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POLISH REGULATIONS CONCERNING SPECIAL PURPOSE RESERVE – CHANGES AND CONSEQUENCES FOR BANKS

Legal regulations concerning special purpose reserve in Polish banks and their changes during the transformation of the banking system are presented, together with general trends in bank activities induced by these changes. The regulations are discussed in three various dimensions: balance sheet, accountancy (methodological), and taxation, taking into account their interconnections.

Keywords: special purpose reserve, banking legal regulations

INTRODUCTION

The year 2002 has been marked in Poland by a nearly 20 per cent share of low-quality assets in total bank assets. This is an alarming symptom. In the banking sector, the share of bad debts now reaches 17.6 per cent. In commercial banks it is 18.3 per cent, while in co-operative banks, 6.1 per cent. This corresponds to an increase of 3 percentage points, compared to the end of the third quarter of 2001 (*Niedaleki...* 2002, p. 12).

The appearance of lower quality assets forces banks to create a reserve, in particular the special purpose reserve. The high level of bad debts and frequent changes of these levels are connected with the increasing credit risk, which is the natural consequence of the lower dynamics of GNP in Poland, but also the restrictive and frequently changing regulations concerning credit risk.

All banks — in conformity with the art of banking — should have their own policy of special reserve, consistent with the current legal and market conditions and constructed in conformity with other elements of internal policy in the credit area (e.g. legal measures of credit securing) and anticipated bank performance. The policy towards reserve determines the banks' activity in the credit market (more or less restrictive financing of the economy, stronger or weaker tendency to offer a credit) and influences the financial standing of the bank. The liberty of

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action in creating their own reserve policy is mainly determined by external regulations. The more stable and less restrictive the regulations for credit risk reserve are, the more stable and extensive is the space for the unconstrained formation of this policy. More rigorous external regulations have in turn a stronger influence on the bank outcome (which is then determined outside the bank). It is also more difficult for the bank to create a sound credit policy if the regulations are frequently changing.

Table 1

Classification of reserves including the special purpose reserves

Classification criterion	Type of reserve	Description
Openness	Revealed	Reserves listed in the balance sheet
	Not revealed	Reserves not listed in the balance sheet
Attribution	Created on debit of costs	Debit side — appropriate cost accounts Credit side — accrued expenses
	Created on debit of other operational costs	Debit side — other operational costs Credit side — reserve
	Created on debit of financial costs	Debit side — financial costs Credit side — reserve
	Created on debit of extraordinary losses	Debit side — extraordinary losses Credit side — reserve
	Created on debit of financial outcome	Debit side — financial outcome Credit side — reserve
	Created on debit of special funds	Debit side — special funds Credit side —reserve
	Created on debit of investment	Debit side — appropriate investment accounts Credit side — reserve
Tax legislation	Income acquisition costs	Reserves diminishing the taxation base
	Other costs	Reserves not diminishing the taxation base
Methodology of reserve classification for credit exposures	Category "normal" — for consumer credits and loans	Detailed classification criteria: the classification of credit exposures and the way the credit exposure is changed is defined by the appropriate administrative act concerning the principles of reserve creation for the bank operational risk
	Category "under observation'	
	Category "in danger"	

Source: own, based on: Dudek 2000, p. 9-10; Bill of Decrees 2001, no 149, pos. 1672; Official Journal of the NBP 1994, no. 23)

In Poland, the regulations concerning the special purpose reserve and related issues seem to be very rigorous and at the same time rather unstable. This has been leading to decreased confidence among banks as to the accuracy of the undertaken strategy, and consequently a great volatility of their relations with debtors. The Polish experience with the special purpose reserve is now over 10 years old, and its beginning dates back to the creation of the two-level banking system in Poland. The banks in Poland, bearing in mind this experience, have understood the implications of an appropriate reserve policy and started to perceive it as an instrument creating the income. The possibility to make creative use of reserve is unquestioned, but it depends on external regulations and their variability.

The aim of the present paper, being contribution to the scientific debate on the regulation environment of banking activity, is therefore to present these external regulations and their changes. This will allow to explain their influence on the past and future behaviour of the banks in Poland (a more detailed discussion of the consequences of the regulation environment variability is beyond the scope of this article and will be presented elsewhere). A deeper explanation of this influence should take into account various dimensions of the reserves in the bank's activity: the balance sheet (accountancy), taxation, and the 'methodological' one. These are presented in more detail in table 1.

The regulation environment concerning the special purpose reserve is formed mainly by the accountancy act (creation and dissolution of the reserve), legal acts that specify the methodology of their classification, and tax laws. This environment will be presented in the following sections, taking into account the three mentioned dimensions in which a reserve should be perceived, as well as their interrelations.

