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## **Do Polish Banks Impose Limits on Crediting Companies?<sup>1</sup>**

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### **Abstract**

The aim of the paper is to verify the hypothesis that Polish banks impose restrictions on crediting in particular with reference to small sized companies. According to the theory, banks are exposed to asymmetric information, and besides objective risk resulting from changes in the borrower's position, they are exposed to moral hazard. It may result in restricting credits with reference to all or some borrowers, directly by rigorous procedures on credit accessibility or by raising interest rates.

As the results of the research carried out among Polish banks show, banks do not declare a strategy of restricting access to credits but they take steps to protect themselves against risk including, among others, more and more sophisticated procedures to investigate the customer's creditworthiness and requirements of collaterals of adequate security value. These requirements adversely affect small sized companies in particular, as their financial reports are not adjusted to supply the required information and they do not have required collaterals at their disposal. Moreover, small sized companies are considered to be less loyal than large sized companies and the profitability of bank operations generated by them is lower. That is the reason why they are not offered lower interest rates what additionally discourages them from applying for credits. This may result in increasing the riskiness of small borrowers portfolio by discouraging to a larger degree those that have low but stable revenues than those that are more risk-prone.

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Key words: asymmetric information, borrowers' behaviour, banks' strategies, transition

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## **Introduction**

The relationship between the bank and the borrowers is subject to heavy objective risk and to asymmetry of information bounding rationality of the decisions of the lender. It is why the individual borrowers may adopt strategies aiming at risk reduction (by securities requirement, creditworthiness assessment, structures of credit contract). Protection against risk may be a source also of common undertakings of the banking sector, especially under the form of information sharing.

Nevertheless, as well information asymmetry as particular risk-protecting measures may imply negative selection of the borrowers. Credit rationing may be differentiated as to particular layers of customers, especially disadvantaging the SME.

The paper summarizes the results of empirical inquiry carried on by the authors in the first half of 2005 in the form of open-ended questionnaire in the headquarters of a dozen of biggest Polish banks. The objective of this research was to reveal the subjective feeling of degree of asymmetry of information as perceived by the bank officers and to indicate the principal strategies applied by the individual banks or by the sector as a whole to reduce creditor's risk.

The purpose of this paper is:

- to define the level and sources of risk in activities of Polish creditors including asymmetric information and the risk of dishonest conduct and differentiating them with reference to different groups of borrowers,
- to identify banks' strategies against the risk of crediting and asymmetric information,
- to verify the hypothesis that there are restrictions in crediting and that costs of credits differ with reference to different groups of enterprises, the banks' customers.

The first section outlines the problem of asymmetric information and its consequences for the strategies of the banks, in particular within the framework of an economy undergoing transition to the free market.

Section 2 underlines the probability of credit rationing and of its impact on the pace of investment in Poland, on the statistical data revealing the high degree of internal financing in

enterprises and on the results of previous inquiries, concerning the role of credits in Polish firms.

Finally, section 3 describes the results of a questionnaire carried on in the principal Polish banks. The questionnaire was aiming at gathering information about the elements of strategy of the bank, on procedures applied in taking credit decision, requirement of collateral, monitoring and debt collection procedures. The qualification and assessment of the bank's staff and opinions on dishonest conduct of the borrowers were subject of inquiry as well. The questions were aiming at identification of differences in providing credit for large and smaller borrowers and of the scope and ways of credit rationing.

It should be underlined that the empirical research of this type has not taken place since early 1990s, so the beginning of transition. Thus the present research may be a good indicator of progress and eventual biases on the way to regular market economy in the banking sector.

The conclusion is summarizing the elements that may discourage especially small sized companies from borrowing even without a strategy of differentiated credit rationing that could be declared by the banks.

### **1. The importance of asymmetric information in the process of bank lending.**

The asymmetry of information between the lenders and the borrowers is one of the key concepts in the contemporary finance and banking theory (Stiglitz, Weiss, 1992, 694-724), (Hubbard, 2002), (Mayer, 1994, 1-13). A credit agreement, and in particular an investment credit agreement, is subject to a high level of uncertainty due to objective reasons: long term of an agreement and specific investment risk. However, the two parties to the agreement are not limited to the same degree in taking a rational decision because of their fundamental asymmetric difference in access to information that enables them to foresee chances of success of their venture. Sharpe points out that while the borrower takes only an objective risk, the creditor takes additional consequences of potential dishonest information provided by the borrower (Sharpe, 1990). That is why banks are exposed to consequences of unfair conduct of their customers. What is rarely taken into account, as well the clients of the banks are subject of asymmetry of information and especially of competence against the banks. In

particular they may be the victims of unfair or unclear information on the products and on the rules of cooperation issued by the banks (Lissowska, 2005).

