

Final Report:
Poland Bank System Development Project

Tranche A – Bank Payment Systems
Tranche B - Credit Rating Agency

Contractor: First Washington Associates, Ltd.

Contract Number: EPE-I-03-95-00050

Country: Poland

Title: Bank System Development Project

Reporting Period: October 1, 1995 – May 31, 1999

Task Orders # One and Three

Prepared for

USAID/OAR Warsaw
USAID ENI/PER Washington

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Final Project Summary: Poland Bank System Development Project

Task Order Summary

The First Washington Associates (FWA) Task Order One for Bank System Development in Poland was signed on September 9, 1995 with a Period of Performance start date of October 1, 1995. In September, a no-cost extension to the Task Order was signed, extending the contract completion date to December 31, 1996. In December and January, further no-cost extensions were granted to a final date of February 25, 1997. A new Task Order (number three), extending the project and expanding activities was signed in September 1996 with a Period of Performance start date of October 1, 1996 and completion date of November 30, 1997. This Task Order was extended and expanded including additional tasks on September 24, 1997, with a Task Order completion of November 30, 1998. In November 1998, a no-cost extension, with additional LOE days, was granted to March 31, 1999, and in March the Task Order was extended to May 31, 1999, with no additional funding or LOE.

Task Order Objectives

The overall objectives of the Task Orders were to assist in the development of the Polish banking system specifically and the financial sector in general, in support of OAR Warsaw's Strategic Objective 1.4: "A competitive, market-oriented private financial sector is developed. The Task Order addresses two areas: Bank Systems (Tranche A) and a Rating Agency (Tranche B). Specifically, Tranche A sought to improve the funds transfer mechanisms and the payment systems currently available in Poland, and/or introduce new ones. Tranche B aimed to facilitate development of the Polish capital market and provide for capacity development within Poland for credit rating services, and to enhance the commercial viability of a Polish Rating Agency through marketing and promotion efforts. Tranche A was completed on November 30, 1998, and Tranche B on May 31, 1999.

The Task Orders required two Resident Advisors based in Warsaw to provide day-to-day operational support for implementation, complemented by short-term experts as required. Mr. Stanley J. Nawrocki, the Payment Systems Advisor, and Mr. J. M. McMullen, Credit Rating Agency Advisor resided in Warsaw, with offices at KIR (the Polish bank clearinghouse) and at the Central European Rating Agency (CERA), as well as at the Polish Bank Association (PBA) until mid-1998, at which time both advisors continued on a part-time basis. Mr. McMullen continued to support CERA with monthly trips to Poland through May 1999. In addition, with the concurrence of USAID/Warsaw, FWA provided speakers in May 1999 for a payments system conference on risk management for electronic banking in cooperation with the Electronic Banking Council of the PBA.

Because the Task Order contains two distinct Tranches, the Final Report is organized as two reports under one cover sheet. Each contains an Executive Summary.

Tranche A: Payment System Final Report

Poland: Bank System Development Project

Contract No. EPE-0005-I-03-5050-00
Amended to Contract No. EPE-I-03-95-00050

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November 30 1998

Bank System Development Project

undertaken by

First Washington Associates, Ltd.

for the

United States Agency for International Development

EXECUTIVE SUMMARY: *Tranche A: Payment Systems*

Background

The United States Agency for International Development (USAID) recognized a need expressed by the Polish Bank Association (PBA) and the National Clearing House of Poland (KIR) for assistance in improving Poland's payment system. The payment system project became Tranche A of USAID's Bank System Development project, implemented by First Washington Associates (FWA) under an Omnibus II Task Order, starting in October 1995. The Tranche A was extended twice through November 1998. The extensions focused on improving the efficiency of the payment system and the requirements for Poland's desired accession to the European Union.

A real time system for bank to bank payments was not available. The central bank (National Bank of Poland - NBP) was working on a project to provide that capability. The role NBP chose to play in the payment system was one of participant. Consequently, there was no single entity to work with on payment system issues. Any progress would be dependent upon reaching consensus and agreement to move forward among the banks and the clearing house.

The Task Orders described tasks to be performed and specified Tangible Results as Benchmarks with defined Objectives. Workplans were developed to address these Tangible Results/Benchmarks/Objectives. Progress relative to the workplans was reported in monthly and quarterly reports.

Short-term FWA experts were used in the project on eight occasions to assist in specific analyses, or for specialized tasks, which contributed to the overall project objectives. The project also experts from Financial Services Volunteer Corps (FSVC), and FSVC funded an educational trip for two officials of the National Clearing House to the United States. Requested assistance was provided to the Warsaw Institute of Banking and to banks and their clients on matters relating to practical and strategic payment issues.

Expected Results

First Task Order: Tranche A

1. Tasks

Fact gathering and review of existing processes and conditions were the focus of initial activity. Meetings, workshops and conferences were organized to address payment system issues at various levels of detail, including a variety of delivery mechanisms.

A consensus was formed on what steps could be taken to improve the payment system in Poland. A process for initiating change and making the improvements was agreed.

2. Tangible Results

A Work Plan was prepared which included definitive tasks to achieve the results specified in the Task Order. It also provided on the job training to selected local personnel and related assistance to banking organizations and banks.

Basic funds transfer mechanisms existed in Poland. The major objective of the Task Order was to improve these and/or to introduce new ones.

The Resident Advisor organized a group of bankers whose responsibilities included the payment function in their respective banks. The group also included representation from KIR and the PBA. The group called itself "The Working Group for Payment Systems." They continue to meet monthly to discuss payment system issues.

The Working Group formed subcommittees to deal with specific issues and present recommended changes in the payment system. Recognizing the potential benefits of electronic clearing, most members of the Working Group shared a desire to move as much payment volume into the electronic clearings as possible.

Also efforts to create an Advisory Council whose purpose would be to deal with payment systems issues at a policy making level. This group was not organized until the project was nearing completion.

The Polish Bank Association sponsored Poland's first payment system conference in May 1996. It subsequently committed to hold two each year. The Resident Advisor participated in the payment system conferences as a member of the planning committee and as a speaker.

Second Task Order: Tranche A

1. Tasks

The Working Group grew in size and its influence increased. Its accomplishments allowed new payment related products and services to be introduced by the banks and KIR.

Work with KIR encompassed a broad range of payment system related tasks including switching networks and chip cards. A national payments strategy was adopted by the PBA encouraging the greater use of electronic payments and new standards were adopted.

A standard availability schedule was recommended. PBA did not consider the climate favorable. Another vehicle for improving availability had to be found.

2. Tangible Results

A new Work Plan was developed for the second Task Order. New Benchmarks and Objectives were identified.

The Working Group for Payment Systems was established as a permanent organization within the Polish Bank Association. Bank representation grew as more banks wanted to participate.

The Polish Bank Association adopted payment system modernization as one of the annual resolutions of its General Assembly, and a program was initiated to make all bank branches capable of receiving electronic transactions. The Polish Banking Association's resolution to modernize the payment system contributed significantly to increased use of electronic transactions in the clearings.

Contributing to the effort for increased electronic clearing, subcommittees of the Working Group did important work on standardization and direct debits.

Changes to settlement procedures adopted by NBP and KIR streamlined the process as it became more efficient requiring less time and less intervention.

Attempts to establish the Payments Advisory Council were renewed. It came very close to realization during this period but was again delayed.

KIR organized a conference for Central and Eastern European clearing institutions. KIR gathered information about these institutions, which it then organized into handout materials at the conference. A number of speakers made presentations on clearings in different countries.

A group of banks organized a committee to pursue a common approach to electronic banking in Poland. A project team was formed to research the subject and make recommendations on how Poland should move forward with this matter. This ultimately resulted in the pursuit of a common electronic banking network.

Changes in capability in payments in the Polish banking system allowed the banks, KIR, and other service providers to offer new products contributing to the growth of the banking system.

Payment system participants moved forward with a more efficient delivery mechanism, and a number of their initiatives made the system more efficient. These improvements are important since a well functioning payment system to support economic growth is necessary for European Union accession.

Second Task Order Extension: Tranche A

1. Tasks

The Working Group's subcommittee on direct debits was to continue its work and bring that project to fruition. Introduction of direct debits also would have a positive impact on electronic clearing.

It was expected that there would be continued encouragement for adoption of standards for account numbers and selected forms. A national payment strategy included finality of settlement, Real Time Gross Settlement, and a common electronic banking approach.

