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**Polish financial sector in the transformation period:
from a national to regional perspective***

Introductory remarks

The financial sector, channeling savings into investments, transforming economic risks and organizing a payment infrastructure represents a crucial element of any social - economic system.

Its size and structure, both in technical as well as in economic dimensions, impacts social and economic structures and processes as well as remains under the influence of these structures and processes. Demographic characteristics of the nation for example impact the level and allocation of savings as well as directions of investment undertaken. Pension system architecture may on the other hand have significant impact on the institutional structure of the financial sectors and financial markets and henceforth on the structure of the real sector of the economy.

These initial observations are particularly valid for the transition countries in which case the financial sector plays the role of a trigger, initiating and accelerating the changes to come. Its inherent fragility at the same time makes it the most important source of systemic risk and instability and hence requires adequate tools to be applied and an adequate financial safety net to be installed. This task of the government however comes under severe pressure with the growing internationalization of the financial sector, both in terms of ownership control, market structure and regulatory powers.

In what follows an attempt to investigate the track record of the Polish financial sector throughout the transformation period i.e. over the last 15 or so years is undertaken. We begin by elaborating on the fundamental characteristics of the Polish financial sector as of today. Its size, architecture, market and ownership structures are at the forefront of the analysis. Additionally the issue of institutional investors and prudential regulations are discussed. Thereafter principal developments in the sector throughout the transformation period are addressed, including the issues of its liberalization, privatization and diversification. It is followed by the discussion of pension funds development as well as the role and size of foreign direct investments in the financial industry. Finally the issue of financial sector integration with the EU is discussed. What particularly matters in this regard is the changing role of the national supervisors and regulators implying the declining role of the national policymakers.

Fundamental characteristics of the Polish financial sector

Analyzing the fundamental characteristics of the Polish financial sector we will focus on its six key features: low level of financial intermediation, strong bank dependency, high mar-

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ket concentration rates, high foreign ownership, strong prudential regulations and high level of crisis resilience.

Small size of the financial sector

One of the most striking features of the present day Polish financial sector is its relatively small size, reflecting the low level of financial intermediation in the Polish economy¹. This is true not only with regard to the developed European economies but also with regard to other new EU accession countries. Measured by size of the overall financial assets i.e. including both bank-based as well as securities-based instruments, the level of financial intermediation in Poland in 2003 is estimated at 95,4% of GDP whereas in Hungary the said ratio was 95,3% of GDP and in the Czech Republic – 141,3% of GDP.

The relative size of the sector has grown dynamically, however, in recent years, mainly due to the growth of non-banking sectors, particularly insurance, investment funds and pension funds followed by the securities market /see table 1/.

Table 1 Financial assets /GDP (in %)

| Item | 1998 | 2000 | 2004 |
|-------------------------|------|------|------|
| Banks | 57,6 | 60,1 | 60,0 |
| Stock exchange | 13,1 | 18,3 | 24,3 |
| Pension funds | - | - | 7,1 |
| Insurance | 3,7 | 5,3 | 8,8 |
| Investment funds | 0,3 | 1,0 | 4,3 |

Source: Zaręba J. – Tendencje rozwoju polskiego rynku finansowego, Zeszyty BRE – Case, Nr 80/2005 p. 23

The differences in intermediation levels are particularly dramatic when we compare the relevant figures with those of the “old” EU economies (EU-15) as the size of the financial sector in the EU 15 in terms of its share in GDP is currently exceeding the ratio registered in Poland by seven times (560% to 80%)².

The low level of financial intermediation in Poland reflects both low propensity for savings, a low level of wealth, as well as a low level of development activities. This is reflected both in a low penetration level of banking assets as well as capital markets assets in the economy. Polish banking sector assets representing the bulk of the financial sector constituted only ca 49% of GDP in 1995 to climb up slowly to around 61% of GDP in 2004³. At the same time the EU - 15 average was about 300% in 2002. The relative size of the problem is well identified in Fig. 1, showing the Polish banking sector across both the old EU-15 average and the new accession countries. It also demonstrates the level of Polish financial intermediation in relation to the historical benchmarks of Greece, Spain and Portugal at the moment of their accession to the EU.

¹ See Thimann Ch (ed) Financial sectors in EU accession countries, ECB, July 2002.

