



Phare

Progress and strategy paper
Banking

Series: PHARIS -

Progress and strategy paper

Banking

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Foreword

This paper is part of a series which will cover each of the main areas of Phare activity. It describes the nature of the problems faced in Phare's partner countries during their transition from planned to market economies. It goes on to examine actions undertaken to date, and to assess their impact on the transformation process.

There is clearly a need to ensure that the approach being taken in any given sector is relevant to the longer-term goals of economic transformation. For this reason, these papers also contain the thinking of those responsible for operating Phare on actions for the future and how Phare should contribute to the next phase of the transition.

The papers do not reflect any official position of the European Commission. They have been written by the Phare Operational Units and are intended as a stimulus to discussion for all those involved in the debate on economic transformation in central and eastern Europe.

Alan Mayhew

Relations with central and east European countries

The Phare Programme

The Phare Programme is a European Union initiative which supports the development of a larger democratic family of nations within a prosperous and stable Europe. Its aim is to help the countries of central and eastern Europe rejoin the mainstream of European development and build closer political and economic ties with the European Union.

Phare does this by providing grant finance to support the process of economic transformation and to strengthen newly created democratic societies. Phare also provides grant finance to help countries with Europe Agreements integrate with the European Union.

In its first five years of operation to 1994, Phare has made available ECU 4,283 million to 11 partner countries, making Phare the largest assistance programme of its kind.

Phare works in close cooperation with its partner countries to decide how funds are to be spent, within a framework agreed with the European Union. This ensures that Phare funding is relevant to each government's own reform policies and priorities. Each country takes the responsibility for running its own programmes.

Phare provides know-how from a wide range of non-commercial, public and private organisations to its partner countries. It acts as a multiplier by stimulating investment and responding to needs that cannot be met by others. Phare acts as a powerful catalyst by unlocking funds for important projects from other donors through studies, capital grants, guarantee schemes and credit lines. It also invests directly in infrastructure, which will account for more Phare funds as the restructuring process progresses.

The main priorities for Phare funding are common to all countries, although each one is at a different stage of transformation. The key areas include restructuring of state enterprises including agriculture, private sector development, reform of institutions and public administration, reform of social services, employment, education and health, development of energy, transport and telecommunications infrastructure, and environment and nuclear safety. Under the Europe Agreements, Phare funding is being used to make laws compatible with European Union norms and standards, and to align practices.

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Executive summary: Future orientation

A two-tier banking system capable of mobilising savings and allocating credit efficiently to competing investment demand is essential to the success of wider market reforms in central and eastern European countries. In view of this, Phare has been involved in banking-sector reforms since 1991, committing a total of over ECU 73 million in the period to the end of 1993.

This paper provides an overview of Phare activity in the banking sector. It begins by assessing the deficiencies of banking as inherited from central planning, and identifying the main assistance needs. These include developing the capacity of central banks to carry out their new roles, establishing the necessary legislative and regulatory framework, and enabling commercial banks to adapt to the new market conditions. It goes on to explain the specific objectives of Phare assistance to date. Apart from training and institutional strengthening, this increasingly covers restructuring and privatisation of state banks, and attention to the problem of bad debt. An assessment of Phare's impact in each of the priority areas follows, along with an analysis of the main constraints, both internal and external to Phare.

The paper concludes with strategic orientation for future action, drawn from operational experience:

- integrated assistance is needed because of interlinkages with the real sector. This is particularly evident in the problem of bad loan portfolios, which cannot be isolated from the question of enterprise restructuring. Assistance should increasingly be delivered through multi-disciplinary teams so as to address all sides of the issue
- government commitment in the partner countries has proved a decisive factor in the success of reform of the banking sector. A more proactive input to promote recognition of the sector's importance could encourage this
- intensified donor coordination has been important to avoid conflicting advice, but also allows Phare to focus on areas where it can make the most valuable contributions, for instance where European Union legislation exists
- institution-building: the ability of banks to operate within a market environment must be further developed. It is also essential that sustainable, in-country capacity for training should emerge. Aid delivered direct to the end-user rather than through a government department is proving particularly valuable in this respect
- privatisation: success in strengthening state banks is increasingly leading governments to embark on their privatisation. Assistance to determine privatisation strategy, perform due diligence audits, etc. can therefore be expected to form a growing part of Phare support to reform of the banking sector.

Section 1 - General

Introduction

The Phare Programme has been active in the banking sector since 1991. The basis for Phare involvement in this sector can be summarised as follows:

- Phare is concerned with the economic reform in the central and eastern European countries and an efficient banking sector is essential to the success of the wider economic reform process. The sector is also indicated as one of the priorities for Phare assistance by the recipient authorities.
- Phare addresses the need for the countries of central and eastern Europe to develop laws, norms and standards in the financial sector approximated to those of European Union Member States.

The latter point is particularly important in the light of the Europe Agreements signed since December 1991 between the Community and a number of central and eastern European countries (Poland, Hungary, Bulgaria, Romania, the Czech Republic and the Slovak Republic). These are a vehicle for progressive integration into the European Union. Moreover, the European Council decided at the Copenhagen Summit in June 1993 that associated central and eastern European countries could become members as soon as necessary conditions were met.

It is also worthwhile noting that the European Commission has considerable experience in the harmonisation of standards in the financial sector because of the body of European Union legislation in this field, particularly Directives in areas such as supervision and regulation of credit institutions, as well as annual and consolidated accounts of banks.

Role of banking in the reform process

The development of a strong banking sector is crucial to the process of transformation from centrally-directed economies to market economies in the central and eastern European countries. This is because an efficient banking system contributes to the growth of an economy through the mobilisation and allocation of savings to productive investment. Without this process, the success of reforms in areas such as agriculture and private sector development could be prejudiced. Viable enterprises would find it difficult to obtain the necessary financial resources to enable them to operate in a market economy.

Within each of the central and eastern European countries, the banking sector has had to grapple with the transformation from a single-tier banking system involving a single credit institution providing credit to enterprises on the basis of a budget calculation determined from the central plan, to a two-tier banking system. This involves a separate central bank acting as a monetary authority, plus independent commercial banks providing a range of services, including credit, to enterprises on the basis of an assessment of commercial risk.

The policies employed by different countries to achieve this process have varied. In some countries, such as Poland, regional banks have been created out of the commercial activities of the central bank. In other countries, such as Romania, commercial banks have been created on the basis of sector specialisation such as agriculture, industry and trade.

