Commercial Bank Lending to SMEs in Poland

Melanie Feakins

ABSTRACT. This paper explores the processes of financial intermediation that are used by commercial banks in their interactions with SMEs in Poland. The paper develops an argument for examining the empirical realities of commercial bank involvement with the SME sector within the context of economic transformation by suggesting that the connection between them influences the trajectories of economic change within transition. The paper provides a history of re-organisation of the commercial banking sector in Poland, paying particular attention to the involvement of foreign capital and foreign banks as the trend towards increasing foreign participation is apparent in the Central European transition economies. The findings from this research suggest that there are some significant variations within the commercial banking sector in the approach to, and practices for, lending to the SME sector.

1. Introduction

Decision-making structures and processes used by commercial banks to deal with lending to small and medium-sized enterprises in transition economies offer an interesting angle on the study of economic transformation because of their 'newness' *and* their potential for indicating how finance from formal financial institutions has begun to interact with the SME sector in these economies. The development of structures and processes *within* commercial banks is striking in the context of a transformation economy because the banks are widely regarded as not having been decision-making organizations under the state socialist economic system (Berglof and Bolton, 2001; Kowalski and Janc, 1999; Van Brabant, 1997; Able and Bonin, 1994) and their development is regarded as a significant element of post-socialist economic transformation because of the changes associated with investment allocated by 'market' principles, rather than directed according to state plan. The development of decision-making structures (i.e. separation of evaluation from decision, centralization or decentralization of decision authority, the reliance on formal stipulations versus discretion) and processes (information gathering and verification, evaluation procedures involving project assessment and previous performance, collateral appraisals, monitoring capacities and inclinations for developing 'relationship lending', possible participation in shared schemes of collateral registration, and practices that facilitate the uptake and use of external finance by this sector of enterprises) in the allocation of financial resources to firms has significantly changed commercial bank practices of lending. This paper examines the developing structures and processes for decision-making for lending to SMEs by focusing on the practices and policies of commercial bank decisions in dealing with SMEs in Poland.

The perspective adopted in this research about the wider economic importance of commercial banks and their lending practices for small and medium sized enterprises is based on ideas about the potential for economic development and growth which are fostered through financial intermediation processes directing funds towards innovation activity (embodied at least partially in the SME sector) (Berglof and Bolton, 2001; King and Levine, 1993a; b; Shumpeter, 1934). The research in this paper draws on those ideas as both research backdrop and incentive, but attempts to use empirically based research to examine 'actual' commercial bank structures and processes of approach in a post-socialist context where commercial bank/SME interactions are relatively new. The

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Jesus College
Oxford
OX1 3DW
UK
E-mail: melanie.feakins@jesus.ox.ac.uk

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paper has three principal objectives: First, to initiate the practice of involving decision-making and process structures into the analysis of commercial bank lending, particularly in circumstances where activities surrounding lending are not long established; Second, to highlight some very tangible findings about commercial bank structures and processes in Poland that are relevant to discussions about the nature of finance available to and used by SMEs (some of which corroborate with findings of Johnson, McMillan and Woodruff, 1999 and Janc and Kowalski, 1999); And third, to develop theoretically and empirically grounded propositions for future research into process of financial intermediation that will further develop and expand the arguments and findings presented here.

The paper has five sections. The first section explores debates about SME financing and the role of financial intermediation for SME's in transition economies; this discussion provides the wider context for research presented in this paper and considers the suitability of the employed methodology in light of the research perspective and objectives. The second section traces the recent history of banking sector development in Poland. The story told in this section illustrates how the post-socialist environment in which banks and SMEs are establishing relations and interacting is particular, suggesting that structures and processes for interacting and dealing with the emerging SME sector are developing within unique circumstances. The third section addresses the distinction between structure and process as means of influencing decision practices, examining how structure and process combine to overcome particular lending issues. The fourth section introduces the data from the interviews conducted with commercial banks in Warsaw, Poland. The presentation of data findings is interwoven with their discussion. This is the largest section and deals with themes revealed as important to how the banks deal with SMEs, namely: centralization/decentralization, hierarchy/dispersal, involvement of third party information as sources of evaluation information, and capitalization issues related to domestic/international ownership. The final section briefly reviews the findings presented in efforts to explore our understanding of how economic transformation is actually unfolding in the post-socialist sphere. This discussion allows for contemplations of theoretical and empirical propositions for further research in this area.

2. Debate and methodology

The development of decision-making structures and processes for commercial bank lending to firms in transition economies is a fundamental element of economic transformation that is not addressed in substantial form in the transition banking literature (As a notable exception see Koford and Tschoegl, 1997). The relative paucity of attention and research dedicated to the qualitative analysis of decision-making by commercial banks within transition economies relates in part to the focus on privatization, regulation, and corporate governance as factors and measurements of transition. Such emphases seem to assume that the financial sector, and in particular commercial banks, will develop adequate and appropriate procedures for dealing with risk in lending to firms if exposed to appropriate regulatory measures and may serve as a disincentive for examining industry norms and variations in how commercial banks structure and process decisions for lending. Expectations for 'rational' profit maximizing/risk-minimizing behavior by the commercial banks in transition economies, *even when* circumstances and realities of inherited bad loans and cyclical problems of government bail-out are recognized (Gray and Holle, 1996, 1997), may displace investigations of actual lending by suggesting that prevailing regulatory frameworks, conditions of uncertainty in the economy, risk associated with firm lending stemming from forms of informational asymmetries, dishonesty, and fraud are the principal factors influencing 'rational' bank lending behavior (For various discussions see: Bonin et al., 1998; Slay, 1996). The research in this paper actively acknowledges the vital role of larger scale commentary and analysis of financial systems in transition research and aims to contribute to this literature from a different perspective.

The research in this paper, which investigates the variations in approaches and procedural aspects of commercial bank actual engagement, recognizes recent empirical research into issues of economic transformation and particularly changing relations *between* sectors and *between* entities which reveal the significance of uncertainty under transformation and the contribution of network relations to the restructuring of obligations and formation of strategies in post-socialism (See especially McDermott and Hayri, 1998; Stark, 1997; Grabher and Stark, 1998). The significant advancements that have been made in the conceptualisation and understanding of 'economic transformation(s)' have been enabled largely through empirical examinations dealing with the processes and interactions of economic entities in negotiating the post-socialist transformation (Grabher and Stark, 1998; Smith and Pickles, 1998); This emerging practice of empirically engaged research has inspired the focus on processes that is adopted in this research (See Pickles and Smith, 1998 on the need to engage with 'real transformations' in order to further our theorization of post-communist transition; Kowalski and Janc, 1999 on the need to collect and study empirical evidence in order to start drawing hypothesis and conclusions.)

Central to the research in this paper is the idea that the connections between the commercial banking sector and the SME sector are composed of intermediation processes that serve a number of functions beyond simply providing a possible source of external financing for firms. There are two issues to consider in order to understand the relevance of financial intermediation in a transformation economy: the funding needs and mechanisms used by SMEs in transformation societies (but especially Poland in this case), and the theoretical concerns surrounding financial intermediation as a driving component of economic change.

