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FINANCIAL SECTOR ASSESSMENT

POLAND

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A joint IMF-World Bank mission visited Poland from February 19 – March 6, 2013 to undertake an update of the Financial Sector Assessment Program (FSAP) conducted in 2006. This report summarizes the main findings of the mission, identifies key financial sector vulnerabilities, and provides policy recommendations.[1]

[1] The team was led by Brett Coleman (World Bank) and Luc Everaert (IMF) and included Katia D'Hulster, Heinz Rudolph, Andrey Milyutin, John Pollner, Ignacio Tirado (all World Bank), external experts David Walker (Canada Deposit Insurance Corporation), Monnie Biety (independent consultant), Karl Driessen, Nancy Rawlings, Yinqiu Lu, Jorge Chan-Lau, Rishi Ramchand (all IMF), and Fernando Montes-Negret (former World Bank and IMF). This assessment is based primarily on the situation that prevailed in March 2013, with the exception of the pensions section – a major pension reform was announced in September 2013, and given its importance, the World Bank's Country Management Unit coordinated the preparation of an updated analysis that has been included in this report.

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GLOSSARY

AML/CFT	Anti-Money Laundering and Combating The Financing of Terrorism
BCBS	Basel Committee on Banking Supervision
ARM	Adjustable Rate Mortgage
BFG	Bankowy Fundusz Gwarancyjny (Bank Guarantee Fund)
BION	Badanie i Ocena Nadzorcza (Supervisory Examination and Evaluation)
CAR	Capital adequacy ratio
CBS	Commission for Banking Supervision
CEE	Central and Eastern Europe(an)
CFS	Commission for Financial Supervision
COCO	Contingent Convertible Debt Instruments
CIRS	Cross-currency interest rate swaps
CHF	Swiss Franc
CRD	Capital Requirements Directive
CRDIV	Capital Requirements Directive IV
CSO	Central Statistical Office
CRR	Capital Requirements Regulation
D-SIFI	Domestic Systemically Important Financial Institution
DTI	Debt-to-income ratio
DVP	Delivery versus payment
EBA	European Banking Authority
EDF	Expected Default Frequency
ESCB	European System of Central Banks
ESRB	European Systemic Risk Board
EU	European Union
EUR	Euro
EWS	Early Warning System
FSAP	Financial Sector Assessment Program
FRM	Fixed Rate Mortgage
FSC	Financial Stability Committee
FSB	Financial Stability Board
FSOC	Financial Stability Oversight Council
FX	Foreign exchange
GDP	Gross domestic product
GIBS	General Inspectorate of Banking Supervision
IADI	International Association of Deposit Insurers
HPA	House Price Appreciation
IAIS	International Association of Insurance Supervisors
IFRS	International Financial Reporting Standards
IT	Information Technology
KAPER	[KAPER is a set of financial ratios facilitating management and supervision of SKOKs]
KNF	Polish Financial Supervision Authority
KNUiFE	Insurance and Pension Funds Supervisory Commission
KPWiG	Securities and Exchange Commission

LTV	Loan To Value – ratio of mortgage loan principal amount to the value of the real estate collateral
MCB	Mortgage Covered Bond
MoF	Ministry of Finance
MOU	Memorandum of Understanding
NASCU	National Association of Cooperative Savings and Credit Unions
NBP	National Bank of Poland
NPL	Non-Performing Loan
OECD	Organization for Economic Cooperation and Development
OFE	Open pension fund
OMO	Open market operation
OTC	Over-the-counter
p.a.	Per annum
PBA	Polish Bankers Association
PLN	Polish zloty
PTE	Pension management company
QRM	Qualified Residential Mortgage
RMBS	Residential Mortgage Backed Securities
ROSC	Report on Observance of Standards and Codes
SKOKs	Credit Unions
SRB	Systemic Risk Board
UCITS	Undertakings of Collective Investment in Transferable Securities (EU Directive 2009/65)
USD	U.S. dollar
WSE	Warsaw Stock Exchange

OVERALL ASSESSMENT AND SUMMARY OF MAIN RECOMMENDATIONS

Poland's financial system appears to be resilient. Skillful policy management and sound fundamentals have allowed the economy to weather the global financial crisis and the Euro Area turmoil. Risk drivers include slow growth abroad and domestically, rising unemployment, and declining residential real estate prices. Vulnerabilities lie in interconnectedness with the euro area and exposure to foreign exchange risk and foreign investors, which in turn may pressure bank funding, especially in the absence of long-term domestic funding sources. The banking system has been profitable and induced to hold high levels of core tier-1 capital. Foreign exchange-denominated lending has been curbed, but the outstanding stock remains high.

Vulnerabilities are contained, though some pockets of weakness are present. Stress tests found that none of the risk factors is likely to take on systemic proportions. Only in the most severe scenarios would a few small banks fail to meet solvency standards or run into liquidity problems. Contagion risk is limited as there are few direct interbank connections.

Asset quality has become a higher priority on the supervisory agenda, given persistent nonperforming loans and cyclical deterioration in credit quality. A thematic supervisory review of impaired assets is getting under way and should lead to updated regulatory guidance which should strengthen oversight. Banks have started cleaning up their balance sheets, but tax disincentives, income accrual practices, and obstacles to out-of-court restructurings impede rapid progress. Further improvements in restructuring, accounting practices, and the insolvency framework would be helpful. Ongoing revisions to supervisory guidance should take care not to contribute to rising nonperforming loans: the loosening of debt-to-income (DTI) thresholds will need to be accompanied by tighter oversight of bank risk management practices. While the proposed tightening of loan-to-value (LTV) ratios and currency matching of income and borrowing for mortgages are welcome, LTV ratios should be set below 100 percent. Standardizing the calculation of the DTI ratio; increasing oversight of restructured loans by requiring more granular reporting by banks and additional transparency will be helpful.

Savings and credit unions require special attention. Credit unions are a weak but small segment of the financial system. However, they show rapid growth, and the sector continues to consolidate. They have low capital and high NPLs, while weak accounting standards mask their true financial condition. The authorities have responded by bringing these institutions under the integrated supervisory agency and will soon extend the national deposit guarantee scheme to them. During the mission, a draft law on credit unions was before Parliament for discussion. Substantial strengthening was needed in the law to gradually bring SKOKs onto a sound financial footing. Prudent management of the transition to stronger regulation and supervision, combined with support to develop realistic capital rehabilitation plans for individual credit unions, will be needed to ensure the survival of viable credit unions.

Financial oversight and safety nets have been improving. Poland is broadly compliant with BCP, IAIS, and IADI Core Principles. Banking supervision has significantly improved, as the frequency of targeted inspections has increased and onsite/offsite coordination has been enhanced, but further improvements are necessary. Under the Polish legal system it remains difficult to provide the supervisor with sufficient powers, independence, and resources, which is of particular concern considering its expanding mandate. Consultations with banks and other stakeholders in the industry could be further strengthened. The deposit guarantee fund's prospective role in bank resolution—when it becomes the designated resolution agency—will further strengthen its position, though it is necessary to continuously ensure adequate funding, analytical capacity, and human and budgetary resources.

Poland's financial system is in the process of rebalancing. Over the past decade, the financial system has grown rapidly, dominated by banks. Competitive pressures are likely to increase in the commercial and cooperative banking sectors, however, leading to consolidation and exit of weaker financial institutions over time. Scarcer foreign funding means that large financing requirements to support economic development will have to be met from domestic sources of finance. Even though mutual and pension funds have become more important, nonbank financial intermediation remains embryonic, and ongoing and proposed modifications of the pension system could countervail the ability of the latter to participate in developing domestic capital markets. In a similar vein, initiatives to develop the mortgage backed securities market through specialized mortgage banks have yielded little so far.

While prudential supervision has yielded good outcomes, impending changes in the regulatory landscape, the potential for consolidation and heightened competition, and the search for innovation require a more risk-based and more holistic approach. Information from individual institutions should include forward-looking analysis to build a complete and timely risk map of the financial system. In turn, this risk-based analysis should feed regulatory changes and be integrated in a systemic approach to the financial sector, including bank consolidation and the development of nonbank financial intermediation.

The authorities are planning further changes to the financial oversight framework. Constraints on supervisory room for maneuver from membership in the EU and the implications of the prospective banking union will shift the onus of oversight onto sound risk management. Draft legislation on resolution is progressing to set up a state-of-the-art bank resolution framework. The planned resolution framework designates the deposit guarantee fund as the resolution agency and puts a complete suite of resolution tools at its disposal, in line with the FSB's Key Attributes and the draft new EU Crisis Management Directive. Similarly, a systemic risk board will be set up at the heart of an explicit macroprudential policy framework. It should provide the opportunity to adopt a supervisory approach to systemic risks and systemic institutions and clarify the objectives and the roles of the respective macroprudential, microprudential, and financial safety net institutions in Poland.

Establishing a similar reform momentum to rebalance the financial system toward capital market development will be important. A stable and well diversified pension system is important for financial development, intergenerational fairness, and sustainable pension benefits. The authorities should carefully consider the design and parameters of all of their pension pillars. For financial market development, pension funds can play an important role as a domestic source of demand for assets. Lifecycle investment strategies will encourage mandatory pension funds to be invested in portfolios that better address the long-term objectives of future retirees. In the case of voluntary schemes, greater incentives and transparency are essential to allow private agents to make informed decisions, especially against the background of low voluntary private savings and low expected replacement rates. Similarly, robust capital market funding frameworks—including mortgage covered bonds and securitization—can address the funding needs and mitigate the foreign exchange and asset quality risks facing the banking system. A number of recent regulatory initiatives strive to remedy the situation, focusing on improved asset quality, loan transferability, and reviving the mortgage banks. In the area of creditor rights, there have been improvements since the 2008 ICR ROSC, although problems remain in enforcement, the use of out-of-court restructuring, and the insolvency framework.

