How to benefit from financial deepening while preserving financial and macroeconomic stability: the case of Poland

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Abstract

Poland has achieved a successful economic transformation. The banking crisis of the early 1990s resulting from a faulty licensing policy and a difficult economic situation was adequately managed at a relatively low cost. State intervention was well targeted and no bad banks were needed. Bad loans continued to be managed by the institutions that granted them, which significantly reduced moral hazard. After the situation stabilised, banks were privatised by selling blocks of shares to international investors. At the same time, some of the banks' shares were floated on the Warsaw Stock Exchange, which was important from the point of view of information transparency and effective supervision. The new ownership structure, with foreign strategic investors in many banks, made it easier to avoid forbearance. The supervisory authority also used a wide scope of soft powers, which proved to be effective and flexible. As a result, it was possible to avoid a credit bubble and systemic risk, which set the stage for economic development with relatively low level of indebtedness. In general, recent decades have seen a gradual process of financial deepening. A major challenge for the future will be the development of the capital markets, especially the corporate bond market. However, due to the dominance of the banking sector as well as supply and demand factors, the development of the corporate bond market will require the involvement of the authorities.

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Introduction

The last two decades have been turbulent in both advanced and emerging market economies. Although the early 2000s were characterised by robust economic conditions and moderate inflation, significant imbalances accumulated in many countries, not least in the form of real estate bubbles. The Great Financial Crisis (GFC) not only led to a contraction of GDP and welfare in a number of countries, but also had significant implications for the functioning of financial markets and banks. Moreover, policymakers recognised the need to address systemic risk in financial systems, which resulted in acknowledging macroprudential measures as a crucial element of stabilisation policy.

Against this background, the Polish economy appears as one of the most resilient, especially among emerging markets. After a painful transformation at the turn of the 1980s and 1990s, Poland has experienced uninterrupted economic growth for almost three decades. Even the GFC did not bring the Polish economy to a halt. Prudent macroeconomic policies were among the key reasons for this success. This remarkable resilience is also partly attributable to a sound banking sector, which two decades before the GFC was practically non-existent. Although by the 1990s, the socialist monobank had already been replaced by newly created commercial banks, this only marked the beginning of a process leading up to the emergence of a modern, competitive and strong banking sector.

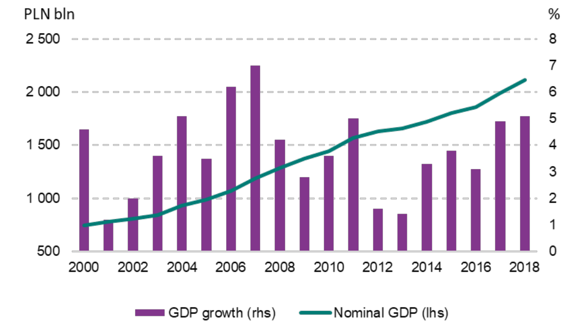
This note focuses on factors that – based on the Polish experience – could either facilitate or hamper the development of the financial system. The first part describes the main lessons drawn from historical developments in the financial sector. The second part discusses potential steps that could further strengthen the positive role of financial institutions for the development of the Polish economy. The final section concludes.

Creating a financial system conducive to sustainable economic growth

Today Poland could serve as an example of economic success story (Graph 1). Almost three decades of GDP growth constitute one of the longest confirmed periods of economic development in the world. This uninterrupted growth allowed for significant narrowing of the economic distance to western Europe and visible improvement of the financial conditions of Polish households and enterprises. But looking three decades back, these positive developments could hardly have been expected. The beginning of the 1990s was marked by extremely unfavourable economic conditions with large imbalances. The Polish economy suffered from major structural weaknesses bequeathed by the socialist command economy. The lack of capital as well as adequate skills and know-how hindered the development of enterprises. At the same time, the underdeveloped banking system could not provide credit to facilitate the growth of the private sector. Considering these circumstances and following the example of other European economies that had a strongly bank-dominated financial system, building a banking sector that would more efficiently allocate capital in the economy became an official priority. Over the following years, a number of decisions and reforms have paved the way for the emergence of a modern, two-tier banking system. As there was no precedent to learn from, this restructuring has been a trial and error process. Although this approach allowed for some mistakes, it proved to be successful and led to the emergence of a sound, competitive and properly managed banking sector. This approach also provided some important lessons regarding the "dos and don'ts" of banking system development, as discussed below.

