benacek, Zemplinerova [1994]; Rocznik Statystyczny [1994].

C. **Private Sector's Share of GDP (%), Selected Countries, mid-1994**



Source: EBRD Transition Report, October, 1994.

APPENDIX II

SELECTED RESPONSES FROM SURVEY OF DYNAMIC ENTREPRENEURS IN CENTRAL EUROPE (1993-94)

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SELECTED RESPONSES FROM SURVEY OF DYNAMIC ENTREPRENEURS IN CENTRAL EUROPE (1993-94)[49]

(Sponsored by the European Venture Capital Association and the European Foundation for Entrepreneurship Research)

1/ What are the biggest problems affecting your business today? (can choose up to three options)

			CZ	HUN	POL	Slovk	Slov
0.	None	%	1	1	1	0	1
1.	Insufficient market	%	8	11	11	15	18
2.	**Insufficient finance/inability to obtain financing**	%	19	23	24	23	14
3.	Out-of-date technology	%	6	4	3	4	3
4.	Limited availability of skilled workers	%	27	8	11	5	9
5.	**Difficulties in collecting payments**	%	21	12	20	21	22
6.	Poor quality of raw material and/or other inputs	%	1	1	2	1	2
7.	Difficulties with transportation	%	0	1	0	0	1
8.	**Unfavorable government regulation**	%	12	35	25	29	23
11.	Other (specify)	%	6	3	3	3	8
12.	N/A	%	1	0	1	1	0

2/ What problems, if any, have you encountered trying to get short-term money for financing working capital and investment? (can choose more than one option)

			CZ	HUN	POL	Slovk	Slov
0.	None	%	6	2	5	4	5
1.	High interest rates	%	28	28	34	35	30
2.	Short amortization periods	%	11	2	5	8	12
3.	Costly insurance, high collateral	%	17	22	15	16	19
4.	Very time-consuming procedure	%	15	21	18	6	9
5.	Size of loans available not sufficient	%	4	7	5	13	6
6.	Bankers prefer to make larger loans	%	1	2	1	1	1
7.	Complicated application procedure	%	13	10	15	13	10
11.	Other (specify)	%	5	6	5	5	8

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49 Criteria for inclusion in this EC survey included a minimum of turnover of one million ECU in 1993 and a minimum employment of 10 persons in 1993. A total of 188 Polish companies were surveyed. Average number of employees per company in this sample was 126.

3/ **What is the most decisive factor influencing your choice of financial source (can choose up to three options)**

			CZ	HUN	POL	Slovk	Slov
0.	No investment planned	%	3	15	**8**	2	6
1.	No selection, take whatever is available	%	5	2	**8**	7	13
2.	Simple and fast application processing	%	12	8	**18**	8	15
3.	Low interest rate	%	34	30	**26**	38	21
4.	Low collateral	%	11	15	**14**	8	7
5.	Additional support of financier	%	13	7	**9**	13	6
6.	Prestige	%	3	1	**2**	3	2
7.	No loss of independence	%	19	34	**22**	19	29
11.	Other (specify)	%	4	3	**2**	4	7
12.	N/A	%	6	3	**4**	3	1

4/ **What changes in the financing environment would motivate you to increase activity, invest more or invest sooner?**

			CZ	HUN	POL	Slovk	Slov
0.	None	%	2	2	**0**	0	1
1.	Better availability of long term credit	%	34	30	**23**	34	26
2.	Better availability of short term credit	%	4	7	**5**	6	5
3.	Better availability of risk capital	%	10	12	**7**	15	8
4.	Less stringent credit conditions	%	12	14	**23**	10	23
5.	Lower interest rates	%	36	33	**39**	33	33
11.	Other (specify)	%	2	2	**2**	1	4
12.	N/A	%	3	1	**1**	0	1

5/ **What changes in the business environment would motivate you to increase activity, invest more or invest sooner?**