Main Recommendations

Recommendations	Responsible Parties	Timeframe
Objective: Addressing Impaired Loans		
Intensify oversight of credit risk management and restructuring practices.	KNF	ST
Standardize and enhance transparency of bank accounting practices	MOF (lead), KNF	ST
Standardize debt-to-income ratio calculation	KNF	ST
Objective: Strengthening Banking Supervision		
Amend the Banking Act to expand the scope for KNF to issue legally binding prudential regulations.	MOF (lead), KNF	MT
Amend the 2006 Act on Financial Market Supervision to allow KNF's Board to delegate administrative and procedural decisions to its management, increase KNF independence, and address other governance issues.	MOF (lead), KNF	MT
Increase KNF budgetary and staff resources and enhance its analytical capabilities to reflect its increasing responsibilities.	MOF (lead), KNF	MT
Objective: Strengthening Credit Unions		
Amend the Credit Union Law to eliminate the dual supervision; mandate a transition to a solvency ratio of 8 percent in 5 years; and clarify the governance of the stabilization fund.	MOF (lead), KNF, NASCU	ST
Develop and implement an inclusive set of SKOK regulations and apply accounting principles for financial institutions to SKOKs.	MOF (lead), KNF, NASCU	MT
Develop and implement capital rehabilitation plans for financially weak SKOKs.	KNF (lead), NASCU	ST

Objective: Developing sound macroprudential policies		
Ensure the macroprudential supervisory law provides for SRB's independence (with a leading role for the NBP), accountability to Parliament, and power to make recommendations coupled with an "act or explain" mechanism.	MOF	ST
Develop clear macroprudential policy objectives that are distinct from those of monetary and microprudential supervisory policy.	NBP, MOF, KNF, BFG	ST
Objective: Improving the Bank Resolution Framework (draft BFG Act)		
Ensure precedence of administrative powers over corporate insolvency procedures.	MOF (lead), KNF, BFG	ST
Ensure that the creditor claims hierarchy protects BFG's claims on resources provided for balance sheet "gap filling" measures.	MOF (lead), KNF, BFG	ST
Ensure discretion to prudentially adjust asset valuations to fix the capital position of a bank.	MOF (lead), KNF, BFG	ST
Objective: Improving the Deposit Insurance System		
Remove the PBA from the BFG Council.	MOF (lead), BFG	ST
Ensure adequate funding and capacity, revise and introduce new regulations, and enhance protocols in light of expanded mandate.	MOF (lead), BFG, KNF	MT
Amend code of conduct to restrict employment in member institutions to all employees.	BFG	ST
Objective: Strengthening Pension Reform		
Manage and mitigate the potential risks arising from the pension reforms announced in September 2013.	MOF (lead), MOL	ST
Revise regulations to allow lifecycle strategies in the pension funds, and measure performance of pension funds in relation to the benchmark portfolio.	MOF (lead), MOL, KNF	ST
Objective: Developing Long-Term Mortgage Funding		
Amend Recommendation S to disallow risk factor stacking, tighten eligibility requirements, and strengthen conditions for using mortgage insurance.	KNF	ST
Amend the MCB framework to allow universal banks to issue MCBs, and adopt a legal framework for mortgage securitization.	MOF (lead), KNF, MOJ	MT

Objective: Strengthening insolvency and credit rights		
Strengthen enforcement of security interests and judicial decisions.	MOJ (lead), JUDICIARY	MT
Create an enabling legal framework for out-of-court restructuring by approving more favorable tax regulation, developing a system of pre-packaged agreements, and adopting a code of conduct for financial institutions.	MOF (lead), MOJ, KNF	ST
Amend the insolvency legislation to adequately define directors' duty to file, streamline the procedure, ensure increased participation of creditors, increase the effectiveness of the reorganization procedures, and strengthen the qualifications of judges and trustees.	MOJ	ST

POLAND: FINANCIAL SECTOR ASSESSMENT

1. **Diversifying Poland's financial system to meet new demands while preserving its resilience and stability is the key task ahead for financial policymakers.** Over the past decade, the financial system has grown rapidly and risks have been well managed along the way. To maintain this track record and supply the financial services needed to support the economy's growth, it will be important to develop nonbank financial intermediation, prepare for possible further consolidation and exit of financial institutions, especially cooperatives, credit unions (SKOKs), and small banks, and promote a competitive banking system, relying less on foreign funding. While these developments will be largely market driven, they need to be supported by enabling regulatory reform and the modernization of the financial oversight framework: supervision focused on risk management, including an independent systemic risk perspective, strong safety nets, and state-of-the-art resolution tools will be indispensable.

I. MACROECONOMIC SETTING AND FINANCIAL SYSTEM STRUCTURE

2. **Poland's economy performed well in a challenging environment.** Strong economic fundamentals and sound macroeconomic management played a key role in keeping the economy out of recession through 2012. At the outset of the global crisis, Poland had no notable macroeconomic imbalances: inflation was contained, credit growth moderate, the banking sector well-capitalized, and public and external debt at moderate levels. Countercyclical policies and the floating exchange rate regime, together with ample international reserves and the precautionary Flexible Credit Line arrangement with the IMF, helped insulate the economy and supported confidence. As a result, the economy performed well in 2010-12.

3. **Nonetheless, the economy has slowed recently, reflecting a combination of external factors and weaker domestic demand since early last year.** Heightened financial and sovereign tensions in the euro area contributed to the weakening – directly through trade links and indirectly through confidence. Financial contagion has been limited to a gradual switch of bank funding towards domestic sources. GDP growth slowed to 1.1 percent in 2012Q4 (year-on-year). Polish firms have cut back on hiring, causing unemployment to rise to 10 percent at end-2012. Credit growth decelerated rapidly to 3.4 percent in 2012 from 8.6 percent in 2011, while residential property prices have been gradually declining. High frequency indicators point to continued slackness in the early months of 2013. In response, the Monetary Policy Council (MPC) has cut policy interest rates by a cumulative 1.75 percentage point since November 2012 to 3.00 percent.

4. **Poland's financial system has been expanding rapidly and remains dominated by banks.** Total financial system assets grew from 86 percent of GDP in 2005 to 124 percent of GDP in 2012. Banks account for about 70 percent of financial assets. At end-2012, there were 698 deposit-taking institutions in Poland: 70 commercial banks, of which 61 were subsidiaries or branches of foreign credit institutions, 573 cooperative banks, and 55 SKOKs.

The share of nonbanks has grown over the same period to 30 percent of financial system assets, with pension and mutual funds playing a key role.

5. **The banking system is dominated by foreign-owned banks, which control about 65 percent of the sector's assets.** Recently, foreign banks have retrenched somewhat, and deleveraging by foreign owners has led to some consolidation in the sector. The state owns controlling shares in four banks, which together account for about 22 percent of banking sector assets, including Poland's largest commercial bank with a market share of 16 percent. The banking system is not highly concentrated; the top five banks account for about 44 percent of system assets.

6. **The Polish banking system is well capitalized and liquid.** In aggregate, capital adequacy reached 14.7 percent by end-2012, 90 percent of which is Core Tier 1 capital (**Error! Reference source not found.** and Figure 1). Profits in 2011 and 2012 were historically high, and recommendations restricting dividend payouts aided capital building. Nevertheless, although they have performed better than the PLN portfolio to date, an overhang of FX-denominated mortgages continues to pose risks to asset quality and funding,.

7. **Cooperative banks constitute a small but rapidly growing segment, accounting for 4.4 percent of total financial system assets.** They serve smaller towns and rural areas where commercial banks are beginning to encroach as they seek domestic expansion. Cooperative banks are operationally less efficient than commercial banks but their capital ratios appear comparable. Consolidation within the sector would provide scope for greater efficiency and competitiveness, provided it takes place in an orderly manner.

8. **SKOKs are authorized to take deposits as well**. The sector holds assets equal to 0.8 percent of financial system assets and is dominated by one institution, with assets comparable to a top-15 bank and equal to about 40 percent of the entire sector. The sector recently came under the purview of the Polish Financial Supervision Authority (KNF). Regulatory data are still limited, but the sector is reportedly poorly capitalized.

9. **There is a small unregulated segment of the financial sector that caters to a narrow layer of borrowers that do not qualify for bank credit.** There are two main business models: one segment provides small consumer loans (up to PLN 1,000) at high interest, while the other provides installment purchase financing. These firms do not take deposits, and are therefore outside the regulatory perimeter. However, risks are contained by regulations that effectively prevent Polish banks from establishing subsidiaries that conduct such activities, although foreign firms (banks and nonbanks) have set up such companies in Poland.

II. FINANCIAL VULNERABILITIES

10. **The financial system appears to be resilient.** Capital adequacy, profitability, and efficiency are high by international standards, though provisioning for residential mortgages is on the low side. While there are pockets of vulnerability, they are not systemic. Main risk drivers are slow economic growth, uncertainty in the euro area, rising unemployment, and

falling residential real estate prices. Vulnerabilities stem from the large outstanding portfolio of foreign exchange loans (some with LTVs well above 100 percent), pressure on bank funding, potential volatility of capital flows, and impaired assets. However, there are mitigating factors: foreign exchange lending has been extended mainly to higher income households, overall household debt is low by international comparison, the duration of foreign exchange hedging has lengthened, the foreign investor base has become more diversified, and banks are relying less on parent funding. Hence, even under severe scenarios, stress tests confirm that the share of assets at risk is small, liquidity sufficient, and contagion risks limited.

