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March 23, 2000

Mr. Mikolaj Lepkowski, USAID
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**SUBJECT: Financial Sector Restructuring and Privatization Services
in the ENI Region, Contract No.: EPE-0005-I-7-5048-00
National Bank of Poland -- Strengthening Bank Supervision:
FINAL REPORT**

Dear Mr. Lepkowski:

Enclosed you will find our Final Report, covering the period of January 1996 through March 1, 2000, encompassing Phase III and Phase IV of the project titled "National Bank of Poland Strengthening Bank Supervision". This report is required by the above captioned contract. We hope this report meets your needs and requirements. We certainly hope you find this report to be meaningful and useful to the mission of USAID.

If you need additional copies please feel free to contact me at 703-747-3248.

Very truly yours,

Barents Group LLC

James E. Horner
Managing Director

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POLAND - NATIONAL BANK OF POLAND
Final Report

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I. EXECUTIVE SUMMARY

This report summarizes the assistance of Barents Group LLC (Barents) to the General Inspectorate of Banking Supervision (GINB), a division of the National Bank of Poland (NBP), as contracted and funded by the United States Agency for International Development (USAID). USAID, through Barents, has provided assistance to the GINB since 1993. However, this Report covers only the time period from January 1996 to January 2000, or Phase III and Phase IV of Barents' assistance. The primary goal of this technical assistance can be best summarized as assisting the GINB to develop, modernize, and strengthen key banking supervision processes. The objectives of this assistance have been to assist the GINB:

- ◆ improve the legal and policy framework in which the banking sector operates and assist with the development of the proper strategic direction of the GINB;
- ◆ strengthen and refine on-site supervision procedures and capabilities;
- ◆ develop processes to administer and resolve problem bank issues;
- ◆ strengthen and refine off-site supervision techniques and monitoring capabilities; and,
- ◆ refine and institutionalize an overall risk-based supervisory approach

This report is written to discuss the tangible results and benchmarks as set forth by USAID. We have also included a brief historical summary of the development of bank supervision in Poland and a brief overview of the major global and regional risks and trends facing the banking industry and banking supervision today.

USAID advisors have effectively assisted the GINB in its efforts to develop, modernize and strengthen key banking supervision processes. The aforementioned objectives have been met and this project has been highly successful in affecting positive change. This is due, in large part, to the dedication to the modernization of the bank supervision of Ms. Sleszynska-Charewicz, the General Inspector of Banking Supervision. The strength and consistency of Ms. Sleszynska-Charewicz, in addition to her loyalty to the goals of the

NBP, has been a strength of the GINB since 1992. Her support, and active use, of the USAID assistance has been the primary cause of a successful project. Barents would also like to acknowledge our partners at USAID who have been consistent, committed, and patient throughout the various phases of this effort. Although the road to success has not always been straight or smooth, the underlying direction and principles of assistance have been consistent.

The cornerstone of Barents' basic approach to technical assistance is to first understand the local banking environment and the individual country's supervisory and regulatory culture before attempting to apply international standards to that environment. Barents advisors have viewed strategies and recommendations in the context of measures already taken by the government of Poland, the National Bank of Poland, the General Inspectorate of Banking Supervision, and others who are directly or indirectly affected by financial sector reforms. However, Barents advisors are also keenly aware of the current trends in globalization and the need for international consistency in a rapidly consolidating financial services sector. Many of the aspects of technical assistance, such as long hours of discussion with the client or research for the client to develop and understand issues relevant to Poland, are difficult to measure.

The GINB has communicated its mission to the banking community and to the various market participants of the banking industry. The Banking Act, the Act on the National Bank of Poland, and a series of prudential regulations are nearing compliance with the European Union expectations. The GINB has accomplished a major reorganization of the headquarters office and added over 200 staff members through inclusion of regional branch employees. A risk-based supervisory process is now in place, including a critical communication link between on-site and off-site bank supervision. Finally, the GINB examiners and analysts are now supported with a set of supervisory tools to perform their role in a more consistent and efficient manner. The following highlights some of the most significant tangible successes achieved by the Barents team during this project:

- ◆ Barents advisors have provided written recommendations and advice to the GINB in the initial drafting and subsequent editing of the banking laws, many banking regulations and recommendations. Advisors also assisted the GINB in their attempt to meet the “25 Core Principles of Banking Supervision” as set forth by the Basle Committee on Banking Supervision. Advisors have assisted the GINB on the understand the complex ramifications of many other Basle Committee documents. Barents advisors also assisted the GINB with meetings with the World Bank, IMF, and other banking supervision agencies and banking groups.

- ◆ Barents advisors and representatives from the United States Office of the Comptroller of the Currency provided advisory assistance to the GINB during on-site examinations of over 20 commercial banks in Poland. These commercial banks, when aggregated, currently manage nearly 80% of the banking assets in Poland. During these examinations, Barents advisors provided guidance in the evaluation of overall bank management and risk management systems, credit risk management, market risk management, and earnings and capital adequacy. Additionally, Barents advisors assisted the GINB with pre- and post-examination activity.

- ◆ Barents advisors assisted the GINB to finalize an On-Site Examination Manual with more than 20 detailed chapters including narrative commentary of the major risk areas of bank operations, examination procedures, and internal control questionnaires. Each of these items were tailored to match the developing banking industry in Poland and the current banking law and regulation. Equally import, the GINB has assembled a highly competent group to continuously update these chapters and ensure the GINB staff is well informed to perform examinations on a consistent basis.

- ◆ The above mentioned On-Site Inspection Manual was used as the basis of a three-week training course that was delivered by Barents advisors and GINB personnel to

nearly 300 GINB employees over the course of this assistance. Further, Barents advisors assisted the GINB in the development and delivery of one-week training courses in advanced credit analysis, foreign exchange risk, advanced derivative products, basic and advanced financial analysis, and information systems and controls.

- ◆ Barents advisors assisted the GINB to develop several supervisory tools, in addition to the On-Site Examination Manual, relative to on-site examinations, including a standard report of examination format, standardized asset quality review information. Advisors also provided written guidance on conducting presentations to bank management boards, loan sampling techniques, and branch review procedures.
- ◆ Barents advisors assisted the GINB to develop a comprehensive policy and procedure guide to be used for an accreditation process, coupled with a 300-question test pool. This process has been approved by the Commission for Banking Supervision and will be used to test the knowledge of GINB staff over a wide range of bank supervision knowledge areas, including major financial and operational risk areas, accounting requirements, and banking law and regulation.
- ◆ Barents advisors assisted the GINB to develop a Uniform Bank Performance Report (UBPR). This complex supervisory tool synthesizes cumbersome bank financial data into a readily usable format that can be used by both on-site examiners and off-site analysts. This tool has greatly improved the efficiency and effectiveness of banking supervision, both from an on-site and off-site perspective.
- ◆ Barents advisors assisted the GINB to develop an automated management information system and electronic storage facility, termed the Executive Summary and Supervisory Profile. The Executive Summary provides the GINB senior management with the most current data on a bank's financial condition, risk exposures, and supervisory plans. The Supervisory Profile is a comprehensive electronic storage

facility for general supervisory information, such as bank organizational structure and ownership, risk management systems, and current issues and correspondence. This supervisory tool marks a cornerstone of a risk-based supervisory approach.

- ◆ Barents advisors assisted the GINB with developing an infrastructure to deal effectively with problem banks. Advisors also assisted the GINB with analysis of restructuring programs for individual banks and for the banking industry.

Again, we would like to stress that these accomplishments would not be possible without the cooperation and dedication of our counterparts at the GINB, the NBP and with our partners at USAID.

II. BRIEF HISTORY OF BANKING SUPERVISION - POLAND¹

A. INTRODUCTION

Early in the transition process, many central banks in Central and Eastern Europe and former Soviet Union countries suffered from constant changes in leadership and lack of clear direction. The transition process for these countries has often started with poor leadership ability of the most senior level of organizations, lack of continuity in management, internal misunderstanding of the mission of a central bank, distrust from the public of the banking system, and general instability of financial markets.

The National Bank of Poland (NBP) began the long road to modernization and reform in 1989. From 1989 to 1992, the reputation and market perception of the NBP mirrored that described above. However, from 1992 forward, stability and steady progress have characterized the banking industry and the bank regulatory system.

B. BANKING INDUSTRY DEVELOPMENT IN POLAND

The two most important legs of the initial transition process are bank legislation and bank accounting. These two areas provide the foundation for the banking industry to grow in a prudent manner. Poland began its reform process and return to capitalism in 1989. Prior to 1939, Poland had a modern central bank and banking system. However, many years of communist rule and a centrally planned economy destroyed the existing infrastructure and eliminated modern banking expertise, especially with respect to lending and understanding of risk. The “Banking Act” and the “Act on the National Bank of Poland” became effective in 1989 and began to radically transform Poland’s banking system.

¹ The primary source document for this section has been prepared using a case study outline designed for use by the Toronto Leadership Centre, Toronto, Canada.

Prior to 1989, the majority of banking activity was channeled through the NBP. In addition to the NBP, four state-controlled, specialist banks operated in the financial market. These banks focused on agriculture (*Bank for Food Economy or BGZ, S.A.*), retail foreign currency savings (*Pekao, S.A.*), domestic currency savings and housing (*PKO B.P.*) and corporate foreign currency and trade (*Bank Handlowy, S.A.*). In addition to these banks, the financial marketplace in Poland included approximately 1,700 small cooperative banks, mostly operating in rural areas and mainly focused on agricultural goods and services.

Under the 1989 banking legislation, the NBP was required to exit the commercial banking business and enter the role of a central bank. As a result, approximately 400 branches of the NBP were separated and transformed into nine regional commercial banks. These nine commercial banks were concentrated in specific geographic regions that made some banks vulnerable to geographical concentrations of credit risk. The thirteen banks mentioned above with the exception of PKO B.P. and the Bank for Food Economy, have now been privatized although the Polish Treasury maintains significant ownership stakes in several. The most recent transfer from state control to private hands was the sale of 52% of Pekao, S.A., the country's largest bank to a consortium made up of *UniCredito Italiano S.A.* of Italy and *Allianz Aktiengesellschaft* of Germany. Most of the thirteen banks mentioned above now have strategic and financial assistance from foreign banks although no single, foreign country has a significant share of the banking assets in Poland. The foreign bank partnerships and financial assistance have improved the level of customer service and overall risk management systems and capabilities and have provided much needed technology to the Polish banking system. Even though risk management capability and consumer service has improved at a more rapid rate with foreign participation in the banking system, this issue is of highly political and public interest.

Starting in 1989, the NBP assumed joint responsibility for licensing banks with the Ministry of Finance. Licensing guidelines were instituted, however these guidelines were

liberal, from a banking supervision perspective. These licensing guidelines were originally aimed at de-monopolizing the banking sector and stimulating competition within the industry, with a view to increasing the quality and quantity of banking services. However, as has happened with many transition economies, the licensing process failed to devote significant emphasis to the “fit and proper” test for new bank managers and owners. By 1992, Poland had 82 licensed commercial banks. The minimum capital required to register a bank was roughly equivalent to \$US 1 million. This minimum capital target has since been raised to the Polish zloty equivalent of 5 million Euro.

The management quality of many of these newly licensed banks was poor, in addition to the minimal level of capital as an offset. This is a further illustration of the difficulties associated with the initial stages of modernization and reform of a banking system. Requiring the National Bank to cease commercial banking operations and license new commercial banks is a relatively easy task. Requiring bank managers and owners, bank borrowers, and other bank customers to learn the concepts of a market based economy and trust the banking system is not a short-term proposition. This involves a significant cultural change. Historically, bank managers received strict instruction from the government regarding banking activities and the National Bank of Poland checked compliance with those instructions. In general, banks in centrally planned economies were merely monetary transfer agents for the government. The central bank’s supervision role was to ensure the transfers were done properly. This is clearly not parallel with operating in a competitive, for-profit environment. Bank lenders were not accustomed to forcing repayment of loans and, likewise, borrowers were not accustomed to repaying loans. In addition, the legal system intentionally made obtaining proper financial information very difficult and enforcement of repayment terms nearly impossible.

