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The Anti-Cyclical Role of PKO BP in Poland during the Global Crisis

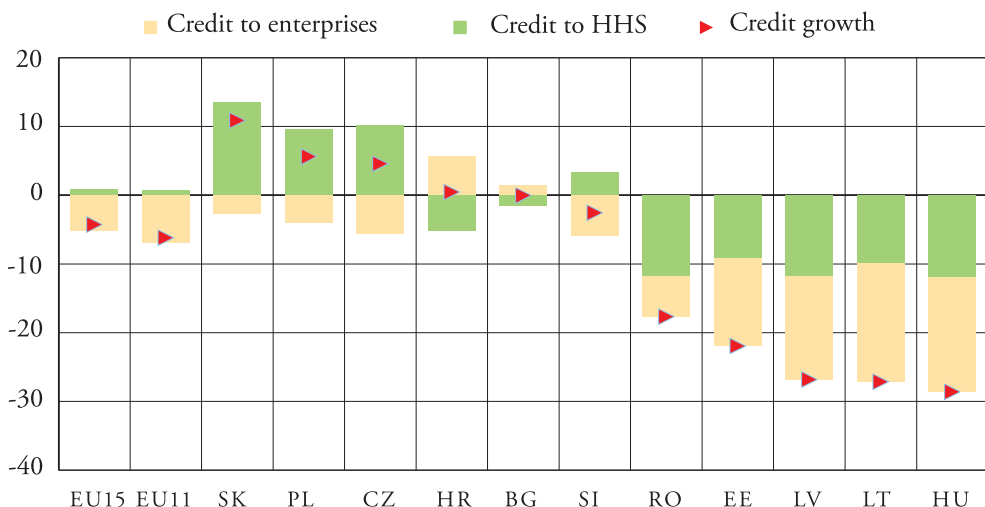
The objective of this article is to highlight the role of PKO BP, the largest bank in the Polish bank market, with a controlling stake of the Polish state, in supporting credit growth during the global crisis 2008-2011.

Poland was the only economy in the European Union to avoid recession in 2009, growing by 1.6 percent. It also experienced one of the fastest economic recoveries in the EU, with an average 4.1 percent GDP growth in 2010-11. This remarkable performance resulted from a number of factors, including timely fiscal and monetary stimulus, depreciation of the domestic currency, relatively small share of external trade in GDP and a healthy banking sector⁴. Moreover, un-

like in most EU10 peers, GDP growth was also supported by growing bank credit, especially for households (Figure 1).

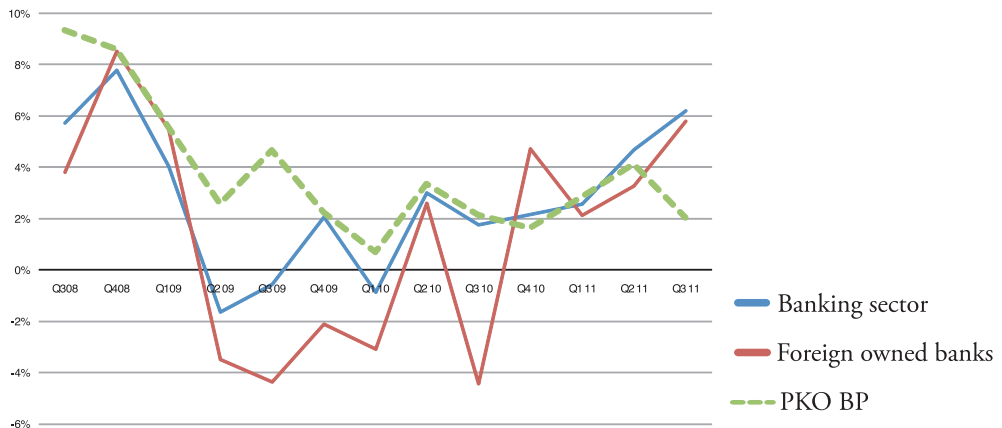
Positive GDP growth, relatively low increase in unemployment, and growing real wages helped sustain demand for loans, particularly among households. On the supply side, growth in lending was supported by strong policy measures undertaken by the Polish Financial Supervisory Authority (KNF) and the National Bank of Poland (NBP), to safeguard banking sector's stability and expand domestic credit, including regulatory measures to increase bank capital buffers, boost confidence in the banking system and provide domestic and foreign currency liquidity⁴.