			CZ	HUN	POL	Slovk	Slov
0.	None	%	1	1	0	1	0
1.	Better economic outlook	%	19	24	19	22	22
2.	Higher consumption	%	16	15	18	14	16
3.	More skilled workers	%	15	3	5	1	6
4.	Better management and support	%	4	1	3	3	7
5.	**Lower taxes**	%	33	28	28	29	21
6.	**Positive changes in government regulation**	%	9	27	26	29	26
11.	Other (specify)	%	3	2	2	1	2
12.	N/A	%	2	1	1	0	0

6/ **What do you think about taxes on profit in your country?**

			CZ	HUN	POL	Slovk	Slov
0.	Too low	%	0	2	0	0	1
1.	Just right	%	13	1	6	9	21
2.	Too high	%	80	90	89	88	73
11.	Other (specify)	%	7	6	5	4	5
12.	N/A	%	1	1	1	2	0

7/ **Does the taxation law in your country stimulate reinvestment of profits?**

			CZ	HUN	POL	Slovk	Slov
0.	No	%	58	93	87	85	71
1.	Yes	%	29	4	8	9	23
11.	Other (specify)	%	13	3	5	5	7
12.	N/A	%	5	1	3	8	0

APPENDIX III

DEFINING BANKING ACTIVITIES:
A COMPARISON OF EXISTING POLISH BANKING LAW
WITH THE NEW DRAFT BANKING LAW PROPOSED BY THE NBP

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DEFINING BANKING ACTIVITIES: A COMPARISON OF EXISTING POLISH BANKING LAW WITH THE NEW DRAFT BANKING LAW PROPOSED BY THE NBP

(differences in wording and key passages have been italicized)

Part A: Definition of Banking Activities in Excerpt from Chapter 2 of Existing Banking Law

Article 11.1. Banking activities are defined as:

1) carrying bank accounts,
2) accepting savings and term deposits,
3) performing cash calculations,
4) granting and obtaining credits and cash loans,
5) undertaking chequing and bill operations,
6) accepting money in the form of deposits and depositing money in domestic and foreign banks,
7) *issuing and accepting bank guarantees (the Polish text includes both the words "gwarancji" and "poręczeń" to describe bank guarantees)*
8) trading in foreign currency [in the understanding of the Foreign Currency Act dated February 15, 1989; e.g. foreign currency (notes and coins), foreign stocks, certificates of shares, securities, cheques, letters of credit, unprocessed gold and platinum in the from of bars and coins made after 1850,] and servicing of international trade,
9) serving state/government loans,
10) * issuing securities, trading in securities and keeping deposit accounts in securities,
11) conducting commissioned activities related to the issuing of securities,
12) storing valuable objects and securities, and safety deposit service,

2. Banks are entitled to conduct the activities specified in Sections 1 and 5 within the scope determined by the statutes of these banks, excluding the provisions of Sections 3 and 5.

3. On the commission of other banks, banks may conduct specified banking activities belonging within the scope of activities of the ordering banks.

4. The banks entitled to trade in foreign currencies may purchase securities issued abroad, whose type will be defined by the President of the National Bank of Poland in agreement with the Minister of Finance. (Refer to the order of the President of the National Bank of Poland dated September 22, 1993 relating to the types of securities issued abroad which may be purchased by banks entitled to the trade in foreign currency, p. 42).

5. The activities mentioned in Section 1 may also be performed by non-banking organizational units if they were authorized by an appropriate Act to conduct these activities.

Art.111.* 1. *With the exception of Article 11 Section 5, the President of the National Bank of Poland, in agreement with the Minister of Finance, may grant permission for a commercial company to perform certain banking activities, excluding, in particular, opening saving and term deposits, issuing securities and giving bank guarantees.*

2. *The permission mentioned in Section 1 specifies in details the conditions of performing banking activities allowed by this permission.*

3. *The President of the National Bank of Poland in agreement with the Minister of Finance will define in the form of a resolution the procedure of granting permission referred to in Section 1 and supervising the implementation of banking activities allowed by this permission.*

Part B: Definition of Banking Activities in Excerpt from the Draft NBP Banking Law Proposal of December, 1994

Article 4.1 Banking Activities cover:

1/ carrying bank accounts, including savings accounts and performing cash calculations
2/ granting credits
3/ granting loans from returnable assets
4/ *issuing bank guarantees (the Polish text includes only the word "gwarancji")*
5/ issuing bank securities

2. The following activities become banking activities provided that they are conducted by banks:

1/ granting loans
2/ undertaking chequing and bill operations
3/ financial operations for specified terms
4/ buying and selling currency liabilities
5/ storing valuable objects and securities, and safety deposit service
6/ trading in currencies
7/ *issuing guarantees (the Polish text includes only the word "poręczeń")*

3. Banking activities mentioned in Section 1 may be conducted by banks according to the principles described in this Law.

APPENDIX IV

LEGAL CONSTRAINTS TO BANKING SECTOR CONSOLIDATION

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LEGAL CONSTRAINTS TO BANKING SECTOR CONSOLIDATION

PART I. Problems Regarding Bank Holding Entities

The process of bank consolidation requires review of three different categories of banks (excluding cooperative banks).

1. State Banks (example: PKO BP)

From the perspective of their legal form, state banks are the equivalent of state-owned enterprises. They are created and liquidated by order of the Council of Ministers. The establishment of any other structure is not possible. In order to change this structure a state bank has to be restructured into a single-person joint stock company owned by the State Treasury, or it has to be liquidated and re-established in the form of a joint stock company owned by the State Treasury.

2. State Banks as single-person joint stock companies owned by the State Treasury (examples: PKO SA, Bank Gdański, Bank Zachodni)

There are three legal methods to consolidate banks which are joint stock companies owned by the State Treasury:

i) By a resolution of the General Meeting of Shareholders to fuse two banks. A new legal entity is created.

ii) The General Meeting of Shareholders of one bank decides to liquidate this bank and sell its shares to another bank.

iii) Ownership of shares of one bank is assigned to another bank and treated as a Contribution-in-Kind.

The first two solutions are simple to apply (the Minister of Finance acts as the General Assembly of Shareholders). However, they do not lead to the creation of a holding entity. In the first case, a new legal entity is created out of two entities; in the second case, one entity is liquidated and then "swallowed" by another.

The third solution is made difficult by existing legal regulations. These include: (i) the need to make available to employees of the bank 20% of initial shares; (ii) the need to estimate the value of these Assets-in-Kind by auditors; and (iii) prohibition to transfer or dispose of these shares for a period of 2 years.

There are different possibilities of creating a holding structure in practice, and each has its advantages and disadvantages. However, doubts arose when four state bank -joint stock companies (Bank Zachodni, Powszechny Bank Gospodarczy, Pomorski Bank Kredytowy and Bank Depozytowo-Kredytowy) wanted to establish a holding entity. In December 1994 these banks proposed to establish "a horizontal holding" which would take over a part of the shares of the four state banks from the State Treasury. The owner of the holding would therefore have been the State Treasury, each of the four banks, and the employees' company created by the banks. The owner of the banks would therefore be the State Treasury and the holding.

The Ministry of Finance, however, does not agree with this concept because the proposed structure would create problems in the privatization process (there are no regulations dealing with privatization of such a holding). Therefore, the Ministry of Finance proposed a vertical structure in which the State Treasury would be the owner of a leading bank, and this bank would in turn be the owner of the remaining banks. This specific proposal has been included in the draft of the new Banking Law. It would eliminate complications arising from reciprocal ownership and allow the holding to be privatized. In addition, the NBP and the MOF advocate adding a provision in the regulations which would prohibit the purchase of shares in the leading bank by a dependent bank. The National Bank of Poland also recommends introducing regulations which would restrict a bank to being a member of only one holding entity (however it could buy shares of other banks).

The above mentioned problems need to be addressed through changes in the Banking Act, regulations concerning the privatization of banks, and the Commercial Code.

3. All banks in the form of joint stock companies

The Banking Act does not define the institution of holding entity or the principles of its creation. Additional restrictions are specified in Art. 35, section 1, point 2 and 3 of the Banking Act: the value of shares and contributions to other legal entities and the value of purchased shares may not exceed 25% of the bank's funds (in extraordinary situations 50%, upon the agreement of the NBP President).