As a result of the situation and history mentioned above, many of the executives running these new private banks were not well equipped to do so in terms of knowledge and experience, and a number of new bank executives were unethical. This fact only

worsened the general distrust and lack of respect that the general population had for banks. This situation clearly highlights the need for a strong, competent bank regulatory body thus solidifying the need and purpose of the General Inspectorate of Banking Supervision (GINB).

C. BANKING SUPERVISION DEPARTMENT DEVELOPMENT IN POLAND

Beginning in 1990, the GINB began to put the building blocks of a basic supervision system in-place. In the early 1990's the Central bank, the government and the courts were only just developing a proper understanding of the role of bank regulators and, at that time, the GINB itself was slowly defining its purpose and responsibilities. A common perception of the GINB in the early years was that of a policeman, created to assist the prosecutors and the government in disciplining banks, disclosing fraud, prosecuting criminals and resolving cases of inadequate liquidity and insolvency. This perception began to change starting in 1992. With assistance provided from several outside advisors, the components of a modern banking supervision system began to emerge. These basic components of a modern banking supervision system include²:

- ◆ *an appropriate legal, regulatory and judicial framework;*
- ◆ *a skilled workforce;*
- ◆ *an accurate information system;*
- ◆ *an acceptance by the general public, banking industry and politicians;*
- ◆ *a reasonably independent regulatory structure; and,*
- ◆ *a process of problem bank identification, resolution and orderly withdrawal of bad banks.*

² Excerpts from a speech by Robert L. Clarke at the Seminar on Modern Banking Supervision by the National Bank of Poland and the Warsaw Institute of Banking, December 7, 1996

Legal, Regulatory and Judicial Framework

After 1989, as the movement toward a free market economy accelerated, it was apparent that the existing legal, regulatory and judicial framework, as it pertained to the supervision of banks, was seriously inadequate. Part of the weakness was the fact that the Banking Act of 1989 gave too little power to the regulators. For example, until the Banking Act of 1989 was amended in April 1992, the NBP did not have a right to issue legally binding regulations for banks. In addition, in the early 1990's the legal and judicial systems were not prepared to deal with natural consequences of a new free market such as insolvency, bankruptcy, white-collar crime and insider self-dealing. Even if the provisions of Polish Commercial Code, Bankruptcy Act, and Arrangement Proceeding Act - all of them dating back to 1934 - allowed taking action against an insolvent company, the courts were not prepared to apply them in practice. Additionally, the after-effects of decades of non-commercial application of provisions of the Commercial Code resulted in better protection for debtors than banks. The first petitions for bankruptcy filed by GINB in 1992 created legal precedence and brought real shock to the Polish public who, prior to that point, were not willing to believe that a bank could fail. The first decisions to fail banks were especially difficult and challenging because deposit insurance was not in place. The potentially significant negative consequences of bankruptcies in the banking system, such as decrease in public confidence and runs on banks, were unknown variables at that time.

Reasonable protection of creditors was provided under the 1993 Act on the Financial Restructuring of Enterprises and Banks yet significant problems persisted. These included a slow court process, poor understanding of financial accounting issues in courts, disorganized and incomplete property registries, and the existence of multiple claims on properties due to the inability to perfect liens. These factors, combined with large loan loss provisions that hit banks between 1992 and 1995, led to a cautious approach to lending. The newly adopted Banking Act (August 29, 1997) provides greater legal backing to banks in the area of debt collection, including the use of debt collection agencies and liquidators for asset repossession when borrowers are unable to meet their

obligations.³ Additionally, since 1995, deposit insurance has been offered, although at a level that is less than European Union standards.

Early on in the process, it was clear that many new legal, regulatory and judicial initiatives would need to be undertaken. While the legislation implemented to date brings much of the legal framework for banking in line with minimum European Union standards, OECD membership requirements, and Bank for International Settlements (BIS) guidelines, additional work is required. In particular, the court system will need to be educated on the process of regulatory judgment of excessive risk taken by a bank, and how a regulator should force corrective measures prior to a bank failure situation. USAID advisors have focused considerable attention and advice to assisting the GINB achieve compliance with the EU, OECD and BIS requirements and standards.

Skilled Personnel

Like many businesses, bank supervision is a people business. Attracting, retaining and developing qualified personnel is critical to the overall mission. In the late 1980's and early 1990's Polish banking supervisors did not think in terms of risk and risk management processes. Most of the GINB staff in early 1990's held masters degrees in economics or law and had been employed in the NBP prior to 1989 performing work unrelated to banking supervision. In 1989, GINB employees had a very limited understanding of credit analysis, lending processes, financial analysis and accounting. Remember, at that time, the government dictated bank activity and the strategic direction and mission of individual banks. Therefore, the bank supervision department's primary purpose was enforcing these government directives. Bank supervisors had almost no understanding of managing a for-profit business or understanding risk management systems. Obviously, several changes were necessary.

In order to attract quality people and retain existing staff, GINB employees were allowed training opportunities, increased compensation, and improved physical and technological

³ Excerpts from a Michael Borish and Company report, 1998.

resources. This was necessary for the GINB to be able to attract well educated, young graduates and to keep pace with the rapidly developing banking industry. In the early years of transformation, this compensation scale was competitive with private industry. However, the GINB's current remuneration schedule, based mostly on years of service without proper emphasis on merit-based incentives, offers remuneration substantially below the level graduates would receive if they joined commercial firms (e.g. auditing firms, banks). Compensation continues to be a problematic issue even though Poland now has a larger supply of qualified people in the job market. Merit-based remuneration, a clear career path with accompanying job descriptions and competence requirements, and modern human resource management systems remain areas of needed assistance for the GINB.

USAID advisors, supplemented by other internal and external training programs have assisted with transferring knowledge and enhancing the skill set of GINB personnel. Additionally, the United States Office of the Comptroller of the Currency (OCC) has provided assistance with a variety of specific assignments within Poland. A number of GINB staff also gained additional experience through short-term postings to OCC offices in the United States. In addition, a number of short-term special academic programs for English speaking staff were held at the University of Wisconsin. The process of calling upon other outside experts and exposing staff to international opportunities continues today.

Accurate Information

Bank financial information based on a standardized accounting chart for banks was available for the first time in 1991. The first three years of reports submitted to the NBP clearly demonstrated the limitations of off-site monitoring and the necessity for on-site supervision. In these early years regulatory reporting suffered from delays, inaccuracies, and purposeful window dressing. In addition to assisting with monitoring banks, reporting discipline also introduced bank management to modern accounting and regulatory concepts, such as non-performing loans, specific provisions, accrual-based

accounting and non-accrual of interest or suspended interest. Significant progress has been made with respect to detailed, accurate and reliable information from banks over this period.

The chart of accounts for banks and related central bank reports plays an important role in promoting sound accounting and reporting among banks. With the passage of time, the accounting and reporting system implemented in 1991 became outdated and was no longer a good fit with new developments in banking supervision. With assistance of various advisors and consultants, and with the support of the IMF and the World Bank, GINB developed a new accounting chart for banks and a related reporting system that was much more modern and comprehensive. This was completed in 1995 and automated the submission of reports to GINB.

USAID advisors assisted the GINB to obtain proper information for specific bank supervision purposes. Next, using the information obtained through bank reports, a Uniform Bank Performance Report (UBPR) was developed, also with the assistance of USAID sponsored advisors. The UBPR was fully implemented in 1998. The Off-Site Methodology Unit of the GINB prepares this supervisory tool. The UBPR contains information on all major components of banking activity such as asset quality, earnings, capital, and liquidity. Financial ratios are calculated and presented relative to peer groups and historical trends.

As stated earlier, the initial financial reporting discrepancies and increasing risk in the banking system highlighted the need for an on-site examination process. The overall banking supervision process must blend the on-site examination verification of data and risk management systems with off-site monitoring or corrective measures, financial risk and trend analysis. USAID advisors assisted the GINB to develop an on-site inspection manual between 1993 and 1996 and formulate a comprehensive set of training courses based on the manual's contents. The manual became the primary source of standardized

procedures and practical knowledge on all major components of examination process. The most important shift in on-site supervision was the move from almost a purely legalistic and compliance focused approach, to a risk-based system that focused primary attention on bank risk management systems. The process of improving on-site expertise in GINB's 400 examiners was a lengthy and compressive exercise in which USAID sponsored advisors played a significant role.

With the growing involvement by Polish banks in complex off-balance sheet transactions, further amendments to the Accounting Act and greater requirements with respect to transparency, are considered necessary. Many suggest that more detailed disclosure of non-performing loans and more transparent reporting of risks with derivative instrument exposures is necessary.

Public, Industry and Political Acceptance

Gaining acceptance and credibility of these key stakeholders has not been an easy task, especially in view of the number of problem banks in the early 1990's. The initial bank closures sent shock waves through the banking community. These actions also increased the anxiety of bank customers as well as decreased their confidence in the banking system. However, even though Poland's licensing efforts were characterized as liberal, Poland has not suffered from widespread bank failures as has happened in many other transition economies through the 1990s. Poland has seen less than 20 bank failures and has gradually watched over consolidation in the co-operative banking sector. Of nearly 1700 cooperative banks operating in January 1993, only 902 remain as of June 1999. This is not necessarily a reduction of service to banking customers, but a result of aggressive consolidation. Through consolidation and resulting economies of scale, banking service through cooperative banks is improving.

The 1990s were a difficult environment for bank supervisors. To overcome prior perceptions and launch the new role of a prudential regulatory force which could potentially add value to a banking organization, a series of "outreach" seminars was held

with senior bankers as well as with GINB staff to explain the new supervisory philosophy. While bankers had long complained about provisioning requirements being too strict and the costs of regulatory compliance being too high, many are now more willing to acknowledge that the steps undertaken by the GINB were justified. At this stage, the banks seem to be more motivated to work more closely with regulators in order to introduce better risk management systems.

Independence

Since legislation was first passed in 1989, the National Bank of Poland has had a clear legal basis and mandate to supervise banks. Following the approval of the Banking Act and Act of the National Bank of Poland of 1997, functional responsibility for banking supervision was moved from the National Bank of Poland to a new body, the Commission for Banking Supervision. Administrative responsibility, in terms of personnel management and compensation issues, remains with the NBP. The members of the Commission for Banking Supervision are: the President of the NBP (Chairperson); the Minister of Finance or a delegated representative thereof (Deputy Chairperson); a representative of the President of the Polish Republic; the President of the Management Board of the Bank Guarantee Fund; the Chairperson of the Securities and Exchange Commission, or a deputy thereof; a representative of the Minister of Finance; and the General Inspector of Banking Supervision. Establishing the Commission has been a step toward effective, consolidated supervision of the financial services industry.

Problem Bank Resolution

The banking industry in the early 1990s had a relatively moderate level of commercial banks that would be classified as “problem” banks and a cooperative banking industry that needed drastic consolidation. Since passage of the Banking Act, the NBP has focused on a strategy of finding merger partners for problem banks having tangible value such as branch networks and liquidating banks when a merger partner could not be found. The identification process for tangible value and proper merger partners is highly labor

intensive. The cooperative banking industry has seen the most drastic consolidation, moving from nearly 1,700 separate institutions to just over 900 as of June 30, 1999. This figure is expected to continue its descent.

As mentioned earlier in this report, problem bank resolution is often a delicate process and can be highly political. The bank supervisor must close banks that do not have adequate capital or adequate liquidity, yet must maintain a goal of financial stability. These objectives are seemingly contradictory. However, financial stability is strengthened when weak institutions are allowed orderly exit from the financial system. With clear penalties for poor performance, strong banks become stronger. While closure of an insolvent or illiquid bank may hamper stability in the short term, long term stability will remain intact as stronger, better managed banks will service the legitimate customers.

The GINB has a method of supervising and monitoring problem banks, and in conjunction with the Bank Guaranty Fund, has a well-defined process for resolution of banks including bank liquidations. The GINB has recognized the importance and speciality of this function by forming a separate organization unit to handle problem bank issues. However, the enforcement process remains somewhat untested due to the stability of the Polish banking system and the cooperativeness of the Polish bankers. It should also be stated that the bank enforcement process is not entirely within the control of the GINB. This process stretches to the NBP attorneys and to the court system in Poland.