2. Tangible Results

A new Work Plan was developed for the Second Task Order extension. The focus of this Work Plan was standardization, education, and efficiency in the payment system.

The PBA's Committee on Infrastructure accepted the work of the account number standards group.

A series of conferences were held with broad industry participation. These were cosponsored by the Polish Bank Association and selected vendors.

Poland's pension system is being reformed and the new system is modeled after pension systems in South America in which banks play a major role in collection and distribution. The pension reform program requires the payments to be made electronically. KIR and PBA were both influential in the design of the flow of funds in the new pension program.

The National Bank of Poland revealed its plans in regards to payments and settlement for addressing the requirements it must meet for European Union accession. As a result, KIR was able to proceed with its development of a strategy for cross border payments.

KIR's strategic plan was rewritten to cover the period 1998 through 2000.

In assessing the needs of the banking system for Poland's European Union accession, the issues of risk, finality, and settlement had to be addressed. The payment system is likely to be in compliance by the required time. No known obstacles exist.

Poland's assessment of the way it should approach a common electronic banking network has changed over time. A common electronic banking network has been defined. Security is a very critical part of the network, which is being addressed, including technical assistance from an FWA short-term advisor.

Conclusion

The tasks of the three task orders were all completed and all benchmarks accomplished.

Poland's payment system will be in a transitional state for a few more years. It has improved in the last three years. Money is moving faster around the country, new services like direct debits and direct deposit have been introduced and card services continue to expand. The payment system is recognized as an integral part of efficient tax collection and a more efficient new pension system. Capital resources are scarce in the banking system in Poland. Changes in the payment system avoided the need for large investments in an infrastructure to process payments efficiently.

The feedback from the Polish Bank Association, the banks, and KIR about the Payment System portion of USAID's Bank System Development Project has been very favorable. Gratitude has also been expressed for the assistance of many experts made available in a broad range of subject areas.

Tranche A: Payment System Final Report

Background

The United States Agency for International Development (USAID) recognized a need expressed by the Polish Bank Association (PBA) and the National Clearing House of Poland (KIR) for assistance in improving Poland's payment system. The payment system project became Tranche A of USAID's Bank System Development project, implemented by First Washington Associates (FWA) under an Omnibus II Task Order, starting in October 1995. Tranche A was one of two Tranches. (Tranche B is credit rating agency development.) Work continued on both Tranches under a second Task Order, which was subsequently extended. This is the Final Report for Tranche A, which has a completion date of November 30, 1998. Tranche B has been extended to March 31, 1999.

A Resident Advisor from FWA was selected to work with counterparts from the two Polish organizations and the banks in Poland to assess the payment system, determine what changes should and could be made, and to provide advisory assistance in the implementation of change. As the project progressed through the first task order, it became apparent that this tranche would further benefit the development of the payment system and other related activity within the banking community if it was extended. A more efficient payment system would be a major contributor to the economic growth of the country. Decisions were made to extend the project twice (as a second Task Order, subsequently extended). Extensions focused on the overall efficiency of the payment system and the requirements on it as Poland moves toward its desired accession to the European Union.

Of major interest was the direction of the National Clearing House (KIR) since it is the principal provider of the mechanism by which almost all bank to bank payments are made. The clearing system as it was originally set up was adequate for that time in Poland's economic development, but as economic activity increased, demand for more payments, faster payments, and more efficient payments made improvement necessary. The Resident Advisor provided KIR with assistance in developing its strategic plan and at the request of KIR and PBA, made many observations, recommendations, and opinions on specific payment system related topics.

Early in the project period, the payment system in Poland used a number of payment vehicles including EFT, BT, checks, credit and debit cards, and transfers. Standardization was minimal and the primary mechanism was a paper exchange process which was inefficient and whose timing was unreliable. No real time system was available for bank to bank payments, although the Polish central bank, National Bank of Poland (NBP), had a project in process which sought to provide that capability at some future date. NBP was receiving assistance from the U.S. Federal Reserve with that project.

There was no single entity to work with on this project. Unlike the situation in other countries, NBP chose neither to own the payment system nor dictate its direction, operation, and development. The role the central bank elected to play in the payment system was one of participant. Consequently, changes in the payment system were dependent upon the National Clearing House (KIR) and the

participating banks, including NBP, reaching consensus and cooperating on implementation of change. This made the change process more time consuming.

A detailed description of the payment system is included as Exhibit 1.

The Task Orders described tasks to be performed and specified Tangible Results in the form of Benchmarks with defined Objectives. These elements were incorporated into Work Plans that were updated as circumstances dictated, and which served as the basis for activity reported on monthly and summarized quarterly. The three completed Work Plans are included as Exhibits 2, 3, 4.

The general success factors in the payment systems project may be summarized as the following:

1. development of a more efficient payment system;
2. adoption of more standards for payments;
3. creation of a forum for continuing discussion and presentation of improvement ideas, needs, and suggestions;
4. commitment to regular payment conferences to broaden knowledge and present new ideas;
5. increasing funds availability for bank to bank payments;
6. advancement toward all electronic clearing;
7. introduction of new products into the financial services market place made possible by an improved payment system;
8. avoidance of a commitment of scarce capital resources to high speed paper processing mechanisms; and
9. consensus on strategic payment issues to be addressed in the future.

All were achieved.

Additional short-term FWA experts were used in the project on eight occasions to assist in specific analyses, or for specialized tasks, which contributed to the overall project objectives. The project also used four volunteers provided by the Financial Services Volunteer Corps (FSVC), and used the resources of FSVC to fund an educational trip for two officials of the National Clearing House to the United States where they visited two Federal Reserve Banks, the New York Clearing House, CHIPS, NACHA, and a major New York bank to gather different perspectives and knowledge on a wide range of payment system issues. FSVC also assisted in bringing representatives from other countries to KIR's international conference of clearing institutions in Central and Eastern Europe.

During the course of the project, assistance was also provided to the Warsaw Institute of Banking in the creation of a Bank Operations Management course, the U. S. Treasury Department's assistance project to Poland's Ministry of Finance, and USAID's assistance project to the Credit Union movement in Poland. Advisory assistance was also provided to several banks and their customers doing business or planning to do business in Poland. Information about the payment system and its possible effect on those enterprises was provided as requested. At the request of individual banks, advisory assistance was provided on matters relating to strategic payment and information technology issues.

Expected Results

First Task Order : , October 1, 1995 – September 30, 1996, no-cost extension to February 25, 1997

1. Tasks

Fact gathering and review of existing processes and conditions were the focus of initial activity. Tasks completed included an in-depth review of KIR's system, a review of SWIFT usage, BT usage, and all aspects of funds transfer mechanisms in the payment system in Poland. A detailed review was also made of the document exchange process. To assist in these efforts, short-term FWA experts were used to analyze the payment card environment and make recommendations, to analyze the current status of international payments utilization and recommend change and future interface to the domestic system, and to analyze the hardware, software, and performance factors in use at KIR and make recommendations as appropriate.

Meetings, workshops and conferences were organized which addressed payment system issues at various levels of detail. Presentations were made on a variety of delivery mechanisms. These sessions provided a forum for payment system participants to raise issues of common interest for discussion, and to learn about different approaches to problem resolution. They were used to provide Polish bankers with information about various aspects of payment system operations in other countries. The conferences were occasionally used to educate participants on methodologies offered by various vendors as payment system processing solutions. An FWA short-term expert and a FSVC volunteer expert in electronic card systems were used to broaden the scope of knowledge in that subject area.

A group of interested bankers was organized to meet regularly to discuss payment system issues. A commitment to semiannual payment system conferences was made by the PBA.

A consensus was formed that certain steps could be taken to improve the payment system in Poland. A process was agreed for initiating change to make the improvements. A structure was established for accomplishing the tasks.

2. Tangible Results

A Work Plan was prepared which included definitive tasks to achieve the results specified in the First Task Order. (See Exhibit 2.) It was also planned to provide on the job training to selected local personnel and provide related assistance to banking organizations and banks as requested.

Basic funds transfer mechanisms existed in Poland. The major objective of the project was to improve these and/or to introduce new ones. Benchmarks and Objectives were established to track project progress.