Article 78 of the Banking Act imposes additional restrictions. It orders all buyers of bank shares to obtain the permission from the NBP President in the case of buying 10%, and then 20%, 33%, 50%, 66% or 75% of the shares. The decision of the NBP President is dependent on the guarantee of the purchaser to operate the bank in an appropriate way. The NBP President will refuse permission if the funds for the purchase of shares come from a loan or credit, or if they are encumbered in any other way.

PART II - Legal Inconsistencies in Polish Law

Commercial Code

The concept of holding does not exist in the Commercial Code and detailed regulations governing the operation of holding entities have not been developed, i.e. to deal with the above-mentioned example of Assets in Kind.

Act on Public Trading in Securities

The concept of "supervising entity" is defined in the Act on Public Trading in Securities and Trust Funds. According to this law, the supervising entity is an entity which has the majority of votes in another (dependent) entity. The supervising entity is entitled to appoint and dismiss a majority of members of the management board of another (dependent) entity; or, if more than half of the members of the management board of the other entity are simultaneously the members of the management board or the persons working as managers in the supervising entity or other entity submissive to the supervising entity.

Accountancy Act

The concept of holding (or capital) group and supervising entity are defined in the Accountancy Act and are compatible with EC accounting standards. It imposes on this capital group an obligation to prepare a consolidated balance sheet, an income statement, and a statement of cash flow.

Taxation Law

Taxation Law has not been adjusted to the requirements of holding and it does not provide guidelines for such a structure. The current Taxation Law requires each entity in a holding group to file separately for tax purposes. This means that enterprises in a holding group must keep one set of separate books for tax purposes and another set of records as required by the Accountancy Act. Taxation Law does not allow a holding company to offset the losses of an enterprise within the holding with the income from other members of the group, and then base taxation on this combined net income. Tax offices will calculate income tax separately for each enterprise in the holding group.

A further constraint is the taxation of dividends. The regulations of the Income Tax Act on legal persons state that incomes from dividends are not added to income obtained from other sources. Instead, dividends are subject to a 20% lump-sum tax. A taxpayer (in this case a supervising bank) may subtract this lump-sum tax on dividends from other incomes which are subject to a 40% tax rate. Thus, in practical terms, a dividend is exempt from income tax. However, this deduction of tax paid on dividends is only possible if a company also obtains income from its own activities. If it does not, which would be the case of a pure holding company, the deduction of tax paid on dividends is not possible. This is a constraint on a typical financial holding group in which the supervising unit is effectively an investment fund.

Changes which unconditionally exempt dividends obtained by a holding entity from taxation should be introduced into tax regulations concerning income tax collected from legal persons. In addition, taxation of income at the holding entity or capital group level should also be introduced to these regulations, which should encourage the establishment of investment groups, including those for venture capital.

APPENDIX V

NBP POLICY ON LOAN LOSS RESERVES

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NBP POLICY ON LOAN LOSS RESERVES

A. Excerpt from an NBP letter to Bank Presidents explaining new reserve policy

NATIONAL BANK OF POLAND

General Inspectorate of Bank Supervision

NB/ZPN/269/94
Warsaw, 1994.12.12

3. The definition of the category of a below-standard obligation included in Attachment 1 to the Order should be developed. In its present shape, the evaluation of the economic and financial situation of a debtor is not determined by financial performance. It does not mean that this measure cannot be the basic element applied to the evaluation of the repayment ability of a bank's clients. There are situations in which a financial result does not always reflect the real picture of a business entity in the short run. However in the long run, this is a basic measure of the results of its activity. Transactions with entities which do not create economic surpluses may not be recognized as risk-free, even if the service of debt is prompt.

   Such a point of view should also be applied by banks when they issue investment credits. Investment projects are by their nature high-risk projects. This risk is even higher if the investment burden leads to a negative financial result. These types of transactions must be evaluated by banks with an application of criteria different from traditional analytical instruments. However, it may not be an argument for their more liberal treatment.