Real GDP growth and nominal GDP in 2000–18

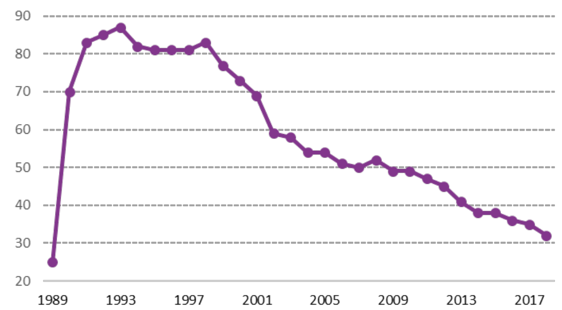
Graph 1



Source: Polish Statistical Office.

Number of commercial banks in Poland

Graph 2



Source: Bank supervision 1989–2006, Reports on bank situation, NBP.

Growth of banking sector is not an end in itself

Having recognised the need to build competitive banking system, in the early 1990s, the Polish authorities chose the privatisation of state-owned banks as the means of reaching this goal. However, considering the low level of domestic private savings and the perception of Poland as a high-risk economy among foreign investors at that time, such a solution seemed unattainable. Consequently, to kick-start the privatisation, NBP initiated a lenient bank-licensing policy, with low capital requirements. This policy encouraged the registration of almost 90 new commercial banks, as of 1993 (Graph 2). However, the quality of these new institutions was not in line with their quantity. On the contrary: the newly created banks were usually small and poorly capitalised. Moreover, many suffered from insufficient know-how that led to poor risk management. These flaws were quickly exposed, as the recession accompanied with strong structural changes in the economy resulted in a dramatic increase in non-performing loans. The deterioration of loan portfolios was especially severe in the case of the new banks, triggering many failures. The poor performance of these banks in the adverse economic environment clearly showed that a strong and resilient banking sector could not be built on numerous but weak entities. Only a banking system comprising well capitalised and prudently managed institutions could facilitate sustainable economic development.

Supporting troubled institutions could be a better solution than relieving them of their problems

The recession took its toll not only on the most vulnerable banks, but on the whole banking sector. Mounting bad loans eroded the financial position of many private banks, undermining their ability to continue their operations. To prevent the negative consequences of widespread bank failures, the authorities had to step in. Both the State Treasury and the NBP participated in restructuring the banking sector. In the case of private banks, the restructuring took several different forms: some institutions were taken over by the authorities, and others by banks in better financial shape that additionally received aid from the government. Still other entities received the financial assistance necessary to implement rehabilitation plans. At the same time, big, state-owned banks were provided with aid in form of high-yielding restructuring bonds issued by State Treasury. Restructuring bonds – eligible as capital – allowed state-owned banks to significantly strengthen their capital position and create adequate reserves against bad loans. In return, banks were obliged to restructure their credit portfolios within one year, by separating non-performing loans and shifting them to newly created debt-collection departments that were expected to gradually collect or liquidate low-quality loans.

It is worth noting that, although banks received substantial financial support from the state, they were left to solve the bad loan problem on their own. This approach contrasts with methods used by some other central European countries, where bad loans were carved out and accumulated in a "bad-bank". The Polish decision-makers decided against such a solution, on the grounds that it could have created a moral hazard. Moreover, the authorities believed that making banks cope with the bad debt burden in-house would provide these institutions with a valuable learning experience. The Polish approach to bank restructuring proved successful, with the relevant banks improving their profitability and maintaining their capital adequacy.

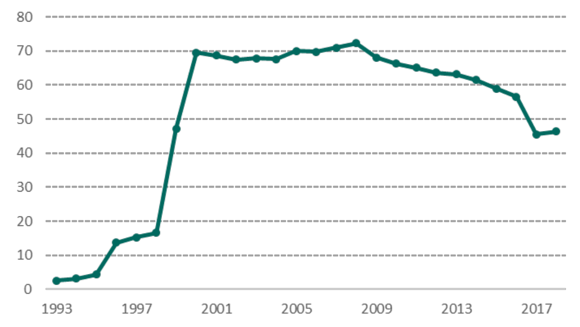
Foreign capital can spur development of banking sector, but timing of its arrival and conditions are crucial

The end of the recession revived the interest of foreign investors in Polish assets, including banks. Yet, considering that the banking sector restructuring process was still under way, the authorities were reluctant to let foreign investors establish new entities that would compete with troubled domestic institutions. However, they also saw an opportunity to facilitate the restructuring process by allowing foreign financial institutions to help ailing banks with both capital injections as well as transfer of know-how. In order to encourage foreign investors, the supervisory authority granted them the eventual option to take over the restructured banks. Such an approach – the involvement of foreign players, but within stated boundaries – contributed to the success of the restructuring process and reduced its cost to taxpayers.

