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Polish financial sector in the transformation period: Financial sector integration with the EU and concluding remarks*

* Paper presented at the International Conference on Transformation and Development, University of Washington, Seattle, 2006.

Financial sector integration with the EU

On May 1, 2004 after several years of preparation Poland joined the European Union. Since that date the Polish financial sector also became part of the single EU financial market.

The concept of the single financial market in the EU, covering as of today banking, insurance and securities sectors, is a unique and complex idea. It is worthwhile to recall that said concept is based on six core principles developed gradually in 1973-1993. They include:

a) first – the principle of national jurisdiction of the member countries,
b) second – the principle of the freedom of establishment,
c) third – the principle of the freedom of services,
d) fourth – the principle of the minimum harmonization,
e) fifth – the principle of the single licence (passport),
f) sixth – the principle of the home country control.

According to the first principle each member state bears the sole responsibility for the financial market-related regulations. There are practically no EU-wide international regulations which directly impact the regulatory system of the member states.

Thus currently the single EU financial market is regulatory-wise an aggregate of 28 national jurisdictions. They include 25 EU member countries and 3 countries of European Economic Area (Norway, Iceland and Liechtenstein) which acceded to the single market on a contractual and voluntary basis.

According to the second principle every financial institution is free to establish it self throughout the single financial market and to carry out its operations the refrom. In the process of establishment the rule of national treatment is applied.

It can also – according to the third principle – provide its transborder services directly to customers without having any physical presence at the point of delivery. To make these three principles work in a coordinated and effective manner three other core principles have been developed. Instrumental among them is the principle number four – that of minimum harmonization. Its essence lies in the acceptance by the member countries of some mutually agreed set of minimum regulatory standards to be followed by all national jurisdictions in their respective national regulatory practice. National jurisdictions are as a matter of principle free to apply more restrictive solutions (for instance higher prudential regulations) as long as it is not forbidden by the international rules adopted. They are not allowed however to apply lower standards unless some derogations are expressis verbis granted.

The implementation of the said principle in the regulatory practice of EU countries made it possible to move further and to adopt the idea of a single licensing i.e. the concept according to which one sole authorization in EU territory is sufficient for the entire EU financial market. Accordingly, once authorised in any EU country every financial institution is free to use this authorisation (frequently referred to as a passport) for establishing itself in other EU countries via branches or transacting contracts by means of transborder operations.

Finally, the sixth principle denotes that supervisory powers over the financial institutions are in principle delegated to their home country supervisors, which become responsible for their prudent and sound activities not only at home but also abroad. This could hypothetically mean that each individual national market becomes regulated and supervised by 28 jurisdictions which follow their customers – financial institutions – headquartered in their respective territories. The more business is written by foreign authorised institutions the less powers rest with the host regulators and supervisors. In the extreme case national host authorities may be practically deleted from the scene. In some smaller EU countries this hypothesis is slowly turning into reality.

Poland joining the EU became an object of this regulatory architecture. As a consequence, 6 EU branches registered in the insurance industry and 5 branches registered in the banking sector have been transferred to other EU regulators and supervisors. The same applies to all financial institutions which will service the Polish market on a cross-border principle (i.e. freedom to provide services). Their operations are until now still insignificant but theoretically substantial. By the end of 2005 over 200 insurance companies, 150 investment funds and around 100 EU-based banks notified their intention of carrying out business operations in Poland via transborder services. Additionally, already a few EU-owned subsidiaries are considering their conversion to the branch formula and thus transferring themselves to the regulatory domain of their home authorities. Current regulatory architecture of the EU single financial market is demonstrated by fig. 7.