1. CHANGES IN THE REGULATORY ENVIRONMENT: THE ACCOUNTANCY ACT OF SEPTEMBER 29, 1994 AND THE AMENDED ACT OF NOVEMBER 9, 2000

Changes in the reserve policy have been induced by the amendments of the accountancy act. These amendments concerned proper accountancy rules and aimed at reflecting economic reality as accurately as possible in financial statements of any economic entity, including a bank. Let us remind ourselves here that the proper accountancy rules include: a true and fair view, going concern, accrual basis, materiality, compensation, comparability, and compactness (*Qualitative...* 1997/1998, p. 33-34). In the light of the

accountancy act, banks should follow the prudent estimation rule. Prudence could be defined here as introducing an element of deliberation when making valuation and estimation necessary under the given conditions and existing level of uncertainty. The aim is to convince that assets and revenues are not overestimated, while liabilities and costs underestimated (*Międzynarodowe* ... 1999, p. 27). In banking practice, the rule of prudent estimation has the strongest influence on the entries in the income statement and balance sheet of a bank. Let us add that this rule has been binding for banks, and the need to introduce amendments to the accountancy act has been dictated by the necessity to make financial statements of Polish banks comparable with those prepared by other entities in accordance with International Accountancy Standards.

The amended Accountancy Act of November 2000 has introduced a number of changes, concerning among others the way in which the special purpose reserve included into costs is presented. The list of situations forcing banks to create this reserve and therefore to lower the financial result obtained by a bank has also been changed. The Accountancy Act of 1994 proclaims that particular elements of assets and liabilities have to be valued using the prices actually paid for their acquisition, and using prudent valuation (Bill of Decrees 1994, No. 121, pos. 591; Kołaczyk 1994, p. 24).

The consequences of incidents have to be included into the statements also when they were revealed after the balance date.

The reserve for liabilities has been created in debit of other operating costs of a bank, what has led to the decrease of financial result declared in the profit and loss (P&L) statement. At the end of the year banks have also created a reserve for the temporary difference due to corporate income tax. This difference results from the lack of synchronization of the moments when the revenue is recognized as acquired and the cost as incurred, as follows from the accountancy law and tax regulations. The positive result has been classified as an obligatory deduction from the net profit, reserved for future income tax. The negative result could be classified as prepaid (accrued) expenses, if their settlement was assumed inevitable in the next budgetary year or in subsequent years. In the case when these liabilities were annulled, prescribed, or their enforced execution was impossible, the occurred losses together with income taxes due were diminishing the reserve earlier created for this purpose. The unused reserve was in turn augmenting other operating costs or revenues from financial operations, however not later than on the balance day.

Besides the already described situations, banks have also ascribed to the costs of the reserve for risk connected with general banking activity (in particular for liabilities and warranties in danger) up to the sum securing the safe activity, including the existing collateral (pledges).

The regulations of the amended law of 2000 have introduced some changes in the organization of accountancy, including the reserve (Bill of Decrees 2000, No. 113, pos. 1186).

The amendment of the accountancy act has considerably limited the range of incidents that can decrease the bank's financial result by treating the created reserve as a cost. It is worth mentioning that the exclusion of numerous incidents from the list that entitles to create the reserve, has also led to a considerably lower distortion of bank income by excessive or insufficient burden of current bank costs with a reserve of unrealistic value. Most probably third parties, interested to know the financial position of a bank, have now a much more clear picture.

It has been mentioned earlier that the percentage of debt in danger is very high in the Polish banking system. This is a consequence of the old accountancy law. The positive symptom is that from the beginning of 2002 it has been amended, and now banks have the right to claim debt repayments also when it is not written in the balance sheet of a bank. This clause is assumed to help the banks to improve their position concerning bad loans.

In its technical aspect, a reserve is ascribed to other operating expenses of a bank, to financial costs or extraordinary losses, depending on the circumstances connected with the liabilities being the reason for the reserve creation. At the moment when the liability, for which the reserve was created, comes into being, the reserve amount is decreased by the value of this liability. If, however, the reserve remains unused, so if the risk justifying its creation disappears or decreases, the day it appears useless the bank proportionally increases the value of the appropriate operating income, financial income or extraordinary profit, depending on the account of which this reserve was created.

Also important for the banks is the clause of one of the administrative acts accompanying the amended Accountancy Act (Bill of Decrees 2000, No. 149, pos. 1674) concerning the deduction of interest on some kinds of loans. For 'normal' debts the older rule said that interest due is regarded as revenues, and the compounded interest is included into the category of reserved interest until it becomes payable. Now, all kinds of interest on normal debts are included into revenues (also the compounded ones). On the other hand, the interest on the debt 'under observation' is presented in the

