Report on the optimal structure of the Polish banking system in the mid-term

Warsaw, 31 October 2012
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Introduction

The purpose of this report is to present the recent debate about the proposed transformation of the structure of the Polish banking sector by way of increasing the share of locally controlled banks in the assets of the banking sector. Such proposals have been put forth in articles published in the public media and subsequently in a Capital Strategy report (hereinafter report of 24 February 2012).

This report expands on the report of 24 February 2012.

This report was prepared by Stefan Kawalec and Marcin Gozdek, making use of analyses made by Jakub Blatkiewicz, Katarzyna Błazuk, Kamil Kamiński and Agata Miskowiec.

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2 Capital Strategy, Analiza możliwości podjęcia przez polskie instytucje państwowe działań prowadzących do zwiększenia udziału banków kontrolowanych lokalnie w aktywach sektora bankowego (Analysis of possibility to undertake by Polish state bodies actions aimed towards increasing the share of locally controlled banks in the assets of the Polish banking sector), Warsaw, 24 February 2012, authors: Stefan Kawalec, Marcin Gozdek and Agata Miškowiec.
Summary

Chapter I – Mandate of the state to influence the structure of the banking sector

National regulatory authorities have a strong mandate to influence the banking sector structure. In fact, in contemporary conditions, the functioning of the sector is possible due to the support of the state which bears the associated fiscal risk.

i. The contemporary banking sector uses support through public safety guarantees:
   - The central bank guarantees banks’ access to emergency financial liquidity.
   - The state deposit guarantee scheme protects banks against outbreaks of panic.
   - The policy consistently pursued for several dozen years by economically developed countries does not allow for the bankruptcy of banks considered to be “systemically important”.

ii. Without those public safety guarantees, the banking system would have been unable to grow to its contemporary size and operate at the existing ratio of equity to assets, which is currently 10-20 times higher than when the banks did not benefit from public support.

iii. Foreign parent banks do not guarantee the pay-out of deposits collected by their Polish subsidiaries. These deposits are insured by the Banking Guarantee Fund (BFG) and Polish taxpayers are responsible for their payment.

iv. State guarantees for the banking sector are not illusory. In the past several dozen years, taxpayers in many countries, including the most developed ones, have on many occasions paid a very high cost of bailing out banks. An extreme case is that of Ireland which until recently had very low levels of public debt. As a result of the 2008 banking crisis, the country was brought to the verge of bankruptcy.

v. Considering the importance of the efficient operation of the banking sector to the economy and the fiscal risk related to the responsibility of the state for the stability of banks, it is obvious that public authorities can and should take measures in order to shape the size and structure of the banking sector so as to ensure that:
   - the potential fiscal liabilities necessary to ensure the stability of banks are bearable for the state;
   - the relationship between the capacity of the banking sector to finance the economy and fiscal risk is as advantageous as possible.

Chapter II – Ownership structure of the Polish banking sector compared to other EU countries

Domination of foreign controlled banks in the Polish banking sector is atypical of a large European economy.

i. More than 2/3 of Polish banking sector assets are owned by foreign banking groups. This structure is typical of small European economies. However, Poland no longer falls within
this category. Today, Poland ranks #7-8 in the EU in terms of GDP size and is likely to become the EU’s sixth biggest economy in 10-15 years. In all large EU economies but Poland, the banking sector is dominated by banks whose decision-making centers are local.

ii. The existing structure of the Polish banking system is not the result of spontaneous market processes but rather of a privatization policy geared towards the acquisition of credible foreign strategic investors. Those strategic investors contributed to the modernization and development of the banking system and had a positive impact on the growth of the Polish economy, but today local banks no longer need management control by foreign institutions.

Chapter III. Consequences of the domination of the Polish banking sector by foreign controlled banks

The excessive share of foreign controlled banks in Poland is not beneficial to the Polish economy and presents an important risk factor.

i. A bank which is part of an international banking group and pursues its business on the Polish market is guided not only by an evaluation of the situation and outlook of the Polish economy and its own financial situation, but also the condition of the entire banking group. In consequence, problems in the economy of the home country of the group or financial difficulties of the group could seriously interfere with the performance of the subsidiary bank’s financial intermediary function in Poland. The dominance of foreign controlled banks interferes with the adequate performance of the banking sector’s financial intermediary function and contributes to the pro-cyclicality of the credit policy. As a result, in the case of a crisis on foreign markets, lending to Polish companies may be curtailed based on the decisions of foreign parent bank companies irrespective of the situation of the Polish economy (which is what happened in 2009-2010).

ii. The dominance of foreign-controlled banks in the Polish banking sector creates a risk of restraining the financing to strategic sectors as a result of political decisions outside of Poland.

iii. The dominance of foreign controlled banks in the Polish banking sector is an obstacle to the stable financing of the public debt and, in the case of turbulences in the global economy, may become a source of economic instability.

iv. If, in the situation of domination of foreign controlled banks in Poland, the European Union adopts the principle of “maximum harmonization” of supervisory norms, Polish banking supervision will be deprived of the power to take effective action and regulators will have limited possibilities of stabilizing the economy with macro-prudential policy tools.
Chapter IV. Possibilities of neutralizing the negative consequences of the dominance of foreign controlled banks through national regulations and banking supervision measures

National regulations and supervisors’ actions cannot fully neutralize the risk resulting from the domination of foreign controlled banks.

i. In the current legal system, the Polish Financial Supervision Authority (KNF) has the instruments and competences necessary to monitor and control liquidity and the minimum capital requirement and to prevent illegal cash flows between banks and their parent companies.

ii. KNF is unable to prevent a potential credit crunch in Poland caused by banks owned by foreign banking groups aiming to improve capital ratios at the group level.

iii. If the European Union implements the principle of maximum harmonization of supervisory norms, the KNF will be deprived of its existing instruments which are needed to mitigate some of the negative implications of the dependence of Polish banks on foreign banking groups.

iv. Regulatory policy and the National Bank of Poland (NBP) bill issue policy may impact the amount of investment in Treasury bonds maintained by banks. However, measures taken by regulators and the NBP cannot prevent a sharp reduction in Polish sovereign risk limits caused by foreign headquarters of banks present in Poland.

Chapter V. Alternatives to foreign control of banks

A dispersed private ownership structure can become an accepted alternative to the foreign control of banks, whereas an increase of state direct or indirect control on banks is not desirable.

i. Dispersed shareholding is the dominant form of ownership in large private banks in Europe and world-wide. In practice, it is the only form of ultimate control of large privately owned banks that is broadly approved by regulators.

ii. For the bank decision-making center to be located in the bank’s home country, it is not necessary that the majority of the shares be held by local shareholders. This is demonstrated by the example of large European banks with dispersed shareholding, where despite the fact that the majority of shares are held by foreign investors, national domiciliation of the decision-making center presents no doubts.

iii. A bank with dispersed shareholding presents different challenges for supervisors than a bank controlled by a strategic investor. If privately owned banks with decision-making centers in Poland are to play an important role in the financial system in Poland as in other big EU economies, then one must accept the model of a bank with dispersed
private shareholding and develop a supervision culture and the tools necessary for supervising this kind of ownership.

iv. The stability of a dispersed shareholding structure can be ensured by introducing a statutory provision limiting the voting rights of a single shareholder, leaving the Polish Financial Supervision Authority (KNF) the right to decide in reasonable cases to waive the provision limiting the percentage of votes allowed for a single shareholder of a bank for the duration of a specific general shareholder meeting.

v. The possibility that politicians could influence the management of a bank creates serious risk. Therefore, the model of a bank controlled by the State Treasury cannot be a viable alternative replacing the model of a bank controlled by a foreign banking group.

**Chapter VI. The target model of the banking system supporting long-term economic growth**

1. **The core function of the national banking sector should be collecting local deposits and lending to local companies and households rather than intermediation in international capital transfers.**

   i. The experience of the global financial crisis, particularly what happened in the Eurozone economies and Baltic states, confirms the thesis that the business model based on financing a country’s lending activity (especially consumer loans and mortgage) with the inflow of foreign credit is dangerous to macro-economic stability.

   ii. The core function of the national banking sector should be collecting local deposits and lending to local companies and households rather than intermediation in international capital transfers. International capital transfers should generally take place in a manner other than through the balance sheets of local banks. This will mitigate the risk of consumer and housing booms financed by loans, which undermine the competitiveness of the economy, pose a threat to the solvency of banks, and create direct fiscal risk.

2. **Loans to the non-government sector as a percentage of GDP should be no more than 100%.**

   The expansion of the banking sector is accompanied by growing fiscal risk related to the obligation of ensuring bank stability while the expansion of the banking sector above a certain size has a negative impact on economic growth. Loans to the non-government sector as a percentage of GDP exceeding 70% should be a warning sign for the regulatory authorities and its approaching 100% should trigger very determined systemic measures using macroeconomic and macroprudential instruments and institutional solutions necessary to prevent the further growth of loans as a percentage of GDP.
3. **The loans to deposit ratio should be under 100%**

Loans from local banks should be financed with local deposits; hence, the loans/deposits ratio should be under 100%.

4. **Households should only be credited by local banks and in the local currency**

FX loans for households on a large scale create a very high macroeconomic risk and undermine the effectiveness of monetary policy. Companies should be able to take out loans both domestically and internationally, but the level and structure of their debt should be monitored.

5. **Investment banking should be separated from deposit-taking and lending operations**

It is common knowledge that the elimination of the separation between deposit-taking and lending operations on the one hand and investment banking on the other hand in the USA by way of the final repeal of the 1933 Glass-Steagall Act in 1999 contributed to the outbreak of the financial crisis less than 10 years later. Nowadays, the USA, the UK and the EU are implementing, drafting or discussing solutions which would restore some form of separation of these activities in order to prevent the use of deposits guaranteed by the state in risky speculative operations.

6. **Proposed ownership structure of banks in 10 year perspective**

<table>
<thead>
<tr>
<th>Group of banks</th>
<th>Share in assets of the banking sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Now</td>
</tr>
<tr>
<td>Subsidiaries of foreign banking groups</td>
<td>69%</td>
</tr>
<tr>
<td>Banks directly or indirectly controlled by the State Treasury (currently: BGK, PKO BP, BOŚ and Bank Pocztowy)*</td>
<td>20%</td>
</tr>
<tr>
<td>Banks with a dispersed shareholding structure controlled by institutional investors and protected from take-over by a strategic investor through special statutory provisions</td>
<td>0%</td>
</tr>
<tr>
<td>Other banks controlled by private investors</td>
<td>5%</td>
</tr>
<tr>
<td>Co-operative banks</td>
<td>6%</td>
</tr>
</tbody>
</table>

* The increase of the share of this group of banks results from the organic growth of existing institutions.

7. **Restrictions on concentration**

In order to limit the fiscal risk generated by the excessive concentration in the banking sector and the existence of financial institutions which are “too big to fail,” regulators should not allow the largest banks to increase their market share in the Polish banking sector through acquisitions. We propose implementing regulations similar to those in the United States, which
prohibit an increase of the deposit market share above 10% through mergers (while allowing for organic growth above that limit).

Chapter VII. Possible scenarios of transforming a bank which is a subsidiary of a foreign banking group into a locally controlled bank

Different options are possible to transform a bank owned by a foreign banking group into a locally controlled bank with a dispersed ownership structure:

i. If regulators’ expectations are clearly stated, the transformation can be managed by an existing strategic investor which would sell its stake on the Warsaw Stock Exchange where shares would be bought by investors not allowed by the regulators to exceed the threshold of 10% of shares.

ii. The transformation can be done through the acquisition of a controlling stake by an investor or group of investors together with the buyer’s guarantee that the acquired bank will be transformed into a stable locally controlled bank among others by way of introducing a provision of the bank’s statutes restricting the maximum number of votes of a single shareholder (or group of related shareholders) to 10% of votes at a general meeting. The restriction may be waived for a specific period of time for the investor transforming the bank into a locally controlled bank.

iii. The transformation can be done by another local bank (Transforming Bank) which would buy the stake of the exiting strategic investor and would guarantee that, after the transaction and the merger, the merged bank would take the form of a locally controlled bank with dispersed shareholding, among others, by way of introducing the above restriction on the maximum number of votes of a single shareholder.

iv. The transformation can be done by public entity (Bridge Vehicle), which would take over the bank from the existing strategic investor and would subsequently sell the bank in a dispersed model following the amendment of the statutes restricting the possibility of shareholding concentration.

Chapter VIII. Scenario of “domesticating” a bank through dispersed private capital

Sample scenario of a transformation consists of the acquisition of a bank by a group of investors (Syndicate) composed of one or more lead investors (Lead Investors) and portfolio investors (Portfolio Investors).

i. The Lead Investors act as representatives of the Syndicate running the due diligence of the bank to be acquired, conducting negotiations with the seller and making arrangements with the regulatory authorities.
ii. After the acquisition of the bank, the Syndicate amends the Statute in order to restrict the possibility of shareholding concentration.

iii. The Lead Investors maintain their stake in the bank for a limited period of time (3-5 years), whereas the Portfolio Investors are allowed to sell their shares on the stock market from the beginning.

iv. Lead Investors can be considered private equity together with the local institutional investor.

Chapter IX. Problem of replacing financing provided by the exiting strategic investor

The high level of dependence of some banks on credit from their parent banks creates risk on the level of each bank and the economy as a whole. Regulators should strive to ensure that this business model gradually disappears. The exit of a strategic investor could be considered as an opportunity for the accelerated improvement of unsound balance-sheet relations.

i. Investors buying a stake from the strategic investor should, in co-ordination with the KNF, decide with the exiting strategic investor about the path of withdrawing the debt financing provided by this investor.

ii. Staggering the withdrawal of financing by the exiting strategic investor over a period of several years would allow the bank to restructure its balance sheet by reducing the growth rate of assets and more actively growing the deposit base, thus preventing a gap in liabilities or a reduction in the size of the gap.

iii. Restructuring the balance sheet too rapidly might cause serious tensions and deposit wars in the banking sector. Therefore, where financing provided by the exiting strategic investor is being withdrawn, it is advisable to have the NBP support the planned restructuring of the bank’s balance sheet by way of replacing part of the financing being withdrawn with the NBP’s refinancing credit secured with the loan portfolio. Analogously, the NBP should also be ready to offer FX swap lines, helping the bank to finance the existing FX loan portfolio with PLN deposits (including a replacement of the swap lines being withdrawn by the exiting strategic investor) or provide access to such swap lines on non-restrictive terms.

Chapter X. Evaluation of the costs and benefits of an alternative model of buying out Polish subsidiaries of foreign banks through investment by large companies in which the State Treasury holds a significant stake

i. The biggest Polish companies controlled by the State Treasury in non-financial sectors such as KGHM (copper mining), PGE, Tauron, Enea and Energa (all four are in the electricity generation and distribution sector), PKN Orlen (oil refining and retailing), and
PGNiG (*natural gas distribution & gas and oil exploration*) have substantial capital and financial resources. However, they face serious strategic challenges in their core business and do not have the know-how necessary to evaluate the prospects of investments in the financial sector or to play the role of an active investor accepting responsibility for the management of a bank. Therefore, in our opinion, it would be unwise to see these companies either as potential strategic investors or even as investors acquiring significant stakes as a long-term investment. Those companies could, however, act as portfolio investors acquiring significant stakes, even of substantial value. Considering such investments to be portfolio investments would enable them to temporarily invest cash to be used in the future (after the sale of the acquired stake) to implement their own investment programs.

ii. Participation of PKO BP (*banking*) in the “domestication” must be considered unadvisable. The acquisition of banks by PKO BP would increase concentration and systemic risk in the banking sector and should not be allowed by the regulators.

iii. PZU (*insurance*) is the only company controlled by the State Treasury which could largely engage in the “domestication” of banks by acting as a lead investor in the transformation of a bank owned by a foreign banking group into a locally controlled bank. PZU is capable of exercising professional owner supervision over a bank using its managers with experience in banking or, if necessary, hiring adequate human resources. In addition, PZU has the financial capacity necessary to support a bank under its control in the case of an emergency. The participation of PZU in the “domestication” of a bank should be combined with the development of a mid-term strategy for such an investment as well as corporate governance rules to prevent PZU’s investment from making the “domesticated” bank from being forever controlled by the State Treasury.

