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ECFIN COUNTRY FOCUS

Highlights in this issue:

- **Polish banks focus predominantly on domestic business**
- **Cumulated profits for first three quarters 2009 ca. 50% worse than in 2008**
- **Banking sector still perceived as a growth market: 44% of Poles do not have a bank account**

The Polish banking system: hit by the crisis or merely by a cool breeze?

*By Michal Strojwas**

Summary

Along with the rest of the economy and thanks to strict supervision, the Polish banking system is showing resilience and has avoided serious problems in 2009. Although Polish financial institutions were not involved in the purchase of "toxic" international assets, the high incidence of foreign ownership made them vulnerable to the outbreak of the global financial crisis, which has mostly affected Poland via the capital markets and the collapse of world trade. The first three quarters of 2009 were characterised by a decrease in confidence on the interbank market[1], by a threefold jump in loan-loss provisions and write-downs compared to 2008 and by the outbreak of a fierce battle for household savings. Bank profits dropped to around 50% of 2008 results and the return on equity tumbled from 27.4% in June 2008 to 11.8% in September 2009.

At the same time, while being exposed to the global downturn, regional uncertainties and declining asset quality, the Polish banking sector may still be considered to be a promising growth market. As much as 44% of Poles still do not own a bank account; over 1.3 million current accounts were opened in 2009 alone and more are expected to be opened in the next few years. Demand for credit remains surprisingly strong and most Polish banks entered the financial crisis with relatively healthy fundamentals.

A competitive landscape focused on domestic business

The Polish banking sector: a total of 647 financial institutions; 72% of assets are foreign owned

In 2009, the landscape of banking in Poland was characterised by 51 banks, 18 branches of foreign banks, a branch network of 578 cooperative banks and 1800 small credit unions (SKOK)[2]. Foreign owners had majority stakes in 37 commercial banks, which accounted for about 72% of the sector's assets (Chart 1).

In contrast to the trend in previous years, 2009 was a year of consolidation. *Inter alia*, GE Money Bank merged with BPH, Fortis Bank Poland was consolidated with Dominet and integrated in the BNP Paribas Group, and finally the AIG Bank Polska sale was closed by an equity swap with Santander Consumer Bank Polska[3].

*** Directorate for the Economies of the Member States.**

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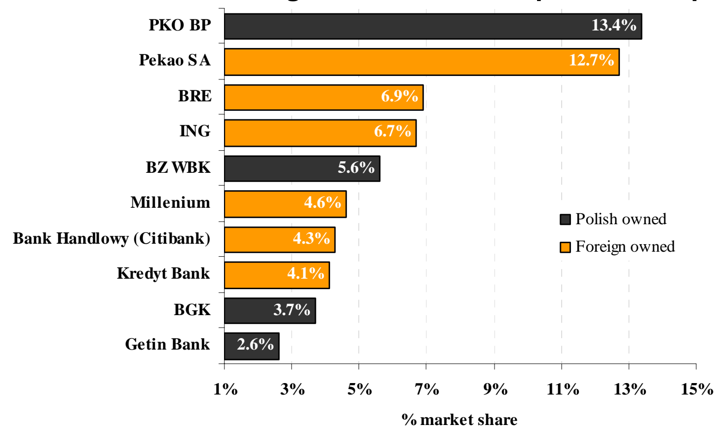
Chart 1: Polish banking sector in 2009 - top 10 market players



Source: market data, ECFIN calculations

2009: Few new entrants; banking sector dominated by mergers & acquisitions

Due to its focus on domestic business the Polish banking system has been partly insulated from the turmoil on world financial markets

Polish banks are predominantly domestic players and as such they have been partly insulated from the turmoil on foreign financial markets. The creditworthiness of the system is strengthened by the long term commitments of foreign shareholders, who view their Polish investments as strategic[4] and continue to share know-how, improve the infrastructure and diversify the banking product lines. With a concentration ratio CR5[5] of 44%, competitive pressure in the Polish banking sector is still relatively low by Western standards and fees and commission revenue remains high. According to Eurostat, over 44% of Poles still do not own a bank account. In the EU, only Latvia scores worse with 48% of the population "excluded" from financial services. Since fees and commissions on basic banking operations (account and loan-related fees, brokerage services…) were generating satisfactory profits, most banks and credit unions focused on expanding their infrastructure and on offering standard banking services rather than looking for more sophisticated and often riskier products. And since the Ministry of Finance envisages, within four years, sending 90% of pensions, grants, scholarships and other social benefits directly to payees' bank accounts, banks will continue growing their infrastructure in order to reach the ca. 5 million "bankless" new clients. This focus on infrastructure and on low-risk domestic operations partly explains the good shape of the financial sector in Poland in the first few months after the outbreak of the financial crisis.

