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Republic of Poland: Financial System Stability Assessment

This Financial System Stability Assessment on the Republic of Poland was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on **February 20, 2001**. The views expressed in this document are those of the staff team and do not necessarily reflect the views of the government of the Republic of Poland or the Executive Board of the IMF.

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REPUBLIC OF POLAND

Financial System Stability Assessment

Prepared by the Monetary and Exchange Affairs and European I Departments

Approved by Stefan Ingves and Susan Schadler

February 20, 2001

The Financial Sector Stability Assessment (FSSA) is based on the work of a joint IMF-World Bank mission that visited Warsaw, Poland as part of the Financial Sector Assessment Program (FSAP), during the periods July 4–8 and September 11–20, 2000. The mission met with senior management and staff of the National Bank of Poland (NBP), the ministry of finance (MoF), supervisory agencies overseeing banks, capital markets, mutual funds, insurance companies and pension funds and the Bank Guarantee Fund. The mission also met with representatives of the financial sector. The findings of the FSAP mission were discussed with the authorities from December 7–14, 2000, in the context of the 2001 Article IV consultation.

The mission was led by Stijn Claessens (World Bank, Team Leader) and Marc Quintyn (IMF, Deputy Team Leader) and comprised Mark O' Brien, Andrea Schaechter, and Adrianna Rota (staff assistant) (all MAE), Peter Doyle (EU1), Laura Ard, Daniela Klingebiel, Esen Ulgenerk, Peter Kyle, Luc Laeven, Donald McIsaac, and Hemant Shah (all World Bank), Shyamala Gopinath (Bank Supervisor, Reserve Bank of India), Stefan Spamer (Bank Supervisor, Deutsche Bundesbank), and Martin Andersson (Payment Systems Expert, Central Bank of Sweden). Franek Rozwadowski and Cyrus Sassanpour (former and current IMF Resident Representatives in Poland) attended some of the meetings.

The Polish financial sector has been modernizing considerably over the last five years. Foreign ownership has contributed to the stability of the sector, and therefore helped the system to withstand external shocks in recent years. The mission concluded that no major immediate issues in terms of systemic stability were apparent. Risk management capacity in banks has improved considerably and regulation and supervision are approaching international standards. Risk management in other subsectors is also improving. Nevertheless, vigilance remains warranted because the financial system faces a range of challenges, stemming from the large (though shrinking) current account deficit, slowing economic growth, and fast growing demand for credit by the small and medium enterprise (SME) and household sectors. Of particular concern is the uncertainty about the exchange rate exposure of the corporate sector, which could translate into increased credit risks for the banking sector. At this moment credit risks are the greatest challenge for the banks and a severe downturn in the Polish economy could create problems for some banks. To reduce the likelihood of systemic problems, regulation and supervision of the financial sector needs to be further strengthened, with immediate attention for the need for consolidated reporting by and supervision of large financial groups, stronger legal backing for imposing principles of good corporate governance, and augmented enforcement powers.

This report is divided in two parts. The first part presents the main findings and overall assessment, while the second part presents a summary assessment of observance of standards and codes regarding banking supervision, payment and settlement systems, securities markets, insurance regulation, and transparency in monetary and financial policies. The FSAP report, containing detailed institutional information and analysis, as well as a detailed assessment of the observance of international codes and standards, will be transmitted to the authorities upon approval by Fund management.

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GLOSSARY

BGF	Bank Guarantee Fund
CAR	Capital adequacy ratio
CBS	Commission for Banking Supervision
CEE countries	Central and Eastern European countries
CPSS	Committee on Payment and Settlement Systems
CSO	Central Statistical Office
EU	European Union
FSAP	Financial Sector Assessment Program
FSSA	Financial Sector Stability Assessment
GIBS	General Inspectorate for Banking Supervision
IAIS	International Association of Insurance Supervisors
IAS	International Accounting Standards
IOSCO	International Organization of Securities Commissions
LOLR	Lender of last resort
LTPS	Law on Public Trading of Securities
MoF	Ministry of finance
MoU	Memorandum of Understanding
MPC	Monetary Policy Council
NBP	National Bank of Poland
NDS	National Depository for Securities
NIK	Superior Chamber of Control
OTC	Over-the-counter
PUNU	State Office for Insurance Supervision
RTGS	Real time gross settlement
SEC	Securities and Exchange Commission
SME	Small and medium enterprise
SROs	Self-regulatory organizations
UNFE	Superintendency of Pension Funds
WSE	Warsaw Stock Exchange

SECTION I—STAFF REPORT ON FINANCIAL SECTOR ISSUES

I. EXECUTIVE SUMMARY AND OVERALL STABILITY ASSESSMENT

1. **The Polish financial landscape has changed dramatically during the past decade, and in particular over the last five years.** The financial sector has become more diversified—insurance companies, and pension and investment funds are becoming important players—and strong foreign strategic investors own key shares in banking and insurance. Commercial banks dominate the market, with over 85 percent of financial system assets. Despite an acceleration in recent years, the privatization agenda has not been completed. In the banking system, an important share of deposits remains mobilized through majority state-owned banks (nearly 30 percent of total bank deposits), while majority state-owned companies also remain dominant players in the insurance sector.

2. **The mission concluded that no major immediate issues in terms of systemic stability were apparent.** Risk management capacity in banks has improved considerably with the introduction of foreign ownership and generally proper regulation and supervision, although state-owned banks and some recently privatized banks still have weak risk management capacity. Risk management in other subsectors is also improving. These sectors do not pose a systemic threat either. Concentration in all sectors is high.

- The banking system is still relatively small compared to similar countries. The system is well capitalized and profitable, although the tail end is composed of a group of small local banks that are struggling. The larger part of bank lending is to large corporates, but lending to the SME and household sector has been growing fast in the past two years.

- The insurance sector has been expanding rapidly in the past few years. However, this growth is concentrated in life insurance. Many smaller companies are unable to compete with the largest institutions. This leads in particular in the nonlife sector to many loss-making companies. Consolidation is therefore needed.

- The pension fund sector is relatively new (pension reform took place in 1999), but pension funds have been mushrooming since then. The sector is struggling with some growth pains—a large number of pension funds incur operating losses—an issue that should be addressed by the authorities, by taking a more flexible stance towards mergers and acquisitions. In the medium term, as the governance framework is improved, investment regulations could be relaxed.

- Securities markets are small, but the markets and their participating firms are operating on a sound basis. Sound macroeconomic fundamentals will be the main contributing factor to further growth in equity and bond markets. In addition, completion of the privatization program will give a boost to the supply in the equity markets. Technical improvements in the government bond market would have positive spillover effects on the corporate bond market.

3. **Domestic money markets operate smoothly, but the authorities should monitor developments closely to prevent liquidity risks that could arise from the concentration of deposits in a few banks.** The largest state-owned bank manages almost 28 percent of total retail deposits, and is a main supplier in the interbank market. Were severe problems to arise in this bank, other banks could be affected and the payment system could be disrupted.

4. **Payment and settlement systems are well organized and sophisticated.** Oversight of the retail systems is not properly defined, but legal initiatives to address this deficiency have been introduced. The introduction of an intraday credit facility by the National Bank of Poland (NBP) would increase the safety of the large value system and a revision of the bankruptcy law should eliminate the uncertainties regarding the zero-hour rule and multilateral netting.

5. **Regulatory and supervisory systems have improved over the past five years.** The regulatory frameworks have been revised frequently to keep up with developments in the respective sectors and trends worldwide. As such they have come closer to international standards and best practices, and more recently, European Union (EU) directives. Supervisory practice has also greatly improved, and supervisors—particularly in the banking sector—try to overcome known weaknesses in the regulatory area through augmented supervision, both on- and off-site.

6. **Despite this favorable profile of growing stability and diversity, vigilance and further efforts to strengthen the soundness of the sector remain required.** Indeed the system needs to gain further strength to withstand potential macroeconomic challenges. Attention should in the first place be given to the banking system because of its systemic importance, without however disregarding the development needs of the other sectors. Continued strengthening of the system will also make full integration into the European financial market a smoother process.

7. **Going forward, the main macroeconomic challenges stem from the still wide external current account deficit, the risks of an economic downturn, and the rapid growth in demand for credit by new and more risky sectors—SMEs and households.**

- The challenge stemming from the current account deficit is diminishing compared to recent years, but caution remains warranted. The banking system's foreign exchange exposure is within the prudential limits, but the uncertain factor in this situation is the extent to which the corporate sector is exposed to foreign exchange risks, which may be translated into added credit risk for the banks.

- The main challenges on the domestic side stem from the possible impact of an economic downturn, and from the rapid growth in demand for credit from more risky borrowers. The latter development is already having an impact on the quality of the banks' loan portfolios. Supervisors and banks are taking appropriate steps, through stringent classification and provisioning of loans.

8. **The authorities are aware of the nature of these challenges, as well as of some lingering weaknesses of the system. The resilience of the system should be fostered by focusing on the following issues:**

- Falling profitability in the banking system is an issue. Under the threat of growing competition, banks are venturing out into more risky lending. These factors, taken together, will strain the capital adequacy positions of some banks. To enhance the stability of the sector, further *consolidation* is needed, including for the cooperative banking sector. The process should be market-driven, but government-stimulated, along the lines the General Inspectorate for Banking Supervision (GIBS) is pursuing currently.

- The *privatization agenda* should be finished in due course. The two majority state-owned banks that are currently slated for privatization do not pose a systemic threat at this moment. However, their early restructuring and subsequent privatization to financially committed shareholders would stimulate competition, contain the current deterioration in their franchise values, limit the costs to the state, and contain risks to the sector.

- The *regulatory and supervisory framework* should be strengthened in critical areas: the move to large groups makes consolidated reporting and supervision a priority; principles of good corporate governance need to be further ingrained in bank management; enforcement powers need to be augmented, for the supervisors to be in a position to stop a problem at an early stage; and solid risk management tools need to be promoted further.

9. **As Poland is transiting to a mature financial system that will soon be fully integrated in the European financial system, the authorities should review the bankruptcy law and associated laws on collateral and pledges.** A more efficient bankruptcy law would not only make crisis resolution easier, it would also take away the uncertainty regarding multilateral netting in the payment system and reduce the interest cost of borrowing for SME's and households. In the end, intermediation will grow and become more efficient.

10. **Assessments of the banking, insurance, and securities regulations, and of the systemically important payment systems, as well as an assessment of the observance of the code of good practices on transparency of monetary and financial policies, confirmed the great progress made in assimilating international best standards and practices.** Common threads in all assessments, with potential effects for the soundness and stability of the system, are the need for (a) more autonomy for the supervisors, including legal protection of supervisors; (b) closer coordination among supervisory agencies; (c) powers to conduct consolidated supervision; (d) stronger enforcement powers; (e) stronger regulations to instill corporate governance principles.

- The assessment of compliance with the *Basel Core Principles for Effective Banking Supervision* indicates that compliance with those principles relating to the rules and regulations is low, but that compliance with the principles relating to the actual supervisory practice is much higher. The amended Banking Law, currently before parliament, addresses several of the key weaknesses and, when implemented, will greatly improve compliance.

- Securities markets regulation complies with most of the *International Organization of Securities Commissions' (IOSCO) Objectives and Principles* and compares favorably to other transition economies. Several of the areas that are noncompliant are being addressed in the amended securities law. The most critical ones are weak enforcement powers and powers to protect rights of minority shareholders.

- The review of compliance with the *International Association of Insurance Supervisors' (IAIS) standards*, while generally favorable, revealed the following areas for improvement: the supervisory agency should have more autonomy and adequate powers to intervene in weak companies; on-site inspections should take place more frequently and should gradually shift away from checklist-driven approaches to a risk-based approach to detect isolated or systemic risks at an early stage.

- The review of compliance with the *Core Principles for Systemically Important Payment Systems* underscored the high quality of the systems and their management. The main weakness relates to the lack of clear oversight responsibility over the retail systems and the legal uncertainty created by the zero-hour rule. Both issues are being addressed by the authorities.

- The vast majority of good transparency practices of the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies* are observed. Most areas for improvement are similar across agencies. The area most in need of improvement is the implementation and publication of standards for the conduct of personal financial affairs and legal protection of officials. Other areas requiring attention are the disclosure of relationships with financial agencies abroad; the need to have external audits done by external auditors; and disclosure of internal procedures and guidelines.

11. **The main conclusions and recommendations of this assessment relate to the following key measures:**

- Monitoring of the exchange rate exposure of the corporate sector could be improved in order to obtain a better assessment of the risks banks are indirectly facing. In this context, the authorities should continue to encourage the development of domestic markets for hedging.

- With large financial groups becoming the dominant structure in the Polish markets, it is necessary that reporting by institutions take place at the consolidated level so that supervisors obtain a complete overview of the groups' risk position.

- Regulatory frameworks for supervision should be further strengthened in other areas as well. Key areas across sectors are the need for legal powers to instill corporate governance principles in the financial institutions' management; and for clear and effective intervention powers in troubled institutions.

- Close cooperation among supervisory agencies should be fostered. The regulatory and supervisory approach to the respective sectors should be harmonized to ensure (a) that the subsectors are subject to similar treatment as much as possible, and (b) that no regulatory and supervisory gaps emerge. Finally, the institutional arrangements for supervision should be reevaluated from time to time, to ensure consistency with developments in the markets.

- All subsectors of the financial system are in need of consolidation. Smaller, weaker institutions with weak corporate governance structures should be encouraged to merge or be absorbed. Consolidation should be market-driven, but government-stimulated.

II. Financial System Overview

A. Structure and Recent Developments

12. **The Polish financial sector has become more diversified, and foreign participation in key sectors has increased significantly**, both of which have contributed to the stability of the sector and the quality of its services. Although commercial banks dominate the market with over 85 percent of financial system assets (Table 1), insurance companies, investment funds and—since their introduction in 1999—pension funds will become increasingly important in the coming years.

- **Financial intermediation is still low,** with banking assets at 60 percent of GDP and private sector bank debt at 22 percent of GDP at end-1999 (Figure 1). Even the largest banks in Poland are small by international standards. Assets of institutional investors amount to 5.4 percent of GDP. The corporate bond market is virtually nonexistent and stock market capitalization was only 20 percent of GDP at end-1999 (Figure 2). Gross insurance premiums, about 3 percent of GDP at end-1999, are well below the EU average of about 7 percent.

- **Foreign ownership has become an important and stabilizing factor.** As of end-March 2000, 45 commercial banks out of 75 had a majority foreign shareholding, and 63 percent of the total commercial banking capital was foreign. Also, 34 insurance companies out of 63 had a majority foreign shareholding, 53 percent of the total capital of the insurance market was foreign. Similar tendencies are visible in the pension fund sector.

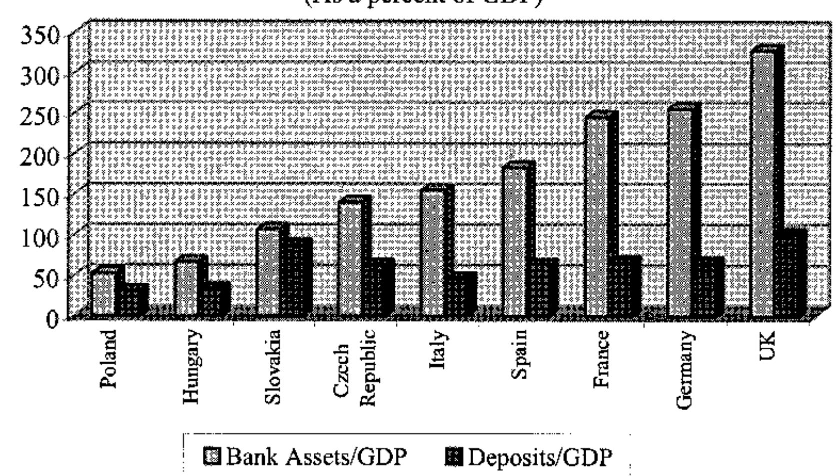
Table 1. Poland: Structure of Polish Financial System

(As of end-1999)

Type of Institution	Assets (In Millions of Zloty)	Share in Assets (in percent)	Number of Institutions
Commercial banks	349,022	86.5	77
Insurance companies	28,935	7.2	56
Cooperative banks	15,410	3.8	781
Brokerage houses	3,604	0.9	48
Investment funds	3,215	0.8	15
Pension funds	2,256	0.6	21
Credit unions	883	0.2	158
Total financial system	403,325	100	1,410

Source: National Bank of Poland.

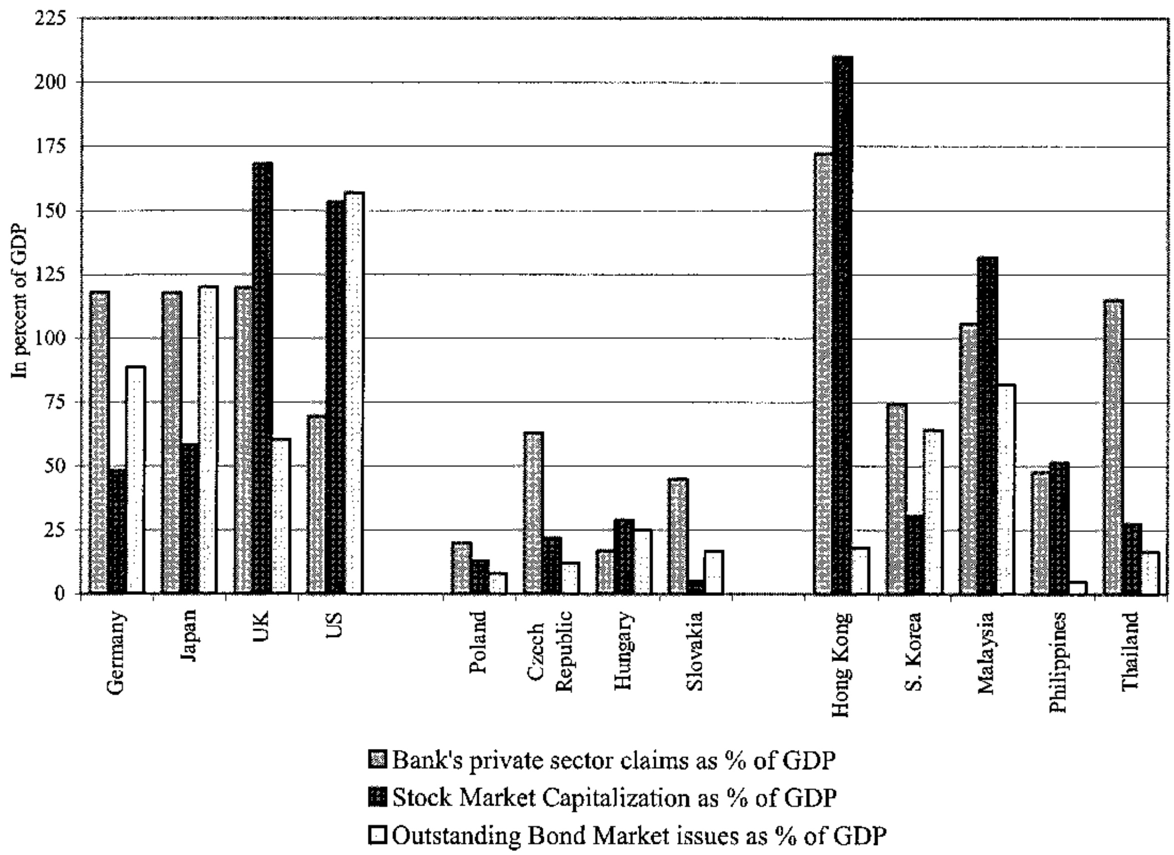
Figure 1. Poland: Bank Assets and Bank Deposits, 1998
(As a percent of GDP)



Source: IMF staff estimates.