With time, as the sector matured and the banks improved their market positions, the restrictions regarding foreign involvement in the banking system could be safely lifted. Indeed, at the beginning of 1999, foreign institutions gained access to the Polish banking sector and promptly started to build their position in the financial market. In 2000, the share of foreign-owned banking assets rose from less than 50% to 70% (Graph 3). Notably, the authorities once again employed a strategy designed to benefit the banking sector's development, namely selling controlling packages of privatised bank shares to highly regarded financial institutions ready to make a strategic investment in Polish banks. This method of privatisation was expected not only to provide banks with additional capital, but also to bring efficiency-enhancing changes to banks' operations. However, to avoid putting too much reliance on single investors and to ensure an external check on management performance, the minority stakes were sold on the Warsaw Stock Exchange. This privatisation strategy brought the anticipated results: the technologies and practices brought in by foreign investors strengthened bank finances and helped to build a competitive and resilient banking sector.

Share of banks with foreign capital in total assets of banking sector in Poland

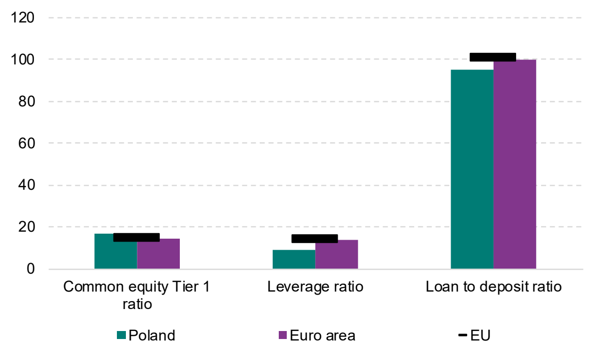
Graph 3



Source: Reports on bank situation, NBP.

Common Equity Tier 1 ratio, leverage ratio and loan-to-deposit ratio of domestic banks at the end of 2018 (%)

Graph 4



Source: ECB Statistical Data Warehouse.

The combination of strong supervisory powers with soft instruments proved to be an effective way to ensure financial stability

The ownership structure of Polish banks shaped by the privatisation process has some important implications for supervision. Strategic investors are natural partners for supervisory authorities to cooperate with and – hence – help them to monitor institutions and – if necessary – enforce corrective actions. Moreover, foreign ownership reduces the risk of supervisory forbearance due to political interference, as any strong links between political bodies and foreign financial institutions are unlikely to emerge. These features of the Polish banking sector help the supervisor authority to fully exploit the broad competences granted by the Polish law. At the same time, the important role played by foreign institutions has also increased the need for supervisors to act. For example, pressures from foreign owners on local management – concerning, *inter alia*, increased exposure to parent company assets – could have a detrimental effect on the stability of Polish banks and hence need to be counteracted. The supervisor has indeed frequently and decisively used its power to avoid any such harmful influence from parent institutions. These as well as other actions aimed at correcting excessive risk-taking have proved successful in maintaining the capital and liquidity positions of Polish banks. Currently, the Common Equity Tier 1 ratio in the Polish banking sector is 2.4 percentage points higher than for all euro area banks, while the leverage ratio and loan-to-deposit ratio in Poland are respectively 4.8 percentage points and 5.1 percentage points lower than in the euro area (Graph 4).

Part of this success was attributable to the way that the Polish supervisory authority chose to act. Instead of resorting to administrative decisions or legislative changes, it made use of more flexible, "soft" instruments, mainly recommendations. Although not legally binding, recommendations proved to be effective in creating a set of market practices that are strictly followed by banks. Thanks to this setup, the supervisory body was able to introduce some macroprudential measures even though it had no formal macroprudential policy mandate. Consequently, the flexibility provided by the "soft" approach played an important role in safeguarding the stability of the Polish banking sector. In particular, it allowed for sufficient flexibility in the conduct of supervisory policies despite the relatively rigid and harmonised EU regulatory environment.

Strong supervision is not a silver bullet for financial stability

The financial system is not ring-fenced from the rest of the economy. On the contrary, it has a strong bearing on real and monetary developments, which – in turn – feed back into the situation of the financial sector. Consequently, the stability of financial system hinges not only on the situation within the system, but also on the developments in the whole economy and the economic policies pursued by all relevant authorities. This point could be illustrated by the impact of monetary policy on the stability and development of the Polish banking sector.

