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## FINANCIAL PROBLEMS OF POLISH CREDIT UNION SECTOR

### **Summary**

*For several years now, there has been more and more information on the difficulties of the co-operative credit union sector in Poland. The Financial Supervision Authority in its reports has pointed to poor financial performance of the sector, intricate capital and personal links between the companies operating within the SKOK Holding S.a.r.l. and, finally, a growing number of credit unions being subject to recovery proceedings<sup>1</sup>. This paper attempts to present the credit union sector in Poland and its current financial situation. The conclusions of the paper confirm that the condition of the credit union sector is weak and that corrective actions such as recapitalization of the sector, its acquisition by the banking sector or other financial institutions as well as the creation of the so-called “bad bank” are absolutely necessary.*

**Key words:** cooperative credit unions, financial supervision, Bank Guarantee Fund

**JEL:** G01, G20, G23.

### **Introduction**

For a couple of years now the information about Polish Cooperative Credit Union Network (hereinafter called SKOK) has been rather alarming. The information refers to bad financial performance of the sector, unclear equity and personal ties, worsening credit portfolio and related increase in operational costs and, as the result, increased number of corrective actions.

An important step to regulate the operations of SKOK was putting it under the central supervision of the Polish Financial Supervision Authority (FSA)<sup>2</sup>. SKOK was forced to undergo financial and

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<sup>1</sup> Department of Cooperative Banking and SKOK 2014.

<sup>2</sup> 27 October 2012.

organizational audits carried out by external auditors and was obliged to hand all relevant information to FSA. In the aftermath of the changes described above, the majority of credit unions in Poland (44 out of 55) had to implement corrective programs and in case of nearly half of them, a judge-commissioner was appointed<sup>3</sup>.

Against such a background, the Polish Financial Supervision Authority together with the Ministry of Finance are undertaking steps to heal the sector. Their activities include the introduction of new accounting principles, recapitalization of the sector from the Stabilization Fund, SKOK Board of Management, Bank Guarantee Fund or through the so called *bad bank*. For the moment, it is difficult to find a solution that would be ideal from the point of view of the judge-commissioner, the unions and their members.

SKOK Credit Union Network is a difficult issue with numerous controversies with respect to the methods and the scope of the undertaken corrective actions.

## **1. Profile and structure of SKOK sector**

From the very beginning the cooperative movement of credit unions was developing dynamically both in Poland and abroad<sup>4</sup>. Particularly rapid changes could be observed in the United States where the savings and current accounts were transferred from commercial banks to credit unions, increasing the number of unions members by 2.16 million between 2011 and June 2012. Credit unions are defined as “financial cooperatives made of an organized group of interrelated people who accumulate savings together and borrow and lend money to one another at a low interest rate. These short-term consumer loans are usually used to purchase cars, household goods, cover medical treatment costs or other unforeseen needs”.<sup>5</sup>

In Europe, the development of credit unions also showed considerable dynamics, especially after 2012 (Table 1).

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<sup>3</sup> Journal of Laws 2009, No 84, item 711 as amended.

<sup>4</sup>*Polish credit unions mark a decade of growth*, Staff Writer. <http://www.cutimes.com/2002/06/26/polish-credit-unions-mark-a-decade-of-growth>, [access: May 2013].

<sup>5</sup><http://www.britannica.com/EBchecked/topic/142339/credit-union> [access: 9th November 2014].

**Table 1. Number of credit unions and their members in 12 European countries (Belarus, Estonia, Ireland, Latvia, Lithuania, Macedonia, Moldova, Poland, Romania, Russia, Ukraine, United Kingdom).**

Years	Number of countries	Number of credit unions	Number of members	Change
2013	12	2390	9194969	623224
2012	12	2320	8571745	444364
2011	12	2321	8127381	-126368
2010	12	2394	8253749	-248226
2009	12	2418	8501975	-226940
2008	12	2569	8728915	484662
2007	11	2671	8244253	686442
2006	10	2719	7557811	853137
2005	11	2863	6704674	-223277
2004	11	5800	6927951	

Source: Author's own work based on *Statistical Report*, World Council of Credit Unions, Inc., 2014

The development of SKOK sector in Poland, after the political transformation, began, as it is assumed, on 31 December 1992. The sector is based on combination of cooperative and financial elements and is characterized by specific legal frames and organizational structure of a cooperative union. SKOK Credit Union Network is subject to regulations of the Cooperative Law Act of 16 September 1987<sup>6</sup> and the Credit Union Act of 14 December 1995 (hereinafter called SKOK Act)<sup>7</sup>. In accordance with Art. 1 § 1 of the Cooperative Law Act, SKOK network consists of cooperatives with variable participation fund, with members joining on voluntary basis (Art. 6 of the SKOK Act). The unions conduct business activity upon consent and for the benefit of their members<sup>8</sup>.