The financing practices and opportunities for accessing finance by small and medium-sized enterprises have been the subject of considerable research attention because of possible constraints placed on SME growth and development stemming from a lack of available financial investment (Recent research includes: Lopez-Gracia and Aybar-Arias, 2000; Scholtens, 1999; Binks and Ennew, 1997; Hughes, 1997; Cressy and Oloffson, 1997 (a review of research); Peel and Wilson, 1996; Keasey and Watson, 1994; Storey, 1994). Interest in the common, or even systemically experienced, limits for small firm development and growth are primarily motivated by concerns that economic attributes associated with SME's (aspects of innovation in products, processes, and organization, the generation of employment opportunities, the persistence and regeneration of economic competition, etc) may be hindered or even thwarted by a lack of financial resources enabling desirable types of expansion. But because there is some lingering question as to whether a lack of 'formal' finance actually does hamper the formation and growth of SMEs, the literature increasingly addresses actual practice of SME financing and documents propensities for using networks of family, friends, and professional connections to acquire initial resources (Winborg and Landstrom, 2000; Bruderl and Preisendorfer, 1998; Johannisson et al., 1994; Koch and Thons, 1997 on such practices in former east Germany) and the use of retained profits to fund investment strategies (Lopez-Garcia and Aybar-Arias, 2000, Johnson et al., 1999 on this practice in Poland). Trade credit provided by other firms is also increasingly acknowledged as a form of financing used by small firms (Cook, 1999), with recent research also citing trade credit and retained profits as particularly used by SMEs in Poland (Feakins, 2001; Johnson et al., 1999b, p. 5). The findings of recent research on the subject of SME financing clearly show that there are financing processes used by SMEs outside of those available through commercial banks (i.e. trade credits, retained profits, borrowing through networks, etc). *However*, there remains a deep concern with the theoretical *idea* and pragmatism of financial resources that might be available to SMEs through the *structures and processes of financial intermediation* present in interactions with commercial banks.

From a different angle of research on SME sector finance, Johnson et al. investigated patterns of SME financing in several transition countries, making links between the security of property rights (these measured in terms of SME manager impressions about mafia, extra payments, and likelihood of using courts) and correlating percentages of SME's using commercial bank finance. The research suggests that significant provision for the development of bank lending or the willingness of banks to lend to SMEs may reflect property-rights insecurity. However, even though the levels of borrowing by SMEs in these transition countries are not near those experienced in the U.S., Johnson et al. suggest that 'a lack of formal bank finance does not seem to be the leading constraint' inhibiting private sector growth (Johnson et al., 2000, p. 18) as 'the absence of external finance does not seem to prevent firms from investing' (Johnson et al., 1999, p. 1). Their research finds that SMEs are not necessarily investment constrained as the availability of retained profits provides sources of investment for financial investment, as do the possibilities for trade credit (especially in Poland). Other research about SME finance in Poland (Kowalski and Janc, 1999; Balicki et al., 1998) confirm that firms make use of other forms of finance (family, friends and trade credit) though these studies find lower levels of engagement with commercial bank borrowing.

Although there is some contention about the actual demands of SMEs for commercial bank finance in transition economies, SME financing remains a concern for economies undergoing economic transformation for both practical and theoretical reasons. On the practical side, it is clear that a significant and increasing proportion of the working population is becoming employed in the SME sector. Data from 1998 in Poland reports that just over 40% of those employed work in firms that have under 50 employees; Firms with up to 5 working persons employ 21.1% of the working population, firms with 6–50 employees have 19.9%, firms with 51–250 employees have 21.6%, and firms with more than 250 working persons employ 37.4% (Source: Statistics for Small and Medium Sized Enterprises in 1998). By comparison with statistics for Hungary in 1998, which report micro firms employing 36.3%, small firms 14.7%, medium firms 19.1%, and large firms 29.8% of working populations, it is clear that a considerable proportion of the working populations are engaged by firms that fall within the SME category (Source: Annual Report 'State of Small and Medium-Sized Business in Hungary 1999'). By sheer virtue of the fact such large proportions of those employed work for firms in the SME sector, finance to firms in this sector is an issue of concern.

The SME sector in transformation economies is portrayed as embodying active economic transformation through the processes of drawing resources out of the direct ownership and control of the state (obviously linking to notions of a shrinking role of the state as owner the production apparatus in post-socialist economies), and through the development of new capital that is captured in the organization of competencies associated with forming new or restructured organizations with economic capacities that are created through these new combinations (Schumpeter, 1934). The formation and development of SMEs also presents opportunities to use networks of contacts (professional, friend and family), and the human and social resources that reside within, to shape and enact economic strategies in ways that were not very present under state socialism (Brzezinski and Franck, 1998; Grabher and Stark, 1998; Brezinski and Fritsch, 1996 on networks).

The attention that is afforded to realities and possibilities for SME financing in transformation countries is related to encouraging the purported practical benefits of SME activities that include: employment provision, use of existing physical resources, provision for services and products historically under-supplied in the state socialist economy, and establishing (though they may be limited) processes of competition. However, SME financing in transformation economies is also of interest because SMEs are understood to capture particular dynamics of innovation (process, product and organisation) that contribute to movements for production and organizational change in capitalist economies, making the current and future support mechanisms of the SME sector especially relevant to the study of economic transformation. Kowalski and Janc in their work addressing transition in Poland suggest that the SME 'sector is the major driving force of market transformation in Poland' and find further reason to study the environment and processes of acquiring finance as 'financing of the small business sector is perceived to be a major hindrance to its functioning and development' (Kowalski and Janc, 1999, pp. 74, 79). While a growing literature about SME finance in transition economies increasingly addresses mechanisms and practices used by SME's (Johnson et al., 1999; Kowalski and Janc, 1999; Brezinski and Fritsch, 1996), the attempt to query and understand commercial bank approaches presented here hopes to provide a different and complementary form of research.

Bearing in mind the potential benefits that may derive from different angles taken on questions surrounding SME finance in transformation economies, one aim of this research approach is to explore and highlight *why* there should be concern with the relations of financial intermediation taking place between the commercial bank and SME sectors,[1] both in terms of the outcomes that are associated with these processes and what its absence may indicate and/or foretell. In a recent paper addressing how financial system structure in transition economies may relate to 'real sector development' Berglof and Bolton find that 'the experience of financial transition in the most successful group of countries provides weak evidence at best of a link between financial development and growth' (Berglof and Bolton, 2001, p. 9). While such findings may appear to suggest that focusing attentions on transforming the functional attributes of financial institutions is not the most effective means of contributing to real and sustainable transformation, the authors surmise that although the basic financial architecture for a market economy is in place in countries including Poland, Hungary and the Czech Republic, 'banking and other financial institutions do not yet perform their intended functions of channeling savings to the most productive investments' (Berglof and Bolton, 2001, pp. 34–35), indicating that it may not be possible to determine the effects for transformation economies should those financial institutions actually perform the processes associated with financial intermediation in more developed capitalist economies.