All central and eastern European countries have now achieved a two-tier system. In all countries, new private banks are emerging to compete with the old state banks. However, transforming the basic structure is just the first step in the deeper transformation needed to create a modern market banking system. Further changes are required at an institutional level and in the approach of bank staff, managers and owners before the key functions required of the banking sector in a modern market economy are available. These functions are:

- efficient credit allocation to competing investment demand
- safe repositories for savings (that are competed for on the basis of service and interest rate)
- transferring funds cheaply, promptly and efficiently.

A banking sector that is not capable of performing these functions is not effective and hinders domestic investment rather than acting as a catalyst encouraging such investment.

Links between the banking and real sector

It is clear that the banking sector, and the Phare programmes within the banking sector, cannot be looked at in isolation from the real sector. Horizontal legislation in fields such as company law, ownership rights or bankruptcy law can have important implications for banks and the way they operate. Conversely, the actions of banks in matters such as the granting of credit and transfer of payments can have important repercussions on enterprise growth and the way that enterprises operate. For example, restrictions on bank lending can lead to an increase in inter-enterprise arrears.

This interlinkage is perhaps even more important in connection with the extensive bad loan portfolios of banks in many central and eastern European countries. It is impossible to restructure such banks without addressing the restructuring of the enterprises that form the bulk of their bad loan portfolios. These are clearly important factors for bank and enterprise restructuring programmes.

Assistance needs in the banking sector

The needs of the banking sector vary from country to country but certain needs tend to be universal in the central and eastern European countries.

Central banks need to be organised and equipped to carry out the functions expected of a central bank in a modern market economy.

This would include monetary and fiscal policy, foreign exchange reserve management, foreign exchange operations and the smooth operation of payment systems. The need for intervention in payments systems is demonstrated by the large number of cash transactions in the countries of central and eastern Europe, which in part reflect the difficulties in using alternatives. For example bank transfers can take several weeks in some countries.

The central bank (or other competent authority) must also be equipped to supervise and regulate the commercial banks and other credit institutions.

It is important to recall that, until very recently, central banks did not exist in Estonia, Latvia, Lithuania, Slovenia or the Slovak Republic.

The introduction of a comprehensive and coherent legislative and regulatory framework is required.

A legislative and regulatory framework is instrumental for the proper functioning of the banking system. While in most countries basic banking legislation has been enacted, it is sometimes piecemeal and may require redrafting, especially to remove discrepancies with new legislation in other areas.

Bank staff need retraining in the techniques required in a modern market economy.

This is a huge task, considering the thousands of bank staff that have to be trained to achieve the critical mass necessary to effect widespread change in attitudes as well as procedures. This is shown in Table 1 below:

Table 1 - Numbers of banking staff in selected countries (1992 figures)

Country	Banking staff	Population (million)	Ratio (population/ banking staff)
Romania	40,000	23.0	575
Czech Republic	48,000	10.3	215
Poland	150,000	39.0	260
Slovenia	7,000	1.9	271
Slovak Republic	18,000	5.2	288
Latvia	4,000	2.7	675
Denmark	50,000	5.1	102
Italy	333,000	57.2	171

The number of bank employees is growing fast. In Poland, the number of bank employees was 40,000 in 1989, growing to 80,000 in 1991, before reaching the 1992 level of 150,000. This imposes a strain on training resources that are already stretched. It is also likely that numbers of bank employees will continue to grow if one compares the ratio of bank staff to population in European Union countries, such as Denmark and Italy, with that in central and eastern European countries.

Many banks do not lend in accordance with standard, commercial criteria prevailing in the West.

Such commercial criteria would include evaluation of the potential borrower in terms of risk, while comparing this lending opportunity with other potential lending opportunities that the bank might have. This deficiency is the result of a number of factors:

- banks do not always have adequate experience in commercial credit assessment

- the state is often still involved in the lending decisions of state-owned banks. Hence bank lending may be directed to enterprises that cannot repay these loans
- banks are often undercapitalised and therefore have limited funding sources
- they are burdened by large portfolios of bad loans which need to be dealt with to allow the banks to concentrate on new business.

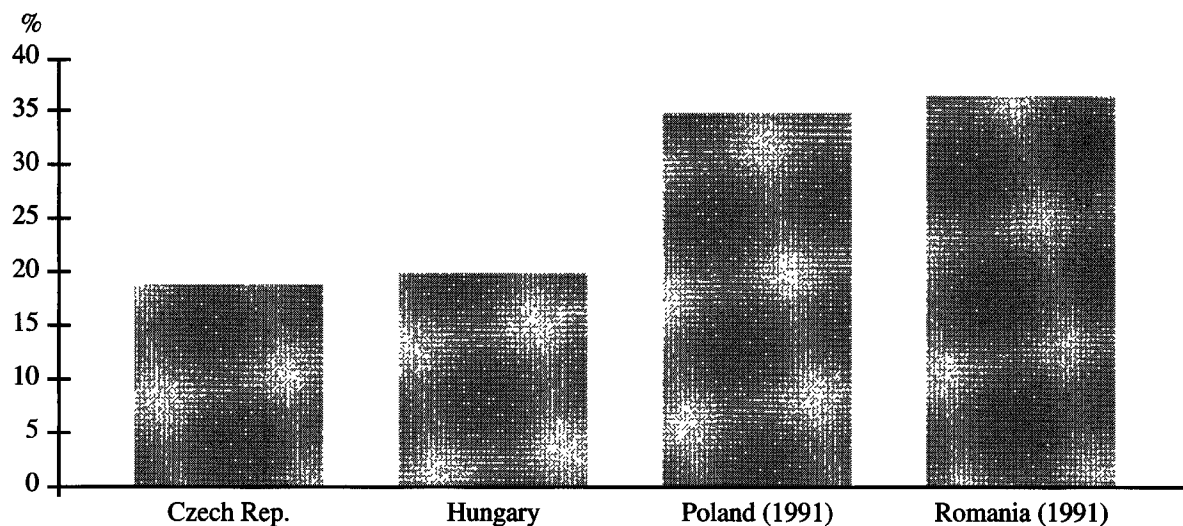
This last factor alone will require substantial resources, both from external sources as well as commitment from the partner countries themselves.

