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REPUBLIC OF POLAND

FINANCIAL SYSTEM STABILITY ASSESSMENT

February 2019

This paper on the Republic of Poland was prepared by a staff team of the International Monetary Fund as background documentation for the periodic consultation with the member country. It is based on the information available at the time it was completed on December 28, 2018.

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FINANCIAL SYSTEM STABILITY ASSESSMENT

December 28, 2018

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This report is based on the work of the Financial Sector Assessment Program (FSAP) missions that visited Poland in January and May 2018. The FSAP findings were discussed during the Article IV Consultation mission in October 2018.

- The FSAP team was led by Michael Moore (IMF) and Loïc Chiquier (World Bank), and included deputy mission chiefs Darryl King (IMF) and Johanna Jaeger (World Bank); Ran Bi, Ivan Guerra, David Jones, and TengTeng Xu (all IMF); Juan Buchenau, Ana Carvajal, Pierre-Laurent Chatain, Jose Antonio Gragnani, Pamela Lintner, Heinz Rudolph (all World Bank); and external experts Jan Brockmeijer, Michel Canta, Johannes Forss Sandahl, Joaquin Gutierrez, David Scott, and Ian Tower.

- The team met with senior leaders and officials from the Ministry of Finance (MoF); National Bank of Poland (NBP); Polish Financial Supervisory Agency (PFSA); and private sector representatives.

- FSAPs assess the stability of the financial system as a whole and not that of individual institutions. They are intended to help countries identify key sources of systemic risk in the financial sector and implement policies to enhance its resilience to shocks and contagion. Certain categories of risk affecting financial institutions, such as operational or legal risk, or risk related to fraud, are not covered in FSAPs.

- The Republic of Poland has a systemically important financial sector according to SM/13/304 (11/15/2013), and the stability assessment under this FSAP is part of bilateral surveillance under Article IV of the Fund's Articles of Agreement.

- This report was prepared by Michael Moore and Darryl King with contributions from the FSAP team.

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Glossary

AML/CFT	Anti-Money Laundering/Countering the Financing of Terrorism
AFS	Available for sale (securities portfolio)
BCP	Basel Core Principles
BGF	Bank Guarantee Fund
BPS	Basis points
BRRD	Bank Recovery and Resolution Directive
CEE	Central and Eastern European
CET1	Common Equity Tier 1
CRD & CRR	Capital Requirements Directive and Capital Requirements Regulation
DAR	Detailed assessment report
DSTI	Debt service to income
FAT	Financial Activities Tax
FATF	Financial Action Task Force
FIAT	Financial Institutions Asset Tax
FSAP	Financial Sector Assessment Program
FSC-K	Financial Stability Committee—Crisis Management
FSC-M	Financial Stability Committee—Macroprudential
FSR	Financial Stability Report
FX	Foreign Currency
GDP	Gross Domestic Product
KNA	Komisja Nadzoru Audytowego (the Audit Supervision Committee)
LCR	Liquidity Coverage Ratio
IOSCO	International Organization of Securities Commissions
LTV	Loan-to-value
MCM	Monetary and Capital Markets Department
MoF	Ministry of Finance
MONEYVAL	European Committee of Experts on the Evaluation of AML/CFT
NASCU	National Association of Credit Unions
NBP	National Bank of Poland
NSFR	Net Stable Funding Ratio
NPL	Nonperforming loan
OSII	Other Systematically Important Institution – equivalent to Basel defined Domestic Systemically Important Bank (D-SIB)
PFSA	Polish Financial Supervision Agency
RAM	Risk Assessment Matrix
RDP	Responsible Development Plan
ROA	Return on assets
ROE	Return on equity
RRP	Recovery and resolution planning
STeM	Stress Testing Matrix
TN	Technical Note

EXECUTIVE SUMMARY

Following several years of very strong growth, the economy is expected to slow to a more sustainable pace. Near-term growth is expected to slow to a still robust 3 to 3½ percent in 2019–20, with low unemployment.

The banking system in the aggregate shows resilience to adverse shocks, although some medium-sized banks appear weak. Stress tests suggest in an adverse scenario, the solvency ratio for the system of commercial banks (common equity tier one (CET1)) declines from 16 to 13 percent of risk-weighted assets, driven by loan loss provisions, valuation losses on debt securities, and funding and interest rate risks. Some medium-sized banks would come under solvency pressure with a small recapitalization need of around 0.5 percent of GDP. Banks appear resilient to short-term liquidity risks in local currency, with limited domestic and cross-border contagion risks except for cooperatives that are exposed to their network affiliating bank. Cooperative banks are also exposed to credit and concentration risks.

For the financial system, sovereign-financial institution linkages have increased, while exposures to foreign-exchange (FX) mortgages has declined. Increased sovereign linkages reflect more state ownership and control in the financial sector through acquisition of controlling stakes in previously foreign- controlled banks and changes to the tax regime (an asset tax) that incentivize holding of government securities. State control of the financial sector is now 36 percent. The asset tax should be redesigned on grounds of both financial stability and efficiency. Because of repayments, risks associated with FX mortgages have declined and any restructuring should therefore be based on bilateral negotiations rather than legislative changes, which would likely be costlier for banks.

Important shortcomings were identified in prudential oversight reflecting budgetary constraints and a governance framework that compromises operational independence. The consequences of under-resourcing the Polish Financial Supervision Authority (PFSA) are likely to become apparent with the inevitable turn in the financial cycle as well as resource pressures from dealing with some troubled institutions. While there was not observable improper influence on the PFSA arising from greater state control, shortcomings in its budget and governance structure raised questions about whether it had the necessary degree of independence. A new law that will be in force in early 2019, while making it more likely that additional financial resources will be available, makes governance changes that will further weaken the PFSA's independence; consequently, reform is still incomplete relative to the need for independent supervision and regulation functions.

The macroprudential policy framework is sound, though untested. There is a good range of instruments available. At present, the authorities have activated capital buffers for Other Systemically Important Institutions (OSIIs) and Systemic Risk, which are in addition to the permanent Capital Conservation buffer. In time, areas of increasing challenge will include a rising share of nonbank activity in the overall financial sector and growing consumer credit exposures that may merit deployment of the macroprudential toolkit.

Arrangements for crisis management are generally sound, although measures are required to strengthen the independence of the Bank Guarantee Fund (BGF) and powers of the PFSA. The recent implementation of the Bank Recovery and Resolution Directive (BRRD) enhanced the BGF's and the PFSA's powers to deal with failing banks and the authorities have taken appropriate steps to be prepared to deal with systemic distress and crisis in practice. However, the PFSA should be empowered to undertake insolvency assessments, without the need for a third-party opinion. The bankruptcy framework should be improved to allow for timelier action. Current exemptions from the requirement to prepare recovery plans for banks subject to rehabilitation plans and for the two affiliating banks are inappropriate.

The supervisory arrangement for about 550 cooperative banks is evolving to a "supplementary" supervision model. The authorities intend that cooperative banks join a network that includes an affiliating commercial bank and an Institutional Protection Scheme (IPS), for which some network functions would complement those of official institutions (e.g., audits of cooperatives, liquidity and solvency support). However, the model is new and the PFSA therefore needs to intensify its supervision through the transition. Elevated risks for the sector stem from uncertainty around how 40–45 cooperatives will come to affiliate within a network and about 12 cooperatives that likely will remain outside of a network may need strengthening; and for the two existing networks, their affiliating banks suffer legacy issues of weak asset quality and capital given their past forays into riskier commercial lending.

For the credit union sector, which is small, overall capital is inadequate due to some larger, weak credit unions. The authorities need to implement a strategy focused on resolving non-viable entities through exit, while determining whether a standalone credit union sector remains appropriate. For those credit unions that are viable, there could be a medium-term path towards consolidation and/or transformation into cooperatives.

Table 1. Poland FSAP 2018: Key Recommendations

Recommendations	Agency[1]	Time[2]
Financial Stability		
1. Address weaknesses in medium-sized banks, including the affiliating banks for cooperative banks, given their systemic importance in the banking system ¶12	PFSA	I-NT
2. Replace the asset tax on financial institutions with a tax on profits and/or remuneration ¶8	MoF	I-NT
3. Pursue bilateral negotiations to restructure distressed FX loans instead of law changes ¶9	PFSA, MoF	I
4. Close data gaps and improve data for credit risk and interconnectedness analysis ¶10	PSFA	I-NT
Financial Sector Oversight		
5. Reform and strengthen arrangements for supervision, based on principles that the PFSA should have (i) sufficient staffing and resources, (ii) operational independence, (iii) effective governance, and (iv) appropriate formal status in the determination of regulatory priorities ¶23 to ¶32	MoF, PFSA, NBP	I
Bank		
6. Provide missing essential enforcement powers including (i) those to ease rigidities constraining prompt corrective action due to Administrative Code procedures; and (ii) power to dismiss both management and supervisory board members ¶34	MoF, PFSA	NT
7. Increase sampling of loans across the supervisory and business cycle ¶36	PFSA	NT
Insurance		
8. Implement approach to supervision of the insurance-led financial conglomerate ¶40	PFSA	I
9. Review approach to insurance conduct of business supervision across the relevant agencies to increase preventative work, especially by the PFSA ¶41	MoF, PFSA	NT
Capital Markets		
10. Review and clarify regulations on private placements, market conduct supervision ¶44	MoF, PFSA	I
11. Conduct periodic assessments of the enforcement functions ¶45	PFSA	I
12. Strengthen criminal law enforcement ¶46	criminal law enforcement	NT-MT
Macroprudential Policies		
13. Include vulnerability assessments of payment and settlement systems in the FSR and overall systemic risk monitoring ¶47	NBP	I
14. Ensure the timely and substantive vetting of all use of macroprudential instruments by the FSC-M, to confirm the FSC-M's overall responsibility, including sufficiency of the toolkit ¶48	Members of the FSC-M	I
Crisis Management and Bank Resolution		
15. Propose legal amendments to provide for (i) more timely petitions for bank bankruptcy ¶53; (ii) harmonize the triggers for bankruptcy and use of resolution powers ¶53; (iii) address the need for third-party opinion on solvency ¶53; (iv) conduct P&A transactions in lieu of a deposit payout ¶63 & ¶66; and (v) BGF independence ¶52	MOF with PFSA & BGF	NT
16. Require recovery plans for affiliating banks, significant credit unions, and banks undergoing rehabilitation ¶54	PFSA	I
Cooperative Banks and Credit Unions		
17. Strengthen the supplementary internal control and resolution arrangements to address elevated risk and develop strategies to promote further integration/consolidation ¶62-¶63, & ¶66	PFSA, MoF, ABs, IPS	I
18. For credit unions, develop and implement a restructuring strategy to (i) consolidate viable and resolve non-viable credit unions through exit ¶66; (ii) revisit whether a stand-alone credit union sector remains appropriate ¶67	PFSA, MoF	I

[1] Agencies: MoF=Ministry of Finance; NBP=National Bank of Poland; PFSA=Polish Financial Supervision Authority; BGF=Bank Guarantee Fund; FSC-M=Financial Stability Committee-Macroprudential

[2] Time Frame: C = continuous; I (immediate) = within one year; NT (near term) = 1–3 years; MT (medium term) = 3–5 years

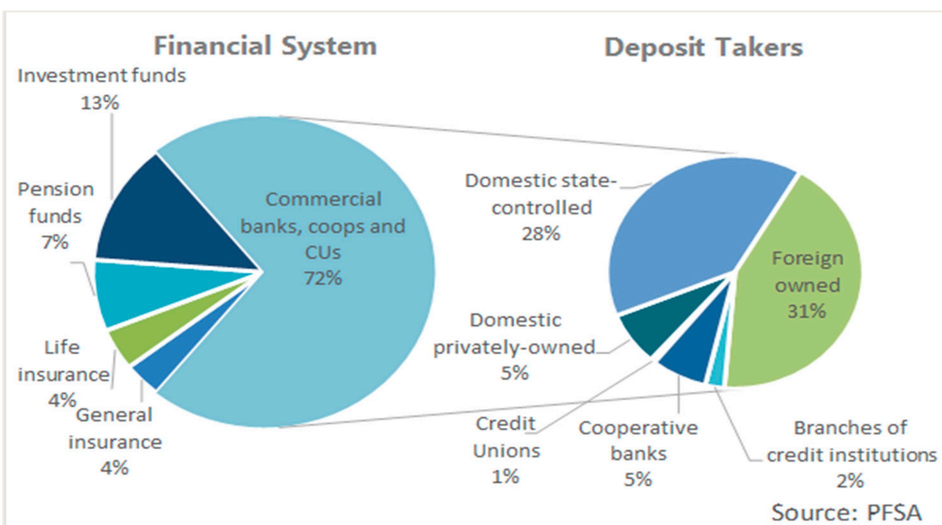
MACROFINANCIAL BACKGROUND

1. The economy is performing well. Real GDP growth accelerated from 3.1 percent (year-on-year) in 2016 to more than 5 percent during the first three quarters of 2018. Real GDP growth is projected to slow to a still-strong 3-3½ percent in 2019-20 (Appendix I). Unemployment rate ticked up modestly in recent months but is expected to remain low in the near term. Wage growth has remained elevated (7.6 percent in Q3:2018), while headline inflation (1.2 percent in November 2018) has been persistently below the NBP's inflation target of 2.5 percent.

2. Credit growth remains moderate, but its composition is skewed toward the riskier segment. Credit growth continues to grow more slowly than nominal GDP growth, with the credit gap remaining negative according to the Bank for International Settlements (BIS) (Figure 1). However, the growth in unsecured consumer lending (with the NPL ratio at 12 percent) warrants close monitoring. Risks on households' and banks' balance sheets have thus increased, although household indebtedness is still moderate (below 60 percent of disposable income). Zloty-denominated mortgage growth has slowed on the step-wise decrease in the loan-to-value ceiling during 2014-17, but growth remains around 11 percent; while new issuance of FX mortgage loans to unhedged borrowers has been banned since 2013. Lending to corporates remains subdued.

3. Solid macroeconomic fundamentals shielded Poland from earlier financial market turbulence, but risks are tilted down in the longer run. Adherence to EU policy frameworks and reductions in fiscal and external vulnerabilities have kept Poland less affected relative to other EMs during the sell-off in early to mid-2018 than during the 2013 "taper tantrum." However, downside risks in the longer run could arise such that global trade tensions escalate further, there is a disruptive Brexit, or if turbulence in global financial markets were to resume.

Structure of the Financial System, December 2017



4. The financial sector is also distinguished by many small cooperatives and credit unions. While servicing about one quarter of the population, with only 8 percent of financial system assets, they are non-systemic. The 553 cooperatives focus on lending to agriculture (providing around half the total) and SMEs. The 35 credit unions mainly provide consumer finance and operate under special regimes with lower capital requirements than banks. There are known solvency issues and past failures have spilled back onto bank profitability through higher deposit insurance assessments on banks. There are significant interconnections within this sector as most cooperatives are affiliated with one of two networks that each own an affiliating commercial bank. Because of the interconnections, these banks are designated as Other Systemically Important Institutions (OSII).

5. The insurance sector is small by comparison with most EU markets, while in capital markets, the equity market is relatively well-developed. The insurance sector is large relative to other Central and Eastern European (CEE) countries, but penetration rates, especially in life insurance, remain well below those of more developed EU markets and the product range is limited. The largest domestic group accounts for one third of total premiums. Equities are traded through both the regulated Warsaw Stock Exchange and a smaller alternative trading system. Bond markets have been growing, although from a low base for corporate bond markets, which remain modest in size, with limited liquidity by comparison with large sovereign debt market.

RISK ASSESSMENT

A. Vulnerabilities and Risks

6. Banks' financial soundness indicators are generally improving, with some exceptions (Appendix II). Tier 1 ratio is 16.5 percent of risk weighted assets (RWA). Profitability has been declining (10.4 percent ROE) due to slower loan growth and low interest rates but remains above EU average (6.1 percent ROE). Banks have generally managed their nonperforming loans (NPLs) well with the system provisioning coverage of NPLs at about 57 percent. However, some medium-sized banks appear to have relatively high NPL ratios and low provisioning coverage.

7. Triggers for increases in systemic risk could come from a retreat from cross-border integration and a faster than expected tightening in domestic and international financial conditions. A retreat from cross-border integration could hurt risk sentiment and consequently investment in Poland. A resulting zloty depreciation and an increase in interest rates could impact both FX and domestic loan portfolios. Domestically, policy slippages and the weakening of key institutions combined with heightened tensions with the EU could further erode investor sentiment.

8. Increasing sovereign-financial institution linkages could amplify financial shocks while distorting credit allocation. The linkages stem from:

- the substantial state control of the financial system: the ownership is organized within the office of the Prime Minister, which at the same time has substantial influence over the PFSA, the financial sector regulator (see Box 1 and Prudential Oversight section). The Significant state-control of parts of the financial sector further justifies the importance that the regulator is independent of government and adequately resourced in line with international standards.

- the financial institutions asset tax (FIAT)[1] incentivizes higher holdings of government securities by banks because such holdings are exempted, and consequently may have steered asset allocation away from more-productive lending for private investment (including corporate bonds).[2] While government debt levels at about 50 percent of GDP are moderate, and capped at 60 percent by the constitution, sovereign exposures can mutually reinforce fiscal and financial vulnerabilities and where the securities are of long duration, interest rate rises amplify shocks. Replacing the FIAT with a tax on profits and remuneration would be less distortive.[3]

9. **Risks associated with FX mortgage exposures have declined,** though legislative proposals, if passed, would negatively impact bank earnings (Appendix III). As with other loans, any distressed FX mortgages should be restructured based on bilateral negotiations rather than mandatory centralized approaches. The concerns from FX mortgages have declined because: mortgage loans in general are performing well relative to other types of loans; FX-denominated mortgages are of generally higher quality than zloty-denominated; banks and borrowers exposed to FX mortgages have been building buffers due to the tightening in prudential regulations since 2006; and robust growth in household income supports debt servicing capacity.

Box 1. State Ownership in the Financial Sector: Recent Developments and Implications

Policy on state ownership is evolving, while state interest in the financial sector has been increasing. The government which took office in 2015 is limiting further privatization and focusing on strategic management and maximizing the value of core state assets, including its interests in the largest banks and insurer. State ownership supervision has been reformed, with new arrangements in the Prime Minister's office for managing key decisions and making appointments to supervisory boards based on skills and expertise. At the same time, the state-controlled large insurer has acquired controlling interests in two banks from foreign owners, furthering a related government objective.

State control of financial institutions raises policy challenges, in particular:

- Maintaining clarity over objectives. Most entities (including the largest banks and insurer) compete with wholly privately-owned institutions. From FSAP discussions, there is no evidence the government uses state control to direct or to influence the institutions, for example by prescribing lending targets; nor has the state sought the payment of excessive dividends.
- Rigorously separating state ownership supervision from other government policy, including regulation and supervision. Centralizing ownership supervision, although the framework is still developing, appears supportive of separation. There are no special provisions in regulation in respect of state-owned institutions and the lead department for regulation (MoF) has no role in ownership supervision. Supervision and the enforcement (by the PFSA), on the evidence of FSAP discussions, is carried out in the same way for all institutions regardless of ownership.

[1] Levied on total assets less 4 billion, own funds, and sovereign debt at 0.44 percent per year.
[2] Bank holdings of government securities increased from 20 percent of RWA at end-2015 to 25 percent at end-2017.
[3] See IMF paper "A Fair and Substantial Contribution by The Financial Sector."

Box 1. State Ownership in the Financial Sector: Recent Developments and Implications (concluded)

- Ensuring that effective governance of the state-controlled institutions is not compromised by government appointments driven by political considerations. The new arrangements for ownership supervision provide a check on political appointments but have not eliminated them (e.g., at least one state-owned financial institution has experienced significant turnover in senior management).

Overall risks from significant state ownership were assessed to be mitigated though there are new reasons for concern. The integrity of the regulatory process and empowerment of the supervisor are important checks on potential adverse impacts of state control. The PFSA has evidenced instances where it has resisted the appointment of management board members, imposed financial penalties, and restricted dividend payments by state-controlled banks without interference. The WSE-listed status of all the large state-controlled institutions contributes to discipline in corporate governance and transparency. However, a new law coming into force in early 2019, provides the government (including the offices of the Prime Minister and President) with majority voting control over the PFSA, including decisions on enforcement, dividends, capital, and other policies. **These changes call into question whether risks from state-ownership will remain sufficiently mitigated.**

B. Resilience and Stress Testing

10. Solvency, liquidity and domestic and cross-border spillover analyses were conducted, and the role of sovereign-bank linkages and the financial stability implications of FX mortgage exposures were also assessed. Data gaps were noted across several areas. These gaps should be addressed to allow for appropriate monitoring and analysis of systemic risks going forward.

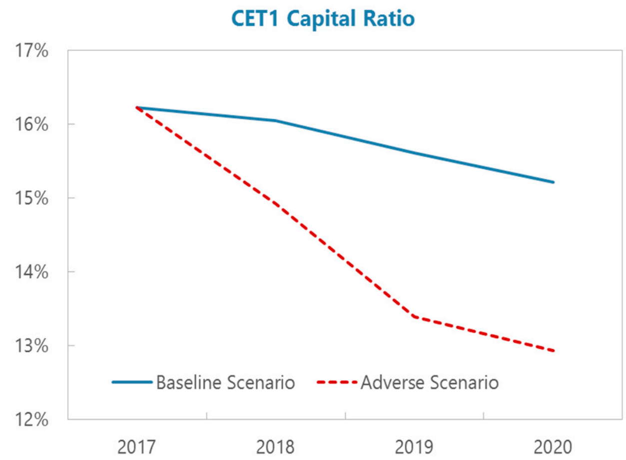
Solvency Stress Test

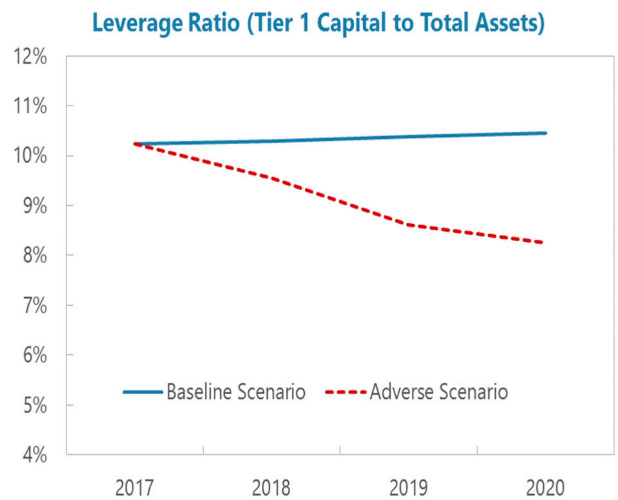
11. The solvency stress test and sensitivity analysis covered 92 percent of banking sector assets with the adverse scenario comparable to the experience of the EU during the Global Financial Crisis (see, Risk Assessment Matrix (RAM), Appendix IV and Stress Testing Matrix (STeM), Appendix V). This scenario potentially arises from external financial market stress and a slowdown in systemic economies, heightened uncertainty and loss of confidence in Europe and the United States, and the macrofinancial impact of domestic policy uncertainty weighing on confidence and growth. In the adverse scenario, output declines to around 11.5 percentage points below the baseline by 2020 (Table 2, Figures 2 and 3).

12. The results suggest that the banking system in the aggregate is resilient to adverse shocks, although some banks including OSIIs show weakness.

- **Under the baseline scenario,** the aggregate CET1 ratio for the 34 commercial banks stabilizes at around 15.2 percent, with the leverage ratio (Tier 1 to total assets ratio) remaining at around

10 percent. The slight decline in capital ratios under the baseline scenario was in part due to a rise in risk weighted assets and valuation losses in the available-for-sale (AFS) securities portfolio due to a rise in interest rates under the baseline scenario.





- **Under the adverse scenario,** CET1 for commercial banks declines from 16.2 percent to 12.9 percent, with 9 out of 34 banks not meeting the regulatory minimum for one of the three capital ratios (total capital, Tier 1 capital or CET1 capital ratios). The leverage ratio for commercial banks (Tier 1 to total assets) declines from 10.2 percent to 8.3 percent, with 5 banks falling below the 3 percent level. The asset share of undercapitalized banks would be 20 percent of the commercial banking system, with a necessary recapitalization of about 0.5 percent of GDP.

- **Contagion impact is limited.** The second-round impact from contagion in the interbank market due to the initial failure in the solvency stress test under the adverse scenario is negligible.

- **The solvency test underscores the need for continued supervisory vigilance of some medium-sized banks and OSIIs, which appear to be the weakest bank segment.** The CET1 ratio of medium sized banks declines from 13 percent to 7 percent in the adverse scenario, with 6 out of 14 such banks not meeting the regulatory minimum capital requirement. Furthermore, four OSIIs are found to be relatively weak. Greater supervisory attention to these banks is warranted to improve banking system resilience.

13. The contributing factors to the decline in capital ratios in the adverse scenario were identified (Figure 4):

- ***Credit risk*** is the most significant driver, reflecting the dominance of the loan book on bank balance sheets and accounting for a 550 basis point decline in capital ratios over the three-year horizon.

- ***Funding and interest rate risks*** contributed a 170 basis points decline in capital over the three years. Funding shocks triggered a decline in the net interest rate margins with margins further compressed because new NPLs that did not generate interest income in the adverse scenario.