USAID advisors have assisted the GINB with analyzing problem bank rehabilitation plans and with developing an overall process for problem bank supervision and rehabilitation.

III. DETAILED SUMMARY OF ASSISTANCE *National Bank of Poland, Strengthening Bank Supervision*

Phases III and IV, January 1996 to March 2000

A. OVERVIEW OF TECHNICAL ASSISTANCE

This report is a summary of the accomplishments of technical assistance to the National Bank of Poland (NBP), the General Inspectorate of Banking Supervision (GINB), and the Bank Guaranty Fund (BGF). This technical assistance was funded through the United States Agency for International Development (USAID) in relation to “Strengthening Bank Supervision: Phase III and Phase IV” (hereinafter, the “Project”). The narrative discussion follows the scope of work requirements, and relates directly to the tangible results and benchmarks established for this Project from the period of January 1996 through February 2000.

The underlying goal of this assistance has been to develop, modernize, and strengthen GINB banking supervision processes. The technical assistance provided by USAID, through Barents Group LLC (Barents), is focused on the following key areas:

- ◆ Legal, Regulatory, and Strategic Framework Relative to Bank Supervision
- ◆ On-site Supervision Techniques
- ◆ Problem Bank Resolution Methods
- ◆ Off -Site Supervision Techniques
- ◆ Risk-Based Supervisory Approaches

This report follows USAID’ assistance and accomplishments in each of these areas.

B. LEGAL, REGULATORY, AND STRATEGIC FRAMEWORK RELATIVE TO BANK SUPERVISION

The primary purpose of this element of technical assistance is to assist the GINB with developing an effective organizational structure, communicating the purpose and goals of banking supervision to the outside public, drafting significant banking legislation, and providing general policy and strategic advice when requested.

Phases I and II of the technical assistance addressed the initial stages of the GINB's transition to a modern and more efficient bank regulatory agency. In these phases senior USAID advisors assisted the GINB with significant banking legislation, with developing a strategic mission statement for the GINB within the NBP, and with several initiatives targeted at the proper organizational structure of the GINB. These initial stages of assistance effectively laid the groundwork for further technical assistance in Phases III and IV.

Phases III and IV focused primary attention on the issues of internal and external communication, banking law and regulation, and other ad-hoc advice across a wide range of strategic issues. In the early stages of this Project, USAID advisors assisted the GINB with seminars and workshops for regional offices of the NBP, for other regulatory and government officials, and for the banking community. The focus of USAID assistance changed slightly with a reorganization of the GINB and NBP and with the formation of the Commission for Banking Supervision.

This document discusses USAID technical assistance in the following areas: communication, legislation, strategic development and other ad-hoc requests.

Communication

USAID advisors, including Mr. Robert Clarke, a former Comptroller of the Currency from the United States, focused particular attention in these Phases of assistance on communication efforts. Relative to inward communication, USAID advisors assisted senior management of the GINB with communicating the strategic goals and modern supervision techniques to other departments and branches of the NBP. USAID advisors

also assisted the GINB with outward communication toward the banking community, the general public and with representatives of the banking regulatory agencies from other countries.

The Commission for Banking Supervision (Commission) was created in 1997 and met for the first time in 1998. The Commission is responsible for banking supervision activities, yet delegates most duties to the GINB. The only duties that can not, by law, be delegated to the GINB are licensing of a bank, enforcement actions on banks or individuals, and closing a bank. USAID advisors offered to meet with the Commission upon their request. Advisors prepared a comprehensive summary of USAID technical assistance provided for the GINB and the various advisor's areas of expertise for the Commission's perusal. Although not directly requested to meet with the Commission, advisors have performed certain research and written documents that were provided to the Commission members through senior management of GINB.

The Commission approved a reorganization of the GINB in 1998. After reorganization, the GINB assumed responsibility for many new staff members who had previously been employees of regional branches of the National Bank of Poland. The GINB appointed Regional Coordinators to assist the bank supervision process and perform the role of examination staffing, a role formerly held by NBP Regional Directors.

The new role of the Regional Coordinator changed the Project goals of periodic meetings with NBP Regional Directors to almost continuous discussion and involvement with the new Regional Coordinators. USAID advisors have discussed several aspects of bank supervision with these Regional Coordinators, mostly on an informal basis, since their appointment. The Regional Coordinators have attended the USAID training courses, and all of the Coordinators have worked with advisors in an on-site examination environment. Additionally, USAID sponsored study visits to the United States for five of the six

Regional Coordinators to view aspects of the examination and planning process of the Office of the Comptroller of the Currency.

On several occasions, USAID advisors assisted senior management of the GINB with banking supervision seminars, sponsored by the Basle Committee on Banking Supervision, for senior regulators from many Central and Eastern European countries and other parts of the former Soviet Union. Throughout the duration of this Project, USAID advisors have provided documentation and other technical assistance to GINB management to prepare for seminars of this type. Specialized topics that USAID advisors have assisted include the purpose and mission of a banking supervision, the effects of the Asian financial crisis on bank regulation, the effects of capital controls in emerging markets, interest rate risk management, and liquidity risk management.

Legislation

USAID advisors have provided detailed written and oral advice during the drafting of the Banking Act and the Act on the National Bank of Poland. Mr. Robert Clarke has provided valuable strategic legal advice concerning bank supervision techniques, including developing risk-related regulations and strengthening enforcement powers. USAID advisors have given both formal and informal advice on regulations considered by the Commission, including the following: organizational structure of the GINB, internal and external audit activities, internal controls, on-site examination methodology, foreign exchange limits, capital adequacy guidelines, asset securitization and syndication, and mortgage lending.

Strategic Development

Throughout this project, USAID advisors have provided advice and assistance with organizational issues surrounding the GINB. Advisors have stressed the role and purpose of bank supervision and have assisted the GINB to develop organizational procedures. USAID advisors assisted the GINB with a comprehensive reorganization in 1998. Recently, USAID advisors drafted recommendations concerning potentially threatening

legislation from Parliament in Poland placing restrictions on GINB employees in an attempt to address potential conflicts of interest. This regulation, if passed by Parliament unchanged, could severely damage the retention of employees and the future recruitment process for the GINB.

USAID advisors have assisted the GINB with several issues related to the global financial architecture that have emanated from the Basle Committee for Banking Supervision. USAID advisors assisted the GINB with feedback on proposed changes to the capital accord, Basle Working Groups on bank transparency and strengthening financial systems, and methods of improving consolidated supervision of financial institutions.

USAID advisors delivered a comprehensive review of recommendations in the area of mortgage banking and mortgage finance. The GINB recommendations address, among other items, appraisal methodology for loans issued by mortgage banks. This regulation is somewhat controversial and has been the topic of considerable discussion in the banking and appraisal industry. USAID advisor feedback provided senior management with a summary of the controversial issues surrounding this regulation and offered suggestions for enhancement.

Ad-hoc Requests

USAID advisors assisted a senior attorney of the GINB in outlining a program for a study visit to the United States. To date, direct transfer of knowledge between legal departments of Poland and the regulators in the United States has been minimal. However, legal staff development is a crucial element of effective prudential supervision. USAID advisors worked closely with this senior attorney during a study visit to the United States to assist with understanding of a complex regulatory structure in the United States.

Other items which USAID advisors have provided planned or ad-hoc assistance include:

- ◆ various presentations to other regulatory bodies such as the Financial Services Authority of the United Kingdom, and to other donor organizations such as the World Bank and the IMF.
- ◆ a translation of a World Bank document discussing the effects of foreign bank entry on a domestic banking market and a translation of transparency guidelines from the Basle Committee on Banking Supervision.
- ◆ a presentation relative to a complex merger transaction between strategically significant banks in Poland.
- ◆ an analysis of regulatory issues relative to credit unions in the United States compared with commercial bank regulatory issues.
- ◆ a three-day seminar with examiners from the National Bank of the Ukraine and an attempt to facilitate a similar seminar for the bank supervision authorities from Central Asia and the Caucasus region.
- ◆ an analysis of strategic risks relative to electronic banking and the potential effects of the Internet on the banking industry.

C. ON-SITE SUPERVISION TECHNIQUES

The purpose of this element of technical assistance is to assist the GINB in building a well-trained, consistent, risk-focused examination workforce. This element of technical assistance has been the most labor-intensive element of the Project. Phases I and II of USAID technical assistance focused primarily on developing the basic chapters of an On-site Supervision Manual (“Manual”) and developing formal training courses based on the Manual.

Phases III and IV focused primary attention on implementation of the Manual, application of the concepts learned at various training courses during actual on-site examinations of commercial banks, and developing courses on more specific risks in the Polish banking industry. USAID advisors have assisted the GINB with further amendments and

additions to the On-Site Examination Manual and basic banking supervision courses. Based on more specific risks in the Polish banking industry, advisors have developed and delivered many formal training courses for GINB examiners and have attempted to build the capacity for GINB to continue with training courses independently. USAID advisors assisted the GINB to develop supervisory tools and key policies to increase the efficiency and consistency of the on-site examination process. Advisors have assisted the GINB with human resource budgeting and planning for on-site examinations, including a system of risk stratification of the banking industry. Finally, USAID advisors assisted the GINB to develop an accreditation process that will measure the learning process and knowledge set of examiners, and demonstrates the qualifications of bank examiners to the banking community.

The narrative below discusses USAID technical assistance in these areas: on-site examinations of commercial banks, the on-site examination manual, supervisory tools related to on-site supervision, a risk stratification system, training courses, and an accreditation process for examiners.

On-Site Examinations of Commercial Banks

USAID advisors have assisted the GINB with examinations of 20 large- or medium-sized banks and with an examination of one branch of a foreign bank. This figure is not inclusive of advisory assistance with planning examinations or assistance with examination follow-up if USAID advisors did not attend the actual on-site examination. This figure is also not inclusive of examinations of banks that were subsequently merged into other, larger entities. During Phase IV of this Project, brief summaries of the primary areas of USAID assistance were provided in monthly reports to illustrate the assistance that has been provided. All of the banks, with the exception of the foreign branch, have multi-branch networks in Poland. The assets of these 21 institutions total over 75% of the total banking assets in Poland as of June 1999. Please see the appendix of this report for detail.

The initial on-site examinations with USAID advisory assistance were completed in 1996. The second examination in 1996 marked the first, comprehensive examination in Poland using the On-Site Examination Manual as a guiding document and a standard Report of Examination as the final product. The duration of this second examination was several weeks. Multiple advisors were used to provide daily technical advice in risk-based supervision and analysis of complex banking risks. Four additional examinations, with USAID technical assistance, were completed in 1997. Five USAID-assisted examinations were completed in 1998 and ten examinations were completed in 1999. During each of the years, the scope and duration of the advisory assistance declined with each examination, as did the overall duration of the on-site examinations. This is clear evidence of the GINB's ability to continue this process without assistance in the future.

USAID advisors provided assistance across a wide spectrum of the bank supervision process, from planning the examination to writing a report of findings and designing a proper strategy to supervise the particular financial institution in the future. USAID assistance typically started with assisting the GINB examiners with planning and budgeting human resources for an on-site examination. Advisors also assisted the GINB with proper information requests from bank management and initial discussions with bank management regarding the purpose and scope of an on-site examination.

During the on-site examination process, USAID advisors often assisted the GINB examiners with the most complex areas of bank operations. Above all, advisors assisted GINB examiners with an evaluation of bank management ability and a review of risk management practices. Advisors routinely assisted the GINB examiners in the following risk areas:

- ◆ *Strategic Risk and Financial Analysis:* Advisors assisted with reviews of bank planning processes and an assessment of strengths, weaknesses, opportunities and threats. Advisors assisted the GINB examiners with analysis of income and capital

trends and planning tools. As a compliment to GINB examiners' verification of the quantity of bank earnings and capital funds, advisors assisted with verifying the quality of earnings and capital.

