Optimal Banking Sector Structure

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Building Market Economies in Europe: Lessons and Challenges after 25 Years of Transition

Panel III: The plumbing: financial sector development

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CAPITAL STRATEGY

INITIAL REMARKS

This presentation is based on:

Capital Strategy, “Report on the optimal structure of the Polish banking system in the mid term”, Warsaw, October 31, 2012, (by Stefan Kawalec and Marcin Gozdek).

The report is available at: **www.capitalstrategy.pl**

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OVERVIEW

Initial remarks

I. **Some observations related to the global financial crisis**

II. Implications of the domination of the Polish banking sector by foreign-controlled banks

III. Proposed strategy for Polish authorities

Summary

The transition is over but it is not the end of history

- After 25 years, the transition from socialism to market economy is mostly complete.
- However, the end of the transition does not mean the end of history.
- The experience of the global financial crisis and the crisis in the euro area largely undermined the pre-existing paradigms of the financial sector and the economy.

CHALLENGING PRE-EXISTING PARADIGMS:
SOME ASSUMPTIONS REQUIRING RE-EVALUATION

1. The bigger the financial sector, the better for economic growth.

2. The absorption of foreign savings is beneficial to economic growth.

3. Entry to the Eurozone enables the safe and virtually unlimited access to the pool of European savings because current account deficits between Eurozone countries do not matter.

4. The dominance of banks belonging to foreign banking groups in post-transition countries is beneficial for economic development.

While some of the above assumptions are correct only to a certain extent and under certain circumstances, others are simply incorrect.

Some attributes of banking system model supporting long term growth

1. The main task of the banking system should be collecting deposits and extending credit to the domestic economy, not intermediating in international capital transfer.
2. The ratio of private credit to GDP should not exceed 100%.
3. The loan to deposit ratio should remain below 100%.
4. Households should be served by local banks and in local currencies.
5. Investment banking should be separated from deposit/loan operations.

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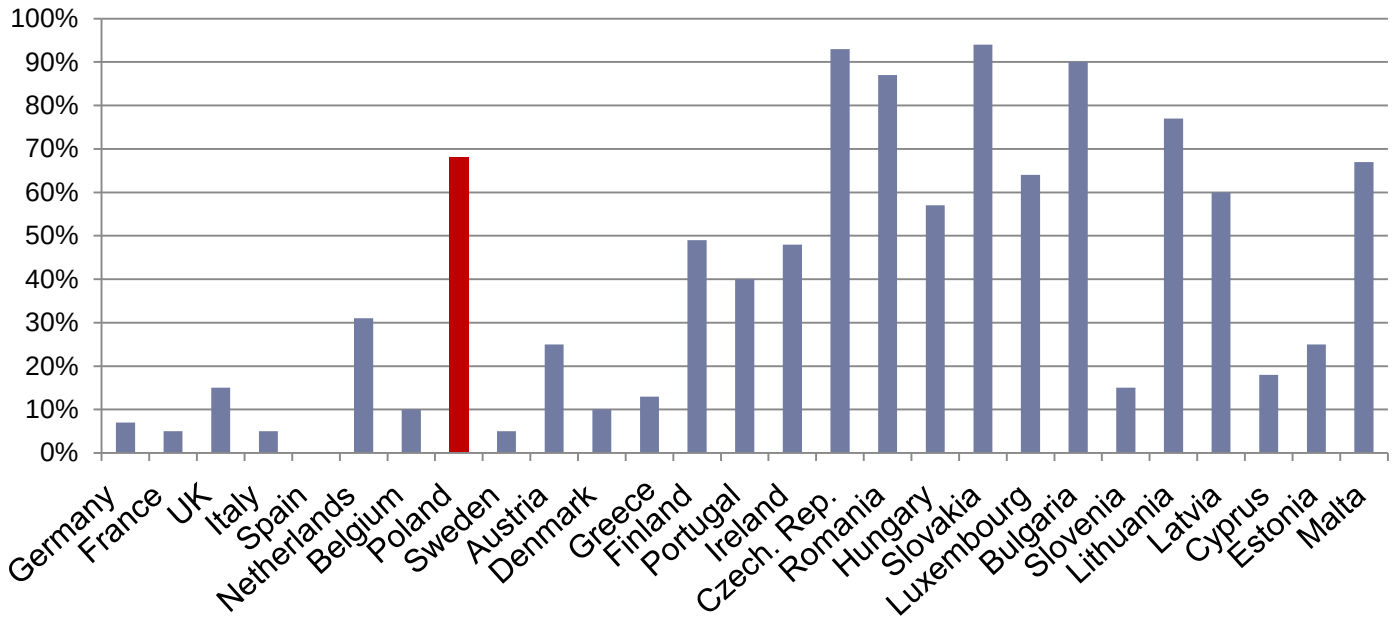
Poland is a large European economy with a banking sector structure typical of small European economies