Figure 1 **Structure and dynamics of real credit growth in EU10 and EU15, cumulative change from October 2008 to August 2011**



Notes: HHS: households. Credit growth: lending to private sector (HHS plus enterprises). Source: World Bank (2012).

Figure 2 Nominal changes in total loans to enterprises and local government, 3Q2008-3Q 2011, quarter-on-quarter



Notes: foreign-owned banks include the seven largest foreign-owned banks in the market (Pekao SA, BRE Bank, Bank Śląski ING, Bank Handlowy, BZ WBK, Millenium Bank, Kredyt Bank). Unweighted average.

Source: PKO BP, NBP.

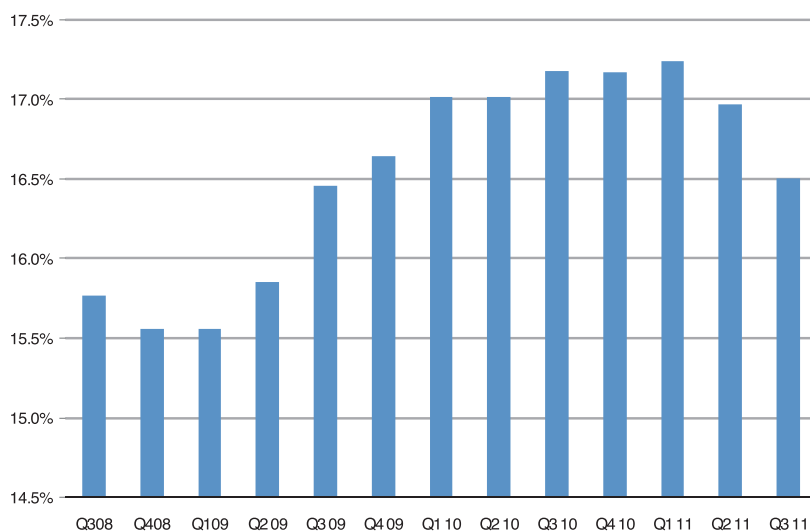
Growth in lending was also supported by PKO BP, the state-controlled bank, which played an important role in financing the Polish economy during the crisis.

PKO BP credit growth during the crisis

PKO BP is the largest bank in Poland and in Central and Eastern Europe by value of assets, equity and market capitalization (of almost US\$14 billion in February 2012). PKO BP has traditionally been a savings bank of choice for Poles, going back to the pre-transition period, when it was the designated state saving bank. In 2004, PKO BP was partially privatized through an IPO on the Warsaw Stock Exchange. Today, the Polish state directly controls 40.99% of shares and additional 10.25% through BGK, a state-owned development bank, for a total of 51.24%. The Government's "Privatization Plan for 2008-2011" stipulates that the State stake in PKO BP will be gradually reduced to 25 percent plus one share³. In line with the Strategy, in August 2011 the government planned to sell a part (15%) of its stake in PKO BP, but the sale was postponed pending improvement in market conditions.

The Supervisory Board of PKO BP comprises nine members, seven of which are selected by the State from among State officials, academics, and business professionals, and two independent members selected by private institutional investors. While there has been a relatively large turnover in the management of the bank in the past couple of years, with the Polish State nominating three different CEOs during 2008-12, the management of the bank is nonetheless perceived by the markets to be fully professional and commercially oriented. As one of the largest and most heavily traded companies listed on the Warsaw Stock Exchange (WSE), the bank is closely followed by a large group of domestic and international equity analysts from leading global investment banks, who help ensure that the bank operations are transparent and commercially driven. PKO BP's accounting and reporting standards are based on IFRS and are comparable internationally. PKO BP complies with the "Code of Best Practice" for corporate governance for companies listed on the WSE.

Throughout the crisis, PKO BP expanded credit much faster than Polish subsidiaries of foreign banks, which con-

