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REGULATORY SHOCK VERSUS COMPETITIVENESS AND DEVELOPMENT OF THE POLISH BANKING SECTOR

1. Introduction

The financial crisis at its consecutive stages triggered great pressure to make far-reaching changes in regulations in order to establish a new architecture of the banking system. Given the scope and weight of regulatory work, it is necessary to ask a number of questions concerning both the very banking sector, as well as its role in the world, European and Polish economy. A new regulatory order is developing for all to see. The use of the word "order" may meet with certain opposition and transform into a more frequent phrase "chaos".

The appearance of such a large number of legislative acts may be associated with an earthquake, which changes landscape unquestionably and causes damage and danger. Maybe this comparison is too explicit since no-one negates a need of changes in world-wide operating principles of the banking sector. This gives rise to a question whether consequences of such actions will not bring about effects opposite to those intended (at least at the national level). Thus, it would be necessary to analyse the set of new regulations in terms of benefits, costs and threats, if any.

Regulatory issues may not be analysed in isolation from current realities of the Polish economy, the existing development shape and stage of the banking sector in Poland. It would be truism to point out the impact of a financial system on an economic development rate, which has been recently strongly stressed in the discussion about the impact of an ownership aspect (domestic and foreign capital) of banks in Poland on their operation and support for the Polish economy. Since 65 per cent of assets of the banking sector are controlled by foreign investors, these are objective conditions where such institutions operate and will operate, mainly from the point of view of their corporate headquarters for which Poland is a host and not home country, that will pay a key role. Therefore, it is a national interest to establish such solutions that should be in favour of stability and stimulate the development potential of banks translating it into real growth, as well.

To analyse consequences of regulations, we may use methodological guidelines applied in the UK, i.e. so called Hampton's principles or a method based on "Regulatory Impact Assessment" (RIA)[1]. Their purpose is to maintain legislative order and take care that in-depth evaluations are made. Hampton claims that attributes (principles) of a good regulation are as follows[2]:

1) transparency,
2) accountability,
3) adequacy (proportionality),
4) coherence,
5) purposefulness.

Hereinbelow, we present a synthesis of the report "*Szok regulacyjny a konkurencyjność i rozwój sektora bankowego"* (Regulatory shock versus competitiveness and development of the banking sector), which was prepared in response to questions concerning regulatory changes in the Polish banking sector in the latest 2-3 years (2010-2012). The authors' intention was to present particular regulations and their consequences, as well as make regulators and all other stakeholders sensitive to the preparation of legal acts, including, in particular long-term, consequences of their implementation. At present, this aspect is of a bigger importance since a main decision-making centre has mostly moved from capitals of particular countries (including Warsaw) to Brussels, Strasburg, Frankfurt, Basel or G-8 and G-20 meeting places. Unfortunately, although they make decisions fraught with consequences for national banking systems, in many of those forums, no direct representatives of all interested countries (e.g. Poland) are present. Such a position was distinctly and directly presented at the European Financial Congress in Sopot in 2011 by Jochen Sanio, Chairman of the German Financial Supervision Authority, BaFin. This objective weakness in expressing national interests should be compensated, at least partially, with intensified efforts and professionalism in international actions taken by such institutions like the government, including the Ministry of Finance, the central bank, the financial supervision authority or banking organisations. Such a situation does not exempt, however, Polish authorities from liability for their own legal acts and acts resulting from decisions made abroad.

[1] *Regulatory Impact Assessment*, http://www.bis.gov.uk/bre, 17.10.2011.
[2] Ibidem.

The authors hope that the report will trigger a wider discussion on the model of contemporary banking in the context of local conditions of particular countries, including, without limitation, Poland, as well. It is an important issue to look at banking activities both from the point of view of an individual country, as well as from a bigger perspective of changes in the world and European financial markets. For such a purpose, the authors used foreign materials and documents and exchanged opinions with, for example, Professor Nicolas Véron from the Bruegel think tank in Brussels and the Peterson Institute for International Economics in Washington and Professor Charles Goodhart from the London School of Economics.

Consequences of new regulations in Poland for the banking sector and the whole economy were already analysed several times. For example, till 2007, the Polish Bank Association (*Związek Banków Polskich*, ZBP) presented reports on the impact of regulatory changes on the activity of banks. However, a great number of new (post) crisis regulations that were prepared and implemented forced the development of a new approach. Particularly that demand for new regulations and the presentation of their consequences grows together with increasing social criticism of the banking sector in media.