Chart 1. Share of foreign controlled banks in assets of top 10 banks (2008). Countries ordered by 2010 GDP



The current structure is not the result of spontaneous market processes. It was shaped by the privatization policy, which was focused on finding reliable foreign strategic investors. While this policy allowed the modernization of the banking system and supported economic development, there is no need for Polish banks to continue to be controlled by foreign institutions.

Implications of the domination of the Polish banking sector by foreign-controlled banks

The domination of the banking sector by foreign-controlled banks has both positive and negative implications.

The main negative implications are:

A. Disturbances in financial intermediation
B. Risk of limiting financing for strategic sectors due to external political decisions
C. Obstacles to the stable financing of public debt
D. Limitations for possible macroprudential policy

A. Disturbances in financial intermediation (1)

While operating in a given country, a bank belonging to an international banking group takes into account not only the macroeconomic perspectives in the country of operation and its own financial situation, but also the situation of the whole banking group.

- → Problems in the parent banking group or its home economy may significantly affect the financial intermediation provided by the bank in its country of operation.
- → If it applies to one bank only, it may not be serious problem.
- → If it applies to a substantial part of the banking sector, it may be a serious problem.

Disturbances in financial intermediation (2)

Poland's experience in 2009-2010

Chart 2a. Cumulative real growth over two year period (2009-2010): GDP and corporate credit