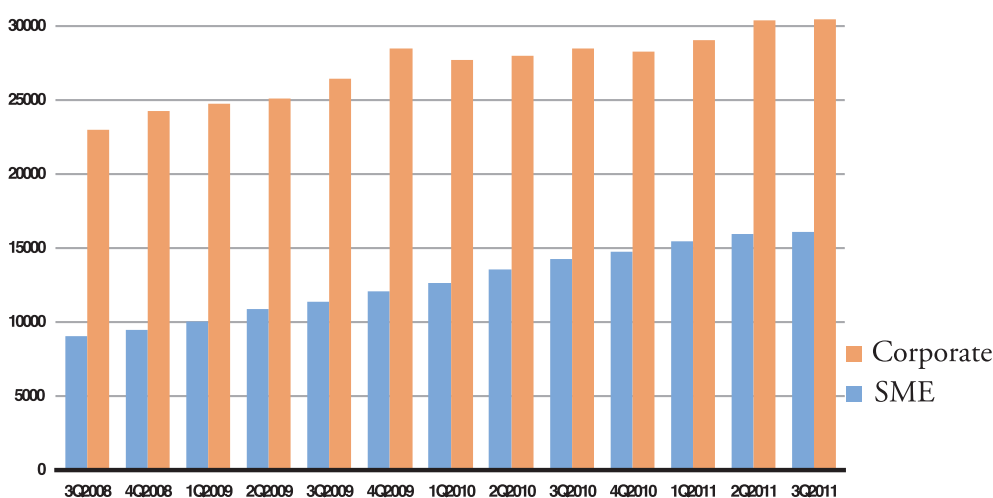
Figure 3 PKO BP's share in total banking sector lending, 3Q2008-3Q2011

Source: PKO BP, NBP.

control almost three-fourths of the sector's total assets, and the banking sector as a whole (Figure 2).

As a result, PKO BP's share in total banking sector lending increased substantially in the period, rising from 15.6% in the third quarter of 2008 to 17.2% at the end-2010 (Figure 3). PKO BP's lending volume increased by PLN 33.8 billion in 2008 alone, or by a substantial 2.7 percent of GDP. PKO BP lending increased by another PLN 17.2 billion in 2009, which represented 39

percent of total new bank lending in that year. During 2009-2011, PKO BP's new loan generation represented more than 1 percent of GDP annually. In late 2011, PKO BP's share in total lending decreased slightly following large depreciation of the domestic currency, driven by the euro zone crisis, which temporarily inflated the PLN value of FX-dominated balance sheets of foreign owned banks. As of September 2011, FX-denominated loans at PKO BP's represented 23.8 percent of the total loan portfolio relative to

Figure 4 PKO BP's lending to corporate and SME sector, in PLN million, adjusted for FX changes, 3Q2008-3Q2011

Source: PKO BP, NBP.

Figure 5 Net interest margin in PKO BP, largest foreign banks and the banking sector, 2007-3Q2011



Notes: foreign owned banks include the seven largest foreign-owned banks in the market (Pekao SA, BRE Bank, Bank Śląski ING, Bank Handlowy, BZ WBK, Millenium Bank, Kredyt Bank). Unweighted average.

Source: PKO BP based on KNF and publicly available data.

the banking sector’s average of 33.4 percent (Figure 8).

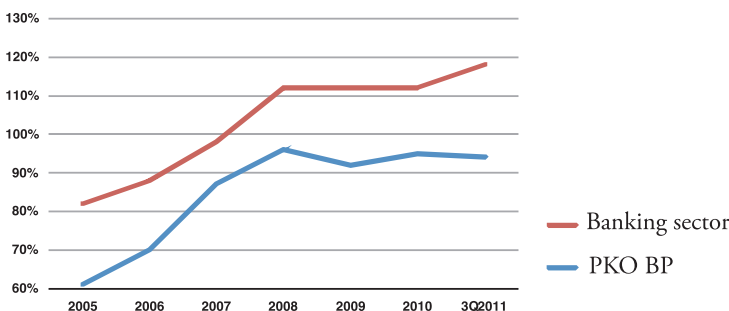
PKO BP’s lending increased for all market segments, including most importantly the corporate and the SME sector, where the nominal value of extended loans expanded throughout the crisis by PLN 7.5 billion and PLN 7.0 billion, respectively, or about 0.5 percent of nominal GDP in 2011 (Figure 4).

Importantly, the surge in PKO BP’s lending during the crisis was not driven by lower credit margins. To the contrary, PKO BP’s net interest margin has been above the average for the largest foreign owned banks, and the banking sector during the whole 2007-2011 period (Figure 5).

Generally, the difference in the pace of lending between PKO BP and average of foreign owned banks in Poland could be attributed to four major factors:

- First and foremost, PKO BP’s credit expansion seems to have been largely driven by arms-length commercial decisions by the bank’s management, to capitalize on a withdrawal of foreign owned banks from the lending market, creating new and attractive business opportunities in the corporate and household sector. Following the collapse of Lehman Brothers and the resulting increase in risk aversion among parent banks, foreign-owned banks in Poland drastically cut domestic credit

Figure 6 Loan to deposit ratio in PKO BP and the banking sector, 2005-3Q2011



Note: Banking sector excludes PKO BP.