- ◆ *Credit Risk:* Advisors were often particularly useful in analysis of large, complex syndicated credits, or other large international credit facilities. Advisors assisted with formulation of loan discussions with senior management and with interpreting international standards and practices for lending.
- ◆ *Market Risks:* Advisors assisted GINB examiners with analysis and understanding of a bank's core funding base and how these funds are re-deployed as income-producing assets. Market risks include a bank's risk to foreign currency movements, interest rate movements, and a review of the bank's risk to a liquidity crisis. USAID advisors assisted GINB examiners in reviewing the bank's treasury function and dealing operations, including analysis of complex derivative products and trading strategies.
- ◆ *Operational Risks:* Advisors have routinely assisted the GINB examiners with a review of overall risk management and internal control systems, including an evaluation of the bank's internal and external audits. Related to operational risks, advisors assisted the GINB with an evaluation of Y2K risk during selected on-site examinations.

Throughout the examination process, USAID advisors assisted the GINB examiners in meetings with senior management and prioritization of key issues and risks. Following the review and analysis portion of the examination, advisors assisted GINB examiners to prepare for a conclusionary meeting with the management board of the bank, to write a concise and consistent report of examination and to draft a letter of recommendations to the bank. Finally, advisors helped the GINB examiners to design a supervisory strategy and to outline the most effective on-site and off-site supervision techniques for the particular bank given its complexity and risk profile.

On-Site Examination Manual

Twenty chapters of the On-Site Inspection Manual were drafted during Phase I and Phase II of USAID assistance to the GINB. During Phases III and IV, advisors assisted with editing the final version of various chapters in more complex areas of bank operations. Most importantly, advisors worked closely with members of GINB staff to ensure that the GINB could independently update existing chapters of the Manual and draft new chapters when necessary.

During the early periods of this Project USAID advisors worked closely with members of the GINB to revise the Manual and ensure the Manual matched the current conditions and risks in the Polish banking environment. USAID advisors drafted a new chapter of the Manual in the area of real estate lending during 1999. Additionally, advisors have assisted the GINB with outlines of chapters related to leasing and related to operational risk and data processing systems and controls.

During August of 1999, the GINB's On-Site Methodology Unit began a comprehensive update of all chapters of the Manual. USAID advisors have assisted with this review. However, this initiative is lead entirely by the GINB. The On-Site Methodology Unit is fully capable of updating the Manual independently. This Unit has effectively and efficiently used external sources of information in this process. On-site examiners are being used to provide feedback for necessary amendments and the examiners recognized as experts will be reviewing the final versions of the chapters for completeness and practical application.

USAID advisors submitted a proposal for a program to simultaneously review and risk rate large, syndicated loans in Polish banks. GINB senior management provided positive feedback regarding this concept and process. However, this process is quite complex and requires a significant outlay of planning resources and ongoing management. This program may involve creating one to two additional full time equivalent persons in GINB

headquarters. USAID advisors have volunteered assistance with this process, if performed during the technical assistance program.

Supervisory Tools Related to On-Site Supervision

As stated earlier, USAID advisors have assisted the GINB with 21 on-site examinations during Phase III and IV of this Project. This figure is exclusive of examinations of banks that have merged with another bank since the GINB examination date. Adding these banks to the total of examinations would increase the number of USAID assisted examinations to 24.

With each examination, Barents advisors have assisted in writing a report of examination, formatting working papers, using the UBPR, and completing a Supervisory Profile (the content and application of the Supervisory Profile will be discussed later in this report). The following highlights the examinations where Barents advisors specifically assisted with developing new, or enhancing old, supervisory tools. Each of these items is designed to ensure a more consistent and more efficient examination process.

Examination Request Letter: USAID advisors assisted the GINB to develop a standard request letter for on-site examinations. GINB examiners have used this standard request letter at every on-site examination. As this process has evolved and the GINB has gained more knowledge of individual banks in Poland, the examiners are now tailoring this request letter to the specific risks in a bank's operations.

Report of Inspection: USAID advisors assisted the GINB to develop a standard report of inspection for on-site examinations. This document ensures that each bank receives a consistent, logical flow of information following an examination. Advisors have also assisted the On-Site Methodology Unit to amend this standardized format to match the changing examination process.

Asset Quality Review Sheets: USAID advisors assisted the GINB to develop a standard asset quality review sheet, primarily for reviewing credit facilities at a commercial bank. This document ensures that examiners are looking for and reviewing similar information

from each borrower. Advisors have also assisted the GINB to develop a specialized asset quality review sheet for a non-traditional loan portfolio. Again, advisors have also assisted the On-Site Methodology Unit to amend this standardized format to match the changing examination process.

Working Papers: USAID advisors have not recommended a standardized format and referencing system for all working papers of an on-site examination. Advisors have, however, advocated a system of providing an audit trail for conclusions reached during each examination.

Capital Adequacy Matrix: USAID advisors developed a capital matrix that provides GINB examiners with a consistent method of evaluating a bank's capital position taking into account the inherent risks of the particular bank. This will also provide a consistent methodology for conclusions, and should be particularly useful in evaluation capital adequacy of a problem bank.

In addition to these supervisory tools, USAID advisors have drafted policy statements discussing:

- ◆ planning and organizing an examination to improve the efficiency;
- ◆ proper loan sampling and branch review techniques for on-site examinations again to improve efficiency; and,
- ◆ organization and content of meetings with management board members following on-site examinations.

The GINB senior management team is currently discussing adoption of these documents for all future on-site examinations.

Multi-Period Planning Process for On-Site Examinations

USAID advisors assisted the GINB to develop the necessary infrastructure to perform multi-period planning for on-site examinations. The necessary infrastructure for an

effective multi-period planning process references several elements of technical assistance.

USAID advisors drafted a proposal to the Director of On-Site Supervision containing a definition of a supervisory cycle for commercial banks and cooperatives in Poland in 1998. The supervisory cycle is defined as the time period between full-scope on-site examinations, including the most recent examination time. Adoption of this concept is fundamental to the success of a multi-period planning process. Advisors recommended this as the basis for a multi-year examination schedule. The proposal stratified the banking industry into three supervisory cycle groups based on a combination of factors including systemic risk (generally based on size and complexity of products) and banks with individual risk (CAMELS rating). The supervisory cycle should be lengthened or shortened based on those factors.

GINB senior management reviewed the supervisory cycle proposal and has amended the recommended supervisory cycle for its internal usage. The vast majority of banking assets are supported by an on-site examination report and have an approved risk stratification recorded. Additionally, the GINB appears to have an appropriate staff size to adopt the supervisory cycle concept. However, the examination staff is young and many staff members lack experience in complex areas of bank operations. Additionally, the examination process needs to improve in terms of efficiency for the supervisory cycle to take full effect. As a result of these factors, GINB management has been resistant to adopt a multi-year planning process. Nonetheless, advisors have advised the GINB On-Site Planning Unit on the planning process and the proper tools that are necessary to perform multi-year planning throughout this Project.

USAID Advisors assisted the GINB to build an automated document that would store all pertinent information about a bank's condition and its major risks. This automated document is termed the Supervisory Profile. More detail on the Supervisory Profile is

located in the Risk-Based Supervisory Approach section of this report. Advisors provided formal and informal training on usage of the Supervisory Profile to GINB staff and to senior managers. The Supervisory Profile collects data on historical and projected workdays for on-site examinations. This data is necessary for the on-site examination scheduling process.

To complement assistance in this area, USAID advisors planned and coordinated a training mission to the United States for several senior members of the GINB On-Site Examination Unit. The training mission included three Regional Coordinators of the GINB On-Site Examination Unit. These Regional Coordinators are integrally involved in the on-site examination planning process. The examiners worked for two weeks on an actual on-site examination with representatives from the Western District of the Office of the Comptroller of the Currency. These examinations focused particular attention on the planning process and the overall examination management function. This training should assist the GINB with implementation of the multi-year planning function.

Risk Stratification System

USAID advisors delivered a draft policy and guidelines for a rating system (similar to the “CAMELS” rating system used by United States regulators) to GINB management in 1997. The GINB examiners have practiced using CAMELS to form the basis of a bank’s overall condition since 1997. This rating further serves to stratify the banking industry and is used to determine the need for follow-up activity. Following each examination of a commercial bank, advisors have formally discussed the risk ratings of the institution and future supervisory activity with respect to this risk with GINB examiners based on that rating. This process has been the cornerstone of the basic bank supervision training course and also an integral part of financial analysis and training courses.

USAID advisors have worked closely with the On-Site Methodology Unit to formulate a formal risk rating policy throughout 1999. The most difficult part of this process has been establishing risk ratings for a bank’s sensitivity to market risks. Advisors worked closely

with the GINB staff to formulate procedures and analytical tools on this component to review sensitivity to foreign exchange, interest rate, and price risks. This policy was formally approved and issued to examiners in September. The policy includes the proper approvals needed to initiate composite and component ratings and how changes are made to risk ratings.

Training Courses

Please see the appendix of this report for a comprehensive listing of all training courses delivered during this Project. The following highlights the training courses and delivery dates for courses that are primarily relative to on-site supervision. Other courses are discussed in other sections of this report.

Basic Bank Supervision Training Course:

USAID advisors have completed eight, three-week lectures regarding core bank supervision techniques (“Manual Course”) to over 220 examiners through the end of Phases III and IV. Adding this to the approximately 75 examiners who had already attended the course in Phase II of USAID technical assistance brings the total to nearly 300 examiners. USAID advisors have continuously amended each section of the training modules to be consistent with banking law and regulation, current practice in Poland, and with international standards.

Specialized Training Courses:

While USAID advisors continued to update the basic bank supervision course, advisors also developed and delivered more specialized training courses, in the areas of foreign exchange risk, advanced derivative products, advanced credit analysis, and information technology.

USAID advisors developed and delivered a one-week course regarding foreign exchange risk in January 1997, in January 1998, and again in October 1998. These three courses

totaled 60 participants. In addition, advisors provided a one-day “refresher” course to the examiners before an on-site examination in early 1998. Advisors also developed and delivered a course entitled “Derivative Products and Advanced Foreign Exchange Risk Management” in July 1999. This course was unique in the sense that it included several presentations from Polish commercial banks.

USAID advisors have delivered a one-week course in advanced credit analysis in December 1997, May 1998, December 1998, September 1999, and January 1999. Finally, advisors delivered two one-week courses titled Information Technology Systems and Controls in March 1999. This course also devoted time to an overview of Year 2000 risk.

This is a total of eleven one-week training courses on specialized topics, eight of which fell under Phase IV of the Project. This listing does not include several, specialized, short-term training sessions designed by USAID advisors, with duration of less than one week that were developed as a result of a specific GINB request. Short term training courses included analysis of subordinated debt instruments, asset securitization, bond valuation and yield analysis, and introduction to the time value of money. Again, a full listing of training courses offered and a brief description of each course can be found as an appendix to this report.

Instructor Training Course:

A one-week course was developed during this Project to provide guidance to GINB selected employees on methods of training course instruction. The first train-the-trainer course took place during January 1999. This was delayed on several occasions from 1997 due to incomplete selection of candidates, and pending the new organizational structure of the GINB. Twelve employees of GINB attended the train-the-trainer course in January. The employees were separated into three groups and the groups were assigned to session one, two, or three of the On-Site Manual Course. Many of these individuals attended and observed these course sessions in the first half of 1999. Barents advisors provided

informal advice to the future trainers throughout the courses they attended. Certain GINB examiners taught portions of the Manual Course in the latter half of 1999 with guidance from resident advisors. A second group of employees was selected to attend the train-the-trainer course in the fall of 1999. However, due to scheduling conflicts with on-site examinations, this course was canceled. Advisors offered, on several occasions, to deliver this course again yet it was not rescheduled. This being said, several of our local counterparts have already taught sections of core bank supervision techniques in the areas of interest rate risk analysis, credit analysis, and financial analysis. The GINB now has a complete training program with various levels of difficulty and specialty knowledge that ties directly to the accreditation process. However, the train-the-trainer objective of this assistance has not been a complete success. Several factors have contributed to this conclusion. The most prominent factor seems to be a general view that training is an external process and function. Management has not expressed a willingness to allocate time to staff members to prepare to deliver training courses. Also, senior management's top priority for resource utilization has been on-site examinations rather than training development. In summary, senior management has difficulty with the organizational tradeoff of the best examiners are also being targeted as the best instructors.

Please see the appendix of this report for a listing of training courses that have been developed and delivered by USAID advisors for the GINB.