2. Objectives of the report

Given a great number of post crisis regulations that have been prepared and implemented, it becomes more and more complicated in terms of methods and interpretations to focus on their impact on development perspectives of the Polish banking sector and economy. Therefore, the major goals of the report were to:

- present new key regulations in the banking sector in the years 2010–2011; show their goals; analyse whether *ex ante* consequences have been assessed and whether consultations with key stakeholders took place; find out to which extent the impact of such regulations after implementation (*ex post* analysis) was monitored and controlled;
- identify key regulatory consequences, in particular long-term threats;
- develop ”new quality” of Regulatory Impact Assessment based on the methodology defined as the evaluation of economic and social consequences, i.e. *Regulatory Impact Assessment* (RIA), and compare it with the existing practices.

3. Key thesis of the report

The key thesis of the report is as follows:

The scope of draft regulations implemented and planned in the Polish banking sector in the years 2010-2011 is very big. Regulations result mainly from the financial crisis and they are unilaterally oriented on prudential goals. There is a serious risk that they will not stabilise the financial system, but they will generate bigger threats, reduce the competitiveness of the Polish banking sector and economy, and decrease development perspectives of Poland.

Such a thesis was based on preliminary observations and reflections concerning, in particular, the following three issues:

1. Objectives of new regulations are intentionally logic, correct and justified, however a ”silos approach” causes that they do not take account of a broader economic and social context or new conditions in the economy, which makes them less efficient and effective.

2. Prevailing regulatory centres are located in Brussels, Basel, Frankfurt, Washington, at G-8 and G-20 meetings and not under Polish institutions, which causes that, on the one hand, an impact on the development of concepts and frameworks of banking sector regulations is very limited (absence, weak power of influence or passivity) and, on the other hand, assumptions are based on phenomena, experience and trends that strongly differ from the unique characteristics and development status of the Polish banking sector.

3. Methodological aspects (the use of integrated models, available databases, verified systems of cooperation with stakeholders) are underdeveloped in the comprehensive Regulatory Impact Assessment at the level of the banking sector. And, first of all, the banking sector is not aware of, and willing to make, such assessments. An attitude that administrative regulations are the most efficient tools that are least costly in the case of problems related to the operation of the sector is quite commonly accepted in spite of regulatory risks. This contributes to the establishment of mechanisms, behaviours and decisions that weaken the competitiveness of the Polish banking system.

4. The scope of economic and social impact assessment

The report is composed of closely related parts addressed to two groups of potential leaders. The first part, ***Regulatory pressure versus operation and competitiveness of the banking sector,*** summarises the results of assessments of consequences of regulations, contemporary challenges, as well as operational alternative actions for regulators and the banking sector based on conclusions drawn from the whole study.

The second part, ***The evaluation of benefits and costs of new regulations in the banking sector,*** comprises the description of selected banking areas and the assessment of the most important, in the authors' opinion, regulations that have been implemented or prepared in the banking sector. Such an approach results from the limited size of the document. This part of the report includes four issues:

- regulatory assessment at the macroeconomic level,
- banking system regulatory policy (international and national review),
- deposit guarantee system and resolution regime,
- the protection of consumers of banking services.

The second part of the report is addressed to those readers that, given their interests and functions, want to know consequences of implemented regulations from a slightly wider perspective. The defined scope of study does not cover all regulations that were implemented in the banking sector in the analysed period. Nevertheless, the authors want their work to become an inspiration for regulators, stakeholders and other researchers to solve practical important problems faced by the national banking sector in the new, turbulent and uncertain market conditions.

5. Key results

Given the very wide scope of comments and conclusions, it is necessary to focus only on key results of Regulatory Impact Assessment for the banking sector in Poland in the years 2010–2011.

- **The Government's focus on the recovery of public finance paralyses developmental actions, including the banking sector.**

The analysis of a situation in public finance shows that actions targeted at not exceeding public finance thresholds (3% deficit and 55% debt) completely dominated the Government's activities and a will, time and relevant resources to develop regulations in favour of further safe development of the banking sector are almost invisible.

One of important challenges is to ensure long-term liquidity of banks, which requires a radical change in the structure of equity and liabilities, a change in short-term items to the benefit of long-term asset funding. Because of the structural mismatch of assets and liabilities in time, it is necessary, without limitation, to increase individual savings, expand the scope of debt securities issues, activate a securitisation market for robust credit portfolios. To carry out such actions, many efforts and expenses will be necessary, a system of long-term savings incentives, e.g. the abolition of a tax on such bank deposits, will have to be established, broad economic education will have to be ensured, long-term savings for housing, health, pension and educational purposes will have to be promoted. In a short run, such actions collide with the implementation of the present priority of authorities, i.e. public finance improvement.

