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THE ESSENCE AND CONDITIONS OF THE BANKING SYSTEM STABILISATION – ANALYSIS OF THE POLISH BANKING SYSTEM STABILITY IN THE POST-CRISIS PERIOD

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Introduction and methodical outline

The financial and the banking system that operates within are the boundary conditions for the development of the whole economy. The stable and effective character of the financial system is the precondition for the stability of the economy. In turn, the instruments functioning within this system are a tool for equity exchange which size and ability to circulate is determined by stable and effective functioning of the financial system. In this context a particular role is attributed to financial institutions – in particular to investments on the capital market – because this is through such investments that the exchange of equity takes place, the equity that has the ability to be put in entities that can use it effectively. In this paper, the stability analysis is based on the study of relationship between the basic macroeconomic indices and changes in the banking system basic characteristics as well as changes in the key performance indicators of the banking system over time.

The papers discusses the essence of banking system stability and its characteristics for the Polish environment under financial crisis present in global markets.

The definition of banking system stability

The category of 'stability' refers to a situation where there is ability to overcome emerging threats. The system is stable if the changes in the environment of this system do not entail changes in the analysed system. In turn, changes in indices' levels characterizing this system do not have negative impact on its overall efficiency. Such a definition is of general nature and only explains the very essence of stability. Stability understood in these terms may relate to any system.

In the present study the object of analysis is the stability of the banking system being assessed in terms of changes in the macro-environment that affect the scope and strength of stability. The stability of the banking system itself should be regarded as the basis for stability of a wider system that a financial system should be recognized for. In this case the relationship lies in the fact that the banking system stability is what the entire financial system relies on.

Financial system stability is understood as a situation when the system performs its functions in a continuous and effective way, even when unexpected and adverse disturbances occur on a significant scale. Disruptions in both the financial system and in the providing effective services of financial intermediation have a negative impact on enterprises' and households' situations. Therefore, the leading central banks carry out studies and research in this area and publish stability reports. The aims of such activities is to strengthen the financial system stability by providing information about risk factors for stability and the assessment of financial system resilience against disruptions. Dissemination of such knowledge is to foster the maintenance of the financial stability, including by better understanding of the scale and extent of risks in the financial system. In this way, without interference of public entities in market mechanisms, the probability of independent adjustment of financial market participants behaviour undertaking too much risk increases.

According to the European Central Bank the stability is a situation where the financial system is capable to prevent shocks posing a threat for the processes of transforming savings into investments and payment settlements in the economy. The banking system stability is an element of financial stability which in turn is part of economic stability.

The very category of stability can be analysed in different sections, among which the most important are:

- short and long-term stability,
- monetary stability,
- political stability,
- legal stability.

Then, the most important measures of stability level are:

- the level and growth rate of gross domestic product, because it is impossible to maintain a long-term stability in recession or stagnation conditions of the economy. Stability is conditioned by the progress in the real economy,
- low unemployment rate, understood as an actual unemployment, overcome by real job offers and not an artificially hidden unemployment, curtailed by administrative methods,
- low inflation rate in the long term. Stable money is the fundamental condition for the stability of all finances and real economy sphere. It should be noted that it is not about the zero level of inflation nor even deflation which undermine the economy at each level. Low inflation rate is the most conducive to making long-term growth,
- stability in the national budget,
- a proper current account balance so as to ensure full and efficient foreign and domestic debt service,
- an appropriate exchange rate formed by market mechanisms under the supervision and only required interventions of the central bank.

Typical threats to the system

The financial system of market economy is the most effective among all the world's existing economic systems, which does not mean, however, that its stability is certain and automatic. The crisis of recent years reveals two features. First, there are no automatic effects and second, the market system has the ability to respond rapidly and through measures of adjustment restores the efficiency and stability of the financial system.

When speaking about potential threats, two typical forms should be demonstrated. The first symptom of destabilisation is the slowdown of the economy which does not result from the phase of the economic cycle. If the economy slows down, companies, due to the drop in sales, start facing difficulties in repaying investment loans, and households, due to the unemployment increase, face difficulties in repaying housing loans, which causes losses for banks and other financial institutions.