- **Government ownership in the sector remains significant.** Despite several years of privatization, an important share of deposits remains mobilized through the fully or majority state-owned banks (nearly 30 percent of total bank deposits). Similarly, majority state-owned companies remain dominant players in their respective segments of the insurance sector and in turn also have an influence on other subsectors, through their share holdings.

Figure 2. Poland: The Structure of the Financial Systems, at end-1998



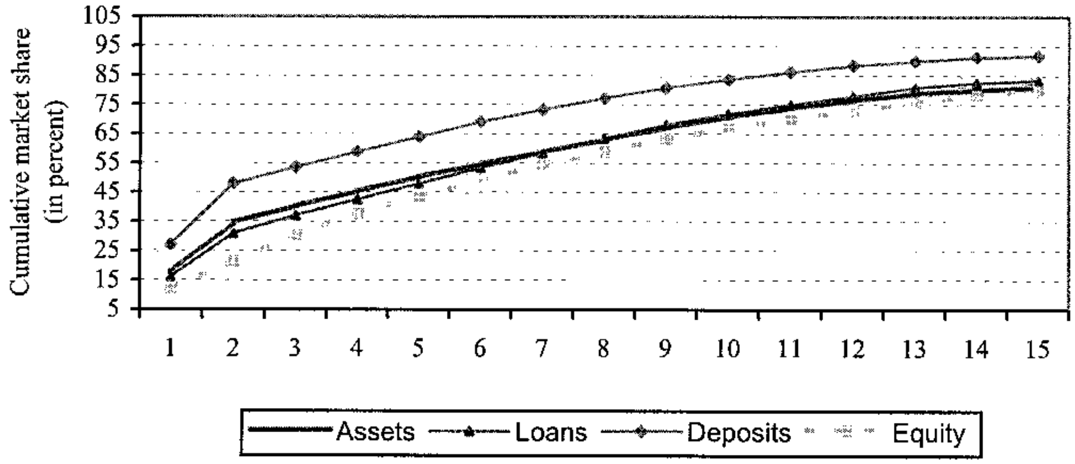
Sources: IFS; IFC; and staff calculations.

- **Banking, insurance, and pension fund markets are highly concentrated.** In part due to a too liberal licensing policy in the early 1990s, Poland has 75 commercial banks (March 2000).[1] The largest 11 banks account for three-quarters of total banking assets (Figure 3). The three largest life insurers account for 80 percent and the three nonlife insurers for 75 percent of the respective markets. The three largest pension funds control 67 percent of the industry's assets.

- **Financial services have grown lately.** The retail-funding base of banks is growing fast and has a large growth potential because almost 40 percent of the households do

[1] There are also 757 cooperative banks. They manage less than 4 percent of total financial system assets.

Figure 3. Poland: Concentration in the Banking Sector, end 1998



Source: National Bank of Poland.

not have a bank account. Despite the high number of banks, the country is underbanked in terms of branches with only 5.8 branches per 100,000 inhabitants (the average for the EU is 48 per 100,000 inhabitants). Although 77 percent of lending to the nonfinancial sector is to the corporate sector, consumer credit is growing rapidly from a low base (over 50 percent growth in 1999), and represents now 18 percent of outstanding bank claims (Table 2). During 1999, gross insurance premiums increased by 14 percent in real terms, in particular in the area of investment-linked life insurance and compulsory motor vehicle liability insurance.

- **External financing of firms is limited and is largely in the form of bank lending.** Lending to SMEs is limited. Over 10 percent of bank credit is extended to a handful of large publicly listed companies, and publicly-listed companies, in total, account for around 25 percent of total bank lending (Table 3).

- **Large corporations increasingly issue international debt.** Debt securities issued internationally by Polish corporations have increased more than fivefold since 1997, with net issues during the second quarter of 2000 amounting to \$1.3 billion. International syndicated credit facilities announced by Polish corporations are substantial as well—\$1.3 billion during 1999. The stock of total corporate sector external borrowings increased by \$5.1 billion in the 12 month-period ending in September 2000. On the other hand, Polish firms, both large and small, have relatively little short-term debt (combining domestic and foreign).

Table 2. Poland: Gross Claims of Commercial Banks on Corporations and Persons

(December 31, 1999)

	Value (In Millions of Zloty)	Share (In Percent)
Claims on corporations	119,420.0	77.0
Claims on persons	34,041.7	21.9
Of which:		
Consumer loans	28,326.3	18.3
Claims on other nonfinancial customers	1,726.6	1.1
Total	155,188.3	100.0

Source: National Bank of Poland.

Table 3. Poland: Bank Credit to Manufacturing Firms (mid-2000)

(In percent)

	Share
Publicly-listed	25
Of which:	
Large	10
Private	75
Of which:	
Large	35
Medium	20
Small	20

Sources: CSO; and staff calculations.

B. Regulatory and Supervisory Framework

13. **The legal framework for financial sector regulation and supervision is the responsibility of the ministry of finance.** The legal framework assigns the responsibility for prudential supervision over the various subsectors to sector-specific institutions. Both the regulatory and institutional framework for financial sector supervision continue to undergo modifications in order to respond to the increasing sophistication and diversification of the financial markets, and the preparation for EU accession.[2]

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[2] At the time of the drafting of this report, new laws on banking, securities, and insurance were either under preparation or before parliament. It is expected that by end-2001,

(continued…)

- **Supervision of the banking sector is in the hands of the Commission for Banking Supervision (CBS).** The president of the NBP is chairman of the Commission. The Commission's executive arm is the GIBS. The CBS has sole authority to license new institutions and withdraw licenses.

- **The Securities and Exchange Commission (SEC) supervises participants in the securities markets.** The Warsaw Stock Exchange is a self-regulatory body. The SEC has sole licensing and delicensing authority for brokers, investment advisors, mutual funds and over-the-counter traders. Stock exchanges are licensed by the prime minister.

- **The insurance sector is supervised by the State Office for Insurance Supervision (PUNU). The pension fund sector is supervised by the Superintendency of Pension Funds (UNFE).** In the insurance sector, the minister of finance has the authority to grant and withdraw licenses. PUNU's role in this area is limited to providing advice. In its supervisory operations, the agency enjoys a great degree of autonomy. UNFE has responsibility for pension funds and plans, and has sole authority for granting and withdrawing licenses.

14. **Arrangements with respect to the autonomy of the supervisory agencies differ** (Table 4). Arrangements for appointment, dismissal, and term of the presidents differ, as well as the accountability arrangements. Budgetary autonomy also varies. Whereas the CBS can issue legally binding regulations for the banking system, the other supervisory agencies cannot for their sectors.[3]

15. **Reflecting the tendency in Polish financial markets towards the formation of large financial groups, the authorities are strengthening the cooperation among respective supervisory authorities**. There has traditionally been a close cooperation between the CBS and the SEC. The procedures underlying this cooperation are laid down in a Memorandum of Understanding (MoU) between both institutions. In late 2000 and early 2001, efforts were started to extend the use of MoUs among supervisory agencies with new ones between banking supervisors/insurance supervisors and banking supervisors/ pension fund supervisors. Others are under consideration. Cross-representation at the level of the Commissions further ensures cooperation and coordination.

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depending on political developments, these laws will be enacted, with implementation starting in early 2002.

[3] However, the CBS' power to issue binding regulations remains largely untested. In 2000, Polish banks disputed in court another agency's right to issue binding regulations.

Table 4. Poland: Supervisory Agencies—Duties, Accountability, Information Sharing, and Autonomy

Supervisory Agency	Licensing Authority	Delicensing Authority	Appointment and Term of Head of Agency	Accountability of Head	MoUs with Other Supervisory Agencies	Use of a Commission Structure	How is Agency Financed?	Regulatory Autonomy
CBS/GIBS	Yes	Yes	President of NBP is head of CBS. Is appointed by parliament at recommendation of president. Term: 6 years The director of the GIBS is appointed by NBP president with approval of the MoF.	President of NBP is accountable to parliament.	With SEC according to banking law. UNFE (2000)	Yes. President of NBP is chairperson of Commission. President the MoF, SEC and BGF are represented, among others.	As an integral part of NBP, GIBS is financed as part of NBP budget.	Has power to issue binding regulations.
PUNU	MoF, upon advice from PUNU[1/]	MoF, upon advice from PUNU[1/]	Appointed and removed by prime minister upon recommendation by the MoF. Term: no fixed term	Prime minister	None 2/	Is proposed in new legislation. UNFE, NBP, SEC would be represented, among others.	Fees—Part goes to government, part returns via budget. Unused fees are returned to insurance companies.	No binding regulations can be issued.
UNFE	Yes	Yes.	Appointed by prime minister. Can be removed at any time after prime minister has obtained the consent of Advisory Committee. Term: 5 years	Prime minister	CBS, SEC	No. (there is an Advisory Committee).	Fees. Part goes to government, part returns via budget.	Same
SEC	Yes for brokers, investment advisors, mutual funds and OTCs. For stock exchanges: prime minister.	Same	Appointed by prime minister on advice of MoF and NBP, with opinion from parliament. Term: no fixed term	Prime minister	CBS (Also possibility to communicate with president of NBP). UNFE	Yes NBP is represented, as the only other agency involved in supervision. Others are from ministries.	Fees Same mechanism as above.	Same

1/ Under the new law, full authority will be with PUNU.
2/ Under the new law, PUNU will have competency to establish cooperation with CBS, SEC, and UNFE.

C. Infrastructure

16. **Money markets in zloty—with the exception of the NBP bills market—are fairly liquid and competitive. Turnover is growing, but activity is concentrated at short maturities.** The three main types of money market activities are uncollateralized lending (interbank money market), collateralized lending (mainly repo and sell/buy-back transactions), and trading in NBP bills. The relatively low spreads between WIBOR and WIBID—about 0.6 percentage points for maturities of one week or longer—indicate that interbank money markets are fairly competitive and efficient.

17. **Following substantial reforms over the last years, the Polish payment and settlement systems are of high quality.** Most systems use modern means of data processing, are efficient, and have appropriate security standards. Large-value payments are settled through SORBNET, a real time gross settlement system (RTGS) operated by the NBP. SORBNET handles about two thirds of all transactions. Retail payments are settled through the electronic system ELIXIR and the paper-based system SYBIR. Both systems are operated by the National Clearing House KIR SA, which is jointly-owned by the NBP, 18 major banks, and the Polish Bankers' Association. Securities settlement takes place through the National Depository for Securities (NDS), the Central Depository for Treasury Securities, and the Register of NBP Bills operated by the NBP (for Treasury and NBP bills).

III. Macroeconomic Environment, Risks and Exposures

A. The Environment

18. **Poland is in the vanguard of transition, reflecting sustained macroeconomic stabilization and structural reform.** These policies have greatly contributed to financial sector stability. The financial sector has been deepening in this relatively propitious environment in recent years, and is unlikely to constitute a source of macroeconomic shocks itself.

19. **Structural reform and macroeconomic stabilization went hand in hand during the 1990s.** After successfully pioneering the shock therapy approach to stabilization and liberalization during 1990–91, Poland maintained steady progress in transition during 1992–97. Rapid progress was made with the mass privatization of small- and medium-sized enterprises, but the restructuring and sale of larger enterprises has been more drawn out. Sales of banks began in 1992 and by 1998, half of bank assets were in private hands. Tax reform and improvements in the legal system hardened enterprise budget constraints and indirectly improved the banks' financial position. Structural reforms accelerated sharply after 1997, with bank privatization picking up speed in 1999 through the sale of two large state banks. The introduction of a new pension scheme was part of a wholesale reform of government operations, begun in early 1999.

20. **Since 1999, Poland's economic performance has been deteriorating somewhat as a result of a combination of factors, including adverse external shocks, the impact of a new round of enterprise restructuring, and a deterioration in the policy mix.** Increasing exchange rate and interest rate volatility and a deterioration of the quality of the banks' loans were three main factors the banking system had to cope with as a result of these

developments. In this respect, the Russian crisis was a real-life stress test, which the sector weathered fairly unscathed (see also Chapter IV). More generally, the sector has been able to absorb fluctuations in the zloty without great difficulty and the impact of the macroeconomic developments on the credit portfolio—though visible—has so far been kept under control. In short, the Polish banking system has demonstrated its growing resilience throughout this two-year period.

21. **The above mentioned recent warnings notwithstanding, an overview of selected macro- and microprudential indicators shows that Poland performs on the whole relatively strongly (Table 5).** Gross reserves are at reassuring levels. Other indicators, including short-term external debt as a percent of total external debt and as a percent of reserves, look equally solid. Selected aggregated microprudential indicators in general underline the observed growing resilience of the banking system. The banks' capital adequacy ratio (CAR) is above 15 percent, loan provisioning is adequate, and indicators on earnings and liquidity do not show major vulnerabilities.

22. **Nevertheless, a few key macro indicators—in particular the current account deficit and the level of real interest rates—indicate challenges at the macroeconomic side with potential implications for banking system stability.** The current account deficit, at around 6 percent of GDP, has been coming down from more worrisome levels, but still needs attention. The level of real interest rates—associated with the deterioration of the policy mix—has been increasing since 1997 (to above 7 percent) and has had an impact on the quality of the banks' loan portfolio. The other area of concern is the rapid increase in the growth rate of commercial bank lending since 1995. In sum, the major challenges for the banking system come from the current account deficit and the potential developments in banking lending. To this should be added the signs of a slowdown in output growth in 2001.

B. Risks of External Shocks

23. **Given that Poland is an open economy that will likely continue to exhibit sizeable external current account deficits, preserving market confidence and reducing the risks of contagion will remain the overriding policy consideration for the medium term to preserve macroeconomic and financial stability.** The combination of a freely floating exchange rate regime and large external deficits exposes Poland to potentially sizeable swings in its exchange rate, reflecting both domestic developments and its standing as an emerging market. These factors could pose challenges for financial sector stability.

24. **Despite the improvement in 2000, the size of the current account deficit remains a key macroeconomic factor influencing foreign investors' sentiment.** The principal reason for Poland's high current account deficit is a half decade long boom in fixed investment (and consumption). However, against the uncertainties created by the size of the current account deficit stand some reassuring facts and developments. Given structural reforms over the last decade, there is some assurance that the quality and rate of return on that investment is appropriately high. Total external debt has been falling relative to GDP, due in large part to

Table 5. Poland: Macroprudential Indicators

(In percent, unless indicated otherwise)

	1995	1996	1997	1998	1999	2000
Macroeconomic indicators						
Economic growth						
Real GDP	6.8	6.0	6.8	4.8	4.1	4.1
Balance of payments						
Current account deficit as percent of GDP	4.2	-1.0	-3.0	-4.3	-7.5	-6.1
Official gross reserves in months of goods and services imports	7.2	6.7	6.7	7.7	7.8	7.7
External debt, total as percent of GDP 1/	34.6	33.0	34.5	37.4	41.5	40.3
Short-term external debt as percent of total external debt 1/	...	10.1	10.4	9.9	10.3	13.2
Short-term external debt as percent of reserves	7.3	27.3	23.9	29.8	38.8	39.1
Nominal effective exchange rate, 12 month growth rate 2/	-7.0	-7.8	-8.7	-2.2	-7.7	6.5
Real effective exchange rate, 12 month growth rate 2/	8.2	13.0	1.7	4.8	-4.0	7.3
Inflation						
Consumer price index growth, end-of-year	21.6	18.5	13.2	8.6	9.8	8.5
Volatility 3/	0.2	0.0	0.1	0.2	0.2	0.1
Interest rates						
Volatility 4/	...	...	...	0.2	0.1	0.2
Level of domestic real interest rates 5/	...	0.2	9.1	4.6	6.0	7.6
Lending and asset prices						
Bank lending to private sector as percent of GDP 6/	18.5	20.9	22.9	25.0	28.6	29.5
Warsaw Stock Exchange Index, end-of-period	7,586	14,343	14,668	12,796	19,470	18,015
Other factors						
Percent of total exports to EU	70.1	66.5	64.2	70.9	70.6	76.0
Public debt as percent of GDP	52.2	46.2	43.5	39.8	42.9	38.0
Market based indicators						
Standard & Poor's foreign currency debt rating	...	BBB-	BBB-	BBB-	BBB	BBB
Spread of benchmark bonds, end-of-period (basis points) 7/	...	...	265.0	396.6	392.8	273.4
Spreads on J.P. Morgan Emerging Market Bond Index (EMBI+), end-of-period (basis points)	...	...	217	266	212	241

Table 5. Poland: Macroprudential Indicators (completed)

(In percent, unless indicated otherwise)

	1995	1996	1997	1998	1999	2000
Aggregated microprudential indicators 8/						
Commercial banks' capital to assets ratio						
Median value	18.5	17.5	16.9	15.0	16.6	15.5
Mean value	11.5	12.3	12.5	11.7	13.1	12.4
Asset quality						
Foreign currency denominated assets (percent of total assets)	21.6	20.8	22.0	19.4	...	...
Nonperforming loans 9/ 10/	20.9	13.2	10.5	10.9	13.7	14.6
Provisioning as percent of required 10/	...	...	...	102.0	104.3	103.9
Management soundness						
Expenses to total income 11/	83.1	80.6	85.3	92.9	93.7	93.7
Total income per employee (thousands of zloty) 11/	198.3	219.5	291.3	414.5	510.1	384.6
Number of commercial banks 11/	81	81	83	83	77	75
Earnings/profitability						
Return on assets, commercial banks	...	...	...	0.7	1.0	1.3
Return on equity, commercial banks	...	...	...	9.2	13.5	18.0
Liquidity						
Ratio of NBP liabilities to NBP claims on banks 12/	1.2	1.1	3.1	4.5	5.9	6.4
Demand deposits as percent of broad money 13/	17.1	21.0	19.5	18.8	19.0	14.3
Foreign currency deposits as percent of broad money	20.4	17.1	17.5	15.2	15.1	17.1
Deposits as percent of broad money 13/ 14/	81.2	82.7	84.6	86.3	85.5	86.8
Commercial banks loans to private sector as percent of total deposits	54.9	69.3	70.1	72.5	82.3	...

Sources: National Bank of Poland; IMF *International Financial Statistics;* IMF *Direction of Trade Statistics Yearbook 2000;* and IMF *Staff Country Report 00/45.*

1/ June for 1999.
2/ Positive numbers indicate an appreciation, negative a depreciation.
3/ Coefficient of variation of monthly year-on-year inflation.
4/ Coefficient of variation of daily tomorrow next interbank money market rate.
5/ 13-week T-bill rate minus actual CPI.
6/ Lending to households and enterprises.
7/ Spread on US$ denominated 30-year bond and Republic of Poland US$ bond maturing in 10/2024.
8/ End-of-period, unless indicated otherwise.
9/ Substandard, doubtful, and loss as a percent of total assets.
10/ For last column, data for September 2000.
11/ For last column, data for June 2000.
12/ Liabilities include bank reserves and NBP securities issued (period average).
13/ For last column, data for October 2000.
14/ Demand, time, savings and foreign currency deposits.

sizeable privatization-related FDI inflows, to around 40 percent of GDP. Though privatization related FDI inflows are projected to subside substantially in 2002 as the privatization process reaches its conclusion, and this source of financing of the current account deficit will diminish, nonprivatization related inflows continue to grow, albeit from a relatively small base. Indeed, Poland is still seen as an attractive destination for investment, reflecting its long-standing commitment to reform and its prospective EU accession.