<sup>6</sup> Journal of Laws 2003, No 188, item 1848 as amended.

<sup>7</sup> Journal of Laws 2012, Item 855, 1166, Journal of Laws 2013, Item 613, 1036, 1289 – Credit Union Act 2009.

<sup>8</sup>SKOK members may be all natural persons professionally or organizationally interrelated. In extreme cases, a union may be created out of workers of the same company or the same social or vocational organization.

Although SKOK credit unions are not regular banks their financial aspect was included in the Banking Law Act of 29 August 1997.<sup>9</sup> It particularly refers to the provisions on bank cash settlements (Articles 63-68 Banking Law Act) and loan contracts (Articles 69-79c Banking Law Act). SKOK as a financial institution (the functional notion of a financial institution applies here)<sup>10</sup>, whose aims are defined by Art. 3 of the SKOK Act, is engaged in accumulating deposits from its members and granting them loans, credits and warranties as well as providing comprehensive service not only of financial nature. The surplus generated as the result of these activities is added up to the unions' current reserves. This surplus, however, may not be divided between the union members because of statutory non-profit character of credit unions operations. The accumulated wealth is a private asset of members of the union.

The structure of SKOK Credit Union Network is rather complex. It includes such entities as: SKOK Holding S.a.r.l., Managing Society SKOK limited joint-stock partnership, Financial Society SKOK Ltd., Investment Fund Society SKOK, Life Insurance Society SKOK Life SA, Assurance Plc., Mutual Insurance Society SKOK, Polish Equity Fund Plc., Media SKOK Plc.

The supervision over SKOK credit unions is the responsibility of the National Association of Co-operative Savings and Credit Unions NACSCU (Chapter 5 of the SKOK Act) which brings together, on mandatory basis, all SKOK credit unions. NACSCU is to make sure that the financial stability and security of accumulated savings is provided and that all legal regulations are observed (Article 35 of the SKOK Act).

## **2. Problems of SKOK sector in Poland**

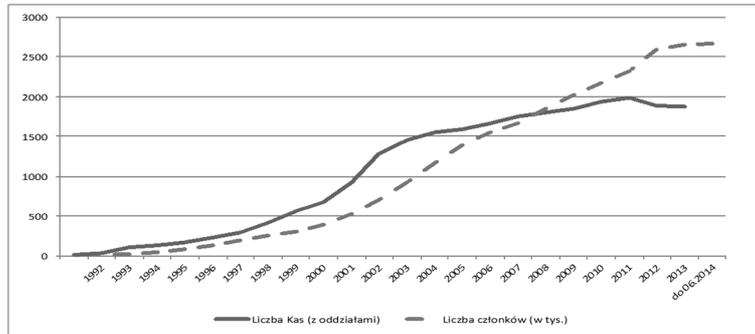
From its very beginning SKOK sector showed dynamic growth with respect to both number of unions and the number of members,

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<sup>9</sup> Journal of Laws 2002 , No 72, item 665 as amended.

<sup>10</sup>This category embraces entities engaged in accumulation and disbursement of financial resources.

