FINANCIAL SECTOR ASSESSMENT PROGRAM

POLAND

CREDIT UNION SECTOR: REGULATORY AND SUPERVISORY FRAMEWORK IN TRANSITION

TECHNICAL NOTE

JANUARY 2014
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<td>MOF</td>
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INTRODUCTION

A World Bank - IMF mission visited Warsaw February 19 – March 5, 2013, to undertake an update of the Financial Sector Assessment Program (FSAP) conducted in 2006. The team was led by Luc Everaert (IMF) and Brett Coleman (World Bank) and included Karl Driessen, Nancy Rawlings, Yinqiu Lu, Jorge Chan-Lau, Rishi Ramchand (all IMF), Katia D’Hulster, Heinz Rudolph, Andrey Milyutin, John Pollner, Ignacio Tirado (all World Bank), as well as external experts David Walker (Canadian Deposit Insurance Corporation), Monnie Biety (independent consultant), and Fernando Montes-Negret (former World Bank and IMF). This Note is prepared by Monnie Biety.

The primary focus of this Note is on the legal, regulatory, and supervisory framework of Poland’s credit unions (SKOKs) at a time when the authorities are transitioning them to a stronger, more stable footing. The Note reviews the law, regulations, and supervision regime in force at the time of the FSAP mission and suggests ways to help strengthen the SKOKs in a phased manner that gives viable SKOKs the necessary time and support to meet the new requirements. While the draft law was not reviewed during the FSAP as it was anticipated that there were to be many changes to the draft, key aspects of the draft law were analyzed using information and reports gathered that discussed the contents of the law. The Note concludes with a discussion of these elements of the draft law.\(^1\) Numeric data used in this report were provided by NASCU during the FSAP mission, with some corrections provided by KNF post mission.

\(^1\) Subsequent to finalizing this Note, the mission learned that a new credit union law was passed by parliament in April and signed into law in May 2013. A review of the final law was, therefore, not possible in the context of the FSAP.
Executive Summary

1. Savings and credit unions (SKOKs) in Poland represent only 0.8 percent of total financial sector assets, but serve 2.6 million depositors and are experiencing robust growth. The sector continues to consolidate as the number of SKOKs has fallen from 61 in 2010 to 55 today. The sector is increasingly dominated by the largest SKOK with assets of PLN 6.8 billion, and the five largest SKOKs hold two-thirds of sector assets. Although SKOKs represent a small portion of the financial sector, their number and outreach could pose systemic risks if the consolidation process that is inevitable under stricter regulation and supervision is not managed prudently.

2. The financial condition of the SKOKs is weak. Since 2009, the financial trends have been negative due to rising delinquency and operating expenses, falling interest income, and implementation of the accounting regulation requiring additional provisions for delinquent loans. SKOKs have not been required to use accounting standards specifically for financial institutions, which has masked their true financial condition. For the five largest SKOKs the average key ratios in 2011 were particularly disturbing, with low institutional capital, delinquent loans far exceeding the international standard of 5 percent or less, and net income too low to allow institutional capital to outpace asset growth. The results for 2012 showed a further decline in the institutional capital to total assets ratio and delinquent loans were more than 22 percent of total loans.

3. The authorities have responded by bringing SKOKs under Polish Financial Services Authority (KNF) supervision. SKOKs came under the purview of KNF when the Act on Cooperative Savings and Credit Unions (amended October 2012) came into effect (hereinafter known as the October 2012 law). KNF has since started to collect financial information from the SKOKs through off-site reports. On-site inspections started in February 2013. The Ministry of Finance (MOF) has issued four regulations that affect accounting, reporting, inspections, and acceptable risks. These supervisory and regulatory changes are significant for the SKOKs. KNF and MOF must be cognizant to the size and risk of the sector and ensure that their supervisory and regulatory requirements and actions are proportional.

4. KNF has established 3 objectives for SKOK supervision: (i) returning to a more traditional interpretation of “common bond”; (ii) making relevant changes so that accounting information and financial statements are reliable; and (iii) working on capital rehabilitation plans with short and long-term goals for SKOKs with low capital and weak financial conditions.

5. The October 2012 Law is ambiguous in many parts and lacks clarity, leaving significant room for confusion and personal interpretation. Under the October 2012 Law the SKOKs are subject to supervision by two entities, KNF and National Association of Savings and Credit Unions (NASCU) who are working independently of each other. This requires the SKOKs to provide off-site reports to both entities and subjects them to at least three on-site inspections (one regular inspection performed by KNF and two by NASCU, a regular inspection and a cooperative audit). This is both time-consuming and costly for the SKOKs. There has been a lot of confusion in the sector as SKOK management is accustomed to reporting to NASCU and continues to report to them first and to KNF second, causing problems among all the entities. A new draft law on credit unions (hereinafter known as the draft law) is now under discussion, but substantial strengthening is needed in this draft law to gradually bring SKOKs onto a sound financial footing.

6. SKOKs should soon have access to the national deposit insurance scheme under the draft Law, which is a positive development. SKOK member deposits are currently insured to EUR 100,000 by a mutual insurance company, TUW, a part of NASCU. The amount of TUW’s resources is limited compared to the banks’ deposit insurance scheme managed by BFG. Moreover, while the banks’ deposit insurance system has backstop funding from the government if needed, the SKOKs’ current scheme does not.

7. The October 2012 Law’s minimum solvency ratio of 5% is too low. This ratio is considerably below international standards which prescribes a minimum 8% institutional capital ratio. SKOKs should be encouraged to increase capital to at least 8% of total assets to enhance their individual and
systemic stability, but SKOKs should be given adequate time to build capital as it is a long-term process. SKOK’s only sources of capital are net income, donations, and member shares that should only be included if share withdrawals are restricted based on attainment of the required capital ratio.

8. **The Law has yet to be supported by a detailed, inclusive set of regulations establishing prudential and non-prudential standards.** Secondary regulations are needed to regulate specific technical issues not addressed by the Law.

9. **It is important that KNF and MOF consult key stakeholders when proposing regulation and implementing change to gain the support of the sector.** New regulations developed by MOF and KNF have been put out for comments to NASCU. However, the comment period was not sufficient for NASCU to circulate the proposed regulation among the SKOKs for their comments. Sufficient transition times should be given to SKOKs to prepare for the changes. NASCU and SKOK management reported that the transition periods have been unrealistically short.

10. **This report provides information on the Polish SKOK experience, analyzes the regulatory and supervisory framework, and provides recommendations.** The financial information presented below was provided by NASCU. The ratios and numbers were provided in groups according to SKOK asset sizes. The financial ratios are unweighted and the ratios cited below are arithmetic averages for the groups. All pertinent documents for the SKOKs were reviewed, and relevant information has been provided for credit union* sectors in other countries to support comments, observations, and recommendations.

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2 Throughout this report, the term “credit unions (CUs)” refers generically to credit unions in any country, and “savings and credit unions (SKOKs)” refers specifically to savings and credit unions in Poland.
Box 1. Recommendations

1. The Law should be amended or regulations drafted to address the following.

- Eliminate the confusion inherent in the current situation whereby NASCU “controls” (Article 66 in the October 2012 Law) the SKOKs and KNF “supervises” them (Article 67 in the October 2012 Law) and makes “recommendations,” which has KNF and NASCU functioning as two independent co-supervisors and requires the SKOKs to report to each entity separately and undergo at least three on-site inspections during the inspection cycle;\(^3\)

- Mandate a solvency ratio requirement of 8 percent\(^4\) in line with international standards, and provide a reasonable transition period of 5 years for compliance (replacing the 2014 deadline to meet a 5 percent solvency ratio);\(^5\)

- Include member shares as institutional capital only if they are nonwithdrawable or withdrawable only if the SKOK meets the required solvency ratio and the shares are available to absorb losses;

- Clarify the powers of KNF and NASCU as they relate to the stabilization fund; and

- Include a section on definitions.

2. MOF should further develop, in consultation with KNF, NASCU, and the SKOKs, detailed regulations addressing: minimum licensing standards, liquidity, asset and liability management, investment, capital adequacy, borrowing, savings and shares, credit, delinquency, audits, supervision, consumer protection, and realistic transitional provisions to ease the way forward for compliance.

3. SKOKs should use the chart of accounts, accounting principles, and reporting formats required for financial institutions. SKOKs report under a general accounting system that is inadequate for a financial institution. However, SKOK operations are generally simpler than a bank, so the requirements should be modified accordingly. An adequate transition period of 1-2 years should be given for training and making the changes needed to IT and accounting systems.

4. KNF and MOF should promote communication with sector stakeholders to gain their support for implementation of changes. New regulations developed by MOF and KNF should be put out for comments to NASCU. The comment period should be sufficient so that NASCU can circulate the proposed regulation among the SKOKs for their comments and provide a response to KNF and MOF. Comments received should be considered and revisions made as appropriate. Sufficient transition times should be given to prepare for the changes. To further communication, KNF and MOF should develop and share with the sector a long-term plan for implementing regulatory and supervisory changes. Training should be provided to SKOKs on the new regulations, forms, and requirements.

5. KNF should develop a SKOK risk rating system such as CAMEL or KAPER to assign a risk score and assist with risk management. Such a system will allow KNF to objectively assess risks in a SKOK and the sector, make comparisons of SKOKs, and prioritize their inspections.

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\(^3\) The three on-site inspections are the KNF on-site inspection, NASCU control audit and the NASCU cooperative audit.

\(^4\) The ratio of 8% was arrived at by considering capital standards around the world, not just the WOCCU standard.

\(^5\) If the 2014 deadline is not eliminated, then the Law should lay out the actions that KNF can take against a SKOK in noncompliance. Ideally, the Law should grant KNF discretion to continue to work with a SKOK that is building capital.
I. CURRENT FINANCIAL SITUATION OF SKOKs

11. As in most countries, credit unions (SKOKs) represent only a small percentage of total financial sector assets. In Poland, SKOKs have 0.8% of the financial sector’s assets, and the percentage of total assets to GDP is small but has increased from about 0.5% in 2005 to almost 1% of GDP in 2011. Poland’s SKOKs serve a large number of small depositors – estimated at almost 2.6 million as of end-2012 – from a country population of 38.4 million. The first SKOK started in Poland in 1992, and the sector has experienced remarkable growth, in fact so fast that it has negatively impacted the sector’s financial strength. In 2012, growth in the SKOKs was robust. Assets and membership continued to grow, 8.4% and 11.9% respectively.

