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***Bank Privatization in Poland:  
The Case of Bank Śląski***

*by Jeffery Abarbanell and John Bonin*

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Bank Privatization in Poland:  
The Case of Bank Slaski

Jeffery S. Abarbanell

*University of Michigan Business School, Ann Arbor, MI, 48109*

and

John P. Bonin

*Department of Economics, Wesleyan University, Middletown CT 06459*

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Please address all correspondence to:

Jeffery Abarbanell  
University of Michigan Business School  
Ann Arbor, MI 48109-1234  
tel. 313-764-4717; fax. 313-763-5688

## **Abstract**

Abarbanell, Jeffery and John Bonin — Bank Privatization in Poland: The Case of Bank Slaski

The privatization of Bank Slaski, one of nine regional commercial banks in Poland, illustrates the benefits of attracting a strategic foreign investor in the process. Internationale Nederlanden Group has contributed substantially to the upgrading of Bank Slaski's credit lending practices, information systems, product and service offerings, and brokerage house operations. However, the prolonged ownership of a core-investor stake by the Polish Treasury slowed progress toward improving performance and created complications for governance. Furthermore, the Polish government's reaction to this privatization and its subsequent preoccupation with precluding a strong presence of foreign banks retarded the development of a dynamic and efficient banking sector in Poland.

**Journal of Economic Literature Classification Numbers: G21, L21, P34**

## 1. INTRODUCTION

The Polish experience with banking sector reform is examined through the lens of the pivotal privatization of Bank Śląski S.A. w Katowicach (BSK), the largest private bank in Poland. The BSK privatization is part of an inconsistent and sometimes chaotic process of bank privatization that has been complicated by the government's desire to achieve multiple and mutually inconsistent objectives. Among these are attracting strategic foreign investors, raising budget revenues from the sale of the banks, advancing enterprise restructuring, protecting a fledgling stock market and promoting a strong domestic presence in the banking sector. Several of these goals were achieved in the sale of BSK, making it the most successful bank privatization in Poland to date. Our primary objective is to describe the policies relevant to the process of privatizing BSK and assess how, given sector-wide conditions, they affected the bank's subsequent organization, competitive position, corporate governance and financial performance.

As a result of its privatization, BSK has undergone significant restructuring. Concrete examples include a reorientation of the bank's loan portfolio away from troubled industries in its historical Silesian client base, the adoption of an aggressive strategy for extending commercial and retail credit in and beyond its home region, the implementation of extensive efforts to recruit and train qualified personnel, and the introduction of new products, services, and information technology installations in cooperation with its strategic foreign investor, the Internationale Nederlanden Group (ING).

Our secondary objective is to link bank privatization strategies in Poland to overall banking sector reform. The government's tendency to engineer too rigidly the pace of bank privatization was manifested in its adherence to a Cinderella-like ordering that requires a chosen bank to be sold before its sisters can entertain suitors. The privatization of BSK highlighted the

government's tendency to focus on its revenue objective in an effort obtain the correct price for state-owned banks. In the aftermath of the BSK privatization, government policy became mainly reactive, responding to the problems encountered in the privatizing the first two banks and driven by a fear of foreign banks obtaining undue influence in the Polish banking sector. Costly delays in meeting the schedule for state withdrawal from the banking sector ensued, leading to the prolonged and active participation of the owner-state in the governance of Polish banks.

According to a timetable announced in 1992, nine state-owned commercial banks were to have been privatized by the end of 1996 to allow the full disbursement of moneys held in the Polish Bank Privatization Fund for servicing debt issued to recapitalize these banks.<sup>1</sup> To date, only four of the nine regional commercial banks have been privatized. The lack of a consistent privatization plan and concern about foreign dominance of the banking sector have stalled bank privatization in Poland. With the planned opening of the Polish banking market to unfettered foreign competition in accordance with European Union agreements, an outcome now pushed back until the beginning of 1999, continued delays in transforming former state-owned banks into modern, efficient institutions will make the goal of retaining a significant domestic presence in Poland more difficult to achieve.

The next section considers the evolution of the Polish banking sector and describes its current market structure. Section 3 presents a series of antecedent actions that shaped the path of bank privatization and banking sector development. Section 4 contains a detailed description of the privatization of BSK. Section 5 characterizes the changes in BSK since privatization, paying particular attention to the impact of the strategic foreign investor on bank performance. Section 6 assesses the effects of the privatization of BSK on subsequent Polish banking sector development. The concluding section draws lessons from the Polish bank privatization experience from the

perspective of developing an effective governance structure for BSK, free from direct state intervention, and from the perspective of creating a market-oriented, contestable banking sector in Poland.

## **2. THE EVOLVING STRUCTURE OF THE POLISH BANKING SECTOR**

After World War II, the National Bank of Poland (NBP) fulfilled the function of a bursar while three specialized banks operating on a national scale: Bank Handlowy w Warszawie S.A. (BH), the foreign trade merchant bank, Bank Polska Kasa Opieki S.A. (Pekao), a savings bank that collected retail deposits in foreign currency and handled foreign currency transactions involving private persons, e.g., money transfers from abroad, and Bank Gospodarki Zywnosciowej S. A. (BGZ), a national umbrella bank for local cooperative banks involved in the financing of agriculture and food processing. Although nominally autonomous, these specialty banks were in reality NBP agencies until the establishment of a two-tier banking system in 1989, after which they continued their functions independently. A fourth large specialty bank, Powszechna Kasa Oszczednosci-Bank Panstwowy (PKO BP), an autonomous savings bank since 1988, has an extensive branch network throughout the country and specializes in zloty household deposit-taking and in financing housing construction. Bank Rozwoju Eksportu S.A. (BRE), a fifth specialty bank, was established in 1987 to engage primarily in export financing. The smallest and most specialized of the state banks, it was the first Polish bank to be privatized.

Two pieces of legislation, the National Bank of Poland Act and the Banking Act, laid the foundation for the establishment of a two-tier banking structure at the end of January 1989. A tier of nine state-owned commercial banks was created from the voivodship and former country bank branches of the NBP. The division of the NBP's commercial portfolio was predominantly

regional, with each bank having the majority of its branches in a home region. However, to encourage competition and to provide some diversification of the balance sheet, each bank was allocated branches outside its region. The regional solution was adopted because of intense political pressure from the voivodships to protect enterprises in their territories and because of the underdeveloped state of telecommunications in Poland which, at the time, forced banks to rely mainly on settling payments by mail.<sup>2</sup> Of these regional banks, four have been privatized to date, namely, Wielkopolski Bank Kredytowy (WBK) in Poznan in March 1993, BSK in December 1993, Bank Przemyslowo-Handlowy (BPH) in Krakow in January 1995 and Bank Gdanski (BG) in Gdansk in December 1995. The other five regional banks are Pomorski Bank Kredytowy (PBKS) in Szczecin, Bank Depozytowo-Kredytowy (BDK) in Lublin, Bank Zachodni (BZ) in Wroclaw, Powszechny Bank Gospardarczy (PBG) in Lodz and Powszechny Bank Kredytowy (PBK) based in Warsaw.

Two specialty banks, one special commercial bank and two private banks, established after 1989, complete the landscape of the nineteen largest banks in Poland. Polski Bank Rozwoju (PBR), established in 1990 as a development bank to aid in restructuring and privatizing state-owned enterprises, has taken an active role in the capital market by providing interbank bid/offer quotes for the Polish money market. Pierwszy Komercyjny Bank (PKB), headquartered in Lublin, was established in 1991 and specializes in factoring. Polski Bank Inwestycyjny (PBI), headquartered in Warsaw, was established in 1993 to complete the hiving off of commercial activities from the NBP. PBI took over mostly non-qualified assets from the NBP's investment portfolio and foreign-exchange accounts liabilities matched on the asset side by dollar-denominated bonds issued by the Finance Ministry. Both PKB and PBI are wholly owned by the NBP. Two private banks quoted on the Warsaw Stock Exchange and widely held are Bank

Inicjatyw Gospdarczch (BIG) and Kredyt Bank (KB), established in 1989 and 1990 respectively by a group of state enterprises and private persons.

BSK is one of the larger commercial banks, beginning its operations with 44 branches and 6 branch offices located, predominantly, in Silesia. Since then, the bank has expanded to 86 branches and increased the size of its workforce from approximately 4,400 to over 6400 people of whom 14% are part of the bank's management. BSK, along with its sister commercial bank BPH headquartered in Krakow, gained control of much of the commercial lending and payments settlements in Silesia. However, no one of the commercial banks has appreciable nationwide market share. Using data for the end of 1995, BSK and BPH each have a 4.2% share in the total assets of the banking sector.