balance sheet as the reserved interest, earlier it had been treated as revenue. Therefore the interest on the debt 'under observation' becomes equalized to the interest on the debt 'in danger'. The changed way in which the interest on the debts classified as 'normal' and 'under observation' are treated has also been followed by changes in their presentation in the balance sheet and P&L statement of a bank. This concerns not only the interest for the current period, but also the interest due for the past periods on debts outstanding. So, it seems advantageous for the bank to have 'normal' debts, and less advantageous are of course the debts 'under observation', as their interest has the same status as on debt 'in danger'. This might cause the banks to reconsider their policy, not allowing debts 'under observation', in particular because of the regulations concerning the classification of financial assets in the financial statements of banks (assets for sale, loans granted and own liabilities, assets kept until maturity, marketable assets). When granting a loan, banks require legal collateral which can thereafter be treated as marketable assets. The valuation of this category of assets is done according to their market value, and the results of such a valuation are revealed in the profit or loss from financial operations. In the banks' opinion, this category of financial assets has been greatly reduced, since banks are forced to include the results of valuation in the P&L statement, while other entities (not banks) have the right to choose one of two methods: the results of the valuation, profits and losses, may either be included into revenues and the financial costs of the reporting period, or may be transferred to the revaluation fund. According to International Accountancy Standard No 39, free choice between these two methods is allowed, while in Polish law it is permitted for all companies except banks. This limitation, allowing the banks to include the results of valuation solely in P&L statements, leads to greater fluctuations in their current financial results. Consequently, banks have become more sensitive to the changes of prices and market parameters of financial instruments (e.g. securities, being the legal collateral for granted loans).

2. EVOLUTION OF THE CLASSIFICATION SYSTEM FOR SPECIAL PURPOSE RESERVE IN POLAND

Except for the brief catalogue of incidents which force to create the reserve, in Poland there is still an extended system of banking reserves, including the category of special purpose reserve, and the system of revaluation of assets and liabilities. This allows the banks to use the so called

creative accountancy (Wąsowski 2000, p. 26), which can be used to make up (decorate) financial statements. Creative accountancy used in practice can make the reserve level inadequate to the risk level, the reserve level can become too low or too high. To minimize playing with the special reserve, regulations are introduced governing the methodology of their classification and introducing some restrictions.

The correct classification system for the debts of a bank should be by definition simple, clear and giving no possibility to circumvent some principles because of imprecise clauses (Lewandowski 1994, p. 89). Unfortunately, no standard classification of receivables, including bank receivables, is possible in economy, and moreover — would not be practical. Consequently the commonly binding norms for them do not exist. This is mainly the result of a different approach to the question of a special purpose reserve creation in various countries and different definition of particular kinds of debt. More broadly, it is a consequence of differences in the wealth level of particular countries, the condition of their public finances, and legal regulations (mainly concerning the taxation of banks). Though the uniform rules of debt classification and reserve creation for special purposes, and international legal regulations do not exist on an international scale, some trends can be seen.

The more affluent countries, with a low percentage of bad debts in their banking systems, launch soft and elastic solutions concerning the special purpose reserve, their supervisory authorities allow greater freedom to the banks in the formation of their internal reserve policy. In poor countries in turn, with high percentage of bad debts in their banking systems, the external regulations are more restrictive, though in some countries these external requirements undergo evolution and may become more or less restrictive (which means the need to create a bigger or smaller reserve). An example may be the Polish system of banking debt classification, frequently and substantially changing. Below, the scope and consequences of these changes will be presented.

The debt classification system was introduced in Poland in 1990 through the recommendation of the President of NBP concerning the review and classification of clients' and banks' debts and preparation of periodical statements (Instruction of the President, NBP 1990, No. 2). This review was intended to demonstrate the default risk, classified into three basic categories. These regulations were afterwards modified at the beginning of 1990 (Instruction of the President, NBP 1990, No. 24) together with the introduction of the new Banking Account Plan. The modified classification of bank debts was similar to the earlier solutions, but the debts were at that time classified into four, not three categories. A subsequent system of debt

classification was set in 1992 (Official Journal of NBP 1992, No. 11, pos. 23). Debts were classified into four categories according to two independent criteria. If any of these criteria was satisfied, the bank was obliged to classify the debt into one of the following classes:

- term debt – here an automatic mechanism was assumed: after some predetermined delay from the moment when the asset became payable and not repaid, it is reclassified into the higher risk class, so these debts undergo objective classification
- conditional debts – being the reflection of the economic and financial situation of a debtor, but perceived subjectively by the bank; the debtor should take into account:

a) objective factors, including: profitability, return on capital, solvency ratio (for banks), liquidity ratios, debt turnover, inventory turnover etc.

b) subjective factors, including: management quality (assessment of senior management), dependence on markets (i.e. the former COMECOM countries), dependence on government grants, on government contracts, on a few big suppliers or clients.

In that time, just as before, some hasty actions of banks could be observed, trying to reclassify their debts to the lower risk class through amendments in the credit agreement clauses. The change of the agreement conditions, for example decreased credit instalment value or delay of repayments, led to little improvement (if any) of the financial and economic situation of a debtor, it served only to keep him in an unchanged risk group. The real financial and economic situation of a debtor has therefore been distorted. On that occasion, it was in the economic interest of banks to hide their worse quality credit portfolio and thus to be able to show a better financial condition; not increasing their costs by a special purpose reserve to show a higher solvency ratio, at least as high as required.