Retail banks heavily invested in infrastructure and concentrated on standard banking services

At the same time, the Polish banking sector is far from being immune to the economic downturn. Both risk appetite and risk management were shaped in the last few years when Poland was experiencing an economic boom and when most banks aimed at outperforming lending and revenue targets often set by their foreign parents. This induced banks to diversify their product offering by introducing and actively promoting currency derivatives. Due care was sometimes not paid to the financial capacity of customers to withstand stress or customers' ability to appreciate the full extent of the risk attached to these products. The subsequent massive zloty depreciation (Chart 4) left some Polish exporters facing hefty losses or even bankruptcy. These derivative products are to some extent responsible for the poor quality of the corporate loans portfolio as many companies were forced to cover their options losses with additional loans[6].

Results for the first 9 months of 2009

Severe contraction in banking activities and earnings generation behind the drop in profitability

A clear weakening of the macroeconomic situation, deterioration in consumer and business sentiment, as well as continuing uncertainty on financial markets, have resulted in a severe contraction in banking activities. The year 2009 was much worse than 2008 or 2007. According to the Polish Central Bank (NBP) the projected end of year profitability of the sector was about 45% lower than in 2008[7] and roughly equal to profits in 2005.

New strategic priorities focus on cautious approach towards lending and liquidity management

Since the outbreak of the financial crisis Polish banks have been focusing their efforts on redefining business models to the new low-growth market conditions. This means stricter cost control policies and a more cautious approach towards lending on the interbank market as well as towards corporate and retail clients. An important change has also occurred in the investment preferences of Polish bankers, who along with the rise in risk aversion expanded their portfolios of treasury securities from the Polish government.

As result of these redefined strategic priorities, the domestic interbank credit market became less liquid and concentrated on short–term maturities. In parallel, credit demand from households and businesses has remained persistently high. Seeking to plug liquidity shortages, most Polish banks focused on attracting deposits from households by increasing interest rates on saving accounts.

The effect of these crisis adjustments is reflected in the weakness of the banking sector's profit and loss account. On the revenue side, the weak results can be attributed to the decrease in interest revenue (by 5.5% year-on-year), which was not offset by income from fees and commissions, or revenue from other financial activities[8].

Cost-cutting slow to kick in because of delayed effects of massive infrastructure growth in 2008

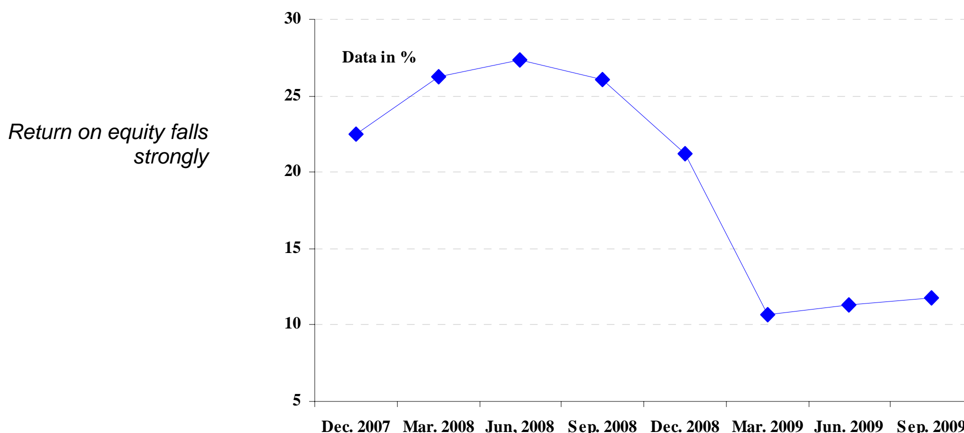
But it is the expenditure side that is mostly responsible for the worsening of the results: the year-on-year cost base is growing by +2.7% as a delayed effect of the 2008 expansion in the number of bank branches, which grew by 1200 units. Operational costs represented as much as 50.3% of income in the first three quarters of 2009, against 48.7% in the corresponding timeframe of 2008. Yet, the largest contributor to the drop of net profits is the nearly threefold increase (year-on-year) of loan-loss provisions and write-downs, which cover the sharply deteriorating financial position of corporate and retail customers, losses on foreign exchange derivative transactions and portfolio investments in Central and Eastern Europe. Provisions and write-downs reduced income in January to September 2009 by 22.5% compared to a reduction of only 7% in 2008. Besides the economic slowdown, inappropriate risk assessment and the lack of stable, long-term sources of financing for business development are most often blamed for this massive rise in write-downs and provisions.