**Chapter XI. Is there a need for a bridge vehicle using public funding to “domesticate” banks?**

The domestication of banks should involve private capital, without constructing a “bridge vehicle” which would use public funds for buying out the banks from foreign strategic investors.

i. The creation of a “bridge vehicle”, which would use public funding to buy out banks from foreign strategic investors exiting Poland and subsequently sell acquired banks to private investors on the stock market, would theoretically fasten and facilitate the process of banks’ domestication.

ii. On the other hand, the use of a public Bridge Vehicle involves serious risks:
   a) Risk of a loss on the investment of the Bridge Vehicle, which could in fact mean using Polish public funding to support a strategic investor exiting Poland.
   b) The risk that, against original intentions, investment by the Bridge Vehicle could lead
to the long-term consolidation of state control over banks.
c) Risk involved in politicization of control over banks.

iii. In the current legal system, there are no public institutions which could be used as a Bridge Vehicle. Therefore, the creation of a Bridge Vehicle would require legislative amendments.

iv. In light of the risk of consolidating state control and politicizing the management of banks, it is recommended that bank “domestication” is carried out without the use of a Bridge Vehicle based on public funding.

Chapter XII. Measures of State bodies necessary to support the “domestication” of banks

The government and regulators should decide on a clear strategy for the transformation of the structure of the Polish banking sector and act together to implement it.

i. There is an urgent need to present an official diagnosis of systemic risk and to define a strategy of transformation of the structure of the Polish banking sector. The official diagnosis could be presented by the Systemic Risk Board and, before it is established, the Financial Stability Committee or possibly the NBP. On this basis, the government should define a strategy for the transformation of the structure of the banking system.

ii. The position of the Polish authorities should be clarified and reasoned to EU institutions and member states.

iii. The actions of the Polish authorities towards existing and potential investors and European institutions as well as necessary legislative changes should be proposed and planned.

iv. The Polish government should oppose the adoption of an EU directive introducing the maximum harmonization of supervisory norms which would significantly restrict the powers of Polish banking supervision over banks which are subsidiaries of European banking groups.

v. In order to enhance the effectiveness of control over ownership transformation in the banking sector, a legislative amendment should authorize the Polish Financial Supervision Authority (KNF) to approve the acquisitions of significant stakes, replacing the existing authorization to file an objection against such transactions.

vi. The Polish government should demand that the European Commission, which is the guardian of the rules of competition, respect the rule whereby banks which have used government aid should sell available foreign assets, in particular their operations in Poland.

vii. The strategy of the transformation of the structure of the Polish banking sector should aim towards an increase in the share of locally controlled banks.

viii. The strategy should imply that the process of increasing the share of locally controlled
banks will obey the rules of competition. More precisely:

a) Foreign investors shall not be discriminated against.

b) Public funds should not be involved in the financing of bank takeovers.

c) There shall not be any possibility of the government influencing the credit policy of a bank.

ix. In the case of the withdrawal of strategic investors from Poland:

a) The preferred solution should be to sell out the shares on the stock exchange and to introduce a statutory limit of voting rights per shareholder.

b) An alternative solution could be to sell the shares to an investor or group of investors, who undertake the transformation of the bank to a bank with dispersed shareholding, by way of introducing the limit of voting rights per shareholder mentioned above.

x. The Polish regulatory authorities should oppose the takeover of banks in Poland by strategic investors whose control of banks could create risks to the stability of a bank or could interfere with the performance of the bank’s core financial intermediary function. In particular, the regulatory authorities should not approve bank takeovers by foreign banking groups in cases where the buyer has been recently recapitalized with the use of public funds, the buyer has a negative rating outlook, or the buyer’s home country has a negative rating outlook.

Chapter XIII. Analysis of the consistency of the proposed solutions with European regulations

The pursuit of the aspiration to increase the share of locally controlled banks will respect the fundamental principles of European law, in particular:

i. It will not discriminate against foreign investors as compared to domestic investors. (The criterion of local control is not a majority stake held by domestic investors, but that the bank is not controlled by any external entity and its actual decision-making center is in the management board and the local head office. So, foreign investors may even hold a majority stake in a bank which is considered locally controlled.) Hence, Article 18 of the Treaty on the Functioning of the European Union, which provides that any discrimination on the grounds of nationality shall be prohibited, will not be violated.

ii. It will not involve the investment of public funding in the acquisition of banks (hence, the state aid provisions within the meaning of Article 107 of the Treaty on the Functioning of the European Union will not apply), with the exception of a potential temporary provision of liquidity to a bank where the existing owner withdraws foreign financing. The liquidity
support instrument is broadly used by central banks around the world (not only in Europe) and, if so required by the situation of a bank, accepted by European legal regimes.

iii. It will not be used to enable the government to exert influence on the directions of the credit policy of banks.

Chapter XIV. New context of the proposed Banking Union.

The strategy of Poland towards the Banking Union should specifically contain two components:

a) Opposition to measures which could potentially restrict the powers of Polish banking supervision and hinder the application of macro-prudential policy.

b) A consistent pursuit of the strategy of “domesticating” banks so as to significantly increase the share of locally controlled banks in the assets of the banking sector.
I. Mandate of the state to influence the structure of the banking sector

The contemporary banking sector uses support through public safety guarantees:

- The Central bank guarantees banks’ access to emergency financial liquidity.
- The state deposit guarantee scheme protects banks against panic outbreaks.
- The policy that has been consistently pursued for several dozen years by economically developed countries does not allow for the bankruptcy of banks considered “systemically important”.

Without these public safety guarantees, the banking system would have been unable to grow to its contemporary size and operate at the existing ratio of equity to assets. In the 19th century USA, where there was no such public support for banks, the ratio of equity to assets in banks was about 40%. Nowadays in large European banks, the ratio is 10-20 times lower and sometimes even less than 2 percent. The Third Basel Capital Accord provides for a minimum ratio of equity to assets at 3 percent.

Banks operating in Poland as subsidiaries of foreign banking groups collect deposits which are insured by the Banking Guarantee Fund and, consequently, the Polish taxpayer is responsible for their pay-out. At the same time, foreign parent banks do not guarantee the pay-out of deposits collected by subsidiary banks. Wojciech Kwaśniak wrote in 2007: “Polish banking supervision has in recent years asked all banks which are subsidiaries of foreign investors: is the holding entity responsible for deposits placed with the bank under the regulations of the home country of the holding entity; did the holding entity undertake to provide such guarantees under an agreement signed with the subsidiary bank; did the holding entity undertake to provide such guarantees under a unilateral declaration? The response given by all banks, both in the EU and outside the EU, was negative.”

Formal and informal guarantees of the state for the banking sector are not illusory. In the past several dozen years, taxpayers in many countries, including the most developed countries, have on many occasions paid a very high cost of bailing out banks. An extreme case is that of Ireland which until recently had a very low public debt. As a result of the banking crisis which broke out in 2008, the ratio of public debt to GDP in Ireland rose from 25 percent in 2007 to 95 percent in 2010 and the country found itself on the verge of bankruptcy (the direct cost of recapitalising banks reached 36 percent of GDP).

Considering the importance of the efficient operation of the banking sector to the economy and
the fiscal risk related to the responsibility of the state for the stability of banks, it is obvious that public authorities can and should take measures in order to shape the size and structure of the banking sector so as to ensure that:

1) the potential fiscal liabilities necessary to ensure the stability of banks are bearable for the state;

2) the relationship between the capacity of the banking sector to finance the economy and fiscal risk is as advantageous as possible.

II. Ownership structure of the Polish banking sector compared to other EU countries

The share of banks controlled by foreign banking groups (hereinafter “foreign controlled banks”) in the banking systems of European Union countries is strongly correlated with the size of the economy as measured by the Gross Domestic Product (GDP). In general, in the biggest EU economies, the dominant share of banks’ decision-making centres are local. In small economies, a dominant share of banks are foreign controlled. Figure 1 presents the share of foreign controlled banks in the assets of the 10 biggest banks in EU member states shown in order of GDP, which clearly shows that Poland is a large European economy whose banking sector has a structure typical of small European economies.

The existing structure of the Polish banking system is not a result of spontaneous market processes but rather the result of a privatization policy geared towards the acquisition of credible foreign strategic investors. In the early stage of transition, Poland did not have the competencies necessary to manage banks in a market economy. It also lacked local investors with capital who were in a position to become competent and credible shareholders to control banks. Therefore, the privatization process aimed to acquire credible foreign strategic investors capable of providing banks with capital support, adequate management control, and know-how transfer. Their emergence in the 1990s contributed to the modernisation and development of the banking system and had a positive impact on the growth of the Polish economy.

Today, after more than 20 years of transition, the Polish financial market is sufficiently developed and no longer needs to rely on foreign institutions for management solutions. Operational and technological solutions applied in banks in Poland are on par with the best in other Western countries. Many local managers have the education and practical experience necessary to manage banks. There is a large group of professional institutional investors, mainly pension funds and investment fund companies, which have sizeable capital and management teams capable of professional expertise and participation in a professional system of owner supervision. In addition, there is a strong and relatively competent supervisory infrastructure.
At the same time, after the transition period, Poland is no longer a small European economy. Today, Poland ranks #7-8 in the EU by size and is likely to be the EU’s sixth biggest economy in 10-15 years, which corresponds to Poland’s position in Europe by population. The share of foreign controlled banks in Poland is several times higher than in other large European countries.

III. Consequences of domination of the Polish banking sector by foreign controlled banks

This section discusses the following consequences of the domination of the Polish banking sector by foreign controlled banks:

1) Interferences with the performance of the banking sector’s financial intermediary function.
2) Risk of restraining the financing to strategic sectors as a result of political decisions outside of Poland.
3) Obstacles to the stable financing of the public debt.
4) Constraints on the application of macro-prudential policy.
1. Interferences with the performance of the banking sector’s financial intermediary function

A bank which is a part of an international banking group pursues its business on the Polish market guided not based on the situation and outlook of the Polish economy and its own financial situation but also the condition of the entire banking group. As a consequence, problems in the economy of the home country of the group or on third country markets, as well as financial difficulties of the group arising from other factors, could seriously interfere with the performance of the subsidiary bank’s financial intermediary function in Poland. As long as this concerns a single bank, it is not a major problem in a country with a competitive banking system such as Poland. The situation becomes more serious where interferences caused by external events affect a larger number of banks.

Behaviour of banks in 2009-2010

In the autumn of 2008, after the collapse of Lehman Brothers and the aggravation of the global financial crisis, attention was drawn to the risk that banks with holding companies in countries deeply affected by the crisis would tighten their credit policy in Poland to a much bigger extent than necessary based on the situation and outlook of the Polish economy.\(^4\)

As a consequence of the global financial crisis, the USA and the European Union member states – the home countries of banking groups which control more than two-thirds of the assets of the Polish banking sector, went into recession in 2009. International banking groups operating in Poland posted big losses in their home markets and had to use government aid. Although Poland was the only European country to report real GDP growth (1.6 percent) in 2009, foreign banking groups present in Poland curtailed credit for Polish companies. In 2010, corporate lending extended by this group of banks which dominates the Polish banking sector further decreased despite relatively strong real GDP growth (3.9 percent). Overall, Poland’s GDP grew by 5.6 percent in real terms in 2009-2010 while the corporate loan portfolio of foreign controlled banks decreased in aggregate by 12.5 percent in real terms,\(^5\) which means that the real growth rate of corporate loans in this group of banks was 18 percentage points lower than GDP growth in the period in question. This stood in contrast with the real growth rate in the


\(^5\) Total loans and advances to enterprises and entrepreneurs based on NBP [National Bank of Poland] data “Banks’ receivables and payables (monthly figures)”. In all calculations, loans and advances to enterprises include loans and advances to entrepreneurs but do not include loans and advances to non-banking financial institutions and to the public sector. Loans and advances to enterprises extended by banks which are a part of foreign banking groups are equal to total loans and advances extended by the banking sector less loans and advances extended by locally controlled banks for which data are available, i.e., PKO BP, GetinBank, Noble Bank, BGK, BOŚ, Alior, Invest-Bank, Bank Pocztowy, and less loans and advances extended by the co-operative banking sector according to FSA [Financial Supervision Authority] data.
group of locally controlled banks (see Figure 2): locally controlled commercial banks grew their corporate loan portfolio by 20.6 percent, a growth rate which was 15 percentage points higher than GDP growth, while co-operative banks grew their portfolio by 35.4 percent, a growth rate which was 20 percentage points higher than GDP growth. Overall, the corporate loan portfolio in the entire banking sector decreased by 6.4 percent in real terms in the period in question, a rate 12 percentage points lower than GDP growth.

It is interesting to note which factors caused the huge difference in the growth rate of corporate loans among different groups of banks in the period in question.

In 2009-2010, the factors which curbed corporate demand for loans included:
   a) falling investments, and
   b) the strong liquidity position of companies despite the economic slow-down, helped by a sharp depreciation of the zloty in 2009.

The fall in demand for loans, generally observed across the corporate sector, does not explain the considerable difference in the growth rate of loans among different groups of banks. The difference in the growth rate among different groups of banks may, however, result from various factors impacting the banks’ ability or willingness to lend:

A. The capital adequacy ratios of the bank
B. The capital adequacy ratios of the banking group of the bank
C. Availability of money for lending
D. Credit risk appetite in the corporate segment
Figure 2. Real growth rate of corporate loans over two years: 2009-2010

* PKO BP, GetinBank, Noble Bank, BGK, BOŚ, Alior, Invest-Bank, Bank Pocztowy
Source: Own calculation based on data from NBP, KNF, GUS [Central Statistical Office], bank data and banks’ financial statements

Figure 3. Share of banking groups in the assets of the banking sector in 2010

* PKO BP, GetinBank, Noble Bank, BGK, BOŚ, Alior, Invest-Bank, Bank Pocztowy
Source: Own calculation based on data from NBP, FSA, CSO [Central Statistical Office], bank data and banks’ financial statements
A. The capital adequacy ratio of the bank

Figure 4 presents the biggest banks in Poland as measured by assets (top ten excluding BGK) in the order of their capital adequacy ratios (CAR) in 2010 at the year-end. PKO Bank Polski SA, which reported a high positive growth rate of corporate loans in 2009-2010 (see Figure 2), reported a CAR of 11.99 percent in 2010 at the year-end, i.e., above the level recommended by Polish Financial Supervision Authority (KNF) in 2010. However, all eight banks belonging to the group of foreign controlled banks, which collectively reported a strongly negative growth rate of loans in 2009-2010, reported a CAR which was higher (in some cases, much higher) than that of PKO BP SA at the 2010 year-end. This means that the lack of capital was not the main reason for the completely different growth rate of corporate loans in this group of banks as compared to PKO BP SA.