B. Attachment No. 1 to the Order No. 13/94 issued by the President of NBP on December 10, 1994

<u>Classification of Obligations Towards Banks</u>

1. In evaluating the risk taken by a bank, the bank applies two independent criteria:

   (i) promptness in repayment of loan principal and interest;

   (ii) the economic and financial situation of a debtor.

2. The evaluation of economic and financial situation of a debtor should include:

   (i) objective factors, such as:
      a/ profitability
      b/ earnings capacity of capital
      c/ solvency coefficient (in the case of banks)
      d/ liquidity

e/ turnover of obligations
f/ turnover of reserves
g/ other factors

(ii) subjective factors, such as:
a/ quality of management (evaluation of managerial personnel)
b/ level of sensitivity to market fluctuations
c/ level of dependability on government subsidies, public procurement, large suppliers or customers
d/ other factors

3. Banks classify obligations (excluding interest and capitalized interest) into the following categories:

(i) Normal Obligations, including:
a/ such obligations with regard to which no failure was recorded in the repayment of loan principal or interest or when the economic and financial situation of the debtor does not raise any concern;

b/ obligations which have a guarantee of the State Treasury or the NBP, to the amount of these guarantees, regardless of the true economic and financial situation of the debtor.

(ii) Below Standard Obligations, including:
a/ obligations in which a delay in the repayment of principal or interest is longer than 1 month and shorter than 3 months;

b/ obligations of debtors, whose economic and financial situation may pose threat to the prompt repayment of a debt.

(iii) Doubtful Obligations, including:
a/ obligations in which a delay in repayment of principal or interest is longer than 3 months and shorter than 6 months;

b/ obligations of debtors, whose economic and financial situation has deteriorated significantly, especially when debtors' losses affect a statutory fund, equity or initial capital, or a capital fund.

(iv) Lost Obligations, including:
a/ obligations in which a delay in repayment of principal or interest has been longer than 6 months;

b/ obligations of debtors against which bankruptcy or liquidation procedure has been instituted, (apart from the liquidation by privatization of state-owned enterprises);

c/ obligations of debtors against which a bank has filed a motion to institute executive proceedings or when it has begun to take over a deposit pledged as collateral;

d/ obligations questioned by debtors in the course of legal proceedings;

e/ obligations of debtors whose place of living is unknown and whose property has not been revealed;

f/ obligations of debtors, whose economic and financial situation has deteriorated irreversibly, making the repayment of debt impossible.

4. Obligations of a debtor, including the debts whose conditions of repayment have been changed after signing new agreements, can be transferred to a lower-risk category after the debtor obtains full credit ability measured by the criteria applied by the bank and indicated in Section 2, however not earlier than:

(i) 3 months after termination of a debt service (repayment of capital installments and interest) in case of doubtful obligations or obligations classified in this category before signing a new agreement;

(ii) 3 months after termination of a debt service (repayment of capital installments and interest) in case of lost obligations or obligations classified in this category before signing a new agreement; in both cases such obligations may be transferred only to the category of doubtful debts.

APPENDIX VI

BANKING SECTOR DEVELOPMENT: SELECTED ISSUES

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BANKING SECTOR DEVELOPMENT: SELECTED ISSUES

There are a number of internal issues affecting the banking sector's growth and development. While not the main focus of this paper, the following is a review of some of the more important of these internal issues.

Lending Policy

Although loans as a percentage of total banking system assets declined in 1993, the beginning of change in lending behavior is perceptible. Signs of competition among the banks for creditworthy industrial borrowers are becoming more evident, including a reduction in some cases of commercial bank interest rates to the NBP refinance rate. Some banks appear to be responding to the demands of a market economy in the form of pricing for risk; interest rate differentials for high and low risk loans have exceeded 15 percentage points.