Potentially high risk of extending credits due to unstable macroeconomic situation, the poor quality of institutional environment and asymmetric information usually result in increasing interest rates on credits. This in turn, according to Mishkin, causes increased risk of negative selection (more hazardous customers are less sensitive to interest rates and hence more inclined to apply for credits than less hazardous customers) and rising irregular credits (Mishkin, 1990). Awareness of asymmetric information and unknown distribution of risk among customers' population may also result in imposing limits on credits by creditors, differentiating accessibility and costs of credits for various borrowers considered to be more or less prone to dishonest conduct.

Imposing limits on crediting and high interest rates result in the deepening of financial restrictions in business activities, both due to difficult access to credits as well as the worsening standing of companies (profitability drops because of increased financial costs, the real value of future profits declines due to increase in discount rates) (Hubbard, 2002). This in turn may lead to enforced giving preference to internal financing. Financial restrictions might affect small sized companies badly as they virtually have no access to financing via capital markets (Whited, 1992).

Another solution aimed at reducing effects of asymmetric information, that new institutional economy suggests, is lending on collateral and improving information data on borrowers (Williamson, 1998). This is of course currently applied in the banking practice nowadays, under the form of creditworthiness analysis and a system of different collaterals required together with sophisticated credit contract formulas.

The value of information on borrowers has an impact on different aspects of banking business. In order to enhance information and to reduce the risk, banks would be willing to maintain long-term relations with their customers (Dell'Ariscia 2001). The practice of relational banking is also profitable for firms, especially the newly set-ups or the distressed ones that can be supported by a promise of sharing future profits (Rajan 1992).

Scarcity of information is an important deficiency in the banking business, and thus a barrier to the entry of new banks. It would be valuable for every bank to broaden the scope of its information that initially would be limited to its clients. Nevertheless, there appears to be a conflict between sharing information and competition (possibility to gain confidential information on good and bad borrowers). In a given structure of the banking sector (that is more or less concentrated) sharing information may be enabled if:

- banks are endangered by high moral hazard due to opportunistic behaviour of borrowers (Dell'Ariccia 2001)
- it is necessary to discipline borrowers (Padilla and Pagano 2000).

In a country like Poland, which has behind it a short, only fifteen years long, history of functioning under the framework of market economy, there exists a higher probability of both asymmetry of information between the lenders and borrowers and of its consequences for the conduct of economic agents in the form of negative selection and moral hazard (Lissowska, 2004), (Grabczan, 1994), (Mesjasz, 1999).

The reason of amplified asymmetry of information is mainly still considerable economic instability and weakness of information resources. There exists and still comes to being a big number of economic agents and out of it a big part disappears within a short time for being unable to cope with market competitors. The other ones are frequently changing the kind of business they carry on, their address of even their name. The cases of apparent successive registrations under another name just to disappear from sight of the lenders are still frequent. The tradition to undertake long term relations with one particular bank is lacking. The period of market economy was too short to stabilize such kind of relations. On the other hand the structure of the banking sector in which a good dozen of big bank strongly competing one another operates makes that the firms are often invited to change the bank and very often they are served in parallel by several of them. Thus the banks usually do not dispose of the full knowledge of the conduct of their clients in the past.

The other reason of information asymmetry the banks are subject of in this situation is weakness of public sources of information about creditors. Only for the last several years the banks are sharing information by transferring data about their clients and their outstanding dues to the Association of Polish Banks (about corporate clients) and to the Credit Information Office (about private customers). Even if this information is not quite complete

(for the reason of delays of transfer and for the differences in definitions applied in different banks) it is obviously of much help for the creditors.

The factor amplifying negative selection was in the past insufficient experience of newly established commercial banks as to creditworthiness analysis and frequent cases of corruption among bank employees. With time the quality of crediting procedures and formalization of the duties of credit officers enhances, with an undeniable positive impact of foreign investors that most of Polish banks have (now 70% of the equity of the banks is of foreign origin).