Figure 4. Capital adequacy ratio of the biggest banks in Poland in 2010

B. The capital adequacy ratio of the holding bank’s group

The parent companies of the biggest foreign controlled banks operating in Poland posted high losses in 2008-2009 and used the emergency capital support of their home governments. Therefore, the aim of improving the consolidated capital adequacy ratio at a group level could have been a factor restricting the growth of assets of those banks on the Polish market and contributing to the negative growth rate of corporate loans. This hypothesis is corroborated by
the fact that, in the period in question, foreign controlled banks reduced their portfolio of corporate loans and significantly reduced the growth rate of the household loan portfolio while sharply increasing the growth rate of loans to the public sector, which carries a much lower risk weight than other categories of lending. Loans to the public sector in this group of banks decreased by 17% in real terms in 2007-2008 but grew by 85% in real terms in 2009-2010.

C and D. Availability of money for lending and credit risk appetite in the corporate segment

In the period under question, the banking sector experienced major liquidity issues. The interbank market froze. The cost of swaps, used by many banks in Poland to finance the portfolio of FX mortgage loans with zloty deposits, increased. At the same time, the depreciation of the zloty required more zloty deposits to cover swaps. Banks owned by foreign banking groups could no longer rely on loans from parent banks to finance the growth of lending. It should be stressed, however, that foreign parent banks did not withdraw existing exposures and, in emergency situations, even provided financial support to their subsidiaries in Poland. The liquidity issues resulted in harsh competition for retail deposits. Owing to its strong position on the retail market and trust enjoyed by a bank controlled by the State Treasury, PKO Bank Polski SA generated dynamic growth in deposits and its share in the deposits of the banking sector increased from 18.1 percent in 2008 to 20.0 percent in 2010.6 As a result, the growth of PKO BP’s lending was not restrained by liquidity problems. Liquidity issues could have potentially contributed to a curbing of lending by foreign controlled banks. However, it is important to note that in the period in question, foreign controlled banks, while reducing their corporate loan portfolio by PLN 19 billion, increased their household loan portfolio by PLN 39 billion and loans to the public sector by PLN 6 billion. Thus, this group of banks experienced a substantial transformation of the structure of the loan portfolio involving a reduction of the share of corporate loans and an increase of the share of household loans as well as a sharp increase of loans to the public sector. These data suggest that it was not the liquidity issues of foreign controlled banks as much as the ambition to quickly reduce exposure to risk of the Polish corporate sector that was the main driver of the reduction of the corporate loan portfolio of this group of banks in 2009-2010.

In response to a question about the reasons for the very high growth rate of corporate loans of PKO BP SA compared to the market in 2009-2010, the following key factors have been quoted:7

1) Increase of credit margins on the market and the opportunity to build a very profitable portfolio of both corporate and retail loans (as a result of weak competition, see below);

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6 Own calculations on the basis of the Bank’s reports (bank’s liabilities to clients other than banks) and NBP data.
7 Conversation with Bartosz Drabikowski, Deputy President of the Management Board and Chief Financial Officer in PKO Bank Polski SA on 23 October 2012.
2) Weak competition due to the fact that banks owned by foreign banking groups considerably reduced corporate and retail lending as a result of problems at the banking group level;
3) The bank’s good liquidity and capital position;
4) Positive macroeconomic outlook.

This opinion coincides with the observation that PKO Bank Polski SA was the only bank in the group of the biggest banks willing to lend to new corporate clients in 2009.

In summary, it should be noted that the situation which emerged in 2009-2010 was very unsound and problematic: banks which are subsidiaries of international banking groups and control more than two-thirds of the assets in the banking sector rapidly curtailed corporate credit. Meanwhile, the growth in corporate lending was generated by local banks that had been formerly less present in the segment. On the one hand, this kind of situation unreasonably restricts the access of the corporate sector to loans. On the other hand, the very sharp increase of corporate lending in locally controlled banks generates a risk of considerable credit losses of those banks, which may result in serious economic and political problems.

Figure 5. Real growth rate of corporate loans

![Figure 5. Real growth rate of corporate loans](image)

*PKO BP, GetinBank, Noble Bank, BGK, BOŚ, Alior, Invest-Bank, Bank Pocztowy
Source: Own calculation based on data from NBP, KNF, bank data and banks’ financial statements, GUS, Eurostat

Experience of the entire period 2007 – 2012 (until 30 June)

Figure 5 presents the real growth rate of corporate loans in different groups of banks as compared to the GDP growth rate of Poland and the Eurozone. The figure suggests that the
The growth rate of corporate loans in foreign controlled banks is much more pro-cyclical than the growth rate in locally controlled banks and seems more closely related to the GDP growth rate of the Eurozone than the GDP growth rate of Poland.

**Summary**

In summary, it should be noted that the dominance of foreign controlled banks interferes with the adequate performance of the banking sector’s financial intermediary function and contributes to the pro-cyclicality of the credit policy. As a result, in the case of a crisis on foreign markets, lending to Polish companies may be curtailed following the decisions of foreign parent banks companies irrespective of the situation in the Polish economy (which is what happened in 2008-2010).

2. **Risk of restraining financing to strategic sectors as a result of political decisions external to Poland**

In the Polish energy strategy, a key role is played or intended to be played by sectors whose growth is contested in many European countries:

- **Coal-based energy** – energy corporations from Germany (RWE) and Sweden (Vattenfall) present in Poland have pulled out from the planned construction of new coal-fired power plants in Poland.
- **Nuclear energy** – Germany has decided to close down nuclear power plants. The construction of nuclear power plants in Poland is opposed by Germany and several other EU member states.
- **Shale gas** – the development of shale gas production is opposed many European countries and jeopardises the interests of Gazprom.

The sentiment of public opinion in the home countries as well as political and business decisions of foreign parent banks may largely hinder or even prevent foreign controlled banks operating in Poland from financing investments in the above sectors:

- Banks from EU member states and Norway (Nordea) will be unwilling to finance shale gas production and coal-fired power plants.
- It is very unlikely that German, Austrian, Dutch or Scandinavian banks would be willing to finance nuclear power in Poland.
- French banks are unlikely to finance nuclear power other than that based on French

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8 Based on a memo of 21 March 2012 by the Special Economic Adviser to the Minister of Foreign Affairs, Maciej Olex-Olszczewski (former investment banker).
technology.
- Poland’s second bank by assets, the Italian UniCredit (Pekao SA), is very unpredictable. UniCredit maintains close relations with the Italian champion Eni, which is an ally of Gazprom.
- The Spanish Santander (BZWBK possibly merged with Kredyt Bank) appears uninterested in big corporate and project loans.

3. Obstacles to the stable financing of the public debt

In every country, local banks are an important category of buyers of public debt. As for foreign controlled banks operating in Poland, their ability to invest in attractive Treasuries is restricted by Polish sovereign risk limits imposed by foreign parent banks.

Due to the structure of the Polish banking sector, the burden of financing of the public debt is increasingly borne by foreign investors. In the case of potential turbulences in the global economy or other events which increase foreign investors’ aversion to Polish risk, Polish risk limits in Polish banks owned by foreign banking groups may be rapidly reduced. Hence, there is a serious risk of a concurrent sell-out of Polish bonds by foreign investors and by most banks present in Poland. Consequently, especially in view of the current situation in the global economy, the dominance of banks controlled by foreign banking groups significantly increases the risk of financing the Polish public debt.

If a bank is a systemically important deposit bank in a country and the country’s state budget implicitly guarantees its deposits, a situation in which this bank has externally imposed risk limits on the sovereign debt of this country should not be accepted by the regulators. It should be remembered that bank deposits in Poland are insured by the Banking Guarantee Fund financed through the contributions of insured banks but, in the case of a serious crisis, the pay-out of guaranteed deposits will require the support of the state budget.

The point is not to force banks to buy public debt on an unlimited scale but rather, to ensure that the bank’s policy in this regard is autonomously defined by the bank’s management. The policy should not depend on limits assigned by the foreign parent bank aimed at optimising the group’s global risk profile, which may have negative consequences for the local deposit institution. For banks operating as a part of international banking groups, it is very difficult in practice to ensure that there are no such externally imposed limits. Therefore, it is reasonable for regulators to take measures to ensure that systemically important banks are locally controlled.
4. Constraints on the application of macroprudential policy

The experience of the global banking crisis suggests that the macroeconomic stability of a country may require more than the application of the interest rate instrument. In order to effectively prevent booms in different market segments, it may be necessary to change the operating parameters of banks such as the capital requirement, the maximum ratio of loans to property value or to income, etc., in order to match them to the situation on the local market. This type of application of prudential regulations to protect macroeconomic stability is called macroprudential policy.

Andrzej Sławiński and Tomasz Chmielewski point out that in a country such as Poland, where the banking sector is dominated by banks owned by foreign banking groups, effective macroprudential policy can be effectively applied only if the local banks are set apart within their parent banking groups, including the separation of local banks’ capital. This requirement rules out the centralisation of capital and liquidity management at the level of the holding company of an international capital group.⁹ Sławiński and Chmielewski emphasize that the application of macroprudential policy will be impossible following the implementation of the European Commission’s proposed regulation introducing the “maximum harmonisation” of supervisory norms, which would imply that uniform prudential parameters are determined across the European Union.¹⁰

The trend of harmonizing supervisory norms will most likely increase in the course of the implementation of the Banking Union concept.¹¹ Hopefully, the Polish government will take the necessary measures and find allies to prevent the implementation of regulations which would deprive the Polish regulatory authorities of the power to make sovereign decisions concerning the application of macroprudential instruments.¹²

If “maximum harmonization” is implemented, local banking supervision will be deprived of the

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¹⁰ Proposed regulatory changes concerning capital requirements were approved by the European Commission on 20 June 2011 as CDR IV Package.
¹¹ The European Commission proposed draft regulations creating a single European banking supervision in the eurozone on 12 September 2012.
¹² The maximum harmonization solutions discussed so far allow for the application of macroprudential instruments under reasonable circumstances with the consent of competent EU institutions. However, this cannot be considered a satisfactory solution. In view of this solution, if a peripheral country requests consent for the application of macroprudential instruments facing the resistance of European banking groups present within its territory, it is very likely to be told by the competent EU institution that it must first use other available tools which do not distort the single banking market, in particular fiscal tools. In practice, this could mean that a peripheral country which does not have a significant budget surplus would be unable to use macroprudential policy instruments.
power to set prudential parameters as uniform parameters will be determined across the European Union. In that case, local supervisors may, however, retain significant influence on the activity of local banks over which they will exercise the majority of supervisory obligations and undertake practical implementation of European prudential rules. However, local supervision will be almost completely deprived of influence on the activity of banks owned by foreign banking groups over which the majority of supervisory obligations will be exercised, in cooperation with the European banking supervision, by the supervision in the home country of the holding company of the group. Therefore, the bigger the share of foreign controlled banks in the Polish banking sector, the greater the dangerous consequences of the implementation of maximum harmonization.

IV. Possibilities of neutralising negative consequences of the dominance of foreign controlled banks through national regulations and banking supervision measures

1. In the current legal system, the Polish Financial Supervision Authority (KNF) has the instruments and competences necessary to monitor and control liquidity and the required minimum capital and to prevent illegal cash flows between banks and their parent companies.

In the current legal system, owing to the possibility of defining standards and the possibility of monitoring the liquidity position of banks, the KNF has the instruments necessary to ensure that banks registered in Poland as subsidiaries of foreign banking groups pursue an adequately prudent liquidity policy. The KNF can monitor and prevent situations where a subsidiary bank operating in Poland would be used as a source of financing of the holding company to the detriment of the growth of lending on the Polish market or resulting in exposing collected deposits to risk. The KNF also has the instruments necessary to enforce the maintenance of banks’ capital at a level that satisfies minimum capital adequacy ratio requirements. In practice, the KNF can force banks to limit the amount of dividends paid out in order to maintain or improve capital ratios above the minimum level if the KNF considers it necessary due to higher business risk. It should be remembered that in 2009, all banks operating in Poland as subsidiaries of international banking groups respected the KNF’s recommendation not to pay out dividends and to retain all profits for the 2008 financial year. More recently, the KNF prepared a general recommendation whereby, due to risks in the external environment, banks should pay out no dividends and allocate the profits generated in 2011 to increase capital. It additionally recommended that those banks which fulfil at least one of the indicated criteria pay out no dividends.  

13 The criteria are as follows: (1) Capital adequacy ratio of less than 12%, (2) Tier 1 ratio of less than 9%, (3) BION score (assessment performed by the supervision on the basis of the Supervisory Research and Assessment process) of less than 2.5, (4) Share of FX loans in the retail loan portfolio of more than 50%, (5) Holding bank has a shortage
However, it should be remembered that the general recommendation to pay out no dividend is an emergency instrument which should be used only in reasonable special situations. Investors’ concern with the unjustified and unforeseeable application of this recommendation by the supervisor could discourage investors from investing in banks in Poland.

2. The KNF is unable to prevent a potential credit crunch in Poland by banks owned by foreign banking groups aiming to improve the capital ratios at the group level

As noted above, there is a serious risk that some Polish banks which are subsidiaries of international banking groups and have a surplus of capital, ample customer deposits, and consider the Polish economy a space for profitable and safe credit expansion, may be forced by their foreign parent banks to curtail lending. Owing to capital consolidation at the group level, international banking groups may benefit from the surplus capital in their Polish subsidiaries without taking dividends and transferring cash abroad. The surplus capital maintained on the balance sheet and on the account of the Polish subsidiary bank improves the capital ratio of the group and allows for the curbing the scale of asset reductions on other markets (see Section III, point 1).

It must be noted that the banking supervision is unable to effectively prevent this form of use of surplus capital of Polish banks. Let us imagine quite hypothetically that the supervision tells a bank that it is extending too few loans and, consequently, has too high capital ratios. In that case, the bank would say that the scale of lending depends on risk assessment and, if the supervisor believes that the bank’s capital ratio is too high, the problem will soon be solved through a high dividend pay-out. In that situation, it would be difficult to stop the dividend pay-out as the right to draw a dividend is a fundamental right of shareholders and the recommendation of the supervision to restrict the dividend pay-out may only be based on its opinion that the bank needs additional capital. If, however, the supervision believes that the bank has surplus capital, then there are no arguments to stop the dividend pay-out. This assessment coincides with the position presented by KNF Chairperson Andrzej Jakubiak. In response to a question about options preventing a situation where “foreign shareholders would exert informal pressure on the management of our banks to curtail lending,” the KNF Chairperson unequivocally stated that the banking supervisor has and, in a market economy, should have no “instruments that would force one bank or another to build up lending.”

of capital compared to the required Tier 1 ratio according to the European Banking Supervision. Cf. letter of KNF Chairperson Andrzej Jakubiak no. DNB/I/7111/4/2/11 of 29 December 2011 addressed to bank CEOs.

14 “Będę pilnował sprzedawania banków”, Maciej Samick interviews Andrzej Jakubiak, Chairperson of the Polish Financial Supervision Authority, Gazeta Wyborcza, 21 November 2011.
3. If the European Union implements the principle of maximum harmonisation of supervisory norms, the KNF will be deprived of its existing instruments necessary to mitigate some negative implications of the dependence of Polish banks on foreign banking groups.

If the directive proposed by the European Commission to implement maximum harmonisation of supervisory norms is approved, the KNF will be largely deprived of its supervisory powers over banks which are subsidiaries of European banking groups (see Section III, point 4). As a result, the KNF will be deprived of its existing instruments and powers necessary to monitor and control liquidity and the required minimum capital level and to prevent illegal cash flows between banks and their holding companies.