In their research exploring financial architecture in transition economies, Berglof and Bolton refer to theoretical work that addresses the nature of financial intermediation in market economies, specifically focusing on commercial banks and the funding of innovation (Berglof and Bolton, 2001, p. 27; King and Levine, 1993a, b). In their papers addressing the connection of financial systems to economic development, King and Levine explore Schumpeterian ties between financial capital and innovation, ties that are made primarily through processes of institutionalized financial intermediation. Rather than only asserting correlations between levels and/or depth of financial systems and rates of growth and economic development, their research explores and distinguishes the various processes that fall under the large guise of intermediation. In their model 'financial institutions play an active role in evaluating, managing, and funding the entrepreneurial activity that leads to productivity growth' which forms a basis for proposing that 'better financial systems improve the probability of successful innovation and thereby accelerate economic growth' (King and Levine, 1993a, pp. 515, 513). In particular they isolate the processes of: evaluating prospective entrepreneurs (through independent research and assessment mechanisms that benefit from wide information and knowledge of alternatives), mobilizing and channeling funding towards the most promising and productivity enhancing innovations, monitoring the performance of funded projects and firms, diversifying the risk associated with financing innovation, and revealing profits from innovation and not merely repetitive production (King and Levine, 1993a). The model assumes a functioning market economy with financial intermediation occurring not only through commercial banks, but also through financial institutions of the stock market. The model also 'requires that property rights be clearly defined and enforced' (King and Levine, 1993a).

This theoretical model, though clearly assuming 'fictionally' well-functioning financial intermediation and conditions for property rights that differ from those found in transformation economies,[2] offers instruction for analyzing the developing processes of intermediation taking place between commercial banks and SMEs. Especially as the transformation countries (particularly Poland, the Czech Republic and Hungary) are understood to have 'bank-based' financial systems (Berglof and Bolton, 2001), the approach and processes used by commercial banks are especially germane to understanding how financial intermediation may interact, or begin to interact with the development and growth promoted through the SME sector. It is through this perspective, one that envisions financial intermediation through commercial banks as a potentially vigorous combination of processes that can direct financial resources towards innovatory production oriented opportunities, that this paper explores the approaches and processes used by commercial banks in the interactions with the SME sector in Poland.

Investigating developing structures and procedures to govern lending requires conducting interviews with commercial banks about their practices. Field research that involves interacting with the employees of commercial banks is the 'type' of research that is receiving increasing regard and recommendation as means for conducting research in economics (Feldstein, 2000; Helper, 2000) and it is a commonly used methodology in economic geography, particularly in the case of querying decision-making (Schoenberger, 1991; Sayer, 1992; Yeung, 1997; Clark, 1998). While the case for 'direct observation and discussion as an integral part of economics research' (Feldstein, 2000) is being made on a broader scale, it is *especially* necessary in the studying aspect of transition economies, as research employing these methods offers a distinct contribution to understanding transformation (Hayri and McDermott, 1998; Smith and Pickles, 1998). The changing *nature and location of decision-making* within these economies, the intense internal restructuring of enterprises, and the large-scale development of new organizational responsibilities and functions within on-going institutions all heartily recommend the use of engaged field research methods (Tan, 2001 on organizations, restructuring and decision-making in transitional economies).

3. The Polish situation

The formal financial intermediation sector in Poland has undergone radical change in organization and orientation through the 1990s. The changes are enactments of economic transformation within a formerly state-owned and operated system. The story told here is an interesting illustration of 'transition' in action and it is also vital for the understanding of the changing structures and procedures for economic decision-making in transition economies. This section provides an abbreviated discussion of the changes to the commercial banking sector in Poland through the late 1980s and 1990s with an emphasis on the changes in organization, orientation, and circumstances in which the banks operate.

The Polish state socialist system supported a state-owned banking system controlled by the national bank, Naradowy Bank Polska (NBP). The NBP was a mono-bank organization comprised of a central bank, and extensive branch banking system, and effective ownership/control of four quasi-separate banks with individual specialties in: foreign trade, foreign savings, transactions for agricultural and food-oriented co-operatives, and domestic savings for households and construction (Abarbanell and Bonin, 1997). The central bank of the NBP was responsible for setting the official exchange rate, printing money, managing a payments system, and dealing with the flow of savings from households to production enterprises. The bank branches of the NBP were principally responsible for managing the extension of credit to state-owned enterprises in accordance with direct orders received from economic planning ministries, or sometimes in accordance with ministry plans, if not direct orders. The branch banks granted credit to state firms without the use of project evaluation procedures as the extension of credit was based on meeting the needs of targets set by planning ministries, not on the assessment of firms' abilities to achieve targets. The branch banks were essentially state outposts for the administration of credit to state firms (Van Brabant, 1997). These banks "functioned as appendages of the National Bank of Poland," acting on the orders of central planners with a decided lack of assessment of the state firms they extended credit to (Slay, 1996, p. 512). The banking system, and it was in fact a *system with particular cohesion* as it was both owned and operated by the state, functioned as an administrative link between central planning ministries and state-owned enterprises.

The structure and procedures of the Polish banking sector described here are fairly exemplary of how banking operated in the state socialist economies of Central Europe (Mullineux and Murinde, 1999). Abel and Bonin suggest that 'in traditional central planning systems, financial institutions and instruments were used mainly to record transactions and monitor compliance with plan directives. Investment decisions were taken directly by the state, formalized in development plans, and financed by issuing state directives to the commercial department of the national bank' (Abel and Bonin, 1994, p. 109). The form of financial intermediation taking place between savings and investment was coordinated as a part of state planning and all under the auspices of state ownership. The lack of appraisal skills was a condition that ensued from the nature of the activities the banks participated in their role as resource administrators (Mullineux and Belka, 1993, p. 4). The absence of decision-making capacities within the banks was an expression of the system structure, not the cause of it.

Restructuring of the banking system began in the 1980s with effects that have been associated with economic transition. In 1988 the NBP was divested of its branching network, a move that created a two-tier banking system by separating the central bank from the branch network that would take on 'commercial' banking responsibilities (Slay, 1996). The branch network was divided geographically into nine regional 'commercial' banks, each of which inherited the loan portfolio that had been created under the previous system of credit extension (Van Brabant, 1997). The specialty banks under the NBP's authority were also removed from its control. These initial reforms created separate organizational bodies, but the separation did not automatically generate investment processes outside of state control (Bonin et al., 1998). The inherited loan portfolios engendered a situation where the 'new' commercial banks that had never made decisions to lend on any assessment basis were involved with a host of state-owned firms whose abilities to pay their debts varied considerably. Also, the geographic concentration of similar economic activities as practiced under the state socialist system ensured that the new regionally based commercial banks could be especially exposed to downturns of specific industries and firms of the state sector.