A forum and process had to be established to facilitate reaching consensus on desired changes, the nature and priority of proposed changes, and agreement on implementation. To accomplish this, the Resident Advisor brought together a group of bankers whose responsibilities included the payment function in their respective banks. The group also included representation from KIR and PBA. The group called itself “The Working Group for Payment Systems” (or “The Working Group”). The group elected leadership and decided to meet monthly. The Resident Advisor supplied them with a suggested “starter” list of issues to be addressed.

Representatives of twelve banks who had expressed interest during personal interviews were invited to join the group. As the group and its activity became better known, more banks became interested and were accepted for membership by the original group. After several months, the membership included representatives of every major bank in Poland.

The Working Group formed subcommittees to deal with specific issues and present recommendations for changes in the payment system to the whole group, as well as the rest of the banking community. When consensus was reached, implementation plans were worked out. The members of the group took care of communications within their respective banks and the PBA communicated the group’s activity through its regular publication.

Recognizing the potential benefits of electronic clearing, most members of the Working Group shared a desire to move as much payment volume into the electronic portion of the clearings as possible. This became an influential factor in much of their work. They also had success in influencing central bank policy in payment system matters.

There were efforts to create an Advisory Council whose purpose would be to deal with payment system issues at a policy making level. The intention was to have the Working Group concern itself with tactical and practical issues of the payment system and recommend action to the Advisory Council on policy issues. There were a variety of difficulties in organizing the Advisory Council and its actual formation did not occur until near the end of the project.

The absence of an Advisory Council created a void. In circumstances where policy issues became involved in change, the Working Group sent its recommendations to PBA’s Steering Committee on Banking Infrastructure. This group is comprised of the members of top management in the 26 largest banks in Poland and deals with a broad range of subjects. The Steering Committee strongly supported the work of the Working Group.

KIR had written a proposed Strategic Plan. KIR's Supervisory Board did not accept the first several iterations of the plan. The Resident Advisor worked with KIR management to write a plan that was accepted. To help coordinate the strategies of KIR and the banks, a survey was planned to canvas the banks on their strategies for future automation and payment related product plans.

KIR was considering employing image technology to assist in converting non-standard documents to electronic payments. A team of FWA experts was brought into the project on a short-term basis to assess the direction, evaluate the impact of using this technology as KIR envisioned, and make recommendations for the future. As a result of the FWA team's work, much was learned about image technology and its capabilities. Recommendations for a more practical approach were made, thereby avoiding what would have been a significant expenditure by KIR for a less than satisfactory result.

PBA sponsored Poland's first payment system conference in May 1996. The purpose of the conference was to inform attendees about payment issues, and about different potential approaches to problem resolution. It also provided a convenient forum for payment services providers to communicate future plans. The Resident Advisor participated in this and other payment system conferences as a member of the planning committees and as a speaker.

Second Task Order : Tranche A, , October 1, 1996 – November 30, 1997

1. Tasks

The Working Group grew in size and its influence increased. Its subcommittees dealt with standardization and recommended various changes in payment processing. Their accomplishments allowed new payment related products and services to be introduced by the banks and KIR. The Resident Advisor participated in much of the group's work and advised the group on payment related topics.

Some revisions were made to KIR's Strategic Plan but a complete rewrite was delayed until early in the following year. This timing corresponded to the end of the period covered by the previous plan. KIR's management board and its supervisory board felt an update was sufficient. A bank automation survey was undertaken which provided some insight to bank planning. KIR was able to incorporate the information into its planning and the next iteration of the Strategic Plan.

Revisions were made in the settlement process involving KIR and NBP. The changes reduced the amount of manual intervention required, which improved the efficiency of the settlement process.

Two KIR officials visited the Federal Reserve Banks of Boston and Richmond, the New York Clearing House, CHIPS, NACHA, and Chase Bank in New York where

they gathered information about the workings of those organizations which improved their perspectives and influenced their planning. FSVC organized and sponsored the trip. The Resident Advisor assisted the KIR officials with the preparation of questions and topics for discussion.

KIR initiated a project that was to find a means of handling cross border payments. Progress on this project was limited because the plans of NBP were not known. Because settlement of these transactions is a critical factor in handling cross border payments, knowledge of NBP's plans was important.

Work with KIR encompassed a broad range of payment system related tasks, including switching networks and chip cards. Processing was reviewed and recommendations were made for changes. A national payments strategy was adopted by the PBA encouraging modernization with greater use of electronic payments and more standards were adopted.

The PBA held two payment system conferences and committed itself to doing so each year. It scheduled one for the spring and one for the fall. The Resident Advisor was an active participant in the conferences.

As requested, proposed content material was created and submitted by the Resident Advisor to the Warsaw Institute of Banking for its new Bank Operations Management course. The Advisor also participated in a number of interviews with Polish bankers to gather their opinions on the topics recommended. He subsequently worked with the subject matter expert on the presentation of the material

In an effort to put more reliability in the payment system, the Resident Advisor recommended the adoption of a standard availability schedule. The Polish Bank Association did not consider the climate favorable for getting a consensus on a published schedule. Another vehicle for bringing about improved availability had to be found.

3. Tangible Results

A new Work Plan was developed for the Second Task Order. (See Exhibit 3.) The Benchmarks and Objectives extended those contained in the First Task Order and added new ones.

The Working Group for Payment Systems became a permanent organization in the PBA structure. It was formally established as the group assigned to deal with the payment system and payment related issues. Bank representation grew as group's work was more widely recognized and more banks wanted to participate.

Electronic clearing achieves a level of consistency and reliability in funds movement. This was a more palatable way of achieving the same result as the adoption of a nationwide standard availability schedule. Some banks were not willing to adopt such a schedule directly and there is no means to force the imposition of such a schedule. However, they were willing to use electronic clearing. As a goal for the payment system, the Resident Advisor and his counterparts agreed that interbank transfers should take an average of three days or less. Since electronic transactions consistently take one business day, it was important to work toward clearing as many transactions electronically as possible. This particular benchmark could be achieved in practice without the formal adoption of a documented schedule.

A significant contributor to the increase in electronic clearing was the resolution by the PBA that as part of its effort to modernize the payment system, every branch was to be able to receive electronic transactions by July of 1998. In support of this direction, KIR instituted a "switch" capability that allowed any bank to enter the clearing with all electronic transactions if they chose. By this change, the clearing system changed from being only as efficient as its least efficient participant to being as efficient as a sending bank wanted to be.

Contributing to the effort for increased electronic clearing, several subcommittees of the Working Group did important work in the areas of standardization and direct debits. An FWA expert assisted one of the subcommittees on a short-term basis with recommended payment standards and national account numbering standards which were subsequently recommended to the Steering Committee on Bank Infrastructure and adopted.

Changes to settlement procedures adopted by NBP and KIR streamlined the settlement process making it more efficient by requiring less time and less manual intervention. This was a small step in the modernization of the payment system but, it allowed banks more time to access the clearing house as well as monitor their positions.

The Resident Advisor was asked to write a number of opinion papers on subjects related to the modernization efforts. The topics ranged from the future of paper clearings to pricing policies on ATMs. He also cooperated with the World Bank during its payment system analysis, assisted the U.S. Treasury Representative at Poland's Ministry of Finance with recommendations for improving the Ministry's cash flow, and assisted the Credit Union Advisor with his efforts to provide the Credit Unions with ATM access. He also produced several analytical reports requested by PBA and KIR.

KIR's efforts to move forward with a cross border strategy were slowed somewhat. The strategy had to recognize the central bank's role and the central bank was unwilling to share very much information about its plans. NBP was slow to reveal

its strategy for real time gross settlement and its future link to E.U. central banks through the TARGET system.

PBA adopted a permanent practice of having two payment conferences each year. The Resident Advisor participated in the preparation of these two conferences and as a speaker at each of them. FSVC supplied a volunteer to speak on electronic payments at the 1997 spring conference. While in Warsaw, the FSVC volunteer also had discussions with NBP and KIR on this subject, planning, and related topics.

Efforts were made to establish the Payments Advisory Council once again. The Council members and leader were named and the positions accepted. Before the first meeting was scheduled, the chairman announced his resignation from NBP and subsequent relocation to Germany. NBP was a critical member and the terms in office for NBP's top management there were expiring, it became prudent to wait until new appointees were in place to try to organize this group once again.

The Bank Operations Management course at the Warsaw Institute of Banking was completed and its inaugural session was scheduled.