Bad debt

Many of the state banks were established with large portfolios of non-performing loans inherited from the previous system, as illustrated in Table 2 overleaf.

Table 2 - Bad asset comparison in central eastern European countries, (end 1992)

Substandard loans as percentage of total loans



Source: National statistics; EBRD; World Bank

The enterprises that comprise these portfolios need to be restructured while the banks themselves need to be recapitalised. This can present problems in terms of political will, because recapitalisation entails the commitment of significant financial resources from the state budget. Given the number of conflicting demands on scarce budgetary resources, governments can be cautious about committing resources to a sector which is often perceived as wealthy. The question of taxation of bank profits is a factor here. If bad loans are recognised and provisions made against them, this reduces the bank's profits, resulting in a significant reduction in government revenue from this source.

It is important that any solution is a 'one-off' process linked to restructuring both the enterprises concerned and the bank itself. Otherwise the bank might continue to make loans to 'non-deserving' enterprises, necessitating a repeat of the bailout process.

There is a need to create competition in the banking sector

This is true both on the deposit side and the lending side.

- on the deposit side, the State Savings Bank usually benefits from a state guarantee. Other banks, in particular the private commercial banks, cannot in general offer similar safeguards, in the form of either guarantee or insurance, to depositors

- on the lending side, the state banks often tend to dominate a particular market (whether geographical, as in Poland, where the state-banking system has been divided geographically, or sectoral, as in Romania, where banks have been created for individual sectors such as agriculture).

Most state banks need to be reorganised institutionally

Their structure in many cases still reflects the fact that they are official institutions rather than commercial banks. For instance, some banks may not be familiar with concepts and practices such as marketing their products, customer service and risk evaluation. Management and procedures need to be transformed while strategies and business plans need to be thought-out and implemented.

This reorganisation may occur within the framework of a government-sponsored restructuring for the whole sector and is, by necessity, often linked to solutions to the bad loan portfolios of the banks.

Section 2 - Phare assistance programmes

General

In response to demands from the beneficiary authorities, there were 13 Phare programmes (in 10 different countries) with a specific banking component up until 1992. The first of these, Hungary started in March 1991. Most programmes are designed to last three years, and the majority are therefore still ongoing.

In 1993, a further 10 programmes were launched in all Phare partner countries except Lithuania. This does not include certain small and medium-sized enterprises or agricultural programmes where technical assistance is given to a specific bank or banks to assist disbursement of credit lines or guarantee schemes in those sectors.

These programmes have been of three types:

- **General Technical Assistance Facilities (GTAF)**

General Technical Assistance Facilities dealing with several sectors, of which the financial sector is one

component, and the banking sector a sub-component.

- **Financial Sector Programmes (FSP)**

Financial Sector Programmes which are programmes designed solely for the financial sector, of which banking is a major component along with accountancy, taxation, insurance and capital markets.

- **Private Sector Development (PSD)**

In 1993, Private Sector Development Programmes have been introduced. These generally include sectors such as privatisation, small and medium-sized, investment promotion and enterprise restructuring, as well as the financial sector. They emphasise the interlinkage between these components.

Table 3 below lists all the programmes undertaken in each beneficiary country, by type, and shows the total sums made available up to 1993. Annex I provides further details about the specific type of activities carried out in each of the central and eastern European countries.

Table 3: Programmes by country

Country	Year	Programme Type	MECU
Albania	1992	GTAF	0.5
	1993	PSD	0.5
Bulgaria	1991	FSP	5.42
	1993	FSP	3.0
Czech Republic & Slovak Republic	1991	GTAF	3.4
	1992	GTAF	2.8
	1993	PSD (Czech)	3.5
	1993	PSD (Slovak)	2.0
Estonia	1992	GTAF	1.1
	1993	GTAF	0.5
Hungary	1990	FSP	3.0
	1991	FSP	5.45
	1993	FSP	1.5
Latvia	1992	GTAF	1.5
	1993	GTAF	0.8
Lithuania	1992	GTAF	1.6
Poland	1991	FSP	10.9 (*)
	1993	FSP	7.5
Romania	1991	GTAF	3.3
	1992	FSP	3.5
	1993	FSP	10.0
Slovenia	1992	GTAF	1.1
	1993	GTAF	1.0
TOTAL	1990-1993	ALL	73.87

(*) ECU 4.0 million transferred to banking sector within FSP in 1993 to fund workout units.

Objectives

Actions in the banking sector contribute to the attainment of general objectives of the Phare Programme as a whole, namely:

- to assist the transition to a market economy
- to encourage private sector development
- to support the economic reform process.

The objectives of actions in the banking sector are also framed in broad terms, such as establishing an effective banking system or improving/strengthening the banking sector. The breadth of these objectives reflects the fact that the banking sector is presently subject to rapid changes and evolution. Hence it is important for the programmes to be flexible in response to these changes, especially where these involve fundamental shifts in government policies.

Within this context, specific objectives, which in turn govern the main areas of assistance as set out in the financing memorandums negotiated for each programme between the Commission and the national authorities concerned, include:

- assistance to central banks and supervisory authorities to perform their roles efficiently and to assist them to regulate and supervise credit institutions
- assistance to commercial banks to develop their ability to allocate credit on the basis of an evaluation of commercial risk and competing investment demand
- the improvement of the capacity of payment and clearing systems to transfer funds promptly and efficiently
- the development of sustainable, in-country capacity for bank training
- to help the state banks address the problem of their non-performing loan portfolios inherited from the old system
- the institutional strengthening and modernisation of the commercial banks.

Differentiation by country

The type, scale and progress of banking sector programmes in each of the central and eastern European countries is influenced by several country factors, including:

the stage of transition in the reform of the banking sector of each country

This may not be the same as the general stage in the overall transition to a market economy. For example, the Slovak Republic may be regarded as being at an intermediate stage in the general transition, but its central bank is at an early stage of transition because of the split of the former Czechoslovakia.

the general perception of the banking sector by the authorities

Where the banking sector is perceived as one of the major agents of change requiring external support, more Phare resources can be devoted to it, reflecting the way Phare works in partnership with the central and eastern European countries and responds to their priorities. Poland is a good example of a country where the government is focusing resources on the banks.