Accreditation of Examiners

USAID advisors met with GINB senior management in the third quarter of 1998 to discuss the accreditation process for GINB examiners. Following this discussion, advisors delivered a comprehensive recommendation for the GINB Accreditation Policy. This recommendation covered administration of the accreditation process, responsibilities, and general job descriptions.

During the first quarter of 1999, USAID advisors delivered a set of 150 questions to Regional Coordinators as a pilot for proper format and general content. Based on

feedback from the Regional Coordinators, advisors amended the current set of questions and another 150 questions were added to the sample set, bringing the total to 300 questions. The primary source materials for the accreditation test are: the Banking Act, the Act on the National Bank of Poland, regulations on accounting, asset quality, capital and foreign exchange, and the On-Site Examination Manual training courses.

In addition to developing test questions, USAID advisors continually discussed the policy for this process with GINB management. The accreditation process touches several other areas of GINB organization, such as examiner job descriptions, career paths, training needs and plans, and the GINB organizational chart. Advisors discussed each of these areas with GINB management. However, due to personnel policy regulations and rules applicable to all staff members of the National Bank of Poland, many recommendations are not easily implemented.

Barents advisors assisted the GINB with revising the final Accreditation Policy for GINB in the third quarter of 1999. The Commission for Banking Supervision approved the comprehensive policy for the accreditation test in the fourth quarter of 1999. Another pilot test of 6 examiners took place in November of 1999. This second pilot test determined the approximate time needed for the examination and to test administrative controls. Additionally, advisors made further amendments to test questions that proved to be too difficult or where wording needing to be clarified. The accreditation testing process will begin during February of 2000 and continue throughout the year.

D. PROBLEM BANK RESOLUTION METHODS

Barents senior advisors have discussed issues related to problem bank supervision and resolution with members of GINB senior management on several occasions. Advisors also discussed these issues with senior management of the Bank Guaranty Fund. This element of technical assistance has not received a high degree of focus and attention

during this Project. USAID advisors have not, however, ignored the issue of problem bank supervision and resolution. Poland has had the luxury of a relatively stable banking environment. During a period of relative stability is often the optimal time to build systems, processes and regulations to deal with problem banks. To this end, USAID advisors have provided GINB management with considerable advice. All Barents advisors have worked closely with GINB management and examiners to ensure proper follow-up to issues discovered through on-site or off-site information. Advisors have also provided diagnostic assistance and consultative input to the problem bank resolution process for individual banks and the banking industry, as a whole.

Early in this Project, USAID advisors provided assistance to the GINB relative to restructuring of the cooperative banking sector. The GINB has been successful in reducing the number of cooperative banks from over 1,600 in 1994 to only 902 as of June 1999. USAID advisors provided assistance to the GINB staff in reviewing restructuring proposals of individual commercial and cooperative banks and with analyzing the restructuring programs industry-wide. Advisors also assisted the GINB to develop standard internal reporting formats for problem banks. This improved the consistency of treatment for these banks.

To form a more orderly process of problem bank supervision and rehabilitation, USAID advisors met with the GINB Special Supervision Unit (problem banks) in 1998 to discuss various needs and organizational changes. Following this meeting, a sample enforcement policy was drafted for the problem bank unit. The draft policy was written to be compatible with existing bank legislation and tied directly to risk and risk ratings of banks. However, Polish interpretation of legislative provisions necessitated that USAID advisors make substantial changes to this policy. The initial draft policy was prudential-based and Polish legislation and interpretation is more aligned with a numerical-based system.

Given this, USAID advisors significantly revised the policy document and delivered a comprehensive presentation on problem bank management to several members of GINB management, including key department managers for Legal, Supervisory Policy, On-Site Supervision and Special Supervision (problem banks). The presentation included the following items, all developed by USAID advisors:

- ◆ a sample enforcement and bank rehabilitation policy;
- ◆ several examples of prudential-driven enforcement actions based on actual problematic situations in Polish banks;
- ◆ a proposed recommendation for a regulation addressing capital-driven enforcement actions; and,
- ◆ a recommended management committee structure for GINB to recommend enforcement and rehabilitation actions to the Commission for Banking Supervision.

These documents were later edited and delivered to the GINB senior management for their perusal and commentary. This area of assistance should be continued in future technical assistance to the GINB.

E. OFF-SITE SUPERVISION TECHNIQUES

The initial stages of this Project focused on accounting issues and later focused on building and implementing a sophisticated supervisory tool enabling the GINB to better perform off-site financial analysis of banks. A modern bank supervision process must have both on-site verification of data and risk management systems and controls, and off-site monitoring of data and risk trends. The off-site supervision portion of this Project focused primarily on financial data, while the risk-based supervisory approach portion of this Project focused on non-financial data and linking the on-site and off-site supervision processes together.

Bank Accounting

USAID advisors supported the GINB in modernizing financial reporting through a wide range of activities, including developing financial report schedules (“Call Report”), drafting report instructions, and testing reports. Advisors also assisted with the development of an interface module (“WEBIS”) to facilitate data transfer from banks into the Central Data Base at the NBP.

The Act on Accounting and an NBP regulation on detailed accounting principles for banks, together with the regulation on the establishment of model chart of accounts, paved the way for development of reporting and analytical systems with a view to modernize methods of supervising Polish banking system. USAID advisors provided assistance in the areas of bank accounting. Particular emphasis was provided on the development of reporting schedules on securities, separating the securities into two accounting portfolios “held to maturity” and “ trading” and assisting the GINB in developing a set of instructions for different valuation and accounting methods of these portfolios. Advisors also supported the GINB in designing Income Statement Schedules to facilitate yield and cost analysis.

The system of bank supervisory reporting introduced by the NBP in January 1997 allowed a more uniform and transparent picture of bank’s financial condition. However, due to the volume of data, the new reporting did not allow analysis of banks in a systematic manner. In order to provide the GINB with a tool for effective method for financial analysis, USAID advisors assisted the GINB in developing a supervisory tool to sort raw data from a bank’s financial report in a meaningful manner.

Uniform Bank Performance Report

The major product of this area of technical assistance has been the design, development, testing and implementation of the Uniform Bank Performance Report (“UBPR”) and a UBPR User’s Manual. This supervisory tool allows the GINB to perform off-site analysis of banks between the on-site examinations. The UBPR forms the basis of a uniform

approach to the evaluation of banks financial condition and trends in financial performance.

The UBPR is based on the information collected from banks and housed at the NBP central database. The report contains over 750 values and financial ratios designed and presented in a way that provides a comprehensive view of a bank's financial performance. The UBPR also presents peer group data allowing analysis of other competitor institutions. The peer group selection methodology groups banks using the basic criteria of asset size and number of branches.

The UBPR presents bank ratios and values across various time bands allowing analysts to observe trends and changes in banks financial condition. On the basis of the UBPR methodology, analysts are able to review a bank's present financial condition and make predictions about future trends. This tool is also helpful during on-site inspections in an examiner's review of earnings performance. To a limited degree, this tool also facilitates early problem detection at individual banks and across the banking system.

During the fourth quarter of 1999, USAID advisors delivered a summary of suggested amendments and changes to the UBPR based on feedback from on-site examiners. The examiners actively use the UBPR in the on-site examination process and have suggested several changes to enhance the readability and effectiveness of the supervisory tool. The GINB Off-Site Methodology Unit will be responsible to evaluating these suggestions and making appropriate changes to the UBPR.

USAID advisors assisted the GINB with formal presentations regarding the bank financial report and the UBPR to the banking community, local universities, and to other regulators and various conferences. The GINB shares the UBPR with commercial banks. This concept places Poland at the forefront of many developing countries.

Accounting, UBPR and Financial Analysis Training

After the introduction of new financial report for banks, USAID advisors conducted several training sessions on the new report and its underlying accounting rules. Advisors also taught GINB analysts and examiners about design, content and verification of the new financial report schedules. The scope of these courses was enlarged by basic ratio analysis techniques. These formal and informal training sessions were designed to prepare the analysts for the introduction of the UBPR to be used as a basic off-site analytical tool.

USAID advisors assisted the GINB with formal classroom training sessions in regional GINB locations to introduce the UBPR concepts and methodology. These sessions were held in Krakow, Gdansk, Lublin, and in Poznan. The number of participants for these courses totalled 70. The course was also taught to nearly 70 additional newly hired GINB employees in the GINB headquarters office. USAID advisors also conducted several UBPR training sessions for over 40 cooperative bank analysts and examiners. These latter training sessions paved the way for introduction of the commercial bank UBPR to be used for cooperative banks as well.

USAID advisors also developed a more formal course on advanced financial analysis techniques. This course carried the basic UBPR analysis techniques to a higher level, incorporating time value of money concepts and case studies to apply UBPR analysis findings to risk ratings and supervisory strategies. This course integrated the concepts of completing an Executive Summary and Supervisory Profile based on this review of financial data. This advanced course was delivered on six occasions in various locations to over 100 participants. Please see the appendix of this report for a listing of training courses that have been developed and delivered by USAID advisors for the GINB.

As part of the reorganization of GINB, the Off-Site Methodology Unit was formed and assumed responsibility for the UBPR and the Supervisory Profile. Members of this newly

created Unit also played an active role in the development of the UBPR and Supervisory Profile as supervisory tools and actively participated in training events mentioned below.

F. RISK-BASED SUPERVISORY APPROACHES

This element of the Project ties together many of the elements mentioned above. On-site supervision is not effective without quality off-site analysis, and vice-versa. In this element, USAID advisors have attempted to bridge the gap between these two functions to allow an effective, risk-based supervisory process. The primary products in this area are the Executive Summary and Supervisory Profile.

The Executive Summary report is a senior management information system. The GINB off-site analysts complete this form in a manner that would allow members of the senior management team of the GINB to gain a quick overview of a bank's financial condition and the most important risks, in priority order, that face the particular bank. Each bank is assigned a risk rating that allows a consistent format for stratifying the bank's risk position relative to other banks in Poland. This should correlate with the resources needed from the GINB to properly supervise the systemic risk, and individual risk, that the bank presents.

The first page of this report is quantitative in nature and contains summary of information from the Supervisory Profile, the UBPR and other sources. The final two pages contain the quarterly risk analysis comments and supervisory strategy. The information contained on pages two and three are extracted from the Supervisory Profile report.

The Supervisory Profile Report contains more detailed information than what is shown in the Executive Summary. The Supervisory Profile is an electronic warehouse of information to cover the risks that each bank represents, the financial condition of the

bank, organizational and branch structure, ownership, regulatory history, current events, etc. The Supervisory Profile is designed to be an electronic warehouse with some sorting and reporting capabilities.

USAID advisors assisted the GINB and NBP to design a framework to integrate the quantitative section of the Profiles with financial information from the UBPR. Advisors worked closely with senior GINB management and with the Information Technology Unit of NBP on the design and expectations of the Supervisory Profile. These discussions focused on the primary information that is needed by management to understand the current financial condition and basic risks associated with a commercial bank and a database that can be used to obtain this information quickly and easily. From these extensive discussions, a framework for combining the narrative analysis and financial description of each bank was completed in addition to an Executive Summary for senior management.

The qualitative integration of the Supervisory Profile and Executive Summary began in earnest in December 1998. Several meetings were held with the GINB information technology experts, department heads, and senior examiners to better understand the criteria for completing the Profile and to outline responsible parties. The GINB Information Technology Unit then obtained a firm understanding of the purpose and function of the Profile in the bank supervision process.

USAID advisors completed a User's Manual for the Supervisory Profile and Executive Summary in December 1998 containing instruction, analysis hints, and practical examples. In March 1999, advisors delivered the first sessions of formalized training on the Supervisory Profile for the primary users. This course was delivered to a second audience of primary users in May 1999. All off-site analysts and representatives of the cooperative bank team attended these courses. The training sessions answered many of the questions and concerns of the analysts and served as a large stride forward in the

Supervisory Profile implementation process. From that point forward, advisors provided ad-hoc advice to analysts and examiners.

The Supervisory Profile has become an integral part of the GINB supervisory culture. Its usage as an efficient management information system will improve through additional usage and acceptance. Supervisory Profiles have been completed for all commercial banks in Poland. USAID advisors have provided assistance to the GINB and the NBP to revise and automate the Supervisory Profile. The programming and automation of the Profile by the NBP programmers was completed in the second quarter of 1999. A significant portion of the Supervisory Profile addresses supervisory strategies for individual banks. The strategies will form the base for the GINB Planning Unit and scheduling of examinations.