If asset prices, e.g. securities, land and buildings as well as production appliances drop significantly or change abruptly, the uncertainty in financial markets grows and in consequence investors bear losses.

If banks are investing large amounts of money, for example in equities or bonds, they may suffer from a drop in prices in the securities markets. A similar process occurs in the case of investment funds which fulfilling the growing demand for fund units redemption are forced to sell securities at ever lower prices, causing – due to their growing supply – consecutive drops in rates. Real investment projects are being carried out with growing precaution and, in consequence, boundary frames of recession are being formed which does not remain without influence on the financial and banking system.

Defense of the stability

Banks, insurance companies and other financial institutions are the first line of defense against the financial crisis. They are obliged to ensure their profitability and solvency as well as check the credibility of the borrowers so as to adequately manage the risks.

The second line of defense are actions undertaken by the authorities in order to prevent the crisis or minimise its effects. These actions include: prudential regulations requiring financial institutions to effectively manage risk and ensure the safety of deposits as well as the financial disclosure in order to maintain market discipline; prudential supervision that consists in supervising that financial institutions comply with prudential regulations; monitoring and appreciation of financial stability in order to identify weaknesses of the financial system as a whole as well as the existing threats.

The government intervention may appear necessary only if, despite these measures, financial institutions find themselves in a difficult situation. It is worth noting the sequence of actions. First, financial institutions themselves implement remedial programs and only with the possible absence of their effectiveness the government intervenes. The reverse order means that financial effects of the intervention are performed by the entities, not only those who have experienced crisis but also those which did not undergo it. For example the increase of the tax for short periods may help to redistribute income but over time reduces the efficiency of the private sector thereby depleting the future tax revenues which triggers a spiral of ever higher tax rates and ever lower volume of tax revenues. This in turn leads directly to further destabilize the entire financial system.

The analysis of the situation of past years since 2006 can explain how in a market economy environment the cyclical financial crisis manifests itself, what are its implications, what is the impact on the financial sector and what are the most effective projects designed to overcome it. Below are selected indicators of Polish banking system in the years 2007-2009. Evidence showed that the Polish conditions for 2007 and the first half of 2008 were not yet feeling the effects of the period of global financial crisis, and the second half of 2008 and the year 2009 were the time in which symptoms of destabilisation have been seen but are also gradually being overcome, even better than in all other European Union countries.

Characteristics of the Polish banking system in terms of its stability in 2007-2009

The global financial and economic crisis is affecting the macroeconomic situation of Poland and the conditions in which the Polish financial system operates. The crisis caused the significant decline of economic growth dynamics, however unlike other European Union countries did not produce the decrease of GDP. Despite the slower pace of economic growth, the Polish economy was the unique in European Union to maintain a positive annual rate of the real GDP, which in the first three quarters of 2009 stood at 0,8%, 1,1% and 1,7%, respectively, whereas in the following quarters of 2008 the economic growth rate amounted to 6,2%, 6,0%, 5,1% and 3,0%. It is worth noting the declining tendency of GDP growth rate in 2008 and increasing in 2009, which is a more significant measure of stability than the GDP level itself.

Domestic financial institutions, banks in particular, in the period preceding the economic slowdown showed high earnings (the average return on equity of the banking system in 2008 amounted to 20,5%. The balance-sheet structure of the domestic banking sector (a relatively low ratio of loans to deposits) and the structure of banks' revenues (focus on deposit taking and lending activities and a relatively insignificant involvement in operations on financial instruments) curtailed the decrease of banks' financial results. Owing to this fact a significant deterioration of operating conditions did not result in losses across the entire banking sector but only lowered the financial results. The main reasons for reducing the financial performance of the banking sector during the analysed period were: increased cost of credit risk and the increase in funding costs.

The deteriorated quality of loan portfolio and banks' earnings as well as the lasting uncertainty over medium-term economic growth prospects made banks tighten their lending policies. In the second and third quarters of 2009 banks continued to tighten their lending policies in all market segments, however, in comparison with the fourth quarter of 2008 and the first quarter of 2009, the percentage of banks that tightened lending policies was lower. The situation of non-banking financial institutions did not pose threats to the financial system stability. As non-banking financial institutions are focusing on providing conventional financial and insurance services and the scale of relationship between these institutions and banks is relatively small, the impact of non-financial institutions on the situation of the banking sector is insignificant.