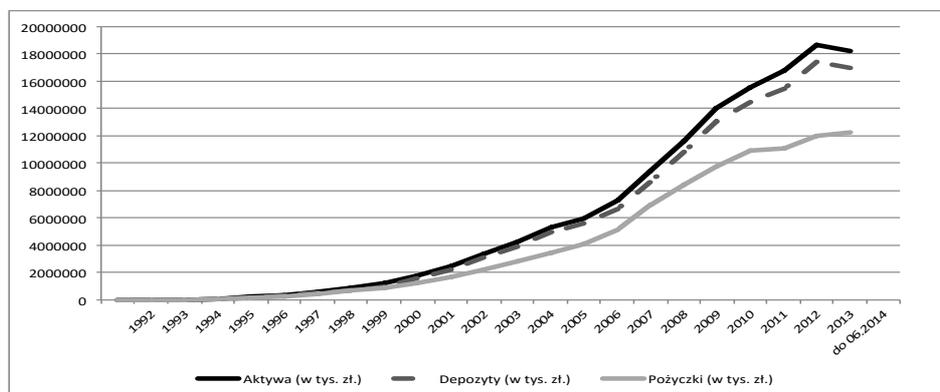
**Figure 1. Number of SKOK credit unions and their members 1992 – 2014.**



Source: Author's own work based on <http://www.SKOK.pl/o-SKOK/SKOK-w-liczbach>

According to 2014 mid-year results, there are 55 unions and more than 2.65 million members in the sector. The biggest increase in the number of unions (including branches and subsidiaries) could be observed in the early stages of SKOK sector's creation – about 231% in 1994 year/year at its highest point. From that moment the dynamics was gradually decreasing reaching the average of 0.9% in the period 2010 - June 2014, and in 2013 alone negative value of (-)4.8%. The number of SKOK members also diminished – in 2013 it dropped by 2.7% year/year, in June 2014 by 0.1% year/year (with an average value of growth of 35.3% between 1995 and 2006). However, there is a considerable increase in total assets, deposits and loans throughout the whole life of SKOK sector in Poland, Figure 2.

**Figure 2. Total assets, deposits and loans within SKOK sector in the period of 1992-2014.**

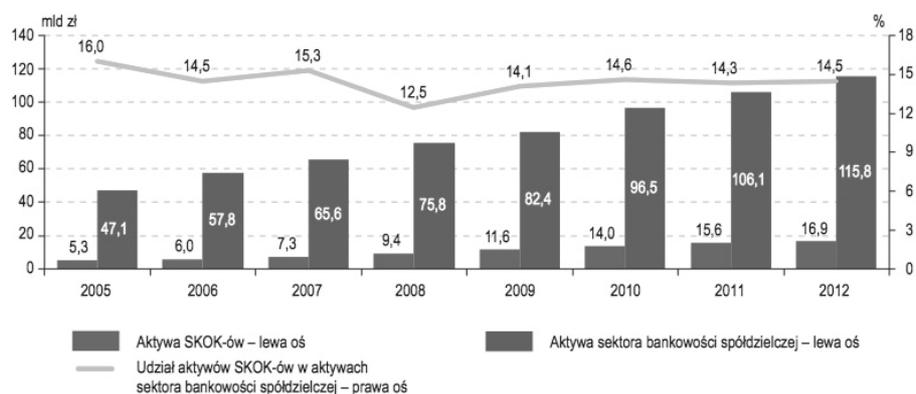


Source: Author's own work based on <http://www.SKOK.pl/o-SKOK/SKOK-w-liczbach>

In the Polish financial system, the significance of SKOK sector is still small, what can be proved by the volumes of loans and deposits of non-financial sector lodged in SKOK, respectively 1.7% and 2.2% of deposits from entities in the banking sector.

Moreover, SKOK sector figures have deteriorated recently. After a period of growth in the value of SKOK assets, which in 2009-2011 were growing faster than the value of assets in cooperative banks, 2012 saw a downturn – the pace of growth in the value of assets was less than 1%. The ratio between balance sum of the credit union sector (without the National Association) and the balance sum of cooperative banking sector fell to the level of about 14.6%,

**Figure 3. SKOK sector assets as compared to the assets of cooperative banking sector 2005-2012.**



Uwaga: dane nie obejmują aktywów Kasy Krajowej.

