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How the Polish banking sector has survived the global crisis

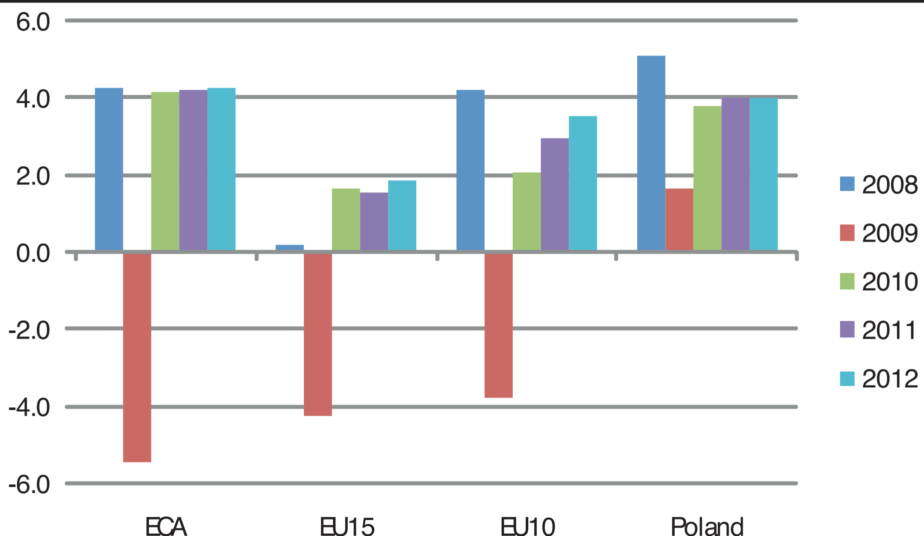
Poland's banking sector has coped well with the global financial crisis, which started in 2008. Unlike most of its peers in Western Europe and some in Central Europe, it remained stable and profitable throughout the whole crisis, the volume of lending increased, and none of the banks needed direct financial support from public authorities.

The objective of this article is to explain the sources of such an impressive performance, and to draw lessons on how to handle potential further turbulence in the global financial markets, driven by the on-going re-assessment of the sovereign debt risks, and prepare for new financial crises in the future.

The macroeconomic background

Poland weathered the global financial crisis with flying colors. It was the only country in the European Union to expand during the global financial crisis, growing by 1.6 percent in 2009 compared to a decline of 4.3 percent in EU-15 countries and 3.6 percent in the EU-10 region. Prospects are improving, with economic growth projected to accelerate to some 4 percent in 2011 and 2012, although recent deceleration of the global growth and unresolved sovereign credit problems in the euro zone represent a significant downside risk to these forecasts[2]. Nonetheless, the Polish economy is projected to grow faster than EU-10 and EU-15 and roughly in line with the whole of Europe and Central Asia (Figure 1).

Figure 1 **Real GDP Growth in Poland, EU-10, EU-15 and ECA, 2008–12, (%)**

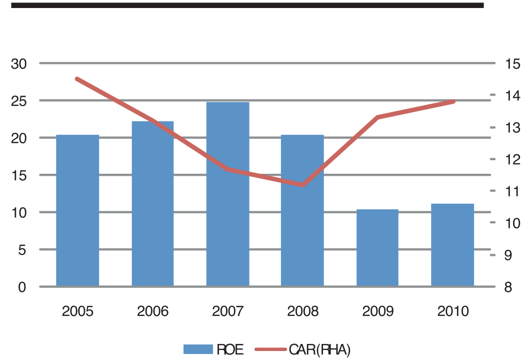


Source: IMF World Economic Outlook database, April 2011. World Bank projections for Poland 2011-12, May 2011.