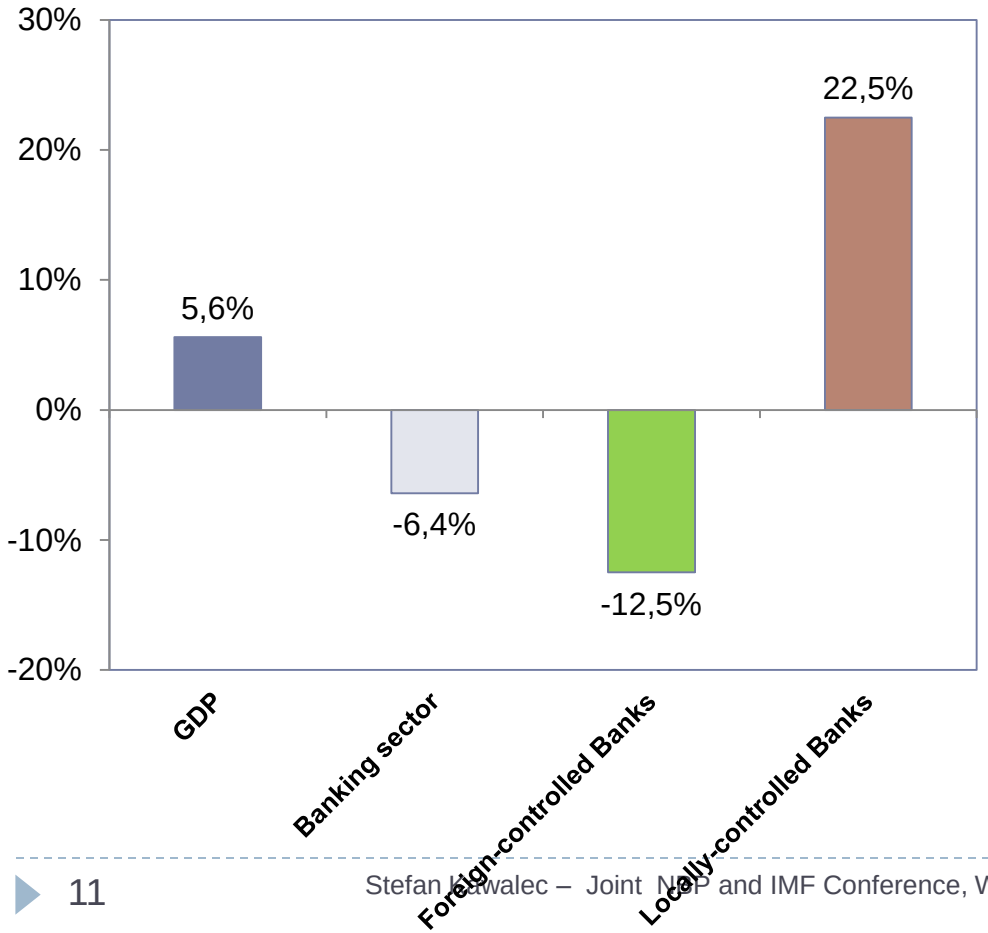
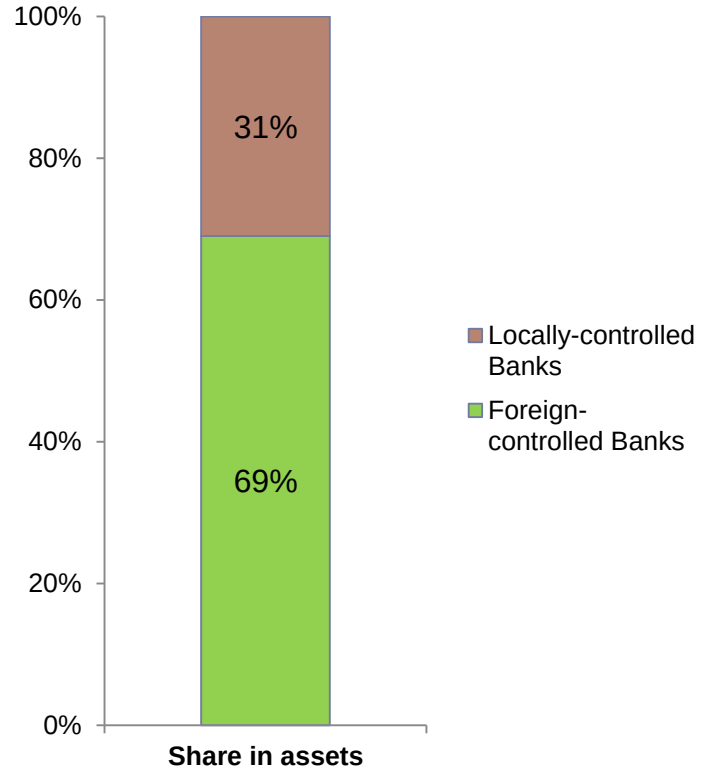


Chart 2b. Share in banking sector assets in 2010



A. Disturbances in financial intermediation (3)
Poland's experience in 2009-2010

Why did foreign-controlled banks curtail corporate credit?

1. Lower demand for credit?

   → Fall in demand cannot explain such differences between bank groups.

2. Availability of loanable funds?

   → At the same time, these banks extended more credit to households and public sector.

3. Capital adequacy?

   → No. See next slide.

4. Capital adequacy of banking group?

   → Probably.