An important factor affecting the Polish financial system stability is the development of zloty exchange rate and its dependence on the economic situation of the countries in the region (regional risk). In the analysed period the zloty strengthened after a strong depreciation at the start of 2009. The appreciation of the zloty was the consequence of a significant decrease in risk aversion of global investors and the fact that they diversified their investment policies by adjusting them to the economic situation of the individual countries of the region. In the present market conditions, pessimistic information about economic prospects for other countries of the region influences quotations on the Polish market to a lesser degree. These developments along with the assessment of Poland's economic fundamentals indicate that a further strong and prolonged depreciation of the zloty seems rather unlikely. As it appears in the first months of 2010, the zloty exchange rate against major world currencies has been stable with tendency to strengthen what enhances the prospect for the growth of Polish banking and financial system stability.

Characteristics of the banking system stability have been presented below in forms of charts demonstrating the Polish banking system according to the situation in the third quarter of 2009 in comparison with the years 2007-2008 where the stabilisation of Polish system was not threatened by external factors.

Figures about the banking system stabilisation:

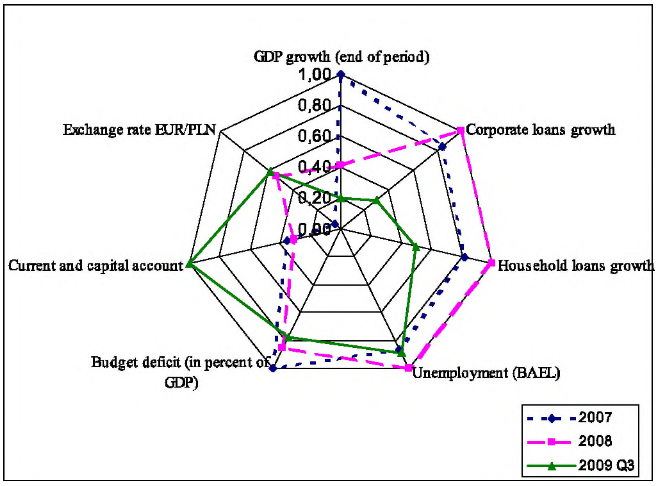

Fig. 1 – The change of macroeconomic indicators over last three years

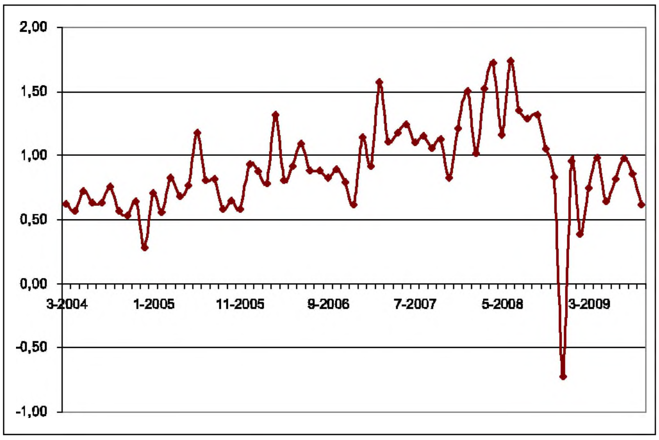

Fig. 2 – Monthly net profit of the banking sector in PLN billions

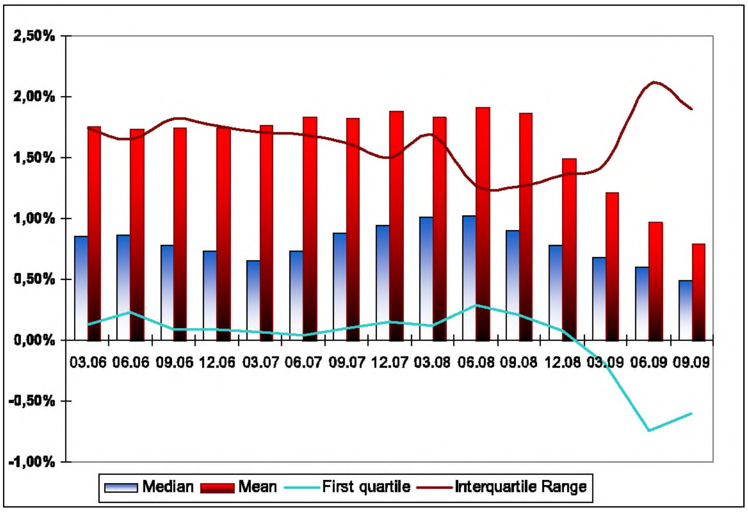

Fig. 3 – Return on assets (ROA)

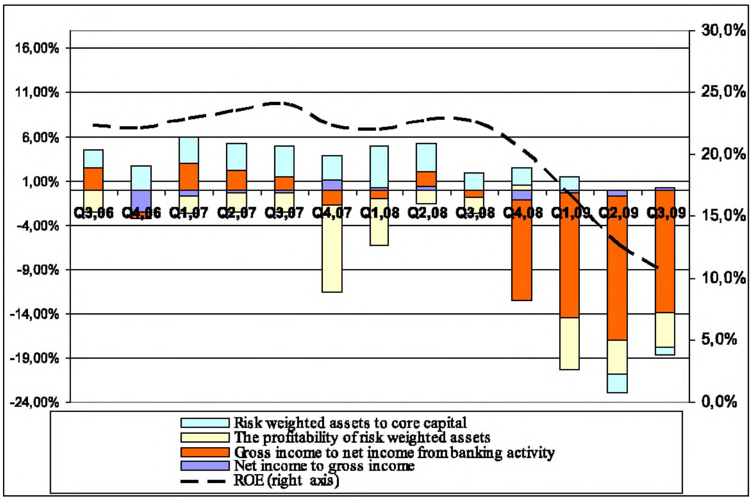

Fig. 4 – Return on equity (ROE) and decomposition of its changes

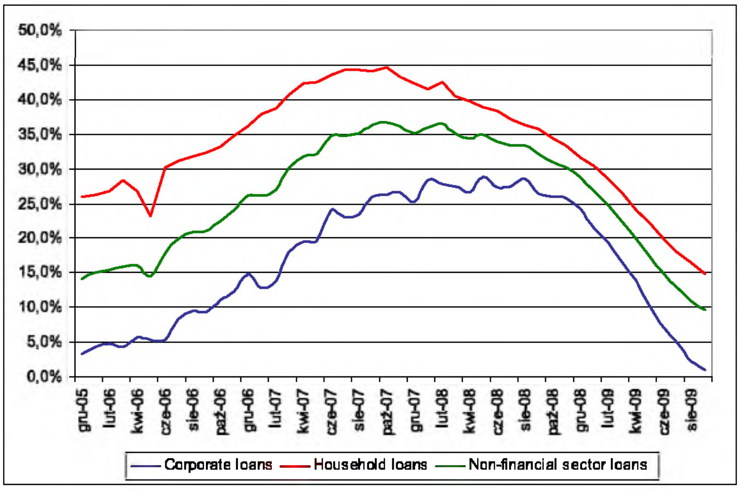

Fig. 5 – Credit growth (y/y)