There are also indications of change on the part of borrowers. This was confirmed in a recent interview with the President of the Polish Development Bank who stated that "entrepreneurs are becoming increasingly mature. The people who apply for credit today adopt a totally different approach than those who visited us in 1991. They are people who realize their own weaknesses and try to eliminate them. I think they have learned how to cooperate with banks; this cooperation between banks and customers is gradually being normalized".[50]

Despite these positive trends, however, banks have been extremely reluctant to lend to SMEs. Banks maintain a strong perception that many entrepreneurs are still inexperienced and unreliable. SMEs counter with the argument that banks are not adequately serving existing customers or actively searching for potentially attractive new borrowers. Common complaints include slow transfer of funds, a lengthy credit decision process, and inadequate customer service. There is limited evidence that this fundamental divergence in opinion between banks and SMEs is narrowing.

Lending policy is the bank's strategic cornerstone. It defines the type of business in which the bank will involve itself and establishes guidelines for prudent business practices. A number of Polish banks do not emphasize portfolio diversification or institute guidelines for judicious lending practices, concentrating instead on how to retain risk-free assets and to focus, where possible, on the largest and most creditworthy of clients. This is despite a study which classifies only about 40,000 of the 2 million legal entities in Poland as medium or large, with many indicators that their number will not grow.[51] Polish banks demand high collateral because they feel that in the current business environment it is impossible to properly assess lending risks. While difficulty in obtaining information on potential customers complicates the credit analyst's job, a number of banks are using collateral more as a substitute for credit and cash flow analysis rather than a last resort means of collection. The problem becomes even more acute since bank

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50 Privatization Update, February 1994, pg.16

51 "To Understand a Partner", Rzeczpospolita No. 283, December 6, 1994.

branches are frequently allowed to operate on a relatively autonomous basis, developing their own policies and procedures.

Bank Training and Educational Efforts

In many banks there remain a number of senior officials whose training and experience is based on policies, practices, and procedures developed under central planning, and who are less familiar with strategic planning, marketing, and human resource development. They are learning to adjust to the demands of the free market but this adjustment will take time. In the interim, and from the standpoint of SME development, there is a need to increase training activities, particularly at the level of lending policy, analysis, and procedures, and, as demand justifies, a greater focus on the more subtle elements unique to SME lending, such as cash flow and project analysis, and customer service. Also important is the need to adapt internal procedures to better service small business clients.

Technical assistance and training are fundamental building blocks upon which to construct an efficient and effective financial sector. Certain institutionalized skills resulting from these efforts are essential in a free market economy.

Poland's financial sector's experience in free market operations is relatively limited, averaging only 3.5 years per person in the banking sector. The sheer scale of the challenge may be best reflected by the increase in the number of Polish bankers, from 40,000 in 1989 to over 150,000 by 1993.[52] It is also likely that the numbers of bank employees will continue to grow if the ratio of bank staff to population is compared with other EC countries (Table 8). Relatively inexperienced seniors are therefore providing "on-the-job-training" to increasing numbers of new employees, imposing a further strain on training resources. In comparison, Western financial institutions have the benefit of established training programs and the service of senior personnel with decades of experience.

Internal bank training programs have been challenged to adjust their curriculums and find experienced trainers skilled in free market banking. Only in the last four years have specialized schools for banking and finance begun training Polish bankers. Since 1990, multilateral and bilateral assistance has been contributed for bank training and financial sector development by USAID, the Polish-American Enterprise Fund, the British Know How Fund, the United Nations Development Program and others. The World Bank has organized a "twinning" arrangement program with seven of the original nine Polish State-owned commercial banks and experienced Western banks in order to transfer banking skills over a 3-year period. It is hoped that more lasting business relationships will result, including possible equity participation by the twinning partners.

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52 Progress and Strategy Paper: Banking. EC PHARE, 1994.

TABLE 8: BANKING STAFF IN SELECTED COUNTRIES
(1993 figures)

Country	Banking Staff	Population (million)	Ratio (population/banking staff)
Romania	40,000	23.0	575
Czech Republic	48,000	10.3	215
Poland	**150,000**	**39.0**	**260**
Slovenia	7,000	1.9	271
Slovak Republic	18,000	5.2	288
Latvia	4,000	2.7	675
Denmark	50,000	5.1	102
Italy	333,000	57.2	171

Source: Progress and Strategy Paper: Banking. EC PHARE, 1994.