4. Regulatory policy and the National Bank of Poland’s (NBP) bill issue policy may impact the amount of investment in Treasury bonds maintained by banks. However, measures taken by the regulators and the NBP cannot prevent a sharp reduction of Polish sovereign risk limits by foreign headquarters of banks present in Poland.

As noted above, the dominant position of banks which are subsidiaries of foreign banking groups hinders the stable financing of the public debt and, in the case of the growing aversion to Polish risk globally, it could trigger instability in the economy. These problems may be prevented to some extent by regulations concerning the liquidity of banks as well as the NBP’s policy of the availability and yield of the central bank’s deposit instruments offered as an alternative to Treasury instruments for banks. Liquidity norms and types of instruments eligible under different liquidity categories defined by the regulators, the NBP’s decisions about interest rates on banks’ accounts with the central bank, as well as the policy concerning the size of issue, the maturity structure, and the yield of NBP bills could, in combination, considerably impact the size of the securities portfolio maintained by banks in practice.

The regulatory policy and the NBP’s policy are, however, unable to prevent a sudden reduction of Polish sovereign risk limits by foreign headquarters of banks operating in Poland.

Such a reduction of limits may come as a reaction to many kinds of events generally increasing investors’ risk aversion or altering the relative perception of risk in different geographic areas or countries. Therefore, limits can be reduced both due to events relating directly to the Polish economy and developments in another European country, the entire European economy or in non-European economies. Under these circumstances, the potentially most stable, primary source of financing the national public debt, namely local deposits, could remain unused by a large part of the banking sector.
A sudden reduction in Polish sovereign risk limit could, in that case, result not from a change of the individual perception of the risk of the Polish economy as much as follow automatically from a more strategic decision to reduce exposures to risks of a greater area to which Poland belongs under the applicable risk management methodology. It should be noted that such a sudden reduction of the Polish sovereign risk limit triggered by events outside Poland is incomparably less likely for a stand-alone bank with a decision-making centre in Poland compared to a bank which is a subsidiary of an international banking group where strategic decisions are made in the foreign headquarters. For instance, if problems arise with the redemption of maturing bonds of another Central European country, Polish sovereign risk limits would most likely be automatically reduced in banks which are subsidiaries of foreign banking groups whereas in locally managed banks this might not happen at all (unless there were compelling reasons to do so depending on Poland’s economic and fiscal standing).

In a locally managed bank, strategic decisions about the size of the Polish Treasury bonds portfolio are made by people who are closely familiar with the Polish economic situation; in a bank which is a subsidiary of a foreign group, such strategic decisions are made in the headquarters of the group by people who are not involved in the daily monitoring of the Polish economy. In the former case, decisions to potentially change the size of the Polish Treasury bonds portfolio will, in the first place, be based on an analysis and assessment of the outlook of the Polish economy while developments in other countries will be considered of secondary importance. In the latter case, such decisions will primarily be based on the global risk allocation strategy for different geographic areas and regions. An assessment of the fundamentals of the Polish economy will, naturally, be considered as an important secondary factor but, in a crisis situation, decisions to reduce limits may be made automatically without going into a detailed evaluation of the fundamentals of the Polish economy.

V. Alternatives to the foreign control of banks

1. Three main models of bank control

Among the 120 biggest banks in the European Union as of 2008 (see Table 1 below), 89 banks (i.e., 74%) have no global ultimate owner. In most cases, this implies a dispersed ownership structure. For 31 banks (i.e., 26%) where the ultimate owner is identified, in almost all cases, the global ultimate owner is either another bank (18 cases) or the central or local government (9 cases).\textsuperscript{15}

\textsuperscript{15} Cf. Josina Kamerling and Arttu Makipaa, “Cross-Border Financial Institutions in the EU: Analysis of Total Assets and Ultimate Ownership – Briefing Note”, European Parliament, Directorate A - Economic and Scientific Policy,
Table 1. Ownership structure of top 120 banks in the European Union in 2008

<table>
<thead>
<tr>
<th>Total number</th>
<th>Banks with no identified global ultimate owner</th>
<th>Banks with a global ultimate owner</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Number</td>
<td>% share</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td>120</td>
<td>100%</td>
</tr>
<tr>
<td>Number</td>
<td></td>
<td>74%</td>
</tr>
</tbody>
</table>

Source: own study based on: J. Kamerling and A. Makipas, “Cross-Border Financial Institutions in the EU...”, op. cit., Table 2, p. 9

Three main forms of bank control can be identified:
1) Dispersed shareholding,
2) Control by another bank,
3) Control by the central or local government.

2. Dispersed shareholding is the dominant form of ownership in large private banks both in Europe and world-wide

Consider the world’s top 12 banks by capital (according to The Banker 2011 ranking). Setting aside three Chinese banks controlled by the state and RBS, which was taken over by the British government, the remaining 8 banks are private banks with a dispersed ownership structure where the stake of the biggest shareholder is typically well under 10% (see Table 2).

As the data in Tables 1 and 2 suggest, banks which have a specific owner are almost always banks owned by other banks or banks controlled by the central or local government. This means that dispersed shareholding is, in practice, the only broadly used form of ultimate control of private banks.
Table 2. Stake of the biggest shareholder in the world’s biggest private banks

<table>
<thead>
<tr>
<th>Position in the global ranking</th>
<th>Bank</th>
<th>Stake of the biggest shareholder*</th>
</tr>
</thead>
<tbody>
<tr>
<td>1</td>
<td>Bank of America</td>
<td>4.5%</td>
</tr>
<tr>
<td>2</td>
<td>JP Morgan Chase</td>
<td>4.1%</td>
</tr>
<tr>
<td>3</td>
<td>HSBC</td>
<td>1.4%</td>
</tr>
<tr>
<td>4</td>
<td>Citigroup</td>
<td>5.0%</td>
</tr>
<tr>
<td>5</td>
<td>Mitsubishi UFJ</td>
<td>6.0%</td>
</tr>
<tr>
<td>7</td>
<td>Wells Fargo</td>
<td>6.9%</td>
</tr>
<tr>
<td>11</td>
<td>BNP Paribas</td>
<td>10.7%**</td>
</tr>
<tr>
<td>12</td>
<td>Barclays</td>
<td>8.5%</td>
</tr>
</tbody>
</table>

*/ Determined by the authors on the basis of banks’ reports (2010 year-end or later)
**/ Stake of the investment fund controlled by the Belgian government as a remainder of the government’s stake in Fortis Bank acquired by BNP Paribas in 2009; the stake of the biggest private shareholder is 5.2%

3. Weaknesses of dispersed shareholding do not prompt proposals to abandon this form of ownership

The weaknesses of owner supervision associated with dispersed shareholding have been quoted as one of the factors contributing to the global financial crisis. However, this has not brought about proposals to abandon or restrict the model of dispersed shareholding in banks. Specifically, no such proposals were put forth in the most renowned diagnostic reports published in 2009: the Group of Thirty report led by Paul Volcker\textsuperscript{16} nor the report of the High-Level Group chaired by Jacques de Larosière appointed by the European Commission.\textsuperscript{17} The Group of Thirty report includes a recommendation to prevent non-financial investors from taking control of banks which collect deposits guaranteed by the government. However, both of these reports include proposals concerning incentive systems for managers, which were taken into account in the regulation approved by the European Commission (implemented in Poland by way of the KNF resolution of October 2011). According to the regulations, a large part of the bonuses of people who have significant impact on risks at the bank should be conditional and their payment should be deferred even for several years and conditional on the lack of deferred negative consequences of the managers’ decisions.

4. Dispersed shareholding as a safety factor in banks

The lack of proposals to restrict the dispersal of shareholding derives, among others, from the fact that dispersed shareholding is considered, all in all, as a factor of the bank’s safety. Supervisors are striving to avoid a situation in which an investor holding companies in non-financial sectors takes control of a bank. This would create the risk that the dominant shareholder would want to use the bank as a source of preferred lending to its companies. This concern is grounded in multiple cases of banks which went bankrupt due to the burden of bad debt extended to companies related to dominant shareholders.

In many countries, dispersed shareholding is favoured by regulations and the supervision. A single shareholder, other than a bank or financial institution, acquiring a significant stake (typically defined as 10-20% of votes at the general meeting) is considered by the authorities to be potentially risky to the bank. This is either prohibited by law or subject to various restrictions. Similar restrictions and control are often imposed on non-financial entities taking control of a bank without holding a significant capital stake. Apart from protecting the safety of banks, the purpose of such regulations is, in many cases, also to stop foreign entities from taking control of local banks.

Data compiled by the World Bank in the Banking Regulation Survey (last updated in June 2008) suggest that it is explicitly prohibited to acquire a significant stake in banks in 47 out of 143 surveyed countries. In addition, acquiring a significant stake (over 10%) in a bank requires the approval of the regulatory authorities.

For example, the US Bank Holding Company Act prohibits investors holding a controlling stake in a non-financial company from also holding a controlling stake in a bank holding.

5. Canadian experience

The experience of Canada is worth examining at some greater length. It is important to remember that, while the country is closely tied to the US economy, Canadian banks proved resilient to the 2008 global financial crisis, which was triggered in the US.

In the second half of the 1990s, the Canadian government appointed a committee chaired by Harold MacKay to evaluate the Canadian banking sector and draft recommendations for the future. The committee came up with a number of reasons to retain Canadian control of Canadian banks. In particular, it noted that local banks are the base for local financial centres
which can offer better quality jobs to qualified Canadians and generate greater tax revenue; Canadian banks are considered to be more sensitive to the local market situation than foreign banks could be, especially in the time of economic slow-down; there is a concern that foreign controlled banks would be less willing than Canadian banks to provide financing to Canadian companies; foreign control of banks could eliminate control over the production and allocation of loans.\textsuperscript{18} Current regulations in Canada accommodate the results of the analyses and recommendations of the MacKay committee. Banks with capital exceeding CAD 8 billion (five Canadian banks operate above that threshold) cannot have a shareholder holding more than 20\% of votes at the general meeting. In fact, control of a bank is not allowed either, even below the threshold of 20\% of capital. The law provides for exceptions and, in particular, allows shareholders that are financial institutions (banks or insurers) with dispersed shareholding to hold more than 20\% of a bank’s capital. With the diminishing size of a bank, the scope of restrictions on the shareholding structure also diminishes; there are no restrictions for banks with capital below CAD 1 billion.\textsuperscript{19}

The case of Canada suggests that the issue of local control of banks can be taken very seriously. The experience of Canada demonstrates that dispersed shareholding can be an effective form of bank ownership from the perspective of the bank’s safety and the retention of local control of the bank, and that there is no need to maintain stringent control rules for all categories of banks.

6. Local control does necessarily mean that the majority of capital must be held by local shareholders

In case of dispersed shareholding, the bank’s actual decision-making centre is in its management in the head office. The management has much more freedom to act as long as it addresses the expectations of the shareholders. The less satisfactory the result of the institution, the more likely it is that shareholders will come to an agreement to replace the management of the bank. The bank is also subject to local prudential regulations and local supervision. For the actual decision-making centre of the bank to be in the country of the bank’s head office, it is not necessary that the majority of shares be held by local shareholders. This is demonstrated by the example of large European banks with dispersed shareholding. For instance, foreign investors hold 53\% of Germany’s Deutsche Bank, 58\% of Italy’s UniCredit and as much as 63\% of Hungary’s OTP Bank.\textsuperscript{20} Observers have no doubts as to where the decision-

\textsuperscript{19} Bank Act, Canada.
\textsuperscript{20} Data published by banks on their websites.
making centre of those banks is even though the majority of shares are held by foreign investors.

7. Dispersed shareholding presents other challenges for the supervision than control by a strategic investor

From the perspective of banking supervision, a bank with dispersed shareholding poses other challenges than a bank which is a subsidiary of a foreign bank. For a subsidiary bank, the local supervision for the most part focuses on monitoring its relations with the holding company and checking whether the holding company is able and ready to provide the subsidiary with necessary support. For a bank with dispersed shareholding, the supervision must ensure that the bank is managed in such a way that it can independently maintain safety and stability. In our opinion, the Polish supervision is experienced enough to be able to face this challenge. However, it is clear that such a transformation of the shareholding structure of a local bank will require a major adjustment of the supervisor’s routine approach.

8. How to ensure the stability of a dispersed shareholding structure

The stability of a dispersed shareholding structure can be ensured by introducing a statutory provision limiting the voting right of a single shareholder to no more than 10% of votes at a general meeting.

Such a statutory restriction also creates a risk. In some cases, the management structure of a bank may be pathologically petrified and restrictions on the voting right may in practice prevent the replacement of the bank’s management by the shareholders. Limits on the voting right may also stand in the way of the ownership transformation necessary to support the bank. Therefore, it is important to consider introducing a safety mechanism in the form of a statutory provision authorising the Polish Financial Supervision Authority (KNF) to decide in reasonable cases to waive the provision limiting the percentage of votes allowed for a single bank shareholder for the duration of a specific general meeting.

9. There is space for banks with dispersed private shareholding in Poland

If private banks with decision-making centres in Poland are to play an important role in the financial system in Poland similar to other big EU economies, then one must accept the model of a bank with dispersed private shareholding. In practice, dispersed shareholding is the only broadly used form of ultimate control of non-state banks approved by regulators.
10. Illusory alternative: direct or indirect state control

Data in Table 1 suggest that the most important form of ultimate control of banks after dispersed shareholding is control by the central or local government. Nowadays, many banks in Europe have a large, often dominant stake of state capital as a result of capital support from the state extended in the time of crisis. However, it is generally considered to be a transitional situation. The assumption is that such banks will be privatised as soon as market conditions allow. In the meantime, public authorities are trying not to interfere in day-to-day management and allow managers to run those institutions as if they were private.

The experience of many countries suggests that the retention of state control of banks involves huge risks as the future of managers depends on the decisions of politicians. Bank managers must seek the favours of politicians to keep their positions. Politicians often try to take advantage of the possibility of influencing banks in order to use them (more precisely, the money they collect) in support of preferred sectors of the economy, specific companies, and to solve ongoing problems or pursue their often very noble ambitions. To fall to this temptation in an open economy usually entails losses and, as a result, the state budget often bails such banks out at the expense of taxpayers. As a cautionary tale, in the early 1990s, the French state bank Credit Lyonnais pursued the ambitious idea supported by the political elite of building a national champion, a competitor to Germany’s Deutsche Bank, and was also used to support important French companies. The bank’s expansion initially inspired admiration but ended with gigantic losses; the bank was saved from bankruptcy through the financial aid of the state. The cost of the intervention was at least USD 20 billion, which in 1997, many years before the current financial crisis, *The Economist* called “the biggest single financial disaster ever seen in the Western world.”

Poland’s biggest bank, PKO Bank Polski SA, is a bank controlled by the state. In recent years, the bank has very successfully improved its market position and maintained a very good financial standing. However, according to opinions voiced in public debate, in its activity, PKO BP SA considers the political context, which in some cases could be disadvantageous to the shareholders and deposit owners. In *Gazeta Wyborcza*, Tomasz Prusek claimed that PKO BP’s decision to save Polimex Mostostal addressed the government’s economic policy to a greater extent than the interest of the bank and its shareholders. We do not wish to express an opinion on the deal as it is not the topic of our analysis or assessment. However, we believe that Prusek’s position quoted above should serve as a warning and an indication that control over

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the management of PKO BP SA exercised by the central government is a significant risk factor. The risk could be augmented by the conviction of the government that PKO BP SA is a bank that is strong enough to be effectively used to solve various problems faced by the government or to pursue noble visions of the state.