Source: Based on<sup>11</sup>

The financial results for 2013, in accordance with the corrections of reporting data, was (-)128 million PLN and it was lower than the originally forecasted by 379 million PLN<sup>12</sup>. Although since June 2014 the equity situation has improved by 161million PLN – the own funds were still on the level (-)70 million PLN, and the profitability ratio was (-)0,42%<sup>13</sup>. Starting from September 2013, profitability ratio kept

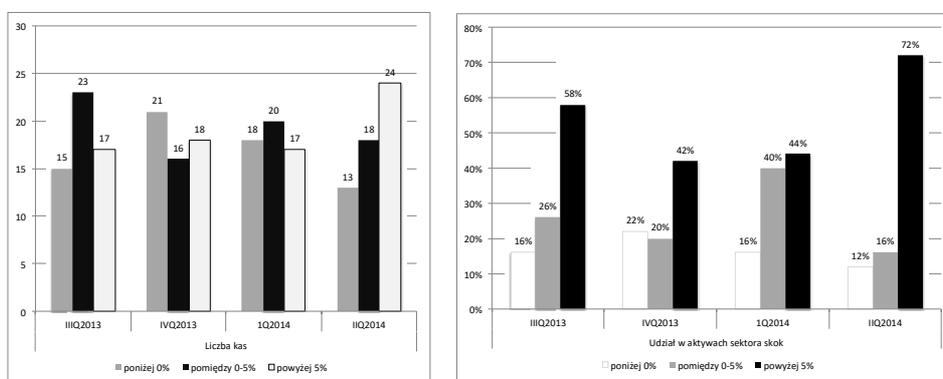
<sup>11</sup>Rozwój systemu finansowego w Polsce w 2012, Department of the Financial System Polish National Bank, Warsaw 2014.

<sup>12</sup> As of 30th June 2014.

<sup>13</sup> Statutory norm is 5%.

deteriorating, reaching in consecutive periods the value of (-)1,33% (December 2013) and (-)1,56% (March 2014). Additionally, more unions showed the above mentioned ratio at the level below 5% (31 unions, 13 of which showed negative value of the profitability ratio – data as for June 2014), Figure 4. In the same period, only 38 unions demonstrated net profit.

**Figure 4. Number of unions, their solvency ratio and share in assets.**



Source: Author's own work based on<sup>14</sup>.

The quality of the credit portfolio is also a problematic issue. At the end of 2014 the value of loans and credit overdue by minimum 1 day was 5.145 million PLN (share of about 38%), from which 2.8 million PLN are loans overdue by more than 12 months (share of about 21%), Table 2.

<sup>14</sup>*Informacja o sytuacji spółdzielczych kas oszczędnościowo -kredytowych w I półroczu 2014 roku*, Department of Cooperative Banking and SKOK, the Office of Financial Supervision Authority, Warsaw 2014.

**Table 2. Loans and credit portfolio as of end of June 2014.**

Product	End IVQ 2013		End IQ 2014		End IIQ 2014	
	PLN	Share %	PLN	Share %	PLN	Share %
Gross loans and credits	13 178 057	100	13 285 333	100	13 560 008	100
Overdue loans and credits	3 928 277	29,81	4 499 811	33,87	5 145 238	37,94
Loans and credits overdue more than 12 months	2 488 895	18,89	2 677 727	20,16	2 857 951	21,08
Write-downs	2 565 027		2 753 660		2 921 914	

Source: Author's own work based on<sup>15</sup>

The portfolio analysis shows that the majority of loans are worth between 10.000 PLN and 50.000 PLN (45.8% of the whole portfolio). A significant position in the portfolio (714 loans by IIQ 2014) is occupied by loans worth more than 1 million PLN (15.9% of the portfolio). Consumer and property loans also constitute a considerable share in the portfolio, 47.7% and 46.5% respectively<sup>16</sup>. Figure 5 and Table 3.

**Figure 5. Structure of credit portfolio.**



Source: Based on<sup>17</sup>

<sup>15</sup> Ibid.

<sup>16</sup> Based on reporting information provided by the unions.

<sup>17</sup> Op. cit. Informacja o sytuacji spółdzielczych kas ...

**Table 3. Structure of overdue loans.**

Credit category	PLN	Non-performing loans [%]
Investment	7726	0,20%
Operational	86720	1,70%
Current account	205027	4,00%
Property	2392626	46,50%
Consumer	2453139	47,70%
Sum of overdue credits	5145238	100,00%

Source: Based on<sup>18</sup>

The weakness in credit risk management along with quite intensive promotional activities lead directly to the increase in overdue receivables. Only in the first half of 2014, with the increase in the credit portfolio of 2.8%, the number of overdue credit increased by 31% (as compared to 2013), what has a direct impact on effectiveness of the unions' operations. The financial results are also affected by the write-downs made as the result of the worsening quality of the credit portfolio. Their value in IIQ 2014 increased by 73 million PLN as compared to the same period in the previous year and amounted to 2.921 million PLN at the end of 2014.