Source: PKO BP, NBP.

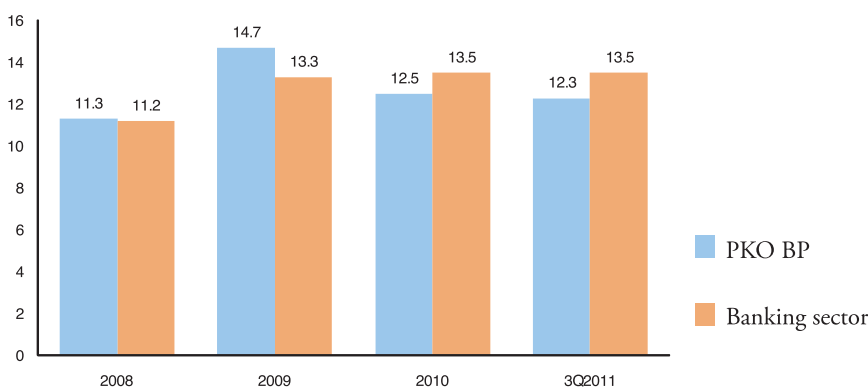
risk limits, increased liquidity buffers and reduced leverage. These decisions were taken largely independently of the specific Polish economic fundamentals, which at the time were among the most auspicious in the whole of Europe.

- Second, while there was no official government plan to increase lending through PKO BP, the Polish government's unequivocal support for PKO BP's expanded lending and continued risk appetite during the crisis, exercised through the State representatives on PKO BP's Supervisory Board and through public pronouncements, is likely to also have played a role. In addition, the State supported PKO BP's rights issue in 2009, which strengthened the bank's capital base.
- Third, PKO BP maintained a conservative funding structure before and during the crisis, with domestic deposits fully financing outstanding loans, as reflected in the loan-to-deposit ratio below 100% (Figure 6). This minimized PKO's dependence on the then moribund wholesale financing market, both domestically and abroad. Foreign owned banks in turn relied on the domestic deposits much less, financing some part of their assets with external funding from parent banks. However, such funding has become more expensive and less stable during the crisis (although, in response to much better

domestic economic prospects than in other EU10 countries, foreign liabilities of the Polish banking sector have actually increased during 2009-10). Somewhat paradoxically, the fact that as a Polish-owned bank PKO BP had no access to attractively priced foreign sources of financing before and during the crisis, forced PKO to adopt a more conservative funding structure, which allowed it to better cushion itself against the crisis than foreign-owned banks. In addition, PKO BP's liquidity was supported by an outflow of individual and corporate deposits from foreign owned banks, especially those whose parent banks were most exposed to the global financial crisis. Finally, PKO BP benefited more than other banks from an early repurchase of long-term bonds by NBP in 2009 and – as the largest deposit bank in the market – from a subsequent reduction in the mandatory reserve from 3.5% to 3.0% in May 2009, as part of NBP's anti-crisis package of measures to increase banking sector's stability⁵). The total additional liquidity injected into the market in these two operations amounted to PLN 11.5 billion, with PKO BP's liquidity rising by almost PLN 3.3 billion.

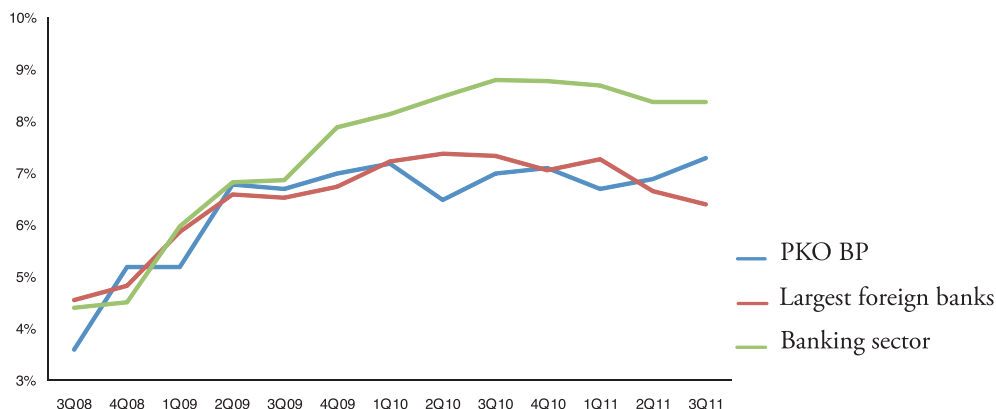
Finally, PKO BP's capital adequacy ratio, already significantly above the minimum 8% regulatory ratio, was additional-

Figure 7 Capital adequacy ratio in PKO BP and the banking sector, 2008-3Q2011



Source: PKO BP, NBP.