² Bakker, M.R., Gross A. – Development of non-bank financial institutions and capital markets in European Union accession countries, World Bank Working Paper no 28, The World Bank, 2004.

³ Sytuacja finansowa banków w 2004 r., Synteza, NBP, maj 2005, zał. 7.

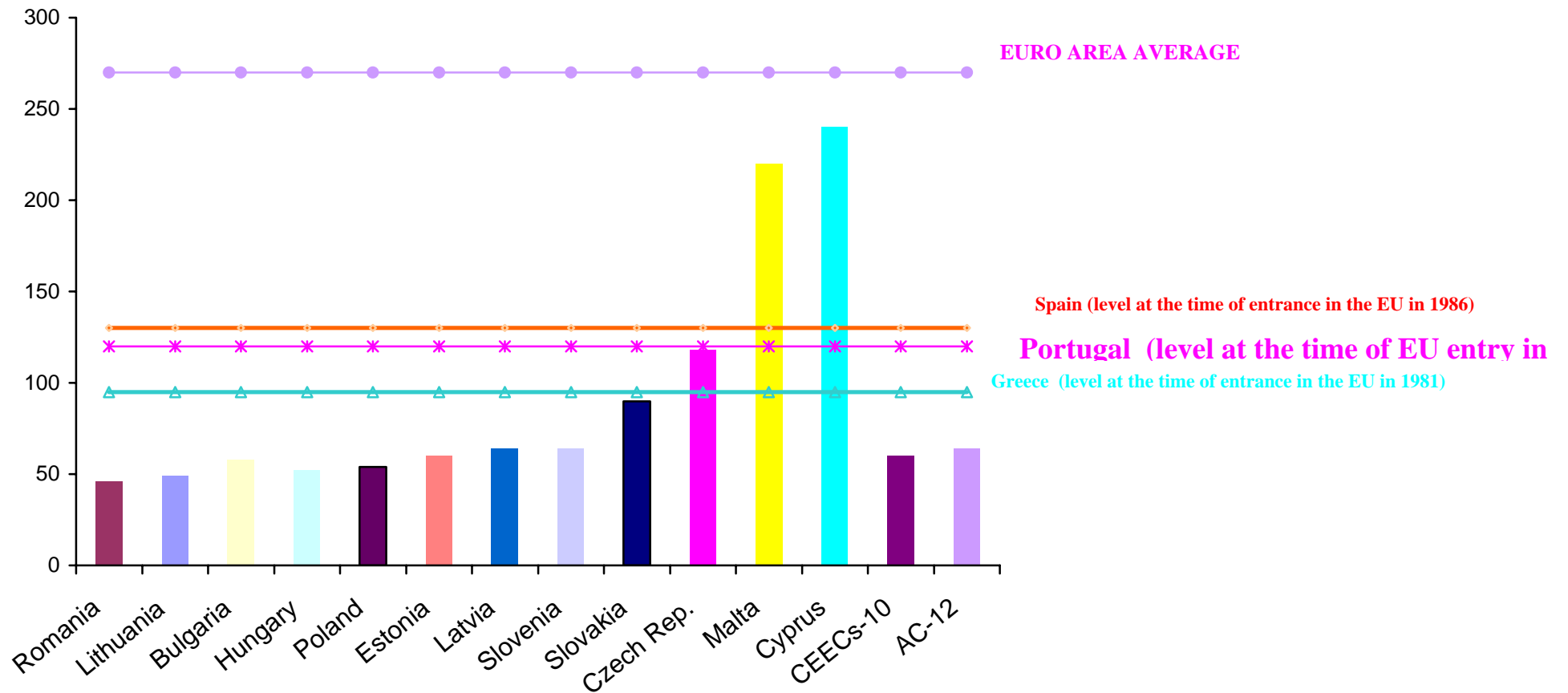


Fig 1 Banking assets in Poland in % of GDP (2001)

As we can see there are **sizable** differences in the depth of banking intermediation between Poland and other countries of Eastern and Central Europe not to mention Malta and Cyprus. There are however at the same instance **profound** differences in comparison to old EU 15 average including its relative latecomers – Greece, Portugal and Spain - at the time of their accession to the European Union.