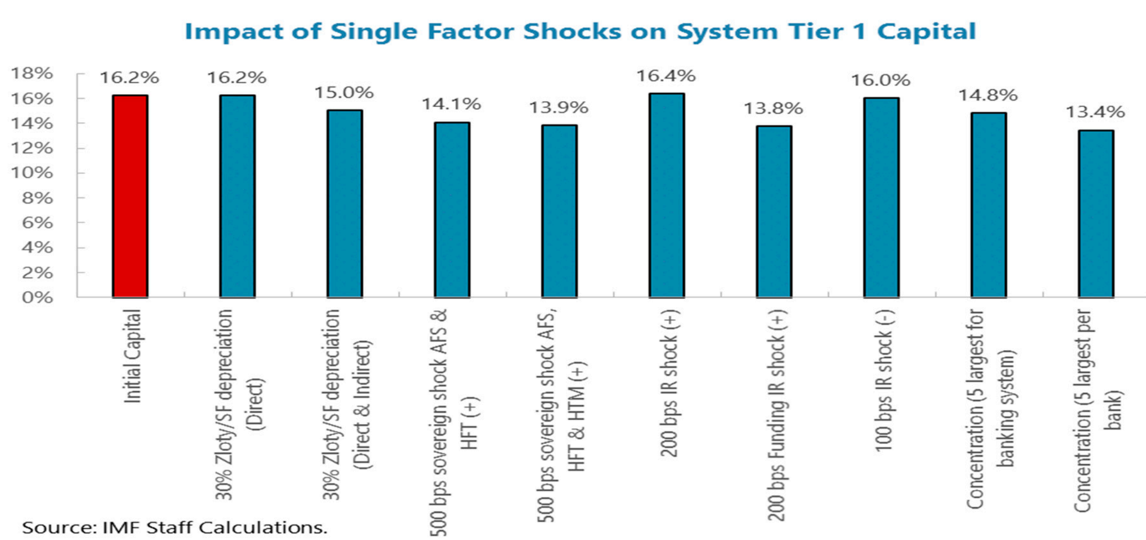
- ***Valuation losses*** on debt portfolios led to a decline in capital by 90 basis points in the first year. The large share of sovereign debt (most accounted for as AFS book, see Appendix II Figure 5) were stressed in the adverse scenario due to a rise of sovereign bond spread of 280 basis points.

14. The sensitivity analysis for commercial banks complemented the solvency stress testing.

- ***Exchange rate shock*: **A 30 percent depreciation of the Zloty against the Swiss Franc was applied to both the net open positions (direct) and the mortgage loan portfolios for NPL ratios (indirect impact). The Tier 1 capital ratio declined by 120 basis points in the combined shocks, with all banks still meeting their Tier 1 capital ratio.

- ***Interest rate shocks:*** A parallel upward (200 bps) and downward (100 bps) shift in interest rates would have a limited impact on the Tier 1 capital ratio. A 200 bps increase in funding and a 500 bps rise in sovereign bond yield (conservative assumption applied to all HFT, AFS, and HTM portfolios) could lead to the failure of one bank.

- ***Concentration risk shocks*:** the simultaneous default of the five largest borrowers for each bank would have a sizable impact on the banking system, leading to a decline in CET1 ratio by 2.8 percentage point and the failure of eight banks.



Source: IMF Staff Calculations.

15. The cooperative sector is generally resilient to interest rate risks, although there is some evidence of credit and concentration risks. The interest rate shocks have a limited impact on capital ratios. On credit risks, an increase in the provisioning coverage ratio of cooperative banks to the same level as commercial banks has a limited impact, but a sharp deterioration in the quality of 10 percent of loans (from performing to nonperforming) could result in a breach of minimum capital ratios for 30 percent of the cooperative banking sector. On concentration risk, the simultaneous default of the five largest borrowers for each cooperative bank could have a sizable impact, with a breach of minimum capital ratios for 61 percent of this sector (5 percent of the total banking system assets), reflecting the relatively undiversified client base.

16. Bank profits are driven by a combination of structural and cyclical factors, including efficiency and interest rates. The cost-to-income ratio and excess capacity measured by the number of bank branches per capita are negatively associated with profitability. Branch density appears to be relatively high compared with several other European countries (Appendix II Figure 4). The short-term interest rate is positively related to profitability (ROAA), as the low interest rate environment puts downward pressure on bank profitability.

Liquidity Stress Test

17. The system-wide liquidity coverage ratio (LCR) under the baseline was 149 percent, with most banks between 100 percent (the regulatory minimum) and 200 percent (Figure 5). One bank failed by a small margin. Some banks were applying assumptions (e.g. for deposit run-off rates) that were outside of the Basel III defined parameters, an issue that the PFSA should address to increase the robustness of the metric while aiding comparability across the industry.

18. The system was resilient to an adverse retail liquidity event, while the wholesale and combined scenarios had a sizable impact. Two medium-sized banks failed the retail event while in aggregate, the system remained above 100 percent of the LCR. In the wholesale event eight banks failed, including two large one with sizable operational deposits. Eleven banks failed the combined event including three large ones, with a total shortfall (compared to 100 percent coverage) of 3.6 percent of GDP.

19. LCR stress tests by currency indicates resilience in local currency but not in foreign currency (Figure 6). In general, commercial banks hold foreign currency loans that are partially hedged by FX swap markets and the convertibility of local currency assets. All banks showed an FX shortfall per the stress events while the retail event had stronger consequences on banks' liquidity than the wholesale event.

20. The NBP LCR stress tests on the cooperative banks resulted in higher LCR levels than the commercial banks due to more deposits over loans. In addition, those banks that did not belong to a network held higher liquidity buffers in the form of NBP bills and/or government bonds. At an individual level, some cooperatives fell below the threshold of 100 percent, though they are exempt from complying with the LCR given their participation in an IPS.

Interconnectedness Analysis

21. Interconnectedness (interbank, cross-sectoral, and cross-border) analysis revealed that spill-over vulnerabilities are generally limited with some material exceptions. Interbank analyses showed that any destabilization to affiliating banks could cause distress to the affiliated cooperative banks (Figure 7), confirming the importance of addressing the identified weaknesses in the affiliating banks. On cross-border linkages, Polish banks have limited exposures on the asset side (Figure 8), and despite the significant presence of foreign banks (mainly EU) that operate through subsidiaries, these exposures and spillover risks are generally contained.

PRUDENTIAL OVERSIGHT

22. This section discusses first the institutional arrangements of the PFSA and then specifically bank, insurance and capital markets regulation and supervision, followed by discussions of arrangements for macro-prudential supervision and anti-money laundering/combating the financing of terrorism (AML/CFT). Appendix VI provides a discussion on the supervision of cyber risk.

A. Independence and Resourcing of Supervision

23. The assessments of the supervision of banking, insurance and capital markets all highlighted resource limitations relative to the high demands on supervisors. Much has been achieved in recent years with the available resources, including the implementation of wide-ranging EU legislation. However, supervisory resources are stretched by high workloads, while the risk-based allocation of resources is not supported by an explicit risk tolerance statement from either the PFSA or government. Most of the gaps and areas for development identified by this FSAP, such as broader loan review in banking, a comprehensive approach to oversight of the new conglomerate, and increased conduct of business supervision in insurance and capital markets, cannot be addressed without providing the PFSA with the needed resources. Budgeted staff increased from 949 to 1017 (and from 895 to 958 staff in post) over the five years to end-2017, but this has not been sufficient to meet demand and lags resource increases in many supervisory agencies internationally.

24. Under law in place and budgetary procedures, the PFSA had sought additional resources, but in practice these proved insufficient. This shortfall arose even though the costs of the PFSA's work are borne by regulated financial institutions through levies and more funding could be raised from industry without exceeding already authorized limits. The PFSA's expenditure, unlike that of the NBP for example, must be approved by the Minister of Finance because the PFSA is subject to central government budgetary process. The FSAP view is that, as the financing of the PFSA is from levies and not from taxation revenues, the supervisor should have reasonable expectation of autonomy from the government's budgetary process. In this regard, the recently enacted legislation would establish the PFSA as a state legal entity and would appear to appropriately grant greater budgetary independence while relying on the same levies on industry.

25. The PFSA's current lack of budgetary autonomy is one aspect of wider limitations on its independence from government. Existing law provides that the PFSA report administratively to the Prime Minister. This gives the Prime Minister powers not only to make the appointment of the Chairman and, on the Chairman's recommendation, the Vice-Chairmen, but also to set the framework for internal administrative matters, including the basis for remuneration of the staff and the internal organization of the Authority. The Board of the PFSA is responsible for the exercise of supervisory powers and Parliament makes the laws, including provisions for regulations which are then issued by government departments. The PFSA makes requests for legislative reform through the MoF, although such requests are not always granted as the views on specific reform may not be aligned.

26. The PFSA's board under the existing arrangement, however, is not sufficiently independent. Currently, there are eight board members, with four representing government (one represents the President of the Republic and three represent relevant ministers). There is a concern that the PFSA may therefore not have sufficient independence from government. In mitigation, the other four board members (the PFSA's chairman and two vice chairmen and a representative of the NBP) do not represent government and in the event of a split vote, the chairman will decide. The need for independence has greater importance given the state's significant control of the financial system and the need to ensure that state-controlled institutions continue to operate on commercial terms, and that supervision across the financial sector is evenhanded and free from conflicts of interest.

27. Recent legislation may address budget constraints but appears to weaken further the PFSA's independence. The law, which comes into force in early 2019, will expand the PFSA's board from 8 to 12 by adding (i) one more voting member representing the Prime Minister, which would provide the government with five of nine voting members; and (ii) three non-voting members, representing the security services, consumer protection, and the bank guarantee fund. While the large scope of representation may achieve an objective of more coordination among government agencies, the risk is that the enlarged board increases political influence, excessively broadens the access to confidential supervisory information, and adds to existing inefficiencies in decision making.

28. The governance arrangements for the PFSA, as well as potentially compromising independence, are also inappropriate for the decisions it is required to take. They appear to be hindering its effectiveness because:

- Successive changes to the legislation establishing the PFSA (the Act on Financial Markets Supervision Act 2006) have restricted the scope of decisions which can be delegated to the Chair and staff of the PFSA. Much of the time of the PFSA board is taken up with a wide range of decisions on the exercise of PFSA powers that in other countries would in many cases be delegated to staff (with appropriate ex post reporting and reservation of the most significant decisions to the board). The time for discussion of broader policy on use of powers or strategic issues is thereby restricted.

- Furthermore, in the context of the lack of delegation as well as the increasingly technical nature of the supervisory issues with which the PFSA is dealing, the composition of the board is increasingly inappropriate: the external members lack available time and required expertise. As representatives of ministries (or the President), they are not always selected (nor required by law, unlike the Chairman and Vice-Chairman) to have pertinent skills or experience.

- These issues are compounded by the absence of an explicit position on the risk tolerance to bank failure that would enable the PFSA board to better oversee resource allocation, particularly whether the intensity of supervisory activities is proportionate to risks and other priorities such as the implementation of EU Legislation. Notwithstanding the extensive PFSA risk-based supervisory processes, the board needs to monitor outcomes against risk tolerance.

29. Important aspects of the new law are contrary to FSAP recommendations regarding PFSA governance. In this regard, further reforms should be undertaken based on certain principles:

- The supervisory authority should be independent in all decision-taking on the use of its supervisory and enforcement powers. To the extent not addressed in the implementation of the new law, the PFSA should have budgetary autonomy, within an overall framework of accountability for its expenditure and for the levies raised from industry; the authority should be explicitly autonomous in the setting of remuneration policy and internal organization.

- The governance arrangements should not include any role for government beyond appointment to the governing body (and dismissal for cause). If it is necessary for government to have oversight of administrative matters, this could be carried out through an advisory or separate administrative oversight body, as is the case in some other countries. The members of the governing body should be selected for expertise and experience, considering the nature and scope of the responsibilities of the board, and there should be appropriate levels of delegation from board to staff. Such a governing body should have responsibility not only for the exercise of powers but also for the oversight of management and resources, providing strategic direction and evaluating supervisory effectiveness against a defined risk tolerance.

- As far as is consistent with the provisions on the Constitution on the source of laws, the supervisory authority should be given some formal status in the determination of regulatory needs and priorities; this could be achieved through administrative arrangements for the MoF to work together with the supervisor; or potentially by giving the supervisory authority the explicit right to request regulatory change and to have its requests made public.

30. While under the new law, the PFSA remains a separate supervisory agency, the FSAP discussed an earlier NBP proposal that the PFSA be merged with the NBP. The NBP proposal sought comprehensive integration of the PFSA within the governance and administrative structure of the central bank (a draft law had been prepared, but ultimately it was not taken up by parliament). Appropriating to supervision the NBP's extensive autonomy for its budget and decision making would help to address key concerns about the PFSA; e.g., it would provide for greater independence of the supervisory functions vis-à-vis the government's ownership/controlling position in major banks and insurance companies. The specific decision-taking governance arrangements for supervisory decisions would have to be consistent with appropriate independence from government and need for selection of members by expertise rather than affiliation, as set out in the principles above.

31. There could be other advantages in locating at least prudential supervision in the central bank, as has been widely debated (and experienced in several countries) in recent years.[4] It could be complementary to the NBP's responsibility for the overall stability of the financial system. There also would be cost savings from combining administrative functions, e.g., human resources, data collection, etc.

32. However, if policymakers take up the proposal that the PFSA be merged into the NBP, the NBP's responsibilities would be enlarged. The challenges in managing both price and financial stability objectives would increase. However, the case for central bank oversight of nonbank financial institutions and capital markets (and for consumer protection, even for banks) is less clear-cut. Central banks with full scope—i.e., prudential, market conduct, and consumer protection—responsibilities are rare. A "twin peaks" approach (separation of prudential and business conduct) could be considered, provided that both peaks clearly met the principles set out above. The "business-conduct" peak would need to be fully empowered to undertake market conduct and consumer protection with sufficient resources.

B. Banking Supervision and Regulation

33. Banking regulation and supervision are largely in line with the Basel Core Principles (BCP), with a need to enhance the approach in some areas (Annex I). The EU Single Rule Book including the capital requirement package is in place, and the Single Supervisory Mechanism (SSM) and the European Banking Authority (EBA) are key partners of the PFSA. The PFSA's supervisory approach is anchored to a robust onsite inspection culture that has evolved to become more risk-based: resource constraints have required the PFSA to give priority to the largest systemic banks at the expense of work on smaller entities. (see Annex).

34. There are gaps and undue procedural constraints in the legal framework governing PFSA's supervisory and enforcement work. The PFSA lacks direct powers to dismiss members of a bank's management or supervisory boards (whom it is also unable to fine) or require a change in the external auditor. The PFSA may issue recommendations for remediation, but further legal measures are then necessary to deliver the required outcome. The PFSA is required to send a warning notice to the relevant person regardless of the seriousness of the breach and to seek a third-party opinion to support its assessment of insolvency. These and other procedural rigidities stemming from the Code of Administrative Procedures, which increase the scope for extended litigation, constrain the PFSA's ability to take prompt corrective action and to intervene early, where necessary. In practice,

[4] See for example IMF working paper "Financial Stability Frameworks and the Role of Central Banks: Lessons from the Crisis", April 2009 (WP/09/70), which discusses the pros and cons for different supervisory arrangements.

both the PFSA and the PFIU (the authority for enforcing breaches of the AML/CFT Act) use sanctioning powers relatively infrequently.

35. There are several other areas where supervision should be improved. Most significantly, risk assessment should be more forward looking, the coverage of loan review expanded, and the supervision of credit and concentration risks enhanced. An enhanced process for escalating supervisory responses and taking more forceful action in case of recurrent breaches of requirements would also be desirable, setting forth a public regime to determine the severity of the breaches.

36. Onsite inspections follow robust processes, but the cycle of inspections should be shorter. The 15 large commercial banks are now being inspected annually. However, the cycle of inspection for smaller banks and cooperatives is too long. For all banks, the level of periodic loan review is low—in number of loans and coverage of the loan books. Attribute sampling (by determining the characteristics of a small sample) would assist in assessing the reliability and effectiveness of credit risk management. A shorter inspection cycle and a wider scope of loan reviews would evidence a more realistic level of resource needs across the business cycle, whilst providing timely assurance of the qualities and performance of front and back-loan books.

37. Off-site supervision is sound and built on well-designed internal processes and information, but further improvements are needed. Risk assessment under the BION (aka Supervisory Review and Evaluation Process (SREP)) needs recalibration to refine its ability to discriminate among different risk profiles.[5] BION should be made more forward-looking by including key indicators that anticipate risk, such as stressed risk indicators and qualitative benchmarks. The creation of a credit bureau would support the strengthening of banks' credit risk analysis and the improvement of their monitoring of credit risk concentrations though enhanced information. It would also support more effective credit risk supervision.

C. Insurance and Financial Conglomerates Supervision

38. Except for issues relating to independence and resources, most recommendations of the 2012 insurance assessment have been implemented. Implementation of the EU Solvency II Directive in 2016 has strengthened regulation and supervision, including through new risk-based capital standards and comprehensive group supervision.

39. The Solvency II changes appear well-embedded, without significant exemptions or transitional arrangements. Implementation was thorough and proportionate. Some additional requirements were added to the EU minimum standards. No insurer has had an internal model approved for use under PFSA rules, although several have started discussions, including some foreign-owned insurers have had group-level models covering Polish business approved by the home supervisor. While the PFSA is seen as relatively conservative in its approach to models, in this area it has simply adopted the Solvency II standards.

[5] BION is the Polish acronym for the Supervisory Review and Evaluation Process (SREP) of the PFSA.

40. The recent emergence of the first Polish financial conglomerate, headed by an insurer, poses supervisory challenges. Most individual elements of the group are supervised by the PFSA, which already carries out Solvency II-based group supervision. Nonetheless, it also now needs to complete the application of comprehensive "supplementary supervision" to the group and to strengthen internal coordination amongst sectoral supervisors. The well-established international supervisory college arrangements for the group, led by the PFSA, have been used to trigger the important process of conglomerate-wide recovery planning.

41. Other findings highlighted strengths, with some scope for further development.

- The supervision framework is sound, with a particularly thorough process for off-site review and a comprehensive risk assessment framework; there is scope to sharpen key supervisory messages to the management of insurers, especially in examination reports; and for increased focus, at least for larger insurers, on key strategic challenges, the adequacy of governance etc.

- Instances of customer mistreatment in recent years have been met by a coordinated response by the authorities and business conduct regulation has been strengthened; however, there is scope for the PFSA to develop a stronger preventative supervisory approach, requiring enhanced processes, stronger cooperation with other agencies and potentially internal organizational change as well as increased resources. Strong leadership is required to ensure that conduct work is not seen as subordinate to supervision.

- Market-wide risk monitoring is carried out, including annual stress testing, and insurance sector issues are considered within the financial sector macroprudential supervisory framework (the FSC-M). Policyholders benefit from a compensation scheme that is comprehensive for compulsory business (such as motor third party liability insurance), but which could be strengthened in life insurance.

D. Capital Markets Supervision and Regulation

42. Overall, capital markets oversight is broadly aligned with the IOSCO Principles, though resource constraints are evident. However, in line with the PFSA's own strategic priorities, conduct supervision needs to be enhanced. To this end, the PFSA should (i) strengthen conduct supervision of banks in the performance of MiFID investment services; (ii) make selective improvements to off-site supervision (some of which are already underway); and (iii) increase the frequency of inspections for the largest participants and make a more extensive use of thematic inspections to address conduct issues in smaller firms.

43. In tandem, the PFSA should continue to strengthen its ability to identify emerging and systemic risk. In the short term, PFSA should add a market trends report (to the sectoral reports already produced) and run market intelligence meetings to strengthen its risk identification process. In the medium term, the PFSA could develop a more structured process for risk identification and monitoring, supported by tools (like a risk dashboard) to assessing the impact of changes of the environment. All should in turn enhance PFSA's ability to monitor the perimeter of regulation.

44. The PFSA should verify whether there are gaps in regulation and/or supervision vis-à-vis the conditions of private placement. Some clarifications about the use of private placement have recently been made. However, in line with ongoing actions, the PFSA should review whether additional changes are needed. In this context, a notification requirement could be considered, not to regulate the offering but to allow the PFSA to monitor whether exemptions are used in a way consistent with the law and regulations.

45. The PFSA should actively use its enforcement authority. The PFSA is willing to use its sanctioning authority when material breaches of conduct obligations are found; however, the experiences leave the question as to whether such tools are being consistently used, and whether enforcement actions are timely enough to produce the desired effect.

46. Without the strategic use of criminal enforcement, the system still lacks a key deterrent component. While the PFSA has been actively referring cases to the prosecutor's office the use of criminal enforcement is limited (especially for crimes different from market manipulation) and when used, the sanctions rarely apply imprisonment, even for the most egregious cases. This challenge is complex, dependent on the legal culture, and it requires actions outside of the jurisdiction of the PFSA.

E. Macroprudential Policy

47. The macroprudential mandate is assigned to the Financial Stability Committee—Macroprudential (FSC-M), with the NBP taking the lead role in systemic risk monitoring. The FSC-M with representation from the NBP, MoF, PFSA, and BGF fosters close collaboration. Due to the constitutional order, it does not have direct powers, but it can issue "comply or explain" recommendations to its members to act. Systemic risk monitoring is primarily performed by NBP. Bi-annually it produces a high-quality analysis of conditions in the financial sector—the Financial Stability Report (FSR)—which should be expanded to cover an assessment of potential vulnerabilities emanating from payment and settlement systems.

48. Steps should be taken to underpin the FSC-M's preeminent position in macroprudential policy. Besides the EU harmonized instruments, the FSC-M has identified a non-exhaustive list of national macroprudential instruments that could be used. To strengthen the accountability of these instruments, there should be timely and substantive vetting of their use by the FSC-M, whether the initiative to activate or adjust the use of the instrument is taken by the FSC-M itself or not.[6] Such vetting will help underpin the FSC-M's overall responsibility for this policy area. To further ensure its position as preeminent forum for macroprudential policy, the FSC-M should be involved in all important financial stability matters. To this end, a strong commitment is needed from the members. Where appropriate, this could involve agreement on the use of ex-ante thresholds for certain indicators to determine whether developments require the FSC-M's attention. The FSC-M

[6] Art. 137 (2) of the amended Banking Law of 29 August 1997 provides scope for such vetting.

should pay close attention to non-bank developments, including a periodic assessment of whether the toolkit is sufficient to address potential systemic risks from non-banks (see technical note).

49. The current macroprudential settings appear to be commensurate with perceived systemic risks, though continued vigilance and possible action is warranted for consumer exposures. Overall risks are considered low, though growing consumer credit (consumer loans and mortgages) merits monitoring and the FSC-M could consider a timely re-introduction of debt-service-to-income (DSTI) limits to help ensure that borrowers have sufficient buffers in case of a rise in interest rates. The PFSA's recent proposal to foster the development of fixed-rate mortgages will help to limit interest rate risks on household balance sheets. Proposals to introduce caps on mortgage maturity and minimum down-payment requirements will further limit risks associated with mortgages, in addition to the LTV limit.

F. AML/CFT

50. The AML/CFT framework was upgraded through legislation that addresses many identified deficiencies. Parliament passed earlier in 2018 a new law implementing the 4th EU AML Directive, which appears to address many recommendations made by MONEYVAL for improving technical compliance in its last evaluation.[7] The law appears to address deficiencies with criminalization of terrorist financing, customer due diligence, and beneficial ownership in line with the FATF standard.

51. The authorities should complete the National Risk Assessment (NRA) and address remaining deficiencies. An action plan should be developed, and measures implemented to mitigate the ML/TF risks identified in the NRA, including an increase in supervisory resources to ensure effectiveness.

CRISIS MANAGEMENT AND SAFETY NETS

52. Legal and institutional arrangements for recovery and resolution planning, and executing resolutions are generally sound, although legal amendments are needed to ensure Bank Guarantee Fund (BGF) independence. The BRRD measures enhanced the BGF's and the PFSA's powers to deal with failing banks.[8] BGF is the sole resolution authority for banks (including cooperative banks), credit unions and investment firms. It exercises resolution powers along with its responsibilities as deposit insurer. The deposit guarantee payout process is efficient and well-tested, although new resolution tools have yet to be used. Concerns remain however over the composition

[7] MONEYVAL (Committee of Experts on the Evaluation of Anti-Money Laundering Measures and the Financing of Terrorism) last assessed compliance with the FATF Recommendations in 2012. The dates for the next assessment have not been determined yet.

[8] Legislation has passed that gives the PFSA early intervention power to compel the merger of a weak bank upon agreement of an acquiring bank. The new amendments are additional to the existing BRRD powers. The timing of the amendments did not allow for discussion or assessment as part of the FSAP.

of the BGF Board and BGF's independence which is neither stipulated in law nor assured in practice, allowing for the dismissal of Board Members by a decision of one institution (the MoF).

53. Other authorities have broadly sufficient powers and cooperation is effective, but with scope for increased coordination in some areas. The PFSA, as the integrated supervisory authority, is responsible for supervising recovery planning, the taking of early intervention measures, and deciding if an entity is considered failing or likely to fail or filing a motion for insolvency to Court. The NBP, as the monetary authority, acts as provider of emergency liquidity assistance. While institutional arrangements among the NBP, PFSA, MoF, and BGF, provide for adequate information sharing and cooperation in normal and crisis times, there is scope for improved coordination on recovery and resolution planning, particularly in having a shared view of bank critical functions. The PFSA should be empowered to undertake its own valuation of assets, including in the context of assessing a bank's prospective insolvency, without being required to seek a third-party opinion or audit. The bankruptcy framework should be improved by widening available tools and allowing for timelier action.

54. Satisfactory progress has been made on recovery and resolution planning. However, the current exemptions from the requirement to prepare recovery plans for banks subject to rehabilitation plans and for the two affiliating banks are inappropriate. Initial resolution plans have been prepared by the BGF. Preferred resolution strategies have been determined and impediments to execution identified and are being addressed, although greater loss-absorbing capacity is needed, including specifying quality and quantity of eligible instruments, and efforts to have it in place should be accelerated. The BGF should continue working to remedy impediments, including legal constraints on the use of resolution powers in the case of cooperatives' affiliating banks. It should adopt policies and procedures to manage and mitigate potential conflicts of interest that arise in use of bridge bank tool, where the BGF would become an owner of a bank.

55. The ability to deal effectively with problem and failing banks is well advanced. For smaller cooperative banks and credit unions the deposit guarantee payout process is efficient and well-tested, though new SRR resolution tools have yet to be used. Adequate resolution funding arrangements are in place, including deposit guarantee and resolution funds, although legal conditions for using funds are, in application of EU rules, set very high (use of the resolution fund requires prior bail-in of 8 percent of the failing bank's total liabilities plus own funds; use of deposit insurance funds for resolution purposes requires prior bail-in of uninsured depositors). Moreover, EC-approved programs for dealing with potentially failing credit unions and small banks are prepared for in case of need.