Probability of moral hazard due to the conduct of borrowers is connected to still very difficult process of enforcement of outstanding dues. According to the data of the World Bank the time necessary to enforce a contract amounts to 1000 days in Poland against 270 in Czech Republic, 365 days in Hungary, 420 in Slovak Republic and 233 on average OECD countries (Goldberg, 2004, 40). Thus the businessmen may feel almost unpunished if their dues have not been supported by securities, because during the process of enforcement they are perfectly able to transfer assets to a newly created firm. The quality of routinely required safeguards is, on its turn, much lower than in established market economies. For example the mortgage on real estate, considered very trustful, may reveal worthless if sale the real estate is impossible (due to insufficient fluency of the market) or, in the case of house or apartment, of it is inhabited because the regulations protecting inhabitants oblige the bank to assure another flat in exchange. As well a lien on movables was up to recently very risky, before a register of liens was initiated by the courts.

The subjective reason of moral hazard is as well a tendency to short-sighted decisions by the businessmen themselves, under pressure of current threads and unable to draw long term strategy. As well a general lack of respect of professional reputation, the outcome of which is a well known corruptive tendency within administration, but also opportunist behaviour with respect to commercial partners, deepens the risk of moral hazard.

## **2. Investing in Polish enterprises and hypothesis of restrictions in crediting**

According to the data quoted by Central Office of Statistics (GUS) in 2004 for the first time in several years a gross investment outlays on fixed assets increased by several percentage

points (by 5.1% over the previous year). In following quarters of the year acceleration in the increase over comparable quarters of the previous year was recorded: from 2% in the first quarter to 7.8% in the last. However, with an analogical rate of GDP growth, the rate of investments remained on the 2003-year level (18.4%). In the opinion of several analysts investment dynamics were lower than it would be justified by needs. In turn, restrictions in crediting were pointed out as reasons of such a state of events.

Statistical data illustrate a low share of credits in financing activities of Polish enterprises. The table below compares the relationship between the value of credits and short and long term loans and the value of equity in the years 2002 and 2003.

Table 1. Relationship of credits and short and long term loans against equity

Range	Year	Loans and Long-Term Credits against Equity	Loans and Short-Term Credits against Equity
Economy all in all	2002	16.5%	14.8%
Economy all in all	2003	16.5%	13.1%
Private Sector	2002	16.9%	16.9%
Private Sector	2003	17.0%	16.1%
Manufacturing	2002	14.8%	25.5%
Manufacturing	2003	14.5%	23.2%

Source: Authors' own calculations on the basis of The Statistical Yearbook 2004, Central Office of Statistics (GUS) Warsaw 2004, table 4 (502) p. 577 and Table 6 (504) p. 580.

As Table 1 shows, the share of credits and loans is insignificant and stable. Moreover, credits and long-term credits constitute only a half of long-term liabilities – and credits and short-term loans constitute a half of liabilities for deliveries and services. Thus mutual crediting of enterprises takes place on a large scale.

According to reports submitted to Central Office of Statistics, 70% of enterprises took advantage of credits in the years 2000-2001 (that is an increase over 40% of enterprises in the mid 90s). Only 40% of enterprises incurred investment credits (Boguszewski, Puchalska,

Kocięcki, Jankiewicz, 2000), (Boguszewski, 2002). Researches on enterprises with the share of foreign equity indicate that even subjects with good financial standing relied mainly on internal sources of financing. For 53% of the latter net profit was the main source of financing, for 30% it was depreciation, and for only 30% it was a long term bank credit (Boguszewski, 2001). Shortage of credits is considered to be a substantial barrier in particular to corporate investments, in the financing of which the bank credit constituted only 11.8% in 2004 (Kotowicz-Jawor, 2005).

Difficulties in obtaining credits are signaled in questionnaires carried out among small and medium sized enterprises (Baruk, 2002). They point to the insufficiency of internal sources of financing and very high interest rates as barriers to their development. It may indicate that there is a different approach to different types of enterprises in restricting credits to them by banks.

