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The Polish Banking Sector and the European Union Banking System

1. General comments

The process of constructing a modern financial sector conforming to market economy rules began in the years 1988-1989 in Poland, concurring with the launch of a banking reform consisting in the introduction of a two-tier banking system: the creation of a network of commercial banks operating on the basis of market rules, and providing the central bank with considerable independence in the areas of setting and enforcing the monetary policy, and of regulating and supervising the financial sector development. This has been reflected in a growth of the number of banks, an expansion of the entity and ownership structure, and in a rapid spread of the array of banking products and financial services.[1]

Subsequently, the Polish financial sector expanded to include trust and equity institutions. The 1999 Securities Trading and Trust Funds Act was of major importance in the area. It established all the major capital market institutions – that is the Stock Exchange and the National Securities Depository – and defined the conditions and framework for brokerage office (house) operations.

The Insurance Operations Act passed in 1990 provided grounds for the development of the insurance market. In light of the said Act – and also in line with the rules of modern market economy – the non-life and life insurance segments were separated. The new law allows for the establishing of insurance companies in a twofold form: that of a joint-stock company, or of mutual insurance companies. It also enables insurance companies to engage in capital

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[1] See W.Baka et al., *Transformacja bankowości polskiej w latach 1989-1995* (*Polish Banking System Transformation in the Years 1989-1995*), Warsaw 1997.

operations and investments while retaining financial asset liquidity at a rate indispensable for the day-to-day business management. Insurance has thus become a commercial form of activity.

The process of forming a market-based pension fund system in Poland has only just emerged from the conceptual and design stage, with the first licenses issued in November 1998. As it seems, even after the implementation stage begins, a high share of the mandatory premium shall prevail (approximately 40% in the year 2001), not fully submitting to market-based management rigours.[2]

Banks play a dominant role in the Polish financial system today. This may be proven – among others – by the volume of savings and deposits at commercial banks versus other financial institutions. In 1996, the volume of savings and deposits of the non-commercial sector located with commercial banks totalled PLN 113,3 billion, whereas the sum of funds placed with trust and equity institutions reached approximately PLN 1,4 billion, i.e. totalled 1,2% of the savings and deposit value, with the insurance premium total reaching PLN 8.2 billion, i.e. 7,3% of the overall savings and deposit volume[3].

In recognition of the above, it seems to have been justified for the Polish legislation to have made priority attempts to resolve and regulate problems related to bank operations, with lesser legislative attention paid to the other financial system elements. Most certainly, in light of the European Union integration processes, such legislative efforts shall be undergoing constant change.

2. Former results of harmonising the Polish banking sector legislation with European Union regulations

Experts see no unambiguous assessment of the condition of harmonising the Polish banking sector legislation with that of the European Union. On the one hand, some believe the Polish banking sector to be separated with a wide institutional and regulatory gap from the European reality[4], on the other – specialists have been known to claim that in this particular area, Poland is closer

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[2] W.Baka, *Sektor finansowy w gospodarce – stan i perspektywy w obliczu integracji europejskiej. Raport przygotowany dla Rady Strategii Społeczno-Gospodarczej przy Radzie Ministrów* (*The Financial Sector in Economy – Its Condition and Perspectives in Light of European Integration. Report Drafted for the Social and Economic Strategy Council of the Council of Ministers*), Warsaw, September 1997.

[3] Ibidem, p.7.

[4] Compare among others: *Banki polskie na drodze do Unii Europejskiej* (*Polish Banks on the Way to the European Union*), ed. W.L.Jaworski, Warsaw 1997; W.Rutkowski, *Europejska Unia Monetarna, perspektywy i szanse dla Polski* (*European Monetary Union, Perspectives and Opportunities for Poland*), Warsaw, May 1997.

to European standards than some European Union member states, such as Greece or Portugal, for example[5]. A further analysis of the matter shall prove the actual condition. It would be noteworthy to emphasise at this stage that the forming of rules in regulating the Polish banking system operations has been considerably influenced by an attempt to adopt fundamental European solutions at the outset of the banking system reform already. This concerned the position of the central bank, the various types of monetary policy implementation tools, as well as prudence regulations and the banking supervision system.

In compliance with the new Constitution of the Republic of Poland and with the National Bank of Poland Act, the Polish central bank displays features required by the Maastricht Treaty, both in terms of institutional independence (all the National Bank of Poland authorities being collegiate and operating in terms of office) and functional sovereignty (authority to establish and implement monetary policy). Institutional rigours of maintaining high macroeconomic discipline have been introduced (a 3% budget deficit, and a 60% public debt tolerance ratio in relation to the GDP).

The set of instruments used by the National Bank of Poland is practically identical to the array of tools applied by leading European central banks, and suggested for use within the framework of the planned European Central Banks System. This set encircles, among others, a variety of open market operations (outright, repo, reverse repo, swaps, lombard loans, bills of exchange rediscount), and mandatory provisions. The next stage of bringing the rules of Polish banking system operations closer to European standards has been the establishing of the Banking Supervision Commission with a membership of representatives of institutions responsible for the functioning of the different financial market segments, and for the monetary and financial policy. Such a solution is consistent with EU requirements stemming from a deregulation and permeation of operations in the various financial sector areas (deposits, the monetary and capital markets, insurance, etc.), and contributes to integration in financial regulation and supervision.[6]

The grounds for forming a uniform financial market in the European Union had been laid by the First and Second Banking Directive. The former was passed on 17 December 1977, with a deadline for member state national law implementation of 15 December 1979. The Second Banking Directive was passed on 30 December 1989, with member states obliged to enter it to their national legislation by 1 January 1993.

[5] W.Baka, *Sektor finansowy…*, op. cit., p.8.
[6] More on the topic in the same, p.l0.

Chief provisions of the First Banking Directive (77/780/EEC) included:

- the introduction of a condition of a licence to be held by institutions collecting deposits and granting loans/credits;
- the setting of general rules of obtaining banking operation licences (a minimum of two board members with adequate professional and personal qualifications, submission of a banking business plan);
- the removal of numerous restrictions to opening foreign subsidiaries;
- a definition of and protection for the term "bank";
- regulations in the area of co-operation among banking supervision authorities with regard to banks with foreign subsidiaries;
- general guidelines concerning the compliance of crediting institutions with liquidity requirements.