Currently the two largest banks in Poland, both state-owned, are PKO BP and the consolidated banking group formed in Fall 1996 by linking Pekao with three of the regional commercial banks, PBKS, BDK, and PBG. As the largest bank in Poland prior to consolidation, PKO BP held 17.4% of the banking sector's assets, 25.6% of its deposits and 9% of its equity at the end of 1995 (see Table 1). Combining the data for the four banks in the Pekao group, total market shares are 21.8% of assets, 24.8% of deposits and 15% of equity. Together these two state-owned entities hold about 39% of the assets, 50% of the deposits but less than 25% of the equity in the Polish banking sector.

The next two largest banks are the state-owned specialty banks, BH and BGZ. BGZ holds 7.9% of total banking sector assets and has been recapitalized by the state prior to the restructuring and consolidation of the entire cooperative banking sector. A new three-tiered structure is being created and government shares in BGZ are to be transferred to regional



cooperative banks by 1999. BH, the largest commercial bank in Poland prior to consolidation, has a 6.2% share of the asset market and a 4.1% share of the deposit market but is strongly capitalized holding 15.5% of the equity in the banking sector. In sum, the four largest banks in Poland, all state-owned currently, held a combined market share of 53.3% of the assets, 60.8% of the deposits, and 39.5% of the equity in the banking sector at the end of 1995. Perhaps the most telling structural characteristic of the Polish banking sector is that more than two-thirds of bank assets still belonged to state-controlled banks as of August 1996 (Bratkowski and Kawalec, 1996).

Twenty-one foreign-controlled banks held 16.4% of the assets and 17.2% of the deposits but 26.5% of the equity in the Polish banking sector. According to Polish law, a bank is considered to be foreign-controlled if the total foreign capital stake is twenty percent or larger. BRE, the first Polish bank to be privatized in which Commerzbank holds only a 21% stake, is considered to be foreign-controlled by this criterion. Three of the nine regional commercial banks that have been privatized by partial divestiture of the state's ownership stake, namely BSK, BPH, and WBK, also satisfy this definition of foreign-controlled.<sup>3</sup> If we take instead majority ownership by foreign entities as determining foreign control, BPH and BRE would not be included and the resulting asset market share of foreign-controlled banks would be only 10.6%.

Of greater significance than the amount of assets held by foreign banks in operational branches in Poland is the fact that their presence has not engendered much competition for domestic banks. Citibank, the largest subsidiary of a foreign bank with an asset market share of about 1%, has only recently begun to pursue blue-chip Polish corporate clients and engage in upscale retail banking. Foreign banks have followed their own clients into Poland and generally limited their activities to

servicing their clients' banking needs (Slay, 1996).

### **3. ANTECEDENT ACTIONS TO THE PRIVATIZATION OF BSK**

Incorporation of the banks was carried out under the Banking Act of 1989. The Act legislated a two-tier structure of governance consisting of a Supervisory Board, called the Bank Council, and a Management Board for each bank. The Bank Council consists of between 5 and 10 members elected for three-year terms at the annual General Meeting of Shareholders. It functions as a Board of Directors, meeting as frequently as monthly, and is responsible for determining the directions of the bank's development, examining its financial and management reports, and passing resolutions on the bank's management rules and regulations. The Bank Council is responsible for appointing and recalling the President of the Management Board and, by his motion or on his acceptance, the other members of the Management Board.<sup>4</sup> The Management Board, consisting of between 3 and 8 people elected to three-year terms, is responsible for the daily operations of the bank. The Management Board proposes actions, e.g., recommended dividend policy, to both the Bank Council and the annual General Meeting of Shareholders at which the Bank Council reports on its activities. The governance structure of banks in Poland provides a clear division of responsibility between the Bank Council, i.e., the Supervisory Board, and the Management Board.

The first step toward developing a private banking system was undertaken in May 1991 when the Council of Ministers decided to transform the nine regional commercial banks into joint-stock companies owned by the Treasury. In October 1991, the Treasury received the newly created bank shares and the Ministry of Finance, acting on behalf of the Treasury, appointed the

Bank Councils of the nine regional commercial banks. Marian Rajczyk, the acting president of BSK at the time, was appointed the first President of the bank's Management Board.

In accordance with the procedures described in the Privatization of State Enterprises Act, the divestiture of state ownership in the banks could be accomplished through any combination of four approved methods; an open tender, a public offering, a negotiated sale initiated through a public invitation, or a sale of shares to bank employees. Initially, the Ministry of Finance proposed a blueprint to create an eclectic ownership structure for the banks. According to this model, the Treasury retained a 30% interest, domestic investors purchased between 40% and 50% of the shares, bank employees were allocated 10% of the shares on preferential terms and a strategic foreign investor was sought to take a stake of between 10% and 20% of the shares.

The Ministry of Finance decided that the nine regional commercial banks would be sold before the four large specialty banks and that these sales would proceed sequentially in an order to be established over time. The two regional commercial banks chosen to spearhead the bank privatization program, WBK and BSK, were highly regarded in terms of financial strength and the quality of their management, e.g., top-level management at BSK, comprised of previously senior managers at the NBP, had been stable for two years. WBK was selected to be privatized first because it was a smaller state-owned commercial bank. This decision reflected a desire on the part of the Ministry of Finance to test the absorptive capacity of the Warsaw Stock Exchange for the initial offering at a price the government considered to be correct. Furthermore, in the event of mistakes in execution or of insufficient public interest in the offering, it was decided that the potential cost of the learning experience was lower for WBK than BSK.

The Ministry of Finance solicited Western consultants to perform due diligence and study

the privatization process. During 1991, reports were prepared that analyzed potential domestic and foreign demand and described the means by which the privatizations could be promoted. The next step in the process was to obtain valuations of the bank and identify target investors. At this stage, the Ministry of Finance revised somewhat its original concept of the desired bank ownership structure and decided on a larger role for strategic investors. The strategy now called for a strategic foreign investor to take at least a 25% core-investor stake, an initial public offering (IPO) to sell another stake larger than 25%, an allocation of 15% to bank employees to be sold at preferential terms and the retention of approximately 30% of the shares by the Treasury. The reasons for the change included the desire to attract a well-established core investor who might otherwise be reluctant to hold a minority stake in a bank and also the possibility that domestic interest in the banks might be low due to an uncertain underlying value.<sup>5</sup>

The first step in privatizing WBK was the filing of a prospectus on March 16, 1993 that announced an issue of new shares to obtain a capital injection amounting to 28.5% of the augmented share base. Initially, the government had intended to sell these shares to a strategic foreign investor but, after an unsuccessful search, it contracted with the European Bank for Reconstruction and Development (EBRD) to purchase the entire new issue at a price of PLZ 115,000 (\$6.89) per share for a total of \$12.6 million of new capital. The same price was applied to a 27.2% stake in an IPO divided into a large investor tranche (7.2%) and a small investor tranche (20%). The subscription periods for both tranches closed by early May. The small-investor tranche was subscribed fully by Polish investors while the 80% of the large-investor tranche was purchased by domestic investors. The total potential employee stake was set at 15%.

WBK opened for trading on the Warsaw Stock Exchange on June 22, 1993 at a price of PLZ 350,000 (\$19.66) per share. The approximately threefold increase from issue price

occurred during a period when the market index, the WIG, increased by 260%. Slawomir Sikora, the person responsible for bank privatization at the Ministry of Finance, claimed that the stock market run up was due to the privatization of WBK because that act convinced investors that the government was serious about supporting privatization and the market.<sup>6</sup>

Unlike WBK, BSK did not require a new capital issue as part of its initial privatization. However, the government did clean up part of its loan portfolio.<sup>7</sup> At the time of privatization, BSK had a large non-performing loan outstanding to FSM S.A., the Polish auto maker about to be acquired by Fiat Italy. The bank's total exposure to this client amounted to PLZ 807.8 billion (\$51 million) or 6.5% of its loan book. A conditional contract between Fiat and the Polish government committed both to restructure this and other loans. Because the arrangement with Fiat had not been finalized by June 1993, BSK provided from its own funds an amount equal to 50% of its exposure to FSM. The final resolution involved writing off the loan and the recapitalization of BSK with long-term government securities serviced jointly by the Polish government and Fiat. The fact that BSK was able to provision partially against the loan from its own funds without raising new equity was testimony to the financial strength of the bank.<sup>8</sup> Hence, the preparation for privatization began with the recognition of WBK's failure to attract a strategic foreign investor but the knowledge that BSK was a highly liquid and relatively healthy bank.