The low level of banking intermediation is well reflected in the share of domestic credit in GDP. In 2004 it reached the level of 42% in comparison to about 117% in the EU -15⁴. Though it increased by around 30% in the course of the last 10 years, which might be taken as a sign of positive development, it remained practically unchanged since 1998. At the same time only less than 57% of the total credit allocations went to the non-financial sector, the same proportion as 10 years ago. The end result is that Polish non-financial corporate bank indebtedness is only ¼ of the EU 15 average reaching in 2004 the level of 15% of Polish GDP⁵.

The low level of bank lending is explained both by the nature of transition from a centrally planned to a market economy, inadequate credit regulations, a relatively low level of economic development as well as an important role played by inter company loans and foreign lending due to the large presence of multinational companies⁶.

The low level of bank lending is accompanied by a low level of bank deposits. Measured in terms of the share of deposit of non-financial institutions in GDP it represented in 2004 only 35%, only five percentage points more than ten years ago. The registered deposit/ GDP ratio is substantially lower than the EU-15 average which remains close to 80% in recent years.

It is worth noting that over 65% of the non-financial sector deposits are owned by households which indicates a possible area of action in order to enhance the deposit ratio of the economy.

The low level of financial intermediation is also confirmed by insurance market development ratios. The insurance penetration ratio in Poland in 2004 reached a level of 3,1% of GDP against 8,6% in EU-15 average and the insurance density indicator was close to 200 USD per capita against 2700 USD in the EU-15 average.

The low level of indirect intermediation is accompanied by a low level of direct intermediation i.e. financing via capital markets. The capitalization of the Warsaw Stock Exchange in 2004 was equal only to 20% of the country's GDP compared to roughly 70% of the EU-15 average and 150% for the United States⁷.

⁴ Banking structures in the new EU member states, ECB, January 2005 p. 14.

⁵ Hajkiewicz - Górecka M. Szanse zwiększenia dostępności kredytów dla przedsiębiorstw, WSUiB, Studia Finansowe 74/2005, p. 46.

⁶ Idem p. 14.

⁷ Banking structures ... op. cit p. 15

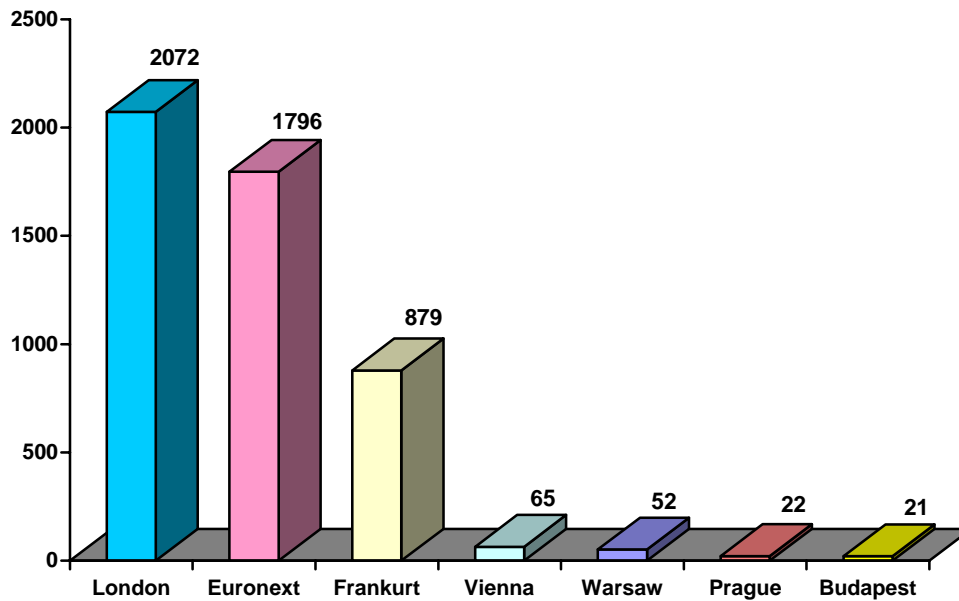


Fig 2 Market capitalization of selected European exchanges, 2004 (bn Euro)

Bank dependency

The Polish financial sector remains clearly bank-centered though the bank's position has slightly eroded in the past few years. The share of the banking assets in GDP remained fairly constant in 2000-2004, oscillating around 60% of the total which favourably compares with the stock market capitalization of around 20% of GDP⁸.

The dominant position of the banking sector is well demonstrated by its role in indirect financing. It turns out that banks are holding around three fourth of the total financial assets held by various financial institutions, the remaining part being split between insurance companies, pension funds and investment funds /see table 2/.