Main areas of assistance

The major areas of assistance defined in the financing memorandums are governed by the specific banking sector objectives set out earlier. They comprise:

- central banks (mentioned in all programmes)
- training/banking institutes (mentioned in all programmes)
- institutional strengthening of commercial banks (mentioned in most programmes)
- restructuring of commercial banks (mentioned in some programmes)

From 1993, there is increasing mention of assistance to Workout Departments (Poland, Romania, Slovak Republic) or to special restructuring vehicles such as the Bank Restructuring Agency in Slovenia. This reflects the increasing perception of the state banks' non-performing loan portfolio being one of the core banking sector issues to be addressed.

Privatisation of banks is also being introduced to banking programmes as recipient governments determine that banks are ready to be privatised.

Annex I shows which of these areas of assistance have been covered in each of the central and eastern European countries.

Main mechanisms of assistance

There have been five principle mechanisms of assistance:

Feasibility/strategic studies

This type of project has been carried out in a number of areas. Predictably, it tends to be required more frequently during the earlier stages of banking reform, when background information for policy decisions is lacking. Initially, studies were wide-ranging, covering a number of issues. Later studies have usually focused on particular institutions or sectoral issues.

Examples of focused strategic studies would be the short-term inputs by consultants in Latvia in late 1993. These assisted the authorities in addressing the problem of the 'missing asset' in the Krajbanka (Savings Bank) and the problem of compensating the newly-formed Unibank for its inherited portfolio of non-performing loans.

Short and long-term advisers

Advisers have been used in a number of positions to act as catalysts for change and to provide 'on-the-job' training. Examples of long-term advisers are the expert in banking supervision and regulation at the Czech National Bank, a strategic adviser at the Romanian Development Bank in Romania and an adviser in bank restructuring at the Central Bank in Estonia.

Teams of advisers bringing different skills to an institution are also used. An example of this would be the team working on areas such as asset and liability management, credit analysis, information technology and accounting at the Ljubljanska Banka in Slovenia.

Operational audits

These are forward looking, diagnostic audits rather than financial audits. They are particularly useful in banks which need reorganisation. In such cases, the consultants can analyse different operational areas, treasury, credit, information technology, human resource development, organisational structure and internal audit, and recommend improvements, within the parameters of an overall strategy or business plan that has been agreed with the management.

Specific portfolio audits have also been carried out to assess the level of bad debt in the banks' credit portfolios.

Supply of equipment

The Phare principle in this area has been to supply equipment within the context of a coherent programme.

This would mean, for example, establishing the needs, the information flows and the production required from a computer network before financing the purchase of the computers. In general, Phare does not provide stand-alone equipment in the absence of an overall plan for reform or reorganisation. Very often, Phare will supply one component of a multi-component project. This is particularly the case in projects where there are clear arrangements for implementation, and where other sources of financing are involved.

Workout Units

These are a relatively recent form of assistance, first used in Poland. Phare assistance in this area emphasises the integrated approach to enterprise and bank restructuring. The Workout Units are departments within banks, specifically concerned with the recovery and restructuring of bad and doubtful loans. In Poland their role has been enshrined in legislation giving the banks specific responsibilities within a conciliatory procedure which is outside the courts.

The restructuring is both financial and physical. The aim is to recapitalise the banks, while at the same time addressing the root cause of the need for recapitalisation, namely the unprofitable and unviable nature of the enterprises which form the bad debt portfolios of the banks. The inter-linkage between the banking and real sectors has now been recognised. This will have important implications for the structure and form of support for reform in the banking sector.

Section 3 - Progress and achievement of objectives

Measuring progress and achievements

The quantitative impact of the Phare programme in the banking sector, in terms of the specific inputs provided, is relatively easy to gauge. Annex II gives details of the concrete measures which have been taken, by country.

The qualitative impact of the Phare contribution to banking reform is much harder to assess. This is because it is subject to a number of factors, including the general economic situation, the government's commitment to reform and the actions of other donors. There are also difficulties in measuring, at this stage, the success of actions whose ultimate objectives, for example contributing to private-sector development, can only be fully delivered over the long-term.

Nevertheless, certain indicators are available, namely the universal assistance needs of the banking sector in the central and eastern European countries. An assessment of achievements according to these criteria is made below.

General assessment

In general terms, the impact has been greatest where there are clear government strategies and policies for the sector. This facilitates Phare's task of supporting reform and restructuring, because it is then possible to devise a tailored programme to support the specific government objectives.

This has been demonstrated most clearly in Poland, where the authorities have adopted an integrated approach to the problem of bad loan portfolios of the state-owned banks. Legislation has been enacted and government funds committed, with a view to recapitalisation of the banks and restructuring of the enterprises forming the bad loans. Phare programmes have been designed to play an active role in support of this process.

The authorities in Romania have also recently drawn up a medium-term economic and social reform programme.

Impact has also been greater in cases where there has been coordination of assistance with other bilateral and multilateral donors and institutions, improving utilisation of resources and avoiding conflicting advice. Many of the projects with the greatest impact have occurred:

- where donors have joined together to put their combined weight behind a project for instance the McKinsey project on bank restructuring in Romania involving inter alia, the World Bank, EBRD and Phare, or
- where donors have coordinated to ensure that there is no duplication of effort, for example, assistance to the National Bank of Slovakia involving the IMF, cooperating European Union central banks, USAID and the UK Know-how Fund.

Often donors offer different abilities and areas of comparative advantage and it is important to maximise the benefit which can be derived from this. There are also obvious advantages in being aware of the latest developments and thinking in the banking sector. Joint missions and the free interflow of information should be encouraged. Activities of other donors also have implications for programming.

In many cases, Phare technical assistance can open up lending opportunities for institutions such as the EBRD. This has happened, for example, in Romania where support in the information technology area to the Romanian Development Bank, through operational audits, IT strategic plan up to invitation to tender and analysis of bids, has assisted the EBRD in approving a loan to the bank for equipment.

Assessment against specific assistance needs

Central banks

Phare assistance has made an impact in one or two key areas such as central bank accounting and the prudential supervision of banks, which are areas where the European Union has experience in harmonisation of national regulations and standards. Activity has also focused on these subjects because other areas, such as monetary and fiscal policy, have been handled by other donors, notably by the IMF and bilateral assistance from western central banks.

The countries where there have been substantial contributions in the area of supervision of banks include the Czech Republic, Romania, Latvia and the Slovak Republic. This has led to improved working methodology and procedures and an increased capability to perform this task effectively. For example, first-hand experience of the assistance in banking supervision granted to what is now the Czech Central Bank, led the Slovak National Bank to request similar assistance, which has since been provided.