25. **The key uncertainty with respect to the present situation is related to the form of financing of the current account deficit and its sustainability.** While the banking system's foreign exchange exposure is largely within the prudential limits, there is little hard evidence on the foreign exchange exposures of the corporate sector. In particular, it is unclear what part of foreign currency denominated debt is covered forward, what part is covered by natural hedges, and what part is covered (implicitly) by the parents of local subsidiaries. The fact that Poland has for a considerable time been steadily widening and recently abolished its exchange rate band, has made foreign currency risk transparent to the market, but empirical evidence that this has led to appropriately cautious management of exposures by corporations is not available. Although short-term external debt is low, foreign holdings of treasury bills and other government liquid paper is sizeable. In addition, there is a liquid derivatives market in the zloty in London, so that speculative positions in the zloty can be built up relatively quickly—even with otherwise illiquid assets—so risks of pressures on the exchange rate can arise independently of the maturity structure of recent capital inflows or of external spot liabilities. The remaining capital controls do little to impede such activity, and even households are able to take positions by virtue of the ready availability of foreign currency denominated bank deposits and loans from domestic banks. Steps should be taken to improve data collection on the exposures in the corporate sector so as to facilitate more effective and timely monitoring, while domestic markets for hedging should further be developed.

26. **In sum, should a large shock to the exchange rate occur, there are some uncertainties about how the financial system would respond.** While the banks' foreign exchange position is within the prudential limits, they could still be affected by credit risk indirectly related to exchange rate volatility if their corporate or household clients are hurt by such exchange rate developments. Data to assess the extent of such risks was not available for the stress test exercise. In addition, in such a scenario, interest rate volatility could increase. The evidence available—notably from the consequences of the sizeable adjustments to nominal interest rates in the past two years—is that these risks are relatively moderate at the level of the system. Finally, there could be output losses in such a scenario, with consequent effects on bad debt accumulation. However, stress tests indicate that this effect is unlikely to be sizeable, unless there is a large output loss.

27. **These uncertain factors underscore that the resilience of the macroeconomic framework to a loss of confidence hinges on the strength of policy.** A further reduction in the current account deficit—with disinflation also being a priority for the authorities and monetary policy already tight—needs to be achieved through an appropriate policy mix.

28. **During discussions with the Polish authorities, there was a common view that among many vulnerability scenarios, the current account deficit was the most**

important challenge. Some other challenges were discussed, such as the impact of a recession in the U.S. economy and a recession in Europe. Under these scenarios, exchange rate, interest rate, and credit risk for the Polish banking sector would increase but, unless these scenarios produce real shocks, the view prevailed that the banking system could cope with such events. Finally, lifting the few remaining capital controls is also not expected to create major problems for the banking system. The remaining controls are minimal and do not really constitute an impediment to speculative pressure on the zloty. On the contrary, abolition would foster domestic financial market growth and facilitate hedging.

C. Domestic Macroeconomic Risks

29. **The main sources of vulnerability on the domestic side seem to come from a weakening in output growth and the rapid growth in demand for bank credit, in particular from more risky borrowers.** There are no clear indications that the real estate market is overheating. On the contrary, available evidence suggests that in major cities the prices of commercial offices are already falling from an earlier peak. The impact on the quality of the banks' portfolios is being felt at this moment, but is minimal because commercial banks' exposure to the real estate sector is small. Nevertheless, given the lessons from elsewhere, close monitoring remains necessary.

30. **Weakening output growth in the near future is likely to have a negative impact on the quality of the banks' loan portfolio.** Even though credit risk is at this moment the largest source of risks for the Polish banking system, the banking system seems solid enough to absorb a moderate shock. However, if a severe downturn were to occur—for instance as a result of a recession in Europe—some banks could run into problems, as indicated by the stress tests (Chapter IV).

31. **Although bank lending is still relatively small in relation to GDP, it has been growing rapidly.** High loan growth rates have often been associated with an even more rapid future growth in nonperforming loans, especially for those banks that have poor credit assessment skills. At present, overall credit risks are still relatively limited due to the generally low leverage of Polish corporations. Data from the Central Statistical Office (CSO), comprising 6,245 Polish firms indicates that short-term (zloty and foreign exchange) borrowing from financial institutions is about 19.4 percent of total liabilities. Nevertheless, banks are also exposed to credit risk, arising from their clients' exposure to interest rate and exchange rate risk, as discussed in the previous section.

32. **The area for concern in this context is the fast growth in lending to more risky borrowers—SMEs and households.** Credit to SMEs has been growing fast in the past two years, but household credit—albeit from a low base—even faster. By June 2000, the 12-month growth rate in household credit reached a peak of 50 percent. By end-2000 this growth was tapering off amidst a general weakening of economic performance (35 percent November over November). However, because a large part of this lending is in response to pent-up demand for consumer durables during the last stages of the transition, the growth rate is expected to remain high. On the supply side, this growth is also spurred by increasing competition among banks to gain a foothold in this market segment. The quality of the banks'

loan portfolios has already been deteriorating since 1999, partly as a result of this development. Going forward, NBP estimates that 4–6 percent of newly granted corporate loans and 10–12 percent of new consumer credit may become nonperforming. Both banks and supervisors remain vigilant. Through the press, banks have announced conservative lending policies and supervisors keep a close eye on loan classification and provisioning.

IV. Soundness of The Financial System

A. Banking Sector Trends, Strengths, and Weaknesses

Overall assessment

33. **During the last 5 years, Poland has made significant progress in building a stable and diversified banking system.** Following the adoption of decentralized restructuring techniques in the early transition years, the government attracted strategic foreign investors in all sectors of the financial system, in particular banking. The presence of strong foreign participation has added to the stability of the system. Banking business in Poland is currently profitable. However, margins are coming under pressure and competition is increasing. Under the threat of enhanced competition, banks are venturing out into more risky lending. These factors, taken together, will strain the capital adequacy positions of some banks, making further consolidation necessary. Although the remaining state banks need further restructuring, they do not pose a systemic threat at the moment. Nevertheless, privatization to financially committed shareholders is essential to protect further deterioration in their franchise values, limit the costs to the state and contain any future risks to the sector.

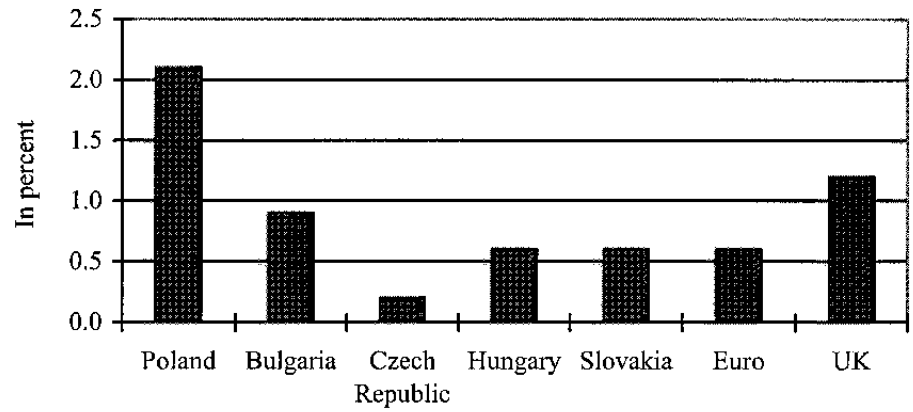
34. **There are no apparent major immediate issues in terms of systemic stability.** Risk management capacity in banks has improved considerably with the introduction of global know-how and generally proper regulation and supervision, although state banks and recently privatized banks still have weak risk management capacity. Foreign exchange mismatches are generally limited, although problems in liquidity management in some banks cannot be excluded, given also the still limited development of the interbank market and the generally very short maturity of financial claims. The largest source of risks relates to credit quality of bank loans. Potential vulnerabilities may exist in the growing offshore borrowing of the corporate sector and portfolio inflows, related to the current account deficit. The current exchange rate flexibility mitigates some of these concerns as it imposes risks on market participants. The generally low leverage of corporations suggests that even large shocks to domestic interest rates would not affect in a systemic way the solvency of the corporate sector.

Profitability and sources of income

35. **In recent years, the Polish banking sector on the whole has been profitable, owing to rapid credit growth with high interest margins.** Starting from a very low base, loan growth averaged around 25 percent during the last five years, while asset growth averaged around 11 percent during the same period. The net interest margin was 4 percentage points in 1999, among the highest in Europe. On an accounting basis, most Polish banks are more profitable than banks in other CEE countries and their international counterparts

(Figure 4). Return on assets of Polish banks has been about twice as high as for U.K. banks, and about three times as high as for banks in the Euro zone.

Figure 4. Poland: Pre-Tax Return on Assets, 1998



Notes: Major banks only.
Sources: BankScope for CEE countries; and ECB for Euro countries and the United Kingdom.

36. **However, net interest margins are expected to decline in the near term.** The average net interest margin, above 10 percent in the early 1990s, steadily decreased to around 4 percent by end-2000 (Figure 5), and is projected to decline further to the levels in the Euro zone. This decrease is mainly due to sharper competition for corporate lending. The past high net interest margin arose from banks funding their loan portfolios with low cost deposits while lending to the emerging and/or profitable foreign or local corporations.[4] Lending to the corporate sector has, however, become increasingly competitive (many Polish corporations have also started to borrow overseas), and spreads over WIBOR have declined to about 100 basis points. A compounding factor is that the Polish banking system depends, more than typical systems in the Euro zone, on earnings from interest income (Figure 6). A further reduction in net interest margins poses risks for those banks that are not flexible enough to transform from traditional banking services (including investing in government securities) to other segments of loan markets with higher margins and fee-based services.

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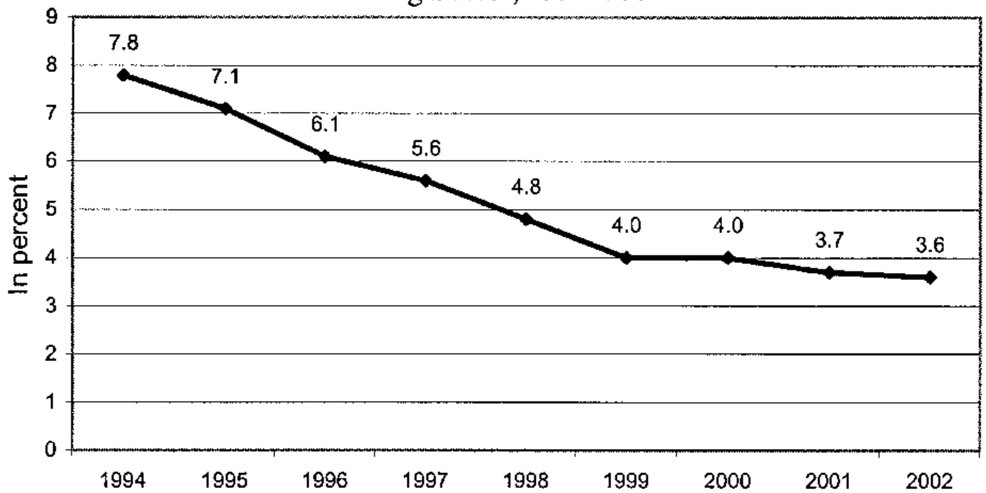
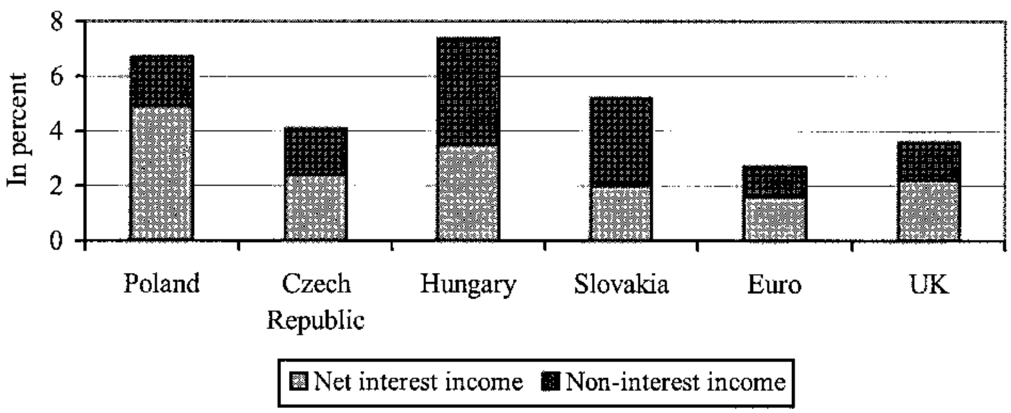
[4] This has been less the case for the two largest retail banks, which have continued to hold government securities or lend to consumers and SMEs.

Figure 5. Poland: Net Interest Margins for the Polish Banking Sector, 1994-2002



Note: Estimates for 2000–2002.
Source: NBP, Erste Bank.

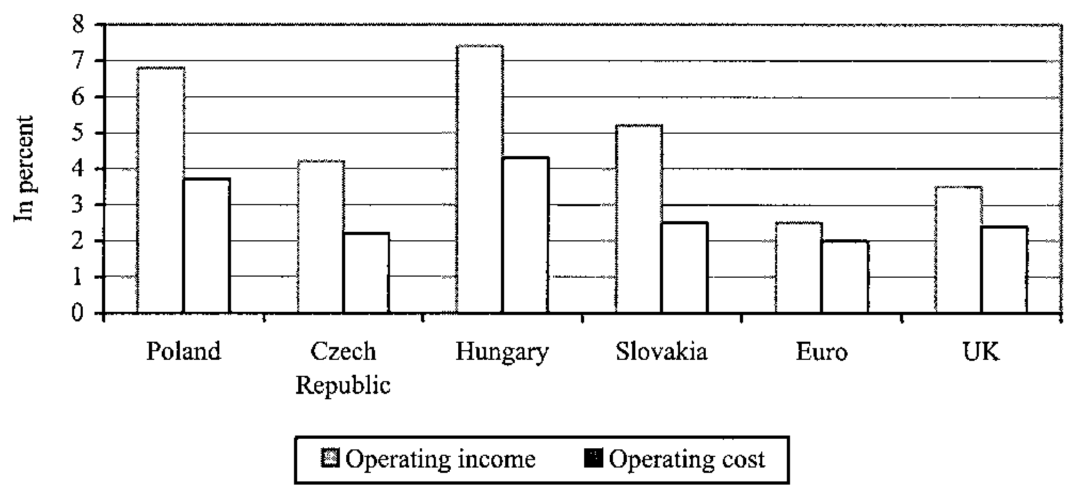
Figure 6. Poland: Composition of Operating Income in Percent of Assets, 1998



Notes: Operating income is split into interest and noninterest income. Major banks only for CEE countries.
Sources: BankScope for CEE countries; ECB and BIS for other countries.

37. **Operating costs of Polish banks are relatively high.** While operating costs, at 3.7 percent of assets, are not much higher than in most countries of similar development, they are almost twice as high as in the Euro zone (Figure 7), which may negatively affect the system, in particular at the time of integration in the EU. While having lower wages per employee, many banks have not reached the level of technical efficiency of global banks as they operate extensive branch networks and employ a large number of employees. The current low personnel expenses make large staff reductions appear not urgent today, but future wage increases call for restructuring now.

Figure 7. Poland: Operating Income and Cost in Percent of Assets, 1998



Notes: Major banks only for CEE countries.
Sources: BankScope for CEE countries; ECB and BIS for other countries.

38. **The general picture given above varies greatly among groups of banks**. Table 6 summarizes performance indicators for groups of banks. Banks with majority foreign ownership (groups C and D) are more profitable and efficient as they generate more loans and net income per employee, despite higher personnel expenses. These banks had an average return on assets of 2.4 percent in 1998 and of 1.8 percent in 1999, well above the returns of state-owned and private Polish-owned banks (groups A and B). The lower return on equity of foreign banks reflects that these banks are better capitalized than most of the Polish-owned banks, in particular the state-owned banks.

39. **Different performance of groups of banks mainly reflects inherited differences as well as present business profiles.** Newly established wholly foreign-owned banks started with a clean portfolio slate and were able to capture the multinational corporate business along with the best Polish enterprises. The regional ex-state banks that were privatized to foreign banking groups have inherited inefficiencies. These banks are in the process of

streamlining their operations and also enjoy the benefit of fresh equity/investments and expertise brought in by their new shareholders. The two largest private banks in the system and the state-owned banks still carry the burden of the past directed policy lending programs, making their operations less profitable. These banks are also overstaffed (per branch) relative to other banks. Restructuring efforts are underway in all large banking groups that have been consolidated under different foreign banks.

Table 6. Performance of Different Groups of Commercial Banks as of end-1999

(In percent, unless otherwise indicated)

	Group A	Group B	Group C	Group D
Pre-tax return on assets	1.0	0.4	1.8	1.7
Pre-tax return on equity	15.9	25.8	19.9	15.5
Net interest margin (in percent of assets)	4.4	3.9	3.3	3.2
Operating income/assets	5.9	4.7	6.1	5.8
Overhead costs/assets	3.7	2.8	3.0	3.4
Capital funds/assets	5.4	5.1	8.9	10.5
Net interest/operating income	75.7	80.7	58.5	54.1
Other income/operating income	24.3	19.3	41.5	45.9
Overhead/operating income	63.1	63.0	54.3	59.2
Loans/employee (in millions of zloty)	.658	.968	1.340	5.005
Net income/employee (in millions of zloty)	.016	.007	.047	.113
Number of banks in each group	3	3	14	9

Notes: figures include the largest banks in terms of assets; figures are group averages, weighted by total assets; Group A indicates state-owned banks (Pekao SA was privatized at the end of 1999); Group B indicates privately-held banks that are majority-owned by local residents; Group C indicates banks whose origin is Polish, but that have recently become majority-owned by foreign banks; Group D indicates foreign banks that have been foreign since the start of their operations (that is, branches and subsidiaries of Western banks).

Funding and assets structure, current loan portfolio quality, and recent risks

40. **Funding and assets structure reflect the early development of the Polish banking system.** Assets are still largely composed of claims on the financial sector, with claims on the nonfinancial sector representing only 44 percent of total banking system assets. The liability structure is similarly traditional with deposits representing about 62 percent of total liabilities. This liability structure has allowed banks to manage interest rate rises by adjusting deposit rates at a slower pace. During the first three quarters of 2000, for example, a period of rising interest rates, most banks improved their financial results as deposit rates lagged (although the full impact of the rise in interest rates on the quality of the loan portfolio may not yet be reflected in the financial statements).

41. **Classified loan levels have risen sharply in the past two years.**[5] The total of the three categories of classified loans, as a percentage of total loans, has risen significantly since 1999 for the 15 largest banks (Table 7), reflecting the impact of the Russian crisis, higher interest rates domestically, the recent dramatic growth of consumer loans, and the less robust business environment, international and domestic. By September 2000, total classified loans exceeded 14 percent of total loans. The distribution of classified loans varies significantly among banks, from a minimum of 7 percent of total loans to a maximum of 24 percent. The banks with the highest ratios were mostly middle sized banks.[6]

Table 7. Poland: Asset Quality of the 15 Largest Banks

(In percent of total loans)

Loan Category	As at End-1996	As at end-1997	As at end-1998	As at end-1999	As at Sept. 2000
Substandard	4.0	3.7	3.7	4.8	5.0
Doubtful	1.9	1.0	1.9	3.3	4.5
Loss	8.2	5.8	5.2	5.0	5.1
Total:					
Doubtful and loss	10.1	6.8	7.1	8.3	9.6
All categories	14.1	10.5	10.8	13.1	14.6

Source: National Bank of Poland.

42. **In general, provisioning rules and practices are conservative, with banks on average having loan loss reserves above required provisions.** In September 2000, actual provisions were 104 percent of required provisions. The pattern of provisioning against classified loans varies among banks, in part reflecting that banks have different levels of collateral in place for classified loans.[7]

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[5] GIBS strictly applies two criteria for loan classification independently, the borrower's repayment performance and his economic and financial standing.

[6] Several of these banks were recently privatized and their higher ratios of nonperforming loans may reflect a conservative reclassification by the new owners.

[7] When adequate collateral is in place, determined by regulations and reviewed by GIBS, banks are permitted to reserve against classified loans less than the standard provisioning requirements (20 percent for substandard loans, 50 percent for doubtful loans, and 100 percent for loans classified as loss).

