Stability of Banking System in Poland and Activity of the KNF – Polish Financial Supervision Authority

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Introduction

This study introduces the activities of the KNF – Polish Financial Supervision Authority during the period of European economic slowdown, i.e. years 2007–2012. It presents a brief outlook of the KNF performance, and shows its influence on financial market and the real sector of the economy. Moreover an attempt has been made to find out how the KNF will look in the future and what are possible threats to the institutional framework of financial supervision in Poland. The paper is divided into three parts. The first contains a short presentation of key macroeconomic figures, the second shows the performance of banking sector, while the third highlights some details about resolutions and recommendations issued by the KNF.

Macroeconomic outlook

Poland's macroeconomic performance over the period 2007–2012 can be considered to be favourable, especially if the country is compared with the EU and eurozone countries. The Polish economy avoided recession, and its output growth was resilient, remaining above the EU average (see Figure 1).

However, despite output growth, labour market remained relatively weak: economic activity did not rise substantially, suggesting so-called jobless growth.[1] The Polish economy had a low employment ratio. This kind of problem had already emerged around ten years previously when Poland was hit by an economic slowdown (although there was no recession), and when weak output development was followed by an extremely high unemployment rate of around 20 percent. It should also be noted that policymakers were aware of the problem related to jobless growth (Ministry of Economy 2004). However, there have been no significant changes to the labour market institutional framework over last years. A deep sensitiveness of employment to business cycles may curb demand for credit and pose problems with loan repayments.

The adverse performance of Poland's economy is forcing banks to develop and use proper risk assessment models, combined with a cautious credit policy, in order to minimize the nonperforming loans ratio. On the other hand, the authority responsible for financial supervision should develop proper requirements for the banking sector in terms of the capital adequacy ratio or liquidity performance, while also making recommendations covering the provision of credits and the assessment of borrowers' creditworthiness. Such an issue is extremely important when one considers the effects of loose mortgage lending policy, which resulted in housing bubbles followed by a deep recession in Ireland and Spain.[2]

In view of the threats linked with the vague assessment of borrowers' creditworthiness it should be noted that, unlike in some other EU countries (for example, Britain),[3] all potential borrowers in Poland were subject to income verification. As a result, even the deterioration in the labour market situation did

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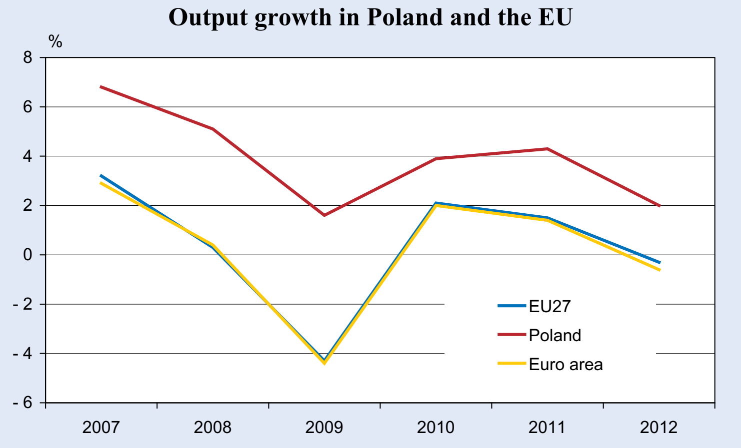
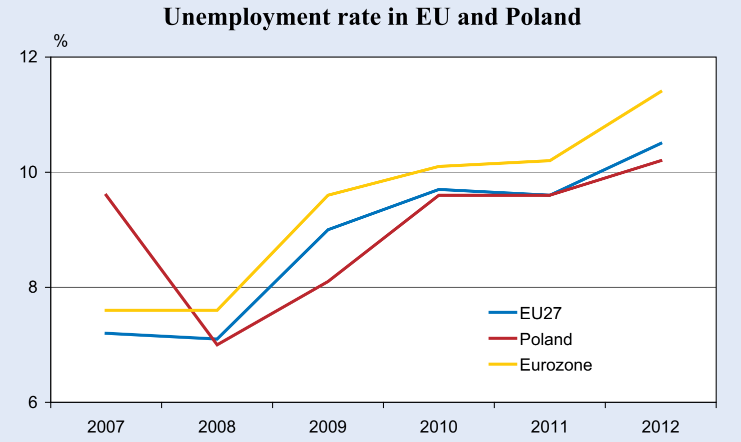
[1] Referring to the term 'jobless growth' or 'jobless recovery' it is important to remember that both the definitions and causes of such a phenomenon are controversial (Cantore, Levine and Melina 2013; Aaronson, Rissman and Sullivan 2004).
[2] Housing Prices Index published by Eurostat shows that average rate decrease in house prices for the period between 2009 Q4 and 2012 Q3 accounted for 7 percent in Spain and 13 percent in Ireland.
[3] FSA (2012) data shows that income verification in Britain ranges from 70 to 87 percent of potential borrowers.

