TITLE: BANK PRIVATIZATION IN POLAND:
CAN THE COMMERCIAL BANKS
SOLVE THE FINANCIAL CRISIS?

AUTHOR: John P. Bonin
Wesleyan University

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1755 Massachusetts Avenue, N.W.,
Washington, D.C. 20036
PROJECT INFORMATION:

CONTRACTOR: Wesleyan University
PRINCIPAL INVESTIGATOR: John P. Bonin
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Abstract

Unique among Central East European (CEE) countries, Poland's multi-pronged attack on its financial crisis consists of a bank-led, bad-loan, workout program including funds for bank recapitalization and a three-year strategy for privatizing its state-owned commercial banks. The Polish commercial banking sector is made up primarily of nine regionally based universal banks. Of these, the two banks considered to have the healthiest portfolios and the most qualified management, Wielkopolski Bank Kredytowy S.A. (WBK) and Bank Śląski S.A. w Katowicach, are being privatized in 1993. The other seven will participate in the 1993 recapitalization scheme which is jointly financed by fiscal budgetary outlays and the złoty stabilization fund. All banks must satisfy full provisioning regulations by the end of the year; they must have worked out their bad loans by March 1994.

The bank-led Polish bad-loan workout program is biased toward debt/equity swaps and loan write-downs accompanied by recapitalization for large debtors and toward liquidation and asset sell-off for small debtors. The tight timetable for completion of workouts creates a situation in which the commercial banks are likely to take substantial equity positions in their large clients and, in so doing, increase their risk exposure. Swapping bad debt at face value for bad equity does not leave a bank in an attractive shape for new investors. Moreover, the Polish experience with privatization is not encouraging. Neither of the two "healthy" banks were able to entice a foreign commercial bank to inject additional equity. Rather the European Bank for Reconstruction and Development (EBRD) agreed to subscribe the full issue of new shares and become a temporary (five-year) holding company with an ownership stake of approximately 30% which is also the target residual share to be left with the Treasury. Bank employees and private investors (in two tranches, large and small) hold the remaining shares. Technical assistance is being provided by Western twin banks but the responsibility for monitoring proper governance and promoting further privatization lies jointly with the EBRD and the state.

Debt/equity swaps leading to partial bank ownership of companies also strains scarce managerial resources as bank executives sit on company boards to protect the bank's investments. Whether the Polish banking system has both the financial resources and skilled personnel to support this ambitious program is questionable. The privatization of WBK does seem to have awakened the stock exchange which is now the deepest and most vibrant in CEE. However, unless Polish banks can attract the capital and expertise of the illusive strategic foreign commercial bank partner, the bank privatization program will not give birth to healthy private commercial banks with the proper governance structure within its allotted time frame.
In February 1989, nine state-owned commercial banks were created as regional clusters from the branches of the National Bank of Poland (NBP). From inception, these nine banks were granted universal charters. During 1990 when the zloty/dollar rate was fixed, commercial banks made large profits by purchasing dollars for their current business transactions at the fixed rate despite significant appreciation in the real effective zloty/dollar exchange. These profits augmented the capital base of the banks at a time when overdue loans had not yet become a serious problem. By the end of 1991, the share of bad loans in the commercial banks' portfolios had risen dramatically. Poland's response to its financial crisis was to design a bank-led, bad-loan, workout program which included funds for bank recapitalization and also to develop a three-year strategy for privatizing its state-owned commercial banks.

Bank recapitalization and the problem of bad loans were dealt with in two parliamentary acts dated December 1992 and March 1993, respectively. The latter act requires the banks to "clean-up" their portfolios and work out problem loans by March 1994. Workout can take one of four forms: conciliation (including debt/equity swaps and loan write-downs), bankruptcy, liquidation, or sale of claims. Due to its relatively weak priority position in bankruptcy proceedings (the fifth creditor behind taxes and wages), a bank is likely to favor either liquidation (in which the priority list of creditors is discretionary) or a debt/equity swap vs. the initiation of bankruptcy proceedings. The

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1 Much of the background information to follow and the data on the Banking system is taken from Pawel Wyczanski, Polish Banking System: 1990-92, forthcoming, the Friedrich Ebert Foundation. I am extremely grateful to Dr. Wyczanski for providing me with a pre-publication version of his manuscript.