56. The authorities have taken appropriate steps to be prepared to deal with systemic distress and crisis. The Financial Stability Committee's role in ensuring interagency cooperation and coordination in the event of a potential threat to financial stability are well defined. The National Contingency Plan updated by the committee is supported by individual plans in each authority that have been or are being also updated. The authorities should consider further addressing cross-border cooperation in the next update to the national plan, and periodically testing the plan by means of crisis simulation exercises.

57. The NBP has a coherent framework to manage liquidity in normal and stressed times, and markets generally function well. Procedural arrangements for the provision of Emergency Liquidity Assistance (ELA) are well-developed with an MOF backstop in place. However, there are legal constraints on the liquidation of collateral in the event of a bank default. Such constraints need to be addressed. Also, the NBP cannot lend directly in foreign currencies which may inhibit its ability to address stability risks arising from impairment in offshore funding markets—given 22 percent of bank assets are denominated in foreign currencies. It can however provide foreign currency liquidity through the FX swaps market. Most financial markets (the exception is corporate bonds) function well and are supported by good infrastructure; nevertheless, further development is slowed by the FIAT.

COOPERATIVE BANKS AND CREDIT UNIONS

58. Most cooperative banks and credit unions are stable, but each sector has its own issues. The FSAP is broadly supportive of the policy direction for cooperatives, while it questions whether the credit union sector should remain standalone.

Cooperative Banks

59. The supervisory arrangement for cooperative banks is evolving to a "supplementary" supervision model. Under EU legislation,[9] the authorities beginning in 2015 promoted that cooperative banks be part of an Institutional Protection Scheme (IPS) that includes an affiliating commercial bank. Currently, there are two IPS networks.[10] All cooperative banks that are not part of the existing two IPS, confront challenges to complete successfully their transition into the desired new models of operation. Two cooperatives are the exception to integration into an IPS, as both have achieved independent status in line with Article 1 of the CRR (e.g., capital over EUR 5 million, other prudential requirements).

60. The IPSs perform internal control functions that complement PFSA supervision, but are in transition, and reliance on the PFSA is still necessary. In addition, the IPS structure can direct liquidity or solvency support to cooperative banks before resorting to (but in coordination with) official institutions. In both cases, the PFSA informally cooperates with the IPS to avoid any turmoil in the cooperative bank sector. Each of the two IPSs has been successfully tested in the assisted merger of a troubled cooperative bank with a strong one.

61. Elevated risk for the cooperative banks' sector stems from three sources: (i) about 40-45 cooperative banks that were seeking to establish their own affiliating bank and network will now

[9] Article 113 (7) Capital Requirement Regulation (CRR).

[10] A proposal to form a third network using an "Integrated Affiliation" as foreseen in the law instead of an IPS now appears unlikely as the PFSA decided to not license the affiliating bank.

need to affiliate back within an existing network;[11] (ii) approximately 12 cooperative banks still appear as likely to remain outside a cooperative bank network/IPS as they are viewed as either too large, and/or too weak to join an existing IPS; and (iii) for the existing 2 networks, their affiliating banks have legacy issues of weak asset quality and capital that in the past has required that their member cooperative banks provide support. Addressing these areas of elevated risk in this period of transition will be fundamental.

62. The two existing IPSs need to be strengthened to ensure sustainability. Key reforms should include: (i) the supplementary internal control models will need to be robust, as the internal control activities of their members would need to be aligned with PFSA requirements; (ii) the scope of the affiliating bank activities should be revisited: consideration should be that the activities of the affiliating bank be limited to supporting their owners/members and that credit activity be limited; (iii) the affiliating banks should promote greater integration of the networks, including through actual and operational consolidation among network cooperative banks; and (iv) ensuring that the liquidity and solvency support arrangements across the schemes are harmonized in relative size, capacity, and accessibility to be viable and promote confidence.

63. Although most cooperative banks are well capitalized and profitable, the situation of some individual banks is declining, and their viability could come into question. This will make it necessary that PFSA, the IPSs (as applicable), and the BGF undertake resolution activities that limit spillovers, namely the use of purchase and assumption.

Credit Unions

64. Despite improvements in recent years, the performance of credit unions and the quality of their financial information is not yet satisfactory. Since coming under the supervision by PFSA, there has been some improvement in the credit union sector mainly due to the resolution of nonviable credit unions and better performance of the remaining entities. These improvements however are not sufficient to reverse the deterioration in the system thus far.

65. The capital adequacy of the credit union sector at end-January 2018 is less than 3 percent (relative to a 5 percent requirement), reflecting the troubled situation of larger credit unions.[12] Of the 5 largest credit unions, only 1 has a capital ratio that exceeds the minimum

[11] Most figures in this text were collected during the FSAP Mission in January/February or provided by the Polish authorities thereafter in April/May 2018. Where updated figures are available, such figures are presented in a footnote. In this case, the number of banks seeking to establish their own affiliating bank had decreased to 42 entities in August 2018.

[12] The minimum requirement for banks is 8 percent, though it is calculated differently and not fully comparable.

5 percent requirement. The source of low capital adequacy has been losses from poor loan underwriting and a series of past mergers that were allowed without addressing viability issues.

66. The sector requires restructuring to consolidate viable entities and resolve non-viable entities through exit. The strategy would foster market solutions either through (i) the merger of weak but solvent credit unions with other viable credit unions or with banks (including eligible cooperative banks); or (ii) the resolution (and exit) through application of the purchase and assumption tool that will allow the franchise value, which is primarily the depositor base and performing loans, to transfer to a successor entity. As the poor financial performance of credit unions is caused significantly by faulty loan management and collection practices, the restructuring strategy should put special emphasis on the recovery of the overdue loan portfolios.

67. Policy-makers need to decide whether a standalone credit union sector remains appropriate and, if not, define a strategy to transition viable credit unions to become or consolidate with banks. Credit unions constitute less than 1 percent of deposit taker assets, most of the sector by assets is deeply troubled, and the legal framework has deficiencies. While reform could be considered, including further recapitalization of weak entities and changes to the Credit Union Act 2009, the alternative could be phasing out credit unions. For those that have remained viable, there could be a medium-term path towards consolidation and ultimately transformation into one or more cooperative banks (or consolidation with a commercial bank).

FINANCIAL SECTOR DEVELOPMENT

68. The government bond market has steadily expanded while the corporate bond market has remained shallow. As the size of the government bond market increased from PLN533 billion in 2013 to PLN621 billion in 2017, market infrastructure improved and the interest of domestic and foreign investors was sustained. The corporate bond market, on the other hand, suffers from low liquidity, under-developed infrastructure (including regulatory arrangements for issuance), and a lack of harmonization in the design of debt instruments, all of which weaken the ability of investors to assess credit risk, which is necessary to build and sustain investor interest. A comprehensive action plan is needed to address priority areas for reforms that relate to money markets, trading platforms, regulations of private placement, and taxation of corporate bonds (including covered bonds).

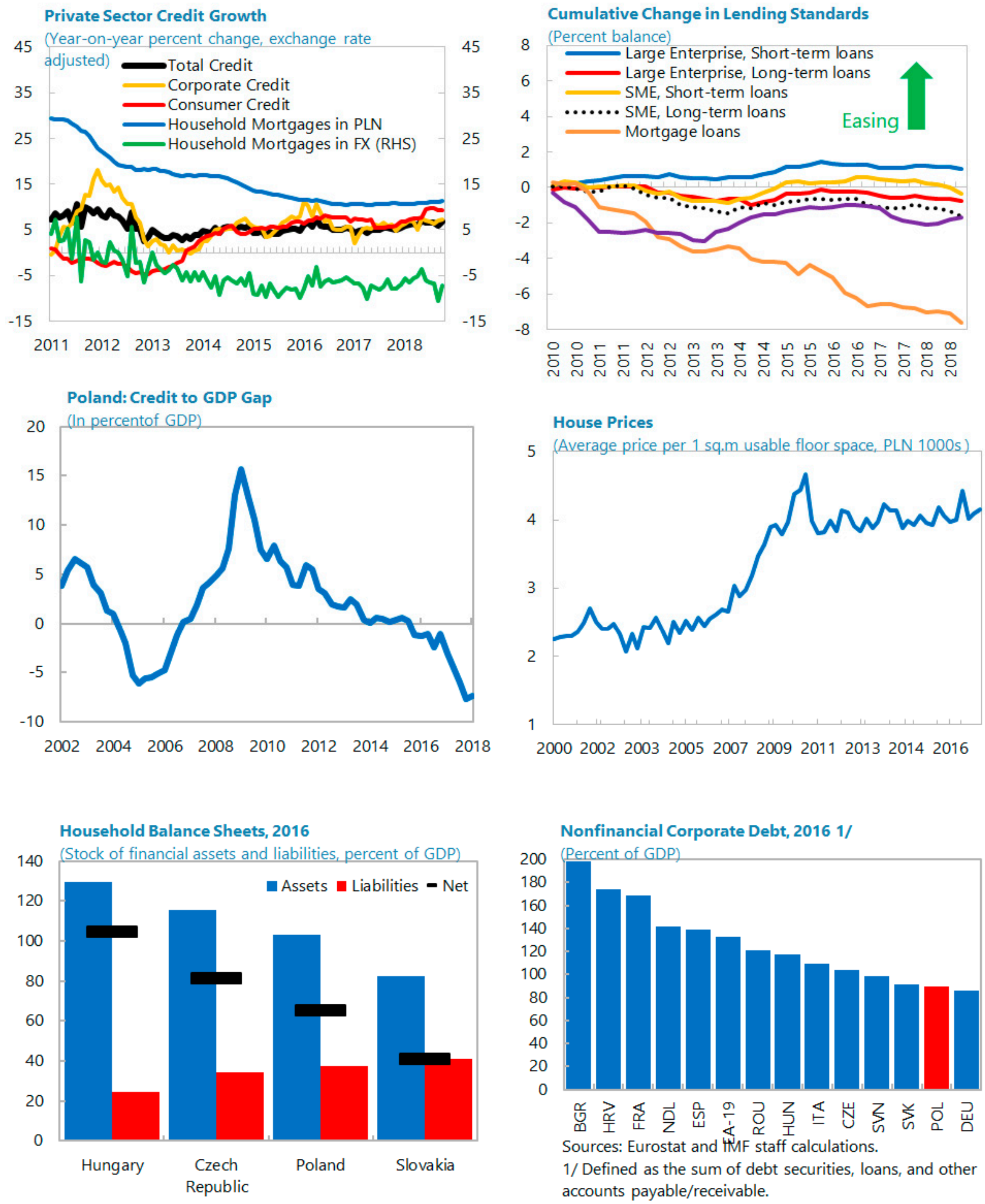
69. The forthcoming voluntary funded pension scheme (PPK) will contribute to capital markets development, but its planned implementation in the near term is raising operational risks and leaves little room for preparatory work. PPK could partially compensate the declining replacement rates for pensioners receiving benefits from the social security system, most notably for low-wage earners. However, there are implementation risks as PPK is expected to start already in July 2019 (or just a few months after the law was enacted).[13] Key preparatory areas include developing and testing the IT systems; putting in place the settlement system at the Polish

[13] Legal amendment approved in November 2018 introduces a new investment rule (Article 37).

Development Fund (PFR); licensing of pension fund managers; enacting secondary regulation for participants (including investment rules with sufficient flexibility to optimize long-term benchmark portfolios); setting up the new supervisory framework at the PFSA; and launching a communication campaign, among other functions.

70. Areas for improvement to make the PPK system more functional include: setting up annuities as a default option to improve the welfare of participants and create a new set of institutional investors with long term horizons; and greater attention to the PPK's payout phase is needed, so individuals have better pensions and longevity risk protection.

Figure 1. Poland: Macrofinancial Developments



Source: Haver Analytics, Eurostat, National Bank of Poland, Statistics of Poland, BIS, and IMF staff calculations.

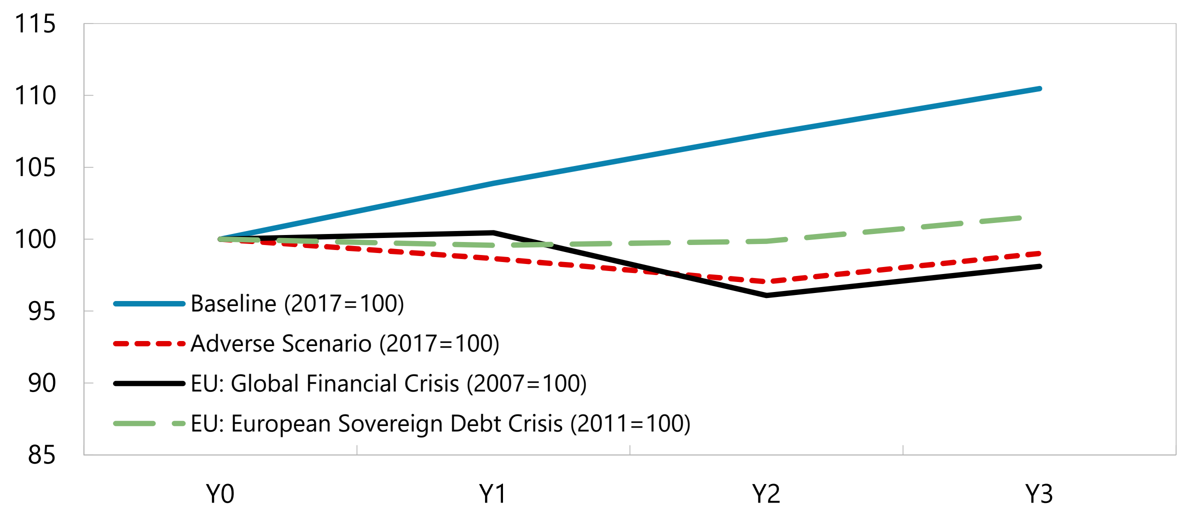
Table 2. Poland: Macroeconomic Scenarios for Stress Tests

In percent (unless otherwise specified)

	Adverse Scenario			Baseline Scenario		
	2018	2019	2020	2018	2019	2020
Real GDP (2017=100)	98.6	97.0	99.0	103.9	107.3	110.5
Real GDP growth	-1.4	-1.6	2.0	3.9	3.3	3.0
Inflation (CPI)	2.0	0.0	-1.0	2.6	2.5	2.5
Monetary Policy rate	1.0	0.8	0.1	1.9	2.9	3.9
Short-term money market rate	2.0	2.0	1.3	1.9	2.9	3.9
Long term government bond yield	6.2	7.0	7.2	3.8	4.2	4.5
Unemployment rate	5.7	6.7	6.5	4.0	3.9	3.8
Exchange rate (Zloty/SF)	4.2	4.3	4.3	3.8	3.8	3.8
Nominal GDP growth	0.6	-1.6	1.1	5.9	5.8	5.3

Source: IMF staff calculations.

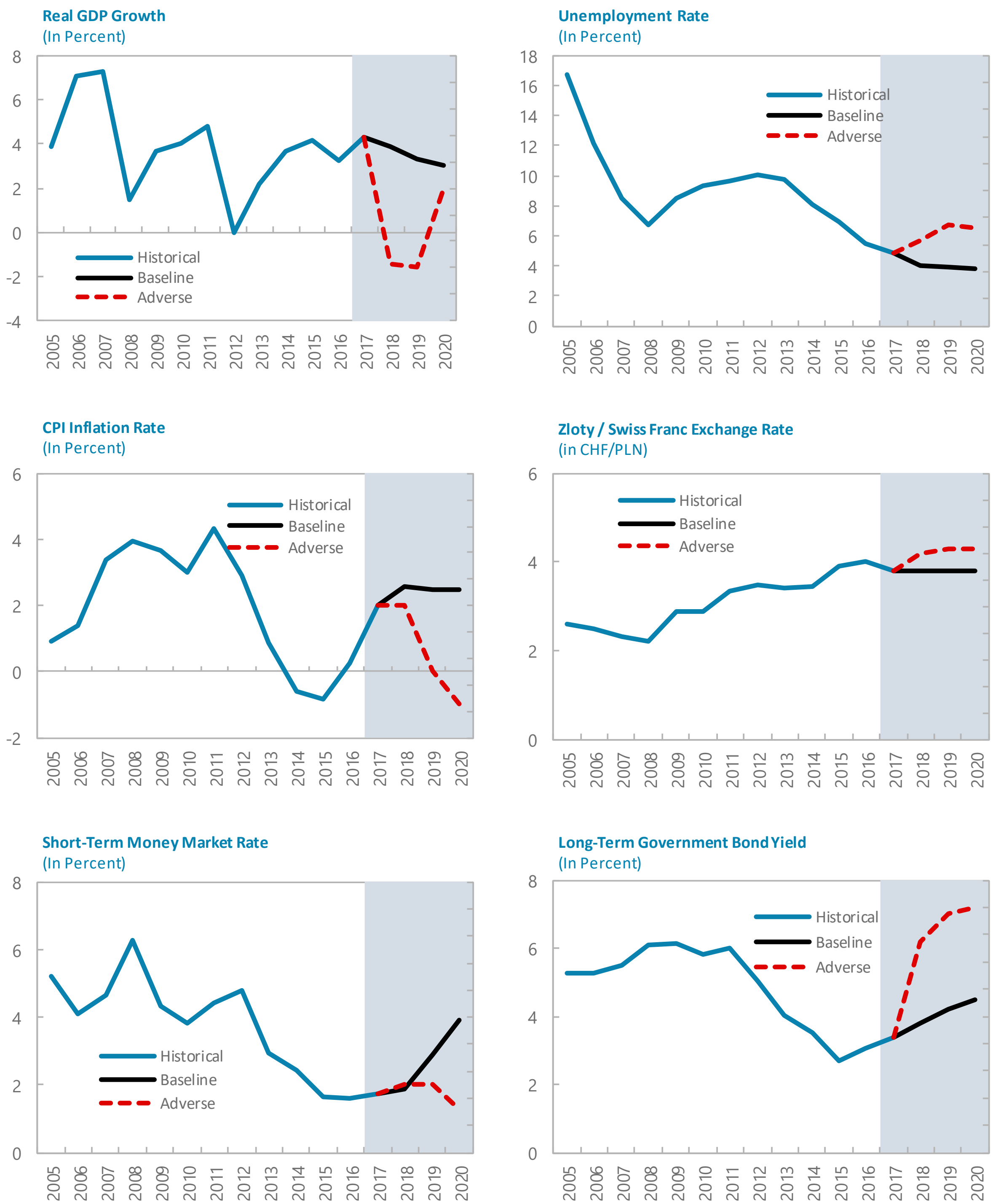
Figure 2. Poland: Scenario Severity From a Historical Perspective



Note: The severity of the scenarios was benchmarked using neighboring countries' (European Union) crisis episodes, since Poland has not experienced a severe contraction since 1990.

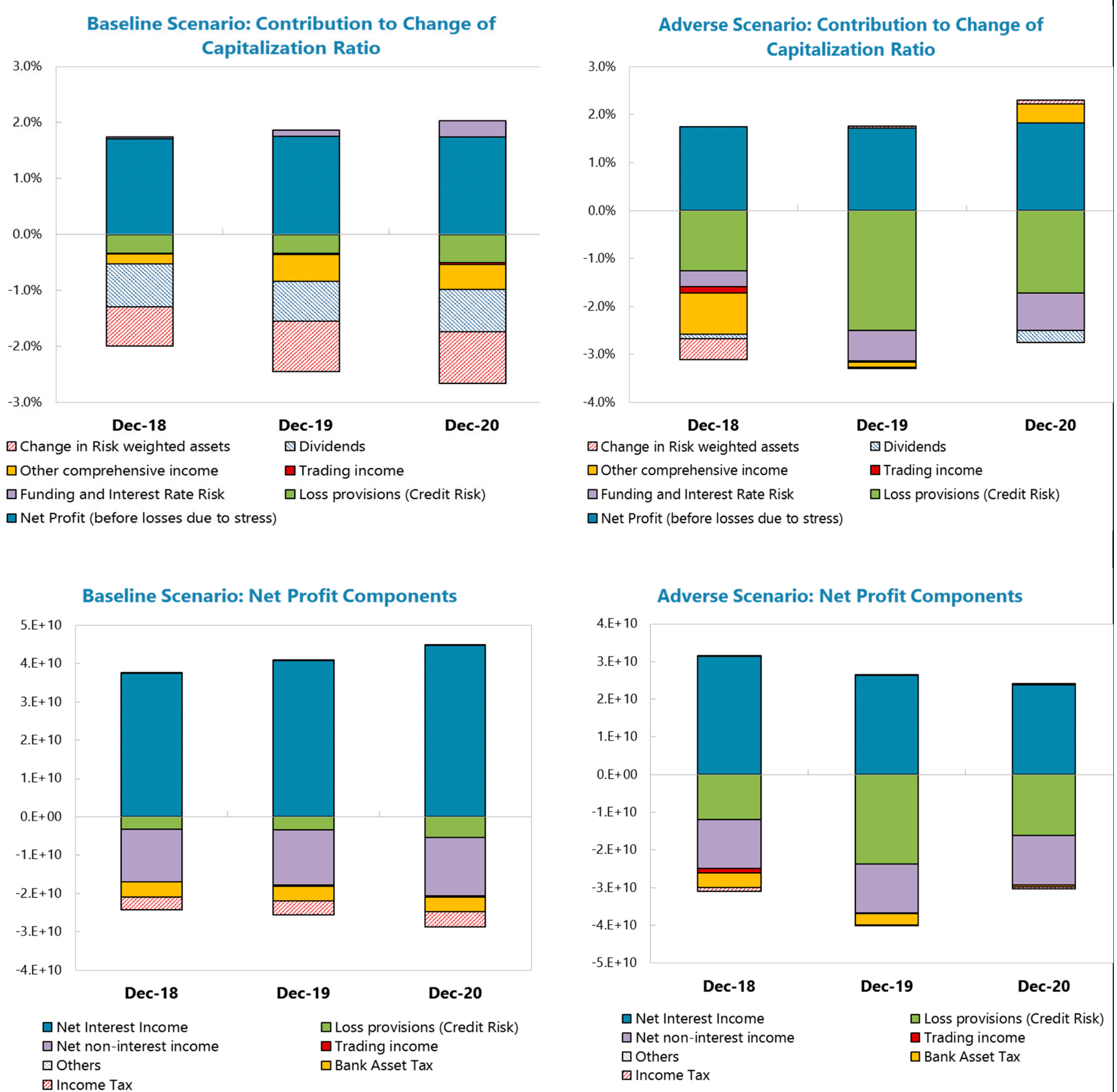
Sources: IMF's WEO database; IMF staff calculations.

Figure 3. Poland: Macroeconomic Baseline and Adverse Scenarios



Source: Haver Analytics, IMF Staff Estimates

Figure 4. Poland: Solvency Stress Testing Results



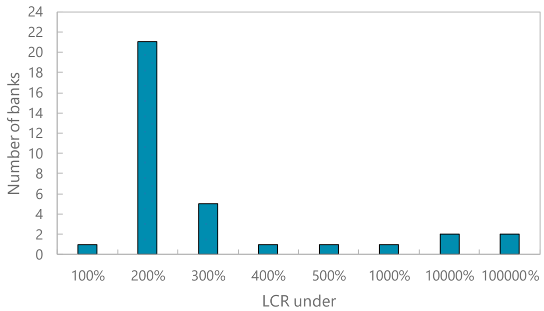
Source: IMF staff calculations.

Figure 5. Poland: LCR Results: All Currencies

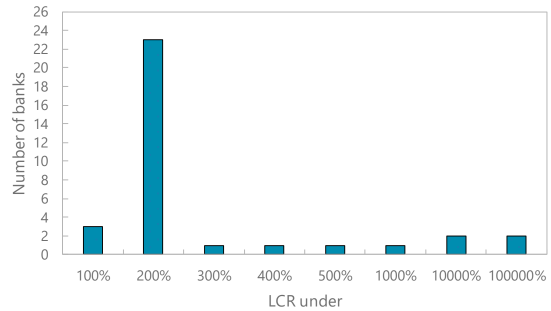
Baseline Event*: Healthy System LCR, one bank already failing*

Retail Event: *Two medium banks fail. System LCR still healthy*

System LCR under Event 1=149%



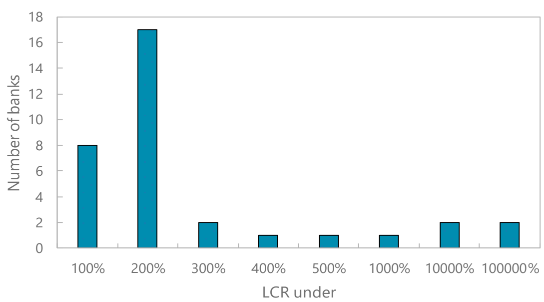
System LCR under Event 2=120%



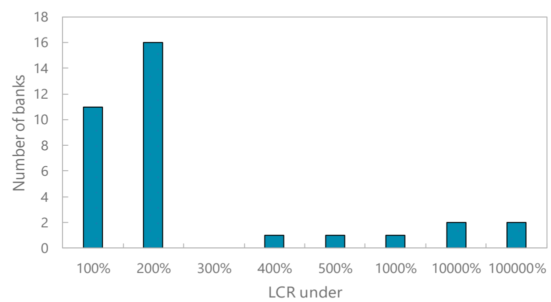
Wholesale Event*: System LCR falls below 100, 2 large banks, 5 medium banks and one small bank fail*

Combined Event*: System LCR falls further, another large, another medium and another small bank fail*

System LCR under Event 3=94%



System LCR under Event 4=88%

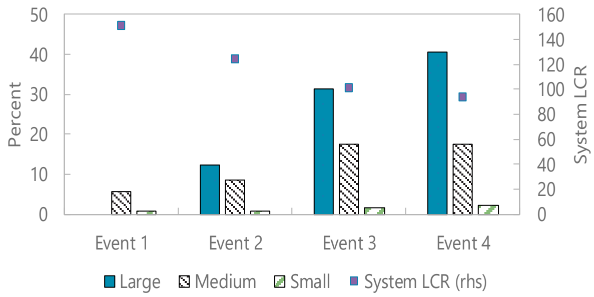


Source: IMF staff calculations.

