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An Assessment and Rating of The Polish Banking System

The United States Agency for International Development
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By
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I Introduction

The following assessment of the Polish banking system has been produced under contract to the United States Agency for International Development/ENI/PER by Michael Borish and Company, Inc with support from Triumph Technologies, Incorporated Michael Borish and Company, Inc would like to thank Jean Lange of USAID/ENI/PER, and Vicki Peterson of USAID in Poland for their kind support and guidance Michael Borish visited Poland from April 21-24, 1998 in conjunction with this project

II Methodology of the Rating System

The rating system utilized to assess the banking sector of Poland is based on a review of more than 200 issues and topics that have been used to construct a diagnostic methodology for the review of banking systems This tool will be utilized by USAID in other parts of "transition Europe," and is applicable to virtually all banking sectors in the world

In its simplest form, the rating system is focused on four general areas of activity—based on 28 "sub-categories," and subject to five general classifications The activities and sub-categories are included below

USAID/ENI/PER Banking Sector Rating System Activities	
General Areas of Activity	***Sub-Categories***
• ***Financial Sector Infrastructure***	• General policy and system • Legal framework • Regulatory and supervisory capacity • Payments systems • Accounting framework • Rating agencies • Financial media • Professional associations • Academic institutions • Miscellaneous areas relevant to financial sector infrastructure—telecommunications postal, safekeeping
• ***Economic Factors and Indicators***	• General trends • Private sector development issues • Monetary and related savings and credit matters • Fiscal considerations • Exchange rates • Balance of payments issues
• ***Banking Structure and System Profile***	• Overview of the system and financial measures • Profile of ownership structures • Governance and management issues • Non-bank competition
• ***Banking Sector Development Based on Prudential Norms***	• Capital adequacy • Asset quality • Management capacity • Earnings • Liquidity • Operating environment • Transparency and disclosure • Sensitivity to market risks

The following classifications are utilized to provide a scoring for the individual issues assessed, as well as in developing a composite rating for the banking sector as a whole Annex 1 provides greater descriptive detail about how the ratings apply by sub-category

	USAID/ENI/PER Banking Sector Rating System Scoring Description
5	Outstanding world class state of-the art best practices virtually no serious systemic risks
4	Solid strong satisfactory competitive few systemic risks or problems and those are manageable
3	Adequate favorable trend improvement needed potential for major systemic risks
2	Inadequate weak significant improvements needed major potential for destabilization via systemic risks
1	Dismal monopolist resistant to competition and change no confidence widespread corruption weak institutions

No effort has been made to weight individual variables, or to quantify ratings along mathematical lines Rather, 28 major sub-categories of the four main groupings were all rated within the five-point rating system, with allowances for pluses and minuses in the event that the direct numerical classification did not fully match with performance The evaluation is both qualitative based on trends and assessments, and quantitative to the extent the figures are useful and meaningful In general, the information available in Poland was sufficient to form a judgment on the banking sector However, there are certain inconveniences associated with the timing of the exercise or the completeness of data These include (i) annual reports and general financial data on a per bank basis for 1997 were not yet prepared by the time of the assessment—only a limited amount of openly disclosed financial information was available on balance sheets and income statements, and this was prior to the release of audited statements, (ii) while indicators from the National Bank of Poland provide a broad overview of annual results with a significant amount of useful information on an aggregate and segmented basis, information on individual banks and their portfolios is not included, and (iii) IMF statistics on the banking system are generally available only through end-1996

III The Poland Rating

The composite score awarded Poland was **3/3+**, which generally reflects Poland's improving legal and regulatory structure, reasonably strong macroeconomic fundamentals, increasing privatization in the banking sector, rising foreign investment from prime-rated institutions in the financial sector, promising capital markets, and growing recognition of the need for strengthened risk management systems as the market opens up to intensified competition in financial services and most economic activities Ratings would be higher if Poland had more judicial capacity for faster dispute resolution, fewer troubled companies in heavy industry and financial services, increased capital in the banking sector, more favorable earnings trends and liquidity in the banking sector, proven management and governance as market integration accelerates, and more listings in the capital markets Overall, the outlook for Poland should be viewed as favorable assuming there is sustained progress towards macroeconomic stabilization, large-scale privatization, and general entry conditions for accession to the European Union Thus, as of mid-1998, the assessment of the Polish banking system is as follows

The Polish Banking System—Summer, 1998	Composite Score 3/3+

The Polish banking system has pursued steady restructuring since 1993, but it is only now beginning to show more rapid momentum towards post-stabilization competition After a tumultuous beginning in the early 1990s, Poland focused on the turnaround of its commercial and specialized banks and the development of its supervisory capacity for safe banking, all in support of a more stable monetary policy and macroeconomic framework Great progress has been made in this direction, along with an improved legal framework for financial services and growing institutional capacity Meanwhile, the economy is in its fourth year of real GDP growth exceeding 5 percent powered by the most dynamic private sector in the region a sound monetary policy an improving fiscal outlook a strong balance of payments position and significant market confidence At the structural level, the banking sector is beginning to show intensified levels of competition Majority-Polish and foreign-controlled banks alike are developing new strategies to capture new market niches The sector is universally investing in new systems technologies and personnel to broaden the array of services they provide to the market Most noteworthy is the push into retail banking supported by new branches and electronic means of transmission, and the growing trend towards *bancassurance* Privatization is moving forward, with only two large troubled banks expected to be state owned after 1998 Consolidation is also taking place—increasingly along market lines and involving Polish and foreign institutions While Polish banks are expected to be more competitive in the coming years they must face current trends which show reduced earnings in dollar terms lower return ratios against average equity and assets and continued investment costs in the coming years for market positioning Capital remains low by global standards—only $60 million on average—even if risk adjusted capital ratios show adequacy Half of Poland's banks are around the EU minimum for capital which is not enough to compete in today s environment except in the narrowest of services Asset quality remains suspect in some portfolios as banks take on increasing risk Earnings have been positive for years but returns are declining due to tightened margins in traditional areas of lending, limited fee-income sources for most Polish banks and higher cost structures (only part of which is depreciable, depending on the type of bank) Meanwhile earnings pressure only serves to underscore generally tight liquidity for most banks In addition to tight monetary policy, increasing competition and higher costs liquidity is also strained due to the relatively low levels of funding in the system and the concentration of deposits in three banks Overall the operating environment is improving as the competitive environment becomes more open and transparent However there are still many risks that remain for the Polish economy and banking sector Governance and management will need to be further strengthened at most institutions to contend with upcoming challenges as market barriers decline and financial services become increasingly universal complex and competitive This will require improved risk management systems across financial services—banking insurance investments—based on improved oversight, more autonomous and professionalized internal audit functions and enhanced capacity to utilize meaningful information for strategic management purposes There is also the unanswered question of the quality of banks' portfolios and underlying assets in the event of an economic slowdown While Poland has shown resilience in the face of potential "contagion' challenges—the Czech Republic Asia, the ruble—there is a risk that a slowdown in Western Europe could cause a slowdown in Poland If so the quality of banks' assets/exposures as well as earnings streams would then be subjected to more of a test than faced since the restructuring efforts began in 1993

- Poland s banking system will be about 75 percent majority-private by end 1998
- Private banks already account for about two thirds of core capital more than half of loans and most fee generating services
- Foreign investment and consolidation are increasing and the number of banks could decline from 83 in the coming years as about 40 banks barely meet minimum capital requirements of ECU 5 million
- Deposits are still concentrated—three banks account for 56 percent of total deposits—and other funding sources are limited resulting in still low intermediation rates
- Competition is increasing resulting in tightened margins—after tax earnings declined $245 million in 1997—and riskier lending to offset declining margins
- Tier I and II capital are adequate—the system has a risk adjusted median capital of 17 6 percent—but total capital for the system is only $6 billion small by global standards
- 1997 ROA 2 0 percent
- 1997 ROE 24 7 percent

The basis for the composite is described by each of the four general activities and the 28 sub-categories below A more detailed summary is attached as Annex 2

Section 1 Assessment of Financial Sector Infrastructure

1 Financial Sector Infrastructure Score 3

Poland continues to evolve slowly towards financial sector modernization Its strengths are found in a dynamic and growing economy geared to EU and global markets, increasing liberalization and investment in the banking sector, high levels of accountability, increasing professionalization, and supervisory structures for banking, insurance and capital markets based on global standards of transparency Recent legal reforms—The Banking Act and The Act on the National Bank of Poland—all reinforce these structures and provide them with the mandate they need for effective enforcement Governance at the state commercial banks and major private banks has also improved since late 1993, when hard budget constraints were placed on most banks and their debtors The new Banking Act spells out basic governance requirements for all banks, including state and cooperative banks However, privatization has been slow—about a dozen banks still remain in non-private hands—and there appears to be preference for some measure of domestic consolidation instead of focusing on increased capital, management know-how, and market links from strategic investment Recent entry into the OECD, expected formal entry into NATO, and future entry into the EU are all providing momentum for institutional reform However, Poland's privatization pace has been sluggish, and only recently has Poland begun to attract significant volumes of strategic investment Even here, large proportions have come from small numbers of investments Its legal and regulatory framework for financial services is being harmonized with BIS, EU and other international standards to ensure continued integration into international markets Its payments system is adequate for now despite weak telecommunications capacity and a high proportion of paper copies Accounting standards have been moving increasingly towards international norms, sustained largely by requirements for the largest reporting banks, the due diligence process that comes with privatization and larger joint-ventures involving equity stakes, and demands from the market on companies trading in the capital markets General support organizations which enhance and help sustain market development—rating agencies, professional associations, media, academic and training institutes—all exist or are evolving towards professional standards There is also cause for optimism that privatization will accelerate in 1998-99 with Pekao SA Group and the smaller Bank Zachodni, bringing the number of non-private banks down to less than 10 However, two of the banking system's largest institutions will remain non-private for the time being—PKO BP and BGZ—as will the troubled PZU insurance company

1 1 Policy and System Score 3/3+

Poland has been perceived to be partly protectionist with regard to several strategic sectors (e g coal steel agriculture) and slow with privatization over the years The latter is due to the decentralized approach to privatization that Poland has followed since the early stages of transition while the former has much to do with the politics of vested interests and concerns about full-scale restructuring Nevertheless Poland has also shown considerable economic growth in real terms and is beginning to attract major foreign investment after years of unimpressive direct investment outlays More recently Poland has been perceived to be on the right track largely the result of its membership in OECD and ambitions for early entry into the EU These require a commitment to democracy free trade and multilateral cooperation Poland s legal and regulatory structure is being reformed to conform to these prerogatives At the structural level Poland s economy banking and financial system have undergone considerable reform since 1989 Its regulatory structures are considered reasonably strong and this should provide for added institutional security in banking and capital markets in the coming years as trade and investment in financial services increase However, the pace of reform has been questioned most particularly with regard to privatization in the steel coal shipyards banking insurance and telecommunications sectors

1 2 Legal
Score 3-/3

Poland recently adopted the Banking Act and the Act on the National Bank of Poland in late 1997 This legislation brings much of the legal framework for banking in line with minimum EU standards, OECD member requirements, and BIS guidelines The two Acts, representing improvements from earlier pieces of legislation, are also meant to provide a legal mandate to alleviate what have been problems associated with judicial infrastructure and the timely processing of claims, uncertainties regarding collateral and contract enforcement, and the utilization of secondary markets for debt collection Poland s legislation is generally considered satisfactory although further changes are envisioned for the future as the system evolves Two likely amendments will be rules for collecting debts by banks, and an increase in limits on deposits However, judicial infrastructure are not yet considered satisfactory for effective operations Courts are overwhelmed with case loads they can not handle Staffing and compensation levels are insufficient The European Commission gives Poland good grades for progress made in recent years in developing capacity to assume EU membership obligations in a number of areas—intellectual property company law taxation accounting and financial services Improvement is still considered needed in competition public procurement, data protection and the liberalization of capital movements With regard to banking membership in the OECD has not been accompanied by a major push for liberalization Poland's interpretation of its membership obligations is to permit foreign banks to set up in the market either as joint stock companies or branches However bank branches are required to maintain capital in Poland This is inconsistent with the spirit of market liberalization, even if Poland's new legislation recognizes home country rule and mutual recognition principles in a manner consistent with EU Directives Poland is taking the position that full opening will not occur until Poland becomes a member of the EU which will not likely occur before 2002, and may not occur until 2005 or later Banks interest in securitization, consumer lending, "plastic cards, ' and mortgage lending may require refinement of some of the legislation over time to be more broadly consistent with EU norms

1 3 Regulatory and Supervisory
Score 3+/4-

Poland s banking supervision department—known as the General Inspectorate of the National Bank (GINB)—represents one of the strengths of Poland s overall financial infrastructure and institutional capacity The regulatory framework conforms to prudential guidelines rendered by the Basle Committee for Banking Supervision, as well as more recently with EU directives and guidelines more consistent with "universal" banking practices The banking supervision department of the NBP has been developed virtually from nothing since 1992 when the magnitude of banking sector problems was beginning to be realized These problems existed at three broad levels First the structural link (e g banking sector developments under commercial conditions) to monetary and broader macroeconomic conditions was poorly understood because the condition of the banks was poorly understood A prudential regulatory framework for banking was needed to help provide NBP with the underlying stability it needed to achieve its objective of price stability Second, it was becoming increasingly clear that the large state banks—both specialized and commercial—were in poor financial condition, and that it was going to be costly to recapitalize and restructure them NBP, the Ministry of Finance and the government as a whole needed to have a better understanding of the magnitude of the losses to assess the potential costs and how these would be financed Further, to avoid a recurrence, better information was needed by NBP to ensure that imprudent behavior on the part of bank boards and management would not lead to greater problems in the banking sector This led not only to a better regulatory framework, but the adoption of an increasingly integrated approach to banking supervision based on comprehensive policy coordination, full-scope and targeted on-site examinations and off-site surveillance focused on regular reports on areas of greatest risk Third, it became clear during the turbulent period of 1989-90 and thereafter that many of the smaller banks that had received licenses just a few years earlier were incapable of managing banking operations in a safe and sound manner under risky conditions In some cases this was due to the volatility of the market during the early period of shock therapy ' and the years shortly thereafter when inflation rates were still high and the political situation was unsettled In other cases this was due to outright corruption and fraud Thus since 1992 banking supervision at NBP has evolved to contain systemic risk in the banking sector and to support NBP s larger objective of pricing stability More recently the role of the GINB has changed slightly In one sense, it has been expanded to play a major executory role on behalf of the Commission for Banking Supervision On the other hand its role may be diluted by the presence of a broader composition of the Commission through which GINB must now coordinate its activities Irrespective of the outcome of this new role GINB is perceived to be effective in its oversight of the banking system It has avoided the weaknesses found in many other neighboring supervisory agencies such as inadequate coordination between/among differing authorities reluctance to use on site inspections reluctance to apply enforcement mandates, and inability to retain competent and trained personnel Poland currently has about 350 personnel employed in banking supervision Banks are generally viewed to be compliant with regulations and the benefits of some reporting systems—such as uniform bank performance reports (UBPRs)—are now being used for internal management purposes not just for regulatory reporting In general supervision is considered strong One weakness includes the non-privatization of some of the largest Polish banks which undermines GINB s mandate to enforce supervisory actions in a manner similar to private banks Additional weaknesses at the technical level are rooted in insufficient information the nature of some reporting forms and methodologies the need for increased training in risks associated with derivatives—mainly foreign exchange interest rate and pricing—and mortgage lending and the need for more targeted inspections when risks are identified (as opposed to comprehensive examinations) There may be inadequate information generated from banks regarding off-balance sheet risks (e g guarantees third party transactions) which could undercut the ability of NBP to identify evaluate and contain risks early enough for a targeted inspection or corrective action This is particularly worrisome in terms of consumer lending and potentially high rates of delinquency Likewise there may be inadequate information reported to NBP from banks regarding the links between interest rate exchange rate and maturity risk Many banks are currently borrowing in foreign currency and lending in zloty Reporting forms to NBP are in zloty This conversion may gloss over the exposure some banks have in the event of a material shift in the exchange rate More specific forms which show the actual currencies exchange rates interest rates and maturities of borrowings and loans on a weighted and time-to-maturity basis might assist NBP with its surveillance This would permit greater sensitivity analysis for borrowing and lending flows As banks become increasingly exposed to derivatives these risks will become increasingly prominent

1 4 Payments System Score 3

Poland s payments system is considered adequate for clearing and settlement but limited in terms of efficiency due to the still high proportion of paper transactions With ambitious plans to significantly increase credit and debit cards point-of sales terminals and ATMs by 2000 it is also possible the system will lack sufficient capacity to handle a marked increase in volume This could be remedied by extending the clearing time but this would mean delays and inefficiencies which also undercut liquidity and the overnight interbank market A regulation from June 24 1992 from the NBP provides banks with three options for inter bank clearances These include a national clearinghouse correspondent accounts and agreements on the direct exchange of payment instructions The system generally has no systemic risk because settlements are conducted on a net basis and do not occur unless there are funds are available from the debtor bank s account held at NBP The pace of electronic processing is increasing with about half of all banks participating on the fully electronic system by end 1996 However the smaller banks are constrained by their own internal capacity Further as most banks estimate their funds at closing and maintain surpluses for insurance the system cuts into liquidity at a time when liquidity is tight due to the restrictive monetary policy of the NBP Meanwhile limited electronic systems combined with courier systems operate on a regional basis for other banks to participate in the settlement system Failure of a bank to settle its liabilities through its NBP current account leads to automatic exclusion from the system

1 5 Accounting Score 3-/3

Poland adopted the Accounting Act of September 29 1994 to bring the country s accounting standards more in line with IAS and the EU Fourth Directive Prior to this legislation most statements had been produced for tax purposes and for the Central Statistical Office Public sector entities and small businesses with net sales and financial income of less than ECU 400 000 are generally exempt However other companies are expected to comply with the standards which are more rigorous as the size of the firm increases Businesses with no more than 50 employees on average throughout the year with total assets of no more than ECU 1 million and with ordinary income of no more than ECU 2 million are permitted to prepare simplified statements While at least 21 of Poland s banks (and possibly more) showed gross income of less than ECU 2 million (about Zl 7 million based on average exchange rates) in 1997, they are still generally required to prepare statements according to IAS In the case of larger firms and firms with foreign participation statements are expected to conform to IAS and are prepared with the assistance of international accounting firms based on International Standards of Auditing This includes consolidation standards applied to intercompany balances and unrealized gains/losses for subsidiaries and associated companies Notes are used to provide needed explanations underlying balance sheets, income statements, and for larger companies cash flow statements These explanations include but are not restricted to depreciation schedules and the impact on fixed asset values, collateral in assets owned by the company, an analysis of share ownership movements in capital, reserve and provision accounts creditor maturities contingent liabilities tax reconciliations information on nonconsolidated joint ventures and loans/compensation to board members and directors In addition to being a standard for larger firms or being prompted by regulatory requirements in the financial sector IAS has been a fundamental element of valuations due diligence, and investment decision making (both for direct investment and portfolio investment) since Poland began opening its markets Thus, Poland's accounting standards are evolving increasingly towards international standards However, numerous weaknesses remain in Poland s accounting framework some of which may point to potential risks for bank portfolios In many cases, accounting is still conducted on a tax-oriented cash basis rather than on an accrual basis This is more the result of years of tradition rather than the fault of the new framework However, it does represent a tiering of the market differentiated by firm size What this provides is a basis for smaller firms to understate income or overstate expenses to avoid tax payments whereas larger firms have an incentive to overstate assets or understate liabilities to increase access to secured loans All the major international accounting firms have been active in the Polish market since 1990 Meanwhile there are many more Polish accounting firms, although they tend to be smaller in scale relatively new and unable to provide many of the financial advisory services that are needed for ordinary Polish companies to strengthen management and competitiveness It is the opinion of some international auditors that there is a lack of political will on the part of the Ministry of Finance and the Polish Institute of Chartered Auditors to introduce national standards that would be universally accepted for widespread use In particular, current accounting standards and statutory rules are considered to not provide sufficient guidance on related-party transactions leasing or deferred taxation These are all of critical importance to bank exposures and portfolio quality

1 6 Rating Agencies Score 3

All the major international rating agencies have been active for several years in the Polish market Poland s ratings in February 1998 were generally favorable in terms of the long-term outlook which reflects confidence in the long-term development of the banks However, Poland remains below prime for foreign currency deposits More recently, S&P affirmed a positive outlook for Poland's foreign and local currency ratings as has Fitch IBCA A domestic rating agency—CERA—has been established but their efforts are partly constrained by information flows and concerns about confidentiality To date, CERA has rated three instruments—one long term company issue and two municipal bonds

1 7 Financial Media Insufficient Basis for a Score

No particular effort was made to assess the financial media However, there are several newspapers that report daily and weekly monetary and financial information There are also many English-language journals Media coverage is generally considered responsible An effort has been made through the Polish Bank Association s Mediabank efforts to provide greater information to radio, television and journals on developments in the banking industry—including product offerings new lending trends and other news that is relevant to the public PBA believes this has contributed to higher customer satisfaction ratings with the banking sector

1 8 Professional Associations Score (for PBA) 4

There are several professional associations in Poland for financial sector individuals and groups Among the largest are the Polish Bank Association (PBA) and the Polish Chamber of Auditors The PBA appears to be one of the most dynamic banking associations in the region, and is engaged in a number of initiatives that have accelerated market development in the banking sector Among these PBA initiatives are a shareholder role in establishing the joint stock company which serves as the clearinghouse for bank settlement development of the TELBANK system managing a modest data bank on delinquent borrowers and development of a credit information bureau which will be launched in late 1998 It is specified in the Act on the National Bank of Poland that a representative of PBA participate in meetings of the Commission for Banking Supervision on matters that relate to regulation and supervision in the banking sector including when the Commission meets to set 'out principles for the conduct of banking activity that ensure the safety of the funds held by customers at banks" Thus, PBA is considered important in coordinating input to/from banks and legal/regulatory authorities Its membership is voluntary, yet it includes all licensed banks as members as well as some of the larger cooperative banks The Polish Chamber of Auditors has 2 500 members and is now providing some post-qualification training and examinations for ongoing professionalization through its institute The Chamber is also responsible for licensing auditing firms

1 9 Academic Insufficient Basis For a Score

No particular effort was made to assess the number or quality of academic institutions in Poland Nor was there a systematic effort to speak with business/management school officials However there are many schools institutes and think tanks that are able to make a significant contribution to banking sector development There are at least 24 business schools in Poland and possibly more Most have cooperation agreements with economics business finance management and marketing programs in Western Europe or the United States The Warsaw Institute of Bankers was established in 1992 and has trained more than 3 000 people working in more than 50 Polish banks The Polish Institute of Chartered Auditors has also introduced post-qualification training and examinations as part of its efforts to contribute to the strengthening of the audit profession The Gdansk Institute of Market Economics and CASE are but two examples of influential think tanks

1 10 Miscellaneous Score 3-/3

In Poland overall electronic and telecommunications capacity is increasing to compensate for what was one of the least developed systems in the region Investment in these areas is clearly evident in the banking and financial sector as many banks are spending to improve their internal information and communications systems for better management and the provision of a wider range of services Part of this has been prompted by NBP which is now requiring electronic links for reporting Poland started the 1990s with one of the least developed telephone systems in Europe Even by ex communist standards the system was poor—only 8 percent of the population had access to main-line telephone service and service levels were poor Even in 1996 there were only 169 telephone mainlines per 1 000 people in Poland which lagged the Baltic States and were about on par with most of the European part of the former Soviet Union Today, it is estimated the number of mainlines per 1 000 has increased to about 196 However, mainlines predictably continue to fall well short of EU standards by a factor of two to four Rather than opting for privatization the government has pursued a program to modernize infrastructure in advance of privatization of the major telecommunications company TPSA which is still wholly state owned The government plans to privatize 20 percent of TPSA in 1998 Additional competition will be introduced for long-distance connections as well as for local phone services However as of early 1998 private companies only serviced 170 000 telephones in 31 of 49 voivodships as opposed to TPSA s 7 5 million telephones in all 49 voivodships Investments so far in the telecommunications sector have been made for international calling and long-distance calling within Poland It is expected that investment will increase as well in the major metropolitan areas However investment requirements of $1 billion or more per year for network expansion will require greater resources than TPSA can provide Postal services appear adequate as does safekeeping from a physical and logistical standpoint Part of the investment made by banks is to strengthen their electronic systems for increased protection particularly as ATMs point of sales terminals, debit credit cards and other features are introduced

Section 2 Assessment of Economic Factors and Private Sector Indicators

II Economic Factors and Indicators Score 3+

Poland has an increasingly open economic system that has been private sector-oriented in terms of ownership for the last several years While much of industry remains in state hands and agriculture needs to be modernized, the Polish economy has grown over the last several years on the strength of its private sector This includes about 5,000 privatized companies, and an estimated 2 million or more companies that are relatively new Consequently, Poland gets good ratings for small-scale privatization, but less impressive reviews of large-scale privatization, restructuring and governance It is possible that the new government will accelerate remaining privatization, although this remains to be seen There are still not specified timelines for privatization of coal mines, steel companies, non-ferrous metals producers, coke producers, and machine tool manufacturers An estimated 30 percent of privatizeable assets are slated to remain in state hands beyond the year 2001, although significant privatization is expected to be finalized in a range of industrial sectors as well as in banking, insurance, power generation, telecommunications and transport Among the largest 100 firms in Poland at end 1996, 60 had at least majority state ownership, mostly 100 percent Pekao SA Group (banking) and TPSA (telecommunications) are the largest firms slated for privatization in 1998 Meanwhile, Poland gets good ratings for its trade and foreign exchange system, having removed most quantitative and administrative restrictions that apply to international trade as far back as 1990, having introduced a fairly uniform customs regime and current account convertibility, and having virtually eliminated government interference in export-import flows from state trading monopolies (likewise in 1990) Competition and pricing policy are generally harmonized with EU legislation, although some trade protection was still in effect in mid-1997 Remaining barriers—mainly in agriculture—are expected to disappear or diminish over time as Poland complies with WTO, EU, EFTA and CEFTA Agreements There has been growing FDI in the automotive, food processing and power plant sectors since 1996 after relatively sluggish inflows, and more recently in the banking sector Poland is also already competitive in a number of products—as shown in its burgeoning merchandise export trade—and about 70 percent of its international trade is with EU markets A major structural challenge in the coming years is for smaller firms that are successful at generating positive cash flow to be able to obtain needed outside financing for needed investments This implies significant development of equity markets and associated transparency and disclosure requirements, as well as sufficient development of banking and bond markets for companies to obtain needed debt financing for long-term needs For the banking sector and the capital markets, there is significant potential for market expansion However, this will require greater capital, increased investment in retail networks, a broader array of service offerings under tighter pricing conditions, strengthened risk management capacity and systems, increased dispersion of zloty deposits across banks, and an overall increase in resource mobilization

2 1 General Score 3+

Poland s economic indicators are broadly favorable at the macroeconomic level although structural weaknesses remain to be solved Growth has been high for several years despite some earlier sluggishness in Western Europe and periodic troubles in Russia and neighboring states After declines in 1990-91 Poland s real GDP is in its seventh consecutive year of real growth—powered mainly by the growing private sector From 1994-97 real growth rates have averaged 6 percent This has contributed to a reduction in the official unemployment rate from 16 4 percent in 1993 to 10 5 percent at end 1997 This translates into more than 700 000 net jobs created since 1994 Tight monetary policy has brought the inflation rate down steadily—from 70 percent on average in 1991 to an average 32 percent in 1994 and about 14 percent in 1997—the year-end 1997 rate was 13 percent, indicating some stability in the actual inflation rate The government fiscal deficit has declined from nearly 7 percent in 1991 to about 4 percent in 1997—including local government and off budget items which go to assist loss making enterprises in coal steel and other selected sectors Pension/social security costs remain very high at 16 percent or more of GDP While pension reform should reduce these costs over time they still represent a significant burden Nevertheless the fiscal picture has improved in recent years as the economy has grown, revenues have increased and expenditure has been brought increasingly under control Reduced rates on investments in government securities serve as an example of the easing of pressure on government finances Exchange rates gradually depreciated under the earlier crawling peg regime and more recent open market intervention with some appreciation in 1998 due to arbitrage opportunities perceived from Poland s generally strong fundamentals and balance of payments position With a steady and significant increase in international trade—total merchandise exports and imports were $66 billion in 1997 or more than twice levels achieved through 1993 While the current account deficit was about 3 percent of GDP at $4 3 billion gross international reserves have mounted steadily since 1995 As of end February 1998 these reserves totaled $24 3 billion or about six months of import coverage of goods and non factor services This compares with about three months coverage from 1991-94 Portfolio flows have grown steadily since 1994 with increasing liberalization and capital markets development providing short-term financing These account for a significant portion of the increase in foreign exchange reserves including the spike in the first half of 1998 However of greater structural importance to the economy in the long run Poland has attracted more than $4 8 billion in FDI since 1996 compared with an unimpressive $2 6 billion from 1989-1995 Thus in just two years average per capita FDI (annually) has increased from less than $10 from 1989 95 to $61 in 1996-97

2 2 Private Sector Development Score 3+/4-

Private sector shares of employment and GDP are reasonably high—at about two thirds By the mid 1990s Poland had nearly 2 million businesses that were individually owned and about 100 000 private companies that were joint stock companies or joint ventures Meanwhile there were less than 6 500 companies that were state owned by end 1995—either directly or as joint stock companies in which the state had a majority ownership position This number has declined to about 4 000 today However the private sector had already established its dominance in commercial trade—wholesale and retail—and construction and was about even with the state sector in industrial output by 1996 Likewise investment trends indicated a growing share from and into the private sector By 1996 private companies accounted for about 52 percent of aggregate investment In terms of employment the private sector dominates in agriculture manufacturing construction trade and real estate and other business services Privatization plans of the current government could push private sector shares to about 90 percent by 2000 although it is more likely that these shares of GDP will be reached after 2001 Many new companies have started in the last five years and these are often among the most creditworthy in terms of prospects For instance new or privatized companies now account for about half of industrial output and transport and 90 percent or more of construction and trade However they are frequently short of capital making it difficult for many of the banks to provide such leveraged financing If there is meaningful expansion of the over the counter (OTC) market over the next few years this financing obstacle might be significantly alleviated However in the absence of viable venture capital and over-the counter markets Poland s small business sector might encounter financing difficulties due to insufficient equity investment and retained earnings Meanwhile the private sector in general is still faced with a fairly high share of the state in the economy and banking svstem State companies account for 60 of Poland s largest 100 companies many of which dominate in large industries and key services including significant investment in transport telecommunications banking insurance power generation, oil and gas, and defense Some state ownership will diminish in 1998 with the partial privatization of Pekao SA Group and TPSA However there will still be large and troubled state owned companies in financial services and heavy industry into the next century While resistance to FDI appears to have significantly diminished since 1996 and the current government appears to be interested in accelerating privatization it remains to be seen how long the state will retain these companies before they are turned over to private ownership and management or definitively liquidated With an estimated 30 percent of privatizeable assets to remain in state hands after 2001 some of these companies may serve as a deterrent to full market liberalization as the date nears for entry into the European Union At the unregistered end there is also pressure to contain open-air market trade due to border crossing requirements of the EU Such attempts to curtail this trade could adversely affect the $6 billion in goods traded in these markets equivalent to about 22 percent of registered exports in 1997

2 3 Money, Savings and Credit Score 3+

The NBP has pursued a tight monetary policy since the hyperinflationary period in 1989-90 Monetary policy and the impact it has had on savings and credit has focused on gradual devaluation of the exchange rate through a floating regime introduced in May, 1996 a steady decline in the inflation rate as reflected in slowly declining interest rates, and generally tight monetary policy to prevent an "overheating" of the economy The latter point was in evidence in 1997 as NBP twice raised reserve requirements on banks This contributed to a 2 0-2 5 percent increase in the refinancing, rediscount and lombard rates after gradual declines through the 1990s The effects of the earlier crawling peg regime and current floating exchange rate policy have shown benefits since 1995-96 Savings and credit have both increased since 1995 Households are now placing more funds in the banks on a term basis However, the cost of funds still remains fairly high for banks due to interest rates, still inadequate funding from deposits, the concentration of deposits in three banks, and the limited debt market for banks There was also some periodic volatility in the interbank market in 1997 suggesting that many banks remain sensitive to both the supply and pricing of funding due to the limited depth and breadth of the interbank market In terms of banking, a downturn in the economy could expose loan portfolios (and off-balance sheet items) to higher levels of provisioning and charge offs This would weaken earnings and capital and possibly prompt a demand-driven rise in interest rates if banks liquidity positions deteriorate At that point, a range of safety and soundness issues could emerge one of the first of which would be deposit safety and the role of the banks in the interbank and lending markets and the NBP as a lender of last resort to shore up the liquidity position of the banks For the time being the challenge to NBP appears to be sterilizing portfolio inflows without an "undue" appreciation of the exchange rate Such an increase might then exacerbate the current account deficit, prompting higher interest rates than the NBP wants to see in the economy

2 4 Fiscal Score 3

Fiscal policy shows declining levels of budgetary deficits despite local government financing gaps high levels of expenditure for social security payments and some continued subsidization of loss-making companies Revenues have increased as the economy has expanded but expenditure has likewise increased The consolidated deficit was estimated to be 3 9 percent of GDP About one-sixth is due to the high social security costs covered by government expenditure some of which is expected to be less of a burden over time if pension reform is successful However these payments were only about 8 percent of GDP in 1989 representing an approximate increase from $6 6 billion in 1989 to nearly $23 billion in 1997 Thus, the implementation of pension reform is one of the most critical items on the Polish fiscal agenda Information on the support for loss-making SOEs is not widely available Banks are not believed to have much exposure to loss-making enterprises Most of the support these enterprises in coal, steel and other sectors are receiving is reputedly in the form of capitalized interest, arrears, or soft loans guaranteed by the government Poland is expected to generate financing from rising FDI However it still has structural deficits from ordinary ongoing budgetary operations which would increase if the economy slowed The current government is trying to bring the central deficit down to less than 2 percent from about 2 8 percent in 1997

2 5 Exchange Rates Score 3

There was pressure on the zloty in the first half of 1998 as a result of portfolio investors perceptions that the zloty was undervalued The zloty had depreciated fairly steadily throughout the 1990s, starting with the crawling peg regime and then moving on to a floating exchange regime in mid-1996 Average exchange rates against the U S dollar were 0 95 in 1990, 1 81 in 1993 and 2 70 in 1996 By end 1997, the year-end exchange rate was 3 52 However in April 1998 the zloty was trading at 3 4 to the dollar Thus, for the first time in several years, the zloty began to show visible appreciation against the dollar at a time when the dollar was appreciating against most major currencies The government has concerns about portfolio investors driving the exchange rate beyond acceptable limits to the point where it would lead to a serious current account deficit Much of Poland s economic growth in the last several years has come from added competitiveness—exports of goods and services have increased from less than $15 billion in 1991 to about $32 billion in 1997 Not only has the dollar value of exports more than doubled but exports to the EU have increased from 47 percent of total in 1990 to 70 percent since 1995 Thus appreciation of the zloty can lead to a dual effect of adding further stimulus to the consumption-led current account deficit in Poland, while reinforcing that deficit by weakening Poland s ability to export to EU and comparable countries This is a particular challenge for Poland in today s markets when Asian currencies and foreign reserves are under pressure and their manufacturers are seeking markets for their output The EU market along with the North American market are the main targets for these exporters presenting competition for Poland in a range of industrial goods where Poland s competitiveness could be undermined by exchange rate appreciation