Table 2 Polish financial sector 2002-2004 (assets in million PLN and %)

| Year | Banks | Credit Unions | Investments Funds | Insurance Companies | Pension Funds | Total millions | |
|------|--------------------|-----------------|-------------------|---------------------|------------------|---------------------|---------|
| | | | | | | PLN | USD |
| 2002 | 468.400 (80,4%) | 2,455 (0,4%) | 22.766 (3,9%) | 57.562 (9,9%) | 31.752 (5,4%) | 582.935 (100,0%) | 166.552 |
| 2003 | 488.962 (76,7%) | 3.343 (0,5%) | 33.229 (5,2%) | 65.723 (10,3%) | 45.439 (7,1%) | 636.696 (100,0%) | 181.913 |
| 2004 | 537.788 (74,7%) | 4.234 (0,6%) | 37.723 (5,2%) | 77.499 (10,8%) | 63.040 (8,8%) | 720.284 (100,0%) | 205.795 |

Memo: 1 PLN ~ 0,3 USD ~ 0,25 Euro

Source: NBP, KNUiFE, KPWiG.

⁸ Sytuacja finansowa banków w 2004 zał. 7, NBP Warszawa, 2005

Banks are also dominating the Polish capital market. At the end of 2004 their share in the capitalization of the Warsaw Stock Exchange exceeded 40%. Out of the total 205 corporations listed 14 of them were banks⁹.

The discrepancy between bank financing and market financing is increased further when considering international linkages. This results from the fact that concurrently bank financing from abroad is far more important than market financing from abroad. The overall foreign indebtedness of the non-financial private sector has increased from 124 billion zloties in 2000 to 180 billion zloties in 2004 and thus exceeded the amount of its home banking sector indebtedness by 50 billion zloties¹⁰. In another words, nearly 60% of Polish corporate debt in 2004 was accounted for by foreign institutions, which thus played a much more important role as a source of financing than local banks.

High market concentration rates

The development path of the Polish financial sector throughout the past period resulted in its highly concentrated market structure. This is true with regard to all major financial institutions. The best situation is registered luckily enough, because of its importance, in the banking sector, in which case Herfindhal-Hirschman (HH) index level indicates an existence of the potentially competitive market (the value of HH index below 0,1). The worst situation on the other hand prevails in the insurance sector where the HH index level indicates the potentially uncompetitive market structure. A potentially dangerous situation exists also in the pension funds and investment funds markets /see table 3/.

Table 3 Concentration level of the financial sector in Poland (HH index)

| Institutions | Calculation criterion | 2001 | 2002 | 2003 |
|--------------------|-----------------------|--------|--------|--------|
| Commercial banks | Assets | 0,0894 | 0,0877 | 0,0830 |
| Pension funds | Assets | 0,1653 | 0,1650 | 1,1646 |
| Investment funds | Assets | 0,1262 | 0,1419 | 0,1494 |
| Life companies | Premium | 0,3196 | 0,2957 | 0,2532 |
| Non Life companies | Premium | 0,3529 | 0,3387 | 0,3097 |

Source: Rozwój systemu finansowego w Polsce w latach 2002-2003, NBP, Warszawa 2004 p. 126.

As far as the insurance industry is concerned this is still largely a historical effect - related to the position of the largest national insurance operator - PZU - which holds well over 50% of the overall insurance market. In the case of other industries however this is entirely a product of the transformation period. The relatively high level of market concentration may lead to unwanted consequences both with respect to market conduct of the said institutions as well as with respect to the financial stability of the country. The opening of the single financial arena of the EU may be extremely important from this point of view.

High level of foreign ownership

High concentration rate of the financial sector is accompanied by the high level of foreign ownership. On the whole it could be estimated to be at the level of ca 70% of the overall subscribed capital and assets. It is interesting to see that a similar degree of foreign ownership

⁹ Zareba J. – Tendencje rozwoju polskiego rynku finansowego, Zeszyty BRE – Case, Nr 80/2005 p. 26

¹⁰ Strategia rozwoju rynku kapitałowego, Agenda Warsaw City 2010, Min. Fin, Warszawa, kwiecień 2004 p. 32.

penetration exists across various financial market segments, following in the past very different development strategies.