More recently, projects have been designed to support the on-site audit function of central banks. One purpose has been to enable the supervision department to investigate troubled banks for example, those where the full extent of the bad loan portfolio is not known but is thought to be significant. Another has been to expand the information received by central banks from commercial banks through the off-site reporting mechanisms. Assistance of this type has proved especially useful where central and eastern European central banks do not have enough staff or experience to carry out such functions.

The supply of equipment to central banks and supervisory agencies in the Czech Republic and Hungary has improved potential productivity and capacity. However, the exploitation of these advantages depends on the management of these institutions and reform elsewhere in these bodies.

Another problem area has been payments and clearing systems. These are often slow and inefficient, and are therefore largely bypassed, with many transactions being carried out in cash. One of the main obstacles to resolving this problem had been difficulty in ensuring the necessary cooperation of the major players in the central and eastern European countries concerned, that is the Central bank, the Ministry of Finance and the banks themselves. There have now been several projects to improve the functioning of these systems in Poland, Romania, Hungary and Slovenia. Generally, these involve processes such as standardisation of payments instruments and formalisation of clearing procedures throughout the whole of the banking sector in a given country. Improvements in speed, reliability and security of payments systems should be seen.

Legislative Framework

Several donors have been active in assisting the central and eastern European countries to prepare the legislative framework needed for a market economy. Sometimes such projects have focused on one sole sector, and there has been insufficient consideration of the interaction with legislation in other fields, such as banking. Nevertheless, this situation appears to be improving, owing to growing realisation among both donors and the central and eastern European countries that legislation sponsored by different ministries needs to be made coherent. Improved donor coordination is also playing a part.

Phare involvement is also being requested increasingly by the central and eastern European countries to help ensure that their legislation is made compatible with that in the European Union, so as to facilitate their ongoing integration. Progress is now being made in this area. A development which is having particular impact in this regard is the tendency towards framework contracts with advisers for assistance across a wide range of commercial and financial legislation. Such frameworks have been set up, for example, in Estonia, Latvia and Lithuania.

Training

Banking training has been one of the important elements of Phare support, with training capacity strengthened, and considerable numbers of bank officers trained in areas such as credit analysis and bank accounting.

Nevertheless, impact has not been uniform across the region, partly as a result of constraints which have been encountered within the countries themselves, such as:

- the need to deliver training through a combination of training institutes which may exist but need reorganisation, and the banks' own in-house training capacity, which may not exist at all
- the lack of awareness that training is part of human resource development generally, rather than an isolated operation
- the sheer scale of the problem - there are, for instance, 150,000 bankers in Poland; 40,000 in Romania)
- the difficulty in getting the right trainees on the right courses. Participants often appear to have been selected by banks on the basis of availability, rather than suitability.

Ongoing evaluation by Phare has helped to improve the impact over the period. Early projects tended to involve the provision of individual training courses. Later projects concentrate on establishing comprehensive training programmes and developing institutions to deliver them, usually through banking institutes or through the banks themselves.

Donor coordination has been very important in the area of training to avoid duplication of effort and to ensure that assistance is effective. This is perhaps best demonstrated in Romania, where a grouping of international and bilateral donors are providing advisers and assistance to the Romanian Banking Institute in a coordinated effort to create a comprehensive and coherent programme to address the needs of Romania's 40,000 bankers.

Lending

Phare is making an impact in this area primarily through training but also through the provision of credit advisers to provide on-the-job training and to lead by example.

Bad loans

Phare is also assisting state banks to address the problems of bad loan portfolios, notably in Poland, Romania and Slovenia:

- Phare involvement in providing assistance to Workout Units in Poland is involving Phare in the very heart of the problem of restructuring the banks and enterprises in that country. The responsibilities given to the banks under the enterprise and bank restructuring law are very extensive.

The banks have been given the right to initiate restructuring of enterprises and to manage conciliatory procedures that can result in a range of options, from debt-for-equity swaps, through sale of loss-making subsidiaries, to liquidation. The banks will require substantial know-how for this task and significant funds have been made available by Phare to meet this challenge

- in Romania, Phare has been instrumental (by funding an EBRD project under the Bangkok Facility) in focusing the attention of the Romanian authorities on the bad loan portfolios of the state banks there, in particular by making clear that recapitalisation of the banks and the restructuring of ailing state-owned enterprises cannot be resolved if tackled separately. This study also proved useful in coordinating donor assistance by acting as the catalyst to create an Advisory Committee on Financial Restructuring, comprising the World Bank, EBRD, Phare, EIB and several other bilateral donors. This body advises a Financial Restructuring Action Committee comprising Romanian ministries, banks and other entities involved in the restructuring
- in Slovenia, the authorities have enacted a law on the rehabilitation of banks and savings banks. It is envisaged that bonds to the value of DM 2.2 billion will be issued to support this process. Within the context of the rehabilitation programme, Phare is providing assistance to banks requiring restructuring and to the Bank Rehabilitation Agency itself.

Creating competition

On the deposits side, competition is hampered by the absence of deposit insurance or guarantee funds for the competitors of the State Savings Bank, which by contrast continues to benefit from a state guarantee. Projects are planned in Hungary and Poland to examine the best way to protect the interests of depositors at commercial banks, particularly individual depositors.

On the lending side, Phare has assisted several banks to reorganise their operations, allowing them to become universal banks rather than banks specialising in, or monopolising, certain sectors.

Reorganisation and restructuring

Operational audits have proved very successful in defining key areas of further assistance within individual banks. This has been demonstrated most clearly in Romania, where assistance in Information Technology, credit policy and general implementation of strategic plans is underway. This technique is now being used in other countries such as the Czech and Slovak Republics, Bulgaria and Estonia.

The audits have also helped quantify the extent of the bad loan problem and have introduced the concept of International Accounting Standards to the banks. Their results have also been used to help the World Bank, EBRD and other international financial institutions to clarify policy and strategy.

Similar reorganisation of specific areas within a bank is also being put in place in Slovenia where a team of experts in asset and liability management, credit analysis and information technology is being provided for Ljubljanska Banka in cooperation with the Agency for Bank Restructuring.

