ARGUMENTA OECONOMICA
No 2 (16) 2004
PL ISSN 1233-5835

*Dorota Korenik**

SPECIAL PURPOSE RESERVE IN THE POLICY OF A COMMERCIAL BANK

A special purpose reserve is presented as a financial management category for a commercial bank, an element shaping the present and future policy of relations with debtors. The emerging trend of conservative policy concerning this kind of reserve has been explained together with its underlying reasons and consequences for debtors in Poland.
Keywords: special purpose reserve, commercial bank, financial management category

INTRODUCTION

An inherent element of any banking activity is credit risk, arising as soon as the agreement to finance the customer is signed. The consequences of this risk occur when the debt is not repaid in due time, either totally or partially. The efforts to gain public credit from present and potential depositors, as well as to secure the best possible conditions to acquire capital financing, require the rational creation of a special reserve. This reserve is the factor determining the economic safety level for a bank, important for depositors and capital investors. The more the credit risk is covered by a specially created reserve, the higher is its economic safety level. This means that depositors are better protected from the situation where they would be forced to vindicate their savings, and the capital investors from the situation where they would be forced to participate in losses of the bank, absorbed by the bank's ownership capital. On the other hand, however, the more the potential credit risk is covered by a special reserve, the greater is the negative influence on the economic effectiveness of a bank, being the focus of interest for capital investors. The level of economic effectiveness defines the attainable remuneration level for the donators of banking capital. This benefit can take the form of a dividend or increased market value of shares. Moreover, the higher the level of created reserve, the more probable it is that the bank keeps higher margins on credits. This is the way of securing high profits, to maintain economic effectiveness good enough to attract and keep capital investors. The margin for credits cannot however be higher than that used by the competitors of a bank, since then the effective demand for credit would decrease

* Departament of Finance, Wroclaw University of Economics

through the bank's fault (some other factors creating effective demand are independent of a bank), and decrease its ability to create profits. Too low level of reserve can in turn provoke undesired reactions of current depositors, prevent new ones from depositing savings in this bank, or deteriorate the conditions of gaining some additional ownership capital. It may force higher or prevent lower credit margins, impeding an increased effective demand of debtors.

In the light of the above, each bank is forced to play a game to protect the interests of different groups of entities (depositors, capital investors, debtors). One of the instruments of this game is a special purpose reserve. The aim is to create demand for the bank's products (deposits, capital, credits) necessary to maintain the long-term ability to generate profits. The play with such reserve is going on separately for one part of the reserve, which is created obligatorily, i.e. according to the regulations governing the banking sector, and for the other part, created voluntarily. The play itself is quite complicated, since the kind and scope of obligatory regulations may influence the conditions of co-operation between the bank and debtors, concerning the forms of credit repayment security and credit cost (credit margin) that are dependent on the classification group of the debtor (the classification framework is defined by the regulations on special purpose reserve). The manifestation of the played game is the commercial bank policy towards the special purpose reserve, connected with:

1. policy of credit risk reduction, including credit repayment security and credit concentration policy;
2. pricing policy.

The aim of this paper, dealing with some aspects of financial management of a bank, is:

1. to present the essence and characteristics of the special purpose reserve as an element of the bank's activity;
2. to present the connections of the reserve policy and the general policy of creating the economic security of a bank;
3. to show the possible influence on the policy of financing the economy.

From the point of view of a bank, the knowledge of these interconnections might be useful when striving to its ultimate objective – economic efficiency. How the banks could use their reserve in the practice will be demonstrated with the example of one of the Polish banks. This study, being comprehensive, is due to the limited space, presented in a synthetic way. First of all, it is a model describing the role and internal relations of a special purpose reserve inside the financial management system of a commercial bank. This model will be also placed in the regulatory environment now in force in Poland.

1. THE ESSENCE AND CHARACTERISTICS OF THE SPECIAL PURPOSE RESERVE IN THE BANK'S ACTIVITY

A special purpose reserve forms an element of financial management of a bank, both in the risk and in the profit area. First of all, it should however be perceived as an element of the risk area.