As far as commercial banks are concerned out of 60 institutions in operation in 2004 as many as 44 of them were controlled by foreign owners. They represented at the same time nearly 68% of the banking assets /see table 4/.

Table 4 Foreign ownership in Polish banking sector

| Country of origin | No of banks | | Share in assets (%) | |
|-------------------|-------------|-----------|---------------------|-------------|
| | 2000 | 2004 | 2000 | 2004 |
| Germany | 14 | 12 | 11,0 | 18,9 |
| Italy | 1 | 2 | 15,8 | 11,3 |
| Netherlands | 4 | 4 | 6,8 | 7,9 |
| Belgium | 3 | 2 | 6,4 | 5,1 |
| Ireland | 2 | 1 | 5,4 | 4,9 |
| Portugal | 2 | 1 | 6,4 | 4,0 |
| France | 3 | 5 | 1,2 | 2,4 |
| Austria | 2 | 1 | 7,0 | 2,0 |
| Sweden | 1 | 3 | 0,1 | 1,2 |
| Denmark | 2 | 2 | 0,1 | 0,3 |
| UK | 1 | 1 | 0,0 | 0,1 |
| Spain | - | 1 | - | 0,5 |
| EU total | 35 | 35 | 60,1 | 58,6 |
| USA | 9 | 7 | 8,6 | 8,6 |
| Czech Republic | 1 | - | 0,2 | - |
| Japan | - | 2 | - | 0,2 |
| South Korea | 1 | - | 0,6 | - |
| Total | 46 | 44 | 69,5 | 67,6 |

Source: *Sytuacja finansowa banków w 2004 r., op.cit. zał. 10.*

The bulk of foreign ownership originated in Germany, Italy and the Netherlands. Investors coming from the United States controlled only 6 institutions representing 8,6% of the total banking assets.

High foreign ownership in the banking sector is a characteristic feature of both transition and emerging economies. Polish indices are in a comparatively lower range in this respect with regard to other Central and Eastern European Countries. They are at the same time much higher than the ones registered in the EU-15 countries /see table 5/.

Table 5 Share of majority foreign-owned banks in total assets (%), 2001

| AC | % | EU | % |
|------------|------|----------------|------|
| Estonia | 97,5 | United Kingdom | 52,1 |
| Czech Rep. | 90,1 | Belgium | 36,3 |
| Latvia | 83,9 | Greece | 21,9 |
| Slovenia | 81,0 | Portugal | 10,5 |
| Bulgaria | 75,0 | France | 9,8 |
| Poland | 68,4 | Netherlands | 7,7 |
| Hungary | 65,5 | Italy | 6,8 |
| Lithuania | 62,6 | Germany | 4,3 |
| Slovakia | 55,0 | Austria | 3,3 |
| Romania | 55,0 | Sweden | 1,6 |

Source: *Stirbu C – Financial market integration in a wider European Union*, HWWA Discussions Paper 297, Hamburg 2004 p. 16

The only exception is the United Kingdom in which case foreign ownership penetration is extremely high in comparison to other developed economies, indicating the truly international nature of the UK financial industry. The other extreme is represented by German, Austrian and Swedish markets, with very low levels of foreign ownership in the financial industry.

Strong prudential regulations

The Polish financial sector has been from the outset formatted along strong prudential regulations. It was therefore able to avoid until now any substantial disturbances. There was no failure of any significant banking institution, no important scandal on the securities market nor any devastating failure of an insurance company.

In the whole transformation period until now there have been altogether 94 failures of banking institutions (of which only 5 commercial banks and 89 small cooperative banks) which affected only 315 thousand deponents compensated with 812 million zloties (ca 260 million USD). The failure of seven insurance companies which has occurred so far affected only about 35 thousand customers and resulted in the financial compensation of ca 300 million zloties.

Strong prudential regulations are reinforced by equally strong supervisory oversight which is split today among three sectoral supervisors: banking, securities and insurance combined with pension funds. They are coordinated by a cross-participation system, a network of MOU as well as by Committee on Financial Conglomerates (so called Troika Committee). These coordination mechanisms are presented in Fig 3.