43. **Bank capitalization is reassuring at the moment.** The average CAR of the sector is above 15 percent. A few banks' CAR is below the required 8 percent, but the GIBS is actively involved in resolving these banks, through merger or closure.

Liquidity

44. **Liquidity risks may arise due to the concentration of deposits with a few large commercial banks.** The two largest banks—accounting for almost 50 percent of all retail deposits—are generally suppliers of liquidity in the interbank markets. Were severe credit or other problems to arise in these banks, they could create problems in other banks that rely on the liquidity from these two suppliers, with possible disruptions of the payment system.

45. **The maturity of deposits and liabilities is very short.** Reflecting the volatile financial sector environment of recent years and the limited development of the financial system, banks' nonfinancial sector assets and liabilities are generally of very short duration. Loan rates are mostly floating on a monthly basis. Many deposits are on a call basis, while the largest part of the savings deposits is for three months. While this protects the banks from interest rate risk, it does mean that they have only limited ability to provide longer-term financial instruments without taking on excessive risk.

Supervision

46. **Banking regulation and supervision has undergone substantial improvements since the early 1990s.** During the latest overhaul of the framework (1997), both the legal framework and the supervisory process underwent substantial change and refinement. The legal structure, while still needing further strengthening, has been amended to increasingly reflect international standards. The banking supervision process has made substantial strides in developing internal procedures, building staff capacity, and developing effective supervisory tools to overcome shortcomings in the regulatory structure. The CBS has adopted a clear set of objectives with the primary goal of safeguarding the banking system while protecting the depositor. These goals and objectives are implemented through supervisory strategies set for each bank, depending on its characteristics and risk profile, and through the ongoing on- and off-site supervisory activity.

47. **In the context of the FSAP mission, the regulatory and supervisory framework in Poland was assessed using the authorities' self-assessment as the point of departure.** While Poland largely complies with the core principles in the areas of supervisory practice, more work is required to achieve compliance with principles specifically addressing the regulatory framework.

48. **The most critical areas in need of strengthening from a stability and soundness point of view, are the following:**[8]

- **Supervision should be conducted on a consolidated basis.** Currently, GIBS does not have the authority to evaluate a bank's risk exposures residing in affiliate or subsidiary companies, nor the consolidated capital position. The amended Banking Act will require consolidated reporting and enable consolidated supervision, taking away one of the greatest uncertainties currently obscuring insights in the risk patterns in the Polish financial system.

- **A key component of consolidated supervision is establishing contact and information exchange with both domestic and foreign supervisory authorities.** Signing MoUs with the relevant supervisory bodies would be a first important step. At the end of 2000, the first such MoUs were signed.

- **Enforcement powers need to be augmented by a set of remedial actions to effectively address banking practices that could potentially threaten the safety and soundness of the sector, and to instill and facilitate better market discipline.** Despite improvements in the 1997 Act, supervisors are required to go through a lengthy process involving a series of iterations before concrete, legally enforceable actions are triggered. Furthermore, the regulatory structure does not provide recourse to prompt corrective action.

- **The ability of the CBS to hold management and supervisory boards responsible and accountable for prudent oversight should be strengthened in the banking law and anchored in supporting laws.**[9] The legal enforceability of management and supervisory board's responsibilities is a fundamental pillar of effective bank supervision and of safe and sound banking. The GIBS has taken many commendable steps to raise the level and visibility of management and supervisory boards responsibilities, and this has in part resulted in increasingly responsive actions from these parties, but the legal backing for such initiatives is weak.

- **The practices of the GIBS to require comprehensive reporting and to enforce the integrity therein need to be strengthened.** Recent events in the banking industry have identified cases of inaccurate bank reporting, both to the GIBS and the public.

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[8] Section II of this FSSA report contains a more detailed assessment of the strengths and weaknesses of the Polish banking regulatory and supervisory framework.

[9] Commercial Code, Civil Code, Criminal Code.

- **The level of independence provided to the supervisory agencies should be strengthened**. Areas of concern are (a) the composition of the CBS that contains several government representatives, which may complicate the decision process and introduce unnecessary perspectives; (b) the degree of legal protection of the GIBS staff; and (c) remuneration and staffing of the GIBS, to safeguard autonomy and quality. GIBS copes with a high staff turnover, which hampers quality and continuity.

- **The frequency of onsite examinations needs to be increased.** Currently the average supervisory cycle (period from the start of an examination to the start date of the next) is up to three years. In order to provide adequate oversight, banks' supervisory cycles should range from 18 to 24 months. The main bottleneck here is a lack of staff.

- **Finally, specific clarifications are needed with respect to:** (a) the definition of the concept of related interests of banks' connected parties and the emphasis placed by the supervisory on it; (b) the emphasis to be place by supervisors on banks' responsibility to develop risk management tools; and (c) the supervisors' ability to identify and combine debt extended to parties with common economic interest (large credit exposure).

49. **Leaving these issues unaddressed would—in the face of an increasingly more complex financial system that is integrating into the EU market—increase the risks for unsound practices and, perhaps, systemic problems in the Polish financial system.** The supervisors are well aware of these deficiencies in the regulatory frameworks and have, in their supervisory practice, identified and applied ways to circumvent them.[10] While these efforts are highly commendable—and have indeed enhanced the soundness of the financial system—it is highly desirable that their efforts be backed by upgrades in the regulatory framework so that there is no question about the enforceability of the supervisors' actions.

50. **The amendments to the banking law, currently before parliament, will address several shortcomings,** including the supervisor's authority to conduct consolidated supervision, capital requirements to apply on a consolidated basis to banks and market risk, improved anti-money laundering legislation, and clear rules for capital acquisitions and bank ownership transfer. These amendments will represent an important step towards full compliance with international standards. However, areas that will require further attention

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[10] The Basel Core Principles (the assessment is discussed in Section II) put relatively more emphasis on the regulatory framework than on the actual supervisory work. As a result of this, the efforts of the supervisors to circumvent deficiencies in the regulations cannot be fully recognized in the assessments, because of the remaining doubts about the enforceability of their actions.

include clarification of the supervisory independence; the need to enforce corporate governance principles; and improved enforcement powers and remedial actions.

Vulnerabilities and safeguards

51. **Four main sources of vulnerability for the Polish banking system have been identified:** (a) the recent fast growth in bank lending to more risky sectors has an impact on the quality of the loan portfolios; (b) the sector's profitability is declining; (c) principles of good corporate governance are still not deeply rooted; and (d) the restructuring agenda is still unfinished. Aware of these vulnerabilities, the Polish authorities and the financial community are taking steps to safeguard and strengthen stability.

52. **Fiercer competition for lending to more risky borrowers may make the banking system more vulnerable, particularly if proper risk management tools are not in place.** Credit risk is increasing and the quality of the loan portfolio is affected. To counteract these developments, banks need to develop proper credit evaluation and monitoring capability. The influx of foreign ownership into virtually all of the larger banks has supported an upgrading of risk management. These new systems are generally consistent with good international practice. However, while corporate lending risk management can be handled through few branches with centralized credit authorizations, retail and downstream lending necessitates decentralized credit risk management capabilities (with central oversight). The multi-branch staff need to be trained in credit risk management and all of the banks need to improve their information technology and systems to establish proper management information system reporting. SME and retail/consumer lending is also better managed if the banks have developed standard loan products (e.g., mortgage loans, credit card lending) and internal credit scoring systems.

53. **The authorities are also contemplating the removal of other barriers to lending to SMEs and households to reduce the risk factor involved in this activity**. Weaknesses in accounting practices, little or no credit history, and problems in seizing collateral are cited by the banks as obstacles for lending, or as cost-increasing factors. Better accounting standards, revisions of the legal framework for registering and seizing collateral, and the establishment of a broad-based credit bureau are among the current initiatives.

54. **The prospect of lower profitability creates risks for the sector, unless consolidation is actively pursued.** Two forces will lead to further consolidation of the Polish banking system. First, movements among the larger banks will be dictated by developments at the level of the parent groups.[11] Second, and more important for the sector's stability, is further consolidation among the smaller (and weaker) banks at the tail end of the sector. The authorities, through GIBS, have taken a proactive role in this area, by encouraging such banks to look for

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[11] To foster stability in the sector, the authorities could request annually "letters of comfort" from the foreign strategic investors, indicating their willingness to support the Polish branch or subsidiary, when adversely affected.

mergers or other solutions. Questioning the strategic directions of these banks and providing vigilant oversight over orderly exit and consolidation should be continued.

55. **The concept of corporate governance is relatively new to Poland. The legal enforceability of management and supervisory board's responsibilities is a fundamental pillar of effective bank supervision and of safe and sound banking.** Significant progress has been achieved to instill the principles in financial and nonfinancial sectors. The GIBS has taken many commendable steps to raise the level and visibility of management and supervisory boards' responsibilities, and this has in part resulted in increasingly responsive actions from these parties. However, the enforceability of these directives in a court of law is not yet tested and is unclear. Moreover, the supervisors acknowledge that the lack of proper corporate governance is an issue in several small, local, institutions. Given that the supervisor is always in a secondary evaluation role, it is imperative that the supervisory boards and management properly oversee banks' businesses through strong internal processes, a principle that should be clearly specified in the Banking Act.

56. **The restructuring and privatization agenda needs to be completed.** Poland has one of the best records in bank restructuring among transition economies with much of the Polish banking system having been restructured and privatized to date at low fiscal costs (Box 1). Restructuring and consolidation efforts have started for the two remaining state-owned banks but are not progressing well. Competition from the rest of the banking sector for the retail funding base is increasing and banks are down-streaming their lending activities to the relatively less-banked SME, consumer, retail, agricultural and municipal/local government sectors. This will reduce the market positions and franchise values of these two banks as the rest of the system starts to encroach on their markets. Restructuring, followed by rapid privatization to financially strong shareholders will be the only way for these banks to protect their present franchise values, limit the cost to the public sector, and enhance competition.

57. **The cooperative banks need restructuring and consolidation.**[12] In 2000, there were 757 cooperative banks, down from 1,653 in 1993. The sector has experienced considerable consolidation over the past years under the monitoring of GIBS. A Draft Law in parliament foresees to increase the minimum capital of cooperative banks gradually to 1,000,000 Euro by 2002, which will put pressure to restructure. The cooperative banks will also be allowed to offer more diversified commercial banking products and services. All of these expected changes will inevitably result in restructuring and consolidation, with some cooperative banks probably becoming niche players, others converting into commercial banks, while some others will be taken over by existing commercial banks.

[12] Total assets, loans, deposit, and capital of the cooperative banks account for 4.5–5 percent of the banking sector.

Box 1. Bank Restructuring in the 1990s

Starting in early 1990 and accelerating in 1993 with the Act on Financial Restructuring of Enterprises and Banks, Poland has successfully restructured the majority of its banking system at relatively low fiscal costs. Poland moved cautiously in privatizing its state-owned banking sector. Foreign investors were initially only allowed to purchase minority stakes in large Polish ex-state banks. The Polish authorities also initially favored consortia of investors rather than single strategic investors resulting in a class of owners that may not have the right incentives or powers to adequately restructure these banks. Direct foreign bank entry through branches was also not permitted. Some foreign banks entered the Polish banking market through establishing their own locally incorporated subsidiaries. These strategic choices protected the local market from direct foreign bank competition and eased the adjustment for local banks and helped keep the fiscal costs low. Gradually, foreign investors increased their stakes as state ownership in the banks was decreased through public offerings or stock market sales. On a net basis, government revenue from privatization is about equal to the direct fiscal support it provided to date to the banking system.

58. **Stress tests support the view that a potential decline in credit quality is the major source of risk in the Polish banking system. They also indicate that a few banks have significant exchange rate or interest rate exposures.** An assessment was made of banks' health by testing the static impact on the balance sheet of shocks that are "exceptional but plausible."[13] The stress tests involved independent shocks to interest rates and exchange rates, as well as an unspecified macro-economic shock that was assumed to result in a significant rise in nonperforming loans. In each case, the size of the shock was based on extreme events from recent Polish experience so that the simulated shocks can indeed be regarded as plausible.[14]

59. **The effects of the shocks could compound each other.** With reference to the discussion in Chapter III, the simulated three shocks—exchange, interest, and credit—could

[13] See Committee on the Global Financial System (2000), "Stress Testing by Large Financial Institutions: Current Practice and Aggregation Issues," Bank for International Settlements, Basel.

[14] The interest rate and exchange rate shocks that were simulated were based on the largest changes experienced over a calendar month in Poland during the last five years. The credit risk shock that was simulated was based on the most extreme experiences over recent twelve month (calendar year) periods. The interest rate involved shock and equal increase in interest rate across all maturities. It was assumed in all cases that these shocks would impact over short periods (i.e., a month or so), so that banks would have little ability to adjust balance sheet structures to offset their impact.

compound each other in a scenario of economic slowdown and financial turbulence with a depreciation in the currency, increases in interest rates, and a deterioration in asset quality, with the latter in part due to the effect of a (large) interest rates rise and currency depreciation. While assuming that a perfect correlation among the three shocks is too strong, adding the impact of the three shocks does provide some indication of the upper bound of a possible worst case scenario. The impact of the sum of the three shocks (increase of 2.5 percent in ratio of classified loans; increase of interest rate by 3 percent; and depreciation of 10 percent of zloty) in terms of additional required provisioning would be a manageable 11.7 percent of Tier 1 capital (for the total of largest 15 banks).

B. Risks Stemming from the Infrastructure

60. **The Polish money markets demonstrated their growing resilience during the 1998 Russian crisis (Box 2).** Four issues related to the stability and development of the domestic money markets deserve attention:

- **The concentration of liquidity and NBP bills in the hands of one large bank poses potential risks.** At present, this bank is highly liquid. Were its liquidity situation to turn around, the possibility for it to quickly obtain liquidity through sales of NBP bills is limited, given the shallow NBP bills market. However, the NBP is addressing this situation by replacing its bills with treasury bonds.

- **The NBP should assess distortions that have resulted from imposing reserve requirements on repos.** Since repos are subject to reserve requirements, a clear preference has developed for sell/buy-backs, which are exempt from reserve requirements. Because repos are internationally generally used, the NBP should consider whether reducing the reserve ratio for repos to zero percent, as is the current practice of the ECB, could avoid the bias against repos. NBP more generally should evaluate the effects from nonremunerated reserve requirements. The suggested changes would require amending the Act on the NBP.

- **To avoid potential systemic liquidity problems and complications, sufficient eligible collateral for accessing the lombard facility should be available.** At present, lombard credit is provided only against treasury bills and treasury bonds as collateral. The NBP should address technical and procedural difficulties restricting the use of treasury bonds in practice, particularly in light of the reduction in the issuance of treasury bills. The NBP should, over time, review the types of eligible collateral and broaden the categories.

- **To strengthen the monitoring and development of money markets, the NBP should widen its collection and publication of data on interbank market activity.** Valuable data include interbank money market turnover by maturity, data on activities in repo and sell/buy-back transactions, and maximum and minimum money market rates.

Box 2. Weathering the Russian and Brazilian Financial Crises

The resilience of the systemic liquidity framework has been tested by the Russian and Brazilian crises. Poland weathered both episodes—in which the zloty depreciated more than 10 percent against the U.S. dollar in less than two weeks in August 1998 and more than 16 percent in early 1999—relatively well. There was hardly any effect on the interbank money market. During the Russian crisis the overnight and WIBOR rates increased for a couple of days by about 4 percentage points. However, since this occurred at the end of the month, it can, most likely, be attributed to the typical tight end-of-month liquidity conditions that could also be observed in earlier periods. Money market rates with longer maturities did not show any unusual behavior. The NBP even cut its main central bank rate by one percentage point in early September 1998. During the Brazilian crisis no interest rate spikes in the money market were experienced. Also, the effect on the government securities market was short-lived. In September 1998, the average spread in the government yield between Polish papers denominated in U.S. dollars and German marks widened by about 190 basis points (as measured by the J.P. Morgan Emerging Markets Bond Index), but continued to fall significantly from October 1998. The Brazilian crisis hardly had any impact on the Polish sovereign spread (Figure 8).

Figure 8. Poland: J.P. Morgan Emerging Markets Bond Index, 1998–2000

(In basis points)

Source: Bloomberg.

61. **To improve the framework of direct inflation targeting, the NBP could further enhance the transparency of its monetary policy actions.** There are no stability issues related to the current set of monetary policy instruments. The instruments allow flexibility in conducting monetary policy (Box 3). As to the targeting framework, the publication of explicit inflation forecasts should over time become an integral part of the NBP's inflation targeting framework to give the public, in the absence of an intermediate target, a yardstick against which to assess its policy actions. The importance of exogenous origins for CPI inflation also calls for fostering the concept of underlying inflation to explain deviations from the CPI target to the public.

Box 3. The NBP's Monetary Policy Instruments in the Run-up to EU Accession

The monetary policy instruments of the NBP comprise reserve requirements, issuance of NBP bills, a lombard, and a rediscount facility. Claims from the refinancing of central government investment projects are still outstanding but new refinancing has been discontinued in 1999. Overall, the NBP is equipped with a flexible set of monetary policy instruments to efficiently carry out monetary policy. The main differences with the ECB instruments can be explained by (i) the current situation of the NBP being a net debtor to the banking system and the still developing interbank money markets; (ii) issuance of own papers as the main policy instrument; (iii) the existence of a rediscount facility; and (iv) the lack of a deposit facility. These differences should be easily adjusted as soon as the NBP moves into a net creditor position and money markets become more liquid. A decisive effort is, however, needed to bring the use of reserve requirements in line with the ECB—allowing for the option of remuneration—adjusting the treatment of repo transactions and eliminating the option to exempt individual banks from reserve requirements for rehabilitation purposes.

62. **The major payment and settlements systems, SORBNET, ELIXIR, and SYBIR were assessed for compliance with the Core Principles for Systemically Important Payment Systems**. For the system to fully underpin the financial system's stability, the following issues need to be addressed:

- At present, neither the NBP nor any other agency has an explicit oversight responsibility over the retail payment and settlement systems. This oversight gap needs to be filled. The authorities are taking legal initiatives to vest oversight in the NBP.

- An intraday credit facility for participating banks in the large value payment system should be created by the NBP.

- The payment system department of NBP should be involved in NBP's crisis management framework.

- Adjustments to the bankruptcy framework are necessary. The legal uncertainty stemming from the zero-hour rule in case of bankruptcy of one of the participants needs to be eliminated and bankruptcy procedures should allow for multilateral netting.[15]

C. Developments in the Nonbank Financial Sector

63. **Although still relatively small, the importance of the nonbank financial sector has been growing steadily in recent years.** Foreign participation is significant and has contributed to the stability of the subsectors, and the quality of the services. Regulation and supervision of the respective subsectors is approaching best international standards, as well as EU directives. The issues to be addressed are mainly of a developmental nature. The growth of these sectors and their participation in financial conglomerates underlines the need for consolidated supervision and reporting.

Securities markets

64. **Securities regulation complies with most IOSCO objectives and principles.** The SEC is generally regarded as a fair and tough regulator, with adequate resources. Over time, more responsibilities could be given to the self-regulating organizations in the system. A better functioning criminal prosecution of white-collar offenses is necessary to ensure effective enforcement. The mechanisms through which ownership positions can be identified can be enhanced to help in enforcing large ownership limits, tender and takeover rules, insider transactions, and protection of minority shareholders more generally.

65. **The most important contribution to further growth of the Polish *equity market* would come from rapid privatization.** While it has grown considerably in market capitalization and liquidity, the Polish equity market is still relatively small. To enhance the supply of investable securities, the authorities should consider floating tranches of large state-enterprises, which would not sacrifice the prospects of a future sale to a strategic investor.