2 6 Balance of Payments Score 3+

Poland s balance of payments figures showed a $3 billion increase in the current account deficit resulting primarily from a $6 billion net increase in merchandise imports against a $3 billion increase in merchandise exports Non factor services showed a limited net change The capital account strengthened as indicated by the $2 billion net increase in gross official reserves This was partly on the strength of increased FDI—$2 7 billion in 1997—but also due to portfolio flows Some of these flows will contribute to gross fixed investment and future competitiveness Overall Poland s total public and external debt is managed and the debt service payments on these debt stocks do not seriously undermine the current account or fiscal resources However there is a risk of a strong zloty leading to a surge of consumer imports which may propel the current account deficit to unacceptably high levels prompting capital flight and then possibly adding to debt service In the banking sector such a development would likely be reflected in a deterioration of loan portfolio quality—in the form of delinquencies and eventual write-offs as well as discounted inventories being sold at levels below effective collateral coverage To preempt these developments NBP has maintained a tight position on interest rates and money supply dating back to early 1997 This seems to have been effective and the general consensus in early 1998 was that interest rates would come down by the end of 1998 However this will not likely occur until there is evidence that consumer lending has slowed and that the consumption driven current deficit is well under control

Section 3 Assessment of Banking Structure and System Profile

III Banking Structure and System Profile Score 3

The Polish banking system is now majority private in terms of asset control and equity, and majority-private banks account for about 40 percent of deposits Balance sheet measures—capital, liquidity—and quality indicators—loan portfolio quality—are generally favorable, although there are concerns about excessive risks associated with lending in the consumer sector There has been a steady harmonization of laws and regulations with international standards to make the environment conducive to ongoing investment, and this has picked up since 1996 However, membership in the OECD has not led to a full opening of the market, perhaps out of concerns about overheated competition after banking sector instability in the early 1990s After-tax earnings in 1997 declined by about 16 percent in 1997, or $245 million on a dollar basis, largely due to the increasing competition emerging in the market As the market becomes more competitive and ownership gradually moves towards a private sector orientation, governance and management are expected to conform increasingly to higher standards Polish banks are beginning to consolidate, such as the BIG acquisition of Bank Gdanski and the Kredyt Bank acquisition of the Polish Investment Bank in 1997 combined with the BRE acquisition of the Polish Development Bank in 1998 More consolidation has occurred with the Pekao SA Group Privatization of remaining state banks may also lead to further consolidation, such as in the case of PBK-Warsaw in which Kredyt Bank is a small shareholder, and the upcoming 1998 privatization of Bank Zachodni Foreign banks are entering the market, which will add to competition in a range of banking markets More generally, private banks are expanding rapidly, which may reflect strategic investors' strategies for expansion in retail banking to diversify bank income sources, to attract more stable funding sources, and to market non-bank financial services However, margins are tightening and after-tax earnings actually declined in 1997 (on a dollar basis) In terms of earnings, margins on exposure to blue chip customers have narrowed significantly, prompting more intensified competition in non-blue chip and consumer sectors This has led to higher earnings from lending to riskier segments of the market—consumer lending for auto and appliance purchases, loans against receivables from leasing companies for asset-based lending, and increasing overdraft facilities for customers with "plastic cards " Meanwhile, the cost of funds increased as a result of 1997 increases in reserve requirements (which receive no interest compensation) applied to all deposits (at varied rates) Liquidity remains tight due to fairly tight monetary policy as well as the limited funding options in the market—concentration of deposits in PKO BP, Pekao SA Group and BGZ, thin and sometimes volatile interbank market, limited corporate bond market, undeveloped mezzanine financing options, and relatively low levels of capital at most banks by global standards In fact, the entire Polish banking system's assets and deposits were less than the second largest bank in Brazil, another "emerging" market Thus, the entire funding side of the banking system still remains small in Poland Overall earnings declined as a result of high operating costs, as well as questionable construction projects at a number of Polish banks The cost of funds is expected to ease over time However, operating costs derive from positive and negative developments, and appear to impact different kinds of banks in different ways On the positive side, many of the newer or recently privatized banks are making competitive investments in technology, systems and personnel development that will yield increased earnings in the future On the negative side, some of the public banks still suffer from excess head count, branches and overall inefficiency rooted in older systems That foreign-controlled banks are investing heavily in information

systems indicates the likelihood of expanding into the retail market, rather than simply relying on fee income and limited balance sheet exposure to generate high returns Meanwhile, the larger majority-Polish banks which have been at least partly privatized are showing increasing competitiveness Bank Handlowy has a diversified ownership structure, but this includes a nearly 29 percent strategic investment stake involving three major financial services companies that provide it with management expertise, and possible additional capital should Handlowy seek to acquire existing banks in the market PBK-Warsaw, Poland's sixth largest bank, is emerging as a *bancassurance* institution that will likely need to push into the retail market to take advantage of synergies from the offering of these financial services The multiple holdings by ING in its own bank, Bank Slaski, and BPH also point to the possibility of consolidation across bank companies The initial success of the Pekao SA Group's privatization is likely to lead to a stronger position in the market, with the outcome of this largely dependent on the winning strategic investor(s) to be determined later in 1998 The recent acquisition by BRE of the Polish Development Bank points to a competitive position in banking and investment banking Thus, the near-term prospects for intensified competition and consolidation are high, which will strengthen underlying competitiveness However, Poland's banking system is still small and largely untested under fully open market conditions

3 1 Overview
Score 3/3+

Poland's banking system is becoming increasingly competitive now that most banks have been privatized and entry by foreign banks is less restricted than in earlier years Banks are now better managed under a new incentive structure introduced in the early 1990s—based on BIS guidelines for prudential regulations and international standards of accounting—and after the 15 month bank restructuring exercise in the commercial banking sector from 1993-94 which carried forward the benefits of improved governance internal oversight and portfolio management NBP regulatory oversight has played a constructive role in helping to monitor for bank risks and to develop risk management systems that are now starting to be used by bank managers themselves While Poland did not pursue government financed recapitalization programs of the same magnitude as in other countries for the state *commercial* banks most of these banks in fact recapitalized from the favorable net spreads received on investments in government securities from 1992 to mid 1995 This reduced available resources for credit to the real sector but was probably prudent at the time given associated weaknesses in the enterprise sector in terms of transparency disclosure and capital structure Lending flows began to increase in late 1995 as net spreads on securities began to decline and as banks reached levels of capital adequacy on a risk weighted basis that permitted them to resume lending As reforms in the banking and enterprise sector began to take hold many private sector firms began to represent good returns for banks relative to risk Likewise as pressure on earnings increased due to improving macroeconomic conditions—lower fiscal deficits and inflation rates—and rising competition in the enterprise sector banks began to increase lending to households for consumer credit Such trends manifested themselves in 1996 and were largely responsible for the high levels of consumer spending that led to an increase in the 1997 current account deficit—as well as the increase in reserve requirements in 1997 to contain what appeared to be a potentially overheated economy Overall balance sheet indicators indicated reasonably safe loan portfolios and overall asset quality at the end of 1997 although there are some concerns about the risks associated with the substantial increase in consumer and small business lending—much of it installment finance—since end 1995 In terms of segmentation majority-Polish banks appear to be diversifying Polish banks recognize their limited funding sources from deposits and the small portion of their earnings which comes from fee generating services Meanwhile foreign controlled banks now appear to be moving into more balance sheet exposure—lending and retail services—now that the blue chip market is saturated and rates for a range of services have come down Preliminary estimates of after-tax 1997 earnings showed that cost structures remain high—costs were 85 percent of gross income Returns on assets and equity both declined from 1996 due to pressure on margins limited fee income and high operating costs For the system as a whole NBP figures show ROA at 2 percent and ROE at 24 7 percent in real terms for 1997 These compare with 2 5 percent and 41 9 percent respectively in 1996 There is significant evidence of competition for large corporate business as intermediation spreads have dropped considerably from high levels in 1992-95 and foreign banks have captured some market share Upcoming challenges at the system level include the ability of the system to avoid contagion effects—such as downturn in Western Europe increasing price competition in Europe or broader global investment trends in emerging markets—, the ability of the government to definitively privatize remaining state-owned banks *and* companies the overall scope of consolidation that occurs in terms of both numbers of financial firms and their respective financial activities, and the ability of bank companies to play a greater overall role in the economy based on higher capital levels higher intermediation rates and a greater array of services At the firm level key risks for banks and financial services companies include strengthened governance and internal audit functions management depth and capacity as greater risks are assumed in the coming years the success of investment in management information systems that produce needed information in a timely manner for management to identify and contain risks as they surface, the strategic direction of various banking firms under open and highly competitive conditions, and the synergies achieved from investment in non-bank services with banking franchises

3 2 Ownership Score 3-/3

Poland s banking sector is still dominated in many ways by the large public banks This is particularly true in terms of deposit mobilization and the consequent funding advantage enjoyed by PKO BP the Pekao SA Group and BGZ There has been an apparent and continuous preference on the part of the authorities to engineer consolidations among Polish banks and large non-bank financial services companies to defend the Polish financial market from foreign competition This has been evident more recently through the privatization process with some of the smaller banks being acquired by Polish financial groups even when their bids have come in lower than those of foreign competitors In other cases holdings have remained dispersed even when greater capital injections could have been obtained from strategic investment Some of this has related to past governments' intentions to redistribute some of the gains to local 'stakeholders " either directly—to employees and managers—or indirectly—to citizens through capitalization schemes for the pension system and possibly off-budget items to support loss making enterprises in strategic sectors However with Pekao SA Group to be majority privatized by end 1998 the banking sector is finally expected to be majority private on the basis of most balance sheet measures Private banks already have about two thirds of banking sector core capital—although the banking system is still limited in total capital the increase of which is needed for modernization and competitiveness—and nearly 60 percent of total loans as of end 1997 Many of the foreign banks all private, also dominate some of the high-fee activities Thus, in some ways the banking system is already majority private in some activities The growing sophistication of Poland s private banks combined with the increasing competition being brought by foreign-controlled banks is expected to modernize the banking sector in the next five years as Poland eventually accedes to the European Union However, for this to happen the authorities will need to attract more strategic investment for needed capital injections, management know how enhanced market links and above all, more sophisticated risk management systems This will require an attitude that vanquishes its fear of foreign competition, and in fact recognizes both the necessity of increased foreign intervention combined with the added opportunities this will inevitably create for majority-Polish institutions Part of this resistance can be overcome by recognizing the need of foreign banks for sound Polish partners and the global tendency away from national orientations in the ownership management and operations of banks

3 3 Governance and Management Score 3

Governance has improved in recent years as the public banks have restructured, recapitalized and been increasingly subject to hard budget constraints However, weaknesses still abound at the supervisory and management board level relative to the next series of risks and challenges that the banking system is likely to face While banks have gotten better at introducing prudent credit management systems other risks are apparently less well managed except in a rudimentary way Even here, there are questions about the degree of risk taken by banks in lending activities as they have shown increasing reliance on third parties and credit agencies There are questions about the slow process of restructuring and privatization of the larger banks in the banking sector—mainly PKO BP and BGZ There are also questions about the process of consolidation in the financial sector the lack of needed capital for modernization and the absence of clearly identifiable owners in many cases Poland is reputed to have supervisory board weaknesses—an absence of experienced financial sector personnel to provide needed oversight—and associated internal audit weaknesses This is to be shored up with a commitment to strengthen the internal audit function by encouraging greater separation of functions, investing in better systems generating better management information providing better compensation for internal auditors and protecting internal auditors from being released unless a majority of the supervisory board votes for such a release As the market becomes more competitive the onus will be on boards to devise appropriate strategic plans and to set corresponding risk tolerance levels to the various activities that are part of that strategy This will require that supervisory boards have the needed financial and business skills to comprehend the growing complexities of risks the banks will soon face Management likewise will need to ensure the personnel systems and procedures are in place to implement the strategies and to identify contain and communicate major deviations when unanticipated risks materialize These challenges will only become greater as the market expands greater resources are at risk and increasing globalization of markets adds to the sensitivity of some of the risks However Poland s banks have generally shown progress in recent years This has been most noteworthy in terms of the financial and operational restructuring of most state owned banks since serious reforms began in 1993 Listed banks are showing better performance than many other banks in the market This is partly related to the rigorous information requirements imposed by the market for ongoing investment The major banks have had external audits conducted for the last several years consistent with IAS Boards and management have focused on loan portfolio restructuring the introduction and observance of stricter credit policies and controls on new lending flows safe and prudent investment in government securities to recapitalize and compliance with prudential regulations with regard to provisions for loan losses liquidity and capital ratios a range of exposures—interest rate exchange rate pricing term— and risks associated with the growth of off balance sheet items Compared to five years ago the larger Polish banks are far more competitive than they were Thus governance and management at most banks appear to have been satisfactory through the initial reform phase of restructuring What remains now is the ability of boards and management to attract capital generate earnings and manage risks in an increasingly competitive and complex environment Particularly if the economy were to slow from its fairly heated 6 percent real growth since 1994 the outcome of this challenge will say much about the financial condition and institutional competitiveness of the Polish banks moving into the 21st century

3 4 Non-Bank Competition Score 3/3+

The non bank sector is beginning to expand In some cases Poland has done an excellent job in developing non bank institutions—namely in the capital markets However in other cases there has been slow progress—notably in the insurance sector and leasing On the positive side there is already considerable turnover on the stock exchange and rapid growth is expected on WSE as well as the CeTO market This will help banks in expanding their potential market for clients with suitable equity financing as well as provide better financial information and accountability standards In other areas there is progress Insurance premiums are increasing and open market competition is expected to intensify from 1999 on The key question in the insurance sector is the fate of PZU the financially troubled insurance giant that accounts for about two thirds of the market but is about $300 million insolvent and slated for privatization in 1999 Reforms in the insurance sector will be important to the banking sector as several banks already have important stakes in life and non life companies A third key sector is the pending emergence of privately managed pension funds Pension reform is one of the key necessities for Poland to get its fiscal house in order Reforms and legislation introduced since late 1996 are making headway Privatizations in 1998 99 will provide proceeds to assist with implementation of pension reform Meanwhile mutual/investment funds venture capital firms and leasing operations are expected to increase their presence in the coming years A new framework for leasing is in process to reconcile current tax incentives with international standards This will have to be accompanied by an improved accounting framework for leasing which the current Accounting Act does not cover A legal framework is now being put in place for mortgage banking which will allow for the trading of mortgage bonds However here time will be required to strengthen registries courts bankruptcy/liquidation procedures and market mechanisms for credit risk evaluation and collection All of these developments are important for the banking sector given their brokerages ownership stakes in insurance companies and expected activity in mortgage financing and leasing As the markets broaden and deepen risks will likewise proliferate In particular the risks associated with securitization will increase as will exotic features attached to differing instruments to fill portfolio niches Now that new legislation provides banks with more of an opportunity to enter non-bank activities they will have to apply proper management principles to prevent systemic or highly damaging risks from materializing Above all up-to-date information systems effective and accountable management structures well-coordinated risk management procedures and substantial capital and reserves for unforeseen risks will be needed It is expected that over time there will be a consolidation of financial services company shares of assets and deposits which would cut across traditional bank' and 'non bank classifications The cross-ownership of banks in insurance provides some indication of how this might evolve However as the banking sector itself is likely to undergo consolidation in the coming years it will take at least that long to develop across sectors

Section 4 Assessment of Banking Sector Development Based on Prudential Norms

IV Banking Sector Development Based on Prudential Norms Score 3

The Polish banking system is adequate in terms of basic financial indicators—capital adequacy, asset quality, increasing liquidity—but it is still small by global standards in terms of financial value and intermediation levels For instance, total capital in the Polish banking system at end 1997 was $6 billion, and assets were only about 50 percent of GDP Such low levels of capital limit the resources available for lending and investment which, in turn, means that Poland will need more time operationally before it is considered competitive for the EU market While many trends are favorable—better macroeconomic conditions and improved financial condition of the banks compared to the early 1990s, improved governance and management at the largest banks, investment in new technologies and training, development of effective banking supervision, increasing transparency, high levels of accountability, continuing demonopolization—other trends are less promising Generally, the fear of competition from large foreign banks has led to a consolidation strategy which has slowed real privatization and modernization This has impinged on earnings, stunted the growth of retail banking, and slowed the development of needed risk management systems for the next stage of banking system development—universal banking—based on more diversified loan portfolios, a wider range of investment options, increased provision and selection of services, broader product and/or market focus, and active positions in traditionally "non-bank" financial activities such as insurance, pension fund management, and venture capital While these trends are currently in process, Poland would probably have a more competitive banking system today had it not been so resistant to foreign investment until recently Notwithstanding such resistance, Poland has generally demonstrated favorable trends in the last several years Capital adequacy ratios are sound according to BIS guidelines, with the median value of risk-based capital at 17 6 percent at end 1997, and 73 of 81 banks operating at year end 1997 having risk-adjusted capital in excess of 8 percent Asset quality has improved as banks have generally cleaned up loan portfolios, although many banks may be taking on excess risk in their consumer lending/installment financing activities, and in third party transactions involving loans and guarantees Earnings were adequate in 1997, although not outstanding—$1 3 billion after-tax, for ROA of 2 percent Liquidity is somewhat constrained by monetary policy which has focused on the steady reduction of the inflation rate without permitting excess exchange rate volatility Deposit mobilization has improved, partly reflecting the rising real incomes of households, and their interest in some of the term deposits offered by the banking system However, there is still significant concentration in the holding of deposits, with three banks accounting for a 56 percent share of total Such concentration weakens liquidity at the other banks The interbank markets are functioning well, but they are thin In the absence of a developed corporate bond market, banks are increasingly drawing on their access to syndicated loans for term financing A dual and interrelated challenge in the coming years will be the ability of the system to increase overall liquidity, and for banks to prudently manage portfolios and liquidity to instill confidence WSE is still heavily weighted towards banks—banks accounting for one third of net assets are traded on the exchange, up from 21 percent at end 1996—and this provides further incentives for prudent management for performance and growth However, the temptations to take on high levels of risk as margins narrow will require significant oversight, both from bank boards as well as from regulators and the markets Here, strategic institutional investors are of critical importance to the system from both the "buy" and the "sell" side All of this points to the ability of banks to properly manage risk

as the market opens up to increasing competition Several questions remain with regard to (i) the near-term pace of privatization and consolidation in the increasingly universal banking system, including the impact of these factors in the insurance sector with regard to cross-ownership, (ii) the ability to raise capital and intermediation levels to a point needed for competitiveness by global/EU standards, (iii) risk management capacity as bank asset structures grow and take on more and diverse risks, (iv) the sustainability of earnings as banks adjust their risk tolerances and venture into activities in which they have limited experience—Polish banks from a product standpoint, and foreign banks from a local market standpoint, (v) the ability to manage credit risk and absorb losses as banks vie for non-blue chip business, extend credit for longer periods, and provide loans with differing interest rate and currency features, (vi) the willingness of mid-sized Polish companies to adapt to international standards of transparency and disclosure to obtain added financing, particularly as many companies still conceal information from fiscal authorities, (vii) the ability of regulatory authorities to monitor for more "exotic" risks—off-balance sheet items, derivatives—and to contain those risks when adverse effects occur, (viii) the overall ability to withstand contagion effects, as was recently threatened by concerns about the ruble and could occur if demand slows in Western Europe, and (ix) the ability of the banking system to weather a downturn in the economy after several years of rapid growth Poland has made progress over the last several years, spurred on by membership in international organizations and prospects for integration into the European Union However, gaps remain in terms of income levels and competitiveness Now that Poland has stabilized its banking system, the next round of challenges will be to close the gap in competitiveness so that Poland's economic landscape is indistinguishable from that found among its EU neighbors This will require significantly greater investment and improved management systems adapted to the risks associated with increasingly rapid and complex movements in the global economy

4 1 Capital Adequacy Score 3

Poland's banks are adequately capitalized by risk based on BIS standards although they remain small in terms of average and total capital—nearly half of Poland's banks would either not meet EU minimum capital requirements or would be barely above these minimum levels Total capital in banks was Zl 21 2 billion at end 1997 or about $6 billion On a risk-adjusted basis according to BIS guidelines, banking system capital was Zl 17 9 billion, or $5 1 billion Netting out cooperative banks from the total this amounts to about $60 million per operating bank at end 1997 Ratios are sound with median risk-based capital at 17 6 percent of assets According to NBP three quarters of banks had risk based capital ratios in excess of 12 percent, and 73 were at or above 8 percent Only six banks were technically insolvent, all of which are in the process of implementing rehabilitation programs Capital ratios have been strengthened in recent years by higher earnings after factoring in provisions for loan losses high levels of government securities investments (which are zero in terms of risk-weighting) and better control of new lending flows which has brought classified loans down to 10 4 percent at end 1997 from 31 percent at end 1993 For listed banks WSE share prices of banks are good which also provides capital strength and needed financing Thus capital appears adequate However among Poland s 81 operating banks reporting at year end 1997, 29 had gross own funds (unadjusted for risk) below Zl 20 million—about ECU 5 million the minimum required for a banking license in the EU Another 11 banks were below Zl 40 million Thus, at least half of Poland s banks are below the minimum, or would be around the minimum for a license once capital is restated according to BIS guidelines Moving forward apart from Pekao SA Group it is unlikely that Poland will be able to attract extraordinary injections of capital from prime-rated foreign institutions through privatization The only other large public banks are PKO BP and BGZ both of which have problems that would lower their franchise value due to problem loan portfolios excessive branch networks and/or political complexities that would make serious operational restructuring difficult and risky to manage Thus banking sector capital growth will now likely have to come from retained earnings asset quality and size and the ability to float shares or obtain equity from other sources and not from privatization proceeds In recognition of this need for capital trends towards market opening are positive as they are in the insurance sector Any attempt to reverse such a position is likely to slow market liberalization which would likely hinder capital growth and slow progress towards competitiveness At the micro level capital adequacy ratios will need to be adjusted as banks shift resources from investments in government securities to increasingly risky exposures Thus there will be even greater challenges ahead in increasing aggregate capital into the system as well as ensuring the adequacy of capital on a risk adjusted basis

4 2 Asset Quality Score 3/3+

Asset quality is perceived to be satisfactory for now although there are questions about underlying quality in the event of an economic downturn In some cases assets are considered overvalued due to generous assumptions regarding collateral or real estate values Loan portfolios to enterprises and households account for 40 percent of assets and the incremental growth in bank assets since 1995 has generally been from new lending flows Loan portfolios were largely cleaned up at the commercial banks in 1993 94 although questions remain about portfolio quality at some of the larger specialized banks Throughout the system the trend towards increasing consumer loans needs to be monitored both in terms of underlying quality as well as off-balance sheet risk in the event of an economic downturn With a 50 percent increase in the stock of loans from 1995-97 and flat returns for banks from loans to the blue chip sector banks have increased lending to smaller companies and to individuals in the hopes of generating earnings from higher spreads in these riskier markets There are asset-based and pricing-related risks for banks to be mindful of as well as broader market risks In terms of assets some of the lending banks are providing is against intermediaries receivables that are secured by asset values Such asset values as well as recovery rates on receivables could decline markedly in the event of an economic downturn In some cases the source of funding for these loans is thought to be foreign currency denominated which is then lent in zloty at higher rates Thus there may be some exchange rate and interest rate risk associated with such lending patterns Published NBP reports do not break down foreign currency exposures on a weighted time-to maturity basis This information would be useful in measuring open positions and how they relate to exchange rate and interest rate risk with regard to loan quality Poland s comparatively high interest rate environment alone presents risks to underlying asset quality even if there is limited term exposure and asset-liability management practices generally observe prudent matching strategies Risks appear to have diminished recently due to the strength of the currency and general decline in inflation rates However a weakening of the economy and exchange rate could reverse this trend Otherwise government securities still represent a significant portion of the balance sheet—20 percent of total assets—while nearly 7 percent represent securities issued by parties other than Treasury Additional lending into the interbank market and to government is considered safe accounting for about 16 percent of assets Fixed and other assets represent 10 percent of total About 7 percent of assets are held at the NBP Thus the main underlying questions regarding asset quality are (i) risks associated with the loan portfolio particularly consumer loans and associated interest rate and exchange rate risks as well as guarantees collateral and other off-balance sheet items associated with lending (ii) the safety of interbank lending (iii) the quality of investments in non government securities and (iv) the quality of fixed and other assets

4 3 Management Score 3

Bank management has improved in Poland in recent years New managers who are better suited to a market based economy have been put in charge of older banks and are accountable to management and supervisory boards Shares help as a form of compensation so that management and employees can benefit from future earnings and privatization New banks often have younger entrepreneurs with an eye to the future To the extent the latter represents significant risk these banks tend to be smaller and pose little potential for systemic risk as long as they remain closely monitored by regulatory authorities for off balance sheet items risky trading exposures and fraud Foreign banks are increasing their presence and this will lead to improved management information systems and application of lessons from more developed markets over time However there are weaknesses in terms of the power and capacity of supervisory boards to exercise governance over banks and of management boards to sometimes identify the risks associated with the strategies they are implementing Supervisory weaknesses are reinforced by insufficient internal audit capacity at majority Polish banks both in terms of experience as well as incentives This is going to change as BIS guidelines are implemented in support of an autonomous internal audit function that is properly equipped trained and compensated In terms of management there are still weaknesses at many banks at the middle management level due to job protection Most banks are also just beginning to use some of the information generated for NBP as a management tool for competitive purposes reflecting the limitations of risk management systems within most

Polish banks Management of credit appears satisfactory and prudent, but questions remain about off-balance sheet exposures the quality of collateral and the potential impact of an economic downturn on portfolio quality There has not only been a shift towards lending to the real sector but such lending accounts for all the incremental growth of banking sector assets since end 1995 The ability to manage this will go a long way in determining the future course of earnings growth and stability in the banking sector Liquidity management appears adequate, as most banks appear to follow prudent asset-liability management practices However, many banks are apparently taking advantage of the lower costs of borrowing in foreign currency and then lending in zloty This can expose the banks to considerable exchange rate and interest rate risk Weaknesses in the management of exchange rate, interest rate and pricing risk may surface in the coming years as banks search for ways to increase earnings in a more competitive market Banks investors in banks and NBP will all need to improve their monitoring of such risks to avoid unanticipated losses that could impair capital This will be particularly true at the larger banks to avoid systemic risk To date Polish banks have generally followed conservative practices to avoid the transactions costs of increased hedging risks Banks may be willing to incur these costs in the future and if so they and those responsible for oversight will need to be certain that hedging strategies are prudent and do not subject the banks/sector to undue risks Overall banks will need to invest in systems and personnel to ensure they have suitable risk management systems in place This has already begun but will need to continue for the foreseeable future This is also an area where competition from prime-rated banks and foreign investment in Polish banks could well serve as a decisive catalyst

4 4 Earnings
Score 3

After-tax earnings were lower in 1997 than in 1996 On a dollar basis after-tax earnings were $1 4 billion in 1997 compared with $1 6 billion in 1996 The 1997 figure averages $17 million per bank, or about 2 percent ROA The reduction in earnings resulted from a combination of three factors pressure on margins in the corporate sector reduced net spreads on investments in government securities and higher cost ratios Reduced spreads in the corporate sector are largely due to increasing competition, which is also partly due to the second factor of reduced net spreads from securities investments As the macroeconomy has strengthened and portfolio flows have increased the government s need for bank financing has diminished This has led to lower earnings from these investments for banks prompting banks to seek out new financing activities With the blue chip market saturated and the banking sector becoming more competitive banks have shown increasing willingness to lend to the riskier consumer market Overall, there has been a 50 percent increase in lending (in dollar terms) from end 1995 to end 1997 Meanwhile, there has been further pressure on earnings due to costs Cost to income ratios were about 85 percent in 1997 up from 81 percent in 1996 and 83 percent in 1995 This is mainly due to high overhead costs related to personnel at majority Polish banks, and high investment costs in information technologies at all banks Most banks also have weak fee income generating capacity due to a limited array of services In many of these existing areas (e g , debit cards) competition is heating up further reducing fees

4 5 Liquidity
Score 3-/3

While funding is improving in the aggregate due to increasing placement of funds in term deposits, general liquidity at the banks is tight due to the NBP s restrictive monetary policy, the concentration of deposits in three banks, the thin corporate bond market and low capital Reserve requirements are high and were raised twice in 1997 Consequently, interest rates are high The secondary markets are still weak for securities which means banks have to rely on real sector deposits for about 60 percent of overall funding and the interbank market for another 12 percent Meanwhile PKO BP Pekao SA Group and BGZ account for 56 percent of total deposits Thus most other banks have weak funding bases While the interbank market is relatively safe and meets some financing needs—essentially through current accounts held at NBP—rates showed some volatility in 1997 This also emanates from the concentration of deposits in three banks Banks also have low levels of aggregate capital Access to syndicated loans has emerged as a substitute for corporate bonds However low capital limits banks exposure to these lines While the payments system is safe and improving it is considered relatively slow by modern standards All of these factors cut into liquidity More broadly, pressure on margins combined with high cost structures reduced earnings in dollar terms This also reduced liquidity in 1997 With tight monetary policy, shallow capital markets, and reduced after-tax earnings due to heightened competition and narrowing intermediation spreads there may be continued liquidity constraints in the near term

4 6 Operating Environment Score 3

Poland s banking system enjoys increasingly high levels of public confidence While intermediation rates are still lower than in some of the neighboring countries—and well below OECD and EU norms—deposit mobilization has been increasing in absolute terms as well as proportionally as a percentage of money supply and GDP One indication of growing confidence is the increasing share of deposits held with banks that are term deposits This partly explains the lack of alternatives or insufficient capital markets offerings relative to demand in Poland However these deposits would not be held in banks if there was a lack of confidence in their soundness Membership in the OECD and the broad array of recently adopted financial sector reforms should reinforce confidence as Poland moves towards membership in the European Union Concentration has diminished in recent years and the best performing banks are ones listed on the WSE Thus market discipline has begun to take hold and incentives are increasingly in line with global standards There has been increasing investment from the private sector in banking, particularly since 1996 Capital markets are viewed as liquid stable and well administered albeit small by global standards All of this has been reinforced by the rapid development of an effective banking supervision department in NBP which has provided increasingly effective oversight in recent years Nevertheless there are several weaknesses that remain as concerns the operating and regulatory environment First and most importantly the privatization process has been sluggish in the banking sector That the public sector still is heavily engaged in some of the largest banks (as well as the largest insurance companies) raises questions about the degree of restructuring that has taken place particularly at PKO BP and BGZ notwithstanding recent agreement to accelerate restructuring efforts These banks continue to represent a burden which has potential implications for monetary and fiscal policy (e g lender of last resort) the solvency and liquidity of the Bank Guarantee Fund and the ability of banking supervision to apply its mandate on an equal footing with other banks Poland has been wrestling for years with the attempted restructuring of BGZ yet problems remain in the cooperative banking sector as they do in the agricultural sector Above all the Bank Guarantee Fund appears to have been utilized as a tool for the restructuring of rural cooperative banks that is costly uncompetitive inefficient and at cross purposes with the banking sector s overall need for enhanced structural competitiveness There is also concern about PKO BP due to its share of deposits—approximately one fifth of total in Poland and almost entirely from households While BGZ and PKO BP are in poor financial condition partly as a result of prior structural rigidities or the transition to more liberalized market conditions their attempts at diversification present additional management and capacity risks that may only lead to a different misallocation of resources if not properly managed That both are building new headquarters appears to be a costly decision at a time when their financial conditions are dubious That the Bank Guarantee Fund has been used to assist weaker banks with limited commercial viability represents cross subsidization that might be more costly to sector competitiveness than alternative approaches—purchase and assumption, and outright liquidation Thus misuse of the Bank Guarantee Fund and larger considerations of lender of-last-resort and too big to fail represent continuing areas of monetary and fiscal risk with direct implications for overall competitiveness at the structural level Meanwhile recent legislation removes some of the judicial obstacles to creditors to recover their loans Nevertheless, the court process remains slow and some banks continue to believe that problems persist with regard to collateral lien perfection and overall court charges

4 7 Transparency and Disclosure Score 3

Poland s largest banks have generally been subject to increasing levels of scrutiny based on high levels of disclosure In some cases, disclosure has become increasingly public as banks have been put on the privatization track In particular for banks listed on WSE—about one third of the WSE s capitalization derives from banks—information disclosure has had to meet international standards to conform to market requirements and to succeed in attracting strategic investment (e g Bank Handlowy) Where there have been shortcomings have been with BGZ and PKO BP due to the sensitivity surrounding their financial condition and the politicization of the restructuring process In terms of companies and households there is far less transparency and disclosure which undermines the effectiveness of banks to share information with each other for improved credit risk assessments Concerns about confidentiality abound partly the result of pre transition constraints on freedom and partly to evade the fiscal authorities While these reactions are understandable such absence of transparency limits the ability of Poland to develop effective credit information systems for better banking and credit rating agencies in support of capital markets development As banks and others expand into retail services and securitized markets, disclosure and transparency will need to increase Poland recently adopted legislation that defines the guidelines under which banks need to provide information to regulatory authorities However the need for market-based systems is still abundant The major banks recognize this and in conjunction with the Polish Bank Association are planning to introduce a credit information bureau later in 1998 This is particularly needed as 'plastic cards" and point of-sales terminals are increasingly utilized as consumer lending increases, and as factoring, leasing, and commercial credit companies slowly start to emerge What is favorable is the growing number of companies that are beginning to qualify for listing on the WSE markets as well as the CeTO Combined with discipline from the banking sector as banks diversify their lending targets and retail customer base these kinds of institutional developments over time can be expected to lead to market-regulated" information requirements By then, it is also anticipated that companies and households will be willing to endure some loss of confidentiality in exchange for greater access to financial resources

4 8 Sensitivity to Market Risks Score 3

Poland does not currently appear to be overly sensitive to "contagion" risks Recent challenges have emerged with the crisis in Asia, questions concerning the stability of the ruble and the deterioration of the Czech Republic s fundamentals in 1996-97 To date Poland seems to have managed these challenges better than other neighboring markets This may be due to its sustained real growth rates exceeding 5 percent since 1994 based on increasing trade with the EU—65-70 percent of international trade is now with the EU—, the size of its foreign currency reserves relative to debt, and the perception of markets in early 1998 that the zloty was *under*valued However, the elements of market risk are there In macroeconomic trends, the current account deficit widened in 1997 and interest rates increased after several years of decreases The current account deficit widened largely on the basis of a consumer spending surge, much of which was financed by bank loans to the consumer sector which could easily lead to portfolio problems in the event of an economic downturn On a more general basis, a downturn in the West European economy or intensified competition in those markets could also weaken Poland s export position Likewise, instability in Russia might interrupt the flow of imported lower-cost commodities on which many Polish industries depend At the banking level, there are many risks which could lead to stress in this sector These include fundamental credit risk—consumer lending and third party exposures (e g syndications, acceptance of company paper, overvalued collateral, tax fraud), exchange rate risk—many portfolios are reportedly long on zloty and this could be more volatile than if long in dollars or DM the absence of hedging to avoid transactions costs—this may be a problem at some of the smaller banks although this is not thought to be a problem at the major banks, possible mismatches in the term structure of portfolios—use of term deposits to finance short-term loans, possible mismatches in the currency composition of portfolios—use of foreign currency-denominated borrowings to finance short-term loans in zloty, insufficient gap or duration analyses conducted by some banks to measure for sensitivities (e g interest rate exchange rate fixed-variable pricing) on weighted and time to maturity bases and the need to conduct stress tests combining interest rate exchange rate, concentration and maturity assumptions to better manage risks as portfolios grow in complexity Future risks will emerge with increasing competition at the retail banking level—mainly from the increasing use of credit cards—as well as rising interest in loan syndications securitization with a range of features and mortgage lending