Such an impressive growth performance reflected, among others, a number of factors. First, Poland had stronger macro-economic fundamentals before the crisis than most other EU-10 countries, including a relatively strong fiscal position, limited exposure to foreign trade, with exports representing about 40 percent of GDP relative to 80 percent of GDP among regional peers, and lower dependence on external capital than the EU-10 average[2)]. As a result, the government was able to implement countercyclical, Keynesian fiscal and monetary policies, which helped cushion the slowdown: general government deficit increased from under 2 percent of GDP in 2007, to 3.6 percent in 2008, 7.2 percent in 2009 and 7.9 percent of GDP in 2010, while interest rates were gradually cut from 6 percent in November 2008 to 3.5 percent in August 2009 (and reserve requirements were reduced from 3.5 percent to 3.0 percent).

Second, Poland was able to significantly step up the utilization of EU funds, including in highly productive investments in infrastructure: inflows of EU funds increased from 1.3 percent of GDP in 2007-08 to 2.2 percent of GDP in 2009, more than in the Czech and Slovak Republic and only slightly less than in Hungary (Figure 2).

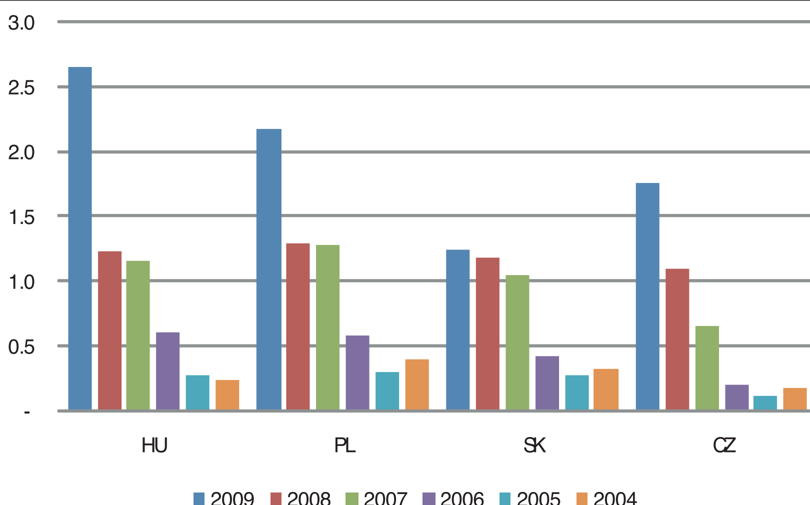
Figure 3 **ROE and capital adequacy ratio of Poland's banking sector, 2005-2010**



Source: National Bank of Poland and the Polish Financial Supervision Authority (KNF).

Third, a floating exchange rate, which allowed zloty to depreciate by 30 percent in real effective terms, eased adjustment to external shocks, improved competitiveness and supported exports. Finally, government's skillful communication strategy, political stability, and support from international financial institutions, including extension of a US$20.5 billion Flexible Credit Line from the IMF in early 2009, helped maintain confidence among domestic consumers and global financial markets.

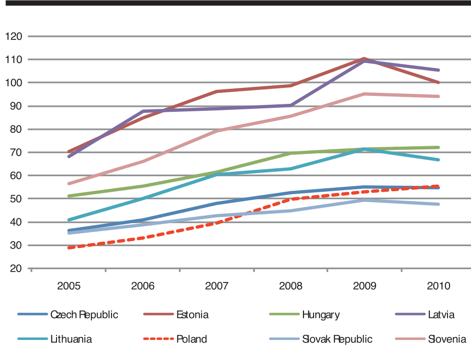
Figure 2 **Absorption of EU funds, 2004-2009, in percent of GDP**



Source: World Bank, based on the European Commission.

Note: combined inflows from Cohesion and Structural Funds.

Figure 4 **Private credit to GDP, in percent, 2005-10**



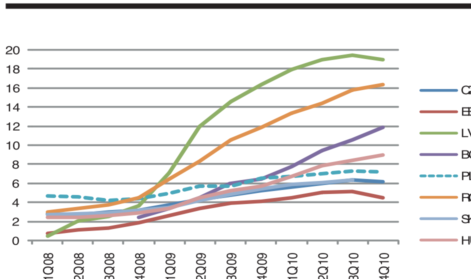
Source: FinStats (IFS).