The research carried out by The Central Bank of Poland (NBP) on the sample of 470 enterprises seems to confirm the hypothesis that credits were chiefly granted to the same group of large enterprises. 100 of largest borrowers received 55% of all the credits granted and 70% of long-term credits (Boguszewski, 2002). On the other hand, in the year 2003 crediting of small sized companies (that employ 10-49 people) declined by 20.1% (Kotowicz-Jawor, 2005]).

### **3. Verification of the hypothesis that there are restrictions in crediting and their causes in the light of questionnaire research<sup>2</sup>**

The questions put forward above will be answered on the basis of the questionnaire research carried out by the authors at the beginning of 2005 in 11 biggest Polish banks. The questionnaire was carried out in the form of interviews with heads of departments in charge of crediting enterprises or/and risk assessment at the level of regional bank branches and bank headquarters. In some cases heads of credit departments in local branches were questioned.

The questionnaire included open-ended questions on (see Appendix 1):

- assumptions of the credit strategy of a bank,

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The authors wish to thank Ms Jolanta Szulfer, M.A. for carrying out the questionnaires and working out their results.

- procedures applied in taking credit decisions, ways of defining creditworthiness of a borrower, methods of rating,
- principles of defining requirements with reference to interest rates on credit and collaterals,
- ways of getting information and assessing its credibility
- debt collection procedures and the effect of the perception of this information on the awareness of bank staff granting credits
- qualifications of bank staff monitoring borrowers and methods of assessing them
- the range of customers' dishonest conduct and its reasons
- differences in providing credit services for large and smaller borrowers
- the scope, reasons and ways of restrictions in crediting.

The questions were asked in some purposeful manner. Namely the answer on credit strategy declared by the bank is confronted with the practice of decision making in credit granting (procedures, creditworthiness, rating) and in requiring collateral together with differentiating interest rate. The two following questions (on monitoring, information and debt collection) enable to assess the degree of institutional risk and the impact of its awareness on banking practices. The following question aims at weighting the degree of moral hazard due to dishonest conduct of the borrower and its eventual impact on revealed strategies of the bank. For every question an explanation concerning differentiation with respect to small and large enterprises was asked for. All those elements enable the assessment of the scope of actual credit rationing, irrespective of declarations of the bank

#### The declared credit strategies of the banks

It is obvious, that this type of questions enables dissimulating of some elements of activity, less favourable for the image of the bank, by responders. They were by the way informed about their right to avoid answers to some questions (rarely used by the responders). Formally none of the banks under this research confirmed the existence of a policy to restrict credits with reference to any type of borrowers. In few cases some restrictions with reference to some sectors were only signaled and these resulted either from the bank's specialization (the bank's experience) or from an investment strategy of the strategic investor (to avoid some sectors) or from observations about increased risk due to the business cycle. On the contrary, looking for opportunities to extend credits strengthened by the recent easing of regulations on reserves for loan losses (since 2004)

was pointed out.<sup>3</sup> Some banks that had a foreign strategic investor were more willing to grant credits to companies originating from the strategic investor's country.

#### The actual principles of credit granting

Nonetheless, decisions about granting credits were motivated by the will to avoid risk. Actual decisions whether to grant a credit or not were based on the assessment of operating units in term of profits generated by them and reserves for loan losses made by them. Then tools to check the profitability of overall cooperation with the customer were applied that included the volume of turnover on accounts, all customer's products, interest rates revenues and non-interest revenues generated by them, and the scale of costs of credit servicing. This approach assured preferential treatment to large enterprises, with high turnover and big transactions that were not very labour consuming. This in turn projected onto differentiating interest rates on credits.

In comparison with the early 90s a significant improvement in developing techniques to investigate the customer's creditworthiness, to rate companies, to train bank staff in providing credit services has taken place (Lachowski, 1995), (Paliński, 1999), (Pawłowicz, 1995).

All the banks under this research have adopted standard procedures for granting and monitoring credits. As a rule, the selling function (winning customers or selling credits) have been separated from the function of risk analysis, though in case of small credits and small sized companies an application for a credit is analyzed by the customer's advisor himself, whose decision may be possibly verified additionally. All the banks, referred to in this research, have determined management levels at which credit decisions are taken; they depend on the volume of credits (or on all the obligations of the borrower) and frequently on the level of risk resulting from the customer's creditworthiness or a type of venture. In the majority of banks decisions are taken at the central level (only decisions on small credits are taken at the branch level; the majority of decisions are taken at the regional branch level or the bank headquarters').