- **Regulations are tailored to solve short-term problems without consideration to long-term consequences.**

For example, an act on possible transformation of a branch of a credit institution operating in the territory of Poland into a domestic bank in the form of a joint stock company may be considered as an ad-hoc regulation prepared for a specific single situation. This regulation may be called emergency and express because it was developed and implemented during one month. Although such a solution was rational, the manner it was prepared raises reservations since legislators completely omitted the assessment of its impact on the public finance sector, including the State budget and budgets of local government authorities, as well as the unexpected protection of a large banking institution with the Bank Guarantee Fund without additional premium compensating for the absence of payments to the aid fund for years. A similar situation took place in the case of an earlier amendment to the 2006 act providing for the division of a domestic bank. Such a solution was tailored to a transaction concerning the acquisition of a part of one of the biggest Polish banks, PBH SA, by another bank, i.e. PEKAO SA. Apart from potential negative system consequences, the act established an institution of an unnatural shape (without attractive assets), additionally combined with a bank concentrated in the threatened consumer finance market.

A similar procedure is also visible in the case of the regulation ”A change in the place of service provision in the VAT act”[3]. The financial impact of this regulation was not assessed. It was justified that no detailed data of the structure of cross-border services were available, but estimations could be made. It was only stated that the draft may influence budget income, although without specifying whether that meant growth or drop, which is a key issue.

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[3] VAT Act of 23 October 2009, Journal of Laws No. 2009.195.1504, as amended.

- **Regulations implemented in the banking sector strengthen unfair competition between banks and unlicensed entities providing financial services and partially between domestic banks and foreign branches of credit institutions (consequences of regulatory arbitration).**

Given the direction of strengthening the scale and new types of regulations, particularly the anticipated and inevitable enforcement of a tax on banks in the form of a tax on financial transactions or quasi taxes on banking activities, financial institutions are more and more likely to be treated unevenly. This results not only in the unintentional stimulation of the development of new entities and a change in the service market structure. This also generates uncontrolled risk likely to bring about economic and social consequences that will have to be covered, fully or partially, by the State and tax payers. Thus, it is necessary to ask a question whether the market of financial services not subject to national financial supervision (credit unions; in Poland: SKOKs, lending companies, foreign branches of credit institutions) must be covered with wider and more uniform regulations than, for example, a new act on consumer loans. It would be reasonable to commence deeper discussion and develop possible system solutions. Arguments for the risk of the reduction of banking sector competitiveness as a result of the regulations comprise not only more restrictive prudential requirements, but increasing administrative costs and charges, which are not taken into account in the justifications of normative acts, either. Regulators treat them as immaterial in terms of finance and shift this problem to banks that must deal with it. There is also a great risk, which is clearly mentioned by the IMF, that increasing costs will be shifted to bank customers and their activity will be adjusted to new operating rules that not necessarily correspond to demand for financial management of the economy and household needs.

- **The implementation of the Directive 2010/76/EU on remuneration system in Poland shows that EU directives are adjusted to the Polish legal system without criticism, irrationally and sometimes unrealistically.**

The justification and Regulatory Impact Assessment of the act, as submitted to the Polish Parliament, referred only to provisions related to the CRD II (new capital requirements, regulatory principles, etc.), while the problem of remuneration stipulated in the CRD III was added almost at the last moment without Regulatory Impact Assessment. Finally, as regards remuneration, the resolution of the Financial Supervision Authority (*Komisja Nadzoru Finansowego*, KNF) set out guidelines for all banks, whatever their size and significance for system risk, although the directive provided for a more pragmatic approach, i.e. a proportionality principle. The KNF's regulation implemented a number of highly disputable provisions concerning, without limitation, the wide definition of persons at management positions subject to the resolution (including directors and persons directly reporting to directors, chief accountant, branch managers and deputy branch managers, heads of audit, compliance, HR and risk management units). An obligation to pay 50% bonus in the form of shares or corresponding property rights or related financial instruments or non-cash instruments in the case of unlisted institutions will have serious repercussions for banks. Reservations concerning this regulation also refer to its compliance with the labour code and the Polish Constitution.