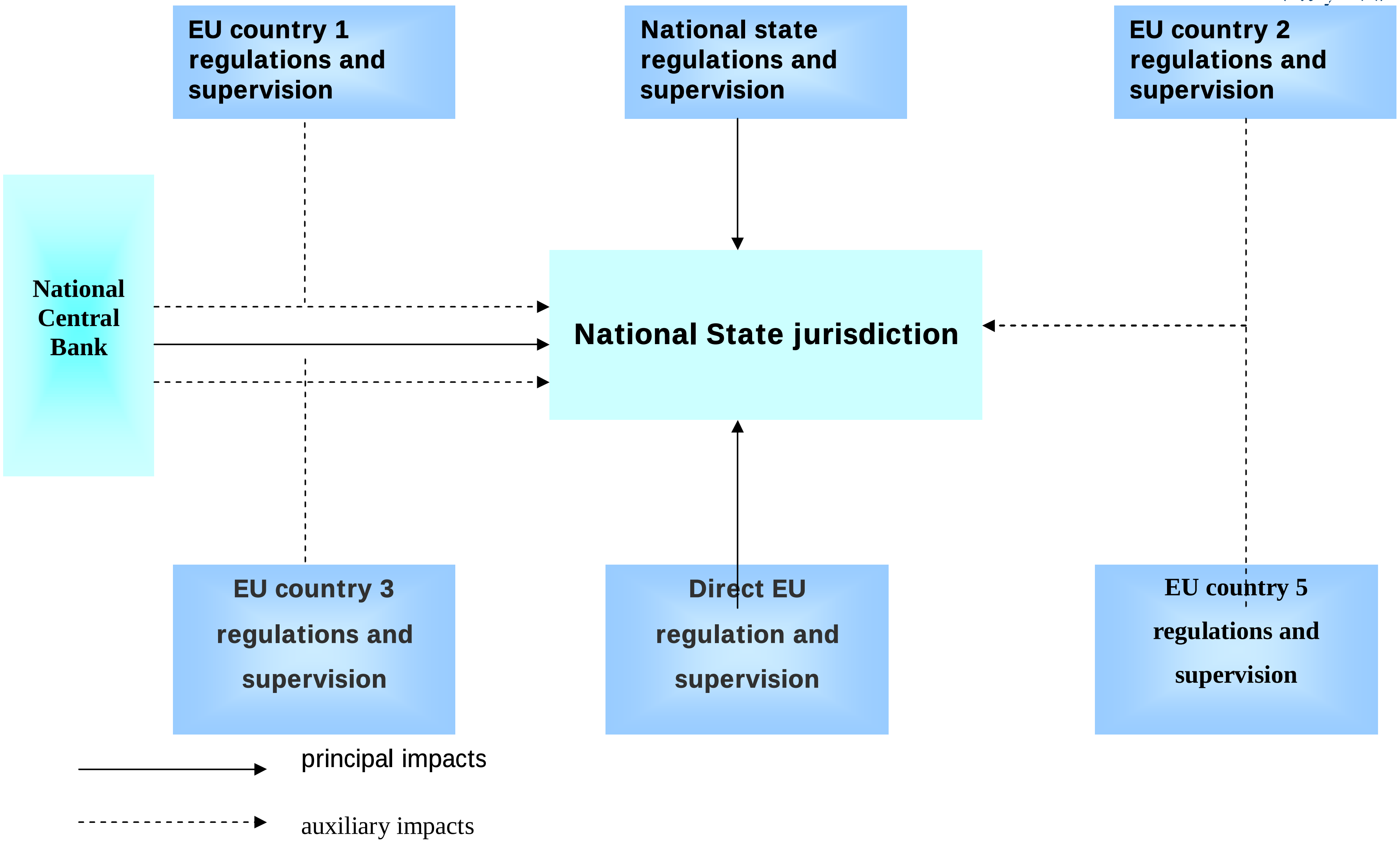

Fig 7 Current regulatory architecture of the EU single financial market

All of this is undoubtedly creating new challenges – both opportunities and risks - for the Polish financial sector. On one hand the new situation opening the Polish financial market to foreign operators enhances local competition and offers better market opportunities for customers who are free to look for their suppliers accross the entire EU. This means that they are no longer constrained by the policies and market conduct of local financial institutions. Their perspective becomes converted from national to regional. If dissatisfied with local institutions they can pass them by and go to others. Of course this theoretical freedom of action is limited in practical terms by the cost and other technical considerations which are of particular importance for retail and small corporate clients. On the whole however the new situation offers new opportunities for the local community.

On the other hand, the dominant position of foreign-owned institutions, particularly EU subsidiaries and hence the absence of equity-based control instruments gives a particularly important role to the central bank and national regulators and supervisors in formatting market operations and overall behaviour of foreign-owned financial institutions. Since EU membership assumes a transfer of a growing part of national regulatory and supervisory powers to other jurisdictions, it brings a serious erosion of the position of Polish regulators and supervisors vis-à-vis respective financial market operators. This important pillar of market conduct and security control will be disappearing.

On the other hand our accession to the Euro system will deprive the National Bank of Poland of its monetary powers and hence will further deteriorate the country's position vis-à-vis financial market operators. It could finally lead to the situation in which the bulk of the financial institutions concerned will be responding to the regulatory and supervisory signals and actions undertaken elsewhere. The shape of the future regulatory regime within the EU is presented in fig. 8.