KIR organized a conference for Central and Eastern European clearing institutions and gathered information about these institutions which it then organized into hand out material at the conference. The Resident Advisor participated in the program preparation and as a speaker. A number of speakers made presentations on clearings in different countries. These included representatives from the U.K., U.S., Germany, and several academics. The conference was well received. FSVC assisted in providing speakers from the U.S. and with attendance by key individuals from other clearing institutions in Eastern Europe. A number of participants expressed the thought that a conference of this type was of such value that it should be held regularly. Several offered to host the conference in the future.

Another contribution to the efficiency of the payment system would have been the establishment of a direct link between KIR and PolCard, the principal card payment processor in Poland. The Resident Advisor had recommended such a link to KIR and to PolCard. It was estimated that the processing speed of transactions (and therefore the funds movement) could be improved by up to 70%. PolCard and KIR discussed the issue for many months and eventually agreed on a process acceptable to both, and to PolCard's settlement bank, which stood to lose the benefit of the float created by the slow movement of funds through the paper system.

As an outgrowth of the continuing work of the direct debit subcommittee of the Working Group, a group of banks organized a separate committee to pursue a common approach to electronic banking leading to the introduction of electronic commerce in Poland. The Resident Advisor encouraged this pursuit and participated in many of the meetings. The outcome was the establishment of a project team funded by the interested organizations to pursue the idea. A project team was

organized to research the subject and make recommendations on how Poland should move forward with this matter.

The direct debit subcommittee of the Working Group continued to make progress. They sponsored two educational conferences, eventually gained consensus among the banks on standard agreement documents, and prodded the NBP to issue a set of needed guidelines for direct debits.

Changes in payments capability in the Polish banking system allowed the banks, KIR, and other service providers to offer new products. These contributed to the growth of the banking system and to growth of the banks themselves.

The payment system participants had established an environment in which they could move forward with more efficient delivery mechanisms. They had a number of important initiatives in process that would make the system more efficient and contribute to economic development. Poland's desired accession to the European Union will require a well functioning, modern payment system to support economic growth.

Second Task Order Extension: Tranche A, December 1, 1997 – November 30, 1998

1. Tasks

In the Second Task Order extension, advising the banks on IT and payment strategies was expected with on-going efforts to provide information, analysis, and opinions as requested.

The users of payments were to receive more attention. To this end, several commercial enterprises anticipating entry into the Polish market requested assistance with payment related planning through their banks, KIR, and the Polish Bank Association. The Resident Advisor encouraged them to require electronic clearing of payments from their banks providing additional emphasis on improvement of clearing times.

The committee on direct debits was to continue its work and bring that project to fruition. Direct debits began flowing through the payment system in June 1998. Direct debits also had a positive impact on electronic clearing.

KIR's efforts to develop a strategy for cross border payments continued. The Resident Advisor provided Assistance for this effort and in reaching a consensus on how extended descriptions for transactions could be handled.

Tasks included continued encouragement for adoption of standards including those for account numbers and selected forms. Advising on a national payment strategy was expanded to include finality of settlement, Real Time Gross Settlement, and a common approach to electronic banking in Poland.

2. Tangible Results

A new Work Plan was developed for the second Task Order extension. (See Exhibit 4.) The focus of this Work Plan was on standardization, education, and efficiency in the payment system. Through these measures Poland's banking system would move closer to compliance with requirements for European Union accession. In the latter stage of the Task Order, the Advisor's activity was expected to be reduced which eliminated the need for the Advisor to continue in residence. The plan called for the Advisor to make several follow up visits to assess progress and help adjust plans as needed.

The work of the account number standards group which received the assistance from an FWA short-term expert was accepted by the Committee on Infrastructure and a deadline of January 2001 was set for compliance. A number of banks have processing system changes planned and the banks want to coordinate these changes.

A series of conferences was held with broad industry participation. These were co-sponsored by PBA and selected vendors. The range of topics varied from image processing to Internet Banking. These conferences served to introduce new concepts and ideas to the bankers in Poland.

KIR developed a "switch" to facilitate increasing electronic input into the clearing house for those banks who wanted it. The "switch" changed electronic transactions to paper for branches that were not prepared to receive electronically. The effect of the change was that electronic clearing increased. Further helped by the resolution to have all bank branches able to receive electronic input, electronic volume in the clearings increased well over 100% in volume and value in less than one year. In excess of 64% of the value of all clearings was electronic in the month of September 1998. Since these are all one day transactions, this and anecdotal evidence in the form of bank customers commenting that the transactions were reaching their accounts faster suggests that the goal of averaging three days has been reached. No other measure exists by which this can be verified. It is also noteworthy that the Ministry of Finance in the newest tax legislation included a requirement that tax payments received by banks must be in the central bank in three days or less. The only way compliance can be assured is through the use of electronic clearing. Direct debits were introduced as electronic only transactions. More progress will be made after the new pension system is in place in January of 1999. Poland's pension system is being reformed and the new system is modeled after pension systems in South America in which banks play a major role in collection and distribution. The pension reform program requires the payments to be made electronically. About two million new transactions per month are expected in the clearing as a result of the pension reform. KIR and PBA were both influential in the design of the flow of funds in the new pension program.

NBP revealed its plans in regards to payments and settlement for addressing the requirements it must meet for European Union accession. This allowed KIR to proceed with its development of a strategy for cross border payments. NBP also announced its plans for allowing banks to use its Sorbnet system to make bank to bank payments. It will permit real time bank to bank payments. Real Time Gross Settlement was addressed and information on NBP's approach to its link with the TARGET system was announced. These things helped the banks in their planning.

The planned link between PolCard and KIR was not completed because of a controversial interpretation of regulations by NBP. NBP's interpretation was that current regulations prohibit such a link, even though no such prohibition was specifically stated.

KIR's strategic plan was revised. It was written to cover the period 1998 through 2000. It included a number of revisions initiated from discussions of KIR's Management Board and the Resident Adviser.

PBA requested a study on charging methodologies in Western countries by providers of card services. An FWA expert prepared the study. The study provided information to banks in Poland for analysis and planning purposes. It was a particularly welcome study to the Card Issuers Board of the PBA.

In assessing the needs of the banking system in Poland for European Union accession, the issues of risk, finality, and settlement have been studied and discussed. While Poland's payment system is not ready to meet all requirements yet, it will likely be in compliance at the required time. The needs are known and no obstacles exist to their being satisfied.

Poland's assessment of the way it should approach a common electronic banking network has changed over time. There continues to be a group working on the common electronic banking network as it has been defined by the banks. A critical element of the network is its security. An FWA security expert was used to assist in this aspect of the project. He provided a framework for building the necessary secure environment and developed procedures to maintain proper levels of security as banks provide their customers with more sophisticated electronic services. He also provided recommendations for structuring the Certification Authority and Certificate Registration support functions.

Conclusion

The tasks for Tranche A of FWA's two task orders and task order extension were all completed and all benchmarks accomplished. As the project progressed, the dynamic environment gave rise to new tasks and benchmarks throughout the project. With the one noted exception, these too were achieved.

Poland's payment system will be in a transitional state for a few more years. It has sound fundamentals that will support the increasingly more vibrant economic activity expected in the foreseeable future. The payment system has improved in the last three years. During this period, the number of places payment cards can be used has more than doubled. The number of ATM installations has increased 700%. Money is moving faster around the country. New services like direct debits, direct deposit and card services continue to expand. The payment system is recognized as an integral part of efficient tax collection and a more efficient new pension system. It has given rise to changes in handling securities transactions, which will produce new efficiencies in securities trading in the near future. The banks are offering new services that provide individuals and businesses with more tools to use to enhance their daily economic activities. This can be expected to continue.

Few scarce capital resources have had to be used in order to obtain improvements in the payment system. The changes that have been made have required minimal investment in the infrastructure of the system.

The feedback from PBA, the banks, and KIR about the Payment System portion of USAID's Bank System Development Project, implemented by has been very favorable. Gratitude has been expressed for the assistance of many experts made available in a broad range of subject areas.

The Executive Director of PBA cited progress in the banking industry in the important areas of strategy, pricing, approach to electronic banking, the role of the central bank, and the role of the Association of the Polish banks. He pointed to improved "cashless turnover" (electronic payments) as a particularly significant outcome of the project. PolCard, Euronet, KIR, Telbank, and all service providers in the financial market place and the industry growth were all mentioned as having been positively affected during the Bank System Development project.

The project met USAID's goals.

Attachments:

Exhibit 1: The Payment System in Poland.