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<sup>3</sup> Following the Regulation of The Finance Minister of 10th December 2003 on the principles how to create reserves against risk associated with banks' activities (The Official Journal No 21 of 2003 item 2147) the classification of credits was changed.

Standard procedures to assess the customer's creditworthiness and to rate companies have also been adopted by all the banks in question. Some banks have eliminated arbitrary decisions by applying computer assessment systems to which appropriate data are fed in. The assessment of the customer's creditworthiness is based on the classic set of financial analysis indicators (profitability, liquidity, the level and structure of indebtedness, rotation) and on quality parameters (the type of a sector and its assessment, the company's standing and prospects for development, the quality of management). Some banks have adopted more sophisticated methods of assessing customers' creditworthiness from their strategic investors. Those more sophisticated assessment methods of customers' creditworthiness take into account the dynamics of cash flow, the character of liabilities and dues, the character of input capital, the actual value of assets. However, one must stress the need to adjust imported investigation methods of customers' creditworthiness and rating companies to the realities of the Polish economy – otherwise the majority of Polish enterprises are said to be in a high-risk group.

The above methods, and in particular those sophisticated ones, cannot be fully applied to smallest enterprises that do not run full accountancy ledgers. Also small sized companies, that run full accountancy ledgers, do not process all the necessary information (cash flows in particular) or the information provided by them is unreliable. Too sophisticated methods of risk assessment in these cases may result in wrong/erroneous conclusions (e.g. on the basis of the value of liabilities and dues defined by the customer himself in his statement). Negative correlation between adopting the strategic investor's procedures and his traditional specialization in providing credit services for large sized companies and efforts to work out risk assessment methods applicable to small borrowers may be noticed.

Against this background one may notice a conflict between different trends aimed at improving banking procedures. Generally, credit-granting procedures have become more restrictive, more objective but also more devoid of personal relationships (it means, the bank staff taking decision about credit granting for borrowers has no direct contact with them). No doubt, it prevents potential corruption of the bank staff. Nevertheless, it is commonly admitted that the direct relationship with a customer and the history of his dealings with the bank are of significant importance in assessment of small sized companies. A stable growth of turnover on the customer's bank account is the best evidence of proper development of mutual relations between the bank and the customer.

Hence, it would be of significant importance in reducing credit risk, if one company was serviced by one bank, but this is a far cry from every day practice due to frequently unfair competition among banks.

#### Factors implying credit conditions

Majority of banks assume systematic interdependence between the company's rating or the assessment of the venture to be credited and the offered credit interest rates (by a spread of the profit margin above the interbank interest rate). Nevertheless, there is some freedom in setting a profit margin and this decision is frequently taken by the bank branch that grants credits. When considering applications for credits branches take into account their own main goals, that is how to work out profit and how to avoid setting reserves for loan losses. Thus the profit margin is an element of profitability of cooperation with the customer in calculation of which the volume of the customer's turnover on the bank's account is of importance as well as other payable bank services that the customer makes use of. Hence, large sized companies are usually offered lower interest rates on credits, particularly those with significant turnovers with foreign countries, for three reasons:

- lower risk and better rating (due to better transparency of information and better skills in presenting this information)
- generally higher profits generated (also on other than interest-providing services)
- tough competition among banks: large sized companies often invite tenders on credits and choose the most competitive offer.

All the three above enumerated reasons as well as more labour intensive credit servicing are disadvantageous for small sized companies; banks have no reasons to lower margins of profit for them and to offer lower interest rates on credits. Moreover, small sized companies, contrary to large sized companies, are not aware of tax shield and so high interest rates seem to them very discouraging.<sup>4</sup>

The polled bank staff think that granting credits is strongly bound with institutional risk resulting from long lasting procedures when they demand settling of debts and with the position of bank borrowers in bankruptcy procedures. That is the reason why, particularly following the recently introduced changes in this respect, banks try to recover debts by

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<sup>4</sup> Tax shield results from the fact that the paid interest rates become the cost of gaining income and thus lower profits subject to taxation.

debt collection from collaterals without undertaking insolvency procedures under which they would be likely to recover an insignificant part of debts.

It has been also pointed out that generally banks are interested in supporting the customer's business activities and are willing to cooperate with him (if only it is possible), sometimes by settling debts with his more aggressive and thinking in short terms trade creditors.