Figure 6. Poland: LCR Results by Currency

While system LCR in domestic currency remains above 100% in most stress scenarios....

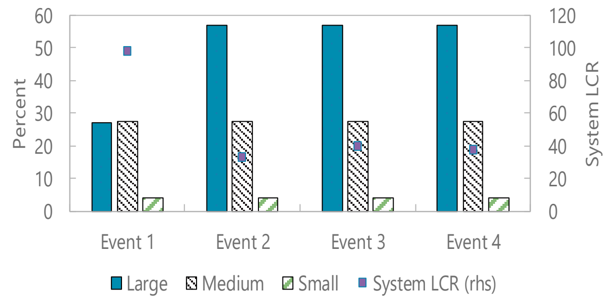
Banks with PLN LCR under 100
(Percent of commercial banks assets)



Source: IMF staff estimates

... banks struggle to meet LCR requirements in foreign currency in all three stress scenarios.

Banks with FX LCR under 100
(Percent of commercial banks assets)



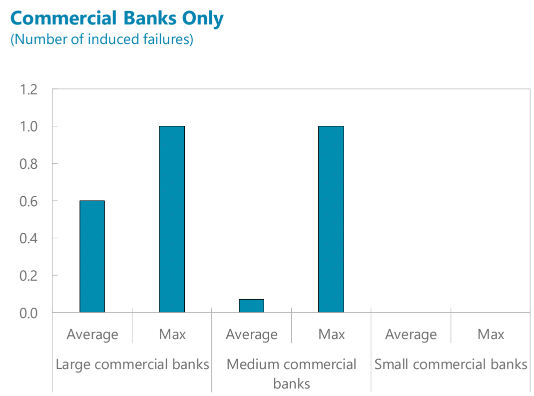
Source: IMF staff estimates

Note: Event 1 refers to the baseline scenario, and events 2, 3 and 4 refer to the adverse retail, wholesale and combined stress scenarios, respectively.

Figure 7. Poland: Interbank and Cross-Sectoral Analysis

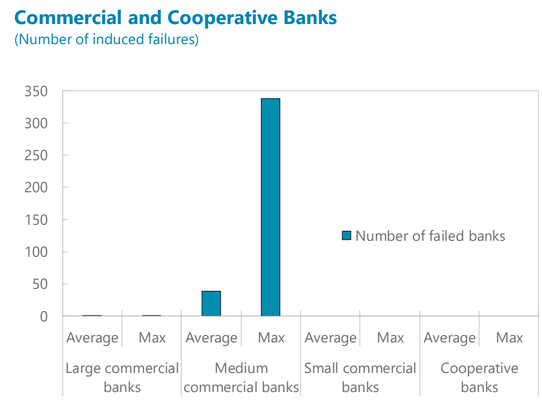
Results of network analysis: Commercial banks only

(in number of induced failures)



Results of interbank network analysis: Commercial and cooperative banks

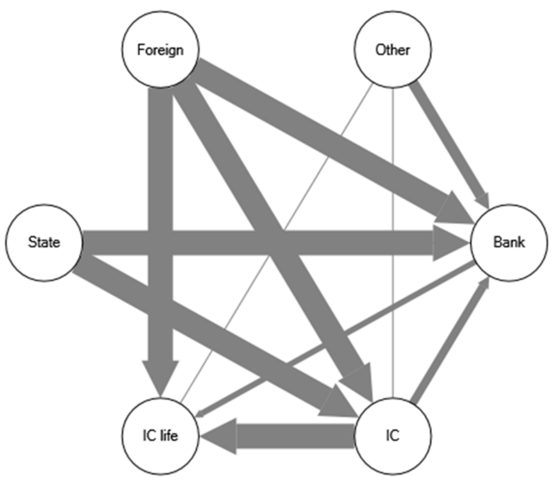
(in number of induced failures)



Source: National Bank of Poland.

Ownership structure, 2017

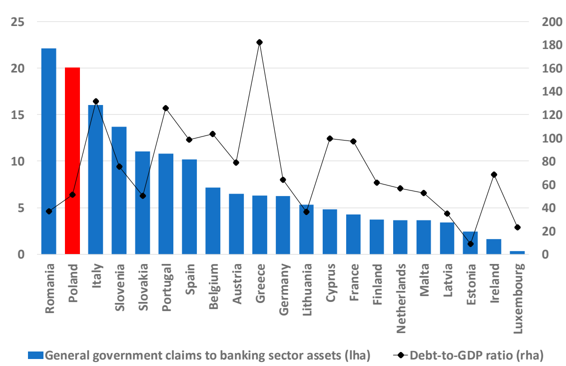
(by percent of total assets)



Source: PFSA and Bankers' Almanac.
Note. Bank = commercial banks, IC = insurance companies, IC life = life insurance companies. The arrows point from the owner. The arrow size reflects ownership in percent of total sector assets. As a reference the largest arrow goes from "Foreign" to "IC life" representing 57 percent of the assets in the insurance life sector. The "other" category predominantly includes non-financial corporations and physical persons.

Sovereign debt, end-2017

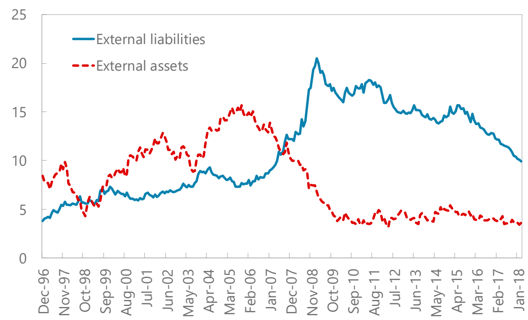
(in percent)



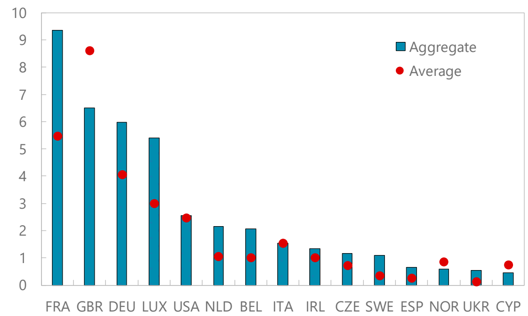
Source: NBP Monetary and financial statistics, International Financial Statistics, IMF Financial Soundness Indicators, Financial Stability Report of the Romanian Central Bank, and IMF World Economic Outlook database.
Note. World Economic Outlook GDP projections were used where public figures on 2017 GDP had not yet been published.

Figure 8. Poland: Cross-Border Analysis

External Assets and Liabilities of Other MFI
(Percent of total assets)

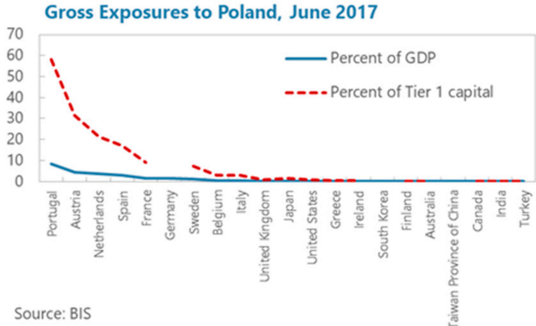


Polish Banks' Consolidated Total Foreign Risk Gross Exposures, end-2017
(Percent of Tier 1 capital)



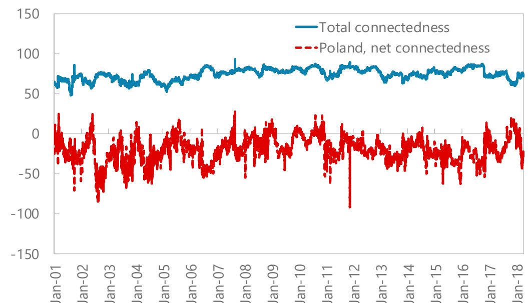
Note. The exposures are reported on the ultimate risk basis and include both on-balance and off-balance positions.

Foreign Banking System's Consolidated Total Gross Exposures to Poland, June 2017



Source: BIS

Index of Connectedness
(Percent)



Note. The exposures are reported on the ultimate risk basis and include both on-balance and off-balance positions.

Note. The index of connectedness was computed based on the Diebold and Yilmaz (2010) approach using two-day average equity returns.

Source: NBP and Datastream.

Table 3. Poland: Status of Key Recommendations from the 2013 FSAP

Recommendations	**Status**
• **Addressing impaired loans:** (i) intensify oversight of credit risk management and restructuring practices; (ii) standardize and enhance transparency of bank accounting practices; and (iii) standardize debt-to-income ratio calculation (paras. 17–20).	Actions included an asset quality review performed in 2014 and sustained onsite supervisory efforts focusing on credit risk management. These actions along with a strengthening economy have resulted in improved asset quality since the last FSAP.
• **Strengthening banking supervision:** (i) expand the scope for PFSA to issue legally binding prudential regulations; (ii) allow PFSA's Board to delegate administrative and procedural decisions to its management, increase PFSA independence, and address other governance issues; and (iii) increase PFSA flexibility to allocate budgetary and staff resources and enhance its analytical capabilities (paras. 27–34).	There is little redress of recommendations. The constitution excludes the PFSA from formal rule-making, as this power is limited to the MoF and NBP as two key agencies for the financial sector. Other recommendations to address issues of PFSA independence, and budgetary and staff resources remain unaddressed.
• **Strengthening credit unions:** (i) eliminate the dual supervision; require a solvency ratio of 8 percent in 5 years; and clarify the governance of the stabilization fund; (ii) develop an inclusive set of SKOK regulations and apply accounting principles for financial institutions to SKOKs; and (iii) develop capital rehabilitation plans for financially weak SKOKs (paras. 36–37).	The PFSA, which already had responsibility for banks and cooperatives, was appointed as the sole supervisor of credit unions. While it has flexibility to allocate budgetary and staff resources for the agency, the envelope of available resources is insufficient.
• **Developing sound macroprudential policies**: (i) ensure the macroprudential supervisory law provides for SRB's independence (with a leading role for the NBP), accountability to Parliament, and power to make recommendations coupled with an "act or explain" mechanism; and (ii) develop clear macroprudential policy objectives that are distinct from those of monetary and microprudential supervisory policy (paras. 38–41).	In 2015, a law was passed that expanded and formalized the mandate of the Financial Stability Committee (FSC) to include macroprudential supervision and crisis management. The FSC's macroprudential supervision and crisis preparedness/ management mandates are undertaken respectively by FSC-Macroprudential, meetings of which are chaired by the NBP Governor and supported by a secretariat based at the NBP, and by FSC-K (crisis management), meetings of which are chaired by the Minister and supported by a secretariat based at MOF.

Table 3. Poland: Status of Key Recommendations from the 2013 FSAP (concluded)

Recommendations	Status
• **Improving the bank resolution framework:** (i) ensure precedence of administrative powers over corporate insolvency procedures; (ii) ensure that the creditor claims hierarchy protects BGF's claims on resources provided for balance sheet "gap filling" measures; and (iii) include a Tier-1 capital trigger and link the "public interest" trigger to financial stability (paras. 48–49).	The key FSAP recommendations are addressed particularly with the implementation of the BRRD.
• **Improving the deposit insurance system:** (i) remove the PBA from the BGF Council; (ii) ensure adequate funding and capacity, revise and introduce new regulations, and enhance protocols in light of expanded mandate; and (iii) amend code of conduct to restrict employment in member institutions to all employees (paras. 50–51).	As for bank resolution, key recommendations are addressed with the implementation of the BRRD. Other actions include the reconstitution of the BGF council to remove the PBA representative. Funding and capacity seem appropriate for the BGF, though resource constraints at the PFSA can slow decisions on resolution.
• **Strengthening pension reform and capital markets:** (i) allow lifecycle strategies in pension funds, and measure performance of pension funds in relation to the benchmark portfolio; (ii) amend MCB framework to allow broader issuance and adopt a legal framework for mortgage securitization; (iii) strengthen enforcement of security interests and judicial decisions (para. 53–54). Source: FSAP team.	The legal framework for MCB was amended to facilitate the issuance of covered bonds, but no legal framework for mortgage securitization was adopted. Investment decisions for the upcoming private pension fund system (PPK) will be guided by portfolio benchmarks through targeted funds.

Appendix I. Selected Economic Indicators 2015–23

Appendix I. Table 1. Poland: Selected Economic Indicators 2015-23

	2015	2016	2017	2018	2019	2020	2021	2022	2023
				Projections					
Activity and prices									
GDP (change in percent)	3.8	3.1	4.8	5.1	3.6	3.0	2.8	2.8	2.8
Domestic demand	3.3	2.3	4.9	5.9	4.4	3.5	2.7	2.7	2.7
Private consumption growth	3.0	3.9	4.9	4.3	4.0	3.5	3.0	3.0	3.0
Public consumption growth	2.3	1.9	3.5	3.0	2.7	2.7	2.6	2.4	2.2
Domestic fixed investment growth	6.1	-8.2	3.9	8.7	8.6	4.8	2.5	2.5	2.5
Inventories (contribution to growth)	-0.2	1.2	0.5	1.1	-0.2	0.0	0.0	0.0	0.0
Net external demand (contribution to growth)	0.6	0.8	0.1	-0.7	-0.6	-0.5	0.1	0.1	0.1
Output gap	-0.5	-0.5	0.2	0.5	0.5	0.3	0.1	0.0	0.0
CPI inflation (percent)									
Average	-0.9	-0.6	2.0	1.7	2.3	2.6	2.5	2.5	2.5
End of period	-0.5	0.8	2.1	1.2	2.6	2.6	2.5	2.5	2.5
Unemployment rate (average, according to LFS)	7.5	6.2	4.9	3.7	3.5	3.4	3.4	3.4	3.4
Saving and Investment (percent of GDP)									
Saving	20.5	19.3	20.1	20.7	21.0	21.0	20.7	20.5	20.2
Investment	20.5	19.5	19.7	21.1	21.6	21.8	21.7	21.7	21.6
Saving -Investment	0.1	-0.3	0.5	-0.4	-0.6	-0.8	-1.0	-1.2	-1.4
Public finances (percent of GDP) 1/									
General government revenues	39.0	38.9	39.7	40.9	41.1	40.4	40.0	39.7	39.5
General government expenditures	41.7	41.1	41.1	41.4	41.9	41.7	41.6	41.6	41.6
General government net lending/borrowing	-2.7	-2.2	-1.4	-0.6	-0.8	-1.3	-1.7	-1.9	-2.1
General government structural balance	-2.4	-2.3	-2.0	-1.6	-1.7	-1.7	-1.8	-1.8	-1.9
General government debt	51.3	54.2	50.6	48.6	46.1	44.7	44.1	43.7	43.6
National definition 2/	48.7	51.9	48.4	...	...	...	...	...	...
Money and credit									
Private credit (change in percent, end-period) 3/	7.5	4.9	3.4	6.2	7.4	7.4	6.4	5.9	5.5
Credit to GDP (percent)	56.9	57.8	56.0	55.5	55.8	56.6	57.3	57.7	57.9
Deposits (change in percent, end-period)	8.8	8.4	3.8	7.2	6.8	6.2	5.5	5.5	5.5
Broad money (change in percent, end-period)	9.1	9.6	4.6	7.1	6.7	6.2	5.4	5.4	5.3
Policy Rate (percent) 4/	1.6	1.5	1.5	1.5	...	...	...	...	...
Balance of payments									
Current account balance (billion U.S. dollars)	-2.7	-2.5	0.6	-4.4	-5.4	-7.1	-8.8	-10.3	-12.1
Percent of GDP	-0.6	-0.5	0.1	-0.8	-0.9	-1.1	-1.3	-1.4	-1.5
Exports of Goods (billion U.S. dollars)	191.0	196.3	228.0	254.2	273.7	292.4	308.7	323.8	338.1
Export volume growth	7.7	8.8	9.5	6.0	5.7	5.2	5.2	4.9	4.5
Imports of Goods (billion U.S. dollars)	188.6	193.1	226.5	259.6	281.3	302.5	320.6	336.6	351.3
Import volume growth	6.6	7.6	10.0	8.0	7.4	6.5	5.2	4.8	4.3
Terms of trade (index 1995=100)	105.2	106.3	107.0	106.0	107.0	107.6	107.3	107.0	106.9
Official reserves (billion U.S. dollars)	94.9	114.4	113.3	113.7	114.0	114.6	115.3	115.9	116.5
In percent of short-term debt plus CA deficit	85.5	88.5	97.6	101.6	98.0	98.2	98.4	98.1	100.8
In percent of IMF ARA metric	111.2	126.5	112.7						
Total external debt (billion U.S. dollars)	331.1	340.1	382.0	378.0	383.0	389.9	398.8	409.5	424.6
In percent of GDP	69.4	72.2	72.8	68.2	64.6	60.5	57.5	54.8	52.7
Exchange rate									
Exchange rate regime				Freely floating					
Zloty per USD, period average	3.8	3.9	3.8	...	...	...	...	...	...
Zloty per Euro, period average	4.2	4.4	4.3	...	...	...	...	...	...
Real effective exchange rate (INS, CPI based) 5/	105.5	100.9	104.3	...	...	...	...	...	...
Appreciation (percent change)	-3.4	-4.4	3.4	...	...	...	...	...	...
Memorandum item:									
Nominal GDP (billion zloty)	1800.2	1861.1	1988.7	2125.4	2270.8	2404.7	2528.4	2658.6	2795.9

Sources: Polish authorities; and IMF staff calculations.

1/ According to ESA2010.

2/ The difference from general government debt reflects different sectoral classification of certain units.

3/ Credit defined as in IFS: "Claims on other sectors."

4/ NBP Reference Rate (avg).

5/ Annual average (2000=100).

Appendix II. Financial Soundness and Balance Sheet Indicators

Appendix II. Table 1. Poland: Financial Soundness Indicators (Commercial Banks)

(In percent)

	2015Q1	2015Q2	2015Q3	2015Q4	2016Q1	2016Q2	2016Q3	2016Q4	2017Q1	2017Q2	2017Q3	2017Q4
Asset Quality												
NPLs to total loans	6.8	6.6	6.6	6.2	6.4	6.3	6.3	6.0	6.0	6.0	6.0	5.9
Loan loss reserve to NPLs (Coverage)	55.3	55.7	56.2	56.8	57.2	57.7	57.8	56.2	56.8	57.0	57.0	57.7
LLR to total loans	3.7	3.7	3.7	3.5	3.7	3.6	3.6	3.4	3.4	3.4	3.4	3.4
Prov for loan loss to total loans	0.7	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	0.6	1.9	1.4
Annualized loan growth	10.3	11.7	11.4	9.2	4.2	3.0	3.0	2.6	5.5	3.2	5.0	3.0
Texas ratio	0.4	0.4	0.4	0.4	0.4	0.4	0.3	0.3	0.3	0.3	0.3	0.3
Profitability												
Net Interest Margin	2.5	2.4	2.4	2.5	2.6	2.5	2.6	2.5	2.7	2.7	2.8	2.7
Efficiency (cost/income)	38.6	40.3	41.0	44.8	45.9	42.9	44.2	44.6	50.2	47.4	46.1	46.0
ROAA	1.2	1.1	1.1	0.9	0.9	1.1	1.0	0.9	0.7	0.8	0.9	0.8
ROAE	18.5	16.8	15.8	13.2	12.4	15.7	14.0	13.0	9.3	11.4	11.7	11.3
Trading gains to income	6.1	5.7	5.6	5.8	5.7	5.4	5.7	5.7	4.9	4.6	4.6	4.6
Liquidity and Funding												
Loan-to-deposit (LTD)	110.4	112.1	109.1	107.0	105.0	105.2	105.1	102.9	104.6	105.1	106.0	102.4
Liquid assets / total assets	20.6	21.3	21.2	21.7	22.6	22.1	21.9	22.6	21.3	21.1	20.9	22.2
Liquid assets / short term liabilities	22.8	23.7	23.6	24.1	25.3	24.8	24.6	25.3	23.9	23.7	23.6	25.0
Wholesale funding	23.7	23.9	22.7	20.5	20.2	19.4	19.1	18.6	18.8	18.3	18.4	17.6
Capital Adequacy												
Capital adequacy ratio (CAR)	14.8	15.2	15.5	15.9	16.6	17.0	17.2	17.1	17.4	18.0	18.0	18.1
Tier 1 capital ratio (Tier 1 capital to RWA)	13.5	13.9	14.2	14.6	15.1	15.3	15.6	15.5	15.8	16.5	16.5	16.2
Financial Leverage (times)	10.0	9.8	9.8	9.7	9.4	9.3	9.2	9.4	9.2	8.9	8.9	8.8
Foreign currency (FX)												
FX loans to total loans	31.2	31.3	30.4	30.2	29.4	29.5	28.4	28.7	26.9	25.8	25.0	23.5
FX deposits to total deposits.	10.7	10.8	10.7	10.7	11.1	11.3	11.9	11.8	12.6	13.0	12.7	13.4

Source: NBP

Appendix II. Table 2. Poland: Financial Soundness Indicators (Cooperative Banks)

	Dec-15	Dec-16	Jun-17	Sep-17	Dec-17
Asset Quality					
NPLs to Loans	6.7	7.7	7.8	8.0	8.3
Prov to NPLs	30.1	31.3	31.5	32.3	42.3
Loan Growth	7.8	4.0	6.2	6.3	3.9
Asset Growth	49.1	11.9	4.5	4.9	7.8
Profitability					
Return on Avg Assets	0.4	0.5	0.7	0.7	0.6
Liquidity					
Loan to Deposits	68.8	63.7	65.0	65.2	60.8
Capital					
Capital to Asset Ratio	9.0	8.4	8.7	8.6	8.3

Source: NBP

Appendix II. Table 3. Poland: Financial Soundness Indicators (Commercial Banks by Ownership)

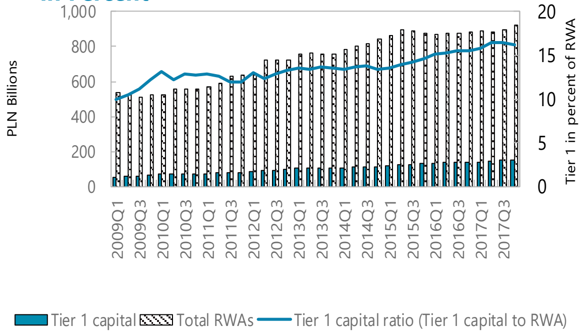
(2017Q4, in percent)

	State-controlled	Domestic private	Foreign-controlled
Asset Quality			
NPLs to total loans	5.8	12.5	4.9
Loan loss reserve to NPLs (Coverage)	59.6	42.0	62.3
LLR to total loans	3.5	5.3	3.0
Prov for loan loss to total loans	1.3	3.3	1.1
Annualized loan growth	4.9	-0.7	2.1
Texas ratio	0.3	0.8	0.3
Profitability			
Net Interest Margin	3.0	2.0	2.6
Efficiency (cost/income)	45.4	41.2	47.2
ROAA	1.0	-0.3	0.9
ROAE	12.9	-6.4	12.2
Trading gains to income	4.0	2.0	5.4
Liquidity and Funding			
Loan-to-deposit (LTD)	100.1	115.3	102.5
Liquid assets / total assets	20.5	18.9	24.0
Liquid assets / short term liabilities	23.2	20.4	27.3
Wholesale funding	12.2	36.9	18.3
Capital Adequacy			
Capital adequacy ratio (CAR)	18.4	13.1	18.7
Tier 1 capital ratio (Tier 1 capital to RWA)	17.0	10.6	16.5
Financial Leverage (times)	8.6	13.2	8.4
Foreign currency (FX)			
FX loans to total loans	17.3	19.5	28.9
FX deposits to total deposits	13.4	13.4	13.4

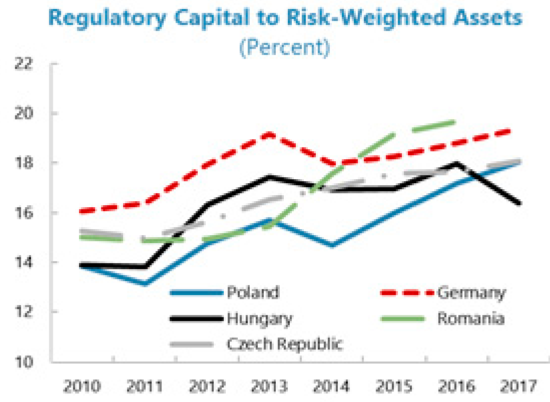
Source: NBP

Appendix II. Figure 1. Poland: Capital – Commercial Banks

Tier 1 Capital and RWA
In Percent



Source NBP

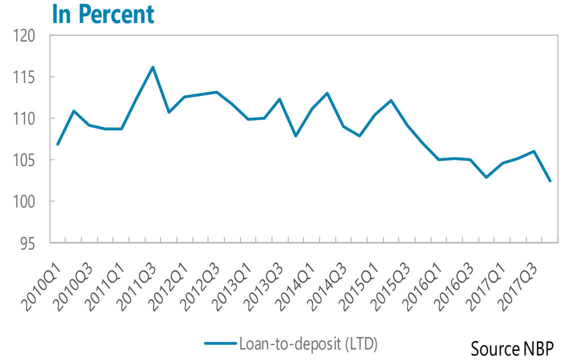


Source: IMF Financial Soundness Indicators

Appendix II. Figure 2. Poland: Liquidity – Commercial Banks

The loan to deposit ratio has declined in recent years…

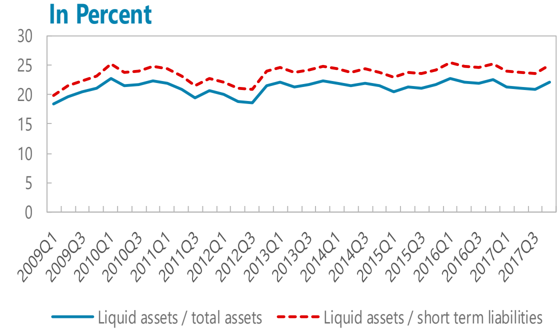
Loan-to-deposit ratio
In Percent



Source NBP

…while the liquidity ratios have been quite stable.