In the area of risk, the question is to determine the risk threshold to be accepted by the bank (not to eliminate it totally), being not lower than that imposed by the external regulations, and to match accordingly the various levels of financial reserve, such as:

- updated value of assets, including those encumbered with credit risk – i.e. special purpose reserve
- minimum profit included into the product price, taking some share of the risk cost, so also credit risk
- created reserve for general risk and general risk fund
- part of profit increasing the ownership capital of a bank.

The creation and maintenance of a special reserve is the activity counterbalancing the risk connected with the granted credits and other debts, and serves to minimize the risk of any single transaction, so directly minimizes the global risk. If the special purpose reserve is created in such a manner that its level counterbalances the risk of future charges of the cost or loss type, the conditions are fulfilled for a bank to exhibit the real financial outcome for the given accounting period. The information on real income is sought by the banking supervision, potential capital investors, and may also be of interest to depositors and debtors. The banking supervision disciplines the bank management at the same time to submit detailed information on special purpose reserves being created and dissolved.

The created reserve level is related to the possibilities and conditions of other reserve creation, firstly however it remains under the influence of external regulations, presented in the preceding article by D. Korenik: "Polish Regulations concerning Special Purpose Reserve – Changes and Consequences for Banks". Any performed activity not complying with external regulations is threatened by possible intervention of supervising authorities, which spoils the bank's image in its environment and, as a consequence, decreases competitiveness (by worse conditions of getting cheap and stable financing and profitable utilization of acquired funds by selling active products).

Banks are obliged to create a special purpose reserve for receivables encumbered by a credit risk. This risk may be realized or not, and the banks should create the appropriate reserve anticipating the potential financial losses connected with this risk. Such a reserve should be created in particular for those credits, which already could not be repaid in conformity with the concluded agreement. The reasons for credits 'in danger' include:

- inaccurate assessment of the market situation and introduction of new products by the debtor's competitors, leading to lost sales and service receivers
- increased cost of production or investment which, due to the competition circumstances, cannot be included into the price, therefore the 'exhaustion' of the debtor's source of credit repayment
- wrong evaluation of the customer creditworthiness by the bank's personnel
- pathological, criminal behaviour of the debtor (swindle, credit fraud).

The role of a special purpose reserve is to absorb the already revealed losses which have their origin in the above reasons. But this is not all – they have also a preventive (systemic) character, they secure the bank in the case of potential losses. The preventive character appears in particular when a special reserve is created for such credits that involve the risk of losses becoming less probable. So, the role of this reserve can be compared to the emergency break, that serves not to stop, but to slow, down to a safe speed, both the credit action and other bank's liabilities. The basic reason for a reserve creation is to guarantee the security of a bank by limiting the possibility of transferring the owners' (shareholders') risk onto the depositors.

In the previous paper published in the 14th issue of "Argumenta Oeconomica"("Polish Regulations concerning Special Purpose Reserve – Changes and Consequences for Banks") two dimensions of the regulatory environment for banking activity concerning the reserve have been presented: the balance-sheet aspect (connected with the accountancy act and the acts concerning the methodology of the reserve classification) and the taxation aspect. It has been shown that there are specific relations between these dimensions. In the present paper the dominant idea is: the bank, being aware how important for the market its estimated value is – being the base for investors' decisions on capital allocation – plays a peculiar game. The valuation of assets and liabilities, in other words the updated value, is indeed the play between the balance sheet and the profit and loss (P&L) statement. A higher asset value in the balance sheet means a higher profit or lower cost in the P&L statement. A lower asset value in the balance sheet means a higher cost or lower revenue in the P&L statement. This persists up to the moment of the transaction settlement, when the cash outcome, i.e. cash flow, discloses the final effect.

For banks, the magnitude of reserve as the outcome of calculated risk, should be first of all an entry into the P&L statement. At the same time, the bank should solve the question of measurable costs, e.g. the reserve cost, including the taxation consequences of the creation or dissolution of this reserve (since not every accountancy cost calculated according to the special purpose reserve classification scheme imposed onto banks can be the taxation cost in a given accountancy period) or the lost opportunity cost due to the particular structure of assets and liabilities kept by the bank, that may be less risky, but also less profitable. All this affects the final effectiveness of a bank, determines the price of the bank's products as well as the internal regulations for its credit activity. Let us add here that the bank's policy concerning the special reserve can vary with the changing regulatory environment (which has been discussed in the previous paper) and the economic environment.