The possibility that politicians could influence the management of a bank, which is hard to rule out in a bank controlled by the state, generates serious risks. Therefore, it is important to restrict the possibilities of expansion of the State Treasury’s realm in the banking sector. In our opinion, the stake of banks controlled directly or indirectly by the State Treasury, which currently represent about 20 percent of the assets of the banking sector, should not exceed 25 percent, even temporarily, in the next 10 years. This means that the model of a bank controlled by the State Treasury cannot be a viable alternative replacing the model of a bank controlled by a foreign banking group if the share of the latter model in the assets of the banking sector is to be reduced by 35-40 basis points.

VI. The target model of the banking system supporting long-term economic growth

1. Main goals of the state’s influence on the size and structure of the banking sector

The stability of the banking sector is important to economic growth; hence, it is necessary to maintain solutions which ensure the stability of the banking sector. Such solutions effectively prevent outbreaks of bank panic and the economic collapse that such panic could trigger. At the same time, the protection of the banking sector by the state generates costs and produces negative developments: it creates fiscal risk and distorts the motivations of managers. Hence, state policy should:

a) aim at maintaining a size and structure of the banking sector such that the potential fiscal obligations necessary to ensure bank stability can be borne by the state;
b) take the necessary measures to shape the structure of the banking sector so as to achieve the most favourable relation possible between the ability of the banking sector to finance the economy and fiscal risk.

2. The core function of the national banking sector should be collecting local deposits and lending to local companies and households rather than intermediation in international capital transfers

In the light of the experience of the global financial crisis, it is obvious that the key to economic growth is the ability to generate local savings and effectively use them for investments enhancing the productivity of the economy.
Foreign capital may contribute to economic growth but its inflow is often a source of instability which may, consequently, have a negative impact on growth. While there is a host of strong and convincing empirical data suggesting that free trade has a positive impact on economic growth, there is no compelling evidence that the free movement of capital has a generally positive impact on growth. The authors of a recent empirical study examining the relationship between international capital flows in some 100 countries in 1990-2010 put forth the following conclusions:

- The impact of foreign direct investments on economic growth is large and robust.
- The impact of equity investments (acquisition of shares on the exchange) on economic growth is smaller and less stable.
- The inflow of capital in the form of short-term debt does not impact economic growth before the crisis and has a negative impact during the crisis.

Those conclusions coincide with everyday observations and are shared by the authors of this report. Foreign debt capital transferred through the banking system may help to accelerate economic growth for some time but it is also a risk factor. The uncontrolled inflow of foreign debt capital, especially if used to finance consumption or property, may erode competitiveness and create bubbles on asset markets. The consequences of the materialisation of such risks can be analysed in the examples of Ireland and the Baltic States, which used foreign debt to generate high growth for some time but were eventually hit with a strong crisis and their economies shrank dramatically after 2008.

Foreign debt transferred through the banking system may help to grow loans over and above the local deposit base. If reasonably controlled, this may be temporarily beneficial for the economy. However, a sudden inflow of such debt and lending expansion based on it may itself become a driver of crisis. This is what happened in Poland, fortunately on a relatively limited scale, in the years directly preceding the global financial crisis. At that time, the dynamic growth of the portfolio of FX housing loans was financed largely through loans extended to banking subsidiaries in Poland by their foreign parent banks. In 2006, the ratio of bank loans to deposits in Poland was 80 percent. However, over the next two years, it increased by 28 percentage

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24 In both cases, the volume of bank loans largely exceeded savings placed as bank deposits. In Ireland, foreign capital which financed lending came in the form of debt issued by banks on the capital and interbank market; in the Baltic States, foreign capital came in the form of loans extended to local banks by their foreign parent banks.
points and reached 108 percent at the end of 2008. It could be said that Poland belatedly but dynamically followed other European countries on the road to unsound and risky relations on the balance sheet of the banking sector.\textsuperscript{25} In hindsight, it seems that the inflow of foreign debt transferred through banks at that time posed a risk to the economy. If the trend had not been stopped in 2008 and if the financial gap and the rate of fx loans to GDP had continued to increase, the Polish economy could have faced a similar crisis as did other countries of the region, in particular the Baltic States.

The distinguishing feature of banks which are subsidiaries of foreign banking groups, namely their ability to grow lending based on foreign funding, is not an obvious advantage from the perspective of the country’s long-term economic growth. In fact, if not properly controlled, it may become a serious risk factor.

The above considerations lead to the conclusion that the core function of the national banking sector should be collecting local deposits and lending to local companies and households rather than intermediation in international capital transfers. It should be stressed that this position does not necessarily imply that major restrictions should be imposed on the movement of capital. However, it implies that transfers through the balance sheets of local banks should be disciplined by conservative prudential criteria so that risk involved in such transfers does not spill over to local banks or generate fiscal risk even indirectly due to its scale.

3. Loans to the non-government sector as a percentage of GDP should be no more than 100%

The experience of the global financial crisis which started in 2008 made economists and politicians realise that the financial systems of some countries are too big compared to their economies. They remembered the opinions previously put forth by some economists that once the financial sector has exceeded a certain size, its further growth may have a negative impact on economic growth. A summary of statistical surveys presented in a study published by the International Monetary Fund suggests that the impact of the financial sector on economic growth changes significantly with the growth of loans to the private sector as a percentage of GDP.\textsuperscript{26} If the percentage is very low, there is no statistically significant impact on economic growth, but once it reaches 30-70%, it has a significant positive impact on economic growth. If the percentage exceeds 70%, its further growth brings no further benefits. Once it exceeds 100%, any further growth of loans to the private sector as a percentage of GDP has a clearly negative impact on economic growth.

\textsuperscript{25} Cf. Stefan Kawalec and Andrzej Sławinski, “Kredyty walutowe mogą szkodzić”, \textit{Gazeta Wyborcza}, 5 August 2010.  
Loans to the private sector as a percentage of GDP in Poland grew in 2007-2011 from 30% to 50%.\textsuperscript{27} It seems that the further growth of loans to the private sector as a percentage of GDP in Poland might still have a positive impact on economic growth. However, it should be stressed that the percentage is quickly approaching a level where its growth by itself is no longer likely to have a positive impact on economic growth.

However, what is important is not only the size of total loans to the private sector but also their structure. Some studies suggest that there is a positive correlation between loans to companies and economic growth and no such correlation for loans to households.\textsuperscript{28}

The size of the banking sector should be monitored and controlled because the expansion of the banking sector is accompanied by growing fiscal risk related to the obligation to ensure the stability of banks. The expansion of the banking sector above a certain size has a negative impact on economic growth. Loans to the non-government sector as a percentage of GDP exceeding 70% should be a warning sign for the regulatory authorities. When they approach 100%, it should trigger very determined systemic measures using macroeconomic and macroprudential instruments and the institutional solutions necessary to prevent the further growth of loans as a percentage of GDP.

4. The loans to deposit ratio should be less than 100%

The loans of local banks should be financed with local deposits; hence, the loans/deposits ratio should be less than 100%.

5. Households should only be credited by local banks and in the local currency

FX loans for households on a large scale create a very high macroeconomic risk and undermine the effectiveness of monetary policy.\textsuperscript{29}

Companies should be able to take loans both domestically and internationally, but the level and structure of their debt should be monitored.

\textsuperscript{27} Own calculation based on NBP and CSO data. Private sector means households and companies other than the sector of public finance (i.e., includes companies controlled by the State Treasury). It should be noted that the World Bank database shows a higher percentage: it increased from 46% to 66% in 2007-2011.


\textsuperscript{29} Stefan Kawalec and Andrzej Sławiński, “Kredyty walutowe mogą szkodzić”, Gazeta Wyborcza, 5 August 2010.
6. Investment banking should be separated from deposit-taking and lending operations

It is common knowledge that the elimination of the separation between deposit-taking and lending operations on the one hand and investment banking on the other hand in the USA by way of the final repeal of the 1933 Glass-Steagall Act in 1999 contributed to the outbreak of the financial crisis less than 10 years later. Nowadays, the USA, the UK and the EU are implementing, drafting, or discussing solutions which would restore some form of separation of these activities in order to prevent the use of deposits guaranteed by the state in risky speculative operations.30

7. Proposed ownership structure of banks

Table 3 below presents proposals for the structure of the banking sector as a target to be achieved in the next 10 years.

Table 3. Target structure of the banking sector in 10 years

<table>
<thead>
<tr>
<th>Group of banks</th>
<th>Share in the assets of the banking sector</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Now</td>
</tr>
<tr>
<td>Subsidiaries of foreign banking groups</td>
<td>69%</td>
</tr>
<tr>
<td>Banks directly or indirectly controlled by the State Treasury (currently: BGK, PKO BP, BOŚ and Bank Pocztowy)*</td>
<td>20%</td>
</tr>
<tr>
<td>Banks with a dispersed shareholding structure controlled by institutional investors and protected from take-over by a strategic investor through special statutory provisions</td>
<td>0%</td>
</tr>
<tr>
<td>Other banks controlled by private investors</td>
<td>5%</td>
</tr>
<tr>
<td>Co-operative banks</td>
<td>6%</td>
</tr>
</tbody>
</table>

*/ We assume that BGK will remain a state-owned bank, PKO BP SA and Bank Pocztowy SA will remain indirectly controlled by the State Treasury while BOŚ SA will be privatised. We assume that a significant increase of the share of this group of banks, despite BOŚ SA leaving the group, may result from the organic growth of the other three banks, mainly the strong growth of Bank Pocztowy thanks to tapping the potential of co-operation with the Polish Post.

30 In the USA, the Volcker Rule is such a solution, currently under implementation as part of the 2010 Dodd-Frank Act. In the UK, recommendations concerning ring-fencing of deposit-taking and lending operations within financial groups have been presented by an independent government-appointed committee headed by John Vickers in its September 2011 report. In the EU, recommendations in this regard have been drafted by a committee of experts chaired by Erkki Liikanen, Governor of the Bank of Finland, appointed by Commissioner Michel Barnier.
8. Restrictions on concentration

After the outbreak of the global financial crisis in 2008, everyone realised the systemic risk generated by excessive concentration in the banking sector and the existence of financial institutions which were “too big to fail”. As a result, a proposal emerged in the public debate in Poland that regulators should not allow the biggest banks in the Polish banking sector to increase their market share by way of acquisitions. This proposal corresponds to the regulations which apply in the USA. The 1994 Riegle-Neal Interstate Banking and Branching Efficiency Act in the USA prohibits an increase of the deposit market share above 10% through mergers (while allowing for organic growth above that limit). Poland’s two largest banks, PKO BP SA and Bank Pekao SA, have a deposit market share well over 10% each. With such a high deposit market share, regulators should not allow any increase of the market share through acquisitions. It is recommended to introduce this rule as a legal regulation.

VII. Possible scenarios of transforming a bank which is a subsidiary of a foreign banking group into a locally controlled bank

Different options are possible to transform a bank owned by a foreign banking group into a locally controlled bank with a dispersed ownership structure. Several such options are presented in this section. The next section presents at greater length one possible scenario of such a transformation.

Possible scenarios of transforming a bank owned by a foreign banking group into a locally controlled bank with dispersed private shareholding:

1) Transformation by an existing strategic investor which sells its stake on the Warsaw Stock Exchange where shares are bought by investors not allowed by the regulators to exceed the threshold of 10% of shares

In this scenario, the strategic investor could be motivated by the need to sell the held controlling stake while being unable to find a strategic investor acceptable to the Polish regulators. In the case of a clear and consistent regulatory policy, before selling the shares, the strategic investor may amend the statutes by restricting the voting rights of a single shareholder to 10% while waiving the restriction for the strategic investor until it exits the investment. The implementation of this scenario would require clear and determined supervisory measures as the introduction of such a statutory amendment would probably have a negative impact on the market valuation of the shares held by the strategic investor.

2) Acquisition of a controlling stake by an investor or group of investors together with the buyer’s guarantee that the acquired bank will be transformed into a stable locally controlled bank by way of introducing a provision of the bank’s statutes restricting the maximum number of votes of a single shareholder (or group of related shareholders) to 10% of votes at a general meeting. The restriction may be waived for a specific period of time for the investor transforming the bank into a locally controlled bank.

3) Acquisition of a bank from which a strategic investor is exiting by another local bank (Transforming Bank) which can guarantee that, after the transaction and the merger, the merged bank will take the form of a locally controlled bank with dispersed shareholding by way of introducing the above restriction on the maximum number of votes of a single shareholder.

- We assume that, for the purpose of the acquisition, the Transforming Bank will have to increase the capital by issuing shares for investors on the Warsaw Stock Exchange.
- The Transforming Bank may, at the outset, be a private bank or a bank controlled by the State Treasury but, for the success of the share issue, the bank’s management must be composed of managers whose qualifications and experience are credible to investors.
- If the Transforming Bank is a private bank, the investor controlling the bank could, for a specific period of time, be exempt from the restriction on the number of votes introduced in the statutes (in practice, due to an increase of the capital of the transforming bank and the merger, the share of the investor originally controlling the Transforming Bank will be significantly reduced after the transaction).
- If the Transforming Bank is a bank directly or indirectly controlled by the State Treasury, it is necessary to ensure that the stake of the State Treasury after the transaction is reduced so as to exclude the possibility that the merged bank remains controlled by the State Treasury.

4) Acquisition of the bank for a transitional period by a public entity (Bridge Vehicle) acting as a bridge buyer, which will subsequently sell the bank in a dispersed model following the amendment of the statutes restricting the possibility of shareholding concentration. The opportunities and risks relating to the creation and operation of a Bridge Vehicle are discussed in Section XI.

VIII. Scenario of “domesticating” a bank through dispersed private capital

Below, a scenario is described in which a bank is acquired by a group of investors (Syndicate) composed of a lead investor (Lead Investor) and portfolio investors (Portfolio Investors). The Lead Investor acts as a representative of the Syndicate running the due diligence of the bank to
be acquired, conducting negotiations with the seller and making arrangements with the regulatory authorities. The function of Lead Investor could be performed by one entity or jointly by two or three entities.

1. Assumptions and key elements of the transaction

1) A foreign banking group wants to sell its subsidiary bank in Poland (Bank) in order to improve its capital ratio.
2) The sale of a controlling stake to a new strategic investor is not possible as there are no interested buyers or such buyers are not acceptable to the Polish regulatory authorities.
3) A group of financial investors decide to use the opportunity of not having to compete with potential investors willing to pay a premium for strategic control of the Bank. The group sets up the Syndicate in order to buy the entire stake held by the foreign strategic investor in a single transaction and to transform the Bank into a locally controlled bank.
4) The stability of “local control” could be ensured by introducing provisions into the Bank’s statutes prohibiting a single investor from taking control of the Bank. Such provisions may in particular restrict the voting rights of a single shareholder to no more than 10% of votes at the General Meeting. However, in order to enable the Lead Investor to act, it might be necessary to exempt the Lead Investor from the restriction on the voting rights for a specific period of time.
5) The target ownership structure and the target rules of appointing and managing the authorities of the Bank should be decided in consultation with the Polish Financial Supervision Authority (KNF) and are subject to its approval.
6) A problem to be resolved where a group of financial investors acquire the stake of a foreign strategic investor is the replacement of financing provided by the parent bank (this issue is further discussed in Section IX). Investors buying the stake from the strategic investor should, in co-operation with the KNF, decide with the exiting strategic investor about the path of withdrawing the debt financing the strategic investor provides. In order to avoid a gap in the bank’s liabilities, due to the withdrawal of funding by the exiting strategic investor, it may be necessary to reduce the growth rate of assets and to grow the deposit base more actively. Under these circumstances, the NBP should consider providing support to cover specific risks in the Bank’s liabilities for some time. For example, the NBP could provide the Bank with refinancing credit or swap lines, replacing the financing being withdrawn by the exiting strategic investor. The NBP could also offer liquidity support if deposits are withdrawn from the Bank after the transaction.
7) The European Bank for Reconstruction and Development (EBRD) could also participate in the transaction as a buyer of an equity stake or provider of financing and liquidity to the Bank, helping to replace financing provided by the exiting strategic investor. The EBRD could also play an active role in the Bank’s management structure for a specific period of time as an additional
factor stabilising the Bank while it develops its new management and supervision structure.