ANNEX 1 A DESCRIPTION OF THE USAID BANK RATING SYSTEM

Ratings Summary for USAID					
Topics/Categories and Description of Coverage	**Description of Ratings**				
	1	**2**	**3**	**4**	**5**
General Description of Ratings • Financial infrastructure • Economic factors and indicators • Banking sector structure and profile • CAMELOTS indicators	Dismal monopolist resistant to competition and change no confidence widespread corruption weak institutions	Inadequate weak significant improvements needed major potential for destabilization via systemic risks	Adequate favorable trend improvement needed potential for major systemic risks	Solid strong satisfactory competitive few systemic risks or problems and those are manageable	Outstanding world class state of the art best practices virtually no serious systemic risks

I FINANCIAL INFRASTRUCTURE					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
1 1 Policy/System	Wholly unsupportive of stable safe and sound banking	Generally unsupportive of stable safe and sound banking significant improvements needed	Partly supportive of stable safe and sound banking but improvements needed	Supportive of stable safe and sound banking	Wholly supportive of stable safe and sound banking
1 2 Legal	Wholly unsupportive of stable safe and sound banking and meaningful levels of risk taking	Generally unsupportive of stable safe and sound banking virtually no meaningful levels of risk taking	Fairly supportive of stable safe and sound banking but implementation deters meaningful levels of risk taking	Supportive of stable safe and sound banking and meaningful levels of risk taking	Wholly supportive of stable safe and sound banking and meaningful levels of risk taking
1 3 Regulatory and Supervision	Wholly inadequate for prudently managed and supervised banking	Inadequate regulatory framework for prudently managed and supervised banking significant strengthening needed	Adequate regulatory framework for prudently managed and supervised banking but strengthening needed	Solid regulatory framework for prudently managed and supervised banking	Outstanding regulatory framework for prudently managed and supervised banking
1 4 Payments System	Wholly inadequate and undermines integrity of banking system	Inadequate and inefficient systems weaken limited efforts to build up integrity of banking system	Adequate but less than efficient systems support increasing integrity of banking system	Solid systems reinforce integrity of banking system	World class systems reinforce integrity of banking system
1 5 Accounting	Wholly inadequate framework for banking	Unacceptable framework for banking significant improvement needed	Acceptable framework for banking but sophistication needed	Satisfactory framework for banking	Outstanding framework for banking
1 6 Rating Agencies and Systems	Wholly unsupportive of banking sector development	Generally unsupportive of banking sector development	Marginally supportive of banking sector development	Supportive of banking sector development	Wholly supportive of banking sector development

1 7 Financial Media	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth professionalization and code of ethics needed	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1 8 Professional Associations	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1 9 Academic	Wholly unsupportive of banking sector development and growth	Generally unsupportive of banking sector development and growth	Marginally supportive of banking sector development and growth	Supportive of banking sector development and growth	Wholly supportive of banking sector development and growth
1 10 Miscellaneous	Wholly inadequate and undermines integrity of banking system	Generally unsupportive of banking system significant improvement needed	Only partly supportive of banking system, but improving	Supportive and reinforces integrity of banking system	Wholly supportive and reinforces integrity of banking system

II ECONOMIC FACTORS/INDICATORS					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
2 1 General	Dismal macroeconomic fundamentals undermine banking sector development	Inadequate macroeconomic fundamentals deter risk taking by banks	Adequate macroeconomic fundamentals assist with banking sector stability	Solid macroeconomic fundamentals provide banking opportunities	Outstanding macroeconomic fundamentals reinforce and enhance banking sector
2 2 Private Sector Development	Poor levels of private sector development in formal economy undermine banking development	Growing but inadequate levels of private sector development for sustainable meaningful growth undercut banking sector development	Adequate private sector development supported by favorable trends but improvements needed	Strong economy based on competitive private sector	World class state-of the art economy predicated on innovative resourceful private sector
2 3 Money Savings and Credit	Dismal monetary fundamentals wholly undermine banking sector development	Weak monetary fundamentals deter banking sector development	Adequate monetary fundamentals boost confidence but improvement needed	Solid monetary fundamentals contribute to strong banking system	Solid monetary fundamentals shaped by world renowned risk management practices contribute to global standards of banking system competitiveness
2 4 Fiscal	Dismal fiscal fundamentals wholly undermine banking sector development	Weak fiscal fundamentals deter banking sector development	Adequate fiscal fundamentals boost confidence but improvement needed	Solid fiscal fundamentals contribute to strong banking system	Solid fiscal fundamentals contribute to stability in support of banking system competitiveness
2 5 Exchange Rates	Dismal exchange rate fundamentals wholly undermine banking sector development	Weak exchange rate fundamentals deter banking sector development	Adequate exchange rate fundamentals boost confidence but improvement needed	Solid exchange rate fundamentals contribute to strong banking system	Solid and stable exchange rate fundamentals shaped by world renowned risk management practices contribute to global standards of banking system competitiveness
2 6 Balance of Payments	Dismal balance of payments position reflects competitive weaknesses of economy	Poor balance of payments position reflects competitive weaknesses of economy	Adequate balance of payments position reflects growing competitiveness of economy despite weaknesses	Reasonably strong balance of payments position reflects competitive strengths of economy	Enviably strong balance of payments position reflects competitive strengths of economy

III BANKING STRUCTURE AND SYSTEM PROFILE					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
3 1 Overview	Wholly uncompetitive banking system	Poor reputation re competitiveness in the banking system	Adequate reputation for competitiveness in banking but strengthening is needed	Solid reputation for competitiveness in banking	World class status re competitiveness in banking
3 2 Ownership	Monopolist protectionist banking system resistant to foreign competition and change	Traditionally closed banking system only beginning to open up to foreign competition and change	Adequate levels of competitiveness and performance due to recent trend towards private ownership and management	Reasonably open and generally privately owned and managed banking system respected for competitive position	Open privately owned and managed banking system globally respected for competitive prowess
3 3 Governance and Management	Dismal governance and management undermine banking and economic development	Weak governance and management undermine banking development despite recent but very marginal improvements	Adequate governance and management for banking but improvements needed to achieve global competitiveness in banking	Strong governance and management sustain competitiveness in banking	World class governance and management reinforce and sustain competitiveness in banking
3 4 Non-Bank Competition	No serious competition from non banks further undermines the need for financial discipline	Very limited competition from non banks provide little pressure on banks to exercise financial discipline	Adequate levels of competition from non banks but lack of market breadth and depth limit impact on competitiveness and financial discipline of banks	Satisfactory levels of competition from non-banks enhance competitiveness and financial discipline of banks	Significant competition from non banks further strengthens levels of competitiveness and financial discipline of banks

IV BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS					
Topics/Categories and Description of Coverage	**1**	**2**	**3**	**4**	**5**
4 1 Capital Adequacy	Wholly inadequate capital	Inadequate capital	Adequate capital	Reasonably strong capital	Enviably strong capital
4 2 Asset Quality	Dismal asset quality	Poor asset quality	Adequate asset quality although significant room for improvement	Reasonably strong asset quality	Enviably strong asset quality
4 3 Management	Wholesale disregard for fundamentals of risk management	General lack of awareness of risk management fundamentals	Fairly weak but improving reputation based on emerging risk management capacity in a market showing increasing levels of competition	Reasonably strong reputation based on satisfactory risk management capacity in a fairly competitive market	Enviably strong reputation based on world class risk management capacity in fiercely competitive market
4 4 Earnings	Sustained losses that have decapitalized the banks by IAS	Weak or unstable earnings	Adequate earnings but room for added stability and diversification	Reasonably strong and diversified earnings	Enviably strong and diversified earnings
4 5 Liquidity	Severe liquidity problems	Liquidity problems	Adequate liquidity position but room for strengthening	Reasonably strong liquidity position on an ongoing basis	Enviably strong liquidity position on an ongoing basis
4 6 Operating and Regulatory Environment	Dismal operating and regulatory environment	Poor operating and regulatory environment	Adequate and improving operating and regulatory environment	Reasonably strong operating and regulatory environment	Enviably strong operating and regulatory environment
4 7 Transparency and Disclosure	Dismal standards for transparency and disclosure	Weak standards for transparency and disclosure	Adequate standards for transparency and disclosure	Reasonably strong standards for transparency and disclosure	World class standards for transparency and disclosure
4 8 Sensitivity to Market Risk	Dismal reputation for sensitivity to market risk under market conditions	Poor reputation for sensitivity to market risk under market conditions	Adequate and improving reputation to manage sensitivity to market risk as market conditions increasingly prevail	Strong reputation to manage sensitivity to market risk under market conditions	World class reputation to manage sensitivity to market risk and continuously prosper under market conditions

ANNEX 2 A DETAILED ASSESSMENT OF THE POLISH BANKING SECTOR

I FINANCIAL SECTOR INFRASTRUCTURE Poland continues to evolve slowly towards financial sector modernization Its strengths are found in a dynamic and growing economy geared to EU and global markets, increasing liberalization and investment in the banking sector, high levels of accountability, increasing professionalization, and supervisory structures for banking, insurance and capital markets based on global standards of transparency Recent legal reforms—The Banking Act and The Act on the National Bank of Poland[1]—all reinforce these structures and provide them with the mandate they need for effective enforcement Governance at the state commercial banks and major private banks has also improved since late 1993, when hard budget constraints were placed on most banks and their debtors [2] The new Banking Act spells out basic governance requirements for all banks, including state and cooperative banks [3] However, privatization has been slow—about a dozen banks still remain in non-private hands[4]—and there appears to be preference for some measure of domestic consolidation instead of focusing on increased capital, management know-how, and market links from strategic investment [5] Recent entry into the OECD, expected formal entry into NATO, and future entry into the EU are all providing momentum for institutional reform However, Poland's privatization pace has been sluggish, and only recently has Poland begun to attract significant volumes of strategic investment Even here, large proportions have come from small numbers of investments Its legal and regulatory framework for financial services is being harmonized with BIS, EU and other international standards to ensure continued integration into international markets Its payments system is adequate for now despite weak telecommunications capacity and a high proportion of paper copies Accounting standards have been moving increasingly towards international norms, sustained largely by requirements for the largest reporting banks, the due diligence process that comes with privatization and larger joint-ventures involving equity stakes, and demands from the market on companies trading in the capital markets General support organizations which enhance and help sustain market development—rating agencies, professional associations, media,

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1 Both of August 29, 1997

2 In February 1993, Poland passed the Act on the Financial Restructuring of Enterprises and Banks This provided a framework for the financial and operational restructuring of commercial banks—but not specialized banks—based on an up-front recapitalization combined with loan recoveries resulting from negotiations with debtors Most of these settlements were out-of-court Since then, most commercial banks have generally been required to operate without government subsidies While commercial banks generally invested in government securities at high net spreads to further recapitalize after the initial recapitalization and 15-month period of negotiated loan recovery, there was no direct subsidization from the budget to banks This led to improved governance and management Conversely the three largest specialized banks still operate with direct support and/or guarantees, along with other forms of support derived from the Bank Guarantee Fund (mainly for cooperative banks)

3 New legislation is interpreted to meet minimum EU guidelines, with changes expected in the future as the system evolves

4 This includes Pekao SA Group, which represented four separate banks at end 1997 but were definitively consolidated into one group in April 1998

5 For instance, the initial public offering of PBK-Warsaw was delayed to allow an improved bid from a primarily domestic consortium of investors who eventually prevailed This led to some incremental capital being brought into the banking system—from Creditanstaalt with its 20 percent share—but this was reported to be less than what a rival bid from Samsung was thought to have presented prior to the delay

academic and training institutes—all exist or are evolving towards professional standards There is also cause for optimism that privatization will accelerate in 1998-99 with Pekao SA Group[6] and the smaller Bank Zachodni, bringing the number of non-private banks down to less than 10 However, two of the banking system's largest institutions will remain non-private for the time being—PKO BP and BGZ[7]—as will the troubled PZU insurance company [8] **Score 3**

1 1 Policy/System Poland has been perceived to be partly protectionist with regard to several "strategic" sectors (e g , coal, steel, agriculture) and slow with privatization over the years The latter is due to the decentralized approach to privatization that Poland has followed since the early stages of transition, while the former has much to do with the politics of vested interests and concerns about full-scale restructuring Nevertheless, Poland has also shown considerable economic growth in real terms, and is beginning to attract major foreign investment after years of unimpressive direct investment outlays More recently, Poland has been perceived to be on the right track, largely the result of its membership in OECD and ambitions for early entry into the EU [9] These require a commitment to democracy, free trade, and multilateral cooperation Poland's legal and regulatory structure is being reformed to conform to these prerogatives At the structural level, Poland's economy, banking and financial system have undergone considerable reform since 1989 Its regulatory structures are considered reasonably strong, and this should provide for added institutional security in banking and capital markets in the coming years as trade and investment in financial services increase However, the pace of reform has been questioned, most particularly with regard to privatization in the steel, coal, shipyards, banking, insurance, and telecommunications sectors **Score 3/3+**

- The *political environment* is now comparatively stable in Poland, although several continuous years of government turnover in parliament and disagreements between the executive and legislative branches slowed the reform process Poland's institutions guarantee the rule of law, human rights and the protection of individual and minority rights According to the EU, there are still weaknesses with regard to the operation of the judicial system, corruption, and press freedom to some degree Poland is organized as a parliamentary democracy according to the so-called "Little Constitution," adopted by parliament in 1992, pending passage of a permanent constitution Poland has a bicameral parliament comprised of a lower house (*Sejm*) and an upper house (Senate) Within the legislative branch of the central government, the Sejm has most of the power The President is elected for five years Poland is currently divided into 49 provinces (*voivodships*), each of which is headed by a provincial governor (*voivode*) appointed by the central government There are also independent locally elected city and

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6 The first 15 percent of shares were issued in June, 1998 for about $270 million By year end, Pekao SA Group is expected to be majority private

7 The Ministry of State Treasury recently signed an agreement with the EBRD for the latter to assist with a due diligence and subsequent restructuring efforts at BGZ in anticipation of a late 1999-early 2000 privatization—with possible EBRD financial participation

8 ABN-Amro was recently selected to serve as advisor for the planned privatization of PZU in 1999

9 In April 1996, the government approved *Package 2000*, a medium-term program covering the second half of the 1990s The program addresses macroeconomic and structural issues with a view to convergence with the more advanced economies of Western Europe A key objective of this program is to sustain an average growth rate of 5 5 percent real GDP A cursory look at Polish economic performance suggests that ongoing efforts to open up the economy to trade and investment will have to be sustained, and social security reform will have to be successfully implemented to reduce fiscal imbalances However, in general, Poland is making progress towards the goals it has set for itself regarding membership in the EU

village governments There are currently plans to consolidate local government into 12-14 voivodships, with locally elected assemblies controlling 15 to 30 percent of VAT and income tax revenues, respectively, which are raised locally [10] Poland is a member of major international organizations such as the World Trade Organization (WTO), European Free Trade Agreement (EFTA), Central European Free Trade Agreement (CEFTA), the World Bank (IBRD), the International Monetary Fund (IMF), and the Organization for Economic Cooperation and Development (OECD) Poland was among the first three countries of the former socialist bloc invited to join NATO in 1997 Currently, Poland is pursuing EU membership, anticipated some time in 2002-05 [11]

- With regard to *legal and regulatory reform*, there is a perception that judicial institutions need strengthening to be effective Poland has recently introduced needed legal reforms to provide a framework that is more conducive to risk-taking for banking based on enforceable contractual agreements with the enterprise and household sectors Previous problems included reliance on a Commercial Code dating back to 1934, and the after-effects of decades of non-commercial applications which protected debtors at the expense of creditors As for banking, reasonable protection was provided under the 1993 Act on the Financial Restructuring of Enterprises and Banks However, significant problems persisted beyond that Law's enactment and the restructuring activities that ensued These included a slow court process, disorganized and incomplete property registries, and the existence of multiple claims on properties due to the inability to perfect liens This led to a cautious, risk-averse approach to lending—there was little lending until late 1995—and much of the lending that has been provided since is still short-term and heavily secured The newly adopted Banking Act provides greater legal backing to banks in the area of debt collection, including the use of debt collection agencies and liquidators for asset repossession and disposition when debtors are unable to comply with legal agreements

- *Economic* developments in 1997 were strongly favorable in Poland Real GDP growth was 6 percent, the fourth consecutive year in which growth has exceeded 5 percent in real terms The unemployment rate declined to 10 5 percent at year-end 1997, compared with 16 4 percent at end 1993 and 13 6 percent at end 1996 Likewise, there was a continued decline in the inflation rate, from 18 5 percent at end 1996 to 13 2 percent at end 1997 The central fiscal deficit remained within Maastricht EMU criteria, at 2 8 percent, although local government and off-budget items would raise this to 3 9 percent High social security and pension costs were the most conspicuous expenditure item Interest rates increased on a nominal basis for the first time in years—the NBP raised reserve requirements twice, and refinancing, rediscount and lombard rates showed a parallel 2 0-2 5 percent increase by end 1997 compared with end 1996 Meanwhile, the exchange rate continued to depreciate against the U S dollar, from a year-end 1996 rate of Zl 2 87 to 3 52 by end 1997 This trend was reversed in the first half of 1998, with mid-year exchange rates at Zl 3 47 to the dollar [12] Debt ratios are satisfactory, and present little strain on the balance of payments However, the tripling of the current account deficit in 1997 was and remains a cause for concern

- The *banking* sector continued its slow march to competitiveness Bank assets were about 50 percent[13] of GDP at end 1997, low by OECD standards and unchanged in the aggregate from Poland's average in 1991 This trend is actually favorable due to the improved asset quality of the measure, as well as

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[10] See "Poland's devolutionary battleground," *The Economist*, February 7, 1998, and "Consummate politician," *Business Central Europe*, June 1998

[11] An EU Association Agreement was signed in March 1992, along with Poland and the Czech-Slovak Federal Republic These were the first Association Agreements signed

[12] While the 1997 current account deficit tripled in both dollar terms and as a percentage of GDP compared to one year earlier, portfolio investment increased significantly in early 1998, driving up the value of the zloty As the dollar has appreciated against most currencies, this reflects a real appreciation of the zloty against most currencies

[13] This figure includes the cooperative banks

the significant growth in GDP over the last several years However about half of Poland's banks are below, at or barely above the EU minimum for capital These banks remain small, and will likely need to grow through mergers or new share issues if they are to be competitive in the market On the larger end, Bank Handlowy raised more than $1 billion in new capital with its share issue in June, 1997 Since then, PBK-Warsaw was privatized as well Two more banks are slated for privatization in 1998—with the first 15 percent of Pekao SA Group already carried out through an IPO PKO BP, BGZ, some private banks, and cooperative banks appear to remain troubled, which represents a significant share of assets but is still down from a far higher number in 1993 In terms of financial measures, the marketplace is becoming increasingly competitive The blue chip market has become saturated, and foreign banks are now beginning to compete with Polish banks for other corporate market segments while introducing new electronic services at the retail level Lending has increased significantly since end 1995 with many Polish banks thought to be lending foreign currency-denominated borrowings to the consumer market in zloty to capture higher rates These trends notwithstanding, earnings leveled off in 1997 Cost ratios remain high, although trends are different among large Polish banks and foreign-controlled banks The nature of these expenses—some reflecting investments that will increase future earnings, others that reflect fixed cost structures that may undermine competitiveness—and the ability to manage various credit, exchange rate, and interest rate risks may provide some indications of the competitive landscape for the coming years

- There is growth in capital markets and *non-bank financial institutions* Insurance premiums exceeded $3 billion in 1996, compared with $1 8 billion in 1994 Legislation enacting pension reform is expected to add resources for investment in the capital markets in the next few years There has been steadily increasing turnover and market capitalization on the Warsaw Stock Exchange (WSE) since 1991, when only nine firms were listed and market capitalization approximated $144 million As of mid-1998, market capitalization approximated $12 4 billion, or about 9 percent of GDP This included more than 165 listed equities Meanwhile, the over-the-counter (OTC) market is poised for growth By global standards, the capital markets and non-bank institutions still remain relatively small, and therefore could be subject to high levels of volatility over time Recent concerns about the ruble and the spillover effects in the region have been reasonably well contained on the Polish exchanges However, they still remain vulnerable to portfolio movements, just as the exchange rate has been impacted by significant market movements of funds in 1998 A significant portion of funding comes from foreign investors—largely portfolio investment that could be removed fairly quickly There is some concern of future risks of decapitalization—net profit transfers out of Poland by large financial institutions—although Poland's comparatively large population, and potential for significantly larger GDP once major privatizations take place provide some measure of comfort compared to smaller regional economies that do not have as much of a "domestic buffer Poland s exchanges also enjoy a solid reputation for accountability, integrity and transparency

- There has been significant *socio-cultural or historical* enmity towards banking This is considered to have contributed to the slow privatization of several financial institutions in banking and insurance However, some of the resentment is also based on incidents of fraud which occurred in the early 1990s after licenses were issued to private banks before effective supervisory capacity was in place to detect and monitor for fraud The difficulty many businesses have had in accessing credit also contributes to resentment—sometimes justifiably, and sometimes not due to the inability of many companies to meet creditworthiness requirements under market conditions However, lending at the consumer level has increased significantly, and more people have accounts with banks The Polish Bank Association claims that more than one million new bank accounts were opened in 1997, and that the number of accounts has risen from 20 percent of the population in 1993 to about two-thirds in 1997 Combined with better efforts at public relations, this may alter some of the negative perceptions that have prevailed until recently

1 2 Legal Poland recently adopted the Banking Act and the Act on the National Bank of Poland in late 1997 This legislation brings much of the legal framework for banking in line with minimum EU standards, OECD member requirements, and BIS guidelines The two Acts, representing improvements from earlier pieces of legislation, are also meant to provide a legal mandate to alleviate what have been problems associated with judicial infrastructure and the timely processing of claims, uncertainties regarding collateral and contract enforcement, and the utilization of secondary markets for debt collection Poland's legislation is generally considered satisfactory, although further changes are envisioned for the future as the system evolves Two likely amendments will be rules for collecting debts by banks, and an increase in limits on deposits [14] However, judicial infrastructure are not yet considered satisfactory for effective operations Courts are overwhelmed with case loads they can not handle Staffing and compensation levels are insufficient The European Commission gives Poland good grades for progress made in recent years in developing capacity to assume EU membership obligations in a number of areas—intellectual property, company law, taxation, accounting, and financial services Improvement is still considered needed in competition, public procurement, data protection, and the liberalization of capital movements With regard to banking, membership in the OECD has not been accompanied by a major push for liberalization Poland's interpretation of its membership obligations is to permit foreign banks to set up in the market, either as joint stock companies or branches [15] However, bank branches are required to maintain capital in Poland This is inconsistent with the spirit of market liberalization,[16] even if Poland's new legislation recognizes home-country rule and mutual recognition principles in a manner consistent with EU Directives Poland is taking the position that full opening will not occur until Poland becomes a member of the EU, which will not likely occur before 2002, and may not occur until 2005 or later Banks' interest in securitization, consumer lending, "plastic cards," and mortgage lending[17] may require refinement of some of the legislation over time to be more broadly consistent with EU norms **Score 3-/3**

- *The Law on the National Bank of Poland* (NBP) became effective in 1989 and legally transformed Poland from a monobank to two-tier banking system Poland's second tier consisted of four "specialized" banks—focused on agriculture (BGZ), retail foreign currency savings (PKO SA), long-term mortgage financing and local currency savings (PKO BP), and corporate foreign currency and trade (Bank Handlowy)—and nine "regional" commercial banks Subsequent to 1989, three more specialized banks were established—the Polish Investment Bank, the Polish Development Bank, and the Polish Export Bank The law assigns responsibility for the implementation of monetary policy to NBP, namely through the use of monetary instruments to set interest rates More recently, the new Act on the National Bank of Poland was adopted in late 1997 The new Act details general provisions, the NBP's organizational structure (including the role of the President of the NBP, the Monetary Policy Council, and the NBP Management Board), the NBP role as a state institution, banking supervision, the issue of currency, monetary policy instruments, the operation of bank accounts, foreign exchange activity, the rights and duties of NBP personnel, NBP finances, and miscellaneous provisions The basic objective of NBP remains the maintenance of price stability Changes to the legislation generally relate to the role of supervision and the new Commission for Banking Supervision, which is adapted to more universal financial services The Commission for Banking Supervision is chaired by the NBP

14 See *Polish News Bulletin*, 21 April 1998

15 Representative offices are also allowed, but cannot engage in financial intermediation

16 In terms of liberalization, such a strategy puts Poland behind such countries as Bulgaria and Hungary which permit foreign branches to locate and be answerable to host country supervisory authorities without keeping capital in the foreign country

17 There is expected to be demand for 4 million new apartments in Poland through 2010 Poland currently has one of the lowest rates of apartments per 1,000 residents in Europe See *Polish News Bulletin*, 13 February 1998

Governor, with six other members from the Ministry of Finance (two members), a representative of the President's office, the Bank Guarantee Fund, the Securities and Exchange Commission, and the General Inspector of Banking Supervision Risks are that the Commission will become preoccupied with political matters or slow in decision-making due to its multi-sectoral focus However, for the time being, these risks are mitigated by the predominance of regulators on the Commission rather than political appointees Decisions are made by majority vote Other key features to the legislation include monetary policy and implementation, including limits set on reserve requirements, and lender of last resort provisions, including NBP lending to the Bank Guarantee Fund

- Poland adopted the new *Banking Act* on August 29, 1997 concurrent with the new Act on the National Bank of Poland The law generally conforms to EU guidelines, and provides NBP and the Commission with broad legal powers for corrective action to ensure a safe, sound, and stable banking sector The law and associated regulations spell out the requirements of banks with regard to general provisions, the establishment and organization of banks (including branches and representative offices), the safekeeping of accounts, settlements, credit and large exposures, guarantees and other off-balance sheet items, the issuance of bank securities, rights and duties of banks and their officers, the association and "amalgamation" of banks, bank capital and finances, banking supervision, bank reorganization (including rehabilitation, liquidation and bankruptcy), civil and criminal liability and penalties, and miscellaneous provisions (including achievement of minimum capital requirements and tax-deductibility related to provisioning expenses) Some of the key stipulations include the following definitions of "core" and "supplementary' capital that are consistent with EU and BIS guidelines, and which specify that core capital must be a minimum 50 percent of the bank's total capital base, bank acquisition of shares in individual companies or funds cannot exceed 15 percent of bank capital, total exposure of bank investment in companies and funds cannot exceed 60 percent of bank capital, minimum capital must be ECU 5 million,[18] capital adequacy ratios must be a risk-adjusted minimum of 8 percent according to BIS guidelines, with higher requirements for new banks,[19] total exposure to single parties on a consolidated[20] basis cannot exceed 25 percent of bank capital, insider loans and exposure cannot exceed 10 percent of a bank's core capital and these have a series of restrictions and conditions to keep them small, contain risk and enhance transparency, banks cannot lend if the proceeds are used to purchase bank securities of their own issue, general disclosure requirements are elaborated subject to the obligation of banking secrecy, as are strict and costly penalties for legal infractions, and the role of the internal audit function is stressed, and will be relied on increasingly for strengthened risk management as well as regulatory compliance

- *The Trust Fund and Public Trading in Securities Act* and the *Act Establishing the Warsaw Stock Exchange* were introduced in 1991 and set the framework for the introduction of the new[21] Warsaw Stock Exchange (WSE) on July 2, 1991 This was later followed by the Bond Act of 1995, and has been supplemented with articles of the Warsaw Stock Exchange, by-laws and regulations which bring the operations of Poland's exchanges in line with EU directives[22] and OECD guidelines, and the

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18 For existing banks that do not fulfill the capital requirements of the new law, notification of capital deficiency to the Commission can then lead to an agreed plan to achieve the minimum target by end 1998, and in some selective cases by end 1999

19 New banks are required to have minimum 15 percent risk-adjusted capital through year 1, and minimum 12 percent through year 2

20 "Consolidated" is defined as "a group of parties related by capital and management and incurring common economic risk " See *The Banking Act*, Article 71

21 The original WSE began in 1817 and was closed in 1939

22 Relevant EEC guidelines are likely to have included (i) 79/279 on criteria for listing on the stock exchange, (ii) 80/390 on harmonization of provisions for stock exchange listing, (iii) 82/121 on regular information published by listed joint stock companies, (iv) 89/298 on harmonization of provisions for public offerings of transferable securities, (v) 89/592 on harmonization of provisions for insider

recently enacted *Act on Investment Funds* and *Law in the Trading of Securities* The new legislation dematerializes securities, permits brokerage firms to become full-fledged investment banks, and allows trading in warrants and derivatives The Polish Securities Commission (PSC) is responsible for supervising the markets The PSC is a member of the International Organization of Securities Commissions, which has been working closely in recent years with the Bank for International Settlements to establish more effective regulatory oversight across borders in a broad range of financial services which link banks and investment firms International standards of corporate governance, accounting and information disclosure are applied in the cases of companies listed on the WSE, as well as on the smaller but growing CeTO[23] (over-the-counter, or OTC market) [24] Brokerages are required to operate as independent units if they are owned by banks Poland's exchanges have a strong reputation for depository, clearing and settlement operations More than 165 companies were listed on the WSE in April 1998—up from 83 at end 1996—and mutual investment funds[25] and bonds are also traded Listings include the 15 National Investment Funds which were listed in June 1997 and are responsible for managing about 512 companies that were "mass privatized " Although Poland has not generated large foreign inflows on a per capita basis, foreign direct investment (FDI) began to increase in 1996, and portfolio flows have accounted for a significant share of WSE volume/value since the early 1990s WSE is considered a highly liquid market (based on high turnover ratios), albeit small Investors are free to transfer capital and earnings in and out of the country as long as tax obligations are complied with The liberalization of current transactions, a function of OECD membership, has assisted in these developments—although the European Commission believes Poland needs to make more progress towards capital account liberalization

- Poland has had long standing problems regarding claims on movable properties through *lien perfection* This served as a disincentive to banks to take risk in the early 1990s, due to their inability to collect on debts that were collateralized Poland initiated a judicial reform project in mid-1995 to review legal structures and case loads, and to strengthen *property registration* procedures and records In January 1998, Poland enacted a new Registered Pledge Law to allow for a uniform, centralized and computerized property registration system for non-possessory pledges over movable properties Enforcement of pledges is possible without court assistance in executing warrants Combined with a strengthened legal mandate for creditors to collect on loans, it is expected that improvements in the new system will provide added incentives for banks to take risk in their lending activities due to better and more up-to-date information on collateral values and the perfection of liens

- Poland has gained experience and commercial training in specialized bankruptcy cases throughout the 1990s However, because of excessive case loads, both *in-court and out-of-court adjudication* procedures are utilized in Poland Commercial cases are generally heard by special divisional economic courts These divisional courts have second-tier voivod-level courts which hear appeals Courts enjoy fairly broad powers, including appointment of liquidators, verification of creditors' claims, and general supervision of bankruptcy proceedings There are at least 10 debt collection companies in Poland, and probably other smaller firms which operate on a local market basis However, with five companies reporting only Zl 12 6 million in 1996 revenues,[26] this does not look like a widely used option These companies also appear to be more closely linked to "credit agencies"

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transactions, (vi) 93/6 on capital adequacy of investment service companies and credit institutions, and (vii) 93/22 on securities investment services

[23] CeTO is the acronym for the Central Table of Offers

[24] While such standards are applied these are slightly less rigorous due to the comparative size of firms on the CeTO

[25] Mutual funds only accounted for about Zl 2 billion in WSE investment, or about 5 percent as of April 1998 Part of this is because only 2 3 percent of savings are placed in funds As more companies are publicly traded, it is expected that mutual funds will play a greater role in the financial sector

[26] The two largest firms, both based in Wroclaw, accounted for virtually all reported revenues—Zl 11 9 million More than coincidentally, Wroclaw is where the two largest "credit agencies" are located

rather than banks When utilized, liquidators are contracted to void specified transactions prior to liquidation, to seize debtors' assets, to inventory property, and to issue financial statements Thus, liquidators play a more financial/administrative role that is overseen by judicial authorities Liquidators are not required by law to possess specific qualifications or certifications Out-of-court settlements can be reached when a majority of creditors reach a binding settlement on a reorganization plan with the debtor In this case, the courts confirm the results without rendering judgments as long as the settlement is legally compliant In general, the in-court process is slow Commercial cases in the Warsaw require one to two years to be heard, and another one to two years for a final judgment for the execution of payment First instance decisions can be appealed There is also an independent right of judicial review of administrative actions initiated by the courts

- The Bankruptcy Law of 1990, which amended the old 1934 law, provides the legal framework for *bankruptcy liquidation and foreclosure* proceedings in Poland Bankruptcy settlements are binding when a majority of creditors agree to a reorganization plan with the debtor At that point, the court appoints a liquidator who carries out many of the financial and administrative formalities of the reorganization under the review of the court From 1990-96, 23,237 bankruptcies were filed, resulting in 20,370 "liquidations" and 2,867 reorganizations The former were often restructurings which permitted companies to escape financial obligations to creditors In fact, one of major weaknesses in the Bankruptcy Law was the low priority given to secured creditors, whose claims were subordinated to government, social security funds, and employee wages prior to collections Recognizing these weaknesses, out-of-court conciliation procedures were initiated under the Act on the Financial Restructuring of Enterprises and Banks in 1993 to strengthen the hand of creditors in negotiations This led to modest development of a secondary market for *liquidation and repossession* along commercial lines, which has since been strengthened by recent enactment of the new Banking Act in late 1997

1 3 Regulatory/Supervisory Poland's banking supervision department—known as the General Inspectorate of the National Bank (GINB)—represents one of the strengths of Poland's overall financial infrastructure and institutional capacity The regulatory framework conforms to prudential guidelines rendered by the Basle Committee for Banking Supervision,[27] as well as more recently with EU directives and guidelines more consistent with "universal" banking practices The banking supervision department of the NBP has been developed virtually from nothing since 1992 when the magnitude of banking sector problems was beginning to be realized These problems existed at three broad levels First, the structural link (e g , banking sector developments under commercial conditions) to monetary and broader macroeconomic conditions was poorly understood because the condition of the banks was poorly understood A prudential regulatory framework for banking was needed to help provide NBP with the underlying stability it needed to achieve its objective of price stability Second, it was becoming increasingly clear that the large state banks—both specialized and commercial—were in poor financial condition, and that it was going to be costly to recapitalize and restructure them NBP, the Ministry of Finance, and the government as a whole needed to have a better understanding of the magnitude of the losses to assess the potential costs and how these would be financed Further, to avoid a recurrence, better information was needed by NBP to ensure that imprudent behavior on the part of bank boards and management would not lead to greater problems in the banking sector This led not only to a better regulatory framework, but the adoption of an increasingly integrated approach to banking supervision, based on comprehensive policy coordination, full-scope and targeted on-site examinations, and off-site surveillance focused on regular reports on areas of greatest risk Third, it became clear during the turbulent period of

[27] This Committee is a formal part of the Bank for International Settlements, or BIS