2. SPECIAL PURPOSE RESERVE AS AN ELEMENT FORMING THE ECONOMIC EFFICIENCY OF A BANK

Economic efficiency is a key criterion when a modern bank is assessed by its owners and potential capital or financial investors (depositors). It is of particular importance if the advantageous conditions of its financing are to be maintained, even when the external environment is quickly changing. Let us remind ourselves that the economy of a modern bank should be evaluated from the point of view of its efficiency, the base of which is the relation between income and costs. When efficiency is used as a criterion, it should have a measurable form, therefore the efficiency of a bank is measured in terms of its profitability. This is due to the fact that the basic objective of a commercial bank is to generate profits at an acceptable risk level. Profitability, as the derivative of an economic activity and its measure, reflects the rationality of the bank's activity. Profitability therefore implies that a surplus of operating profits over costs, so net profit is obtained. Therefore profitability as a criterion of assessment is for banks the basic way to measure the efficiency of their activity, and the most common here is the factor analysis. For example, the Polish National Bank evaluates the gross and net profitability of the banking sector (*Sytuacja ...*, 2001).

When we try to decompose the economic efficiency criterion (ROE – return on equity) in the context of risk, the special purpose reserve category appears. This is presented in Fig. 1.

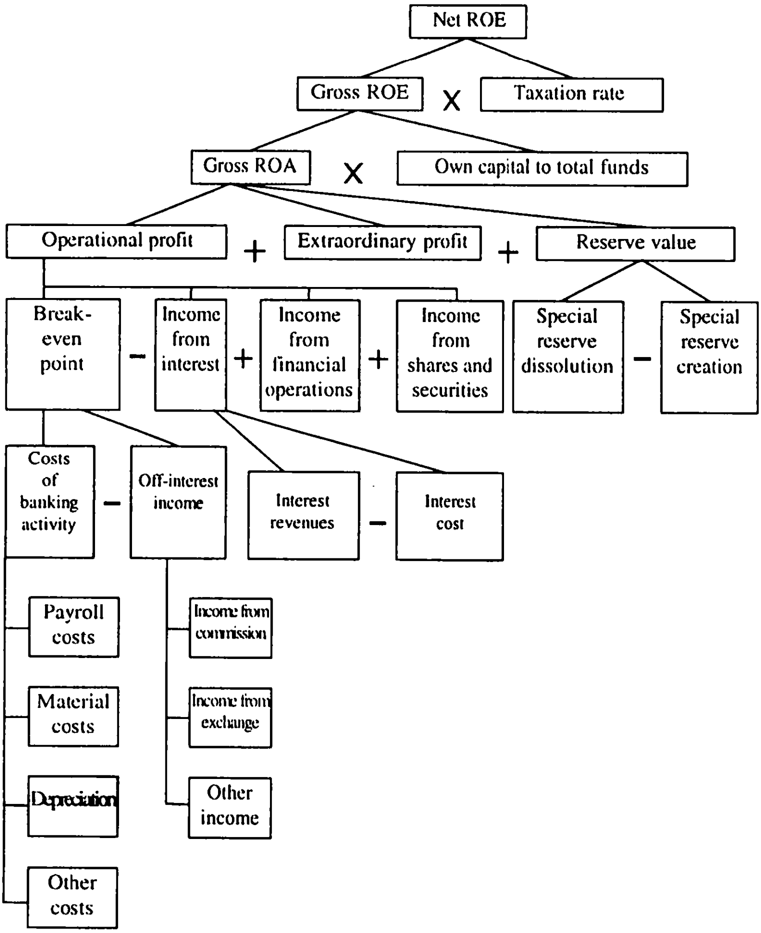

Figure 1. Index model of effectiveness assessment based on the DuPont system
Source: J. Świderski, *Finanse banku komercyjnego*, Warsaw 1998, p. 80