8) The preparation and implementation of such a transaction requires the active engagement of the Lead Investor (whose role is discussed at greater length below). In order to act effectively, such an investor should get some kind of “soft” support from the KNF, such as a letter of conditional approval of the Lead Investor’s efforts.

9) It should be noted that the Lead Investor acquires a minority stake in the Bank, guided not so much by strategic motivation but as a prospect of financial gain it will realise by selling its stake on the Warsaw Stock Exchange after the agreed minimum holding period.

10) After closing the transaction, the Portfolio Investors should have the freedom to sell their stake on the Warsaw Stock Exchange, but must realise that they cannot expect to earn a premium by selling the stake to an entity interested in taking control of the Bank as taking such control is prohibited by the statutory provisions or the policy of the supervisory authorities.

2. Composition of the investor group

1) It is advisable for the Syndicate to include both Polish and foreign investors. The greater the share of foreign investors in the Syndicate, the lesser the outflow of capital from Poland as a result of the transaction. The participation of Polish investors is necessary in light of the objective of ensuring “local control of the Bank” and because the engagement of local institutional investors is a factor enhancing the credibility of the transaction and reducing the risks perceived by foreign portfolio investors. An aggregate share of foreign investors in the Bank’s shareholding at 50% or even slightly more should not be considered contradictory to the retention of local control.

2) It is likely for the Syndicate to include 10-50 investors, where each Portfolio Investor would buy a stake of 1-10% while the Lead Investor would acquire a stake of 10-20%.

3) The structure and implementation of the transaction must respect the rights of existing minority shareholders of the Bank. In most cases, the transaction will require a tender offer as the members of the Syndicate will be considered as acting in concert (their stakes will then have to be aggregated). We assume that after the Syndicate has acquired the stake of the strategic investor and bought the shares in a tender offer, at least some of the existing minority shareholders will remain shareholders of the Bank. The Bank will remain a public company listed on the Warsaw Stock Exchange.

4) The Syndicate may include:

- Polish institutional investors such as pension funds, investment funds, insurance companies and large industrial companies with substantial cash reserves.
- Foreign portfolio investors such as pension funds, investment funds and private equity investors.
5) Members of the Syndicate acquiring significant stakes will be likely to expect representation on the Bank’s Supervisory Board.

6) Assuming the potential assets of local portfolio investors, their contribution to the transaction may significantly exceed PLN 4 billion. It should be stressed that the propensity of local investors to participate in the transaction will largely depend on the financial strength and reputation of the Lead Investor.

7) Pension funds may play an important role in the group of local portfolio investors. Due to their financial potential and broadly recognised role as an active local exchange investor, they may make the transaction credible to foreign portfolio investors and local retail investors. The current rules of evaluating the performance of pension funds do not promote more radical investment decisions due to mutual benchmarking, which results in a kind of “herd behaviour” of this group of investors. It could be expected that the decision of one or two of the larger pension funds to take part in the transaction would encourage other funds to do the same. However, pension funds cannot be expected to be willing or able to play the role of the Lead Investor.

3. Lead Investor

The Lead Investor should have experience with investments in the financial sector. It should have its own capital resources and the ability to attract partners for investments. It should also be able to negotiate with the seller and the regulatory authorities. The Lead Investor should perform the following tasks:

1) Conducting a valuation of the Bank and identifying the main opportunities for revenue growth as well as potential difficulties in taking over ownership from the exiting strategic investor.

2) Preparing the proposed ownership structure of the Bank after the transaction and solutions, ensuring the long-term retention of local control.

3) Identifying potential co-investors and arranging the Syndication whereby each member commits to acquiring a specific stake (from 1 to 10% of the Bank’s shares).

4) Potentially approaching the EBRD to gain its support for the investment and arranging the nature and scope of its participation.

5) Evaluating the suitability of the Bank’s management board members. If it is deemed necessary to replace the management of the Bank, the Lead Investor should identify a candidate for CEO and, jointly with the candidate, come up with the proposed composition of the management board.

6) Arranging potential liquidity lines with the NBP (e.g., refinancing credit for the Bank secured with a separate part of the loan portfolio, swap lines) which allow for replacing the financing
being withdrawn by the exiting strategic investor on terms which are not restrictive in nature.

7) Consulting the KNF in order to define a management structure conducive to the stability of the Bank and to confirm that the proposed mechanism of ensuring long-term local control and the transaction as a whole are acceptable to the supervisor.

8) Preparing and presenting on behalf of the Syndicate a non-binding offer to buy the entire stake from the exiting strategic investor.

9) Negotiating with the seller and closing the deal.

10) Introducing agreed amendments to the Bank’s statutes and changes to the composition of the Bank’s authorities together with the other Syndicate members.

11) Playing an active role in owner supervision by means of adequate representation on the Supervisory Board, which should also include representatives of other significant Syndicate members and independent Supervisory Board members.

12) Holding a stake in the Bank for at least for the agreed minimum holding period (3 – 5 years) with an early exit option subject to the KNF’s approval.

The function of Lead Investor could be performed by one entity or jointly by two or three entities. We believe that local institutional investors and international private equity investors could be potential candidates for Lead Investor (or Co-Lead Investor).
IX. Problem of replacing financing provided by the exiting strategic investor

When a group of financial investors acquire the stake of a foreign strategic investor, replacing the financing provided by the parent bank may be a problem. Data illustrating the scale of the problem in the group of Poland’s top 10 banks are presented in Table 4 below.

Table 4. Debt financing provided by foreign parent banks to their Polish subsidiaries
(Poland’s top 10 banks by receivables from clients at year-end 2011)

<table>
<thead>
<tr>
<th></th>
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<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>PLN bn</td>
<td>% of loan portfolio</td>
<td>PLN bn</td>
</tr>
<tr>
<td>PKO BP</td>
<td>Not applicable</td>
<td></td>
<td>30.9</td>
</tr>
<tr>
<td>Pekao SA</td>
<td>2.6</td>
<td>3%</td>
<td>3.0</td>
</tr>
<tr>
<td>BRE</td>
<td>28.8</td>
<td>45%</td>
<td>21.5</td>
</tr>
<tr>
<td>ING BŚ</td>
<td>3.4</td>
<td>9%</td>
<td>3.0</td>
</tr>
<tr>
<td>Millennium</td>
<td>0.0</td>
<td>0%</td>
<td>0.2</td>
</tr>
<tr>
<td>GetinNoble</td>
<td>Not applicable</td>
<td></td>
<td></td>
</tr>
<tr>
<td>BZ WBK</td>
<td>0.2</td>
<td>0%</td>
<td>0.0</td>
</tr>
<tr>
<td>Kredyt Bank</td>
<td>12.2</td>
<td>41%</td>
<td>6.5</td>
</tr>
<tr>
<td>BPH</td>
<td>17.1</td>
<td>58%</td>
<td>15.5</td>
</tr>
<tr>
<td>Nordea</td>
<td>17.5</td>
<td>67%</td>
<td>18.1</td>
</tr>
<tr>
<td>Total</td>
<td>81.1</td>
<td>Not applicable</td>
<td>68.0</td>
</tr>
</tbody>
</table>

Source: banks’ financial statements.

In addition to loans, advances, and deposits, some banks also use standing FX swap lines, which allow them to finance the portfolio of FX loans with PLN deposits.

Taking control of banks without ensuring how to replace the financing previously provided by parent banks would impair the liquidity of the Polish banking sector and, in some cases, could actually prevent the continuation of bank’s activity.

In cases where the exiting strategic investor is being replaced by portfolio investors, none of whom are acquiring a controlling stake, they cannot be expected to be willing or able to provide debt financing to the bank.
Three ways to solve the problem of financing:

1. The exiting strategic investor continues to finance the bank until the expiration of the loan portfolio originally financed by credits provided to the bank by this investor.

This solution is justified by long-term commitments to ensure the stability of the institution given to the supervision by investors when taking control of Polish banks. This solution could be combined with transferring the loan portfolio onto the balance sheet of the former parent bank while keeping the administration of the portfolio in the former subsidiary.

Disadvantages of the solution:
- It could be very disadvantageous from the perspective of the capital ratios of parent companies, which the latter will be striving to avoid (it would also additionally increase the selling price of the bank).
- Transferring the loan portfolio onto the balance sheet of the holding company could be very complicated. It could be hard to perform and difficult to manage due to the risk of insufficient control over later servicing and administration of the portfolio.

2. The exiting strategic investor maintains its credits to the bank until the expiration of contractual maturities.

According to the KNF, about 50-60% of wholesale financing has maturities of less than 1 year. This would require an accelerated adjustment of the bank’s balance sheet by way of reducing the growth rate of assets or even reducing the assets and attracting more deposits.

Disadvantages of the solution:
- Temporary very negative impact on the results of the bank.
- It may trigger “deposit wars”, i.e. a significant increase of deposit margins on the market.

3. Replacing financing from the existing investor with NBP refinancing credit extended to the bank on the date of maturity of financing from the former parent bank.

For this purpose, the bank could use the NBP’s refinancing credit secured with the loan portfolio. A solution consisting in transfers of credit receivables as security of funding provided by the central bank has been used by the Deutsche Bundesbank. The NBP would have to set the criteria of accepting debt as collateral. A two-pronged approach to a debt credit rating is possible:
- Use and application by the NBP of its own credit rating system; for example, the
Bundesbank has its own credit rating system for debt under loans to companies and individuals pursuing a business.

- Use of debt rating assigned by banks extending the loans – in that case, it would be advisable to have the NBP/KNF perform annual reviews of debt rating methodologies (recommended due to lack of time to develop and test its own system of credit rating).

Refinancing credit should be extended in the currency of existing financing provided by the parent bank or else its currency structure should correspond to the currency structure of the loan portfolio financed with it. Refinancing credit should be extended on terms which are not restrictive in nature.

**Advantages of the solution:**
- No dangerous tensions in the balance sheet of the bank being acquired.
- The solution does not trigger deposit wars.

**Disadvantages of the solution:**
- For some banks, this could imply the dependence of a very large part of the bank’s balance sheet on refinancing credit.

**Conclusions**

The strong dependence of some banks on lending provided by parent banks is indicative of unsound balance-sheet relations. Difficulties in the financing of the bank after the exit of a strategic investor are only a part of the problems caused by such a business model at the level of a single bank and the entire economy. Therefore, in our opinion, the regulators should strive to ensure that this business model gradually disappears. The exit of a strategic investor could be considered to afford an opportunity for the accelerated improvement of unsound balance-sheet relations; however, it should be performed in such a way so as not to create excessive tensions leading to deposit wars.

Investors buying a stake from the strategic investor should, in co-ordination with the KNF, decide with the existing strategic investor about the path of withdrawing the debt financing provided by the investor, which does not necessarily need to overlap with existing contractual maturities. By evoking the prior commitments of the exiting investor and the classification of the financing in the bank’s liquidity reports, the KNF may raise expectations that part of the financing will be extended for a specific period of time.

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32 Cf., e.g., Stefan Kawalec and Andrzej Sławiński, “Kredyty walutowe mogą szkodzić”, *Gazeta Wyborcza*, 5 August 2010.
Staggering the withdrawal of financing by the exiting strategic investor over a period of several years could allow the bank to restructure its balance sheet by reducing the growth rate of assets and more actively growing the deposit base, thus preventing a gap in liabilities or reducing the size of the gap. Such opportunities of restructuring the balance sheet are demonstrated by data for Kredyt Bank SA and BRE Bank SA presented in Table 4 above. Both banks significantly reduced their dependence on financing from holding banks within 12 months, from the end of September 2011 until the end of September 2012. However, it should be noted that:

a) a too rapid restructuring of the balance sheet is a factor stimulating deposit wars in the banking sector;
b) replacing loans from the holding company with PLN deposits to finance the fx mortgage portfolio exposes the bank to the risk of the cost and availability of fx swaps.

Therefore, where financing provided by the exiting strategic investor is being withdrawn, it might be advisable to have NBP support the planned restructuring of the bank’s balance sheet by:

1) replacing part of the financing being withdrawn with NBP’s refinancing credit secured with the loan portfolio;
2) offering FX swap lines to help the bank finance the existing FX loan portfolio with PLN deposits (including the replacement of swap lines being withdrawn by the exiting strategic investor).

X. Evaluation of the costs and benefits of an alternative model of buying out Polish subsidiaries of foreign banks through investment by large companies in which the State Treasury holds a significant stake

The biggest Polish companies controlled by the State Treasury in non-financial sectors such as KGHM (copper mining), PGE, Tauron, Enea and Energa (electricity generation and distribution), PKN Orlen (oil refining and retailing) and PGNiG (natural gas distribution & gas and oil extraction) have substantial capital and financial resources, as demonstrated by the high dividend drawn from those companies by the State Treasury. These companies, or at least some of them, could theoretically invest in a buy-out of banks operating in Poland and controlled by foreign banking groups. However, it should be noted that all these companies face serious strategic challenges in their core business and are planning multi-annual investment programmes without having secure sources of financing. It is largely on the financial strength of these companies that the planned implementation of strategic programmes depends, including the modernisation of the Polish energy sector and the development of shale gas extraction, as well as the development of nuclear power. At the same time, these companies do not have the know-how necessary to evaluate the prospects of investments in the financial sector or to play
the role of an active investor accepting responsibility for the management of a bank.

Therefore, in our opinion, it would be unwise to see these companies either as potential strategic investors or even as investors acquiring significant stakes as a long-term investment.

These companies could, however, act as portfolio investors acquiring significant stakes, even of substantial value. Considering such investments to be portfolio investments would enable them to temporarily invest cash to be used in the future (after the sale of the acquired stake) in order to implement their own investment programmes. Such an investment is conditional on the existence of other lead investors which could play a more active role in evaluating the price factors of the offer and later actively participate in owner supervision. The above mentioned non-financial companies controlled by the State Treasury could participate in such transactions if, at a given time, they have the liquid assets to invest in the mid-term provided that they are certain that the valuation of the stake to be acquired is correct and attractive. In that case, the above companies could, in some cases, provide a significant part of capital necessary to close a transaction.

The participation of financial companies controlled by the State Treasury, PKO BP SA, and PZU SA in transactions related to “domesticating” a bank is another issue.

The participation of PKO BP SA in “domestication” is unadvisable. The acquisition of banks by PKO BP SA would increase concentration and systemic risk in the banking sector and should not be allowed by the regulators (see Section VI, point 8. Restrictions on concentration). It would also be unadvisable to acquire significant stakes in competitive banks.

PZU SA is the only company controlled by the State Treasury which could, in a large part, engage in the “domestication” of banks, acting as a lead investor in the transformation of a bank owned by a foreign banking group into a locally controlled bank. PZU is capable of exercising professional owner supervision over a bank using its managers with experience in banking or, if necessary, hiring adequate human resources. In addition, PZU SA has the financial capacity necessary to support a bank it would control in an emergency. The participation of PZU SA in the “domestication” of a bank should be combined with the development of a mid-term strategy for such an investment as well as corporate governance rules so that PZU SA’s investment does not turn the bank being “domesticated” into a permanent subsidiary of the Treasury.
XI. Is there a need for a bridge vehicle using public funding to “domesticate” banks?

