POLAND
The Polish Banking Industry Twinning Program
1994
by
Marie-Renée Bakker
The Polish Banking Industry Twinning Program by Marie-Renée Bakker was originally published as a chapter in Eastern European Bank by James Essinger, pp. 73-83, Chapman and Hall, 1994.

Reproduced with permission of Cengage Learning (EMEA) Ltd.

© 1994 Cengage Learning (EMEA) Ltd

This paper can be used under the World Bank Terms and Conditions at http://www.worldbank.org/terms
<table>
<thead>
<tr>
<th>Acronym</th>
<th>Description</th>
</tr>
</thead>
<tbody>
<tr>
<td>FSU</td>
<td>Former Soviet Union</td>
</tr>
<tr>
<td>IFC</td>
<td>International Finance Corporation</td>
</tr>
<tr>
<td>NBP</td>
<td>National Bank of Poland</td>
</tr>
<tr>
<td>MIS</td>
<td>Management Information System</td>
</tr>
<tr>
<td>TA</td>
<td>Technical Assistance</td>
</tr>
</tbody>
</table>
TABLE OF CONTENTS

A Brief History of the Polish Bank Twinning Program..........................................................5
How Were the Pairs of Twinning Banks Matched?.................................................................6
Why Twinning?..........................................................................................................................6
What was to be Achieved under the Twinning Arrangements?..............................................7
Results Achieved To Date..........................................................................................................8
Which Factors Contribute to Success or Failure, And What Lessons Can Be Learned?........11
  Commitment to Twinning.........................................................................................................11
  A Flexible Approach................................................................................................................13
  Shareholder Control..................................................................................................................13
The Polish Banking Industry Twinning Program

As part of its financial sector reform program, the Polish government has embarked on a set of innovative twinning arrangements between Polish state-owned banks and West European commercial banks, comprising comprehensive, two- to three-year institutional development programs covering all aspects of banking. This article explores how the pairs of Polish/West-European twinning banks were matched, why the concept of twinning was chosen, rather than more traditional technical assistance (TA) arrangements, what the twinning arrangements were to achieve, the initial results, and lessons to be learned from the Polish experience for applying the concept of twinning to other Eastern European and Former Soviet Union (FSU) countries.

A Brief History of the Polish Bank Twinning Program

In early 1989, nine regionally organized banks were split off from the National Bank of Poland (NBP). These nine banks inherited the physical branch networks, staff and the loan and deposit portfolios of the former monobank. Under Polish banking legislation, they were all licensed as universal commercial banks. During 1990-91, the government undertook to corporatize the banks, and by October 1991 all the new banks had been transformed into joint stock companies 100% owned by the Ministry of Finance. Turning the banks into joint stock companies allowed newly appointed supervisory boards to exercise governance over the banks' managements, and created the possibility of eventually privatizing the banks. The corporatization and other reforms initiated in that period (macroeconomic stabilization, adoption of new banking legislation and liberalization of interest rates) set the stage for the development of an efficient banking system. The new banks still suffered, however, from major distortions inherited from past policies. Their major weaknesses included a lack of autonomy, small branch networks and a limited product range inhibiting the development of competition, a lack of banking skills needed in a market economy environment, and an inadequate financial structure.

To address these shortcomings, and as banking skills were scarce and the legal and regulatory infrastructure was weak in Poland, the Ministry of Finance as the banks' new owner looked for options to bring in foreign banking expertise. The Ministry early on announced its intention to eventually privatize all nine banks, in an attempt to bring in new capital and banking expertise and to strengthen governance. The World Bank, which at that time was designing a loan supporting the authorities' reform efforts in the financial sector, suggested the pursuit of twinning arrangements between foreign banks and the newly created Polish banks. Under such arrangements, foreign banks were to build up strong institutional relationships with Polish banks, including equity participations, and were to undertake comprehensive technical assistance and institutional development programs. The Bank argued that twinning arrangements were the most suitable vehicle for developing the Polish banks' institutional strength, not only because of the inherent advantages of such partnership arrangements over more traditional TA arrangements, but also because of Poland's proximity to Western Europe (see below).