#### **4. THE BANK SLASKI PRIVATIZATION**

Many of the actions and policy decisions taken by the government in the case of BSK were responses to events surrounding the prior sale of WBK. Similarly, actions taken in subsequent privatization have been influenced significantly by the perceived success or failure of the privatization of BSK. Since BSK was almost twice the size of WBK, its privatization was to

be an even truer test of whether domestic investors were willing or able to absorb bank equity at the anticipated price. The attention paid to pricing the shares of the banks reflects the concerns of government officials to raise revenues for the state budget, to avoid selling attractive assets too cheaply for the sake of the uncertain long-term benefits of rapid privatization, and to prevent providing ammunition to the political opposition who might use a post-IPO increase in the market price to argue that corruption or incompetence was involved in the initial sale of a bank's shares.

The preparations for BSK's privatization were finalized at the annual General Meeting in June 1993. Two Paris-based advisors, Banque Paribas and Jeantet et Associates were involved. The 9.26 million outstanding shares created at the time of incorporation with a face value per share of PLZ 100,000, approximately \$5 at the prevailing exchange rate, were divided initially into three components. As in the prior privatization of WBK, the first component consisted of approximately 30% of the shares to be retained by the Treasury.<sup>9</sup> A second component of equity, up to 10% of the shares, was reserved for employees on preferential terms.<sup>10</sup> The final component of equity to be sold consisted of 5.56 million shares or 60% of the total. These shares were split into two tranches, 1.39 million or 15% in a small investor tranche and 4.17 million or 45% in a large investor tranche (45%). Because an attempt to attract a strategic foreign investor in the earlier WBK privatization had failed, the Ministry altered its approach for BSK and structured the large investor tranche as a tender offer for both institutional investors and strategic investors. The small investor tranche was to be handled through an IPO on the Warsaw Stock Exchange.

According to the prospectus dated August 31, 1993, bids for the large investor tender were accepted from September 14 to October 15, 1993. The minimum required amount for a bid was 185,000 shares and the maximum stake allowed to any one investor was 2.4 million shares or

25.9% of total bank capital. In the tender, a bidder submitted two envelopes. The first envelope contained information about the bidder and a statement of the time period during which the bidder would commit to hold the shares. Bidders were invited to provide other pertinent information such as financial statements, a brief description of strategic interests, and information about individuals who the bidder would propose for membership in the Bank Council. The second envelope contained the number of shares requested and the price proposed per share. These bidders were pre-selected based on the information provided in the first envelope at the sole discretion of the Treasury.

Pricing of the shares of BSK was an important issue because government officials did not want to be perceived as having given away this relatively strong bank. The first Polish bank to be privatized, BRE, was priced so that its total valuation was about 50% of its book value. The issue price for WBK shares was set to correspond to approximately 75% of book value. At that price, demand had been unexpectedly high and WBK had opened for trading on the exchange three months later at 350% of its issue price. During the fall of 1993, WBK was trading on the Warsaw Stock Exchange at almost six times its issue price. The upward market index trend in general and the performance of WBK's shares in particular along with BSK's favorable financial condition were all important considerations in the Ministry's decision to set the minimum price of a share in the large investor tender so that the total value of BSK's shares were approximately equal to its book value. At this minimum purchase price of PLZ 230,000 (\$11.50) per share, the smallest allowable bid in the tender would have required an expenditure of PLZ 42.55 billion (\$2.1 billion). Many argued that this amount was too large for any Polish buyer so that it would be unlikely for a Polish investor to bid in the large-investor tranche. The tender was structured to attract foreign investors.

The allocation of shares in the tender was to proceed by first ranking the accepted bidders according to proposed price in descending order and then filling requests for shares until all available shares were placed. The strike price was to be the lowest price bid by the final bidder to receive shares so long as it was above the minimum price of PLZ 230,000 (\$11.50) per share set in the prospectus. The offer price for the subsequent small investor IPO was to be set by the government depending on the strike price in the large-investor tender. The prices proposed by participants in the tender ranged from the minimum of PLZ 230,000 (\$11.50) to PLZ 750,000 (\$37.50). However, once again no significant strategic foreign investor was attracted and the demand for shares in the tender was generally low. It appeared that the strike price from the exercise would have been around PLZ 250,000 (\$12.50).

Because the WIG had continued to rise after the minimum price had been set, this price was substantially below what the Ministry of Finance believed to be the correct price based on market expectations. Adding to the concerns of officials at the Ministry was a growing criticism of the bank privatization program by newly elected members of the ruling coalition that was formed in September of 1993. The Peasant Party, an influential partner in this coalition, took a populist approach to bank privatization and argued against any significant foreign participation in the ownership of BSK. The failure to attract a strategic foreign investor even at the minimum price and increasing political pressure contributed to the Ministry's decision to cancel the tender in October of 1993.

In the aftermath of the cancellation of the tender for the large investor tranche, the Ministry of Finance pressed forward with the small investor tranche IPO. Experience with WBK indicated that even if a strategic foreign investor were not found, a domestic IPO could still be successful. Applications for the small investor IPO were to be accepted in November of 1993.



Prior to the application period, the Ministry of Finance announced that the search for a strategic investor would continue but, if it proved to be unsuccessful, the shares from the large investor tranche would be sold in the market at a later date. For the small investor tranche, the minimum request was ten shares and the maximum was 5,000.

With the cancellation of the large investor tender, the Ministry of Finance faced the problem of setting the IPO offer price without a strike price to use as a benchmark. A price of PLZ 500,000 (about \$25) per share was set, reflecting the government's elevated revenue goals in light of the run up in the WIG. At this price, the total value of BSK shares was now set at about twice book value, leading to a ratio of offer price to book value for BSK that was higher than the actual market to book value ratio prevailing at the time for WBK on the Warsaw Stock Exchange.

<sup>11</sup> The total value of the issue was about six times greater than the biggest issue floated on the market to that date. However, the offer price-to-earnings ratio for BSK of four was still significantly below the actual multiple for WBK and other stocks trading on the exchange at the time, reflecting the government's desire to avoid pricing small domestic investors out of the market for BSK shares. In this case, the attempt to set a price administratively that could accomplish multiple goals resulted in setting a price that proved to be significantly below market clearing.<sup>12</sup>

According to the prospectus, bank employees were to receive their shares, some of which were purchased on preferential terms in accordance with the privatization law, between November 22 and December 3 while the shares in the IPO were to be allocated by the Treasury on December 7. The IPO timing was affected by the canceled tender; the application period was extended to December 1 and the allocation date delayed to December 20. Demand far exceeded

supply in the IPO as over 817,000 buyers received three shares each.

To be eligible for trading shares on the Warsaw Stock Exchange, a holder is required to set up an investment account at a brokerage house and register ownership of the shares. The late allocation date of December 20 coming just before Christmas and the number of shareholders who did not already have investment accounts overwhelmed the limited capacity of the system. In Gdansk, Bank Gdanski had the only brokerage operation in the city able to open accounts for the estimated 50,000 residents who had received shares in BSK. This office was processing about 500 new accounts per business day (Bobinski, 1994). At such a rate, it would take twenty weeks to open accounts for all the residents of Gdansk holding shares in BSK but the opening of trading in BSK shares on the Warsaw Stock Exchange was set for January 25, 1994. In the meantime, employees purchasing shares received them on December 3 and could register their much greater allocation of shares immediately in investment accounts at BSK brokerage houses.

On December 15, 1993, in a surprise move, representatives of the Ministry of Finance, BSK and ING signed an agreement according to which ING would purchase 2.4 million shares, the maximum allowed in the initial tender in which ING had been a participant. The agreed price was the same as the IPO price, so ING paid about PLZ 1.2 trillion (\$60 million) for a 25.92% stake in BSK.<sup>13</sup> Given that this price was twice as high as the minimum set in the canceled tender, a question arises as to what motivated ING's new interest in BSK. One explanation suggested by the chronology of events is that ING possessed information about the excess demand in the IPO prior to committing to its own purchase, which was executed on January 13, 1994. Another likely explanation is that ING's decision to purchase a stake in BSK was intended to gain favor from a beleaguered Ministry of Finance so that ING could pursue its larger strategy regarding the Polish banking sector. After all the relevant transactions had been consummated, the remaining

stake held by the State Treasury in BSK was 33.2% (see Table 2).

