Basic forms and impact of corporate governance in banking

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Banks play a key role in the corporate governance system. This role varies from one model to another. This is due to the banks' function as credit issuers, as banks still remain primary providers of credit to the economy, to their borrower monitoring function, as well as to their ownership functions performed within companies. Banks are also business entities, and as such they rank among some of the largest corporations on a global, regional and local scale. The interest in corporate governance in banking has been growing in recent years, primarily because of the sustained high share of debt financing of the economy, systemic transformations taking place in many countries, and the role of banks in ensuring financial stability. In Poland, we have been witnessing significant changes in the banking sector over the last dozen or so years, following the liberalization of the finance system and the consolidation and privatisation of banks. As a result, the ownership structure of some banks and the entire banking system has changed.

The purpose of the study is to determine the concentration of ownership and the structure of corporate governance in banks both in Poland and in selected OECD countries, as well as in emerging markets. Among others, we are looking for the answer to the question whether the ownership concentration observed in banks in Poland is also reflected in other banking systems.

The study was based on the data from the largest banks (those with total assets in excess of U$ 1 billion) from 23 countries. A total of 736 banks were analysed. The analysis covered the structure of ownership supervision. Listed banks were not treated separately. The study's findings were compared against the ownership structure of the companies operating in selected countries and in Poland.

Co-ordination of economic policies in the European Union. Part I

Konrad Szeląg

The co-ordination of economic policies of Member States was envisaged as early as the Treaty of Rome (1957). Consequently, relevant committees were formally established and appropriate procedures developed (among others, medium-term economic programmes). The Werner Plan (1970), which postulated, among other suggestions, the ultimate establishment of a decision-making centre for economic policy and a Community system for the central banks as well as the consequent shift from co-ordination to implementation of a common (economic and/or monetary) policy, was also a landmark. Nevertheless, the results of co-ordination were unsatisfactory and it could be said that as late as the early nineties there was practically no co-ordination of economic policies within the Community in the full meaning of the word.

The turning point proved to be the implementation of the Maastricht Treaty (1993) whereby some basic provisions related to EMU and a single monetary policy in the euro area were put in place. This also required the implementation of relevant regulations regarding economic policy. However, unlike the monetary policy conducted at a supranational level, analogous regulations could not be introduced with respect to economic policy. Thus, its development rests with individual EU Member States.

The central element of the co-ordination of economic policies are the Broad Economic Policy Guidelines (BEPGs), formulated on an annual basis by the EU Council based on a proposal submitted by the European Commission. The BEPGs are politically, but not legally, binding for Member States. It is a document consisting of two main parts: general economic policy guidelines for the Community and country-specific economic policy guidelines. It is of utmost importance to ensure supervision over the actual enforcement of the guidelines by individual states, under so-called multilateral surveillance. Additionally, the Commission prepares the Implementation Report annually. Once it is established that the economic policy of a given country is not in compliance with the BEPGs or constitutes a threat to EMU operations, the ECOFIN Council may send appropriate recommendations to such a country, and should these prove ineffective, makes its recommendations public. For the first, and so far, the only time, the Council – at the request of the Commission – sent a public recommendation to Ireland (in February 2001).

In the EU, the budgetary policies of Member States are also co-ordinated, and the key document in this area is the Stability and Growth Pact (1997). It is binding both politically and legally. The Pact imposes

on the governments of Member States an obligation to avoid excessive deficit (over 3% of GDP) and maintain medium-term public finance at a level close to balance or in surplus (which involves the operation of so-called automatic stabilisers). Any violation of the Pact's provisions leads to severe sanctions being imposed on participating Member States. They are under the obligation to put in place non-interest-bearing deposits, and in some cases those can even be replaced with financial penalties (as high as 0.5% of GDP). The procedure of excessive deficit does provide, however, for certain circumstances that allow for less strict interpretation of the Pact's provisions (e.g. a severe economic downturn). The Pact obliges the euro area Member States to develop medium-term stability programmes, whereas those states operating outside the euro area are expected to prepare convergence programmes. These programmes should, among other activities, establish appropriate safety margins as well as take account of future budgetary burdens related to the so-called ageing of populations.

As so far, the recommendations resulting from the excessive deficit procedure have been sent by the EU Council to Portugal (November 2002) and Germany (January 2003), while France was given an early warning (also in January 2003).

The problem of aggregation in the theory of intra-industry trade and in empirical research

Elżbieta Czarny

The author analyses the problem of ambiguity contained in the definition of intra-industry trade i.e. the simultaneous import and export of goods from the same industry and shows that the definition of intra-industry exchange of goods is applied to different trade streams. In such context, definitions applied to branches of industry also tend to vary. Such an approach results in difficulties with respect to the definition of the factors that affect the intensity of the intra-industry exchange and measuring the size of trade operations. Since the problem described in the article arises at the point of junction between the theory of economics and empirical research, the considerations are preceded by a short analysis of selected aspects of an argument between theoreticians and empiricists and the presentation of theoretical explanations regarding the genesis of international trade.