Similar to the UBPR, as the Executive Summary and Supervisory Profile have been in use for nearly a year, GINB management is revisiting certain portions of its content. USAID advisors have assisted the Off-Site Methodology Unit with these revisions.

G. PROJECT MODIFICATION RELATED TO YEAR 2000 RISK

The USAID advisors requested and received a modification to the existing task order to assist the GINB with analysis of the banking industry relative to Year 2000 risk. Although this topic was tangentially covered in the existing contract by mention of assistance with electronic data processing issues, the contract did not specifically address Year 2000 risk. At the time of contract finalization, the magnitude of this problem was not anticipated. However, given the potential damage that Year 2000 risk could have caused to the banking industry, advisors desired to assist the GINB through a subcontract relationship with a firm that specialized in this field.

USAID advisors assisted the GINB to stratify the Polish banking industry into similar groups based on size and business risk. Advisors then assisted the GINB specialists assigned Year 2000 risk to develop a questionnaire for each of these groups to assess Year 2000 Risk. After receiving responses, advisors assisted the GINB with an individual analysis of strategically significant banks and the banking industry.

USAID advisors assisted the GINB with prioritization of risk and assessment of year 2000 preparedness. The GINB used this information to design examination strategies and areas of focus for Year 2000 examinations. Additionally, this information was used for various meetings and presentations to media groups in Poland. Advisors met with members of the Commission for Banking Supervision and with several members of the senior management of the GINB to discuss this topic.

H. LESSONS LEARNED

The following discusses several of the critical “lessons learned” through this assistance to the NBP and the GINB. These comments are intended to be constructive in nature and not a criticism of any shortcoming on the part of the NBP, the GINB, USAID advisors or USAID.

Human Resource Management

The GINB, like many governmental entities in transitional economies, lacks many critical elements of modern-day human resource management. For instance, employees do not have a clear career path; a merit-based system is not commonly used for promotions; training is primarily considered an external function; and internal communication channels are mostly informal and often inconsistent. These issues have been further highlighted during the reorganization of the GINB. The reorganization changed the number and location of employees from approximately 100 personnel mostly located in Warsaw to approximately 400 personnel located in nearly forty cities. The issue of

modern human resource management has hampered technical assistance in several of the elements of this Project such as the multi-year planning process, the accreditation process, and instructor training.

To realize the effectiveness of these areas mentioned above, USAID should consider human resource management as a critical element of future technical assistance. This element would include an analysis of existing processes and systems with an eye toward removing obstacles for advancement to modern-day human resource management. The technical advisor would issue initial recommendations for advancing human resource management systems and assist the client with this implementation. Examples of potential deliverable products are: a recruiting method for new employees, a formal and reasonably transparent career path, merit-based performance management system, an interactive training needs analysis system, and a training policy and program covering both internal and external training needs. Additionally, a highly useful tool would be an automated human resource planning system or staffing model that not only plans on-site examinations, but also includes allocations for training, annual leave, special projects, and administration. Each of these items would be based on the employee's position in the client agency and demonstrated expertise and experience.

Legal Assistance

USAID advisors have provided considerable legal assistance to the GINB with regard to significant legislative changes. Temporary advisors can provide assistance with major articles of legislation, if consistency of the advisor is maintained. USAID advisors have not provided the GINB with significant technical assistance in daily application of legislation, organization of a bank regulatory law department, or enforcement of laws and regulations. This type of assistance requires a resident advisor.

Further, technical assistance would be useful in the Polish court system with educating and training judges on banking issues. From hearsay alone, the reforms in the Polish legal

system go well beyond training. However, training on banking issues is a necessary part of legal process reform. Emphasis must first be placed on the banking regulator's ability to identify instances of excessive risk or unsafe and unsound risk management. After this is achieved, legal reform can begin to assist the regulatory body with enforcement measures.

This type of legal reform technical assistance would emphasize the purpose and mission of a banking regulator and the method and logic of enforcement decisions. While USAID technical assistance has given the GINB the ability to recognize problems and determine their problem cause, the legal staff and the court system are hesitant to properly enforce correction of potentially unsafe and unsound banking practices. The legal staff and court system often prefer to wait for significant operating losses in banking operations. This is quite often too late to correct the problematic situation. USAID assistance with the legal process would be beneficial to ensure the next step relative to enforcement of safe and sound operating practices.

Ownership of a Financial Reporting Database

During the initial stages of designing of a central database for the NBP, advisors promoted development of one, common database containing all the information gathered from the financial institutions to be used by different departments of the NBP for different analytical purposes. The basic reasons for this approach were threefold. First, this avoids onerous and duplicative reporting by banks to individual departments of the NBP. Secondly, proper internal control of confidential information is more easily accomplished with one, centralized database. Lastly, this approach seemed to remove a source of interdepartmental tension created by constantly reconciling differences in financial information. However, based on experience with the database, advisors have concluded that despite these advantages it might have been wiser to take a slightly different approach to building a supervisory database for the GINB. While consolidated reporting should

generally continue to be emphasized, departments must be allowed to create individual reports. This issue may or may not carry forward to other countries.

Currently, the GINB lacks flexibility with requesting and maintaining certain information for a bank supervision purposes. The dynamic development of financial institutions, constantly adding new products and developing new areas of operations, requires the GINB to revise its reporting requirements on an on-going basis to evaluate new areas of operations and ascertain the risk associated with them. Introducing changes to the existing financial report schedules requires extensive interdepartmental consultations and approval of the NBP management board. This is a time consuming process, especially since other departments exhibit low level of appreciation of reporting need for risk based supervisory approach.

Another critical issue that illustrates the need for separate databases, particularly in Poland, is a conflict between gathering information for money supply and for bank supervision. This has resulted in financial reports that only capture domestic data from banks, leaving aside any financial data from foreign affiliate operations of a bank. This is a weakness in the GINB's efforts to promote consolidated supervision.

Another important consideration is the frequency of reporting. The GINB only needs quarterly financial data from banks. The NBP receives information monthly and has denied the GINB's repeated requests to ease regulatory burden on banks and reduce the reporting frequency.

As a potential solution to this difficult issue, we might suggest an external committee structure for bank financial reporting. Although politically difficult, this process might be easier to overcome if a committee was formed with a member from the monetary policy unit of the NBP, the bank supervision department, the foreign exchange department, two external auditors, and a representative from the Polish Bankers Association.

Senior Management Interaction with Counterparts in the United States

Senior management acceptance of concepts is obviously a critical element of success to any technical assistance project. During USAID's technical assistance at the GINB, senior management was supportive of our efforts to build modern, risk based supervisory approach for the GINB. Management visits and study trips to other supervisory institutions played an important role in this acceptance building process. This was particularly visible after visit by the General Inspector to the Office of the Comptroller of the Currency, Federal Reserve, FDIC and OFHEO. While we fully appreciate direct and indirect costs involved, including translation for senior managers who do not speak the relevant foreign language, sponsoring and facilitating senior management visits proved to be a valuable investment. USAID advisors have routinely participated in formulating agendas for such visits using the opportunity to structure them in a way to demonstrate practical concepts and methodologies.

Interaction and Cooperation with USAID Partners

Periodic interaction and cooperation with other USAID technical assistance providers is important to a country's overall technical assistance program. USAID advisors to the GINB cooperated with other firms providing help to Polish financial sector. This cooperation proved beneficial to all clients, especially to the NBP. The synergies resulting from cooperation between other technical assistance providers allowed optimal and unique assistance to the GINB and the NBP. This approach is to be encouraged in other countries because in addition to the obvious benefits for the clients it allows for the optimal use of the USAID resources.

Establishing a Separate Translation Budget Item

The purpose of technical assistance has generally been to provide experienced advisors to the client site, not to provide pure translation of foreign language documents. However, given the increasing complexity of bank supervision topics and given the consolidation of the global financial architecture, a separate translation budget item to be given directly to

the client would be useful. The USAID advisors could monitor the release of funds to the client based on receipts, but the client would be able to decide what documents they want to translate and how much they wish to pay for the translation. This line item would be used at the discretion of the client for items like Basle Committee documents that are not primary topics of focus in the advisor's scope of work.

IV. OVERVIEW OF THE BANKING INDUSTRY

A. GLOBAL TRENDS AND CHANGES IN BANKING

Several changes and trends that began in 1999 will continue in the year 2000. The banking, stock brokerage, insurance, pension fund and mutual fund industries are continuing to rapidly consolidate into one, global, financial services industry. The global business strategy of the financial services industry is placing heightened stress on the traditional segmented regulatory structures surrounding this industry. The financial service industry supervisory authorities will need to adapt to these new organizational structures. Proper supervision of these financial service conglomerates requires not only strong communication channels with other domestic supervisors, but open communication lines with other supervisors around the globe.

Technology has enabled companies and persons to conduct financial transactions faster and further than at any other time in history. This is a tremendous benefit for the global economy. However, new advances in technology have had both a positive and negative effect on the banking industry and financial services industry in general. Technology is both expensive and mandatory to compete on a global or even regional scale. The advancements in electronic banking and the Internet have recently highlighted weaknesses in global financial supervision, particularly in the area of operational risk and with the issue of money laundering. Computer hackers have had a high success rate with obtaining access to many company's client information. Unless this is rapidly brought under control, public confidence could begin to erode. In addition to general operation risk, money laundering is also becoming more of a threat. The criminal element often focuses attention on the weakest link in a financial chain to properly launder money. The weakest link often takes the form of a country that offers numbered bank accounts to frustrate law enforcement officials. However, the weakest link could also take the form of a country that has weak investigative or enforcement powers. No country, large or small, is immune from the issues of money laundering.

Investments in emerging market economies from foreign entities continue to be subject to close scrutiny as many foreign investors lost considerable confidence in emerging markets in 1997 and 1998. The highly negative impact of Asia, Russia and South America will have a lesser effect on emerging markets in 2000 than in the previous three years. Direct exposures to these countries were identified quickly in late 1998. 1999 saw the emergence of more indirect exposures through loan customers and suppliers to companies dealing directly with Asia, Russia or South America continue to surface. Many predict the year 2000 will begin renewed albeit cautious interest from investors in emerging markets.

B. LOCAL TRENDS AND CHANGES IN BANKING

As inflation and general interest rates in Poland move lower, projections show that commercial bank's net interest margins will continue to decline. Due to the high level of competition in the financial industry, including new types of financial institutions such as mortgage banks, demand for funds, and thus the cost of funds, will not decrease as fast as asset yields. This will further cause net interest margins to decline at a time when increasing competitive pressures from foreign banks continue to force local banks to spend money on technology and other overhead items to improve customer service. Banking customers in Poland are rapidly learning the benefits of customer service and are choosing banks that provide the best service.

Until the events of 1998, foreign exchange income represented a significant portion of earnings for commercial banks. Foreign exchange income fell in 1998 and in 1999. Foreign exchange income will very likely continue to fall, as a percentage of total revenue in 2000. The direction of the Polish Zloty relative to the United States Dollar and the Euro has become less predictable, thus forcing banks to have smaller open positions in other currencies. The local currency is likely to become even less predictable with the

NBP moving toward a free float mechanism. One cause for concern from the standpoint of a bank supervisor is that market volatility often increases a bank's desire to speculate. Banks will likely use more derivative products to speculate on currency movements. Derivative products ease a bank's ability to open and close currency positions quickly. The derivative product market has deepened in terms of products and overall liquidity of existing products over the past two years. However, risk management systems must be more accurate to properly avoid the downside risks of these complex products.

Like currency rates, interest rates exhibited more volatility in 1999 than was originally anticipated. As the NBP's Monetary Policy Council focuses attention on Poland's current account deficit and inflation, interest rates have become increasingly difficult to predict. A once general downward trend in interest rates has been replaced with increased short-term volatility. On the positive side, interest rates are approaching a maintainable single digit level for the first time since reforms began. Single digit long-term interest rates will open the door for banks to utilize more long-term products, on both the funding side of the balance sheet and income generating side. However, longer-term products will increase the dangers of interest rate risk for banks and banks will increasingly turn to additional advanced derivative products to counteract this risk.