On January 25, 1994, the first day of trading for BSK on the Warsaw Stock Exchange, the price reached PLZ 6,750,000 (\$337.50), a staggering 13.5 times the IPO issue price. Very few of the general shareholders were able to trade at this price due to the delayed distribution of shares and the required registration procedures at brokerage houses. The volume of trading on that day amounted to 32,410 shares or 0.35% of the total shares outstanding. The preferential treatment of employees allowed them to take advantage of the excess demand from the IPO and to sell on the opening day. Employees who paid PLZ 250,000, half the issue price, per share stood to make a first-day profit of PLZ 6.5 million, about \$325, per share. The secretive and swift nature of the negotiations with ING contributed to a public perception that ING had extracted too large a discount for its stake in BSK. This situation caused a public outcry and demands within the ruling coalition for an official investigation.

On January 28, 1995, almost a year after the first hectic day of trading in BSK shares, Prime Minister Waldemar Pawlak dismissed Stefan Kawalec, the deputy finance minister responsible for bank privatization, in response to the public reaction to the so-called Slaski Affair. Marek Borowski, the finance minister, quit in protest over the dismissal and Marian Rajczyk resigned as president of BSK's Management Board. BSK's brokerage license was temporarily suspended. The Sejm privatization committee undertook a year-long investigation into the incident. This committee determined that the agreement reached with ING had been properly conducted. However, the committee did find that BSK's brokerage house had wrongly favored the bank's employees while processing the shares and thus had violated the principle of treating all shareholders equally. As a result, the suspension of the brokerage house's activities was only lifted partially and its authority to operate in the IPO market remains curtailed at the end of 1996.

More important is the impact that the political furor over the timing and consequences of BSK's privatization had on the privatization policies for the remaining state-owned commercial banks. After we analyze the effects of privatization on the activities of BSK in the next section, we consider subsequent Polish bank privatizations and banking sector reform in section 6.

## **5. BSK AFTER PRIVATIZATION**

The most important change attributable to privatization has been a reorientation of management and staff attitudes at BSK. While examples from other countries in the region indicate that privatization does not lead necessarily to the establishment of an efficient bank, BSK's management fostered a shift toward customer-oriented business practices.<sup>14</sup> Tangible evidence of this new attitude are found in the rapid expansion of BSK's branch network, extensive employee recruiting and training, and the adoption of an aggressive business strategy designed to penetrate new commercial and retail markets.

Although it had used the services of consulting firms and had some contracts with Western banks to obtain training, BSK had not agreed to a match with a Western counterpart in the twinning program. Hence, attracting a strategic foreign investor to provide new banking expertise took on added importance in its privatization strategy.<sup>15</sup> ING has contributed significantly to improving credit assessment at the bank through better documentation and to upgrading both its lending procedures and its loan monitoring. ING has also been involved with the development of loan workout procedures in the bank. Finally, ING has played an active role in upgrading BSK's unrestricted brokerage house operations by developing new marketing expertise and introducing new financial products. Below we discuss specific areas of success as well as continuing

obstacles to BSK's transformation from a state-owned to a private bank.

### 5.1 *Bank Governance*

Improvement in BSK's management and performance did not follow immediately upon privatization due to the resulting ownership structure. A typical feature of bank privatizations in Central and Eastern Europe is the retention of the top management who ran the banks after their separation from the monobank. Frequently these managers, through strength of personality, political influence and superior knowledge of banking, are entrenched and wield significant power over the affairs of the bank.<sup>16</sup> The public pressure to fix responsibility for the problems associated with BSK's privatization led to a break with this pattern as Marian Rajczyk resigned in March 1994 immediately following the public outcry over the Slaski affair. At the annual General Meeting in May, the shareholders replaced all but one member of a Bank Council that had consisted wholly of appointments made by the Ministry of Finance. At the same meeting, the new Bank Council appointed a three-person Management Board that featured only one continuing member. Brunon Bartkiewicz, the lone remaining Ministry of Finance appointee from the previous Board, was named acting president and subsequently Board president, a role in which he currently serves.

A tripartite governance structure evolved as the Ministry of Finance voted the Treasury's holdings of 33% of the shares, ING as strategic investor held a smaller 26% stake, and the bank's management had two bosses. Immediately after purchasing a stake in BSK, ING maintained a relatively passive role in the governance of the bank having decided to proceed cautiously with the Ministry of Finance while pursuing its other banking interests in Poland. However, the

opening created by Rajczk's departure allowed ING to assert some influence over the choice of Management Board members. Andrzej Walkiewicz, a new member of the three-person Management Board, had extensive experience in banking and financial services both in the United States and in Poland before joining BSK and was regarded as ING's representative on the board. Serving as chairman of the new Bank Council while also an employee of the Ministry of Finance, Andrzej Wroblewski stated in an interview that he and the new Management Board members consider themselves to be agents of both ING and the Ministry of Finance.

Actual governance was complex as Walkiewicz was known to take positions contrary to ING interests and Bartkiewicz was not always in complete agreement with the Ministry of Finance. At times, both the Bank Council and Management Board members took positions that were at odds with the Ministry's requests. For example, in an interview, Wroblewski described a confrontation over dividend policy. The Management Board proposed a dividend target of 20% over a two year period. The Ministry of Finance, seeking revenues for the state budget, wanted a higher dividend on the Treasury's shares. Although no specific protection for minority shareholders could be used to support a case for preventing the Ministry's action, the chairman of the Bank Council and ING argued that its dominant owner was not acting as a true shareholder of the bank. Nonetheless, the dividend target was adjusted upward to 25% indicating the Ministry's direct influence on bank governance.

From this experience, a management-centered view of governance evolved with the bank's management playing its two large investors off against each other. The prolonged presence of a large and active government interest in BSK served to strengthen management's position in matters customarily decided by private owners. One example of management's opposition to ING was the expression of its displeasure with efforts by ING to move BSK commercial accounts

to ING's Warsaw offices. Conflicts with ING also arose after ING introduced products and services from other Polish operations into the market in direct competition to those marketed by BSK. Management Board members joined officials from the Ministry in expressing their concern that ING was using its access to internal BSK information to increase its competitive advantage over BSK. At the same time ING's concern over alienating officials of the Ministry while they pursued a broader strategy in Poland contributed to its reluctance to press management on certain matters related to the conduct of BSK operations. Conflicts between the two large shareholders affected adversely the development of BSK's strategy and also had ramifications for the broader relationship between foreign investors in the banking sector and the Polish government.

The governance issue was resolved in July 1996 when ING purchased additional shares from the state to bring its total shareholdings to a 54.1% stake, leaving only a nominal 5% stake in BSK with the Treasury. Whether ING's decision to take a majority stake in the bank was motivated by a desire to exercise tighter control over policy and strategy is not known. Interestingly, the government decided to cede majority ownership to ING only after Bank Gdanski, ING's former twinning partner, had been privatized. The division of responsibility has been clarified as ING has decided to focus on investment banking in Poland and leave the retail segment of the market to BSK. Hence, the spheres of influence of the two partners are now clearly established and conflicts over BSK management's domain and strategies should be minimized in the future.

## *5.2 Reorganization, Restructuring and Strategy*

Within the first year of privatization, BSK undertook substantial reorganization and, by 1995, four new departments had been created including those responsible for capital investments

and retail banking. Essentially, the bank changed from a functional organizational form to a regional form consisting of five designated regions within and around upper Silesia each with semi-autonomous branch operations. BSK's comprehensive development program emphasizes new information technology projects and product development in both retail and commercial markets. Although this program was begun prior to privatization, ING contributed to the design and implementation of various elements after becoming a strategic partner. Specifically, ING was involved in creating the new Commercial Development Department that is responsible for steering and supporting activities in the area of marketing, communications and sale of services. The department is an advisory body that reports directly to the Management Board.

A persistent problem for BSK's management is its overly large staff. Employment expanded with growth in the branch network and the introduction of new products and services. While qualified new personnel were required to perform new activities, management has had difficulties eliminating inefficient and redundant staff left over from the pre-privatization period. The redundancy problem has become even more acute with the introduction of new information technology systems. Members of the Management Board have stated publicly that the staff should be cut by 25% to 50%. Officials representing the state's stake in BSK have lacked the incentive or political will to reduce the workforce due to the government's employment objectives. Management, for its part, has been reluctant to lay off personnel for fear of labor action. Finally, ING decided to move cautiously and avoid confrontation with the government, bank employees and management in this matter. Overstaffing and the retention of workers with outdated skills is a serious remaining issue, representing an obstacle to achieving a level of efficiency or customer responsiveness comparable to Western banks.