The privatization efforts and twinning schemes of the Polish government begun in the early 1990s aimed to encourage the newly separated commercial banks to develop capacities associated with active forms of commercial banking and financial intermediation present in market-oriented economies. The twinning program that was run from 1992 to 1994 arranged for management from western banks to be paired with management from the state-owned commercial banks as a method of encouraging the acquisition of know-how and technical assistance from abroad (Belka and Mullineux, 1993; Slay, 1996; Bonin et al., 1998). The twinning program obliged no equity position on the part of the participant western bank, but did allow western banks to acquire forms of insider knowledge about the state banks' operations, portfolios, practices etc. In some cases the twinning arrangements did serve as an incubation period, as the western banks later became strategic investors in the arrangements for privatization (Bonin et al., 1998).

The twinning and privatization arrangements were used by the government to deal with lack of specific skills (i.e. market-oriented financial intermediation) for the allocation of financial resources. The banks previously had little need for addressing issues of evaluation and assessment of firms and projects, much less ideas of creditworthiness in lending and assignment of appropriate conditions in terms of collateral, interest rate, and monitoring specifications. It is also suggested that the banks were categorically ill-prepared to deal with the idea of risk and obviously much less prepared to deal with the reality of *evaluating* risk (Poznanski, 1995; Santomero, 1995 on forms of risk relevant to finance organisations). The expertise supposedly brought through twinning and privatization addressed these issues by helping the banks to develop organizational structures appropriate to dealing with evaluation and decision-making in addition to skills and procedures for credit application assessment and lending arrangements. Of course, the extent to which banks have actively undertaken their newly acquired roles and their displayed capacities to perform under the circumstances of economic transition are varied and debatable.

Also intended as a means to help the banking sector acquire skills to deal with economic transition and the privatizing of investment processes was the opening of borders to foreign bank participation. The debates on the opening of domestic banking sectors to foreign participation, and hence the perils and benefits of competition in an industry that can worsen in the face of increased competition, are vigorously argued from different points of view (See Buch, 1997). The early years of the 1990s saw a large number of licenses given and after a spate of very few granted in the middle years, the laws on open access for financial institutions within Europe as part of a wider effort to comply with European Union regulations, have opened the Polish market to increased foreign participation. The continued growth of foreign presence within the banking sector is recorded in the annual reports of the NBP, where swelling organizational and financial control over the banking sector by foreign parties is very apparent.

Although there has certainly been significant variation in how banks have been privatized and the timing has varied by country, there are some discernable patterns within the more advanced transition economies. In particular, the pattern of increasing foreign participation is clear; it concerns both concentration of financial power and organizational control. By 2001 in Poland there were 69 operating commercial banks (down from 73 in 2000), 7 of which were controlled by the treasury and 62 were majority private sector owned (down from 66 in 2000). Within the private sector 44 banks were majority foreign equity, which was an increase from 39 in 1999. These 44 banks controlled by foreign investors accounted for 79.1% of capital funds and 68.4% of total assets of the whole banking sector (compared to 77.6% and 69.5% in 2000).[3] In the Czech Republic at the end of 2000, there were 40 commercial banks (down from 42 in 1999): 5 were controlled by state entities (including municipalities), 9 were controlled by Czech entities, 16 were predominantly foreign owned while the last 10 were branches of foreign banks. The foreign banks and branches controlled 65.8% of total banking assets, but this was estimated to hit 90% soon.[4] The classifications for Hungary are slightly different; by 2000 there were 41 commercial banks, 33 were classified as banks, 4 as credit institutions, and 4 as home savings and loans. State ownership of the sector was 21.3% (up from 19.7 in 1999), while residents accounted for 30.8% (down from 32.4 in 1999) and non-residents held 66.6% (up from 65% in 1999).[5] Foreign credit institutions held 53% of the registered capital of the banking sector in Hungary.[6] The banking sectors in all three countries follow a clear trend towards increasing foreign control over banking assets and capital, in addition to tendencies for mergers and increased concentration in fewer banks.

The continuing struggles for restructuring of the banking sectors run concurrent with needs to develop internal decision-structures, processes for evaluating lending possibilities and practices of engaging with firms. But what is unique, and more to the core of investigations in this paper, is the need for these banks to develop *methods of engagement for new firms*. Because new firms do not benefit and/or suffer from similar types of inherited relations with commercial banks, the relationships between new firms and commercial banks are distinct from those that extend from the socialist period. The development of strategies and procedures for commercial banks to engage with the new, small and medium-sized enterprise sector is usefully separated from the development of strategies to deal with inherited, privatizing clients. The developing SME sector represents a particularly strong source of economic differentiation and growth and is categorically separate from the population of privatized or privatizing state-owned enterprises (Tan, 2001).

4. Evaluation and decision in commercial bank lending

Commercial banks often strategically combine the decision structure of their organizations *with* the design of evaluation processes in order to create lending systems that encourage inspection and monitoring of work accomplished within the bank as a matter of regular procedure. The construction and use of in-built systems of monitoring, systems that force evaluations of potential borrowers and lending arrangements to be reviewed by decision-makers not involved in the actual evaluation procedure, confronts problems associated with combined assessment and decision-making for the allocation of finance including: sending good money after bad, covering or hiding past decisions that have created non-performing loans, and difficulties associated with ‘knowing’ clients and ‘doing favors.’ Separation of assessment and decision creates inhibitions and difficulties for the coordination of possible ‘wrong-doing’ by agents within the bank (actively initiated or used to cover past mistakes), but separation also renders benefits to the overall process of credit assessment, decision and allocation through requiring multiple forms of exposure and opinion within a bank.

The dilemma of using the separation of evaluation and decision through procedures that rely on structure and process is heightened when dealing with SMEs. The resources dedicated to the evaluation of potential clients and their projects do not necessarily vary according to the size of the project and the amount of the loan. There are two points here. First, loans for small amounts are more expensive to make because they endure relatively similar costs to large loans. Second, the methods commercial banks might use to accommodate the fixed costs of loan evaluation, which could include varying interest rates and charging clients for the consideration of loan applications (i.e. bank fees), are thought to select out the better borrowers and bring on the more risky ones. The difficulties that commercial banks have in lending to small firms are in part drawn from these issues. The associated costs of processing loans are not appreciably less for loans of smaller amounts that SMEs are more likely to apply for and banks cannot pass the costs without damaging the pool of applications and incurring costs associated with increased risk and default (See Stiglitz and Weiss, 1981 on asymmetries and perverse selection).