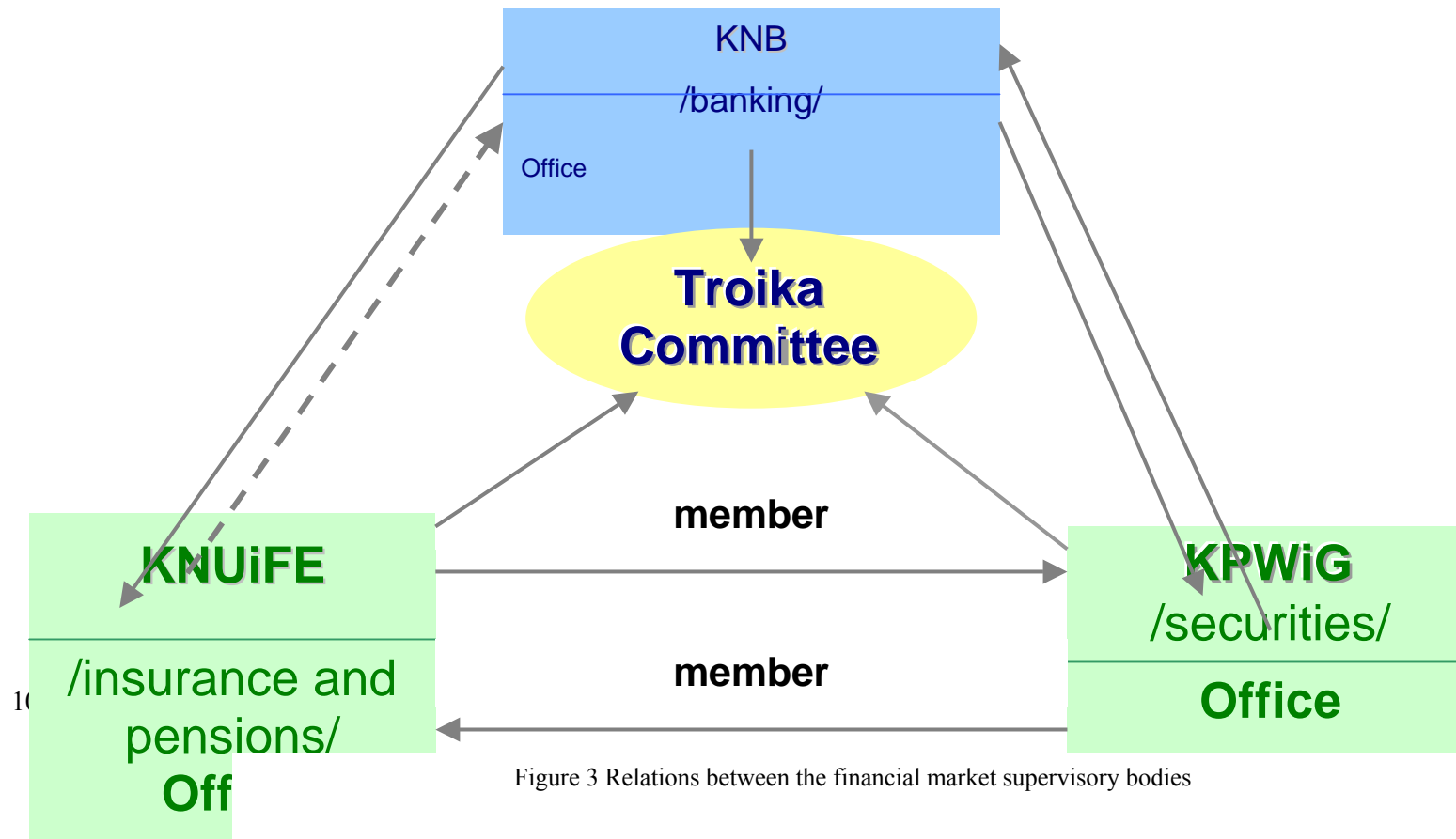


Figure 3 Relations between the financial market supervisory bodies

— Existing
- - - Planned

Major developments in the 1990s

The Polish economy in the 1990s went through two inter-related dramatic shocks: conversion from a centrally planned to a market driven economy and conversion from public to private ownership. Both these shocks were accompanied by dramatic social and economic consequences recorded in terms of short as well as long term effects. The same two shocks took place in the Polish financial sector and in particular in its major component – the banking sector.

Reform of the banking system constituted one of the principal elements of the Polish economic transformation. It was based on four legislative initiatives:

- Banking Act of 1989,
- Act on the National Bank of Poland 1989,
- Act on Financial Restructuring of Enterprises and Banks of 1993,
- Act on Restructuring of Cooperative Banks and the Bank for Food Economy of 1994,
- Act on the Banking Guarantee Fund of 1994.