Payment Systems in Poland

One of the biggest challenges facing the financial system in Poland is building a payment system that will support economic development within Poland and support economic activity when Poland becomes a member of the European Union.

In emerging from a central system, Poland has made a great deal of progress in developing its banking system. Critical to the continuing development of the system is the ability to effectively make payments and settle transactions. There has been progress in this direction. More needs to be done.

Domestic payments among bank branches are made using one of two mechanisms. The SYBIR system is used for paper transactions and the ELIXIR system is used for electronic transactions. Settlement occurs three times each day. Timing for exchange of transactions is determined by type of transaction. ELIXIR and SYBIR credits are exchanged in the first session of the day and settlement is accomplished by the National Bank of Poland posting the banks' settlement accounts in the central bank. Only ELIXIR credits are exchanged and settled in the second session. ELIXIR credits and SYBIR debits are exchanged and settled in the third session of the day. According to the Clearing House Rules, a branch has two days to decide whether it will accept a SYBIR debit for posting or not. Since there is no date indication on the transactions, the two day period is essentially on the honor system. There are no ELIXIR debits. Banks are interested in introducing Direct Debits.

The SYBIR system has been operational since 1993. The ELIXIR system came into operation in 1994. There have been few changes since the inauguration of the systems.

The paper clearing system receives input from bank branches. This input consists of plastic bags containing smaller plastic bags. The smaller plastic bags contain documents most of which are payments in the form of transfers and a small number of checks. Each small bag contains transactions destined for another individual bank branch. The receiving branch totals of the smaller bags (accumulated into larger bags for sending) and the totals of the larger bags from the branches are input to the system for accumulation of net bank totals which are passed to NBP for settlement. There are no payment rules involving timing. For credit transactions in SYBIR, the exchange occurs on one day and the settlement on the following day. KIR accumulates the branch level monetary totals of sent and received amounts to the bank level and passes the information to NBP. NBP preapproves the settlement based on the adequacy of the balances in the bank settlement accounts. Upon notification of acceptance by NBP, exchange is approved and the session is settled.

The electronic clearing system exchanges transactions three times each day. At the end of each of these exchanges, the exchanged totals are added to those of SYBIR before transmission of data to NBP. ELIXIR transactions are settled the same day they are exchanged.

There are no formal mechanisms in place for returning transactions. In ELIXIR, if a bank's file cannot be properly included or has a problem transaction, the file is excluded until the situation can be corrected. For exceptions in SYBIR, KIR employees contact the branch for a resolution. In either case, there are no timing restrictions. For SYBIR debits that are not accepted, they are returned to the sending branch without having been posted.

There are over 40 banks that are members of ELIXIR - the electronic side of the clearing house. Some banks choose to funnel transactions through a single point to the ELIXIR system while others have multiple branches "on line" to the ELIXIR system. In this instance, "on line" means a telecommunications link to KIR for use in batch transmissions. Some branches initiate transactions for ELIXIR by accumulating them on a diskette and sending the diskette to the BRIR for input to ELIXIR. Branches receive transactions from ELIXIR in the form of batch transmissions or diskettes. There are a variety of means of posting these transactions to accounting application systems at the banks. Some post the transactions directly. Others print out the transactions for use as source documents to update internal systems.

KIR manages a courier network. The network operates among bank branches for pick up and delivery of clearing packages. It also operates among the BRIR's (clearing house branches). Some banks operate proprietary courier networks which incorporate stops at BRIR's and other branches. Some banks use KIR's network for the interbranch flow of documents. The paper clearing occasionally includes other documents besides payments as attachments to the payments.

As would be expected, banks are at different stages of development with their internal systems. Some have on line systems throughout their branch networks. Others are in various stages of implementation of internal systems and systems which offer automated access to customers. Several banks offer remote banking service to corporate customers. There are some banks offering remote banking service to consumer clients in the form of home banking. Quite a few banks are members of SWIFT and offer international payment services to customers. The number of correspondent relationships maintained by these banks is very high.

Banks are able to offer customers accounts in other currencies. However, Polish domestic banks must settle other currency transactions outside of Poland.

Over 40 banks offer clients some kind of payment card. Most of these are affiliated with Polcard, VISA, American Express, or Europay. Polcard is a third party payment card servicing company owned by nine banks and a travel company. There are proprietary cards in circulation that have limited distribution and acceptance. Over 90% of the cards in circulation are debit cards. The credit cards in circulation are generally associated with a corporate client arrangement at the issuing bank.

Polcard plays a key role in the payment system in Poland. Polcard has links to the major international card authorization networks. It competes with the banks in merchant

acquisition and the issuance of Polcard payment cards. Polcard supports 2,500 POS terminals installed in merchant locations. About 25,000 merchants accept payment cards.

Access to ATM services has grown in the last year. Around 500 ATMs are installed in the country. More and more are being installed on-line and several banks have agreed to sharing arrangements in local or regional networks. Access to international ATM networks is beginning to be available in Poland. Banks have issued around 500,000 ATM cards. An independent network, Euronet, allows banks to give domestic and international access to their customers in a variety of schemes which for some banks reduces the required initial investment. Polcard has installed software that will drive ATMs and switch transactions among banks, networks, and other ATM drivers.

Many people in the banking community are anxious to get more plastic into the hands of Polish consumers. These will necessarily continue to be mostly debit cards. Credit history is needed to assist the banks in issuing credit cards and credit history for individuals is not available. There is a lot of interest in electronic purse and chip cards but the infrastructure to accommodate these methodologies will not be in place for a long time. A new company has emerged called Elbank, which is focused on bringing chip card technology to the Polish market place. This may accelerate the time frame for chip cards being issued but acceptance will be the problem. There are assumptions that charges for ATM usage and other payment card usage will be a source of high fee income for a long time. Existing clients and potential clients will be influenced in a way that will surprise some banks. Market forces, more than bank policy, will influence the behavior of consumers and merchants.

Payments are settled among businesses and consumers in several different ways. The greatest number are cash transactions. Poland is a cash society with only around 30% of the consumer households maintaining banking relationships. Virtually all bills are paid in cash. Virtually all purchases are made with cash, though card usage is growing.

The most frequently used form of non-cash payment is the transfer. Transfers are payment orders used to move money from one place to another. Transfer sources are cash or a deposit in a bank. Transfers move monetary value from one financial institution (branch) to another. After cash, transfers are the most widely used payment vehicle in Poland. Forms are not standardized although efforts to do so have been under way for some time. Checks are also used in the payment system. Checks are the least popular means of making paper payments. Domestic checks are not standardized although efforts to do so are being made. The lack of standardization prevents paper based payments from being processed using a mechanized means. There is no agreement on a standard mechanized means so there is little incentive for standard documents. Building an infrastructure to process paper transactions in a mechanized manner would be very expensive and take a long time to implement. With the technology and knowledge available today, Poland should be able to avoid building a large interbank paper processing infrastructure.

All of the banks have access to and use the SYBIR system. Not all banks are users of ELIXIR. Banks which use ELIXIR sometimes use SYBIR for payments because of the advantage provided by a delay in settlement for paper transactions. This is particularly true

for small value payments. ELIXIR requires inputting more information than SYBIR. For low value payments, the combination of delayed settlement and less input is very attractive. This is especially true when there are many low value payments going to one destination.

The clearing house, KIR, has a pricing structure for clearing paper transactions that is based on packages. It effectively ignores the contents of the package. The structure similarly ignores the number of documents in the package. The pricing structure for electronic transactions is an accumulation of file charges and transaction charges. Charges for electronic transactions are thus more sensitive to volume than paper transactions.

KIR is concerned about being able to provide clearing and settlement services for cross border payments. It wants to work with other European clearing houses on establishing links. KIR will most likely have to develop some new payment types before it develops these links. However, KIR will not be able to participate in cross border exchanges without changes in current NBP policy about the finality of settlement.

There is confusion in the payment system about legal requirements and NBP policy. Efforts are in process to change the banking laws. NBP has expressed a willingness to listen to the banks on recommended changes in policy. These things need to be sorted out.

The Post Office is the largest single processor of payments. The Post Office uses fourteen banks in addition to having its own bank. There are approximately 7500 post offices in the country. All take payments for utilities, cash checks, and process transfers. There are 300 post offices that have computers in them which are used in payment processing. However, magnetic media is not provided to the utilities for use in processing the payments accepted. The post office is also the distributor of national pension payments. There is an effort to build more automation into the combination of the Post Office and the Post Office Bank. There should also be efforts to build more automation between the banks and the Post Office, and between the banks and other members of the business community.