The banking sector during the crisis

Poland's banking sector has proven to be remarkably resilient to the global financial crisis. Immediately after the collapse of Lehman Brothers in September 2008, the Polish interbank market froze, and in the subsequent six months, the stock markets declined by close to one half and the zloty depreciated substantially. Nonetheless, Poland's banking sector remained stable and profitable throughout the whole crisis period (Figure 3). In 2009, net profit of the banking sector amounted to almost US$3 billion, only one third less than in the record 2008. None of the banks needed direct financial support from public authorities.

Strong banking sector's performance stemmed from several factors. First, Poland had a low initial level of corporate and household indebtedness, with credit amounting to less than 50 percent of GDP in 2008, much less than in other EU-10 countries (Figure 4). The slow speed of financial deepening reflected lagged effects of a restrictive monetary policy from the early 2000s, which dampened GDP growth and credit demand, and a high stock of NPLs among banks during 2002-04, which weakened credit supply, especially to enterprises. Second, strong macroeconomic performance reduced the extent of an increase in unemployment and supported corporate profitability, mitigating the rise in non-performing loans (NPLs) to households from 3.5 percent in 2008 to 4.9 percent in 2009, and to enterprises from 6.2 percent to 11.9 percent at the end of 2009. Total NPLs were much lower than among most other EU-10 countries (Figure 5). Third, real estate prices also held up quite well, declining by only around 10 percent on average, supporting the value of mortgage loan collateral (Figure 6). Finally, a wide distribution of household debt, with total household debt repayment exceeding 30 percent of household budgets in only 8 percent of Polish households, the lowest share among EU10 countries, also helped stem credit losses (Figure 7)[6)].

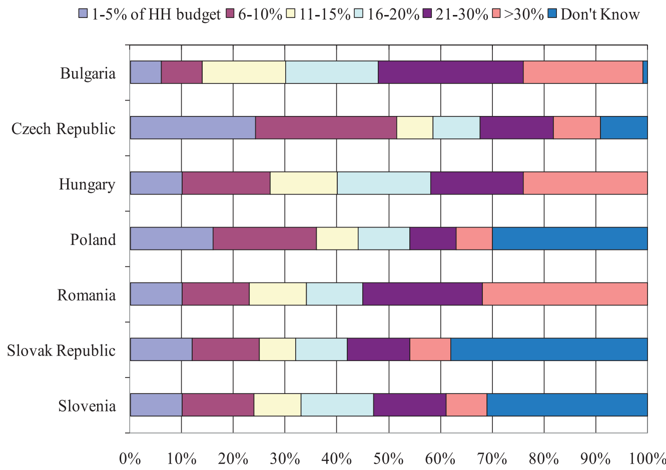
Figure 5 **Non-performing loans in EU-10 countries, 2008-10**



Source: World Bank, based on Source: data from central banks.

Focus on the domestic market, conservative funding structures, and continued support from mother banks were also helpful. Banks operating in Poland have avoided investing in "toxic assets" abroad, largely because of being focused on the fast growing and profitable domestic market. They have also largely maintained conservative lending policies, although credit policies had been progressively relaxed just before the crisis in response to rising real estate prices, high consumer confidence and abundant liquidity. The specific ownership structure of the Polish banking sector can partly explain the overall more conservative approach to lending than elsewhere in the region: the two largest banks in the market, the state-owned PKO BP

Figure 6 **Share of household income used for debt repayments, in percent of all households, 2008**



Source: World Bank (2009).

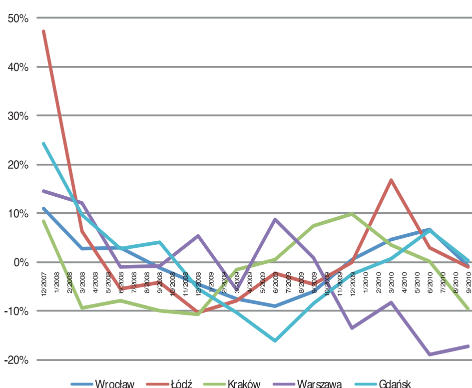
and the Italian (Unicredit)-owned Pekao SA maintained quite conservative lending policies, the former arguably because of its saving bank type risk-aversion, and the latter because of Unicredit's negative experience with FX lending in Italy in early 1990's.