Rigorous credit procedures and high requirements regarding collaterals on credit agreements are the result of the above-described situation. Granting unsecured credits, even short-term credits, is very rare. The hierarchy of the required credit guarantees is also characteristic. A bank draft is considered merely as a quasi-guarantee, hard to recover, almost a reminder to settle debts.

Similarly, a clause introduced routinely into credit agreements that provides for bank execution against the borrower is of little importance. Industrial real estate mortgages are the most desirable collaterals (but not house mortgages), registered lien on movables (with cession of rights from the insurance), assignment for the benefit of creditors, pledge on stocks (that, however, may be pledged several times or may disappear), appropriation to a debt (that may be not revealed and also made use of several times) are next in order of preference.

The above-enumerated bank procedures applied to investigate creditworthiness of borrowers and to assess credit collaterals are selective with reference to bank customers. Small and medium sized companies are not adjusted to more and more sophisticate rating methods because they are not able to provide the required information (in particular those that do not run full accountancy ledgers) and they lack competence. Modern assessment methods make use of methods and concepts (e.g.: cash flow or EBITDA) that are hard to understand for small business entrepreneurs and their bookkeepers. This approach, even simplified, cannot be applied with reference to small sized companies due to their special reporting requirements (a tax license, an income and expenditure account book); on the other hand, banks do little to develop assessment tools adequate for such customers. Moreover, even in the case of medium sized companies that run full ledgers, banks are aware that the information provided by them is less reliable than the information provided by large sized companies that are externally audited.

The second handicap in case of small sized companies is the scope of contractual safeguards they are able to provide. Generally, they do not own real estate or it is difficult to distinguish between the real estate of a company and that of a company owner, thus they are required to submit guarantees of higher nominal value in order to compensate for their lower reliability. Personal securing of the claims by the owner's property is the most common requirement. It is the most important sign of the customer's reliability for the bank. However, it is not difficult to understand that such conditions are highly discouraging for the borrower.

#### Monitoring and enforcement of the contract

Banks have also greatly improved procedures how to monitor borrowers and how credits are spent. Not only is the situation of the borrower and the regularity of credit repayments monitored periodically (usually every 3 months), but it is also monitored whether the credit is put to proper use by settling only those invoices that are related to the credit agreement. In this way banks avoid financing investments by short-term credit, easier to be granted but creating a wrong and risky structure of financing the company.

It is also more difficult to monitor investment credits granted to small sized companies because part of the investment works is done under one's own team without any invoices for external contractors. In such cases banks agree to advance cash payments, but it is bound with time-consuming inspections of building sites and supervision of the work done.

One should also mention a trend to include a number of clauses in a credit agreement, the violation of which, without further negotiations, results in undertaking defined steps by the creditor including dissolving the agreement. Including such clauses makes the borrowers conduct more stable and lowers the risk of the borrower's dishonest conduct after concluding the credit agreement.

#### Degree and sources of moral hazard

In the opinion of banks cases of ex post moral hazards on the part of borrowers still take place but are significantly less frequent than in the early 1990s. Various borrowers, including large sized companies, that may take one by surprise, also display such

dishonest conduct. It happens that large sized companies try to exert pressure on banks due to unfair competition on the part of other banks (offers to take over a customer).

Banks are of the opinion that companies are aware of poor opportunities of debt collection due to inefficient jurisdiction and this is a reason that makes them conduct in such a disloyal way. It refers to companies that encounter difficulties in their operations. Small sized companies are considered to be more prone to dishonest conduct. They are aware that it is difficult to verify the information provided by them and thus it is more difficult to assess the feasibility of their investment projects and to monitor them. Moreover, small sized companies, whose situation has been worsening, frequently undertake short term and panic steps not taking into account liabilities towards creditors (for example, they incur credits in other banks or sell collaterals). Another source of customers' disloyal conduct may be insufficient qualifications of bank staff (who might not be properly prepared to deal with this type of customers) that are additionally encouraged by the banks strategy to search for borrowers in an aggressive way. Customers' disloyal conduct may also be the result of the importance of collaterals and the ease with which they may be manipulated (borrowers may sell them or lower their value).