Given that the domestic commercial banks are operating with inherited loan portfolios that contain: defaulting loans, non-performing loans, and forms of obligation to clients continuing from the socialist period that vary in terms of risk and profitability (See Gray and Holle, 1996 and 1997 on the possibilities of write-offs and work-outs attempted in the early 1990's to 'clean the balance sheets' of commercial banks and free them from binding hindrances and obligations of lending to firms in order to provide firms with means to service their loans), it seems quite possible that these banks could be eager to develop means for engaging with the new, private firm sector. Also, in the situation where large client firms of domestic commercial banks are often state firms with uncertain futures which they may be further ill-prepared to deal with because of out-dated, declining-value fixed assets and a lack of flexibility in responding to market change, it seems further possible that commercial banks may be interested in acquiring SMEs as clients because of the their growth potential.

5. Policies and strategies of commercial banks in Poland

An examination of policies and strategies employed by commercial banks in their dealings with SMEs is provided in this section. The information is drawn from a series of interviews conducted in Warsaw with risk management departments of commercial banks during 1997 and 1998. The semi-structured interviews were conducted with individual heads of risk management departments and in one case, with a six-person committee. The interviews lasted between one and half and three hours. Supplementary interviews were conducted with bank loan officers from two of these banks and an additional non-Warsaw bank. The information taken from the supplementary interviews contributes to this section in the sense of providing further background and corroboration with data obtained in the main interviews, but they do not constitute a separate source of information analyzed here. While the number of interviews conducted is reasonably limited, it should be noted that they were conducted with major banking institutions in Poland.

This section is organized around the themes that were revealed as significant through the field research interviews. The themes are considered in succession and discussion takes place throughout rather than in a subsequent section. As each of the topic areas is raised, the information from the various interviews is presented and identified with the specific bank. This form of identification provides a means of displaying patterns of domestic/foreign bank differentiation.

Bank A – A foreign bank that established itself in Poland to serve corporate clients. The bank had no dealings with the SME sector in Poland prior to 1998.

Bank B – A foreign bank that established itself to serve corporate clients, but has had dealings with the SME sector in Poland.

Bank C – A previously state-owned bank that now has a strategic foreign investor. The bank is in a protracted privatization process and the state remains partial owner. The bank has had a fair amount of dealings with the SME sector during the period of economic transition.

Bank D – A state-owned bank that has had and continues to have extensive dealings with the SME sector.

5.1. *Official policy*

The official policy stance of the banks towards the SME sector was the starting point of the interviews and is an appropriate opening to the discussion. The questions asked focused on understanding both how the policies had changed over time and on querying the contemplations and provocations for change with regard to SME sector policy. There was, in general, a pattern of changing policies. But the reasons for policy changes differed significantly and will be dealt with in the next sub-section.

Bank A had not previously dealt with any subset of SME category, but had very recently (early summer 1998) begun a strategy to establish itself as a bank serving medium-sized clients. The bank categorized medium-sized as a firm having minimum annual turnover of 2 million USD. Although the bank had not historically had dealings with SMEs in Poland, research conducted over a period of 18 months had convinced the bank to form a strategy to target firms in this particular category. The decision to target medium-sized domestic firms as a policy objective was a significant change for this multi-national bank. The decisions and eventual formation of policies and strategies signaled a desire and willingness to participate in a market it had previously withheld from and required that the bank establish lending policies and practices different from those it used with the large, corporate sector. The recent research and assessment of the potential within the SME sector in Poland was part of a larger strategy change the bank was engaging in. The interviewee talked about how the bank had been reassessing its position on engaging with firms from the 'SME' sector in several countries as part of a continued reassessment of its possibilities for expanding business in 'less-developed' or 'transition' economies. The recent research made Poland one of several countries where new policies and practices were to be developed in order to engage with the SME sector.

Bank B had some dealings with firms from the SME sector, both small and medium. The bank was actively disengaging from relations with small firms as it considered this sector to represent a 'too risky' category. It was however, interested in establishing a base of medium-sized clients. Bank B defined medium-sized as firms with a minimum annual turnover of 3 million USD. The bank had not instituted any policies that were specific to the medium-sized sector, nor had they established any clear policy objectives, targets, or programs. The similarity between banks A and B was their shared identity as multinational corporate banks that were interested in pursuing relations with the medium-sized domestic market. Bank A defined the category with lower minimum turnover and had taken serious actions to pursue these objectives.

Bank C dealt with firms from all size categories, but had a portfolio history that focused on large Polish firms. The bank considered itself to be reasonably well-established with the medium-sized firm sector, as it offered services that were particularly attractive to this sector and had a reputation for reliability in their provision. This was confirmed by interviews conducted with SMEs, several of whom had relationships with this bank because of the specific services offered. Bank C was interested in establishing a larger customer base with the medium-sized firm sector. The two interviews I conducted at this bank gave different definitions of 'medium', but the interviewee from risk management who was closest to bank policy defined medium as firms with minimum annual turnover of 1–2 million USD (obviously smaller than definitions used by banks A and B). Bank C did not want to move away from any of the categories it was already serving, i.e. it was not interested in severing its relations with small firms, but it had begun to target the medium-sized sector. The somewhat passive attitude toward small firms was, among other things, related to the perception of this category as 'risky' and possibly populated by bad borrowers as the interviewee remarked that 'SMEs made up almost 40% of the outstanding loan portfolio.' The bank's opinion about the risk inherent to dealing with SMEs is based on past experience and interaction.

Bank D had always served the SME sector and was not changing its policies. They were engaging in research programs intended to better their services and competitive edge for attracting business from the SME sector. Bank D is described as an autonomous savings bank mainly dealing with household deposit taking and housing construction (Aberbarnell and Bonin, 1997), but interviews with SMEs confirm that this bank is a major player for this sector.

Banks A, B and C were generally avoiding strategies for the small firm sector. Bank A had no experience with small firms, but their research suggested the category was 'too risky', which in the context of the interview implied it was too difficult to break even or make a profit dealing with this sector. Bank B had experience with small firms that suggested the category was too risky, principally because they 'lacked management and collateral.' Bank C had dealings with the whole of the SME sector and was not pursuing relations with small firms that entailed lending and credit facilities. However, Bank C was happy to continue its relations with small firms outside of those activities. There was general interest, and some specific policy mandates about the medium sized sector (variously defined as 1–2 million USD annual turnover to minimum of 3 million USD annual turnover) and a pattern of passive avoidance towards the small firms sector.

The terminology '*too* risky' that was used by interviewees from risk management departments when discussing small firms is interesting. Clearly the interviewees reflect on the status of particular loan portfolios when offering these appraisals, but how they use the statistics from defaulting or non-performing loans is not clear. One interviewee suggested small firms were too risky because they lacked management and collateral. Lacking management could be a cause of poor performance and eventual forced default on a loan. Lack of collateral however, is not necessarily a cause of default. Lack of tangible assets as collateral may inhibit a bank from lending to a small firm (Hughes, 1997 on collateral in bank landing to small versus larger firms), but it does not necessarily mean that the firm or its projects are riskier. Small firms with limited collateral may represent greater risk of unrecoverable asset loss in case of default, but it does not necessarily indicate they are more apt to default.