Banks have also retained relatively conservative funding structures, with loan to deposit ratio not exceeding 120 percent in 2008, lower than in most other EU-10 countries (Figure 8). Finally, in contrast to foreign banks located in other EU-10 countries, subsidiaries of foreign banks in Poland, which hold a predominant position in the domestic bank market with more than two-thirds of the market, have not only maintained exposure to their Polish subsidiaries throughout the crisis, but even increased it to benefit from lower risk and higher returns than elsewhere (Figure 9).

The role of financial supervision

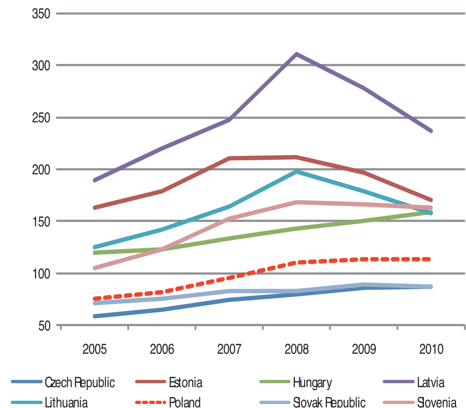
Skillful policy intervention in supporting the banking system has also been crucial, including before the onset of the crisis. Polish authorities have been proactive in reducing risks in the banking sector already before the crisis. In 2006, as

Figure 7 **Growth in residential property ask prices in the largest cities in Poland, secondary market, 2007-10**



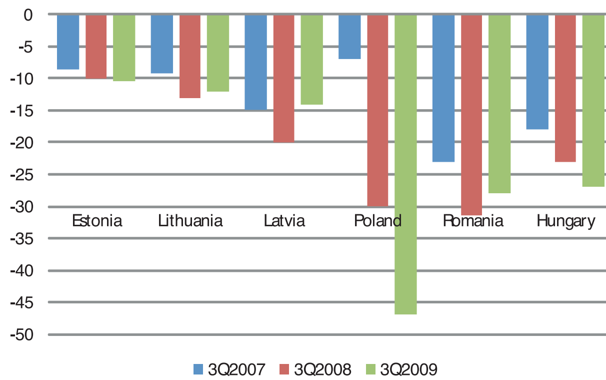
Source: National Bank of Poland.

Figure 8 **Loan to deposit ratio, 2005-2010**



Source: IFS.

Figure 9 **Net foreign assets of the banking sector in selected EU-10 countries, in US$ billion**

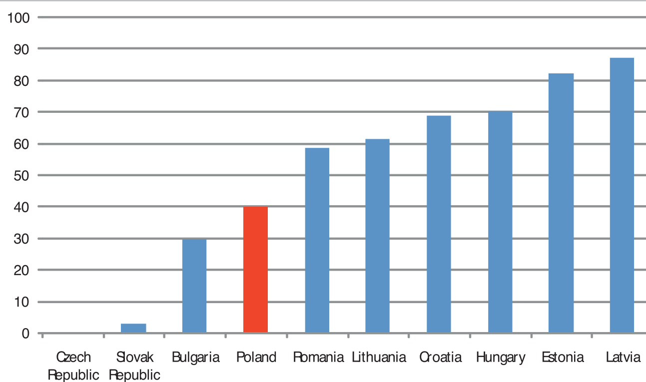


Source: KNF based on the IMF's International Financial Statistics database.