2 Polish banking regulations use four classifications for loans: normal, substandard, doubtful, and lost. The categories depend on the debtor's delay in servicing and repayment of principal and the debtor's financial situation in the following manner: substandard - less than three months or debtor makes losses for at least three months, doubtful - less than six months or debtor forced to tap own capital, and lost - more than six months or debtor in receivership or liquidation.

3 Moreover, by liquidating an enterprise, the creditors can create a new company shorn of the auxiliary costly social activities that burden the existing entity.
legislation also requires full provisioning against the qualified part of the portfolio by the end of 1993. The December act legislates funding for bank recapitalization in the 1993 fiscal budget and prescribes as instruments long-term (14 to 20 year) Treasury bonds (second-tier bank capital). The (unused) $1 billion zloty stabilization fund provided by international donors in 1990 has also been made available to finance bank recapitalization. Seven of the nine regional commercial banks are expected to receive funds in 1993 to facilitate bad loan workout through loan write-downs.

Privatization of the nine state-owned regional commercial banks began in 1993 and is planned to be completed by the end of 1996. Privatization is a crucial component of promoting proper governance of commercial banks. If recapitalization of the banks simply provides rent to the current management and shareholders, the public money will have been squandered. Banks must be induced to make loans on an economically rational basis, to manage prudently their portfolios, and to preserve and increase their equity. Although privatization is a necessary condition for promoting these objectives, it is not sufficient. Bank behavior is influenced strongly by the regulatory environment, the market structure, and other inherited conditions. 4

By definition, privatization is the shift of any activity from the public to the private sector. In the case of Polish commercial banks, the first stage of privatization involves a transfer of only some portion of ownership from the government to private hands. The state’s share and influence will be diluted but complete state divestiture will not occur immediately. Nonetheless, privatization is expected to concur substantial benefits to the commercial banks including an injection of fresh capital, the upgrading of technical and management skills, and access to lower cost funding partly through economies of scale. The Polish government’s original strategy focused on finding a foreign commercial bank to act as a strategic partner to promote these ends. Technical assistance is being provided by Western partners in the

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4 In Enrico C. Perotti, "Bank Lending in Transition Economies", Boston University, October, 1992, the author argues that value-maximizing banks burdened by inherited bad debts have an incentive to redirect funds from more profitable new loans toward their clients who are currently not servicing existing debt. Hence, the inherited bad debt problem must be resolved prior to privatization if proper lending behavior is sought.
World-Bank supported twinning arrangements to eight of the nine regional commercial banks. Although having a twinning agreement in place is a precondition to privatization, the foreign partner is not obliged or even expected to participate in the raising of new capital.

The Polish bank privatization program calls for the Treasury to retain at least 30% of the total shares in the "privatized" bank although the state’s voting rights are limited to strategic decisions. Private placement of new shares is to be used to generate the requisite injection of new capital, preferably from a strategic foreign commercial bank. Bank employees are offered up to 20% of the existing shares on preferential terms, i.e., at one-half of the price offered to the public. The remainder of the existing shares (constituting about 30% of the total augmented shares) are sold by initial public offering (IPO) to private entities (both domestic and foreign) in two tranches, a large and a small investor tranche.

The first of the nine regional state-owned commercial banks to be privatized, Wielkopolski Bank Kredytowy S.A. (WBK), offered its shares to the public in a prospectus dated March 15, 1993. As of the end of 1992, WBK ranked twelve among Polish banks (eighth among the regional nine) in terms of total assets. Preparation for the privatization of WBK started in June 1991. A strategic foreign partner (commercial bank) was sought initially but it was determined subsequently that continuing this search would delay privatization unduly. Instead, an agreement was reached with the European Bank for Reconstruction and Development (EBRD) in which EBRD subscribed the total issue of new shares (1,826,000) and thus acquired 28.5% of the augmented capital of WBK. By exercising

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5 Two banks, Bank Inicjatyw Gospodarczych S.A. (BIG) and Bank Rozwoju Eksportu S.A. (BRE), had been privatized by public offering prior to 1993. Both are relatively young banks set up under the provisions of the Banking Law of 1982 which permitted the creation of new banks. BIG was founded by a group of state enterprises with the help of some private individuals as a bank of economic initiatives, i.e., investment projects not directed by a ministry. BRE is an export development bank founded by NBP, the Ministry of Finance, the Ministry of Foreign Economic Relations, and the two Polish banks engaged in foreign exchange transactions, Bank Handlowy w Warszawie S.A. (enterprises) and Bank Polska Kasa Opiecki S.A. (individuals and time deposits). As of the end of 1992, BIG and BRE ranked fourteenth and fifteenth, respectively, among Polish banks in terms of total assets.