1989-90 and thereafter that many of the smaller banks that had received licenses just a few years earlier[28] were incapable of managing banking operations in a safe and sound manner under risky conditions In some cases, this was due to the volatility of the market during the early period of "shock therapy," and the years shortly thereafter when inflation rates were still high and the political situation was unsettled In other cases, this was due to outright corruption and fraud Thus, since 1992, banking supervision at NBP has evolved to contain systemic risk in the banking sector and to support NBP's larger objective of pricing stability More recently, the role of the GINB has changed slightly In one sense, it has been expanded to play a major executory role on behalf of the Commission for Banking Supervision On the other hand, its role may be diluted by the presence of a broader composition of the Commission through which GINB must now coordinate its activities Irrespective of the outcome of this new role, GINB is perceived to be effective in its oversight of the banking system It has avoided the weaknesses found in many other neighboring supervisory agencies, such as inadequate coordination between/among differing authorities, reluctance to use on-site inspections, reluctance to apply enforcement mandates, and inability to retain competent and trained personnel Poland currently has about 350 personnel employed in banking supervision Banks are generally viewed to be compliant with regulations, and the benefits of some reporting systems—such as uniform bank performance reports (UBPRs)—are now being used for internal management purposes, not just for regulatory reporting In general, supervision is considered strong One weakness includes the non-privatization of some of the largest Polish banks, which undermines GINB's mandate to enforce supervisory actions in a manner similar to private banks Additional weaknesses at the technical level are rooted in insufficient information, the nature of some reporting forms[29] and methodologies,[30] the need for increased training in risks associated with derivatives—mainly foreign exchange, interest rate, and pricing—and mortgage lending, and the need for more targeted inspections when risks are identified (as opposed to comprehensive examinations) There may be inadequate information generated from banks regarding off-balance sheet risks (e g , guarantees, third party transactions) which could undercut the ability of NBP to identify, evaluate and contain risks early enough for a targeted inspection or corrective action This is particularly worrisome in terms of consumer lending and potentially high rates of delinquency Likewise, there may be inadequate information reported to NBP from banks regarding the links between interest rate, exchange rate and maturity risk Many banks are currently borrowing in foreign currency and lending in zloty Reporting forms to NBP are in zloty This conversion may gloss over the exposure some banks have in the event of a material shift in the exchange rate More specific forms which show the actual currencies, exchange rates, interest rates and maturities of borrowings and loans on a weighted and time-to-maturity basis might assist NBP with its surveillance This would permit greater sensitivity analysis for borrowing and lending flows As banks become increasingly exposed to derivatives, these risks will become increasingly prominent **Score 3+/4-**

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[28] In 1989, 13 Polish banks had licenses to operate By 1992, the number of banks had increased to 90 Most of these were very small and poorly capitalized Minimum capital requirements were *old* Zl 4 billion, or the equivalent of about $3 5 million at the time Thus, entry into the banking market was very easy The number of banks superseded the capacity of NBP to properly oversee the banking system

[29] For instance, property-related figures are not broken out into residential, commercial and other forms of property or real estate development Differing trends may have a significant impact on portfolio quality

[30] While foreign currency values are reported and required to comply with regulations on open positions—15 percent in individual currencies, and 30 percent globally—they are not necessarily analyzed on a time-to-maturity basis or sensitized for risk This weakens the value of off-site surveillance, and the ability to conduct targeted on-site inspections that hone in on foreign exchange risk

- *Licensing requirements* and regulations were tightened in the banking sector in 1992 when NBP began to realize that its earlier liberal licensing policy was premature and risky The new Banking Act and Act on the National Bank of Poland, which became effective on August 29, 1997, further tighten requirements This includes raising minimum capital to at least ECU 5 million, and a clear specification of the principles governing the internal audit function The Commission for Banking Supervision is now responsible for licensing It is expected that licenses will be issued not only on the basis of the stated requirements, but within the context of the Commission's judgment of the risks of issuing a license within a universal banking context in which the "bank" may engage in a range of "non-banking" activities Thus, requirements for bank managers and members of the board, higher minimum capital, internal audit functions, business plans, and other considerations will likely come under more intensive scrutiny relative to the risks associated with the issuance of these licenses It remains to be seen how the Commission manages the balance between the need for prudence on the one hand, and the use of such prudence to stifle meaningful financial sector liberalization and competition on the other

- The NBP has long had a *clear legal basis and mandate to supervise* the banks The new laws clearly delineate the role of the Commission for Banking Supervision and its mandate for supervision of the banks This is based on principles of cross-border reciprocity driven by EU Directives—host country responsibility mutual recognition—as well as cross-sectoral cooperation with other regulatory agencies driven by Basle Committee guidelines for oversight of financial services—the SEC, Agency for Supervision of Pension Funds, the State Agency of Insurance Supervision, and international counterparts The Commission's objective is to ensure the safety of funds held in banks, and overall compliance with the laws and regulations that pertain to the banking sector While supervision of state-owned banks may be somewhat undercut,[31] this is due to the rehabilitation scenario that has been in effect for years In general, supervision has a legal mandate to ensure the solvency and liquidity of the banking system to ensure banks operate within the laws and regulations in effect, to issue recommendations for corrective action to suspend or modify banking operations, and to revoke bank licenses if needed

- *Penalties* for regulatory non-compliance by bank managers and employees can be assessed, as they can for board members as well This includes penalties for violations of insider loans, bank lending to parties for the latter to purchase shares in the former, divulging confidential information, and other violations of prudential regulations Penalties can also be assessed on companies mobilizing deposits without a banking license with the intention of lending

- The Accounting Act of September 29, 1994 introduced new accounting principles that largely conform to the EU Fourth Directive Prior to that date, most statements were cash-based and prepared for tax and Central Statistical Office purposes The new act, along with other legislation that applies to the financial sector, introduced standards of *disclosure* that are adequate at the major banks and insurance companies,[32] as well as for firms listed on the stock exchange This includes consolidated statements, and notes to amplify on assumptions that underlie financial statements so that these statements are reliably and clearly presented According to the Commercial Code, disclosure requirements for joint-stock companies—which includes most large banks and companies—include delivery of statements and associated reports to shareholders at least two weeks prior to the annual

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[31] As employees of NBP, bank supervisors are civil servants However, this is the same status as those employed at state-owned banks This can create political complications which can weaken GINB s enforcement mandate

[32] There are still reservations about some of the potential risks associated with the statements of PZU These concerns should come out and be resolved in the next year or two if the government becomes serious about privatizing PZU However, at a minimum, regulations are in place for the insurance companies to provide adequate disclosure of financial information based on audited statements, and conforming to IAS and the EU Fourth Directive

shareholders meeting Shortened versions of these statements and auditors' opinions need to be published in the Polish Monitor Additional disclosure requirements apply for reporting to tax authorities and the Central Statistical Office Thus, at the upper end of the market, Poland's accounting standards are serving as a catalyst for increased transparency and disclosure for the market, for regulators, and for management This is helpful for market development, as well as for effective banking supervision However, there are questions about the level of disclosure from smaller private firms Firms with sales/income[33] below ECU 400,000 are not required to file IAS statements due to the costs of preparation In terms of banking, this means that most firms do not meet the information and disclosure requirements applied to larger firms As banks increasingly compete for new markets, it can be expected that pricing for loans will remain very high for the vast majority of Polish enterprises seeking loans For banking supervision, it will be important to identify if the net spreads on these loans are sufficient to compensate for the risk, and if stricter information requirements should be applied for banks to contain these risks

1 4 Payments System Poland's payments system is considered adequate for clearing and settlement, but limited in terms of efficiency due to the still high proportion of paper transactions With ambitious plans to significantly increase credit and debit cards, point-of-sales terminals and ATMs by 2000, it is also possible the system will lack sufficient capacity to handle a marked increase in volume This could be remedied by extending the clearing time, but this would mean delays and inefficiencies which also undercut liquidity and the overnight interbank market A regulation from June 24, 1992 from the NBP provides banks with three options for inter-bank clearances These include a national clearinghouse, correspondent accounts, and agreements on the direct exchange of payment instructions The system generally has no systemic risk because settlements are conducted on a net basis, and do not occur unless there are funds are available from the debtor bank's account held at NBP The pace of electronic processing is increasing, with about half of all banks participating on the fully electronic system by end 1996 However, the smaller banks are constrained by their own internal capacity Further, as most banks estimate their funds at closing and maintain surpluses for insurance, the system cuts into liquidity at a time when liquidity is tight due to the restrictive monetary policy of the NBP Meanwhile, limited electronic systems combined with courier systems operate on a regional basis for other banks to participate in the settlement system Failure of a bank to settle its liabilities through its NBP current account leads to automatic exclusion from the system **Score 3**

- Poland has a somewhat slow but increasingly modern *clearing and settlement* system A network of couriers is still used for clearing documents for nearly half of banks Some of these banks also participate in the limited electronic system available—SYBIR, which came on line in April 1993 A growing proportion of banks are members of the fully electronic system—ELIXIR, which came on line in September 1995 The trend towards fully electronic systems will enhance overall competitiveness, and should contribute to increased liquidity over time However, it is uncertain now if Poland will have sufficient capacity to handle projected volume by 2000 At that time, the banks hope to have 150,000 point-of-sales terminals, 3,500 ATMs, and 6 million "plastic" card holders

- *Management MIS and technology* development related to payments systems are considered sound, as are internal systems, procedures and controls However, these same systems are sometimes criticized for being excessively paper-driven, time-consuming and redundant in certain functions (e g , debit transfers) A new chart of accounts was introduced in 1997, and banks have had to redo their systems accordingly New technologies and systems have provided the banks with the increasing benefit of electronic bank transfers, although many of the smaller banks are constrained by limits on technical

[33] These are net sales of goods and finished products plus financial income

capacity

1 5 Accounting Poland adopted the Accounting Act of September 29, 1994 to bring the country's accounting standards more in line with IAS and the EU Fourth Directive Prior to this legislation, most statements had been produced for tax purposes and for the Central Statistical Office Public sector entities and small businesses with net sales and financial income of less than ECU 400,000 are generally exempt However, other companies are expected to comply with the standards, which are more rigorous as the size of the firm increases Businesses with no more than 50 employees on average throughout the year, with total assets of no more than ECU 1 million, and with ordinary income of no more than ECU 2 million are permitted to prepare simplified statements While at least 21 of Poland's banks (and possibly more) showed gross income of less than ECU 2 million (about Zl 7 million based on average exchange rates) in 1997, they are still generally required to prepare statements according to IAS In the case of larger firms and firms with foreign participation, statements are expected to conform to IAS and are prepared with the assistance of international accounting firms based on International Standards of Auditing This includes consolidation standards applied to intercompany balances and unrealized gains/losses[34] for subsidiaries and associated companies [35] Notes are used to provide needed explanations underlying balance sheets, income statements, and for larger companies, cash flow statements These explanations include but are not restricted to depreciation schedules and the impact on fixed asset values, collateral in assets owned by the company, an analysis of share ownership, movements in capital, reserve and provision accounts, creditor maturities, contingent liabilities, tax reconciliations, information on nonconsolidated joint ventures, and loans/compensation to board members and directors In addition to being a standard for larger firms or being prompted by regulatory requirements in the financial sector, IAS has been a fundamental element of valuations, due diligence, and investment decision-making (both for direct investment and portfolio investment) since Poland began opening its markets Thus, Poland's accounting standards are evolving increasingly towards international standards However, numerous weaknesses remain in Poland's accounting framework, some of which may point to potential risks for bank portfolios In many cases, accounting is still conducted on a tax-oriented cash basis rather than on an accrual basis This is more the result of years of tradition rather than the fault of the new framework However, it does represent a tiering of the market, differentiated by firm size What this provides is a basis for smaller firms to understate income or overstate expenses to avoid tax payments, whereas larger firms have an incentive to overstate assets or understate liabilities to increase access to secured loans All the major international accounting firms have been active in the Polish market since 1990 Meanwhile, there are many more Polish accounting firms, although they tend to be smaller in scale, relatively new, and unable to provide many of the financial advisory services that are needed for ordinary Polish companies to strengthen management and competitiveness It is the opinion of some international auditors that there is a lack of political will on the part of the Ministry of Finance and the Polish Institute of Chartered Auditors to introduce national standards that would be universally accepted for widespread use [36] In particular, current accounting standards and statutory rules are considered to not provide sufficient guidance on related-party transactions,

[34] Financial accounting standards account for unrealized income/gains as deferred income, while unrealized losses are recognized This represents a more prudent standard than is commonly practiced Meanwhile, tax accounting standards only focus on realized gains and losses

[35] Beginning in 1999, holding company statements of firms listed on the WSE will have to be presented semi-annually on a consolidated basis

[36] See "Doing business in Poland," Price Waterhouse, October 31, 1997

leasing or deferred taxation These are all of critical importance to bank exposures and portfolio quality **Score 3-/3**

- The authorities have shown steady movement to ensure that *international accounting standards are consistently applied* in the annual reports of "large" enterprises,[37] and all major banks and insurance companies This has been particularly true for the blue chip sector of the economy, as listing on the WSE requires detailed information that conforms to IAS The OTC market generally applies IAS as well based on Securities Commission standards, approved auditors, regular reports, and mandatory annual audits In general, this has played a role in providing confidence to outside investors in the underlying quality of listings on the exchanges However, most Polish companies are either exempt from IAS filings or are only required to file simplified versions of financial statements There is also the question of cost, as most enterprises can not absorb the cost of hiring an international accounting firm

- The Banking Act is strict in terms of reporting, requiring banks, bank groups and financial holding companies to report to supervisory authorities on a regular basis This is specified in the Act as part of the particular duties of banks and obligations of banks with regard to banking supervision Banks have frequently relied on international auditors to assist with preparation of needed annual reports and financial statements, and these firms are credited by bank managers as having provided significant assistance However, there are thought to be weaknesses in some of the information produced—overvalued assets, and understated liabilities—partly resulting from an undeveloped internal audit function, weaknesses in supervisory and management board oversight, and inadequate risk management practices

- There are *accounting training programs* and institutes in Poland for international as well as Polish accounting standards IAS is largely based on the EU Fourth Directive Some of Poland's smaller (non-Big 6) accounting firms are certified in IAS as well as local standards However, most domestic accounting firms are small, with no more than one office They are also new, having become established in the 1990s The Polish Institute of Chartered Auditors has 2,500 members

- As of end 1996, the then six *international accounting firms* had been located in Poland since 1990, and all were active in the market Among the five largest international firms reporting, four of them have at least three offices in Poland At least another six "second-tier" international firms were also located in Poland Most of these firms appear to be generating a majority of their revenue from audit and accounting work, as opposed to tax and other activities There are also at least another 24 *Polish accounting firms*, mostly engaged in accounting, audit and tax work like their international counterparts Some of the local accounting firms also provide legal services These firms tend to be very small, with the largest Polish firm reporting revenues about one tenth the size of the four reporting international firms Weaknesses at local accounting firms include old traditions of financial control that are cash- and tax-oriented instead of accrual-based, a reluctance to point out when firms are in deep financial trouble and would require a qualified statement, and general limitations on the array of services they can provide

1 6 Rating Agencies/Systems All the major international rating agencies have been active for several years in the Polish market Poland's ratings in February 1998 were generally favorable in terms of the long-term outlook which reflects confidence in the long-term development of the banks However, Poland remains below prime for foreign currency deposits More recently, S&P

[37] This would generally be firms with greater than 50 employees, fixed assets exceeding ECU 1 million, and revenues exceeding ECU 2 million

affirmed a positive outlook for Poland's foreign and local currency ratings, as has Fitch IBCA [38] A domestic rating agency—CERA—has been established, but their efforts are partly constrained by information flows and concerns about confidentiality To date, CERA has rated three instruments—one long-term company issue, and two municipal bonds **Score 3**

- Poland has received ratings from the three major *international rating agencies* on a regular basis for several years Moody's granted Poland a Baa3 credit rating for long-term bonds in 1997 Moody's ratings for bonds and notes as well as bank deposits were unchanged from one year earlier [39] Standard & Poor's likewise assigned a comparable BBB- rating the same year Fitch IBCA has maintained a BBB rating, although this may be subject to change if conditions in Russia become unstable These ratings keep Poland in the lowest "investment grade" level for its long-term bonds—"neither highly protected nor poorly secured"—but "speculative" in terms of foreign currency bank deposits

- There is a *domestic initiative* to develop a fully competitive rating agency—the Central European Rating Agency, or CERA—for a wide range of instruments issued by banks, companies and municipalities However, CERA's efforts have been undermined by insufficient disclosure of information Disclosure is apparently improving with WSE-listed companies and with municipalities However, bank information is harder to obtain notwithstanding the shareholders of CERA, which are primarily Poland's main banks along with the Polish Bank Association [40] The banks appear to have limited willingness to disclose information for more open ratings in support of capital markets development Apart from CERA the main Polish banks and the Polish Bank Association are planning to develop a credit information bureau to be utilized by the banking sector for delinquent borrowers As for banks, GINB is in the process of developing a more formal CAMEL[41] rating system for banks The system is currently being tested on a mix of about 10 banks, with a focus on risks associated with credit, interest rates, liquidity, foreign exchange and internal controls However, these findings are kept confidential by NBP/GINB authorities Credit rating information on individuals and companies is generally limited due to strict concerns about confidentiality This is becoming increasingly important as a concern and tool of risk management due to the quickly rising share of consumer credit found in bank portfolios, and the growing demand for credit from small businesses which pay higher spreads on loans to banks but which have little or no documented credit history through the banking system

1 7 Financial Media No particular effort was made to assess the financial media However, there are several newspapers that report daily and weekly monetary and financial information There are also many English-language journals Media coverage is generally considered responsible An effort has been made through the Polish Bank Association's "Mediabank" efforts to provide greater information to radio, television and journals on developments in the banking industry—including product offerings, new lending trends, and other news that is relevant to the public PBA believes this has contributed to higher customer satisfaction ratings with the banking sector **Insufficient Basis for a Score**

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[38] Fitch IBCA cautioned recently that it would review sovereign ratings for the region depending on developments in Russia Even though Poland's trade with Russia and other FSU countries has diminished as a share of total, Russia remains a large supplier of energy and other commodities which could impact Poland's economy

[39] Moody's ratings as of February 1998 were Baa3 for long-term bonds, Ba1 for long-term bank deposits, and NP (not prime) for short-term bank deposits Short-term notes remain unrated

[40] Other shareholders include the Pioneer mutual fund and one of the brokerages

[41] There will be increasing efforts to incorporate sensitivity to market risk into this internal rating system, particularly as universal banking and globalization proceed Thus, the system might need to become a CAMELS rating system in the not too distant future

1 8 Professional Associations There are several professional associations in Poland for financial sector individuals and groups Among the largest are the Polish Bank Association (PBA) and the Polish Chamber of Auditors The PBA appears to be one of the most dynamic banking associations in the region, and is engaged in a number of initiatives that have accelerated market development in the banking sector Among these PBA initiatives are a shareholder role in establishing the joint stock company which serves as the clearinghouse for bank settlement, development of the TELBANK system,[42] managing a modest data bank on delinquent borrowers,[43] and development of a credit information bureau which will be launched in late 1998 It is specified in the Act on the National Bank of Poland that a representative of PBA participate in meetings of the Commission for Banking Supervision on matters that relate to regulation and supervision in the banking sector, including when the Commission meets to set "out principles for the conduct of banking activity that ensure the safety of the funds held by customers at banks" [44] Thus, PBA is considered important in coordinating input to/from banks and legal/regulatory authorities Its membership is voluntary, yet it includes all licensed banks as members as well as some of the larger cooperative banks The Polish Chamber of Auditors has 2,500 members, and is now providing some post-qualification training and examinations for ongoing professionalization through its institute The Chamber is also responsible for licensing auditing firms **Score (for PBA) 4**

1 9 Academic No particular effort was made to assess the number or quality of academic institutions in Poland Nor was there a systematic effort to speak with business/management school officials However, there are many schools, institutes and think tanks that are able to make a significant contribution to banking sector development There are at least 24 business schools in Poland, and possibly more Most have cooperation agreements with economics, business, finance, management and marketing programs in Western Europe or the United States The Warsaw Institute of Bankers was established in 1992 and has trained more than 3,000 people working in more than 50 Polish banks The Polish Institute of Chartered Auditors has also introduced post-qualification training and examinations as part of its efforts to contribute to the strengthening of the audit profession The Gdansk Institute of Market Economics and CASE are but two examples of influential think tanks **Insufficient Basis For a Score**

1 10 Miscellaneous In Poland, overall electronic and telecommunications capacity is increasing to compensate for what was one of the least developed systems in the region Investment in these areas is clearly evident in the banking and financial sector, as many banks are spending to improve their internal information and communications systems for better management and the provision of a wider range of services Part of this has been prompted by NBP, which is now requiring electronic links for reporting Poland started the 1990s with one of the least developed telephone systems in Europe Even by ex-communist standards, the system was poor—only 8 percent of the population had access to main-line telephone service, and service levels were poor Even in 1996, there were only 169 telephone mainlines per 1,000 people in Poland,[45] which

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42 This system provides clearinghouse, point-of-sales, and electronic banking services

43 This data base had 175,000 names as of April 1998 Only the names of borrowers and the banks are included in the data base This will be expanded later in the year with development of a more complete credit information bureau

44 See *The Act on the National Bank of Poland*, Article 25

45 See *World Bank Atlas*, 1998

lagged the Baltic States,[46] and were about on par with most of the European part of the former Soviet Union [47] Today, it is estimated the number of mainlines per 1,000 has increased to about 196 [48] However, mainlines predictably continue to fall well short of EU standards by a factor of two to four Rather than opting for privatization, the government has pursued a program to modernize infrastructure in advance of privatization of the major telecommunications company, TPSA, which is still wholly state-owned The government plans to privatize 20 percent of TPSA in 1998 Additional competition will be introduced for long-distance connections as well as for local phone services However, as of early 1998, private companies only serviced 170,000 telephones in 31 of 49 voivodships, as opposed to TPSA's 7 5 million telephones in all 49 voivodships [49] Investments so far in the telecommunications sector have been made for international calling and long-distance calling within Poland [50] It is expected that investment will increase as well in the major metropolitan areas However, investment requirements of $1 billion or more per year for network expansion will require greater resources than TPSA can provide Postal services appear adequate, as does safekeeping from a physical and logistical standpoint Part of the investment made by banks is to strengthen their electronic systems for increased protection, particularly as ATMs, point-of-sales terminals, debit-credit cards and other features are introduced **Score 3-/3**

- The decision to move forward with the privatization of TPSA was adopted by the Council of Ministers in 1996 A planned 20 percent privatization in 1998 is projected to generate $2 billion Full privatization is expected by 2000 Siemens, Lucent and Alcatel have recently entered the market by acquiring troubled telecommunications equipment firms This, along with the demonopolization of the sector has led to increased investment and improvements in *telecommunications* system capacity and networks in Poland Outgoing phone calls have increased in recent years, partly reflecting improved capacity and investment in infrastructure However, Poland generally still lacks competitive telecommunications capacity This has slowed the payments system which weakens bank liquidity and adds to costs This also raises the question of whether Poland will have adequate capacity in the coming years as ATMs increase to 3,500, point-of-sales terminals increase to 150,000, and plastic card holders increase to 6 5 million Lack of capacity will slow processing, adding to delays and inefficiency Already, the banks have had to bypass TPSA due to the lack of capacity provided by this company, contracting out electronic data and other services to Motorola

- The postal system is considered adequate Consumers still use the postal system for transactions, although electronic banking and enhancements in the payments system can be expected to reduce this role over time However, in many rural areas where the level of banking services is less competitive, it is likely that the postal system will continue to make transfers and provide confirmations

- No effort was made to review the safekeeping practices of banks No major complaints were made about the safekeeping features of the payments system, although there was mention of float problems associated with three-day processing of transactions Systemic risk is not considered likely through the payments system because of the system s ability to block accounts in the event of inadequate payer liquidity

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46 Estonia Latvia and Lithuania had 299 298 and 268 mainlines per 1,000 people, respectively, in 1996

47 In Belarus, Moldova, Russia and Ukraine, the range is 140 (Moldova) to 208 (Belarus)

48 Total telephones = 7 67 million in a population of 39 2 million

49 See *Polish News Bulletin*, 23 April 1998

50 In addition to investment in TPSA, the government issued GSM licenses to two consortia in 1996 These consortia have focused on network development

II ECONOMIC FACTORS AND INDICATORS Poland has an increasingly open economic system that has been private sector-oriented in terms of ownership for the last several years While much of industry remains in state hands[51] and agriculture needs to be modernized, the Polish economy has grown over the last several years on the strength of its private sector This includes about 5,000 privatized companies,[52] and an estimated 2 million or more companies that are relatively new Consequently, Poland gets good ratings for small-scale privatization, but less impressive reviews of large-scale privatization, restructuring and governance It is possible that the new government will accelerate remaining privatization, although this remains to be seen There are still not specified timelines for privatization of coal mines, steel companies, non-ferrous metals producers, coke producers, and machine tool manufacturers An estimated 30 percent of privatizeable assets are slated to remain in state hands beyond the year 2001,[53] although significant privatization is expected to be finalized in a range of industrial sectors as well as in banking, insurance, power generation, telecommunications and transport Among the largest 100 firms in Poland at end 1996, 60 had at least majority state ownership, mostly 100 percent Pekao SA Group (banking) and TPSA (telecommunications) are the largest firms slated for privatization in 1998 Meanwhile, Poland gets good ratings for its trade and foreign exchange system, having removed most quantitative and administrative restrictions that apply to international trade as far back as 1990, having introduced a fairly uniform customs regime and current account convertibility, and having virtually eliminated government interference in export-import flows from state trading monopolies (likewise in 1990) Competition and pricing policy are generally harmonized with EU legislation, although some trade protection was still in effect in mid-1997 Remaining barriers—mainly in agriculture—are expected to disappear or diminish over time as Poland complies with WTO, EU, EFTA and CEFTA Agreements There has been growing FDI in the automotive, food processing and power plant sectors since 1996 after relatively sluggish inflows, and more recently in the banking sector Poland is also already competitive in a number of products—as shown in its burgeoning merchandise export trade—and about 70 percent of its international trade is with EU markets A major structural challenge in the coming years is for smaller firms that are successful at generating positive cash flow to be able to obtain needed outside financing for needed investments This implies significant development of equity markets and associated transparency and disclosure requirements, as well as sufficient development of banking and bond markets for companies to obtain needed debt financing for long-term needs For the banking sector and the capital markets, there is significant potential for market expansion However, this will require greater capital, increased investment in retail networks, a broader array of service offerings under tighter pricing conditions, strengthened risk management capacity and systems, increased dispersion of zloty deposits across banks, and an overall increase in resource mobilization **Score 3+**

2 1 General Poland's economic indicators are broadly favorable at the macroeconomic level, although structural weaknesses remain to be solved Growth has been high for several years, despite some earlier sluggishness in Western Europe, and periodic troubles in Russia and

[51] Most SOEs are in the industrial sector This includes petrochemicals, electrical appliance manufacturers, and pharmaceuticals companies targeted for privatization by 2000 and power generation, mining and quarrying, sugar processing, pulp and paper, furniture, chemicals, plastics building materials, and gas extraction and distribution companies slated for privatization by 2001

[52] About 3,400 SOEs still existed in early 1998

[53] See *Polish News Bulletin*, 21 April 1998

neighboring states After declines in 1990-91, Poland's real GDP is in its seventh consecutive year of real growth—powered mainly by the growing private sector From 1994-97, real growth rates have averaged 6 percent This has contributed to a reduction in the official unemployment rate, from 16 4 percent in 1993 to 10 5 percent at end 1997 This translates into more than 700,000 net jobs created since 1994 [54] Tight monetary policy has brought the inflation rate down steadily—from 70 percent on average in 1991 to an average 32 percent in 1994 and about 14 percent in 1997—the year-end 1997 rate was 13 percent, indicating some stability in the actual inflation rate The government fiscal deficit has declined from nearly 7 percent in 1991 to about 4 percent in 1997—including local government and off-budget items which go to assist loss-making enterprises in coal, steel and other selected sectors [55] Pension/social security costs remain very high, at 16 percent or more of GDP While pension reform should reduce these costs over time, they still represent a significant burden Nevertheless, the fiscal picture has improved in recent years as the economy has grown, revenues have increased, and expenditure has been brought increasingly under control Reduced rates on investments in government securities serve as an example of the easing of pressure on government finances Exchange rates gradually depreciated under the earlier crawling peg regime and more recent open market intervention, with some appreciation in 1998 due to arbitrage opportunities perceived from Poland's generally strong fundamentals and balance of payments position With a steady and significant increase in international trade—total merchandise exports and imports were $66 billion in 1997, or more than twice levels achieved through 1993 While the current account deficit was about 3 percent of GDP at $4 3 billion, gross international reserves have mounted steadily since 1995 As of end February 1998, these reserves totaled $24 3 billion, or about six months of import coverage of goods and non-factor services This compares with about three months' coverage from 1991-94 Portfolio flows have grown steadily since 1994 with increasing liberalization and capital markets development, providing short-term financing These account for a significant portion of the increase in foreign exchange reserves, including the spike in the first half of 1998 However, of greater structural importance to the economy in the long run, Poland has attracted more than $4 8 billion in FDI since 1996, compared with an unimpressive $2 6 billion from 1989-1995 Thus, in just two years, average per capita FDI (annually) has increased from less than $10 from 1989-95 to $61 in 1996-97 **Score 3+**

- *Real GDP growth* was 6 percent in 1997, slightly lower than 1996 Growth was powered by increases in consumer spending, partly the result of increased lending from banks and other intermediaries to the consumer market This led to some tightening throughout the year of reserve requirements to try to contain the potentially inflationary impact of such trends, as well as to contain a burgeoning current account deficit Initial projections for 1998 are that Poland will experience real GDP growth of 5 7 percent on the strength of increased investment, continued job creation, rising purchasing power, reduced tax rates, and a reduced fiscal deficit

- The registered *unemployment* rate was 10 5 percent at end 1997, down dramatically from 13 6 percent at end 1996 and 16 4 percent at end 1993 This equates with about 1 8 million people being out of work at end 1997 [56] Productive *employment* is a more difficult measure to gauge However, if GDP figures are applied in dollar terms to employment levels productivity increased by 2 percent, from

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[54] Most of the increase has come from new job creation There has also been an annual decline of about 90,000 from the work force This means on a "gross" basis, the Polish economy has created about 1 million new jobs since 1994

[55] This is in the form of arrears, capitalized interest, and other forms of assistance

[56] This is based on a work force of approximately 17 3 million people

$9,026 per worker in 1996 to $9,210 per worker in 1997 [57] In terms of sector distribution, about a quarter of the work force is employed in the agricultural and industrial sectors, and about half are in services Some of the service sector—shops, wholesalers, transport companies, restaurants, hotels—is currently under pressure due to attempts to restrict unregistered trade with neighboring countries to the East

- *Inflation rates* have steadily declined since 1991 That year, the average CPI inflation rate approximated 70 percent Rates dropped to 43 percent in 1992, and an average 20 percent by 1996 In 1997, the average CPI inflation rate was about 14 percent Initial targets for 1998 are to bring the inflation rate down to about 11 percent The producer price index (PPI) was little changed from 1996-97, rising from 11 2 percent to 11 6 percent The CPI rates are still high by EU standards This has translated into an extension of tight monetary policy, which is likely to continue for the foreseeable future to bring the inflation rate down further

- *Exchange rates* were previously set by NBP on a monthly crawling peg basis against a basket of currencies that reflected the mix of its foreign trade patterns [58] In 1996, this policy shifted to one favoring open market intervention The policy of gradual depreciation continued until early 1998, when the zloty appreciated against the dollar and main European currencies For instance, the zloty was valued at 3 40 to the dollar in April 1998, compared with year end 1997 rates of 3 52

- *Fiscal deficits* have been fairly deep throughout most of the 1990s due to high social welfare costs (social security), and weak revenues due to the avoidance of tax payments by many companies and households On-budget subsidies have been cut throughout the 1990s, from 10 percent of GDP in 1989 to 2 percent in 1996 This helped to bring central government fiscal deficits down to less than 3 percent in 1997, which was about half of original projections on a zloty basis—Zl 6 1 billion, as opposed to Zl 12 2 billion However, adding local government and off-budget items adds to the deficit, estimated at about 3 9 percent of GDP in 1997 The government hopes to bring the central government deficit down to less than 2 percent in 1998 Stronger revenues resulting from a stronger economy and the introduction of pension reform in 1998 should help in subsequent years Privatization should help with a reduction in off-budget expenditure Administrative reform based on gradual decentralization will put much of the onus on localities to develop and maintain a viable fiscal base However, the most important item is the reduction of transfers from the budget, mainly for the social insurance and labor funds which index pensions and benefits to wages This has led to a nearly fourfold increase in social security costs in dollar terms since 1989 [59] Efforts have been made in the last year to reverse these trends, including suspension of indexation for one year, limiting the real increase in benefits to 2 5 percent, tightening eligibility criteria for disability pensions, and requiring tripartite negotiations over new pension increases The introduction of mandatory contributions to privately managed funds will also help over time, although initially this may lead to foregone fiscal revenues in the next few years

- *Debt and debt service* are under control Total public debt was about 54 percent of GDP in 1996, down from higher levels in previous years and within the Maastricht guidelines for EMU membership Total gross external debt has approximated $42-43 billion since end 1994 This debt stock has diminished as a percentage of GDP—from 46 percent in 1994 to about 29 percent by end 1997 Meanwhile, gross foreign exchange reserves approximated $20 billion at end 1997, and have risen further in 1998 to about $25 billion (as of mid-1998) due to the influx of portfolio investment Total external debt had declined to about 130 percent of total exports by end 1997 Debt service as a percent

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[57] This is based on GDP of $134,924 million and employment of 14,949 thousand in 1996, and GDP of $143,019 million and employment of 15,528 thousand in 1997

[58] The policy of NBP was been to pursue a slow but steady devaluation of the zloty against a basket of currencies In late 1997, the basket was composed of the U S dollar (45 percent), the DM (35 percent), and the British pound, Swiss franc and French franc accounting for the remaining 20 percent

[59] As a share of GDP, this cost doubled from 1989 to 1997

of the current account peaked in 1991 at 69 percent This has declined steadily since and has been less than 8 percent since 1995 With its growing export trade and foreign exchange reserves, Poland is not expected to have any problems servicing or repaying according to schedule

Table 1 General Economic Indicators

	1990	1991	1992	1993	1994	1995	1996	1997	1998(e)
Real GDP Growth	-11 6%	-7 0%	2 6%	3 8%	5 2%	7 1%	6 0%	6 0%	5 7%
Per Capita Incomes									
GDP in $	1 547	1 998	2 198	2 232	2 402	3 057	3 495	3 948	
PPP in $	4 570	4 490	4 750	5 010	5,380	5 400	6 000		
Registered Unemployment	6 3%	11 8%	13 6%	16 4%	16 0%	14 9%	13 6%	10 5%	10 1%
Inflation Rate—CPI (yr-on-yr)	249 3%	60 4%	44 3%	37 6%	29 5%	21 6%	18 5%	13 2%	9 5%
Yr-end. Exchange Rate									
Zl DM									
Zl US$*	95	1 06	1 36	1 81	2 43	2 51	2 87	3 52	
Fiscal Deficit/GDP	-3 7%	6 7%	4 9%	2 3%	2 2%	1 9%	2 8%	2 8%	
Debt Service/Current Account	53 7%	68 9%	19 3%	20 1%	14 3%	6 7%	7 6%	7 5%	
Total Debt/GDP			147 3%	108 6%	69 0%	59 0%	53 6%		
Gross External Debt in $ bn	48 5	48 4	47 0	47 3	42 2	43 0	40 4	41 3	