one of the first in the European Union, the National Bank of Poland (NBP) introduced "Recommendation S", which aimed at reducing foreign currency denominated lending, by increasing loan-to-value (LTV) ratios for FX mortgage loans and raising capital weights. This measure seems to have helped mitigate the rise in FX loans relative to other countries in the EU-10, despite the existing high interest rate differential between the domestic and foreign currency lending rates, which attracted household demand (Figure 10). The measure has also helped stabilize LTV ratios at sound levels throughout the 2008-2010 period (Figure 11). Together with more stringent internal bank lending policies, which limited access to FX loans to relatively better off households, these measures limited the rise in NPLs, despite a substantial depreciation of the zloty. NPLs on foreign currency denominated loans have stabilized at a very low level of 1.0-1.2 percent during the whole 2008-2010 period, less than half of the level of NPLs for local currency mortgages. However, the improved quality of FX loans notwithstanding, "Recommendation S" was not fully effective in stemming the rise in FX loans, which continued until the onset of the global crisis in late 2008 (Figure 12).

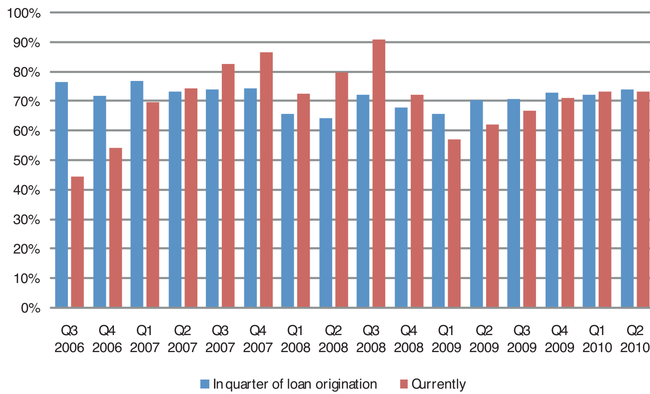
Additional measures to improve banks' liquidity have also been helpful. In June 2008, KNF introduced new liquidity standards aimed at reducing bank's vulnerability to reduced access to external financing. New standards were based on the "time-to-wall" concept that assumes that banks should normally operate during 30 days without the need to seek external financing. Banks were authorized

Figure 10 **Share of foreign currency denominated loans in total bank loans to households, 2008**



Source: World Bank, national central banks.

Figure 11 **Average values of LTV of Swiss franc-denominated loans by quarter of loan origination**



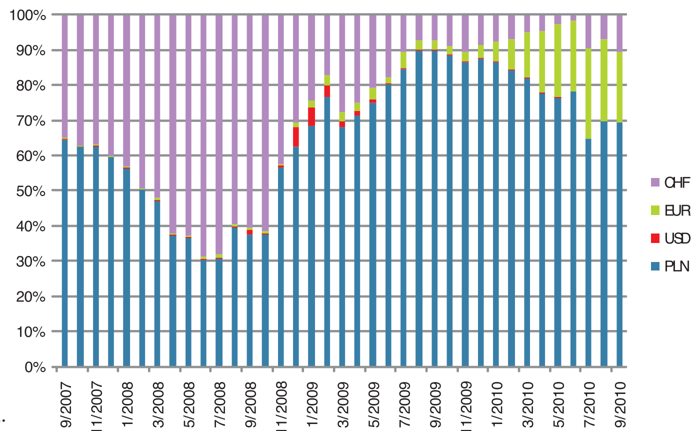
Source:
National Bank of Poland.

to come up with their own short, medium and long-term liquidity indicators based on internal models[1, 5]. As a result of the introduction of new standards, liquidity position of Polish banks has started improving already before the collapse of Lehman Brothers in September 2008, rising from 17 percent in 2008 to 20.3 percent in 2009. Hence, banks were better prepared to face the money market freeze in late 2008.

Policy interventions have substantially intensified during the global crisis. KNF, NBP and the Ministry of Finance have undertaken a large number of interventions to maintain banking sector's stability, increase confidence, and boost domestic credit. While a large number of factors contributed to cushioning the impact of the crisis, several interventions are likely to have had the biggest impact. First, KNF's intervention to encourage banks to retain the bulk of their record 2008 profits, amounting to almost US$ 4 billion, has substantially improved banks' capital ratios from 11.2 percent in 2008 to 13.3 percent at the end of 2009 (Figure 13), boosting market confidence, reducing risks of a coordination failure among banks, providing a cushion against rising NPLs and reinvigorating lending, especially to households (Figure 14).