Fourfold increase in provisions and write-downs

As a consequence, the ROE (Return on Equity) of the Polish banking industry has dropped to 11.8% (September 2009) from 27.4% in June 2008 (Chart 2).

Return on equity falls strongly

Chart 2: Evolution of the ROE of the Polish banking sector



Source: Polish Financial Services Authority

High funding costs will persist and revenue from fees and commissions unlikely to recover anytime soon

In the short run, the interest income of the Polish banks, traditionally their main revenue source, will remain under pressure as a result of relatively high deposits rates and decreasing interest rates charged on existing loan portfolios[9]. Furthermore, fees and commissions income, the second most important source of revenue of the Polish banking industry, is not likely to contribute significantly to revenues due to sluggish sales of new loans.

On the cost side, the still expanding infrastructure of branches and agencies[10], which has further risen from some 14700 at the end of 2008 to over 14900 units in September 2009, will make it difficult for the sector to avoid an increase in its operating expenses. This is likely to be the case although, for the first time in many years, the workforce employed by the banking sector diminished from 181 thousand in 2008 to 176.5 thousand in September 2009.

To lend or not to lend?

Lending has suffered a blow from the banking sector's adjustment to the crisis. Nonetheless, the value of loans (measured in Polish zloty) to the non-financial sector grew by 5.8%[11] between December 2008 and September 2009. This is far from the 2008 growth rate of over 20%, but is still quite robust for crisis standards.

Lending suffered a blow from the redefined strategic priorities of the banking sector; yet, it is still showing growth led by surprisingly strong consumer lending

This increase of 5.8% is partly due to the weakening of the zloty (Chart 3), which has the effect of boosting the zloty value of the 36% of loans denominated in foreign currencies. Taking the euro as base currency points to a year-on-year slowdown of -1.4% in total loans (Table 3). However, an important distinction needs to be made between household loans, still in growth mode: +9.3% between September 2008 and September 2009, and the corporate loans segment, which fell sharply by 13.8% due to the economic slowdown.

Table 1: The structure of the credit market in Poland

	Jan 2005	Dec 2005	Dec 2006	Dec 2007	Dec 2008	Mar 2009	Jun 2009	Sep 2009
Year-on-year increase in total loans	**22.4%**	**17.5%**	**24.4%**	**41.3%**	**20.3%**	**3.4%**	**-2.2%**	**-1.4%**
Household loans to total loans	40.2%	45.1%	49.4%	52.5%	56.3%	57.0%	58.3%	59.6%
Year-on-year growth in household loans	**41.7%**	**30.9%**	**36.4%**	**50.1%**	**29.0%**	**11.5%**	**8.2%**	**9.3%**
Corporate loans to total loans	59.8%	54.9%	50.6%	47.5%	43.7%	43.0%	41.7%	40.4%
Year-on-year growth in corporate loans	**12.1%**	**8.4%**	**14.6%**	**32.7%**	**10.7%**	**-5.7%**	**-13.7%**	**-13.8%**
Mortgage loans to total loans	17.9%	22.5%	28.1%	31.9%	37.5%	38.9%	38.3%	37.7%
FX/total loans	26.3%	28.8%	30.6%	27.6%	37.7%	40.4%	38.2%	36.3%
Loans to deposits ratio	**73.6%**	**74.2%**	**81.3%**	**96.7%**	**113.5%**	**115.1%**	**112.2%**	**114.4%**