Figure 1



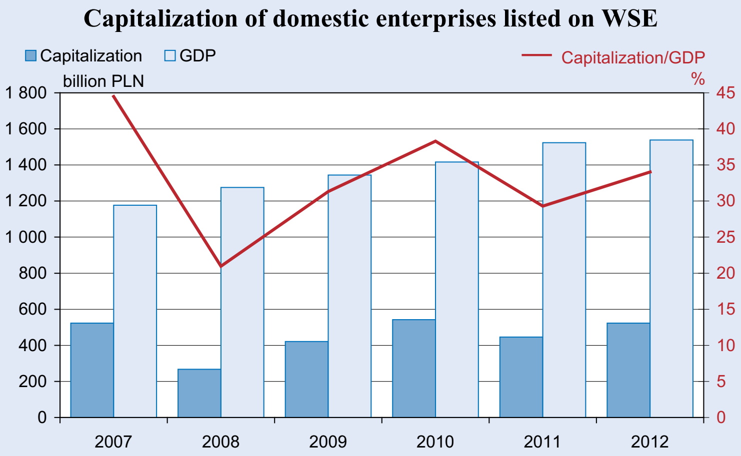
Source: Eurostat.

Figure 2



Source: Eurostat.

Figure 3



Source: WSE data.

not lead to a sharp increase in the nonperforming loans ratio. In the mortgage sector the relationship between provisions for impaired loans and the net value of credits was recently lower than 0.5 percent in Poland. This figure suggests a proper attitude towards credit scoring policies and risk assessment in the case of both supervision and of banks in this country. In Spain, on the other hand, the ratio of nonperforming mortgages rose from 0.8 percent to 7.6 percent during the period 2005–2011 (IMF 2012).

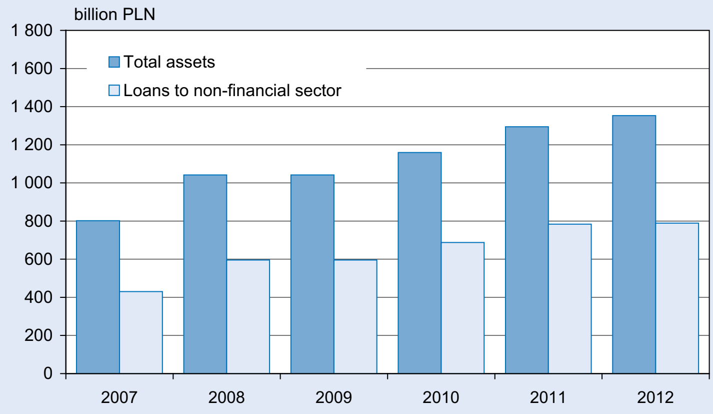
Contrary to the relatively sound situation in the real sector economy, the global financial crisis hit the Polish capital market more substantially. In 2007 the capitalization of domestic enterprises listed on the Warsaw Stock Exchange (WSE) accounted for 45 percent of GDP, but it fell by 10 percentage points to 35 percent of GDP in 2012 (see Figure 3). The sharpest decrease was observed in 2008 when the corresponding value of companies was below 30 percent of GDP (in nominal terms it expresses the downwards movement from 500 billion PLN to around 250 billion PLN). Yet it has to be stated that such a poor performance on the part of the capital market was not accompanied by a deterioration in the overall economic situation and did not amplify any adverse trends in the real sector.

Situation in the banking sector

In the period from 2007–2012 the development trends in the banking sector can be assessed as fairly positive. In these years assets grew by 68 percent, which implies a solid 13 percent annual growth rate. In absolute terms such a

Figure 4

Banking sector assets in 2007–2012



Source: National Bank of Poland (NBP) and KNF data.

change means a balance sheet increase from around 800 billion PLN in 2007 to 1.35 trillion PLN in 2012 (see Figure 4).