The SKOK sector’s remarkable growth is due, in large part, to the leadership and organizational efforts of NASCU. Prior to the October 2012 Law, NASCU was responsible for all sector activities including the regulation and supervision of all SKOKs. Under the October 2012 Law, NASCU now performs control activities of the SKOKs in place of supervision activities. NASCU will continue to provide cooperative auditing services, and financial stabilization, investment, and central finance/settlement services. SKOKs maintain reserves at NASCU in the form of liquid reserves, stabilization funds, capital reserves and deposit resources that are not being used. NASCU also continues as a link between the SKOKs and banking systems and pursues: i) financial activities, ii) accumulation of SKOK deposits, iii) granting SKOK credits, iv) investing free resources and v) organizing financial settlements.

13. The SKOK sector continues to consolidate; there are now 55 SKOKs down from 61 in mid-year 2010. The industry consolidation has been facilitated by NASCU, largely so that SKOKs and their members can take advantage of efficiencies enjoyed by larger SKOKs. A few mergers have occurred because of financial problems that could not be overcome. As compared to other countries (see Table 1), the number of members per SKOK is very high. The members are served through a network of 1987 branches. The sector is increasingly dominated by the largest SKOK, SKOK Stefczycka with assets of approximately PLN 6.8 billion. The next largest SKOK has approximately PLN 2 billion in assets. The five largest SKOKs, all with assets that exceed PLN 500 million, now hold two thirds of sector assets.

14. The current open SKOK membership model has worked well as evidenced by the remarkably high membership growth rate, including members among the poorest households, and providing members a sophisticated range of services. In the Polish SKOK system, there are no geographical, professional, or other restrictions on SKOK membership. This is similar to many SKOK systems in the world, which have undergone an evolution from a closed to relatively open membership. Open membership helps distribute risks better owing to a wider geographical and sectoral range of membership and thus increases the stability of the SKOK system. However, an open membership model has a disadvantage that often there are no natural barriers to growth in membership, which often leads to the weakening of the SKOK’s links with local communities, one of the primary objectives of credit unions, and increasing competition with commercial banks. This seems to be the case now in Poland, where the largest SKOKs are increasingly competing with commercial banks in terms of geographical reach and clients’ profile.

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6 The ratio information provided by NASCU in this section are unweighted averages for the SKOKs in each group. The ratios were not provided for each SKOK, but instead for five groups according to asset size. The groups are as follows:

- Group 1 includes the 5 largest SKOKs all with assets of 500 million zlotys or more;
- Group 2 has 19 SKOKs between 100 and 499 million zlotys;
- Group 3 has 11 SKOKs between 50 and 99 million zlotys;
- Group 4 includes 14 SKOKs between 10 and 49 million zlotys; and
- Group 5 includes 6 SKOKs between 1 and 10 million zlotys.

7 2012 financial data was unaudited as of the mission, but has since been verified by KNF.

8 SKOK Stefczycka has 850,000 members or 33% of the total members.
SKOKs continue to grow, but the growth has slowed over 2012 (see Figure 1). However, asset growth is still high at 8.2% in 2012. The past focus on growth by SKOKs has to change in order to build capital and improve the financial soundness of the sector. Institutional capital growth must substantially outpace asset growth if the SKOKs are to meet the solvency ratio any time soon. Savings growth has slowed to 7% in 2012 but remains above loan growth of .3%. SKOKs for the most part are able to use savings deposits to fund loan demand. Loans are 65% of savings deposits and this ratio is comparable to that of other countries (see Table 1). Any funds in excess of loan demand will have to be invested. Investment yields are generally lower than loan interest rates, thus reducing the interest income earned.

Table 1: Selected SKOK data by Country for 2011

<table>
<thead>
<tr>
<th>Country</th>
<th>Credit Unions</th>
<th>Members</th>
<th>Assets- in thousands (USD)</th>
<th>Savings &amp; Shares- in thousands (USD)</th>
<th>Loans- in thousands (USD)</th>
<th>Savings/Loans</th>
</tr>
</thead>
<tbody>
<tr>
<td>Poland</td>
<td>59</td>
<td>2,315,324</td>
<td>4,614,548</td>
<td>4,242,520</td>
<td>3,187,151</td>
<td>69.5%</td>
</tr>
<tr>
<td>Ireland</td>
<td>494</td>
<td>3,070,000</td>
<td>17,378,917</td>
<td>15,009,065</td>
<td>6,941,207</td>
<td>46%</td>
</tr>
<tr>
<td>Great Britain</td>
<td>405</td>
<td>983,982</td>
<td>1,372,090</td>
<td>1,128,203</td>
<td>919,962</td>
<td>81%</td>
</tr>
<tr>
<td>Korea</td>
<td>954</td>
<td>5,862,969</td>
<td>42,712,783</td>
<td>39,199,768</td>
<td>26,572,780</td>
<td>68%</td>
</tr>
<tr>
<td>Brazil</td>
<td>765</td>
<td>4,398,141</td>
<td>29,594,411</td>
<td>19,104,265</td>
<td>16,918,117</td>
<td>89%</td>
</tr>
<tr>
<td>Mexico</td>
<td>63</td>
<td>3,756,251</td>
<td>4,059,103</td>
<td>3,551,983</td>
<td>2,989,510</td>
<td>84%</td>
</tr>
<tr>
<td>Canada</td>
<td>813</td>
<td>10,605,815</td>
<td>270,925,045</td>
<td>122,109,864</td>
<td>222,218,736</td>
<td>182%</td>
</tr>
<tr>
<td>Australia</td>
<td>106</td>
<td>4,504,000</td>
<td>84,427,981</td>
<td>67,786,939</td>
<td>68,642,257</td>
<td>101%</td>
</tr>
</tbody>
</table>

The institutional capital to total assets ratio, the most important ratio in determining financial soundness, fell dramatically for all SKOKs in 2012 (see Figure 2). For the five SKOKs that hold two thirds of the sector’s asset, this ratio decreased from 2011 to 2012 but at a much slower rate than...
the ratio for the sector. The ratio for the sector remains well below the international standard. The decline in the ratio is due to total assets growing faster than institutional capital. Institutional capital is made up of member shares, reserves and prior and current year’s net income. SKOKs must focus on increasing this ratio to an acceptable level. Building capital does not happen quickly as SKOKs have few options aside from grants, additional membership shares, and net income.

Figure 2: Institutional Capital to Total Assets

![Institutional Capital/Total Assets Ratio](image)

Data Source - Central Statistics Office (2008-10) and KNF (2011-12).

17. **The rate of capital growth has been unable to keep pace with asset growth largely because of declining net incomes that are due to rising delinquency.** According to SKOK management and NASCU, the increase in delinquency is largely due to worsening economic conditions for the members. The level of delinquency is alarming in the largest SKOKs and in the sector overall as the international standard is 5% or less for loans 30 days or more delinquent. The KAPER\(^9\) standard is 10% or less. In 2012, the ratio was 22.47% for the largest five SKOKs and 23.58% for all SKOKs. In 2012 the SKOKs sold delinquent loans at a discount and received commercial paper. The loans were sold to a new company, ASK LLC based in Luxembourg with substantial experience in Poland. Per the contract between the company and SKOKs, if the company is unable to collect all the loans purchased, the SKOKs will share in the future loss, and any losses may be written off by the SKOKs over 10 years. Selling loans is a highly unusual tactic for credit unions to decrease delinquent loans. Delinquent loans usually decrease for three reasons: the loan has been paid current, written off, or the terms have been changed through extension, refinance, or manipulation. This is a good example that demonstrates the importance for SKOKs to follow financial institution accounting rules. If the commercial paper is not worth the face value of the loans, it should be written down and the write down disclosed on the financial statements.

18. **Delinquent loans have negatively impacted net income.** Interest income decreased because loan interest was not collected as anticipated, and the SKOKs had to increase their provisions for loan loss expense to account for the potential loan write-off. This situation also directly impacts institutional capital. Income as compared to assets for the SKOKs is unacceptably low for financial institutions that need to increase capital. The ratio for the largest SKOKs was 1.15% in 2011 and for all SKOKs it was -0.351% (see Figure 3). The KAPER standard for this ratio is greater or equal to 0.8%, and the international norm is 1% or more. In 2012 net income was severely affected as

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\(^9\) KAPER is a set of financial ratios facilitating management and supervision of SKOKs. The system was developed using a previously existing CAMEL supervisory system and the PEARLS system of monitoring and financial standing recommended by WOCCU. Since the 2010 World Bank report, the KAPER system has been expanded to include numerical ratings to assist in assessing risk. The KAPER ratios have no status such as prudential standards under the Law; however, today it is the only inclusive set of financial norms for SKOKs.
SKOKs were required to provision 35% for loans delinquent 3-12 months and 100% for loans > 12 months delinquent. Previously SKOKs were not obligated to provision for delinquent loans. The provisions as recommended by NASCU were 20% for loans 4-6 months delinquent and 100% for loans > 6 months delinquent. Due to the severity of the impact on net income, few SKOKs were provisioning at the NASCU-recommended rates, and NASCU was lax in their enforcement of their own recommendation.

Figure 3: Net Income to Total Assets

![Net Income to Asset Ratio Graph](image)

Data Source – NASCU (2008-11) and KNF (2012 data)

19. An upward trend in operating expenses has also had a negative impact on net income and institutional capital in the largest SKOKs. For the largest 5 SKOKs, the ratio of expenses to assets increased from 11% in 2011 to 12.8% in 2012 (see Figure 4). For all SKOKs expenses/assets ended 2012 at 12%. The KAPER goal ratio is 7% and the international norm for this ratio is less than 10%. Generally the larger the financial institution, the lower the ratio should be as there are economies of scale.