66. **While *government bond market* development has accelerated since 1999,** further impetus could come from establishing a competitively determined yield curve across maturities that provides a benchmark for corporate long-term debt. Development could also be spurred by committing to a regular issuance up to a certain maturity and maintenance of a yield curve

[15] The zero-hour rule implies that all transactions, made on the day that one of the participants is declared bankrupt, will be reversed. The consequence is that transactions with finality during the day will be reversed, even though they appeared to be final, which creates legal uncertainty about the finality of settlement.

up to that maturity; developing a trading mechanism that permits nonbank institutional investors access on equal footing with banks and that does not segment the retail market completely from the wholesale market; and establishing a primary dealer network that has some obligation to ensure a continuous market and smooth price determination.

67. **The *corporate bond and other fixed-income markets* are still small and their further development will take time.** Market development will mainly be influenced by fundamental factors, including prudent macroeconomic policies, improvements in the functioning of the government bond market, the growth of institutional investors, and to some extent, asset securitization.

Institutional investors

68. **The institutional investor base (insurance companies, pension funds, and mutual funds) is still relatively small in Poland but growing rapidly.** Given their small size these sectors do not pose any significant threat to the stability of the financial system, but vigilance is warranted, particularly in light of the formation of financial conglomerates. Some specific issues hamper the development of the insurance and pension markets. In the insurance sector, early reduction of the large role of the state should enhance the competitive structure. In the pension fund industry, there is an urgent need to allow consolidation.

69. **The *insurance sector* has developed well in recent years.** To further develop the market, policies for the sector need to address the following issues. Concentration in some segments in the industry remains high, particularly in group life insurance; low profitability is a concern, in particular for nonlife insurance services; and PZU's early and transparent privatization will be important to the development of a competitive market.[16]

70. **A review of compliance with the IAIS standards revealed the following shortcomings**: The supervisory agency should have adequate powers to intervene in weak companies. On-site inspections should gradually shift away from checklist-driven approaches to a risk-based approach to detect isolated or systemic risks at an early stage. As supervisory resources are further built up, frequency of inspections should be increased. There is considerable concern that insurance premiums in property and casualty areas are not adequate. The ongoing review by the supervisor will be useful to determine whether competition has pushed prices to an inadequate level.

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[16] Many insurance companies in the nonlife sector are unable to compete with the largest institutions. In 1999, the aggregate net technical result for all companies combined was a negative 425 million zloty mostly due to nonlife insurance losses. For the industry as a whole this loss was compensated for by investment income, although 38 of 57 companies reported losses overall.

71. **Following the recent comprehensive reform of the *pension fund sector*, a number of important issues need to be further addressed.** Pension funds will become an important source of institutional investment in Poland in the near future and may dominate net investment in the capital markets. The functioning of the pension industry is at the moment hampered by problems in the Social Security Administrator. Other measures that need to be considered include:

- A large number of pension funds incur operating losses. Supervisory authorities should, therefore, take a more flexible approach towards mergers and acquisitions.

- Regulations should be liberalized to allow the sector to grow more efficiently and offer beneficiaries the right products. Over time, as the governance framework for pension funds is improved, investment regulations on domestic and foreign assets should be relaxed and the minimum rate of return guarantee be evaluated. A more flexible approach should be taken towards multiple financial products; outsourcing of asset management be allowed; and the scope for cross-selling of products be expanded.

- UNFE's procedures governing matters such as licensing and processing of requests for mergers should be publicly disclosed, in order to ensure adequate transparency of its activities. Supervisory activities should focus more on risk management practices and solvency, instead of on compliance with rules and regulations.

D. Financial Safety Net and Crisis Management Capacity

72. **Throughout the 1990s, the Polish authorities have used a combination of financial sector restructuring policies and tools that enabled them to build up a sound financial system,** while at the same time avoiding a banking crisis—unlike some of the country's neighbors. Weaknesses in the regulatory framework and the enforcement powers of the supervisors were broadly offset by proactive policies, such as the resort to mergers and acquisitions, and the government restructuring program for state-owned banks. In the process, the authorities also started building the features of the financial safety net, consisting of a lender of last resort (LOLR) function, deposit insurance, and insolvency regulation. Some refinements should be considered to enhance the effectiveness of possible interventions and minimize moral hazard.

73. **The NBP has procedures in place for operating its LOLR support.** With the transition to a mature banking system, the NBP should refrain from its past practice of also granting emergency loans to insolvent institutions. Granting credit should be on a short-term, collateralized liquidity assistance basis only. As soon as a bank is being intervened by GIBS, the Bank Guarantee Fund (BGF) should assume the responsibilities of any financial support.[17]

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[17] Should LOLR lending to insolvent banks be deemed necessary because of their systemic importance, the lending decision should be an integral part of a well-designed crisis management plan. LOLR lending in such cases should be made in consultation with the CBS

(continued...)

It is recommended that the NBP discontinue the policy of exempting troubled banks from reserve requirements. This instrument should be strictly used for monetary policy purposes.

74. **The BGF has two main tasks: to operate as a deposit guarantee fund and to assist in restructuring and rehabilitating banks.** The choice between both options depends on "the least costs" principle. Since end-1999, all Polish banks are included in the deposit insurance scheme on the same terms. The deposit insurance scheme contains the key attributes of an effective deposit insurance framework. The BGF is an "ex post" fund (contributions from the sector) that provides for some market discipline, but can complicate the efficacy of intervention and speed of resolution as the Fund lacks resources. The authorities may consider building up some "ex ante" funding to deal with individual bank failures.

75. **At this juncture, BGF should be allowed to merge its assistance fund for restructuring banks with its deposit guarantee fund to streamline its focus: resolution of weak banks at the least costs based on careful analysis.** The current distinction between two funds can only limit the flexibility of BGF and can introduce a bias to extend concessional loans (in case, for example, when the insurance fund is short of resources), with attendant risks. Such course of action would also reduce the role of the NBP in providing assistance to the BGF.

76. **Basic arrangements for coordination among key agencies in times of crisis are in place, but remain untested.** Based on experiences from other countries, some refinements could be made:

- Coordination among NBP, CBS, and BGF is ensured. The NBP president is also the president of the CBS; and BGF and CBS coordinate through cross-representation on each other's boards.

- As discussed in Chapter IV, there are still some weaknesses in the CBS's enforcement powers. If left unaddressed, these weaknesses could, in case of a systemic banking crisis, render the task for the supervisors—and the authorities in general—much more difficult and, therefore, lead to a situation wherein the crisis spreads faster and becomes deeper than otherwise.

- The role of the ministry of finance in crisis management arrangements need to be clarified. As the budgetary authority, the ministry should have a clear role.

- The NBP's payment systems department should be formally involved, from the onset of a crisis, in its management. It is important that the NBP develop a contingency plan

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and receive the explicit approval from the ministry of finance. The government should fully guarantee uncollateralized lending in these cases and cover all losses that were to occur. For state-owned banks, solvency support should come directly from the budget.

on how to deal with crisis situations and involve the payment systems department in the development and implementation of this plan.

E. The Broader Legal Framework

77. **A common theme in most CEE transition countries is the need to upgrade the broader legal framework as it pertains to financial sector issues, as well as the judiciary system.** Rigid or outdated bankruptcy laws, laws on collateral and pledges can make the resolution of a systemic crisis very inefficient and can, by prolonging action, make a crisis deeper and wider than otherwise would have happened. The same applies to the judiciary system to the extent that it is not familiar with sophisticated financial dealings and transactions. As Poland is transiting to a mature financial system that will soon be totally integrated in the European financial markets, the authorities should review these laws and systems. A more efficient bankruptcy law will, for instance, take away the uncertainty regarding multilateral netting in the payment system and will reduce the interest cost of borrowing for SME's and household.

SECTION II—OBSERVANCE OF FINANCIAL SYSTEM STANDARDS AND CODES: SUMMARY ASSESSMENTS

This section contains information on adherence to and consistency with major international standards and codes relevant for the financial sector. The assessment has helped to identify the extent to which the supervisory and regulatory framework has been adequate to address the potential risks in the financial system. It has also provided a source of good practices in financial regulation and supervision in various areas.

Detailed assessments of standards were undertaken based on a peer review process, as part of the Financial Sector Assessment Program (FSAP), by Laura Ard (World Bank), Stefan Spamer (Bundesbank), and Shyamala Gopinath (Reserve Bank of India) for the *Basel Core Principles for Effective Banking Supervision*; Martin Andersson (Central Bank of Sweden) for the *Core Principles for Systemically Important Payment Systems*; Hemant Shah (World Bank) for the *International Organization of Securities Commissions' Objectives and Principles of Securities Regulations*; Donald McIsaac (World Bank) for the *International Association of Insurance Supervisors' Supervisory Principles*; and Andrea Schaechter (IMF) and Shyamala Gopinath (Reserve Bank of India) for the IMF's *Code of Good Practices on Transparency in Monetary and Financial Policies*. The expert team prepared detailed assessments by drawing on information provided by the Polish authorities, including self-assessments, and on fieldwork during July and September 2000. This section contains a summarized version of the assessments included in the FSAP report.

The assessments confirm the great progress made by Poland in assimilating international best standards and practices. However, some weaknesses remain, which need to be addressed in order to support the building up of the financial system's resilience. Indeed, common threads in all assessments, with potential effects on the soundness of the system, are the need for (a) more autonomy for the supervisors, including legal protection of supervisors; (b) close coordination among supervisory agencies; (c) powers to require consolidated reporting and to conduct consolidated supervision; (d) stronger intervention and enforcement powers; (e) stronger regulations to instill corporate governance principles. With respect to the payment systems, specific issues to be addressed are the lack of clear oversight responsibility over the retail systems and the legal uncertainty created by the zero-hour rule. Both issues are currently being addressed by the authorities. The current revision of key laws applying to the respective sectors—planned to be implemented in early 2002—is expected to significantly enhance compliance.

I. Introduction and Summary

1. This section contains summaries of the reviews of compliance and consistency with key principles and standards applicable in the financial sector. Specifically, it reviews compliance with (a) the Basel Core Principles for Effective Banking Supervision; (b) the IMF Code of Good Practices on Transparency in Monetary and Financial Policies; (c) the Committee on Payment and Settlement Systems' (CPSS) Core Principles for Systemically Important Payment Systems; (d) the International Organization of Securities Commissions' (IOSCO) Objectives and Principles of Securities Regulations; and (e) the International Association of Insurance Supervisors' (IAIS) Supervisory Principles. The detailed assessments for each of these standards and codes formed an integral part of the FSAP and an input into the Financial System Stability Assessment (FSSA). It should be noted that some of the standards are still in draft form, while some do not yet have a complete methodology on which the assessment can be based.[1]

2. The assessments confirm the great progress made by Poland in assimilating international best standards and practices. However, some weaknesses remain, which need to be addressed to ensure that the regulatory and supervisory frameworks fully support the building up of the financial system's resilience against a background of rapid financial development and integration in the global markets.

3. In this context, it is worthwhile emphasizing that many of the areas in need of further improvement are similar across subsectors. This is understandable in light of the fast development that the Polish financial markets underwent in the past decade, whereby all issues needed to be tackled at the same time, and regulation and supervision of one sector could not learn from the experience of others, as is the case in (western) economies that have gone through more gradual developments. Nevertheless, the identified remaining weaknesses should be addressed in due course because they could have potentially negative effects on the soundness of the system. They are the need for:

- more autonomy for the supervisory agencies, including legal protection of supervisors;

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[1] The Basel Core Principles were issued in September 1997 and the Core Principles Methodology was released in October 1999 by the Basel Committee on Banking Supervision. The IMF Code of Good Practices on Transparency in Monetary and Financial Policies was adopted by the Interim Committee in September 1999 and the supporting documentation was approved by the Executive Board in July 2000. The draft Core Principles for Systemically Important Payment Systems, including the methodology were issued for comments in December 1999. The final set of principles was issued in January 2001. The IOSCO Objectives and Principles were issued in September 1998 and a detailed self-assessment methodology is being developed. The IAIS Supervisory Principles were issued in September 1997 and a self-assessment program has been developed to assist the members in evaluating compliance.

- close coordination and exchange of information among supervisory agencies;
- powers to require frequent consolidated reporting and to conduct consolidated supervision—highly important in light of the tendency to form large financial groups;
- stronger intervention and enforcement powers; and
- stronger regulations to instill and enforce corporate governance principles.

4. Another common finding of the respective assessments is the fact that in all sectors the supervisors are well aware of these deficiencies in the regulatory frameworks and have, in their supervisory practice, identified and applied ways to circumvent them.[2] While these efforts are highly commendable—and have indeed helped to strengthen the functioning of the financial system—it is more than desirable that their efforts be backed by upgrades in the regulatory framework so that there is no question about the enforceability of their actions. The current revision of key laws in most sectors—planned to be ready for implementation in early 2002—is expected to largely overcome this discrepancy and, thus, enhance compliance with the standards greatly.

II. Basel Core Principles for Effective Banking Supervision

Summary Assessment

General

5. The assessment of the regulatory and supervisory framework for banking was performed under the FSAP. The main objectives were to assess the level of compliance with the Basel Core Principles for Effective Banking Supervision, and to suggest areas for further improvement.

6. The legal framework for the Polish banking sector is provided in the Banking Act of 1997, as well as relevant sections of the National Bank of Poland (NBP) Act of 1997 and the Accounting Act of September 1994, as subsequently amended, the Act on Mortgage Bonds and Mortgage Banks of 1997, and the Act on Cooperative Banks and Their Associations (2000). An amended Banking Act is currently before parliament and it is hoped that this Act will be adopted in the course of 2001. The amended Banking Act, once fully implemented will lead to a much higher degree of compliance with the core principles, although not all of the issues listed in the introduction will be fully addressed. Further improvements are suggested with respect to (a) the need for more efficient and effective intervention powers for

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[2] The standards that are part of this assessment all put relatively more emphasis on the regulatory framework than on the actual supervisory work. As a result of this, the efforts of the supervisors to overcome deficiencies in the regulations cannot always be fully recognized in the assessments, because of the remaining doubts about the enforceability of their actions.

the supervisors; (b) the ability to require effective corporate governance by bank boards; and (c) the level of independence from the government.

7. Supervision of the banking system is conducted by the Commission for Banking Supervision (CBS), created under the 1997 National Bank Act. The executive arm of the Commission is the General Inspectorate of Banking Supervision (GIBS) that is headed by a General Inspector, appointed by the president of the NBP, acting in agreement with the minister of finance. The GIBS is an autonomous entity within the NBP.

8. The detailed assessment was prepared by Laura Ard (World Bank), Stefan Spamer (Deutsche Bundesbank), and Shyamala Gopinath (Reserve Bank of India). The assessment was based on a review of the legal framework and discussions with the supervisory authorities who cooperated extensively and provided much of the data quoted in the summary—including a self assessment—as well as market participants.

Institutional and macroprudential setting, market structure—Overview

9. The Polish banking system has developed significantly over the last five years. Commercial banks dominated the financial market with as of end-1999 over 85 percent of financial system assets. Financial intermediation is still low compared to other Central and Eastern European countries, with banking assets at 60 percent of GDP and private sector bank debt at 22 percent of GDP at end-1999. Even the largest banks in Poland are small by international standards and the entire banking sector is smaller in absolute terms than many large Western European banks.

10. Following the adoption of decentralized restructuring techniques in the early transition years, the government attracted strategic foreign investors. Foreign ownership has become an important and stabilizing factor. As of end-March 2000, 45 commercial banks out of 75 had a majority foreign shareholding, and 63 percent of the total commercial banking capital is foreign. Government ownership in the sector remains significant. Despite several years of privatization and increasing competition for deposits, majority state-owned banks still manage 30 percent of total bank deposits.

11. The banking system is highly concentrated. The two largest banks' market share in deposits is 44.4 percent. Most banks are relatively profitable, but net interest margins have recently decreased substantially. The retail-funding base of banks is growing fast and has a large growth potential because 45 percent of the population does not have a bank account. The country is under-banked with only 5.8 branches per 100,000 inhabitants (the average for the European Union (EU) is 48 per 100,000 inhabitants). Although 77 percent of lending to the nonfinancial sector is to the corporate sector, consumer credit is growing rapidly from a low base, up by over 50 percent in 1999.

General preconditions for effective banking supervision

12. The objectives of the CBS are precisely defined in the Banking Act: "The objective of supervision is to ensure the safety of funds held on bank accounts, and compliance by the

banks with the provisions of the present Act, the Act on the NBP, their articles of association and the rulings issued on authorization to establish those banks." The Act on the NBP enumerates the responsibilities of the Commission in the form of an open-ended list. Measures to be taken by the CBS are listed in the Banking Act. According to the NBP Act, the CBS is responsible for establishing the principles for the conduct of banking activity, overseeing compliance by banks with their statutes and other regulations, performing periodic assessments of the financial condition of banks, and providing advice on the structure of banking supervision and the performance of such supervision. Work has currently been undertaken to extend the responsibilities of banking supervision to include the safety of all repayable funds taken by banks.

13. The Commission is composed of the president of NBP as Chairman, the minister of finance or his representative as Deputy Chairman, representatives of the President of the Republic of Poland and of the ministry of finance (MoF), the president of the Management Board of the Bank Guarantee Fund (BGF), the Chairperson of the Securities and Exchange Commission (SEC) and the GIBS. In addition, a representative of the Polish Bank Association has limited rights of participation in meetings of the Commission.

14. The 1997 Banking Act provides for the establishment and organization of banks and of branches and representative offices of banks. It also deals with bank accounts, bank settlements, guarantees, issue of bank securities, rights and duties of banks, association and amalgamation of banks, bank capital, banking supervision and bank rehabilitation proceedings, liquidations, and bankruptcies. New features of this law included an increased level of prudential regulation and stricter regulations on money laundering. General disclosure requirements are elaborated subject to the obligation of bank secrecy. Licensing provisions were amended in light of EU banking directives and large exposure limits were established. The amended Act will include new provisions with respect to consolidated reporting and supervision, solvency ratios, limits of foreign exchange positions, and insider lending. Although corporate governance issues have been addressed in the new Law on Commercial Companies, it is recommended that particular safeguards for the governance of banks be incorporated in the Banking Act as well, because of their importance.

15. The banking supervision process has made substantial strides in building staff and in developing the internal process and effective tools within the more limiting regulatory structure. The Commission has adopted a clear set of objectives with the primary goal of safeguarding the banking system while protecting the depositor. These goals and objectives are effectively implemented through supervisory strategies set for each bank, depending on its characteristics and risk profile, and through the ongoing on- and off-site supervisory activity. Supervisory objectives are also supported through internal departmental communication and regular interaction with the banking community. Staff demonstrate a deep and wide knowledge of their respective areas and of the objectives and responsibilities of banking supervision.

Main findings—Summary

16. The assessment reveals that compliance of the current regulatory framework is not complete, while compliance of the actual supervisory practice is much higher. Main areas to be addressed include (a) the ability to apply consolidated supervision across banks, their related interests, and banking groups; (b) the need for more efficient and effective intervention and enforcement powers for the GIBS; (c) the ability to require effective corporate governance by bank boards; and (d) the level of independence from the government. The amended Banking Act, once fully implemented will lead to a much higher degree of compliance with the core principles, although not all of the above issues will be fully addressed.

17. The 1997 Act laid the foundations for an independent supervisory authority. The authorities should further build on this achievement by extending more autonomy to the CBS in the interest of soundness and safety of the banking sector. One issue that raises concern is that the government seems to have a strong influence on the composition of the Commission. The structure of the Commission provides an avenue for potential intervention, if such motivations existed. In addition, certain decisions cannot be made outside a meeting of the Commission, such as those regarding bank licensing, suspending bank operations, and imposing sanctions. Also, specific agreement with the ministry of finance on licensing decisions is required.