Banks in Poland have not made many efforts to cooperate with each other. The conflict that arises between cooperation and competition is in evidence among the Polish banks. There have been efforts by the Polish Bank Association to encourage cooperation through the formation of special interest groups. These have been good starting points. The banks and KIR have undertaken some initiatives to make improvements in the payment system.

Cooperation among the banks in Poland is vital if the Polish banking community is to support growing economic activity. The banks must cooperate with each other and with KIR on standards, electronic payments, small value international and domestic payments, and in voicing their needs for policy changes to NBP. There is much to be done.

Several entities have a role and a stake in the development of payment systems in Poland. The largest stakeholders include Polcard, KIR, Telbank, NBP, the post office, and all banks. Success will be a function of carving out roles for each participant in the payment mechanism and pursuing them vigorously. Success will require cooperation in development of capabilities that satisfy common interests without duplicating resources. Inactivity

brought on by concern about potential competition will slow progress. Individual organizations will see the interests of the entire community not in their best interests. In the short term, that may be true. In the long term it is in everyone's best interest that the payment system become as effective and efficient as possible. At this stage the challenge created by welcoming all competitors will bring viable payment mechanisms to serve businesses and individuals, and increase the credibility and growth of the banking community among consumers.

S. J. Nawrocki
March, 1996
Rev. March, 1997

Tranche B - Credit Rating Agency Final Report

Poland: Bank System Development Project

Contractor: First Washington Associates, Ltd.

Contract Number: EPE-I-03-95-00050

Country: Poland

Title: Bank System Development Project

Reporting Period: October 1, 1995 – May 31, 1999

Task Order #: Three

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June 30, 1999

Bank System Development Project

undertaken by

First Washington Associates, Ltd.

for the

United States Agency for International Development

EXECUTIVE SUMMARY: *Tranche B: Credit Rating Agency*

From October 1995 through May 1999, First Washington Associates (FWA) implemented two Task Orders for the United States Agency for International Development (USAID) Bank System Development Project in Poland. The overall objectives of the Task Orders were to assist in the development of the Polish banking system specifically and the financial sector in general, in support of OAR Warsaw's Strategic Objective 1.4: "A competitive, market-oriented private financial sector is developed." The Task Orders addressed two areas: Bank Systems (Tranche A) and a Rating Agency (Tranche B). Tranche B aimed to facilitate development of the Polish capital market and provide for capacity development within Poland for credit rating services, and to enhance commercial viability of a Polish Rating Agency through marketing and promotion.

FWA, under Tranche B of the Polish Bank System Task Order with USAID, and in cooperation with the Polish Bankers Association (PBA), conducted market research, developed investment memorandums and business plans, conducted training, and raised capital to establish the Central European Rating Agency (CERA), the first credit rating agency in Central Europe. CERA is wholly staffed, and majority owned, by Polish entities. CERA operates as an independent credit rating agency utilizing standards and methods consistent with those of the major international rating agencies. FWA continued to provide training and technical assistance during the first two years of operation, including supporting the raising of additional capital and negotiation of minority participation by a major international rating agency, Thomson BankWatch.

Tranche B of the Bank System Development Project provided the Polish financial system with the following benefits:

- Focus on credit quality and safety as investment characteristics is widely known
- Broad cross-sections of investors, intermediaries and issuers now know about ratings
- Access exists to independent, objective fundamental analysis of debt issuers
- Beginnings of a framework for rational pricing of securities created
- Cadre of trained, expert analysts able to employ western credit principles is in place
- Expert analysts capable of dealing with limitations in disclosure and transparency are now working
- Principles of sound structured finance introduced
- Initial organization of a commercial paper SRO underway
- Organized disclosure and discussion of capital market activity
- Objective and independent rating agency with a committed strategic investor in operation
- Regulators now able to refer to objective ratings in market regulations
- Increased media attention to all ratings, reflecting enhancement of the "credit culture"

***Bank System Development Project in Poland:
Tranche B - Credit Rating Agency***

undertaken by

First Washington Associates, Ltd.

for the

United States Agency for International Development

I. Background of the Project

The First Washington Associates (FWA) Task Order for Bank System Development in Poland was signed on September 9, 1995 with a Period of Performance start date of October 1, 1995. In September, 1996, a no-cost extension to the Task Order was signed, extending the contract completion date to December 31, 1996. In December and January, further no-cost extensions were granted to a final date of February 25, 1997. A new Task Order, extending the project and expanding activities was signed in September 1996 with a Period of Performance start date of October 1, 1996 and completion date of November 30, 1997. This Task Order was extended and expanded including additional tasks on September 24, 1997, with a Task Order completion of November 30, 1998. In November 1998, a no-cost extension, with additional LOE days, was granted to March 31, 1999, and in March the Task Order was extended to May 31, 1999, with no additional funding or LOE.

A. Task Order Objectives

The overall objectives of the Task Orders were to assist in the development of the Polish banking system specifically and the financial sector in general, in support of OAR Warsaw's Strategic Objective 1.4: "A competitive, market-oriented private financial sector is developed." The Task Order addresses two areas: Bank Systems (Tranche A) and a capital markets Rating Agency (Tranche B). Specifically, Tranche A sought to improve the funds transfer mechanisms and the payment systems currently available in Poland, and/or introduce new ones. Tranche B aimed to facilitate development of the Polish capital market, provide for capacity development within Poland for credit rating services, and to enhance the commercial viability of a Polish Rating Agency through training, marketing and promotional efforts. Tranche A was completed on November 30, 1998. The counterpart for both Tranches was the Polish Bank Association (PBA).

The Task Orders required two Resident Advisors based in Warsaw to provide day-to-day operational support for implementation, complemented by short-term experts as required. Mr. Stanley J. Nawrocki, the Payment Systems Advisor, and Mr. J. M. McMullen, Credit Rating Agency Advisor resided in Warsaw, with offices at KIR (the Polish bank clearinghouse) and at the Central European Rating Agency (CERA) after it was established, as well as at the Polish Bank Association until mid-1998, after which time both advisors continued on a part-time basis. Mr. McMullen continued to support CERA with extensive monthly trips to Poland through May 1999.

The following narrative describes the important accomplishments of the project, and many of the features of the market. Pursuant to the task orders, the rating agency project entailed seven distinct stages of development. These were:

- Market assessment
- Creation of the business plan and information memorandum
- Raising capital
- Hiring the initial and replacement staff
- Training
- CERA Marketing
- Establishing continuity to ensure commercial viability

Market Assessment

In conjunction with its agreement with PBA, USAID specified a market survey was to be conducted to define the status of the market, and the need for a credit rating agency. The survey was conducted by FWA experts including the Credit Rating Advisor between November 7 and December 24, 1995. Interviews were held with more than ninety individuals active in the Polish financial markets in Warsaw and Krakow. The initial objectives of the survey as stated in the Terms of Reference were the following:

- Assess the adequacy of the legal framework for the market
- Identify key investors and explain their current decision process
- Determine the level of ratings comprehension
- Clarify the need for analytical research
- Explore intermediary views and activity
- Evaluate the benefits of an efficient capital market with selected issuers

The survey found the following conditions:

- Very high inflation existed
- The current interest rate level was not economically viable for most industries to utilize debt financing
- The debt market consisted of the weekly full spectrum primary government auction
- Institutional investors such as insurance companies and pension funds were absent
- For selected companies, bank financing was an easy choice
- The quality and depth of company information needed improvement
- Management was not accustomed to disclosure
- Accounting and auditing standards required attention
- Collateral law and procedures limited the utility of assets for security
- Competing government debt interest payments were tax advantaged
- Pricing was affected by the same tax advantage

While the purpose of the survey was market assessment, the participants often independently offered comments regarding the necessity for a rating agency. Several, in fact, expressed interest in participating as investors. As the discussions proceeded, a range of negative and positive observations were made, some of which have been alluded to above. Market changes over the life of the project have alleviated many of the concerns raised, although transparency, disclosure and information systems remain problematic.

While there was no non-governmental fixed income market in Poland at the time, key participants, including regulators, banks, investors, intermediaries and prospective issuers, welcomed the proposal to create a Polish rating agency. Virtually all those interviewed expressed willingness to support the project through rating applications, subscriptions for research, and requests for consulting arrangements. In addition to potential bank equity participants identified by PBA, several other organizations expressed serious interest in investing in the agency. There was a clear need for enhanced analytical and research products combined with extensive education about efficient capital markets in principal and practice.