Figure 4: Operating Expenses to Total Assets

![Operating Expenses/Assets Ratio Graph](image)

Data Source - NASCU
20. **Liquidity in the SKOKs appears to be adequate based on the KAPER ratios.** The ratio of liquid reserves (maturities < 3 months) to deposits declined somewhat in the largest SKOKs to 12.1% in 2011 and then ticked up to 12.6% for 2012 (see Figure 5). The ratios remain above the KAPER standard of 10%; however they are below the international standard of 15% of deposits. The ratio of loans as compared to deposits in the largest SKOKs was 75.4% of deposits in 2011 and fell further in 2012 to 65%. The KAPER goal ratio range is from 60-80%. The decline in loans as compared to deposits will probably have a negative impact on net income and institutional capital. If the deposits cannot be used to fund loans, then the funds will have to be invested. Interest rates on investments are generally lower than loan interest rates.

![Figure 5: Liquidity Ratio and Loans to Deposits](image)

Data Source - NASCU

II. **OCTOBER 2012 LAW ON CREDIT UNIONS**

21. **The Law on Credit Unions dated November 5, 2009, and amended as of October 25, 2012, assigns supervision of all SKOKs and NASCU to KNF, the body that regulates other financial institutions in Poland.** Prior to the 2009 law, SKOKs were regulated under the Credit Union Act of December 14, 1995, and NASCU had the responsibility to regulate and supervise the SKOKs.

22. **In the October 2012 Law, KNF’s sanction authority is not comprehensive and the trigger event is not well defined.** Sanctions will be implemented by the KNF off-site supervision department. If SKOKs do not follow “recommendations” then KNF may remove or suspend a member of the management board, order the SKOK to limit its scope of operations, order the SKOK to stop carrying out a specific activity, impose fines, or place the SKOK under administration. Currently, KNF has no authority to merge, liquidate, or revoke a license. It is anticipated that in the draft law, KNF will have these essential supervisory powers.

23. **The October 2012 Law lacked clarity and there was considerable room for interpretation.** The law included general provisions discussing: the objective of a SKOK, the process to obtain a permit to form a SKOK, and reasons KNF can refuse to grant a permit for establishment. The law covered: i) the rights and duties of SKOK members, ii) SKOK governance bodies, iii) SKOK financial management and a few prudential standards, iv) NASCU objectives, responsibilities, permissible activities, governance, and management of the stabilization funds, v) SKOK supervision purpose and authority, supervision responsibilities of NASCU and KNF, actions that KNF can take against a SKOK, and supervision of NASCU by KNF, and vii) amendments to the laws in force along with transitional and final provision. However, there are certain articles of the October 2012 Law that need further clarification and discussion by the authorities to make improvements to the law. The following comments are made on the articles or areas that need additional clarification.
24. There is no section discussing definitions of words and phrases used in the Law. A section of definitions would alleviate some of the confusion and ambiguity of this Law and should be a part of the draft law.

25. The law is silent on several essential issues, such as permissible activities for SKOKs, conflicts of interest, and the requirement for “arm’s length” transactions. These issues may be addressed in the cooperative law, but usually that is not adequate for CUs as most other types of cooperatives are not stewards of their member’s money. The Credit Union Law should be specific as to the activities that SKOKs are allowed to pursue. Without this set out in Law, SKOKs may get involved in activities in which they lack expertise and put their members’ money at risk. Much like permissible investments are included in the Law so should be permissible activities. As is the case in many other countries too, many SKOKs and NASCU are controlled by a small number of influential people. For this reason, it is important that the Law addresses conflicts of interest, codes of conduct, and arm’s length transactions.

26. Article 7 addressing the creation of SKOKs, needs to be clarified and limited in the Law or through further regulation. Additional direction is needed to address issues on: i) minimum amount of start-up capital (membership shares); ii) minimum number of members as the current requirement of 10 members (set by the Cooperative Act of 1982) is too low; iii) requirement for a business plan demonstrating that the proposed SKOK is viable; and iv) requirement to submit the names and resumes of the proposed officials in order to determine if these individuals are qualified to hold the positions.

27. Art. 21 states that the president of the management board of a SKOK shall be appointed with the consent of KNF. Within 9 months of the enactment of the October 2012 law, all presidents of SKOK management boards must be approved by KNF. There is no deadline given as to when KNF must complete this approval process. A reasonable deadline should be established such as approval for each president of the management board within 60 days of starting the approval process in each SKOK. Without a deadline, the process potentially could be very long and may be disruptive to SKOK operations. KNF may review their decision a total of two times and if the applicant is not in agreement with KNF’s final decision, then the decision may be appealed to the court. During the entire process, the applicant may remain in their position.

28. Articles 24 and 54 provide for the inclusion of the share fund as part of the institutional capital. Usually, only funds to which no party other than the SKOK has legal rights should be included as institutional capital. Shares are withdrawable upon termination of membership, but only at the end of the year after it is determined that net income is sufficient. In order to use these funds as institutional capital, a threshold should be established (such as the required solvency ratio). With the threshold, the SKOK is not the legal owner of the funds but has control over the funds. This should be the only way that membership shares may be considered part of institutional capital (see Box 2).

Box 2: Treatment of Shares as Capital for Selected Countries

| In Canada | membership shares are included in common equity if the CU has the irrefutable right to refuse redemption, or when redemption would be automatically prohibited if withdrawal would cause or exacerbate a capital deficit. |
| UK Building Societies | allow cooperative common equity which absorbs losses, does not guarantee or indicate a distribution, and can only be redeemed upon approval from the regulator if the mutuals have the irrefutable right to refuse redemption. Redemption would be prohibited if withdrawal would cause or exacerbate a capital deficit. |
| Brazil and India | consider membership shares as capital. |

Source: Dave Grace and Associates – Basel III Jurisdictional Comparison

10 WOCCU recommends a minimum of 100 members. But in a developed economy such as Poland, if the CU is going to be viable, WOCCU recommends a much higher number, more like a minimum of 1000 members, and USD 1 million in assets.
29. Article 38 establishes a liquid reserve ratio of at least 10% of the savings and loan fund. This ratio is low as compared to international standards. For example, WOCCU promotes a ratio of 15% liquid assets to deposits and short-term (<30 days) liabilities. See Box 3 for international examples.

**Box 3: Liquidity Requirements for Selected Countries**

<table>
<thead>
<tr>
<th>Country</th>
<th>Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>United Kingdom</td>
<td>A CU must at all times hold liquid assets of a value equal to at least 10% of its total relevant liabilities. For the purpose of the regulation, liquid assets are those that can be converted into cash at short notice (within at most eight days).</td>
</tr>
<tr>
<td>Canada</td>
<td>Class 1 CUs (CU assets &lt; $50 million) must hold 7% of deposits and borrowings as liquid assets. Class 2 CUs (CU assets &gt; $50 million or a CU that grants at least one commercial loan) must maintain liquidity levels and forms of liquidity that are sufficient for cash flow.</td>
</tr>
<tr>
<td>Ireland</td>
<td>The CUs must maintain a liquidity ratio (liquid assets/total deposits) of 20%. If loans with maturities &gt; 5 years are more than 29% of loans, then the liquidity ratio must be 30%.</td>
</tr>
<tr>
<td>Australia</td>
<td>CUs must maintain a liquidity ratio (liquid assets/modified liabilities) of 12% of deposits. In practice, CUs hold about 18% of deposits in liquid funds.</td>
</tr>
</tbody>
</table>

Source: United Kingdom Financial Services Authority, Canadian Cooperative Association, and WOCCU.

30. The list of activities performed by NASCU in Article 66 is similar to the list of activities performed by KNF in Article 67. The lack of clarity and distinction has caused problems between the KNF and NASCU and confusion in the SKOKs as this form of double supervision does not assign ultimate authority to either entity. Article 68.2 then states that “KNF shall have the right to control the methods and rules of control activities performed by NASCU for their efficiency and adequacy” yet the next part of the article does not go far enough as KNF may only recommend to NASCU to make changes in the rules and methods of control carried out in SKOKs. Article 60 already confers upon KNF the authority to supervise SKOKs and perform on and off-site inspection. There is no need for NASCU to also perform an independent “control” function that has the same objective and scope as KNF inspections.

31. Article 48 (2) states that each member of NASCU shall have one vote at the General Meeting regardless of the number of shares held. This is contrary to procedures globally as recommended by the International Cooperative Alliance and WOCCU, which advise that governance structures should be proportional to the size of the CU member-owners. Moreover, Guiding Principle 4 of the International Credit Union Regulators’ Network states that supervisory authorities should recognize that some second-tier organizations have proportional voting for members. It is not appropriate for an individual or group of individuals to be in a position to exercise control from a minority position.

32. Article 70 (1) implies that NASCU will report irregularities found during control activities to KNF and make recommendations to the SKOKs. Item (2) of this article implies that NASCU would be responsible for the follow-up on recommendations made to the SKOK and would report any non-compliance to KNF. This means that the SKOKs would receive recommendations from KNF and NASCU after their inspections. Which of the two entities’ recommendations should the SKOK follow? This will most likely cause confusion amongst the SKOKs and conflict between KNF and NASCU. Providing recommendations, time frames to implement the recommendations, and assigning a responsible party to see through the implementation of the recommendations is one of the most important functions of the inspection. If this responsibility is assigned to one entity, it should be KNF not NASCU as KNF is ultimately responsible for supervision and ensuring that the SKOKs are sound financial institutions.

33. Article 83 of the October 2012 Law refers to the possibility of the NBP granting a loan to NASCU in case of a threat to a SKOK’s liquidity. This would allow supporting the stabilization fund managed by NASCU on the condition of providing adequate security. The article does not state, however, if NBP can require NASCU to submit any requested reports. The draft law should include a provision that NBP may require NASCU to submit reports that support the need for a liquidity loan.
III. CURRENT SKOK REGULATORY FRAMEWORK

34. **With the change in supervisor from NASCU to KNF, higher regulatory standards are anticipated.** These standards may strengthen overall performance of the SKOK sector, but higher standards will also increase the regulatory burden for smaller SKOKs. It is likely that increased regulatory compliance will contribute to mergers and additional consolidation of the sector. The effects of the regulatory change have already been felt with the increased loan loss provisioning requirement. Additionally all SKOKs are now required to have an annual audit, and the small SKOKs will find meeting the reporting requirements of NASCU and KNF costly and burdensome.