18. In the interest of autonomy and quality, staffing and remuneration of the GIBS could be improved. GIBS staff salaries are still not comparable with those of the financial industry, with the corollary of heavy staff turnover, and a negative impact on the on-site inspection cycle.

19. An important issue that was not fully resolved in the 1997 Banking Act is the explicit right for the supervisory agency to address compliance with laws. This power is at present derived implicitly from Article 138 of the Banking Act, but in times of crisis this might be disputed and, as such, may delay the resolution. Explicit powers should be given to the supervisory authority to make its actions more effective.

20. It is essential that clear criteria be defined for the protection of supervisors so that the agency can carry out its actions without any influence. The Banking Act should be amended to give supervisors protection for actions performed while discharging their duties in good faith, and protection against the costs of defending their actions while discharging their duties.

21. The legal framework is clear on such essential aspects as the definition of a bank, the licensing process, the eligibility criteria for becoming a member of a bank's management board and the role of the commission in approving such members. The amended Banking

Act, currently before parliament, will contain additional criteria for the CBS to refuse authorization for a bank to operate, and to revoke a license.

22. However, less clarity exists in the current Act with respect to the definition of significant ownership. A better definition would enhance the transparency of the ownership structure and the authority in the supervisor. The Banking Act should also be amended to clearly define the type and amount of investments which need supervisory approval. In addition, criteria to ensure that acquisitions and investments do not expose the bank to undue risk, or hinder effective supervision have to be established.

23. The Banking Act has most of the essential prudential regulations and requirements in place. The Act clearly sets capital requirements for banks, and puts limits on large exposure and on connected lending. It requires the banks to have internal control systems in place, to review their assets and off-balance-sheet risk exposures and classify them, and to detect, combat, and prevent fraud and other activity of criminal nature. Recommendations also set out the supervisory requirements in terms of risk management process.

24. Two areas for improvement stick out. The first is the urgent need to require reporting on a consolidated basis and the need to undertake supervision on a consolidated basis, to get a grip of the financial groups' risk position. The second is the need to clearly define and raise the level of responsibility and accountability of the banks' management and supervisory boards. While the supervisors have taken commendable steps to start and continue this process, the core laws (Commercial Code, Civil Code, and Banking Law), which anchor these responsibilities and, therefore, provide the ability to enforce such accountabilities, must be strengthened. From a systemic stability point of view, both issues are becoming of great importance for the Polish financial system. The amended Banking Act will require consolidated reporting and enable consolidated supervision. On the other hand, the amendments still fall short of providing the best regulatory framework to instill corporate governance principles.

25. Further refinements and additional requirements could make the prudential regulations framework more effective and fully compliant with international standards. Issues to be addressed include the inclusion of market risk in the capital adequacy provisions; the use of indicative benchmarks for triggering action on inadequate capital adequacy to prompt timely supervisory response; the introduction of supervisory guidelines for market risk that should be embedded in the law, thereby possessing full enforcement capacity, rather than being effected only through "moral suasion," and requiring banks to establish policies and procedures that assure adequate, periodic collateral reviews, updated valuations, and reviews of external collateral valuations; and clarifications and improvements in the definition of large exposures and connected lending.

26. Banking supervision is conducted through on-site examinations and off-site analysis. Both functions are very well organized as separate divisions in GIBS. On conclusion of a full-scope examination, the bank is assigned a composite rating, together with component ratings for capital, credit risk (asset quality), management (including internal controls), earnings, liquidity, interest rate risk, foreign exchange risk, and operational risk. These

ratings are developed within the CAMELS/CAMELIFO framework. GIBS has indicated that work on the implementation of a more developed risk-based supervisory cycle has begun.

27. In performing their task, off-site analysts maintain constant contact with management of the banks they supervise. A basic supervisory tool employed since 1998 has been the Uniform Bank Performance Report, which contains several hundred financial ratios and is generated every quarter on the basis of the information provided in bank returns. This permits identification of the risks incurred by the bank and potential problems in the future.

28. Banks submit overnight reports (foreign exchange position), ten-day reports, monthly, and quarterly reports. Banks are also required to submit to the Commission annually their audited accounts on a solo and consolidated basis, together with the auditor's opinion and report. Because data for monetary and supervisory purposes are reported within a single reporting system, it is necessary that GIBS communicate clearly its needs in terms of reporting requirements to NBP management to ensure that supervisory reporting stays in tune with market developments.

29. As indicated earlier, the Banking Act makes no provision for the performance of supervision on a consolidated basis, except for the requirement of submitting consolidated *annual* accounts to the CBS. This remains a major weakness. Consolidated banking operations and related risks (such as market risk and credit risk) should be monitored on a more frequent basis to ensure the overall risk assessment of a banking group. Considering the increasing number of banking-group formations in the country, priority should be given to introducing consolidated capital requirements. The CBS is aware of the danger that banks may transfer higher-risk activities to their subsidiaries. As a result, attempts are made, within the current legal framework, to obtain information on a bank's subsidiaries.

30. The ministry of finance is considering taking over the authority to set accounting requirements (for all financial institutions). It is recommended that the CBS, through the GIBS, maintain an important influence in the process because the ability to prescribe accounting policies and reporting is critical to ensure that banks' accounts and capital properly reflect underlying asset values and that the supervisor receives meaningful information through which to detect bank and systemic risks.

31. Under the Law on Accounting, all banks are required to publicly disclose their audited annual accounts together with the auditor's opinion and a copy of the decision approving the accounts and the distribution of net profits or absorption of losses. However, disclosure requirements both on a consolidated and solo basis are in need of further improvement. Although a bank holding company is required to prepare group consolidated financial statements, regulations exempt consolidated account disclosure. Requirements for banks listed on the stock exchange are more demanding in terms of the level of information to be disclosed. Such banks are also required to report along the standards promulgated by the International Accounting Standards (IAS). Planned amendments to Polish accounting regulations will bring these regulations fully in line with international accounting standards and thus apply to all banks.

32. Measures available to the Polish banking supervisors are set out under Title 11 of the Banking Act. It is worth noting that the Commission has no sanctions at its disposal with respect to a bank's supervisory board or its members. In the framework of rehabilitation and liquidation proceedings, the Commission is empowered to apply a separate class of supervisory measures. Despite improvements in the 1997 Act, supervisors are required to go through a lengthy process involving a series of iterations before concrete, legally enforceable actions are triggered. Steps should be taken to amend the full spectrum of enforcement tools available to bank supervision, to upgrade the set of corrective measures and to introduce prompt corrective actions, so that supervisors can better follow up on their initial remedial actions and enforce them. The ability to hold management and supervisory boards responsible and accountable for the prudent oversight of their banks (i.e., strong corporate governance) must be provided in the Banking Act and anchored in supporting laws (Commercial Code, Civil Code, Criminal Code, etc.).

33. The shortcomings with respect to supervision of cross-border banking follow directly from the fact that consolidated supervision has not been implemented so far. At this time, GIBS supervises the activities of foreign branches if there is no agreement that the host performs such supervision but supervision of foreign subsidiaries of domestic banks has not been established. Thus, supervision of foreign entities remains problematic, although branches and subsidiaries voluntarily submit quarterly reports through their headquarters. According to the Banking Act, the CBS can prohibit the establishment of new branches, but cannot demand the closure of existing ones, a discrepancy that should be addressed.

34. The provisions of the Banking Act allow for the establishment of co-operation and exchange of information with foreign supervisors. The first such agreement has recently been concluded, and negotiations are underway with agencies from over a dozen other countries.

Authorities response and next steps

35. The authorities pointed out that, in their view, the autonomy of the supervisory agency was well established and that political interference in the process was not an issue, hereby referring to developments since 1997. They agreed that the lack of consolidated reporting and consolidated supervision is a major weakness. However, they emphasized that the supervisory practice has been trying to overcome this deficiency by asking the appropriate questions during on-site inspections. They agreed they would feel more comfortable about developments in the sector once they will be empowered to analyze and inspect on a consolidated basis. On intervention powers, remedial actions and their enforcement, they underlined that the 1997 Banking Act has given them much more powers than before. However, they agreed that these powers have remained untested so far. The authorities were also of the view that the legal protection of supervisors is well established in the Civil Code. They agreed that the amended Banking Act, once implemented, will greatly increase the degree of compliance.

36. Adoption and implementation of the amended Banking Act should not be delayed, as this new law will indeed significantly strengthen supervision and regulation. In particular, the legal requirement for frequent (i.e., more than annual) reporting on a consolidated basis, and a legal mandate to conduct supervision on a consolidated basis is long overdue. While the amended law will address several of the issues raised above, further strengthening of the legal framework in the areas of corporate governance and remedial actions remains necessary. The current weaknesses in the legal framework put a heavy, and more than necessary, burden on the supervisory function. Polish supervisors have been doing the best they could to find ways around the vacuums in the Act by actively using their existing powers and developing internal skills to properly execute their responsibilities. However, proper legal backing of their actions is necessary in the interest of the system's soundness.

Table 8. Poland: Summary of Main Findings of Assessment of Implementation of the Basel Core Principles for Effective Banking Supervision

CPs Main Categories	Main Findings
Objectives, Autonomy, Powers, and Resources (CP 1)	Structure of CBS could be revised, as it is now open to political interference. Staffing should be further enhanced and legal protection of staff needs to be clarified. Enforcement powers need further enhancement. Improvements are needed with respect to information sharing with foreign supervisors.
Licensing and Structure (CPs 2–5)	Further improvements are included in amendments to the law, such as the ability to reject applications.
Prudential Regulations and Requirements (CPs 6–15)	Improvements under way. The most urgent improvements are needed in consolidated risk assessment and in improving corporate governance standards and practices. Other deficiencies to be addressed include: the standards for approval of acquisitions and investments; the parameters for large exposure; the authority of the supervisors to identify connected lending; better regulations for country and market risk. Several of these issues are addressed in the amended law, including consolidated risk assessment), but corporate governance is not.
Methods of Ongoing Supervision (CPs16–20)	Methods are well established, with the exception of the requirement to conduct supervision on a consolidated basis. But supervisory practice explores ways to overcome this deficiency.
Information Requirements (CP 21)	Better enforcement powers would make the supervisory work more effective. Improvements in accounting standards are under way (in line with IAS).
Formal Powers of Supervisors (CP 22)	Remedial actions need further strengthening. Full spectrum of enforcement tools for supervisors needs to be reviewed.
Cross-border Banking (CPs 23–25)	The weakness in the regulatory framework in this respect is directly related to the lack of powers to undertake consolidated supervision.

III. Observance of the Code of Good Practices On Transparency in Monetary and Financial Policies

Introduction

37. The assessment of observance of good transparency practices in monetary and financial policies by the NBP, the respective supervisory agencies (banking, payment system, securities markets and insurance) and by the Bank Guarantee Fund (BGF) was carried out as part of the joint Fund-Bank FSAP based on information available up until September 2000.

38. The assessment was based on the *IMF Code of Good Practices on Transparency in Monetary and Financial Policies (the Code).* No assessment methodology has been developed as yet, but the assessment has taken into account the implementation issues mentioned in the *Supporting Document to the Code*. The Polish authorities cooperated fully with the assessment and provided all necessary clarification and documents.

A. Transparency in Monetary Policy: NBP

39. The assessment of NBP's observance of good transparency practices relating to monetary policy was undertaken by a staff member of the FSAP team and was based on: (a) a pre-FSAP questionnaire response; (b) information available on the NBP website; (c) relevant laws; and, (d) discussions with relevant NBP departments.

Legal framework, institutions, and market structure—Overview

40. The *Act on the NBP* of August 29, 1997 establishes the NBP as the Central Bank of Poland. The Act defines maintaining price stability as the primary objective of the NBP. The bank's responsibilities and the monetary policy instruments it has at hand are also defined in the Act. The NBP has adopted an inflation targeting framework under which it publicly announces quantitative inflation targets, including the index for the inflation target (consumer price index) and the timeframe within which the targets are to be achieved.

41. Overall, the NBP is equipped with a flexible set of monetary policy instruments, comprising reserve requirements, issuance of NBP bills, a Lombard, and a rediscount facility. NBP bills are the main intervention instrument at present. The NBP Act and relevant resolutions also allow for outright operations and repurchase agreements in government securities. Repos have not been used since 1997. However when moving into a net creditor position vis-à-vis the markets, the NBP intends to use repos as its main refinancing instrument–similar to the European Central Bank. These will be issued using variable or fixed rate tenders, similar to current issuance methods for NBP bills (and the latter will be phased out).

42. The directing bodies of the NBP comprise its president, the Monetary Policy Council (MPC), and the NBP Management Board. The president of the NBP is appointed by the lower house of parliament (Sejm), at the proposal of the President of the Republic of Poland, for a term of six years. The president of the NBP cannot be in office for more than two

consecutive terms. The MPC, which is responsible for the conduct of the monetary policy, is chaired by the president of the NBP and includes nine other members appointed in equal numbers by the President of the Republic of Poland, the Sejm and the Senate. Their terms are for six years, not renewable. The NBP Management Board, the executive body of the NBP, is composed of the president of the NBP and six to eight other members, of which two are vice presidents of the NBP. The Board members are appointed by the President of the Republic of Poland, at the advice of the president of the NBP.

43. The NBP president is required to submit an annual report on the NBP's activities, on behalf of the MPC and the annual monetary policy targets in the Monetary Policy Guidelines, to the Sejm. The bank is also required to publish an Annual Report. A further factor ensuring accountability is the publication of the voting record of the MPC six weeks after decisions have been taken.

Main findings—Summary

44. The NBP observes most transparency practices of the Code. As with the financial agencies assessed in conjunction with other aspects of the Code, the NBP has undertaken considerable efforts to conduct policies in a transparent manner and to resort to a variety of means for public disclosure, including annual reports, official bulletins, press releases, a web site, research work, brochures, and speeches by officials. The NBP's process of formulating and reporting monetary policy decisions, in particular, is very transparent, as are the bank's practices regarding the release of data. The use of the bank's website has gained importance for wide and quick dissemination of information, with much of the contents being available in English as well as Polish.

45. Transparency could be further improved in the following areas: (a) the mechanism of profit allocation and maintenance of capital should be explained in more detail; (b) a list of the NBP's holdings of commercial enterprises should be made public by the bank;[3] and (c) the publication of the terms (maturity and interest rate) and amounts of government deposits on the NBP's books, a decision that is in the hands of the government.

46. The NBP observes the majority of the good transparency practices regarding accountability and assurances of integrity. To come into full observance, information on accounting policies and any audit qualification to the annual accounts of the NBP should be made an integral part of the publicly disclosed financial statements. Internal governance procedures regarding standards aimed at avoiding conflicts of interest for members of the MPC, as well as NBP staff and management, should be publicly disclosed. The degree of legal protection of NBP staff when executing their duties is unclear.

[3] Currently, this information is available through court registers.

Table 9. Poland: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Monetary Policy

Subject	Main Findings
I. Clarity of roles, responsibilities, and objectives of central banks for monetary policy	Greater clarity would be appropriate regarding the mechanism for profit retention and maintenance of NBP capital; the NBP's holdings of equity in commercial enterprises; and the amounts, maturity; and interest rates payable on government deposits with the NBP. All other aspects are transparent.
II. Open process for formulating and reporting monetary policy decisions	No action required. The process of formulating and reporting monetary policy decision is highly transparent.
III. Public availability of information on monetary policy	No action required.
IV. Accountability and assurance of integrity by the central bank	Information on NBP accounting policies and any qualifications to the annual accounting statements should become an integral part of the publicly disclosed financial statements. Internal governance procedures should be publicly disclosed. The degree of legal protection of NBP staff when executing their duties is unclear.

Authorities' response and recommended next steps

47. The authorities were in broad agreement with the assessment and planned to address most of the issues mentioned in this assessment. On the legal protection for staff, the authorities were of the view that the stipulations in the Civil Code were clear enough to provide protection. The staff were of the view that the issue should be carefully revisited to ensure that legal protection is indeed ensured. It was pointed out that this issue pertains to all agencies assessed for compliance with the code.

B. Transparency of Financial Policies: Banking Supervision

Information and methodology

48. The assessment of the observance of good transparency practices relating to banking supervision by the CBS and its executive arm, the GIBS was undertaken by a member of the FSAP mission team and was based on (a) a pre-FSAP questionnaire response; (b) information available on the *NBP*'s website; (c) relevant laws; and (d) discussions with Commission and NBP officials, a number of commercial banks and the Polish Bank Association.

Main findings—Summary

49. Good transparency practices are observed with regard to banking supervision. The conduct of banking supervision is made transparent in the Banking Act through the definition

of measures that may be taken and sanctions that may be imposed, as well as through public disclosure of the actions taken as administrative resolutions published in the *Official Journal of the National Bank of Poland* and in the media. Changes in financial policies are also published in this journal and explained in letters by the GIBS to banks, the Polish Bank Association, external auditors, and rating agencies. Moreover, changes are presented and explained in conferences hosted by the CBS or meetings with the Polish Bank Association.

50. The president of the NBP appears annually before parliament, Moreover, officials of the Commission are available to appear, upon request, before parliamentary commissions or the parliament to answer questions on banking supervision.

51. Since the CBS does not have its own budget, all of its financial activities are part of the NBP's financial statements, but they are not separately distinguished. Legal protection of the members of the CBS and NBP staff is limited to protection under the Civil Code. It is recommended that the expenses and revenues related to the CBS's and GIBS' activities be explicitly shown in the NBP's financial statements, that a Code of Ethics for members of the CBS and GIBS be developed to increase transparency and accountability, and that the legal protection for supervisors be enhanced.

Table 10. Poland: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Banking Supervision

Subject	Main Findings
I. Clarity of roles, responsibilities, and objectives of financial supervisory agencies	No action required.
II. Open process for formulating and reporting of financial policies	No action required.
III. Public availability of information on financial policies	Financial activities of CBS could be explicitly disclosed as part of NBP financial statements.
IV. Accountability and assurance of integrity by financial supervisory agencies	A Code of Ethics for CBS members should be developed. Legal protection for staff when discharging their duties is unclear and should be clarified.

Authorities response and recommended next steps

52. The authorities were in broad agreement with the assessment. On the legal protection of staff, the GIBS representatives were of the view that the stipulations in the Civil Code are strong enough to protect staff of supervisory agencies. The mission was of the view that this issue needs to be revisited carefully, because it had been receiving conflicting statements from Polish officials in this regard.

C. Transparency of Financial Policies: Payment System Supervision

Information and methodology

53. The assessment of the observance of good transparency practices relating to supervision of the payment system was undertaken by a member of the FSAP staff team and was based on (a) a pre-FSAP questionnaire response; (b) information available on the *NBP*'s website; (c) relevant laws; and (d) discussions with NBP officials.

Main findings—Summary

54. Overall oversight responsibility over the retail payment system is currently not specifically assigned to any financial agency. The NBP is the owner, operator, and decision-making body for the large value payment system. Article 68 of the Banking Act authorizes the NBP president to specify the means of payment and procedures for settlement via banks and the manner of clearing interbank settlements. Based on this, the NBP issues regulations covering the real time gross settlement (RTGS) system, SORBNET. Governance over this system is, therefore, effective, transparent, and accountable. However, no explicit or implicit oversight responsibility over other parts of the payment system has been defined. This gap needs to be filled. The best candidate for this task would be the NBP, given its role (a) in SORBNET, (b) as operator of the Central Register for Treasury Securities and the Register for NBP bills, and (c) as a shareholder of the National Clearing House KIR SA. As a result of this shortcoming, the four principles are not observed. The authorities are addressing this issue through a new Act, expected to be adopted and implemented in 2001. This act will lead to well-defined oversight and transparency.