If we analyse the causal and consecutive relations of ROE and focus on its element: "reserve value change", it can be seen that the more positive it is, the better for gross ROA (return on assets), and in consequence for gross ROE. An abrupt increase of reserve can be a method to improve ROA, but on the other hand it can lead to suspicion that it is due to a worse economic situation and connected with a decreased quality of credit portfolio, or is due to strong credit expansion. In the latter case, the reaction is always delayed with respect to debt creation. If a considerable part of the profit is a result of the reserve dissolution, the question arises whether the reserve in the previous year was of a 'political' character, and now has been made real, or maybe it was real in the last year, and is now 'political'. Such manipulations may be intended to create a 'hidden reserve' or conditions necessary to apply for extra financing. The bank management may lead some policy in this matter: to present the given level of special purpose reserve as necessary for the economic safety of a bank, and another time to dissolve them since the reasons justifying their creation are no longer valid. The space for such manoeuvre in Poland does exist now and banks are allowed to create a higher reserve than the minimum obligatory level (Bill of Decrees 2001, No 149, pos. 1672).

It is believed that a creative reserve policy like that (defined as 'conservative') is indeed applied, as shown by the example of ING Bank Śląski (Kowalik 2002, p. 14). The mechanism of the conservative policy is based on the assumption that though the special purpose reserve seriously affects the profits of a bank in the accountancy records, it is calculated only in the accountancy sense. When a bank creates some reserve, no real cash outflow occurs (of course, if this deduction is separated from its reasons). The manipulations of this type have also another dimension – they allow to create revenues concerning this part of the reserve that covers the cost of income acquisition. Indeed, ING Bank Śląski demonstrates an unflagging surplus in the creation of the special purpose reserve (the highest figure was at the end of 2001). A part of this reserve was counted as income acquisition cost. Thus the bank cumulates the funds that can be temporarily invested. Of course, when the reserve is dissolved, money should be returned back. Meanwhile it can work, e.g. in the interbank market. Based on such an assumption a simplified calculation can be done, as presented in the specialized journals (Kowalik 2002, p. 14).

It has been assumed to the calculation, that the special purpose reserve structure for irregular credits did not undergo essential changes (in the reports prepared by the Securities and Exchange Commission in Warsaw such a specification is lacking). A half-year reinvestment of funds has also been assumed, and the base to calculate the appropriate profitability was the return of a three-month WIBOR. Therefore the cumulated value of saved money has produced more and more profit each year, regardless of the decreasing interest rate. The total profit, counted for six years, during which the bank continuously creates new reserve, is near to PLN 100 million. This manipulation would be even more attractive if attempts were done to calculate profits obtained due to reinvenstment of this surplus.

It should however be mentioned that such a positive result can be obtained when neglecting the reasons, namely the credit policy of a bank. If the credits were totally lost, all this operation would mean losses for the bank. Quite different is the situation, when the increased reserve is connected with the changed standards of the bank's portfolio classification. Under this situation, the standing of debtors and therefore the quality of the credit activity does not change, this is only the banking viewpoint that requires other perspective to see this phenomenon. The consequences for the cash management of a bank are however serious and connected with taxation duties. In order to treat such a calculation and the resulting surplus as pure profit it should be assumed that the sum of the two operations – creation and dissolution of reserve – equals zero, and all the created reserve could be fully recaptured. (The last amendment of the Accountancy Act of 2000 has given the possibility to vindicate debts even when they are not written into the balance sheet of a bank.) This is however an ideal situation. Of course, it is difficult to judge unambiguously if the high level of reserve in ING Bank Śląski is indeed due to the bad quality of the credit portfolio – this may be known to the banking supervision. Taking however into account that this bank treats over 23% of credits as irregular, while for the banking sector as a whole this percentage at the end of 2001 was equal to 17%, one may speculate that at least a part of these PLN 100 million makes a true surplus for the bank.

3. SPECIAL PURPOSE RESERVE AS AN ELEMENT OF A BANK'S POLICY TOWARDS REGULATORY CAPITAL

The level of reserve is connected with the regulatory capital of a bank – being a key category in its functions and activities. Before these interconnections will be explained in more detail, let us remind ourselves of their fundamentals.