- **Given a movement from the national micro prudential supervision of the banking system to supervision supplemented with European micro and macro prudential supervision, as well as the primacy of supranational regulations, deeper analytical studies and a more active position of Polish entities (regulators, organisations associating banks) in the international market are required to counteract the enforcement of unfavourable solutions.**

The establishment of European micro and macro prudential supervision over the financial market is certain, although it is not clear what the final role and function of new European institutions will be. Thus, we have ESRB (European Systemic Risk Board) and ESFS (European System of Financial Supervisors, including EBA – European Banking Authority). Poland has participated in consultations on principles of operation of such institutions. However, the existing experience shows that it has to strengthen opinions presented and intensify work over the development and better argumentation of the Polish position, including consequences of regulations for the Polish economy and banking system. While, as regards the location of regulatory authorities, it would be necessary to absolutely underline the principle: as much authorities, as much liability.

The new European regulatory architecture seems to be constructed in quite a chaotic regulatory system that is complex, costly and based on many new institutions that stress financial stability at the cost of market effectiveness, which weakens domestic regulatory authorities. For "home" countries where headquarters of large global banks are located, benefits from the new regulations exceed costs. For "host" countries, such costs seem to be disproportionate to benefits. Poland and generally the whole EEC region needs a bigger supply of loans, less restrictive and complicated regulations than the economy of Western

Europe, which is more developed in terms of economy and banking. Since it is necessary to make up for a distance to old 15 EU member states, Poland should, in particular, demand national options and the strict application of the proportionality principle, which enables to reduce the burden of expanded directives enforced on medium-sized and smaller banks (e.g. cooperative banks)[4].

- **Basel III will be the most important challenge for the banking sector in the next years**[5].

The regulatory package is determined by the achievement of two major goals:

- ✓ strengthening international principles for the calculation of capital requirements and liquidity risk management in order to obtain a more resistant banking sector;
- ✓ increasing the banking sector's ability of absorbing shocks resulting from financial and economic crises.

The implementation of such regulations on capital and liquidity requirements was preceded with consultations and benefit and cost evaluation. Polish institutions presented their opinions quite actively. Opinions were delivered by four organisations from Poland: the National Bank of Poland through the Financial Supervision Authority (*Komisja Nadzoru Finansowego*), the Ministry of Finance, the Polish Bank Association (*Związek Banków Polskich),* and the Chamber of Brokerage Houses. Their opinions were critical, without limitation, about the role of a regulator in the host country, the implementation of liquidity ratios based on stiff measures, the extension of a grace period for the package of regulations.

The consequences of Basel III were quantified, but without reference to conditions of the Polish banking system (models, data, results)[6]. Estimated calculations show that:

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[4] For example, draft CRD IV is composed of 950 pages, including 70–80 pages of the EC regulation that must be directly applied by banks (without transposition). Such an application of law directly from Brussels is another example of the limitation of the principle of aidness and a domestic regulator and it will create problems with legal interpretation.

[5] Basel III refers to a draft regulation and EC directive (Capital Requirements Directive IV, CRD IV) published on 20 July 2011.

[6] KNF carried out a quantitative survey in the banking sector in Poland to assess the impact of new regulations on banks' liquidity, however its results have not been published, yet. KNF also developed a simulation analysis of macroeconomic consequences of the implementation of new prudential standards for the banking sector in Poland on the basis of an econometric model (2011). 4 years after the enforcement of new regulations, the growth of an average solvency ratio by 2.5 percentage points resulted in the immaterial growth of interest rates (credit margins) of consumer and housing loans (respectively up 56 and 41 base points), which, together with other (income and price) factors influenced demand for loans.

- ✓ long-term economic benefits may consist in the growth of Gross Domestic Product from 0.3 to 2.0%, which results from the reduction of the expected frequency and probability of future system crisis;
- ✓ an anticyclical buffer and liquidity standards should reduce the amplitude of economic cycles, which is particularly important to strengthen the stability of an SME sector;
- ✓ the growth of own funds as a result of increased minimum shareholders' capital from 2 to 4.5% and a fund protection buffer of 2.5% will result in the significant growth of own funds consisting in the increase of the shareholders' capital or the retention of earnings in the banks' balance sheets (capitals may increase by EUR 84 billion to 2015 and EUR 460 billion to 2019) (new capital requirements are implemented gradually during the eight-year transition period).