Table 11. Poland: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Payment System

Subject	Main Findings
I. Clarity of roles, responsibilities, and objectives of financial supervisory agencies	Clear oversight responsibility over the multilateral payment systems need to be established. Legal initiatives are under way.
II. Open process for formulating and reporting of financial policies	Once clear oversight will be defined, no further actions for II, III, and IV will be needed.
III. Public availability of information on financial policies	Same as above.
IV. Accountability and assurance of integrity by payment system supervisors.	Same as above.

Authorities response and recommended next steps

55. The authorities were in broad agreement with the assessment. The lack of clear oversight responsibility is being addressed through a new law.

D. Transparency of Financial Policies: Securities and Exchange Supervision

Information and methodology

56. The assessment of the observance of good transparency practices relating to securities and exchange supervision by the SEC was undertaken by a member of the FSAP staff team and was based on (a) a pre-FSAP questionnaire response; (b) relevant laws; (c) information available on the SEC's website; and (d) discussions with the SEC, the Warsaw Stock Exchange (WSE), and market participants.

Main findings—Summary

57. Generally good transparency practices are observed with regard to the roles and objectives of the SEC. The objectives and the institutional framework are defined in the Act on Public Trading of Securities (LTPS) and explained in the SEC's *Annual Report*. The law also provides clearly stated responsibility and supervisory powers over brokers, investment advisors, exchanges, issuers, and depository institutions. The prime minister supervises the SEC's functioning and the SEC reports annually to parliament.

58. The relationship between the SEC and the NBP should be more clearly disclosed. The LTPS indirectly defines the SEC's cooperative relationship with the NBP. There is a formal memorandum of understanding (MoU) with the NBP, but this document is not publicly disclosed. Functionally, brokerage activities of banks are clearly subject to SEC jurisdiction, and the roles of the SEC and the NBP in the issuance of directives on common subjects, such as margin lending and capital requirements, are clearly specified in the law. SEC has signed a MoU with UNFE, while the new law will also allow for a MoU with PUNU.

59. Good transparency practices are observed with regard to formulating and reporting of financial policies by the SEC. The LTPS spells out in considerable detail the SEC's powers for approving, licensing, de-listing/de-licensing new issues, brokers, investment advisors, exchanges, depository institutions. It also defines supervisory powers for periodic reporting, requiring specific information, surveillance, and punitive powers over subject matters.

60. Good transparency practices are similarly observed with regard to the public availability of information on financial policies, through the SEC's annual report and press releases, all of which are available through the agency's website.

61. Generally good transparency practices are observed regarding accountability and assurances of integrity by the SEC. However, further efforts are needed regarding the publication of regular financial statements, including disaggregated information on operating expenses and revenues, accounting policies, and any audit qualification to the statements. No financial statements were published in 1999. At present SEC's financial statements are audited by the Superior Chamber of Control (NIK), the Polish auditor general. NIK assessment's have been published, but only with a long delay. Another area where greater public

disclosure is desirable is the SEC's internal Code of Ethics concerning permanent and periodic limitations on investments and divestments by staff with access to confidential information, and SEC's internal audit governance processes. There is also no specific formal legal protection for SEC officials and staff—other than what is specified in the Civil Code—when discharging their official duties.

Table 12. Poland: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Securities and Exchange Supervision

Subject	Main Findings
I. Clarity of roles, responsibilities and objectives of financial supervisory agencies	The relationship between the SEC and the NBP could be more fully disclosed.
II. Open process for formulating and reporting of financial policies	No action required.
III. Public availability of information on financial policies	No action required.
IV. Accountability and assurance of integrity by financial supervisory agencies	Financial statement of SEC should be published regularly and audits completed in a timely basis. The SEC's internal Code of Ethics and internal governance procedures should be publicly disclosed. Legal protection of staff should be specified and disclosed.

Authorities response and recommended next steps

62. The authorities were in broad agreement with the assessment. They stated that publication of the internal Code of Ethics and the internal governance procedures is under consideration.

E. Transparency of Financial Policies: Insurance Supervision

Information and methodology

63. The assessment of the observance of good transparency practices relating to securities and exchange supervision by the State Office for Insurance Supervision (PUNU) was undertaken by a member of the FSAP staff team and was based on (a) a pre-FSAP questionnaire response; (b) relevant laws; (c) PUNU's website; and (d) discussions with the PUNU and market participants.

Main findings—Summary

64. The large majority of good transparency practices are observed with regard to the roles and objectives of the supervisor. The objectives and the institutional framework of PUNU are clearly defined in the Insurance Business Act, and are explained through government publications, press releases, and PUNU's website. Some improvements in the clarity of

roles and responsibilities could, however, be made. Criteria for the removal of the president and the vice-president of PUNU are not clearly defined. Also, broad accountability modalities are lacking. For example, there is no statutory requirement to issue an annual report. In practice, however, PUNU publishes an annual report and sends quarterly activity reports to the minister of finance. The latter information is not necessarily disclosed to the public.

65. Good transparency practices are observed with regard to formulating and reporting of financial policies by PUNU. The regulatory framework is disclosed in legislation, through ordinances, through reports in PUNU's quarterly Official Bulletin and press releases. Good transparency practices are similarly observed with regard to the public availability of information on financial policies, through PUNU's Official Bulletin and its annual report. PUNU's balance sheets are submitted to parliament but are not published.

66. Generally good transparency practices are observed regarding accountability and assurances of integrity by PUNU. However, the reports to the parliament on its balance sheet and income position are not made public, while completion of audits of these accounts by the Supreme Chamber of Control have tended to be excessively long. As with other public officials, PUNU officials and staff have no specific legal protection other than those provided under the Civil Code.

Authorities response and recommended next steps

67. The authorities were in broad agreement with the assessment.

Table 13. Poland: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Insurance Supervision

Subject	Main Findings
I. Clarity of roles, responsibilities, and objectives of financial supervisory agencies	Grounds for dismissal of the president and vice-president of PUNU should be defined and disclosed. PUNU should be required to publish its annual report.
II. Open process for formulating and reporting of financial policies	No action required.
III. Public availability of information on financial policies	No action required.
IV. Accountability and assurance of integrity by financial supervisory agencies	Financial statements should be published regularly and audits completed on a timely basis. As for the other agencies, the issue of legal protection of PUNU staff when discharging their duties should be clarified and disclosed.

F. Transparency of Financial Policies: Bank Guarantee Fund

Information and methodology

68. The assessment of the *observance of good transparency practices* by the Bank Guarantee Fund (BGF) was undertaken by a member of the FSAP staff team and was based on (a) a pre-FSAP questionnaire response; (b) information available on the BGF website; (c) relevant laws; (d) discussions with, and written information received from, BGF officials.

Overview of the institution

69. The BGF was established in 1994, with two objectives: to operate as a deposit guarantee fund and to assist in restructuring and rehabilitating banks. The choice between both options depends on the "least costs principle". Its operations are supervised by the ministry of finance.

70. The BGF guarantees bank deposits up to the amount provided in law in the event that the bank fails to repay them. The Fund insures the depositors and not the deposit, implying that all the accounts of the single depositor in a bank are added together to calculate the amount of the guaranteed deposit. The coverage limit has been revised upward almost every year to reach EU levels. In 2001, the coverage is Euro 15,000 and will reach Euro 22,500 (the EU level) by 2003. Deposits up to Euro 1,000 are guaranteed up to 100 percent of the amount of the deposit. Deposit between Euro 1,000 and the eligible amount are guaranteed for 90 percent of the deposit. Since the inclusion of PKO BP SA, Pekao SA, and BGZ SA at the end of 1999, all Polish banks have been included in the deposit insurance scheme on the same terms.

71. The contribution of each bank to the Fund is determined each year, capped at 0.4 percent of its total deposits, with premiums that are tax deductible. For the year 2000, the rate was 0.4 percent. The nature of the Fund is *ex post*. The contributions are managed by the banks and can only be invested in treasury securities and securities of the NBP or in an interest bearing current account with the NBP. These assets cannot be pledged or encumbered in any way and are not subject to court or administrative debt collection procedure.

72. The BGF is also authorized to extend assistance in the form of a loan guarantee or purchase of the bank's debts. This support can be to weak banks for elimination of the danger of insolvency or for acquisition of the bank's shares or stocks by new shareholders. The assistance is subject to detailed rules and is granted at concessional rates. Banks are required to pay an annual contribution to the BGF, calculated as a percentage up to a maximum of 0.4 percent of risk weighted balance sheet assets and guarantees and endorsements and up to 0.2 percent of the remaining risk weighted off balance sheet liabilities. The rates are determined every year by the Fund's Council. Since 1998, the NBP has been contributing to the Fund. In 2001, the Fund was constituted of equal contributions from the banks and the NBP.

Main findings—Summary

73. Good transparency practices are observed by the BGF. The agency complies with the vast majority of the Code's good transparency practices. The BGF Act defines the objectives and responsibilities of the BGF. The objectives comprise deposit protection and solvency assistance. The combination of the two functions enables the Fund to adopt a least cost solution and achieve financial stability in addition to client asset protection. BGF's responsibilities relating to both objectives are publicly disclosed through the BGF Act and further documented on BGF's website, in the *Annual Report*, the *Official Bulletin*, and through public appearance before legislature and in press conferences.

74. The BGF Act also describes the modalities of accountability and provides the BGF with the authority to conduct financial policies. The procedures for appointment, removal and terms of office of the BGF's governing bodies—the Fund's Council and the Management Board—are spelled out in the BGF Act. The Chairperson of the Council is appointed by the prime minister upon agreement between the minister of finance and the president of the NBP and approved by the relevant parliamentary committee. The other members of the Council are appointed by the minister of finance (three), the NBP (four), and the Polish Bank Association (three). No criteria are specified for the removal of members of the governing bodies. However, if the Sejm rejects the *Annual Activity Report* of the BGF, this results automatically in the removal of all the members of the governing bodies.

75. The relationship between the BGF and other financial agencies is defined in the BGF Act. Details are set out in the Act with respect to information sharing with the NBP. Moreover, the BGF has entered into agreements with the NBP, the ministry of finance, and the Supreme Chamber of Control for providing information that affects implementation of its tasks. The contents of these agreements are not being made public.

76. The BGF conducts its policies in a transparent manner. Significant changes in policies are explained immediately after the announcement through press releases, and subsequently published in the *Official Bulletin* and the *Annual Report*. For confidentiality reasons, the BGF does not disclose the names of the banks availing of its assistance. However banks may, at their discretion, disclose the information. The regulations for financial reporting are also stipulated in the legislation. For substantive technical changes and changes in the structure of fees, the BGF has a presumption in favor of public consultations. Industry views are submitted through the representatives of the Polish Bank Association. Moreover, the BGF directly consults banks, the NBP, the ministry of finance, the Polish Bank Association and organizes seminars.

77. The BGF maintains a comprehensive publication program. This consists of the *Annual Report,* in which it discloses developments relating to its responsibilities, the quarterly journal *Safe Banking*, which includes research papers, the *Official Bulletin*, which contains regulations, laws, and articles as well as excerpts from the balance sheet, and brochures on specific topics of interest. The BGF also maintains a website on which all of the above publications are available.

78. The *Annual Activity Report* along with the audited financial statement has to be submitted to the Sejm. BGF's Council and the Management Board appear before the Sejm when the activity report is presented and upon request before parliamentary commissions. They also stand ready for press conferences or media interviews. The financial statements are audited by an external auditor and the expenses and revenues related to its activities are shown in the annual financial statement, which is audited and included in the *Annual Report*. Internal audit procedures are not publicly disclosed. BGF officials and staff do not enjoy special legal protections.

Table 14. Poland: Summary of Main Findings of Assessment of Observance of MFP Transparency Code—Bank Guarantee Fund

Subject	Main Findings
I. Clarity of roles, responsibilities, and objectives of financial supervisory agencies	Cooperation agreements with other agencies could be published.
II. Open process for formulating and reporting of financial policies	No action required.
III. Public availability of information on financial policies	No action required.
IV. Accountability and assurance of integrity by financial supervisory agencies	A Code of Ethics for BGF members should be developed. Explicit legal protection for officials and staff does not exist. This issue needs to be addressed.

Authorities response and recommended next steps

79. The authorities were in broad agreement with the assessment and repeated their commitment to transparent policies and operations. They underlined that the need for explicit legal protection for staff when discharging their function needs to be addressed on a cross-agency basis.

IV. Assessment of Core Principles for Systemically Important Payment Systems

Summary Assessment

General

80. The assessment of the Polish payment and settlement systems was performed under the FSAP for Poland (September 2000). The main objectives were to assess the level of compliance with the Core Principles for Systemically Important Payment Systems issued by the Basel CPSS, and to suggest areas for further improvement.

81. The legal framework governing establishment, operation, and membership of the respective payment and settlement systems is set out in sections of the Act on the NBP (1997) and the Banking Act (1997), further supported by specific regulations.

82. The detailed assessment was prepared by Martin Anderson, Central Bank of Sweden. The assessment was based on a review of the legal framework and discussions with staff of the Payments and Legal Departments of the NBP and representatives of other institutions and agencies involved. NBP staff cooperated fully with the conduct of the assessment.

Institutional and macroprudential setting, market structure—Overview

83. Following substantial reforms over the last years, the Polish authorities have established payment and settlement systems that are of high quality. Some of the systems use very modern means of data processing, are efficient, and have solid security standards. Large-value payments are settled through SORBNET, an RTGS system operated by the NBP. SORBNET handles about two thirds of all transactions. Retail payments are settled through the electronic system ELIXIR and the paper-based system SYBIR. Both systems are operated by the National Clearing House KIR SA, which is jointly-owned by the NBP, 14 major banks, and the Polish Bank Association. Securities settlement takes place through the National Depository for Securities (NDS), the Central Depository for Treasury Bills, and the Register of NBP Bills operated by the NBP (for Treasury and NBP bills).

General preconditions for effective payment systems

84. SORBNET, ELIXIR, and SYBIR have been assessed on compliance with the Core Principles for Systemically Important Payment Systems. The paper-based SYBIR system was included in the assessment because it was deemed that, at the present stage of financial development, retail systems matter for stability. Payment statistics show that over 30 percent of the value of transactions are settled within the retail payment systems, which is a very high number in an international comparison. The implication of this is that, in a country where financial deepening is taking place, problems in the retail system could create severe confidence problems, possibly hampering the transition to more modern means of payments. The Polish authorities agreed to the assessment but stated that (a) if SYBIR experiences problems, ELIXIR automatically takes over; and (b) by 2003 both systems will lose much of their importance because all transactions above 1 million zloty will go through SORBNET.

85. In terms of general preconditions, it was found that the major weakness in the operation of the Polish payment and settlements systems relates to the lack of clear oversight over the multilateral netting systems. The respective laws do not provide the NBP—or any other agency—with explicit or implicit oversight responsibility for the payment and settlement system, e.g., clearing houses. The NBP's main channel of influence over these institutions is as a shareholder. It is strongly recommended that the NBP be given explicit oversight responsibility, including over safety and efficiency aspects. Legal initiatives have already been taken to address this issue (the Act on Settlement Finality in and Oversight of Payment Systems was submitted to parliament in late 2000).

Main findings—Summary

86. All systems assessed show a high rate of compliance with the CPSS principles. The main issue with systemic implications—lack of clear oversight responsibility—is highlighted in the previous section and the authorities are already dealing with this. The following paragraphs deal with other issues.

87. To enhance the safety and security of the operations conducted via SORBNET, it is important that the zero-hour rule that applies in case of bankruptcy be removed. The zero-hour rule means that all transactions made on the day of the bankruptcy of one of the participants will be reversed. The consequence is that transactions with finality during the day will be reversed, even though they appeared to be final. This causes legal uncertainty about the finality of settlement. When implementing the EU directive on settlement finality this problem should be solved.

88. In addition, the NBP should consider the establishment of an intraday credit facility to smoothen the settlement in SORBNET. The main source of funding for the participants at this moment is the reserve requirements, which can be used for settlement purposes. However, in the run-up to EU-accession and entry in the Euro zone, it is expected that the reserve requirements will be reduced. The only alternative funding is the NBP Lombard facility or interbank overnight loans. As a result of the absence of intraday credit, the liquidity risk for participants is larger than is normally the case in RTGS systems, since there is a substantial risk for delay in the payment traffic. From an efficiency point of view, this means that the settlement time could be longer than necessary. In addition, the liquidity costs for participating banks could be rather substantial. The NBP is considering the introduction of an intraday credit facility.

89. For the retail systems, one issue that needs attention is the legal uncertainty stemming from the fact that bankruptcy procedures do not recognize multilateral netting. This means that payments that are regarded as final and irrevocably and unconditionally settled, may need to be reversed in case of bankruptcy of a participant. This is an uneasy situation in light of the still relative high importance of retail payment systems in Poland. A revision of the bankruptcy code and procedures is recommended.

90. The security settlement systems comply with most of the draft recommendations for securities settlement systems, prepared by the joint working group of CPSS and IOSCO. Four issues need attention. First—similar to the payment systems—there is the legal uncertainty stemming from the zero-hour rule and the fact that multilateral netting is not recognized under the Bankruptcy Law. Second, there seems to be some conflict between the trading act (Article 139) and the Banking Law regarding the latter's instruction that insolvent banks should be suspended from settlement systems and not allowed to make payments. Third, banks sometimes circumvent the delivery versus payment settlement procedures for government bonds, to save transaction costs because NDS fees are considered rather high, and banks cannot get their funds through the NDS on the same day. This kind of circumvention introduces substantial risks for the banks and may lead to contagion effects.

The authorities should consider appropriate measures to take away the incentive to go around NDS.

91. Fourth, a review of NDS' safeguards might be useful. The NDS operates, besides its securities lending facility also a guarantee fund. This fund only covers securities traded in the stock market. Government bonds, representing 98 percent of the total turnover in 1999, mainly trade in the over-the-counter (OTC) market. To bring the safeguard in line with internationally agreed minimum standards, i.e., ensuring that the system is able to settle even in case of default by the participant with the largest net position, it is recommended that discussions be initiated to cover all securities by the guarantee fund or to find other ways of fulfilling this standard, such as the NDS acting as a central counterparty.

Authorities response and next steps

92. The authorities acknowledged the need to vest oversight of the respective payment and settlement systems in the NBP. Legislative initiatives are under way to address the issue (The Act on Settlement Finality in and Oversight of Payment Systems). The NBP is also preparing the introduction of an intraday lending facility. Initiatives are planned to overcome the weaknesses in the bankruptcy procedures as part of the legislative work for EU accession. When these initiatives are implemented, compliance will be full. The authorities also contemplated to reconsider some of the procedures governing the NDS in light of the assessment.

Table 15. Poland: Summary of Main Findings of Assessment of Observance of CPSS Core Principles for Systemically Important Payment Systems

Subject	Main Findings
Well-founded legal basis in all relevant jurisdictions (CP 1)	Oversight over retail systems should be clearly defined. The zero-hour rule should be removed. The authorities are addressing both issues.
Understanding of the system's impact on risks; and procedures for the management of risks (CPs 2-3)	No action required.
Final settlement; inability to settle by the participant with the largest single settlement obligations (CPs 4-5)	No action required.
Assets for settlement (CP 6)	No action required.
Security and operational reliability; and contingency arrangements (CP 7)	No action required.
Practical for the markets and efficient for the economy (CP 8)	Establishment of intraday credit facility of NBP would reduce cost and risk for participants in SORBNET.
Objective and publicly disclosed criteria for participation (CP 9)	No action required.
Governance of the system should be effective, transparent, and accountable (CP 10)	No action required.
Responsibilities of the central bank in applying the Core Principles (CP 11)	Once oversight will be vested in NBP, the latter's responsibilities will be defined.

V. Assessment of IOSCO Objectives and Principles of Securities Regulation

Summary Assessment

General

93. The assessment of the Polish securities regulation was performed as part of the FSAP assessment for Poland. The main objectives were to assess the levels of observance with the IOSCO Objectives and Principles of Securities Regulation, and to suggest areas where further development may be appropriate.