Growth in total assets was followed by an increase in loans to non-financial sectors. The latter grew faster than the sum of assets: the total increase reached 83 percent (i.e. 13.8 percent per year), rising from 430 billion PLN in 2007 to 788 billion PLN in 2012. Growth, also expressed in relative terms, was rapid, soaring from 36 percent in 2007 to 60 percent in 2012 as compared to GDP, whereas credit as a share of GDP equalled 60 percent (in 2012) and was thus much smaller than that of many other EU countries.[4]

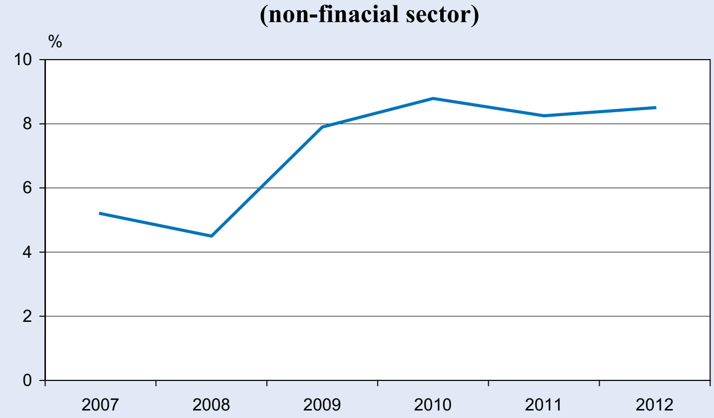
It is important to observe that such rapid growth in exposure was not associated with a worsening of the credit portfolio in Poland. The share of nonperforming loans grew from 5.2 percent to 9 percent between 2007 and 2012. At the end of 2012 nonperforming loans amounted to a total of about 71 billion PLN. One serious problem that has recently emerged is the heavy involvement of banks in lending to the construction industry. Many construction enterprises lost their financial liquidity in the second half of 2012; and some of them (like PBG) declared bankruptcy. Others were liquidated while several firms restructured their debt. Such loans reached 60 billion PLN (the so-called 'big exposures'), which account for 11.2 percent of total major exposures. The construction sector accounted for around 24 pecent of impaired loans.

Changes in assets were followed by an increase in owners' equity and liabilities. The total amount of deposits grew from 419 billion PLN in 2007 to 931 billion PLN in 2012 (= 120 percent). Such numbers confirm the sustainable growth of the banking sector in Poland in recent years. The LTD (loans to deposit) ratio was around 110 percent. One flaw was the fact that the majority of long term loans (especially mortgages) were financed by short-term deposits. As a result, the KNF recommended strengthening the capital base, primarily by means of profit retention, in order to stabilize the situation of banks.

The resilience of the banking sector is also confirmed by the Financial Stability Reports published semi-annually by the National Bank of Poland (NBP). For the purposes of the analyses conducted by the NBP, the three main strategies of asset financing are separated into: (1) deposit based, (2) foreign financing and (3) mixed (NBP 2012). The share of deposit-based financing reaches around 70 percent, and amounts to 40 percent when mixed strategy is applied, while it accounts for 30 percent when banks rely on foreign financing. In cases where another significant compo-

Figure 5

Nonperforming loans as a share of total exposures (non-finacial sector)

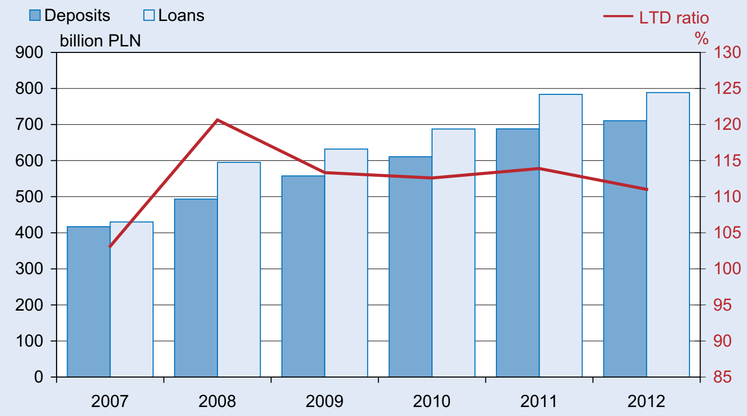


Source: NBP and KNF data.

[4] According to the World Bank, the comparable ratio for Britain was 186 percent, 208 percent in Denmark and 104 percent in Germany.

Figure 6

Value of deposits and loans, and LTD ratio



Source: NBP and KNF data.