In view of such incorrect practices of banks, changed regulations have been introduced. The new instruction of the President of NBP (Instruction of the President..., NBP 1993, No. 12, pos. 22) has limited the possibility of moving loans to the lower risk classes. In both cases, the debts could be reclassified only to the category of 'questionable' ones.

A successive system of debt classification was introduced in 1994. (Appendix..., NBP 1994, No. 13, pos. 36) and did not considerably infringe the construction of the former. Basic changes concerned the delay in repayment necessary to classify the debt as being below the standard, now one month instead of seven days. Another change consisted in a more general presentation of economic evaluation criteria, not so directly as in the older instruction of 1992

(e.g. debtor's losses persisting longer than three months). Moreover, in the new regulations the debts guaranteed by the State Treasury, even if not repaid for some longer time, were treated as regular. This improved the statistics of banks, as the irregular debts became lower. According to previous rules, these debts were treated as irregular, but this was important only in statistics as banks were not obliged to create reserve for these debts.

The new classification of debts and new accountancy act of 1994 forced a change in the rules of creation of the risk reserve. Instruction no. 13 of 1994 maintained the rules of the special purpose reserve creation as well as the amount of required reserve on the same level as in 1992. The basic change was the extension of the title to create a special reserve including all off-balance sheet assets and liabilities at risk, not only those of worse quality, which is common practice in most Western countries. The former instruction clearly mentioned only the reserve for bad credits and guarantees. Besides this change, in force from January 1995, three other amendments to the instruction of 1992 had already been already introduced earlier. These concerned:

- wider catalogue of legal securities taken into account in defining the basis for calculation of a special purpose reserve
- particular and general deadlines for attaining the required level of appropriated reserve for credit risk in banks (a considerable deficit of this reserve was revealed)
- limited possibility to reclassify receivables into the lower risk classes (see Instruction no. 11 mentioned above).

Further changes concerning the classification of bank receivables and creation of a special purpose reserve were introduced in the resolution of the Banking Supervision Committee of December 22, 1998 (Official Journal NBP 1998, No. 29, pos. 65).

The most important changes are presented in table 2. Let us add that the resolution of the Banking Supervision Committee largely extends the list of securities which reduce the base for special purpose reserve creation. The high level of receivables recognized as being in danger is connected with the relatively restrictive Polish regulations concerning credit risk. In practice it appears that banks in Poland cautiously classify receivables, taking into account both the promptness of debt and the financial situation of a debtor. They present also a quite conservative approach towards securing pledges, which have to be included into the calculation of reserve created by banks, but do not influence the classification of a credit. In other words, in Poland a high level of receivables in danger is observed, but a great part of them is very well secured and should not cause any trouble to the bank (Niedaleki ..., 2002, p. 12).

Table 2

Comparison of the classification rules for bank receivables and requirements concerning the creation of special purpose reserve in the instruction of 1994 and the resolution of 1998.

Instruction of the President of NBP No. 13 of 1994	**Resolution of the Banking Supervision Committee No. 13 of 1998**
Instruction issued on the basis of the *Accountancy Act* and *Banking Law*	Resolution issued on the basis of the *Accountancy Act*
Banks create and maintain reserve to secure the *gathered savings and fixed deposits*	Banks create and maintain reserve to secure the *money gathered by the customers*
Banks are obliged to create reserve among others for: *liabilities concerning the issued guarantees or credit repayment backing*	Banks are obliged to create reserve among others for: *off-balance-sheet liabilities of financing and guarantee character*
Banks classify the receivables into *four categories*	Banks classify the receivables into *five categories — the new one is "under observation"*
Off-balance sheet receivables *in danger* and liabilities not defined	Off-balance receivables *in danger* and liabilities understood as the items classified as below standard, questionable or lost
When establishing the banking risk bank applies two independent criteria: promptness of the credit/interest repayments economic and financial situation of a debtor	When establishing the banking risk, bank applies (except the situations defined in the Resolution) two independent criteria: promptness of the credit/interest repayments economic and financial situation of a debtor
The assessment of the economic and financial situation of a debtor should include: *objective factors* *subjective factors*	The assessment of the economic and financial situation of a debtor should include in particular: quantitative measures qualitative measures (new element — quality of collateral offered)
The sum of receivables or liabilities due to offered guarantees or warranties, used to calculate the special purpose reserve, should be diminished by the value of liabilities due to the *nine points*	The base for special purpose reserve calculation is the sum of receivables or off-balance sheet liabilities diminished by the value of collateral classified in *seventeen points (more detailed catalogue — new entries are among others the guarantees or backing of the Banking Guarantee Fund, insurance policies of KUKE SA, registered pledge)*
Special purpose reserve is *gradually* decreased according to the debt repayments or due to its reclassification into the category of lower risk level or due to the increase of the market value of the asset	Special purpose reserve is decreased according to the debt repayments or due to its reclassification into the category of lower risk level, *increased collateral value* or due to the increase of the market value of the asset

(changes marked in italics)

Source: own, based on: Zaleska 1999

3. TODAY'S SYSTEM OF SPECIAL PURPOSE RESERVE

The consequence of experience gained by banking supervision as to the reserve policy carried out by banks is the modified and currently binding system (Bill of Decrees 2001, No. 149, pos. 1672). So, a special purpose reserve is created for receivables in danger, and in remaining categories — the receivables in a normal situation and being under observation — see table 3. For the last two categories the reserve is rather a systemic one, similar to the general risk reserve.