The changes in exchange rates and interest rates will force banks to search for more innovative methods and activities to increase their interest margin and overall earnings performance. Interest expenses will be difficult to lower for reasons discussed above, and similarly, banks will find it difficult to lower their interest expenses if they wish to maintain market share. Banks can not easily lower overhead or capital expenditures due to necessary technology advances.

Since banks will have difficulty decreasing expenditures, they will be forced to search out ways to increase revenue. The loan portfolio offers the highest yields within the bank's asset base. However, the market for the best credit customers is well developed and

highly competitive. Many banks are competing for the same customer base and this often causes banks to relax their pricing strategy or underwriting standards to increase their loan portfolio. Banks may find it difficult to maintain interest income from existing customers due to the competitive market and may turn to non-interest fees for loan and deposit products and services to improve performance.

Banks may begin to turn to loan customers in higher risk categories to increase interest income. Banks may also aggressively seek out portfolio increases or new loan products in higher-yielding consumer lending such as car loans and credit cards in an effort to increase revenue. Further declines in interest rates will also make room for longer term lending such as residential mortgage lending. Longer term lending will increase the amount of interest rate risk in the banking system, as the average maturity of a loan becomes much longer than the average maturity of a deposit. Increasing mortgage lending will introduce new operational risks to the banking industry that have not been witnessed to date. Longer term lending will also put pressure on a bank's ability to monitor and maintain adequate liquidity. Until recently liquidity in the banking system has been strong. Overall liquidity is now showing a steady decline and will pose increasing risk on the banking system.

Outside of the loan portfolio, banks may also turn to new investment products, other than Polish treasuries, to increase interest income from the investment portfolio. The advent of asset securitization in Poland may add a new hybrid (a pool of loans that is sold as a security) investment product to the banking system. Banks will also turn to new off-balance sheet products to increase revenues or protect existing revenues. In this highly competitive market, it is easy for banks to lose sight of the risk and return tradeoff.

Expected merger and acquisition activity may help lower expenditures on a macro level for the banking industry. However, as seen with the attempts to merge banks under the Pekao, S.A. group, this activity is difficult to manage efficiently due to a number of

reasons. The GINB should be supportive of merger and acquisition activity to eliminate poorly managed or inefficient banks. With the significant amount of Polish bank capital controlled by foreign entities, the Polish banking industry can change its shape very quickly. This has recently resulted in highly politicized and public takeover battles between banks with an element of foreign capital.

Electronic banking will also become an increasingly higher risk in the banking industry. The Internet has brought new strategic challenges for the banking industry to deal with. From a strategic risk viewpoint, every bank will need an Internet strategy. This includes small and large banks, although obvious differences in strategy will reflect the size and complexity of operations for each bank. From an operational risk viewpoint, each bank must address the issues of accuracy and security with electronic banking transactions.

The following table illustrates some of the changes that have taken place in the Polish banking industry since the start of USAID technical assistance to the NBP and the GINB.

Item	Description (z 000,s)	1993⁴	1999⁵
I	Total Number of Commercial Banks	87	80
I.a.	Commercial Banks controlled ⁶ by State Treasury	29	10
I.b.	Commercial Banks controlled by Private Sector	58	70
I.b.1	Private Sector Banks controlled by Polish Equity	48	34
I.b.2	Private Sector Banks controlled by Foreign Equity	10	36
I.c.	Total Number of Branch Offices	1,436	2,060
I.d.	Total Number of Other Banking Service Delivery Points (including ATMs)	0	8,112
II.	Total Number of Cooperative Banks	1,653	902
III.	Total Capital Base of Banks in Poland ⁷	5,967	28,737
III.a	Percentage of Commercial Banks Above Regulatory	79%	91%

⁴ Data as of December 31, 1993.

⁵ Data as of June 30, 1999.

⁶ "Control" is established at 50% ownership.

⁷ This figure is gross capital funds, not adjusted for common deductions used to determine capital adequacy of a bank. However, the trend is the same for adjusted capital.

	Minimum for Capital Adequacy		
III.b.	Percentage of Cooperative Banks Above Regulatory	79%	95%
	Minimum for Capital Adequacy		
IV.	Total Profit	2,954	7,134 ⁸
V.	Total Assets in Banking System	104,067	349,845
VI.	Total Deposits From Persons	31,696	149,308
VII.	Total Loans to Non-Financial Sector	33,197	134,932

All financial figures in the above table are listed in Polish Zloty. The USD equivalent exchange rate is .26.

C. TRENDS AND CHANGES IN BANK SUPERVISION

One of the largest challenges that faces the GINB, and banking supervisors on a global scale, is consolidated supervision of financial conglomerates or non-financial conglomerates that include a bank. Presently, the Commission for Banking Supervision and the GINB do not have authority or access to review or verify information from non-bank affiliates of a bank. This is a significant weakness that must be corrected. The Polish Parliament may consider including other financial service regulators, such as pension and insurance regulators, to the Commission for Banking Supervision. The Commission might consider drawing a penetrable, legal wall around banking entities with reference to transactions with affiliates. This wall may not stop transactions with affiliates, yet should clearly limit those transactions in terms of risk. Lastly, the Commission may need to make better use of the audit industry to review non-bank affiliates financial records and internal controls.

As stated earlier in this section, market risks and derivative products will continue as a high priority for overall assessment of banking risk. As the product market and liquidity of these complex instruments becomes deeper, GINB examiners will be challenged to keep pace with the most current terminology and general risks. This will require

continuing education, formation of a group or groups of specialty risk examiners, and more communication with the banking industry and trade groups.

The changes in the banking industry will force several changes within the GINB in order to keep pace and continue as an effective regulatory and supervisory agency. The primary mission of an established bank regulator and supervisor is to promote stability, growth, and transparency in the banking and financial service industry. Early in the transition period, the NBP and GINB adopted a mission statement or general philosophy to protect banks from failure. Promoting the banking industry in the transition stages proved to be a highly effective philosophy, and effectively showed bank customers that the banking industry had the support of the Polish government. The steady growth of the deposit base of Polish banks is evidence of the success of this philosophy.

The GINB is now beginning reevaluate it historical philosophy and look closely at the issue of "*transparency*." Market participants should now decide which banks survive and which banks fail. The role of the regulator is to enforce the decisions of the market. Bank failures may be negative on a micro level (local community) but are rarely negative to the banking industry as a whole. Bank failures send a clear message to the bank management that penalties exist for those who do not follow prudent management principles, laws and regulations.

The issue of transparency is one that is difficult to precisely define, but the concept goes well beyond clear bank financial statements to its supervisor. Transparency also involves disclosure of timely, complete, and accurate information to all market participants. Market participants include shareholders, depositors and the general public. Market participants need to know which banks are in strong financial condition and which banks are in weak financial condition. Knowing this information, the market participants can

⁸ Annualized estimate from a figure of 3,567 at June 30, 1999.

make decisions about where to place their money. This system rewards banks in good condition and penalizes banks in poor condition.

Market participants do not need to know the level of financial information that the GINB knows, but they do need basic information on a bank's capital, solvency and liquidity. This can be accomplished by individual bank disclosure of its balance sheet, income statement and solvency ratio on a periodic, at least quarterly, basis. This information should be disclosed in every deposit taking office of every bank. The disclosure should be in a widespread news publication on a quarterly basis as well.

Historically, the National Bank of Poland and the Bank Guaranty Fund have tended to protect and assist problem banks by forgiving obligatory reserves or allowing creative methods of calculating solvency. While this strategic regulatory posture was justified from a systemic risk viewpoint, this strategy contradicts the principles of market transparency and the core principles of bank supervision. This posture is no longer a necessary precaution in a stable environment. One of the major criticisms of the Asian crisis is that the central banks were supporting many weak banks by providing liquidity through below market rates. This action hurts healthy banks that have strong management, adequate capital and liquidity and are complying with the laws and regulations that are in force. Additionally, if management and shareholders are able to continue poor operations without penalty, their tolerance for risk is likely much higher than prudently run banks.

PROJECT TANGIBLE RESULTS AND BENCHMARKS

PHASE III ONLY

PROJECT TANGIBLE RESULTS

1. The bank supervision authority will have set up a schedule to examine all licensed banks based on priority.
2. The bank supervision authority will have developed a basic examination manual based on CAMEL components (capital, assets, management, earnings, and liquidity) that is used during on-site inspections.
3. The bank supervision authority will have developed and be using standardized documents relating to on-site examinations e.g., request letters to bank management, reports of examination, and formatted working papers.
4. The bank supervision authority will have developed a training program for inspectors.
5. The bank supervision authority will have developed formats and procedures and training staff in developing packages of detailed information to determine the least cost options for dealing with failed banks.
6. The bank supervision authority will have begun to establish risk-based supervisory strategies for the largest banks.
7. Banks will be reporting to the NBP using a Uniform Bank Performance Report. The UBPR Instruction Manual will be completed and the NBP will be receiving more reliable and timely information from the banks.

PROJECT BENCHMARKS

1. At the end of every third month after the starting date, the completion of targeted on-site training inspections (normally lasting two weeks) and inspection reports according to the timetable laid out in the work plan. Approximately six such inspections with the participation of Barents advisors are planned for the entire project.
2. At the end of every third month after the starting date, evidence that the GINB, with the help of Barents advisors, is completing, revising, and formatting chapters of the on-site supervision manual. The chapters will be available for inspection by USAID staff.
3. In each of two three-month periods after the starting date, one additional session of intensive one-week classroom training to 25-30 GINB examiners will have taken

place. In each of the four three-month periods after the starting date, training for trainers will have been conducted.

4. In each of the two three-month periods after the starting date, one training session of the heads of supervision (about forty) at the NBP's regional offices will have taken place.
5. By December 15, 1996, a 4-6 week full-scope training examination will have taken place at a large Polish bank with the participation of Barents advisors.
6. Preparation by Barents, in every three-month period following the starting date, of documents to help GINB develop the normal functions of the bank supervision systems. This may include development of processes to evaluate risk, implementation of a system to ensure comprehensive internal communication channels, participation in special projects, strengthening of banking laws or regulations, or other NBP/GINB priority issues.
7. Within the first eight months after the starting date of the contract, Barents advisors will have conducted at least two seminars/workshops with the banking community and/or government and elected officials regarding the importance of bank supervision and the relative roles and responsibilities of regulators and bankers in promoting a safe and sound banking system.
8. In each three-month period following the starting date, Barents advisors will have trained GINB staff in developing and assessing the cost of various alternatives for dealing with failed banks.
9. In each three-month period following the starting date, Barents advisors will have met with the banking community to instruct them on the new Chart of Accounts and the detailed instruction manual relating to the Uniform Bank Performance Report. GINB staff will also have received training in each period on analyzing the data received on the new report.

PROJECT TANGIBLE RESULTS AND BENCHMARKS

PHASE IV ONLY

PROJECT TANGIBLE RESULTS

1. The bank supervision authority will have formalized a multi-year on-site scheduling process based on supervisory profiles developed for all banks and the completion of on-site inspections of priority banks.
2. The bank supervision authority will have expanded the basic inspection manual. Additions will include procedures for complex or new areas within a bank and the uniform assessment of large syndicated credits.
3. The bank supervision authority will strengthen the quality and content of the report of inspection and will continue to enhance on-site supervisory tools; e.g., request letters to bank management, reports of inspection and formatted working papers.
4. Approximately 275 of the GINB supervision staff will have received intensive training in all core bank supervision techniques and procedures. (including the 175 inspectors who have already received such training). A core group of GINB staff will also have received specialized training.
5. The bank supervision authority will have developed a formal internal training program focusing on teaching on-site supervisory techniques. Once trainers complete the formal program they will have participated in the teaching of the On-site Inspection Manual Course.
6. The NBP will have established a standardized accreditation program for the inspection staff based on written examinations and will have begun to implement it.
7. The bank supervision authority will have completed risk-based Supervisory Profiles that include supervisory strategies for all Polish commercial banks. The profiles will be automated and integrated into the existing NBP system-wide computer network.
8. The bank supervisory authority will have implemented a uniform bank rating system that will be used to monitor aggregate trends in the overall soundness of financial institutions. The system will also provide a means to monitor, for various statistical and supervisory purposes, the types and severity of problems that institutions may be experiencing and to determine the level of supervisory concern that is warranted.