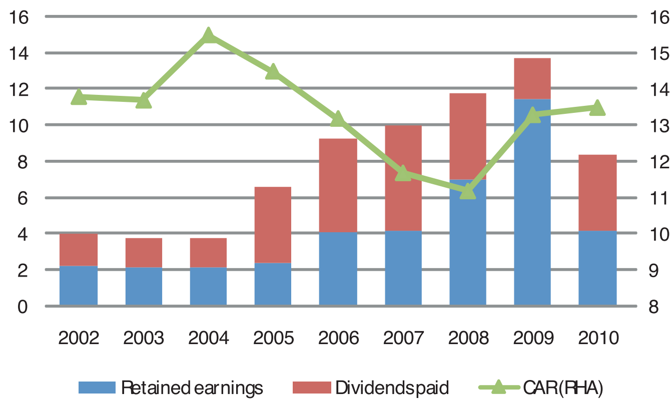
KNF's decision to request banks to submit daily reports on new exposures to foreign entities has also been helpful to reduce real and perceived risks among retail and corporate clients of a potential outflow of liquidity from domestic subsidiaries to foreign parent-banks. Second, forceful actions by NBP to provide sufficient local and foreign currency liquidity, supported by relatively high foreign cur-

Figure 12 **Currency structure of new mortgage loans, 3Q2007-3Q2010**



Source: National Bank of Poland.

Figure 13 **Dividend policy of banks operating in Poland and capital adequacy ratio, 2002-2010, in billion PLN and percent**



Source: KNF.

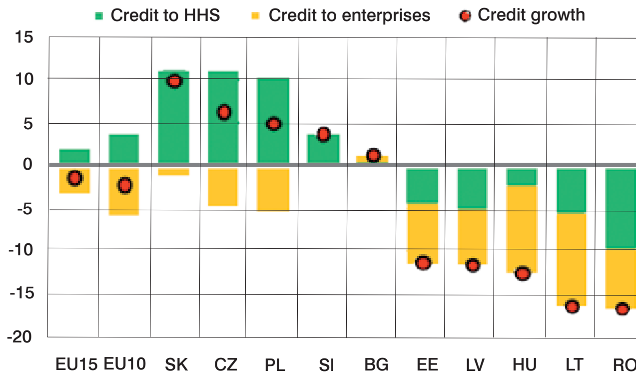
rency reserves, promptly established swap and repo credit lines with the Swiss and the European Central Bank, and extension of a new US$20.5 billion precautionary IMF Flexible Credit Line, supported market confidence, even though utilization of the newly available facilities was not significant.

Active money market operations by PKO BP, the state-owned bank, which unlike in other countries in the region has been a beneficiary of an outflow of deposits from foreign owned banks, was also helpful in reducing liquidity stress in the market. In contrast to foreign owned banks, which on the whole reduced their credit exposures during the crisis, relative insulation from global financial markets and a PLN 5 billion equity injection in October 2009, has helped PKO BP to increase lending during the crisis (Figure 15). Third, top-down and bottom-up stress tests undertaken in early 2009 by NBP and KNF, have helped enhance confidence in the solvency of domestically operating banks. Finally, improved public communication by the public authorities, supported by establishment of new coordinating mechanisms, primarily the Financial Stability Committee, was also beneficial.

Regulatory reform momentum continued during the economic recovery**.** Drawing on the lessons from the crisis, KNF has adopted a number of new regulations aimed at better insulating the domestic banking sectors against future crises. In 2010, KNF amended "Recommendation A" to strengthen banks' management of derivatives risks, amended "Recommendation I" to improve bank's internal FX management, and introduced new "Recommendation T" aimed at tightening criteria for local and foreign currency consumer lending, mandating that an individual cannot allocate more than half of his/her monthly income for a loan repayment (65 percent for wealthier individuals), and imposing a minimum 20 percent down payment for FX-denominated mortgage loans. In January 2011, to further limit risks resulting from foreign currency lending, KNF amended "Recommendation S" to require banks to ensure, that in case of foreign currency mortgage lending the loan repayment cannot exceed 42 percent of a client's monthly income (for maturities of up to 25 years, regardless of the actual maturity).