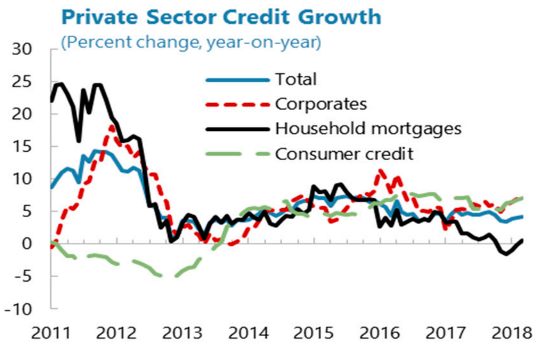
Liquidity ratios
In Percent



Source NBP

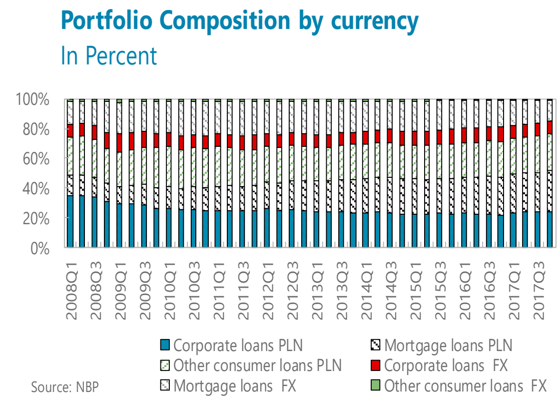
Appendix II. Figure 3. Poland: Credit Growth and Asset Quality

Credit growth remains relatively low…

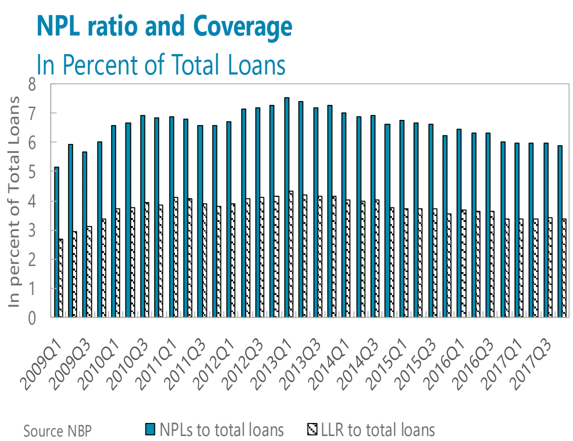


Sources: Haver Analytics, Bank of Poland, and IMF staff calculations.

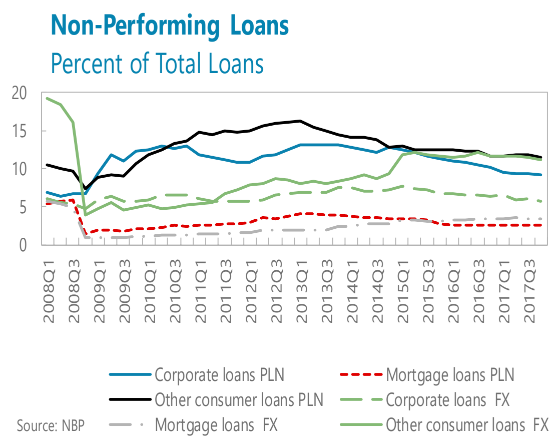
…and the share of FX mortgages is declining.



The NPL ratio has continued to moderate…



…with the NPL ratio in mortgages being the lowest loan segment.

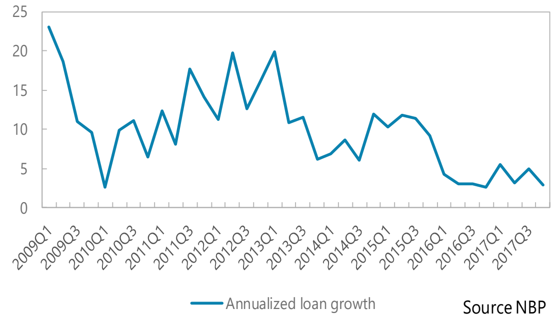


Note: credit growth is based on banking sector; the other charts are based on commercial banks.

Appendix II. Figure 4. Poland: Bank Profitability

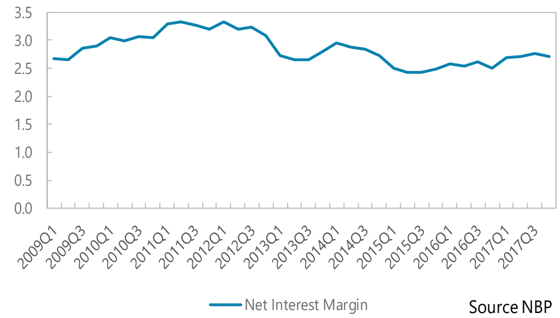
Asset growth has slowed…

Annualized loan growth
In Percent



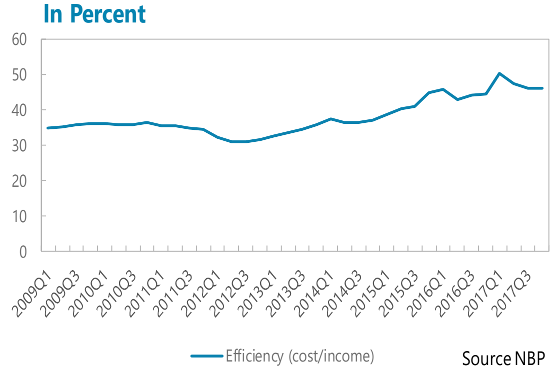
…while NIMs, though still sound, show moderation.

Net Interest Margin
In Percent



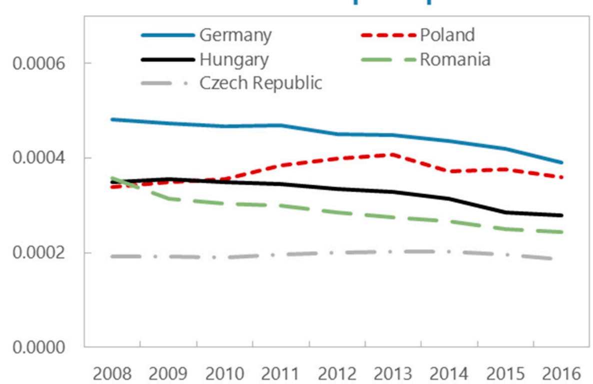
And costs have risen in part due to the FIAT….

Efficiency
In Percent



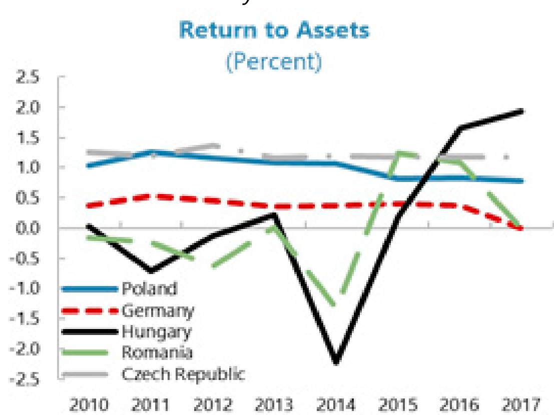
…with relatively high branch density.

Bank Branches per Capita



Source: ECB

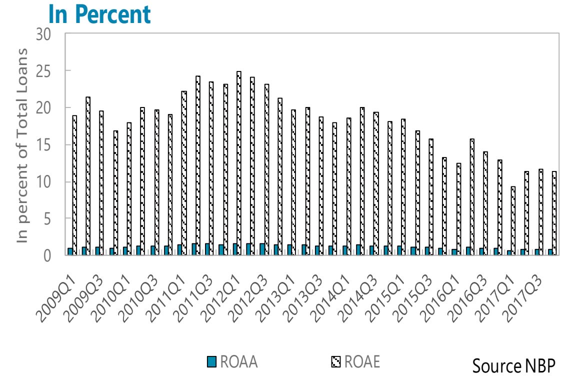
Though little affected by the crises, the return on assets has declined in recent years….



Source: IMF Financial Soundness Indicators

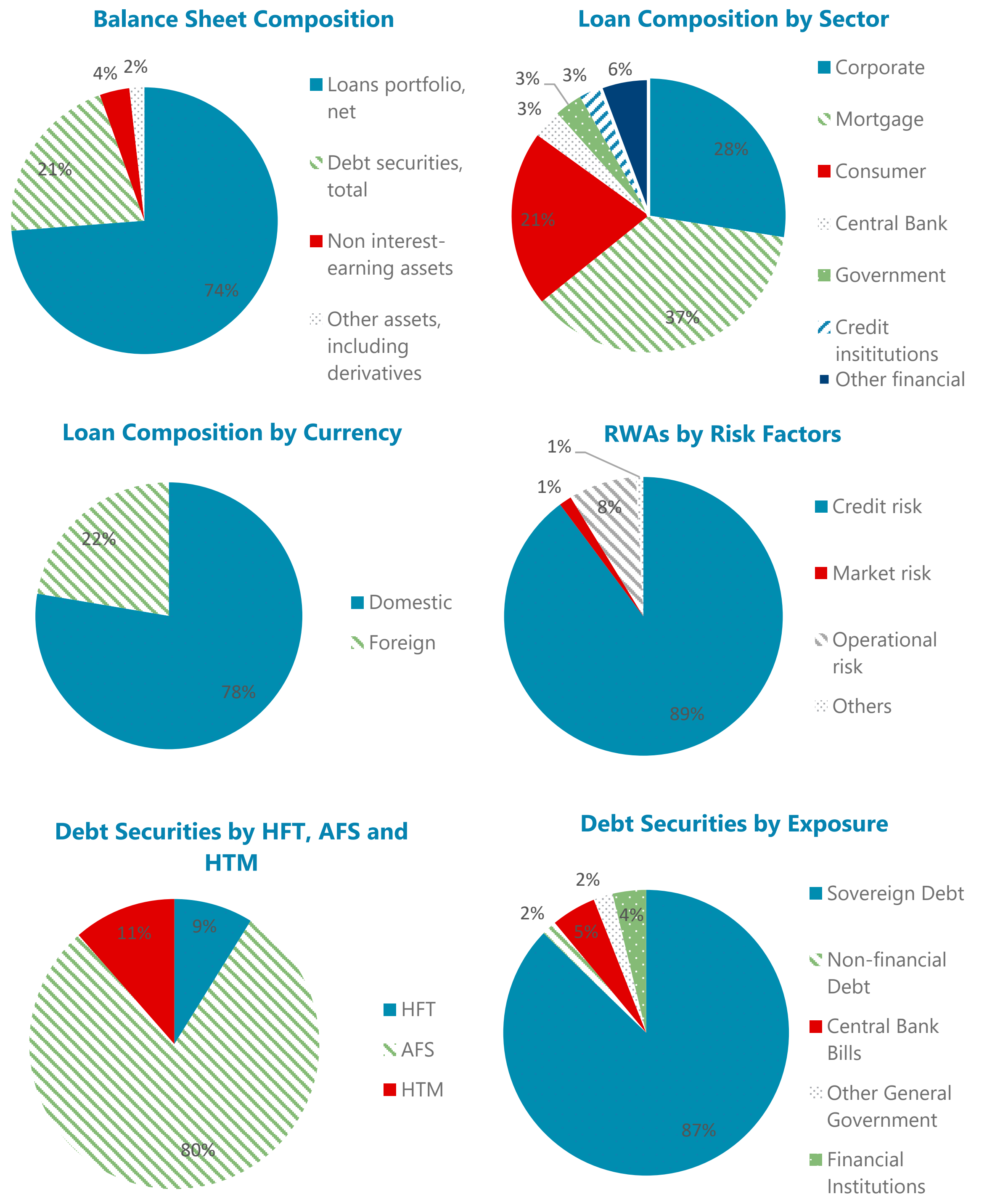
…with similar trends in the return on equity.

ROAA and ROAE
In Percent



Note: NBP data is for commercial banks only; ECB and FSI data is for the banking sector

Appendix II. Figure 5. Poland: Balance Sheet of Commercial Banks (2017)

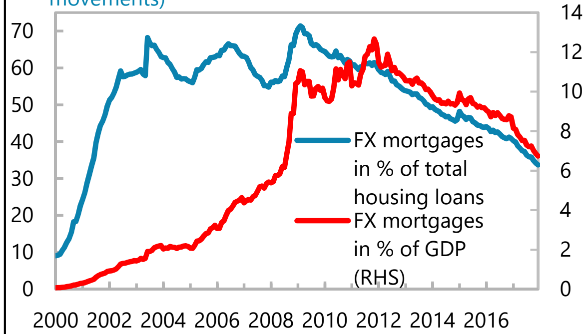


- Source: IMF Staff Calculations.
- Note: Other loans include loans to the central bank, the government and financial institutions.

Appendix III. Risk Analysis of FX Mortgages

1. Mortgage loans extended in foreign currency (FX mortgages), mostly in Swiss franc, became popular in Poland in the run-up to the Global Financial Crisis (GFC). As in other regional peers, Poland had seen a boom of Swiss franc-denominated mortgages prior to the GFC, thanks to the sizeable differential between the Swiss and Polish interest rates and a favorable PLN/CHF exchange rate. The size of the FX mortgage portfolio grew from 2 percent of GDP (around 60 percent of total outstanding housing loans) at end-2004 to 11 percent of GDP (around 70 percent of total outstanding housing loans) by end-2008 (Figure 1). At its peak, the FX mortgage portfolio was relatively wide-spread across the banking sector, with medium-sized and foreign-controlled banks (that are incorporated in Poland) most exposed, and borrowers tended to be wealthier households.

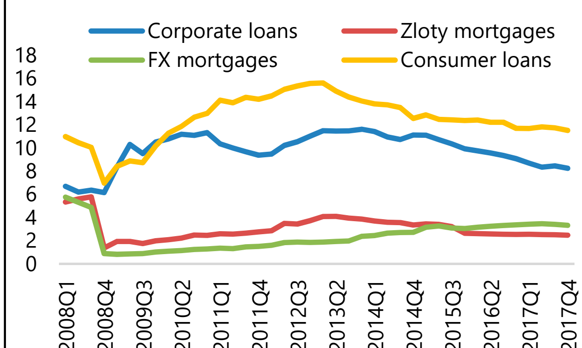
1. Share of FX-Denominated Housing Loans
(In percent; numbers not adjusted for exchange rate movements)



Sources: National Bank of Poland, and IMF staff calculations.

2. The FX mortgage portfolio has been performing well in the last decade, even during stress episodes—the resilience of the portfolio has been supported by both domestic and external factors. FX mortgages have had relatively low NPL ratios in the last decade (below 4 percent), even during stress episodes (Figure 2). Notably, when the zloty depreciated significantly during the GFC and following the Swiss National Bank's (SNB) removal of the exchange rate cap on Swiss franc in early 2015, the NPL ratios of this portfolio rose only moderately. Both domestic and external factors have contributed to the resilience of FX mortgages. During the 2015 episode, a key external mitigating factor was the simultaneous reduction in Swiss LIBOR rate, which partially offset the increase in debt service due to the Swiss franc appreciation. Domestically, prudential regulations on FX mortgages have been tightened in steps since 2006, requiring banks to be more diligent in risk assessment and informing customers of all relevant risks, to build buffers on both banks' and borrowers' side (e.g., FX mortgage loans can only be offered to borrowers with higher income buffers; measures have been taken to raise capital requirements for banks exposed to FX mortgages), to limit borrowers' risk exposure, and to

2. Non-financial Sector NPLs
(Percent of loans in given segment)



Sources: National Bank of Poland, and IMF staff calculations.

eventually ban new FX mortgage loans to unhedged borrowers effectively from 2013[1]. As a result, the stock of FX mortgages started to decline from early 2012 (with an average annual amortization rate of 8 percent in recent years), reaching 6½ percent of GDP by end-2017.

3. Despite the resilience of the portfolio, its risk profile deteriorated after the stress episodes, and public debate intensified on potential measures to protect FX mortgage borrowers. Average LTV ratios for FX mortgage loans increased considerably after the 2015 Swiss franc appreciation, especially for those granted during 2007–08.[2] By end-March 2015, the share of Swiss franc mortgages with LTV higher than 80 and 100 percent reached 68 and 53 percent of total Swiss franc mortgages outstanding.[3] Debt service burden on Swiss franc mortgages also rose considerably. Public concerns on the risks associated with the FX mortgage portfolio have thus increased. While the NBP concluded after the 2015 Swiss franc appreciation that the FX mortgage portfolio posed no systemic risk to banking sector stability,[4] there was an increasing call for measures to protect FX mortgage borrowers as some of the loans were seen to be extended without adequate consumer information.

4. Several legislative proposals have resulted from the public debate, but the final decision remains pending. Four draft bills are currently under Parliamentary discussion. Two of them involve some form of mandatory conversion, submitted by the Civic Platform and Kukiz'15, respectively.[5] The other two were submitted by the President's office in August 2016 and August 2017, respectively. The August 2016 proposal from the President's office requires banks to repay "excessive" FX spreads charged to FX mortgage borrowers. This proposal is assessed to cost between 4 to 9 billion zloty (up to three-quarters of the 2016 banking sector profits)—though less costly than the proposals involving mandatory conversion, it could still exert pressures to banking sector profitability. The August 2017 proposal from the President is to establish a dedicated "Restructuring Fund" with contributions from banks with FX mortgage portfolios—the quarterly contributions (capped at 0.5 percent of the FX mortgage stock) can be used to reimburse banks for costs incurred during FX mortgage restructuring, thus incentivizing banks to offer conversion. Under this proposal, the contribution would be capped at 2¾ billion zloty for the first year, with the current stock of FX mortgages. However, the cumulative cost is difficult to estimate, as the speed of

[1] For details, see Box 1 of the Background note on the "Risk Analysis of Foreign-currency Mortgages".

[2] See the NBP *Financial Stability Report*, January 2015. An additional reason for the increase in the LTV ratios of FX mortgages granted during 2007-08 was the decline in housing prices after 2007.

[3] Based on PFSA survey data including banks with FX loans over 10 percent of total loans.

[4] See the NBP *Financial Stability Report*, January 2015.

[5] The draft bill submitted by the Civic Platform requires conversion of FX mortgages into zloty-denominated ones at the exchange rate of the day when the restructuring agreement is signed, and the cost shall be divided between banks and borrowers. The bill submitted by Kukiz'15 requires conversion at the exchange rate of the day when the mortgage loan agreement was signed with banks bearing the cost. These two draft bills, though remain under discussion, are deemed less likely to be implemented.

conversion is uncertain, and the cost of each conversion could vary from case to case. Currently, borrowers have little incentive to convert given the substantial interest rate differential. Meanwhile, the FSC-M released nine recommendations in early 2017 to further mitigate risks associated with FX mortgages and to enhance banking sector resilience more generally. The key ones include increasing the risk weight for FX mortgages from 100 percent to 150 percent, imposing a 3 percent systemic risk buffer (from zero percent) regardless of banks' FX mortgage exposure, and requiring additional capital for banks with FX mortgage portfolios. Most of the recommendations have been in effect since late 2017 or early 2018, while progress in voluntary FX mortgage conversion has been limited so far.

5. **The FSAP assesses that risks associated with the FX mortgage portfolio has declined and no systemic policy response is warranted.** The improvement in the quality of the FX portfolio is supported by robust wage growth, favorable Swiss franc interest rates, and income buffers of FX mortgage borrowers. Further tightening in prudential regulations following the implementation of the 2017 FSC recommendations strengthens banks' resilience to exchange rate shocks. The FSAP stress tests show that the impact of a significant exchange rate depreciation on the banking sector solvency is generally contained in aggregate, though pockets of vulnerability exist. Such vulnerabilities, as with any other loans, should be addressed case by case—a systemic policy response is not warranted.

6. **Scenario analysis can be used to gauge the possible range of the cumulative costs if the proposed "Restructuring Fund" is established.** A "no conversion" scenario and a "fast conversion" scenario provide the upper and the lower bound of the cost, respectively (assuming the contributions are set at the maximum level throughout the scenario period). In the "no conversion" scenario, banks pay contributions proportional to a gradually amortizing stock, which defines the upper bound of the cost; in a "fast conversion" scenario, the stock would reduce more rapidly due to conversion, reducing contributions paid by banks. The speed of conversion depends on the amount of debt relief acceptable to both banks and borrowers. We assume that haircut rates that equalize the pre- and post-conversion debt service (in zloty terms) would be acceptable to borrowers, and the cumulative debt relief a bank is willing to offer each quarter is equal to its contribution. It is also assumed that only FX mortgages "at risk" (i.e., with LTV above 80 percent and DSTI above 50 percent) would be converted. Under these key assumptions, ranges of cost are calculated for both the main adverse scenario used in the solvency stress test, and the 30 percent zloty depreciation scenario in the sensitivity analysis[6]:

- ***Under the main adverse scenario, the three-year cumulative cost ranges between 7.3 and 8.1 billion zloty*** (0.2–0.3 percent of RWAs annually). The cumulative amount "at risk" after the shocks is around 26 percent of the end-2017 stock of FX mortgages, which could take 4½ years to convert. Significant haircuts (25–30 percent) are needed to equalize

[6] For more details on the assumptions and calculations, see Box 3 of the Background note on the "Risk Analysis of Foreign-currency Mortgages."

monthly installments pre- and post-conversion. The cost (relative to RWAs) is the highest for larger medium-sized and small banks, as well as for foreign-controlled banks.[7]

- ***Under the 30 percent depreciation scenario, the one-year cost ranges between 3 and 3.3 billion zloty*** (22–25 percent of net profits and other comprehensive income). The total amount "at risk" after the one-time shock is around 75 percent of the end-2017 stock of FX mortgages, which could take 11½ years to convert. A haircut rate of 29 percent is needed to equalize monthly installments pre- and post-conversion.

7. In conclusion, risks associated with the FX mortgage portfolio has declined and no systemic policy response is needed. As with any other loans, solutions to distressed FX mortgages should be case-by-case and risk-based. If any policy actions are to be taken to meet objectives other than addressing financial stability risks, they should aim to minimize the adverse impact on bank profitability and financial stability risks.

[7] Bank-level cost distribution should be interpreted with caution, as the risk profile of FX mortgages is assumed to be the same across banks due to data limitation.

Appendix IV. Risk Assessment Matrix

Source of Risks	Overall Level of Concern	
	Likelihood of realization in 1–3 years	**Expected Impact**
External		
Tighter and more volatile global financial conditions.	High/Medium Financial market stress arises from politically driven de-globalization initiatives in Europe and the United States. Tighter global financial conditions: Fed normalization and tapering by the ECB increase global rates and the term premia, strengthen the U.S. dollar and the euro vis-a-vis the other currencies, and correct market valuations. Adjustments could be disruptive if there are policy surprises. Higher debt service and refinancing risks could stress leveraged firms, households, and vulnerable sovereigns, including through capital account pressures in some cases. European bank distress: Strained bank balance sheets amid a weak profitability outlook could lead to financial stress to some euro area banks, with possible knock-on effects, including a sell-off in stock markets.	High/Medium Significant further strengthening of the US dollar and a faster-than-anticipated U.S. monetary policy normalization could put pressure on the capital account. Investors could reallocate assets away from Poland with a rise in risk aversion, resulting in capital flow reversals and zloty depreciation. A depreciation could adversely impact the quality of foreign currency loans (including in Swiss Francs). Tighter financial conditions could lead to a decline in credit supply. Increased default risk for banks would further impair profitability. Substantial increases in high spread euro area sovereign yields would cause valuation losses in banks. Banks would take a hit in capital ratios, as interest and trading income deteriorate further. Alternatively, banks may search for yield and take up excessive risks.
Policy and geopolitical uncertainties.	High Policy uncertainties in the U.S. and Europe could slow down or even reverse cross-border integration, international trade liberalization and financial flows. Two-sided risks to U.S. growth with difficult-to-predict policies and global spillovers. In Europe, uncertainty associated with negotiating post-Brexit arrangements. Policy divergence could lead to rising global imbalances and exacerbate exchange rate and capital flow volatility.	Medium Potential damage to global supply chains, reduced trade and FDI, and increased capital flow volatility could adversely impact the Polish economy and financial markets. Uncertainty can weigh on market sentiment, lead to confidence losses and dampen private consumption and investment. Bank credit losses and NPLs could increase as growth slows, which would impact banks' capital position and profitability.

<table>
<tr><th rowspan="2">Source of Risks</th><th colspan="2">Overall Level of Concern (continued)</th></tr>
<tr><th>Likelihood of realization in 1–3 years</th><th>Expected Impact</th></tr>
<tr><td colspan="3">External</td></tr>
<tr><td>Weaker-than-expected growth in key advanced and emerging economies.</td><td>Medium
Structurally weak growth in key advanced economies: Low productivity growth (U.S., the Euro Area, and Japan), a failure to fully address crisis legacies and undertake structural reforms, and persistently low inflation (the Euro Area, and Japan) undermine medium-term growth in advanced economies.

Significant China slowdown and its spillovers: Efforts to rein in financial sector risks, though desirable, expose vulnerabilities of indebted entities and reduce near term growth. Weak domestic demand would lower commodity prices, roils global financial markets, and reduces global growth.

Significant slowdown in other large EMs/frontier economies: Resource misallocation and policy missteps could exacerbate the impact of declining productivity and potential growth. The turning of the domestic credit cycle could generate disorderly household and corporate deleveraging and increase default probability.</td><td>High/Medium
Significant trade linkages with Europe would weaken growth in Poland through lower exports and adverse confidence effects.

Indirect trade linkages to China through the German supply chain would lower Polish exports to Germany and other CEE countries.

