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## **POLISH BANKING SYSTEM DURING THE GLOBAL FINANCIAL CRISIS**

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**JEL Classifications:** G32

**Key words:** Banking, financial crisis, financial stability.

**Abstract:** Lasting for over a year the global crisis in financial markets, affected individual countries' banking systems to a different degree. The present article discusses the phenomenon and its effects on the Polish banking system. The aim of the article is to present trends, the scale of the crisis and the current level of danger to stability of domestic financial market. The result of the research is a synthetic estimation of the level of the financial sector stability, taking into account the risks to solvency, liquidity, profitability, and quality loan portfolio and changes in deposits.

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### **Introduction**

The date of the emergence of the global financial crisis is associated with the 14th September 2008, which is the day of the bankruptcy of U.S. investment bank Lehman Brothers. Nevertheless, even beforehand, the concern was already present on the international financial markets. The main source of the current crisis is associated with the American sub-prime market, which was based on financing of real estate loans, granted to people with low credit ratings. Despite the many actions aimed at stabilizing the situation, including interventions of central banks in the United States and in European countries, all the attempts have failed and in a short period of time, the deteriorating economic situation and a collapse in one market quickly disclosed in other parts of the world. Those destabilizing consequences are global and they are a result of a free movement of capital, as well as the ownership structure of financial institutions in which the country of origin was also a "country of origin" of destabilization.

Polish banking system experienced a very difficult period in the nineties of the last century. The situation was caused by the political and economic transformations. Even in the early nineties, almost all banks in Poland were under the control of the Treasury, granting credits mainly to the state-owned enterprises, which have proved to be totally unprepared for changes. For example, in 1993, there was a total number of 1740 banks in Poland, where 77 of them were state banks, 10 were in the hands of foreign owners, and in 1653 were the co-operative banks. In the asset structure obtained by the above mentioned sector, state and foreign banks accounted for 93.4% of all assets, and the remaining 6.6% was accounted for by the cooperative banks. A very difficult financial situation of the companies operating those days, their unpaid debts towards the banks, high inflation, which e.g. in 1990 was 686%, and high interest rates during this period amounting to 49% in the quarterly period, resulted in the fact that the dominant part of the loan portfolios were based on bad loans and the results of these events led to the bankruptcy of many banks. It should be stressed that the Polish banking crisis in the first half of the nineties had only a local scope and its cause was a result of the fact that the Polish economy was

unprepared to market conditions. Destabilizing consequences of this crisis were lasting nearly until 2004 when Poland joined the European Union.

As for the 30th September 2009, Polish banking system had a total of 647 banks, of which 578 are cooperative banks, 51 commercial banks and 18 branches of foreign credit institutions. Although the number of cooperative banks is the highest, their participation in the sector is not high as their assets constitute only 5.6%. Commercial banks account for 89.1% of assets, and credit institutions for 5.3%. Ownership structure of the banking sector looks quite differently than a in the 90s. If one was to measure the involvement of banks in the banking sector by means of measuring bank's assets, then 69.4% of the assets are from foreign investors, including 61.8% of investors from European Union countries. What is significant is that the foreign capital located in the Polish banks is dispersed geographically (for example the USA accounts for only 6.7% of assets), which reduces the risk of dependence of the Polish banking sector on the economic situation of one country of the investor.

The current Polish economic ties with the rest of Europe are strong, mainly due to the joining the European Union. In addition, trade and the participation of investors from the U.S. banking system is far greater now than in the nineties, which leads to a conclusion that the Polish banking system is in a greater danger in the event of the emergence of signs of instability in the countries of investors. For example, these major investors are globally known financial institutions such as AIG (USA), Citigroup (USA), Fortis (Belgium), AIB (Ireland), Santander (Spain), which are currently experiencing considerable difficulties.

### **Macroeconomic situation**

Banking is very strongly correlated with the economy. This follows from the fact that any change in the economic and financial situation of depositors and borrowers is almost immediately reflected in banks' balance sheets.

In 2005-2007, the Polish economy was in a phase of a rapid growth. Gross domestic product at the end of the third quarter of 2007 was 6.6%, reflecting the investment boom, especially in the housing market.

TABLE 1. MAIN INDICATORS DESCRIBING THE POLISH ECONOMY IN THE PERIOD BETWEEN 30TH SEPTEMBER 2007 AND 30TH SEPTEMBER 2009 (QUARTERLY DATA).

	GDP growth	Inflation	Unemployment	EURO/ZŁ	\$/ZŁ	WIG *
3Q2007	+6.6%	2.3%	11.6%	3.79	2.73	60 368
4Q2007	+6.6%	4.0%	11.4%	3.60	2.47	55 648
1Q2008	+6.2%	4.1%	11.1%	3.54	2.28	48 011
2Q2008	+6.0%	4.6%	9.6%	3.37	2.17	41 146
3Q2008	+5.1%	4.5%	8.9%	3.39	2.34	37 367
4Q2008	+3.0%	3.3%	9.5%	4.02	2.97	27 228
1Q2009	+0.8%	3.6%	10.5%	4.62	3.54	24 036
2Q2009	+1.1%	3.5%	10.7%	4.51	3.21	30 419
3Q2009	+1.2%	3.4%	10.8%	4.16	2.85	37 580

Source: www.money.pl

Note: \* WIG - the Warsaw Stock Exchange Index.