* *Note* Average exchange rate through 1993 and year-end rate from 1994 on

Sources NBP EBRD IMF World Bank OECD *Business Central Europe*

2 2 ***Private Sector Development*** Private sector shares of employment and GDP are reasonably high—at about two thirds By the mid-1990s, Poland had nearly 2 million businesses that were individually owned, and about 100,000 private companies that were joint stock companies or joint ventures Meanwhile, there were less than 6,500 companies that were state-owned by end 1995—either directly, or as joint stock companies in which the state had a majority ownership position This number has declined to about 4,000 today However, the private sector had already established its dominance in commercial trade—wholesale and retail—and construction, and was about even with the state sector in industrial output by 1996 Likewise, investment trends indicated a growing share from and into the private sector By 1996, private companies accounted for about 52 percent of aggregate investment [60] In terms of employment, the private sector dominates in agriculture, manufacturing, construction, trade, and real estate and other business services Privatization plans of the current government could push private sector shares to about 90 percent by 2000, although it is more likely that these shares of GDP will be reached after 2001 Many new companies have started in the last five years, and these are often among the most creditworthy in terms of prospects For instance, new or privatized companies now account for about half of industrial output and transport, and 90 percent or more of construction and trade However, they are frequently short of capital, making it difficult for many of the banks to provide such leveraged financing If there is meaningful expansion of the over-the-counter (OTC) market over the next few years, this financing obstacle might be significantly alleviated However, in the absence of viable venture capital and over-the-counter markets, Poland's small business sector might encounter financing difficulties due to insufficient equity investment and retained earnings Meanwhile, the private sector in general is still faced with a

[60] This trend increased in 1997, as the private sector is reported to have accounted for 76 percent of investment in 1997, against 10 percent in the state enterprise sector See *Polish News Bulletin*, 10 March 1998

fairly high share of the state in the economy and banking system State companies account for 60 of Poland's largest 100 companies, many of which dominate in large industries and key services, including significant investment in transport, telecommunications, banking, insurance, power generation, oil and gas, and defense Some state ownership will diminish in 1998, with the partial privatization of Pekao SA Group and TPSA However, there will still be large and troubled state-owned companies in financial services and heavy industry into the next century While resistance to FDI appears to have significantly diminished since 1996 and the current government appears to be interested in accelerating privatization, it remains to be seen how long the state will retain these companies before they are turned over to private ownership and management, or definitively liquidated With an estimated 30 percent of privatizeable assets to remain in state hands after 2001, some of these companies may serve as a deterrent to full market liberalization as the date nears for entry into the European Union At the "unregistered" end, there is also pressure to contain open-air market trade due to border crossing requirements of the EU Such attempts to curtail this trade could adversely affect the $6 billion in goods traded in these markets,[61] equivalent to about 22 percent of registered exports in 1997 **Score 3+/4-**

- *Sector value-added* in the Polish economy has experienced a shift increasingly towards services Services accounted for about 48 percent of value-added in 1990, a comparatively high figure for ex-socialist economies at the time This figure increased to about 65 percent by 1995, and has stayed in that range In dollar terms, this amounts to an increase from about $28 billion in services output in 1990 to about $93 billion in 1997 Growth has come from a wide range of sectors—market research, advertising, software development, electronics, engineering, architecture, accounting, banking, insurance, other financial services, commercial trade, legal, medical, construction—much of it in response to the modernization needs of the Polish economy as it prepares for entry into the European Union Industry accounts for another 30 percent or so of total value added, down from about 45 percent in 1990 In dollar terms, industrial output has increased from about $26 5 billion in 1990 to about $40 billion in 1997 The scale of Polish industry has declined considerably during the reform period, and growth is now often found in some of the smaller manufacturing companies that have been established in the 1990s Meanwhile, some heavy industry is still making a strong contribution to GDP growth, such as in the auto sector Precision instruments, motor vehicle production and parts, and publishing and printing experienced the highest growth rates in 1996 among industrial categories Agriculture accounts for 5-7 percent of overall value-added Agricultural value-added has increased from about $4 billion in 1990 to about $9-10 billion in 1997 As for *employment*, total employment at end 1997 was estimated to be nearly 15 5 million About half are employed in services, while about a quarter each are employed in agriculture and industry The comparatively high level of employment in agriculture is traditional, largely based on private small-holdings that escaped nationalization and collectivization during the communist era These farms are relatively small—the average farm size is about 8 hectares, or 20 acres, and is focused on the production of potatoes, fruit, vegetables and meat Farming in Poland frequently serves as a base of subsistence rather than as economic enterprises focused on global competitiveness Thus, agricultural employment shares are about four times the relative contribution to GDP from the primary sector Modernization will be required in some of the large-scale state farms that have still not been significantly restructured In the industrial sector, Polish manufacturing is increasingly competitive as smaller, more efficient firms increase their presence in the market However, there are still many large SOEs in the mining and manufacturing sectors that remain overstaffed, in need of significant investment, and highly inefficient in terms of energy consumption and dependence There have been more than 23,237 bankruptcies filed in Poland since 1990, but the "too big to fail" theory has been applied in many cases in Poland, slowing competitiveness Meanwhile, employment and productivity have surged in the services throughout the 1990s Overall, labor productivity increased about 25 percent through the mid-1990s but only about 10 percent in the agricultural sector

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[61] See *Polish News Bulletin*, 22 April 1998

- Private sector value-added and employment are both high, estimated roughly to be about two thirds of the economy Overall *private sector value-added* has been estimated to be about 60-65 percent since 1995 This may understate the actual total contribution to GDP if estimates from the "shadow" economy are added to official GDP figures [62] In many small-scale operations, informal employment and output have played a significant role in keeping down operating costs and overall cost structures This was also an important part of the social safety net when unemployment rates started surging upward around 1991 [63] Private sector growth has resulted from a reduction of budgetary subsidies to loss-making state enterprises—either directly from fiscal sources, or through banks—although off-budget financing continues Private sector growth has also resulted from more open competition, and the gradual privatization of both enterprises and banks While privatization has never been a fast process in Poland, it has continued throughout the years When the Law on Privatization was passed in 1990, there were 8,441 enterprises to be transformed About 3,400 remained in state hands in early 1998 *Employment in the private sector* was estimated to be about 10 million by end 1997, or about two thirds of those employed The private sector is also widely credited as being responsible for the increase in employment in Poland since 1994 as well as for most of the overall increase in labor productivity

- *State sector value-added and employment* represent a slowly declining segment of the economy There are still about 3,400 SOEs, down from 8,441 in 1990 The state share of overall value-added has declined from 69 percent in 1990 to about one third in 1997 This actually translates into an increase in overall state contribution to GDP—from $41 billion in 1990 to about $50 billion in 1997 However, the state's share of total GDP has declined by about half Increased output from state enterprises includes several that are likely to generate significant investment interest, such as in telecommunications, transport and some industries As many of the SOEs have themselves undergone restructuring programs some of them are more efficient or less uncompetitive than in prior years Meanwhile employment in the state sector was estimated at about 5 5 million at end 1997, down from an estimated 8 25 million in 1990 Thus there has been a fairly steady decline in public sector head count, averaging nearly 350,000 per year Many of the remaining jobs are in public administration, education, health, social security, and other community social and personal service activities

[62] Some of these figures are estimated and factored into overall GDP, such as trade in open-air markets, which has been considerable to date—estimated to be $6 billion in 1997, or 4-5 percent

[63] The unemployment rate was 6 3 percent at end 1990, but 11 8 percent by end 1991 and 16 4 percent by end 1993 Thus, the actual number of officially unemployed individuals increased from 1 1 million at end 1990 to nearly 2 9 million by end 1993 The increment exceeded 10 percent of the total active work force

Table 2 Private Sector Indicators

	1990	1991	1992	1993	1994	1995	1996	1997(e)
GDP ($ bn)	59 0	76 4	84 3	85 9	92 6	118 0	134 9	143 0
o/w Agriculture (%)	7 4	6 8	6 7	6 6	6 2	6 6		
o/w Industry (%)	44 9	40 2	34 0	32 9	32 2	28 9		
o/w Services (%)	47 7	53 0	59 3	60 5	61 6	64 5		
Private Sector GDP ($ bn)	18 2	32 2	39 7	44 6	48 3	70 0	85 7	93 0
State Sector GDP ($ bn)	40 8	44 2	44 6	41 3	44 3	48 0	49 2	50 0
Employment ('000)	16,145	15 443	15 010	14,761	14,924	14 968	14,948	15,447
o/w Private Sector ('000)	7,895	7,752	8,060	8 384	8,865	9,265	9,716	10,041
o/w PS in Agriculture('000)					3,723	3,853	3,905	
o/w PS in Industry ('000)					1,483	1,630	1,884	
o/w PS in Services ('000)					3 159	3,372	3 200	

Sources EBRD World Bank CASE estimates

2 3 Money, Savings and Credit The NBP has pursued a tight monetary policy since the hyperinflationary period in 1989-90 Monetary policy and the impact it has had on savings and credit has focused on gradual devaluation of the exchange rate through a floating regime introduced in May, 1996, a steady decline in the inflation rate as reflected in slowly declining interest rates, and generally tight monetary policy to prevent an "overheating" of the economy The latter point was in evidence in 1997 as NBP twice raised reserve requirements on banks This contributed to a 2 0-2 5 percent increase in the refinancing, rediscount and lombard rates after gradual declines through the 1990s The effects of the earlier crawling peg regime and current floating exchange rate policy have shown benefits since 1995-96 Savings and credit have both increased since 1995 Households are now placing more funds in the banks on a term basis However, the cost of funds still remains fairly high for banks due to interest rates, still inadequate funding from deposits, the concentration of deposits in three banks,[64] and the limited debt market for banks There was also some periodic volatility in the interbank market in 1997, suggesting that many banks remain sensitive to both the supply and pricing of funding due to the limited depth and breadth of the interbank market In terms of banking, a downturn in the economy could expose loan portfolios (and off-balance sheet items) to higher levels of provisioning and charge-offs This would weaken earnings and capital, and possibly prompt a demand-driven rise in interest rates if banks' liquidity positions deteriorate At that point, a range of "safety and soundness" issues could emerge, one of the first of which would be deposit safety and the role of the banks in the interbank and lending markets, and the NBP as a lender of last resort to shore up the liquidity position of the banks For the time being, the challenge to NBP appears to be sterilizing portfolio inflows without an "undue" appreciation of the exchange rate Such an increase might then exacerbate the current account deficit, prompting higher interest rates than the NBP wants to see in the economy **Score 3+**

- *Policy design and implementation* are the responsibility of the NBP It is the apparent goal of the government to reduce the inflation rate to 5 percent by 2000 from the year-end 1997 figure of 13 percent Monetary policy is based on a floating foreign exchange rate which NBP manages through its interest rate policy and intervention through open market operations Available and utilized instruments to implement monetary policy include reserve requirements, the rediscount rate for bills of exchange, the lombard rate and the sale by NBP of securities under reverse repurchase agreements

[64] PKO BP, Pekao SA Group and BGZ

and the sale of money-market bills In 1997 NBP reverse repurchase agreements and money market operations approximated Zl 80 billion or nearly 40 percent of total budgetary expenditure NBP s crawling peg policy through early 1996 was to follow a monthly depreciation schedule of the zloty based on trade developments and reserve levels However, in mid-1996, Poland opted to pursue a floating exchange rate policy which permits the rate to appreciate when trade or investment developments justify an appreciation In the first half of 1998, portfolio flows have driven up reserve levels, leading to an appreciation of the zloty

- *Data collection and forecasting* appear adequate Poland's monetary forecasts have been reasonably accurate and sustained by a fairly consistent policy for several years Where there may be some weaknesses are with regard to the informal sector of the economy However, even here, a steady decline in the inflation rate and an improving fiscal position (in terms of collections) suggest that satisfactory assumptions have been built in to monetary forecasts Where there is a higher level of uncertainty is with portfolio flows Recent concerns regarding Asia and the ruble have been weathered reasonably well, but smaller emerging markets will likely remain vulnerable to rapid shifts in portfolio flows until they have broadened and deepened their markets to provide needed cushion Poland is still engaged in this process, but it will take time before Poland has adequate economic and capital markets capacity to reduce its current level of vulnerability In Poland's favor, its vulnerability appears to be anchored more in the level of growth in EU countries rather than in prevailing trends elsewhere around the globe

- Poland has taken *regional and global considerations* into account since efforts began in the early 1990s to be positioned for membership in the WTO OECD, EU and other international and multilateral groups The signing of the EU Association Agreement (1995), and membership in the WTO (1995) and OECD (1996) have provided an economic catalyst for Poland to pursue economic reforms Poland removed most trade barriers as early as 1990 Poland underperformed on the investment front through 1995, although its performance has improved since This is partly due to depreciation allowances which were previously not in effect, which helped increase gross domestic investment in fixed assets Poland also has been more successful in attracting FDI since 1996 Much of Poland's institutional transformation is being driven by anticipated membership in the European Union Thus, achieving Maastricht criteria will be important for membership Poland actually has reasonably good figures for now, although the inflation rate is still high by EU standards Thus, it can be expected that NBP will continue to follow a tight monetary policy that debt management will continue to follow principles to maintain satisfactory ratios—public debt below 60 percent of GDP—and that there will be continued pressure on Poland's government to bring the fiscal deficit down to 3 percent of GDP The ability to achieve these measures will depend largely on the effectiveness and efficiency of structural reforms, including administrative reform, pension reform, privatization of the three major loss-making banks and insurance companies, large-scale privatization in the real sector, and constraints on subsidies to industries unlikely to be privatized before 2002

- *Management* of monetary resources is the responsibility of NBP and based on the floating exchange rate policy with NBP monitoring interest rates and trade developments NBP pursues open market transactions and sets interest rates according to its desire for a stable exchange rate or gradually changing exchange rate

- There is limited *liquidity* in the banking system as funding still remains relatively small Savings have increased, and households are now beginning to place more funds in banks on a term deposit basis The interbank market is reasonably well developed, although it is thin However, there is virtually no corporate bond market for banks This has resulted in an increase in syndicated borrowings from banks abroad Liquidity in zloty is frequently subject to the availability of funds provided by PKO BP or Pekao SA Group, given their hold on nearly half of banking system deposits About 13 percent of balance sheet exposure was to the interbank market at end 1997 Interbank rates closely correlate with trends in the NBP rediscount and lombard rates Reserve requirements were raised in each of the first two quarters of 1997 These included an increase from 17 to 20 percent on zloty demand deposit accounts, from 9 to 11 percent for zloty time deposits, and from 2 to 5 percent (two increases) for foreign currency demand and time deposit accounts

- *Deposits* have been increasing since 1992 However, Poland has had relatively low levels of financial intermediation, as measured by broad money to GDP These rates have moved up slowly, from about 32 percent in 1990-91 to about 37 5 percent in 1997 The recent influx of portfolio investment has driven up broad money measures, and represents one of the key challenges NBP faces in maintaining interest rate and exchange rate stability

- *Credit* began to increase at the end of 1995 as the major commercial banks had strengthened their capital positions (and therefore their lending capacity), and as net spreads on investments in government securities began to decline Over the last two years, as competition has intensified in the corporate sector, a great deal of new lending has shifted to the consumer sector to take advantage of greater turnover and higher margins Much of this has been installment finance for the purchase of autos and appliances In terms of overall credit, net domestic credit as a percent of GDP has diminished from a high of 40 7 percent in 1993, declining to 34 6 percent in 1995 before rising to the 35 percent range in 1996-97 Thus, credit has actually increased, but not as a proportion of GDP Key trends are a steady increase in credit to the private sector—from only 3 1 percent of GDP in 1990 and 11-13 percent from 1991-95, rising to 15 4 percent in 1996 and about 16 5 percent in 1997 Meanwhile, net domestic credit to government has declined from more than 19 percent in 1993-94 to 12 percent in 1997 Net credit to the state enterprise sector has declined from 18 percent in 1990 to less than 7 percent in 1997 In dollar figures, net domestic credit has grown from less than $34 billion in 1994 to $44 billion in 1997 Most lending remains short-term

- *Rates* generally declined throughout the 1990s in real terms In 1997, real rates began to increase as NBP maintained a tight monetary policy through its reserve requirements, interest policy and open market interventions Year end 1997 rates showed the rediscount rate for bills of exchange at 24 5 percent, the lombard rate for three- to twelve-month funds at 27 0 percent, and general refinancing rates—which have become the most closely watched rates—at 27-28 percent The lombard and refinancing rates were generally 200 basis points higher at end 1997, and 250 basis points higher on the rediscount rate Spreads tightened marginally in 1997 Lending rates generally ranged from 22 5 percent to 29 4 percent at the 15 largest commercial banks on loans up to one year Deposit rates paid on comparable maturities at the same banks ranged from 19 0 percent to 22 8 percent Thus, the spread parameters on loans and deposits ranged from 3 5 percent to 6 6 percent at end 1997 By contrast, at end 1996, the spread parameters were 2 5 percent to 5 8 percent Interest rates on deposits and loans were freed of administrative restrictions years ago, so pricing in credit has been liberalized for years With increasing competition, particularly for "blue chip" business, net margins have begun to come down In some cases, banks are reported to be taking spreads barely above zero, and even sometimes negative spreads on loans to blue chip customers in efforts to increase/retain market share, build goodwill with the enterprise, or obtain fee-income business that makes the relationship profitable to the bank on a consolidated basis Declining intermediation spreads are due to increased competition from larger foreign banks that are in a position to provide cheaper lending rates or improved advisory and trade finance services, strengthened capital positions of the larger Polish institutions which have provided these banks with the ability to price credit more aggressively, and the increase in deposit mobilization in some of the larger banks which provides these banks with a more stable funding base and an opportunity to lower prices on credit (as opposed to relying on overnight markets for funding where pricing is more volatile)

Table 3 Money, Savings and Credit Indicators

	1990	1991	1992	1993	1994	1995	1996	1997
Money Supply Growth (%)		34 9	59 9	36 0	38 2	34 9	29 4	28 8
Broad Money/GDP (%)	32 2	31 6	35 8	35 9	36 7	36 5	37 1	
Year-end Base Interest Rate (%)	48 0	36 0	32 0	29 0	28 0	25 0	22 0	
Commercial Bank Rates (Zl)								
Interbank < 30 days (%)		36 7	30 8	25 2	21 1	24 7	21 2	
3-month T-bill (%)			41 4	33 7	27 0	24 2	18 8	
One-yr time deposit (%)*	53 0	36 0	32 0	25 0	26 0	22 0	18 3	19 0-22 8
One-yr loan (%)*	61 0	40 0	39 0	35 0	31 0	24 0	23 3	22 5-29 4
Net Domestic Credit/GDP (%)	19 5	34 9	38 2	40 7	39 2	34 6	35 3	35 1
o/w Claims on Gov't	-1 6	10 9	16 5	19 3	19 2	14 6	12 9	12 0
o/w Claims on SOEs	18 0	12 9	10 3	9 2	8 0	7 2	7 0	
o/w Claims on Private Sector	3 1	11 1	11 4	12 2	12 0	12 8	15 4	

* *Notes* Rates on deposits and loans are for maturities up to one year at end 1997

Sources NBP EBRD IMF World Bank

2 4 ***Fiscal*** Fiscal policy shows declining levels of budgetary deficits despite local government financing gaps, high levels of expenditure for social security payments, and some continued subsidization of loss-making companies Revenues have increased as the economy has expanded, but expenditure has likewise increased The consolidated deficit was estimated to be 3 9 percent of GDP About one-sixth is due to the high social security costs covered by government expenditure, some of which is expected to be less of a burden over time if pension reform is successful However, these payments were only about 8 percent of GDP in 1989, representing an approximate increase from $6 6 billion in 1989 to nearly $23 billion in 1997 Thus, the implementation of pension reform is one of the most critical items on the Polish fiscal agenda Information on the support for loss-making SOEs is not widely available Banks are not believed to have much exposure to loss-making enterprises Most of the support these enterprises in coal, steel and other sectors are receiving is reputedly in the form of capitalized interest, arrears, or soft loans guaranteed by the government Poland is expected to generate financing from rising FDI However, it still has structural deficits from ordinary ongoing budgetary operations which would increase if the economy slowed The current government is trying to bring the central deficit down to less than 2 percent from about 2 8 percent in 1997 **Score 3**

- Fiscal *policy design and implementation* are focused on a reduction of the fiscal deficit to EU levels of 3 percent (consolidated), but without the social dislocation that comes with overly strict fiscal policy when accompanied by a fairly tight monetary policy Overall, subsidies as a percent of GDP have diminished from a high of 8 percent in 1990 GDP to less than 5 percent since 1992 and less than 2 percent since 1996 However, "transfers" are still high at about 20 5 percent of GDP, rates which have generally persisted on average through the 1990s due to demographic trends and the generosity of social security benefits Most of this has to do with the indexation system followed in Poland by which pensions and benefits are indexed to wages This has not only been damaging in terms of fiscal expenditure, but has also served as a deterrent to companies to hire employees Since late 1996, reforms have been introduced to limit real increases and to tighten eligibility criteria Meanwhile the introduction of mandatory transfers to privately managed pension funds will bring down fiscal expenditure over time and contribute to efforts to put the overall social security system in a sound position

- D*ata collection* and accuracy of *forecasting* are considered adequate, although the authorities may have underestimated the actual degree of economic activity in its 1997 forecasts The central government deficit was about half of forecast The fiscal authorities are aware of the foregone revenue that is not collected due to the still-high proportion of the economy that is "informal "[65] However, the stock of tax arrears—including social security payments—began to diminish in the mid-1990s, and collection is improving as well Poland is now gradually lowering its corporate tax rate from 40 to 32 percent from 1997-2000

- *Regional and global considerations* are taken into account in policy and planning Above all with regard to fiscal policy, Polish officials are aware of the 3 percent fiscal deficit target that is one of the four key Maastricht criteria for joining the European Monetary Union Poland is attempting to reduce the central government deficit to as low as 1 6 percent of GDP in 1998 If the economy continues to grow, administrative reform succeeds at the local level, the effects of pension reform show themselves within a year to two of introduction, privatization proceeds and FDI increases, it is possible that Poland will achieve the 3 percent target by 2000 on a consolidated basis However, with social security costs at about 16 percent of GDP, it is unlikely that the effects of pension reform will manifest themselves so rapidly In fact, the immediate impact on the budget from the introduction of the second pillar is the likelihood of foregone revenues to help capitalize the privately managed funds Thus, along with some delays, the benefits of such a system are not likely to materialize in fiscal figures until at least 2001-2002

- Budgetary processes and procedures are still generally *centralized*, although there is gradual movement towards *decentralization* The government is moving to shift the administrative structure of Poland from 49 voivodships to about 12 regions and 320 self-governing boroughs [66] This will provide some devolution of tax and expenditure powers from Warsaw to the local level Meanwhile, there is some movement towards municipal bond markets, but these are at the embryonic stage right now

- *Collection* of most tax revenues is based on fairly high personal income tax rates—as high as 44 percent—and a VAT system In 1997, Poland lowered the corporate tax rate—which includes capital gains[67]—from 40 to 38 percent This is expected to continue through 2000 to 32 percent Only 13 percent of total tax revenue collected in 1996 was from corporate taxes Lowering the rate may reduce the incentive to firms to under-report income, and encourage greater compliance with payment requirements However, corporate compliance is still questionable due to the high contributions required of companies into payroll tax contributions for social security In 1997, these stood at 48 18 percent of gross compensation, for which employers are wholly responsible The dividends tax rate is 10-20 percent, depending on whether Poland has a bilateral treaty with another country Overall, central government revenues have fluctuated between 42-48 percent of GDP, while expenditure has ranged from 44-50 percent Gross collections have increased in recent years, but declined as a percentage of GDP

- NBP *reports* on a monthly basis on public finance This includes a variance analysis of actual and targeted central budget figures The Central Statistical Office also reports central government figures in a timely manner

- *MIS* for fiscal matters appear satisfactory based on data reported, and the reasonable range of fiscal deficits throughout the 1990s While persistent, there has been less volatility associated with Poland's deficits than found in other transition economies

- *Fraud and corruption* were apparently a greater problem in the early and mid-1990s due to a declining economy, high corporate tax rates, bureaucratic corruption and delays, and a general unwillingness to

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[65] The unofficial economy was estimated to account for 12 6 percent of GDP in 1995, down from 15 7 percent in 1989 and higher levels through 1993 See EBRD *Transition Report 1997*

[66] See Consummate politician, *Business Central Europe*, June 1998

[67] Poland had no separate capital gains tax as of late 1997

provide information to fiscal authorities The share of the unofficial economy in GDP was estimated to be as high as 196 percent in 1990 but then declined steadily from 23 5 percent in 1991 to 12 6 percent in 1995 [68] While there is no definitive way to measure the full extent of fraud and corruption, it appears that problems are less severe today as a result of an improved economy, rising incomes, and fewer administrative and bureaucratic obstacles for small businesses As a significant portion of tax income is derived from VAT, import taxes, customs duties and excise taxes, it also appears that the authorities have shifted their focus on consumption-oriented taxation for revenues which are easier to administer Increasing electronic capacity should also assist in monitoring collections while widening the base of transactions for collections

Table 4 Fiscal Indicators

(Zl *billion*)	**1990**	**1991**	**1992**	**1993**	**1994**	**1995**	**1996**	**1997**	**1998**
Total Expenditure	24 4	39 6	57 5	77 8	106 2	142 1	177 1		
Total Revenue	26 5	34 2	51 9	74 2	101 6	136 8	166 9		
Budget Deficit*	2 0	5 4	5 6	3 6	4 6	5 3	10 2	6 1	
Central Fiscal Deficit/GDP*	3 7%	6 7%	4 9%	2 3%	2 2%	1 9%	2 8%	2 8%	
Consolidated Budget Deficit									
Consolidated Deficit/GDP								3 9%	

* Measure is *the deficit* therefore a negative sign = fiscal surplus the consolidated deficit is an estimate
Source NBP IMF World Bank

2 5 Exchange Rates There was pressure on the zloty in the first half of 1998 as a result of portfolio investors' perceptions that the zloty was undervalued The zloty had depreciated fairly steadily throughout the 1990s, starting with the crawling peg regime and then moving on to a floating exchange regime in mid-1996 Average exchange rates against the U S dollar were 0 95 in 1990, 1 81 in 1993, and 2 70 in 1996 By end 1997, the year-end exchange rate was 3 52 However, in April, 1998, the zloty was trading at 3 4 to the dollar Thus, for the first time in several years, the zloty began to show visible appreciation against the dollar at a time when the dollar was appreciating against most major currencies The government has concerns about portfolio investors driving the exchange rate beyond acceptable limits to the point where it would lead to a serious current account deficit Much of Poland's economic growth in the last several years has come from added competitiveness—exports of goods and services have increased from less than $15 billion in 1991 to about $32 billion in 1997 Not only has the dollar value of exports more than doubled, but exports to the EU have increased from 47 percent of total in 1990 to 70 percent since 1995 Thus, appreciation of the zloty can lead to a dual effect of adding further stimulus to the consumption-led current account deficit in Poland, while reinforcing that deficit by weakening Poland's ability to export to EU and comparable countries This is a particular challenge for Poland in today's markets when Asian currencies and foreign reserves are under pressure, and their manufacturers are seeking markets for their output The EU market along with the North American market are the main targets for these exporters, presenting competition for Poland in a range of industrial goods where Poland's competitiveness could be undermined by exchange rate appreciation **Score 3**

- Exchange rate p*olicy design and implementation* have been based on a floating exchange rate regime with open market operations A crawling peg formula was used until May 1996, with 45 and 35 percent weights assigned to the dollar and DM, respectively Exchange rates at year-end 1997 for the

[68] See EBRD *Transition Report 1997*

dollar were Zl 3 52, wıth average rates at ZL 3 20 Thıs compares wıth Zl 2 88 at end 1996 and an average rate of 2 70 ın 1996

- *Data collectıon and forecastıng* have generally been consıdered strong If there are weaknesses ın data collectıon, these have more to do wıth the level of "ınformal" sector actıvıty whıch ıs eıther not captured ın offıcıal statıstıcs, or ıs estımated from cross-border trade flows The zloty has been convertıble for most current account transactıons sınce the mıd-1990s ın preparatıon for OECD membershıp (whıch occurred ın 1996) These developments, ıncreasıng exports and dırect ınvestment, and the abılıty to weather "contagıon" effects from Asıa, Russıa and neıghborıng countrıes durıng perıods of fınancıal and economıc crıses ın 1997-98 suggest that zloty exchange rates are reasonable under current cırcumstances, and that data collectıon and forecastıng have met reasonable tests for accuracy Poland's greatest sensıtıvıty ıs currently to portfolıo ınvestment resultıng from perceptıons of undervaluatıon of the currency and potentıal arbıtrage opportunıtıes

- The floatıng exchange rate polıcy ıs monıtored by the NBP, wıth partıcular focus on movements ın the dollar and DM It ıs expected that the Euro wıll replace the DM, Brıtısh pound, Swıss franc, and French franc ın the basket of currencıes generally monıtored Polıcy reflects Poland's focus on *regıonal and global* consıderatıons ın the development and ımplementatıon of ıts exchange rate polıcy When Poland followed a crawlıng peg formula, the formula was based largely on trade developments and how these were reconcıled wıth movement ın real ınterest rates It ıs presumed that such an approach ıs utılızed as a basıs for open market operatıons ın support of one currency or another

- *Rısk management* practıces are consıdered satısfactory for now, although ıt ıs not fully clear ıf there ıs excess exposure on a foreıgn exchange basıs due to borrowıngs abroad that are re-lent ın zloty Major open posıtıons are not allowed at the banks—15 percent for ındıvıdual currencıes, and 30 percent globally—yet much of the data ıs converted to zloty before ıt reaches NBP Further, there are questıons about whether current reportıng forms provıde suffıcıent ınformatıon on the volume and types of transactıons ın foreıgn currency NBP should contınue to monıtor syndıcated lendıng patterns and the denomınatıon of the source of funds for whıch the banks are oblıgated NBP should also obtaın more precıse ınformatıon on the types and volume of transactıons takıng place, partıcularly as banks are lıkely to show more derıvatıves ın theır actıvıtıes and portfolıos Banks and companıes are thought to routınely hedge theır foreıgn currency rısk, and to do so wıthout ıncurrıng heavy transactıons costs However, ıt ıs ınevıtable over tıme that Polısh banks wıll take on ıncreasıng exposure to ınstruments that may present sıgnıfıcant rısk Wıth the average Polısh bank havıng only $60 mıllıon ın capıtal, one or two sıgnıfıcant losses relatıve to exposure could undermıne a bank's solvency and challenge ıts lıquıdıty The NBP wıll need to ıdentıfy these possıbılıtıes early on to prevent systemıc consequences

- Foreıgn *reserves* were about $20 7 bıllıon at end 1997, nearly $2 bıllıon more than at end 1996 [69] The December 1997 figure equates wıth about sıx months of current account expendıtures net of transfers Thıs ıs the same as 1996, and up sharply from earlıer years when offıcıal reserves ıncreased from $5 8 bıllıon ın 1994 to $14 8 bıllıon ın 1995 Reserves have sınce ıncreased due to portfolıo flows, although these may leave on short notıce However, fundamentally, Poland's reserves have generally been consıdered satısfactory sınce debt reductıon occurred ın 1994

2 6 Balance of Payments Poland's balance of payments figures showed a $3 bıllıon ıncrease ın the current account defıcıt, resultıng prımarıly from a $6 bıllıon net ıncrease ın merchandıse ımports agaınst a $3 bıllıon ıncrease ın merchandıse exports Non-factor servıces showed a lımıted net change The capıtal account strengthened, as ındıcated by the $2 bıllıon net ıncrease ın gross offıcıal reserves Thıs was partly on the strength of ıncreased FDI—$2 7 bıllıon ın

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[69] Accordıng to NBP, the end 1996 figure for gross offıcıal reserves was $18 0 bıllıon

1997—but also due to portfolio flows Some of these flows will contribute to gross fixed investment and future competitiveness Overall, Poland's total public and external debt is managed, and the debt service payments on these debt stocks do not seriously undermine the current account or fiscal resources However, there is a risk of a strong zloty leading to a surge of consumer imports which may propel the current account deficit to unacceptably high levels, prompting capital flight and the possibly adding to debt service In the banking sector, such a development would likely be reflected in a deterioration of loan portfolio quality—in the form of delinquencies and eventual write-offs, as well as discounted inventories being sold at levels below effective collateral coverage To preempt these developments, NBP has maintained a tight position on interest rates and money supply dating back to early 1997 This seems to have been effective, and the general consensus in early 1998 was that interest rates would come down by the end of 1998 However, this will not likely occur until there is evidence that consumer lending has slowed, and that the consumption-driven current deficit is well under control **Score 3+**

- *Current account* movement was unfavorable in 1997 Poland's current account deficit was only $1 35 billion in 1996, or about 1 percent of GDP This increased to $4 3 billion in 1997, or about 3 percent of GDP Poland has generally maintained low current account deficits—all deficits from 1990 were below 3 percent of GDP until 1997, and Poland generated surpluses in 1990 and 1995 Thus, the deficit in 1997 (and into early 1998)[70] combined with the rapid inflow of portfolio investment in 1998 is worrisome to the authorities Notwithstanding these developments, Poland increased exports significantly in 1997, and monetary policy is designed to contain further erosion in the current account

- The *capital account* was partly liberalized in 1995 before Poland joined the OECD, although the EU believes Poland needs to do more in the area of capital account liberalization Debt reduction played a significant role in improving the debt profile and official foreign exchange reserves held between 1994-95 Total public debt is roughly $77 billion, of which external debt represents about $40 billion Official foreign exchange reserves approximated 60 percent of total external debt in early 1998, a more than satisfactory coverage ratio As for current account transactions, foreign *reserves* increased by about $1 7 billion in 1997 to remain at levels equivalent to about six months of 1997 current account expenditure net of transfers

- *Portfolio flows* have fluctuated since 1994, and they represent a risk to exchange rate stability Some of the inflows are comparatively fixed, as they are placed on the exchanges and have shown limited movement out of Poland However, more recently, significant net portfolio investment has entered the Polish market since January 1998 Much of this is presumed to be short-term portfolio money betting on a further appreciation of the zloty, some of which has already occurred in the first half of 1998

- *Direct investment* was fairly weak from 1992-94, averaging about 15-16 percent of GDP However, in 1995, tax laws were changed to permit allowable deductions such as depreciation This prompted an increase in investment in fixed assets, which has contributed to overall economic growth and competitiveness Poland got a second boost starting in 1996 as FDI began to enter more freely Poland attracted $2 1 billion in FDI in 1996, nearly equivalent to the previous seven years Another $2 7 billion entered Poland in 1997 Thus, while Poland has not yet met some of the per capita FDI figures found in other countries, the trend is certainly favorable The partial privatization of such large