The function of regulatory capital, similarly to the special purpose reserve, is to absorb the possible losses of a bank. The primary function of this capital however (and more precisely – the economic capital, it does not necessarily have to be equivalent to regulatory capital) is to finance the activities. This capital should therefore be the first line of defence when the operational risk appears. This is the reason why the banking act determines the minimum capital necessary to obtain the permission for the creation of a bank, and later for its operation. According to the Commercial Company Code, the spare capital should be created to cover losses, other types of capital may also be statutorily created to cover particular losses or expenses (reserve capital), including the general risk fund. The basic measure of the solvency of a bank, its solvency ratio, is dependent on the magnitude of its own funds. At the same time it is a synthetic measure of the quality of a bank. It should be added however that some theorists would treat own funds rather as a kind of a buffer securing stable activity under conditions of market expansion, not as coverage for losses. In the theory, the low share of own capital in the balance sum of a bank does not allow capital to absorb losses. The norms of credit and capital concentration, applying also to funds, permit however to considerably dissipate the magnitude of losses from a particular customer.

The special purpose reserve, through its interrelations with regulatory capital, can influence the ability of a bank to create this capital. This reserve is connected with the solvency ratio, which for the banks becomes even a goal in itself, through:

1. the credit exposure value decreased by the value of a created special purpose reserve – important for the denominator of the solvency ratio,
2. the weight of risk attributed to the particular credit debt – important for the denominator of the solvency ratio,
3. the income from credit exposures – important for the numerator of the solvency ratio.

It should be noticed that banks are not allowed to create a special purpose reserve for interest on credits, so income acquisition costs cannot increase in this way, while at the same time in the solvency ratio there is a capital requirement for interest receivables (Official Journal NBP 2001, No 22, pos. 43: The Resolution ... 2001 No 5; Official Journal NBP 2001, No 22, pos. 43.: Appendix) – this forces them to increase their own capital. The source of this increased capital could be the current profit, which under the present construction of the solvency ratio is not foreseen at all, and in addition, the interest from credits usually cannot be included into the revenues of a bank. This is a restrictive approach to the banks, it will increase their demand for capital to keep the solvency ratio. Increased capital requirements should cause a decrease of solvency ratios and consequently deteriorate the chances for the bank's activity and development. They can also lead to a decreased competitiveness of Polish banks. An additional capital requirement, estimated by the banks as 15-20 per cent of their present value, can force them to search extensively for new solutions concerning the denominator of the solvency ratio.

An improvement of this ratio through the increase of the denominator can mean a reduced share of some entries (including credits) with high risk weight. It can be particularly sensible to exclude these credits, which require the special purpose reserve not counted as a taxation cost. The picture of the solvency ratio would thus be improved and the operational costs decreased. An improved solvency ratio could also mean the creation of assets with respect to the risk weight obligatorily attributed to them: the lower the risk weight is, the lower the denominator of the solvency ratio. Granting credits with a deduced reserve value can be therefore reasonable, if these credits are characterized by a low risk weight – cf. Table 1. So, the regulations concerning the special purpose reserve combined with those for the solvency ratio determine the credit activity of a bank, which will be discussed in the next part of the paper.

Banks are also obliged to use the concentration limits for receivables. The main regulations of the Polish Banking Supervision Commission (KNB) call for:

1. taking into account the face value of these receivables without a deduction for a special purpose reserve and with no risk weight in the concentration measures;
2. decreasing the concentration by the receivables guaranteed by securities;
3. annual revaluation of mortgage security;

4. conversion of receivables and off-balance sheet liabilities into Polish currency.