Table 1

Capital adequacy ratio

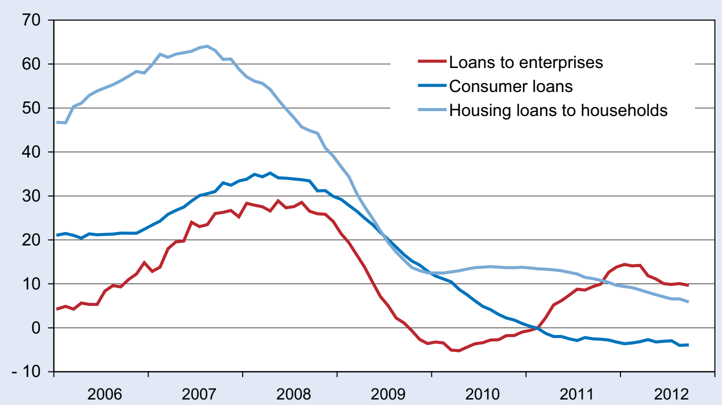
Year	2007	2008	2009	2010	2011	2012
CAR	12.0	10.8	13.3	13.9	13.1	14.7

Source: NBP and KNF data.

Figure 7

Growth of credit

year-on-year %-change



Source: NBP data.

nent – the claims of non-resident financial companies (usually parent companies) against banks – is considered, the share is 8 percent for the deposit strategy, 16–18 percent for the mixed strategy and 46 percent for foreign financing. When the structure of total assets financing is analysed, the corresponding numbers amount to 51 percent, 27 percent and 22 percent, respectively. The dominance of a deposit-based strategy is very important when one considers the fact that the majority of Polish banks are subsidiaries of foreign institutions: this made it possible to avoid a sudden outflow of funds during the economic slowdown when parent companies needed liquidity support.

The Polish banking sector maintained adequate capital buffers, which were higher than those recommended by the Basel Committee. Moreover, the capital adequacy ratio (CAR) in Polish banks was mainly based on Tier I capital, which makes banks even more resilient to adverse economic conditions (see Table 1).

The value of CAR calculated for Polish banks over the period 2007–2012 was above 10 percent, which appears to be a good result.[5] Moreover, relatively high CAR did not lead to a drastic reduction in credit supply (see Figure 7). The decrease in its growth stemmed mainly from the economic slowdown and was not primarily caused by supervisory regulations. Such a slowdown is clearly visible in the case of mortgages (especially FX mortgages), which can be triggered by the rational restrictions imposed by supervision. The Polish real-estate market behaved similarly to the markets in other countries, however, the downwards movement of housing prices was neither very deep nor did it pose any threat to the stability of the banking system. With regard to the data presented above on nonperforming mortgage loans, it is important to underline once again that the relatively conservative lending policy of Polish banks supported by the KNF protected the Polish economy against 'bubble prices' in the real estate market.

Activities of the KNF during the economic slowdown

The Polish integrated financial supervision system was established in 2006, when banking supervision,

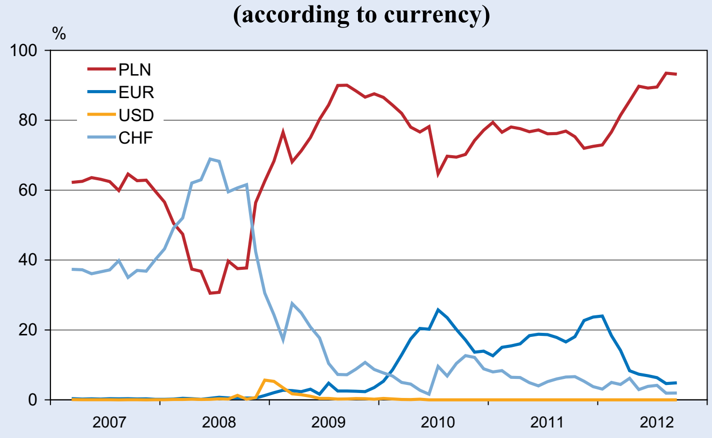
[5] According to the Basel Capital Accords, CAR should not to be lower than 8 percent: since 2011 the KNF has recommended to maintain at least 12 percent level.

the securities commission and the insurance authority were merged under the single roof of the KNF. Such an action was designed to improve the performance of the authorities and to prevent the country's economy from succumbing to the crisis (Čihák and Podpiera 2006). In general, integrated supervision in Poland has operated properly because:

- There has not been any bank failure since the beginning of the global financial crisis and none of the banks in Poland required recapitalization using public funds;
- Polish banks are well capitalized, liquid and fully capable of satisfying on-going credit demand;
- The off-balance sheet positions of Polish banks are mainly financing provisions or guarantees, but there are virtually no OTC (over-the-counter) derivatives;
- Despite weak labour market conditions, the number of nonperforming loans did not rise sharply; and
- The balance sheets of Polish banks were free of any burdens stemming from investment in the securities or governmental bonds issued by countries struck by financial crisis.