A global recession would fuel credit and market risk and deteriorate asset quality. The correction of overvalued asset prices triggers wealth and confidence effects which weigh on consumption and investment. Provisioning needs for banks would increase considerably, negatively affecting already low profitability. Some banks may search for yield and take up excessive short-term risks in an environment of higher financial market volatility.</td></tr>
</table>

Source of Risks	Overall Level of Concern (concluded)	
	Likelihood of realization in 1–3 years	Expected Impact
Domestic		
Domestic policy uncertainty and slippages	Medium Inflation could accelerate faster than expected which would require more abrupt tightening. Rapid tightening of interest rate could dampen domestic consumption and investment. Fiscal slippages and the weakening of key institutions could result in rating downgrades and increase the perceived risk and uncertainties. The interaction of fiscal and financial sector policy missteps could result in a vicious cycle of weaker public finances and financial sector health and lower growth. Policy uncertainties surrounding the final solution to address consumer protection concerns associated with swiss franc mortgage loans and the potential cost could impact bank balance sheet and confidence.	High Tighter domestic financial condition could dampen credit and increase NPL ratio and impair asset quality. Tighter financial conditions both externally and domestically would hurt consumption and investment. Rating downgrades could push up financing costs and banks' funding costs. Higher cost would then impact bank profitability and its ability to accumulate capital. A rise in Polish sovereign bond yield could also lead to valuation losses for banks as they hold a sizable share of domestic government bond. Potential costly solution to swiss franc mortgage loans could further impair bank profitability.

Note: The Risk Assessment Matrix (RAM) shows events that could materially alter the baseline path (the scenario most likely to materialize in the view of IMF staff). The relative likelihood of risks listed is the staff's subjective assessment of the risks surrounding the baseline ("low" is meant to indicate a probability below 10 percent, "medium" a probability between 10 and 30 percent, and "high" a probability of 30 percent or more).

Appendix V. Stress Test Matrix (STeM)

Appendix V. Table 1. Poland: Stress Test Matrix: Solvency Risk (Using December 2017 Data)

Banking Sector: Solvency Risk			
Domain		**Assumptions**	
		Top-down by FSAP Team	Top-down Sensitivity Analysis by the NBP
1. Institutional Perimeter	Institutions included	• 34 commercial banks.	• 553 cooperative banks.
	Market share	• 85 percent of total banking sector assets.	• 7 percent of total banking sector assets.
	Data and baseline date	• European reporting templates (FINREP and COREP). • Supervisory data from the NBP, based on national reporting templates. • Macrofinancial data from Haver Analytics, Datastream and WEO. • December 2017 data. • Scope of consolidation: perimeter of individual banks (including foreign subsidiaries).	• Supervisory data, based on national reporting templates (more detailed than FINREP and COREP). • December 2017 data. • Scope of consolidation: perimeter of individual banks.
2. Channels of Risk Propagation	Methodology	• Macroeconomic scenarios quantified using IMF Macrofinancial model (Vitek, 2016). • Detailed balance sheet stress test, covering key risk-sensitive exposures. • Based on satellite models and methodologies developed by the FSAP team.	• Sensitivity analysis, covering counterparty, credit and interest rate risks.

Appendix V. Table 1. Poland: Stress Test Matrix: Solvency Risk (Using December 2017 Data) (continued)			
	Satellite Models for Macrofinancial linkages	• Credit losses: the nonperforming loan ratios and provisioning ratios are estimated and projected by three main sectors: mortgage, other-consumer and corporate. The projections are based on various macro and financial variables, such as GDP growth, unemployment rate, interest rates, house price growth and wage growth. • Funding costs are estimated and projected based on macrofinancial factors such as three-month Wibor and sovereign bond yields. • NPLs assumed to not provide any accrued interest.	• N/A.
	Stress test horizon	• Three-year horizon: 2018–20.	• Instantaneous sensitivity analysis.
3. Tail shocks	Scenario analysis	• Macroeconomic scenario analysis: agreed between the FSAP team and the authorities. • The baseline scenario is based on the December 2017 World Economic Outlook (WEO) projections. • The adverse scenario features external financial market stress and growth slowdown and captures the macrofinancial impact of domestic policy uncertainty. The narrative assumes financial market stress and a tightening in financial conditions in systemic economies, heightened	• N/A.

Appendix V. Table 1. Poland: Stress Test Matrix: Solvency Risk (Using December 2017 Data) (continued)

3. Tail shocks	Scenario analysis	uncertainty and confidence losses in Europe and the United States, as well as protectionist measures in Europe and the United States that ultimately lead to growth slowdown, given constrained macroeconomic policy responses. • It also assumes domestic policy slippages, weakening in key institutions and heightened uncertainty weighing on confidence and consequently consumption, investment, and output.	
	Sensitivity analysis	• Sensitivity tests evaluate the effects of additional exchange rate shocks (30 percent Zloty depreciation); interest rate shocks; and counterparty risk shocks (simultaneous default of the five largest non-financial borrowers) for the commercial banking sector.	• Sensitivity tests evaluate the effects of counter party risk shocks (simultaneous default of the five largest non-financial borrowers); credit shocks and interest rate shocks for the cooperative banking sector.
4. Risks and Buffers	Risks/factors assessed	• Risks assessed include: credit, market (equity risks, exchange and interest rates), sovereign (repricing and spread risks), funding interest rate risk in the banking book and concentration risk.	• Risks assessed include: credit, interest rates and concentration risk.
	Behavioral adjustments	• Balance sheet grows in line with nominal GDP, with a floor set at zero, and accounting for differentiated risk weights for domestic and foreign currency mortgage portfolios. • Dividends are paid out by banks that remain adequately capitalized with positive	• N/A.

Appendix V. Table 1. Poland: Stress Test Matrix: Solvency Risk (Using December 2017 Data) (concluded)

4. Risks and Buffers	Behavioral adjustments	profits throughout the stress, taking into account their FX mortgage exposures, in accordance to the dividend policy of the PFSA. • Invariant asset allocation, i.e., no change in business models, lending standards, or investment pattern in response to shocks (over three years).	
5. Regulatory and Market-Based Standards and Parameters	Calibration of risk parameters	• Based on credit models estimated by IMF staff. Credit losses are calculated through the estimation of satellite models using NPL ratios and historical provisioning ratios.	• N/A.
	Regulatory/ Accounting and Market-Based Standards	• CRD IV / CRR fully loaded levels for CET1. • Capital shortfalls to be measured in terms of CET1, T1, total capital and the leverage ratio. • Two sets of hurdle rates: 1) Pillar I and Pillar II requirements (main results); 2) Pillar I and Pillar II requirements and OSII buffers (robustness checks). • 150 percent risk weights for FX mortgages (reflected in end-2017 reporting data).	• CRD IV / CRR fully loaded levels for CET1. • Capital shortfalls to be measured in terms of CET1, T1, total capital and the leverage ratio.
6. Reporting Format for Results	Output presentation	• System-wide capital shortfall. • Number of banks and percentage of banking assets in the system that fall below certain ratios.	

Appendix V. Table 2. Poland: Stress Test Matrix: Liquidity Risk (Using December 2016 Data)

Domain		Assumptions	
BANKING SECTOR: LIQUIDITY RISK			
		Top-down by the FSAP team	Top-down by the NBP
1. Institutional Perimeter	Institutions Included	• 34 commercial banks (including domestic, state-owned and foreign-owned but excluding foreign-owned branches).	• 553 cooperative banks.
	Market share	• 85 percent of total banking sector assets.	• 7 percent of total banking sector assets.
	Data and baseline date	• Latest data: December 2017. • Source: supervisory data. • Scope of consolidation: perimeter of individual banks.	• Latest data: December 2017. • Source: supervisory data. • Scope of consolidation: perimeter of individual banks.
2. Channels of Risk Propagation	Methodology	• An extended Basel III LCR scenario with variants (retail/wholesale/combined shock).	• An extended Basel III LCR scenario with variants (retail/wholesale shock).
3. Risks and Buffers	Risks	• Funding liquidity (liquidity outflows). • Market liquidity (price shocks).	• Funding liquidity (liquidity outflows).
	Buffers	• Counterbalancing capacity. • Central bank facilities.	• Counterbalancing capacity. • Central bank facilities.
4. Tail shocks	Shocks	• Run-off rates calculated following historical events and LCR/NSFR rates. • Rollover rates for the FX swaps calculated following Basel III benchmarks. • Bank run and dry up of wholesale funding markets, taking into account haircuts to liquid assets.	
5. Regulatory and Market-Based Standards and Parameters	Regulatory standards	• Basel III liquidity standards for LCR and NSFR. • For LCR, see: BCBS (2013), The Liquidity Coverage Ratio and liquidity risk monitoring tools, Basel, January 2013. • For NSFR, see: BCBS (2014), Basel III: The Net Stable Funding Ratio, October 2014.	
6. Reporting	Output presentation	• Liquidity ratios, disaggregated by type (domestic vs. foreign) and size of bank.	

Appendix V. Table 3. Poland: Stress Test Matrix: Interconnectedness Analysis

Domain		Framework
Cross-border analysis	Data and Methodology	The FSAP team applies two approaches to examine interconnectedness and contagion, based on cross border exposure and market data: Espinosa-Vega and Sole (2010) Methodology • Examine cross-border banking sector exposures, with the BIS consolidated banking statistics, NBP data and regulatory capital data from FSI as of 2017. Note that data on Polish banks' exposures are not available in BIS statistics, limiting the analysis to one simulation. • Simulation: Positions include aggregate total exposures. Consider the impact of credit shocks to total foreign claims using NBP and BIS consolidated statistics. • List of economies to be considered: France, United Kingdom, Germany, Czech Republic, Luxembourg, United States, Netherlands, Belgium, Italy, Ireland, Sweden, Austria, Switzerland, Portugal, Spain, Japan, Russia, South Korea, Greece, Australia, Canada, Taiwan, Province of China, Finland, Turkey, Chile, Norway, Slovakia, Ukraine, and Cyprus. Diebold and Yilmaz (2014) Methodology • Examine the cross-border interconnectedness between the banking sector in Poland and other countries with strong financial and trade linkages with Poland. • The data will be sourced in the beginning of May 2018 at daily frequency using as longtime series as possible. • Equity returns are computed as the average two-day log returns to control to the differences in trading hours due to time zones. • The interconnectedness measure is derived from the forecast error variance decomposition of the underlying VAR. • List of countries to be considered: France, United Kingdom, Germany, Czech Republic, United States, Netherlands, Belgium, Italy, Ireland, Sweden, Austria, Switzerland, Portugal, Spain, Japan, Norway, Slovenia, and Russia.

Appendix V. Table 3. Poland: Stress Test Matrix: Interconnectedness Analysis (Concluded)

Interbank market analysis	Data and Methodology	The NBP conducted the interbank market analysis. <u>Espinoza-Vega and Sole (2010) Methodology</u> • Conduct three simulations separately for loans only and all exposures. • Examine the interconnectedness among the 34 commercial banks, 553 cooperative banks, and 352 foreign bank counterparties. • The source for the interbank bilateral exposure data and the regulatory capital data: the NBP (2017Q4). • Simulation 1: The standard Espinosa-Vega and Sole simulation testing contagion of each bank's failure. A bank is assumed to fail when losses exceed Tier 1 capital. • Simulation 2: The Espinosa-Vega and Sole simulation testing contagion due to the collective failure of the banks that fail the solvency stress test at the end of the horizon. Two thresholds will be tested: (i) a 6 percent Tier capital ratio in line with solvency stress test assumptions, and (ii) a 3.5 percent Tier 1 capital ratio in line with standard NBP assumptions. • Simulation 3: The Espinosa-Vega and Sole simulation testing contagion due to each foreign bank exposure's failure. A bank is assumed to fail when losses exceed Tier 1 capital.
Cross-sector analysis	Data and Methodology	<u>Diebold and Yilmaz (2014) Methodology</u> • Bank and insurance linkages within Poland. • Examine the spillover risks among publicly listed Polish banks and one insurance company. • Use as daily equity returns from 15/08/2015 to May 2018 for publicly listed Polish banks and insurers. The index of connectedness will be constructed based on data from 12/05/2010 but with fewer institutions. Robustness checks are made to see that results of estimations on long and short time series are consistent. • Interconnectedness measure is derived from the variance decomposition of the VAR.

Appendix VI. Cyber Risks

1. Cyber risks are monitored under financial institutions' operational risk management framework in Poland.[1] The type of cyber risks analyzed by the authorities and financial intermediaries include malware, phishing, Distributed Denial of Service (DDoS) attacks, advanced persistent threat (APT), data confidentiality and integrity breaches, among others. For the central counterparty (CCP), the monitoring of cyber risks is particularly important, given the legal requirement that the maximum recovery time for the CCP's critical functions shall not exceed two hours.

2. Financial intermediaries use business impact analysis and stress tests to assess the impact of potential cyber events. For the commercial bank, annual business impact analysis and stress tests with cyber risk scenarios are performed, with a focus on APT and DDoS type of threats. The CCP uses a model-based approach to consider cyber risk scenarios including hacking, theft or loss of data and breaches in their impact analysis. In addition, financial intermediaries developed Business Continuity Plans and Disaster Recovery Procedures to mitigate the impact of emergency events, including cyberattacks. While financial intermediaries have not purchased dedicated *cyber insurance*, cyber risks are covered by other insurances that target fraudulent activities and IT crimes.

3. The authorities have made efforts to collect information related to cyber risks, however, more granular information could only be gathered with new regulations. Currently, the NBP in cooperation with the European Central Bank (ECB) and the PFSA collect cyber-related self-assessments, as part of the Cyber Resilience Strategy developed by the ECB. The PFSA collects information on security incidents and electronic banking through the quarterly reports of key risk indicators from all commercial and cooperative banks in Poland. However, detailed information on the number, type of cyber-attacks and the incurred losses could only be collected with the issuance of the necessary domestic executive regulations.

4. At the current juncture, cyber risks are not considered systemic by the PFSA. The PFSA estimated the potential loss exposure in electronic banking channel (due to lawsuits) to be about 26 million Zloty for commercial banks, and 1.6 million Zloty for cooperative banks in 2017, accounting for about 0.001 percent of GDP in total. However, losses from potential disruption of services or indirect reputational impact from cyber risks could be much higher.

[1] The appendix on cyber risks is based on questionnaire responses from the NBP, the PFSA and financial intermediaries including the CCP and one commercial bank.

Annex I. Report on Observance of Standards and Codes: Basel Core Principles

1. This assessment of the implementation of the Basel Core Principles (BCP) in Poland was completed as part of the 2018 FSAP, jointly undertaken by the IMF and the World Bank.[1] The assessment reflects the regulatory and supervisory framework in place as of the completion of the assessment in May 2018. It is not intended to analyze the state of the banking sector or crisis management framework, which are addressed by other parts of the FSAP and technical notes. An assessment of the effectiveness of banking supervision requires a review not only of the legal framework, but also a detailed examination of the policies and practices of the institutions responsible for banking regulation and supervision.

A. Information and Methodology Used for the Assessment

2. This assessment was against the standard issued by the Basel Committee on Banking Supervision in 2012. Since the past BCP assessment, which was conducted in 2011, the BCP standard has been revised. The revised Core Principles (CPs) strengthen the requirements for supervisors, the approaches to supervision, and the supervisors' expectations of banks through a greater focus on effective risk-based supervision and the need for early intervention and timely supervisory actions. Furthermore, the 2012 revision placed increased emphasis on corporate governance and supervisors' conducting sufficient reviews to determine compliance with regulatory requirements and thoroughly understanding the risk profile of banks and the banking system. This assessment was thus performed according to a significantly revised content and methodological basis, compared to the previous BCP assessment carried out in 2011.

3. Both essential and additional criteria have been assessed, but only essential criteria have been graded by the assessors. To assess compliance, the BCP Methodology uses a set of essential and additional criteria for each principle. The essential criteria were usually the only elements in which to gauge full compliance with a CP. The additional criteria are recommended as the best practices against which the authorities of some more complex financial systems may agree to be assessed and graded.

4. Grading is not an exact science and the CPs could be met in different ways. The assessment of compliance with each principle is made on a qualitative basis. Compliance with some criteria may be more critical for effectiveness of supervision, depending on the situation and circumstances in a given jurisdiction. Emphasis should be placed on the commentary that should accompany each Principle grading, rather than on the grading itself. The assessment used a four-part grading system: compliant; largely compliant; materially noncompliant; and noncompliant, in line with the BCP assessment methodology.[2] The team reviewed the framework of laws, regulations,

[1] The Detailed Assessment Report has been prepared by Joaquin Gutiérrez (IMF, consultant) and Pierre-Laurent Chatain (World Bank).

[2] http://www.bis.org/publ/bcbs230.htm.

and supervisory guidelines and benefited from a self-assessment performed by the PFSA and comprehensive responses to FSAP questionnaires. The PFSA also facilitated access to supervisory documents and files and staff.

5. The team appreciated the excellent cooperation, including extensive provision of internal guidelines, supervisory files, and inspection reports. The assessment team held extensive meetings with PFSA officials, as well as the MoF, The Polish Financial Intelligence Unit, the industry (including a sample of Polish banks and audit companies), and other relevant counterparts who shared their views. In particular, the team would like to thank the PFSA staff, who responded to the extensive and detailed requests promptly and accurately during the assessment, at a time when supervisory staff were burdened by many supervisory and regulatory initiatives.

B. Preconditions for Effective Bank Supervision

6. An effective system of banking supervision needs to be able to develop, implement, monitor, and enforce supervisory policies under normal and stressed conditions. There are a number of elements or preconditions that are necessary for effective supervision:

- ***Sound and sustainable macroeconomic policies:*** See Macrofinancial Background section in this report.

- ***A well-established framework for financial stability policy formulation:*** See Prudential Oversight section in this report.

- ***A well-developed public infrastructure:*** Systemically important payment systems in Poland are efficient and secure. The NBP business continuity plan protects the banking sector as a whole against negative effects resulting from operational failures and the related liquidity risk. In addition, the very low failure rate and the accessibility ratios to date of systems operated both by the NBP (SORBNET2 and TARGET2-NBP) and KIR SA (ELIXIR) since 2010 reflect the high level of technical reliability of individual payment systems functioning in Poland. In emergencies, the NBP can provide collateralized short-term loans to illiquid banks for a period not exceeding three months, as a lender of last resort (LOLR). Loan recovery has been efficient in the past and a new Polish Restructuring Law (PRL) entered into force in January 2016. There is growing concern among market and industry participants that the legal system might become less supportive of creditors and investors in the future. Uncertainty on the direction of court rulings has been frequently mentioned, with an apparently increasing number of cases against banks and banks' appealing accordingly, including international investors more frequent resorting to EU case arbitration rather than to the Polish court circuits (for example, the windmill cases).

- ***A clear framework for crisis management and financial safety nets:*** See Crisis Management and Safety Nets section.

- ***Effective market discipline:*** Listed companies in Poland are required to use International Financial Reporting Standards (IFRSs) as adopted by the EU in their consolidated accounts beginning in 2005. All banks in Poland are also required to apply IFRS in their consolidated financial statements. Two smaller commercial banks, one affiliated bank and all the cooperatives and credit unions use Polish Accounting Standards (PASs), which implement relevant EU Accounting Directives. According to the Banking Act, all commercial banks and cooperative banks are subject to Pillar 3 disclosure requirements. Oversight of external auditors was strengthened in 2009 with the establishment of the Audit Supervision Committee, an independent public administration body financed from the public budget. Its duties include approval of the National Chamber of Statutory Auditors resolutions and yearly control plans as well as controlling audit plans.

C. Main Findings

Responsibilities, Objectives, Powers, Independence, and Accountabilities (CPs 1–2)

7. The responsibilities, the objectives, and the powers of the four agencies in charge of banking oversight in Poland are clearly set up by law.[3] The agencies coordinate through the FSC, and banking supervision is under the responsibility of the PFSA, as Competent Authority, which is an integrated financial supervisor. As Poland is a member of the EU, Poland's banking regulation is significantly harmonized and integrated to the EU's regime. Laws and regulations have been regularly updated, and the Polish regime in place has fully implemented the provisions of the CRR/CRD IV and the BRRD. Going forward, the Polish authorities may wish to consider posting on PFSA and other relevant authorities' websites more domestic legislations/regulations in English to permit greater accessibility to the above framework.

8. Several gaps in the law restrict PFSA regulatory powers.[4] These belong exclusively to the MoF, in which the PFSA has to rely for law initiatives and to enacting binding regulations. This hinders the speed and the flexibility of the regulatory process, which is more exposed in this manner to the political cycle. However, the PFSA has the prerogative to set business standards that it actively uses to require observance of a broad set of safe and sound banking practices. It lacks a few key enforcement powers, such as to swiftly remove managers and to remove and discipline directors serving in the supervisory board. It is also bound to a lengthy administrative process whose due process hinders its anticipatory actions. Market participants would welcome more proportionality and better structured regulatory costs assessment.

9. The governance of the PFSA and its operational capacity need improvement. Its board lacks reasonable independence and the PFSA office is hampered by limited resources. The board has not defined a clear policy framework to govern official risk tolerance, and to evaluate and to report on its effectiveness. It is subordinated in many ways to the government, which directly or indirectly

[3] Ministry of Development and Finance, National Bank of Poland, Polish Supervision Authority, and Bank Guarantee Fund (see previous section on Institutional Market Structure Overview), also discussed in CP1.

[4] The power to issue binding regulations is strictly prescribed by the constitution with the result that such regulations may only be promulgated by public bodies explicitly authorized to do so under the constitution and the PFSA has no such explicit constitutional authorization.

nominates and can remove a majority of its members without public cause. The external members on the PFSA are not independent directors dedicated to serving the agency and function at the pleasure of their incumbents without specific fit and proper requirements. The budget, the salaries, and the staff count levels of the PFSA are determined by the government, which also approves its internal organization. As a result, the Office workload is under high stress, and there is a lack of staff, with insufficient financial resources to cover its needs in spite of these being defrayed now at about one third of its maximum level to the institutions supervised.[5] The requests made by the Office to lessen these constrains have not yet been acted. Legal protection post-employment still needs enhancing and a cooling-off framework within reasonable parameters established.

Ownership, Licensing, and Structure (CPs 4–7)

10. Licensing regime for banks has been improved but is still lacking important features. The PFSA has exclusive competence for granting and withdrawing the license of banks incorporated in Poland and branches of banks located outside the EU. A new provision in the Banking Act has been added whereby supervisory board members should have adequate expertise, skills, and experience, and the draft Recommendation Z aims to foster the conditions under which banks perform their diligence on the suitability of their management. There are, however, several missing elements such as the absence of formal fit and proper tests for supervisory board members at the licensing stage; the PFSA has not developed a manual for licensing yet, and only a limited number of board members are subject to fit and proper tests.

11. The PFSA has a detailed framework to review transfer of significant ownership. However, the conditions for approving major acquisitions do not seem logical and could be improved. Major acquisitions require only notification to the PFSA while the establishment of subsidiaries abroad and branches require explicit ex ante approval. Further, the Banking Act does not restrict individual holdings in nonfinancial entities.

Ongoing Supervision (CPs 8–10, 12)

12. The risk-based approach of the PFSA has now been tested over a supervisory cycle and seems to hold well. There is a sound supervisory culture in the PFSA that operates a reasonable BION, implementing the EBA’s Guidelines (EBA/GL/2014/13) into the Polish supervisory practice. BION should be officially approved by the MoF to anchor the risk tolerance framework and engagement model of the PFSA, including supporting workload estimation to better assess resource needs. The approach of the PFSA deploys a broad mix of onsite and offsite supervisory tools and techniques within its prevailing resource constraints. However, BION is in need of recalibration to augment the discrimination power of its risk scores, by including forward-looking and stressed key risk indicators (KRIs) and other indicators from benchmarking actual risk governance and control practices to better differentiate risk profiles across banks. Without prejudice of the work by the FSC,

[5] The Office is the body instituted to assist the PFSA and its Chairman in the performance of their responsibilities as per Article 10 of the PFSA’s Act and it hosts all its technical functions and staff.

the assessment of the macroeconomic environment along the business cycle also should be better ingrained in BION following the guidelines of EBA.

13. Onsite and offsite activities are robust, but the staff is stressed due to resource unbalances. This forces a long inspection cycle in small banks and cooperatives, and lower than safer loan sampling review. Information sources, systems, and software tools seem good, although their interface for cross-checking risk scores is needed. Manuals of procedures are well detailed, although checklists could be structured from a core to an expanded assessment, leading to an impact analysis routine to graduate the depth of transactional review. Albeit, the extension of loan reviews is too short, even in this phase of the cycle, and needs to be increased. The cycle of inspection of cooperatives, now beyond five years, needs to be shortened considering the official risk tolerance to failure. The need and convenience to integrate onsite and offsite responsibilities, for example, starting with large banks and groups, should be considered to achieve synergies. This could include centralizing bank relationships for more frequent visitation and direct contact with bank management, including integrating risk assessments and ratings. These changes would help to recalibrate the workload and assess staff levels and resource needs.

14. Supervisory reporting looks good, although a few changes are recommended. The NBP collects a broad set of information with its ample powers and shares a data mirror with the PFSA based on existing legal provisions. Almost all banks report the package FINREP/COREP to the NBP on IFRS solo and group bases, and all the cooperatives under the PAS. The PFSA prepares with it a versatile Uniform Bank Performance Report (UBPR). The Office supplements the UBPR in two ways: first with an annual Self-Assessment Questionnaire (SAQ), which provides offsite access to a broad set of internal risk governance documentation, and second by using the NBP's credit database (NB300) on client exposures, which does not contain transactional information and has limited attributes. NB300 should add an indicator to flag renewal and refinancing, inter alia. In addition, migrating to a full Credit Risk Register to warehousing individual transaction data and key loan and borrower attributes would be a strategic decision. The PFSA has powers to access additional information needed, yet its investigation powers could be more clearly spelled out in case of need.