Main provisions of the First Banking Directive (89/646/EEC) concerned:

- the setting of the minimum crediting institution capital (5 million euro);
- the adoption of a rule of supervision of a crediting institution by the country of origin;
- control of crediting institution shareholders (holding more than 10%) by a supervision authority;
- a limitation of crediting institution shareholding in non-banking institutions to (a total of) 60%, and of a single shareholding to 15% of equity in the latter.

When comparing the aforementioned list of requirements concerning the general rules of establishing and operating financial institutions in European Union countries with the Banking Law passed in Poland recently (29 August 1997), a substantial harmonisation of the two can be noted. The condition becomes more apparent in comparison with the so-called directives specifying the enforcement of the First and Second Banking Directives, that is:

- Directive on Own Funds of a Crediting Institution (89/299/EEC) passed on 5 May 1989, with a deadline of entering into the member states' national law by 1 January 1993. It defines all and any components accepted as forming part of own equity of a crediting institution, and introduces a division of equity into basic and supplementary. In the Polish banking law, Article 127 corresponds to this Directive, as it also contains a detailed listing of all and any elements recognisable as forming own equity of a bank, specifies detailed rules of establishing and increasing a bank's own funds.
- Solvency Ratio Directive (89/647/EEC) passed on 30 December 1989, with a deadline of entering into the member states' national law by 1 January 1993. It defines the ratio of own equity to the weighted sum of assets and off-balance sheet transactions at a minimum of 8%, whereas assets and off-balance sheet transactions may be recognised as carrying weights of 0, 10,

20, 50, and 100 per cnet. In the Polish banking law, this Directive is reflected in Article l28: not only does it in clause 3 fully confirm the requirement of an 8% capital adequacy, but it also requires – for new banks during the first 12 months of their existence – a capital adequacy ratio of 15%, and of 12% during the subsequent 12 months.

- Crediting Institution Supervision Directive (92/30/EEC) passed on 6 April 1992, with a deadline of entering into the member states' national law by 1 January 1993. It amends the Directive (83/350/EEC) by introducing more detailed rules of supervision, consisting – among others – in a mandatory consolidation of all and any institutions with shares held by a financial institution, i.e. of financial holding groups as well; in a reduction of the mandatory consolidation threshold to 20% of a share held by a given crediting institution; in case of majority shareholdings – in full consolidation, and in case of 20-50% shareholdings – in an option to choose between full and quota consolidation. In the Polish banking law, this Directive is reflected in Article 134 clause 2, albeit – as ought to be emphasised – it is not as detailed in regulating the bank control process.
- Large Credits Directive (92/121/EEC), passed on 21 December 1992, with a deadline of entering into the member states' national law by 1 January. It concerns the granting of large loans, i.e. loans whose value exceed 10% of the bank's own capital. According to the Directive, no large loan shall exceed 25% of the capital, with the total sum of credits granted not exceeding 800% of a crediting institution's own equity. In the Polish banking law, Article 71 clauses 1 and 4 correspond to the Directive. Their content is identical to that of the latter.
- Directive on Securing Deposits (94/19/EEC) passed on 12 April 1994, with a deadline of entering into the member states' national law by 1 July 1995. It concerns the uniformity of deposit security systems in member states. This Directive introduces an obligation of membership in such system, and requires it to guarantee deposits at a minimum of 20 000 euro. Moreover, the Directive enables the acceptance of foreign subsidiaries of banks to the deposit securing system within the country of operation, should such system adopt higher deposit securing limits. On the other hand, foreign subsidiaries of banks from a country with higher deposit security guarantee limits cannot apply such higher rates, should the country of operation allow for lower limits. Under Polish banking regulations, mandatory deposit security shall apply to amounts up to 3 000 euro.
- Directive on Counteracting the Use of the Financial System for Money Laundering Purposes (91/308/EEC) passed on 10 July 1991, and concerning the concept of making the laundering of money from illegal transactions more difficult. In light of the Directive, the accomplishment of this objective

was to be made easier by identification of individuals engaging in transactions with a value exceeding 15 000 euro on the one hand, and by co-operation of banks with investigation authorities in case of any suspicion on the other. In the Polish law, Article 106 of the Banking Law and §5 clause 1 of Resolution No. 4/98 of the Banking Supervision Commission[7] correspond to the Directive. The latter sets such amount at 100 euro.

- Directive on the Capital Holdings of Crediting Institutions and Brokerage Houses, frequently referred to as the Capital Adequacy Directive (93/6/EEC) passed on 15 March 1993, with a deadline of entering into the member states' national law by 31 December 1995. This Directive introduces uniform capital requirements for brokerage houses, and defines the relations of equity to different types of risk. In case of companies with no permits to manage customer portfolios and to engage in transactions on their own account, initial capital of 50 000 euro is considered sufficient. Companies engaging in customer property management require capital of 125 000 euro. Brokerage houses engaging in securities transactions to their own account have to have capital totalling 730 000 euro. Moreover, this Directive expands the Solvency Ratio Directive to include additional types of risk. It sets capital requirements for risks present in case of securities and foreign exchange transactions. Polish law does not regretfully feature any article corresponding to this Directive in the Securities Trading Act.
- Securities Market Services Directive (93/22/EEC) passed on 12 May 1993, with a deadline of entering into the member states' national law by 31 December 1995. It applies to rules of operation to be applied by brokerage houses, and the supervision thereof on an integrated market. In the Polish law, Chapter IV of the Securities Trading Act corresponds to the Directive.