Table 3

Classification of the credit exposures

Class of credit exposure	Credit exposure		
	Towards the State Treasury	Being the receivables due to consumer loans	Other
"normal"	Receivables for which the delay in principal or interest repayments (relative to the term or schedule defined at the moment when the liability towards the State Treasury is created) does not exceed one year	Receivables for which the delay in principal or interest repayments does not exceed one month	Credit exposures for which the delay in principal or interest repayments does not exceed one month and the economic/financial situation of a debtor is not alarming
"under observation"	not applicable	not applicable	
"below standard"	not applicable	Receivables for which the delay in principal or interest repayments exceeds one month but does not exceed three months	I. Receivables for which the delay in principal or interest repayments exceeds one month but does not exceed three months II. Receivables from the debtors of an economic/ financial situation being a threat for the timely loan repayment
"doubtful"	I. Exposures for which the delay in principal or interest repayments (relative to the term or schedule defined at the moment when the liability towards the State Treasury is created) exceeds one year but does not exceed 2 years;	Receivables for which the delay in principal or interest repayments exceeds three months but does not exceed six months	I. Receivables for which the delay in principal or interest repayments exceeds three months but does not exceed six months II. Receivables from the debtors of an economic/ financial situation considerably deteriorated, in particular if the losses occurred break into the statutory fund, equity capital

	II. Exposure of undefined term (schedule) of repayments, for which the period from the moment when the liability towards the State Treasury is created to one, when it is classified, does not exceed one year		or shares fund, with the reservation that the exposure is a result of investment enterprise being after its completion a base for main activity of a debtor if the losses occurred do not exceed the level assumed in the project being the base of debtor's credit rating; the limitation of the loss level assumed in the project being the base of debtor's credit rating does not concern both the investment project and the financial enterprise
"lost"	I. Exposures for which the delay in principal or interest repayments (relative to the term or schedule defined at the moment when the liability towards the State Treasury is created) exceeds 2 years; II. Exposure of undefined term (schedule) of repayment, for which the period from the moment when the liability towards the State Treasury is created to one, when it is classified, exceeds one year III. All contested exposures	I Receivables for which the delay in principal or interest repayments exceeds 6 months II. Credit exposures towards the debtors for which bank filed a petition to start the executive proceedings or began to satisfy the claims from the object of securing in other mode III. Credit exposures contested by the debtors in court proceedings IV. Receivables from debtors of unknown domicile and undisclosed property	I Receivables for which the delay in principal or interest repayments exceeds six months II. Credit exposures towards the debtors of announced bankruptcy or for whom liquidation is in progress, except if it is done in the spirit of the commercialization and privatization of state enterprises act III. Credit exposures towards the debtors for whom the bank filed a petition to start executive proceedings or began to satisfy the claims with the object of securing in other mode IV. Credit exposures contested by the debtors in court proceedings V. Credit exposures from debtors of unknown domicile and undisclosed property VI. Credit exposures from the debtors of an economic/financial situation irreversibly deteriorated in a way excluding the debt repayments

Source: own, based on: Bill of Decrees 2001, No. 149, pos. 1672

In general, this system can be presented in the following way. The level of special purpose reserve is related to principal, without interest. The regulations

define the minimum level and leave the possibility to create a higher reserve. Such a reserve makes a cost without any pecuniary expense, in fact it is utilized when the principal is amortized. The actual system concentrates on the assessment of the bank contractor as to the promptness of repayments and his economic condition, next the legal securities are considered to estimate the potential loss. Quite a new solution is that security is classified according to quality, this means easy vindication, and the exposures are divided into the following categories: with secured risk, limited risk and unsecured. Such a solution leads to the creation of a reserve for such loans, which in fact do not cause any risk, taking into account the value and quality of their securing. Therefore the portfolio of a bank is always perceived as worse than it really is.

When considering the system of classification and creation of a special purpose reserve, let us pay attention in more detail to their minimum levels, which make quite a new element. So:

1. a special purpose reserve for normal receivables is created in an amount at least equal to the obligatory reserve level, being 1.5 per cent of the base

2. reserve for other categories of receivables is created based on individual assessment of risk connected with given exposure, not less however that the obligatory level equal to:

- 1.5 per cent of the standard base for the special purpose reserve — for the category "under observation"
- 20 per cent of the standard base — for the category "below standard"
- 50 per cent of the standard base — for the category "doubtful"
- 100 per cent of the standard base — for the category "lost".