Table 1

Risk weight for assets to determine the solvency ratio of a bank

Risk weight (per cent)	Selected assets
0	1. Receivables from class I entities 2. Receivables from class II and III entities, in their part secured by class I entities with • sum of money transferred to the bank account • guarantees (warranties) given by class I entities • securities emitted by class I entities 3. securities emitted by class I entities 4. securities emitted by class II and III entities, in their part guaranteed (warranted) by class I entities
20	1. Receivables from class II entities, in their part not covered by the 0% risk weight 2. Receivables from class II entities, in their part not covered by the 0% risk weight but secured 3. Guarantees (warranties) given by class II entities 4. Securities emitted by class II entities 5. Securities emitted by class III entities, in their part not covered by the 0% risk weight, but guaranteed (warranted) by class II entity
50	1. Receivables from class III entities, in their part not covered by the 0% and 20% risk weights, but secured by the mortgage upon real property inhabited at present or in the future by the debtor or leased (intended for lease)
100	1. Receivables not included into the risk weight 0, 20 or 50% (including the receivables due to the settlements with contractors of not established identity) 2. Securities in their part not covered by the 0, 20 or 50% risk weight, shares and other elements of own funds of other entities

Class I entities – central banks and governments of states included into the A zone and the Polish State Treasury (and government institutions of the central level), Polish National Bank NBP, Corporation of Insurance and Export Credits KUKE, Banking Guarantee Fund

Class II entities – banks domiciled in the A zone countries and banks domiciled on the territory of Poland; local or regional authorities of the A-zone countries, Polish self-government units and their associations, multilateral development banks, European Development Bank

Class III entities – entities not included into classes I or II.

Source: Official Journal NBP 2001, No 22, pos. 43

The creation of a special purpose reserve is therefore of no meaning for the base used to calculate the concentration limits. This does not apply however to the collateral securities – so for the sake of concentration limits it is reasonable to accept the securities. In contrast the mortgage as the collateral becomes troublesome, though in the solvency ratio it is taken with a 50% risk weight, not 100%.

4. SPECIAL PURPOSE RESERVE IN THE CREDIT ACTIVITY OF A BANK

The credit activity of Polish banks has revealed their characteristic trend to limit the scope of expenses not included into the income acquisition cost. In practice, this can take the form of:

1. reduced creation of credits that need a special reserve, not being the income acquisition cost;
2. reclassification of credits into the class that allows for the creation of a special reserve counted as the income acquisition cost, without influencing the real quality of credit activity;
3. creation of credit portfolio secured in such a way that the accepted legal securities make an element decreasing the level of those special reserves that are counted as the income acquisition cost.

Some small compensation for the banks that keep their credits in the'normal' category for consumption credits and 'under observation', for which the special purpose reserve cannot be treated as the taxation cost, is the possibility to decrease the credit value by an amount equal to 25 per cent of the general risk reserve (this reserve is only partially created in debit of the income acquisition cost).

For the banks particularly unfavourable is the credit category 'under observation', even though the above mentioned possibility to reduce the reserve exists. The interest from the receivables 'under observation' is treated in the balance sheet as reserved revenue and cannot enter into the profit and loss statement, though under the former regulations it was included into revenues. In this way the interest from the receivables 'under observation" has been equalled to that from the receivables 'in danger'.

Here another question should be raised by Polish banks, which is connected with the proposal of the then Minister of Finance, G. Kołodko, to include the banking sector into the so-called emergency plan. The considerations made until now concerned the special purpose reserve utilized as an instrument guaranteeing the economic security of a bank and banking sector as a whole. In practice, this kind of reserve can also be applied as an economic tool of public aid given to enterprises. This has already happened under the act of financial restructuring of enterprises and banks issued in 1993. It has been proposed by Minister Kołodko that the Act on public and legal receivables from enterprises would involve banks into the financial restructuring of enterprises being the debtors of a bank. Under this project, banks would amortize the debts classified as 'lost' from the enterprises covered by the restructuring program. The reserve created for these receivables could be counted as the income acquisition cost that would permit paying lower taxes. Therefore "the image of the credit portfolio of banks will be improved" and an additional benefit would be "lower cost of maintaining the reserve" – according to the announcement given at a government meeting. Banks would also be allowed to convert the debts into shares of the enterprises without the need to show them as revenues in the taxation sense. This would induce different fiscal treatment of a reserve created by banks. In the present situation, the magnitude of reserve created according to the recommendations of the banking supervision authorities is greater than the reserve in the fiscal sense; this could be balanced in the nearest future, and from the taxation point of view it would be advantageous for the banks. The Ministry of Finance itself estimates this benefit as high as PLN 300 million, this is not much regarding over 18% share of debts 'in danger' in the portfolio of the banks for the end of 2001 (this would make nearly one sixth of the obligatory liabilities of the banks' financial outcome, mainly taxes, in that year).