The World Bank's support for financial restructuring is contingent in part on training to support NBP supervisory capabilities. The Peace Corps has placed volunteers with business backgrounds at grass roots levels to assist the business and banking community in its development and has organized successful seminars through the American Bankers Association covering a wide variety of topics.

These and other efforts have encouraged many banks to recognize their weak areas and to request more specific assistance. The placing by USAID-funded Citizen's Democracy Corps of several consultants in one of the larger private banks was designed to analyze and make recommendations in specific departments as opposed to utilizing assistance for general bank operations.

SME lending skills are only just being introduced as a topic into the curricula of training schools. There is a considerable time lag between the identification of a training need, the direct participation of a bank in an appropriate training vehicle to address the need, and being in a position to measure the bottom-line results of this effort. It is important, therefore, that the skills typically associated with SME lending become a training priority for the banking sector in the near future.

The most important element in more effectively utilizing training will be the commitment of banks to develop their own in-house training capacity. Banks need to view training more as part of human resource development generally, rather than as an isolated operation which sends trainees to courses often on basis of availability rather than suitability. Training must be consistent with banks' internal strategies and significant resources be allocated to it. In the final analysis, training must be viewed as an investment in people which will improve bottom line performance.

Financial Resources

The ability of a traditional retail bank to lend money in an open market is based upon its ability to attract a substantial deposit base. In Poland, where many depositors are hesitant to deposit in local currency, foreign currency deposits make up 49% of the household deposit base and about 1/3 of the total deposit base (Table 9). In 1993 zloty deposits declined in real terms while foreign currency deposits increased 15% and remained popular in 1994 despite declining profitability.[53] When depositors do place their money in banks, it is generally with one of the seven commercialized banks since their deposits are guaranteed by the State Treasury. There is a tremendous psychological comfort associated with depositing funds in these well-known institutions. The result, however, is that Treasury-owned banks currently control the vast majority of all banking assets.

TABLE 9 POLAND - MONETARY AGGREGATES (Trillions of Polish Zloty)

	1990	1991 1/	1991 2/	1992	1993
Zloty Money	130.8	215.5	192.7	309.2	398.3
(real % increase)	42.1	2.7	-8.1	11.2	-6.4
Currency	39.3	56.4	56.4	78.0	99.8
(real % increase)	14.0	-10.7	-10.7	-4.1	-7.0
Bank Deposits in Zloty	91.4	159.1	**136.3**	**231.2**	**298.5**
(real % increase)	58.9	8.5	-7.0	17.5	-6.2
Firms	58.7	71.8	...	109.5	128.6
(real % increase)	100.2	-23.7	...	5.7	-14.7
Households	32.8	87.4	...	121.7	169.9
(real % increase)	17.4	66.2	...	-3.5	1.5
Foreign Exchange Deposits	59.8	65.4	**64.3**	**101.9**	**160.9**
(real % increase)	-75.4	-31.8	-32.9	9.8	14.7
Firms	4.1	2.6	...	3.6	4.1
(real % increase)	-94.8	-50.5	...	-22.5	-18.1
Households	55.7	62.8	...	98.3	156.8
(real % increase)	-52.3	-30.4	...	9.5	15.9

1/ former NBP methodology 2/ recent NBP methodology
Sources: NBP, World Bank calculations

[53] Annual Statistics 1994, Central Office of Statistics, Warsaw.

The newly-commercialized and privatized banks also appear to be seeking to expand their traditionally low deposit bases at the expense of State-owned specialized savings banks. For deposits at any maturity there is now a larger spread of interest rate offers.

Encouraging is the recently passed Deposit Insurance Law which will extend guarantee coverage to a significant percentage of the deposit base in private banks, The deposit insurance bill, scheduled to come into force in February 1995, would formally extend deposit insurance to all banks but limit the liability. The bill proposes 100% insurance for private persons on accounts up to 1000 ECU, with smaller levels of insurance on larger accounts. Approximately 50% of deposits by value would be so covered. Funded by the banking system, the NBP and the government, the required reserve level on zloty demand deposits has been lowered an additional percentage point as compensation for the banks' share of the funding.