Section 4 - Constraints

Constraints can be divided into internal constraints, created by the rules and regulations of Phare itself, and external constraints, arising from the environment in which banking sector programmes operate.

Internal constraints

Partnership approach

The partnership approach of the Phare programme, whereby partner countries determine the priority areas for assistance within a framework established by the European Union, has the advantage of allowing Phare to respond flexibly to the specific reform needs of the individual central and eastern European countries. On the other hand, in the banking sector, it has often resulted in shopping lists of actions drawn up by the recipient authorities. These sometimes seem designed more to ensure equitable distribution among all interested parties of the budget allocated to the banking sector than to tackling its core needs. Such an approach can be expected to produce fewer benefits over the medium and long-term than a more focused strategy would deliver.

Delivery mechanism

A major constraining factor is the inadequacy of delivery mechanisms. These have to be built up over time, delaying the implementation of programmes. For instance, Programme Management Units can take up to six months to be established, due to legal protocols. Other delivery mechanisms, such as training institutes or methods of administering legal or central bank assistance, all require time and coordination to strengthen them or put them in place.

Phare procedures

Phare involves the disbursement of significant amounts of public funds. This disbursement needs to be controlled and is therefore subject to complex and exhaustive procedures for approval of programmes, and for procurement. These procedures can be less flexible and expeditious than would be demanded by the rapid evolution of the banking sector in the partner countries.

External constraints

Government commitment

Inadequate government commitment in the partner country can prevent banking programmes from having meaningful impact. If a favourable environment is not created, through legislation and the financial commitment of the authorities, it is difficult for Phare to tackle effectively the core issues in the sector, such as bad loans. Equally, if the national strategy is unclear, or is not stable and predictable, similar constraints can follow.

Recognition of the role of banking in economic reform

Donors and governments have been slow to appreciate that a proactive approach is required to strengthen the role of the banks as the lubricant of economic reform. At the same time, the banks themselves have so far failed to act as efficient financial intermediaries, providing finance to generate private-sector development. This failure has led to greater recognition by national authorities of the need for effective banking reform. It is also generally recognised now that a more coordinated and proactive approach to banking reform is necessary.

Extent of needs

The extent of the banking sector's needs is so great that no single donor is likely to make a significant impact, regardless of its level of funding. This is because each donor has different abilities and these must be coordinated to produce significant results. Even then, the size of the problem is very great. There are for instance 150,000 bankers to be trained in Poland alone; therefore it will take time to address these needs satisfactorily.

It should also be stressed that donors alone cannot satisfy needs on this scale indefinitely. Local training capacity and institutions therefore need to be developed and this takes time.

Size and capital of banks

Many central and eastern European banks are extremely small by western standards. This is partly the result of authorities wishing to encourage the creation of new, private banks. However, the removal of barriers to entry of new banks has resulted in a proliferation of banks that do not necessarily have the resources, either human or financial, to become viable. Recognition of this has led to merger and consolidation programmes in countries such as Bulgaria, while in Poland the central bank is attempting to encourage stronger banks to take over other banks which are in difficulty.

Lack of capital in both small and large banks is also a constraint for many banks. This is partially a function of the way many state banks were created, with low capital bases and with large portfolios of bad loans which require provisioning.

The combination of these two factors means that many banks may not be the ideal vehicles for efficient technical assistance.

Some idea of the scale of these problems can be drawn from the two tables in Annex III.

Finding appropriate advisers

Many areas of banking require specialist expertise. Given the scale of the demand, there are often supply side shortages, and it is sometimes difficult to find advisers who can combine the required specialist knowledge with external assistance experience. There is also intense competition for the limited number of suitable advisers, resulting from similar assistance needs in the New Independent States and other developing areas. These difficulties can be expected to increase as recession in the European Union eases and bankers find employment more easily in their countries of origin.

Section 5 - Orientation for future assistance

General policy

Focused assistance

Phare should concentrate on areas where it has a specific advantage in comparison to other donors. These advantages may result from the quantity and quality of funding available from Phare, or from involvement in areas where there is a specific Community policy, for instance, harmonisation of banking supervision.

Size of projects

In general, Phare should continue to develop larger-scale framework projects rather than numerous small projects that may be better addressed by bilateral assistance from European Union Member States.

This can often be achieved by formulating single projects to cover a number of issues in a more comprehensive manner within one project, rather than opting for several separate projects. For instance, if long-term advisers are provided, then the project should include sufficient back-up support to allow it to adapt and respond to quickly changing local situations. An example of this would be the bank restructuring project in Estonia, with a resident adviser who is able to call upon auditing assistance to assess the situation of banks in difficulty.

Integrated assistance

The extent to which reform of the banking sector is linked to restructuring of the enterprise sector was not fully apparent to the central and eastern European countries and to donors of assistance at the outset of the reform programme. It is particularly evident now, for example, in the context of the bad loan portfolios of the state banks, which are composed of industries which have to be restructured to be viable. The new role of banks in making credit available to enterprises on the basis of commercial criteria, including assessment of risk, also requires an integrated approach. Banks must develop credit appraisal at the same time as companies learn how to submit business plans, cash flows, etc.

Phare is responding to the consequent need for integrated assistance through the Private Sector Development programmes which were put in place in 1993. The importance of ensuring assistance which takes account of the interlinkages mentioned above will continue to govern Phare assistance to the banking sector in the foreseeable future.

Assistance for solving the problem of non-performing loans portfolios of the banks will continue to be one of the core areas where Phare assistance will be focused. This can be in the form of assistance to Workout departments of banks themselves, as in Poland, or to separate vehicles for this purpose, such as the Bank Restructuring Agency in Slovenia.

Whichever method is chosen by the partner authorities to deal with this problem, it is clear that restructuring of the enterprises forming the bad loan portfolios is a clear priority. Assistance for Poland envisages support in areas such as corporate banking, corporate recovery, debt-for-equity swaps, workout accounting, legal specialists and industrial specialists. The early experience here tends to show that, of these services, legal and industrial expertise is in most demand. It should be noted that much of the assistance is carried out in the enterprises themselves rather than the banks, even though both the banks and the enterprises benefit from the assistance.

The Polish experience certainly suggests that comprehensive, multi-disciplinary teams are required for this purpose. However, there is no point in providing such assistance where the legal and circumstantial framework does not exist to enable such teams to function efficiently. Such a framework necessarily includes such things as a workable bankruptcy law.