In summary, it may be said that a comparative analysis of the fundamental norms of the Polish banking law forming the rules of establishing and operating banks in Poland with European Union regulations relating to the Single Financial Market is indicative of an extensive harmony of all these regulations, thus proving Poland not to differ significantly from all the European standards adopted. This applies to norms related both to the First and the Second Banking Directive, that is to principles concerning the process of financial institution licensing and supervision. In light of the comparative analysis performed one may conclude that European Union regulations and Polish legal standards alike require a "crediting institution" – as a bank is referred most frequently to by the European Commission – to be managed by individuals with adequate experience and enjoying public confidence, and for such institution to be equipped with proper own capital as a counterbalance to the banking risk carried by the given

[7] *"Official Journal of the National Bank of Poland"*, No. 18/98, item 40.

bank. Moreover, these regulations also require the overall system to be transparent, and for both the free market and the consumer to be protected.

The aforementioned comments obviously do not mean a total absence of discrepancies between the standards quoted. Although we do not believe them to be legally decisive to the convergence of both systems, they are worth mentioning with a concurrent description of the reasons for their presence.

As we know, community regulations have introduced certain minimum standards, which may be made more “strenuous” or more “liberal” in different states, depending on their legal, institutional, and economic condition. This applies to the so-called adjustment period in particular. Hence the discrepancies described, among others. They should not, however, be seen as “fixed elements” of discrepancies between the legal norms of the Union and regulations applied in an accession country. They should be rather perceived as a gradually disappearing phenomenon.

In Poland, this shall for example relate to matters concerning:

1. Own funds of co-operative banks. In light of Community regulations, an amount of 1 million euro of own equity is required to establish co-operative banks, whereas in Poland, the Supreme Banking Supervision Inspectorate and legislators demand that co-operative banks have a capital of 5 million euro.

2. Bank deposits security. In light of Community law, the interest of small deposit owners is protected to a higher limit, that is to an amount of 20 000 euro. In Poland, in conformity to the Bank Guarantee Fund Act, protection is offered up to an amount of 3 000 euro only, and then exclusively on a declarative basis, as there is no option to revoke a license, should the bank fail to meet obligations due to the Bank Guarantee Fund.

Moreover, Poland has no transparent domestic deposit guarantee system, stemming chiefly from the co-existence of State Treasury guarantees for savings deposits of private individuals in three banks until the end of the year 1999 (PKO BP, PKO SA, and BGŻ SA), and of Bank Guarantee Fund guarantees. Furthermore, it is not fully clear, whether a passbook is to serve as the distinguishing factor for a savings deposit, whether such passbook can be used with a password, whether non-registered savings products are included as passbook-valid, and if yes – what should the cap amount be, and so on.

3. Equity involvement of banks in other entities. According to European Union standards, such involvement shall not exceed 25% of the banks’ overall own funds. Hence, such may the maximum value of shares held in and contributions made to a third legal party be (or the value of any stocks and/or bonds purchased). In Poland, on the other hand – pending the consent of the President of the National Bank of Poland – such investments can total 50% of the amount concerned.

4. Consumer (borrower) protection is definitely provided at a lower level in Poland, e.g. in the area of access to information, or of legal assistance accompanying consumer loan agreements, early loan repayment options, etc. Everything seems to prove that the full adjustment of national law to European Union standards shall bring an improvement in the small borrower's position in contact with banks, as may at least be concluded from the afore-quoted relevant Directives, of which the following could be mentioned yet again:

- Directive 87/102/EEC on Consumer Loans Offered by Crediting Institutions. This Directive is considered as a precedent in the area of financial services, as it provides the consumer (borrower) with a direct right to repay any liabilities stemming from the loan agreement prior to the dates contained therein, and to demand in such case that total loan costs be reduced as appropriate. The Directive obviously precisely defines parties eligible to receive such loan. A consumer loan of 200 to 20 000 euro can be granted to a private individual intending to use the funds assigned to own (direct) benefit, not for professional or business operations.
- Directive 93/13/EEC on Dishonest Practices when Signing Agreements with a Consumer, which – as opposed to Polish solutions – seems to be offering priority to borrower protection before protection of crediting institution interests, with a concurrent differentiation between the professional and non-professional bank customers.

Furthermore, the European Union membership perspective may be attractive to the consumer, given the potential minimisation of transaction costs, among others as a result of a reduction in the spread.

5. Freedom of engaging in banking business. In light of European Union regulations:

a) there is a freedom of engaging in banking business within the territory of all Union member states without the need of obtaining permits from the authorities of the respective states, i.e. exclusively on basis of a licence to establish a bank issued in the country of origin;
b) there is a freedom of providing banking services in their full array, with no extra authority concerning the various types of activity required;
c) there is a freedom of bank services purchase by customers in various states, country of origin of the bank notwithstanding;
d) any control and restrictions in capital flow have been removed;
e) full freedom in securities trading has been introduced throughout the area of the Single Financial Market.

3. Development perspectives of the Polish banking sector in light of the European Union integration processes

Deliberations concerning the development perspectives of the Polish banking sector in the process of Poland's economic integration with the European Union shall require an analysis of at least the following group of issues: the current condition of the banking system in Poland, the process of organisational and ownership transitions in the banking system in the nineties, and the share of the foreign financial sector in the Polish banking system.

Chief problems of the Polish banking system in the nineties include:

1. Low capital concentration rate. The largest Polish banks (PKO BP, PKO SA, BGŻ, BH) control slightly less than 50% of banking sector equity; furthermore, 7 banks with a Polish majority shareholding with assets exceeding PLN 10 000 held approximately 66% of assets in July 1998. In western countries, three or four largest banks control 75-80% of all the capital in the banking system of the given country. Such a condition can among others be encountered in Germany, Great Britain, Spain, etc. One of the fundamental advantages of strong equity concentration in the banking system is an opportunity of using its influence on setting the monetary policy in a given country. It is a common belief that strong banks are the best assessor of the financial policy of any given state, as well as the best partner in building the strategy for such policy. According to the June 1998 condition, Poland had 84 commercial banks (excluding banks under bankruptcy and in liquidation). Of the 53 banks with a majority Polish shareholding, 30 had net assets with a value below PLN 1 000, which constituted 4,7% of net assets held by commercial banks in this group of banks.