A. Foreign Exchange Loans

11. **The issuance of foreign exchange (FX) mortgages increased rapidly through 2008 but has fallen since.** FX mortgages comprise about 22 percent of the total loan portfolio and more than half of mortgages. The proportion of impaired FX mortgages in the housing loan portfolio has been decreasing as customers with FX mortgages tend to keep monthly payments constant thereby prepaying more, given the decreasing Swiss interest rates, and banks tend to convert FX mortgages to PLN mortgages if they become impaired. Nevertheless, the level of impaired FX mortgages has continued to increase slightly to 1.8 percent as of year-end 2012; for comparison, PLN loan delinquency was 4 percent, and the weighted average for total FX and PLN NPLs 2.8 percent of the overall loan portfolio.

12. **Loan-to-value (LTV) ratios remain quite high for one third of the housing portfolio.** The majority of loans with LTV's over 100 percent are FX-denominated, and 25 percent of the FX housing portfolio has LTV's over 130 percent. While the average LTV for newly originated loans is about 70 percent, some banks reported they are continuing to offer mortgages at 100 percent LTV. The reserve coverage for impaired housing loans is 48 percent which may be low considering the lengthy recovery process and falling asset prices, raising the potential loss given default.

13. **Supervisory measures were taken to contain systemic risks associated with mortgage portfolios.** These included tightening of prudential rules in 2006 and 2011, such as lowering the maximum debt-to-income (DTI) ratio for new FX loans to 42 percent and increasing risk weights on these loans to 100 percent. Authorities are discussing revising Recommendation S, which sets forth standards for mortgage loans in general, by tightening LTV requirements for all mortgage loans; however, requirements regarding DTI thresholds would be loosened.[2] Proposed changes to Recommendation S also call for prohibiting FX loans to clients without adequate FX income, though risks to the outstanding stock of FX loans remain. While many of these proposed revisions will strengthen underwriting of mortgages, the proposed amendment would benefit from some fine tuning.

[2] Subsequent to the mission, the FSAP team was informed that the amended Recommendation S was published in June 2013.

B. Bank Funding

14. **Funding from parent banks is declining in an orderly fashion, and the loan-to-deposit ratio has remained stable in the post-global financial crisis period.** In the run up to the global financial crisis, increased funding from parent banks to domestic subsidiaries drove this ratio to about 120 percent (Figure 2). Since 2008, the ratio has stabilized, with signs of some decline in 2012. Continued orderly decline of parent funding, increased reliance on domestic deposits, and weak credit growth are likely to further reduce the ratio, easing pressure on banks' funding.

15. **Balance sheet currency mismatches, however, require banks to increasingly hedge their exposures as parent funding declines.** At the aggregate level, the on-balance sheet open foreign currency position is about 5 percent of total commercial bank assets. Faced with reduced foreign currency funding from parent banks and other cross-border sources, a number of banks are increasingly hedging through FX swaps. Hedging needs are declining, however, as new issuance of FX mortgages has drastically slowed, and principal is being repaid faster owing to the low level of Swiss franc interest rates.

16. **Progress in strengthening net stable funding ratios is being hampered by the lack of available long-term funding.** Ahead of the Basel III implementation, KNF has recommended banks to lengthen the duration of their funding partly to mitigate risks from mortgage portfolios being financed mainly with deposits. However, a shallow domestic investor base, regulatory constraints on pension funds, and the virtual absence of securitization and covered bond markets pose obstacles for progress in this area.

C. Capital Flows

17. **The sizeable portfolio inflows into the domestic bond markets since 2009 increase Poland's vulnerability to changes in market sentiment.** Nonresidents' share of sovereign bond holdings has risen to 36 percent. Growing demand from foreign investors has driven the five-year government bond yield even below the National Bank of Poland's (NBP's) policy rate. However, a higher proportion of foreign investment makes the Polish bond market vulnerable to a sudden shift in investors' risk appetite. The risk of sudden reversal is mitigated by a relatively stable and diversified bond investor base, high domestic liquidity, and sound hedging practices. Nevertheless, besides continuing to pursue prudent macroeconomic policies, the authorities should monitor closely the bond investor base and investors' funding and hedging behavior.

D. Asset Quality and Nonperforming Loans

18. **Asset quality deteriorated rapidly between 2008 and 2009.** The increase in impaired loans is most notable in the consumer loan portfolios, due to lenient underwriting practices and increased competition for market share in this segment before the 2008-09 financial crisis. The corporate sector's capacity to repay bank credit was affected by the crisis and the economic slowdown in 2009, resulting in a doubling of the impaired loan ratio between 2009 and 2010. The impaired loan ratio stabilized at above 8 percent after 2010,

reflecting tightened underwriting standards, credit expansion and sales of impaired consumer loans to third parties. The overall provisioning coverage for impaired loans is 54 percent; however, the ratio varies across sectors and ranges between 36 and 77 percent, suggesting it may be low for certain sectors such as SMEs and housing, especially given the lengthy recovery process, age of portfolios, and falling house prices.[3]

19. **With the economic slowdown and expected rise in unemployment, asset quality is likely to deteriorate further.** Financial difficulties in, and the bankruptcy of a few, large construction companies that implemented public infrastructure projects impacted the corporate asset class in 2012 and as such, impaired loans increased by 35 percent – the highest increase for all asset classes. The impaired loan ratio is also expected to increase in the residential mortgage portfolio, as this portfolio ages.

20. **Cleaning up bank balance sheets faces a number of obstacles.** The majority of loans past due 90 days or more have been past due at least one year. The consumer loan asset class comprises almost 50 percent of this stock, while the housing stock and corporate stock comprise roughly 20 percent each. While this overhang of impaired loans is covered to a large extent by provisions, maintaining them on the balance sheet slows down the resolution process and distorts financial indicators. Banks are legally allowed to accrue high rates of interest on impaired loans for three years after the debtor stops repaying which may provide disincentives for swift resolution. Further, the current tax law restricts the amount of provisions or losses that are tax deductible creating incentives for banks to under-provision. Moreover, limited creditor rights protection makes out of court restructurings for corporate loans unattractive. Finally, mortgage foreclosures and evictions carry social costs and legal challenges, reducing effective recovery values after expenses.

21. **With impaired loans likely to increase and restructuring becoming more pressing, several mitigating actions should be undertaken:**

- **Tightening oversight over credit risk management practices:** The newly amended Recommendation T, which provides guidance on retail lending, and proposed changes to Recommendation S, which provides guidance on mortgage lending, have abolished uniform DTI thresholds for banks and placed greater responsibility on bank boards for setting such thresholds and overseeing risk management. But the proposed changes also have appropriately tightened LTV and income requirements for FX loans.[4] Nonbank financial institutions' reporting to the credit bureau would assist banks in their underwriting decisions given the increase in lending by these institutions.

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[3] Provisioning covering two thirds of NPLs is generally considered prudent as per the European Banking Coordination Vienna Initiative's Report from the Working Group on NPLs.

[4] The amended Recommendation T was published in February 2013. Previously, Recommendation T established a maximum ratio of DTI at 50 – 65 percent and under the amended Recommendation T, banks will be required to pay special attention to loans that would bring the DTI for a given client above 40 or 50 percent (depending on income).

- **Increasing vigilance over restructuring practices:** Supervisors should tighten the definition of restructured loans and collect more granular data on them. Information should be collected on a monthly basis regarding performance, re-aging, sector composition, amount modified year to date, accruals, and cash revenues. Banks should also be required to disclose their restructuring activities under Pillar 3 requirements.
- **Increasing standardization and transparency of accounting practices:** While most banks' models for calculating incurred losses and associated provisions are sophisticated and follow international financial reporting standards (IFRS), there is room for aggressive accounting treatment, and thus there may be a risk that levels of provisions are too low or too high given the flexibility in determining the model assumptions. The practice of continuing to accrue income on impaired loans should be reviewed.
- **Improving the insolvency framework to preserve value and lower collection costs:** Poland still has a liquidation culture when it comes to insolvency though it is incrementally moving towards a system that encompasses rescue or rehabilitation. Creditors lack an effective voice in the insolvency process. There is no effective supervisory mechanism over insolvency cases. Creditors' rights can be enhanced by adopting an out-of-court code of conduct. The market for impaired mortgage loans is still incipient, and one way to increase efficiency is to facilitate the transfer of security rights in case of assignment of impaired loans from loan originators to the buyers of impaired loans.

III. FINANCIAL SECTOR OVERSIGHT

22. **Oversight of the financial sector is mainly the task of the KNF.** It is an integrated supervisor with oversight functions over the banking, insurance, pension fund, and securities sectors, as well as payment institutions, and is responsible for prudential supervision and enforcement as well as for competition, conduct of business, consumer protection, and development issues. The NBP performs financial stability analysis and data collection. The BFG manages Poland's deposit guarantee scheme.

A. Microprudential Supervision

23. **While prudential supervision has yielded good outcomes so far, impending changes in the regulatory landscape and the structure of the financial sector require a more risk-based and holistic approach to supervision (Figure 3).** Information from supervised institutions should include forward-looking analysis and aggregate information to build a complete bottom-up risk map of the financial system. In turn, this should feed regulatory changes and be integrated in systemic risk management and the overall policy approach to the financial sector.