TABLE 2. SELECTED MONETARY INDICATORS IN POLAND BETWEEN 3Q2007 - 3Q2009

	Lombard credit	Warsaw Interbank Offer Rate 3 Month rate (WIBOR 3M)	Interest rate of zloty deposits in commercial banks with agreed maturity up to 2 years
3Q2007	6.25%	5.10%	3.3%
4Q2007	6.50%	5.68%	3.5%
1Q2008	7.25%	6.15%	3.7%
2Q2008	7.50%	6.65%	4.0%
3Q2008	7.50%	6.63%	4.6%
4Q2008	6.50%	5.88%	6.1%
1Q2009	5.25%	4.17%	6.2%
2Q2009	5.00%	4.44%	5.4%
3Q2009	5.00%	4.18%	5.3%

Source: www.money.pl ; CSO Statistical Bulletin, 2009.

TABLE 3. MAJOR ECONOMIC PARAMETERS CHARACTERIZING THE POLISH BANKING SYSTEM IN THE PERIOD 3Q2007 - 3Q2009.

	Total balance sheet (mln Euro)	Deposits (mln Euro)	Loans (mln Euro)	Financial result (mln Euro)	The share of loans in the portfolio	Solvency ratios
3Q2007	194 191.9	98 144.7	101 789.8	2 621.4	4.4%	11.8%
4Q2007	198 840.5	104 827.0	106 888.2	3 418.6	4.1%	12.1%
1Q2008	209 606.9	107 845.7	114 706.5	2 789.0	4.0%	11.5%
2Q2008	220 373.3	110 864.5	122 524.7	2 159.3	3.8%	10.8%
3Q2008	234 246.3	115 394.0	132 399.9	3 164.2	3.5%	11.5%
4Q2008	260 442.2	123 536.1	148 394.5	3 483.7	3.5%	10.8%
1Q2009	268 907.6	127 873.9	157 463.4	500.5	3.8%	11.2%
2Q2009	263 050.5	131 135.3	156 631.5	1 325.4	4.2%	12.5%
3Q2009	261 422.2	131 209.1	156 874.7	1 751.9	4.9%	13.1%

Source: UKNF 2007-2009.

Since the beginning of 2008, however, this index began to decrease gradually, which was a sign of “overheating”, and this was particularly evident in the growth of prices for investment goods. For example, housing prices in Warsaw at that time already exceeded 3 000 Euros per square meter, and this trend that favoured by low, compared to previous periods and still falling, foreign exchange rates (Table 1). The first signs of the upcoming economic imbalances were already visible in the fourth quarter of 2007. This conclusion can be

drawn from the observation the level of the Warsaw Stock Exchange Index (WIG), being a stock market index of companies. It is calculated as a weighted average of daily quotations on the Stock Exchange in Warsaw (for example, on 17th November 2009, WIG covered 313 companies with a total value around 37 billion Euros). Since the beginning of 2008 the above mentioned index steadily declined, and between the third quarter of 2007 and the second quarter of 2008 its decrease exceeded 32%. Then, between the third quarter of 2007 and the first quarter of 2009, WIG's decrease

exceeded 60%. Crisis is also visible in the GDP decrease as its figure is six times lower than in the prior two years, even though GDP growth rate has continued to be positive. There is also a noticeable decline in inflation, which is, *inter alia*, a result of the inhibition of consumption, and a rising unemployment rate, which at the end of the third quarter of 2009 rose by one fifth compared to the third quarter of 2008. Exchange rate of the zloty against the euro and U.S. dollar also showed an obvious increasing trend, and its rate level of the first quarter of 2009 corresponded to the one from December 2004.

Equally significant changes can be found in the money market. Lombard rate fixed by the Polish National Bank (NBP) in 3Q2007 was 6.25% and the end of 3Q2008 showed an increasing trend. Since 4Q2008 there was a decrease in the interest rates, which may be explained as an attempt to maintain the momentum of investment growth. Already in June 2008 international bank market reacted sharply, initially towards rumours and then towards the news about the bankruptcy of Lehman Brothers, through the loss of confidence between banks. This was manifested through an increase of WIBOR 3M from 5.1% at the end of 3Q2007 to 6.63% at the end of 3Q2008. In November 2008 The Bank Guarantee Fund increased the guaranteed amount of deposits from 22 500 to 50 000 Euros in order to avoid an avalanche of deposit withdrawals from banks, which could lead to a loss of liquidity by this sector (Table 2).

Since the end of 2Q2009 some signs of stabilisation are visible. Gross domestic product has ceased to decline, showing little signs of growth, inflation stabilized at 3.4%, strengthening the zloty against foreign currencies, and the index WIG began to show an upward trend. Similar signs of stabilization can be observed when it comes to the price of money (lombard credit), which in 3Q2009 declined by 0.25% when compared to the previous period. A significant risk, *i.e.* high and rising levels of unemployment, still remains and it is at the level of less than 11%.