5.2. *Foundations for policy*

The next series of questions in the interviews tried to ascertain why the banks were making strategy decisions to target medium-sized firms.

Bank A had a very deliberate set of responses to these questions, indicating that specific reasons had driven much of the research on policy formation for the medium sector. This multi-national bank wanted to have a larger domestic client base, a goal that would not have been feasible without forming links to the medium-sized sector. Bank A's research suggested that with an appropriately designed and well-implemented program, it would be possible to engage in relations with this sector and balance the revenues and losses. The bank was not expecting to make a profit in the short-term, but rather expected that a well-developed program would pay for itself. More importantly however, the bank was trying to partner itself with medium-sized firms that would develop into large corporate clients. It was a strategic long-term objective responding to the market structure of firms in Poland where most of the large domestic companies are state or former state-owned firms that have established relations with domestic banks. There was no direct statement about the saturation of the corporate market in Poland, but the interviewee indicated that forming relationships with large Polish firms was difficult because of their historical connections with state-owned banks. The comparative openness of the medium-sized market, likely attributable to their newness and lack of institutionalized relationships for finance, rendered them a particularly approachable and attractive group. The interviewee spoke about a number of structural features of the economy and political situation that had influenced the bank's decision to focus more on the domestic market. The increasing stability of political and economic circumstances, with particular emphasis on legal stability and tax regulation, was a significant factor in creating the impression of a more certain and defined market (Johnson et al., 1999 on regulation and enforcement in transition; LaPorta et al., 1997 on legal determination of external finance; Santomero, 1995 on legal risk). Future membership in the European Union had also been influential in the bank's decision to pursue the domestic market for firms.

Bank B responded simply to questions regarding the reasons for change in policies towards the medium sector. The interviewee said it was entirely market driven. The bank had decreasing possibilities for business expansion with large firms because of market saturation and the bank perceived the medium sector as presenting business possibilities. The statements of the interviewee clearly resulted from active engagement with the bank's activities and were not dictated by report or policy. The interviewee did not talk about increasing or intensifying stability in the economic and/or political situation as influencing policy. The interviewee did however, mention the difficulties associated with enforcing bankruptcy procedures with small clients. The waiting period for court hearings (nearly two years) and the requirement of advanced financial contributions (10% of the entire amount the firm was liable for) were regarded as prohibitive. The interviewee portrayed the difficulties of bankruptcy procedures in Poland as a systemic hindrance to the bank's engagement with the small firm sector (Santomero, 1995 on legal risk). This interviewee's portrayal of risk as also involving problems with unavailability of collateral is related to past difficulties with seizure experienced when the bank tried to take legal steps towards defaulting clients. By the time a bankruptcy hearing could provide grounds for any 'seizure' of collateral, the collateral had disappeared and there was nothing serving as a physical asset that could be used as a replacement. The experience should bear some light on the idea that small firms are 'too risky', and perhaps move the argument towards saying that engaging with small firms is risky because the institutional forms of regulation and enforcement do not adequately fix conditions of risk. This is particularly true with the limited effectiveness of recievorship as means of holding the assets until the court date for bankruptcy proceedings.

Bank C had a series of reasons for wanting to increase engagement with the medium-sized market. Bank C was eager to increase its capacity for risk diversification and to de-concentrate its portfolio away from its current focus on large, domestic firms, i.e. relations that populate its inherited loan portfolio (Santomero, 1995 on diversification and deconcentration). In general, Bank C wanted to expand its base of clients beyond state-owned and recently privatized large firms to also include a population of medium-sized firms. Bank C viewed the medium sector as a source of savings that would increase its deposit base, addressing issues of capitalization that are significantly on the minds of *domestic* banks. The interviewee discussed the bank's desire to engage with the medium sector as driven by its expectations of being able to do so profitably. (This is, of course, quite different from Bank A's notion of balancing profit and loss, but no immediate expectation of profitability.) Because larger firms in Poland were increasingly gaining access to other sources of funding through stocks, equity positions, and heightened competition among the banks to serve their needs, Bank C said that margins earned in the large firm sector were shrinking. Lending to the medium-sized sector was portrayed as potentially more profitable because of higher interest rates and wider margins. The interviewee also expressed the opinion that medium-sized firms were a tremendous source of current and future growth in the Polish economy and that the bank was eager to develop strategies to become more closely allied to the sector.

Bank D did not report any changes in their policies and strategies.

The increasing attention paid to the medium-sized firm sector seems to correlate to domestic versus foreign/multinational status. Banks A and B were focusing on the medium sector as a market they had not yet tapped and which might create early relations with growth-oriented firms. Both interviewees gave the impression that after investing time, energy and organization efforts in Poland, indicated by numbers of employees and branch networks, they were interested in expanding beyond the corporate, international sector. Neither bank mentioned the medium sector as a source of funds, nor as a market with wider spreads and increased rates of profitability. Bank C, on the other hand, was driven to engage with the medium sector because of desires to: acquire cheap funds, diversify and de-concentrate its portfolio, serve a market with higher rates of profitability, and to partner themselves with future corporate clients. This domestic bank clearly viewed the increased interaction with the medium sector as means to reach several different ends.

5.3. *Structures and processes for dealing with SMEs*

Questioning how the banks proposed to, and actually did/serve the needs of SMEs, was intended to provide a sense of how eager/committed the banks were to their stated policies. In reality, this became principally a description of their engagement with the medium-sized sector.

Bank A had undertaken an 18 month-long research program in order to design a functioning department and set of procedures tailored to dealing with medium-sized firms. The bank created a separate department to undertake both the solicitation of new clients and to deal with the on-going maintenance of these relations. The research program developed special application processes catering to the realities and circumstances of firms in the medium-sized sector. These processes aimed to confront problems of information gathering and information asymmetry that the bank had foreseen as potential problems. The procedures instituted by Bank A to counteract informational problems relied heavily on the use of third-party information. The procedures for checking information and reputation made use of: banking industry blacklists, false document and fraud lists, inquiries to potential client's previous bank, inquiries made to potential client's suppliers and customers, business histories, and efforts to obtain sense of general reputation of the potential client in the market where it interacts (Koford and Tschoegl, 1997 on these issues in Bulgaria). The exacting list given by the interviewee of methods for gathering information and the nature of the list suggested that the bank perceived its ability to participate fruitfully in this market as very dependent on its ability to gather information about the firms, their backgrounds, their reputation, and the possibility of previous acts of fraud. Moreover, the information was solicited from sources other than the potential client. This outsourcing, both in checking fraud lists and reputation according to 'others' that the firm interacts with, suggests that the bank perceives limits to its own capacity to assess trustworthiness and potential.