Objectives, autonomy, powers and resources of the KNF

24. **KNF's limited legal powers, which are limited by the constitutional framework, have led it to rely to a large degree on non-legally binding "Recommendations" and**

“Letters”.[5] It runs significant reputational risk if some of these recommendations or letters were successfully challenged in court. To mitigate these risks, amendments to the Banking Act should be enacted to broaden the areas where the KNF can issue binding resolutions, particularly the powers to regulate permissible risks in bank’s activities.

25. **KNF’s independence needs to be strengthened further.** Having a majority of outside members on the KNF Commission compromises its operational independence and does not guarantee that all its actions are subordinated to the primary objective of safety and soundness of banks. Consideration should be given to modifying the composition of the commission and explicitly stating the primary objective of the KNF in the Financial Market Supervision Act. The prospective establishment of the Systemic Risk Board provides the opportunity to do so and to clearly delineate the respective agencies’ responsibilities and instruments.

26. **Commissioners are overburdened by work that in other jurisdictions is typically delegated to management, restricting the attention they can devote to high-level matters.** The KNF Commission should assess the accumulation of risks in the system, pay attention to the workings of the agency – by endorsing supervisory practices and methodologies – and provide strategic direction. It should receive frequent analyses of emerging risks in the financial system and approve regulations addressing those risks.

Banking supervision

27. **Building on recent progress in implementing EU Directives and BCP recommendations, regulatory gaps on corporate governance, accounting and external audit should be closed.**[6] Specifically, the KNF should obtain the powers to apply fit-and-proper criteria or remove a member of a bank’s supervisory board, verify the fitness and propriety of all members of the management board, and reject or rescind the appointment of an external auditor.

28. **Significant improvements have been observed in the frequency of inspections and onsite/offsite coordination.** For 2013, the KNF has planned 4 full-scope and 25 targeted inspections in commercial banks. These consist of 13 horizontal targeted inspections on seven specific topics and 12 targeted inspections in individual commercial banks. The inspections will cover 86 percent of total assets of commercial banks. The KNF has adopted the practice to inspect the largest commercial banks at least every two years and the others between three and four years.

29. **The Supervisory Review and Evaluation Process (SREP) assessment should be better integrated into the overall supervisory approach.** A full overhaul of the SREP is planned for 2014 to bring it into line with the EBA risk assessment templates and further integrate onsite examination outcomes. Bank level information obtained in the SREP

[5] Resolutions issued by the KNF, in the narrow set of fields defined in the Banking Act, are legally binding
[6] The February-March 2011 BCP assessment was published in August 2012, and is available here: http://www.imf.org/external/pubs/ft/scr/2012/cr12232.pdf.

assessment needs to be analyzed and fed into a bottom-up risk map that would form the basis for regulatory initiatives and a more systematic approach to prudential supervision. The Commission's role in this process is essential: it should approve the supervisory methodology and endorse the industry-wide outcomes of the SREP process and their use for supervisory actions and policies. KNF should also disclose its general supervisory philosophy, including features of the internal supervisory rating systems, the principles underpinning supervisory cycles and inspection frequency, impact assessments and resource allocation.

30. **Interaction with external auditors has become more common since 2011 and should be further expanded.** External auditors expressed concern about limited industry consultation, with the recently released rotation recommendations a case in point. They thought that the KNF had unrealistic expectations on the usefulness of audit work for prudential supervision. Auditors feel that they are being asked by the KNF to go beyond their mandate.

31. **KNF resource allocation must accommodate an expanding supervisory perimeter, new regulatory challenges, closer realignment to industry risks, and the need to minimize staff turnover.** The inclusion of SKOKs in KNF's perimeter of supervision and increase in international and European regulatory requirements have delayed the allocation of additional resources to the commercial banking sector.[7] Following higher start-up costs associated with the first comprehensive on-site inspections of SKOKs, which will be conducted in 2013, it is expected that resources allocated to cooperative banks and credit unions will be gradually decreased. Moreover, salary limits for a prolonged period of time have affected the KNF's ability to attract and retain talent. Frequent salary and benefits benchmarking against the banking industry should be done, and staff turnover rates analyzed. A clear career development path should also be established for KNF staff so that it becomes a more attractive employer.

Insurance supervision

32. **A recent assessment of the International Association of Insurance Supervisors (IAIS) Core Principles indicated high observance.** Out of the 28 Principles assessed, 14 principles were found to be fully observed, 13 largely observed, and only one partially observed (CP3 on Supervisory Authority). As was the case in the BCP assessment, the weakest areas found in the assessment dealt with KNF powers and the resources to exercise them. Moreover, the assessor found that KNF effectiveness would be enhanced by the addition of further staff directed toward insurance supervision, more independence in setting budgets, salaries and organizational structure, and some strengthening of legal protections of its personnel.

Savings and credit union supervision

[7] In terms of financial assets, the cooperative banks and SKOKs represent only 7 percent of the financial system.

33. **Important upcoming changes to the legal framework governing SKOKs will strengthen their supervisory framework and boost their statutory capital. SKOKs in Poland represent only 0.8 percent of total financial sector assets, but serve 2.6 million depositors and are experiencing robust growth**. The sector continues to consolidate as the number of SKOKs has fallen from 61 in 2010 to 55 in March 2013. The sector is increasingly dominated by the largest SKOK with assets of PLN 6.8 billion, and the five largest SKOKs hold two-thirds of sector assets. Although SKOKs represent a small portion of the financial sector, they are growing rapidly and their number and outreach could pose systemic risks if the ongoing consolidation process is not managed prudently.

34. **The financial condition of some SKOKs is weak.** Since 2009, the financial trends have been negative due to rising delinquency and operating expenses, falling interest income and the need for additional provisions. SKOKs with weak financial conditions should adopt capital rehabilitation plans that allow them to meet the solvency ratio in five years or less. SKOKs that show good trends and meet their capital goals should not be subject to supervisory penalties or administrative actions, even if they have not met the required 5 percent solvency ratio by January 2014 as currently envisaged. This ratio will be difficult to achieve since SKOKs have few sources for increasing capital.

35. **Critical legislation has just been adopted, but further amendments would be desirable.** The law covers: (i) enhanced KNF supervision tools; (ii) increased scope of information provided by SKOKs to KNF; (iii) BFG guarantee for SKOK deposits; (iv) regulation of the SKOKs' liquidity reserve; and (v) modifications to the existing resolution framework. In addition, the law should be amended or regulations drafted to: (i) eliminate the confusion between the roles of NASCU (which "controls") and KNF (which "supervises"); (ii) mandate a solvency ratio requirement of 8 percent, in line with international standards, and provide a reasonable transition period; (iii) include member shares as institutional capital only if they are available to absorb losses; and (iv) clarify the powers of KNF and NASCU as they relate to the stabilization fund. MOF should develop a comprehensive set of regulations, in consultation with KNF, NASCU, and the SKOKs, addressing: minimum licensing standards, liquidity, asset and liability management, investment, capital adequacy, borrowing, savings and shares, credit, delinquency, external and internal audits, supervision, governance, consumer protection, and realistic transitional provisions to ease the way forward for compliance.

36. **SKOKs should use a simplified version of the chart of accounts, accounting principles, and reporting formats required for banks**. An adequate transition period of 1-2 years should be given for training and making the changes needed to IT and accounting systems.

37. **KNF and MOF should promote communication with sector stakeholders to gain their support for implementation of changes**. New regulations developed by MOF and KNF should be put out for comments to SKOKs and NASCU. After a sufficient commenting period, comments received should be considered and revisions made as appropriate. Sufficient transition times should be given to prepare for the changes. KNF and MOF should develop and share with the sector a long-term plan for implementing regulatory and

supervisory changes. Training should be provided to SKOKs on the new regulations, forms, and requirements.

B. Macroprudential Policies and Framework

38. **The Polish authorities are developing a formal macroprudential framework, similar to those recently established elsewhere.** Legislation is being drafted to establish a Systemic Risk Board (SRB), which would be the macroprudential decision maker, responsible for systemic risk identification and analysis, empowered to request that other agencies take action to limit systemic risk, and empowered with certain tools to control or limit systemic risk. It will be important for the NBP to take a leading role in the SRB, which can help shield the SRB from political pressures, and ensure that macroprudential policy draws on NBP's expertise in the analysis of financial and macroeconomic developments. It is essential to safeguard the independence of the SRB and endow it with powers to make recommendations regarding the use of tools. Recommendations should be made public and coupled with an "act or explain" mechanism. The law should also require publication of the minutes of SRB's meetings, and establish SRB accountability.

39. **The authorities have been active in developing an analytical framework for systemic issues.** Efforts should continue in designing such an analytical framework and the SRB should build on the expertise of BGF, KNF, and NBP with the aim of producing a list of domestic systemically important financial institutions (D-SIFI's) and a set of risk indicators for these institutions.

40. **On the policy side, Polish authorities have been broadly effective in addressing cross-sectoral systemic risks.** The authorities took measures to address the rapid growth of FX mortgages and related systemic risks, and to manage the high leverage in the retail credit sector during a particular phase of the credit cycle. Other tools have been deployed to increase capital buffers for all banks.

41. **There is need for clarity on policy objectives and the involvement of the various prudential and safety net institutions.** The authorities need to set clear objectives that are separate from monetary and microprudential supervisory policy objectives. The SRB should use macroprudential policies to manage the quality of underwriting standards and avoid that its measures jeopardize underwriting quality. Conversely, the KNF should not use tools to manage the credit cycle, but focus on the safety and soundness of financial institutions. The SRB should identify and seek consensus on the policy approach to D-SIFIs, including the use of surcharges, additional supervisory tools, and resolution plans. A complete toolkit of instruments should be identified to pursue macroprudential objectives.