The first two acts provided a legal basis for the de-monopolization and liberalization of the Polish banking system. They converted the semi-commercial National Bank of Poland into a full-fledged central bank, opened the banking market to new entrants by abolishing the State monopoly in this area, and reconstructed the existing relationship of the State with the banking system by abolishing automatic loan facilities for government-sponsored projects.

It is worth mentioning that by 1989 the Polish banking sector was under full control of the State. Interest rates were fixed by the government, the same was true with regard to lending activities. A major role in the banking system was played by the National Bank of Poland (NBP), performing both central bank and commercial functions, with its regional branches closely linked to state-owned corporations. Apart from NBP there were four other specialized banks (Bank Handlowy, Bank PeKaO S.A., PKO BP and BGK) and two more in the early stage of development (BRE, ŁBR). There were also numerous cooperative banks with their long historical traditions.

The shocks produced by the transformation of the Polish economy found their repercussion in the banking sector which soon became affected by negative developments in the real economy. Hence three consecutive legislative initiatives mentioned above addressed the newly emerged major problem areas:

- non-performing loans of failing industrial companies (Act on Financial Restructuring), non-performing loans of State agriculture-related corporations (Act on Restructuring of Cooperative Banks) and increased danger of bank failures due to the said processes and liberal licensing policy (Act on the Banking Guarantee Fund).

The new governance of the banking system and liberal licensing policy adopted by the National Bank of Poland, responsible for the regulation and supervision of banking institutions, resulted in the rapid development of the banking institutions in the beginning of the 1990s. Apart from nine large regional commercial banks created from NBP branches in 1989-1992, over 70 new banks were licensed, most of them controlled by private capital, frequently however with some participation of public funds. They were in most cases coming from State-owned companies. In 1993 there were altogether 87 commercial banks already in operation of which 29 were still majority State-owned. There were at the same time 1653 cooperative banks, mostly small, locally oriented institutions. Since then the number of the banking institutions, both due to severely increased prudential requirements and a restrictive licensing policy of the supervisory authority as well as growing consolidation processes, was continuously declining (see table 6). As a final result at the end of 2004 there

were only 60 registered commercial banks and 596 cooperative banks, 40% fewer in comparison to the 1993 level.

Table 6 Banks according to type, ownership (nos) and assets (%)

| | 1993 | | 1997 | | 2000 | | 2004 | |
|---------------------------|--------------|--------------|--------------|--------------|------------|--------------|------------|--------------|
| | No | Assets | No | Assets | No | Assets | No | Assets |
| Commercial banks (CB) | 87 | 93,4 | 83 | 95,5 | 74 | 95,8 | 60 | 94,7 |
| CB majority state owned | 29 | 80,4 | 15 | 49,3 | 7 | 22,9 | 5 | 20,5 |
| CB majority private owned | 58 | 13,0 | 68 | 46,2 | 67 | 72,9 | 52 | 74,2 |
| Polish investors | 48 | 10,4 | 39 | 30,9 | 20 | 3,4 | 5 | 6,6 |
| Foreign investors | 10 | 2,6 | 29 | 15,3 | 47 | 69,5 | 47 | 67,6 |
| Cooperative banks | 1.653 | 6,6 | 1.295 | 4,5 | 680 | 4,2 | 596 | 5,3 |
| TOTAL | 1.740 | 100,0 | 1.378 | 100,0 | 754 | 100,0 | 653 | 100,0 |

Source: NBP

It is also worth mentioning that in 1993-2000 at least 12 relatively large credit institutions were rescued by foreign investors at the initiative of the supervisory authority which used its strong position to convince foreign investors to contribute to the co-financing of the Polish banking sector, heavily subsidized by public aid in the 1993-1995 period¹¹. The direct public cost of the resolution of bad debts of the banking system in 1993-1995 amounted to over 10 billion zloties (ca. 3 billion USD).

The overall costs of bank restructuring are estimated however to be much higher. Total fiscal cost of the said operation in 1991-98 according to the World Bank accounted for 8% of the country's GDP. They were still much lower compared to the Czech Republic (25% of GDP) and Hungary (13%)¹².