Bank B had no separate department, nor set of specific procedures for dealing with medium-sized firms differently than corporate clients. There was no stated, procedural action for information checking and collection outside of the documents provided by the clients. Although Bank B recognized that medium-sized firms were likely to operate under quite different circumstances than corporate clients, especially regarding issues of assets for collateral, limited history of performance, limited financial history, and often needs for shorter-term revolving credit rather than long-term investment (Hughes, 1997), the application processes, requirements, and personnel were not different from those for corporate clients. The bank did not use alternative methods of information gathering and verification similar to those described by bank A. Using the client as the single source of information may have led the bank into situations where its client base of small firms was abundantly characterized by firms giving misleading or inaccurate information, a situation typified in the description of the 'information asymmetry' scenario (Stiglitz and Weiss, 1981). These practices may have been influential in leading this bank to its opinion that small firms were 'too risky', as there was no investigation into the reputations and interactions of the firms from sources other than the firms themselves. Bank B had not tailored the approach to fit any of the specific characteristics of the sector, nor had it taken steps to address the issues of risk through any alternative or innovative mechanisms, but rather sought to limit risk exposure through limiting interaction with small firms.

Bank C did not have a separate department, nor special procedures for SMEs. This bank however, did offer specific services that attracted small and medium-sized clients and had, as a result, been serving the sector without any specifically designed procedures. No information checking procedures were mentioned. The interviewee suggested that procedures for checking the provision of collateral was a type of check on the client, but nothing about third party information was mentioned.

Bank D did not have a separate department for dealing with firms of varying sizes, but the SME sector made up 85% of its client base. In fact, the core application procedures and general service structures were geared towards the SME category, exemplified by the bank's acceptance of the simplified accounting practices used by many smaller firms. The bank used information verification procedures which involved contacting the tax and ZUS (social security) offices to check whether firms make timely payments. The interviewees did not mention other procedures that might involve third parties from the private sphere, such as those described by Bank A. The use of state institutions as sources of outside verification was likely possible because Bank D was a state bank.

The questions regarding special departments and/or procedures geared towards attracting and serving the SME sector did not suggest clear categorical lines. However, the part about information checking processes suggests that Banks A and D both consider third party opinion/information as necessary for the bank to evaluate potential clients. The strategy of Bank A was more rigorous in terms of the number and variety of sources used, drawing on forms of opinion sought from interacting parties (i.e. from customers, suppliers and previous bank) in addition to information sought from non-interacting parties (i.e. fraud and banking industry black lists). Bank D was able to use special relationships to access very particular forms of 'information' about potential clients from state agencies. In both cases the banks were aware of the possibilities for gaining knowledge about the firm and its history through sources other than the firm itself. These forms of knowledge are obviously not the same as those shared through professional, social, and family networks, but the desire of these banks to consider and evaluate firms on a basis wider than simply reported financial history is significant.

5.4. *Evaluation and decision procedures*

The credit evaluation procedures and decision-making structures are defining features of bank/SME interactions. In practice credit evaluation methods of commercial banks typically distinguish themselves on the basis of how much of the evaluation is based on opinion and impression versus how much is determined by the results of computer generated risk analysis reports. Evaluation procedures are considered in tandem with decision-making structures because they are effectively intertwined. Decision-making structures are typically differentiated by their hierarchical characteristics and their allowances for discretionary judgments (Santomero, 1995 on position limits and rules), but in this case they should also be distinguished by the use of pre-determined decision frameworks.

Bank A used a set of evaluation procedures designed by the SME research team, which was subject to change and adaptation as firsthand experience with the medium-size sector was gained. Their evaluations were limited to firms with minimum annual turnover of 2 million USD and were at least 3 years old, measured by their ability to provided full financial statements for the previous 3 years. The credit evaluation of any particular firm was determined by a combination of the following: the trend in sales over the past years (minimum 3 years), the firm's current situation of debt and leverage, interest coverage, and the evaluation of collateral. A scoring mechanism of these factors allowed loan officers to assign the client a final evaluation of A, B, C, or D. Scores of A, B, and C correlated directly to credit limits. A score of D represented a risk level unacceptable to the bank.

The evaluation methods used by Bank A provided little room for the opinion of the loan officer, instead relying on a numerically-based system of credit evaluation. The scoring system used by Bank A to assign a letter of A, B, C, or D as an evaluation which also dictated the terms of a credit facility eliminated much of the decision process where discretion often plays a role. The pre-determined nature of the decision, as simply an extension of the evaluation process, effectively rendered the evaluation the final decision. Bank A developed its evaluation/decision process to eliminate the discretionary powers of bank loan officers and decision-making individuals and bodies. The pre-structured mechanisms were designed to provide specific evaluations for medium-sized firms whose past activities indicate future activities within the reaches of the bank's preferences for 'predictable risk'. The predetermined nature of decisions and lack of decision-making apparatus also reduced the fixed costs associated with consideration of credit applications. Combining evaluation and decision into a single process was portrayed as a cost-effective policy for engaging with the medium-sized sector.

Bank B used evaluation procedures and decision-making structures that were almost opposite to those of Bank A. Bank B's procedures were characterized by information passing, double evaluation, and hierarchically arranged, centralized decision-making on a case by case basis. The procedures of Bank B applied to the entire range of firms they served; they were not designed to deal with the commonly recognized challenges of serving the SME sector.

The evaluation mechanisms of Bank B relied on information gathering activities by bank loan officers and a series of communications by email and telephone straight from the officer to the central office in Warsaw. The loan officers contributed to the evaluation process by gathering information directly from the client and passing this information in the form of an assessment to the central office in Warsaw. A few individuals at the Warsaw office dealt with the incoming assessments, generated the computer risk reports, checked the ratings assigned and sometimes, revised the ratings according to their own assessments. A one-to-five point rating system for three distinct categories: finance, customer, and collateral, was used to generate the final evaluation. The loan officers contributed to the final evaluation by communicating their opinion of the client, but the evaluation was actually completed by individuals in the Warsaw office.

The decision procedures were simple and concentrated. The same individuals who were involved in creating the evaluation made the final decisions. The Warsaw office had a few highly trained persons with a great deal of discretion in these matters. These individuals would have been privy to and part of the assessment, which offered the benefits of increased knowledge and understanding of situations while simultaneously imposing the detriments associated with the consolidation of evaluation and decision. This process of complete centralization for decisions was thought by the bank to provide very tight controls over lending. It also offered possibilities for comparative assessment of different lending opportunities, which can be difficult with a decentralized scheme.

Bank C had recently restructured their processes and structures for evaluation and decision-making. The new system allowed for decentralized decision-making at the regional level, in contrast to the previous system where decisions were systematically made either at the branch or passed straight to the central office in Warsaw. The creation and implementation of new evaluation mechanisms and decision structures was assisted by Bank C's foreign strategic investor whose experience elsewhere influenced the design of this new system.

The evaluation procedures relied principally on loan officers producing assessments and final evaluations that were passed on to regionally-based committees for decisions. The evaluations were based on a points system; 50% of the points were awarded according to the evaluation of financial standing and the other 50% were awarded on the basis of judgments for quality of management, market position, and potential for firm development. While the interviewee felt that the second 50% was definitely the more important, he also acknowledged and lamented the difficulty of judging such qualities especially with smaller firms. A credit assessment based on computer generated risk reports, different from the evaluation, was included in the information passed to the decision-making committee.