Source: Polish Central BanECFIN calculations based on outstanding amounts in EUR

Lending to households has been hit merely by a cool breeze rather than a crisis

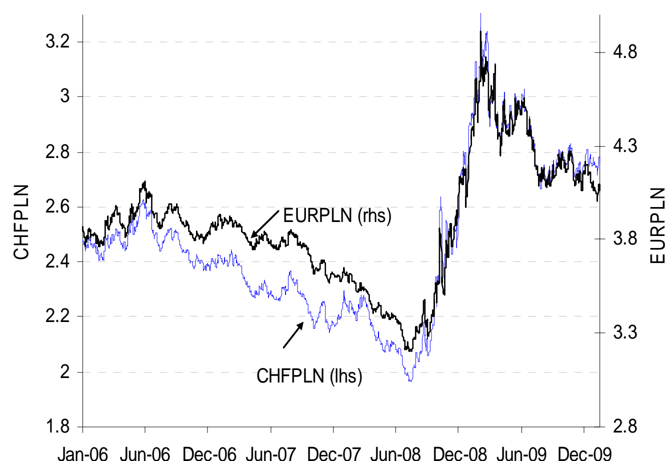
Total loans to households increased between September 2008 and September 2009 by 9.3%. This appears to have been the lagged effect of earlier strong growth in employment and wages that still affects both consumer and mortgage lending.

Due to the drying up of foreign currency funding, zloty mortgage loans rose faster in H1 2009 than mortgages denominated in foreign currencies

Mortgage loans increased by 8.8% in the first three quarters of 2009. In 2009, for the first time in years, the value of mortgages in zloty grew quicker (by 19%) than mortgages in foreign currencies +4.3%. The liquidity shortage on the inter-bank market and the drying up of foreign exchange (FX) funding have lead major Polish mortgage lenders to rapidly tighten their FX lending products consistently discouraging Poles from borrowing in currencies other than the zloty. Some lenders went as far as dropping FX loans from their product offering. However, in most cases, stricter loan requirements, higher interest rates and additional fees made these loans less competitive.

FX lending, dominated by the Swiss franc, experienced a significant slow down due to liquidity shortages on the interbank market and to the weakening of the zloty

Chart 3: Polish zloty against the Swiss franc and against the euro



Source: Bloomberg

For reasons of macrofinancial stability and consumer protection, the Polish Financial Services Authority has advocated this change for a long time, but it is finally the financial crisis that has led banks to limit their FX lending.

The crisis redefined corporate lending standards

Since the outbreak of the financial crisis, more than 80% of banks have raised their margins to corporate clients and nearly 60% expect higher guarantees to cover risk,

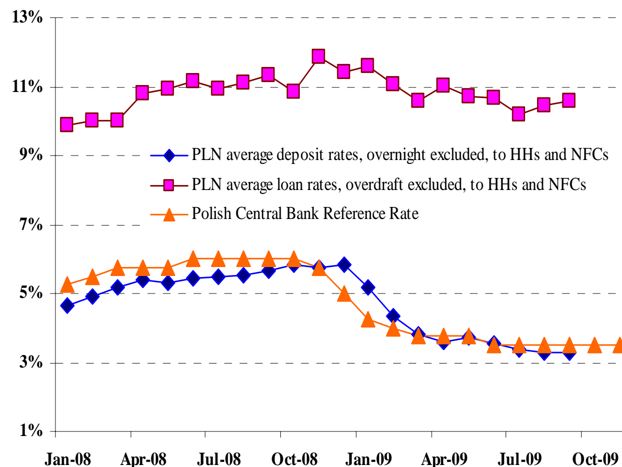
Credit standards became tougher because of the crisis

while a third of them have reduced the maximum credit amounts available. Consequently, credits granted to the corporate sector decreased by 13.8% in the three quarters of 2009[12]. One quarter of banks envisage further tightening of the credit conditions for the corporate sector; however, they also expect a higher demand from that sector[13].

In this context, in order to boost credit, the NBP has been steadily reducing its reference rate (chart 4). It also lowered the minimum required reserves from 3.5% to 3%. Furthermore, Polish banks have been granted loans from development banks to sustain credit to small and medium-sized enterprises.