C. EU Dimension

42. **Poland's regulatory, supervisory, and resolution frameworks are strongly influenced by those of the EU, which are undergoing important changes.** Given that Poland's banking system is highly interconnected with the European financial system, arrangements that could strengthen the financial stability at the EU level and, at the same

time, represent financial stability interests of Poland (as host country) are highly desirable. When adopted, the CRD IV/CRR, and EU Directives on deposit guarantee schemes and on bank recovery and resolution will need to be transposed into Polish law and regulation. With minimum capital standards and risk weights determined by CRDIV/CRR, it will be important for the KNF to focus its supervision more intensively on banks' risk management practices to preserve the resilience of the banking system. In the area of macroprudential policy, one way to ensure measures taken by the Polish authorities are applied to EU branches operating in Poland is through the "reciprocity" principle agreed with EU institutions (e.g., ESRB).

43. **The development of the Single Supervisory Mechanisms (SSM) and Banking Union (BU) may influence the shape of the Polish banking sector.** More clarity is needed about the SSM arrangement, and other elements of the prospective BU for Poland to be able to make a full assessment of the implications of the SSM and BU and the benefits and costs of "opting-in". Under the SSM, home-host coordination will be replaced by that between the ECB and KNF, which has the potential to improve such cooperation, but at the same time risks downplaying Polish national concerns. As noted in the EU FSAP, it will be important to safeguard the cooperation between home and host authorities and acknowledge the concerns of host supervisors. Moreover, as not all home authorities relevant for Poland will be members of the SSM, strengthening of cross-border supervisory and crisis-management colleges remains essential.

44. **Opting in could have benefits in terms of influencing the design of information sharing and cooperation mechanisms within the SSM, and enhancing credibility.** Since Poland is bound by the accession treaty to join the euro zone at some point in the future, opting in at this early stage will give it some, albeit limited influence on the setup of the SSM and BU. An additional benefit would be better access to information and supervisory input on parent banks. From the point of view of investors, opting in could enhance the credibility of Poland as a member of the pan-European banking union, provided the SSM worked effectively.

45. **However, opting in does not appear to provide benefits in terms of liquidity and solvency support.** Poland is ahead of other prospective SSM members in building a strong, ex ante funded safety net and has a well-tested resolution culture which is being further strengthened. Given the current shape of the BU, opting in could mean transferring supervisory powers to the ECB without transferring corresponding responsibility for the stability of the national banking system, as access and contributions to a common fiscal safety net remain to be spelled out, as do arrangements for access to ECB liquidity.

IV. Crisis Management and Safety Nets

A. Overview

46. **The global financial crisis has prompted Poland to bolster its arrangements for crisis prevention, preparedness and management.** A Financial Stability Committee (FSC) was created. In addition, strong anti-crisis measures were taken. At the European Union level, the European Systemic Risk Board (ESRB) was set up, and a multi-national, multi-

agency MoU on cross-border cooperation was signed; in addition, an array of extraordinary monetary policy and other measures was adopted. Mirroring these developments, in Poland inter-agency cooperation agreements were concluded, and the NBP adopted a “confidence package” to alleviate liquidity pressures in domestic markets, allowing longer maturity liquidity and offering new foreign exchange refinancing options.

47. **Crisis prevention has taken on greater importance as awareness of the need to manage systemic risk and enhance ex-ante coordination increased.** The FSC coordinates the crisis efforts of financial sector agencies, and has coordinated work on a new bank resolution regime. Buffers have been strengthened throughout the financial system: international reserves increased, facilities with foreign central banks arranged, and prudential requirements tightened, including through mandatory profit retention. All safety net participants have created contingency plans, and have undertaken crisis simulations, including two joint exercises. The NBP has worked out the details of its emergency liquidity assistance. Poland has joined crisis management groups for a number of its larger banks. With respect to state solvency support, laws were passed in 2009-2010 specifying the conditions for Treasury support and recapitalization of banks. The FSC crisis management contingency plan specifies each institution’s responsibilities in case of a threat to financial stability.

B. Bank Resolution Framework

48. **The Polish financial authorities are in the process of adopting a modern bank resolution framework based on the Key Attributes for Effective Banking Resolution and the draft new EU Crisis Management Directive, and the FSAP has limited itself to a review of this draft framework.**[8] The draft BFG Act includes more flexible tools for, inter alia, starting resolution before a bank reaches full insolvency, allowing partial transfers of a bank’s balance sheet to other banks, [9] applying administrative vs. judicial powers, and deploying new debt write-down tools.

49. **Despite much progress in the draft BFG Act to incorporate new resolution tools, additional revisions would strengthen it and assure its effective design and implementation.** In terms of execution, the draft BFG Act refers to the use of “administrative powers” and “administrative courts” but the lack of elaboration or prioritization of these could result in procedures defaulting to the judicial system. These tools should also allow the immediate suspension of shareholder rights. Thus, the administrative tools, powers, and pertinent bodies should be given highest priority with detailed definition as to how they will operate.

50. **The draft BFG Act should eliminate the use of “open bank” assistance by BFG.** If a BFG loan instrument is considered it should only be explicitly part of a resolution

[8] A comprehensive World Bank TA to strengthen bank resolution has been ongoing for over a year.
[9] Via the use of the asset separation tool, sale of business tool, and/or bridge bank tool.

process that applies the least cost test; otherwise, such support should be provided by the MoF (solvency) or NBP (emergency liquidity) in systemic situations.

51. **The proposed BFG Act contains several quantitative and qualitative solvency-related indicators to trigger resolution, but some triggers should be added or modified.** A tier-1 capital deficit ratio should be added. Moreover, the "public interest" trigger is overly general and would easily be challenged legally. More apt, for systemic issues, would be specifying such trigger as always being directly linked to any development "having an adverse impact on financial stability."

52. **The authorities need the discretionary power to recast a bank's financial statements and reports according to adjustments deemed prudent.** Prior to resolution, KNF as the supervisor should invoke powers to demand (based on its examinations) that a bank reclassify its assets or adjust its risk weights with commensurate adjustments to capital and provisioning levels; and BFG should have the same powers after resolution has been invoked. The draft BFG Act (as well as the Banking Act) and any subsidiary regulations should make these powers explicit.

53. **The draft BFG Act should be explicit regarding the new creditor claims hierarchy required for resolution.** This is needed to clarify the seniority of BFG claims for contributions made to fill purchase-and-assumption balance sheet gaps when these do not entail any payments to insured depositors. In addition, adding explicit depositor preference would further strengthen the deposit guarantee scheme.

C. Deposit Insurance IADI Assessment

54. **Poland's deposit insurance system displayed a high degree of conformity with the BCBS-IADI Core Principles for Effective Deposit Insurance Systems.** The BFG has grown and developed over the years to become a critical component of Poland's financial system safety net and has many notable achievements. The BFG was established as a government legislated and administered agency in 1995 following a banking crisis, and since its creation has reimbursed depositors in 94 bank failures and provided financial assistance in 101 bank interventions. Membership is compulsory for all domestic banks (and foreign banks which are not already covered by their home country deposit insurance system) and coverage is limited to EUR 100,000 per depositor per bank. The BFG has seen its mandate expand over the years and is now responsible for collecting deposit insurance premiums; analyzing data on its member banks; reimbursing depositors; and providing financial assistance to member banks on a least cost basis. Depositor reimbursement systems are highly developed and capable of payouts well within the BFG's 20-working day target.

55. **Despite the many accomplishments of the BFG, there are some areas where deficiencies exist and/or enhancements could be made.** Overall governance arrangements for the BFG could be enhanced to better follow best international practices. The BFG is governed by a Management Board and its operations are overseen by an eight-member Council. Members of the Council include two representatives of the Polish Bankers Association (PBA), which creates the potential for conflicts of interest. It is recommended

that the representation of the PBA be removed and consideration be given to involving the PBA through arrangements such as an external advisory committee.

56. **The BFG has comprehensive and sufficient funding resources although the need for so many individual funds should be reviewed.** The BFG has in place numerous *ex-post* and *ex-ante* funds (e.g., for stability, the deposit guarantee, resolution, and for restructuring banks and cooperative banks). In a bank failure, e*x-post* funds are used first followed by the BFG's *ex-ante* funds, and if required, supplementary back-up funding from a number of sources (e.g., NBP, MOF).[10] Transfers among funds require a Council decision. While this arrangement is functional, it is complex and should be reviewed.

57. **The BFG should also re-assess its fund adequacy in light of EU-mandated coverage increases, the addition of SKOKs and the planned introduction of expanded resolution powers.** In 2007, the BFG's funds were sufficient to cover the payout of guaranteed deposits up to the 10th largest bank in Poland (reflecting an *ex-ante* coverage ratio of 2.72 percent of guaranteed deposits). As of 30 September 2012, the increase in the coverage limit lowered the coverage ratio to 1.87 percent of guaranteed deposits, leaving BFG *ex ante* funds sufficient to cover payouts only up to the 12th largest bank). The team supports BFG plans to raise fund adequacy by increasing the coverage ratio back to 2007 levels; and, by 2020 to the EC recommended ratio of 1.5 percent of eligible deposits.

58. **Although the BFG and those working on its behalf are provided with legal protection, the codes of conduct applied to the BFG and its employees have some gaps which need to be addressed.** Codes of conduct restricting employment in member institutions are only applied to the BFG Management Board but should be extended to all employees.