Banks' views on the importance of reputation as a restraint to disloyal conduct of customers seem to be divided. The majority says that good reputation still is not appreciated in the sector of small sized companies, the feeling that is strengthened by social tolerance for unreliable conduct. On the other hand, the bank staff point out that the importance of good reputation has been growing due to improved public information (available in the Credit Information Office) and negative consequences of poor reputation (e.g. refusal to grant credits).

#### **4. Conclusions**

The results of the questionnaire research show that there are some objective factors that worsen the perception of small sized companies as borrowers. First of all the information provided by them is bound to bear higher risk of distortion. We have been informed about several obvious irregularities resulting from the fiscal system that allow concealing profits. There are frequent cases of unprofitable enterprises according to ledgers that offer deposits to secure credits. Thus, in the opinion of banks, submitted tax reports are unreliable to a large extent and they cannot be taken as the basis for the assessment of

credit worthiness. According to the opinion of bank staff, audited financial reports may be taken as a reliable source of information, it means financial reports of large sized companies; and the best information in terms of quality and range is provided by companies listed on the stock exchange.

Moreover, in case of small sized companies, the poor financial management poses a frequent risk. It is true that, according to the opinion of banks, a significant improvement in this respect has taken place over the recent few years. Information and trainings how to make use of financial aid provided by the European Union have played an important educational role.

Higher probability of disloyal conduct on the part of small sized companies and greater difficulties in the assessment of their credit worthiness and in monitoring them have been pointed out. Small sized companies are also more expensive as well as less profitable in services provided for them. The transactions they conclude are smaller in scale and frequently they need professional help and visiting.

In conclusion one may claim that although banks try to develop their credit services in an aggressive way, yet motivated by profitability and avoiding risk, they discourage some customers, in particular small sized companies, by a number of elements.

Discouraging elements are following:

- high profit margins and hence high interest rates on credits; generally, it results from worse rating of a small sized company (objective risk) and aversion to soften the risk rating because of the subjective assessment of risk (dishonest conduct, less reliable information) and being aware of low profitability of overall cooperation
- requirements to provide contractual safeguards of high nominal value and definitely unfavorable for customers personal guarantees
- incomprehensible procedures and information requirements.

Thus, in fact, the policy of avoiding risk differentiates access to credits for large and small sized companies, adversely affecting the small ones. The hypothesis that there are restrictions in crediting small sized companies by Polish banks is justified.

One may add that the application of higher interest rates for small sized companies and a strong negative perception of these rates (because of lack of knowledge about the tax shield effect mentioned above) multiply the risk of adverse selection by borrowers. A company with moderate and stable profitability and low risk will avoid incurring such a credit, and a highly risky company will decide to incur such a credit, in hope that either it will succeed and will repay the credit or it will fail and will disappear from the market. Thus, the consequence of a high profit margin is a portfolio of high risk. It seems that Polish banks are totally unaware of this well known from literature and world business mechanism.

Credit rationing for small and medium sized enterprises is a general phenomenon, well known from the literature. In the case of Polish firm its specific condition is still going on transformation of the economic system. For this reason the level of professionalism of the managing staff, and especially its financial and managerial skills, is still weaker than in the countries of established market economy. Thus the degree of maladjustment to the requirements of the creditors is higher and difficulty to be granted a credit – more acute.

The results of the present inquiry appeal for a "mirror" research, namely asking for the opinion of enterprises about their relations with the banks – how they structure them themselves and how they perceive the quality of cooperation of the banks together with assessment of barriers of access to credit. It would be of interest to learn about the opinion of enterprises as to differentiation of the manner the banks treat different clients, especially bigger and smaller firms. In absence of such inquiries fulfilled by the banks (even if their representatives manifested their interest in receiving the results) the authors of the present paper prepare this research as a consecutive step.

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## Appendix 1

### Questionnaire

#### I. Name and type of bank

State owned bank/ joint-stock company/cooperative bank /set up from a state owned bank or not/ with the foreign capital share/ joint stock company quoted on the stock exchange (public – private).