It soon became apparent, however, that at this early stage of Poland's development foreign banks could not be convinced to take equity participation. The macroeconomic and political environment were perceived to be too unstable, high inflation obscured the true financial condition of the banks, and
unfamiliarity with Polish accounting practices complicated due diligence efforts. Also, restrictions on foreign majority ownership may have deterred some banks. To preserve the transfer of banking skills and other institutional relationship benefits sought through foreign investment, the authorities therefore decided to pursue twinning arrangements without the requirement for foreign banks to take equity participation.

**How Were The Pairs Of Twinning Banks Matched?**

At the request of the Polish authorities the International Finance Corporation (IFC), the private sector arm of the World Bank Group, undertook to assist in the ‘match-making’ of the pairs of banks to be twinned. To find the best matches, IFC visited each of the nine Polish banks, and a number of foreign banks with whom it had developed good relationships in the course of its normal operations. IFC also arranged meetings in Poland, where foreign and Polish banks were given an opportunity to familiarize themselves with the terms and conditions of the prospective twinning arrangements, and to verify the validity of the proposed matches. As the twinning arrangements were not eligible for IFC funding, the Ministry of Finance agreed to finance the arrangements using World Bank resources.\(^1\)

**Why Twinning?**

At the time the Polish twinning arrangements were designed, other Eastern European countries, with the assistance of the World Bank, were pursuing institutional development efforts for their banking systems using more traditional TA schemes. Until the Polish twinning arrangements came along, the Bank had no experience with large-scale twinning of universal banks in commercially attractive markets close to the foreign banks’ home base. Positive results at that time, however, were already apparent from using the concept of twinning for development finance institutions and mortgage banks, as well as in other sectors such as energy, water supply, other municipal services, and education. Therefore, bringing Western European banks into Poland through twinning arrangements was considered an effective mechanism of institutional development and of increasing foreign interest in the Polish-banking market.

The aim of twinning arrangements is to build strong institutional relationships between entities performing similar activities. In such relationships, more experienced entities transfer skills to less experienced counterparts. Transfer of skills is to be distinguished from development of skills. The rationale for using twinning, rather than more traditional TA schemes, is to provide the counterpart with established and successful ways of improving organizational efficiency and effectiveness through the selection of a foreign twinning partner involved in similar activities. Furthermore, rather than merely agreeing to provide a set of predefined services, under a twinning arrangement a foreign twinning partner is expected to be interested in maintaining a strong institutional relationship with the counterpart beyond the duration of the twinning arrangement. A single twinning partner normally

---

arranges for all activities to be undertaken under a twinning arrangement, although subcontracting arrangements for parts of the work are also possible.

Twinning differs in some important aspects from more traditional TA:

- The scope of the services performed by a foreign twinning partner under a twinning arrangement is much broader than under more narrowly defined TA schemes and the duration is much longer (two to three years, as opposed to a few months)

- A foreign twinning partner may at an earlier stage of development have experienced certain operational problems, specific to its activity, that are now facing the counterpart. It can use that experience in dealing with such problems in approaching the counterpart's problems.

- A foreign twinning partner can tap into a reservoir of ready-made systems, products, and procedures, and can use operational experience and in-house resources not available to more traditional TA providers (e.g. international accounting firms; while such firms may have staff with banking expertise, the experience they can draw on is limited as banking is not their main operational focus).

- A foreign twinning partner is expected to be able to more flexibly adjust its staffing to the absorptive capacity of the counterpart. Traditional TA suppliers may have more difficulty doing so, due to widespread use of subcontracting. Also, staff from a twinning partner are usually available for back-stopping and follow-up on implementation of recommendations, thereby ensuring that the assistance is more productive.

- Through a twinning arrangement, a counterpart can access commercial services offered by the foreign twinning partner more easily than it otherwise could (i.e. establishing correspondent banking relationships, obtaining co-financing or guarantees for attractive, but large lending operations exceeding the capital-capacity of the counterpart bank, etc.).