Monetary policy played a major role in the development of financial system right from the start of the transformation. The high dollarisation of the economy and extremely high inflation at the beginning of 1990s hindered the development of financial intermediation. Rebuilding trust in the domestic currency was a prerequisite for the successful reform of Polish banking sector. Hence, the conservative monetary policy that resulted in gradual disinflation – to the extent that it strengthened the confidence in domestic currency – was important for the development of Polish banks. At the same time, the long period of high real and nominal interest rates moderated the growth of financial intermediation, as it encouraged enterprises to rely on internal resources and financing from parent companies, instead of on bank credit. High interest rates also affected banks' business models. First, higher interest rate volatility made retail deposits the preferred source of funds for banks instead of wholesale funding. Second, they promoted the widespread use of floating rate contracts for both loans and deposits. These factors were ultimately conducive to the longer-term resilience of the banking sector.

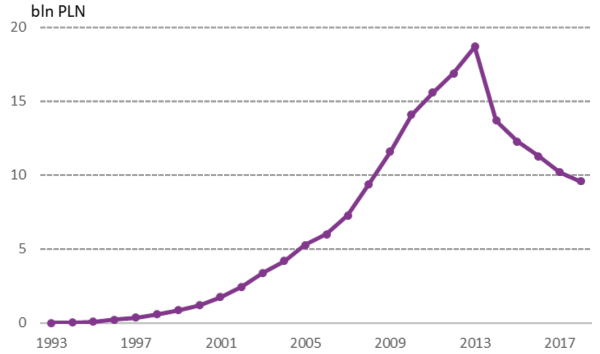
However, conservative monetary policy also created some unintended risks for financial sector stability. Relatively high interest rates in Poland, together with the strong presence of foreign-owned banks that had access to FX funding from parent institutions, led to a large increase in FX mortgages granted to unhedged borrowers in the early 2000s (Brzoza-Brzezina et al (2010)). As the build-up of FX credit portfolios created potential risks for the banking sector – including higher credit risk and spillover risk from parent institutions – the supervision authority stepped in, issuing a recommendation that initially mitigated credit risk stemming from FX loans and later – after amendment – banned FX credits to unhedged borrowers altogether (KNF (2013); Willmann (2013)). Fortunately, the large portfolio of FX loans caused no major disruption in the banking sector, even after the strong zloty depreciation in 2009. As these loans were based on floating rates, the effect of a weaker currency was, to a significant extent, offset by a fall in market interest rates after monetary policy easing by the Swiss National Bank and the ECB (Głogowski and Szpunar (2012)).

To sum up, the development of the financial system in Poland has been unusual for two main reasons. First, at the beginning of 1990s, Poland started to build its financial sector nearly from scratch amid challenging economic conditions. Second, as there were no precedents to learn from, Poland was forced to adopt a "learning-by-doing" approach. Consequently, the development of financial system has not been free of mistakes. However, this provided important lessons that have influenced the subsequent decisions of Polish authorities and which could constitute a valuable insight for other economies.

Keeping up with the economic development – a way forward

Considering the severe underdevelopment of the financial system that Poland inherited from the socialist command economy, facilitating the development of this sector for many years has constituted an important goal for Polish authorities. Consequently, over the last three decades, the Polish financial sector has experienced a significant evolution: starting nearly from scratch, the size of financial sector increased to nearly 129% of GDP in 2018 (Graph 5). According to IMF experts, the size and structure of financial system in Poland is optimal with regard to its ability to facilitate economic growth (Sahay et al (2015)). Such an assessment indicates that Poland was successful in terms of developing adequate financial system.

However, for this statement to remain true, there are still some issues to be addressed. First, the Polish banking sector – despite being strong and resilient – still has its weak points and challenges. The proper management and correction of these flaws are necessary to avoid potential setbacks in the future. Second, even in the areas that clearly constitute a strong feature of the Polish financial system – eg effective macroprudential policy – there is still some scope for improvement. Finally, as the Polish economy evolves, its needs regarding financial intermediation change. Yet, the financial system might not adjust to these changes on its own accord, but rather may require a "nudge" from the authorities.

Financial sector assets as per cent of GDP Graph 5	Assets of credit cooperatives in Poland (PLN billions) Graph 6
	
Source: Financial System Development Reports, NBP.	Source: KSKOK data, Financial System Development Reports, NBP.