Figure 8

Structure of newly sold mortgages (according to currency)



Source: NBP data.

In the period 2007–2012 the KNF drafted numerous recommendations and resolutions aimed at stabilizing the situation in the banking sector. The most notable of these initiatives were the recommendations regarding capital requirements for certain risks. According to the KNF resolution, the 75-percent weight of FX loans was replaced by the 100-percent weight (despite the Basel requirement of 35 percent). As a result, the sales of new FX credits in Swiss CHF were curbed, which reduced the possible exchange rate losses. It is important to note that in the period 2008–2009 up to 60 percent of newly sold mortgages were granted in CHF. After 2010 this share fell to below 10 percent (see Figure 8).

An important solution aimed at stabilizing the Polish banking sector was the establishment of legally binding liquidity norms in 2008. It is worth noting that such a solution was introduced prior to the issue of liquidity norms by the Basel Committee (its recommendations defining the LCR (Liquidity Coverage Ratio) and the NSFR (Net Stable Funding Ratio) were proposed in 2010 – see BIS (2010)).

In general the activities of the KNF deserve a positive opinion not only because there was no financial crisis caused by banks pursuing flawed policy, but also because the probability of such threats in the future was reduced. Banking supervision in Poland has been active, instead of being reactive. this is important when Poland's rating position is considered. A good credit rating is one of the factors confirming the soundness of an economy, and financial supervision performance is a significant element in rating methodology. Rating agencies assess the activity of supervision and considers its results when determining an overall rating score (S&P 2011). In other words, if any particular country suffered from a financial crisis, especially in cases where banks required state-backed assistance or nationalization (see, for instance, the US Troubled Asset Relief Program – TARP), then the overall grade for supervision is poor. From this perspective the KNF has effectively fulfilled its mission (Fitch 2013).

Other important issues deserving further analysis are the role and position of the KNF in the new institutional framework proposals of the European Commission linked with the Banking Union, or the way that Basel III and the CDR IV have been implemented. The main pillars of the European Banking Union are common supervision rules (the so-called 'single rulebook'), the single supervision mechanism for the entire euro area, the common deposit guarantee scheme, and the harmonized framework for the recovery and resolution of financial institutions. Such supra-national proposals, especially when one looks into intragroup financing, appear to change the position of the KNF (as a host supervision authority) in the future. Yet it is premature to discuss this issue in detail since the majority of draft proposals require further analysis (some recommendations are controversial even for eurozone members like Germany[6]). Moreover, several foreseen instruments are mandatory for eurozone members, while other EU countries can voluntarily participate in this framework.

Conclusions

In Poland the credit-to-GDP ratio rapidly rose from about 36 percent in 2007 to 60 percent in 2012. Such an increase itself might potentially be a source of risks to financial stability, but it was also coupled with relatively new phenomena, and above all by massive foreign currency lending. Thanks to the proactive attitude of the Polish authorities and sound economic fundamentals, the risks have largely failed to materialize. In its recommendations for banks the financial supervisor has addressed the problem of FX lending, which contributed to the high quality of the portfolio. Before the economy slowed down, the KNF – Polish Financial Supervisory Authority persuaded banks to accumulate an additional capital buffer that helped to protect them from the negative consequences of the downturn. Some regulatory concepts that have been put into practice in Poland in recent years, including quantitative liquidity requirements, are now being implemented globally.

The KNF participates in international debates (especially at the EU level) on a new regulatory regime for the financial system. The major message that the KNF intends to convey is that all new regulations must be tailored very carefully. Regulators should strive to ensure that the benefits of a higher quality capital base, or of the countercyclical buffer, are not compromised by international overregulation that could undermine national authorities' ability to pursue effective country-specific policies.

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[6] See press release from G. Fahrenschon, President of Deutschen Sparkassen- und Giroverbandes (DSGV), http://www.dsgv.de/_download_gallery/Pressemitteilungen_2012/121213_Einigung_zu_EU-Aufsicht_122.pdf.