In the second half of the 1990s there was an increase in the consolidation process driven by market considerations initiated, by the already existing Polish banks. They were as a matter of fact mainly controlled by foreign shareholders. In 1997-2001 there occurred at least 13 consolidation operations of this type. The new element that was added to the consolidation drive in recent years are consolidation projects originated abroad that were influencing the Polish segment of the consolidated groups. The principal examples are the merger of Cracow-based BPH and Warsaw-based PBK in 2002 due to the acquisition of Bank Austria by German HVB and the most recently planned merger of Pekao S.A. and BPH as a result of the European-wide merger of Uni-Credito Italiano and HVB.

The strategic part of the banking sector transformation constituted its privatization, both via establishment of new privately-owned banking institutions as well as via divestment of the State from the existing State banks. In terms of numbers of banking institutions, the first path was producing more visible results, in asset terms however it was the second path that contributed most to the changing panorama of the Polish banking industry.

Overall the State Treasury has received for its stakes in the banking sector to date ca. 23 billion zloties (ca. 7 billion USD) of which 7,6 billion zloties (ca. 2,2 billion USD) for the sale of its shares in the PKO Bank Polski in fall 2004 (the State Treasury still retained 62,9% of the shares of the said bank in its hands)¹³.

¹¹ System bankowy w Polsce w latach dziewięćdziesiątych, NBP, grudzień 2001 p. 58.

¹² Tony H., Zoli E., Klytechnikowa J. – Banking crisis in transition countries; fiscal costs and related issues, World Bank Policy Research Paper 2484, Washington, 2000.

¹³ Szelągowska A. – *Kapitał zagraniczny w polskich bankach*, Poltext, Warszawa, 2004 p. 101.

Transformation of the banking industry was accompanied by the transformation of the insurance sector including its privatization. Out of three insurance companies existing before 1989 one failed, one was completely privatized and one - PZU - is still in the privatization process. Currently the insurance industry is composed of 67 companies and 7 foreign branches; all but three companies – PZU Non-Life and PZU Life - and KUKI, specialized in export guarantees - are privately owned.

As far as the capital market is concerned the setting for its development in the 1990s was set up by two legislative initiatives: the Act on Commercialization and Privatization of State – Owned Companies of 1991 and the Law on Public Trading in Securities and in Trust Funds. It led to the establishment in 1991 of the Securities and Stock Exchange Commission (KPWiG) and the Warsaw Stock Exchange (WGPW). The Warsaw Stock Exchange organizes trading in shares, pre-emption rights, treasury and corporate bonds, foreign exchange and derivatives. It continues to be a State-owned joint stock company with only 1,2% of the shares in the hands of 21 private entities (mostly banks). It housed by the end of 2004: 2005 listed companies (12 in 1991). The average size of the listed Polish companies is still small reaching the value of 165 million Euro in comparison to 250 million Euro in Prague, 320 million Euro in Budapest or over 500 million Euro in Vienna¹⁴. Out of the 20 largest Polish corporations in 2003 only 5 were listed on the Warsaw Stock Exchange. Ten of the Polish listed companies are currently also traded abroad on other European stock exchanges /see table 7/ .

To complete the picture we should perhaps also add that around 30% of the present capitalization of the stock exchange is accounted for by foreign issuers. They include some leading corporations like BA-CA, Ivax, MOL, Borsodchem, BMP.

It is worth mentioning that the securities market plays a growing role with regard to household savings. Whereas in 1995 about 90% of the household savings were allocated in banks, in 2004 this share diminished to 60%. The remaining 40% is accounted for by securities (20%), pension funds (10%) and life insurance (10%)¹⁵.

Table 7 Foreign listings of Polish publicly-traded companies

| | London | Berlin | Frankfurt | Munich |
|------------------------|--------|--------|-----------|--------|
| Agora | + | + | + | + |
| Bank Millenium | - | + | + | - |
| KGHM | + | + | - | - |
| Mostostal Export | - | + | + | - |
| PeKaO S.A. | + | - | - | - |
| PKN Orlen | + | + | + | + |
| Prokom Software | + | + | + | - |
| Softbank | - | - | + | - |
| Stalexport | - | + | + | - |
| Telekomunikacja Polska | + | + | + | - |

Source: KPWiG

¹⁴ Data supplied by KPWiG

¹⁵ Zaręba J. – Tendencje rozwoju ... op. cit p. 19