94. The primary legal acts governing securities trading in Poland are the LPTS of 1997 (amended in late 2000), the Investment Funds Act of 1997, and the Bonds Act of 1995. The LPTS defines the responsibilities and objectives of the SEC. The Act on Investment Funds (1997) provides comprehensive eligibility standards and regulation for mutual fund managers. The Polish Accounting Act of 1994 is being revised to ensure compliance with EU directives and internationally accepted accounting standards. The revision also sets new standards for leasing, mergers, treatment of investment funds, and derivative transactions. Poland plans to comply with EU standards and IAS in two stages.

95. Securities regulation in Poland complies with most IOSCO objectives and principles. While the authorities should consider some improvements in regulation and supervision of the securities markets, the most important contribution to market development at this time would be to enhance the supply of investment securities.

96. The detailed assessment was prepared by Hemant Shah, Lead Financial Economist, Financial Sector Group, World Bank. The assessment was based on a review of the legal framework and discussions with the supervisory authorities, who cooperated extensively and provided much of the data quoted in the summary, and market participants.

Institutional and macroprudential setting, market structure—Overview

97. The principal equity market in Poland is the WSE, created in 1991. It is about 98 percent owned by the government, with the rest held by brokers. By law, any exchange must be a joint stock company. The WSE cannot distribute dividends, according to its Articles. A plan to privatize the stock exchange is under consideration. As of 1999, the WSE traded equity, bonds, equity allotment certificates (warrants), futures on the WIG20 index (the principal index of the stock exchange), and U.S. dollar and Euro futures. In 2000, the WSE became the majority owner of the Central Table of Offers, which operates an OTC market.

98. The exchange has seen sizeable growth in number of listed companies, market capitalization, and turnover—from extremely small beginning, however—and market capitalization remains small relative to GDP. At the end of 1999, the WSE had 221 listed companies, a market capitalization of 123.4 billion zloty (about 20 percent of GDP) and a

turnover of 95 billion zloty. There were 54 primary market offerings in 1999—27 made by public companies, 5 IPOs, and 22 by new companies—for a total of 5 billion zloty.

99. The market remains concentrated. The top-10 companies account for over two-thirds of market capitalization, with the top company (TP SA) for 31 percent alone. Turnover is also concentrated in the largest firms, with the top-10 traded companies accounting for nearly 49 percent of total turnover. There were 1.16 million brokerage accounts in Poland at the end of 1999 and less than 5 percent of Poles own stocks or bonds directly. The number of companies listed is a rather small fraction of the total number of enterprises registered in Poland (more than 3 million). In 1999, 28 new companies listed on the WSE, adding about 15 percent to the number of listed companies.

100. Listing and trading requirements are fairly accommodating of small issuers. The WSE offers three classes of equity listings. The "*main market*" listings require at least 40 million zloty of issuance, 25 percent free float, and a 3-year track record. The next level down is the "*parallel market*", and the third class is the "*free market*", requiring at least 4 million zloty of issuance, no minimum float, and a one-year track record. Public trading of securities also requires a prior permission from the SEC.

101. The WSE offers three classes of trading, to accommodate stocks of varying size and liquidity. Upon opening, all stocks are traded in a *single-price auction system*, which pools demand and supply schedules, and whose rules are designed to maximize trading volume while limiting price fluctuations. More liquid stocks (99 of 221 in 1999) are also traded in the *continuous trading session*. Finally, *large blocks* can be negotiated outside of these sessions and price fluctuation limits. Trading is electronic. In 2000, a new trading system was introduced to provide for opening and closing fixed price auctions with continuous trading in between. Poland also does not discriminate against foreign investment and has treaties for avoidance of double taxation with 61 countries including most other OECD nations.

General preconditions for effective securities regulation

102. The LPTS clearly defines the responsibilities and objectives of the SEC and assigns it both a regulatory and developmental role. The LPTS also provides for minimum standards for brokerages, individual brokers, and investment advisors. The regulatory responsibilities of the SEC include: supervising the observance of fair trading and competition rules in public trading; ensuring that universal access to accurate information on the securities market is available; protecting investors' interests; and drafting acts concerning the securities market for legislative approval. The prime minister oversees the activities of the SEC. The Commission is required to submit an annual report to parliament and the chairperson appears upon request before parliamentary committees. The SEC is provided with clear powers as a central government administrative body to license securities admitted to public trading, brokers, investment advisors, OTC markets, mutual funds, commodity exchanges, exchange clearing houses, commodity brokers, and brokerage houses in commodities markets.

103. The LPTS defines in detail many of the requirements for admitting securities to public trading, licensing/de-licensing procedures for brokers, and investment advisors. The SEC licenses/de-licenses OTC markets, and the prime minister does the same for exchanges, but upon SEC advice. The LPTS defines clearly the subjects for which the SEC can issue directives, as well as the division of responsibilities between the SEC and the NBP. Finally, for most subjects, the SEC can issue—through the Council of Ministers—explanatory and detailed requirements.

104. The LTPS stipulates that members of the Commission, employees of the Commission office, and persons participating in the Commission's meetings with advisory voting rights are all obliged to maintain professional secrecy. The obligation to maintain professional secrecy endures beyond the legal relationship. In ensuring its responsibility to supervise the observance of fair trading and universal access to information, the Commission and its staff have adequate powers to access privileged information, carry out inspection and surveillance, and take remedial actions or assess penalties.

105. Poland makes relatively limited use of self-regulatory organizations (SROs). In large part, this is explained by the simultaneous creation of Polish capital market institutions and regulator in the early 1990s. The WSE is nearly 98 percent owned by the government, while the NDS is owned equally by the WSE, the government, and the NBP. As these institutions are all publicly owned, the division of oversight responsibility among them is somewhat less consequential than where the exchanges or depositories have evolved privately, frequently before the regulatory agency. A greater role for SROs is envisaged in the future.

Main findings—Summary

106. Securities regulation in Poland complies with most IOSCO objectives and principles, and the areas where compliance could be strengthened are reasonably minor in importance. While the SEC has enjoyed a reasonable degree of financial and operational independence so far, the LPTS does in theory allow for possible political interference in its operations. The chairman of the SEC is appointed and dismissed by the prime minister, upon joint advice of the finance minister and the president of the NBP, with the relevant parliamentary committee providing an opinion. There are two deputy chairpersons, while the six other members are ex-officio representatives (usually deputy minister or director) of the ministries of finance, agriculture, treasury, and economy, the president of the NBP, and the president of the Competition and Consumer Protection Office. Brokers, investment advisors, issuers, and exchanges are permitted to participate as nonvoting members of the Commission. A more transparent and independent structure could be achieved if the chairman was appointed for a fixed term, as is the case with the president of the NBP.

107. As the Polish securities markets develop, trading will become continuous, derivative volume will increase, and financial conglomerates will start trading for proprietary purposes. Against this background, questions of conflict of interest and proper observance of trading rules will become more relevant and tighter standards will need to be applied for the declaration of, and changes in, large individual/group blocks. It may therefore be desirable to require

SROs to play a more aggressive role in detecting/ punishing trading violations and offer them commensurate authority.

108. The regulatory regime needs to be strengthened in defining large group control, identifying true ownership interest, retrieving profits of abusive trading practices, and enforcing criminal penalties. The SEC is developing a definition of a group concept, in accordance with EU directives. Obtaining full reports of beneficial ownership could be enhanced if the NDS was to maintain records not only up to the broker level but also the final beneficiaries. There are also some weaknesses in criminal prosecution, mainly related to the caseloads and the lack of familiarity of district prosecutors with white-collar offenses. This matter needs to be reviewed to identify appropriate action. One option would be to create a special unit for prosecution of financial crimes in the Office of the Public Prosecutor.

109. The SEC has adequate authority to share information with the president of NBP (who is also the chairperson of the CBS) and under reciprocal arrangements with foreign securities regulators (in 1999, SEC adopted a standard bilateral MoU model based on the IOSCO template and several MoUs have already been signed). It is suggested that arrangements be established for exchange of information with PUNU as well.

110. Improvements in the commercial code are needed to better ensure fair treatment of security holders, especially minority shareholders. Polish commercial law—introduced in 1934 and under revision—protects shareholders by allowing cumulative voting and requiring a supervisory board to oversee the management board. However, the law also allows a general meeting to be called by notices in two national newspapers. A shareholder does not receive individual notice of the meeting, largely because neither the company nor the NDS maintains a complete shareholder register. Poland also does not permit postal votes.

111. The LPTS provides for minimum standards for brokerages, individual brokers, and investment advisors. The Polish regulation for conduct of brokerage activities is fairly tight. There are initial and ongoing capital requirements based on the scope of the activities and the volume of transactions. The Council of Ministers and the Minister of Finance set these requirements by directives and also specify procedures for conducting brokerage transactions, record-keeping, setting up and executing collateral, lending, security lending, avoidance of cash transactions, and related information requirements. Market intermediaries are required to comply with minimum standards of internal organization and operational conduct, to protect the interests of their clients, and ensure proper management of risks. The management of intermediaries has primary responsibility for these matters. There are safeguards in place to deal with a failure of brokerages to contain systemic risk and improvements are planned to reduce the risks to investors from failure of brokerage houses.

Table 16. Poland: Summary of Main Findings of Assessment of Implementation of the IOSCO Objectives and Principles of Securities Regulation

Subject	Main Findings
Principles relating to the regulator (CPs 1–5)	The Chairperson should be appointed for a fixed term to ensure political autonomy.
Principles of self-regulation (CPs 6–7)	Many SRO-powers are exercised by the SEC. Division of responsibilities should evolve consistently with market maturity and development of SRO's. The authorities state that more responsibilities will be given to SRO's as markets develop.
Principles for the enforcement of securities regulation (CPs 8–10)	Changes may be necessary in the Office of the public prosecutor to ensure enforcement of cases identified by SEC.
Principles for cooperation in regulation (CPs 11-13)	Cooperation with PUNU should be formalized.
Principles for issuers (CPs 14–16)	There is a need to revisit the protection of minority shareholders. This can be achieved if NDS keeps records up to final beneficiaries. IAS standards need to be raised.
Principles for collective investment schemes (CPs 17–20)	No action required.
Principles for market intermediaries (CPs 21–24)	Guarantee fund for clients will be established.
Principles for the secondary market (CPs 25–30)	Interbank market-trading in treasury bonds is not DVP. Incentive structure should be changed.

Authorities' response and recommended next steps

112. The authorities emphasized that the presence of government representatives on the SEC Commission has not led to any political interference. They consider the SEC operationally independent. It was also noted that SRO's will receive more supervisory power as and when markets develop further. Plans are under consideration. They also underlined that, once Polish accounting standards will be raised to IAS levels, treatment of security holders will be easier. A cooperation agreement with PUNU will be considered.

VI. Assessment of IAIS Insurance Supervisory Principles

Summary Assessment

General

113. The assessment of the Polish insurance sector supervision was performed as part of the FSAP assessment for Poland. The main objectives were to assess the levels of observance with the IAIS Supervisory Principles, and to suggest areas where further development may be appropriate.

114. The legal framework for the Polish insurance sector is provided by the Insurance Act of 1990, as subsequently amended, as well as relevant sections of the Accounting Act of September 1994, as subsequently amended. Ordinances have also been issued by the minister of finance on detailed accounting principles for insurance companies, and on calculating the solvency margins and guarantee capital for insurance companies. Standards of insurance industry regulation have been raised to the point of near conformity with the relevant EU directives. Supervision follows a modern solvency monitoring approach, with the solvency formula in use being that prescribed by the EU's Third Insurance Directive. Remaining inconsistencies with EU standards are expected to be removed by December 31, 2002. Corporate governance oversight and internal rules, nevertheless, need to be further developed. Some of these issues will be addressed by the passage of the Insurance Business Act (planned to be enacted by 2002).

115. Supervision of the insurance sector is performed by the PUNU, with licensing, merger, and ownership changes requiring the permission of the minister of finance. The minister may also, at the request of PUNU, order the compulsory liquidation of an insurance company. The duties of PUNU include the monitoring of financial condition of companies as well as the supervision of market conduct activities of the licensed insurance companies. In general, compliance with IAIS principles is adequate, although there are some areas in need of further strengthening.

116. The detailed assessment was prepared by Donald McIsaac, lead insurance specialist, Financial Sector Development, World Bank. The assessment was based on a review of the legal framework and discussions with the supervisory authorities, who cooperated extensively and provided much of the data quoted in the summary, and market participants. This assessment was performed using the Core Principles Methodology document drafted in Summer 2000 by the IAIS Secretariat and subsequently approved at the October 2000 annual meeting of the association.

Institutional and macroprudential setting, market structure—Overview

117. Significant growth in the industry has occurred over the last five years, in part due to the launch of investment-linked life insurance products. Such products offer flexibility in premium payments and better opportunities for inflation protection of insured amounts. Growth in the nonlife sector has been boosted by a strong increase in motor insurance business, as car ownership has increased and financiers insist on insurance for protection of the collateral. The insurance industry has also seen a significant growth in the number of companies, from 40 as at end-1995 (13 life and 27 nonlife insurance companies) to 63 at end-1999 (30 life and 33 nonlife insurance companies).

118. Total premiums received by Polish insurance companies during 1999 amounted to 18,490 million zloty, of which 6,940 million zloty (38 percent) was for life insurance and 11,550 million zloty (62 percent) for nonlife insurance. Total premium income is estimated to represent 3 percent of GDP in 1999, comparable to other transition economies in the region, but still well below levels in developed countries.

119. Concentration in the industry, however, remains high and state ownership significant. For the year to December 1999, the largest nonlife insurance company (PZU SA), which is state controlled, accounted for more than 60 percent of premiums in that sector, while a subsidiary (PZU Life) accounted for over 40 percent of life insurance premiums. All told, the three largest nonlife insurance companies accounted for about 75 percent of premiums in that sector, while the three main life insurance companies accounted for about 80 percent of life insurance premiums. Foreign ownership in the insurance sector has been growing rapidly.

General preconditions for effective insurance supervision

120. The legislative framework has undergone major improvements since the collapse of the old system in the late 1980s. PUNU has made great strides in recent years in enhancing its technical capacity. The office has been capably managed and its technical capacity has increased through careful recruitment, a vigorous training program, including technical assistance from a variety of donors. Funding of PUNU through levies on the industry has permitted an adequate budget, allowing the agency to retain competent staff including actuaries and analysts. Information technology improvements have been important—financial returns, for example, are now collected in electronic form and can be analyzed instantly. An automatic set of early warning tests is under development.

Main findings: Summary

121. The regulation and supervision of the Polish insurance sector has been significantly strengthened in recent years due to improvements in both the regulatory framework—as it has been upgraded with the goal of EU accession—and the supervisory practices and capabilities of PUNU. The legal and regulatory system within which PUNU must operate is broadly observant of IAIS Core Principles. However, several deficiencies warrant attention.

122. The allocation of some supervisory responsibilities to the minister of finance, who can in principle act independently of PUNU's views is potentially problematic. For example, while changes in the control over a company must be reported to the minister, these reports do not need to be reviewed by PUNU and PUNU's approval of the transfer is not required. While the minister and the PUNU may generally cooperate on these issues, this is not a requirement and in some cases has not happened. The new Insurance Business Act, which is in preparation, is expected to transfer some responsibilities from the ministry to PUNU.

123. Despite commendable progress towards incorporating the OECD Principles on Corporate Governance and relevant EU standards into the legislation dealing with insurance companies, there is insufficient emphasis on corporate governance in the regulations of the insurance sector (a deficiency noted in the regulatory framework and supervisory process of other parts of the financial system as well). The insurance supervisor has no obligation to seek to instill corporate governance best practices in the industry. While the supervisor looks

to the supervisory boards of insurance companies to monitor and enforce proper standards of governance, the supervisory boards tend to assume that this is the prerogative of PUNU.

124. The supporting legislation should specify a minimum frequency for on-site inspections by PUNU. Currently the desired frequency of inspections is indicated only in internal guidelines. These specify that insurance companies should be inspected every three years, although a shortage of resources has prevented this objective from being achieved. These on-site inspections should be risk-based, top-down assessments of areas of major risk exposure for the companies, rather than compliance oriented. PUNU should also adopt a practice of sending inspection reports to the Chairman of the supervisory board of a company, once they have received management's reactions to the findings of the inspection.

125. Capital rules should be applied in such a manner as to eliminate double gearing of capital within conglomerates. At present, requirements for solvency margin tests do not include the need to eliminate double-gearing of capital. Since several life insurance companies have established pension fund subsidiaries, there is a risk that the capital invested in the subsidiary would continue to be regarded as capital for the life insurance company. The Insurance Business Act under preparation is expected to rectify this. The industry also needs rules to limit transactions with related parties. One other area in need of improvement—also noted in the supervision of other sectors, notably banking—is the need for a more flexible set of tools for the supervisors to sanction misbehavior by the industry. The supervisors should be able to use "cease and desist" orders as well as a "ladder of compliance" to address various problems. Without such instruments, supervisors might not be able to effectively stop problems in the sector from escalating.

126. PUNU should develop formal arrangements for the exchange of information with all other domestic supervisors. An agreement with the Commission for Banking Supervision is under preparation. PUNU also has no formal arrangements for exchange of information with supervisors abroad. This in part may derive from its lack of authority to enter into such arrangements. While through personal contacts with supervisors in other jurisdictions, the necessary information on foreign insurance companies has been obtained, this has been on an informal basis and should be replaced by MoUs. The new Insurance Business Act is expected to permit PUNU to co-operate with other supervisory bodies.

Authorities response and recommended next steps

127. The authorities noted, when commenting on this assessment, that in fact the minister of finance and PUNU work closely together, both formally and informally, so that in their view the separation of responsibilities and the noted lack of independence are not problematic. In their view, PUNU is responsible for ongoing supervision and the ministry of finance deals with such matters as granting and withdrawing licenses and changes of ownership. The staff expressed the view that, in the interest of safety and soundness of the system, this dual responsibility should evolve into a structure with more responsibility and autonomy for PUNU. While the fact that many insurance companies have been in operation only for a short period of time has meant that the initial inspections have had a compliance

focus, PUNU has the intention to refocus its inspections more on areas of major risk exposure.

128. It is expected that the new Insurance Business Act, when enacted, will resolve a number of the deficiencies identified during the assessment. Others will be covered by the enactment of other legislation and regulation in the period until December 31, 2002 aimed at achieving conformity with EU directives relating to insurance business.

Table 17. Poland: Summary of Main Findings of Assessment of Observance of the IAIS Supervisory Principles

Principles	Main Findings
Organization of Insurance Supervisor (CP1)	Autonomy of the agency should be strengthened (licensing and withdrawing licenses should fall under its jurisdiction)
Licensing and Changes in Control (CPs 2-3)	See above. PUNU should receive more autonomy in the areas of licensing and withdrawing licenses.
Corporate Governance (CP 4)	Legislation should clearly establish the responsibilities of supervisory board and provide legal backing to PUNU to instill good governance principles.
Internal Controls (CP 5)	Company boards should have responsibility for prudential oversight.
Prudential Rules (CPs 6-10)	Regulations should be augmented with rules to prevent double gearing of capital. Regulations are needed to limit transactions with related parties.
Market Conduct (CP 11)	No action required.
Monitoring, Inspection, and Sanctions (CPs 12-14)	Frequency of on-site inspections should be increased. PUNU also needs more flexible tools for purposes of sanctions, to make its interventions more effective.
Cross-border Business Operations (CP 15)	MoUs should be concluded with other domestic supervisors.
Supervisory Coordination and Cooperation (CP 16)	PUNU should be empowered to enter into agreements to share information.
Confidentiality (CP 17)	No action required