2. Low capitalisation rate in comparison with developed states. Only three Polish banks can be found among the 1 000 largest banks in the world in terms of capital size (BH, PKO SA and PKO BP), though even their capital rating gives them a very distant position. For example, PKO SA ranks 347th with assets worth USD 14,2 billion, whereas the largest bank as of year-end 1997 (HSBC Holdings) had assets worth USD 473.6 billion. The World Bank Report drafted as of the end of 1997 also proves that assets of the Polish banking system constitute a mere 5 per cent of assets of the Spanish banking sector.

3. Technological obsoleteness and the constantly low number and quality of banking products, the weak development status of investment and international banking, and of housing loans. One ought to fully emphasise, however, that recent years have brought immense progress in the computerisation and automation of Polish banks. We are, nevertheless, still well behind the development rate of such systems in well-developed western countries, including European Union member states. It still happens that even at the largest and most prestigious

Polish banks, clearance and information systems crash, as a result of which it takes bank customers several hours or even days, instead of a mere few minutes, to complete basic operations. In comparison with well-developed banking systems, the quality and quantity of products also leave a lot to be wished for. Some of these accusations can obviously be explained – or justified, even – by the absence of closer ties of Polish banks to the external world over many a decade. Hence, we have had no practical opportunities of co-creating events on international financial markets, not to mention a detailed observation thereof. In particular, we have certain changes in global banking in mind, stemming among others from a deregulation in trade volumes on international financial markets, and from an increase in the volume of funds traded, which had appeared *en masse* following the introduction of so-called derivatives. What we are after may indeed seem trivial, and that is the loan granting procedures applied by Polish banks, as a result of which the process of receiving a loan – even by a sound business entity – may take weeks if not months. Such phenomena cause good customers to walk away from Polish banks, heading for the foreign, where a similar loan can be processed and granted over the span of a dozen or even a few days. Consequently, Polish banks are losing both their customers and their loan-granting skills, thus becoming less competitive in the integration process not only for reasons of poor assets and own funds ratings, but also for reasons of deficiencies in fundamental skills.

4. The low "credit capacity", understood as the ratio of loans possible to be granted to GDP. Empirical research proves that should we make an attempt at a comparison against banking systems encompassing entities with comparable own capital funds, the German banking system would prove four times more effective; the Spanish – three times as effective; the Czech – twice as effective. It may thus be said that Polish banks have "felt" a reluctance to grant loans. A confirmation of the condition as described can be found in an analysis of the asset structure of the Polish banking system against the asset structure featured by commercial banks in developed market economy countries. There, loans constitute approximately 70% of assets total, on average, whereas in the Polish banking system, they amounted to 15-18% in the first half of the nineties, to reach 33-37% in the years 1996-1997. Albeit this spells definite progress, Poland is still well behind global standards in the area. What has the main reason been behind such minor interest of Polish banks in offering loans to the non-financial sector, and thus – behind a deformation of banking system assets? It seems that the main reason for the phenomenon ought to be sought in the fact that commercial banks have been showing an inclination to invest in high-yield and low-risk treasury bills issued by the State Treasury to finance the public debt. Thus, as can be found in Professor K.Ryć's writings, *"it is not production*

but distribution that has been and in a sense still is the source of prosperity for the banking sector in Poland".

5. Employment surplus blended in with low work efficiency. The cost to income ratio reaches 0,84 in Poland on average, whereas in the European Union this ratio reaches 0,69. The labour cost to asset value ratio is also less advantageous in Poland (1,29) than in the majority of European Union countries (France: 0,78%, Germany: 0,80%).

By mid-1998, Polish banks employed a grand total of more than 147 000 people, which from the viewpoint of the employment numbers against asset value (in comparison with western countries) was a gross over-employment condition. It is also noteworthy that such labour surplus could be justified if the banking penetration factor were to be increased in Poland, that is if a higher number of businesses engaged in monetary operations. This problem relates to an increase in the "monetisation" of the economy, that is an increase in supply of money against the GDP ratio, reaching 37% in Poland in 1996, whereas in Germany, for example, this ration fell above 200%.

Moreover, the low banking penetration rate in Poland stems from the existence of a number of niches banks have not reached yet at all. According to Pentor research results, only 46% of Poles used banking services in 1996. Despite the steady growth recorded in the area (by 6 percentage points in 1996), this rate continues to be very low as compared with western countries. In real categories, such a condition means that approximately 13,5 million Poles use no banking services at all.

4. The economic condition and organisational-and-ownership transitions in the Polish banking sector in the second half of the nineties

Receivables from the non-financial sector predominate in the asset structure of the banking sector. In 1998, they totalled 39,95 per cent. In comparison with the previous year, they grew by 25,5%, amounting to PLN 13 429,6 million. Securities ranked second position in the banking sector asset structure – 25,4%, totalling a value of PLN 85 037,5 million. In 1998, banks had been investing much more intensely in securities, which fact was then reflected in the relatively high dynamics of the growth of that item, nominally reaching 130,2%. In 1998, banks had been making securities investments to make proper use of liquid funds, among others. To a large extent, securities investments made by banks were stimulated by the central bank issuing monetary bills to absorb the banking system liquidity, using them as a substitute for treasury bills.

The next item in the banking sector asset structure were receivables from the financial sector, with a share of 17,4%, translating into an amount of PLN 58

282,9 million. The dynamics of the item nominally totalled 173,8%, thus exceeding the overall average for assets by 46.9 percentage points. Receivables from the National Bank of Poland – which had grown by 56,7% – played a crucial role in the accrual in this particular asset group. This was a highly unfavourable phenomenon, as such assets bring no income. Such a major increase in non-profit assets had primarily resulted from a change in rules concerning cash mandatory provisions. In 1997, up to 50% of the mandatory provision could be stored in the form of a declared amount of cash. In December 1997, this proportion was reduced to 10%, and the basis for calculating the mandatory provision was also expanded. Receivables from the banking sector had a major share in receivables from the financial sector. Their dynamics reached 198,8% in 1998, with a nominal accrual of PLN 16 689,2 million. This proves the existence of a dynamically developing interbank market, and is also a potential signal of increasing disproportion in access to liquid funds.