Multiple states of balance in second-generation currency crisis models – a critical concept review

Adam Koronowski

This paper constitutes a critical review of the concept of multiple states of balance and the associated idea of self-fulfilling expectations. The occurrence of multiple states of balance and self-fulfilling expectations represents a conclusion derived from second-generation currency crisis models. If the assumptions behind these models, including rational expectations and highly accurate forecasts, are taken into account, the stated conclusion – pointing to the absence of an unambiguous outcome – seems slightly surprising. It also clearly contrasts with conclusions generated from first-generation currency crisis models whose output is always unambiguous unless it depends on the variability of a factor not explained by the model. The paper does not discuss the mathematical formula of second-generation models, which always accept the existence of more than one solution. However, multiple states of balance are questioned, using arguments suggesting that only one of mathematical solutions of the model constitutes a viable state of economic balance. These arguments refer to the basis of the conclusion regarding the occurrence of multiple states of balance which, in turn, relies on the theory of strategic games.

Parliamentary supervision over state debt in the years 1920-1939

Helena Góralska

The paper presents the issues related to public debt in the years of the Second Republic of Poland, and in particular supervision over state debt as well as the issues involved in the definition of public debt. Supervision over state debt was one of the elements of public finance transparency and was conducted by the parliamentary State Debt Supervision Committee (SDSC). Subsequent SDSCs were appointed pursuant to the provisions of laws on state debt supervision (of 1922 and 1936).

The Committee was responsible for ensuring formal supervision over state debt, i.e. checking whether the debt was incurred in compliance with statutory powers and whether incurred debt and granted guarantees were properly entered into the State Debt Ledger kept by the Treasury Ministry. SDSC was under an obligation to publish a statement of state debt and granted guarantees twice a year.

The definition of state debt was provided by both laws on state debt supervision. There was an ongoing debate throughout the Second Republic in the SDSC over the interpretation of the concept of state debt. The subject-matter of the dispute between subsequent committees and the government was the incorporation (or not) into public debt of the following items: state enterprises' debt, specific funds' debt, and, first of all, maturing liabilities. Subsequent governments of the Second Polish Republic were in favour of narrow interpretation of debt definition, whereas subsequent committees made a wider interpretation.

In the dispute, history did justice to the SDSC. The currently applicable definition of state public debt is close to the interpretation encouraged by subsequent State Debt Supervision Committees.

Barriers to credit and loan financing for local government bodies. Part II

Sebastian Skuza

This analysis of legal collateral related to the reduction in the possibilities of incurring debt by local government bodies is aimed at proving the incompatibility of the said collateral to the current standing of public finance, as well as at identifying own proposed solutions to the problem. The current financial standing of local government bodies, combined with restrictive regulations on the limitations in incurring liabilities, may be a negative factor that effectively prevents the development of local government.

The picture of local public debt in Poland presented in the paper provides a justification of the advisability, and necessity, of implementing fundamental systemic changes, especially with regard to the issues of limitations or the thorough reform of local public debt.

The development of local government bodies will certainly depend on their financial standing. Despite advanced work on changes to the law on revenues generated by local government bodies, they cannot count on a real-term increase in revenues that would dramatically change their situation and allow for a significant extension of their investment scope.

Nevertheless, the paper is not limited to a critical review of individual solutions and contains proposed changes to the applicable legal regulatory framework. According to the author, amendment of the Law on public finance would be a major step towards successful growth of local government administration in Poland, under a general 'less limitations, more monitoring' motto. The correctness of the author's line of reasoning may be confirmed by the example of French solutions. The legislative and executive bodies did not respond to the financial difficulties of French local government bodies with increased sanctions or limitations on the accessibility of debt financing. The restructuring of insolvent local government bodies consisted primarily in the re-negotiation of terms of repayment for individual liabilities and in the state's assistance through temporary increases in the revenues generated by local government administration. Along with solving the financial problems of individual local government units, French central government authorities strengthened monitoring activities of the state of French local finances.