Moreover, in justified cases, the Banking Supervision Committee upon the request of a bank may allow to create the special purpose reserve in another percentage, in particular based on the credit risk models.

A link between the special purpose reserve and the general reserve of a bank has also been provided. The required level of reserve for the risk connected with credit exposures is reduced:

- by 25 per cent of the amount of general risk reserve — for credit exposures being the receivables due to consumer credits and loans classified as "normal" receivables
- by 25 per cent of the amount of general risk reserve — for credit exposures classified as "under observation".

Let us add that the special purpose reserve is also reduced according to:

- decreased credit exposure

- changed (lower risk) category of credit exposure as a result of reclassification
- increased value of collateral that lowers the base for reserve creation
- increased value of general risk reserve.

It should be pointed out that the new regulation for a special purpose reserve does not cause such resistance in the banking environment as it did a few years ago. This is the result of a more rational attitude of banking supervision to the rating of debtor quality, in particular in housing loans. The economic and financial situation of a debtor had to be inspected once a year and this made housing loans quite burdensome and reduced clients' demand. Nevertheless, a number of issues in the reserve regulations is considered by the banks as too rigorous.

The common problem for all banks are overdue but unimportant credit repayments. These are situations when the repayments are regular, but the modifications of exchange rate or interest rate cause small discrepancies in the actual repayments compared to the currently set sum of instalment. Allowing therefore for some difference, say PLN 10, can be treated as justified for private borrowers taking small loans, but for the companies such a clause cannot be used. A small surplus over the allowed level does not practically change the quality of the debt, but for the bank the consequences are serious — a special purpose reserve has to be created and the interest due is not included into the P&L statement, but makes the reserved revenue. The allowed sum of discrepancy in the debtor's dues can be justified for small consumer loans, in general one should however more adequately relate the sum of outstanding payments to the amount of the credit allowed by the bank to the particular client.

The above mentioned question is of detailed character. A more general problem is to define the delay in credit or interest repayment that requires the reclassification of the credit. When we use the second criterion of receivables qualification, i.e. the economic and financial situation of the debtor, the possibilities to ascribe these receivables into different categories are increased. In the banking environment the opinions appear that "it is purposeful to consider more elastic methods as to the promptness of capital and interest repayment, [...] it seems that increased knowledge and experience gained by banks in expediency and rules of special purpose reserve creation allows them to introduce some elasticity to the promptness criterion, when the quality of receivables is assessed" (Zygierewicz 2002, p. 48).

4. SPECIAL PURPOSE RESERVE IN THE TAX LAW

For Polish banks, the heaviest fiscal burden is the corporate income tax (CIT). This is particularly strongly felt in the situation where banking services are excluded from value added tax. The effective tax rate for banks has been considered high, now and in the past, though it has changed in subsequent years (Ocena ... 2001, p. 30). Large fluctuations of the effective tax rate in recent years indicate that the basic problem for banks is the question of how to include the special purpose reserve created for risky receivables into costs. From the early days of the two-level banking system in Poland the situation of banks did not improve in this matter (Korenik 1994, p. 7–9), and the possibilities to deduce this kind of costs have been even reduced (Zygierewicz 2002, p. 50). This phenomenon is connected with the fact that a part of the reserve methodologically created by banks is in fact not revenue acquisition cost, so it becomes a certain kind of tax (Czarny et al. 1999, p. 352). For taxation purposes the costs are: reserve created for the receivables previously counted as revenue, if it is highly probable that they become uncollectable; the general risk reserve, and some kinds of special purpose reserve (Bill of Decrees 2000, No 54, pos. 654). Despite the statutory requirements concerning the creation of reserve for the receivables originally treated as revenues, when the tax-payer is informed that his receivables are potentially uncollectible, he may not treat them as a taxation cost unless the requirements of taxation law are fulfilled.

From the beginning of 2001 a rule is in force that into the cost of income acquisition may enter only the reserve for some receivables classified in the categories 'doubtful' and 'lost', if these receivables are requisite, so, after this amendment, reserve created for requisite but uncollectible loans can be included into the cost of income acquisition.

Under the term "uncollectibility" the situation is understood, when one of the circumstances listed below occurs:

1. the debtor has died or has been removed from the business activity register, set into liquidation or declared bankrupt,
2. composition proceedings has started upon request of a debtor (before also compromise proceedings in the sense of the act on financial restructuring of companies and banks),
3. the delay in principal or interest repayments exceeds six months,
4. the amount due is questioned by the debtor by virtue of a court action,
5. the amount due has been directed into execution proceedings,

6. the actual domicile of a debtor is unknown and his property has not been disclosed, despite the actions undertaken by the creditor to establish the place and property.