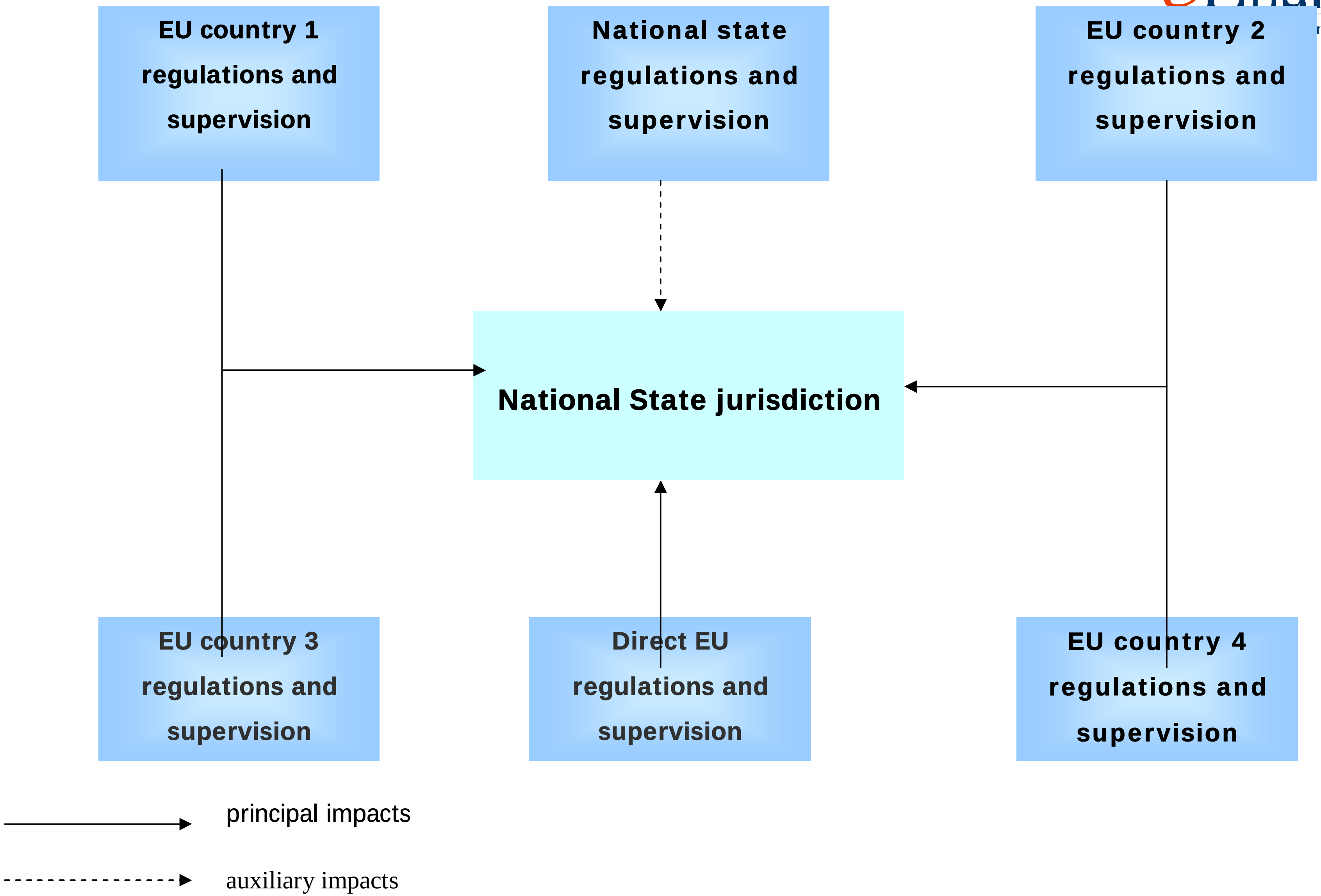

Fig 8. Future regulatory architecture of the EU single financial market

This scenario may be further aggravated by new regulatory concepts discussed recently in the framework of the Solvency II project in the EU according to which the principle of home country control would be extended to include subsidiaries of EU internationally active groups with the help of the concept of a lead supervisor. It could happen then that in a short time the only financial institutions left for the Polish regulatory system are pension funds and credit unions which are luckily enough still outside the single financial market coordination mechanism.

Concluding remarks

The foregoing analysis of the Polish financial sector in the transformation period allows for a much better understanding of its past and present characteristics as well as its role in the context of the real economy.

What is worthwhile to note is its smooth conversion from a state monopoly to a market competitive structure and transition from purely banking to banking plus architecture. Six years ago the banking sector still accounted for about 90% of the country's financial assets, coming down to around 75% in 2004.

It is also worthwhile to note that in the meantime the bulk of this sector slipped equity-wise from local hands. With Poland acceding to the EU there is a growing possibility of further enhancement of the said phenomenon via crowding out of local regulators and supervisors to the benefit of other EU countries.

With such developments Poland will represent one of the most open and internationalized financial markets. This however remains an entirely one-sided or passive phenomenon in a sense that Polish domiciled, particulary Polish-owned institutions, are not becoming beneficiaries of the new opportunities.

At the same time a substantial and growing part of Polish financial needs is covered by foreign financial markets via transborder operation. Joining the EU simplifies the procedures and may further assist this phenomenon. This means that the former, old-time national approach becomes irrelevant and is replaced by the regional perspective. This requires undoubtedly new forms of action and new forms of dialogue between national policymakers and the industry.

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