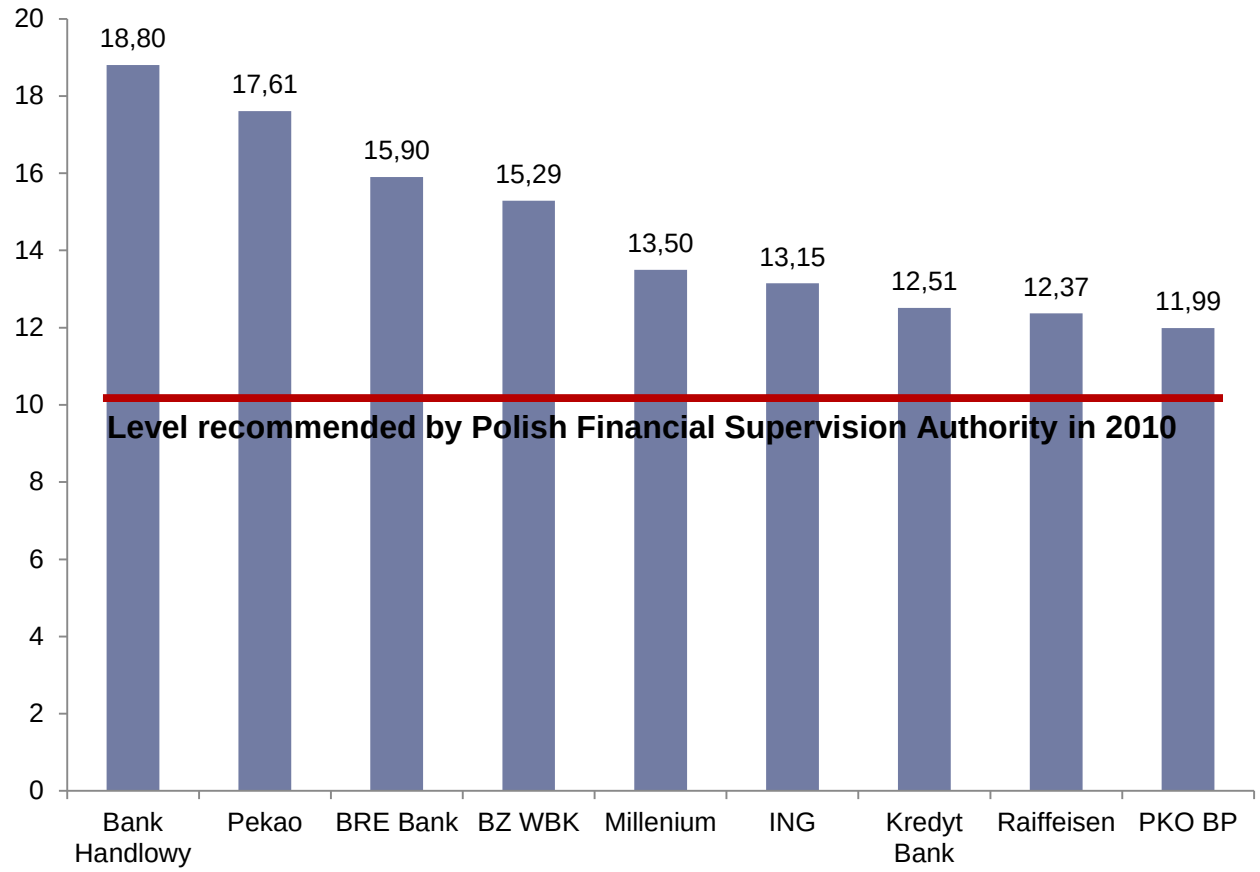
5. Risk appetite for corporate credit?

   → Most probably this is the key factor.

A. Disturbances in financial intermediation (4)

Poland's experience in 2009-2010

Chart 3. Capital adequacy ratio of the biggest banks in Poland in 2010



B. Risk of limiting financing for strategic sectors in the Polish economy due to political decisions outside of Poland*

One of the examples is the current situation in the energy industry:

1. Poland's energy strategy is based on sectors whose development is controversial in many European countries:
   - **Coal energy** – German (RWE) and Swedish (Vatenfall) energy companies active in Poland withdrew from the construction of coal-fueled power stations.
   - **Nuclear energy** – Germany decided to shut down its nuclear power plants. Construction of such a power plant in Poland is criticized by Germany and some other EU countries.
   - **Shale gas** – exploration of shale gas is criticized by many European countries and is against Gazprom interests.
2. EU and Norwegian banks are unlikely to finance shale gas exploration and coal-fueled power stations.
3. It is doubtful if German, Austrian, Dutch or Scandinavian banks will finance nuclear energy in Poland.
4. French banks are unlikely to finance nuclear energy based on anything other than French technology.

** Based on note from March 21, 2012 by special economic advisor to Minister of Foreign Affairs Maciej Olex-Szczytowski (ex-investment banker)*

C. Obstacles to the stable financing of public debt

1. In every country local banks are significant buyers of public debt.
2. Foreign-controlled banks in Poland face group sovereign risk limits which may prevent them from investing in profitable Polish bonds.
3. At a time of world turmoil, limits on Polish risk may be suddenly cut by foreign-controlled banks in Poland.
4. There is a serious risk of a simultaneous sell-off of Polish bonds by foreign investors and banks in Poland. In the current global environment, the domination by foreign-controlled banks increases risks for the financing of Polish public debt.