At the time of formation of CERA, bond and commercial paper pricing was on an ad hoc basis, and there were no expert, independent analysts opining on credit quality. Then, only research to sell securities was available in Poland, and this research was not necessarily comprehensive.

In actuality, the positive encouragement received during the market assessment period did not translate to action on the part of the interview subjects. Many of the participants did invest, but a much smaller number actually followed through with requests for analysis and ratings from CERA. Consequently, company development followed a somewhat different course than laid out in the business plan. Rather than a focus on actual rating applications, which proved to be few in numbers, it became necessary to emphasize industry studies and case studies as the basis for training. Moreover, product development emphasized market information and general analytical commentary in the bulletin rather than comprehensive analytical reports supporting ratings.

Creation of the business plan and information memorandum

The CR Advisor drafted a business plan for the agency with the participation of Wojciech Lipka, the counterpart designated by PBA, who provided the necessary data on costs in the local market. This was a critical component of the on-the-job training for Mr. Lipka, as it was contemplated he would manage the company once formed. The process entailed extensive reviews of market needs, product development to meet those needs, identification of staffing requirements and qualifications, preparation of a recruiting and training framework, full costing of all requirements and preparation of a plan, budget and capital memorandum. The key elements of the plan were summarized at the time as follows:

CERA is organized like the U.S. based rating agencies, and is developing a similar product line. Special provisions are contemplated to ensure independence of rating judgments and impartial service to the capital market. Since the Polish capital market is in the very early stages of operation, the agency should be instrumental in the creation of a rational and efficient framework for future growth. Its principal products include

- Ratings for the Polish financial markets
- A parallel rating system for external markets and international issuers
- A weekly publication describing bond and CP market activity and new ratings
- Detailed analytical reports covering rated issuers
- A market handbook created from the front pages of analytical reports
- Comprehensive industrial and financial sector studies
- A bank counterparty risk assessment service
- Seminars on fundamental analysis as employed by the agencies

The Business Plan incorporated a systematic marketing and product development program designed explicitly for the local market. The program is well underway with compilation of significant data already accomplished, and the thrust of market development clearly defined. The Articles of Incorporation contain features designed to foster independence of rating judgment for the agency.

Raising capital

Mr. Lipka and the CR Advisor identified thirty-five potential investors with the assistance of the Managing Director of the PBA, Krzysztof Pietraszkiewicz. A presentation was scripted based on the plan and memorandum, transparencies prepared and Mr. Lipka rehearsed in presentation techniques with the assistance of the USAID project officer and the USAID investment banking assistance project.

The process resulted in commitments for capital of approximately 1.7 million zlotys versus the plan requirement of 5 million. Mr. Lipka and Mr. Pietraszkiewicz decided to proceed based on their judgment that additional capital would be forthcoming as needed.

CERA completed the corporate registration process, in November, 1996, and began operations in independent premises in February, 1997 at which time it had a staff of five.

Subsequent capital raising efforts following formation of the company succeeded in raising the total to approximately 2.5 million zlotys. The 25 institutional investor shareholders are primarily investment banks and commercial banks, although the group includes the Warsaw Stock Exchange, the Industrial Development Agency (a national government body) and the Fund for Silesian development, a government funded organization. The participation is viewed as "indicating public confidence in CERA's viability as a self-sustaining commercially viable entity." Insurance regulators declined to allow the major insurance companies to participate.

The intention at the outset was to capitalize the company as a Polish rating agency. Over time, however, it became clear there would not be sufficient capital to sustain the company during the development period. CERA management, with the assistance of the CR Advisor, explored at length the potential for investment by a strategic investor that could support CERA following completion of the USAID contract. Following preliminary discussions with three global agencies, the decision was taken in 1998 to conduct formal negotiations with Thomson BankWatch, Inc. These negotiations resulted in the investment by Thomson in early 1999, which raised capital to nearly 5 million zlotys, and gave Thomson a significant minority interest in the company of about 45%.

Hiring the initial and replacement staff

The initial plan called for hiring and training four senior analysts who would constitute the core of the rating committee and provide a nucleus for future management development. A long-term acquaintance of Lipka's was engaged as director of marketing and deputy president. In addition, as called for in the business plan, there was a research associate (junior analyst), secretary and desktop publishing specialist. Mr. Lipka also hired an office manager to handle government-mandated reporting requirements and administration.

The analysts' experience and qualifications were very strong, although actual exposure to credit analysis as employed in the West was very limited. Two held PhD's, one had completed an MBA program at a Warsaw school affiliated with the University of Illinois and the last held a business degree from an American college. There is enormous demand for western-trained, bilingual financial analysts in Poland, and three of the four are now engaged in other pursuits, including head of pension supervision and heads of analytical departments in banks.

Following commitment of the Thomson capital, CERA changed its hiring strategy and added three younger analysts with limited work experience to its cadre of team leader, senior analyst and junior analyst. The training was replicated and expanded to create the necessary skill base, and the rating committee was re-constituted to include the new people.

Training

The core of all project training was on-the-job instruction by the CR Advisor in management, marketing and analysis. Training was a continuous activity designed to equip the management and professional staff of CERA with the necessary skills to conduct the business of the rating agency and introduce sophisticated analytical methodology to the Polish financial market. The focus was on-the-job active participation in the business activities of the firm with the intent to limit formal classroom activity because it distracts from business. The following topic headings illustrate the most significant elements of CERA training with the general number of participants in parenthesis.

Marketing as a Business Orientation (13)
Design and Conduct of Market Survey (3)
Process for Creation of A Business Plan (1)
Creation of the Business Plan and its Components (13)
Principles of Raising Capital (3)
Derivation of an Investment Memorandum (2)
How to prepare an Investment Presentation (1)
Presentation Skills (7)
Effective Scheduling (7)
Financial Modeling for Business Plans (2)
Characteristics of an Adequate Accounting System (1)
Management By Objectives (3)

How to Define Staff Requirements (3)
Determination of Facilities Needs (1)
Collegial Decision Process for Hiring Decisions (3)
Concept Introduction for Professional Staff (13)
Ratings in Markets (13)
Principles of Rating Agency Analysis (13)
Process for Product Development (13)
Creation of Products Responsive to Market Needs (13)
Spreading Financials and Interpreting Footnotes (13)
Creation of Data Bases for Rating Assignments (13)
Requirements for Creating a Rating Library (7)
How to Evaluate Data Sources (13)
Rating Committee Practices and Constraints (13)
Chase Manhattan Basic Credit Course (13)
Case Studies, Creating Credit Reports, and Ratings (13)
Detailed Approach to Municipal Credit Analysis (13)
Municipal Rating Policy (13)
Insurance Rating Policy and Analytical Methodology (7)
Implementation of the Marketing Plan (7)
Development of the Media Plan (7)
Rating Policy and Process (13)
Bank Analysis (13)
Survey of Industrial Analysis (13)
Design and Writing of Analytical Reports (13)
How Capital Markets Work (7)
Investment Banking Practices and Techniques (7)
Proposal Writing for Research Projects (6)
How to conduct Research Projects (6)

Supplementing instruction by the CR Advisor, FWA experts providing specialized training in several areas including accounting, municipal ratings and sovereign ratings.

Rating frameworks have been completed for banking, municipals, sugar, steel and food oils. Analysts have gathered data for petroleum refining and petrochemicals, grocery retailing, gasoline distribution, food processing (in conjunction with a rating) with others being selected. The process is an integral part of the training provided by the CR Advisor, and requires substantial amounts of financial, economic and market information for accurate and verifiable results.

The training provided is the most significant contribution to development of the Polish financial system. Fundamental analysis was virtually unknown in the market in 1995, but by virtue of the agency's presence, hundreds of capital markets participants have been exposed to the concepts and methodology employed by rating agencies.