The small amount of lost taxes in the prognoses of the Ministry of Finance suggests that the scope of the new solution is not as wide as the importance attached by the government to the emergency plan. As has been stressed by the Minister, this aid for the banks will not be for nothing. The bankers would have to decide whether to grant new credits to the restructured companies, for which they had kept some reserve in the balance sheet quite recently. This would not differ much from the procedure of rolling credits, and quite soon the 'new' credits would be classified into 'old' risk groups. One of the banks has called this the 'rejuvenation' of the credit portfolio, but not the amelioration, which would be possible if the State Treasury could take an active role giving its guarantee for the new credit. This is however quite near to evoke once more the situation highly undesirable for the banks they already have experienced regarding the Polish State Railways. When this company was unable to repay several hundred million zloties of the credit guaranteed by the State Treasury, the government simply prolonged this guarantee. The banks moved the repayment deadline and again everything was 'in order'. The problem is that the State Treasury cannot guarantee credits for everyone. In the light of the communication after the Cabinet meeting it seems that this aid would concern "the industries particularly threatened and extraordinarily important for the national economy". This requirement means that the whole restructuring operation may become 'centrally controlled', though the project of the restructuring act states that the decisions should be undertaken by the first instance institution and all enterprises can take advantage of the act. Only for some key industries could the authorities making the decision and having some doubts as to the advisability of giving permission for the financial restructuring, ask the opinion of the ministers of finance, labour, economy, treasury or environment protection. The proposals of the Minister of Finance concern companies with overdue taxes, and these companies would receive the taxation premium, not the companies regularly paying their taxes and having no outstanding payments. The same debtors would be also rewarded by the banks offering them 'new' credits. According to the amended corporate income tax law, the enterprise cleared from debts would not count the amortized debt as a revenue in the taxation sense. The reduction of the credit debt would lead to an improved creditworthiness of the restructured company (so the possibility to take development credits), and this is considered as permitting an increase of production capabilities and keeping an increased employment level. The designer of the amended company income tax law tries to make the amortization of credit liabilities from the restructured enterprises connected with the banking arrangement proceedings under the regulations on financial restructuring of enterprises and banks or settlement proceedings under separate acts, especially beneficial for the banks. The bank could make some taxation savings by:

1. increased income acquisition costs through the possibility of including the reserve created for the 'lost' receivables and to increase the base for the creation of reserve 'doubtful' in the taxation sense;
2. including the amortization of credits for the restructured enterprises into the income acquisition costs;
3. the possibility to deduce 20 per cent of the amortized credit from the basis of taxation.

All this gives rise to some fears, also among the banks, that it is always better to be an unreliable debtor. Not paying liabilities may show a difficult situation, that should be understood even by commercial banks. If the banks however start to be convinced that debtors go unpunished, they should tighten the procedures and requirements towards the potential debtors rather than soften them.

As has been demonstrated in the previous section, credit activity is influenced by other regulations, also concerning the solvency ratio. It would be reasonable that the bank creating the special purpose reserve for credit assets, choosing the direction of the credit activity takes into account not only the taxation aspect, but also the connection with risk-weighted assets. So, in the first order the most advantageous for the solvency ratio are credits given to banks domiciled in the countries of the A-zone and the banks domiciled in Poland, as well as to territorial self-governments and their associations in Poland. The best credits are those backed by:

1. sum of money transferred to the bank account;
2. guarantees (warranties) given by the State Treasury or NBP;
3. securities emitted by class I entities, e.g. the State Treasury or NBP.

Such assets have a 0 per cent risk weight. Let us also mention that a similar result will be obtained by the bank when it refrains from granting credits and buys securities emitted by class I entities, e.g. the State Treasury or NBP, or securities emitted by the class II or III entities guarantees (warranted) by class I entities. This is a kind of competition in the banking business: to credit or to invest in securities. A similar phenomenon can be seen for assets of 20 per cent risk weight.