#### II. Essential information about the respondent (optional)

1. Work experience
2. Department
3. Position
4. Main duties
5. Number of years in the present team
6. How long and where the respondent studied/or was trained for the present position
7. Number of subordinates

#### III. Credit management in a standard situation

1. When assessing an application for credit, does your bank take into consideration the social and economic strategy of the government or the principles of the strategy of your own capital group?
2. Does your bank offer interest rates, the value of credit, the credit duration according to differentiated criteria for each enterprise?
3. Will you please explain details of administrative procedure from the first contact with a potential borrower till the moment of taking a credit decision? (distribution of competences, management levels at which decisions on granting credits of different values are taken, the level of centralization).
4. Does this process follow a course book pattern, other formal recommendations, formalized credit procedures or a method worked out by a bank?
5. What elements are taken into account when assessing the creditworthiness of a customer?
6. Do the history of cooperation with a potential borrower, previous agreements, opinions of bank employees in the assessment of the credit application play any role?

7. Are guarantees required in case of any credit?
8. What kind of guarantees is usually required?
9. In what cases guarantees are not required?
10. Does your bank apply any rating system for enterprises?
11. Has the rating been worked out by an internal body or an external one?
12. How does your bank monitor the use of the credit granted for the financing of an investment project? (by visiting the enterprise/site, by delegating a permanent bank representative to work for the enterprise, etc.)
13. Is the borrower made to open a current account with your bank as a principle so that the bank could monitor the cash flow?
14. What steps does your bank take in case the borrower infringes the credit agreement by insufficient or excessive financing of the investment in question or uses the credit for other purposes?
15. How does your bank get access to information about the enterprise necessary to process the application for credit, to take a decision and to monitor the investment? (Describe in detail).
16. Is your bank pleased with the level of internal information supplied by enterprises? If not, say why?
17. Is it easy to obtain from enterprises information and data besides the range of obligatory financial reports?
18. Does the way your bank considers applications for credits from big enterprises differ from the way it considers applications from small and medium sized enterprises? Does it use the same procedures when taking decisions and monitoring the use of credits with regard to big enterprises and small and medium sized enterprises? Or does it use different procedures taking into account the duration of relations with an enterprise? Describe the differences.

#### IV. Measures taken in case of outstanding credit.

1. What is more beneficial for a bank in case of an enterprise going bankrupt: legal bankruptcy procedure or an agreement negotiated between the parties involved?
2. What are the main problems of negotiating an agreement between creditors, if any?

3. Does the way of taking a decision to initiate the legal bankruptcy procedure differ in case of large, medium and small sized enterprises? Or does it depend on the duration of relations with the given enterprise? What degree does it differ to?

V. Incentives for the bank's employees and the risk of moral hazard on the part of enterprises.

1. How many borrowers does one bank employee service on average?

2. What are bank's employees professional qualifications involving credit processing?

3. Does the same bank employee monitor an enterprise from the first contact till a potential enforcement of debt?

4. To what degree is the bank's employee responsible for outstanding credits that he monitors?

5. What incentives are granted to bank's employees? E.g.: Salary raises, promotions bound with the number of borrowers, the volume of credits and their quality?

6. What are the main factors increasing the risk of moral hazard on the part of enterprises?

- Insufficient access the bank is given to the internal information of an enterprise.

- Granting credits based on guarantees.

- Principles of the accounting system of an enterprise.

- Low professional qualifications of bank's employees and their lack of responsibility.

- Deficiencies in feasibility systems of investment projects or in monitoring by the bank.

- Underprivileged position of the bank in legal bankruptcy proceedings.

- State administration interventions.

- Substantial difficulties in carrying out legal bankruptcy proceedings.

- Inefficiency of jurisdiction.

- Short-term strategy of enterprises.

- Others (Enumerate).

7. Are the factors of moral hazard different with respect to big and small and medium sized enterprises? Do they differ taking into account the duration of relations with the enterprise? How they differ?

VI. Restrictions on granting credits.

1. Why does your bank impose restrictions on granting credits to some groups of borrowers?

- It is aware that the information supplied by borrowers may be unreliable.

- It is aware of the bank's underprivileged position in legal bankruptcy proceedings.
- Problems with the enforcement to settle outstanding credits and with making use of guarantees.
- The risk of moral hazard on the part of borrowers.
- Restrictiveness of prudential regulations.
- Shortage of a sufficient number of well qualified bank's employees able to assess and monitor investment projects.
- Other reasons (Explain).

2. Does your bank impose more severe restrictions with regard to granting credits to small and medium sized enterprises than to big enterprises? If yes, explain why