Foreign receivables in the asset structure reached 5,7% – PLN 18 956,7 million in nominal terms. Relatively high negative dynamics of 74% was recorded for the item, Concurrently, a minor trend of increasing foreign receivables arose (with dynamics of 121,2%), thus proving that foreign exchange items were closed under conditions of diminishing exchange rate benefits.

Budget sector receivables totalled 1,9% of assets as of the year-end, having slightly grown in nominal terms as compared with the end of 1997 (dynamics for the item reached 127,7%, with a nominal growth of PLN 1 423,3 million).

Other assets totalled 9,6% of overall assets as of the end of 1998 (PLN 32 024,2 million in nominal terms). Despite the nominal growth by PLN 4 978,9 million, the share of the item in the asset structure dropped by 0,9 of a percentage point. Albeit this is a minor change, given the continuation of the trend over the past four years, the phenomenon ought to be seen as positive.

In 1998, as in the previous years, non-financial sector deposits were the major item in the liability structure. They totalled 55,5% of liabilities total, and a nominal value of PLN 185 398,4 million. Against the year-end 1997, the share of this group of liabilities in liabilities total increased by 1,5 of a percentage point. In 1998, the currency deposit dynamics reached 107,4%, and was thus significantly lower than the Polish zloty deposit dynamics, which totalled 136,7%. The accrual of deposits in currency accounts, considerably lower than that on Polish zloty accounts (Polish zloty accounts: 36,7%, currency accounts: 7,4%) stemmed from the very strong position of the zloty in 1998, and from the rather low profitability of keeping any money on currency accounts.

In 1998, the financial sector deposits grew by 30,5%. In nominal terms this amounted to PLN 43 281,7 million. This amount was more than sufficient to cover loans granted to the non-financial sector (PLN 27 153,4 million). The

growth in the deposit segment in nominal and real terms alike confirms the growing confidence in the banking sector, and the increasing tendency to save.

In terms of other liability items, it would be worthwhile to point out the basic and supplementary bank funds, whose overall share in the liability structure totalled 7,3%. The dynamics of basic funds reached 162%, with a nominal accrual by PLN 8 374 million. To a large extent, the growth of funds in the category related to foreign sources.

Foreign payables remained practically unchanged, reaching a share of 5,5% in liabilities total. The dynamics of the item reached 121,2%, with a nominal accrual of PLN 3 195 million. Foreign payables constituted an alternative source of funding bank operations. Fixed-term deposits or credit lines with foreign banks were available to banks with sound financial standing, and chiefly to banks being branches of or owned by foreign financial institutions.

5. Financial result of the banking sector

In 1998, the gross financial result of the banking sector reached PLN 5 423,7 million, and was thus lower than the 1997 result by PLN 1 360,9 million. The net result reached PLN 3 062,1 million, being lower than that recorded in 1997 by PLN 1 704,9 million.

The deterioration of the financial result of the banking sector as compared with the year 1997 stemmed from a higher rate in the growth of costs incurred by banks over the rate of revenue growth. Cost grew by 58,8%; revenues – by 46,9%.

In 1998, for the second year running the financial result of the banking sector was lower in real and nominal terms than that recorded for the previous year. In general, the chief reason had been the decidedly lower interest margin collected on credit and deposit operations and on securities. The financial result dynamics on such operations reached 109,2%, with an overall asset dynamics of 126,9%. moreover, the dynamics of the commission result was relative low (112,1%), whereas the result on other revenue and costs of operation reached a dynamics rate of 128,3%. A significant growth in exchange operations (dynamics of 146,8% and a nominal growth of PLN 536,1 million) could not compensate for the deteriorating banking business conditions. Despite the high costs and relatively low incomes, however, the gross operational result for the entire banking sector was slightly higher than the 1997 result (by 1,7%, or by PLN 143,6 million in nominal terms).

Table 1. Financial result of the banking sector (PLN million, National Bank of Poland excluded)

No.	Specification	Revenue	%	Costs	%	1998 Result
1	2	3	4	5	6	7
1	Interest	39 525,1	59,5	26 615,9	43,6	12,909,2
	– from financial institutions	4 395,8	6,6	5 098,1	8,3	-702,3
	– from clients and the budget sector	21 624,7	32,5	21 270,4	34,9	354,3
	– on securities	11 558,2	17,4	-	-	11,558,2
	– other	1 946,4	3,0	247,4	0,4	1,699,0
2	Commissions	3 618,2	5,4	454,2	0,7	3,164,0
3	Revenue on stocks and shares	423,5	0,6	-	-	423,5
4	Financial operations	1 837,4	2,8	1 658,7	2,7	178,7
5	Exchange operations	17 198,8	25,9	15 518,5	25,4	1,680,3
6	Other revenue and cost of operations	687,6	1,0	455,7	0,7	231,9
I	Banking business result	63 290,6	95,3	44 703,0	73,3	18 587,6
	General costs	-	-	10 095,0	16,5	-10 095,0
	– payroll expenses	-	-	5 815,4	9,5	-5 815,4
	– other expenses	-	-	4 279,6	7,0	-4 279,6
II	Gross operational result	63 290,6	95,3	54 798,0	89,8	8 492,6
1	Depreciation	-	-	1 241,6	2,0	-1 241,6
2	Collateral	3 118,3	4,7	4 942,7	8,1	1 824,4
III	Net operational result	66 408,9	100,0	60 982,3	100,0	5 426,6
	Extraordinary income and costs	6,0	-	8,9	-	-2,9
IV	Result before taxes	66 414,9	100,0	60 991,2	100,0	5 423,7
	Deductions on result	-	-	-	-	-2 361,6
V	Result after taxes (Net)	-	-	-	-	3 062,1

Source: National Bank of Poland, own analysis.