From the review of risk weights it appears that the most advantageous is for a bank to credit territorial self-governments, while enterprises or public only if the repayments are guaranteed by class II entities or backed with securities emitted by class II entities. Due to the attributed risk weight somewhat worse are the receivables secured by a mortgage on inhabited real property. Credits of another kind or otherwise secured have the most unfavourable influence on the level of solvency ratio.

From the above it follows that the choice of repayment securing has a twofold meaning for the bank: firstly – it influences the attribution of an appropriate risk class into the solvency ratio, secondly – defines the possibility or lack of possibility to deduct it from the base for a special purpose reserve calculation. Let us also add that the lower reserve exerts an unfavourable influence on the solvency ratio. Therefore, if a bank needs to lower the base for a special reserve, it should require from their debtors to back their debts using the securities from the allowed list (Bill of Decrees 2001, No 149, pos. 1672). Additional restrictions are however applied to some allowed securities that can decrease the base for the reserve calculation. When the credit is secured by mortgage, cession of property rights of movable goods, cession of property rights on securities (except emitted by the State Treasury or NBP, central banks or governments of the OECD states and other banks), this deduction cannot concern the full amount. Keeping this in mind, the banks have to work out their own policy to secure the repayment of credits in the context of a special purpose reserve.

CONCLUSION

All this leads to more stringent requirements towards debtors, they are expected to fully cover the credit and have more difficult access to the credit. Limited credit activity does not favour lower interest on credits, desirable according to the principle: high turnover with a low margin. The price for obtaining credit remains therefore comparatively high, composed not only of the interest, commission and fees, but also of the cost of creating the collateral accepted by the bank. It is also stressed that banks lead a conservative policy towards collaterals. They require from customers such securing that reduces for them the need to create the special purpose reserve, but on the other hand these collaterals are of no meaning when classifying the debtor to a better risk class – this translates directly into the price of credit paid by the customer. Finally, the banks actually demonstrate a high level of credits 'in danger', but a large part of them is very well collateralized (Niedaleki ... 2002, p. 12) and should not cause any problems for banks. Thus, in the most general and concise way, can be presented the influence of special purpose reserve on the behaviour of the banks and their relations with debtors.

Last of all, let us add that probably the banks in Poland are already prepared to improve their systems of risk coverage, try to make them 'most friendly' for the ability to strengthen economic efficiency. The systems that secure banks from risk are in fact extended and contain: information of risk exposure, control of norms included in prudential regulations and internal limits, anticipation of future potential losses (e.g. special purpose reserve, value reassessment, reduction of risk consequences), and the distribution of risk (derivatives or credit insurance).

REFERENCES

Official Journal NBP 2001 No 22, pos. 43. The resolution of the Banking Supervision Committee No 5 of 2001 on the scope, procedure and rules to determine the capital requirements for particular kinds of risk, including that of exceeding the limits of debt concentration, and on the way and detailed rules of calculating the solvency ratio.

Official Journal NBP 2001 No 22, pos. 43. Appendix No 3 to the resolution of the Banking Supervision Committee No 5 of December 12, 2001.

Bill of Decrees 2001 No 149, pos. 1672: Instruction of the Minister of Finance of December 10, 2001, on the rules of creation the reserve for the risk connected with banking operations.

Kowalik, F. *Zysk rezerwowy* [*Reserved Profit*]. „Gazeta Bankowa", February 5–11, 2002.

Niedaleki koniec swobody [*Soon the End of Freedom*]. Wywiad z Generalnym Inspektorem Nadzoru Bankowego [An interview with the General Inspector of Banking Supervision] „Bank" 2002 no 1.

Sytuacja finansowa banków w 2000 r. [*Financial Situation of Banks in 2001*]. „Synteza NBP" Warsaw, April 2001.

Świderski, J. *Finanse banku komercyjnego* [*Finances of the Commercial Bank*]. BmiB, Warsaw, 1998.

Załącznik nr 1 do Zarządzenia nr 13 Prezesa NBP z dnia 10 grudnia 1994 r. [Appendix to the Instruction of the President of NBP No 13 of December 10, 1994].

Received: November 2002; revised version: May 2003