[10] The *ex-post* funds are used following a bank failure. Each bank sets aside a segregated fund made up of high quality securities which are used first in a depositor payout. If these funds prove insufficient to compensate all the insured depositors then the *ex-ante* funds of the BFG are used.

V. Development and Market Structure

59. **Maintaining financial stability while addressing new demands for financial services requires a shift away from bank-dominated financial intermediation.** Developing capital market instruments is essential to build a competitive and safer banking system more efficient at spreading risks and lengthening the maturity of financial savings. Reform in the pension system and in covered bond markets would be helpful.

A. Pension System

60. **On September 4, 2013, the Government announced plans to reform the Polish pension system**. These plans include: (i) the transfer of Government bonds held by Open Pension Funds (OFEs) to the State Social Insurance Institution (ZUS) and prohibiting of any further direct investment by OFEs in Government bonds;[11] (ii) the introduction of a clause making contributions to the second pillar voluntary, with the default option being non-participation; and (iii) the gradual transfer of OFE funds to ZUS over a ten-year period ahead of a contributor's retirement age.

61. **These changes represent a partial reversal of the 1999 pension reform**. The 1999 reform introduced a defined-contributions scheme based on a multi-pillar system: (i) a mandatory pay-as-you-go scheme based on notional defined contribution (NDC) accounts and run by ZUS ("first pillar"); (ii) a mandatory fully-funded defined contribution scheme run by OFEs ("second pillar"); and (iii) a voluntary private pension scheme ("third pillar"). The planned changes will result in a significant downsizing of the second pillar in terms of both assets and participants.

62. **The proposed changes seem to be motivated by the increase in public debt associated with financing the transition costs of the 1999 reforms.** The reforms that accompanied the 1999 pension reform did not include an explicit mechanism for financing the transitional deficit. Consequently, successive governments financed liabilities through debt rather than, e.g., privatization proceeds or expenditure cuts. Much of this debt was purchased by the OFEs.

63. **While the 1999 reform was positive overall, some adjustments were needed**. The shift from a defined-benefits to a defined-contribution system was the most important contribution to the long-term sustainability of the system – Poland is one of only five EU countries where spending on pensions is projected to decrease between 2010 and 2060. The introduction of the second pillar made explicit liabilities which would otherwise be implicit, yet real – this was an integral part of the package that made the move to a defined-contributions system acceptable, and it diversified the sources of pension benefits. The main

[11] OFEs will be obliged to transfer to the State Social Insurance Institution 51.5% of their net assets in the following sequence: government bonds, bonds issued by BGK for the Toll Motorways and National Road Fund, other securities guaranteed by the Treasury, cash, bank debt securities, and municipal bonds.

shortcoming of the 1999 reform appears to have been the failure to secure a sufficient stream of guaranteed non-debt revenues to finance the transition costs.

64. **The proposed changes to the pensions system raise two main risks for the development of capital markets which will need to be carefully managed or mitigated.** These risks may be compounded by perceptions of market operators: any substantial change in the pension system raises the risk of a loss of confidence, by creating a sense that the "rules of the game" can change at any time.

65. **First, the government will need to counteract the impact of the OFEs scaling down on the Polish capital market**. The OFEs have played an important role as long-term institutional investors to date. The proposed changes may cause market volatility, in particular if (i) the transfer of remaining assets to ZUS ten years prior to retirement implies a forced sale of stocks and private securities;; and/or (ii) Poland begins relying more on foreign investors to take up the potential extra supply of securities. In the medium-term, to counteract the OFEs' scaling down, Poland will need to continue its expansion as a regional financial center and bring in new domestic institutional investors and external investors.

66. **Second, the Government will need to develop alternative instruments and investors to mobilize long-term savings**. The introduction of the second pillar did not result in an increase in national savings (since OFE-managed resources were largely offset by the government sector's dissaving) but it made it possible to mobilize long-term capital. The proposed changes may substantially reduce the (already limited) ability to finance investments with long maturities, which would undermine investment and economic growth. The authorities should also make the process simpler for those who wish to stay in OFEs, since the opt-out default option creates a strong bias towards ZUS.

67. **To mitigate the medium-term impact on the financial sector the Government will also need to carefully manage two additional risks which could indirectly impact financial markets.** First the Government will need to carefully manage the fiscal space created by the reform (national debt is expected to be reduced by about 8.5 percent of GDP, to about 45 percent of GDP, with annual savings of 0.5 percent of GDP), building on its strong track record of fiscal management. Second, the authorities should take additional measures to ensure the adequacy and sustainability of pension benefits since the low replacement ratio remains the central risk faced by the Polish pension system.

B. Covered Bonds

68. **The Polish mortgage market has been spared the negative effects of the global financial crisis, yet significant risk factors and inefficiencies prevail.** The portfolio outstanding is just over EUR80 Billion (1.6 million loans), representing 32 percent of the banking loan book. More than half of the portfolio is in FX (primarily CHF), although FX originations have been negligible since 2011 (Figure 4). In the absence of long-term domestic financing options, mortgages are funded by deposits or interbank loans (mainly intragroup loans from foreign banks to Polish subsidiaries). The average LTV is over 80 percent, more than half of the loans have LTV over 100 percent, and more than 25 percent of the FX loans

have LTV over 130 percent. While weighted average NPLs are low at 2.6 percent (4 percent for PLN loans), there is a clear upward trend (Figure 5). The combination of multiple risk factors (e.g., FX and adjustable rate mortgages, inefficient loan transfer and foreclosure procedures, a 20 percent portfolio share of subsidized loans, low PLN portfolio seasoning, and consumer indebtedness) add to the risk profile of the mortgage portfolio.

69. **A number of recent regulatory initiatives are aimed at strengthening the sector.** The draft Recommendation S introduces explicit LTV limits and the requirement to match the currency of the borrower's income with the currency of the mortgage. Certain tax inefficiencies of loan sales to the mortgage banks have been recently resolved, and the electronic centralized re-registration mechanism is expected to be available in 2013.

70. **Domestic long-term funding sources are absent, and the system of the specialized mortgage banks has become largely irrelevant.** The two remaining mortgage banks have almost entirely switched to the commercial mortgage sector. Universal banks do not have access either to the mortgage covered bond (MCB) or the securitization funding channels and instead rely on short-term deposits for mortgage lending. In addition to creating maturity gaps in the banking system, the absence of a modern mortgage financing mechanism has contributed to the mortgage portfolio risks. Since the terms and conditions of mortgages from the universal banks can be more flexible,[12] mortgage banks have little chance of sizeable origination. The transfer of mortgage rights between creditors is inefficient due to issues in taxation, re-registration, nontransferability of the Banking Execution Title, and the requirement to obtain borrower consent to the transfer. The mortgage banks, therefore, do not have sufficient volumes of the conservative MCB-compliant mortgages.

71. **The universal banks should be allowed to issue MCBs which would be subject to the same terms and conditions as those issued by the mortgage banks**. The MCB framework should be modernized to include the latest features on prudent and efficient treatment of such challenges as asset encumbrance, potential fiscal liabilities, prudent loan eligibility criteria, robust cover asset monitor functionality, issuer licensing, and MCB integration in the bank insolvency framework.

72. **The legal and tax obstacles of mortgage rights transfer should be eliminated,**[13] **and a modern securitization framework should be established.** The draft securitization law will likely benefit from consultations with international legal and financial experts on the ongoing EU and US regulatory initiatives aimed at strengthening the quality of mortgage loans and the securitization instruments.[14]

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[12] Covered bonds, for example, impose market discipline on banks to originate high-quality eligible mortgages.

[13] Specific obstacles include imposition of VAT in a general case of mortgage loan transfer, e.g., between a lender and an SPV; inefficient tax treatment of mortgage loans sold at a discount; inefficient mortgage rights re-registration process; BTE non-transferability; requirement for a borrower's consent for the loan transfer; and requirement for only the specialized mortgage banks to be back-up servicers in case of a default of a covered bond issuer.

[14] The mortgage banks need not be abolished but could provide important services to smaller and lower rated originators, e.g., loan aggregation or provision of own balance sheet (without loan transfer) for the purposes of mortgage covered bond issuance.

73. **The MDM program may play a catalytic role in ensuring prudent lending practices and providing an eligible pool of mortgages for capital market transactions.** The loan parameters, origination, and servicing practices for MDM loans and borrower eligibility may need to be revised in line with the draft securitization framework, with introduction for example of fixed rate mortgages or loans with long interest rate reset periods.

74. **Draft Recommendation S would benefit from fine tuning.** First, risk factors should not be allowed to stack, e.g., for a given loan, maximum values of both DTI and LTV should not be allowed. Second, the decision to exclude DTI limits from the Recommendation should be reconsidered; at the very least there should be a standard methodology for calculation of this ratio as well as a prudent upper limit. Third, the use of credit risk insurance in connection with LTV limits needs to be clarified and stringent conditions applied to such insurance vis-à-vis related party transactions, pricing, and other regulatory treatment. Consideration should be given to applying Basel 2 and 3 to the mortgage insurance regulatory framework.

C. Insolvency and Creditor Rights—Follow-Up of 2008 ICR ROSC

75. **Despite improvements in the system of registration of security interests over collateral, further progress is necessary to address the remaining problems identified in the 2008 assessment**. Substantial progress seems to have been made in terms of digitalizing files and migrating to electronic databases. According to the Ministry of Justice, the current average time for proceedings in land registries has decreased to 0.6 months. The Land Registries and Mortgage Act of 2009 has been amended to introduce the "mortgage administrator" aimed at streamlining the process of registration for multiparty loans. No improvement seems to have been made, however, regarding the impediments to the system of securitization of mortgage loans identified in 2008.