Government commitment

Where beneficiary governments have shown clear commitment to reform the banking sector, identifying it among their priorities, Phare can in turn make available significant resources for the sector. The Commission services involved in dialogue with national authorities during the programming stage should seek to promote recognition of the importance of the banking sector to the wider reform process.

Institution building

At this stage in the reform process, another priority area for Phare activity on banking reform is promoting the institutional capability of the banks and training institutes. Apart from a goal to be pursued in its own right, this is a positive consequence of those banking programmes where know-how is transferred direct to a bank rather than through a government department. The work carried out by Phare to date is invaluable in this regard.

Banks: on the basis of the operational audits and diagnostic studies carried out as part of earlier

programmes, it has been found necessary to build up the abilities of banks to operate in a market environment.

Experience has shown that teams from European Union commercial banks or teams of ex-commercial bankers are often best-suited to provide such assistance. This is because a wide range of banking skills are required. Credit analysis, treasury, accounting, information technology, trade finance, management information systems, internal auditing and personnel development skills are among the skills identified by recipients as needing most attention. Generally a mix of resident and on-call assistance has proved to be most appropriate. This combines the advantages of flexibility (as needs change and crises occur) with accessibility. It is also necessary that the operational consultant teams receive the requisite support from Head Office and are not just abandoned.

Training and training institutes: assistance in this area must now be geared towards developing sustainable, in-country capacity. Generally, the type of project best-suited to this objective would include:

- long-term advisors for banking institutes to develop programmes and facilities
- train-the-trainer programmes to develop a core group of local trainers
- developing the in-house training units of the banks themselves. Ideally, this should be complementary to building up the capabilities of the banking institutes, in that it would enable the banks to identify their training needs more easily, and provide more appropriate trainees for the institutes' courses
- distance learning is an ideal mechanism to reach a mass audience of bankers requiring training. However, it requires a methodical, lengthy development to ensure the most appropriate form for each country. Start-up costs are also very high.

Most progress on institution-building in the field of training can be observed where institutes have become independent of the central bank. Otherwise there is a risk of friction, since the institute can be perceived as an extension of the central bank's supervisory arm.

Financial investment and other instruments.

The European Council decided at Copenhagen in June 1993 that 15 per cent of future Phare budgets were to be devoted to infrastructural investment support measures. A case can be made for using a share of this in the banking sector. Investment is certainly needed, given the weakness of capital adequacy of many of the large state banks.

It remains to be decided at the time of going to press whether it is appropriate for these funds to be invested in the banking sector, in the light of the various competing demands for the limited resources provided under this facility. Moreover, if banking is identified as one of the sectors which should benefit, appropriate mechanisms and criteria for carrying this through remain to be devised.

Phare will be developing its policies in this area through structured meetings with Member States, partner countries and technical specialists from financial institutions during 1994.

Privatisation

Phare actions in favour of commercial banks have to date been aimed primarily at state-owned rather than privately-owned banks, simply because of the relative sizes of these subsectors. However, as state banks are strengthened and reach the point where recipient authorities wish to privatise them, the character of a significant portion of this aid can be expected to change.

Phare will be involved with national authorities in the privatisation process. Action may be undertaken, for example, to help determine privatisation strategy, to perform due diligence audits, identify strategic partners, and arrange private placements and/or public offerings.

Conclusion

Phare assistance to the banking sector is making an impact where there is recognition by the partner country of:

- the importance of an efficient banking sector in the overall development of market economies and the need for proactive support to achieve this
- the need to develop an integrated approach to break the vicious circle of self-reinforcing factors that both hinder real-sector restructuring and undermine the financial soundness of the banks.

Although progress has been made, a great deal remains to be done before the central and eastern European countries each have a banking sector able to perform the functions required of it in a modern market economy. Phare's experience in this field since 1991 puts it in a strong position to make a substantial contribution to the continuing process of financial sector reform in the coming years.

Annex I - Main areas of activity in the banking sector 1990-1993

	Albania	Bulgaria	Czech Rep.	Slovak Rep.	Hungary	Poland	Romania	Slovenia	Estonia	Latvia	Lithuania
Central bank	■	■	■	■	■	■	■	■	■	■	■
Payment systems		■	■		■	■	■	■			
Legal framework		■	■	■	■	■	■				
Deposit insurance		■			■	■					
Banking associations				■	■	■	■	■	■	■	■
Commercial banks		■	■	■		■	■	■	■	■	■
New financial institutions					■					■	
Banking institute	■	■	■	■	■	■	■				
Training		■	■	■	■	■	■	■	■	■	■
Privatisation					■		■				
Restructuring		■				■	■	■	■	■	■
Bad debts/Workout Units					■	■	■	■		■	
Support to credit lines	■	■	■	■	■						

■ Areas covered by Phare support

Annex II - Specific measures taken in the banking sector by country

There are 23 Phare programmes involved in providing assistance to the banking sector, with total funding of around ECU 74 million (of which ECU 31 million made available in the 1993 programmes). This support is divided between 11 different countries.

The quantitative achievements detailed by country are roughly as follows:

Albania

- long-term adviser on foreign exchange in place in Central Bank.
- assistance in credit management to the Savings Bank in relation to the SME credit line.
- short-term assistance to Central Bank to set up management information systems.
- assistance to the Bank Training Centre through equipment and an adviser is in the pipeline.

Bulgaria

- Programme Management Unit (PMU) established.
- training courses in various subjects.
- assistance in human resource development to Bulgarian National Bank.
- projects on payments systems, supervision and capital market regulation are scheduled to commence soon.
- operational and financial audits of three consolidated State banks are also programmed for 1994.

Czech Republic

- PMU established.
- several needs assessments carried out.
- numerous training courses arranged through banking institutes.
- two operational audits carried out
- long-term adviser in bank supervision in place at Czech State Bank (CSB).
- design and supply of an Information Technology system for CSB.

Estonia

- short and long-term advisers in bank training.
- long-term adviser in bank restructuring (plus audit back-up) based at the Bank of Estonia (BOE).
- institutional strengthening support to be supplied to Union Bank of Estonia.