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[70] The first two months of 1998 showed worrisome trends regarding the balance of payments The current account deficit was higher than the corresponding point in 1997 as a result of a 10 percent increase in import expenditure and a negative services account While exports grew at a faster pace, the current account deficit was still about 10 percent greater than at end February 1997 With project real growth rates of 5 7 percent for 1998, these figures portend a current account deficit approximating 3 3 percent For figures, see *Polish News Bulletin*, 24 April 1998

companies as TPSA and Pekao SA Group may lead to equal or greater FDI in 1998 Poland's gradual approach to privatization means that it still has potential to generate increased FDI from privatization Meanwhile, other features—rising incomes, population base of nearly 40 million, proximity to potentially large markets in Ukraine and Russia—might also serve as an incentive for FDI in new or existing ventures

Table 5 Balance of Payments Indicators

	1990	1991	1992	1993	1994	1995	1996	1997
Merchandise Trade Balance ($ bn)	2 2	0 1	0 5	-2 3	-0 8	-1 8	-8 2	-12 8
Current Acct Balance ($ bn)	0 6	0 8	-0 3	-2 3	-0 9	5 5	-1 4	-4 7
Remittances/Transfers ($ bn)	2 0	1 2	2 9	3 0	1 9	0 0	0 2	1 1
Capital Account and Reserves ($ bn)	-3 2	2 9	3 3	5 6	0 9	-0 3	2 9	
Portfolio Flows ($ bn)	0 0	0 0	0 0	0 0	0 6	1 2		
Direct Investment ($ bn)*	15 1	15 2	12 8	13 4	14 7	21 6	26 7	30 2
o/w Domestic	15 1	15 1	12 5	12 8	14 2	20 5	24 6	27 5
o/w Foreign	0 0	0 1	0 3	0 6	0 5	1 1	2 1	2 7

* *Note* Domestic direct investment is a residual subtracting FDI from gross domestic investment gross direct investment is determined by the percent of GDP in dollar terms
Sources NBP EBRD IMF OECD World Bank

III BANKING STRUCTURE AND SYSTEM PROFILE The Polish banking system is now majority private in terms of asset control and equity, and majority-private banks account for about 40 percent of deposits Balance sheet measures—capital, liquidity—and quality indicators—loan portfolio quality—are generally favorable, although there are concerns about excessive risks associated with lending in the consumer sector There has been a steady harmonization of laws and regulations with international standards to make the environment conducive to ongoing investment, and this has picked up since 1996 However, membership in the OECD has not led to a full opening of the market, perhaps out of concerns about overheated competition after banking sector instability in the early 1990s After-tax earnings in 1997 declined by about 16 percent in 1997, or $245 million on a dollar basis, largely due to the increasing competition emerging in the market As the market becomes more competitive and ownership gradually moves towards a private sector orientation, governance and management are expected to conform increasingly to higher standards Polish banks are beginning to consolidate, such as the BIG acquisition of Bank Gdanski and the Kredyt Bank acquisition of the Polish Investment Bank in 1997 combined with the BRE acquisition of the Polish Development Bank in 1998 More consolidation has occurred with the Pekao SA Group Privatization of remaining state banks may also lead to further consolidation, such as in the case of PBK-Warsaw in which Kredyt Bank is a small shareholder,[71] and the upcoming 1998 privatization of Bank Zachodni Foreign banks are entering the market, which will add to competition in a range of banking markets More generally, private banks are expanding rapidly, which may reflect strategic investors' strategies for expansion in retail banking to diversify bank income sources, to attract more stable funding sources, and to market non-bank financial services However, margins are tightening and after-tax earnings actually declined in 1997 (on a dollar basis) In terms of earnings, margins on exposure to blue chip customers have narrowed significantly, prompting more intensified competition in non-blue chip and consumer sectors This has led to higher earnings from lending to riskier segments of the market—consumer lending for auto and appliance purchases, loans against receivables from leasing companies for asset-based lending, and increasing overdraft facilities for customers with "plastic cards " Meanwhile, the cost of funds increased as a result of 1997 increases in reserve requirements (which receive no interest compensation) applied to all deposits (at varied rates) Liquidity remains tight due to fairly tight monetary policy as well as the limited funding options in the market—concentration of deposits in PKO BP, Pekao SA Group and BGZ, thin and sometimes volatile interbank market, limited corporate bond market, undeveloped mezzanine financing options, and relatively low levels of capital at most banks by global standards In fact, the entire Polish banking system's assets and deposits were less than the second largest bank in Brazil, another "emerging" market [72] Thus, the entire funding side of the banking system still remains small in Poland Overall earnings declined as a result of high operating costs, as well as questionable construction projects at a number of Polish banks [73] The cost of funds is expected to ease over time However, operating costs derive from positive and negative developments, and appear to impact different kinds of banks in different ways On the positive side, many of the newer or recently privatized banks are

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71 Kredyt Bank has a 6 6 percent share of PBK-Warsaw

72 Total assets and deposits in Polish banks were reported to be $71 5 billion and $41 billion, respectively, at year end 1997 This is less than the asset and deposit base of Banco do Brasil, the second largest bank in Brazil See *Latin Trade*, July 1998

73 Two troubled state banks—PKO BP and BGZ—are building new headquarters, a questionable use of funds given their weak financial conditions Kredyt Bank and BPH are also building new headquarters See *Polish News Bulletin*, 24 April 1998

making competitive investments in technology, systems and personnel development that will yield increased earnings in the future On the negative side, some of the public banks still suffer from excess head count, branches and overall inefficiency rooted in older systems That foreign-controlled banks are investing heavily in information systems indicates the likelihood of expanding into the retail market, rather than simply relying on fee income and limited balance sheet exposure to generate high returns Meanwhile, the larger majority-Polish banks which have been at least partly privatized are showing increasing competitiveness Bank Handlowy has a diversified ownership structure, but this includes a nearly 29 percent strategic investment stake involving three major financial services companies[74] that provide it with management expertise, and possible additional capital should Handlowy seek to acquire existing banks in the market PBK-Warsaw, Poland's sixth largest bank, is emerging as a *bancassurance* institution that will likely need to push into the retail market to take advantage of synergies from the offering of these financial services The multiple holdings by ING in its own bank, Bank Slaski, and BPH also point to the possibility of consolidation across bank companies The initial success of the Pekao SA Group's privatization[75] is likely to lead to a stronger position in the market, with the outcome of this largely dependent on the winning strategic investor(s) to be determined later in 1998 The recent acquisition by BRE of the Polish Development Bank points to a competitive position in banking and investment banking Thus, the near-term prospects for intensified competition and consolidation are high, which will strengthen underlying competitiveness However, Poland's banking system is still small and largely untested under fully open market conditions **Score 3**

3 1 Overview Poland's banking system is becoming increasingly competitive now that most banks have been privatized and entry by foreign banks is less restricted than in earlier years Banks are now better managed under a new incentive structure introduced in the early 1990s—based on BIS guidelines for prudential regulations and international standards of accounting—and after the 15-month bank restructuring exercise in the commercial banking sector from 1993-94[76] which carried forward the benefits of improved governance, internal oversight, and portfolio management NBP regulatory oversight has played a constructive role in helping to monitor for bank risks and to develop risk management systems that are now starting to be used by bank managers themselves [77] While Poland did not pursue government-financed recapitalization programs of the same magnitude as in other countries for the state *commercial* banks,[78] most of these banks in fact recapitalized from the favorable net spreads received on investments in government securities from 1992 to mid-1995 This reduced available resources for credit to the real sector, but was probably prudent at the time given associated weaknesses in the enterprise

[74] These include Morgan Guaranty, Zurich Group and Swedbank These three own 28 86 percent of Bank Handlowy, Poland's third largest bank based on net assets (and assuming aggregation of the assets of the Pekao SA Group)

[75] The 15 percent IPO floated in June 1998 translates into a market value of $1 8 billion for the institution Poland's total book value of capital at end 1997 was $6 billion

[76] The restructuring of seven state-owned commercial banks' portfolios was conducted under the Enterprise and Bank Restructuring Law passed in 1993

[77] Bank Handlowy and BRE are considered to have some of the best risk management capacity among majority Polish banks Other banks will need to strengthen their risk management systems as more risks are assumed in the marketplace and competition intensifies

[78] However, Poland has pursued costly and time-consuming restructuring programs for the troubled specialized banks—namely BGZ and PKO BP

sector in terms of transparency, disclosure, and capital structure [79] Lending flows began to increase in late 1995 as net spreads on securities began to decline, and as banks reached levels of capital adequacy on a risk-weighted basis that permitted them to resume lending As reforms in the banking and enterprise sector began to take hold, many private sector firms began to represent good returns for banks relative to risk Likewise, as pressure on earnings increased due to improving macroeconomic conditions—lower fiscal deficits and inflation rates—and rising competition in the enterprise sector, banks began to increase lending to households for consumer credit Such trends manifested themselves in 1996, and were largely responsible for the high levels of consumer spending that led to an increase in the 1997 current account deficit—as well as the increase in reserve requirements in 1997 to contain what appeared to be a potentially "overheated" economy [80] Overall, balance sheet indicators indicated reasonably safe loan portfolios and overall asset quality at the end of 1997, although there are some concerns about the risks associated with the substantial increase in consumer and small business lending—much of it installment finance—since end 1995 In terms of segmentation, majority-Polish banks appear to be diversifying Polish banks recognize their limited funding sources from deposits, and the small portion of their earnings which comes from fee-generating services Meanwhile, foreign-controlled banks now appear to be moving into more balance sheet exposure—lending and retail services—now that the blue chip market is saturated, and rates for a range of services have come down Preliminary estimates of after-tax 1997 earnings showed that cost structures remain high—costs were 85 percent of gross income Returns on assets and equity both declined from 1996 due to pressure on margins, limited fee income, and high operating costs For the system as a whole, NBP figures[81] show ROA at 2 percent and ROE at 24 7 percent in real terms for 1997 These compare with 2 5 percent and 41 9 percent, respectively, in 1996 There is significant evidence of competition for large corporate business, as intermediation spreads have dropped considerably from high levels in 1992-95 and foreign banks have captured some market share Upcoming challenges at the system level include the ability of the system to avoid contagion effects—such as downturn in Western Europe, increasing price competition in Europe, or broader global investment trends in emerging markets—, the ability of the government to definitively privatize remaining state-owned banks *and* companies, the overall scope of consolidation that occurs in terms of both numbers of financial firms and their respective financial activities, and the ability of bank companies to play a greater overall role in the economy based on higher capital levels, higher intermediation rates, and a greater array of services At the firm level, key risks for banks and financial services companies include strengthened governance and internal audit functions, management depth and capacity as greater

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79 While many Polish enterprises were creditworthy and justified in complaining about the lack of available bank credit, banks were also justified in not providing credit In addition to the banks' safer returns from investments in government securities, banks were also in the process of developing better credit risk management capacity in the early to mid-1990s On the enterprise side, enterprises themselves often did not provide adequate and meaningful information to banks to persuade them to lend to the enterprises Enterprises sometimes lacked the ability to generate this information in a professional manner In other cases, they simply presented errant or misleading information—exaggerating cash flows to influence a bank to lend, overstating the value and/of security of property put up as collateral, or conversely, understating income and assets due to concerns about information leaking out to the fiscal authorities In yet other cases, information was not the problem, but lack of equity investment was Thus, an enterprise's capital structure was biased towards excess debt, representing leverage that more conservative credit management criteria could not accept

80 The current account deficit of 3 percent of GDP in 1997 would have likely been larger had it not been for the restrictive measures taken in the first half of 1997

81 See *Polish News Bulletin*, 24 April 1998

risks are assumed in the coming years, the success of investment in management information systems that produce needed information in a timely manner for management to identify and contain risks as they surface, the strategic direction of various banking firms under open and highly competitive conditions, and the synergies achieved from investment in non-bank services with banking franchises **Score 3/3+**

- There were 83 banks in Poland at end-1997[82] along with 1,295 cooperative banks Of these, 54 had majority Polish equity and 29 were majority foreign-owned Private sector banks outnumbered public sector banks, at 68 and 15, respectively This compares with figures in 1993, when there were 58 private banks and 29 publicly-owned banks Thus, there has been a slow but steady trend of winding down public ownership in the banking system, and limited net growth in the number of private banks The latter trend is partly due to NBP licensing practices from 1992-95, and partly the result of consolidation [83] The *structure* of the banking system based on NBP figures reveals segmentation into three different groups—majority public sector, private sector banks (based on majority Polish and majority foreign ownership), and cooperative banks [84] Public banks still account for a large share of most balance sheet indicators—50 percent of net assets,[85] 43 percent of net loans,[86] 58 percent of deposits and 32 percent of Tier I capital Cooperative banks generally account for about 5 percent of most measures Private banks account for the balance, with differences between Polish-majority and foreign-majority private banks Aggregate figures show the public banks account for about half of balance sheet figures However, because there are fewer of these banks, their balance sheets are considerably larger than private banks on average—10 of the 20 largest banks on an "own funds" basis are public banks At year end exchange rates,[87] public banks averaged $2,384 million in net assets, $851 million in net loans, $1,672 million in deposits, and $129 million in total equity [88] This was primarily based on the size of PKO BP, Pekao SA (aggregated) and BGZ, which accounted for about 80 percent of the public banks' net assets By contrast, private banks[89] averaged $493 million in net assets, $222 million in net loans, $237 million in deposits, and $58 million in capital [90] Thus, on average, public banks are about four to five times the size of private banks in terms of net assets and loans Public banks clearly enjoy a funding advantage, with an average seven times deposits [91] Public banks also have two times the capital of private banks What these figures do not indicate is the earnings stream of the various banks Here, public banks generated about 46 percent of banking system net earnings in 1997, resulting in ROA of only 1 6 percent but achieving ROE of 26 percent in

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82 As two banks were not yet reporting to NBP at end 1997, financial results apply to 81 operating banks

83 Even year end 1997 figures had changed by the first half of 1998 The total of 15 public banks included the four banks that made up the Pekao SA Group—PKO SA plus BDK (Lublin), PBG (Lodz) and Pomorski (Szczecin) These have been consolidated into one, further reducing the number of public banks

84 NBP also presents data on the basis of majority-Polish ownership as opposed to majority-foreign ownership However, these figures frequently commingle public and private majority-Polish bank figures

85 Net assets are defined as total assets less accumulated depreciation, specific provisions and valuation allowances

86 Net loans are defined as loans and advances less specific provisions

87 There were Zl 3 52 to $1 at end 1997

88 This figure may not be entirely accurate It pro-rates Tier I capital of the public banks and applies the figure to NBP's total capital base for end 1997

89 Figures do not include cooperative banks Figures are based on 66 active private banks at end 1997

90 The largest private banks are Bank Handlowy, BIG, Bank Slaski PBK and BPH All of these have been privatized in the last several years aside from BIG BIG Bank is the largest private bank in Poland that was not previously owned by the state, although much of its size is attributable to the acquisition of the former state commercial Bank Gdanski

91 Much of this is derived from deposits kept with PKO BP and Pekao SA Group, which skews the average

zloty terms [92] By the same measure, private banks net earnings[93] were 50 percent of banking system net earnings in 1997, resulting in ROA of 2 7 percent and ROE of 23 percent Thus, private banks showed superior earnings from assets, but slightly lower ROE due to their larger capital ratios

- *Competition on the asset side* has been increasing in the corporate lending arena, bringing down spreads [94] Banks have consequently shifted resources, primarily into increased lending to the non-corporate sector and the interbank market Meanwhile, there has been a decline in dollar terms in securities investments due to narrower spreads,[95] and relatively flat figures for investment in real estate[96] and other assets In currency terms,[97] year end loans to the non-financial sector increased from Zl 70 billion (about $24 billion) in 1996 to Zl 97 billion (about $27 billion) in 1997 [98] About 82 percent of these loans were to the enterprise sector at end 1997, compared with 84 percent at end 1996 The balance of loans is due from persons Thus, of the $3 billion net increase in these loans in 1997, nearly 40 percent of this was to individuals—with the highest growth in installment financing, which doubled in 1997 This was primarily for auto financing and for the purchase of appliances with bank lending frequently against receivables or assets to third parties The interbank market accounted for an additional 13 5 percent of total net assets at end 1997 up from 12 1 percent at end 1996 This represents an increase of nearly Zl 10 billion, or about $1 3 billion in dollar terms Total loans due from the financial and non-financial sectors represented 54 percent of total net assets at end 1997 compared with 50 percent at end 1996 Investment in securities decreased in real terms, registering a Zl 3 1 billion increase but a $3 billion decline in dollar terms By end 1997, securities investment declined from 33 percent of total net assets to 27 percent Declines were registered across the board—in Treasury and non-Treasury securities—as a percentage of net assets The balance is generally held in reserve at NBP (7 percent), or invested in fixed and other assets Thus, the major asset trends in 1997 were increased lending to the real sector with a particular focus on consumer lending, increased lending in the interbank market, and declining investments in marketable securities

- Significant concentration remains on the *funding* (deposit mobilization) side This is largely due to the concentration of deposits held with three banks—PKO BP, the Pekao SA Group and BGZ—and limited additional financing for banks The three major deposit-taking public banks together held Zl 84 3 billion in deposits, or 56 percent of total deposits Public banks in general held 62 percent of total deposits Overall, deposits as a share of total liabilities and capital remained high, at about 59-60 percent This figure reflects the absence of non-deposit funding in the market for banks, at least at year end on the balance sheet Many of the larger Polish banks appear to have access to the international

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[92] ROA is based on net earnings from 1997 divided by the average year-end 1996-97 zloty assets ROE applies 1997 net earnings to the pro-rated share of public banks' Tier I capital at end 1996-97

[93] This excludes cooperative banks' figures

[94] Blue chip customers frequently receive little or no interest charge on their borrowings as banks vie for their business For some blue chip customers, banks have lowered their spreads to zero and in some cases even provided negative spreads to obtain or retain market share

[95] Investment in securities as a percent of total assets decreased from 31 percent in 1996 to 26 percent in 1997 Investment in securities has decreased as a proportion of total assets due to declining yields as the fiscal deficit decreases, the inflation rate continues to abate, and the exchange rate remains fairly stable without a major deterioration of the current account About 80 percent of investments are in securities issued by the Treasury

[96] Exposure to real estate is not considered as grave a risk in Poland Tenants rights provide for restrictions on eviction, which limits the collateral values found in market economies Likewise, difficulties regarding bankruptcy proceedings make it difficult to repossess immovable properties Finally, limitations on funding for long-term investments and project financing have kept exposure to real estate within what are perceived to be prudent limits More recently, foreign developers have entered the market and begun to provide financing for new property development However, to date, this has not been a major activity for most banks

[97] The year-end 1996 exchange rate was Zl 2 8755 per $1

[98] Loans as a percent of net assets increased from 34 percent in 1996 to 37 percent in 1997

syndicated loan market as a substitute for a domestic bond market,[99] and this may lead to changes in percentages during the year when borrowings are booked Foreign borrowings were estimated to have increased from $3 billion in 1996 to $7 billion in 1997, with much of the foreign currency-denominated funding lent in zloty to take advantage of differential spreads However, these values account for only 4 6 percent and 10 3 percent, respectively, of year-end net assets in 1996 and 1997 Total deposits from the non-financial sector were valued at Zl 143 billion ($41 billion) at end 1997, up from Zl 111 billion ($39 billion) at end 1996 Household deposits accounted for about 72 percent of total deposits,[100] little changed from 1996 At end 1996, demand deposits were only 23 percent of deposits held with banks Money in circulation was about equivalent to the level of demand deposits held Most deposits appear to be time deposits [101] While deposit mobilization and financial intermediation rates are still not as high as in some other neighboring countries or most EU countries, it does appear that intermediation rates have continued to rise since the mid-1990s This signals growing confidence in the banking sector In the long term, it can be expected that increasing banking sector competition—as reflected in the pressure on margins, the diversification of activities, and the increased focus on the retail market—will lead to increased aggregate deposits held with banks, as well as intensified efforts to reduce the concentration of deposits Advances in consumer finance through debit and credit cards, payroll processing for companies, compensating balances for loan accounts, savings/pension plans, insurance and brokerage offerings, and other services provided by a more competitive banking system are bound to serve as an incentive to households and enterprises to place more funds with banks

- In terms of *coverage*, Poland's banks are currently at a stage where they need to make investment and strategic decisions First, competition is increasing with the entry of an increasing number of foreign banks after a period of protection Second, large privatizations are expected in 1998-99, beginning in June 1998 with Pekao SA Group's IPO and followed later in the year with PKO SA Group's 35 percent[102] "strategic" share and the projected $150-$200 million privatization of Bank Zachodni To date, Handlowy is the only large "specialized" bank that has been majority privatized But as these privatization transactions proceed, this will change the composition of boards and management, lead to investment in training and new technologies/systems, and position Polish banks for the European market Third, consolidation is likely to occur across banks—such as the BIG acquisition of Bank Gdanski, and the more recent acquisition by BRE of the Polish Development Bank—as well as across financial sub-sectors in preparation for universal banking Thus, banks need to determine their strategic positions—either as smaller niche players specialized in certain types of lending, investment and services, or powerhouse banks that seek to provide a wide range of services to a broad audience Since the fourth quarter of 1995, banks have increased lending, improved internal systems to comply with regulations, and invested in various technologies to strengthen their competitive positions However, as the "blue chip" corporate lending market becomes saturated, many banks are now tooling up to expand their lending in other segments of the economy and to provide fee-generating services that help diversify their earnings, capture or retain market share, and increase funding Poland has an estimated 2 to 2 5 million enterprises, many of which have difficulty accessing any bank financing, let alone term financing Already, there appears to be movement to increase the quantity and quality of financial services available, as banks introduce more branches which are better equipped technologically, staffed with fewer but better trained personnel, closer to markets, and able to provide more services [103] As for expanded retail services, banks are investing in electronic systems to provide

[99] Many of the large banks are estimated to have access to the syndicated loan market

[100] This was equivalent to 43 percent of total liabilities and capital

[101] Figures for quasi-money at end 1996 showed Zl 85 6 billion in time, savings and foreign currency deposits Figures for money showed Zl 49 3 billion, of which Zl 25 7 billion was in demand deposits See "International Financial Statistics " IMF, February 1998

[102] This should approximate $630 million based on mid-year market capitalization

[103] Poland has only 271 branches per 1 million inhabitants, and less than 100 branches per 1 million inhabitants if PKO BP is excluded from the total This compares with about 900 branches per 1 million inhabitants in Germany and France See *Polish News Bulletin*, 17 February 1998

plastic card' services via ATMs—initially debit card services [104] with credit card services being introduced in 1998 Other banks are providing brokerage services for trading activities on the WSE/OTC markets Corporate advisory services, payroll processing custodial services, trade finance and other services are bound to figure more prominently in banks' earnings streams over time More recently, captive finance companies with bank licenses—namely for auto financing—have entered the market [105] In the enterprise sector, it can be expected that many banks will enter/expand their presence in factoring, commercial credit, and leasing For individuals, many banks will offer mortgages and insurance/investment/pension plan options However, at present, most of these markets remain underdeveloped

- In terms of *financial statement indicators* and contingencies, banks' were only marginally more profitable after-tax in 1997 in zloty, and showed reduced profitability in dollar terms According to NBP, banking system net earnings were Zl 4 4 billion in 1997 compared with Zl 4 2 billion in 1996 (net of cooperatives) In dollar terms, this shows a decline from nearly $1 6 billion in 1996 to $1 3 billion in 1997 (at average exchange rates[106]) This translated into a 16 percent decline of $245 million While income increased nearly $1 7 billion (more than 13 percent in dollar terms), expenses increased nearly $2 billion (more than 19 percent) On the income side, lower earnings resulted from a tightening of margins, and in the limited sources of earnings for banks Nearly three quarters of income derives from interest income, and fee income and commissions only contributed 7 percent of total gross income On the cost side lower earnings resulted from the high cost structure and personnel load many Polish banks still have,[107] and the investments that banks are generally making to tool up for enhanced competition Banks with majority Polish equity have 1,460 domestic branches (this is net of cooperative banks), as opposed to only 169 branches by foreign-controlled banks While staff-per-branch ratios are similar [108] the cost involved in maintaining an extensive branch network is likely to put many majority Polish banks at a disadvantage as private banks introduce more electronically-based services It is difficult to determine from the aggregate expense figures how much of the sector's expense load is productive as opposed to counter-productive In some cases, higher costs today will be reflected in enhanced productivity and earnings, such as investment in training and information systems In other cases high personnel or depreciation expenses may yield little future return For instance, foreign-controlled banks are investing in "other physical expenses" net of occupancy, while majority Polish banks are carrying higher personnel expense costs The former is bound to generate far greater productivity and efficiency in the future Based on these figures provisions are less of an expense to the overall banking system, although net provisions increased in 1997 by Zl 590 million Overall, after-tax margins decreased from 16 6 percent in 1996 to 11 9 percent in 1997 Based on NBP figures, after-tax margins were lowest among banks with majority foreign equity, at only 9 7 percent Majority Polish banks generated 12 5 percent after-tax margins, with private banks performing better than the public banks Regarding the increase in provisioning by the banks and general loan portfolio quality, the increase is due to the increase in lending In 1993-94, provisions were significant However the overall portfolio of the banking system is considered far stronger than a few years back, and banks generated net income from the release of provisions in 1995-96 Part of this is due to the

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[104] Many banks have introduced debit card services This increases funding into the banks and generates fee income although annual fees are now coming down as more banks enter the market Thus, these services will become more volume-oriented However, banks also need to have adequate liquidity management electronic capacity and information systems to conduct such operations efficiently Debit cards are essentially used as direct payment methods from accounts to save time from other methods of payment (e g , at the post office)

[105] "Banks" geared to auto finance and other kinds of equipment financing/leasing include (but are not limited to) Opel Bank, Ford Bank, Fiat Bank, Volkswagen Bank, and GE Capital

[106] The average exchange rate used for 1995-96 is Zl 2 69 per $1 The average exchange rate used for 1996-97 is Zl 3 20 per $1

[107] Personnel accounted for 60 percent of total expenses in banks with majority Polish equity

[108] Majority Polish banks have domestic staff of 130,823, or 90 per branch Foreign-controlled banks have 16,272 domestic staff, or 96 per branch

multi-year clean-up and restructuring of portfolios and companies Some of this is also due to the booming economy, which has assisted troubled companies with a favorable environment in which to restructure The share of "irregular" loans was estimated to be 10 4 percent at end 1997, compared with 31 percent at end 1993 and 21 percent as recently as the end of 1995 Of these end 1997 irregular loans, about half are considered "loss" and are fully provisioned Likewise, on a risk-adjusted basis, banks are considered by NBP to be adequately capitalized, with 73 of 81 banks exceeding the BIS-recommended minimum of 8 percent Median capital on a risk-adjusted basis was 17 6 percent Six banks were technically insolvent

- In terms of *funds flows*, banks' funding sources are 60 percent from deposits from the non-financial sector, primarily term deposits from household sources and, to a lesser extent, corporate sources For overnight or short-term needs, there is an interbank market where banks obtained about 12 percent of their funding Capital contributes another 8 percent Thus, about 80 percent of funding derives from deposits, bank borrowings and capital In terms of uses, about 40 percent of funds are lent to enterprises and individuals, with another 14 percent lend to the financial sector Most of the balance goes to the government, either in the form of investment in government securities (20 percent), cash and reserves held with NBP (7 percent), or direct loans to government (2 percent) There appears to be less crowding out of private investment than in earlier years, as the total year end 1997 balance sheet exposure to government was about 30 percent In terms of matching sources and uses of funds, banks seem to have sound exposure Obligations to/from government and NBP show little mismatch There is limited exposure to the financial sector The net surplus of deposits to loans has generally been invested in securities, most of which are risk-free "Other" liabilities generally offset fixed and "other" assets Capital is eight percent As for the term and currency structure of assets and liabilities, there is insufficient information Most banks are thought to have provided limited term lending as a means of containing term exposure However, there may be risks to currency exposure, as reports to NBP from the banks convert values into zloty With Poland's sensitivity to potential "contagion" effects and rapid portfolio movement, bank portfolios may be subject to short-term exchange rate risk Many banks are thought to have inadequate gap analysis when managing their foreign currency exposures

- *Ratings* are available from all three major international rating agencies on Poland's foreign and local currency issues For example, in early 1998, Moody's rated Poland's long-term bonds at Baa3, long-term bank deposits as Ba1, but short-term bank deposits as NP This basically places long-term bonds in the medium-grade obligation class that is neither highly protected nor poorly secured Bank deposits on a long-term basis are not considered "well-assured", and short-term deposits are below prime In June 1998, S&P affirmed Poland's BBB- long-term foreign currency rating, and an A- long-term local currency rating, with a positive outlook for both ratings Short-term ratings were A-1 for local currency and A-3 for foreign currency Fitch IBCA assigned a BBB rating for long-term foreign currency

- Poland's banks have excellent *correspondent networks,* and *payments systems* are generally considered adequate Most of Poland's largest banks, both public and private, already had well established networks years ago Such networks have improved as banks have restructured, and as more strategic investment is now entering the Polish banking sector

3 2 ***Ownership*** Poland's banking sector is still dominated in many ways by the large public banks This is particularly true in terms of deposit mobilization, and the consequent funding advantage enjoyed by PKO BP, the Pekao SA Group, and BGZ [109] There has been an apparent and continuous preference on the part of the authorities to engineer consolidations among Polish banks and large non-bank financial services companies to "defend" the Polish financial market from foreign competition This has been evident more recently through the privatization process,

[109] Together, these three banks accounted for 59 percent of end 1997 banking system deposits

with some of the smaller banks being acquired by Polish financial groups even when their bids have come in lower than those of foreign competitors [110] In other cases, holdings have remained dispersed, even when greater capital injections could have been obtained from strategic investment [111] Some of this has related to past governments' intentions to redistribute some of the gains to local "stakeholders," either directly—to employees and managers—or indirectly—to citizens through capitalization schemes for the pension system and possibly off-budget items to support loss-making enterprises in "strategic" sectors However, with Pekao SA Group to be majority privatized by end 1998, the banking sector is finally expected to be majority private on the basis of most balance sheet measures Private banks already have about two thirds of banking sector core capital—although the banking system is still limited in total capital, the increase of which is needed for modernization and competitiveness—and nearly 60 percent of total loans as of end 1997 Many of the foreign banks, all private, also dominate some of the high-fee activities Thus, in some ways, the banking system is already majority private in some activities The growing sophistication of Poland's private banks combined with the increasing competition being brought by foreign-controlled banks is expected to modernize the banking sector in the next five years as Poland eventually accedes to the European Union However, for this to happen, the authorities will need to attract more strategic investment for needed capital injections, management know-how, enhanced market links, and above all, more sophisticated risk management systems This will require an attitude that vanquishes its fear of foreign competition, and in fact recognizes both the necessity of increased foreign intervention combined with the added opportunities this will inevitably create for majority-Polish institutions Part of this resistance can be overcome by recognizing the need of foreign banks for sound Polish partners, and the global tendency away from national orientations in the ownership, management and operations of banks **Score 3-/3**

- There were 83 banks in Poland at end-1997 along with 1 295 cooperative banks Of these 54 had majority Polish equity and 29 were majority foreign-owned Thus, banks in Poland are predominantly *domestic* banks These banks account for 77-82 percent of banking system assets, loans and deposits, and 71 percent of core capital Thus, at end 1997, majority-Polish banks had about $57 5 billion in net assets, $22 billion in loans to the non-financial sector, $35 billion in deposits, and about $4 billion in capital Of the Polish banks, 15 were either directly or indirectly owned by the Treasury,[112] while the rest were majority private Of these two were state-owned—BGZ and PKO BP—while the rest were joint-stock companies Most private Polish banks remain small If large, they are recently privatized The two exceptions are BIG and Kredyt Bank, which have grown through the acquisitions of Bank Gdanski (BIG) and the Polish Investment Bank (Kredyt) both formerly state-owned banks At end 1997 the average Polish private bank had $559 million in net assets, of which nearly half—$247 million—were in loans to the non-financial sector Polish private banks' deposits were about the same

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110 For instance, the privatization of PBK-Warsaw involved the resubmission of a bid from a primarily Polish consortium despite a reportedly higher bid from Samsung during the first round There may be several reasons for this, including a preference for the *bancassurance* concept submitted by the local consortium, concerns about a consumer finance orientation from Samsung, or worries about the impact of South Korea's financial and economic problems on Samsung's ability to carry through on proposed plans However Poland's openness to foreign investment in the banking sector has long been debated due to reservations in some political circles

111 For instance, in the cases of Bank Handlowy and Pekao SA Group, strategic shares have been limited to 30 and 35 percent, respectively In the case of Handlowy, strategic shares are divided among three institutions Strategic investors for Pekao SA Group are expected to be known by end 1998 These shares may change over time, as they did with some of the smaller commercial banks—Slaski and Wielkopolski—but the initial privatization process has limited the share of strategic investment

112 Poland's 20th largest bank (by own funds), Pierwszy Komercyjny Bank, was owned by NBP

as loans—$264 million Capital was about $60 million on average Generally, private majority-Polish banks have grown from about 10 percent of total banking system resources to about 30 percent, with a weaker deposit base but higher levels of core capital On average, Poland's public banks have about three to four times the assets and loans of majority-Polish private banks, about six times the deposits, and twice the total equity In terms of earnings, majority-Polish banks accounted for about 80 percent of 1997 net earnings Polish public banks accounted for 46 percent, while Polish private banks accounted for 35 percent This compares with 1996, when majority Polish banks generated 82 percent of net earnings, 68 percent of which derived from public banks and only 14 percent from Polish private banks Much of this has to do with the privatization of Bank Handlowy and PBK

- Poland had 29 *majority foreign*-controlled banks at end 1997 These banks accounted for only 12 5-17 percent of net assets, loans to the financial sector, and deposits Foreign-controlled banks accounted for nearly a quarter of core capital By end 1997, banks from Germany, the U S and the Netherlands accounted for 29 percent of total banking system equity capital, and about 70 percent of foreign investment in the banking sector [113] On average, foreign-controlled banks are comparatively small by global standards They are also smaller than their private Polish counterparts on average Foreign-controlled banks had $370 million in net assets, $174 million in loans to the non-financial sector, $185 million in deposits, and $50 million in capital at end 1997 This suggests that despite the number of prime-rated foreign banks and high real growth in Poland since 1994, that the larger foreign banks have yet to commit significant resources to the Polish marketplace while the smaller banks are getting established, researching the market, and making needed investments This may be partly due to prudent risk aversion as the market slowly develops This may also be the result of an interim period in which foreign banks are preparing for a broader array of retail and other banking services In 1997, foreign-controlled banks had the lowest after-tax margins among banks Foreign-controlled banks are also the only group of banks that has shown rising cost-to-income ratios since 1993 Thus, while majority-Polish banks may be trimming costs due to their high cost structures or lack of comparative efficiency, foreign-controlled banks are showing a steady increase in costs relative to income It remains to be seen how foreign-controlled banks intend to pursue the Polish market, although it is likely that much of the increased cost is related to new systems, technologies and training that are expected to generate significant earnings in the coming years

3 3 Governance and Management Governance has improved in recent years as the public banks have restructured, recapitalized, and been increasingly subject to hard budget constraints However, weaknesses still abound at the supervisory and management board level relative to the next series of risks and challenges that the banking system is likely to face [114] While banks have gotten better at introducing prudent credit management systems, other risks are apparently less well managed except in a rudimentary way Even here, there are questions about the degree of risk taken by banks in lending activities as they have shown increasing reliance on third parties and credit agencies There are questions about the slow process of restructuring and privatization of the larger banks in the banking sector—mainly PKO BP and BGZ There are also questions about the process of consolidation in the financial sector, the lack of needed capital for modernization, and the absence of clearly identifiable owners in many cases Poland is reputed to have supervisory board weaknesses—an absence of experienced financial sector personnel to provide needed oversight—and associated internal audit weaknesses This is to be shored up