35. **MOF develops SKOK prudential standards and detailed rules and methods for performing control activities per the October 2012 Law.** MOF has the authority to draft binding regulation, while KNF can only issue recommendations, none of which are binding. This approach appears to limit KNF’s authority. This is also how it is done in the banking sector. Even though KNF issues only “recommendations” the banks reportedly have a good history of following the recommendations. To date MOF has issued the following regulations: Reporting Information for SKOKs and NASCU, Accounting Principles for SKOKs and NASCU, and Norms of Acceptable Risk. MOF plans to issue one more regulation on the division of the supervision fee between KNF and NASCU. KNF is charged with implementing these rules and regulations. All previous SKOK regulations and prudential standards developed by NASCU are no longer valid except for the institutional capital and solvency ratio calculations which are in force until MOF publishes their ratio calculation in April 2013. Under the October 2012 Law, NASCU has developed 3 new regulations. They are: Administration of Stabilization Fund, Methodology of Examination for SKOKs, and Instruction for Cooperative Examination. The latter regulation designates NASCU as the cooperative auditor for SKOKs and authorizes full control over all areas of SKOK activity.

36. **There is a prudential standard in the October 2012 Law for solvency, but the ratio calculation has not been defined by MOF.** This Law establishes a 5% minimum solvency ratio. The requirement of 5% in the October 2012 Law and the actual ratios are considerably below international standards which prescribe a minimum 8% capital ratio (see Box 4). That being said, SKOK’s should be encouraged to increase capital to more than 5% of total assets to enhance their individual and systemic stability. Capital should be plentiful enough to cover operational risks such as credit, interest rate, and internal control risks and it is currently so low that it is not adequate to cover these risks. It must also be sufficient to:
- withstand unexpected economic shocks caused by cyclical economic conditions;
- protect depositors (and other creditors) from loss;
- fund future growth; and
- protect the system if the SKOK is large or complex.

37. **Estimations of future capital needs reveal that capital must increase substantially to meet stricter regulatory requirements (see Table 2).** Using the average annual asset growth for 2012 and reducing it slightly in subsequent years due to stricter supervisory requirements, capital would have to increase to PLN 2.4 billion by 2018 to reach an 8% capital ratio, implying an average annual growth rate of almost 37%. As of end 2012, capital was PLN 747 million or 4.4% of total assets. With a capital ratio requirement of 5%, the required capital in 2018 is estimated at PLN 1.5 billion, implying a 16.7% annual growth rate in capital.

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11 NASCU uses 2 ratios (included in the KAPER ratios) to evaluate capital – institutional capital/total assets ratio (K5) and solvency ratio. Institutional capital includes retained earnings, member shares, and net income. This ratio should be no less than 4%. Solvency includes all of the aforementioned, revaluation reserve and stabilization funds if applicable. This ratio should be not less than 5% and the goal is 8%.
Box 4: Capital Adequacy for Selected Countries

**Lithuania**
Like Poland, Lithuanian CUs are exempt from CRD IV. CUs in both countries offer credit and debit card products, are fast growing, have an integrated model of development, and have access to central liquidity. The Bank of Lithuania treats CUs as credit institutions and requires an 8% capital adequacy ratio.

**United Kingdom**
The Financial Services Authority requires a minimum capital to assets ratio of 3%. This ratio is a minimum as the regulation states that the Version 1 CU should transfer 20% of their profits to reserves until reserves are equal to 10% of total assets. Version 2 CUs are required to have a risk adjusted capital to total assets ratio of 8%. These capital requirements were announced in mid-2010, and the CUs have until 30 September 2013 to satisfy the requirements.

**Kenya**
CUs must meet two capital adequacy ratios. The minimum core capital (which includes shares, reserves, undivided earnings, donations, grants less equity investments) to assets ratio is 10%, and the minimum institutional capital (excludes shares) to total assets ratio is 8%. CUs were given a 5-year transition period to meet these standards. The five-year period is over as of June 2013. Many CUs have been unable to meet the capital adequacy standard. The regulator plans on giving the CUs additional time to meet the standards.

**Ireland**
Since 2009 all CUs are required to have a regulatory reserve ratio of not less than 10%. Reserves available to a CU for the purposes of the Regulatory Reserve must be realized, unrestricted and non-distributable. A minimum of 8% of total assets must be held in the Statutory Reserve. The remaining 2% of total assets required to meet the overall ratio may be held in Statutory Reserve or in a reserve account called the “Additional Regulatory Reserve” which must be clearly identified as non-distributable. The regulation emphasizes that this is the minimum requirement and CUs are expected to operate with levels above the minimum requirement.

When a CU does not have adequate reserves to meet the Regulatory Reserve ratio, the board of directors of the CU must provide the Registrar with a plan for achieving compliance. Such CUs must achieve the ratio within the shortest time possible. If the ratio falls below 10%, payment of a share dividend must be approved by the Registrar, and the CU board must provide a plan on how to increase the ratio within short-term timeframes.

**Brazil**
A modified Basel II approach is used. The base requirement is an 8% tier-1 capital-to-risk-weighted-assets ratio, and a 2.5% buffer is added for single affiliated CUs. The requirement is 11.5% for central CUs and 15.5% for CUs not affiliated with a central CU.

**Australia**
CUs are required to have Common Equity Tier-1 capital of 4.5% and additional Tier-1 capital of 6% by 2013.

**Canada**
CUs are required to meet the same standards as Australian CUs; however, they have until 2015 to meet the standards.

Source: WOCCU, Dave Grace and Associates, Canadian Cooperative Association, and other regulators.

**Table 2: Capital Growth needed to Meet Regulatory Requirement**

<table>
<thead>
<tr>
<th>Year</th>
<th>Assets (thousands PLN)</th>
<th>Asset Growth</th>
<th>Institutional Capital (thousands)</th>
<th>Institutional Capital-5% (thousands)</th>
<th>Institutional Capital-8% (thousands)</th>
</tr>
</thead>
<tbody>
<tr>
<td>2012</td>
<td>16,907,884</td>
<td>11%</td>
<td>747,000</td>
<td>845,394</td>
<td>1,352,631</td>
</tr>
<tr>
<td>2013</td>
<td>18,598,672</td>
<td>10%</td>
<td>929,934</td>
<td>1,487,894</td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td>20,458,539</td>
<td>10%</td>
<td>1,022,927</td>
<td>1,636,683</td>
<td></td>
</tr>
<tr>
<td>2015</td>
<td>22,504,393</td>
<td>10%</td>
<td>1,125,220</td>
<td>1,800,351</td>
<td></td>
</tr>
<tr>
<td>2016</td>
<td>24,754,832</td>
<td>10%</td>
<td>1,237,742</td>
<td>1,980,386</td>
<td></td>
</tr>
<tr>
<td>2017</td>
<td>27,230,315</td>
<td>10%</td>
<td>1,361,516</td>
<td>2,178,425</td>
<td></td>
</tr>
<tr>
<td>2018</td>
<td>29,953,347</td>
<td>10%</td>
<td>1,497,667</td>
<td>2,396,268</td>
<td></td>
</tr>
</tbody>
</table>

Source: World Bank staff calculations

38. The regulation transition periods have been unrealistically short. The SKOKs have until January 2014 to meet the solvency ratio of 5%. Many SKOKs will have a very difficult time...
meeting the new solvency requirement by January 2014 as their capital is so low. Building institutional capital is a long-term process, and SKOKs should be given adequate time to reach the required solvency ratio. The accounting regulation includes a provision for loan loss requirement of 35% for loans delinquent between 90 days and 12 months and 100% for loans delinquent more than 12 months. These percentages were based on the World Council of Credit Unions (WOCCU) model. The regulation became effective as of January 2012 and applied as of the first financial statement prepared in 2012. No transition period was given, and the impact of this regulation was negative on net income as the loan loss expense increased dramatically and in many SKOKs caused institutional capital to be negative.

39. **KNF and MOF should engage with key stakeholders as they begin regulation and supervision of SKOKs to gain the sector’s support to implement the changes.** Direct communication should be established among the SKOKs and KNF; it already exists between the SKOKs and NASCU. Open communication channels should also be present between KNF, MOF and NASCU, as NASCU would represent the SKOKs and their concerns to the government authorities. New regulations developed by MOF and KNF should be put out for comments not only to KNF, BFG, NBP, NASCU and the National Auditor’s Association but to the SKOKs as well. Comments received should be considered and revisions made as appropriate. Sufficient transition times should be provided so that the SKOKs can prepare for the changes. For example, there was little notice given for the off-site reporting regulation. The SKOKs received a letter on 11 January 2013 that required the SKOKs to submit 30 November 2012 data by 14 January 2013. This data had to be input manually into the forms and there was no ability to save data or correct errors. There were no instructions provided on how to complete the forms. Training should be provided to the SKOKs on the new regulations, forms, and requirements; and training in the form of a webinar or power point presentation should be provided to SKOKs on how to complete the off-site forms. On average the forms had to be returned by KNF three times to the SKOKs to get the requested information. In the future, KNF should provide training on the new regulations, licensing and on-site inspection. To further communication, KNF and MOF should develop a long-term plan for implementing regulation and supervision and provide this plan to the SKOK sector so that participants can prepare for the upcoming changes.

40. **Additional provisions on a number of issues not addressed by the October 2012 Law or regulation need to be further developed to enhance the regulatory and supervisory framework.** The following sections analyze and summarize technical measures that need to be further developed in the regulations to promote a sound SKOK system in Poland.