The situation of credit unions has been made even worse by the activities of the National Association of Co-operative Savings and Credit Unions (hereinafter referred to as NACSCU). These activities were questioned by FSA. A subsidiary called SKOK Holding S.a.r.l., founded by NACSCU to ensure transparency of ownership and equity structure in the SKOK system, was discovered to transfer profits abroad. The National Association of Co-operative Savings and Credit Unions is the original and sole shareholder of SKOK Holding S.a.r.l. and since the company was created, NACSCU started moving there its shares from other entities in the system. Through SKOK Holding S.a.r.l. NACSCU can control the group's key entities of which it is the main shareholder - Mutual Insurance Society SKOK – 80.11% of shares; Financial Society

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<sup>18</sup> Ibid.

SKOK Plc. - more than 63% of shares; Assurance Ltd. - 100% of shares; Social Rating Agency - 100% of shares<sup>19</sup>.

There are complicated personal and equity ties between the companies within the Holding. A lot of SKOK financial resources are transferred, in the form of various kinds of fees, to SKOK Holding S.a.r.l. Such payments in 2013 amounted to more than 83 million PLN<sup>20</sup>, and in the following year are assumed to reach about 70 million PLN<sup>21</sup> (Figure 6)<sup>22</sup>.

To make matters worse, SKOK Holding S.a.r.l. failed to pay the National Association of Co-operative Savings and Credit Unions 141 million PLN of generated income as dividends and, as the result, did not feed its Stabilization Fund. The ongoing restructuring processes of unions were, thus seriously hindered. At this point it is also worth mentioning that incomes of the above mentioned subsidiary come predominantly from dividends from companies of which it is a shareholder. The activities of the discussed subsidiary are only formal and the subsidiary does not employ any staff.

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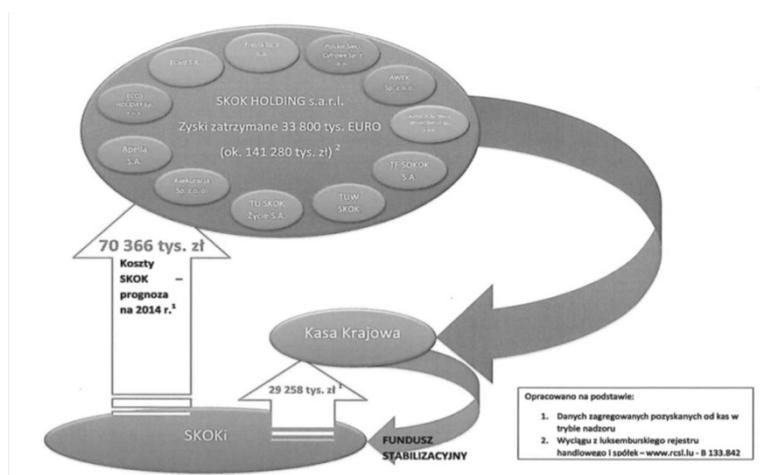
<sup>19</sup>Data quoted herein is based on the information obtained from credit unions in the surveillance mode and presented in a report titled *Informacja w sprawie powiązań kapitałowych i personalnych w sektorze spółdzielczych kas oszczędnościowo-kredytowych*, Financial Supervision Authority, Warsaw 2014, p. 6.

<sup>20</sup> Ibid.

<sup>21</sup> Ibid.

<sup>22</sup> Ibid.

Figure 6. Simplified outline of financial flows in SKOK



Source: Author's own work based on<sup>23</sup>

### 3. Corrective actions

At this point, a unanimous standing so as to the optimum cure for the SKOK sector has not been developed. The sector's current situation is exemplified by the bankruptcy of SKOK Wspólnota (900 million PLN worth of deposits and 6% share in the market), the acquisition of a SKOK branch in Rumia in the Pomeranian region by Alior Bank (20 thousand of customers and 100 million PLN of their deposits), expectations of yet another acquisition of SKOK Kopernik (130 thousand of customers, 400 million PLN in deposits, 3% of market share) by PKO BP or Pekao Bank, or the presence of 22 receivership law firms.