Weaknesses to be addressed

Lack of proper supervision – especially vis-à-vis numerous smaller institutions – might have long-lasting adverse effects. Although a deteriorating financial situation or even the failure of small entities would not create systemic risk for the financial sector, it could have negative spillovers in the form of loss of confidence in the financial system. Such risks are potentially material if fragmented, small and fragile but numerous entities have a relatively large client base. In Poland, this is exactly the case with cooperative banks and financial cooperatives, known as SKOKs.

The cooperative banking sector as a whole is functioning in a stable manner, although it still faces a number of challenges associated with the financial distress of individual entities and the need to define its long-term strategy. Cooperative banks in most cases meet the supervisory and liquidity requirements; however, in the case of certain banks, firm action has to be taken to define their business model. The sector's low efficiency associated with its business model and its low integration rate pose challenges to cooperative banks' profitability and their capacity to expand in the future (NBP (2019)).

The total assets of the SKOKs account for less than 0.5% of banking sector assets. However, the number of the SKOK members remains high (approx. 1.5 million clients). Consequently, a potential failure of these institutions may create problems that cannot be disregarded. The risk of such a scenario materialising is not negligible, as the quality of SKOK loan portfolios is poor, their efficiency is low and currently five of these cooperatives fail to meet capital requirements (KNF (2019)). The weak position of the sector is to a large extent the legacy of past supervisory neglect. SKOKs were included under the supervision of the Polish Financial Supervision Authority (KNF) in late 2012, ie after 20 years of operations during which the sector had continued to grant a large volume of high-risk loans. In subsequent years, some financial cooperatives were taken over by commercial banks, many were suspended in their operations and several merged with other cooperatives. The impressive expansion of SKOKs over many years has proved to be unsustainable (Graph 6). Despite recovery programmes that most of credit cooperatives have been obliged to join, the situation in this sector has remained complex.

The fragile financial condition of some cooperative financial institutions is problematic for at least two reasons. First, – due to the high number of SKOK members – it may create social and reputational problems. Second, the ongoing restructuring process of credit cooperatives requires a significant use of the financial resources of the Polish deposit guarantee fund (BFG). Hence, it reduces the capacity of the BFG for any problems that might be identified in other financial institutions, especially in the banking sector, which still remains the main contributor to the BFG.

The central bank's role in safeguarding financial stability should be strengthened

Macroprudential supervision in Poland has proved effective in mitigating systemic risk. Although a formal macroprudential authority – the Financial Stability Committee (KSF) – was established only in 2015, the steps aimed at curbing sector-wide risks had previously been taken informally by the microprudential supervisor.

The institutional setup of macroprudential policy created in 2015 is in line with international best practice. The KSF comprises representatives of four major financial safety-net institutions, the NBP Governor, the Chair of the KNF, the Minister of Finance and the President of the Bank Guarantee Fund (BFG), with the central bank playing a key role within this framework as far as macroprudential policy is concerned. Meetings devoted to macroprudential issues are chaired by the NBP Governor (as opposed to crisis management meetings, which are chaired by the Minister of Finance), who has a casting vote in case of a tie. Moreover, the KSF has a clearly stated mandate and formal independence, which is vital for the committee's ability to pursue this mandate. It also has an appropriate set of policy instruments.

Despite this institutional setup and track record, keeping systemic risk in check in the years to come might require further efforts. These should be partly aimed at addressing the problems that could emerge irrespective of the state of the economy, including the inaction bias of macroprudential authorities, political resistance to macroprudential actions or an inability to clearly show the benefits of measures as opposed to their costs. Apart from these universal challenges, Poland – as a relatively small, open economy with strong role played by foreign strategic investors in its banking system – could be prone to some specific risks. These risks include vulnerability to regulatory arbitrage or negative spillovers – mainly in the form of capital and liquidity outflows – should the parent financial institution became distressed. For a small open economy, it is also crucial to keep all channels for credit flows under scrutiny, including the cross-border direct lending and cross-border capital flows, since both may fuel domestic credit booms (Davis and Presno (2017)). Addressing these risks could require a more active macroprudential policy than in the bigger European economies. However pursuing such a policy could be quite challenging as room for manoeuvre for local authorities is limited by the harmonisation process applied to all EU countries under the CRD IV/CRR package. One way to build up authorities' capacity to address country-specific risks is by using non-standard tools, including microprudential or fiscal measures. To pursue such an approach effectively requires a strong cooperation between fiscal, monetary and supervision authorities, which is to a great extent ensured by the current macroprudential institutional framework in Poland. However, the ability to effectively mitigate risks to financial stability could be strengthened by bringing microprudential supervision back to the central bank, which would benefit not only from the trust and authority the NBP enjoys, but also from the data and expertise at its disposal. Further improvement of the institutional framework of prudential policy and effective use of non-standard measures would allow Poland to face up to both universal as well as country-specific challenges that would emerge in the years to come.