PROJECT BENCHMARKS

1. Twice a year, advisors will participate in at least one complex inspection of a large multi-branch bank. However, two smaller banks could be substituted for one large bank. Normally, inspections of large banks are two to three months in duration. Advisors will assist in all areas of the inspection process from pre-inspection planning to follow up of inspection findings and conclusions.
2. At the end of every fourth month after the starting date, evidence that the GINB, with the help of advisors, is making the additions and revisions necessary to strengthen the on-site supervision manual.
3. Four 3-week intensive classroom-training sessions for 25-30 GINB inspectors will have taken place in Spring/Fall 1998 and Spring/Fall 1999.
4. Approximately 8 one-week training courses for 20-25 GINB inspectors will take place (an estimated four per year). These sessions will focus on specialized and/or advanced areas e.g., foreign exchange, advanced credit analysis, derivatives, mortgage lending, and electronic data processing.
5. Regarding the accreditation program: by end-August 1998, the infrastructure will have been developed including the establishment of position descriptions for bank supervision personnel and performance criteria for positions; the design of corresponding training curriculum and the development of inspections; and, by end-December 1998, the above framework would have been completed and approved by NBP and/or the Bank Supervision Commission so that pilot testing of the process could begin.
6. Advisors will have worked with lead supervisory analysts on the utilization of UBPR data/reports. Additionally, twice a year at least two training sessions will be held on how to analyze and draw conclusions from the new UBPR reports. This training will ensure that the off-site supervisory function has consistency in its approach toward the type of analysis performed and in communication of conclusions to other supervisory units.
7. Regarding the automation and integration of the Supervisory Profiles of banks: by June 1998, the advisors will have assisted GINB staff to design a framework to integrate the quantitative section of the profiles with the UBPR financial database; by December 1998, the advisor will have completed an instructional manual and provided training to GINB staff in the supervisory surveillance system; by December 1998, the advisor will have assisted GINB staff to design a framework to integrate the qualitative section of the Profile with the bank's existing computer network; by June 1999, with the guidance of the advisor, the GINB will have begun implementing the

automated supervisory surveillance system, including the verification and testing of the integrated financial data.

8. At least one additional training session of the NBP Regional Directors at the NBP's regional offices will have taken place. This training will include the importance of communicating new organizational responsibilities arising out of the reorganization and decentralization of supervisory functions.
9. Advisors will assist in the preparation of documents to help GINB to develop the normal functions of the bank supervision system. This may include development of processes to evaluate risk, implementation of a system to ensure comprehensive internal communication channels, participation in special projects, strengthening of banking laws or regulations, or other NBP/GINB priority issues.
10. Advisors will have conducted at least two more seminars/workshops with the banking community and/or government and elected officials regarding the importance of bank supervision and the relative roles and responsibilities of regulators and bankers in promoting a safe and sound banking system.
11. Advisors will meet periodically with the new Bank Supervision Commission (expected to be established in 1997 as part of pending banking legislation) to discuss the Commission's new role and the members' responsibilities and priority issues facing bank supervision.
12. Advisors will have worked with the problem bank unit in developing supervisory responses to several banks warranting additional supervision. In developing these supervisory responses, the problem bank unit will have utilized information arising out of the off-site and on-site supervision process. Additionally, advisors will have worked with GINB staff in the follow-up processes to these supervisory responses.

PROJECT MODIFICATION AND SUBCONTRACT RELATED TO YEAR 2000 RISK

1. Stratify the Polish banking industry into strategically similar groups and develop a questionnaire for each group to assess Year 2000 Risk. Provide an individual analysis of strategically significant banks and for the banking industry, as a whole.
2. The Banking Supervision Department will determine a group of strategically significant banks, not to exceed more than twenty-five (25) banks. The analysis of the banks individually and the analysis of the banking industry shall contain, at a minimum, the following items: an evaluation of the integrity of the data submitted by the bank(s) via the questionnaire and an analysis of the risks relative to the Year 2000 problem as reflected in the bank's answers to the questionnaire. With respect to each of the strategically significant banks, the Subcontractor shall provide an expert opinion, based on the answers to the questionnaires from each of the banks, stating whether the individual bank's Year

2000 readiness is extremely poor (lack of Year 2000 awareness and clearly inadequate preparation), less than adequate (some preparation yet is probably not enough to be Year 2000 ready), adequate (preparation has begun and is continuing on a time schedule that is projected to allow Year 2000 readiness), or good (estimates are for the bank to be Year 2000 ready by June 30, 1999).

3. Assist the National Bank of Poland with follow-up plans, based on weaknesses identified within the questionnaires. The Subcontractor should prepare follow-up plans on each of the strategically significant banks and the banking industry, as a whole. The follow-up plans should address suggestions for short-term plans (one month), medium term plans (through June 30, 1999) and long term plans (through December 31, 1999).
4. Develop and provide two to three hour presentations to the Commission for Banking Supervision and senior management of the Banking Supervision Department, and a three to four hour presentation to the Polish Bankers Association.

USAID ADVISOR-ASSISTED ON-SITE EXAMINATIONS

<i>PROJECT PHASE</i>	<i>BANK¹</i>	<i>BANK TYPE²</i>	<i>NET ASSETS³</i>
III	96-A	Local	1,516
III	96-B	Large Regional	8,332
III	97-A	Nationwide ⁴	57,666
III	97-B	Large Regional ⁵	15,945
III	97-C	Large Regional ⁶	13,600
III	97-D	Regional	4,599
IV	98-A	Nationwide	19,505
IV	98-B	Nationwide	61,732
IV	98-C	Regional	1,402
IV	98-D	Nationwide	16,816
IV	98-E	Foreign Bank Subsidiary	3,171
IV	99-A	Local	1,096
IV	99-B	Foreign Bank Branch	3,500
IV	99-C	Large Regional	13,488
IV	99-D	Large Regional	13,989
IV	99-E	Large Regional	4,032
IV	99-F	Large Regional	8,312
IV	99-G	Foreign Bank Subsidiary	1,500
IV	99-H	Foreign Bank Subsidiary	884
IV	99-I	Large Regional	9,140
IV	99-J	Regional	1,485
		TOTAL ASSETS FROM ABOVE	261,710
		TOTAL POLISH BANKING ASSETS	345,093
		PERCENTAGE OF ASSISTED EXAMINATIONS TO ASSETS IN BANKING INDUSTRY	75.83%

¹ See monthly reports for a complete summary of assistance corresponding to this code name.

² The banks where USAID assisted examinations have occurred are divided into six types. A “local” bank is one that is primarily in one city. A “regional” bank has the majority of its operations and market share in one region of the country. A “large regional” has the majority of its assets in one region yet has limited market share around the country. A “nationwide” bank has offices and significant market share across the entire country. A “foreign bank subsidiary” is a wholly owned and consolidated subsidiary of a foreign bank. A “foreign bank branch” is simply a branch of a foreign bank.

³ Net assets as of August 1999. Financial Figures above are listed in Polish Zloty. The U.S. Dollar exchange rate as of December 31, 1999 is .26.

⁴ Advisors provided assistance with examinations of three banks that have subsequently merged to form this one entity. The total assets figure is of the combined entity.

⁵ Advisors provided assistance with examinations of two banks that have subsequently merged to form this one entity. The total assets figure is of the combined entity.

⁶ Advisors provided assistance with examinations of two banks that have subsequently merged to form this one entity. The total assets figure is of the combined entity.

PROJECT TRAINING COURSES

ON-SITE SUPERVISION

Basic Banking Supervision

This course is taught as three part series, each part lasting three weeks. In the first part of this course, participants will learn the basic theory of bank supervision and the bank supervision process, how to apply CAMELS ratings, and the general use of the On-Site Inspection Manual. Next, participants will learn the basic inspection procedures for evaluating the quality of bank management. In this section participants will also learn the risks and inspection procedures to review transactions with insiders, and risks and inspection procedures with regard to transactions with related organizations. Additionally, participants will learn the importance of internal controls and the inspection procedures for reviewing internal and external audits. Finally, the participants will learn how to analyze a bank's earnings performance and capital adequacy, and how to use the Uniform Bank Performance Report (UBPR). A case study will be used to facilitate participant learning for use of the UBPR.

In the second part of this course, participants will learn the basic theory of market risks and how market risks affect the earnings performance of a bank. Participants will learn the concepts, and inspection procedures, for liquidity risk, interest rate risk, and foreign exchange risk. A significant portion of the course is devoted to concepts of foreign exchange terminology/products, principal risks involved with trading FX, methods used to manage and control these risks). To facilitate the learning process, case studies will be used extensively in this course.

In the third part of this course, participants will learn the basic theory of credit risks and how credit risk can affect the overall condition of a bank. Participants will learn the concepts, and inspection procedures, for reviewing asset quality of a bank. Additionally, participants will discuss the asset classification guidelines, provisioning requirements, and accounting guidelines relative to lending. To facilitate the learning process, case studies will be used in this course.

Advanced Credit Analysis

In this course, participants will discuss more advanced topics relative to the credit process. Participants will discuss topics of trade finance, loan participation agreements, loan securitization, and advanced credit analysis techniques. As this course is targeted at a more advanced and experienced audience, participants will be expected to discuss the asset classification guidelines and provisioning requirements relative to more complex credits. To facilitate the learning process, case studies will be used in this course.

Advanced Risk Management and Derivatives

This one-week course is designed for participants who have demonstrated an advanced knowledge of foreign exchange risk. The course is not primarily designed to be a lecture. Rather, participants will be discussing advanced foreign exchange management techniques with senior members of bank management. Participants will be expected to be active in discussions. The case study developed for this course will be used to ascertain both analysis skills and communication skills. Unlike many other courses, this course uses selected guest speakers according to desired knowledge areas. The guest speakers will be asked to make half-day presentations and then hold a discussion of question and answer session with participants. After the presentations and discussions, the instructor should lead a discussion on the guest speaker's topic, focusing on examination concerns.

Information Technology Systems and Controls

This one-week course introduces the participants to the fundamentals of Information Technology (IT) as it relates to a banking environment. Participants will be introduced to the background of bank data processing and the risks common to this area of activity. Participants will also be given exposure to basic systems and controls that are used to reduce or compensate for IT risks.

In addition to classroom exposure to IT risk, participants also will visit a commercial bank. The bank visit will expose the participants to the basic hardware and software used in a bank's data processing center and the process of how original entry documents are collected eventually recorded on the bank's general accounting records. The participants will also view the controls and procedures relative to internal programming. Finally, the participants will view the general control procedures and safety measures that are relative to a bank data processing center.

OFF-SITE SUPERVISION

Basic UBPR Analysis

This one-week course introduces the participants to the UBPR. The course is designed to ensure participants know the physical layout of the UBPR, understand the formulas related to key ratios, and comprehend peer group formation. This course uses a case study format for participants to learn the proper usage of the UBPR as a supervisory tool.

Advanced Bank Financial Analysis

This one-week course begins with a one-day lecture on various theoretical topics covering the offsite analysis of financial institutions. The remainder of the course deals with a thorough review of the UBPR and reinforcement of the theoretical concepts and how they are used to assign risk ratings.

GENERAL SUPERVISION ISSUES

Instructor Training

This one-week course is designed to strengthen the participant's presentation skills. Topics include how to overcome public speaking fears, prepare and deliver effective multimedia presentations, develop effective training tools and evaluate participants reactions to the training.

Asset Securitization

This one-day presentation is designed as an introduction to the asset securitization process. Topics discussed include: the history and evolution of asset securitization, risks and rewards of issuance, basic structure of securities, the mechanics of structuring a transaction, cash flow characteristics, risk-based capital implications, and strategies used.

Subordinated Debt

This one-day presentation covers the basic characteristics of subordinated issues, types of issues, recent development in the debt markets, and potential benefits from the use of these instruments. Several examples are included to reinforce concepts.

Introductory Electronic Data Processing Examinations

This one-day presentation is a very brief introduction into the basic elements of Electronic Data Processing examinations. It describes the three-tiered approach to supervision based on varying degrees of risk.