The new decision-making structure was based on the idea of separating information gathering and evaluation procedures from final decision-making. The design of this system attempted to capture regional knowledge without allowing evaluation and decision to occur at the same branch of the bank. Final evaluations and credit assessments were passed from branches to regional branches (which occupy the next highest level in the pyramid) where committees rendered decisions. The committee was depicted as being able to use specialized knowledge of regional industries to understand the comparative investment prospects. The committees were able to exercise a fair degree of discretion in their decisions, as the decision-making process was described by the interviewee as 'fairly subjective.'

Bank D had evaluation procedures and decision-making structures that were intertwined and decentralized. The stated objective was to capture and make use of local experience and knowledge. The evaluation procedures involved information gathering by bank loan officers who in turn generated an assessment. The assessments included the officer's opinion of the client and the project, and also a numerical score based on credit risk evaluation, financial information, and business information. The numerical score translated directly to interest rates and usually dictated the amount of the loan. The opinion of the loan officer could be influential, but was more likely to affect the size and duration of the loan rather than the terms of interest.

The decision-making apparatus was decentralized to the point where, at least for loans the size that SMEs would be applying for, decisions were made at the branch where the loan officer worked. The relationship between the loan officer and the person responsible for decisions could be close and characterized by continual communication or it could be a more distant formal working relationship. The actual decisions seemed to be an outcome of the loan officer's evaluation. Because the score fairly well correlated to an offer (similar to the pre-structured decision framework of Bank A) the actual decision-making hierarchy, though established, did not exercise much control over decisions.

The evaluation and decision structures were quite different for each of the banks, though a few striking patterns were evident. Banks A and D (the first multinational and the latter domestic, state-owned) both had formulated decision procedures that used assessments to virtually dictate decisions and offers. This method eliminated forms of discretion that often reside with decision-makers and was likely an attempt to negate the power of second order decision-making structures. These methods used pre-fabricated decision menus in decentralized fashions to confront high costs of assessments and decisions associated with financing of SMEs. They relied intensively on the experience, knowledge, and abilities of bank loan officers to evaluate clients and projects.

5.5. *Summary*

The empirical evidence presented here provides a base from which we can assess statements about the evolution of the banking sector and its possible future directions in relation to the SME sector. Clearly it is not the case that all foreign/multinational banks in Poland are simply outpost branches serving the needs of their international clients. The direction of change is towards greater participation in the domestic economy and increased interaction with the medium-sized sector. There seems to be evidence to suggest that domestic commercial banks are increasing their attention and regard for the medium-sized sector firm sector. This phenomenon is partly the outcome of increased competition for the near stagnant number of large Polish firms, but may also have been encouraged by general understanding of the sources of growth and development within the Polish economy. The domestic banks however, quite clearly draw on local and regional knowledge in their decision-making mechanisms which is very different from the mechanisms that were described by the multi-national banks. This specific difference may have significant effects in terms of sectoral and regional lending practices.

6. Conclusion

The research presented in this paper aims to expand the discussion of banking in transition economies by focusing attention on the developing practices and processes of commercial banks in their interactions with firms from the SME sector. Much of the transformation literature that has enabled a deeper understanding of actual economic transformation has been achieved through the empirical study of connections between economic entities, and the research presented here attempts to use this approach to understand structural and procedural change within commercial banks (Grabher and Stark, 1998; McDermott and Hayri, 1998; Smith and Pickles, 1998; Koford and Tschoegl, 1997). The emphasis on changing structures and practices that are directed towards the SME sector is born from the Schumpeterian analysis which suggests that economic change is promoted through intermediation processes between SME's and commercial banks; this paper aims to bring these types of conceptual connections more to the fore of research in this field (Berglof and Bolton, 2001; King and Levine, 1993a, 1993b). One of the basic tenets of this approach is that the changing nature of decision-making for investment created within the banking sector renders the investment activities and structures of commercial banks an important part of economic transformation. It suggests that the re-organized and internationalized commercial banking sector plays an important role in the

Polish economy through its ability to affect and direct investment towards firms and in particular, firms from the SME sector.

The case study section of this paper presents an analysis of how commercial banks are developing processes, or not, to deal with the small and/or medium sized enterprise sector by using data from interviews with commercial banks. The empirical research suggests that there are noticeable patterns of change in how the banks regard the SME sector, or more specifically, the medium-sized sector. The changes in policies and strategies of commercial banks for increased interaction with medium-sized firms clearly indicates that there are specific responses in the commercial banking sector to the specific circumstances of transition. There are some 'norms', which generally include the use of computer generated risk reports to aid the evaluation of potential clients and their projects. There are also some significant differences in terms of collecting information and structuring decision-making. The differences expressed through the varied uses of centralization/decentralization and the extent to which decisions are dictated by evaluation or alternatively, are considered within a decision structure, are important. The varied use of third party sources of information and the diversity of decision-making procedures suggests that there are reasonably diverse procedures operating within the commercial banking sector.

Situating the findings gleaned from the case study of developing commercial bank policies and practices for lending to SMEs within the ideas of intermediation processes as influential to trajectories of economic change gives reason to suggest that the variations in bank approaches and practices may be significant for development stemming from the small firms sector and the medium-sized firm sector. The interesting divergence on issues of centralization/decentralization and discretion versus bound risk analysis obviously presents opportunities for further enquiry and would be an interesting subject of future research. In particular the different responses of the multi-national banks operating in Poland suggests that deeper analysis of their processes for engaging with domestic enterprises may offer insights to the actual nature of foreign involvement and control of financial resources operating in transition economies.

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Notes

[1] This concern perhaps needs to be explored even more urgently in light of the recent research that examines SME financing practices from the SME perspective and finds that in Poland in particular, arrangements with commercial bank for investment finance is very low compared to those experienced in the U.S. (Johnson et al., 1999); and further findings that suggest SMEs use financing available through internal sources before resorting to the external sphere of the market (Feakins, 2001; Johnson et al., 1999; Kowalski and Janc, 1999).

[2] Property rights in transformation societies have been the topic of recent research that is both theoretical and empirical in nature (See Johnson et al., 1999, 2001 for discussion of property rights relating to SME financing strategies; See Rieker and Weimer, 1993 on problems of property rights for transition).

[3] Source: National Bank of Poland, General Inspectorate of Banking Supervision. 'Summary of Evaluation of the Financial Situation of Polish Banks First Half of 2001. Warsaw, September 2001.

[4] Source: Czech National Bank Annual Report 2000. 'The Banking Sector and Banking Supervision.'

[5] Source: National Bank of Hungary. 'Operation of the banking system' from the Annual Report 2000.

[6] Source: National Bank of Hungary. 'The Hungarian Banking Sector Developments in the First Half of 2000. December 2000.

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