There are some limitations stating that the reserve being the cost of income acquisition cannot exceed the sum of the receivables after deduction of collateral. In practice, the reserve for uncollectible receivables corresponds to its part for bad loans. However, a major part of the lost credit reserve cannot be deducted in the tax calculation: the cost of income acquisition is in general 50 per cent of the sum of special purpose reserve created by a bank for doubtful debts and 50 per cent of the sum of doubtful receivables due to the issued guarantees or warranties for credits or loans repayments. Other special reserves created by banks cannot be deducted in the tax calculation at all. This concerns therefore all reserve for the receivables classified as below standard or under observation, as well as the reserve for consumer loans in the normal situation.

Particularly inconvenient for banks is the fact that, due to the amended rules of special purpose reserve creation introduced in the last few years, first by NBP, then by the Minister of Finance, some discrepancies appeared between the principles, according to which some debts can be treated as lost, and the reserve amount reduced by the value of existing collateral, and the analogous principles that are in use in corporate income tax law. Since the solutions used in tax law are more stable, banks are *de facto* forced to consider each special purpose reserve twice — once for prudential purposes, and once for the income tax calculation.

The regulations of corporate income tax require to reduce the base for the special reserve creation, which is contrary to the provisions of the Banking Supervision Committee (KNB) resolution (voluntary reduction of the reserve by the value of legal security). The cost in taxation aspect can be only the reserve (or its part) after deduction of the security value. This is the first difference in this matter, which is less important, as the practice to reduce the reserve base by the security value is quite common. More important is the difference between the generic kind of securities which may (KNB resolution) or must (income tax law) reduce the special purpose reserve base. This applies also to the amount of reserve treated as income acquisition cost, the receivable being a base for this taxation should be diminished by the value of only those securities that are allowed by tax law. When we compare the voluntary securities reducing the base for special purpose reserve creation and those of the mentioned tax law, substantial differences can be seen. If the given kind of legal security is not mentioned in the tax

regulation, but is listed in the KNB resolution, its value can be taken into account for prudential purposes, but not for taxation.

The reserve for doubtful receivables is counted as the taxation cost only if the already mentioned classification criteria are fulfilled. These criteria in the KNB resolution differ somewhat from those in the tax law. Taking into account the promptness of loan and interest repayments, the tax regulations allow for the earlier creation of reserve counted as the taxation cost when it concerns the receivables of a bank from the State Treasury. Since according to the KNB resolution the prudential reserve for lost receivables can be created only when the repayment delay exceeds one or two years, the "taxation" reserve can be already created when the State Treasury is delayed more than six months with its repayments. In order to count this reserve into the taxation costs it is however necessary to fulfil other conditions specified in the tax law (the KNB resolution does not provide for other evaluation criteria). In the banks' estimate, only a small percentage (a few or a dozen per cent) of reserve is in effect treated as the income acquisition cost.

The limitations to count the reserve as taxation cost are not the only fiscal barrier that hinders the lending activity of a bank. Even if the reserve has been counted as the taxation cost, some other obstacles can appear. The transaction to sell the receivables to other entities becomes quite unprofitable. When a bank sells the debt being in danger, the reserve created for this debt has to be released (in taxation this is equivalent to some income, if the reserve was counted before as the cost), and moreover the bank is not allowed to include the losses due to the debt disposal into its costs. Therefore the bank takes the negative taxation consequences twice when selling the debt. This is the reason why many debts that should be sold (also to better present the bank's assets) remain in the balance sheet or undergo amortization (Zygierewicz 2002, p. 50).

5. DIRECTIONS OF REGULATORY CHANGES FOR THE SPECIAL PURPOSE RESERVE IN THE TAX LAW

In the nearest future, banks may expect the above described fiscal barriers to be cancelled. This will be connected with the program planned by the Minister of Finance to restructure the economy via banks. This program points out that an urgent and necessary task for the government is to undertake actions which should help the banks to improve their credit portfolio through the disposal of the debts 'in danger' that are stacking in their balance sheets. On the other hand, the program should help the

industries important from the economic point of view and being in trouble. So, the legislator has proposed two kinds of solutions as an amendment to the tax law:

1. systemic — valid for all credit exposures of a bank;
2. restructuring — for credit exposures of enterprises subject to the restructuring program.

In the area of systemic solutions, the first step is to unify the taxation catalogue with that of the balance sheet. The corporate income tax law will in practice gain a complete list of securities mentioned in annex two of the Minister of Finance's decree on the rules of creation of the reserve connected with the bank operating risk (Bill of Decrees 2001 No. 149, pos. 1672 with amendments). Besides the changed catalogue of securities, the change of obligatory deductions from the base for creation the special purpose reserve is also proposed. The tax regulations concerning the deduction from this reserve would be applied on the same scale, on which the bank decreases the base for reserve creation (counted as the cost in the accountancy regulations sense taking into account the value of security allowed by these regulations). Let us add that, according to accountancy regulations, the bank is allowed, but not obliged, to reduce the base for the special purpose reserve creation by the value of security; if the security is weak, the bank may drop it and create a higher reserve, better reflecting the real credit relation with a debtor.