Consolidation of banking sectors in developing countries – contemporary trends in mergers and acquisitions

Michał Buszko

In the last decade, the banking sectors of developing countries, referred to as emerging markets, have been subject to particularly strong pressure towards the consolidation of capital and the concentration of services in an increasingly smaller number of entities. The basis for their transformation comes from changes in political and economic conditions and, first of all, from more and more intense global competition. General liberalisation and globalisation of financial services not only resulted in a substantial change of operating conditions of finance institutions in developed markets, but rendered possible the entry of powerful global financial groups into developing countries. These groups very quickly began to gain the upper hand in competition against local banks which, in Central and Eastern Europe, had to develop over a short time the same resources as had accumulated for many years in highly developed countries. Foreign entities, owing to their huge financial potential, also dominated the processes of consolidation and concentration. The former led to a significant decrease in the number of commercial banks in the developing countries. The latter resulted in the concentration of the financial services' market in an increasingly limited number of entities. At present, the growth of banking sectors in developing countries is closely linked to the decisions of foreign financial institutions, in particular those from the European Union Member States. These decisions also govern mergers and acquisitions in emerging markets. Their nature is primarily international and nowadays they are becoming a basic method for expanding banks. Without doubt, they contribute to an increasing quality of provided banking services, together with the development of innovative products or new channels for their distribution. On the other hand, they may further monopolise the sector and expose it to the effects of financial crises occurring even in distant regions of the world.

Financial leverage - theory and Polish economic practice

Marta Kardyś

The issue of financial leverage involving the use of debt in the enterprise's capital structure has been extensively researched in the theory of corporate finance. When shaping the structure of its capital by means of financial leverage, the enterprise should consider the cost of securing external sources of financing and the return on its equity. Additionally, the use of debt financing by the enterprise contributes to the so-called optimisation of its capital structure, which in turn should translate into an increase in the business market value.

The viability of securing external capital may be measured by the economic return on total capital. If the economic return on total capital exceeds the interest paid on external sources of financing, the phenomenon of financial leverage will occur. This is the so-called necessary condition for generating positive financial leverage. Once the above condition for establishing financial leverage has been fulfilled, the purchasing power of equity is increased and reflected in the return on equity rate.

The theory should, however, be set against the results generated by real business entities operating in Poland. Therefore, empirical studies should be aimed at enhancing the knowledge of our economy, attempting to answer the question whether in Poland the phenomenon of financial leverage, so often stressed in theory, does manifest itself in practice.

The analysis of the potential to use debt in order to generate the effect of financial leverage in the years

1997-2000 involved 15 companies from five industries, namely distributors of pharmaceuticals (Polska Grupa Farmaceutyczna, Prosper, ORFE, and Farmacol), telecom operators (Telekomunikacja Polska and Netia), electrical engineering companies (Elektrim, Elektromontaż Export, and Elektrobudowa), construction businesses (Mostostal Zabrze, Exbud Skanska, and Budimex) and metal wholesalers (Impexmetal, Centrozap, and Stalexport).

As mentioned earlier, use of debt to achieve financial leverage may be found viable provided that the necessary condition is fulfilled for its occurrence, i.e. the return on total capital proves higher than the interest charged on external capital. The findings of empirical studies have led to surprising conclusions. The most important of them is that, given relatively high level of interest rates in the Polish economic environment, the necessary condition for financial leverage to occur has not been fulfilled for the majority of examined enterprises (the only exception being Elektrobudowa in 1999 which, however, did not make use of long-term debt financing in the years 1997-2000). This means that the use of external capital in the analysed period failed to generate in the scrutinized enterprises advantageous performance measured by the increase in the return on total capital.

The examined enterprises showing the highest return on total capital could fulfil the condition necessary for generating the financial leverage effect (in addition to Elektrobudowa, the only company to make use of financial leverage in 1999), if the average interest rate on long-term debt were lower by roughly 6.7 percentage points in the years 1997-1999, and by 8 to 13 percentage points in 2000. As it was, in the years 1997-2000 debt financing could not be used in Poland for purposes of optimising enterprises' capital structure against their market value assessment, given the risk of its future decrease in value.

Issues related to measuring joint-venture

Andrzej Rutkowski

Joint ventures are complex investment projects, a sort of strategic alliance whereby two or more businesses establish a new legally independent entity. The parties combined the resources necessary to achieve the goal set. They contribute fixed and current assets, know-how, skills and other intangible components to the new entity. They expect that the investment will generate the assumed return.

A venture may be assessed individually from the standpoint of each partner or from the perspective of the newly-established entity. In each of these cases, other results will be obtained and different recommendations as to the advisability of project execution.

Assessment of the effectiveness of this type of ventures is difficult. One of the reasons is that relevant decisions are taken based on incomplete information; contributions to joint ventures are often made in kind, and are hard to evaluate. Transfers are made between the entities undertaking joint ventures that are difficult to track and evaluate. Many effects of investment projects are not fully identifiable as they are determined by future conditions generated in the business environment and activities to be initiated in the future.

Sometimes the dominating contract party attempts to modify previously made contractual arrangements. This leads to changes in the distribution of planned cash flows over time and alterations to the venture's effectiveness.