Exploiting its new source of expertise, BSK moved from a relatively complacent business



strategy that was focused almost entirely on servicing its traditional upper Silesian clients to an aggressive strategy aimed at increasing new lending in regions outside of Silesia. The bank has upgraded and expanded foreign-currency operations; it has introduced new corporate finance and investments services. ING's management consulting group was charged with the development of a medium-term business strategy for BSK. The expansion of financial services at BSK is consistent with ING's own financial-services-shopping-center strategy that involves retail and commercial lending, investment banking, insurance, and asset management worldwide.

Retail financial services is a growth industry in Poland. Opportunities in retail banking are especially attractive as only one person in ten has an individual bank account and less than one percent of the population has a plastic card of any type (Bratkowski and Kawalec, 1996). In the first nine months of 1996, retail lending in Poland increased by 68% compared to a 21% increase in corporate borrowing. BSK has made significant strides to tap into retail banking. BSK has a large household deposit base accounting for over 60% of all deposits and retail lending as a percentage of the loan portfolio grew from 2.9% in 1993 to 12% in 1995. ING has helped the bank promote complementary products and services for retail customers and has cooperated with BSK in the development of a model branch for retail banking services.

### *5.3 The Commercial Loan Portfolio*

Improvements in BSK's commercial loan portfolio since privatization are less dramatic than in other areas, but some positive changes are evident. While loans to customers as a percentage of assets has remained stable at around 33% since 1992, provisions for loan losses as a percentage of assets has decreased by 50%. As Table 3 indicates, the ratio of irregular loans to total loans has declined from around 50% to 23% from 1992 to 1995. In part, this dramatic

change reflects improvements in credit selection, supervision and monitoring capabilities. In 1995, NBP regulations changed to allow banks to exclude loans guaranteed by the government from the class of irregular loans to which they had been relegated prior to this time. Hence, some of this change is due to the new classification policy. Nonetheless, immediately after the change in January 1995, 34% of the portfolio was classified as irregular and by the end of 1995 this figure had decreased to 23%. Furthermore, the NBP regulation on classifying loans as substandard is harsher than the International Accounting Standards (IAS) method for classifying loans as non-performing. At the end of 1995, almost three quarters of the loans classified as substandard by BSK would be considered performing by IAS.

Clearer evidence of a change in BSK's lending strategy is indicated by the composition of the commercial loan portfolio. Loans outstanding to state organizations and state-owned enterprises have declined to less than 60% of the total although some of this change is a result of old BSK clients being themselves privatized. Nonetheless, the industrial composition of the portfolio reflects decreasing exposure to traditional financially troubled industries, e.g., chemicals, and diversification into healthier industries, e.g., trade and food processing. Table 4 contains information on the ten largest loans in BSK's commercial portfolio from the time of privatization through the end of fiscal 1995. These loans comprise a decreasing percentage of the portfolio. Only three of the ten debtors on the list in 1991 were still among the ten largest borrowers in 1995 and only one of these had a loan classified as substandard. This clear improvement is attributable partly to BSK's efforts to reorient the structure of its loan portfolio with the encouragement and assistance of ING.

Unlike the banks receiving support from the Polish Bank Privatization Fund, BSK was not required to set up a work-out department but did so voluntarily when it established a fifteen-

person unit prior to its privatization. Table 5 provides a rough description of BSK's methods of resolving troubled loans. Since 1991, the bank has increased the frequency of rewriting terms of debt instruments or swapping debt for equity, its primary means of "resolving" troubled loans.. Current income statements show substantial write-offs of restructured loans but no evidence on the direct profitability of restructuring activities is presented.<sup>17</sup> Recently bank management has elected to scale back its efforts in restructuring in favor of upgrading lending expertise and pursuing aggressively new strategies to alter the composition of its loan portfolio.

While the procedures for screening, servicing and monitoring commercial loans have improved, BSK's balance sheet is representative of a persistent feature of banking in Poland; a low level of commercial lending to the enterprise sector. BSK commercial loans comprised only 39% of bank assets in 1995, up from 34% in 1994 but well below Western European standards. Still, BSK's performance in this area is substantially better than average as the ratio of commercial credits to GDP in Poland is approximately 20%.<sup>18</sup> Obstacles to lending familiar in all transition economies, e.g., difficulties in identifying high-quality new clients, the nascent stage of institutional infrastructure supporting property and creditor's rights, and information asymmetries, contribute to BSK reluctance to lend and the generally underdeveloped commercial lending market in Poland. Moreover, high returns on low-risk government bonds have provided incentives to banks to concentrate to a large extent on lending to the government. Government securities comprised over 25% of total BSK assets at the end of 1995.

In sum, BSK is well-positioned to compete for the rapidly growing retail banking business in Poland thanks in large part to the significant investment in information technology and branch development that was made possible by capital from ING.<sup>19</sup> With ING's assistance, commercial loan activity, while lower than desired, has improved in both volume and quality. BSK's new

management information system, modeled on the one used by ING, consists of on-line systems to manage accounts in BSK's brokerage house and to integrate branch office payment clearing. BSK was the first Polish bank to serve all of its customers on line. ING has been instrumental in introducing new products and services such as life insurance and commercial paper operations. Together the partners have improved internal accounting and external financial reporting capabilities. Trade finance activities were expanded using ING's extensive international correspondent network. As a strategic partner, ING has played an important in restructuring the bank so that BSK ranked third in 1995 among the top banks in Poland (*Gazeta Bankowa*, June 23, 1996).

## **6. THE EFFECTS OF BSK PRIVATIZATION ON POLISH BANKING**

After BSK, the next bank to be privatized was BPH in Krakow. The sale of BPH, a bank of equivalent asset size to BSK, marked a change in basic privatization strategy in Poland. The institutional infrastructure problems related to the BSK initial public offering and accusations that a large share of the bank had been given away to ING intensified the political debate over privatization policy. This, in turn, contributed to the wariness of potential strategic foreign investors and made it difficult for some officials in the Ministry of Finance officials to deal with each other. In this more uncertain environment, Janusz Quandt, the CEO of BPH, was able to delay privatization and preclude the search for a strategic foreign investor. Instead, the government decided to let the market set the price and agreed to sell 50.2% of the shares in BPH by IPO only on a special market day at the beginning of 1995. Unfortunately, by the end of the year, the WIG had lost about two-thirds of its value from a March 1994 high and the Mexican

crisis dampened foreign interest in emerging markets. Demand for BPH shares was low and, as a result, the EBRD as the major underwriter of the IPO was left with a 15% passive ownership stake. ING and BSK each took 5% of the shares; a stake that the group increased subsequently to 12%. The state retained a 47% stake in BPH after privatization while the remainder of the shares are widely held (Table 2).

The combination of a near majority interest by the government and diffuse or passive ownership among private investors left Quandt temporarily in control of BPH. However, in March 1995, Quandt was dismissed by the Bank Council purportedly for having led an ineffective advertising campaign to increase interest in BPH's shares and for his failure to attract a strategic investor. Over a year passed before a permanent replacement for Quandt was agreed upon by the new owners of the bank. During this time, existing management was unable to pursue major strategic initiatives and suffered through ongoing governance problems.

Following the privatization of BPH, in an effort to meet Polish Bank Privatization Fund deadlines, the Ministry of Finance temporarily relaxed its policy of privatizing the state-owned commercial banks in a planned sequence. With assistance from the United States Department of Treasury, the Ministry began to market all of the remaining regional commercial banks to strategic foreign investors simultaneously. A combination of the political fallout from the Slaski affair, uncertainty about the franchise value of the banks remaining to be privatized, and the divergent objectives of the government and potential investors prevented any progress.

Thus, the scheduled privatization of Bank Gdanski, about equivalent in size to WBK, proceeded as originally planned in December 1995 with a two-tier IPO. The government's plan called for 33% of the shares to be sold to foreign portfolio investors using global depository

receipts and a 33% stake to be sold to domestic investors only at a price of PLZ 240,000 (\$9.70) per share. Employees were expected to take a 4% stake and the state was to retain 30% of the shares. Foreign strategic investors were again spurned. Bank Inicjatyw Gospdarczch (BIG), a Polish private bank, and two of its subsidiaries took a 24.1% stake in the domestic tranche and subsequently increased this to 31% while the state retains ownership of 40% of the shares in Bank Gdanski.