Hungary

- provision of equipment to State Bank Supervision Agency and National Bank of Hungary.
- advisers and equipment have been supplied to the International Training Centre for Bankers.
- short-term assistance has been supplied to the Hungarian Bankers Association.
- PMU established on 1 September 1992.
- studies on mortgage finance, training needs assessment and National Deposit Insurance Fund.
- data security project at GIRO RT (payments network).
- long-term assistance to the Hungarian Bank for Investment and Development (Loan workouts and enterprise rehabilitation).
- project on distance learning for bankers

Latvia

- training-needs assessment and several training courses carried out.
- long-term advice in banking supervision at Bank of Latvia.
- assistance to develop strategy concerning State bank bad loan portfolios and the confiscated assets of the Savings Bank.
- an audit programme for the Latvian Universal Bank has commenced and assistance to the Savings Bank and a comprehensive training programme are envisaged.

Lithuania

- three financial and operational audits of major State banks commenced in March 1994.
- assistance to Central Bank, bank training and restructuring are areas where future projects have been identified.

Poland

- PMU established.
- numerous training courses for the National Bank of Poland (NBP), Polish Credit Unions, PKO BP, Polish Development Bank, Polish Bank Association, Warsaw and Katowice Banking Schools and Bank Pocztowy (Giro payment training).
- short-term consultants and studies for Polish Development Bank, National Clearing House, electronic payments, Ministry of Finance (Draft FX legislation) and prefeasibility study for operational audit of BGZ (Bank for Food Economy).
- six portfolio audits to obtain information on bad loan portfolios of State-Owned Commercial Banks (SOCBs).
- nine short-term experts for Workout Units of state-owned commercial banks.
- the largest banking sector project in Poland involves the provision of 35 man-years of know-how to the workout units of seven Polish state banks. Assistance includes corporate recovery, corporate analysis, debt-for-equity-swap expertise, legal and accounting expertise as well as several types of industrial expertise. The objective of this assistance is both financially and physically to restructure the enterprises within the bad loan portfolios of the banks.
- long-term assistance to develop strategic plan at PBG, Lodz.
- financial and operational audit of BGZ.
- on-site audit assistance to the General Inspectorate Banking Supervision (GINB).
- assistance to BIG Bank on restructuring of Lodzki Bank Rozwoju.
- projects in pipeline for diagnostic audit of PEKAO S.A, implementation of information technology strategy at BDK Lublin and workout assistance to BGZ.

Romania

- PMU established
- three strategic studies (savings bank, training and leasing).
- draft securities + stock exchange law drafted for National Bank.
- long-term assistance in supervision to National Bank.
- operational, financial and diagnostic audits of 4 main state-owned commercial banks
- long-term training adviser to Romanian Banking Institute.
- assistance to Romanian Banking Association.
- long-term strategic adviser at Romanian Development Bank, Romanian Commercial Bank and Banca Agricola.
- long-term credit advisers at the Romanian Commercial Bank and Romanian Development Bank.
- assistance in developing information technology plans in 2 banks.
- long-term adviser for development of the payments system.
- training units established within main banks, train-the-trainer courses funded.
- due diligence audit to prepare privatisation of Romania Development Bank.

Slovakia

- PMU established.
- several needs assessments carried out.
- numerous training courses arranged through Banking Institutes.
- two operational audits carried out
- long-term adviser in bank supervision in place at National Bank of Slovakia (NBS).
- development of new chart of accounts at NBS.
- strategic assistance to NBS to develop strategy concerning banks' bad loan portfolios.

Slovenia

- **assessment studies accomplished in Bank of Slovenia, Ljubljanska Banka (LB) and the payments system.**
- **team of experts to support LB (Credit, Asset and Liability Management, Information Technology and Management Accounting).**
- **comprehensive long-term assistance to develop payments system.**
- **assistance to further banks, the Bank Restructuring Agency and assistance to the Bank of Slovenia are in the pipeline.**

Annex III - Poland - Selected indicators for the nine state-owned commercial banks

Bank	total loans	non- perf. loans	total assets	capital	loans/ assets	capital assets	non-performing loans as percentage of:		
							loans	assets	capital
Pomorski Bank Kredytowy	7,927	1,349	13,774	1,498	57.6	10.9	17.0	9.8	90.1
Bank Depozytowo-Kredytowy	n/a	1,102	46,120	1,258	n/a	2.7	n/a	2.4	87.6
Bank Zachodni	5,737	979	107,980	1,328	5.3	1.2	17.1	0.9	73.7
Powszechny Bank Gospodarczy	13,468	681	22,099	917	60.9	4.1	5.1	3.1	74.3
Bank Przemyslowo Handlowy	13,237	741	31,091	1,712	42.6	5.5	5.6	2.4	43.3
Wielkopolski Bank Kredytowy*	7,352	1,100	108,021	1,418	6.8	1.3	15.0	1.0	77.6
Bank Slaski*	10,741	987	26,815	2,587	40.1	9.6	9.2	3.7	38.2
Powszechny Bank Kredytowy	12,089	969	25,971	1,683	46.5	6.5	8.0	3.7	57.6
Bank Gdanski	6,550	1,578	17,294	1,426	37.9	8.2	24.1	9.1	110.7
Aggregate	77,101	9,486	399,165	13,827	19.3	3.5	12.3	2.4	68.6

Non-performing loans as of 31 December 1991. All other figures as of 1 July 1992.

* Now privatised

(In billions of Zlotys)

Source: Central European, February 1993

Annex III - Estonia - Banks operating, by size of assets

March 1993 (millions of Kroons)

Name of bank	capital	assets
Social Bank	44.8	818.4
Northern Estonian Bank	44.3	656.6
Hansa Bank	29.9	575.4
Estonian Union Bank	57.1	495.4
Savings Bank	1	434.1
Bank of Construction and Industry	15.1	256.7
Estonian Land Bank	9.1	136.5
Tallinn Bank	11	134.5
ERA Bank	7.9	82.1
Nowe Bank	7	71.6
Estonian Investment Bank	70.9	70.9
Narva Commercial Bank	9.8	67.2
Estonian Credit Bank	14.1	57.4
Virumaa Commercial Bank	9.6	54.6
Revalia Bank	11.3	53.1
Esttex Bank	8.4	48.1
Rahvabank	7.1	46.7
Evea Bank	12.2	45.5
Estonian Foreign Exchange Bank	6.6	32.2
Innovation Bank	5.2	26
Keila Bank	5.5	23.6
Tallinn Business Bank	7.7	11.8
Baltic American Bank	4	10.6



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