The Polish Central Bank's reference rate is at an all-time low

Chart 4: Average interest rates in the Polish economy



Source: Polish Central Bank (NBP)

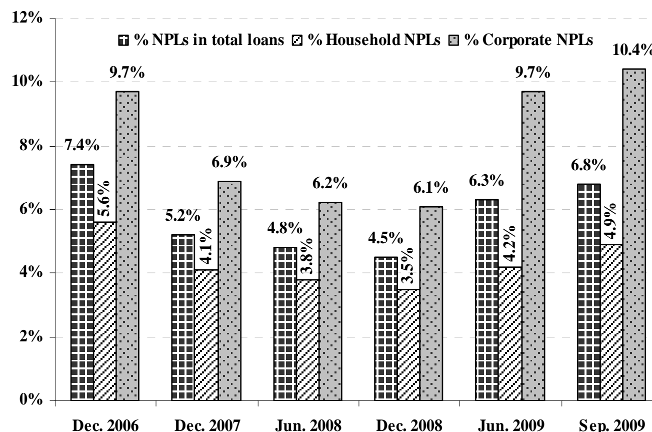
Risks for the Polish banking business

Deterioration of assets quality will dominate the agenda

In the first 9 months of 2009, non-performing loans (NPL)[14] jumped to 42.6 billion zloty (ca. 10 billion euro), their highest level ever. This is an increase of over 60% since December 2008, raising the share of NPLs in the total loans portfolio from 4.5% to 6.8% and reaching 2006 levels.

Asset quality has dramatically declined and Polish banks have seen a jump in non-performing loans

Chart 5: Non-performing loans since 2006



Source: Polish Financial Services Authority (KNF)

These numbers are considerably worse when looking at the credit quality of corporate loans, where NPL grew by almost 70% between December 2008 and September 2009. A large portion of this deterioration was sparked by the foreign exchange derivatives that corporate clients (mainly exporters) massively invested in when the Polish currency steadily appreciated throughout 2007 and 2008. In the same time frame, household NPLs rose by more than half. The portfolio of loans

Payment delinquencies abound in corporate and consumer loans segments…

"under observation"[15] expanded by 40%, which suggests that a further deterioration of asset quality is to be expected in the medium term. Again corporate loans are the riskier ones with an increase close to 70%, whereas household loans "under observation" grew by 3%.

…while mortgage segment remains characterized by its relative high credit quality

The household sector's payment delinquencies abound mostly in the consumer credit segment. This is the consequence of both the pre-crisis over-expansive credit policies pursued by many banks and imprudent behaviour by consumers. As a result, some households have fallen into the trap of over indebtedness and subsequently into payment delinquencies once their often pro-cyclical incomes diminished. Mortgages have up till now been characterised by relative low NPL ratios. The value of "at risk" mortgages has slightly increased due to the weakening zloty, but its share in the total loan portfolio equals only 1.4% at present.

Financing of banking operations – competition for retail funding

Liquidity shortfall has led Polish banks to replace maturing wholesale funding by retail deposits

Growth in the Polish banking sector was for years mainly financed by an increase in liabilities to the financial sector, *inter alia* to foreign parent banks. Global credit woes have thinned these cash flows and, notwithstanding the pre-crisis healthy system-wide liquidity, Polish banks have not been able to avert a crisis of confidence that affected wholesale funding. Hence, the new 2008-2009 trend was all about focusing on funding basics i.e. deposits from the non-financial sector. Starting in the fourth quarter of 2008, a fierce battle for retail clients' savings broke out. The rush gathered speed in the first quarter of 2009, but gradually fizzled out around summer. As a result, non-financial sector deposits increased since the end of 2008 by 6.2%, with corporate deposits falling by 1.7% and households deposits increasing by 9.2%, fuelled by last year's wage increases and the crash on the stock market at the beginning of 2009.

Although harsh on the financial results the aggressive measures to raise deposits have had a positive impact on the sector's balance sheet

The aggressive measures to raise deposits undertaken by most Polish banks since November 2008 have contributed not only to the increase, but also to the stability of the deposits base. The long-term deposits on the balance sheet of the banking sector increased from 29% of the sector's balance sheet in 2008 to 32.3% at the end of Q3 2009. Moreover, banks have also managed to stabilize their short term liabilities, mainly deposits maturing in less than one month, at a level of 53.4% of the sector's balance sheet.