**What Was To Be Achieved Under The Twinning Arrangements?**

Under the Polish twinning arrangements, the foreign banks were asked to implement extensive institutional development programs in their counterpart banks, in order to facilitate their transition, within a three to five-year time-frame, to autonomous, competitive commercial banks capable of functioning in a market environment. The arrangements envisaged work to be undertaken by the foreign banks in separate modules to be implemented successively or, in some cases, in parallel, depending on their urgency and the extent of any interdependencies:

- Development of a strategic planning capability and preparation of an initial strategic plan and supporting business plans.

- A review and revision of the existing organizational set-up and the introduction of budgeting systems, to build a structure and internal financial and managerial tools conducive to realizing the objectives identified in the strategic plan.
• Strengthening the banks’ credit function by developing prudent credit policies and procedures, and building an asset- and liability-management capability.

• Assisting the automation of the banks' operations and building management information systems.

• Building marketing and human resource development capabilities, strengthening and modernizing the banks’ internal audit function, and developing large-scale staff and management training programs.

For the foreign banks to be able to formulate detailed technical proposals for the provision of these services, they received copies of diagnostic studies undertaken by international accounting firms at the request of the Polish Ministry of Finance. These studies analyzed the banks' recent financial performance and identified their major institutional weaknesses. They also included a credit exposure analysis, an internal control review, a financial assessment and a business and organizational review.

**Results Achieved To Date**

The foreign banks developed their technical proposals in the latter half of 1991. While it was expected that the Polish banks would review these technical proposals and negotiate the resulting contracts on their own, the World Bank guided the process to ensure that the final proposals were sufficiently responsive and that the final contracts were fair to both parties. Seven twinning arrangements were reviewed and negotiated during December 1991 and the first quarter of 1992. The final contracts were signed in March—May 1992.

Teams from the foreign banks started to work in the Polish banks in mid-1992. The arrangements have been running as of the time of writing for just over a year. Thus, it is still too early for an in-depth assessment of the results achieved. However, regular consultations between the Polish banks and the World Bank provide strong evidence of early favorable results.

Most counterpart banks have succeeded in developing sound strategies and business plans, combining consolidation of their traditional operations with focused expansion in a limited number of high-profit areas (e.g. trade finance, leasing, advisory services). However, as counterpart management was unfamiliar with the concepts routinely used in strategic planning, some delays occurred as the foreign banks first had to undertake substantial management training. For some counterpart banks that had already embarked on a rapid expansion of their branch networks, the strategic planning exercise served the purpose of showing the risks and downsides of such an approach.

Developing and implementing new organizational structures has been slower than anticipated, as documenting existing structures has been hindered by language and communication problems. There has also been some initial reluctance to change. Nevertheless, the first results are encouraging, demonstrating a strong learning effect on the part of bank managers. A few banks have completely overhauled their organizational structure, reigning in the power of the branches. Others have enhanced control over their branch networks by lowering credit competencies for individual branch managers, or
by creating regional 'lead branches'. Slow progress towards the automation of the banks' operations has complicated the detailing of organizational structures.

Most banks have developed a budget format and are preparing for use of these formats in future budgets. Some banks have requested that loss-making branches should develop business plans to improve their financial situation. Others are developing systems linking managers' performance against budget to their remuneration. Problems have been posed by the unfamiliarity of counterpart management with the concept of transfer pricing, and by the need to distribute banks' overall credit ceilings among branches in the absence of branch profitability analysis.

Impressive progress has been made by the counterpart banks in strengthening their regular credit function. Credit policies have to a large extent been redefined, and new, lower competencies for the branches have been set by most banks. Loan classification systems have been introduced ahead of the issuance of prudential rules by NBP. Due to repeated portfolio reviews by external auditors, the banks' managers have become increasingly familiar with the techniques underlying proper loan classification. Manual monitoring of the portfolio on a monthly basis is now in place in all banks. Existing credit procedures also have been improved in most banks. A number of banks have introduced standardized credit application formats. In some banks, new credit manuals have been completed and draft manuals for dealing with problem loans have been prepared. Most banks are running large training programs in credit analysis. Little training has been undertaken, however, in recovery strategies and corporate finance packaging. Not all foreign twinning banks have been allowed immediate and full access to data relevant for building new policies and procedures. Problems have also been posed by confusion over decision-making responsibilities of different organizational levels of the counterpart, including supervisory boards, with regard to large lending operations and troubled asset restructuring.