Discussions about the “domestication” of banks that the authors of this report have participated in frequently give rise to the proposal of “domesticating” banks by using an entity (hereinafter “Bridge Vehicle”) which would use public funding to buy out banks from foreign strategic investors exiting Poland and subsequently sell the acquired banks to private investors on the stock market. The discussions consider both the scenario of using an existing institution as the Bridge Vehicle and the scenario of using a newly created institution.

This section attempts to describe and critically evaluate the concept of a Bridge Vehicle.

1. Potential goals of using a Bridge Vehicle

The proponents of the concept of using a Bridge Vehicle generally suggest two potential goals that a Bridge Vehicle could pursue.

Goal 1: to enable a quick take-over of a bank from a strategic investor in distress

A Bridge Vehicle would buy out a bank from a foreign strategic investor where the strategic investor experiencing problems would be forced to sell a subsidiary bank in Poland, but market conditions would not allow for such a transaction to be quickly closed while, on the other hand, continued control by the strategic investor in distress would pose a threat to the Polish subsidiary bank. A Bridge Vehicle would, by definition, serve as a temporary owner of the bank. Bridge Vehicle managers would be required to sell the bank to dispersed shareholders as soon as market conditions allow.

Goal 2: to introduce amendments to the statutes, ensuring the stability of the dispersed shareholding structure

A Bridge Vehicle could buy a bank from a foreign strategic investor in order to introduce amendments to the bank’s statutes, imposing shareholding concentration limits to ensure the stability of the dispersed ownership structure.33 This goal could be pursued in combination with goal 1 or independently where it is not necessary to pursue goal 1.

2. Public institutions that could act as a Bridge Vehicle

Currently, there is no institution which could act as a Bridge Vehicle. Performance of the functions of a Bridge Vehicle would require legislative amendments enabling an existing public institution to perform this function or legislative amendments enabling the creation of a new institution fit for this function. Several possible institutional scenarios of a Bridge Vehicle are presented below.

National Bank of Poland

Under the existing NBP Act, the Polish central bank cannot be a shareholder of other legal persons other than entities which provide services only to financial institutions and the State Treasury.\(^\text{34}\) This regulation deprives the NBP of the possibility of providing banks with support by way of acquiring their shares, which was allowed until the Banking Guarantee Fund (BGF) was established in 1995 (in 1989-1997, the NBP made 4 capital investments in total and temporarily acquired shares of restructured banks in an aggregate amount of PLN 104.8 million, holding shares of banks until 1997).\(^\text{35}\) Currently, the NBP’s support for banks is limited to extending refinancing credit in order to supplement their financing. The same regulation also seems to preclude the possibility of the NBP becoming a shareholder of an entity which could perform the functions of a Bridge Vehicle. Performing the functions of a Bridge Vehicle could hardly be considered a provision of services to financial institutions or the State Treasury.

Potential amendment of the legislation enabling the NBP to acquire shares of banks or entities authorised to acquire shares of banks would be contradictory to the function of the NBP as a central bank and would stir public controversy, which would partly turn against the very idea of “domesticating” banks. This does not mean that the NBP should not be involved in the process of “domesticating” banks. The NBP has a very important and irreplaceable role to play in the process by providing adequate liquidity support to banks being “domesticated” (see Section X). This function can be performed without legislative amendments and is not contradictory to the function of the NBP as a central bank.

Banking Guarantee Fund (BFG)

According to the Banking Guarantee Fund Act, the responsibilities of the BFG to assist entities covered by the guarantee scheme include the provision of returnable financial aid in case of a

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\(^{34}\) National Bank of Poland Act (Journal of Laws from 1997, No. 140, item 938, as amended), Article 5(2).

\(^{35}\) Nadzór bankowy 1989-2006, NBP.
risk of insolvency or as necessary to buy shares of banks.\textsuperscript{36} The Act does not provide for the BFG itself to buy shares of banks which use the financial assistance of the Fund. Therefore, the participation of the BFG in the creation of a Bridge Vehicle in order to take over a bank, as allowed by the existing legislation, could be limited to extending a loan, guarantee, or surety (including, under Article 19(1) of the Act, on terms more favourable than those generally used by banks) for the acquisition of shares of a bank by a Vehicle provided, however, that the bank is at risk of insolvency. (Risk of insolvency is defined as all of the following criteria being fulfilled jointly: the bank has posted a loss and the evaluation of the bank’s financial standing is negative; the definition was implemented in an amendment of BFG Council Resolution No. 35/97 of 22 April 2009).

It is theoretically possible to amend the legislation in order to enable the BGF to directly act as a Bridge Vehicle or to acquire shares of an entity which performs this function. The possibility of performing the functions of a Bridge Vehicle would largely expand the scope of responsibilities of the BGF, which could hinder the BGF’s performance of its core function: that of guaranteeing deposits.

\textbf{State Treasury}

The Act on State Treasury Support for Financial Institutions sets out, among others, the forms of State Treasury support provided to local banks aiming to maintain solvency, including credit expansion.\textsuperscript{37} The allowed forms of State Treasury support do not include the acquisition of shares. Under Article 3(1) of the Act, support can only be extended in the form of guarantees, Treasury securities lending, and Treasury securities sale (with deferred payment, by instalment, or under an offer addressed to a specific financial institution).

To enable the State Treasury to directly perform the function of a Bridge Vehicle or acquire shares of an entity which performs this function would require a separate legislative mandate and a state budget allocation.

\textbf{National Asset Fund}

The National Asset Fund could potentially be used as a Bridge Vehicle to acquire the shares of a


bank being “domesticated”. According to the proponents of the concept of creating the Fund,\textsuperscript{38} the assets of the State Treasury would be split into three parts: around 30 companies of key importance to the Polish economy in which the state wants to keep a stake (“blue chips”), companies marked for privatization, and properties of the State Treasury. The National Asset Fund would group all of these assets and manage a net asset value well above PLN 100 billion, a financial resource sufficient to perform the functions of a Bridge Vehicle or to create a Bridge Vehicle (as a separate special-purpose vehicle) and equip it with capital.\textsuperscript{39}

The National Asset Fund concept is currently at the stage of preliminary development and does not yet have specific implementing solutions: it is not clear, for instance, how the goals of the Fund would be defined, how control of the Fund would be exercised, who would manage it, on what terms it would raise financing, whether and how the operations of the Fund would be reflected in the public accounts, or how the creation of the Fund would reflect on privatization revenues and dividend income of the state budget.

It should be stressed that the potential functions of a Bridge Vehicle in the process of “domesticating” banks would be only one of many goals of the National Asset Fund, and that this goal is not being proposed in the original concept by its authors. As an analysis and elaboration of the National Asset Fund concept is not the purpose of this study, we shall limit ourselves to concluding that, if the Fund is established, it could theoretically perform the role of a Bridge Vehicle in the process of “domesticating” banks.

3. Selected problems related to use of a public Bridge Vehicle

Where shares of a bank are acquired from an exiting strategic investor by a public Bridge Vehicle, there are three serious risk-generating problems:

- the risk of loss on the investment,
- the timeframe of owner control exercised by the Bridge Vehicle,
- the rules of control of the bank exercised by the Bridge Vehicle.

\textit{a) Risk of loss on the investment}

In a situation where market conditions do not allow the investor to quickly sell the held stake to other investors, the acquisition of a bank’s shares by the Bridge Vehicle would take place at a

\textsuperscript{38} Concept developed by the Gdańsk Institute for Market Economics (IBnGR) and McKinsey & Company in the autumn of 2011.

\textsuperscript{39} The National Asset Fund would use cash from dividends and sale of shares of privatised companies. It could also issue investment certificates or take debt secured with assets.
price higher than the price realisable by the investor on the market. The introduction of statutory limits on shareholding concentration would have an additional negative impact on the attractiveness of the shares to stock market investors. In fact, it would rule out future acquisition of the bank by a new strategic investor and the related prospect of a premium for the shareholders. There is a risk that the Bridge Vehicle willing to sell shares of the bank on the stock market would have to accept a loss on the investment for a long period of time. The loss could in fact be interpreted as a form of using Polish public funding to support a foreign strategic investor.

b) Timeframe of owner control exercised by the Bridge Vehicle

It is important for the structure of the Bridge Vehicle to determine how long the mechanism should operate (i.e., when to carry out a public offering of shares of the bank addressed to dispersed shareholding). It is difficult to anticipate how soon the exchange market conditions will pick up or the results and the outlook of the bank will improve in order to allow for the shares of the bank to be sold at a price exceeding the purchase price. If an absolute requirement to sell the shares within a specific time limit is imposed, the risk of a loss on the transaction cannot be ruled out. If there is no absolute time limit for the sale, the unwillingness to accept a loss on the investment could make the management of the Bridge Vehicle postpone the decision to sell the shares of the bank in hope of an improvement in market conditions. Hence, against all intentions, a temporary investment may become a long-term investment. This justifies the concern expressed in discussions that investment by a Bridge Vehicle could lead to the long-term consolidation of state control over banks.

c) Rules of control of the bank exercised by the Bridge Vehicle

Upon its acquisition of a controlling stake of the bank, the Bridge Vehicle takes control of the bank and, in particular, control over the composition of the supervisory board and the management board. The question arises how and under what rules the Bridge Vehicle makes personal decisions concerning the composition of the authorities of the bank as well as other owner decisions. This question can be addressed in various ways. However, there are no proven institutional solutions that would protect the independence of managers of a bank controlled by a public entity from political influence. Since there is a serious risk, as mentioned above, that the Bridge Vehicle would control the bank for a long period of time, public investment by the Bridge Vehicle may lead to greater politicisation of the banking sector.

While the risks enumerated above related to the operation of a Bridge Vehicle could be mitigated by means of diverse institutional solutions, in our opinion, it may not be possible to
eliminate some of those risks. In this context, it is reasonable to consider whether the goals for which a Bridge Vehicle would be established really must be achieved and whether such goals can be achieved through other means.

4. Is it necessary to use a public Bridge Vehicle?

_Is it necessary for a Bridge Vehicle to take control of a bank where the strategic investor is in distress?

In recent years, there have been several banks in Poland where the holding company found itself in serious distress and eventually sold or decided to sell its subsidiary bank in Poland. These included AIG Bank SA, BZ WBK SA, and Kredyt Bank SA. In none of these cases would the prolonged process of the strategic investor’s exit interfere with the stability of the Polish subsidiary bank.

This suggests that there are no reasons to believe that every time that a strategic investor is in distress and wants to sell its bank in Poland it is necessary to take swift measures in order to take control of the bank. However, it cannot be ruled out that, in special cases, problems faced by the strategic investor may pose a threat to the stability of the Polish subsidiary bank. In those cases, the banking supervision could exercise its powers and use available instruments (from drafting recommendations through introducing a restructuring supervisor to introducing compulsory administration) while the NBP and the BFG could provide financial support according to the rules governing those institutions.

_Is a Bridge Vehicle necessary to introduce amendments to the statutes ensuring the stability of a dispersed shareholding structure?

Amendments to the statutes ensuring the stability of a dispersed shareholding structure could also be introduced without resorting to a Bridge Vehicle. In particular, in the presented “domestication” scenario, such amendments could be introduced by the Syndicate of financial investors buying a controlling stake from the exiting strategic investor (see Section VIII). Another possible scenario is that the exiting strategic investor, following negotiations with the KNF, agrees to introduce amendments to the statutes to ensure the stability of a dispersed shareholding structure before initiating the sale of the held stake on the exchange.

5. Summary

The Bridge Vehicle is a mechanism which could be used to accelerate the sale of a bank by
strategic investors exiting Poland and to facilitate the introduction of statutory amendments ensuring the stability of a dispersed shareholding structure. On the other hand, use of a public Bridge Vehicle involves serious risks:

a) Risk of a loss on the investment of the Bridge Vehicle, which could in fact mean using Polish public funding to support a strategic investor exiting Poland.

b) Investment by the Bridge Vehicle could lead to the long-term consolidation of state control over banks.

c) Risk involved in the politicisation of control over banks.

In the current legal system, there are no public institutions which could be used as a Bridge Vehicle. Therefore, the creation of a Bridge Vehicle would require legislative amendments (e.g. restoring the NBP’s right to buy shares of banks or making a systemic change in the management of the assets of the State Treasury by creating the National Asset Fund).

However, irrespective of potential institutional solutions, in view of the risk of consolidating state control and politicising the management of banks, it is recommended that the “domestication” of banks is carried out without using a Bridge Vehicle based on public funding.

**XII. Measures of State bodies necessary to support the “domestication” of banks**

**1. Introduction**

Discussion on the “domestication” of banks has been spurred by the turbulences around the implementation of the Third Basel Capital Accord and the Eurozone debt crisis, which international banking institutions have recently been facing as well as the fact that foreign financial institutions control two-thirds of the assets of the Polish banking sector. However, a strategy of “domesticating” banks should not be considered a mid-term emergency measure. Its goal is a fundamental change of the Polish banking system to better reflect the current position of Poland in Europe, a position which is completely different than at the outset of transition.

The “domestication” of banks should not be expected to happen within a very short period of time. Just like the privatization of banks in Poland took almost a decade, the “domestication” of banks may also take several years.

It is important to define a clear strategy and framework of ownership transformation in the banking sector. These strategic decisions should be more permanent than changing market conditions in the banking sector in Poland and in Europe. A clearly defined strategy and

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40 Another option, not analysed here, is the creation of a Bridge Vehicle using only the money of private investors.
framework will facilitate the co-ordination of measures taken by state bodies and institutions and impact the expectations of existing strategic investors as well as investors interested in investing in the Polish banking sector.

If a clear strategy and framework is defined and the Polish authorities pursue a consistent policy, the “domestication” of banks will take place gradually through subsequent transactions concluded in the banking sector.

2. Premises for a strategy of the Polish authorities concerning influence on the structure of the banking sector

- The domination of banks controlled by foreign banking groups in the Polish banking sector is atypical of a large European economy such as the Polish economy.
- The existing ownership structure of the Polish banking sector is not a result of spontaneous market processes but rather an effect of a determined privatization policy aimed at accelerating the modernisation of Polish banking sector.
- The experience of the financial crisis in Europe and research on the consequences of capital flows suggest that the core function of the national banking sector should be collecting local deposits and lending to local companies and households rather than intermediation in international capital transfers.
- The current dependence of Polish banks on foreign banking groups generates serious risks to the Polish economy; those risks cannot be fully mitigated through national regulation and measures taken by the banking supervision.
- The national regulatory authorities have a strong mandate to influence the structure of the banking sector as its operation is possible thanks to the support of the state which bears the associated fiscal risk.

3. Proposed outline of a strategy of the Polish authorities regarding the structure of the banking sector

1) In light of the premises listed above in point 2, the Polish regulatory authorities should strive to increase the share of locally controlled banks in the Polish banking sector. The goal is not to eliminate banks which are subsidiaries of foreign banking groups but rather to gradually reduce their share in the assets of the banking sector and to transform the existing structure in which banks which are subsidiaries of foreign financial institutions own around two-thirds of the assets of the sector while the share of locally controlled banks is only about one-third.

2) The process of increasing the share of locally controlled banks should respect the principles of
competition, in particular:

- It will not discriminate against foreign investors as compared to local investors (as local control is understood not as a majority stake held by local investors in the shareholding of the bank as much as the bank is not controlled by any external entity and its actual decision-making centre is in the management board and the local head office).