Table 2. Comparison of the financial result for the sector with 1997 (PLN million, National Bank of Poland excluded)

No.	Specification	1997 Result	1996=100	1998 Result	1997=100
1	2	3	4	5	6
1	*Interest*	11 818,8	101,1	12 909,2	109,2
	– from financial institutions	-446,2	x	-702,3	157,4
	– from clients and the budget sector	2147,9	x	354,4	16,5
	– on securities	8 638,6	87,9	11 558,2	133,8
	– other	1 478,5	x	1 699,0	114,8
2	Commissions	2 821,7	138.7	3 164,0	112,1
3	Exchange operations	1 144,2	169,0	1 680,3	146,8
4	Other revenue and cost of operation	650,1	94,1	834,1	128,3
I	Banking business result	16 434,8	109,2	18 587,6	113,1
1	General costs	-8 085,8	114,6	-10 095,0	124,8
	– payroll expenses	-4 797,0	113,5	-5 815,4	121,2
	– other expenses	-3 288,8	116,1	-4 279,6	130,2
II	Gross operational result	8 349,0	104,8	8 492,6	101,7
1	Depreciation	-937,7	126,2	-1 241,6	132,4
2	Collateral	-624,4	380,0	-1 824,4	292,2
III	Net operational result	6 786,9	96,2	5 426,6	79,9
	Extraordinary income and costs	-2,3	x	-2,9	126,1
IV	Result before taxes	6 784,6	95,7	5 423,7	79,9
	Deductions on result	2 017,6	88,6	-2 361,6	117,0
V	Result after taxes (net)	4 767,0	99,0	3 062,1	64,2

Source: National Bank of Poland, own analysis.

In professional literature, the following fundamental ratios have been adopted to measure the operational effectiveness of commercial banks:

- **ROA (Return on Assets)** = net income/bank assets (in general terms, this ratio reflects the bank's profit per PLN 1 of balance-sheet sum assets);
- **ROE (Return on Equity)** = net income/bank's own capital (this ratio gives us the bank's profit per PLN 1 of equity).

The 1995-98 effectiveness of Polish banks is shown in the Tables 3.

Table 3. Selected operational ratios for banks – condition as of year-ends, 1995-1998 (percentage)

Specification	1995	1996	1997	1998
Interest income/Assets (b:a)	5,1	5,9	5,2	4,3
Non-interest income/Assets (c:a)	1,7	1,8	2,0	2,0
Costs of bank operation/Assets (d:a)	3,4	3,9	4,0	3,9
Net provision deductions /Assets (e:a)	0,3	0,1	0,3	0,6
Total costs/Assets (f:a)	3,6	4,0	4,3	4,6
Return on Assets (ROA) net	2,0	2,5	2,1	1,1
Return on Equity (ROE) net	53,7	68,1	43,2	17,3

Notes:
a) Average assets,
b) Interest income = interest revenue (including on securities operations), with interest-related costs deducted,
c) Non-interest income = non-interest revenue (i.a. commissions, fees, exchange rate differences, brokerage house results) with non-interest-related costs deducted,
d) Cost of bank operation = cost of payroll, depreciation, other general costs,
e) Net provision deductions = provision deductions, with termination revenues deducted,
f) Total costs = cost of bank operation + net provision deductions + extraordinary costs.

In 1998, the operational effectiveness of the banking sector dropped. This was reflected in the values of ROA (1,1% net) and ROE (17,3% net) ratios recorded. In 1997, these ratios amounted to 2,1% and 43,2%, respectively. Disadvantageous phenomena also include an advancing growth of the relation of the banks' cost of operation (i.e. total costs) to assets total. In conformity to generally adopted rules, the rate of this ratio should not exceed 3%, whereas in 1998 it reached 4.6%. For a more complete assessment of the effectiveness of the Polish banking system, it seems noteworthy to take a glance at its profitability by the various bank groups.

An analysis of ratios of bank effectiveness results in the quoted Tables above proves the following:

Effectiveness ratios for the various bank groups do not show any major advantage of any such group. Although in 1995, the dominance of banks with majority foreign equity is apparent, one year later their situation undergoes severe deterioration in terms of effectiveness. Sound results, on the other hand, have been achieved by stock exchange-listed banks and by public banks (state-owned banks or banks with a state shareholding). A distinct improvement in effectiveness has been accomplished by co-operative banks.

Table 4. Effectiveness ratios by bank groups

Specification	Cost level ratio		Profitability ratio				Bank result: Assets*		Net interest Assets*		ROA net profit Assets*		ROE net profit Assets**	
			Gross		Net									
	1995	1996	1995	1996	1995	1996	1995	1996	1995	1996	1995	1996	1995	1996
1	2	3	4	5	6	7	8	9	10	11	12	13	14	15
Banks total	84,2	82,7	15,5	18,2	9,9	12,5	6,82	6,87	4,94	5,09	1,98	2,26	25,81	24,54
State-owned banks	83,8	81,3	16,5	18,6	11,2	13,4	7,20	6,32	5,26	4,72	2,41	2,27	42,13	29,79
Private banks	85,7	82,0	13,7	18,0	6,6	11,4	5,39	7,68	3,69	5,52	1,00	2,28	7,85	17,70
Co-operative banks	91,3	85,9	8,6	14,1	5,4	9,1	9,26	9,84	7,34	7,70	1,32	1,89	15,57	21,19
Banks with a majority Polish shareholding	86,5	81,1	13,3	18,9	9,0	13,3	5,03	6,54	3,65	4,87	1,48	2,29	21,74	27,14
Banks with a majority foreign shareholding	76,5	83,9	23,1	16,0	15,3	10,0	18,34	7,90	12,98	5,51	5,72	2,21	42,79	15,79
Including those with a 100% foreign shareholding	77,9	90,6	22,7	9,4	12,8	4,8	8,77	5,79	10,08	3,77	2,75	1,22	17,69	8,17
9 banks disseminated from the NBP	77,4	78,0	22,2	22,0	13,0	14,2	7,89	7,72	5,58	5,85	2,50	2,49	25,62	24,21
Specialist banks	84,8	81,0	15,0	19,0	11,4	14,7	6,04	6,05	4,31	4,42	2,29	2,49	48,64	34,32
Banks quoted on the Warsaw Stock Exchange	75,9	77,9	23,6	22,1	14,6	14,5	9,05	8,27	6,28	6,01	3,06	2,80	23,05	20,94

* assets as of year-end
** own equity as of year-end

Source: own analysis on basis of Central Statistics Office (GUS) data.