The counterpart banks' managers, while unfamiliar with certain types of risks and risk management techniques, have quickly perceived the importance of asset and liability management. Counterpart staff are perceiving work in the treasury area, which is new and non-contentious, as potentially rewarding. Some banks have completed the organizational structure of the treasury function, including the creation of asset and liability management committees. These banks have generated substantial profits through short-term interbank placements of excess liquidity previously kept in unremunerated balances with NBP. Constraints are posed by the poor quality of management information, and the quality and number of staff with risk management capabilities.

Progress in automation and management information systems (MIS) is mixed. Some counterpart banks have contracted with suppliers for a comprehensive, sometimes very expensive capability. Others have upgraded, with limited investment, their core processing capabilities, and are planning to use their strategic plan as the basis for purchasing a comprehensive MIS capability. Still others have chosen to first detail their strategic information needs and organizational structure. The main bottleneck to quicker progress has been the need for the banks to first complete the modernization of their internal accounting systems. Progress in this area accelerated noticeably when NBP expanded and clarified its plan of accounts for supervisory reporting purposes.
Progress has also been made in the area of human resource development. Some banks have created a
data base concerning staff skills, and have introduced performance measurement and bonus systems.
While sizeable training programs are in place, however, most banks do not yet use adequate training
methodologies (e.g. case studies and ‘train-the-trainer’ approach) and structured training needs
analyses to target efforts. Few banks have addressed their overstaffing problem, which will become
increasingly apparent once their operations are fully automated. Lay-offs are hindered by low labor
mobility as a result of a severe shortage of affordable housing. This factor also may have driven some
banks to open new branches and hire new employees, rather than to reallocate staff of existing
branches.

Few counterpart banks have started to develop marketing strategies and tools. Some banks expect to
obtain an increased share of target markets as a result of rapid growth of demand for banking services
ensuing from privatization and private sector development. Others have undertaken market research,
often in support of strategic planning, and occasionally using newly emerging external market survey
bureaus. Given other urgent priorities, particularly in the credit area, there is a risk that counterpart
management will pay insufficient attention to developing a more proactive marketing stance.

Progress in internal audit has been limited. While most counterpart banks have hired additional audit
staff, they are just starting head office function audits. For historical reasons, internal auditing is still
perceived by counterpart staff as an uninteresting profession, and the banks have difficulty attracting
staff with modern audit skills.

There are indications that the twinning arrangements, while only one factor among many influencing
their financial position, are generating positive financial results for the Polish banks. One area where
gains are apparent is in asset and liability management. More generally, portfolio reviews and audits,
commissioned by the Ministry of Finance point to more autonomous, market-oriented lending practices,
contributing to a reduction in future losses. Increasingly, banks are asking their customers to provide
them with enforceable security for their loans, where previously unsecured lending was the norm. In a
significant number of cases, banks have actively initiated foreclosure on enterprise assets or have
petitioned for formal bankruptcy or liquidation of enterprises. Action of this nature has become
significantly more pronounced with the creation, at the instigation of the Ministry of Finance, of bad
loan departments in the banks, charged with the task of resolving problem loans. The banks also have
managed to keep loans to loss-making state-owned enterprises more or less stable in real terms. While
the Ministry of Finance instructed the banks early in 1991 no longer to extend new loans to borrowers
classified by external auditors as doubtful or loss, the banks themselves also have shown an increasing
awareness of the risks they face in lending to non-restructured enterprises which continue to be state-
owned. With the economy in recession, there have been few attractive alternative lending
opportunities. In this environment, the banks have resorted to less risky uses of funds such as short-
term interbank lending and investment in government securities.

The efforts by the banks' management to become independent, commercially operated banks can also
be seen in the diversification that has taken place in their funding base. In the period 1989-92 the banks
significantly reduced their dependence on NBP refinancing as a source of funds, and successfully
attracted a large share of household and private enterprise deposits. Increasingly, banks are using interest rates as a tool to compete with traditional monopolies in the deposit taking area, such as the Polish savings bank, PKO BP.