15. The legal framework and procedures for consolidated supervision with regard to the banks that are subsidiaries of European banking groups was found to be adequate. Consolidated supervision of these banks is performed for most of the groups by the ECB, and in a few cases by national respective authorities from Germany and Norway. As a host supervisor for these banks, the PFSA participates in the colleges organized by the consolidated supervisors. Participation in these colleges ensures the PFSA with necessary information to identify and assess the risks associated with each banking group. The PFSA would like to rule out the existence of undeclared horizontal-parallel banking groups (see CP12).

Corrective and Sanctioning Powers (CP 11)

16. The enforcement regime in Poland and the conditions to apply sanctions exhibit important weaknesses. The recommendations or orders issued by the PFSA are not binding acts and the moral suasion exercised by the PFSA may not be enough should urgent situations arise. The

Office misses important powers that are critical in both normal and difficult conditions. The Office cannot directly dismiss a bank's management board, either the president, vice president, or any other member. The PFSA has no power at all with respect to any supervisory board members. Another impediment to early intervention is the need for the Office to a send warning notice. There is no internal guideline that could assist the Office in determining the most adequate response in case of breach or violation. The PFSA has not yet developed in-house methods or criteria that could provide staff minimum guidance on how to apply criteria for sanctions, such as determining the severity of infringements, including for setting the quantum for fines. The PFSA indicated that criteria are enumerated in the Code of Administrative Procedure and constitute common guidelines for imposing administrative sanctions by the Commission. The PFSA and the PFIU (the latter being the only authority to enforce breaches with the AML/CFT Act) have low track records in using sanctions. Lastly, the new early intervention and resolution powers attributed in June 2016 to the BGF and the conditions of cooperation between the PFSA and the IMF remain to be tested.

Cooperation and Cross-Border Banking Supervision (CPs 3, 13)

17. Adequate information sharing arrangements are in place with all relevant domestic authorities. The legal and institutional arrangements for recovery planning, resolution planning, and executing resolutions are generally sound. However, there is scope for improved coordination on recovery and resolution planning, particularly in having a shared view of banks' critical functions. For cross-border cooperation, PFSA is in a position to exchange information and to cooperate effectively with home supervisors over Poland-based subsidiaries of foreign banks through a number of bilateral MoUs. The majority of cooperation takes place within supervisory colleges whose operations are detailed in regulations directly applicable in all EU member states.

Corporate Governance, Risk Management, Internal Control, and Audit (CPs 14, 15, 26)

18. The corpus of norms, regulations, and guidance governing corporate governance appear broad and aligned with the EU framework. However, many provisions that enrich the corporate governance regime are new (for example, the revised 2017 MDF regulation) or not entered in force yet (for example, PFSA Recommendation Z, which has been in the making since 2015). It is true that the delay is due to the fact that the text of the future Recommendation Z had to be aligned and made consistent with recent documents such as the EBA guidelines on internal governance (EBA/GL/2017/11) and the EBA/ESMA Guidelines on the assessment of the suitability of members of the management body and key function holders (EBA/GL/2017/12). Whatever it might be, effective implementation of these new Polish norms remains to be tested. The oversight of this topic has been made by the PFSA mainly on the basis of the general principle for corporate governance and Recommendation H. In addition, there are a few aspects that handicap PFSA oversight; this includes the lack of power vis-à-vis unfit or unsuitable board members, a limited vetting process, a limited interaction with supervisory board members in the course of onsite inspections.

19. Risk management has been a focus of attention since the inception of supervision in Poland. All the prudential recommendations of the PFSA include detailed qualitative elements that, in combination with the new 2017 Risk Ordinance by the MoF, create a reasonably enforceable framework of sound practices. The assessment or risk management is evident through the inspection procedures, the thematic controls in BION, and the observations made to banks. However, there is little benchmarking practice to visualize actual implementation gaps, inconsistencies, and cross industry wide issues. One issue would be the preeminent role of management rather than the supervisory board in centralizing the reporting of key central control functions, such as risk management, whereby the activism expected from the latter board would seem detached, curtailing its responsibilities somewhat. Another concern is that the determination of the risk profiles considering the market and macroeconomic environment is in need of further attention to fully embrace the SREP guidelines in EBA/GL/2014/13 (Sections 7.7 on meeting requirements over the cycle).

20. The regime governing internal control and audit in banks has been improved and is now fully compliant with the BCP. A new PFSA recommendations strengthen the position of the compliance function and imposes new duties, including vertical verifications (unless attributed to other cells) and testing. The compliance mandate has been also extended to market abuse, AML, conflicts of interest, etcetera. Another important new feature in Recommendation H relates to the acceptable scope of cooperation between the parent company and its subsidiaries within internal audit/compliance area: the scope and terms of cooperation should be defined in a formal policy (approved by the supervisory board) and may include exchange of knowledge, experience, formalized audit/compliance procedures and methodologies and possible participation in the audit/compliance process. Furthermore, the Ordinance of the MoF of March 6, 2017, on the risk management and internal control systems implements the provisions of the CRD IV in this domain. Also, the analysis by the assessors of a sample of inspection reports and letters of post-inspection recommendations have shown attention from the PFSA to the issue of internal control and audit in banks.

Capital Adequacy and Liquidity Risk (CPs 16, 24)

21. Banks report good capital levels, and the 2014 AQR findings did not reveal residual asset quality issues or significant forbearance. Capital ratios at 18.65 percent are more than 92 percent made up of Core Tier 1, thanks to conservative dividend policies by the PFSA and a more rigorous regime than the EU of risk weights for mortgages. This latter more than compensates the SME adjustment factor, with insignificant cover bonds booked, and the effect of the permanent and temporary partial use marginal in a few banks under IRB. Risk weight densities are among the highest in Europe. Banks comply with three layers of additional capital buffers and, in addition, the PFSA requires a Pillar 2 add-on for mortgages in foreign currency and is refining an algorithm to factor in its BION assessment. Leverage is taken into account in the BION methodology and banks report a robust 9.5 percent leverage ratio.

22. Liquidity requirements follow the EU (LCR) and, temporarily, Polish (long term) requirements. Target and full scope inspections review liquidity and funding risk and the reliability and effectiveness of their risk management framework. A number of minor aspects in the BION elements need refinement, such as articulating better risk appetite and strategies, capturing intra-risk considerations, reinforcing the consistency of liquidity contingency and recovery plan triggers, and explicitly visualizing stress testing into BION using stressed KRIs. As for other risks, the KRIs may need recalibration and a benchmarking practice developed, including to factoring market and macroeconomic conditions. There is need to compile bank practices regarding the implementation of outflow rates for the deposit in order to identify outliers and instill consistence if needed.

Credit Risk and Problem Assets (CPs 17–18)

23. The Credit risk assessments are an essential routine of the PFSA as per its risk-based policies. The frequency of targeted inspections for large banks covers the relevant aspects reasonably well within the prevailing resource constrains.[6] To reinforce this approach, there is the need to do attribute sampling to quantifying with reasonable precision the exceptions flagged for scoring the reliability of management and controls. It also will be essential to recalibrate the credit risk scorings used in BION by adding forward-looking KRIs, to develop proxy benchmark indicators and to obtain and factor in additional data on the behavior of the front and the back books. The limited scope of the Banking Act regarding conflicts of interest and formal requirement for board approval of significant exposures should be supplemented in regulation. A Central Credit Register to warehouse transactional information will complement the credit risk surveillance information system based on the NBP NB300 obligors' exposures.

24. Since the last BCP assessment, the authorities have continued enhancing prudential policy regarding loan classification and provisioning. The MoF amended in 2015 its Asset Ordinance for non-IFRS reporting. Recommendation R of the PFSA should be updated considering the guidelines of EBA/GL/2017/06 and blend in the nascent IFRS 9 practice, with an explicit compilation of practices observed, including condensing the doctrine set in the pastoral letters issued since 2013 on IAS impairment. Credit sampling needs to be increased from the relatively low levels now practiced, ensuring even more attention than now paid to screening refinancing and forbearance practices as per the Commission Implementing Regulation (EU) 2017/1443 , which should be brought into the 2015 Asset Ordinance.[7] Until a full Credit Risk Register is in place, the client records in the NB300 should include an attribute to report all forms of forbearance including renewal. In addition, given the lack of PFSA's regulatory powers, the MoF should set enforceable rules of collateral appraisal and provide powers to PFSA to require re-appraisals without legal challenging by the bankers.

Related-Parties Transactions, Concentration, and Country Risks (CPs 19–21)

25. The legal provisions in respect of arm's length credit decisions are detailed, but the rules governing related parties' transactions needs to be strengthened. The definition of related parties should be expanded to include close relatives or affiliations of the persons identified in the Banking Act. Also, a more general ban for Board members with conflicts of interest to not take part

[6] Banks in cycle C and cooperatives should get more attention once resource imbalances are taken care of.

[7] Focusing systematically on testing observance of paragraphs 167 and 173 of FINREP Annex 5.

in credit decisions should be envisaged. The law should also be amended to extend the list of transactions that are subject to related parties' regime.

26. The regime for concentration risks is deemed satisfactory. The PFSA applies the large exposure regime set in CRR and has issued Recommendation C concerning the concentration risk management and the resolution concerning the risk management system and internal control. These acts provide proper legal framework for the efficient identification of the significant sources of concentration risk and their implementation by banks are assessed through onsite visits and regular reporting. However, the credit reporting tool (NB300) exhibits some flaws and the long inspection cycle limits the verification of compliance with large exposure requirements.

27. Country risk is not significant. It is periodically monitored through a combination of sources such as FINREP and the NBP's reporting (NB300). Individually relevant transactions are singled out for review as necessary. Should provisioning of exposures be ever needed, the PFSA will follow the advice of statutory auditors and supplement them as seen necessary.

Market Risk, IRRBB, and Operational Risk (CPs 22, 23, 25)

28. The risks from trading activities and interest rate risk gaps are not significant in Poland. The banks do not hold complex instruments and most assets of longer tenor (mortgages) are variable rate instruments**.** No bank is using the advanced approach for computing market risk capital charge. Besides monitoring both offsite risks, the PFSA reviews them through target inspections, which are scored in BION annually and at the end of an inspection. The 2002 Recommendation G on interest rate risk in the banking book (IRRBB) is being updated to render it consistent with the guidelines of EBA/GL/2018/02 and the BCBS 2016 paper on IRRBB.

29. The PFSA has made important progress in fostering regulation and supervision of operational risk. Most if not all the observations made in the 2012 BCP report have been addressed. Furthermore, improvements have been made in terms of staffing and expertise in the areas of ICT. The analysis of a sample of onsite inspection reports also shows attention the paid to OR that has given rise to many recommendations. In addition, the offsite department of the PFSA is closely monitoring OR, in particular operational losses stemming from certain types of OR events.

Financial Reporting, Auditing, and Disclosure (CPs 26–28)

30. Important progress has been made to foster internal control and audit in banks. The issue of fitness and propriety of the members of the supervisory board and the lack of enforcement power to suspend them are still a matter of concern and are discussed in other CPs. Otherwise many of the observations made in 2012 would have been taken into account. The 2012 Recommendation H on internal control systems in banks was updated in April 2017 by PFSA Resolution 141/2017. This new regulation puts a lot of emphasis on the importance of the compliance function, particularly in the areas of staffing, independence, access to information, conflicts of interest, and the role assigned to the supervisory board over this critical function. It strengthens the position of the compliance function and imposes new duties, including vertical verifications.

31. Financial reporting and external auditing requirements are largely harmonized at the EU level. Polish banks are required to prepare financial statements in compliance with IFRS and have them certified by an external auditor, which complies with international auditing standards. Banks' external auditors belong to the networks of the four biggest global auditing firms, with the exception of the credit cooperative network, which are audited mostly by domestic audit companies. Poland also adopted on April 1, 2015, the International Standards on Auditing. It is noteworthy that the country has organized a large technical assistance program for enhancing implementation of the EU *acquis communautaire* as it relates to financial reporting in Poland, in particular through implementing a public oversight system and quality assurance system for statutory auditors and supporting institutional capacity building regarding financial reporting. However, further improvements are still needed, such as the adoption of IFRS by all banks for individual financial statements and the swift adoption of the new Recommendation L in order to increase powers of the PFSA over the audit firms, including the possibility to access auditors' working papers.[8]

32. Disclosure requirements follow the EU regime, including additional Polish conditions. The last system-wide review of disclosure practices took place in 2012 and should be updated. The Office also needs a formal routine to score Pillar 3 disclosures under BION, following a more systematic approach to compile and keep updated a reasonable inventory on the lines of the BCBS' Pillar 3 template tables. It will be particularly convenient to agree on a consistent approach between the PFSA and the Komisja Nadzoru Audytowego (KNA), in order to ensure that in the event of write-down and capital conversion (WDCC) ordered by the BGF, their respective responsibilities are well supported, providing an ex-ante consistent strategy to deal with any third-party litigation.

Abuse of Financial Services (CP29)

33. In the area of money laundering and combating terrorist financing, Poland has made clear progress in addressing many of the deficiencies identified in previous evaluations. A new law was passed in 2018 that implements the 4th EU AML Directive. The new law addresses many recommendations made by Moneyval in its last evaluation. These include the obligation of banks to appoint a Money Laundering Risk Officer, a clear definition of ultimate beneficial owner, and more dissuasive pecuniary sanctions. This new law will enter into force in July 2018. There are, however, other aspects that would merit further attention in order to improve AML/CFT supervision, including, but not limited to, the need to: (1) increase staffing for both onsite and offsite surveillance; (2) issue-specific KYC/CDD guidelines; and (3) instituting a periodic national risk assessment.

[8] The PFSA is of the opinion that the Polish Accounting Standards are sufficiently appropriate for cooperative and small commercial banks.

Annex I. Table 1. Poland: Summary of Compliance with Basel Core Principles	
Core Principle	**Comments**
1. Responsibilities, objectives, and powers	• Key powers are missing to remove members of the management board and to remove and to discipline members of the supervisory board. • The rigidities of the administrative code hinder early remedial action and may impede swift action in a crisis. • The reliance on the regulatory powers of the MoF delays the regulatory process, exposing it to the political cycle. • The investigative and information gathering powers (in the CRD IV 65.3.b sense) are somewhat limited untested. • There is need of a public approach to account formally for the costs of regulation and to enable simplified proportional requirements for non-complex institutions.
2. Independence, accountability, resourcing, and legal protection	• Lack of official diligent action to reasonably resolve the issues observed in the previous 2011 BCP assessment. • The PFSA still lacks reasonable independence and resources, its governance arrangements are trivial, and operates without a framework to manage the official risk tolerance, and to evaluate and report on its effectiveness. • There are conflicts of interest risks regarding state-controlled institutions given the composition of the PFSA. • The government directly or indirectly nominates (and can remove without public cause) a majority of members of the PFSA; its external members are not independent directors. • The government approves the budget, salaries, staff-count levels, review process, and the PFSA's internal organization, but its workload keeps under high stress, and there is lack of staff and insufficient resources to cover its needs. • Legal protection post-employment still remains to be enhanced and a cooling-off framework within reasonable parameters needs proper design and establishment. • There are no grounds specified for dismissal of vice chairman and there is lack of eligibility criteria, tenure, and dismissal grounds for representatives nominated as non-executive members in the PFSA.
3. Cooperation and collaboration	
4. Permissible activities	
5. Licensing criteria	• Formal fit-and-proper tests for supervisory board members are still lacking at the licensing stage. • The law is also subjecting to fit-and-proper testing a limited number of management board members, the president, and the CRO. • The PFSA has not developed a manual for licensing yet.
6. Transfer of significant ownership	

Annex I. Table 1. Poland: Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
7. Major acquisitions	• Differences in treatment between major acquisitions by domestic banks requiring only notification to the supervisor and establishment of subsidiaries abroad and branches in third countries requiring explicit ex ante PFSA approval. • Investments require only one-month prior notification to the PFSA. • Criteria for individual acquisitions are defined only for merger. For other types of major acquisitions, full discretion applies. • The Banking Act does not restrict individual holdings in non-financial entities as a percentage of capital, as long as they do not exceed the single counterparty exposure limits.
8. Supervisory approach	• BION remains to be officially approved by the members of the PFSA and by the MoF to anchor its risk tolerance and engagement model, including to supporting workload estimation and to reasonably assess resource needs. • BION needs recalibration to augment the discrimination power of its risk scores, by including forward-looking and stressed KRIs and indicators from benchmarking risk governance and control practices. • BION needs an integrated risk assessment for banking groups and mixed conglomerates including explicit references to capture risks from membership to a broader group, as well as any issues from unregulated parents above the consolidation point (for example, horizontal groups).
9. Supervisory techniques and tools	• Overly long inspection cycle and low loan sampling due to unbalanced workload to existing resources including overburden tasks and documentation among analysts. • Specifically, the cycle of inspection of cooperatives, now beyond five years, needs to be shortened considering the official risk tolerance to failure (also for cycle C banks). • Less-than-conveniently frequent follow-up of bank internal audit programs to leverage on them and to gauge their quality and effectiveness to rely on them selectively. • A "know-your-banker" policy should foster more frequent management visitation, suggesting the need to consider instituting a central contact point relationship manager. • Would need an in-depth assessment to elucidate pros and cons of keeping onsite/offsite activities separated or integrating them for large, more complex banks, inter alia. • The above also to evaluate the opportunity to structure the inspection assessments (into core and expanded, leading to an impact analysis routine for graduating the depth of transactional review, that should be increased). • Convenience to build up a costing tool to better account for and estimate workload and enable resource allocation planning to control and to manage the engagement model. • Need to enhance the quality assurance function scanning scores against other measures from the UBPR and CAM to benchmarking through score-ranking analysis.

Annex I. Table 1. Poland: Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
10. Supervisory reporting	• The NB300 database obligor exposure should add an attribute indicator to flag renewal and refinancing of credit transactions, inter alia (until the below is implemented). • Consider the NBP operating a full Credit Risk Register to warehouse individual transaction data and key loan and borrower attributes would be a strategic decision. • Add an additional control element in the Management Thematic Group of BION to score explicitly prudential reporting (reliability, frequency of assessment, issues).
11. Corrective and sanctioning powers of supervisors	• Recommendations or orders issued by the PFSA are not binding acts. • The PFSA misses important powers that are critical in both normal and difficult conditions: (1) It cannot directly dismiss a bank's management board, either the president, vice president, or any other member; and (2) It has no power with respect to any supervisory board members; • Fines cannot be imposed to members of the supervisory board; • A written warning notice is a prerequisite for the PFSA to step up a sanction or corrective measure under art. 138.3. • The conditions for appointing a bank's board of receivers are more limited than those applying to cooperative and credit unions. • There is no internal guideline that could assist the Office in determining the most adequate response in case of breach or violation. • Low track record in terms of enforcement. • The new early intervention and resolution powers attributed in June 2016 to the BGF and the conditions of cooperation between the PFSA and the IMF remain to be tested.
12. Consolidated supervision	• The legal framework for performing consolidated supervision is generally adequate. • However, the processes and procedures with regards to the consolidation supervision of the banking groups affiliated to the automotive industry, and the degree of understanding of the reputational risks associated with all consolidated groups are not optimal. • There is no mechanism that would ensure the identification of all undeclared mix-activity groups.
13. Home-host relationships	
14. Corporate governance	• Many provisions that enrich the corporate governance regime are very new (e.g. the 2017 MDF regulation) or not entered in force yet (e.g. PFSA draft Recommendation Z). Their effective implementation remains to be tested. • Few aspects handicap PFSA oversight, including a lack of power vis-à-vis unfit or unsuitable board members, a limited vetting process, and a limited interaction with supervisory board members in the course of on-site inspections.
15. Risk management process	• Lack of a benchmarking practice across banks using proxy benchmark indicators designed to spot risk accumulation, oddities, and inconsistencies among scores.

Annex I. Table 1. Poland: Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
	• Across-the-board need in most risk areas to optimize the information being warehoused through the offsite SAQ and the onsite CAM to support the above benchmarking. • The backward-looking orientation of BION needs more forward-looking perspective using stressed KRIs and benchmark proxy indicators (built per the above). • The risk governance role of the supervisory board need more preeminence to mitigating the lack of enforceability of its responsibilities, inter-alia. • The procedures of BION do not follow similar market and macroeconomic environment aspects as those referred to in the SREP of EBA/GL/2014/3 (sections 7.7 and 10.7).
16. Capital adequacy	• Need to finalize and set in operation the complementary Pillar 2 add-on capital procedures being developed. • Need to continue monitoring any gaps among regimes (Basel III versus EU), require compensating measures in the banks' though the above add-on, though the banks' ICAAP programs, or both (where and if significance is warrants).
17. Credit risk	• Lack of an attribute sampling practice to quantifying with precision the exceptions flagged to scoring the reliability of management and controls (as objective "irregularity" level). • Need to recalibrate the credit risk scorings used in BION, adding forward-looking and proxy benchmark indicators. • Lack of availability of essential information regarding the behavior and attributes of the front and the back books. • Limited scope in the Banking Act regarding conflicts of interest and formal requirement for board approval of significant exposures should be supplemented in regulation. • Lack of information on transaction attributes in NB300 that is limited to provide aggregated obligor exposures.
18. Problem assets, provisions, and reserves	• Lower than safe credit sampling, whose needs increase with more explicit attention paid to screening refinancing and forbearance practices per CIR (EU) 2017/1443. • Need to update the PAS set by the 2015 Asset Ordinance, including similar forbearance standards as required under FINREP Annex 5 paragraphs 167 and 173. • Need to update Recommendation R, considering the guidelines of EBA/GL/2017/06, blending the nascent IFRS 9 practice and the pastoral letters on IAS impairment. • Lack of an attribute in NB300 to report forbearance flags including renewal, refinancing, and restructuring. • Lack of enforceable collateral appraisal rules and of powers granted to the PFSA for requiring re-appraisals without challenging by bankers.

Annex I. Table 1. Poland: Summary of Compliance with Basel Core Principles (continued)	
Core Principle	**Comments**
19. Concentration risk and large exposure limits	• Low sampling for loan large exposure (LLE). • Absence of a full-fledged Credit Registry in Poland preventing the PFSA from getting some business intelligence around LLE and concentration risks. • No legal requirement that all material concentrations be regularly reviewed and reported to the bank's board.
20. Transactions with related parties (RP)	• There is no clear definition of RP in the Banking Act. • List of transactions subject to related parties' regime not broad enough. • No legal provisions ensuring that all types of transactions, exceeding the specified amounts or otherwise posing special risks, with all related parties are subject to prior approval by the bank's board. • No obligation for banks to approve, monitor, or report transactions with the party that subsequently becomes a related party of the bank. • Lack of PFSA power to deduct exposures exceeding the limit from capital when assessing capital adequacy, or to require collateralization of such exposures.
21. Country and transfer risks	• Less than significant risk exposures
22. Market risk	• No significant risks noted, though there is need (as in other risk CPs) to recalibrate BION using more forward-looking stressed and management benchmark indicators.
23. Interest rate risk in the banking book	• No significant risks noted, though there is need (as in other risk CPs) to recalibrate BION using more forward-looking stressed and management benchmark indicators.
24. Liquidity risk	• Need to compile banks' practices in implementing outflows rates per DA 25-28 to identify outliers and to obtain LCR information for significant foreign currencies. • Convenience to refine BION, better articulating risk appetite and strategies, capturing intra-risk considerations, reinforcing the consistency of liquidity contingency and recovery plan triggers, and visualizing explicitly stressed KRIs for scoring. • Need to recalibrate liquidity KRIs and to benchmark management practices, including factoring explicitly market and macroeconomic conditions.
25. Operational risk	
26. Internal control and audit	
27. Financial reporting and external audit	

Annex I. Table 1. Poland: Summary of Compliance with Basel Core Principles (concluded)	
Core Principle	**Comments**
28. Disclosure and transparency	• Lack of an updated compilation of Pillar 3 disclosure practices (the last dates from 2012). • Lack of explicit scoring of Pillar 3 disclosures under BION to keep a reasonably updated compilation, with need to formally apply the EBA/2014/14 guidelines, inter alia. • Lack of a consistent approach between the PFSA and the KNA to ensuring a robust litigation defense in case of write-down and capital conversion (WDCC) by the BGF.
29. Abuse of financial services	• The new AML/CFT Act aimed at implementing the fourth EU AML Directives was adopted in first half of 2018. • The PFSA is clearly understaffed. • Poland has not performed a national risk assessment yet. • No KYC regulations or other relevant guidelines from the PFSA. • The PFIU Handbook for AML/CFT compliance has not been updated. • The PFIU has poor track records on enforcement. • Offsite surveillance of AML/CFT could be strengthened.