### 3.1 Licensing and Start-Up Capital

41. **Initial capital requirements and a minimum number of members need to be established to obtain a license.** These requirements are important for various reasons: to limit the number of SKOKs that KNF has to supervise; to ensure that the SKOKs are economically viable and can offer their members the services and products they want; and to allow the SKOKs to take advantage of economies of scale in their operations. Evidence of the initial capital should be included with the application for licensing. In addition, it would be important to include provisions so that individuals intending to establish a SKOK need to demonstrate a common bond. Initial capital concentration limits should be established per member and related parties. No member and his/her related parties should own more than 10% of the initial capital. Fidelity bond insurance should be purchased for all officials and employees.

42. **All applicants should be required to submit a 3-year business plan.** This plan should include the mission statement, market analysis, proposed organizational structure, the written assumptions used to develop the plan, and the pro-forma financial statements. In addition, specific information should be provided on the planned location of the SKOK’s business, the management information system to be used, and minutes of the General Meeting. In order to ease regulation and supervision and

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12 When the government of Mexico introduced financial reforms for credit unions, it initially allowed for a 3-year transition period for CUs to meet new capitalization levels. It has since extended the timeframe an additional 5 years.
enhance governance, the use of standard by-laws is recommended. This will contribute to standardize important aspects for the management and operation of the SKOK.

43. **The process and procedures to follow to obtain a license should be clear in the regulation.** These should include: (i) the deadline that the SKOK must start operations upon receiving KNF approval; (ii) the process to be followed by KNF when a license is denied; (iii) the type of correspondence that the KNF will use to inform the applicant; and (iv) any method of recourse that applicants may have in case they disagree with the denial decision along with any deadlines that may apply.

44. **Officials and proposed management should meet all fit and proper tests.** In order to determine if the officials have the personal integrity, educational background and professional experience to be an official or manager, a thorough background check should be conducted. This check should include a review of the candidates’ CVs, personal and business references, and a credit check.

45. **KNF should be able to conduct an on-site visit if deemed necessary to ascertain if the proposed SKOK is viable.** This visit can be used to determine: (i) if the SKOK will be operated responsibly by individuals considered fit and proper; (ii) the nature and sufficiency of the financial resources of the applicants; (iii) the soundness and financial sustainability of the business plans, and (iv) whether the public interest will be served by licensing the SKOK.

### 3.2 Capital Adequacy

46. **The new solvency ratio to be drafted by MOF should be based on Basel standards.** The October 2012 Law defines capital as member shares, reserves, and net income (or loss) in the prior year, current year, and in process of approval. When members join a SKOK, they are required to purchase a minimum amount of shares as defined in the statute. These shares are known as member shares and are withdrawable only after the annual general meeting approves the financial statement and after covering any losses. Under Basel, these shares do not represent high-quality capital. Quality capital is considered to be undivided earnings, reserve funds that have not been designated for a specific use, cash donations, and grants. None of these funds should be spent except upon liquidation. Net income from the current year should be included only if loss provisioning is adequate, accrued accounting is used, and net income cannot be reduced by membership share dividends at year-end. Shares should be included as capital only if they are non-redeemable or if there is a minimum fixed amount established in the regulation below which capital cannot fall. If the SKOKs do not consider shares as institutional capital, then the actual solvency ratios are even lower than stated above. No institutional capital account should be used by a SKOK as collateral on external borrowing.

47. **Based on international standards, the minimum net profit to average assets ratio should be 1% in order for SKOKs to build their capital.** KNF should require a SKOK to have a higher minimum capital ratio than the one established in the regulation when a particular circumstance suggests it as appropriate. No SKOK should be able transfer from the reserve fund if the institutional capital ratio is below the minimum required. **SKOKs should be required to build their institutional capital by retaining a percentage of gross income.** The fastest way to build the capital ratio is to reduce assets; this however, is probably not realistic and could be counterproductive given the ongoing demand for services offered by SKOKs. In the UK, CUAs are required to transfer 20% of their profits after taxes – but before dividends – to reserves each year until reserves reach 10% of total assets. **In the US, CUs are required to transfer 10% of gross income (before operating expenses and financial costs) if their statutory reserves are less than 4% of assets.** Once that level is achieved, they are required to transfer 5% of gross income until statutory reserves are more than 6% of assets. After the 6% ratio is obtained, no further transfers are required. In the US, gross income is used to ensure that capital reaches the required minimum even if the CU is operating at a loss. If the net result were used instead of gross income, there would always be the chance that there would be a net loss instead of net income and no transfer would be made.

48. **Regulation should stipulate the power that KNF has over a SKOK if it does not comply with the requirements on capital adequacy.** Nowhere in the October 2012 Law or current regulation does it state what will happen to a SKOK if it does not meet the required solvency ratio or falls below the required ratio. The supervisor frequently has the ability to: (i) suspend CU lending and
investment; (ii) prohibit the CU from acquiring, through purchase or lease any additional land or buildings; (iii) prohibit the CU from accepting further deposits or other lines of credit; or (iv) any other action deemed appropriate by the supervisor.

3.3 Delinquency and Loss Provisions

49. SKOKs should be required to have a written collection policy that is reviewed by the Supervisory Board no less than annually. The policy should establish: (i) when the credit control procedure is activated in respect to delinquent loans; (ii) a description of the various stages of the credit control procedure from first contact with members in arrears to the legal recovery process and/or enforcement of security; (iii) the criteria and procedure, including approval procedure and authorization required for rescheduling loans and for transferring members’ deposits against loan arrears; and (iv) the criteria and procedure including approval procedure and authorization required for writing off bad loans.

50. Regulation should require that loans be reported as delinquent when a full payment has not been received. The day on which the loan should be reported delinquent depends on the loan repayment schedule. Any loan in which the payment is less than a full payment according to the loan contract should be considered in arrears and should be classified delinquent depending on the number of days since the last payment was received.

51. Regulation should require that when disclosing delinquency the entire outstanding loan balance should be reported as delinquent, not just the amount of the delinquent payments. The prudential standard for delinquent loans as compared to total loans should be disclosed. This ratio should be calculated by taking the sum of all reportable delinquent loans divided by total loans. Normally this ratio is 5% or less.

52. In some cases, regulation may also consider provisions for the performing loans portfolio. In some countries CUs are required to have a provision for performing loans on the order of 1-2%. This provision is established in anticipation of loan losses that are present in the loan portfolio but have not appeared as of the provision date. Based on the rising delinquency trend in SKOKs over the past few years and the negative impact on earnings of the 35 and 100 percent provision requirements, a more forward looking provision is strongly recommended.

53. All current loans that have been restructured or have been adjusted in their original terms should be provisioned at no less than the lowest provision percentage for problem loans. In addition, if a loan is restructured more than one time it should be provisioned at 100%. Restructured loans should be reported separately on the balance sheet and reported no less than quarterly to KNF.

54. KNF should establish stricter measures in special circumstances. KNF should require more severe classifications of specific loans or additional provisions in the following cases: (i) general deterioration in the loan portfolio; (ii) a change or absence of adequate SKOK lending procedures; (iii) abnormal losses within a particular loan type; (iv) weak delinquent loan collections; (v) a concentration of large or risky loans; (vi) negative trends and conditions in sectors or industries the SKOK serves; and/or (vii) natural disasters that affect the borrower’s ability to repay.

55. Provision accounts should be established for each asset class. Provisions should be required not only for loans, but for all asset types for which a loss is likely, or when the recoverable amount of the asset is less than its carrying value.

56. Standardization of loan write-off procedures is needed as it appears the SKOKs do not routinely write off uncollectible loans. Generally CUs should write loans off if: (i) they are more than 365 days delinquent; (ii) the CU has lost contractual rights over the loans, such as when a borrower is declared bankrupt; (iii) the loans are deemed uncollectible, such as when a court has ruled against the CU, all collateral has been repossessed, valued and sold, and the proceeds failed to cover the entire amount due; (iv) a CU is unable to collect or there is no collateral; or (v) efforts to collect the debt have been abandoned.

3.4 Liquidity and Asset Liability Management

57. The SKOK Supervisory Board should have a written Liquidity and Asset Liability Management (ALM) policy. The board should be responsible for annually reviewing and adjusting
the policy to identify: (i) who is responsible for liquidity management; (ii) who may access or establish a line of credit for liquidity purposes; (iii) how liquidity will be monitored; (iv) types of liquid assets the SKOK may hold; (v) minimum and maximum levels for total cash assets and for amounts kept on-site at the SKOK; (vi) liquidity related ratios; (vii) the process that will be used to monitor ALM; and (viii) how often the ALM analysis will be performed.

58. **In addition to the liquidity reserve requirement of 10% stated in the October 2012 Law, SKOKs should have 15% of savings and deposits in liquid assets to provide for savings withdrawals, loan demand and operating expenses.** SKOKs should establish a line of credit for liquidity purposes with NASCU or a different source. Each SKOK should analyze liquidity needs no less than monthly. This means that management should look at the liquidity needs over the past month and ensure that liquidity is adequate to meet the liquidity needs for the next month. Special consideration should be given to seasonality or any special circumstance that might affect liquidity.

59. **External borrowing should be limited to a percentage of assets and be short-term in nature.** According to WOCCU standards, external borrowing should be limited between 5% and 15% of total assets depending on the level of institutional capital. External borrowing should be no more than 5% of total assets for CUs with institutional capital of 8% or more, 10% of total assets for CUs with institutional capital of 10% or more, and 15% of total assets for CUs with institutional capital of 12% or more. Borrowing should generally be limited in CUs as their basis is savings and shares, not external credit. A CU’s ability to borrow depends on its financial condition, adequacy of its capital base, and presence of highly liquid collateral. External credit frequently has a destabilizing effect on CUs and therefore should be minimized. An exception could be made for newly established CUs. The maximum level of borrowing may be higher for start-up CUs and those that have been in existence less than 3 years.