D. Limitations for possible macroprudential policy

1. The experience of the global financial crisis shows that in order to maintain macroeconomic stability and prevent asset bubbles, some banking system parameters, such as capital adequacy ratio, Loan to Value ratio or Debt to Income ratio need to be adjusted. Such adjustments are called macroprudential policy.
2. In the case of ‘maximal harmonization’ of prudential regulations as proposed by the European Commission:
   - Macroprudential policy in the EU will be conducted at the single EU level.
   - Local supervisors will lose authority over foreign-controlled banks, which will be supervised by home country institutions.
   - Local supervisors will in practice retain authority over local banks, which will be supervised locally, and to which European macroprudential rules will be implemented by local supervisors.
3. The higher the share of foreign-controlled banks in the Polish banking sector, the more significant the negative implications of “maximal harmonization”.

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STRATEGY FOR CHANGE IN THE BANKING SECTOR (1)

1. Strategy for the transformation of the Polish banking sector structure should be directed towards increasing the share of locally controlled banks.

Table 1. Desired banking sector structure that could be achieved within 10 years

Bank Groups	Share in banking sector	
	Currently (2012)	Desired
Banks controlled by foreign groups	69%	30-35%
Banks directly or indirectly controlled by the state	20%	Up to 25%
Banks with dispersed ownership structures that are protected from take-over by strategic investors via statute provisions	0%	30%
Other banks controlled by private investors	5%	4-12%
Cooperative banks	6%	6-8%

The goal is not to eliminate banks which are subsidiaries of foreign banking groups, but to gradually reduce their share in order to create a more balanced banking sector structure with significant shares of different ownership models.

STRATEGY FOR CHANGE IN THE BANKING SECTOR (2)

2. Dispersed ownership without a strategic investor may be a viable alternative to control by a foreign banking group.
   b) The durability of such arrangements may be ensured by adding appropriate provisions to the bank's statute, which would limit the voting power of a single shareholder to 10%. The Polish Financial Supervision Authority may be allowed to suspend such provisions in some cases.
   c) In order to ensure that the decision center is in Poland, the majority of shares do not necessarily need to be in the hands of Polish shareholders. It is crucial that the banks' real decision centers are at the headquarters in Poland.
3. Process of increasing the share of locally controlled banks will respect competition rules, especially:
   a) Foreign investors will not be discriminated against.
   b) Public funds will not be used in financing bank take-overs.
   c) The Government will not influence the credit policy of particular banks.

STRATEGY FOR CHANGE IN BANKING SECTOR (3)

4. Some seemingly simple solutions should be avoided, as they increase systemic risk, instead of limiting it:
   d) State Treasury or dependent entities should not take over banks. The model in which the state controls a bank despite holding a minority stake should also not be extended.
   e) High concentration is not desirable as US and European experiences have shown that too-big-to-fail banks pose a serious threat to system stability. Regulators should prevent the biggest banks from growing further via mergers or the acquisition of competitors.
5. If foreign strategic investors withdraw from Poland,
   - Shares should be sold on the stock exchange with appropriate changes in company statutes that would limit the voting power of single shareholders
   - Alternatively, shares may be sold to investors or groups of investors who commit to changing the company statute and dispersing ownership.

STRATEGY FOR CHANGE IN BANKING SECTOR (4)

6. 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 must sell available foreign assets, in particular their operations in Poland.

7. Polish authorities should oppose the acquisitions of banks by banking groups which were bailed out, had their ratings downgraded, or originate in countries most affected by the Euro crisis.

8. In the perspective of the Banking Union, Poland should:

   a) Oppose solutions that limit the authority of local supervision and decrease the efficiency of macroprudential measures.

   b) Consequently engage in a strategy of bank domestication in order to increase the share of locally controlled banks in banking sector assets.

SUMMARY

1. The financial sector and economic paradigms should be changed as a result of the world financial crisis and the Eurozone crisis.

2. Foreign strategic investors contributed to the modernization of the banking system in CEE economies but banks in former transition countries do not need to be controlled by foreign institutions anymore.

3. The domination of the banking sector by foreign-controlled banks constitutes an important risk factor and may have negative economic consequences.

4. The proposal is not to eliminate banks which are subsidiaries of foreign banking groups but to gradually reduce their share in order to create a more balanced banking sector structure with significant shares of different ownership models.

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Thank you for your attention