The establishment of a joint venture is accompanied by numerous contingent provisions, among others, on the distribution of benefits resulting from the undertaking of a given activity, possibility of subsequent expansion of the activities, possibility and terms of earlier termination of the agreement, or the possible abandonment of the venture by one of the partners. Traditional evaluation methods relying exclusively on discounted cash flows have proven inadequate. A more comprehensive evaluation of joint ventures requires the application of an optional accounting method.

Mutual Guarantee Schemes – an alternative source of credit collateral

Bożena Mikołajczyk, Piotr Podgórski

Banking credit remains relatively the most accessible external source of financing small and medium enterprises. This is due to the fact that there is virtually no alternative form of financing (such as bond issues or others not resulting in the creation the entrepreneur' liabilities with respect to the bank) to the most extensive offer of commercial banks for small businesses.

Given the above facts, small and medium-sized businesses are forced to use credit lines on terms imposed by banks which, in turn, require full creditworthiness from their clients (translating into the necessity to submit collateral for the full amount of credit with interest, despite having creditworthiness throughout the crediting period).

As shown by research, the securing of good, from the bank's perspective, credit collateral, is one of the major obstacles to entrepreneurs taking advantage of offers developed by financial institutions. In this context, the idea of mutual guarantee schemes seems to provide at least a partial solution to the problem.

Mutual Guarantee Schemes, often referred to as MGS, are institutions established by entrepreneurs (sometimes grouped in federations or chambers of industry), banks, as well as by small and medium-sized enterprises. They operate as private businesses at the points where three equal partners coincide: enterprises, banks and the public sector. They also combine the interests of small and medium-sized enterprises, directly and indirectly, provide the entrepreneurs with an opportunity to take part in fund management (and thus have impact on the directions of economic growth), through making use of personal experience for the benefit of the growth of other businesses.

This solution also offers more than just financial benefits. It contributes to building solidarity among entrepreneurs who, acting jointly, have an opportunity to propose certain systemic solutions to accelerate growth and improve the operating conditions of small and medium-sized businesses.

The idea of establishing mutual guarantee schemes in Poland seems real and promises improvement in the standing of businesses looking for capital to finance, for example, necessary investments to nurture higher effectiveness and competitiveness.

The analysis indicates that Poland, applying for the EU membership, will be more likely to take a greater account in its policy of this solution in providing financial support to small and medium-sized enterprises operating in countries with a developed market-economy, as displayed by the recent government initiative – Capital for the entrepreneurial.

Cross-selling of banking products

Marek Szczepaniec

Cross-selling consists in building fundamental relationships with clients via current or mortgage credit accounts, and in the subsequent selling of new financial products. Given the powerful impact of cross-selling on the banks' financial performance, its application in marketing practice is increasingly common. The cross-selling strategy is currently pursued by the largest and most profitable global banks, such as Citigroup, Wells Fargo, Bank of America, Barclays, HSBC, UBS, and Fleet Boston. The highly successful Wells Fargo Bank managed to sell each of its clients approximately 4 financial products (nevertheless, the long-term goal of the bank is to achieve an average level of 8 products per client).

The bankers' attention to the benefits resulting from cross-selling was attracted by the findings of studies conducted over the last decade. These findings show that the cost of attracting a new client may be as much as 5 times higher than the cost of encouraging an existing client to take advantage of additional financial services. Furthermore, banks tied by strong and multidimensional client-relations have an information-based advantage over the banks that aim to conclude single transactions (the processing of credit applications is easier along with the monitoring of the borrower's financial standing during the course of the crediting period). By selling additional products to existing clients, the bank not only raises the

profitability of the relationship but at the same time establishes a network of ties that will be difficult to sever in the future.

The interesting thing is that clients (in particular, retailers and small businesses) are also interested in strengthening their ties with the bank (the findings of opinion polls conducted in the US by Bank Administration Institute and Cambridge Group in 2000 indicated that there is a 94% likelihood that a client holding a check account at a given bank will also make use of other products). This happens because clients are likely to gain a lot of benefits through intensive co-operation with a single provider of financial services (first of all, they save time and money). When applying for credit, they do not have to prepare full documentation on every occasion regarding their financial situation, do not need to wait for a long time for their application to be processed (credit history and history of operations conducted in the current account substantially simplify and shorten all procedures) and do not need to learn new procedures. Owing to easier access to credit lines and higher credit limits they are able to manage their finances in a flexible manner. The comprehensive service is also very important to clients, as well as the possibility to obtain special prices (banks usually offer their own reliable clients more advantageous terms).

Although in Poland the issue of cross-selling has not been so far described in detail in the banking and marketing publications, empirical research (presented in the paper) shows that some Polish banks are already very successful at selling additional products to the existing client base.