6 A twinning agreement with a wholly-owned subsidiary of Allied Irish Banks was arranged in May 1992.
their preferential option of buying existing shares at half price over a one-year offer period, the employees of the banks could accumulate up to 15% of the total outstanding shares. The public offer (1,740,000 shares) constituted 27.2% of WBK’s increased share capital and was divided into two tranches with the small-investor tranche defined as purchases of less than 5,000 shares. In each tranche, the par value of a share is 100,000 zloty and the selling price was 115,000 zloty per share. The large investor tranche closed first resulting in the sale of 7.2% of the total shares (80% Polish, 20% foreign). The other 20% was sold to small investors in the second tranche. The state will retain at least a 30% ownership stake from the shares remaining with the Treasury after the employees have exercised their options.

EBRD participation is intended to provide a counterbalance to the state’s influence in bank governance; EBRD placed 2 members on the supervisory board of WBK joining the 7 already appointed by the Ministry of Finance. According to the agreement, EBRD is required to hold its shares for at least one year. EBRD has announced its intent to sell all of its holdings within five years. Hence, EBRD is a temporary holding company; it is likely to be a somewhat active, rather than purely passive, partner. Although it is not the most-desired strategic foreign partner, EBRD can serve as a catalyst in promoting proper governance and encouraging further privatization. To this end, some continuing concentration of ownership is desirable especially as a counterbalance to the state until the time of total state divestiture. Finding a commercial foreign bank or a Polish private investor to play this role is a tall order for the EBRD.

Bank Slaski S.A. w Katowicach, the second of the nine banks to be privatized, is ranked seventh among Polish banks (third among the regional nine) with almost twice as many total assets at the end of 1992 as WBK. Preparations for the Bank Slaski’s IPO were completed at the end of June 1993. Recapitalization involved writing off a large non-

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7 Bank supervisory boards in Poland are mandated to influence profound changes in the bank but not to monitor daily operations. Consequently, the supervisory board discusses and reviews equity investments and loans over a certain threshold. It also has the authority to replace members of the executive board which is itself involved in monitoring the daily operations of the bank.

8 The Swiss Bank Corporation was chosen by tender to be a technical partner.
performing loan to the joint-venture automaker FSM and replacing it with long term
government securities funded jointly from the stabilization fund and by Fiat, the foreign
partner. The injection of new capital will come again from the EBRD. After recapitalization
and the new share subscription, financial projections indicate that Bank Slaski would have a
capital adequacy ratio (CAR) of 26% according to international accounting standards. The
1993 recapitalization strategy calls for equalizing the CARs of the nine banks at about 12% which is 4% above the BIS minimum requirements.9 Hence, Bank Slaski will be
"decapitalized" by remitting 55% of its net profits in dividend payments to the Ministry of
Finance after which it will have a projected CAR of 15%. The planned ownership
percentages for Bank Slaski are similar to those in WBK with one exception. The employee
share is expected to be significantly lower (6 - 7%) reflecting the larger financial size of
Bank Slaski relative to the financial resources of its employees.

The two banks chosen to spearhead the Polish privatization program are regarded to
be the best two commercial banks in terms of the quality of both their portfolios and their
management. Management at Bank Slaski has been stable for two years; the top-level
managers in both banks were previously managers at NBP. Although the order of
privatization depended on the state of preparation, the fact that WBK is one of the smallest of
the regional nine provided a test of the absorption capacity of investors. The Warsaw Stock
Exchange (WSE) reacted favorably to the news of WBK's impending entry. The WSE index,
WIG, rose by a multiple of three from mid-March (when the WBK prospectus was made
public) to late May of 1993. The first day of trading in WBK stock on the WSE, June 22,
1993, yielded a transaction (single-quote) price of 350,000 zloty, about three times its IPO
selling price. The price quote fell on the second day of trading (June 24) to 330,000 zloty but
it never went below 320,000 zloty. As of August 19, 1993, the price quote was 590,000
zloty. Given the evidence from secondary trading in WBK stock, the IPO price turned out to
be a bargain.