- It will not involve the investment of public funding in the acquisition of banks with the exception of potential temporary provision of liquidity to a bank where the exiting owner withdraws financing.

- It will not be used to enable the government to exert influence on the directions of the credit policy of banks.

3) When extending support to ownership transformation in order to increase the share of locally controlled banks, efforts should be made to avoid solutions which could seem to be the simplest ones but which increase instead of mitigate systemic risk in the banking sector:

- Taking control of banks by the State Treasury or its subsidiaries should be avoided. An ownership structure model in which the State Treasury holds a minority stake but controls institutions thanks to dispersed remaining shareholding should also be avoided.

- Excessive concentration in the banking sector should be avoided, bearing in mind the current debate in Europe and the USA concerning the approach to banks which are “too big to fail” and which could create serious systemic risk. Hence, the regulators should not allow the biggest banks in the Polish banking sector to increase their market share by acquiring competitors.

4) Where strategic investors exit Poland:

- The preferred solution should be to sell shares on the stock market after introducing a statutory provision restricting the voting rights of a single shareholder to 10% of votes present at the general meeting.\(^{41}\)

- An alternative acceptable solution is to sell shares to an investor or group of investors who commit to transforming the bank into a bank with dispersed shareholding by introducing the above-mentioned statutory provision restricting the voting rights of a single shareholder.\(^ {42}\)

5) The Polish regulatory authorities should prevent strategic investors from taking control of banks in Poland if their control of banks could create risks to the stability of a bank or a risk

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\(^{41}\) Such a statutory restriction should be accompanied by a safety mechanism authorising the Financial Supervision Authority to decide in reasonable cases to waive the provision restricting the percentage of votes allowed for a single shareholder of a bank for the duration of a specific general meeting (see Section V, point 8).

\(^{42}\) The introduced voting right restriction may be waived for a specific period of time for the investor transforming the bank into a locally controlled bank (see Sections VII and VIII).
of interference with the performance of the bank’s core financial intermediary function. In particular, the regulatory authorities should not approve bank takeovers by foreign banking groups, if the buyer has been recently recapitalized with the use of public funds, or the buyer has a negative rating outlook, or the buyer’s home country has negative rating outlook.

6) In order to enhance the effectiveness of control of ownership transformation in the banking sector, a legislative amendment should authorise the Polish Financial Supervision Authority (KNF) to approve acquisitions of significant stakes replacing the existing authorisation to file an objection against such transactions.

7) The Polish government should demand that the European Commission, which is the guardian of the rules of competition, respects the rule whereby banks which have used government aid should sell available foreign assets, in particular their operations in Poland.

8) The Polish government should oppose the adoption of an EU directive introducing maximum harmonisation of supervisory rules which would significantly restrict the powers of the Polish banking supervision over banks which are subsidiaries of European banking groups. If there is a realistic prospect of implementing maximum harmonisation, it will be necessary to intensify and accelerate measures aiming to “domesticate” banks so as to increase the share of banks in Poland for which the Polish banking supervision is the home supervision.

4. Tasks of state bodies and institutions

1) To present an official diagnosis of systemic risk and to define a strategy of transformation of the structure of the Polish banking sector. The official diagnosis should be presented by the Systemic Risk Council and, before it is appointed, the Financial Stability Committee or possibly the NBP. On this basis, the government should define a strategy for the transformation of the structure of the banking system.
2) To clarify and reason the position of the Polish authorities to EU institutions and member states (Governor of NBP in the European Systemic Risk Council, Minister of Finance in Ecofin, Prime Minister and Minister of Foreign Affairs in the European Council and bilateral relations).
3) To pursue a policy in relation to banks and strategic investors which is consistent with the adopted strategy – KNF.
4) To support transactions leading to the transformation of banks by facilitating the resolution of the financing problem – NBP.
5) To contact international financial institutions, in particular the European Bank for Reconstruction and Development, to ensure that those institutions are ready to participate in
the transformation of banks (which foreign strategic investors are exiting) into banks with dispersed private shareholding (see Section VIII, point 1, item 7) – Governor of NBP and Minister of Finance.

**XIII. Analysis of consistency of the proposed solutions with European regulations**

1. **Free movement of capital**

Article 63 of the Treaty on the Functioning of the European Union provides that all restrictions on the movement of capital between Member States and between Member States and third countries shall be prohibited.

In addition, Article 65 of the Treaty on the Functioning of the European Union provides that free movement of capital shall be without prejudice to the right of Member States to take all requisite measures to prevent infringements of national law and regulations, in particular in the field of taxation and the prudential supervision of financial institutions, or to lay down procedures for the declaration of capital movements for purposes of administrative or statistical information, or to take measures which are justified on grounds of public policy or public security.

The strategy of “domesticating” banks is not a restriction on the movement of capital and is not discriminatory to foreign capital as local control is understood as a situation where the decision-making centre of a bank is local rather than as a majority stake held by Polish capital.

It should be noted that European law accepts situations with respect to the free movement of capital where the prudential supervision may be forced to take all requisite measures to protect the stability of the financial system if necessary.

2. **Powers of the national supervision in “support” of ownership transformation of banks**

Already today, the KNF has the legal instruments necessary to prevent the taking control of a bank by strategic investors whose control of banks could create risks to the stability of a bank or pose a threat to the interest of customers.

According to Article 25 of the Banking Act, any party intending to take up or acquire shares in a domestic bank, directly or indirectly, in an amount which would result in that party being entitled to or more than 10%, 20%, one third or 50% of the total number of votes at a general meeting or to take or acquire shares in the authorised capital shall be required to notify the
Polish Financial Supervision Authority of its intention of taking up or acquiring such shares every time. The KNF may file an objection against the acquisition of shares in cases set out in Article 25h of the Banking Act, in particular where it could pose a threat to the stability of a local bank or the interest of its customers.

These powers of the supervisor are consistent with European law. Moreover, the powers of supervision in some Western European countries are broader and include the approval of the prudential supervision for some transactions impacting the structure of the financial sector.

In our opinion, in the current situation, there are obvious reasons for filing an objection against transactions leading to the takeover of banks in Poland by banks which are established in countries directly at risk of the Eurozone crisis and in the process of a rating downgrade or at a risk of a rating downgrade or banks which have used any form of government aid, in particular those which have not repaid such aid.

In order to enhance the effectiveness of control over ownership transformation in the banking sector, a legislative amendment should authorise the Polish Financial Supervision Authority (KNF) to approve the acquisitions of significant stakes replacing the existing authorisation to file an objection against such transactions.

3. Defining limits of a maximum stake held by a single investor in the shareholding of a bank

This solution is nothing new in Polish legislation. According to the Code of Commercial Companies and Partnerships, it is admissible to restrict, in a company’s statutes, the maximum number of votes of a single investor at the general meeting to 10%. These regulations are consistent with European law. Such restrictions are provided for in the statutes of: PKO BP SA, PZU SA, PKN Orlen SA, GPW SA and PGE SA. In four of these companies, the statutes provide that the restriction shall not apply to shareholders entitled to exercise more than 10% of votes at the time of adoption of the resolution which introduced the restriction (by the way, in all these cases, the State Treasury is that shareholder). In PKN Orlen SA, the statutes explicitly waive the restriction for the State Treasury, Nafta Polska SA and the depository bank which issued the depository receipts related to the shares of the company.

Where a 10% restriction on the number of votes of a single shareholder is introduced in the statutes, it is advisable at the same time to introduce a safety mechanism in the form of a statutory provision authorising the Polish Financial Supervision Authority (KNF) to decide in reasonable cases to waive the provision restricting the percentage of votes allowed for a single shareholder of a bank for the duration of a specific general meeting. Reasonable cases may
include situations where: (1) it is necessary to implement ownership transformation to ensure the stability of the bank, or (2) the management structure is pathologically petrified and restrictions on the voting rights in practice prevent the replacement of the bank’s management by the shareholders.

4. Directions of changes of the supervisory policy of the KNF in response to a potential transformation in the ownership structure of the Polish banking sector

Potential changes of the supervisory policy are not so much a legal problem as a matter of the KNF coping with a new situation where there is no foreign majority banking investor. Certainly, adapting to the new reality will force out the drafting of a new supervisory strategy and, first and foremost, foster a new supervisory culture.

5. Measures of Polish authorities in the EU context

The strategy of the Polish state authorities aimed at increasing the share of locally controlled banks in the assets of the banking sector is geared towards enhancing the stability of this sector, which is absolutely crucial from the perspective of Poland’s economic growth.

Measures ensuring the safety of the Polish financial sector are the responsibility of the Polish public authorities since, in the case of a banking crisis in Poland, Polish taxpayers will be responsible for bailing out banks at the risk of bankruptcy.

In view of Poland’s membership in the European Union, ownership transformation in the Polish banking sector will take place within an institutional framework defined among others by European law. The European Treaties are of key importance, especially the Treaty on the Functioning of the European Union, as well as secondary legislation, including in particular Directive 2006/48/EC of the European Parliament and of the Council of 14 June 2006 relating to the take up and pursuit of the business of credit institutions.

For these reasons, in combination with adequately communicating the objectives of the strategy of “domesticating” banks, the Polish authorities should strive to carry out the transformation in the ownership structure of the banking assets in Poland in a transparent way.

Due to the Eurozone crisis, European legislation governing the banking sector will be thoroughly reformed in the context the proposed Banking Union; hence, it should be a goal of the Polish authorities to ensure that the legal environment of the European Union is friendly towards the implementation of the strategy of “domesticating” banks.
The pursuit of the aspiration to increase the share of locally controlled banks will respect the fundamental principles of European law, in particular:
1. It will not discriminate against foreign investors as compared to local investors (as local control is understood not as a majority stake held by local investors in the shareholding of the bank as much as the fact that the bank is not controlled by any external entity and its actual decision-making centre is in the management board and the local head office). Hence, Article 18 of the Treaty on the Functioning of the European Union, which provides that any discrimination on grounds of nationality shall be prohibited, will not be violated.
2. It will not involve the investment of public funding in the acquisition of banks (hence, the state aid provisions within the meaning of Article 107 of the Treaty on the Functioning of the European Union will not apply) with the exception of the potential temporary provision of liquidity to a bank where the existing owner withdraws foreign financing. The liquidity support instrument is broadly used by central banks around the world (not only in Europe) and, if so required by the situation of a bank, accepted by European legal regimes.
3. It will not be used to enable the government to exert influence on the directions of the credit policy of banks.

XIV. New context of the proposed Banking Union

The Banking Union concept is partly contradictory to what is required to avoid another crisis

An analysis of the experience of the crisis in recent years offers the following specific conclusions:
1) The core function of the national banking sector should be collecting local deposits and lending to local companies and households rather than intermediation in international capital transfers.
2) Bank lending, especially to households, should grow on the basis of local deposits.
3) International capital transfers should generally take place separate from the balance sheets of local banks. This will mitigate the risk of consumer and housing booms financed with loans which undermine the competitiveness of the economy, pose a threat to the solvency of banks and create direct fiscal risk.
4) Each country should be free to use prudential regulations in the banking sector for macroeconomic purposes (macroprudential policy).
5) Local supervisors should supervise and be able to effectively regulate the activity of all banks within their territory (including banks which are branches or subsidiaries of foreign banking groups).
These conclusions are in stark conflict with the aspirations voiced at the time of creating the Eurozone to create a single European banking market, with unrestricted transborder movement of banking capital, with single European prudential norms, and with the currently proposed Banking Union concept.

The Banking Union concept is a substitute for proposals for Eurozone countries to take joint responsibility for the debt of countries at risk

1) The proposal to enhance the fiscal union by creating a joint Eurozone treasury institution capable of issuing debt (eurobonds) and levying taxes has so far been unfeasible, mainly due to the inability to reconcile the positions of Germany and France.
2) However, it has been possible to get the Eurozone leaders to agree to support the Banking Union concept.
3) The development of the concept was prompted by the problems of Spanish banks and the realisation that the cost of bailing out the banking sector could undermine the creditworthiness of Spain, as happened in Ireland.
4) An important driver of acceptance of the Banking Union concept is a very high ratio of banking assets to GDP in many Eurozone countries, which means that the potential problems of the biggest banks could undermine the creditworthiness of more countries (see Figure 6).

Figure 6. Assets of the banking sector to GDP in selected countries, 2011
Objective of the Banking Union

The objective of the Banking Union is to create conditions ensuring that the cost of bailing out big banks can be borne by the entire Eurozone rather than their home countries, which may be unable to carry such burden:

- According to the European Commission’s proposal, the Banking Union should consist of four main elements:
  - Harmonisation of supervisory regulations and norms (a single rule book for the banking sector),
  - Single European banking supervision,
  - Single deposit guarantee scheme,
  - Single procedures of supporting, restructuring and liquidating banks in distress.
- A European deposit guarantee scheme will only be introduced once Germany is satisfied with the effect of banking supervision solutions.
- Implementation of the Banking Union will increase pressure for the harmonisation of supervisory norms and regulations across the European Union and the introduction of solutions restricting the powers of local banking supervisors over banks which are part of European banking groups.

The development of the Banking Union is an important argument in favour of accelerating the “domestication” of banks

1) The development of the Banking Union attempts to shift responsibility for banks which are “too big to fail” from the national to the community level.
2) The aspiration to harmonise prudential regulations and rules and restrict local powers is largely contradictory to the conclusions of an analysis of the reasons for the recent crisis and contradictory to the principle of subsidiarity, which is one of the fundamental rules of the European Union enshrined in the Treaty.
3) Without attempting to propose a comprehensive strategy for Poland with regard to the development of the Banking Union, it seems that, in addition to other important directions and measures, the strategy should specifically contain two components:
   a. Preventing solutions which restrict the powers of the Polish banking supervision and hinder the application of macroprudential policy.
   b. Consistently pursuing the strategy of “domesticating” banks so as to significantly increase the share of locally controlled banks in the assets of the banking sector.
About the authors

Stefan Kawalec
President and CEO of Capital Strategy Sp. z o.o. Supervisory Board Member of Kredyt Bank SA [until 4th January 2013] and Lubelski Węgiel „Bogdanka” SA. In 1994-2006, worked at senior managerial positions in important Polish financial institutions (Bank Handlowy w Warszawie SA, Commercial Union/Aviva Polska group, PZU group). In 1991-1994, Undersecretary of State in the Ministry of Finance; in 1989-1991, General Director in the Ministry of Finance and Chief Economic Advisor to Deputy Prime Minister and Minister of Finance. Had a significant role in the preparation and implementation of the stabilization and transformation program of the Polish economy (‘Balcerowicz Plan’, 1989). Led the bad debt restructuring scheme for banks and privatization of state-owned banks (1990-1994). In 2001, member of a team of 4 independent experts appointed by the Polish government to review the Minister of Finance’s preliminary calculations for the 2002 state budget. On various occasions served as a consultant to international institutions including the World Bank and the International Monetary Fund as well as governmental and commercial institutions in several Central and Eastern European countries. Arbitrator and mediator of the Court of Arbitration affiliated with the Polish Financial Supervision Authority. Holds a Master of Science in Mathematics from the University of Warsaw.

Marcin Gozdek

Contact
Stefan Kawalec – President: skawalec@capitalstrategy.pl +48-601-29-39-85
Marcin Gozdek – Executive Vice-President: mgozdek@capitalstrategy.pl +48-601-90-98-98

Capital Strategy
Al. Jerozolimskie 65/79
00-697 Warszawa
Poland

Tel. +48-22-630-57-57

www.capitalstrategy.pl