Many factors indicate that the 1994-1995 bank results have stemmed from a number of positive phenomena, of which the following have been crucial:

- decreasing the load of target provisions as a result of restructuring operations, the alleviation of any fiscal rigours related, and a change in the rules of establishing such provisions,
- a decrease in the share of non-profit assets in assets total, among others by a reduction in the mandatory provision rates,

– a reduction in the budget sector demand for loans, enabling a more intense loan campaign targeting the non-financial sector.

Table 5. Net profitability of banks in Poland – 1997

Specification	Net profitability = Net financial result / Total costs
1. Commercial banks	11,94
a) with a majority Polish shareholding	12,46
b) with a majority Polish shareholding, state equity included	10,45
c) with a majority foreign shareholding	9,70
2. Stock exchange-listed banks	15,93
3. Co-operative banks	11,13

Source: *Sytuacja finansowa banków w 1997r. (Financial Situation of Banks in 1997)*, Narodowy Bank Polski (National Bank of Poland), p.29, quoted from A.Kaźmierczak, Rządowe Centrum Studiów Strategicznych (Governmental Centre for Strategic Studies), Warsaw 1998, mimeographed typewritten text, p.6.

A growth in profitability enabled banks to rebuild their capital assets at least in part, with this opportunity used by foreign banks to a greater extent. It would be worthwhile to emphasise something claimed before already, namely that the structure of bank assets and operations shows specific features typical for certain bank groups. Specialist banks have a relatively high share of deposits and securities (restructuring bonds – creating a vast part of income in this bank group – included), and a low share of loans. A low share of own equity is typical for specialist banks, which partly determines the loan campaign volume.

Banks with a foreign majority shareholding, especially banks with a 100% foreign shareholding, display a relatively high own equity funding rate, which allows them to engage in more risky loan operations, and to adjust it to the needs emerging. In 1995, loans were the main source of revenue in this group of banks, with foreign exchange being such main source in 1996. Although in 1995 this group of banks showed much more favourable results, any such differences disappeared in 1996.

Stock exchange-listed banks owe an improvement in financial results to the high loan dynamics, facilitating the process of equity contributions via public share issues.

Co-operative banks are a unique group. Their operations are practically restricted to deposit and loan operations, which in 1995-1996 alone was sufficient to vastly improve their financial result.

Table 2 shows that in 1997, the ever-growing competition under conditions of increasingly restrictive monetary policy, displayed – among others – in a growth of interest rates and of mandatory provision rates, has led to a deterioration in financial conditions. It seems that more intense profitability decreases may also occur as a result of the Polish banking sector opening to foreign competition, which is why increased capitalisation of Polish banks is a matter of extreme urgency.

The Table 6 shows the condition and changes in the Polish banking system in the nineties.

Table 6. Banks in Poland in years 1991 and 1996

Specification	1991	1996
1. Total (co-operative banks excluded and included)	76/1741	89/1483
2. State-owned banks	16	19
2.1. Central bank	1	1
2.2. State-owned joint-stock companies	12	9
2.3. State-owned / co-operative mixed ownership bank	1	1
3. Private banks (established on basis of the 1998 Banking Law)	60	64
3.1 Foreign banks	6	19
3.2 Branches of foreign banks	2	3
4. Co-operative banks	1655	1394
4.1 Forming part of the Bank of Food Economy (BGŻ)	1574	518
4.2 Forming part of other structures	91	876
5. Private banks listed on the stock exchange	-	13

Source: B.Pietrzak, Z.Polański in: *System finansowy w Polsce (Financial System in Poland)*, PWN, Warsaw 1998, p.62.

When describing organisational-and-ownership changes in the Polish banking system, attention ought to be paid to the following tendencies:

1. An increasing share of private banks in the Polish banking sector. For example, the number of banks with a majority state ownership dropped in 1997 from 24 to 15, of which only 6 have remained state property. Moreover, 1 bank belonged to the National Bank of Poland. As of the end of last year, the assets of those 6 banks owned directly by the State formed a mere 40% of the overall banking system assets. In the nineties, the number of co-operative banks dropped as well. A part of them went bankrupt, while other – weaker – were taken over by stronger banks, or by other financial institutions with a different form of ownership. For the sake of clarity, one ought to add that in numerous European

states, the share of state-owned banks in the banking sector is vastly greater than that in Poland. In Portugal, for example, it totalled 87,5% in the early nineties; in Greece – 85%; in Italy – 68%; in Germany – 50%; in France – 42%; and 47% in Poland. It seems that a transition period of state ownership in the banking system would be a solution typical for other European Union countries. This ought to be linked to management privatisation in banks, which means the introduction of the following:

- manager contracts providing for the achievement of results no worse than those recorded for private banks in Poland;
- management staff share in bank profits;
- forty percent of the remuneration of top managerial staff to be offered as an option to purchase bank shares at nominal prices.

2. The strengthening of banks of major financial power. This process occurs through the liquidation of loss-incurring banks, the acquisition of weaker banks by stronger banks, and through the overtaking of equity control over small banks. This phenomenon, fully conforming to global tendencies, is referred to as "banking system consolidation" in reference books. Natural reasons for banking system concentration are believed to include the ever-increasing differentiation, resulting among others from a rapid development of large and medium-sized banks enjoying public confidence. In many such banks, not only does growth take on the form of an expansion of the network of own units, but also of acquiring banks experiencing difficulties already, or threatened by such difficulties. The tendency to acquire varies as well. It depends (among others) on the load (losses) carried, on the possible effects (network expansion – attempts to expand the scope of operation, to attract customers, to dispose of competition, etc.), on the opportunities of receiving external assistance – including Bank Guarantee Fund loans to cover any deposits insured – and on a reduction in the mandatory provisions established. Occasionally, consolidation may be an expression of care shown by monetary authorities for the banking system safety, and the protection thereof against strong foreign competition. Such attitudes have, for example, been displayed in works on the governmental concept of banking sector consolidation, and of establishing two equity groups in the Bank Handlowy SA and Bank Polska Kasa Opieki S.A. environments.