In the Western bank environment, there are a number of sources for increasing a bank's funds position. These include the money market, the secondary market and the interbank market. These markets are sophisticated, on-line possibilities for financial intermediaries. In Poland, these markets exist only in basic form.

Western marketing techniques to develop a stable deposit base and support long-term lending are relatively unknown in Poland. In spite of the trend in some banks to increase their deposit bases, the implementation of active marketing programs is recommended. Despite a real increase in household savings over the last year, recent surveys show 75% of the population believing that saving will not be possible in 1994,[54] with nearly 60% of Poles believing that there is no point in saving money in general.[55] This high disregard for savings could undermine recovery if it manifests itself in a long-term depletion of reserves needed for investment.

Management Information Systems, Computerization and Technology

The effectiveness of a banking system rests on its ability to quickly and accurately process information. This places heavy reliance on computerization, telecommunications, and information processing technology.

The general lack of automation and advanced systems in the Polish banking system has created problems for many enterprises. Most use the inter-bank payment system to satisfy debt obligations. This system not only is fraught with administrative difficulties (for businesses and banks alike) but also creates cash flow problems for firms. As an alternative to the inter-bank payment system, many businesses settle their obligations in cash. Check payment systems are still not popularly used.

Without necessary computer systems and networks, the NBP is unable to adequately

monitor and supervise the Polish financial system. In addition to the NBP, Polish banks themselves are often not computerized. Many of the banks are still processing information and preparing financial data manually.

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54 "How Much Money Under the Mattress?", Rzeczpospolita No. 264, November 14, 1994, p.1

55 "Polish News", Central European Business Weekly, October 28 - November 3, 1994, p. 5.

As of July of 1994, banks have been making settlements through the National Clearing House (KIR), thus making it possible for weaker banks to use money currently tied up in the Central Bank. Prior to this date some banks carried out mutual settlements through the NBP and some through the KIR, the latter being considerably more efficient. At present, settlements are made through a system based on the exchange of documents between bank branches and regional KIR chambers using a special bank post. Ultimately, the carriers and paper documents will be replaced by the Elixir system based on the transmission of data through telecommunications equipment. This system is now used by 12 banks.

Bank Services and Products

Due to the added risk and higher transaction costs of smaller loans, many bankers decline lending to start-up enterprises or offer short term credit with restrictions that most SMEs cannot meet; many good credit applications are routinely rejected even before undertaking serious analysis. However, as competition intensifies in the financial markets, banks will be encouraged to develop other sophisticated services to meet the needs of their SME communities.

In the long term a wide range of services and financial products can result in increased bank profitability. Developing long term customer relationships that will generate interest and commission income over time (and investing in the skills necessary to bring those relationships about) will have a much greater impact on profitability than the interest earned on government paper. This includes introducing many of the more sophisticated services available in most Western countries. Credit services to a large degree are limited to short/medium term loans and guarantees to other banks. Export Letters of Credit generally must be collateralized with cash except for the most credit-worthy. Asset-based lending is also limited. The market does not have the issuance or digestive capabilities for asset-backed security instruments. Factoring facilities and Cash Management and Lock-Box services are also limited.

SMEs would not presently qualify for a number of these services, which, when introduced, will meet the needs of larger enterprises. However, this would then presumably create "trickle-down" demand from growing SMEs that would eventually qualify.

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Financial Assistance to Microenterprise Section:

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*5. "Monetary Incentive Schemes for Staff." Katherine Stearns, ACCION International. April 1993. $3.80. Also available in Spanish and in French.

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*2. "Facilitator's Guide for Training in Subsector Analysis." Marshall A. Bear, Cathy Gibbons, Steven J. Haggblade, and Nick Ritchie. December 1992. $35.00. Also available in Spanish and in French.

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Field Research Section:

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Special Publications:

*1. "GEMINI in a Nutshell: Abstracts of Selected Publications." Compiled by Eugenia Carey and Michael McCord. Special Publication No. 1. 1993. $10.00

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