The surprise purchase of Bank Gdanski by BIG immediately raised questions about how the transaction was financed. Knowledgeable observers claimed that BIG did not have the liquidity or reserves to carry out the purchase and were suspicious of the role of BIG's subsidiaries in providing financing. Since ING had been Bank Gdanski's twin in the earlier program organized to transfer technology and managerial skills to Polish banks, it seemed reasonable to expect ING to be interested in taking a core-investor stake in its twin. Anecdotal evidence suggests that ING had coveted Bank Gdanski at the time it took a stake in BSK. Moreover, ING's commitment to take a significant holding in BPH earlier may have been intended to cultivate relations with the Ministry of Finance prior to the privatization of Bank Gdanski, a bank that ING had coveted. The strategy was apparently not effective in overcoming government wariness of ING's growing influence in Poland. Within the Polish banking community, it is conjectured that the Ministry of Finance encouraged and aided BIG's purchase in order to pre-empt the possibility of ING taking a core investor stake in the bank. Given that ING appeared to be a willing and financially capable buyer for Bank Gdanski, any Ministry support of BIG would indicate that ensuring a large domestic presence in banking and preventing foreign domination in the banking sector had become a dominant government objective.

In the of Fall 1995, while the privatization program was stalled, the government announced plans to consolidate the banking sector. Polish banks were considered to be too small in size to survive the invasion of foreign banks when entry restrictions are relaxed according to the association agreement with the European Union (Bonin and Leven, 1996). As part of its orchestrated consolidation, the government announcement its intention to place its stake in BPH with one of the two proposed consolidated groups headed by BH. Although BPH was traded on the Warsaw Stock Exchange at the time, much of the non-government portion of the shares was widely held leading to a weak governance structure. The bank's management objected to consolidation and its private owners viewed the government's proposal as a broken promise somewhat akin to the renationalization of BPH (Slay, 1996). The stalemate was resolved because the Polish legislation on bank consolidation applies only to state-owned banks, a term interpreted to mean banks in which the state has at least majority ownership. Hence, the government withdrew its proposal leaving in limbo for the time being the placement of the state's near majority ownership stake in BPH.

That consolidation has, for the time being, superseded privatization as the Polish government's major policy objective in the banking sector is reinforced by its dealings with the Warsaw-based state-owned commercial bank, Powszechny Bank Kredytowy (PBK). In October 1996, the government transferred a 33% stake in the Polish development bank, Polski Bank Rozwoju (PBR), an investment bank playing an active role in Polish capital markets, to PBK as partial recapitalization. At that time, the government also announced its intention to privatize PBK by the end of March 1997. In this case, the privatization strategy calls for the formation of a financial group of four banks, namely, PBK, BPH, PBR, Kredyt Bank (KB) and an insurance

company, Warta. The group would become the third largest bank in Poland with broad regional and product coverage.

In addition to the pursuit of consolidation as a substitute for privatization, complementary government policies have impeded the development of contestability in the banking sector. Following abuses that resulted from lenient licensing policies early in the reform process, the NBP reversed its position, granting few new licenses to domestic banks and virtually excluding greenfield operations by foreign banks. In addition, the NBP steadily raised the minimum capital requirement for new domestic banks, first to PLZ 10 billion, then to PLZ 20 billion and finally to PLZ 70 billion (\$5.1 million) in April 1992. Regulatory requirements are even more stringent for new banks with foreign ownership in the capital structure. For example, the minimum capital requirement for establishing a bank with foreign ownership is \$6 million in local currency. Restrictions also apply to the amount of profit that can be transferred out of Poland by foreign owners. Although foreign-controlled subsidiaries have full banking licenses, Polish regulations dictate that the maximum amount of risk exposure carried by a branch of a foreign-incorporated bank depends not on the total capital of the bank but only on the capital dedicated to its Polish branch (Bratkowski and Kawalec, 1996). Regulatory policies help to explain why wholly foreign-owned banks have played only a minor role in Polish banking through 1995.

Apart from attempts by the Ministry of Finance to sell core investor stakes two of the commercial banks, government policy has been aimed at steering foreign investors toward taking over failed domestic banks.<sup>20</sup> Until recently, foreign investors have avoided this path of investment in Polish banking. These policies have deterred competition and reinforced the regional and national monopolies created when banks were first carved out of the NBP. The lack of domestic competition, the low level of foreign penetration, and the availability of attractive



alternatives in the form of government assets and interbank loans has slowed progress in restructuring domestic banks, retarded new product innovation and arrested the development of private-sector lending in the Polish banking sector. Clearly, the Polish banking system has not achieved its full potential as an intermediary between savers and non-government borrowers.

## **7. CONCLUSION: LESSONS FROM POLISH BANK PRIVATIZATION**

At a fundamental level, the results of privatization should not be judged only by short-run financial performance or even by the long-run survival of the privatized entity in a market environment. The basic idea behind the drive to privatize is the notion that some assets in the state's custody have intrinsic value that could be exploited better by private owners. One criterion for evaluating the Polish approach to bank privatization is the extent to which it promoted the realization of the potential value of the banking franchises carved out of the NBP's commercial portfolio. A critical lesson to be learned from the privatization of BSK is the importance of a foreign financial investor taking an active role in the development of bank strategy to bring about the fundamental changes necessary to realize this potential franchise value. BSK has made significant strides in upgrading its technical capabilities and increasing its aggressiveness in areas such as new lending, marketing, product innovation and management information systems as a result of the expertise and support of ING. Pure IPOs and voucher programs do not lead immediately to such a partnership. While alternative arrangements, e.g., the Polish twinning program, can generate transfers of knowledge on a limited scale, they are no substitute for a properly incentivized, highly knowledgeable financial investor in initiating and carrying through fundamental change in a privatized entity.

To generate quickly the required attitudinal and organizational changes necessary to realize the potential franchise value of the privatized entity, two conditions are fundamental to successful bank privatization. First, and tautologically, privatization should ensure the complete disengagement of the state from the governance and operations of the bank. With ING's recent purchase of a majority stake in BSK, this goal has been achieved. However, the method of privatizing BSK and subsequent government actions delayed the process for two and a half years. Because the government stake remained substantial and above that of ING after privatization, the Ministry of Finance was able to play an active role in bank governance during this time. A large state ownership stake need not necessarily mean state control of the affairs of the bank. The government could agree to be only a passive investor.<sup>21</sup> However, the imposition of increased dividend payouts over the objection of bank management at BSK argues that the Ministry of Finance was unable or unwilling to resist the temptation to meddle in bank policy when it found its own objectives more pressing. As long as this situation continues, prolonged and active government involvement in the privatized regional commercial banks through large block ownership appears to be inevitable consequence of Polish officials pursuing multiple policy objectives in the bank privatization program.

A second condition for successful state divestiture is to leave the ultimate control of the bank in the hands of outside, preferably private, owners. In many bank privatizations in Eastern and Central Europe, incumbent managers are left with a stronger hold on the bank than its shareholders. In some cases, explicit rules that give management veto rights over issues traditionally decided by owners are written into bylaws.<sup>22</sup> In other cases, diffuse ownership structures combined with an immature market for corporate control leaves entrenched incumbent management holding a dominant position in the bank.<sup>23</sup> With respect to the control issue, the

method of privatizing BSK gets mixed reviews. On the one hand, the governance structure and voting rules in the bank were designed to allow large shareholders to remove incumbent management at BSK. On the other hand, by retaining an active ownership interest and pursuing policies that were not compatible with private owners' objectives, the government provided the bank's management with the opportunity to pursue policies that were, at times, at odds with the objectives of the bank's private owners.

A corollary to these two conditions drawn from the Polish experience with bank privatization is that the transfer of control to private interests should be rapid. Under certain circumstances, swift progress may lead to bank failures and sector instability (Gorton and Winton, 1996). However, the Polish experience suggests that long delays have distracted both government officials responsible for privatization and bank managers awaiting privatization from the more important goal of transforming the banks into viable and dynamic entities.

Faced with competing objectives, the Ministry of Finance used the delays to react to perceived problems and redesign the privatization program. The commitment to the idea of a private banking sector lost its pre-eminence. The fear of excessive foreign influence in Polish banking began to distort previously coherent government policy goals. The strategy for bank privatization supported by deadlines imposed by the donor countries for use of the Polish Bank Privatization Fund was no longer credible. The privatization of BSK generated political pressure to avoid giving away Polish banks to foreign investors and an intense dissatisfaction with the IPO process. As a result, BPH was privatized with the Treasury left holding an almost-majority stake and without a core foreign investor to help upgrade its operations and develop better management strategies.<sup>24</sup> Furthermore, the subsequent privatization of BG was intentionally designed to

preclude the possibility of attracting a large foreign investor and to encourage the attention of a domestic core investor.