60. **SKOK management should take appropriate steps to manage interest rate risk by reviewing and managing the balance sheet structure.** This process should include: (i) determining rate-sensitive assets and liabilities; (ii) matching the maturities for rate-sensitive assets (such as loans and investments) with rate-sensitive liabilities with similar terms (such as loans from external sources and member deposits); (iii) matching fixed assets with institutional capital; and (iv) matching liabilities and member deposits with no maturity with short-term (maturity < 30 days) assets. This analysis of the SKOK’s balance sheet should be documented. The regulation should include precise definitions for liquid assets, rate-sensitive assets and liabilities, and interest rate risk.

61. **KNF should impose restrictions on the operation of a SKOK if it fails to comply with the regulation.** These measures should include: (i) suspension of lending and investing; (ii) suspension of taking new deposits; (iii) prohibition on acquisition of additional assets; (iv) prohibition on declaring dividends; and/or (v) prohibition or suspension of activities that KNF perceives to be contributing to the liquidity problem.

### 3.5 Investments

62. **The SKOK Supervisory Board should be responsible for formulating, reviewing and amending an investment policy that is consistent with the Law and any related regulation.** The policy should address: (i) purpose and objectives of investment activities; (ii) types of investments that can be made; (iii) investment characteristics such as issuer, investment quality, maturity, and interest rate; (iv) who has authority to make investments and the extent of this authority; (v) the need for adequate investment diversification and concentration risk management across investment type and/or entity; (vi) limitation with regards to specific type, quantity, and maturity of investments; and (vii) any necessary mechanism of internal control. SKOK management should provide an investment report to the SKOK Supervisory Board no less than monthly with the following

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13 This ratio is calculated: Liquid Assets (those with no maturity or a maturity of 30 days or less) – Liabilities due in 30 days or less / Average Savings Deposits over last 3 months.

14 There is no foreign exchange risk involved as the Polish SKOKs are not legally allowed to take deposits or extend loans in foreign currency.
information: (i) all investments held by the SKOK; (ii) interest rates, maturity dates, and other applicable terms; (iii) investment activity for the month such as buying and selling, principal repayment, and interest repayment; (iv) comparison of the book value to the current market value where possible; and (v) adequacy of provisions established for investment loss.

63. **Investments should be made with the intention of “holding to maturity”**. Maximum investment maturities for each of the permissible types of investments should be defined. At no time should the portfolio be used to trade securities for profit, placing the SKOK’s capital at risk.

64. **A clear definition of fixed assets should be provided in the law**. If a SKOK wants to invest in fixed assets in excess of the limit established in the Law, it should first receive a waiver from KNF. The request for a waiver shall include a detailed investment appraisal showing the cost and justification for the investment, including how it will improve members’ services, and an analysis of expected impact on the profitability, liquidity, and capital adequacy requirements. When a SKOK acquires property for future expansion, at least partial utilization of the property – as related to SKOK operations – should be accomplished within two years from the date of purchase, unless KNF authorizes otherwise.

65. **Property that is repossessed from a delinquent borrower should be transferred to the SKOK’s books at the lower value of the outstanding loan balance or its current market value**. The current market value should be established by an appraisal. The appraisal should be performed by a qualified employee or official, provided that appropriate steps have been taken to ensure independence of the designated individual. Any losses due to loan balance being greater than the market value of the property should be charged to the provision for loan loss when the asset is transferred to the SKOK’s books. Any decline in property value while on the SKOK’s books should be charged to an account established to recognize such decline in value on the SKOK’s balance sheet. Charges for such declines in value should not be made to provisions for loan loss as the asset is no longer considered a loan.

66. **Disposition of the repossessed asset should take place within three years by sale or write off**. The property should be advertised publicly for sale once the asset is on the SKOK’s books. If a SKOK is unable to sell the property in a year, the SKOK should reduce the value of the asset by 50% each year for two years until the value is zero. The reduction in the asset should be made through a contra asset account designated for the write down. After the third year, the asset should be written off the accounting records. Any direct costs and expenses associated with the acquisition of the title to the property and its maintenance should be considered a SKOK expense.

### 3.6 Savings and Shares

67. **Member savings generally represent the largest liability on the SKOK’s balance sheet**. Regulation should address the types of accounts that may be offered, any specific terms, conditions, and disclosures for the savings and share accounts, and how dividends and interest are to be calculated, accounted for, and paid. Interest on savings accounts may be fixed or variable in nature, paid at various rates, and the interest payments may occur at different frequencies depending on the type of deposit and its terms. Interest on savings and term deposits should be accrued no less than on a monthly basis, unless the interest is paid out monthly.

68. **KNF should establish a maximum amount of shares and deposits that a member and his/her related parties may own in order to limit concentration risk**. Usually a member and related parties may own no more than 10% of shares and deposits.

69. **Share withdrawals should be allowed only if the SKOK has met all capital adequacy and liquidity requirements**. No member should be allowed to pledge shares as collateral or security for a loan. A member should be allowed to transfer shares to other members – if allowable at the SKOK – upon leaving membership if the SKOK would not refund the shares. Shares dividends should not be guaranteed. Dividends should be paid from net income for the current year only after: (i) adequate provision for losses have been made, (ii) required transfers to reserves have been made, and (iii) capital adequacy requirements have been met.
3.7 Credit

70. The SKOK Supervisory Board should be responsible for formulating and approving a lending policy and revising the policy, as needed, no less than annually. The policy should include: (i) eligibility requirements for receiving a loan; (ii) permissible loan purposes; (iii) acceptable types of collateral; (iv) loan portfolio diversification with regards to collateral and loan types; (v) loan types granted along with the interest rates, terms, frequency of payments, and conditions; (vi) maximum loan size per product type; (vii) maximum loan amounts as a percentage of the collateral’s value; (viii) factors used to evaluate the borrower’s ability to repay the loan; (ix) borrower and related borrower loan limit concentrations; (x) restrictions on loans to employees and officials; (xi) loan approval authority and limitations for individuals with credit granting authority; (xii) reporting requirements to the Supervisory Board and report content of individuals with loan approval authorization; (xiii) required loan documentation; and (xiv) requirements for co-signers and guarantors.

71. Each SKOK should be required to have written procedures that address how to determine a borrower’s ability to repay a loan and the value and condition of any collateral. These procedures should include: (i) an interview with the borrower; (ii) collection of adequate financial information; (iii) how financial information presented, including income and expense, is verified and analyzed; (iv) calculation of appropriate financial ratios; (v) a physical examination and valuation of collateral; (vi) mechanisms to prevent conflicts of interest; and (vii) controls to assure segregation of duties between the approval and payment of loans.

72. Regulation should include the maximum amount of the savings and loan fund that may be lent. The established maximum amount should not only be related to one member, but to a member and their related parties. A member should be allowed to repay a loan prior to maturity in whole or in part on any business day without being penalized. When a loan application is denied, the SKOK should communicate to the applicant in writing the reason(s) within 14 days.

73. No legal or regulatory restrictions should exist that prohibit a SKOK from charging either fixed or variable interest rates on loans. The effective loan interest rate (including all interest, fees and costs) to be paid by the borrower should be disclosed in writing prior to granting the loans. A SKOK should be allowed to assess penalties for late loan payments.

74. All collateral used as security for a loan should be adequately insured. Every guarantor should be adequately informed in writing of the nature of the liability prior to signing an agreement creating guarantor liability. All collateral should be located within a reasonable geographic proximity of the SKOK’s office and never outside of the country. If the owner of the collateral is not the borrower, the borrower should have written permission to use the collateral to secure the loan and proof that it is adequately insured to cover the loan balance. The SKOK should have the legal right to place a lien on the collateral.

75. SKOKs should be required to report to the credit bureau. In an effort to provide financial institutions with the best information for making a loan decision, SKOKs should be required to report member loan payments to the credit bureau. SKOKs make many small loans, so it might make sense to establish a threshold in which they have to report loans that exceed the threshold amount.15

3.8 Accounting and Auditing

76. SKOKs should use the chart of accounts, accounting principles, and reporting formats required for other financial institutions. SKOKs continue to report under a general accounting system required for a wide array of non-financial businesses such as retail stores. This type of reporting is inadequate for a financial institution; it does not require provisions for bad loans or write downs on investments.

77. Regular reporting of financial statements should be required. SKOKs should produce an income statement and balance sheet no less than monthly that details all transactions for the month.

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15 In 2012, the average loan size was PLN 8,882 for the 5 largest SKOKs and PLN 4,224 for all SKOKs.
Transparency and disclosure of financial information should be encouraged. Upon request, SKOKs should be required to provide their members a copy of their annual financial statements and external auditor report. Internal audits should be reported directly to the Supervisory Board. The internal auditor should not report to the head of the management board, as there is a potential for conflict of interest in this reporting scenario. An audit plan covering all aspects of the SKOK’s business should be developed. The plan should identify the scope and frequency of work to be carried out in each area. Areas identified with higher risk should be covered more frequently. However, all areas should be covered over a one-year period.\footnote{16}

78. The internal or external auditor should perform a random sampling verification of member loan, savings, and share account balances annually. Under no circumstances should the verification be performed by a SKOK employee or official. Account statements should be sent to the members, and the statement should instruct the members to contact the auditor if any of the account balances are different than what is in their records. The members’ verified balances should then be compared to the amount in the SKOK’s records to ensure they match.

3.9 Supervision

79. The October 2012 Law gives KNF supervision authority and powers over SKOKs and NASCU and establishes the supervision activities and objectives. Article 71 states that KNF can recommend certain actions when there are financial, operational, or managerial problems. These actions include taking measures needed to: (i) restore liquidity; (ii) meet and maintain the standards mentioned in the Law; (iii) correct irregularities; (iv) increase the ownership funds; and (v) discontinue specified types of advertising. Article 71 further states that KNF may also ask the SKOK supervisory board to: (i) remove management board members; (ii) suspend members of the management board; (iii) order the SKOK to limit the scope of its operation; and (iv) order the SKOK to stop carrying out a specific activity. These powers do not make up a full complement of supervisory tools. Usually the supervisor can issue administrative actions such as Memorandums of Understanding, Cease and Desist Orders, and Prohibition Orders that prohibit the SKOK from doing business with individuals or entities and prohibit the SKOK from taking certain operational decisions such as declaring dividends, expanding activities, or purchasing fixed assets above the limit. These powers should be elaborated in a regulation. Additional regulations are also needed to support the new powers included in the draft Law that give KNF the right to take over, merge and liquidate SKOKs.