3. An increase of the banking sector share in stock market capitalisation. This on the one hand means an increasing number of Polish banks with opportunities of issuing securities on the capital market, and thus of expanding own funds. There are 15 banks listed on the Warsaw Stock Exchange, Inc., today, with the overall capitalisation in the banking sector reaching approximately PLN 11 863 million, that is about 32% of the capitalisation rate recorded for the basic stock market. On the other hand – theoretically, at least – the major share of financial institutions in the capital market, banks included,

improves the options of manufacturing enterprise access to investment funds. As mentioned above, this mechanism does not operate to its full extent in Poland yet, as banks in Poland have to date been more interested in investing in treasury bills than in shares of privatised companies.

4. The increasing share of foreign banks in the Polish banking sector. In the years 1995-1997, the number of branches and subsidiaries of foreign banks and of banks with a majority foreign shareholding grew from 18 to 29 in Poland. The number of banks with Polish (or majority Polish) shareholding dropped from 69 to 61. In 1997, the share of foreign equity in Polish banks' own funds was estimated at approximately 41,5%, whereas foreign shareholdings in European Union member state banks reached 12-15%. The foreign shareholding in Polish bank assets is equally high (approximately 15,4%), while in Germany, for example, it totalled 4,5%, and 3,5% in Italy.

Foreign shareholding in the Polish banking system ought to be considered in two aspects at least (economic and political). At least two opinions are presented in terms of politics. According to the first, excess foreign shareholding in the Polish banking sector means a loss of national identity by Polish banks, and of economic independence by the state. The other proves, on the other hand, that any restrictions in foreign banks' shareholding in the privatisation process shall condemn privatised banks to be taken over by "equity of the former regime", thus expanding the area of its rule. It seems that economic factors ought to be the chief reasons behind the various forms of privatisation, although the safety of the country is also an element of importance here. Hence, the issue concerns – among others – the volume of financial resources to be allocated for the privatisation of the banking sector. Empirical data and practice both indicate that these funds are insufficient. Thus, monetary authorities shall decide whether to generate additional funds, or to privatise with the assistance of foreign capital, with all the consequences outlined above. The positions presented above should by no means be neglected. Were they without meaning, neither the Federal Reserve System, nor the Central Banks in Western Europe would be introducing the so-called prudence standards for purposes of foreign shareholdings in own funds of national banks.

6. A banking sector model supporting Polish integration with the European Union

The contemporary world basically features two fundamental banking models: the Anglo-Saxon and the German, with further mutations thereof. The Tables 7 and 8 describe the basic differences between and similarities of the two.

In analysing these Tables, one ought to conclude that there is no single global or indeed European banking model. Banking systems in Europe differ

greatly, among others in the extent of state presence in the sector, the acceptability of foreign strategic investors' participation in the banking sector, the position taken by universal and investment banking within the system, the forms of clearance applied, the type of monetary policy implemented, etc.

Table 7. German and Anglo-Saxon financial system (framework)

German system	Anglo-Saxon system
Funding of operations	
– major importance of external funding	– major importance of internal funding
– external funding based on fixed-interest individually negotiated bank loans	– external funding provided by anonymous capital markets
– bank shareholding in corporate equity	– no bank shareholding in corporate equity
Nature of banks	
– universal banks	– specialist banks
Monetary policy	
– pressure on monitoring the banks' crediting operations	– pressure on monitoring the money supply
– refinancing credit	– open market operations
Payment mechanism	
– credit transfer (giro)	– debit transfer
– mail	– clearing houses

Source: own analysis.

Table 8. Contrast comparison of two financial system models

Comparison dimension	Germany	United States
Universal banking	yes	no
Number of banks	small	large
Duration of bank-company contact	long-term	Limited
Competition among banks	minor	major
Number of stock exchange-listed companies	small	large
Options and futures market	non-liquid	Liquid
Access to company information	limited	Extensive
Market control over banks	none	Present

Source: *The regulation of Non-Bank Financial Institutions*, World Bank, Washington 1997, p.70.

Most certainly, the introduction of the euro shall intensify system convergence, which – though under way for some time now for economic reasons – does not lead to the unification thereof.

What should thus the path for Polish banking be? Regretfully, the answer to the query is neither easy nor unambiguous, although the launch of integration talks with the European Union seems to be a good enough period for a more precise definition of a development concept for the Polish banking sector. Historically speaking, Polish banking has been closer to the German system, with its fundamental typical features of universal banking and of supporting the development thereof with bank loans. It seems that since 1989, Polish monetary authorities have decided to support the banking system development along the lines of the Anglo-Saxon model, primarily based on specialist banking and on anonymous financial markets boosting the economic growth. Such attitude was expressed – among others – in the establishing of the Warsaw Stock Exchange. Considering the role of the this institution in the financial aspect of economic development measured against the capitalisation rate, this concept does not seem to be fully justified. Does economic practice provide us with examples of successful mixes of both entirely different systems? Most probably until recently, the reply to the above would have been unambiguously affirmative. The Asian crisis, following attempts at the concurrent development of the capital market and the banking sector, and bringing results in the form of a hidden asset inflation stemming from stock exchange or real estate market speculations, forces us to provide a rather negative response, however.

In a certain sense, a pattern to be followed should rather be the German system, showing the following features in its “contemporary version”:

- a strong sector of lead banks servicing the fundamental economic groups in the country,
- a strong sector of municipal banks providing financial support to a process of administrative decentralisation in the state,
- a consolidated sector of co-operative banks, capable of survival under competition conditions on the Single European Market.

As J.Solarz has it, the dual and oligopolistic structure of the German banking system blends in various forms of ownership, and a retention of national control over the banking sector with European integration processes. Hence, it is an attempt at a sustainable use of competitive pressure and an encouragement to save.