The Polish banks also have significantly widened the range and quality of the services they offer (e.g. foreign operations, credit cards, Euro cheques). Most notably, banks' headquarters and key branches have been physically upgraded. The attitude of management has changed, with managers demonstrating a noticeably stronger commitment to preserving their banks' assets and financial integrity.

Generally, co-operative relationships have evolved between the foreign twinning banks and the counterpart banks. There have been numerous visits of teams of counterpart management to the headquarters of the foreign banks. Some foreign banks have provided assistance to their counterparts in developing work-out plans for individual bad loans, going beyond the original scope of work envisaged under the twinning arrangements. Not all twinning arrangements, however, have been equally successful. As is apparent from the earlier description of progress in individual modules of work, there are differences in the speed with which the Polish banks are acting on the foreign banks' advice, driven primarily by variations in the philosophy and sophistication of counterpart management. Also, there are differences in the extent of flexibility the foreign banks have demonstrated in the staffing and timing of the provision of services. These and other factors are likely to be important determinants of success or failure.

**Which Factors Contribute to Success of Failure, And What Lessons Can Be Learned?**

*Commitment to Twinning*

Counterpart management must be committed to the twinning arrangement. If management is resistant to change, or unwilling to acknowledge its inexperience and to accept the foreign bank's recommendations, the chances of a successful co-operation emerging are slim.

One way to tackle management resistance would be to allow foreign banks to act in a line (i.e. decision-making) capacity, rather than in a purely advisory capacity. There is a risk, however, that allowing foreign banks to assume line responsibility will backfire, if it is perceived by the authorities as selling out to foreign interests. Also, shifting decision-making authority to foreign bank managers may weaken the counterpart management's sense of responsibility and may undermine the spirit of a twinning arrangement. A less drastic alternative would be to allow an independent third party to perform quality control on the services provided by the foreign bank and on the co-operation by counterpart management, and to arbitrate in case of disputes. The quality of twinning services is hard to measure, and counterpart management, due to its inexperience, cannot be relied upon to make sound judgments. Using independent outsiders may help overcome counterpart management resistance. It may also be advisable, rather than defining terms of reference up-front, to split a twinning arrangement into two separate phases, a diagnostic phase and an implementation phase. During the diagnostic phase, the foreign bank and the counterpart bank can then work together to define in more detail the scope of
work to be undertaken during the implementation phase, thereby building counterpart commitment to the arrangement.

Commitment to a twinning arrangement by counterpart management may become apparent in the extent to which the counterpart bank is willing to pay for the twinning services. In the case of the Polish twinning arrangements, the counterpart banks paid fully for the services, thus strengthening their interest in receiving maximum benefits out of the arrangement. There is, however, also a possible downside to the counterpart bank paying 100% of the costs of the services. In the Polish banks, there has on occasion been resentment of the large number of staff employed by the foreign bank, and of the high salaries paid to such staff. Inevitably counterpart management will compare their own salaries with those earned by the foreign twinning bank’s staff, who are often junior in rank.

One way to deal with such resentment would be to reduce the foreign bank’s project management staff to as low a level as is compatible with maintaining high quality of services, and to avoid multiple layers of project management in the field and at headquarters. Also, minimizing subcontracting arrangements might lower the foreign banks' staff costs. Allowing counterpart staff to be associated with the successful introduction of deliverables such as manuals, guidelines, etc. may stimulate staff enthusiasm for the twinning arrangement.

When the counterpart bank is very small in terms of total assets, however, it may be unrealistic or even irresponsible to encourage it to pay the full cost of a twinning arrangement. While twinning arrangements for smaller banks will require less resources, they are by their nature expensive and the counterpart bank should assess the maximum burden it could carry in relation to its normal operating costs and profit margins. Seeking a blend of grant and loan funding may be justifiable for smaller banks. A consideration to keep in mind in this respect is the extent to which such a blend of financing will impact on the level playing field between large (in Eastern Europe and the FSU mostly state-owned) and small (mostly privately owned) banks.