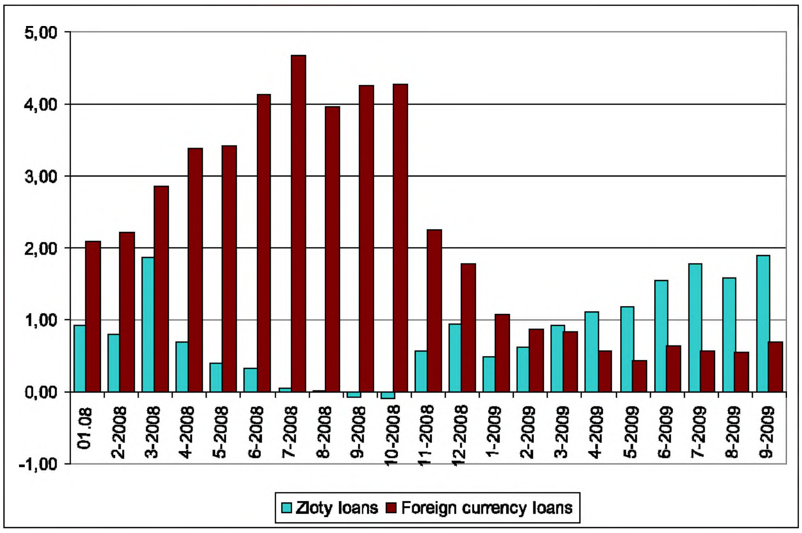

Fig. 6 – Monthly changes in the value of housing loans to housholds - by currency PLN billion

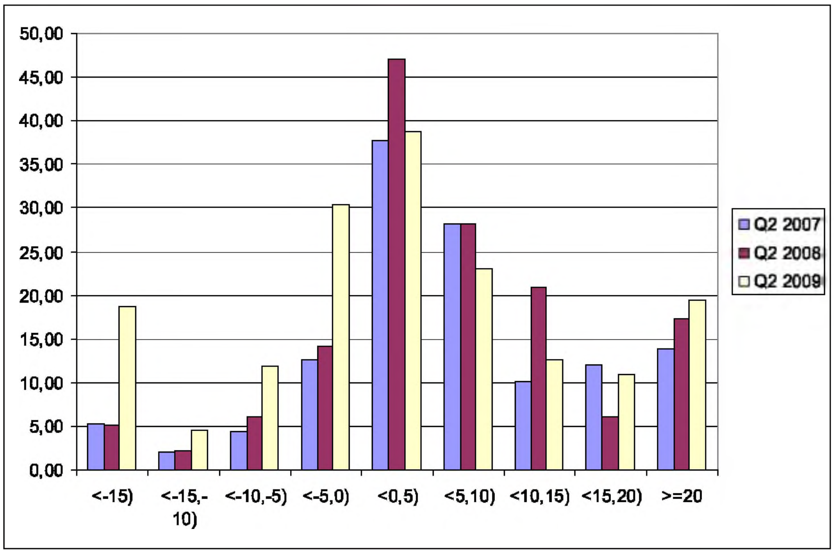

Fig. 7 – Distribution of debt of enterprises by pre-tax profit in PLN billion

Conclusions

The stability of the banking system is of particular importance for financial system stability. This is due to the role of banks in financing the economy and in the settlement of payments. Banks also perform another important function, i.e. they provide products that allow other entities to manage their financial risk. Therefore, a special emphasis is put on the analysis and assessment of banking system stability.

Financial system stability is also the object of the NBP's particular interest due to its tasks to contribute to the stability of the domestic financial system and to establish the necessary conditions for the development of the banking system.

The global crisis continues to have a strong impact on the Polish economy; however the economic outlook improved as uncertainty over the future business climate, as perceived by economic entities, diminished. The situation on the world financial markets considerably improved, which contributed to a reduction of tensions on domestic markets. These factors helped reduce the risk to the stable functioning of the Polish financial system, as compared with the assessment presented in the June Report. However, due to a large scale of the economic slowdown recorded since the fourth quarter of 2008, the revenue of some financial institutions was lower. Moreover, banks' funding costs rose and the costs resulting from the materialisation of credit risk accumulated in the years of favourable economic conditions increased as well. These processes cause the risk to the stable functioning of the financial system to remain elevated.

After a period of turmoil at the turn of 2008 and 2009, the situation in the domestic financial markets was improving in the second and third quarters of 2009. This was reflected by a decrease in volatility, notable particularly in the FX market, appreciation of the zloty and stabilisation of government bond yields. The improved situation on the domestic financial markets mainly reflected global factors, in particular the increase in global investors' propensity to take risk which may be indicated by, among others, increase of foreign investors' holdings of Polish government bonds.

The rise in propensity to take investment risk resulted, among others, from both a better outlook for global economic growth and very low interest rates in major world economies.