[113] This is thought to number 19 of 29 foreign banks licensed to operate in Poland at end 1997 Many of these banks are small and/or specialized, while some are associated with large global financial services companies

[114] Two major exceptions are Bank Handlowy and BRE, both of which have a sound reputation for governance and management Other banks have varying reputations, but are considered less strong than these two banks

with a commitment to strengthen the internal audit function by encouraging greater separation of functions, investing in better systems, generating better management information, providing better compensation for internal auditors, and protecting internal auditors from being released unless a majority of the supervisory board votes for such a release As the market becomes more competitive, the onus will be on boards to devise appropriate strategic plans and to set corresponding risk tolerance levels to the various activities that are part of that strategy This will require that supervisory boards have the needed financial and business skills to comprehend the growing complexities of risks the banks will soon face Management likewise will need to ensure the personnel, systems and procedures are in place to implement the strategies and to identify, contain and communicate major deviations when unanticipated risks materialize These challenges will only become greater as the market expands, greater resources are at risk, and increasing globalization of markets adds to the sensitivity of some of the risks However, Poland's banks have generally shown progress in recent years This has been most noteworthy in terms of the financial and operational restructuring of most state-owned banks since serious reforms began in 1993 Listed banks are showing better performance than many other banks in the market This is partly related to the rigorous information requirements imposed by the market for ongoing investment The major banks have had external audits conducted for the last several years consistent with IAS Boards and management have focused on loan portfolio restructuring, the introduction and observance of stricter credit policies and controls on new lending flows, safe and prudent investment in government securities to recapitalize, and compliance with prudential regulations with regard to provisions for loan losses, liquidity and capital ratios, a range of exposures—interest rate, exchange rate, pricing, term—, and risks associated with the growth of off-balance sheet items Compared to five years ago, the larger Polish banks are far more competitive than they were Thus, governance and management at most banks appear to have been satisfactory through the initial reform phase of restructuring What remains now is the ability of boards and management to attract capital, generate earnings, and manage risks in an increasingly competitive and complex environment Particularly if the economy were to slow from its fairly heated 6 percent real growth since 1994, the outcome of this challenge will say much about the financial condition and institutional competitiveness of the Polish banks moving into the 21st century **Score 3**

- According to the Company Law, the *legal* process for forming and registering a company in Poland is fairly straightforward The process takes one to three months, although in some cases it can take up to a year There are clear guidelines for types of corporate structure, and the general obligations of directors There are also restrictions on insider dealing of shares in publicly listed companies As for banks, the Banking Act elaborates requirements expected of banks' boards and management teams, specifies minimum capital and capital adequacy requirements for a license, limits insider dealings to 10 percent of a bank's core capital, defines other limits on a range of exposures, stresses internal audit and disclosure requirements, and describes penalties for legal violations

- *Cross-ownership* is now permitted as legal barriers to universal banking are coming down However, there are clearly specified limits on the amount of exposure banks can have in non-bank companies This includes limits on bank shares in individual companies or funds to 15 percent of bank capital, and total exposure of bank investment in companies and funds to 60 percent of bank capital There is an allowance for banks to convert debt to equity, but on the basis that such equity will be sold within three years The Commission for Banking Supervision is empowered to request and share information with other regulatory bodies in the pension, insurance and investment fields to ensure that banks and other institutions remain in compliance with regulations It is expected that increasing liberalization will be accompanied by increasing oversight to ensure that risk parameters are not exceeded

- *Minority shareholders* are partly protected in Poland under Company law They have the right to pool their votes to ensure at least one member who represents their interests sits on the board Shareholders are also given preemptive rights on the issuance of new shares This helps to protect a minority position from being diluted, at least on non-commercial grounds However, companies are not required to send proxy forms to shareholders in advance of meetings As Poland is seeking to expand its capital markets activity and to gain entry into the EU, it is expected that protection of minority shareholder rights will be increasingly and satisfactorily maintained in accordance with "international standards " To date, it has not appeared to be a problem for strategic investors in banking institutions

- Governance in the banking sector has improved since the restructuring of the seven state-owned commercial banks began in 1993 The hard budget constraint imposed on non-private commercial banks played a significant role in strengthening internal governance and management This led to better *oversight* of management performance (based on strategic targets to position the banks for subsequent privatization), improved information and reporting systems, high standards of accountability, and the adoption of new credit procedures under commercial conditions While four[115] of the seven state commercial banks that were part of the restructuring program, and three[116] of the four major specialized banks have not yet been majority privatized, it is believed that much of what provides the remaining public banks with a measure of franchise value is their strengthened governance and management This is being tested in 1998 with the privatization of the remaining commercial banks (mostly under the Pekao SA Group banner) However, despite progress, the state has been slow to permit full-blown privatization based on strategic investment The entry of prime-rated foreign banks was slowed considerably from 1992-95 to provide time for domestic banks to restructure internally and recapitalize from investments in government securities While Polish banks are now more competitive than in 1992-93, there are questions about whether the more gradual approach has actually delayed the benefit of management know-how, improved information systems, market links, and policies and procedures for improved *oversight* of bank management that tends to come from strategic investment In effect, the Treasury (Ministry of Finance) and NBP became the banks' strategic investors, the former exercising governance over the banks while the latter controlled licensing policy and supervision On a financial basis, such an approach has left the Polish banking system with limited capital, stifling growth to date

- There are no restrictions on *compensation*—salaries and benefits—of bank directors, managers and employees However, the Commission for Banking Supervision can restrict salaries, benefits, dividend payments and other bank expenses in the event of needed corrective action

3 4 Non-Bank Competition The non-bank sector is beginning to expand In some cases, Poland has done an excellent job in developing non-bank institutions—namely in the capital markets However, in other cases, there has been slow progress—notably in the insurance sector and leasing On the positive side, there is already considerable turnover on the stock exchange, and rapid growth is expected on WSE as well as the CeTO market This will help banks in expanding their potential market for clients with suitable equity financing, as well as provide better financial information and accountability standards In other areas, there is progress Insurance premiums are increasing, and open market competition is expected to intensify from 1999 on [117] The key question in the insurance sector is the fate of PZU, the financially troubled insurance

[115] These are the three commercial banks—BDK of Lublin, PBG of Lodz, and Pomorski of Szczecin—that have been grouped together into the Pekao SA Group along with Pekao SA, and Bank Zachodni of Wroclaw The privatization process for the Pekao SA Group began in June 1998 with an IPO for 15 percent of the bank The smaller Bank Zachodni is expected to be privatized later in 1998

[116] Pekao SA, BGZ and PKO BP The first one is being privatized in 1998-99, and the second is slated for privatization in 1999-2000

[117] New regulations are expected to be ready by end 1998 permitting foreign insurance companies to sell insurance premiums through their offices in Poland from January 1999 on

giant that accounts for about two-thirds of the market but is about $300 million insolvent and slated for privatization in 1999 Reforms in the insurance sector will be important to the banking sector, as several banks already have important stakes in life and non-life companies A third key sector is the pending emergence of privately managed pension funds Pension reform is one of the key necessities for Poland to get its fiscal house in order Reforms and legislation introduced since late 1996 are making headway Privatizations in 1998-99 will provide proceeds to assist with implementation of pension reform Meanwhile, mutual/investment funds, venture capital firms, and leasing operations are expected to increase their presence in the coming years A new framework for leasing is in process to reconcile current tax incentives with international standards This will have to be accompanied by an improved accounting framework for leasing, which the current Accounting Act does not cover A legal framework is now being put in place for mortgage banking, which will allow for the trading of mortgage bonds However, here, time will be required to strengthen registries, courts, bankruptcy/liquidation procedures, and market mechanisms for credit risk evaluation and collection All of these developments are important for the banking sector given their brokerages, ownership stakes in insurance companies, and expected activity in mortgage financing and leasing As the markets broaden and deepen, risks will likewise proliferate In particular, the risks associated with securitization will increase, as will exotic features attached to differing instruments to fill portfolio niches Now that new legislation provides banks with more of an opportunity to enter non-bank activities, they will have to apply proper management principles to prevent systemic or highly damaging risks from materializing Above all, up-to-date information systems, effective and accountable management structures, well-coordinated risk management procedures, and substantial capital and reserves for unforeseen risks will be needed It is expected that over time, there will be a consolidation of financial services company shares of assets and deposits which would cut across traditional "bank" and "non-bank" classifications The cross-ownership of banks in insurance provides some indication of how this might evolve However, as the banking sector itself is likely to undergo consolidation in the coming years, it will take at least that long to develop across sectors **Score 3/3+**

- There were 1,295 *cooperative banks* at end-1997, down from 1,653 as recently as 1993 Their total assets and deposits account for about five percent of the total banking system These banks are remnants of the BGZ system set up to finance and provide safekeeping services for the agriculture sector and rural populations New legislation regulating *mortgage credit institutions* and the issuance of mortgage bonds was passed in August 1997, although there is limited mortgage activity

- *Capital markets* activity in Poland has focused on the Warsaw Stock Exchange (WSE), which has been active since 1991 under the new market-based framework Market capitalization was estimated to be about Zl 43 billion in mid-1998, or about 8-9 percent of projected 1998 GDP [118] This compares with market capitalization of only $8 4 billion at end 1996—about 6 percent of GDP—and $4 6 billion in 1995—less than 4 percent of 1995 GDP In April 1998, WSE had 165 equity securities listed, as compared with 83 in 1996 and 16 in 1992 By end 1998, 200 listings are expected One weakness is the limited investment from mutual funds, which only accounted for about 2 percent of investment on the exchange This is because Poles still place only a limited amount of their savings in mutual funds There are about 150,000 mutual fund accounts estimated to be about 2 3 percent of total savings To list on the WSE primary market, certain minimum requirements must be met [119] A parallel market for

[118] Zl 43 billion approximated $12 4 billion at June 1998 exchange rates GDP could approximate $150 billion in 1998

[119] These include share values must have a minimum value of Zl 24 million, while other securities must have a minimum value of Zl 12 million, the listing company's share capital must be at least Zl 7 million, the value of shares to be admitted must be at least Zl 12 million, which must be at least 25 percent

smaller companies has also been established, with easier listing requirements As of end 1996, there were more than 24 investment banks and advisers, 43 brokerages, 13 emerging market funds, 15 national investment funds, and 12 venture capital funds WSE has long been heavily weighted towards banks in terms of value Bank stocks accounted for 33 percent of WSE market value at end 1996, followed by chemicals (19 percent), trading (17 percent) and food (10 percent) These trends were bolstered by the privatization of Bank Handlowy and PBK-Warsaw in 1996-97 The privatization of Pekao SA Group will contribute additional value to the WSE—the 15 percent IPO generated about $270 million in June 1998 The privatization of Bank Zachodni should also make a minor contribution WSE also trades government securities—state bonds and treasury bills—which are responsible for attracting significant portfolio investment from abroad

- In addition to WSE, there is also the CeTO, or over-the-counter market for companies that do not meet the size requirements of the WSE Minimum requirements for CeTO pertain more to share registration and information disclosure based on regulations This market is geared to accommodate SMEs, particularly those that are generating positive cash flow but are unable to obtain the levels of financing needed for major investments As of early 1998, CeTO had 25 companies listed, and capitalization of $400 million Daily trading exceeded Zl 1 billion in early 1998 By end 1998, CeTO projects 50-60 companies will be listed, and market capitalization will approach $1 billion This market's growth could accelerate if a "recompensation" program valued at Zl 14 billion takes effect [120]

- In 1997, Poland passed three pension reform bills One of the bills transforms the pay-as-you-go pension system to a system that is more in line with the three-pillar approach being adopted in the region [121] This calls for the introduction of a second pillar to the pension fund scheme—mandatory contributions to regulated but private *pension funds*—to go along with the first and third pillars (mandatory contributions to state funds, and voluntary contributions to private funds, respectively) Thus, by establishing privately managed, fully funded pension funds to supplement the first pillar, fiscal and pension reform are expected to serve as a catalyst for capital markets development The new pension system will benefit from the proceeds of privatization transactions Key requirements are expected to include minimum capital of ECU 4 million, limits on cross-holdings, prudent standards of governance and management, independent supervision, and prudent investment guidelines which will limit investments to risk-free securities in Poland and OECD countries, bank deposits and securities, liquid and quoted shares on WSE, investment certificates in investment funds, traded and fully-secured local government securities and bonds, bank-guaranteed domestic bonds, and in foreign bonds and equities issued by firms registered in OECD countries and traded on the main markets of the OECD countries Over time, these approaches combined with changes already made in the indexation system are expected to generate significant fiscal savings by reducing transfers from the budget for social insurance and labor funds Mandatory contributions are expected to be 1-2 percent of GDP in the next few years While this will lead to reduced fiscal revenue, it will lead to even further reduction in expenditure for a favorable net benefit The new system also tightens eligibility requirements for the first pillar—a higher retirement age was introduced, and sectoral privileges were eliminated Thus, in the interim, about a quarter of all mandatory contributions are likely to flow into the mandatory second pillar

- There is a growing *insurance* sector in Poland In 1997, total gross premium income was about Zl 12 3 billion ($3 84 billion)[122], or about 2 7 percent of GDP These figures were up nearly 51 percent from Zl 8 1 billion (about $3 billion), or 2 2 percent of GDP In 1994, these figures were Zl 4 0 billion

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of the total shares of the company, there must be at least 500 shareholders of the shares to be admitted, and combined pre-tax profits of the company issuing shares must be at least Zl 5 million for the previous three years

[120] This program would issue vouchers as compensation to government employees whose wages/salaries were improperly indexed The vouchers could then be invested in the markets

[121] See *The Act on Organization and Functioning of Pension Funds of 28 August 1997*

[122] Average exchange rates in 1997 were Zl 3 2 to one dollar

($1 76 billion), or 1 9 percent of GDP Thus there is a clear trend in terms of premium income growth both absolutely as well as in terms of GDP Premium income growth is from life insurance products as well as property and casualty policies [123] However in terms of profitability the sector is moving in two different directions The sector generated a meager Zl 36 2 million ($11 3 million) in net profits after showing losses in 1996 In terms of segments, life insurance increased profits 80 percent in 1997, to Zl 213 million Meanwhile, property and casualty losses showed about the same losses in 1997—Zl 176 million—as in 1996 Most of this is with PZU Concentration in the sector is beginning to break down Less than a decade ago, there were only two state-owned insurance companies—PZU and Warta—compared with at least 33 at end 1996 In 1991, PZU was broken up into two companies focusing on life and non-life insurance products to conform to legislation separating the two activities However, in terms of ownership, PZU owns 99 percent of PZU-Life, and PZU is 100 percent owned by the state PZU and PZU-Life accounted for about 70 percent of gross premium income, and Warta accounted for another 9 percent These three companies also had nearly half the offices of the sector in Poland, reflecting their broad retail coverage Thus, concentration remains in both life and non-life However, the next seven insurance companies account for about 15 percent of gross premium income, and these firms were generally established in the early 1990s Thus, there is some movement towards competition, and this is expected to intensify from 1999 on with the introduction of amended legislation One of the key trends in the insurance sector is the growing cross-ownership between banks and insurance firms Banks' stakes in insurance firms include the following Bank Handlowy owns a small stake in PZU-Life PBK-Warsaw owns 20 percent of Warta as well as 100 percent of its own insurance firm, WBK owns 10 percent of Commercial Union, PBG owns nearly 41 percent of Heros non-life and 5 percent of the life company, BISE has a nearly 17 percent stake in TUW, Gdanski has a nearly 11 percent stake in Azur and ING owns 100 percent of its insurance concern Further, there are many distribution arrangements in which banks and insurance companies cooperate [124] Thus it is anticipated that Poland's banks will intensify their activities in insurance as barriers to universal banking have come down, *bancassurance* offers retail synergies, and incomes and demand are rising Most firms have "cooperation" agreements with insurance firms in Switzerland and Germany Poland's amended Insurance Law of 1995 brings the insurance sector closer to EU standards [125] This will be further amended in late 1998 to permit foreign insurance companies to sell insurance premiums from their offices in Poland, further intensifying competition in the sector and accelerating openness to foreign investment, some of which has already entered the market—Commercial Union and American Insurance Group are but two widely recognized names [126] However two bankruptcies in 1995-96[127] indicate that adequate regulations are not enough to guard against insolvency Low levels of capital and poor risk management contributed to these bankruptcies The estimated Zl 1 billion capital shortfall of PZU further reinforces this point, particularly in the case of property and casualty when unanticipated risks such as flooding are precisely the kinds of events

123 Property and casualty increased 53 percent in 1997, to Zl 8 25 in premium income Life increased 47 percent in 1997, to Zl 4 06 billion See *Polish News Bulletin*, 20 April 1998

124 See *Polish News Bulletin*, 17 April 1998

125 Formulas for solvency margins are in compliance with EU regulations, as are guarantee capital and "own funds" guidelines Investments are regulated and insurance companies must notify Poland's independent insurance regulator—the State Office of Insurance Supervision—if it purchases more than 10 percent of the equity capital in a different company, and of any investments in a dependent company A Guarantee Fund has been established Upper limits on admissable investments as a percentage of net technical reserves are specified in a manner consistent with EU guidelines These include up to 100 percent for investments in government securities, up to 100 in bank deposits (but not to exceed 20 percent of the bank's own funds), up to 30 percent in quoted shares, up to 15 percent in non-quoted shares (with a 10 percent limit for individual company shares), up to 15 percent in loans secured by life insurance policies, up to 25 percent for investments in real estate (with a 5 percent maximum per project), and up to 5 percent in bonds and loans for mortgages

126 Others with a currently limited presence—Allianz, Aegon, CIGNA—are expected to play a larger role as the market opens up

127 These were the Hestja and Gryf companies

which require deep reserves Other smaller Polish insurance firms are reputed to generate insufficient premium revenue relative to their overhead

- There are 39 *leasing* companies operating in Poland Leasing has not yet fully developed due to tax incentives, and problems associated with collateral Current tax legislation permits double-taxation, first on income from operating leases and then on the sale of equipment This can be arbitrary in some cases due to a weak legal and accounting framework Another disincentive is that the lessor can not expense depreciation as a pre-tax item New laws are aimed at strengthening the legal and accounting framework for leasing The new Pledge law assists in this direction with regard to lien perfection and collateral values However, there are current risks to banks in terms of their exposure to leasing companies First, banks are lending against receivables These receivables are collateralized by assets However, the value of those assets is frequently considered to be high for leasing companies to access greater bank funding Second, because many leasing companies are reputed to be undercapitalized or to engage in fraudulent conduct, they can be assessed back taxes In some cases, this can close them down In the absence of well developed repossession and court procedures, banks run the risk of losing on their leasing exposure

IV BANKING SECTOR DEVELOPMENT BASED ON PRUDENTIAL NORMS The Polish banking system is adequate in terms of basic financial indicators—capital adequacy, asset quality, increasing liquidity—but it is still small by global standards in terms of financial value and intermediation levels For instance, total capital in the Polish banking system at end 1997 was $6 billion, and assets were only about 50 percent of GDP Such low levels of capital limit the resources available for lending and investment which, in turn, means that Poland will need more time operationally before it is considered competitive for the EU market While many trends are favorable—better macroeconomic conditions and improved financial condition of the banks compared to the early 1990s, improved governance and management at the largest banks, investment in new technologies and training, development of effective banking supervision, increasing transparency, high levels of accountability, continuing demonopolization—other trends are less promising Generally, the fear of competition from large foreign banks has led to a consolidation strategy which has slowed real privatization and modernization This has impinged on earnings, stunted the growth of retail banking, and slowed the development of needed risk management systems for the next stage of banking system development—universal banking—based on more diversified loan portfolios, a wider range of investment options, increased provision and selection of services, broader product and/or market focus, and active positions in traditionally "non-bank" financial activities such as insurance, pension fund management, and venture capital While these trends are currently in process, Poland would probably have a more competitive banking system today had it not been so resistant to foreign investment until recently Notwithstanding such resistance, Poland has generally demonstrated favorable trends in the last several years Capital adequacy ratios are sound according to BIS guidelines, with the median value of risk-based capital at 17 6 percent at end 1997, and 73 of 81 banks operating at year end 1997 having risk-adjusted capital in excess of 8 percent Asset quality has improved as banks have generally cleaned up loan portfolios, although many banks may be taking on excess risk in their consumer lending/installment financing activities, and in third party transactions involving loans and guarantees Earnings were adequate in 1997, although not outstanding—$1 3 billion after-tax, for ROA of 2 percent Liquidity is somewhat constrained by monetary policy which has focused on the steady reduction of the inflation rate without permitting excess exchange rate volatility Deposit mobilization has improved, partly reflecting the rising real incomes of households, and their interest in some of the term deposits offered by the banking system However, there is still significant concentration in the holding of deposits, with three banks accounting for a 56 percent share of total Such concentration weakens liquidity at the other banks The interbank markets are functioning well, but they are thin In the absence of a developed corporate bond market, banks are increasingly drawing on their access to syndicated loans for term financing A dual and interrelated challenge in the coming years will be the ability of the system to increase overall liquidity, and for banks to prudently manage portfolios and liquidity to instill confidence WSE is still heavily weighted towards banks—banks accounting for one third of net assets are traded on the exchange, up from 21 percent at end 1996—and this provides further incentives for prudent management for performance and growth However, the temptations to take on high levels of risk as margins narrow will require significant oversight, both from bank boards as well as from regulators and the markets Here, strategic institutional investors are of critical importance to the system from both the "buy" and the "sell" side All of this points to the ability of banks to properly manage risk as the market opens up to increasing competition Several questions remain with regard to (i) the near-term pace of privatization and consolidation in the increasingly universal banking system, including the impact of these factors in the insurance sector with regard to cross-ownership, (ii) the ability to raise capital and intermediation levels to a point needed for competitiveness by global/EU standards, (iii) risk management capacity as bank asset structures grow and take on more and diverse risks, (iv) the sustainability of earnings as banks adjust their risk tolerances and venture into activities in which they have limited experience—Polish banks from a product standpoint, and foreign banks from a local market standpoint, (v) the ability to manage credit risk and absorb losses as banks vie for non-blue chip business, extend credit for longer periods, and provide loans with differing interest rate and currency features, (vi) the willingness of mid-sized Polish companies to adapt to international standards of transparency and disclosure to obtain added financing, particularly as many companies still conceal information from fiscal authorities, (vii) the ability of regulatory authorities to monitor for more "exotic" risks—off-balance sheet items, derivatives—and to contain those risks when adverse effects occur, (viii) the overall ability to withstand contagion effects, as was recently threatened by concerns about the ruble and could occur if demand slows in Western Europe, and (ix) the ability of the banking system to weather a downturn in the economy after several years of rapid growth Poland has made progress over the last several years, spurred on by membership in international organizations and prospects for integration into the European Union However, gaps remain in terms of income levels and competitiveness Now that Poland has stabilized its banking system, the next round of challenges will be to close the gap in competitiveness so that Poland's economic landscape is indistinguishable from that found among its EU neighbors This will require significantly greater investment and improved management systems adapted to the risks associated with increasingly rapid and complex movements in the global economy **Score 3**

4 1 Capital Adequacy Poland's banks are adequately capitalized by risk based on BIS standards, although they remain small in terms of average and total capital—nearly half of Poland's banks would either not meet EU minimum capital requirements or would be barely above these minimum levels Total capital in banks was Zl 21 2 billion at end 1997, or about $6 billion On a risk-adjusted basis according to BIS guidelines, banking system capital was Zl 17 9 billion, or $5 1 billion Netting out cooperative banks from the total, this amounts to about $60 million per operating bank at end 1997 Ratios are sound, with median risk-based capital at 17 6 percent of assets According to NBP, three quarters of banks had risk-based capital ratios in excess of 12 percent, and 73 were at or above 8 percent Only six banks were technically insolvent, all of which are in the process of implementing rehabilitation programs Capital ratios have been strengthened in recent years by higher earnings after factoring in provisions for loan losses, high levels of government securities investments (which are zero in terms of risk-weighting), and better control of new lending flows which has brought classified loans down to 10 4 percent at end 1997 from 31 percent at end 1993 For listed banks, WSE share prices of banks are good, which also provides capital strength and needed financing Thus, capital appears adequate However, among Poland's 81 operating banks reporting at year end 1997, 29 had gross own funds (unadjusted for risk) below Zl 20 million—about ECU 5 million, the minimum required for a banking license in the EU Another 11 banks were below Zl 40 million Thus, at least half of Poland's banks are below the minimum, or would be around the minimum for a license once capital is restated according to BIS guidelines Moving forward, apart from Pekao SA Group, it is unlikely that Poland will be able to attract extraordinary injections of capital from prime-rated foreign institutions through privatization The only other large public banks are PKO BP and BGZ, both of which have problems that would lower their franchise value due to problem loan portfolios, excessive branch networks, and/or political complexities that would make serious operational restructuring difficult and risky to manage Thus, banking sector capital growth will now likely have to come from retained earnings, asset quality and size, and the ability to float shares or obtain equity from other sources, and not from privatization proceeds In recognition of this need for capital, trends towards market opening are positive, as they are in the insurance sector Any attempt to reverse such a position is likely to slow market liberalization, which would likely hinder capital growth and slow progress towards competitiveness At the micro level, capital adequacy ratios will need to be adjusted as banks shift resources from investments in government securities to increasingly risky exposures Thus, there will be even greater challenges ahead in increasing aggregate capital into the system, as well as ensuring the adequacy of capital on a risk-adjusted basis **Score 3**

- Poland's methodology for calculating *capital adequacy ratios* as well as capital targets is consistent with EU and Basle standards These changes were introduced in 1993 after the magnitude of loan losses was uncovered in many of the larger public banks, and the degree to which this distorted earnings and capital Since then, NBP has strictly enforced these measures as part of its regulatory oversight function of the banks—through regular reports, off-site surveillance, and on-site inspections In addition to NBP oversight, all public and listed banks are required to have annual external audits conducted according to IAS The findings of the auditors are presented to NBP Most of the foreign-controlled banks have annual audits according to IAS as a matter of routine, as well as well-developed internal audit functions and regular reporting to boards Thus, many of Poland's largest or newest banks appear to have their capital positions well scrutinized on an ongoing basis Banks will need to adjust their risk weights as they lend more, expose their portfolios to more off-balance sheet risk, and invest less proportionally in government securities As of end 1997, most banks are generally considered to be strong on a capital adequacy basis However on an average and aggregate basis capital is considered insufficient to meet global competitiveness standards

- Poland has been erratic in its approach to *foreign ownership* in the banking sector Initially, bank licenses were issued liberally to domestic and foreign applicants as the system was transformed from a monobank system to a two-tier system As elsewhere, low entry requirements in the absence of supervisory capacity ushered in a host of problems—among them mismanagement and fraud—which led to a period of restructuring and retrenchment During this latter period, from 1992-95, NBP followed an unofficial licensing policy which attempted to steer foreign banks towards existing Polish banks This led to limited foreign investment Since 1995-96, the market has again begun to open up to strategic investors, although less openly than in other neighboring markets Foreign ownership now accounts for only 12 5-17 5 percent of net assets, loans to the non-financial sector, and deposits, and about a quarter of core capital Foreign-controlled banks are also comparatively small by global standards, which suggests that they have yet to commit significant resources to the Polish marketplace Part of this may be due to a less than fully open environment for foreign-controlled banks which has bypassed the focus on strategic investment in favor of minority and diluted shares in existing Polish banks, or the greenfield alternative which requires time to take off and mature in the marketplace There have been some successes at Bank Slaski and Bank Wielkopolski However, by and large, the investment and presence of foreign banks has been limited in spite of Poland's real growth rates, population base, and rising purchasing power A more resolute policy of restructuring and privatization, including liquidation, might have led to increased investment However, this approach has been consistently rejected in Poland due to political complications as well as fears originating from the early stages of the reform process

4 2 Asset Quality Asset quality is perceived to be satisfactory for now, although there are questions about underlying quality in the event of an economic downturn In some cases, assets are considered overvalued due to generous assumptions regarding collateral or real estate values Loan portfolios to enterprises and households account for 40 percent of assets, and the incremental growth in bank assets since 1995 has generally been from new lending flows Loan portfolios were largely cleaned up at the commercial banks in 1993-94, although questions remain about portfolio quality at some of the larger "specialized" banks Throughout the system, the trend towards increasing consumer loans needs to be monitored, both in terms of underlying quality as well as off-balance sheet risk in the event of an economic downturn With a 50 percent increase in the stock of loans from 1995-97 and flat returns for banks from loans to the blue chip sector, banks have increased lending to smaller companies and to individuals in the hopes of generating earnings from higher spreads in these riskier markets There are asset-based and pricing-related risks for banks to be mindful of, as well as broader market risks In terms of assets, some of the lending banks are providing is against intermediaries' receivables that are secured by asset values Such asset values, as well as recovery rates on receivables, could decline markedly in the event of an economic downturn In some cases, the source of funding for these loans is thought to be foreign currency-denominated, which is then lent in zloty at higher rates Thus, there may be some exchange rate and interest rate risk associated with such lending patterns Published NBP reports do not break down foreign currency exposures on a weighted time-to-maturity basis This information would be useful in measuring open positions and how they relate to exchange rate and interest rate risk with regard to loan quality Poland's comparatively high interest rate environment alone presents risks to underlying asset quality, even if there is limited term exposure and asset-liability management practices generally observe prudent matching strategies Risks appear to have diminished recently due to the strength of the currency and general decline in inflation rates However, a weakening of the economy and exchange rate could reverse this trend Otherwise, government securities still represent a significant portion of the balance sheet—20 percent of total assets—while nearly 7 percent represent securities issued by parties other than Treasury Additional lending into the interbank market and to government is considered safe, accounting for about 16 percent of assets Fixed and other assets represent 10 percent of total About 7 percent of assets are held at the NBP Thus, the main underlying questions regarding asset quality are (i) risks associated with the loan portfolio, particularly consumer loans and associated interest rate and exchange rate risks, as well as guarantees, collateral and other off-balance sheet items associated with lending, (ii) the safety of interbank lending, (iii) the quality of investments in non-government securities, and (iv) the quality of fixed and other assets **Score 3/3+**

- Poland's laws and regulations address *large exposures connected/related party/insider lending, nonperforming loans interest accruals provisioning, and exposure limits* These are basically consistent with Basle and EU guidelines Large exposures and risks are consolidated to include credit, securities and other potential risks

- There is favorable *tax treatment for loan loss provisioning* Specific provisions are generally treated as pre-tax expenses, although general provisions are not Current regulations require that banks provision against classified loans as follows (i) substandard loans at 20 percent (after 30 days), (ii) doubtful loans 50 percent (after 90 days), and (iii) loss loans at 100 percent (after 180 days) Provisioning expenses were about Zl 590 million in 1997 In 1993-94, these were significant As loan portfolios began to show improved quality, provisioning costs decreased However, the surge in lending since 1996 has led to an increase in provisions The overall portfolio of the banking system is considered far stronger than a few years back, and adequately provisioned today relative to potential risks The share of "irregular" loans was estimated to be 10 4 percent at end 1997, compared with 31 percent at end 1993 and 21 percent as recently as the end of 1995 Of these end 1997 irregular loans about half are considered "loss" and are presumed to be fully provisioned

4 3 Management Bank management has improved in Poland in recent years New managers who are better suited to a market-based economy have been put in charge of older banks and are accountable to management and supervisory boards Shares help as a form of compensation, so that management and employees can benefit from future earnings and privatization New banks often have younger entrepreneurs with an eye to the future To the extent the latter represents significant risk, these banks tend to be smaller and pose little potential for systemic risk as long as they remain closely monitored by regulatory authorities for off-balance sheet items, risky trading exposures, and fraud Foreign banks are increasing their presence, and this will lead to improved management information systems and application of lessons from more developed markets over time However, there are weaknesses in terms of the power and capacity of supervisory boards to exercise governance over banks, and of management boards to sometimes identify the risks associated with the strategies they are implementing Supervisory weaknesses are reinforced by insufficient internal audit capacity at majority Polish banks, both in terms of experience as well as incentives This is going to change as BIS guidelines are implemented in support of an autonomous internal audit function that is properly equipped, trained and compensated In terms of management, there are still weaknesses at many banks at the middle management level due to job protection Most banks are also just beginning to use some of the information generated for NBP as a management tool for competitive purposes, reflecting the limitations of risk management systems within most Polish banks Management of credit appears satisfactory and prudent, but questions remain about off-balance sheet exposures, the quality of collateral, and the potential impact of an economic downturn on portfolio quality There has not only been a shift towards lending to the real sector, but such lending accounts for all the incremental growth of banking sector assets since end 1995 The ability to manage this will go a long way in determining the future course of earnings, growth and stability in the banking sector Liquidity management appears adequate, as most banks appear to follow prudent asset-liability management practices However, many banks are apparently taking advantage of the lower costs of borrowing in foreign currency and then lending in zloty This can expose the banks to considerable exchange rate and interest rate risk Weaknesses in the management of exchange rate, interest rate and pricing risk may surface in the coming years as banks search for ways to increase earnings in a more competitive market Banks, investors in banks, and NBP will all need to improve their monitoring of such risks to avoid unanticipated losses that could impair capital This will be particularly true at the larger banks to avoid systemic risk To date, Polish banks have generally followed conservative practices to avoid the transactions costs of increased hedging risks Banks may be willing to incur these costs in the future, and if so, they and those responsible for oversight will need to be certain that hedging strategies are prudent and do not subject the banks/sector to undue risks Overall, banks will need to invest in systems and personnel to ensure they have suitable risk management systems in place This has already begun, but will need to continue for the foreseeable future This is also an area where competition from prime-rated banks and foreign investment in Polish banks could well serve as a decisive catalyst **Score 3**