### **The banking system**

When analyzing the impact exerted by the crisis on international financial markets on banks operating in Poland, it is clear that these banks were not directly linked to the subprime credit market. This relationship, however, occurred indirectly through a "parent companies", which at the end of 2007 were institutions in the need of a rapid recapitalization. In a situation where banks operating in Poland in 2008 showed record profits, the kind of actions that were expected from the "parent companies", were the ones which would be demand high dividends. This action were prevented by the Polish Financial Supervision Authority.

It is important to mention that throughout the global financial crisis, none of the Polish banks was subject to insolvency proceedings and neither the Central Bank nor the government gave any financial assistance to any bank.

However, the crisis had adversely affected the situation of the banking sector and a negative scenario of a worsening situation is still possible. Although the total balance sheet of banks in the period between 3Q2007 and 2Q2009 increased, the pace has been significantly weakened, and in 3Q2009

there has been a loss of 2 billion Euro in the balance sheet. A similar situation developed in the deposit market, especially in the period following the disclosure of the crisis. Though in this case the initial factor of the rapid growth of deposits has proved to be just a crisis, and the cause of this phenomenon, which lasted over the period from 3Q2008 to 3Q2009, was the transfer of funds from investment funds into banks, where they were located in the form of deposits. The collapse of an inter-bank money market and the higher interest rates offered by banks was a significant factor in the increase of deposits in the banking sector. (Table 2.). That is one of the reasons why the period ranging from end of the 2008 to the beginning of 2009 was named "the deposit war" period (Table 3).

In the case of loans the situation was somewhat different, since till the end of the first quarter of the present year (2009), the state of the loans showed an increasing trend. This trend, however, was not the sole effect of the active bank loan lending action. As a result of the increase of the interest rate for loans in the first three quarters of 2008 some borrowers began to have problems repayments. Banks thus prolonged periods of credit, but it was only a short-term success, because in longer periods of time, banks are obliged to create reserves for such loans, which negatively affects not only the financial result, but also banks' state of the balance sheet. In 3Q2009 the increase in loans was effectively blocked and banks have shown profit lower by a half when compared to the same period of the previous year. However, it seems that the negative phenomena associated with the deterioration of the profitability of the industry have been halted. This is because the comparison of the sector after the first quarter of 2009 and 2008, shows that the outcome of the previous year was more than five times higher than today.

The growth in loans in a situation of risk in the loan portfolio in general is a worrying phenomenon. While in the period between 3Q2007 and 4Q2008 this index showed a favourable downward trend, 2009 is characterized by a reversal of this trend, and at the end of 2009 it is likely to exceed 5%, which amongst others, is the result of high unemployment and more bankruptcies of enterprises, than was the case in previous years.

In such circumstances, it is difficult to expect an increase in profitability of banks and the sector as a whole. Banks have adopted a strategy of survival. Throughout the analysed period ratio of deposits towards loans remained unfavourable. This poses a threat to liquidity, because in such relationships, the banks gave more loans than they had deposits. Coverage ratio of loans by deposits was less than 100% and at the end of 3Q2009 reached 84%, even though before the crisis it exceeded 90%. This phenomenon is also the result of financial difficulties of banks with foreign capital operating in Poland as before, their owners, kept significantly helping the daughter banks by giving them the necessary capital to finance loans.

As far as the solvency of the sector is concerned, it is much higher than in previous periods. This is due to retention of profits in between 2007 - 2008, which increased the banks' equity. According to the Polish Financial Supervision Authority, only 3 banks showed a solvency ratio below 8%, of which one was a commercial bank and the second was a cooperative bank.

## **Conclusion**

Global financial crisis has negatively influenced the financial position of the banking sector in Poland, though its effects were minimal. When summing up the above observed phenomena, it shall be noted that the Polish banking system remains stable and solvent. As a result of the stop in profits in previous years and a raise in equity the ability to absorb potential losses was strengthened, which might possibly develop in the future.

The main danger for the Polish banking sector is the external environment, in particular, hardly stable situation on international financial markets. It may be argued that the greatest threats to international financial institutions have been identified and actions of central banks and governments have stabilized the situation, but the crisis has highlighted a number of weaknesses in the banks, which should strengthen loan procedures, paying careful attention not only to the creditworthiness, but also the security of credit. Another weak point proved to be the regulation of risk management, especially market risks. Bank strategies are also in the need of reconstruction, which should be based on long-term sustainability, rather than being focused on the profitability of operations (UKNF, 2009). Threats are also associated with positive information about managing the financial crisis well, because they may cause a return to more aggressive policies aimed at profit, and inefficiency and to mitigate the credit terms. This threat is so real and dangerous as for Polish banks, affected by the crisis to a little extent, it may cause false feeling of power company, "genius" boards, as well as certainty of an incoming aid from the government and new crisis regulators.

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