Consequences of Basel III implementation in Poland were analysed to the biggest extent by PWC together with the Polish Bank Association on the basis of an extended survey conducted in the second half of 2011. The results of the survey have showed that the Polish banking sector has a solid capital base composed of top quality funds and safe solvency ratios. Only in the case of several banks, own funds could be increased solely through the application of new requirements for the capital protection buffer of 2.5%. The biggest challenge for the Polish banks will be liquidity, in particular long-term liquidity (NSFR). An average short-term LCR for the banking sector in Poland was 128% (minimum requirement: 100%). While, in Europe it was from 67 to 87% on the average, However even this ratio in Poland may be a challenge for some banks. NSFR (long-term liquidity ratio) will cause most problems. Although the survey showed that it would be 97% on the average, over a half of banks did not achieve it (given their balance-sheet total). Such a shortage of long-term liquidity has been a problem for several years, in particular in the context of the banks' mortgage portfolio and the absence of an access to universal bank funding with long-term debt instruments and the complete absence of securitisation instruments for robust credit portfolios. In the context of the real reduction of financial support for foreign banks by their parent companies (e.g. subordinated debt), the implementation of NSFR will bring about far-reaching consequences. It will be necessary to change the structure of banks' balance sheets, adjust business models in order to meet new regulatory liquidity requirements. Similarly, the implementation of more restrictive liquidity standards may contribute to the growth of the cost of finance for banks, which will translate into bigger lending costs for retail and corporate customers (in particular large companies), as well as financial institutions. It is also possible that banks will withdraw from some unprofitable business segments[7].

- **The consumer loan agreement of 2011 implementing a relevant EU directive may slightly influence consumer protection and have a negative impact on economic growth in Poland**[8].

In spite of many favourable amendments to the act, its major consumer protection goals are threatened since:

- ✓ information asymmetry resulting from knowledge, skills and capabilities of promoting lending business and tangible and intangible assets of credit institutions and borrowers' poor credit education and requirements is maintained;
- ✓ implemented regulatory amendments generate many benefits to customers (although consumers realise that to a very small extent) and mainly costs of adjustment activities to other market players (creditors and credit agents);
- ✓ other regulations (e.g. T and S Recommendations) which initially have a negative impact on credit availability and on-going growth of the value of loans granted are implemented at the same time;
- ✓ except for housing loans, consumer loans have tended to decrease for some time because of many regulatory and economic conditions, including, in particular, increasing uncertainty and risks in the financial markets, which will influence the quality of the regulation implementation.

6. Key conclusions

1. Strengthen the activity of Polish official representatives (the Minister of Finance and the Financial Supervision Authority, in cooperation with the National Bank of Poland, and the Bank Guarantee Fund in terms of their authorities) and the banking environment with regard to the planned EU regulations so that it is possible to discuss new normative acts related to the banking sector at the national level in advance. The purpose of such discussion will be to develop a common position based on strong factual arguments. If possible, such arguments should be strengthened with supporting arguments of other EEC countries.

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[7] *Podsumowanie badania wpływu Bazylei III na polski system bankowy* (Summary of the survey of the impact of Basel II on the Polish banking system0, PWC and ZBP, Warsaw, December 2011, http://www.zbp.pl/photo/konf0211/Podsumowanie.pdf, 20.12.2011.
[8] The act on consumer loans of 20 July 2001, Journal of Laws No. 2001.100.1081.

2. Intensify work connected with Regulatory Impact Assessment for the banking sector so that to quickly react to currently implemented and prepared legal, both national and EU, regulations.

3. Perform an in-depth review of the most crucial regulations and assess their (in particular long-term) impact *ex post* and then prepare proposals of amendments or even resignations from some regulations and, in other cases, maintain them consistently in spite of reported doubts.

4. Protect and ensure the key influence of a national regulator on the banking sector with the use of all possible measures (for such a purpose it is worth stimulating and integrating EEC markets so that interests of less developed and banked countries are not omitted at the EU level).

5. Prepare the package of regulatory and/or alternative actions (so called quasi regulations) on the principles of fair competition and control of risk connected with institutions providing financial services, but not subject to KNF supervision and/or the implemented regulations.

6. Prepare the list of necessary regulatory actions necessary for further development of the banking service market to support economic growth adequately to a development stage of a given state, and then develop and widely promote key assumptions for such regulations.

7. Exert strong pressure so that all regulation drafts are assessed in accordance with intentions, rules, best practices and methods developed as a part of Regulatory Impact Assessment, including, in particular, obligatory social consultations, i.e. an adequately early access to draft regulations and justifications and possibility of presenting comments thereon.