- Some of the main issues facing banks from 1998 on will be their ability to generate sustainable earnings in a more competitive environment in which pressure on margins is increasing Thus, asset growth plus a range of new services will be needed for banks to increase and diversify their earnings Fundamental *risks* include a wide range of credit and credit-related activities, as well as the evolution of capital markets products as a source of leverage and risk Efforts to diversify sources of earnings, particularly given the small capital base of most banks, will entail risks that may constitute poor strategic decisions and generate periodic losses Management of credit currently appears satisfactory and prudent, but questions remain about off-balance sheet exposures, the quality of collateral, and the potential impact of an economic downturn on portfolio quality Credit to enterprises and individuals now accounts for about 37 percent of net assets, up from 34 percent at year end 1996 and 32 percent at end 1995 In dollar terms, loans outstanding to the real sector were $27 billion at end 1997, compared with about $18 billion just two years earlier when lending resumed [128] Thus, there has not only been a shift towards lending to the real sector, but such lending accounts for all the incremental growth of banking sector assets since end 1995 [129] In terms of risk, key issues include increasing exposure of bank portfolios to consumer lending, including the ability of banks to assess the cash flow, collateral value and character of the individuals to whom the banks are lending A second issue is the syndication of consumer loan portfolios, which some banks are reputed to be purchasing at a discount A third issue is the potential for securitization based on these portfolios, as is already happening in a fundamental way on a working capital basis for loans provided against batches of receivables A fourth issue is how these activities may be affected by off-balance sheet contingencies, namely in the form of third-party guarantees that tend to be asset-based Minimizing on-balance sheet risks—loans and securitization holdings—will require sound underwriting standards, effective monitoring of borrower compliance with loan covenants, ensuring adequate reporting standards, collecting on loans, and perfecting liens for adequate collateral For syndication and off-balance sheet risks, banks will need to ensure that cash flow is properly estimated for risk-adjusted discounts/premiums to be applied to make markets and to protect capital These risks are particularly pertinent in Poland today as a result of the increase in consumer lending and installment finance that has occurred since late 1995 With up to 2 5 million businesses that have no formal credit history, banks will clearly need to develop strong credit information systems and prudent strategies as exposures increase to the retail sector [130] Poland will also need to develop a better credit rating service as "plastic cards" are more widely circulated—the current 2 5 million holdings are projected to increase to 6 5 million in 2000 This makes development of the banks' credit information bureau all the more urgent The availability and quality of credit information on individuals and households as well as on many enterprises will eventually have to increase for retail banking to expand, for risks to be prudently managed, and for fees to decline Even prior to more open disclosure of credit information, Polish banks will need to continue to invest in information technologies linked to point-of-sales and other electronic systems to reduce the risk of fraud as credit, debit and ATM cards are more widely used Fraud will also have to be monitored as banks increasingly market to high net worth individuals As universal banking becomes the norm, there will be a risk of connected lending resurfacing Many banks own brokerage houses, and these and other subsidiaries frequently carry risky assets that are not always uncovered until it is too late However, so far, Poland has introduced systems and controls that strictly monitor for such developments There is also widespread understanding in the market that such offenses are punishable, and that regulatory authorities have a legal mandate to enforce penalties as needed Thus, the risks of insider/connected lending appear to be less in Poland than in many other neighboring countries Mortgage lending activities will require the development of specialized credit risk management skills, particularly as this kind of lending is long-term in tenor and heavily dependent on securitization and syndication in the markets backed by an effective legal framework for collateral Thus, banks that enter the mortgage lending market will need to enhance their management of interest rate and pricing risk, monitor changes in the tax code, and monitor movements in secondary and syndicated markets when they develop There are also likely to be growing risks associated with securities investments, particularly as capital markets activities are linked to more complex and exotic instruments that are sometimes bundled across products and markets In terms of basic technologies, Poland's branches will need to be more universally connected to their home offices for real-time reporting—as opposed to next day reports The Y2K problem does not seem to be a significant risk in Poland as much of the investment in new technology is based on systems which account for these changes NBP has circulated a note on this to the banks consistent with BIS guidelines

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[128] Loans outstanding were Zl 44 161 million at year end 1995, or $17 6 billion This is net of past due interest

[129] At end 1995, the banks had a total of Zl 149 billion in assets, or $59 5 billion By end 1997, net assets were Zl 240 billion, or $68 billion This is virtually identical to the net increase in lending from 1995-97

[130] This is already happening at a number of banks This includes compensating balances, higher interest rates and fees, or limiting such exposure to higher income levels

- As elsewhere around the world, bank boards and management will need to continuously adjust their risk-taking strategies based on sound and timely information This will require ongoing development and modernization of information systems for *risk management* purposes Banks are currently learning to use many of the reports they generate for NBP supervisors for their own internal management purposes While a positive step, banks will need to move more quickly to strengthen internal controls and oversight of their institutions Strengthened systems will need to include a host of portfolio considerations for lending, trading and investment activities—maturity, pricing, and currency issues from a portfolio standpoint, as well as the underlying quality of each asset Poland has benefited from declining inflation rates and fiscal deficits in recent years, and the zloty has strengthened in 1998 due to Poland's strong underlying balance of payments position For Poland to continue to benefit from this trend, bank lending and investment will require an increasing focus on the underlying soundness of business fundamentals in assessing and managing risk In the mid-1990s, banks prudently recapitalized from safe investments in government securities and relatively conservative approaches to new loans However, more recent trends indicate a tightening of intermediation spreads, prompting banks to adopt more aggressive and diversified strategies Thus, banks will need to demonstrate their ability to set prudent risk tolerances under changing conditions, and to identify deterioration in lending, investment and real estate portfolios early on to prevent such developments from having a material adverse effect on capital and liquidity A more stable macroeconomic environment is already helping in terms of stabilizing interest and exchange rates On the other hand, such stability has reduced net spreads and ushered in more competition To increase earnings, banks will have to increase their volume of stable earning assets, and/or increase their willingness to take risk in other activities that carry with it greater upside and downside potential on earnings Polish banks are investing in information technologies and systems frequently devised on their own or through alliances This should assist with overall risk management capacity, and the governance and management of banks

4 4 Earnings After-tax earnings were lower in 1997 than in 1996 On a dollar basis, after-tax earnings were $1 4 billion in 1997 compared with $1 6 billion in 1996 The 1997 figure averages $17 million per bank, or about 2 percent ROA The reduction in earnings resulted from a combination of three factors pressure on margins in the corporate sector, reduced net spreads on investments in government securities, and higher cost ratios Reduced spreads in the corporate sector are largely due to increasing competition, which is also partly due to the second factor of reduced net spreads from securities investments As the macroeconomy has strengthened and portfolio flows have increased, the government's need for bank financing has diminished This has led to lower earnings from these investments for banks, prompting banks to seek out new financing activities With the blue chip market saturated and the banking sector becoming more competitive, banks have shown increasing willingness to lend to the riskier consumer market Overall, there has been a 50 percent increase in lending (in dollar terms) from end 1995 to end 1997 Meanwhile, there has been further pressure on earnings due to costs Cost to income ratios were about 85 percent in 1997, up from 81 percent in 1996 and 83 percent in 1995 This is mainly due to high overhead costs related to personnel at majority Polish banks, and high investment costs in information technologies at all banks Most banks also have weak fee income-generating capacity due to a limited array of services In many of these existing areas (e g , debit cards), competition is heating up, further reducing fees **Score 3**

- *Interest* contributions were Zl 45 2 billion ($14 2 billion) in 1997 About 43 percent derived from interest income from lending, 28 percent came from interest from securities, 13 percent came from foreign exchange gains and only 7 percent came from commissions and fees Meanwhile, *operating costs* are still high due to personnel costs, premises, and depreciable investments Operating expenses were Zl 38 5 billion ($12 1 billion), or a high 85 percent of gross income Interest expense accounted for 53 5 percent of total, while general expenses were 20 percent and foreign exchange losses were 12 percent From these figures, it appears that *net interest income* approximated Zl 7 8 billion ($2 5 billion), and *net foreign exchange gains* were Zl 1 2 billion ($385 million) However, due to limited earnings from fees and commissions, general expenses significantly cut into earnings from lending, securities investment and foreign exchange trading More importantly, the increase in lending led to a net increase in provisioning charges, and this also adversely impacted earnings *Provisions* increased in 1997 by Zl 590 million Overall, *after-tax profits* were Zl 4 4 billion net of cooperatives, or Zl 54 million per bank (about $17 million per bank based on average 1997 exchange rates)

- *Interest rates* on loans and deposits are not subject to *controls*, nor are other fees Whereas banks benefited from high net spreads through 1995, these benefits are diminishing quickly due to intensified competition

- There is little evidence of *mandated lending* in Poland Some banks are reputed to carry loans to loss-making enterprises, but most financial support to loss-making SOEs is reportedly not run through the banks Lingering privatization in the real sector adds to the vulnerability of the banking system to potential meddling from line ministries or other government offices, particularly in the agriculture, coal and steel sectors However, in general, directed lending has been significantly reduced Membership in the OECD in 1996 further reduced possibilities of mandated lending There are some government programs to try to fill gaps, including some from donors In other cases, relief to the sectors or enterprises is in the form of capitalized interest, arrears, soft loans, or guarantees However, in most cases, it now appears that the banking sector is able to manage portfolios without government interference

- There is a 38 percent corporate income *tax rate* which applies to banks, reduced from 40 percent in 1996, plus additional taxes In 1997, the effective corporate income tax rate for banks was 32 percent,[131] compared with 31 percent in 1996 These rates are expected to decline over the next several years as the corporate income tax rate is reduced each year by 2 percent until 2000 at a 32 percent statutory rate

4 5 Liquidity While funding is improving in the aggregate due to increasing placement of funds in term deposits, general liquidity at the banks is tight due to the NBP's restrictive monetary policy, the concentration of deposits in three banks, the thin corporate bond market, and low capital Reserve requirements are high and were raised twice in 1997 Consequently, interest rates are high The secondary markets are still weak for securities, which means banks have to rely on real sector deposits for about 60 percent of overall funding and the interbank market for another 12 percent Meanwhile, PKO BP, Pekao SA Group and BGZ account for 56 percent of total deposits Thus, most other banks have weak funding bases While the interbank market is relatively safe and meets some financing needs—essentially through current accounts held at NBP—rates showed some volatility in 1997 This also emanates from the concentration of deposits in three banks Banks also have low levels of aggregate capital Access to syndicated loans has emerged as a substitute for corporate bonds However, low capital limits banks' exposure to these lines While the payments system is safe and improving, it is considered relatively slow by modern standards All of these factors cut into liquidity More broadly, pressure on margins combined with high cost structures reduced earnings in dollar terms This also reduced liquidity in 1997 With tight monetary policy, shallow capital markets, and reduced after-tax earnings due to heightened competition and narrowing intermediation spreads, there may be continued liquidity constraints in the near term **Score 3-/3**

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131 This is subject to change as 1997 figures are unaudited

- Banks' *funding structures* have improved in the last few years, as households in particular have placed increasing funds with the banks in term instruments However 56 percent of real sector deposits are held by PKO BP Pekao SA Group and BGZ Thus most banks lack an adequate deposit base which limits a potentially low cost source of funding for the other 80 banks operating in the market This is particularly important as pressure increases on earnings In response, Poland has developed an active but still small interbank market—providing about 12-13 percent of bank funding However, for the foreseeable future, what Poland will need is a combination of increased deposits along with an active and growing securities market for bank paper to provide for liquidity needs Foreign markets will also continue to be utilized for financing and liquidity, as shown in the substantial increase in foreign borrowings in 1997—from $3 billion to $7 billion

- Bank management is in a position to manage fundamental *sensitivities to pricing interest rate and exchange rate movements* Prudential regulations are adhered to, and bank managers have recently had experience with volatility due to increased interest rates, high levels of foreign exchange in the banking system, and significant exposure to foreign portfolio flows which have challenged the devaluation policy of NBP in 1998 Banks are thought to use maturity buckets on a monthly and quarterly basis, and to generally match these Where there may be a weakness is that gap analysis suffers from a lack of automation of the general ledger With limited transactions or exposures, this is not much of a risk However as volume increases such manual processing may subject monitoring of interest rate, exchange rate and pricing risk to human error NBP monitors movements in exchange rates and sets interest rates as part of its open market operations and focus on pricing stability NBP might benefit in the future from requiring more detailed and disaggregated reporting[132] by banks on a more frequent basis once systems are more integrated and automated With a fairly strong reserve position a key challenge will be monitoring for a wider current account deficit and the impact this may have on both exchange rates and interest rates Interest rates increased in 1997 largely due to NBP concerns that banks were financing a consumer goods binge With the increase in interest rates introduced in the first half of 1997 the current account deficit increased threefold in 1997 The current account deficit might have increased more had these restrictions not been introduced Early indications are that the current account deficit might increase about 10 percent

- *Reserve requirements* are currently a part of mandatory bank deposits held with NBP The level of overall assets placed with NBP was about 7 3 percent of total assets at end 1997 This was virtually the same proportion as at end 1996 Banks receive no compensation for these reserves Reserve requirements in effect at end 1997 were 20 percent of zloty demand deposits, 11 percent zloty time deposits, and five percent of foreign currency deposits

- Banks are generally considered to be in compliance with NBP regulations which limit open exposures in terms of currency, pricing and tenor The data presented in NBP's evaluation of the financial condition of the banks do not provide sufficient information to make a judgment of the *asset-liability management practices* of the banks However, zloty exposures are considered to be generally matched, and most exchange rate and interest rate exposure is thought to be prudently or conservatively hedged The main zloty risk is thought to be with maturity mismatches Regular reports on the term structure of assets and liabilities are presented to NBP from the banks, and supervision is clearly aware of the risks as are most bank managers Where there may be a shortcoming to the information presented is in the mix of sensitivities—fixed or variable interest rates, exchange rates, and duration—on a time to maturity basis

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[132] Instead of open positions, NBP might consider types and volumes of transactions by type of currency and amount, any indexation features, maturity, and interest rate features These could be presented on a weighted and time-to-maturity basis for further testing or sensitization The onus should be on banks to conduct the testing However, such reporting could assist NBP with regard to potential systemic risk

4 6 Operating and Regulatory Environment Poland's banking system enjoys increasingly high levels of public confidence While intermediation rates are still lower than in some of the neighboring countries—and well below OECD and EU norms—deposit mobilization has been increasing in absolute terms as well as proportionally as a percentage of money supply and GDP One indication of growing confidence is the increasing share of deposits held with banks that are term deposits This partly explains the lack of alternatives, or insufficient capital markets offerings relative to demand in Poland However, these deposits would not be held in banks if there was a lack of confidence in their soundness Membership in the OECD, and the broad array of recently adopted financial sector reforms should reinforce confidence as Poland moves towards membership in the European Union Concentration has diminished in recent years, and the best performing banks are ones listed on the WSE Thus, market discipline has begun to take hold, and incentives are increasingly in line with global standards There has been increasing investment from the private sector in banking, particularly since 1996 Capital markets are viewed as liquid, stable and well administered, albeit small by global standards All of this has been reinforced by the rapid development of an effective banking supervision department in NBP which has provided increasingly effective oversight in recent years [133] Nevertheless, there are several weaknesses that remain as concerns the operating and regulatory environment First and most importantly, the privatization process has been sluggish in the banking sector That the public sector still is heavily engaged in some of the largest banks (as well as the largest insurance companies) raises questions about the degree of restructuring that has taken place, particularly at PKO BP and BGZ, notwithstanding recent agreements to accelerate restructuring efforts These banks continue to represent a burden which has potential implications for monetary and fiscal policy (e g , lender of last resort), the solvency and liquidity of the Bank Guarantee Fund, and the ability of banking supervision to apply its mandate on an equal footing with other banks Poland has been wrestling for years with the attempted restructuring of BGZ, yet problems remain in the cooperative banking sector as they do in the agricultural sector Above all, the Bank Guarantee Fund appears to have been utilized as a tool for the restructuring of rural cooperative banks that is costly, uncompetitive, inefficient, and at cross-purposes with the banking sector's overall need for enhanced structural competitiveness There is also concern about PKO BP due to its share of deposits—approximately one fifth of total in Poland, and almost entirely from households While BGZ and PKO BP are in poor financial condition partly as a result of prior structural rigidities or the transition to more liberalized market conditions, their attempts at diversification present additional management and capacity risks that may only lead to a different misallocation of resources if not properly managed That both are building new headquarters appears to be a costly decision at a time when their financial conditions are dubious That the Bank Guarantee Fund has been used to assist weaker banks with limited commercial viability represents cross-subsidization that might be more costly to sector competitiveness than alternative approaches—purchase and assumption, and outright liquidation Thus, misuse of the Bank Guarantee Fund and larger considerations of lender-of-last-resort and "too big to fail" represent continuing areas of monetary and fiscal risk with direct implications for overall competitiveness at the structural level Meanwhile, recent legislation removes some of the judicial obstacles to creditors to recover their loans Nevertheless, the court process remains slow, and some banks continue to believe that problems persist with regard to collateral, lien perfection, and overall court charges **Score 3**

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[133] This has been based on on-site inspections that have been effectively coordinated with comprehensive off-site surveillance More recently, some bank managers have begun to effectively utilize a range of reports (such as Uniform Bank Performance Reports) for their own internal management needs

- Poland introduced a deposit insurance scheme in 1994 consistent with EU designs Until December 1994 no general deposit insurance scheme existed in Poland Based on the 1989 Banking Act the state Treasury guarantee was extended to savings deposits only in banks established prior to that date Thus, only two state banks, BGZ, 1,664 local cooperatives, and 11 joint-stock banks predominantly under Treasury ownership enjoyed a deposit guarantee This created an uneven competitive environment for new private banks, undermined private banks' incentives to mobilize deposits, weakened their funding bases from the start (particularly private Polish banks, as foreign banks could access funds from external sources), and raised the level of risk presented by private banks to the safety of the banking system at large [134] New legislation—the Bank Guarantee Fund Law—provided a framework for more comprehensive deposit insurance The Fund guarantees deposits at all banks held by individuals and legal entities up to the equivalent of ECU 5,000 (about $5,400), less than annual per capita incomes on a purchasing power parity basis [135] However, there are numerous problems with the administration of the Fund which point to structural weaknesses in the banking system, excess politicization, and a higher-than-justified tax on the banking sector The Fund is required to entertain requests for assistance from virtually all troubled banks As a result, the Fund provides fairly large long-term loans at preferential rates for deeply insolvent institutions Least-cost methodologies are not employed, adding to "bailout' costs while reducing opportunities for consolidation and the retail expansion of stronger banks throughout Poland Recovery rates from insolvent institutions are low—about 5 percent—which indicates banks are deeply troubled when they apply for assistance Deposit payoff is slow and cumbersome, which undermines confidence in the system Banks pay obligatory contributions to the Fund which then pay the guaranteed portion of the deposits in banks that fail or face such a threat As this is cash-based, this clearly represents an expensive transfer from stronger to weaker banks at a time when Polish banks need to gear up for increasingly competitive conditions in the market Thus, while the existence of a Fund is intended to reinforce confidence in the banking system, the administration of the Fund in Poland appears to be working at cross-purposes with the need for efficiency and competitiveness in the system

- While Poland has not followed an explicitly expensive bank recapitalization program for its troubled banks, there has nonetheless been significant cost involved In terms of fiscal costs, the restructuring of the seven state commercial banks was estimated to cost about $1 billion based on the up-front recapitalization, as well as the higher net spreads on government securities that were used by the banks to continue to recapitalize from operations Larger restructuring efforts at PKO BP, BGZ and Pekao SA are more difficult to estimate in terms of cost, although they likely exceed the $1 billion figure In the case of BGZ, the Bank Guarantee Fund has been utilized for cross-subsidization purposes in a costly, uncompetitive, and apparently politicized manner The Fund has also been used for soft loans to other banks In effect, these activities have sustained a policy of providing resources for *bank rescues* through the active use of *lender of last resort* financing as well as outright recapitalization for insolvent institutions While some of the decentralized restructuring approach followed by Poland has the benefit of building internal capacity within the banks—stricter credit management policies and internal oversight—there are questions about the viability of many of these banks and whether more open and competitive methods could be applied that are more in concert with least-cost considerations

- Poland's banking system is becoming increasingly competitive, as evidenced by the growing private sector share of banking activities The only noticeable category in which *high concentration* is evident is in the deposit category, with PKO BP, Pekao Group SA and BGZ accounting for 56 percent of total deposits The largest share is with PKO BP, with 28 percent of total banking system deposits, partly due to its large network of about 1,000 branches and agencies around the country Pekao SA Group

[134] While private Polish banks were small, mismanagement and fraud in some of these institutions reinforced the lack of confidence many people had in banks as a whole This was a particularly sensitive issue after the turbulence of 1989-90, when many peoples' zloty savings lost value The implicit guarantee afforded the public banks reinforced some of this confidence, but such an approach was clearly anti-competitive

[135] 1996 incomes were $6,000 on a purchasing power parity basis See *World Bank Atlas*, 1998

has an additional 22 percent of deposits The market and NBP will need to monitor the capital and liquidity positions of PKO BP and BGZ to prevent any portfolio deterioration from causing panic In particular, any spread of bad news regarding PKO BP could cause a run on that bank, which might also have repercussions on the interbank market and prompt NBP into lender-of-last-resort intervention The Pekao SA Group's financial condition is far stronger, as indicated by the successful IPO in June 1998 which gives the bank a current market capitalization of about $1 8 billion

- One of Poland's success stories in recent years has been the increasing *effectiveness of banking supervision* NBP has developed effective institutional capacity in tandem with the restructuring efforts that have been pursued through most of the 1990s GINB has avoided some of the weaknesses found in other countries—fragmented organizational structure, dispersed authority, inadequate coordination, flawed surveillance due to poor information, insufficient funding Supervisors have generally had a growing mandate to ensure that banks accurately report needed information to monitor for compliance with liquidity, solvency and general prudential requirements, and to more broadly support NBP's efforts to achieve pricing stability While bankers have long complained about provisioning requirements being too strict, and the costs of regulatory compliance being too high, they are now in the process of working more closely with regulators to introduce better risk management systems New legislation stresses the role of the internal audit function With the new Commission for Banking Supervision expected to follow a more risk-oriented approach in conjunction with regulators in other financial services (and across borders), this approach will rely more heavily on the banks' themselves adapting their own new systems, procedures and controls to protect the system against undue risks Where supervision could become more effective is in areas that the banks are likely to move in to over time—securitization, larger syndications, third party risks, and the range of risks associated with derivatives There is also the matter of GINB's mandate with regard to banks still owned by the state Part of these risks may have been mitigated by the banks' period of recapitalization from 1993-95, and by the payments system which tends to work off of current accounts at the NBP Movement into more credit exposure, retail banking and fee-oriented services may raise the level of risk assumed by the banks, and thereby test GINB in a way that it has not been fully tested to date However, based on the last several years, banking supervision has become effective at monitoring for many of the risks that can imperil the liquidity and solvency of banks In time, the government might consider providing effective regulatory institutions with the right to issue their own regulations subject to *ex post* review, rather than having to rely on the legislative and judicial branches for regulatory mandates

- Effective since the early 1990s, public banks and WSE-listed banks have been required to produce IAS statements with the help of *external auditors* Because the regulatory framework was so weak in Poland in the early 1990s, the large international accounting firms were brought in to assess the magnitude of nonperforming loans and general losses of the Polish banks by international norms As elsewhere, these audits generated results that differed markedly from the statements produced by local standards, and prompted the restructuring and recapitalization of the banks Today, more than half of Poland's banks are audited by one of the major international accounting firms Thus, about 80 percent of the banking system's assets are subject to external audit in accordance with international standards

4 7 Transparency and Disclosure Poland's largest banks have generally been subject to increasing levels of scrutiny based on high levels of disclosure In some cases, disclosure has become increasingly public as banks have been put on the privatization track In particular, for banks listed on WSE—about one third of the WSE's capitalization derives from banks—information disclosure has had to meet international standards to conform to market requirements, and to succeed in attracting strategic investment (e g , Bank Handlowy) Where there have been shortcomings have been with BGZ and PKO BP due to the sensitivity surrounding their financial condition and the politicization of the restructuring process In terms of companies and households, there is far less transparency and disclosure, which undermines the effectiveness of banks to share information with each other for improved credit risk assessments Concerns about confidentiality abound, partly the result of pre-transition constraints on freedom and partly to evade the fiscal authorities While these reactions are understandable, such absence of transparency limits the ability of Poland to develop effective credit information systems for better banking and credit rating agencies in support of capital markets development As banks and others expand into retail services and securitized markets, disclosure and transparency will need to increase Poland recently adopted legislation that defines the guidelines under which banks need to provide information to regulatory authorities However, the need for market-based systems is still abundant The major banks recognize this, and in conjunction with the Polish Bank Association are planning to introduce a credit information bureau later in 1998 This is particularly needed as "plastic cards" and point-of-sales terminals are increasingly utilized, as consumer lending increases, and as factoring, leasing, and commercial credit companies slowly start to emerge What is favorable is the growing number of companies that are beginning to qualify for listing on the WSE markets as well as the CeTO Combined with discipline from the banking sector as banks diversify their lending targets and retail customer base, these kinds of institutional developments over time can be expected to lead to "market-regulated" information requirements By then, it is also anticipated that companies and households will be willing to endure some loss of confidentiality in exchange for greater access to financial resources **Score 3**

- Most banks and companies trading in the capital markets are required to observe IAS in the preparation of statements they disclose to the public, and stricter requirements for regulators Poland's largest banks have produced *consolidated statements* for several years, and accounted openly for loan losses and *nonperforming loans* As the inflation rate has come down, the *revaluation* of assets has not been a major issue since 1995 Tax incentives have been operative since 1994 for banks to adequately *provision for loan losses* In fact, in 1996 releases from provisioning accounts were a source of income (or reversed expense) for banks Pre-tax profits are reported *after* provisions, thus most loan loss provisions are expensed The regulatory framework for universal banking treats exposures and risks on a consolidated basis, and this is expected to account for *unincorporated affiliates* as well The Commission for Banking Supervision will need to monitor for this with other regulatory bodies to protect against risk However, it is expected that banks' financial reporting will conform to new regulations which are consistent with EU guidelines *Mark-to-market* accounting is applied for securities investments for their own portfolio management purposes, as well as for prudential regulatory purposes

- New legislation spells out guidelines regarding banking secrecy These limitations generally apply to other banks on a transactions basis, the banking group for consolidation purposes, the Commission for Banking Supervision, legal and fiscal authorities, other regulatory and government authorities, and external auditors contractually appointed to audit the bank's accounts IAS ensures a certain level of *public disclosure*, but there are still questions about the level of disclosure provided by many banks The effectiveness of GINB/NBP and the success of listed banks has provided incentives to increase public disclosure, and this has occurred as banks are readied for privatization That international accounting firms conduct external audits on all the major Polish banks adds to the integrity of information presented, as does the presence of numerous investment houses and funds in Poland While transparency is still considered a problem, Poland has made an effort to move increasingly towards more open disclosure as it has assumed membership in the OECD, as it continues to move towards EU accession, and as it recognizes that market development and expansion require more open disclosure of reliable and useful information Findings from *examinations inspections*, and regular reports to GINB are not disclosed to the public, although reports on groups of banks and the banking system are presented by NBP in its summary evaluation of the banks on a quarterly basis If there are regulatory violations, it is unclear to the public if *enforcement actions* have been taken, and if they have been consistently applied However, GINB has a legal basis to enforce its mandate in cases of non-compliance What has been called in to question at times is if GINB has a political mandate regarding large public banks

4 8 Sensitivity to Market Risk Poland does not currently appear to be overly sensitive to "contagion" risks Recent challenges have emerged with the crisis in Asia, questions concerning the stability of the ruble, and the deterioration of the Czech Republic's fundamentals in 1996-97 To date, Poland seems to have managed these challenges better than other neighboring markets This may be due to its sustained real growth rates exceeding 5 percent since 1994 based on increasing trade with the EU—65-70 percent of international trade is now with the EU—, the size of its foreign currency reserves relative to debt, and the perception of markets in early 1998 that the zloty was *under*valued However, the elements of market risk are there In macroeconomic trends, the current account deficit widened in 1997, and interest rates increased after several years of decreases The current account deficit widened largely on the basis of a consumer spending surge, much of which was financed by bank loans to the consumer sector which could easily lead to portfolio problems in the event of an economic downturn On a more general basis, a downturn in the West European economy or intensified competition in those markets could also weaken Poland's export position Likewise, instability in Russia might interrupt the flow of imported, lower-cost commodities on which many Polish industries depend At the banking level, there are many risks which could lead to stress in this sector These include fundamental credit risk—consumer lending and third party exposures (e g , syndications, acceptance of company paper, overvalued collateral, tax fraud), exchange rate risk—many portfolios are reportedly long on zloty, and this could be more volatile than if long in dollars or DM, the absence of hedging to avoid transactions costs—this may be a problem at some of the smaller banks, although this is not thought to be a problem at the major banks, possible mismatches in the term structure of portfolios—use of term deposits to finance short-term loans, possible mismatches in the currency composition of portfolios—use of foreign currency-denominated borrowings to finance short-term loans in zloty, insufficient gap or duration analyses conducted by some banks to measure for sensitivities (e g , interest rate, exchange rate, fixed-variable pricing) on weighted and time-to-maturity bases, and the need to conduct stress tests combining interest rate, exchange rate, concentration and maturity assumptions to better manage risks as portfolios grow in complexity Future risks will emerge with increasing competition at the retail banking level—mainly from the increasing use of credit cards—as well as rising interest in loan syndications, securitization with a range of features, and mortgage lending **Score 3**

- Poland's bank earnings decreased in 1997 on a dollar basis As margins tighten and cost ratios remain high, banks will be under increasing pressure to increase earnings Lending activity will need to increase to accomplish this objective Already, Polish banks have shown a more than two-year willingness to increase consumer/installment financing to diversify their credit portfolios, particularly as the market for blue-chip customers has become saturated *Credit risk* will be a clear challenge in the coming years Most banks were prudent and risk-averse from 1993-96 as they recapitalized, readied themselves for privatization, and simply benefited from the high net spreads available to them on a relatively risk-free basis However, now that most banks have recapitalized and real net spreads have narrowed, it can now be expected that banks will take on more credit risk to increase earnings This will lead to a shift in risk tolerances, which will prompt the need for strengthened risk management practices This will require testing and refining underwriting standards, structuring appropriate loan covenants as market conditions change, actively monitoring borrower compliance with covenants and promptly identifying and containing risks to portfolio quality to avoid costly losses This will take time as Poland modernizes it legal system and judicial infrastructure Until then, banks are likely to continue to make a significant proportion of loans on a "character" basis, while relying on out-of-court arrangements in the event that problems emerge The positive side to this is that many companies are now beginning to present meaningful information to banks for credit risk assessment However, what is unknown is the degree to which economic growth is masking company/portfolio/transactional creditworthiness, and the degree to which these would decline if the economy were to become less buoyant Likewise, it is not certain that the full credit risk associated with the consumer lending market—not just loans, but off-balance sheet risks where banks may be providing guarantees for third parties engaged in the financing of fixed assets and the factoring of receivables that might deteriorate in the event of an economic downturn—is fully accounted for

- Poland's banks are currently liquid by regulatory standards, but this is limited by the fairly tight monetary policy in place and generally low level of funding available Higher reserve requirements in 1997 led to a pass-through of higher interest rates However, high operating costs prompted banks to shift their funding increasingly to smaller consumer loans to offset the declining net interest margins earned in the blue chip sector About 60 percent of total liabilities and capital are in the form of deposits, which reflects more the absence of well developed capital markets than a high level of deposits Consequently, banks are increasingly relying on the syndicated loan market for incremental funding *Liquidity risk* is likely to diminish as the pool of available funding increases However, this will be subject to the strategies in place at banks, and their ability to manage such strategies In the near term, macroeconomic conditions should assist with liquidity,[136] as should improved technologies [137]

- In addition to increased and riskier lending to increase net interest margins, there is a risk that Polish banks will enter financial services that they are ill-equipped to manage Currently, only a quarter of income is derived from fee or service income During a period when earnings are strained, it is inevitable that Polish banks will add to their currently limited array of services to increase and diversify income sources This may lead to pricing, maturity and currency mismatches that are imprudent and lead to periodic losses It is not uncommon for investment-grade institutions in OECD markets to report losses, sometimes significant, in trading activities, on derivatives contracts, and from other risky exposures Thus, losses can also be expected at Polish banks Risk management practices will need to ensure that the banks have adequate capital and liquidity to cover such risks Bank management, the market, and the Commission for Banking Supervision will need to closely monitor investments in instruments with financial structures that are exposed to significant volatility in *interest rates exchange rates and pricing* A rise in off-balance sheet liabilities has been reported in recent years, with most of it considered risk-free or prudent hedging mechanisms against exchange rate or interest rate volatility However, this presents an example of potential risk to the banks and NBP If banks have excess exposure in dollars or European currencies[138] at a time when exchange rates or interest rates turn, such changes could adversely impact earnings trends It is not fully clear if there is excess exposure on a foreign exchange basis due to borrowings from abroad that are re-lent in zloty Major open positions are not allowed at the banks, yet much of the data is converted to zloty before it reaches NBP Given the increase in foreign borrowings from $3 billion in 1996 to $7 billion in 1997,

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[136] As fiscal reforms take effect, mainly in the area of social security, deficits should come down Revenues are already growing enough for Poland to be in the process of reducing corporate tax rates on a phased basis Privatization revenues will also provide extraordinary sources in the event the economy slows without adding materially to currently manageable debt levels The inflation rate has come down steadily, and Poland's target is to have this rate brought down to 5 percent by 2000 These trends all point to improved prospects for liquidity management, with the only major question mark in the area of exchange rates, the impact portfolio flows will have on the rapidity and magnitude of exchange rate movements, and what these developments portend for interest rates

[137] Increased use of electronic technologies should accelerate processing, reduce clearing and settlement time, and provide banks with better information by which to estimate their net funds position These should all ease liquidity constraints

[138] Or, increasingly over time, the Euro

bankers, investors and regulators should continue to monitor the denomination, trends, terms and conditions of funds sources to which the banks are obligated Bankers, investors and regulators should also be mindful of and monitor the risks associated with fixed-variable interest rate or exchange rate formulas as they apply to single or multi-currency investment options This also includes instruments that carry pricing risk—linked to commodities or other instruments The risk of abrupt changes in these markets needs to be fully acknowledged in advance of taking positions in these instruments Banks and companies are thought to routinely hedge their foreign currency and pricing risks to avoid high transactions costs, but this probably should be subject to closer and more frequent verification

- As in any banking sector, there are ripple effects in the event that individual banks are imprudent in the management of resources This is an issue of considerable importance for the remaining large public banks, given their share of deposits This is also an issue of considerable importance with regard to the use of resources in the Bank Guarantee Fund, and the potential future costs that a misuse of such resources can have at both the macroeconomic and the structural levels Banks will need to continue to prudently manage resources to be able to honor *transactions*, a challenge that will become increasingly demanding as competition increases and margins narrow Banks will need to maintain strong internal controls, high levels of accountability, and effective governance and management Banks will need to be in *compliance* with contractual agreements, which also is tied to the transaction risk just mentioned Compliance with prudential regulations, and public disclosure of such compliance, sends a signal that banks appear safe and sound The absence of compliance again undermines confidence, and reduces efficiency Where high levels of forbearance are provided on an ongoing basis, as in the cooperative banking sector, this can also weaken confidence Regulatory compliance backed by a well functioning legal framework will be needed to manage compliance risk Poland is still working to develop its judicial capacity, to strengthen banks' internal audit functions, and to extend the full banking supervision mandate to all banks Deposit insurance is meant to provide confidence to depositors, and the Bank Guarantee Fund is meant to provide resources prior to the need for lender-of-last-resort financing However, in the case of the latter, there are significant questions about how prudent this policy is, or how prudent the administration of this policy has been given the costly transfer to deeply insolvent institutions Likewise, slow privatization and costly restructuring have also prevented the application of GINB's supervisory mandate to all banks This has translated into Poland still failing to level the playing field for competitive banking Capacity to monitor for compliance should also be a consideration with regard to overall *strategic* risk Poland's banks have strengthened governance and management after several years of restructuring, yet there are still questions about the adequacy of information systems and their use for risk management purposes, the capacity of staff at the public banks, and the effectiveness of some supervisory and management boards Finally, competitiveness of individual institutions and the market as a whole will need to increase to enhance the existing *reputation* of Poland's banking sector This is improving, and the increasing entry of prime-rated institutions will help as will the growing sophistication of majority-Polish banks The real test will be its risk management capacity as growth unfolds, risks increase, and globalization accelerates Poland's pace to date provides room for optimism due to its determination to accede to the EU, and due to the general momentum fostered by high real growth, increases in purchasing power, and clear progress made to date when compared to the beginning of the transition period 10 years ago However, Poland has also delayed the entry of much needed investment and management into the banking sector which would have increased levels of capital and expertise far sooner

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