IV. SKOK Supervision

80. KNF, the supervisor of all financial institutions in Poland, is now responsible for performing off and on-site supervision of the SKOK sector. KNF has to be mindful that their approach cannot be a “one size fits all”. The approach must also be proportional keeping in mind the size and risk of the sector as compared to the overall financial sector (see Box 5).

\footnote{16} The internal audit work plan should include: verification of cash without prior notification; bank account reconcilement; checking loan files for compliance; verification of the SKOK’s assets and investments; ensuring all provision for loss accounts are adequate; checking for compliance with policies and procedures; checking for compliance with the Law, legislation and regulation; checking minutes and reports of the committee of management and other committees for compliance and assessing regularity and completeness; evaluation of the reliability of the information produced by the SKOK accounting and computer systems; determining that reports and information submitted to the KNF are accurate and provided timely; determining accounting procedures and controls are adequate; verification that management has implemented and maintains appropriate internal controls throughout the SKOK; assistance with the selection of the external auditor; and ensuring that all internal and external audit findings and recommendations are implemented as agreed upon.
Box 5: Supervision of Credit Unions: General Guidelines

Credit Union supervision includes objectives, principles and methods similar to those of banking supervision. As addressed by the Basel Committee in the “Core Principles of Effective Banking Supervision”, supervision should have clear objectives and responsibilities. The supervisor should be independent, apply transparent processes, have sound governance, adequate resources and be accountable for their actions and discharge of their duties. The International Credit Union’s Regulators’ Network has established 21 principles for effective supervision that should be in place to achieve successful supervision in a credit union sector. A summary of the principles is as follows.

- The licensing authority must have the power to set criteria and reject applications for CUs that do not meet the standards.
- The supervisor must ensure that all CUs comply with cooperative principles, recognizing that some second-tier organizations have proportional voting for members.
- Permissible activities of CUs must be clearly defined.
- Minimum capital adequacy requirements have to reflect the risks that CUs undertake and the components of capital have to be defined in terms of its ability to absorb losses.
- Supervisors need to certify that CUs have a comprehensive risk management process (including Board and senior management oversight) to identify, evaluate, monitor and control, or mitigate all material risks.
- Supervisors must be satisfied with CU’s policies, procedures and processes to assess, identify, measure, monitor and control credit, liquidity, operational and interest rate risks.
- Supervisors must require CUs to maintain adequate reserves.
- Supervisors must be satisfied with CUs processes to manage concentrations within portfolios and prudential measures to limit exposure to single members or related parties.
- Supervisors must have the power that permits intervention when there are conflicts of interest in CUs and related party exposure.
- CU internal controls must: (i) be adequate for the size and complexity of the business; (ii) include clear arrangements for delegating authority and responsibility; (iii) address separation of the functions that involve committing the CU and paying away its funds; (iv) have reliable accounting for assets and liabilities; (v) safeguard the CU’s assets; and (vi) include appropriate internal audit and compliance functions to test adherence to applicable laws and regulations.
- Adequate accounting records must be kept in accordance with widely accepted accounting policies and practices and an acceptable level of disclosure should be provided.
- Supervision should consist of a group of examiners designated specifically to CU supervision with the means to collect, review, and analyze prudential reports, and with the capacity to verify these reports.
- Supervisors must have complete access to all documents, information and staff members.
- The supervisor must have a range of enforcement tools to facilitate timely corrective action. These include the authority to issue appropriate legal orders, revoke licenses (or recommend revocation), impose restrictions on the activities and operations that CUs conduct, and approve all mergers, liquidations, or changes in organizational.

Source: International Credit Union Regulators Network.

4.1 SKOK Supervision Scheme

The October 2012 Law does not do away with NASCU in a supervisory capacity but has established a confusing scenario for KNF and NASCU to act as co-supervisors. NASCU is responsible for controlling activities of SKOKs. KNF has the right to control the principles and methodology of examination activities carried out by NASCU with respect to effectiveness and adequacy of these activities. KNF oversees and controls SKOK and NASCU activities. As the supervisor, KNF can issue recommendations, order preparation of recovery plans or appoint administrators in case of SKOK insolvency. KNF may recommend to NASCU to make changes in methodology and principles defining the manner and scope of carried out control activities. General terms such as “controlling activities” by NASCU and “recommendations” to be made by KNF are not defined in the October 2012 Law; thus allowing ample room for interpretation.
82. Thus, SKOKs are subject to a form of “double supervision” from KNF and NASCU as supervision is performed by KNF, but NASCU has to control SKOKs. This means for off-site reporting, as of 11 January 2013, (effective date of MOF regulation on off-site reporting) SKOKs now are obliged to complete two different sets of forms on a monthly and quarterly basis for NASCU and KNF. The KNF off-site report is 32 pages. The entire report is completed quarterly while about half of the report is required monthly. The NASCU report is about 8 pages, all of which is completed monthly by the SKOKs. The SKOKs will also be subject to on-site supervision by KNF and NASCU. KNF will perform on-site inspection every 3 years or more regularly as needed. NASCU will also perform on-site inspections of 2 kinds per the October 2012 Law. Article 44.3 states NASCU shall perform the Cooperative Audit (known as inspection) per the Cooperative Law, and Articles 63 and 66 state that NASCU shall “control SKOKs for conformity of their operations with the Law” and NASCU will do so by performing an audit as described in their “Methodology of SKOK Control”. This current dual supervision system is overly burdensome on the SKOKs both with regards to time and cost. Per comments made by NASCU and KNF, SKOKs are confused as to which entity they should answer to first and with whose recommendations they should comply. SKOKs are accustomed to working and complying with NASCU; most in the near term will continue to meet NASCU’s requests and recommendations before answering KNF. This does not provide for a good working relationship between the parties involved.

83. Supervision and regulation of the SKOKs has been divided up amongst four KNF departments – off-site, on-site, licensing, and regulation. Supervision costs will be covered by an assessment of .024% of total assets set out in the October 2012 law. This fee is currently allocated between KNF (90%) and NASCU (10%). In the draft Law, KNF will receive all of the fee to cover its costs. The off-site department is the only department with dedicated SKOK supervision staff. There are ten analysts. To date the off-site department has received data for October-December 2012. The KNF off-site reporting was difficult for the SKOKs as they did not receive any training on how to use and complete the forms, and the forms could only be completed on-line, were populated manually, and the users were unable to save the data.

84. KNF has prioritized its supervision objectives. First, KNF believes that the SKOKs should have close common bonds and not the open type of bond that has allowed the SKOKs to grow very quickly. KNF plans on moving the SKOKs back to the more limited common bonds through stricter licensing requirements and does not plan on licensing SKOKs in the future with more than 10 employee groups. Second, KNF is in the process of gathering information on the SKOKs. Per Article 87 of the October 2012 Law, all SKOKs had to be audited within three months of the effective date of the Law. This was a one-time audit with an effective date of 30 September 2012, and the results were due to KNF as of 25 January 2013. The terms of reference for the audit were developed by the KNF off-site department and were broader in scope than an annual audit. The SKOKs chose the auditors and paid for the audit. The results of this audit will be provided to KNF, NASCU, NBP, MOF, and the National Cooperative Council. Annual audits are required for all SKOKs as of 31 December 2012. NASCU also submitted to KNF on-site SKOK examination reports performed between October and December 2012. Third, many SKOKs have low capital; KNF plans on dedicating significant time to developing and monitoring SKOK capital rehabilitation plans in cooperation with NASCU.

85. These capital rehabilitation plans should have short and long-term goals that allow the SKOKs to meet the solvency ratio in five years or less. SKOKs that show good trends and meet their capital goals should not be subject to supervisory penalties or administrative actions, even if they have not met the required 5 percent solvency ratio\(^\text{17}\) by January 2014.\(^\text{18}\) This ratio will be difficult to achieve since building capital is a slow process for SKOKs, which have few sources for increasing capital.

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\(^\text{17}\) This ratio will be defined by MOF by April 2013. The most similar ratio currently in use is the KAPER Institutional Capital/ Total Assets ratio.

\(^\text{18}\) The Law is silent on the actions to be taken if a SKOK does not meet the ratio, and KNF should exercise discretion to the extent possible in applying this aspect of the law.
86. **On-site SKOK inspections by KNF started in February 2013.** The inspections of NASCU and ten SKOKs are planned for 2013. The final on-site inspection report will be received by four entities – SKOK Management and Supervisory Boards, KNF, and NASCU. Full on-site inspections by KNF will be conducted every three years, and follow-up inspections will be conducted as needed for SKOKs and NASCU. Currently KNF does not have a SKOK risk rating system such as CAMEL or KAPER to assign a score and assist with risk management.

87. **Future SKOK supervision should do away with the two entities working independently. KNF should perform all off and on-site supervision. NASCU should focus on assisting the SKOKs in addressing KNF supervisory concerns and providing operational, managerial, and financial solutions for SKOKs.** Additionally, NASCU could participate in the (i) licensing process by giving an opinion on candidates for the position of president of the management board and on proposals for changes to statutes and (ii) regulating process by giving opinions on issued regulations that effect SKOKs. KNF should use the resources of NASCU as appropriate, as NASCU has more experience working with SKOKs than any other entity in the country, is well known internationally, and has a full staff that is trained and versed in SKOK issues.

88. **Additionally, NASCU could function more as an apex organization and continue to provide a link between the SKOKs, KNF, and the financial system.** Just as in the past, NASCU could: (i) represent SKOK interests within the country and internationally; (ii) undertake activities for development of the sector by expressing opinions on laws and regulations; (iii) participate in the preparation of legislation and a Code of Ethics for member SKOKs; and (iv) develop training as needed. NASCU could pursue financial activities, accumulate SKOK deposits, grant SKOK credits, invest free resources, and organize financial settlements. SKOKs could maintain reserves at NASCU in the form of liquid reserves, stabilization funds, capital reserves, and deposits that were not being used. NASCU could raise additional funds for liquidity maintenance and for granting credits to SKOKs by means of cooperation with banks, which would include transaction of credits and issuing commercial term investment bills (KWIT). NASCU could also provide settlement services to SKOKs (involving the use of payment cards and ATM cards).