76. **The system of enforcement of security and commercial claims remains one of the most important shortcomings in the Polish legal framework**. Although efforts have been made to increase the technical level and performance of bailiffs, the efficiency of their performance remains low. The regulation of the process of valuation and auction of collateral has not been amended yet. No measures have yet been adopted to improve the process of seizure of assets in debt enforcement proceedings either. The allegedly frequent use of delaying tactics in courts continues to be a problem.

77. **Credit referencing agencies have increased their coverage of the market, although the main shortcomings identified in the 2008 ICR ROSC have not been addressed**. The 2008 assessment referenced complaints of the system's users concerning the amount and the quality of the information. This has not changed, although there seems to be an increase in the percentage of debtors included in the databases. The current system has not changed the obstacles surrounding banking secrecy detected in the previous assessment; substantive amounts of relevant information included in public registers is still disconnected from the bureaus; and nonfinancial companies (e.g., utilities) can neither provide nor receive information from the current credit referencing systems.

78. **Corporate restructuring and out-of-court workouts are slowly becoming more commonplace in the banking sector, although the regulatory framework still offers limited support**. The legal environment lacks sufficient tax incentives to foster workout agreements and there is no code of conduct for Poland's financial sector concerning out-of-court solutions. The non-existence of an efficient formal insolvency procedure in the shadow of which out-of-court agreements can be negotiated constitutes another shortcoming of the legal environment. Improvement of the insolvency system would likely bring about an increased use of informal restructuring practices.

79. **In spite of positive legal reform, the insolvency system still does not serve the commercial and financial communities as well as it should.** In the area of corporate insolvency, the 2008 ICR ROSC concluded that the legislation was in need of urgent reform. Despite reforms having been implemented, the current system seems unable to achieve its main objectives and is generally perceived by stakeholders as value-destructive. The main causes seem to be:

- **Insolvency proceedings are opened too late, when there is little to rescue, in part due to the deficient design and implementation of the duty to file by company directors**. The duty to file by directors was rarely complied with in 2008 ICR ROSC, and the situation persists today. Full implementation of the rule will not be attained until the system is amended and designed in a coherent manner: (i) action to determine the liability of directors for breach of the duty to file should be assigned to the insolvency representative, not to creditors individually considered; (ii) the court competent to determine the liability ought to be the insolvency court, not an external court; and (iii) the scope of the liability of directors should be broadened to pose a credible threat and foster adequate corporate governance.
- **Excessive formality and rigidity cause the procedural structure to function in a manner that is slow and cumbersome**. Since 2008, no efficient actions have been taken to streamline the procedure. Legal requirements to file for insolvency are burdensome and strict, and many insolvency petitions are rejected due to minor formal deficiencies. Proceedings take too long, sometimes even years. One of the main problems of the procedural structure lies with the system of appeals against the list of creditors.
- **The system of rescue and reorganization of insolvent but viable businesses is deficient and therefore underused.** The vast majority of troubled businesses end in piecemeal liquidation. This can be due to the following shortcomings: (a) the new rehabilitation procedure included in the Insolvency Law as amended in 2009 is hardly ever used since it is accessible only to businesses in relatively good condition; (b) there continues to exist no specific regulation providing for a pre-packaged solution to the insolvency; and (c) as in 2008, there are doubts as to the adequacy of the current legal framework to allow for a post-commencement financing of the insolvent debtor.

80. **The institutional setting for the implementation of the insolvency system needs further improvements**. Although some progress has been made, judges continue to lack sufficient insolvency and commercial training. There is a general improvement in the system

of insolvency representatives, but an increase in their technical capabilities is still necessary. Adequate mechanisms for supervision and control of the profession are still to be implemented.

Table 1. Poland: Financial System Structure, 2000–12

	2000	2005	2008	2010	2012
Assets			**(In billions of PLN)**		
All financial institutions	488.4	834.1	1407.2	1664.7	1962.3
Commercial banks 3/	410.4	552.5	978.2	1088.1	1266.8
o/w majority foreign-owned	297.9	410.3	746.7	767.6	859.5
o/w majority government-owned	98.1	118.8	180.6	249.2	310.2
Cooperative banks	18.0	33.9	56.5	70.4	85.8
Credit unions 1/	1.2	5.4	9.4	14.1	16,3
Insurance companies	37.8	87.6	137.9	145.1	162.9
Pension funds	10.0	86.1	138.3	221.3	269.6
Brokerage houses 4/	3.9	6.6	8.6	9.2	9.4
Investment funds/companies 2/	6.9	61.4	73.9	121.8	151.5
Assets			**(In percent of total)**		
All financial institutions	100.0	100.0	100	100	100
Commercial banks 3/	84.1	66.3	68.4	63.8	64.6
o/w majority foreign-owned	61.0	49.2	53.1	46.1	43.8
o/w majority government-owned	20.0	14.3	11.8	13.7	15.8
Cooperative banks	3.7	4.1	5.4	5.8	4.4
Credit unions 1/	0.2	0.6	0.7	0.8	0.8
Insurance companies	7.7	10.5	9.8	8.7	8.3
Pension funds	2.1	10.3	9.8	13.3	13.7
Brokerage houses 4/	0.8	0.8	0.6	0.6	0.5
Investment funds/companies 2/	1.4	7.4	5.3	7.0	7.7
Number of institutions					
All financial institutions	1,056	872	888	897	895
Commercial banks 3/	73	61	70	70	70
o/w majority foreign-owned	46	50	60	61	61
o/w majority government-owned	7	4	4	4	4
Cooperative banks	680	588	579	576	573
Credit unions 1/	146	75	62	59	55
Insurance companies	67	68	66	63	61
Pension funds	21	15	14	14	14
Brokerage houses 4/	49	42	58	65	68
Investment funds/companies 2/	20	23	39	50	54
Memorandum items:					
Financial system assets (in billions of euros)	126.7	143.3	396.4	416.2	478.9
Financial system assets (in percent of GDP) 5/	65.6	85.6	110.3	117.6	123.8

Source: National Bank of Poland; KNF; GUS; and National Association of Credit Unions.
1/ Cedit unions—2012 data as of end-June 2012.
2/ The data on assets relate to assets of investment funds. The number of institutions is the number of investment companies managing the investment funds.
3/ The data refer to banks and branches of credit institutions.
4/ Number of brokerage houses includes both standalone brokerage houses as well as brokerage arms of banks (some of which are not separate legal entities).
5/ 2012 GDP—sum of nominal GDP for 4 quarters ending Q3 2012.

Table 2. Poland: Financial Soundness Indicators, 2006-12

(In percent)

	2006	2007	2008	2009	2010	2011	2012
Capital adequacy							
Regulatory capital to risk-weighted assets	13.2	12.0	11.2	13.3	13.9	13.1	14.8
Regulatory Tier I capital to risk-weighted assets	12.9	11.8	10.1	12.0	12.5	11.8	13.2
NPLs net of provisions to capital	11.6	11.4	8.3	13.8	11.5	11.6	13.0
Bank capital to Assets	7.8	8.0	7.5	8.1	8.2	7.8	8.7
Asset composition and quality							
NPLs to gross loans (nonfinancial sector)	7.4	5.2	4.4	7.9	8.8	8.2	8.9
Sectoral distribution of loans to nonfinancial sector							
Loans to households	56.7	59.3	62.0	65.3	68.3	67.1	65.8
Loans to nonfinancial corporations	43.0	40.3	37.6	34.3	31.2	32.3	33.6
Earnings and profitability							
Return on average assets (after-tax)	1.7	1.7	1.5	0.8	1.0	1.3	1.2
Return on average equity (after-tax) 1/	22.5	22.4	20.7	11.2	13.3	16.3	15.7
Interest margin to gross income	58.9	59.4	55.7	51.9	53.0	55.7	54.9
Noninterest expenses to gross income	69.6	68.7	58.4	58.5	56.0	54.7	54.5
Liquidity							
Liquid assets to total assets (liquid assets ratio)	20.1	17.1	17.0	20.3	20.8	19.5	21.0
Liquid assets to total short-term liabilities	28.1	24.2	25.3	29.8	31.2	28.8	31.4
Sensitivity to market risk							
Net open positions in FX to capital 1/	-0.1	0.6	0.0	2.7	0.3	-0.3	0.1

Sources: National Bank of Poland; and

1/ Data for domestic banking sector.