CERA Marketing

From the outset, the project was designed to ensure that the rating agency would be a marketing-oriented concern. This simply means it must know its clients' needs and provide products (solutions) that meet those needs. This is a precondition to success, and is taught in all American business schools. CERA is in virtually continuous contact with its clients and subscribers. Knowing its clients' needs, and providing products that meet those needs are central to its activities. The CERA has as its initial focus the financial markets in Poland. Its marketing plan is designed to systematically

- Identify and segment the market
- Organize comprehensive databases
- Define and describe the needs of key market participants
- Describe the agency products responsive to those needs and the benefits for customers associated with those products
- Serve as a control for the programmed calling schedule for regular client contact
- Outline and produce required marketing literature
- Define media program schedule and objectives

The creation of necessary products was a crucial achievement of the project. Products created and benefits associated therewith are noted in the following paragraphs. These did not exist in Poland prior to the advent of the project.

Rating and Rynek

The bulletin provides comprehensive coverage of financial market activity with specific reference to the fixed income and derivatives markets as they develop. In view of the small size of the market, this is also the vehicle for covering developments in the commercial paper market.

The key sections of the publication include:

- New bond issue ratings and descriptions of unrated new issues (with quality opinions and identification of analytical issues that would define a rating level)
- Calendar of issues announced, recently sold and prospective issues with a high degree of certainty with amounts, terms, covenant summaries, current yield and YTM, underwriters and target investors by type
- Commercial paper calendar listing issuers, program amounts, amounts outstanding, dealers, and details of alternative liquidity (i.e. what happens if the dealer cannot sell new paper to meet maturities)
- An economic commentary highlighting developments in the capital markets, particularly the implications for credit quality, market liquidity and to begin to comment on the pricing context to stress rating correlation's.

A benchmark was set of 1,000 subscribers to CERA publications. This is a long-term objective that sets 100% penetration of the total calculated target market as a benchmark. Based on the experience of other rating agencies, and CERA's pricing strategy, it was expected capital market institutions

would purchase multiple subscriptions for staff. This has not happened and illegal copying is rampant. Actual number of subscribers is over 100, but usage is much higher based on conversations with bankers and others. Production steps are being evaluated to make copying more difficult. It is expected the recast marketing program with defined calling schedules for all professionals instead of just the marketing VP will establish momentum toward this company objective and benchmark. This is the only task order benchmark that has not been met by the agency.

Ratings

Ratings for all types of fixed income instruments were available from the time CERA was established, although as anticipated the early emphasis was on ratings for municipal debt. Issuer ratings were added in the second year. Ratings are also provided for convertible corporate debt, and commercial paper since these are the instruments now appearing in the market. The ratings are determined by the internal rating committee of the agency without participation in the decision by any external body. The exception to this will be future participation by officials of Thomson Financial BankWatch.

Bond ratings are normally applicable to specific issues. In addition to the conclusions of the fundamental analysis, the terms and covenants of the issue have significant bearing on the rating that can be assigned to issues. Commercial paper ratings and deposit ratings apply to the issuing institutions as issuers of short term paper. In addition to the analytical considerations applicable to long term rating assignments, they incorporate an assessment of plans for alternative liquidity.

CERA has completed 30 actual and case study ratings, and another 40 are pending as part of an intensive marketing program.

Municipal Ratings

Ratings for municipal issuers are provided at the request of the issuer or his investment banker. The analytical process, as defined in company's policies, has been presented to municipal financial officers, investors in municipal bonds and intermediaries under the marketing plan.

Corporate/Bank Ratings

Bond ratings for companies and banks are provided at the request of the issuer or his investment banker. The analytical process, as defined in the company's policies, is presented to corporate and bank financial officers, investors and intermediaries under the marketing plan.

Commercial Paper/Deposit Ratings

These ratings are provided at the request of issuers or their dealers. The analytical process and considerations with respect to alternative liquidity are presented to issuers, commercial paper buyers and dealers under the plan.

CERA Reports/Sector Studies

Analytical reports and sectoral studies constitute the core of the value added for investors. In addition to a rating framework offering the opportunity for rational risk pricing on debt, it is imperative the internal due diligence of investors utilize the best information and the most sophisticated analytical techniques available. A Gmina study (municipals) has been published and sold. A sugar study is complete, and others are in process including a survey of the Polish insurance industry.

Bank Risk Handbook

The Bank Risk Handbook is a tool used to support counterparty risk assessment. It consists of the front pages of the analytical reports, and is designed to permit a quick assessment of the position of a potential counterparty to a money market, forex or futures transaction. Currently, it is anticipated the product will be coordinated with Thomson Financial BankWatch, which has similar products.

Agency Analytical Seminars

The seminars are available to banks that desire to enhance staff analytical capabilities for large scale commercial lending and to broaden counterparty risk assessment skills. CERA conducted or participated in at least one seminar per quarter, including participation by the CR Advisor. CERA is cooperating with Thomson Financial BankWatch for bank analysis workshops.

The time lines to permit efficient completion of necessary tasks have been identified for all these products and preliminary schedules prepared, but actual implementation remains the focus of management attention.

Throughout the period of the Task Orders, the CR Advisor has participated in conferences and written articles for publication (at least quarterly) in Poland. In addition, numerous press conferences were held and interviews given by the CR Advisor and CERA managers with input from the CR Advisor. These efforts substantially added to the understanding of ratings, development of a credit culture and the potential for CERA to operate profitably in Poland.

Establishing continuity to ensure commercial viability

Business development must be an on-going, continuous cycle. The CR Advisor worked with CERA management to ensure an appreciation of this fact. A Management by Objectives (MBO) program was introduced with sample schedules and strong recommendations that objectives be *negotiated* with staff members. This is counter to traditional Polish and European practice which stresses hierarchical management with one or two decision-makers. Necessary basic products and services have been created, but the actual marketing effort - meetings with investors, intermediaries and issuers - is not yet fully implemented.

The opportunity is clear. Market activity is accelerating as reflected in Rating and Rynek. There have been more than 100 private placement bond issues by municipalities, corporations and banks.

And there are more than 150 issuers of commercial paper compared with five at the outset. New industries, auto leasing for example, are looking at utilizing ratings for borrowing.

Finally, the participation of Thomson Financial BankWatch, Inc. as a strategic investor ensures the necessary analytical knowledge will be available to support CERA's rating committee, and that the management board will continue to have access to the business principles that foster success in free market economies.

Lessons Learned

The following are some of the issues encountered, which were challenging for the establishment and development of the rating agency, and needed constant attention of the CR Advisor to address:

- Accounting standards and formats limit the ability to recreate the asset conversion cycle
- The residual reluctance to fully disclose information impedes analysis
- The normal (western) link between equity investment and willingness to do business is missing
- As in other markets, survey participants tend to tell the questioner what they want to hear
- The investment decision process is cumbersome, and not stratified to scale
- The ultimate attitude demonstrated by Polish investment bankers is similar to that in the West - "don't bother us."

While the situation is improving, the regulatory chart of accounts does not provide sufficient information regarding asset categories and the components of liabilities to permit accurate forecasting by the analyst. Estimation and arbitrary allocations of balance sheet aggregates result in potential risk for the rating committee as it seeks to forecast future cash flow.

Management of companies is often unwilling to provide details of sales and costs. And they are inhibited by stock exchange requirements regarding accuracy of forecasts, choosing caution to avoid criticism.

Normally, equity investors want to do business with companies in which they have an investment. While this was anticipated for CERA, such a requirement was stricken from the corporate by-laws, and several shareholders have avoided supporting the company with referrals.

The inaccurately positive responses during the initial market survey were alluded to above.

The banks appear to employ the same decision process and board attention for a 50,000 zloty investment in CERA as they do for a 20 million zloty loan. This makes it difficult for entrepreneurial organizations like CERA to raise capital efficiently.

The primary market purpose of a rating agency is to provide a professional, independent and objective quality framework for pricing securities in the market. Some investment bankers consider the existence of such a rating universe a hindrance in pricing as it imposes a discipline they would prefer to do without. This attitude exists in all markets, and can be found in Poland as well.

Opportunities for on-going assistance

The most important opportunities for continuing assistance relate to the systemic issues noted above. While CERA can benefit from additional training in specialized analytical topics such as the proposed FSVC follow-up in structured finance, programs to foster attention to credit quality, full disclosure and international accounting standards would substantially contribute to a safer market. This could be coordinated with Transparency International, directed in Poland by Jolanta Luxmoore.

A second opportunity for assistance lies with the structure of the Local Government Partnership Project. If it is designed to provide funds for rating applications by the municipalities being assisted, it could benefit CERA as well as the local government.

Another opportunity would be assistance with implementation of the marketing program. In essence, this would entail focus on the discipline required to set objectives and maintain an intensive calling schedule for all professionals.