The foreign twinning bank must also be committed to the success of the arrangement. While it seems obvious that any foreign bank entering into such an arrangement is interested, the degree and the nature of individual foreign banks’ interest may differ. Some banks may be interested in twinning exclusively for the fee; capital adequacy standards are driving banks in the direction of pursuing more fee-generating business, as opposed to lending activities. Other banks may be interested in familiarizing themselves, through twinning arrangements, with the local market with a view to prospective lending operations or co-financing with the counterpart bank. Yet another factor influencing the commitment of foreign banks to twinning arrangements is whether or not they are allowed to open branches or subsidiaries in the country concerned, or whether they can enter the domestic banking market only through buying into local banks. In the latter case, entering into a twinning arrangement may be the only way for a foreign bank to gain access.

One way in which the authorities of a recipient country can influence foreign bank interest in twinning arrangements is to allow entry only though buying into local banks. By maximizing the existing banks' franchise value, foreign banks may be more easily persuaded to enter into and successfully conclude
twinning arrangements. Particularly small countries, where foreign interest is in any event limited, may benefit from such an approach.

A Flexible Approach

The foreign twinning bank should be able to respond flexibly to changes in planned time schedules for work to be delivered, and in planned staffing requirements. All seven Polish twinning arrangements have experienced delays in one or more modules of work. Foreign banks working with subcontractors, particularly consulting firms, may find it difficult to accommodate such delays. Also, during the implementation of individual modules it may become apparent that the technical proposal is deficient in certain areas or redundant in others. Thus, the foreign bank should be able to exchange or supplement staff already committed to the work. Another problem for foreign banks in these long-term arrangements is that they may have difficulty finding qualified staff willing or able to spend long periods of time in the recipient country.

One way to enhance flexibility would be to request the foreign bank to work with a very small resident staff, supplemented by periodic short missions from staff permanently employed in the foreign bank headquarters. Another possibility would be to limit the extent to which foreign twinning banks can use subcontractors. As already noted, limiting subcontracting is also likely to contribute to lowering the costs of a twinning arrangement; it may also avoid foreign banks becoming mere wholesalers of more traditional consulting services.

The counterpart bank should also be able to absorb effectively the advice provided by the foreign twinning partner. This requires full-time availability of key counterpart staff, as well as foreign language skills. As particularly the latter may be lacking, it may be advisable to request the counterpart bank to engage in language training as a precondition for a twinning arrangement. To avoid the risk of counterpart staff benefiting from language training and from technical training provided under the arrangement, then leaving the bank to earn higher salaries elsewhere, counterpart management may consider using incentive-based schemes to retain such staff. Incentive-based schemes are commonly used in Western banks.

Shareholder Control

It is important that some shareholder control is exercised over the counterpart bank's management, to keep it as much as possible under pressure to ensure that the arrangement is successful. In the case of Poland, the Ministry of Finance, as the banks' owner, has been able to exert such shareholder control effectively through the supervisory boards of the banks it selected and appointed. These supervisory boards were given significant powers to replace or otherwise correct management. When such control is absent, or supervisory boards themselves are reluctant to change, it will be much harder to implement twinning arrangements successfully.

Similarly, strong regulatory control exercised by the bank supervisory authority will enhance the chances of successful co-operation. By imposing regulatory constraints on counterpart management behavior, the foreign banks' recommendations will be reinforced. While there has been some delay in
implementing key prudential rules in Poland, NBP nevertheless has succeeded in ensuring that minimum controls are now in place. The supervisory authority also has an important role to play in steering counterpart management towards adopting sound accounting and auditing practices and management information systems, including loan classification and provisioning systems. Finally, a strong supervisory authority will also be able to provide assurances to foreign banks that the counterpart management is not dishonest. This may help in overcoming foreign bank aversion of twinning arrangements with private banks, where there is a larger risk of the foreign bank becoming associated with bank scandals. Thus, it would be advisable to supplement a program of bank twinning arrangements with a program to strengthen bank regulation and supervision.