The second system solution, indispensable for solving the first one, is the introduction to the amended act of the definition of „credit exposures", mentioned already in the resolution concerning the rules for the reserve creation for bank operating risk. Credit exposures are understood as:

1. receivables, excluding the interest (also compounded);
2. off-balance sheet commitments (financing and guarantees).

A subsequent important systemic solution concerning all credit exposures is the reclassification of receivables category from 'doubtful' to 'lost' — if the uncollectibility in the taxation sense cannot be evidenced with documents. When the credits (loans), guarantees and warrantees for credit and loan repayments, granted by a bank to the entities not included into the restructuring program, are ascribed to the category 'lost', but their uncollectibility has not been demonstrated, the cost of income acquisition becomes the amount of reserve equal to that for the 'doubtful' receivables (i.e. in fact 12.5 per cent of the balance sheet reserve).

In the second area of planned solutions, distinct rules are introduced for the creation of the reserve treated as an income acquisition cost for credits, guarantees and warrantees for credits and loans, given to the entities not

included into the restructuring program according to separate regulations. In the intention of the legislator the term "the restructuring program according to separate regulations" denotes restructuring based on the following legal acts:

1. Act of November 26, 1998, on adaptation of the coal mining industry to market economy conditions and on particular powers and tasks of mining communes;
2. Act of October 7, 1999, on supporting the restructuring of the national defence industrial potential and the technical modernization of the Polish military forces;
3. Act of July 14, 2000, on the financial restructuring of the sulphur mining industry;
4. Act of September 8, 2000, on the commercialization, restructuring and privatization of the Polish Railways State Enterprise;
5. Act of August 24, 2001 on the restructuring of the iron and steel industry.

The term "separate regulations" is of great importance for banks, as this may ease some operations supporting the restructuring of enterprises without the obligatory monitoring and control of these restructuring processes.

The project of the amended act provides to increase from the sum of credits (loans) qualified as 'doubtful' 25% to 50%: receivables due to the guarantees and warrantees for credit and loan repayments given by a bank to the entities undergoing the restructuring program upon separate regulations. This would in fact allow to include 25% of the created balance reserve into the taxation costs. The proposed amendment to the tax law introduces a 'privilege' to classify the special purpose reserve created for the receivables treated as 'lost' and due to the guarantees and warrantees for credit and loan repayments given by a bank after January 1, 1997 to the entities doing the restructuring program upon separate regulations.

The legislator has also proposed some facilities concerning the amortization of a debt of restructured enterprises. The rule is, as stated before, that the amortization of a debt is not counted as the cost of income acquisition in the taxation sense. According to the amended rules, the exception to the above rule is the amortization of debts connected with:

1. arrangement proceedings of a bank, in the sense of the regulations concerning the financial restructuring of enterprises and banks;
2. composition proceedings, in the sense of the relevant regulations;
3. restructuring program realized based on separate regulations.

The possibility to count the amortization of a debt as the income acquisition cost is however conditioned, since it may be only applied to banks taking part in the restructuring program based on separate regulations, if 100% of the sum of receivables being amortized is directed and spent for new credits and loans for the enterprises taking part in this program.

Another solution is proposed, consisting in the lowering of the taxation base by 20% of the sum of credits and loans, amortized in connection with the realization of the restructuring program by virtue of separate regulations, if they are classified as 'lost' and counted as the income acquisition cost.

All the actions discussed above could be an incentive for banks for stronger engagement in the restructuring of the economy, since they allow for the earlier inclusion of the reserve for 'doubtful' or 'lost' receivables into the income acquisition cost. Bearing in mind that it is impossible to force the banks to take part in this restructuring, it seems advisable to introduce the tax regulations being an appropriate incentive. This is why the project of the amended tax law provides for an additional possibility to convert banking receivables into shares of the enterprise undergoing the restructuring, without counting this conversion as an income in the taxation sense. Moreover, banks forced to release the earlier created reserve for these receivables (conversion into shares would be the reason for this), are not obliged to count this released reserve as 'taxation' income.

CONCLUSION

The banks in Poland, from the very beginning of their activity under the new political conditions, have gained experience concerning the special purpose reserve and become conscious how important they are and how they can influence the behaviour of the banking market. Already introduced external regulations concerning this reserve and their particular dimensions — accountancy and methodology — are not consistent with the taxation system. This inconsistency is a source of serious consequences for banks, and most probably have influenced their economic efficiency. It clearly exerted a negative influence on increasing their equity in the period, when the need for increased capitalisation was pointed out as a priority. The solutions concerning the reserve continuously address to the needs of banks, both in taxation and accountancy (methodology) aspects.

Regardless of the already less stringent rules of classification and the creation of special purpose reserve, the common opinion is that the Polish regulations in this area are still more rigorous than those in force in European

Community countries. The consequences are that banks analyse the existing regulations in great detail and on this basis try to work out their own methods to improve their economic efficiency, keeping at the same time their good image among banking supervisors and investors.

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