Figure 1. Banking System Selected Indicators

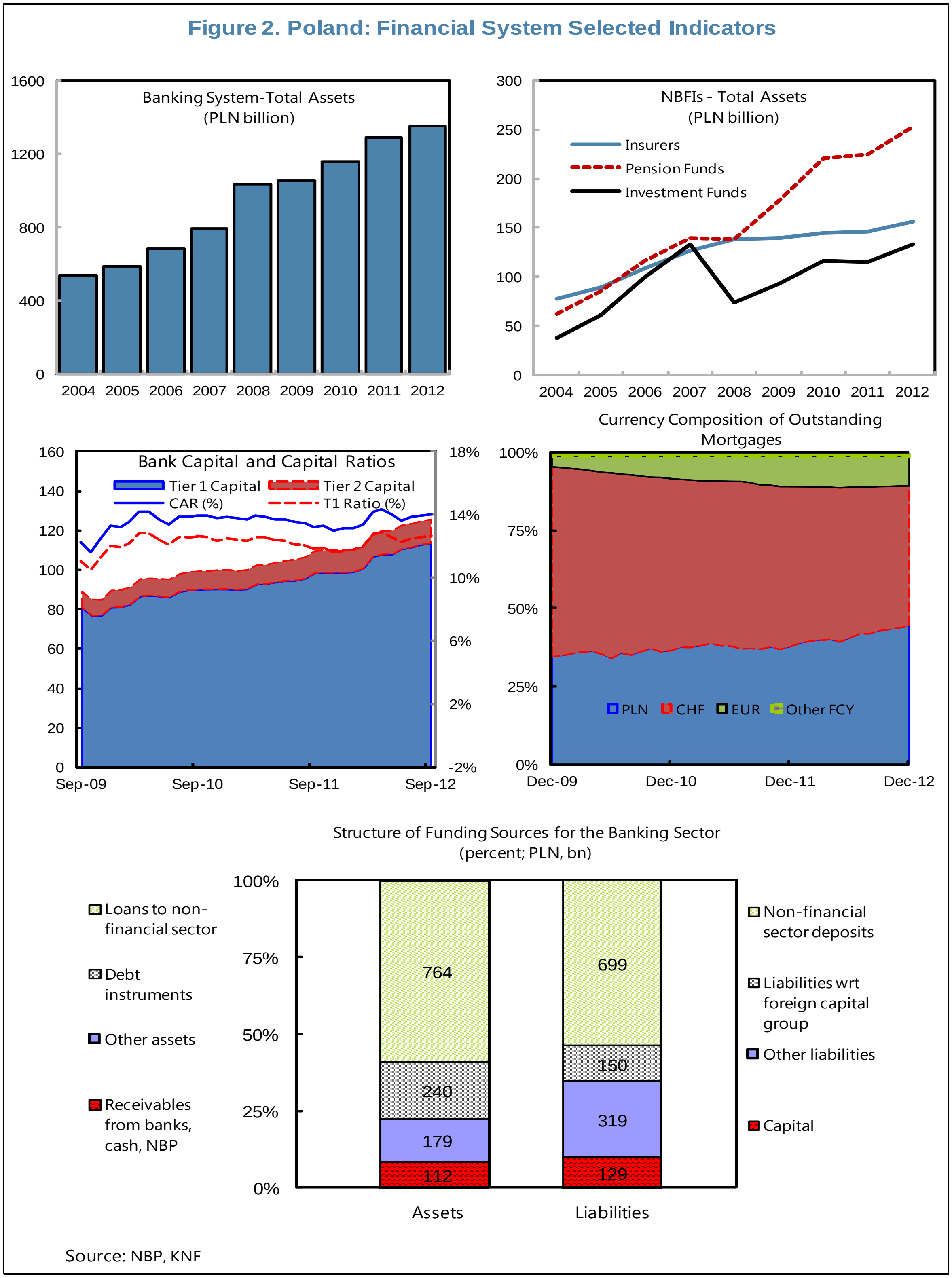
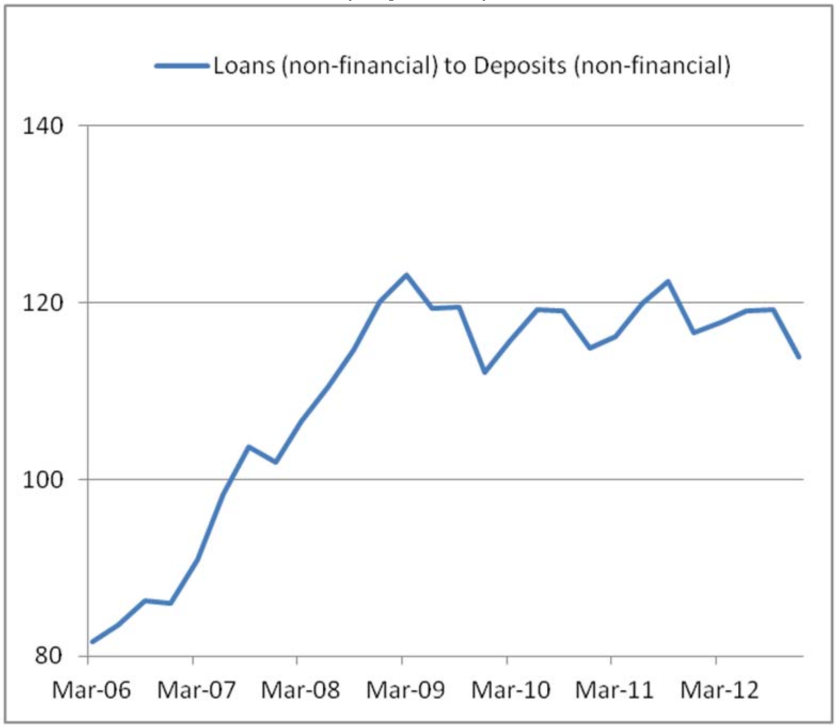


Figure 2. Poland: Loan to Deposit Ratio

(In percent)



Source: National Bank of Poland; and IMF staff calculations.

Figure 3. Poland: Developing an Integrated Approach for the KNF

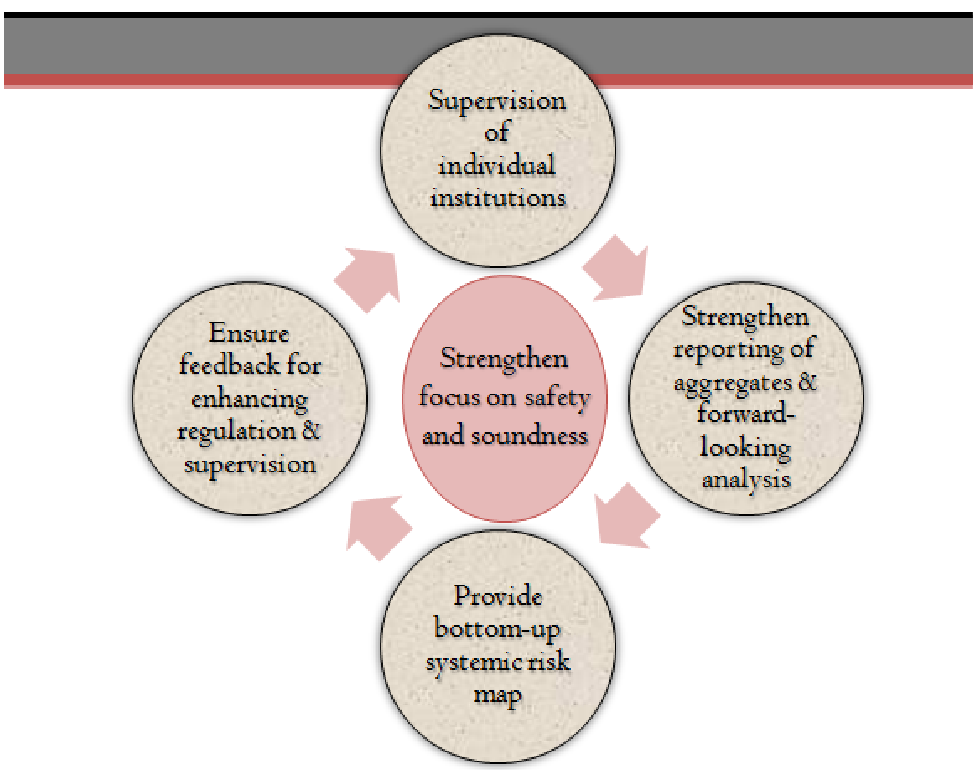


Figure 4. Poland: Mortgage Portfolio Dynamics 2009-12 (PLN million)

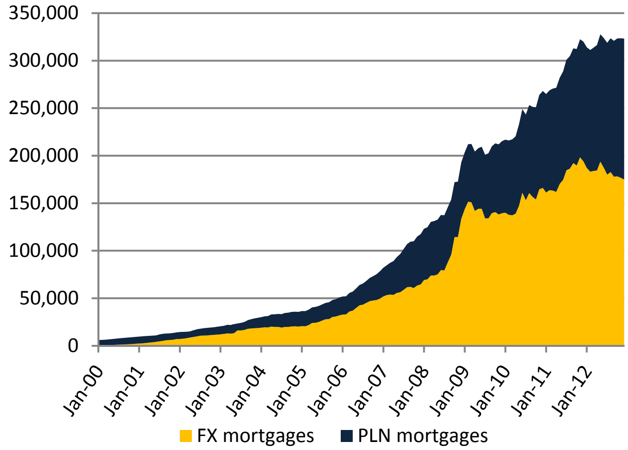
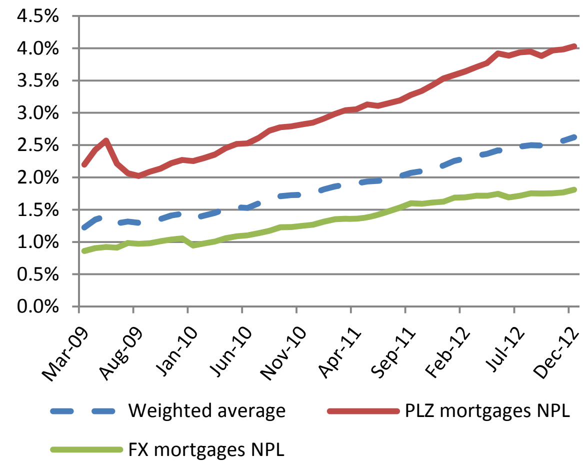


Figure 5. Poland: Mortgage NPL Dynamics 2009-12 (in percent)



Source: KNF.