The growing role of the state in the domestic financial system is another reason why the microprudential supervision should be moved back to the central bank. The role of the state manifests itself through: (1) ownership of a number of large financial entities, including in the banking and insurance sectors; (2) a significant representation of the government sector in the decision-making body for microprudential supervision of the entities; and (3) the growing share of government bonds on bank balance-sheets. Amid the growing state role in the financial system in recent years, it is desirable to reduce the risks that may arise as a result of a divergence of objectives between the supervisory and ownership functions. The effective separation of the supervisory and ownership functions could be achieved by the reintegration of financial market supervision into the structures of the NBP. Such a change would be in line with the global trend towards placing microprudential supervision with the central bank (NBP (2019)).

The need to develop market-based financing for enterprises

Over the last three decades, credit growth has broadly been maintained at a level that facilitated economic development without creating imbalances. However, much of this credit has supported consumption rather than production: as of November 2019 consumer and mortgage loans accounted for 60% of banks' credit portfolios. Corporate credit has not only lagged behind loans to the household sector, but also – due to the high risk aversion of banking institutions – has flowed mainly to bigger, well established enterprises. In turn, small or young companies that have neither a good credit history nor high-quality collateral have limited access to bank financing, which could have an adverse effect on the development of new technologies and innovations, and consequently on long-term economic prospects. Another result of banks' reluctance to accept risk is the strong procyclicality of the financial system based on these institutions (eg Huizinga and Laeven (2019)). In turn, capital markets are more willing to accept higher risk, if it is rewarded with a higher expected return. As a result, they are more apt to finance start-ups, small enterprises or innovative products that, if successful, might help to fuel economic development. Moreover, the equity and bond markets provide a more effective mechanism of risk-sharing and consumption-smoothing, as it is investors – as opposed to depositors – who bear any losses. For these reasons, moving from mainly bank-based to a more market-oriented financial system might prove beneficial, as it would not only create more opportunities to increase the innovativeness and long-term growth potential of the economy, but also would reinforce its financial stability (ESRB (2014)).

Poland's financial markets are still heavily dominated by banks. Although its capital markets have also grown substantially over the last two decades – with stock exchange capitalisation increasing from 18.8% of GDP at the end of 2000 to 53.4% of GDP at the end of 2018 and the value of corporate debt securities rising from 0.2% to 1.0% of GDP – they provide financing for only a limited number of Polish enterprises, mainly large ones. It seems that such organic growth – hindered by a number of barriers – will not be enough to drive a significant move towards more market-based financing. Hence, speeding up the development of capital markets would require public intervention aimed at eliminating both supply- and demand-side obstacles to growth. On the supply side, the major impediments – pertaining mainly to SMEs – include limited financial literacy and the high cost of obtaining funds. On the demand side, the lack of a diversified investor base strongly hampers the ability of firms – especially SMEs – to secure funding. Addressing these issues with proper public interventions would make capital markets a viable source of funds for larger share of Polish enterprises. Such a change could not only spur economic growth, but would also be conducive to the more efficient and stable functioning of the financial system.

Conclusions

The last three decades have seen a steady development of Poland's financial system. Although this has been to a large extent a process of trial and error, it has proved to be quite successful, resulting in a strong and competitive banking sector. The lessons learnt have surely contributed to this success and could provide important insights for other economies, especially with regard to the Polish approach to restructuring distressed banks, as well as conducting supervisory policy. However, for the financial system in Poland to remain resilient and supportive of further economic development, there are issues that should be addressed. First of all, further restructuring of the lending cooperative sector is necessary to avoid potential negative spillovers to the whole banking sector. Secondly, to mitigate risks for financial stability, the macroprudential framework and toolkit need further adjustments and microprudential supervision should be moved back under the umbrella of the central bank. Finally, decisive steps to spur the development of market-based financing for enterprises seem crucial for enhancing the financial stability and long-term growth of the Polish economy.

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