Financial sector funding remains important for the Polish banking secto

As result, practically all banks complied with the binding banking liquidity standards set by the Polish Financial Services Authority and had a ratio of loans to deposits of 115-120%, which is regarded as being a relatively safe level (table 1). However, the Polish banking sector continues to rely on financial sector funding[16] for liquidity management. A significant part of this is derived from parent institutions; in particular new market players have to rely heavily on both financial market borrowing and their parent companies to kick start banking operations in Poland. These funds are complementing deposit-based financing. The first 9 months of 2009 witnessed a decrease of 2.2% in this flow.

Concluding comments

Polish banks benefit from operating in a country showing economic resilience, which did not enter into recession in 2009. Overall, the Polish banking system has weathered the crisis well so far. Capitalization in the system is at a healthy 13.1% level and the rate of earnings retention was close to 100% in 2008 after the Polish Financial Services Authority convinced the financial industry to withhold its 2008 profits in order to strengthen balance sheets. Nonetheless, banks' fundamentals have deteriorated in the worsening economic environment. Notably asset quality has suffered a blow and earnings generation has seen a severe contraction. This rather mixed health of the sector is echoed by rating agencies such as Standard & Poor's, which considers the Polish banking industry to be an "average risk", placing it in group 5 out of the 10 groups in its Banking Industry Country Risk Assessment[17].

The medium-term outlook for Polish banks will largely depend on developments in the job market and on the prospects for the corporate sector. These factors will impact directly payment delinquencies. The medium-term agenda of Polish bankers and regulators alike will continue to be dominated by the quality of assets as well as by liquidity and risk management considerations.

References

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Polish Central Bank (NBP) Statistics and Polish Central Statistical Office (GUS)

Bloomberg data

DG ECFIN data

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[1] Following the bankruptcy of US investment bank Lehman Brothers in late 2008, turnover on the Polish interbank market collapsed. According to the Polish Central Bank, by September 2009 only the short term segment of the market had recovered. Lending limits and confidence levels remain low on the medium and long term segments.

[2] Under the current legislation the SKOKs are not considered to be banks and hence are not regulated by the Polish Financial Services Authority.

[3] The last two transactions are a direct result of the financial crisis: Dominet Bank was linked to the Fortis group whereas the sale of AIG Bank to Santander was motivated by the new strategy of the American insurer to focus on domestic activities.

[4] Parent exposure, monitored by the Financial Services Authority, has been maintained throughout 2009.

[5] The concentration ratio CR5 measures the market share of top 5 market players.

[6] Currency options were mostly used for hedging but also to a certain extent for currency speculation. The Polish Financial Services Authority assessed the scale of the currency options problem at ca. PLN 15 billion, of which up to 2.25 billion zloty had to be written off. Polish banks were mostly intermediaries in the currency option transactions. Most options originated in a few investment banks like Goldman Sachs, JP Morgan and others.

[7] This was based on the cumulated net profit of ca. EUR 1.7 billion achieved by the sector up to October 2009.

[8] Income from stocks and shares, FOREX gains and other financial operations.

[9] Most loans are indexed to the WIBOR rate.

[10] Only a few banks continued to open branches: Alior Bank, Eurobank and Allianz Bank account for most of new openings.

[11] From PLN 593 billion in December 2008 to PLN 627 billion at the end of September 2009. To account for the extremely high volatility on the foreign exchange market these data on the increase of loans to the non-financial sector are being provided both in Polish zloty and in euro.

[12] As table 1 is based on EUR values this movement has been accentuated by the weakening of the zloty.

[13] According to the Polish Central Bank survey.

[14] A loan is categorized as non-performing when payments of interest and principal are past due by 90 days or more.

[15] 1-3 months delay in loan repayment.

[16] Banks and financial markets.

[17] The Polish banking sector has therefore a lower risk than the corresponding sector in other Central and Eastern European countries, but a higher risk than in Western European countries, which generally rank in Groups 1 to 3.

The *ECFIN Country Focus* provides concise analysis of a policy-relevant economic question for one or more of the EU Member States. It appears fortnightly.

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