Figure 8 Non-performing loans for PKO BP, foreign banks, and the banking sector, 3Q2008-3Q2011



Notes: foreign-owned banks include the seven largest foreign-owned banks in the market (Pekao SA, BRE Bank, Bank Śląski ING, Bank Handlowy, BZ WBK, Millenium Bank, Kredyt Bank). Unweighted average.

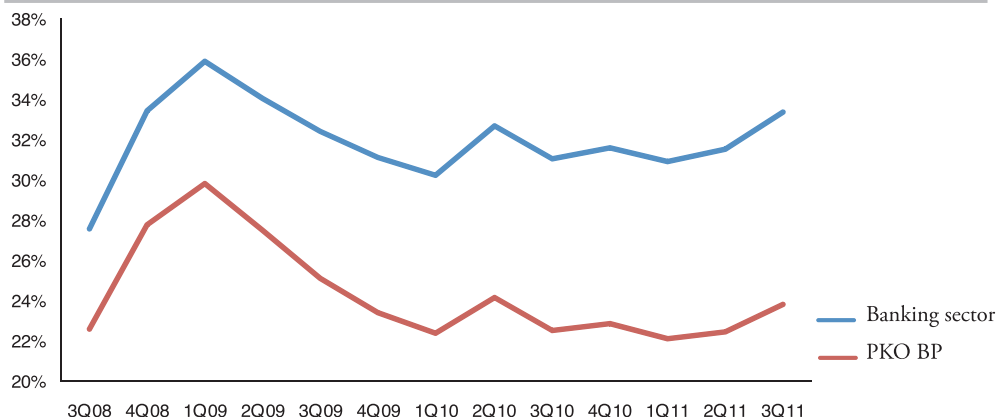
Source: PKO BP based on KNF and publicly available data.

ly raised following a PLN 5 billion rights and new share issue in late 2009 (Figure 7). The rights issue was heavily oversubscribed, with 99.15% of shareholders signing up for new shares; share allocations in the additional tranche of shares were reduced by more than 99%²⁾, drawing significant interest among domestic, and as international investors attracted by a conducive risk-return balance, between the relatively low price on the newly issued shares and a perceived low market risk of PKO BP. As a result, unlike a number of foreign owned banks, PKO BP had sufficient capital space to step up its lending, lowering its CAR from 13.3 per-

cent in 2009 to 12.3 percent in 3Q2011. There were only two foreign-owned banks that increased capital by issuing shares in 2010, as there was not much appetite for expanding loan portfolios and therefore no need for capital increases to fund it. In addition, it would have likely been less expensive for the parent banks to issue shares in international markets, especially after the global crisis subsided in 2010, and then use the proceeds to increase equity in Polish subsidiaries, then to issue shares directly in the Polish market, where the investor base is significantly smaller.

Despite the substantial increase in lending during the crisis, PKO BP's non-

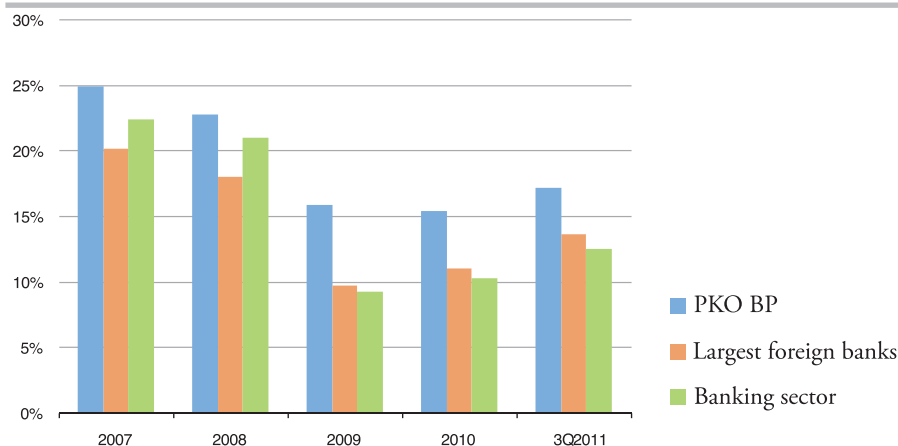
Figure 9 Share of FX denominated loans in total lending, PKO BP and the banking sector, 3Q2008-3Q2011



Note: data are not adjusted for changes in the foreign exchange rate.