In June 2011, it supplemented this measure by increasing capital weights on FX mortgage lending from 75 percent to 100 percent, starting in 2012. KNF has also introduced periodical bottom-up stress tests, and started work on amend-

Figure 14 **Structure and dynamics of real credit growth in EU-10 and EU-15, October 2008 to January 2011**



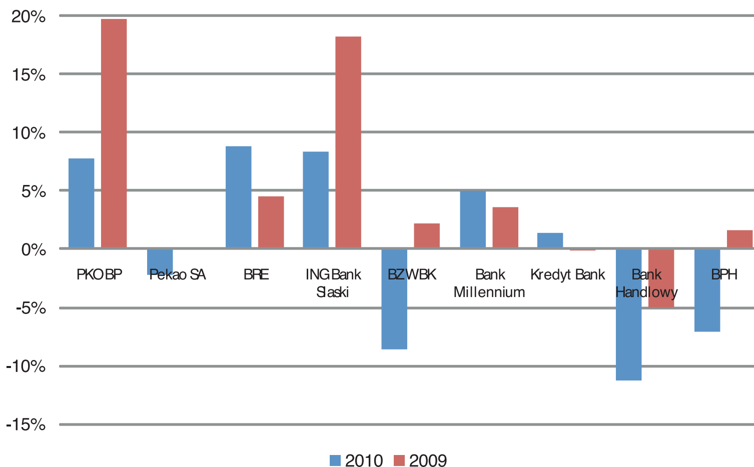
Source: World Bank (2011).

ing legislation to facilitate transformation of foreign bank branches into domestic subsidiaries operating under the Polish law, limiting potential spillovers from turbulence in foreign markets.

Poland's success in insulating the financial sector from the global economic turbulence was due to strong macro-economic fundamentals before the crisis, including a relatively strong fiscal position, relatively low dependence on external capital, and a limited exposure to foreign trade, a healthy and well capitalized banking sector and a timely and prudent policy interventions, which enhanced financial sector's stability even before the onset of the global crisis. Given the darkening prospects for the global economy and the downside risks to the stability of the global financial system, to ensure continued healthy growth of the financial sector, Polish authorities will need to face a number of challenges on both the macroeconomic and financial sector side.

On the macroeconomic side, Poland will need to maintain macroeconomic stability, especially by reducing general government deficit, and support growth by re-adjusting its post-crisis growth model in line with the recommendations of the new Warsaw Consensus[4)]. On the financial sector side, it will be

Figure 15 **Growth in lending in selected Polish banks, 2009 and 2010 (%)**



Note: growth in outstanding loans
calculated in US$. Nine largest banks in Poland by assets, all foreign owned except for PKO BP.

Source: World Bank, based on BankScope.

essential to further reduce foreign exchange denominated lending, design a new bank resolution framework, and efficiently implement new EU and global financial sector regulations. Specifically, Polish authorities will need to monitor whether the newly introduced regulatory measures will be able to effectively limit foreign currency lending to unhedged households. As of the mid-2011, foreign currency denominated mortgage loans still represented almost two-thirds of the total outstanding stock, although the share of FX lending in new loan generation has recently dropped substantially, partly in response to a recent substantial strengthening of the Swiss franc.

Moreover, they will need to ensure compliance with new EU and global financial sector regulations, including Basel III and Solvency II. Furthermore, the Polish authorities might need to further strengthen the independence of the KNF and strengthen its authority to issue legally binding systemic regulations. They will also have to design a new bank resolution framework and introduce additional macro prudential measures. Lastly, to improve long-term sustainability of banking sector's funding and reduce reliance on foreign wholesale funding, it will be important to increase domestic savings, particularly long-term ones, and develop new long-term financing instruments, such as covered bonds.

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