Current government privatization efforts are dominated by the issue of bank consolidation. Plans for privatizing the financial groups formed by consolidation are not fully formulated although proposals involve placing shares with yet-to-be-created pension funds. The privatization of the smallest of the nine state-owned commercial bank, BZ, remains to be completed. However, the prospects of attracting a foreign bank as a strategic investor are bleak because the lack of a consistent privatization strategy and the government's fear of foreign penetration have sent negative signals to foreign investors.

The Polish experience highlights the important interrelationship between bank privatization strategies and complementary policies designed to create a market-oriented banking sector. A consensus among the NBP, the Ministry of Finance and Parliament exists in favor of avoiding any instability and ensuring a significant Polish presence in the banking sector. The NBP pursued a restrictive licensing policy that reinforced monopolies and retarded competitive pressures. More stringent licensing requirements and a virtual moratorium, until recently, on greenfield operations applied to foreign competitors have hindered the introduction of new expertise and innovation in the banking sector. Even for BSK, a comparatively progressive privatized bank, the low level of regional competition has lessened the urgency to restructure its workforce and to terminate relationships with troubled former state-owned enterprises. Thus, the presence of a strategic foreign investor is not a complete substitute for external market discipline. Poland stands in stark contrast to Hungary and Russia, where external competition, rather than internal changes, has been the driving force behind banks becoming responsive to customer needs

by introducing new products and services.

Complementary government policies also have a substantial impact on the performance of banks as intermediaries between savers and borrowers. Polish GDP has grown more rapidly than that of any other transition economy. To sustain this growth over time, banks will have to engage in more active lending to new enterprises, an activity that they have been reluctant to pursue so far. Highly liquid banks have preferred to direct funds to the government securities and interbank markets that offer safe and lucrative profit opportunities. The recent reduction in Treasury bill and government bond rates appears to reflect the Polish government's recognition that the use of nearly 25% of regional commercial banks assets to fund large government deficits is counterproductive in the long run.

Finally, the Polish government's policy of using banks to restructure troubled enterprises is counterproductive as it leads to a continuation of long-standing client relationships of questionable profitability with troubled state-owned firms. Furthermore, dealing with a bad loan problem of the magnitude faced by Polish banks today should not be a permanent activity of any bank. Thus, the advisability of devoting bank resources to these efforts rather than focusing them on the development of expertise that will ensure bank viability in the future is questionable.

The Polish economy is poised for steady growth and partial integration into the European Union. Recent interest among foreign investors in small, troubled banks as a platform to grow larger operations gives reason for some optimism that the banking industry will move closer to providing the magnitude of financial support necessary to realize Poland's full economic potential in the near term. To date, the results of Polish efforts to privatize the regional commercial and national specialty banks have been a less important catalyst for reform in the Polish banking sector than had been originally anticipated. Ultimately, bank privatizations may become irrelevant when

Poland is forced to open its doors to competition from European banks. This attests to the importance of speed in executing privatization and early promotion of domestic competition to provide the discipline necessary to force banks to become viable entities. Some instability and bank failure should be expected as a matter of course.

In conclusion, the Polish experience indicates the importance of committing to the goal of a private contestable banking sector and developing a credible and consistent strategy to reach this objective. To remove the state from direct influence over bank activities and turn over control to outside, preferably private, new owners, the process of privatization and the complementary government policies regarding financial sector liberalization both matter. For example, the position taken on foreign entry will have significant influence on the contestability of the banking sector. Similarly, the method chosen to privatize banks will have a direct influence on their resulting governance structure. The Polish program of bank privatization failed the tests of consistency and coherence in general due to the government's inability to prioritize within a set of multiple, often conflicting, objectives. Furthermore, an undue fear of foreign bank competition led the Polish government to implement policies that are contrary to the development of an efficient and dynamic banking sector. Bank Slaski and WBK stand as exceptions rather than examples of Polish bank privatization policy in that both finally attracted a strategic foreign investor policy. It is not by chance that both are considered to be among the five best, and most aggressive, banks in Poland today.

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<sup>1</sup> Established in 1992, this fund contained 700 million dollars from money originally made available by donor countries, of whom the United States was the largest contributor, to support the exchange rate fix in 1990. The money was not needed to support the zloty and many of the donors agreed to make it available to support bank privatization in Poland. The donors allowed for disbursements to finance the recapitalization of a commercial bank once it was privatized. BSK was not eligible to participate since its privatization was already underway when the arrangements were made. Even though the timetable has not been met, the remaining balance of 300 million dollars may still be available because the agreement with the donor countries has been renegotiated (Bratkowski and Kawalec, 1996).

<sup>2</sup> Bonin (1995) provides a detailed survey of the actual carving out processes carried out on the monobanks prior to privatization in the Visegrad countries.

<sup>3</sup> Of these four banks deemed foreign-controlled, only BSK has a single majority foreign owner while WBK currently has two foreign owners with a combined majority stake.

<sup>4</sup> The Bank Council has the authority to dismiss all members of the Management Board and replace them with new appointees. Owners are not represented on the Bank Council in exact proportion to their holdings because members of the Bank Council are elected at the annual General Meeting.

<sup>5</sup> Prior to their privatization and in conjunction with the World Bank and the IMF, the Polish government sought Western twins to provide technical improvements to the nine state-owned commercial bank. However, the Western twin was under no obligation to take an ownership stake at a future date.

<sup>6</sup> In March 1995, Allied Irish Bank (AIB) participated in a second new share issue by WBK and acquired a 16.26% stake for \$20 million. AIB had been WBK's twin but had declined to participate in the initial offering. The new issue reduced EBRD's stake to 24% and AIB signed an agreement with the EBRD to purchase its stake at a future date. Later AIB increased its stake to 36% by purchasing an additional 20% of the shares from the Treasury's holding. AIB plans to take a majority interest of 60% in WBK by exercising its option to buy the EBRD's stake.

<sup>7</sup> As do banks in all transition economies, the state-owned Polish commercial banks have clients heavily indebted to the government and to their suppliers in addition to their liabilities to the banks. At the end of 1992, bank debt in Poland was highly concentrated in that companies accounting for 11% of sales revenues held 62% of the total credits and loans to businesses. Non-performing loans as a percentage of total loans were 26% in the aggregate and ranged from 25% to 60% for the state-owned commercial banks (Dittus, 1994).

<sup>8</sup> BSK and WBK did not participate in the plan for recapitalizing the loan portfolios of state-owned banks supported by the Polish Bank Privatization Fund and administered by the Ministry of Finance. The Financial Restructuring Act of March 1993 governing the disbursements from this fund applies only to banks that were at least 50% Treasury-owned at the time. The program requires a participating bank to separate out its bad loans from its portfolio, establish a loan work-out department, and present a restructuring plan to the Ministry of Finance for approval.

<sup>9</sup> No official reason has been given for the government's retention of large blocks of shares although several unofficial conjectures have been offered. They include lending credibility to the security of the bank in the eyes of Polish depositors, providing for government monitoring of the bank to compensate for inadequate regulation and supervision, and sharing in market price

increases subsequent to privatization. Little evidence is available to evaluate the merit of the first two arguments. With respect to the last conjecture, viable alternatives to holding shares with full voting rights are available to the government for sharing in the upside of future price increases.

<sup>10</sup> Because BSK was a larger bank than WBK, employees were expected to buy a smaller percentage of shares in BSK at the offered price than the 14.3% eventually acquired by WBK's employees.

<sup>11</sup> From this pricing decision, the government seemed to have been prepared to sell a stake in BSK to strategic foreign investors at a price below what they later offered to domestic investors in the IPO. Nonetheless, no strategic investor was attracted to the earlier tender.

<sup>12</sup> An article in *Gazeta Bankowa* dated October 8, 1995 argued that the price of BSK shares in the IPO should be set at a PE of 8 or 9 leading to an issue price of at least PLZ 1 million.

<sup>13</sup> Budget revenues from these transactions would have amounted to approximately PLZ 2.8 trillion (about \$140 million). According to the Ministry of Finance, the total proceeds from privatizing BSK amounted to PLZ 4.5 trillion (\$225 million).