Source: National Bank of Poland and PKO BP.

Figure 10 ROE of PKO BP, the largest foreign banks and the banking sector, 2007-3Q2011



Notes: foreign-owned banks include the seven largest foreign-owned banks in the market (Pekao SA, BRE Bank, Bank Śląski ING, Bank Handlowy, BZ WBK, Millenium Bank, Kredyt Bank). Unweighted average.

Source: PKO BP, KNF and publicly available information of the largest foreign banks.

performing loans have increased less than the market average, and were largely in line with that of the largest foreign owned banks (Figure 8). PKO BP also did well on an alternative indicator of credit overdue by more than 90 days, where PKO BP's ratio amounted to 4.2% in the third quarter of 2011 versus the market average of 5.8%^{2, 6)}. PKO BP's assessment of NPLs is based on international accounting standards (IFRS) and internal risk models. These are audited by international auditors (currently PWC). While NPLs are usually backward looking, in the third quarter of 2011 slightly more than half of PKO BP's stock of NPLs was based on a forward-looking assessment of risks related to loans, which were classified as risky – based on the performance of similar loans in the past – for other reasons than a 90 day delay in payment.

The better-than-average NPL performance of PKO BP was likely due to its more conservative lending policies before the crisis, partly driven by lack of attractively priced access to foreign financing, reflected inter alia in a lower share of foreign exchange denominated loans than in the banking sector as a whole (Figure 9). Robust risk management, based on the largest client data-

base in the country, which allowed for prudent price and risk assessment, is likely to have also been helpful. That said, the latest pick-up in NPLs suggests that more time will be needed to fully assess the impact of increased lending on loan quality.

During the whole crisis period, PKO BP has remained profitable, as reflected in high ROE, which were higher than the average for the largest foreign owned banks and the sector as a whole (Figure 10). The cumulative net profit for the 2008-2011 period amounted to more than PLN 12 billion or some US\$4 billion. PKO BP maintains a ranking of A2 from Moody's, with a stable outlook²⁾.

Conclusions

The case of Poland's PKO BP suggests that domestically owned banks can play a useful counter-cyclical role during crises, by supporting lending to the economy, becoming de facto "creditors of last resort". This is largely because they are less subject to exogenous shocks, are more often funded in the domestic markets, and are more inclined to react to changing credit market conditions based on domestic fundamentals alone. They are also insulated

from exogenous decisions of foreign parent banks, affecting lending policies of their domestic subsidiaries.

State ownership has further enhanced PKO BP's ability to withstand the crisis, by imposing on the bank a conservative lending and funding culture, enhancing the bank's ability to attract deposits during the crisis thanks to the implicit State guarantee, and participating in the crucial capital increase.

PKO BP story also highlights the benefits of Poland's diversified bank ownership structure, with foreign banks playing a very positive role in supporting financial deepening⁷⁾, especially during good times, and domestically owned and state-controlled banks taking the lead on lending during times of external turbulence.

However, the case of PKO BP suggests that for the state-controlled banks to be successful, they need to be commercially-oriented, open to free market competition, and focused on "utility banking". They also need to be transparent, profes-

sionally managed, ideally by managers chosen through a meritocratic selection process, and subject to hard budget constraints.

All of these key conditions can be at least partly achieved by taking state banks public and listing them on a stock exchange. This not only forces these banks to adopt international accounting and reporting standards, but – thanks to a watchful eye of domestic and international shareholders – also helps impose market discipline, ensure compliance with best global practices of corporate governance, strengthen commercial orientation and sustain high quality of lending, including by mitigating political pressures. Without such market pressures, the key conditions for success are not always easy for state-owned banks to adhere to. A well embedded culture of transparency, accountability and strong business ethics is also useful, although policy recommendations on how to achieve it are not straightforward.

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