The research and analysis conducted by FSA showed that restructuring activities should include:

- simplifying the structure of subsidiaries created out of SKOK sector resources,
- conducting efficient supervision and monitoring activities over companies operating within SKOK network,
- regular feeding the Stabilization Fund with dividends generated by the network.

<sup>23</sup> Ibid.

In the view of Financial Supervision Authority, the corrective actions and recapitalization of the indebted sector should be financed by:

- National Association of Co-operative Savings and Credit Unions – about 400 million PLN in total (170 million PLN from the Stabilization Fund, 230 million PLN as a loan for SKOK recapitalization),
- Mutual Insurance Society SKOK – a loan of 90 million PLN,
- SKOK Holding S.a.r.l. – 120 million PLN from 2013 profits of the company,
- a loan from the USA warranted by the World Council of Credit Unions, Inc. This solution, however, seems rather unlikely.

It is also possible to obtain resources from the Bank Guarantee Fund, which disposes of the sum of about 13 billion PLN. There is, however, a problem in its expenditure when it comes to acquisitions. Following the decision of the European Commission, BGF may mobilize 3,3 billion PLN of its resources to pay institutions taking over SKOK credit unions. Although this sum is still insufficient, it can considerably enhance the processes of putting the credit unions back on their feet. The processes may include:

- securitization of debt portfolios,
- change in balance sheet structure,
- restructuring of retail network,
- change of model of operations,
- accumulation of extra capital by the union members,
- SKOK unions being taken over by banks.

A possible solution could be also the creation of the so called *SKOK Bad Bank*<sup>24</sup>, in which the portfolio of bad credits would be collected as well as any debts difficult to recover, all this would be excluded from the SKOK system. The main shareholders of *SKOK Bad Bank* would be the Bank Guarantee Fund and representatives of other banks (with a really small share). In this way, the SKOK Credit Union Sector would be free from the ‘burden’ and the specialists in restructuring would manage the *Bad Bank*. Here, however, questions arise whether such a venture would be effective and what will the fate of *SKOK Bad Bank* be? Because the

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<sup>24</sup> "Zły bank" lekarstwem na SKOK?, Polskie Radio, <http://www.polskieradio.pl/42/273/Artykul/1062790,Zly-bank-lekarstwem-na-SKOK>, [access: 27th February 2014].

SKOK network is made of a large number of strongly decentralized institutions, carrying out operations of transferring bad assets would be technically difficult and also very expensive. It is impossible to guarantee that once the bad assets are removed, the network will start to function smoothly again based on the old business model, which relied heavily on granting fast and risky loans. Restructuring costs of *SKOK Bad Bank* should also be taken into account. Although the *bad bank* solution is quite common in rescuing banks, the European Commission has not yet issued a statement on implementing this solution with respect to rescuing SKOK sector in Poland.

### **Conclusions**

Although credit unions are not banks as such and are not oriented towards maximizing profits<sup>25</sup>, their financial results from a couple of recent years raise considerable doubts. The instances of bankruptcy acquisitions, receiverships within the SKOK network is a picture revealed by FSA. The situation calls for prompt corrective actions but the coherent course of actions has not been determined yet. The steps undertaken by the Ministry of Finance are quite controversial as they may lead to restrictions for the cooperative system in Poland and limitations in access to cheap ways of financing through cooperative financial institutions<sup>26</sup>.

Regardless of the kind and scope of undertaken activities, it is vital to restore the credit union sector troubled with financial and organizational weaknesses.

### **Legal acts**

- [1.] Journal of Laws 2003, No 188, item 1848 as amended.
- [2.] Journal of Laws 2002, No 72, item 665 as amended.
- [3.] Journal of Laws 2012, item 855, 1166 of 2013 items 613, 1036, 1289 – Act on Cooperative Banking and Credit Unions, 2009.

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<sup>25</sup> *Spółdzielcze kasy działają dla dobra społeczeństwa*, Super Express, <http://www.skok.pl/o-skok/media-o-nas/spoldzielcze-kasy-dzialaja-dla-dobra-spoleczenstwa>, [access:4th November 2014].

<sup>26</sup> Ibid.

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