<sup>14</sup> Poland did have the advantage of a legacy of Western-style banking prior to World War II and some consumer traditions, e.g., a large private agricultural sector, during the communist period.

<sup>15</sup> The working relationship between ING and BSK was formalized in the Agreement on Support of Management signed by the Ministry of Finance and ING. The agreement did not give ING responsibilities for the day-to-day management of the bank, but did identify twenty specific projects to be undertaken at BSK.

<sup>16</sup> Abarbanell [1996] describes this phenomenon and discusses the advantages and disadvantages of retaining incumbent management throughout the privatization process.

<sup>17</sup> Lissowska (1996) reports that the recovery rate on debt covered by restructuring agreements is 40% compared to 20% for debt sales and 10% for bankruptcy. Moreover, she finds that up to 30% of enterprises are not able to fulfill the conditions required to implement a restructuring agreement.

<sup>18</sup> More generally, Poland's ratio of bank assets to GDP stood at 35% at the end of 1995, one-half of its comparative measure in Hungary and the Czech Republic.

<sup>19</sup> ING has infused \$500 million into BSK since 1993 (Slay, 1996).

<sup>20</sup> The Ministry and the NBP also approached large domestic banks to take over failing private banks. Kredyt Bank and Bank Zachodni have been active in takeovers. Two banks that had also taken over failing banks, Prosper Bank and Pierwszy Komercyjny Bank (Lublin), were themselves taken over by the NBP when they failed. In brokering rescue schemes, the NBP had invested PLZ 3 trillion (\$133 million) by mid-1994.

<sup>21</sup> To date, the Polish government has shown no interest in retaining shares with restricted voting rights or setting legal limitations on state ownership of private entities as has been done in Russia.

<sup>22</sup> Abarbanell and Meyendorff (1996) describes such an example in Russia's Mosbusinessbank.

<sup>23</sup> See Snyder and Kormendi (1996) for the example of Komercni bank.

<sup>24</sup> Effectively, the government was left in control of BPH even though the bank's stock was traded on the Warsaw Stock Exchange. A clear indication of the government's control of bank governance was its plan to place the shares held by the Treasury in BPH with Bank Handlowy S.A. as part of a proposed bank consolidation scheme.

Table 5: Type and frequency of methods used by BSK to resolve troubled loans over time.

	<b>In 1991</b>	<b>In 1995</b>
<b>Method of resolving troubled loans:</b>	Frequency of Use	Frequency of Use
<b>Rewrite term-</b> bank agrees to changes terms of the debt instrument or trades debt for equity or rewrites the loan in a substantive way.	less than 50% of cases	nearly 60% of cases
<b>Discounted Payoffs</b> - bank accepts lower payments than were required by the loan contract.	less than 20% of cases	nearly 30% of cases
<b>Write-off / Forgiveness</b> - bank removes loans from its books and charges loss to income.	less than 5% of cases	over 5% of cases
<b>Bankruptcy</b> - borrower is placed in the hands of a liquidator and assets are sold to meet obligations of bank and other creditors.	over 5% of cases	over 5% of cases
<b>Company Workout</b> - banks works with borrower to improve its operations and generate cash flow.	less than 5% of cases	less than 5% of cases
<b>Foreclosure</b> - bank gains ownership of specific assets through judicial process.	less than 5% of cases	less than 5% of cases
<b>Selling off Assets</b> - borrower sells capital assets to meet its bank obligations.	less than 5% of cases	less than 5% of cases
<b>Collateralization</b> - bank accepts specific assets as payment for the loan.	less than 5% of cases	less than 5% of cases

BSK internal data.

Table 4: Top ten loans as a percentage of the loan portfolio and status of each loan since 1991

Rank	Firm	12/31/91			12/31/92			12/31/93			12/31/94			12/31/95		
		loan %	status	firm	loan %	status	firm	loan %	status	firm	loan %	status	firm	loan %	status	
1	A	0.14	N	A	0.11	N	B	0.10	N	A	0.08	S	F	0.04	S	
2	B	0.13	N	C	0.11	N	C	0.08	D	F	0.06	S	S	0.03	S	
3	C	0.12	N	B	0.10	N	F	0.07	S	B	0.06	D	L	0.03	N	
4	D	0.10	N,S	K	0.09	N	A	0.06	S	C	0.05	D	R	0.03	N	
5	E	0.07	N	F	0.07	N	K	0.06	N	D	0.04	S	E	0.03	N	
6	F	0.00	N	D	0.06	N,D	D	0.04	D	E	0.04	N	B	0.03	N	
7	G	0.03	N	E	0.05	N	E	0.04	S	L	0.03	S	P	0.02	N	
8	H	0.02	N	L	0.02	N	L	0.03	N	P	0.03	N	T	0.02	S	
9	I	0.02	N	G	0.01	N	N	0.02	N	R	0.02	N	M	0.02	N	
10	J	0.02	N	M	0.01	N	O	0.02	N	O	0.02	N	U	0.02	N	
total		0.7			0.635			0.52			0.44			0.27		

BSK internal data. Firm names omitted for proprietary reasons. N=normal, D=doubtful and S =substandard

**Table 3: BSK Loan portfolio by classification provisions and reserves since privatization**

	12/31/93		12/31/94		12/31/95	
	PLN (Mln)	percent of total	PLN (Mln)	percent of total	PLN (Mln)	percent of total
Regular loans	784	53%	965	51%	2226	77%
Irregular loans:	691	47%	930	49%	682	23%
<i>substandard</i>	359	24%	535	28%	489	16%
<i>doubtful</i>	227	15%	262	14%	41	1%
<i>loss</i>	<u>104</u>	<u>7%</u>	<u>132</u>	<u>7%</u>	<u>152</u>	<u>5%</u>
<b>Total loans</b>	<b>1475</b>	<b>100%</b>	<b>1475</b>	<b>100%</b>	<b>2908</b>	<b>100%</b>

Sources: BSK, 1994 and 1995 annual reports.

**Table 2**

**Structure of Ownership for the Four Privatized Regional Commercial Banks**

	<b>WBK</b>		<b>BSK</b>		<b>BPH</b>		<b>Bank Gdanski</b>	
	At date of privatization	August 1996	At date of Privatization	August 1996	At date of Privatization	August 1996	At date of Privatization	August 1996
Strategic <sup>1</sup> Investor	None	AIB <sup>2</sup>	ING	ING	None	ING partners	BIG	BIG

Owner group	percent	percent	percent	percent	percent	percent	percent	percent
EBRD	29%	24%	-	-	15%	15%	-	-
Strategic Investor	-	36%	26%	54%	12%	12%	24%	31%
Treasury	30%	10%	33%	6%	43%	47%	40%	40%
Other	41%	30%	33%	32%	30%	26%	36%	29%

Sources: Polish Ministry of Finance: The Financial System in Poland; 1993 BSK Prospectus; 1994 BPH Prospectus, Bratkowski and Kawalec [1996].

<sup>1</sup> The abbreviations AIB, ING, BIG, and ING Group stand for Allied Irish Bank, Internationale Nederlanden Group, Bank Inicjatyw and ING and partners, consisting of ING, Barings and BSK.

<sup>2</sup> AIB intends to increase its stake to 60% by exercising its option to buy EBRD's 24% stake in the near future.



**Table 1**

**Structure of Polish Banking: Bank Assets, Deposits and Equity by Concentration Groupings**

Banks	Share in Sector's			Comments
	Assets	Deposits	Equity	
Pekao Group: Pekao S.A. BDK PBKS PBG	21.8%	24.8%	15.0%	The group created in 1996 by the Government transfer to the state-owned bank Pekao S.A. of shares of three state-owned regional banks: Bank Depozytowo-Kredytowy S.A. in Lublin (BDK), Powszechny Bank Gospodarczy S.A. in Lodz (PBG) and Pomorski Bank Kredytowy S.A. in Szczecin (PBKS)
PKO BP	17.4%	25.6%	9.0%	State-owned savings bank
BGZ S.A.	7.9%	6.3%		Owned by the State Treasury (66%) and regional cooperative banks (34%). Under restructuring process.
Bank Handlowy w Warszawie S.A.	6.2%	4.1%	15.5%	100% owned by the State Treasury
Foreign capital controlled banks	16.4%	17.2	26.5	Wholly-owned subsidiaries of foreign banks, branches and banks effectively controlled by foreign shareholders.
Remaining banks	30.3%	22.0%	34.0%	
Total	100.0%	100.0%	100.0%	

Source: Bratkowski and Kawalec, 1996.