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9 According to its prospectus, WBK will have a CAR of about 12% after the EBRD
subscription of new shares.
The privatization of WBK and Bank Slaski covers about 22.5% of the total assets of the regional nine. The remaining 77.5% are held by banks with presumably less-skilled management and poorer quality portfolios. If this is an accurate assessment, it does not augur well for rapid privatization of the other seven banks. By the end of September 1992, WBK had classified about 35.5% of its loans as doubtful or overdue. By that same date, WBK had accumulated, as specific provisions, an amount equal to 10.4% of its loan portfolio and, as general provisions, an additional 4.7% of its loans. Thus, total provisions covered less than one-third of the qualified portion of WBK's portfolio at the end of September 1992. Prior to privatization, WBK converted into equity a large loan (3% of its total loan portfolio) to Huta Warszawa, a manufacturer of specialized steel products. WBK acquired a 22% ownership stake in Huta Steelworks; this holding accounts for 6.5% of WBK's total capital investments. An estimated 5 or 6 other large problem loans amounting to about 25% of the bank's share capital are yet to be worked out. Hence, WBK's risk exposure in both its lending and investment portfolios is not inconsequential.

Given that WBK is judged to have a high quality portfolio relative to the other regional banks, the severity of the bad loan workout problem is obvious. Polish banking regulations call for full provisioning by December 31, 1993. The March legislation mandates bank-led work out of problem loans by March 1994. To meet these two requirements, banks are likely to resolve their large problem loans by swapping debt for equity at face value. Thus, the risk exposure of banks to these large clients will actually increase as the banks' cash flows will be used to subsidize directly the losses of the companies they own. Bad debt will have been converted to bad equity! Furthermore, bank directors will be required to sit on the supervisory boards of the companies their banks own to protect these investments.

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10 The data to follow come from an English translation of the WBK prospectus filed with the Polish Securities Commission on March 16, 1993. I am extremely grateful to Professor Witold Malecki for making this available to me.

11 Banking regulations limit exposure of a bank to no more than 25% of the company's capital.

12 Private estimates indicate that the quality of the portfolio in Bank Slaski is similar to that in WBK.
Hence, already scarce skilled managerial talent will be diverted to monitoring current enterprise performance and to overseeing company restructuring. Consequently, both the financial and managerial resources of commercial banks will be strained during this period.

The Polish experiment of combining bank-led, bad-loan, workout and enterprise restructuring with bank privatization raises several crucial questions. First, to what extent is the seemingly strong financial position of Polish banks as compared to their counterparts in other economies in transition\textsuperscript{13} an illusion? Until bank-led loan workout and enterprise restructuring is well underway, it will be difficult to tell. A strong negative signal will be given if the timetable of bank privatization is derailed or if the only partner willing to invest in new shares offered by the banks being privatized continues to be the EBRD. Second, given that the commercial banks are the depositaries of the best financial information on companies, is their a better alternative to bank-led, bad-loan, workout? Currently, there are no success stories using alternative methods although the obvious comparator is the "sink" or "hospital" bank program in the Czech Republic. Third, will the Polish program induce banks to take on too much equity exposure thus overextending their financial and managerial resources? As the future unfolds and provides evidence, the obvious comparator is Hungary, a country in which the commercial banks do not have universal charters and where draconian bankruptcy legislation with a harsh trigger has already generated a wave of court proceedings and enterprise liquidations.

\textsuperscript{13} In Hungary, the only large bank with a CAR above 8\% is the Hungarian Foreign Trade Bank while the other three large commercial banks have estimated CARs of 2.2\%, - 7.9\% and - 8.5\% (Abel and Bonin, "Bank Recapitalization: Hungary’s Second Attempt at Resolving the Credit Market Crisis", this series, July 1993).
Appendix

INTERVIEWS

Warsaw, Poland: June 21 - 25, 1993

Dr. Danuta Gotz-Kozierkiewicz, Professor, Research Institute of Finance

Dr. Grzegorz W. Kolodko, Director, Research Institute of Finance and Professor of Economics, Warsaw School of Economics

Dr. Witold Malecki, Member of the Bank’s Council, Wielkopolski Bank Kredytowy S.A. and Institute of Finance

Dr. Marek Mazur, Chairman of the Supervisory Board, Powszechny Bank Kredytowy, S.A. w Warszawie and Advisor to the Minister of Finance

Mr. Krzysztof Opawski, Chairman of the Bank Council, Bank Slaski S.A. w Katowicach

Mr. Slawomir Sikora, Director, Banking and Financial Institutions Division, Ministry of Finance

Dr. Pawel Wyczanski, Banking and Monetary Research Institute, National Bank of Poland