89. **NASCU has an experienced and developed monitoring department.** There are six persons in off-site monitoring responsible for analyzing monthly, quarterly, and annual off-site reports and for developing recommendations that are shared with the on-site department and SKOK management. As a result of this information, they produce a comprehensive report for each SKOK and the SKOK system as a whole based on the KAPER ratio system. The report focuses on the key areas of capital, profitability, liquidity, overdue loans, and reserves. Each SKOK receives an overall KAPER rating. The rating is based on points, and the ratings range from A to E, with an A rating being the best. This system is used to evaluate the risk associated with each SKOK and to prioritize supervision. There are fourteen persons in the on-site department, and they perform on-site monitoring in the SKOKs generally every two years and more frequently if needed (every three years is required in the Cooperative Act). The department plans to perform a number of audits as the “controller” of SKOKs, including a comprehensive audit covering all the activities of the SKOK, an issue audit that reviews selected aspects of the activities of the audited entity, a follow-up audit intended to verify the implementation of the recommendations from the previous audits, a planned audit carried out in accordance with the annual (periodic) audit plan, and an ad hoc audit carried out independently of the annual (periodic) audit plan and applying simplified procedures as indicated. If serious irregularities are found during any audits, NASCU plans to provide recommendations to the SKOK to address the irregularities within a prescribed period and notify KNF.

### 4.2 Stabilization Fund Supervision

90. **In the October 2012 Law it is unclear as to the entity that has ultimate control and decision-making authority over the stabilization fund. KNF has supervisory powers over SKOKs yet has no power or decision-making authority over the SKOK stabilization fund administered by NASCU.** The stabilization fund, which is constituted by at least 1% and no more than 3% of SKOKs’ assets, remains at NASCU. The Law provides for an arrangement where KNF decides about rehabilitation programs and NASCU decides about the use of stabilization funds, while in the draft law the resources of the stabilization fund would be transferred, if necessary, by NASCU to the
Currently SKOKs have a two-tier protection scheme for member deposits. The first level of protection is the stabilization fund. The fund is used to assist SKOKs with problems if they can be rehabilitated. In the past, the fund has proven adequate. Rehabilitation loans have a maximum 5-year term with a 0% interest rate. The future of the fund and its adequacy will be tested due to the provision for loan loss requirement of 35% of loans delinquent more than 3 months and 100% of delinquent loans more than 12 months. This requirement became effective as of January 2012. This change resulted in negative net earnings for many SKOKs. There are currently 7 SKOKs with stabilization fund loans, and NASCU anticipates that the number could grow substantially (see Table 3). NASCU may have to prioritize stabilization loans based on need, something they have never done in the past. Moreover, NASCU representatives inferred that most of the resources of the fund would be used in capital rehabilitation plans for SKOKs with negative or very low capital. The second level of protection is the mutual insurance company fund – TUW. The fund insures SKOK member deposits up to EUR 100,000 in cases when the stabilization fund cannot provide adequate coverage.20

Table 3: Structure of the Stabilization Fund in PLN (December 2012)

<table>
<thead>
<tr>
<th></th>
<th>Value</th>
</tr>
</thead>
<tbody>
<tr>
<td>Retained Earnings - NASCU</td>
<td>237,947,305</td>
</tr>
<tr>
<td>Shares from SKOKs</td>
<td>173,431,003</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td><strong>411,378,308</strong></td>
</tr>
<tr>
<td>Number of SKOKs with stabilization fund loans</td>
<td>7</td>
</tr>
<tr>
<td>Amount of Stabilization Fund Loans</td>
<td>31,152,785</td>
</tr>
<tr>
<td>Balance of Stabilization Fund Loans</td>
<td>28,283,447</td>
</tr>
</tbody>
</table>

Source: NASCU.

V. DRAFT CREDIT UNION LAW UNDER DISCUSSION DURING FSAP MISSION

92. At the time of the FSAP mission, a draft credit union law was under discussion in Parliament. The most critical issues under discussion were: (i) enhanced KNF supervision tools; (ii) clarification of the scope of information to be provided by SKOKs to KNF; (iii) BFG guarantee for SKOK member deposits up to EUR 100,000; (iv) more comprehensive regulation of the SKOKs’ liquidity reserve; and (v) modifications of the existing framework for the reorganization, restructure, winding up and insolvency of SKOKs making it easier for KNF to divide, merge, takeover, or liquidate SKOKs.

93. In the draft law, SKOKs would have access to the mandatory deposit guarantee system (BFG). This would be a very positive change for SKOKs. There are no requirements or exclusions for BFG insurance; insurance will be granted to all licensed SKOKs. It is also anticipated that SKOKs would be able to access BFG financial and restructuring assistance. Regarding coverage of guaranteed

20 TUW terminated the insurance agreements effective 1 May 2013. Thus, this level is no longer in place.
deposits, SKOKs would have 6 months from the effective date of the amendment for deposit insurance (this waiting period is due to IT and data requirements).

94. In the draft law, BFG financial support and restructuring measures would have a two-tier structure for SKOKs that require assistance. The first tier would be early intervention. The trigger for this intervention would be, generally, of a qualitative nature. Trigger events would include: i) the SKOK has incurred, or is likely, to incur losses; ii) solvency of the SKOK is under threat, a solvency ratio of less than 1% is considered solvency under threat; or iii) the liquidity of the SKOK is under threat and it is likely the SKOK will be unable to pay its debts. The SKOK would go to NASCU first, and if NASCU could not meet its needs then the SKOK would apply to BFG for assistance. The source of the assistance funds would be the SKOK Sub-fund. BFG assistance would be available only to SKOKs that were subject to reorganization proceedings conducted according to KNF requirements, with a positive decision by KNF, and in which the BFG claim were fully collateralized. BFG could offer a guarantee, warranty, or loan. The second tier of assistance would occur when the net worth/total assets ratio reached the legal trigger of 1%. NASCU would have the option to assist the SKOK, if financially possible. If NASCU declined, then KNF could merge the SKOK with another SKOK or Bank.²⁰ do a Purchase and Assumption (P&A) transferring the rights and liabilities of the SKOK at risk to an acquirer, with financial support given to the acquirer as needed, or liquidate the SKOK. In case the liabilities were greater than the assets, KNF could suspend the SKOK’s operations, thus triggering the guaranteed deposit payout process. The first source for pay-out would be the SKOK Fund that would start with a balance of zero and would be capitalized by SKOK annual fee contributions of up to 0.3% of total assets and off-balance sheet liabilities. The fee percentage would be determined annually by BFG’s Council and the fee could be increased to 0.6% by MOF. The second source for payout would be the NASCU Stabilization Fund. All or part of the Stabilization Fund would have to be transferred to BFG, if necessary by NASCU. The amount transferred to BFG would be equal to the amount of the deficit needed for pay-out. NASCU would still have decision-making authority over the Stabilization Fund amount that remained with NASCU. The third source is BFG Other Funds known as the assistance, statutory and reserve funds. These funds are well established and are available for use by other financial institutions, not just SKOKs. The final source is extraordinary sources and includes a loan or grant from NASCU, the state budget, or a short term loan from NBP.

VI. CONCLUSIONS

95. SKOKs represent a small portion of the financial sector, but provide a variety of products and services to over 2.6 million depositors largely of low to moderate income. Around the world, lower income people are frequently not well served by banks, so they look for other financial alternatives such as CUs. Similarly, Polish SKOKs have effectively filled this gap and this is evident by the asset growth over the past two decades. SKOKs offer a wide variety of savings and loans and other sophisticated electronic products. The development of the sector is largely due to innovative leaders and a strong national association, NASCU. The sector has now reached a point where the largest SKOK has assets large enough to put the SKOK in the top twenty banks (by asset size) in the country, and the larger SKOKs are competing with banks and are nationally recognized. With these large SKOKs, comes the need for public supervision and regulation by an entity such as KNF. Government authorities recognized this and transferred SKOK supervision and regulation to KNF at the end of October 2012.

96. KNF must prudently manage their new supervision and regulation responsibility. This means the SKOKs must have adequate time and support to transition their operations to meet the new stricter regulation and supervision. International experience has shown that a considerable amount of effort has to be made by the supervisory agency to: i) develop reasonable timelines for reforms, ii) provide clear and realistic transition rules, iii) clearly communicate the new framework to the sector, iv) establish deadlines for SKOKs to implement changes as directed by KNF, and v) allow for

²⁰ There is no law or precedent on how to merge a SKOK with a bank, so this may prove difficult.
adequate follow-up to ensure the changes have been made. Without this process in place, the implementation may well be flawed and the supervisory and regulatory changes could negatively impact the sector and pose systemic risk. The largest SKOK holds 40% of the sector’s assets and has 850,000 members.

97. KNF should move ahead with its off- and on-site supervision plans as provided for in the draft Law. Future SKOK supervision should do away with KNF and NASCU working independently of each other. The law or regulation should allow for KNF to delegate as they see fit certain activities to NASCU to assist them in their supervisory role.

98. KNF should work closely with MOF to develop regulations that support the draft law and regulate specific technical issues. The development of additional regulations should be done in consultation with key stakeholders to gain the support of the sector, and the comment periods should be sufficient for NASCU to circulate the proposed regulation among the SKOKs for their comments. Comments received and presented by NASCU should be considered and revisions made as appropriate.

99. The SKOK sector is clearly at a turning point. If the CU management and members support the process of rehabilitation and regulatory and supervisory changes are handled well, the sector will continue to grow, provide a safe place for members to save their money, and do what it does best – provide affordable financial products and services to low and moderate income members. If the CU management and members do not support the process of rehabilitation and supervision changes are not handled well, then one of the more developed CU sectors in the world could be negatively impacted, as well as the millions of SKOK members that have come to rely on their SKOK for dependable and affordable financial services.