Annex I. Table 2. Poland: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks	
Reference Principle	**Recommended Action**
Responsibilities, objectives, powers (CP1)	• Amend the Banking Act, providing missing powers to remove members of the management board and to remove and to discipline members of the supervisory board. • Amend the Banking Act to ease rigidities of the administrative code in the key early remedial action and crisis resolution phases. • Test and amend the investigative and information gathering powers to provide similar flexibility, as in the CRD IV 65.3.b. • Implement a public approach to account formally for the costs of regulation and to enable simplified proportional requirements for non-complex institutions. Ensure a dedicated budget and web team to update translations of banking laws, regulations, and supervisory process into English. • Ensure a dedicated budget and web team to update translations of banking laws, regulations, and supervisory process into English.
Independence, accountability, resources, and legal protection (CP2)	• Execute a plan to reasonably resolve the issues on governance, independence, and resources observed in this and in the previous BCP assessment in 2011 to provide: - reasonable independence and resources; - an effective governance framework; - an official statement of risk tolerance; - an explicit framework to report impact and accountability; and - quantify per the above two work-loan and resourced needed. • Amend the FMSA to enable the above in addition to: - ensure reasonable dedication, compensation, and independence of external members, including that these are subject to fit-and-proper test conditions; - set post-employment legal protection and a reasonable cooling-off framework within reasonable parameters; - set specific grounds for dismissal of vice chairman; and - mitigate conflicts of interest (state-controlled institutions).
Cooperation and collaboration (CP3)	
Permissible activities (CP4)	

Annex I. Table 2. Poland: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)	
Reference Principle	**Recommended Action**
Licensing criteria (CP5)	• Ensure that fit-and-proper tests by the PFSA apply to the supervisory board members; • Extend the PFSA fit-and-proper tests beyond the CFO and CRO; • Equip the PFSA with a detailed licensing manual; • Establish explicit requirement whereby the PFSA determines that the proposed legal, managerial, operational, and ownership structures of the bank and its wider group will not hinder effective implementation of corrective measures in the future; and • Establish explicit processes to determine that the petitioner has in place an adequate risk management system related to the detection and prevention of criminal activities as well as the oversight of proposed outsourced functions.
Transfer of ownership (CP6)	• Empower the PFSA to reject, modify, or reverse the change in significant ownership when this change was based on false information; and • Require banks to notify the supervisor as soon as they become aware of any material information which may negatively affect the suitability of a major shareholder or a party that has a controlling interest.
Major acquisitions (CP7)	• Improve the regime governing major acquisitions by developing clear criteria by which to judge individual proposals, beyond the case of mergers; • Specify in the Banking Act or in regulations the criteria for the authorization of cross-border activities of domestic banks by the PFSA; and • Prohibit Polish banks from exercising control over such entities.
Supervisory approach (CP8)	• Adopt a framework for the Board of the PFSA operating with an official risk tolerance policy and engagement model that support a reasonable estimation of the work load associated to BION and the adequacy of resource allocation. • Recalibrate BION to augment its discrimination power, including forward-looking and stressed KRIs and indicators from benchmarking risk governance and controls; and • Risk score in BION banking groups and mixed-conglomerates to capture explicitly the risks from membership to a broader group, as well as any issues from unregulated parents (above consolidation).
Supervisory techniques and tools (CP9)	• Shorten the inspection cycle closer to around three years and ensure more frequent target exams in cooperatives and cycle C banks, increasing coverage in loan reviews across the board; • Follow up more frequently (onsite) with the banks' internal audit programs to rely on them based on their quality and effectiveness; and • Consider performing an in-depth process assessment to elucidate pros and cons and to visualize reengineering opportunities for: - adopting a more frequent ("know-your-banker") visitation policy such as by means of a central point relationship manager; -integrating onsite/offsite activities for large, complex banks;

Annex I. Table 2. Poland: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)	
Reference Principle	**Recommended Action**
	-structuring onsite assessments into core and expanded, leading to an impact analysis routine for graduating transactional review; -building up a costing tool to account for and to control workload, enabling resource planning to manage the engagement model; and -enhancing quality assurance through systematic scanning scores against benchmarks through ranking/cluster analysis.
Supervisory reporting (CP10)	• Add an attribute indicator to the NB300 database obligor exposure to flag renewal and refinancing of credit transactions (until the below is implemented); • Consider implementing a Credit Risk Register to warehouse individual transaction data and key loan and borrower attributes; and • Add an additional control element in the Management Thematic Group of BION to score "explicitly" the reliability of prudential reporting.
Corrective powers (CP11)	• Grant the PFSA the power to dismiss management and supervisory board members; and • Grant the PFSA the power to impose fines on supervisory board members; • Align the conditions for appointing a receiver in banks with those applying to cooperative banks; • Establish formal guidelines for supervisory enforcement, linking supervisory findings to specific remedial actions, and establishing procedures for setting the severity of fines; • Empower the PFSA to issue binding acts; and • Introduce specific indicators for determining whether a bank is in crisis mode using more quantitative triggers to ensure early intervention to adverse developments.
Consolidated supervision (CP12)	• Improve the quality of information collected on the banking groups affiliated to the automotive industry; • Implement news (social media) analytics tools that would ensure the collection of the information about the events that may generate reputational risks for the supervised banks. Tool functionality also may be used in the process of the supervision of large exposures or related parties' transaction during the onsite/offsite supervision; and • Perform a deep analysis of the shareholder structure of the banks that are not part of any international financial group to ensure that there is not any undeclared mixed-activity group linked through direct or indirect holdings.
Home-Host relationships (CP13)	
Corporate governance (CP14)	• Speed up the issuance of Recommendation Z concerning rules of internal governance in banks; • Update inspection methodologies and tools to reflect the last developments from the 2017 MDF Regulation and Recommendation Z;

Annex I. Table 2. Poland: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)

Reference Principle	Recommended Action
	• Establish more frequent interaction with board members during onsite inspections to better estimate suitability, skills, expertise, knowledge of risks, etcetera; • Establish more systematic interaction between PFSA inspectors and audit committee members; • Build a database of corporate governance practices by completing a survey of the banks' governance practices and structures; • Analyze the information published by banks with the view to monitor the tendencies and practices about the remuneration policy in force in the industry; and • Conduct a thematic review for evaluating the implementation of the new standards on corporate governance.
Risk management process (CP15)	• Develop a practice for benchmarking and implement a process to compare management and control practices across banks using proxy benchmark indicators designed with a view to spot risk accumulation, oddities, and inconsistencies among scores and institutions; • Optimize the information being warehoused through the offsite SAQ and the onsite CAM to support the above benchmarking; • Compensate the backward-looking perspective of BION, adding further forward-looking indicators, such as stressed KRIs and benchmark proxy indicators (built per the benchmark practice recommended above); • Enhance the risk governance responsibilities assigned to the supervisory board mitigating centralization of reporting key control functions into the management board; and • Ensure that BION, for capital and the risk management of significant risks, follows similar market and macroeconomic environment aspects as those referred to in the SREP of EBA/GL/2014/3 (Sections 7.7 and 10.7).
Capital adequacy (CP16)	• Finalize and set in operation the complementary Pillar 2 add-on capital procedure being developed; and • Monitor banks practices, for example through their ICAAP program to compensate for differences in regimes (Basel III versus EU) if significance is warranted.
Credit risk (CP17)	• Adopt an attribute sampling practice and policy (see CP18 below); • Recalibrate the credit risk scorings used in BION, adding forward-looking (say, stressed) and proxy benchmark indicators; • Obtain and factor in the BION periodic risk assessments information regarding the behavior and attributes of the front and the back books; and • Amend the Banking Act or include in the 2017 Risk Ordinance of the MoF enhanced requirements on conflicts of interest and formal for supervisory board approval of significant exposures.

Annex I. Table 2. Poland: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)	
Reference Principle	**Recommended Action**
Problem assets and provisioning (CP18)	• Amend the Banking Act providing powers to the PFSA for requiring re-appraisals overcoming any legal challenges by bankers; • Complement the above with more precise collateral appraisal regulations issued by the MoF under the PAS applied in a subsidiary manner to IFRS reporting institutions; and • Adopt a comprehensive credit sampling policy, that: - uses (a more scientifically construed) attribute sampling to test the reliability and effectiveness of selected credit management and control elements to yield an approximated quantified risk score under BION; - conceptualizes errors flagged above a given confidence level (say, 5 percent) as “irregular” (in the sense of the Banking Act art. 135.1), determining a risk score not better than [say,] 3, subsequently empowering the PFSA to require a suite of expanded additional asset review work, including deep-dive impact quantification;[1] and - increases “coverage” (of the combined samples) in the credit reviews on and above a given threshold (say, 10 percent) for well-scored banks, and above the threshold (toward 20 and above 30 percent) as the levels of exceptions and errors in the attribute sampling, combined with the scores of credit risk management, become more adverse; • Update Recommendation R, considering the guidelines of EBA/GL/2017/06, blending the nascent IFRS 9 practice and the doctrine being provided in the pastoral letters on IAS impairment since 2013; • Update the PAS set by the 2015 Asset Ordinance including similar forbearance standards as required under FINREP Annex 5, including the criteria of paragraphs 213-268 of CIR 2017/1443 (crucial for cooperatives, inter alia); and • Add an attribute indicator to the NB300 database obligor exposure to flag renewal and refinancing of credit transactions.
Concentration risk (CP19)	• Implement a full-fledged Credit Registry integrated with a performing Business Intelligence Tool that will ensure: (1) advance validation of reported information’ (2) reporting of each individual loan; (3) reporting of the group code for loans; (4) automatic aggregation and reconciliation of larger exposure per bank or banking sector; (5) effective offsite supervision of compliance with large exposure requirements; and (6) support for the onsite inspections and more efficient sampling process;

[1] Inter alia, conducted by the PFSA, performed under its control and oversight by a bank’s internal audit or loan review function, or contracted with third service providers under terms of reference and specifications indicated by the PFSA and at the expense of the bank (which may be used to compensate the current resource unbalances).

Annex I. Table 2. Poland: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)	
Concentration risk (CP19)	• Add to the regulations the requirement that all material concentrations be regularly reviewed and reported to the bank's board; • Increase the number of large exposure loans checked during the onsite inspection, particularly in cases where the offsite supervision will flag suspicions regarding the compliance of the bank with large exposure requirements; • Implement an onsite supervision tool for loans verification that will ensure: (1) automatic upload of the credit information from the Credit Registry; (2) automatic upload of information from other registries or ad-hoc reports; (3) monitoring of the exposure dynamic of the debtor and group of connected counterparties in the banks and at the level of the banking sector; (5) reuse of the information collected during the previous inspection of inspections in other banks; and (5) inspectors to focus on analytical activities instead of spending time on data collection; and • Use a customized checklist during the onsite inspection, depending on the risk profile of the particular bank.
Transactions with related parties (CP20)	• Provide a clear definition of related parties, considering the definition provided in the footnote to this principle, and eliminate discrepancies between the Banking Act and the Commercial Companies Code; • Extend the list of transactions that are subject to related parties' regime; • Adjust the legal provisions to: ensure that all types of transactions, exceeding the specified amounts or otherwise posing special risks, with all related parties are subject to prior approval by the bank's board; -regulate the approval, monitoring, or reporting of the transactions with the party that subsequently becomes a related party of the bank; -provide power to the PFSA to deduct exposures exceeding the limit from capital when assessing capital adequacy, or require collateralization of such exposures; • Develop minimum recommendations for banks with regard to the development of policies and processes to identify individual exposures to transactions with affiliated parties, and to monitor and report such exposures by means of an independent process of verifying or auditing the credit activity; • Adjust the reporting framework and implement analytical tools for offsite supervision that will support the supervision of related-parties' transactions through automatic processes of validation and reconciliations; and • Review the onsite inspection procedures that will ensure identification of undeclared related parties' transactions before these will start to affect the financial stability of banks.
Country/transfer risks (CP21)	

Annex I. Table 2. Poland: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (continued)

Market risk (CP22)	• Recalibrate BION as seen fit using more forward-looking stressed and management and control benchmark indicators.
Interest rate risk (CP23)	• Recalibrate BION as seen fit using more forward-looking stressed and management and control benchmark indicators.
Liquidity risk (CP24)	• Review bank practices in implementing outflows rates to identify and deal with outliers and obtain LCR information for significant FG.CY. • Refine BION procedures by articulating better risk appetite and strategies, capturing intra-risk considerations, reinforcing the consistency of liquidity contingency and recovery plan triggers; • Recalibrate liquidity KRIs by including explicitly stressed KRIs for scoring and benchmarks for management and control practices; factor also explicitly market and macroeconomic conditions.
Operational risk (CP25)	
Internal control and audit (CP26)	• Establish an explicit provision requiring the internal audit department to be advised of material changes in operations of the bank; • Develop benchmarks on the design and implementation of internal control and audit requirements at the industry level; and • Perform a fit-and-proper assessment of the Head of Internal Audit and impose a notification requirement on commercial banks for the dismissal of the Head of Internal Audit.
Financial reporting and external audit (CP27)	• Promote the adoption of the IFRS by all banks for individual financial statements; • Speed up the issuance of the new Recommendation L in order to increase powers of the PFSA over the audit firms, including the possibility to access auditors' working papers; • Establish regular collaboration between auditors and supervisors at least for the systemic banks; • Arrange on a more systematic basis collective and individual dialogues with the audit firms to discuss generic issues of common interest relating to banking (and other) operations; and • Establish a formal MoU between the KNA and the PFSA for cooperation and information exchange.
Disclosure and transparency (CP28)	• Update the 2012 compilation of Pillar 3 disclosures and explicitly score the disclosures in BION, formally applying the EBA/2014/14 guidelines; and • Adopt a common approach between the PFSA and the KNA to ensure a robust litigation defense in case of write-down and capital conversion (WDCC) by the BGF.

Annex I. Table 2. Poland: Recommended Actions to Improve Compliance with the Basel Core Principles and the Effectiveness of Regulatory and Supervisory Frameworks (concluded)	
Reference Principle	**Recommended Action**
Abuse of financial services (CP29)	• Increase staffing of the PFSA and the PFIU to a reasonable level; • Augment the number of onsite visits by the PFIU to complement PFSA onsite surveillance; • Introduce into law an obligation to report fraud to the PFSA when it is material to the safety, soundness, or reputation of the bank; • Impose higher sanctions using the new AML/CFT law on banks in case of AML/CFT breaches, including imposing sanctions on senior management; • Combine sanctions from both the PFIU (fines) and the PFSA in case of grave or recurrent violations of the AML/CFT Act; and • GIFI to provide feedback to the PFSA on suspicious operations encountered during their onsite inspections and reported to the PFIU; and • Increase intensity of offsite surveillance as part of BION.

D. Authorities' Response to the Assessment

34. **The Polish authorities welcome the IMF's and World Bank's comprehensive review of the supervisory and regulatory framework in Poland.** We would like to express our appreciation to the assessment teams as we believe that every edition of the Financial Sector Assessment Program contributes significantly to the improvement of banking supervision and thus promotes the soundness of domestic financial market.

35. **The Polish authorities would also like to appreciate acknowledgement of the significant progress made since the last FSAP in 2013 through evolution of the supervisory approach of the PFSA that is now far more complete and risk-based.**

36. **Please find below comments of more general, systemic nature referring to the assessment of adherence to given Basel Core Principles as presented by the assessment team in the report.**

<u>Principle 1: Responsibilities, Objectives and Powers</u>

37. **The main source of law in Poland is the act of Parliament.** It is not possible in the light of the Polish Constitution to give the PFSA the right to set freely the prudential standards limiting this right only by the purpose, i.e. ensuring the safety and the soundness of the banking sector. On the other hand, the PFSA has the power to issue the recommendations dealing also with prudential standards. Indeed, the recommendations are not legally binding, however it is a common and established practice that banks do follow them.

38. **With regard to managers and the supervisory board of bank,** The Ministry of Finance informs that in the current draft act on amending the act on supervision over the financial market

and some other acts (UD265) there is a provision according to which the Polish Financial Supervision Authority may impose a financial penalty of up to 80% on a supervisory board or a bank management board member remuneration, with the minimum wage determined based on the Act of 10 November 2015 on the minimum remuneration for work, for each subsequent month of taking up this position, payable after three months from the date of delivery of the application referred to in art. 22d (1), if it does not meet the requirements imposed on members of the management board and supervisory board in art. 22aa of the Banking Law Act and was not dismissed by the competent bank body or did not resign within three months from the date of delivery of the application referred to in art. 22d (1) above of the Act, bearing in mind the need to ensure the effective functioning of the statutory bodies of the bank and the prudent and stable management of the bank.

Principle 2: Independence, Accountability, Resourcing, and Legal Protection For Supervisors

39. The peer review conducted by FSAP recommended actions that would comprise inter alia strengthening of the independence, resources and legal protection of the supervisor. As implementation of those changes would require amendments to legal acts regulating the financial markets, we would like to comment on the progress made since FSAP mission visits in Poland in January and May 2018. On 30 November 2018, the *Act of 9 November 2018 on the amendment to some legal acts in connection with the strengthening of supervision over the financial market and protection of investors in that market* has been published (hereinafter: the Act).

40. The new legislation should substantially strengthen the financial independence of the PFSA, as it implements fundamental changes to the organisation and functioning of the PFSA, which — following entry into force of the draft law — will become a State legal entity. The PFSA new legal setup means that it will be independent in disposing of funds, which will allow for more flexible allocation of funds according to its current needs. Another amendment would be that the fees for supervision and examinations would be classified as the revenues of the PFSA. The increase of the charge (fees) imposed on the market would be proportional to the costs of supervision.

41. Pursuant to the Act, on January 1, 2019, the PFSA Office will be transformed into a state legal entity and will be financed directly from fees paid by supervised entities of the financial market. At present, both the PFSA and the PFSA Office are financed from contributions and fees paid by supervised entities, but via the state budget. Such a change will allow the PFSA Office to be independent in disposing of funds held, as its budget will not be covered by the expenditure rule, which should translate into a free allocation of funds in line with current needs. These may include additional workforce, thereby more frequent and detailed inspections of supervised entities and strengthening analytical facilities.

42. It should also be stressed that pursuant to the Act, all employees of the PFSA will become employees of the 'new' PFSA, which will allow for the continuity of the supervisory activities of the Polish supervisor.

43. Thus, the new organisational form takes into account the draft FSAP recommendations in the area of increasing the independence of the supervisory body.

The Act also extends the composition of the PFSA Board (the decision-making body) to include four additional members, i.e.:

- the representative of the Prime Minister who will ensure proper planning and implementation of the State policy in relation to the financial market with voting rights;

- the representative of the Bank Guarantee Fund (BFG) who will improve the functioning of supervision and increase the effectiveness of possible restructuring activities [without voting rights];

- the representative of the President of the Office for Competition and Consumer Protection (PL: UOKIK) who will ensure better coordination of supervisory activities undertaken in connection with the functioning of the financial market and facilitate the undertaking of activities relating to competition and consumer protection [without voting rights];

- the representative of the minister (member of the Council of Ministers) competent for coordinating the activities of special services who will ensure prompt identification of potential threats relating to the functioning of the financial market [without voting rights].

44. The extension of the composition of the PFSA Board is aimed at ensuring better cooperation between State authorities in the field of the financial market. Close cooperation between the existing members of the PFSA Board and the representatives of the above-mentioned authorities will allow for a more effective identification of threats that may potentially expose financial market participants to harm / risk.

45. Supervision over the financial market, regardless of the country or the degree of market development, determines the safety of market participants. Over the years, along with subsequent experience and observations, the rules as well as institutional financial supervision models have evolved in such a way that supervisory activities are more and more effective and thus increase the safety and stability of individual financial market sectors, which at the same time is an essential foundation for further market development. Based on the acquired knowledge and experience, over 10 years ago, a supervisory authority was created, which was entrusted with supervision over all institutions of the financial market sectors. Taking over the entire market by a single authority allows a holistic view taking into account all connections to minimize the risk of irregularities. In addition, it should be emphasized that the PFSA is an independent body operating on the basis of legal provisions. Therefore, the Ministry of Finance does not see any justification for including the PFSA to the NBP.

46. Narodowy Bank Polski (NBP) shares the view presented in the Report saying that moving financial supervision into the orbit of the NBP is one of the possible solution that would strengthen the supervision, including its independence.

47. Moreover, in NBP's view this option seems to be the preferential one and optimal in the Polish case. First of all it would ensure a clear separation between ownership and supervisory function of the state, which is especially important given the increasing presence of state-owned firms in the financial sector. Reintegration of PFSA into the central bank would also enhance coordination of micro- and macro-prudential policy under one roof, therefore allowing for more comprehensive and timely identification and analysis of systemic risks and facilitating solution of potential conflict between both policies.

Principle 11: Corrective and Sanctioning Powers of Supervisors

48. The PFSA would like to address a number of issues that are relevant to the presented FSAP report regarding corrective and sanctioning process (Principle 11). Firstly, the PFSA is aware of the impediment in the form of the obligation to send a warning notice, before imposing the sanction. To deal with this issue, an amendment to the Banking Law was proposed, which would allow the PFSA to impose a monetary sanction on the bank without the need to issue warning notice. Currently, the proposed legislation is being analysed by the Ministry of Finance.

49. Secondly, the PFSA noticed the need to have the power to directly dismiss members of the management board of the bank and have been notifying the Ministry of Finance since December 2015 about the need to introduce such regulation in Banking Law.

50. Thirdly, the PFSA agrees that there should be a possibility to impose administrative sanctions on members of the supervisory board of the bank. The recently proposed amendment to the provision gives the PFSA the power to impose pecuniary sanction on the members of the supervisory board of the bank in the event when the supervisory board does not comply with the PFSA's order to dismiss members of the board. Consideration was also given to the possibility of granting the PFSA the power to dismiss members of the supervisory board or to suspend their powers for a certain time. Currently, the above-mentioned proposal is being analysed by the PFSA.

51. Additionally, it should be noted that apart from the criteria regarding imposition of pecuniary sanctions indicated in the Administrative Procedure Code, specific criteria concerning sanctioning banks are stated in Article 138(3)(c) of Banking Law. The regulation states that the PFSA, while deciding on the severity of the sanction, should consider gravity of the infringement and its duration, reasons of infringement, current financial situation of the sanctioned bank and previous infringements of Article 138 of Banking Law. It also needs to be underlined that the PFSA has got its internal regulations regarding the examination of the financial situation of the sanctioned bank. The PFSA should take into consideration income, net revenue from sales, financial results, equity and other essential information. Therefore, although the PFSA does not have internal guidelines setting specific quantum for fines, the existence of criteria set in statutory law should not be ignored for the purpose of the FSAP report. Such criteria are used in other administrative proceedings and the PFSA gained relevant experience in applying them correctly in the enforcement cases, which was highly valued by the administrative courts on several occasions.

52. Moreover, referring to the main findings of the report which reads that (Paragraph 56) '*The PFSA has no power at all with respect to any supervisory board members*', we would like to note that according to Article 22d of the (Polish) Banking Act, the supervisory powers of the PFSA are the same as towards the management board. Therefore, they could be assessed as insufficient, but not as 'non-existent'.

Principle 16: Capital Adequacy

53. With regard to the report's findings (included in the detailed assessment of Essential Criterion 5 of this Principle), the PFSA would like to raise that Recommendation W has a universal nature and is designed for all types of banks (commercial and cooperative) irrespective of the scope of proliferation of the models in their risk management practices and irrespective of whether they use internal approaches or not. Its aim is to give guidance and promote sound model risk management practices across institutions. Standards covered by Recommendation W are not for validation purposes: Recommendation W considers the international standards on sound risk model management practices.

Principle 18: Problem Assets, Provisions, and Reserves

54. Regarding the FSAP recommendation on the adoption of the comprehensive credit sampling policy, it should be pointed out that the increase in the sample of loans to be audited will, as noted in the FSAP report, entail an increase in the number of inspectors available for loan reviews. At the same time, the PFSA would like to point out that the currently applied sampling methodology has taken into account the bank's credit risk profile and concentration of credit exposures in the bank's portfolio. In case of significant irregularities and a significant scale of irregularities resulting from the on-site loan review, the inspectors increase the sample of loans above the target level in order to carry out a proper evaluation of the portfolio.

55. Moreover, during the on-site examination, detailed research is also conducted with regard to the processes relating to credit risk identification, monitoring and mitigation.

Principle 19: Concentration Risk and Large Exposure Limits

56. Regarding the opinion presented in the FSAP report (detailed assessment, Essential Criterion 2) on the effectiveness of the on-site process regarding large exposures, in the PFSA's view, this opinion is not exactly accurate. The PFSA examination findings show that deficiencies have been identified during the inspections in this area. Post-examination recommendations prescribed removal of the irregularities regarding identification and records of group of interrelated entities. It should be noted that although the PFSA has reported this issue during the reconciliation of the report, the FSAP didn't require relevant evidences.

57. The PFSA also explains that the on-site examination manual clearly presents the types of concentration risk that banks are recommended to identify, including industry concentration, geographical concentration, same type of collateral, FX concentration.

58. With regard to the FSAP recommendation regarding customisation of the checklists used, the PFSA explains that although the available checklists, as well as procedures, are universal, their practical usage differs. The application of respective checklists and procedures is based on the risk profile of a given bank, so the risk focus is applied respectively.

Principle 20: Transactions with Related Parties

59. As the FSAP assessors rightly pointed out, the legal definition of related parties is not aligned with the definition proposed for example in IAS 24. It should be stressed that the PFSA has to operate within the framework provided by the law and the PFSA has no power to issue legally binding regulations. As a regulator of financial market, the Ministry of Finance would be the authority best suited to follow-up on the recommendations regarding the strengthening of the legal framework in case of widening the definition of related parties. The PFSA however, based on present experience, would duly consider proposing that the Ministry of Finance should make amendments to the legal framework regarding related parties regime.

60. Regarding the recommendation to adjust the reporting framework and implement analytical tools for off-site supervision that will support the supervision of related-parties' transactions through automatic processes of validation and reconciliations, the National Bank of Poland, which is responsible for the reporting framework, has started work to implement the Credit Register, based on the AnaCredit concept, developed by the European Central Bank. The PFSA will participate in the process and it is likely that the recommendation would be addressed by this new reporting system.

61. Regarding the FSAP mission guidance to develop recommendations for banks on the development of policies and processes to identify individual exposures to transactions with affiliated parties, and to monitor and report such exposures by means of an independent process of verifying or auditing the credit activity, we understand this recommendation, the proposed rule, should be an element of Pillar 1 requirements. As Pillar 1 requirements and the definition of capital are specified in the directly applicable CRR (Capital Requirements Regulation), the competent authorities cannot set additional requirements, if it is not envisaged in the CRR. Therefore, such requirement cannot be implemented at the national level.

62. Following changes in the law and reporting system, the onsite inspection procedures that will ensure identification of unreported related parties' transactions will be duly revised.

Principle 26: Internal Control and Audit

63. Regarding the opinion expressed in the FSAP report that no comparison is made between banks with a view to establishing best practices and improving the practices of weaker systems, the PFSA explains that during an onsite inspection, with the use of dedicated software, data points are collected on every assessed area of bank's activity. It should be emphasised that with regard to on-site supervision perspective, the PFSA has implemented a number of actions to ensure a consistent approach during on-site inspections, e.g.:

- Quality Assurance Expert responsible for ensuring the consistent approach inter alia post-inspection recommendations
- CAM – IT system which supports on-site inspectors – enables easy comparisons of data (and findings) collected during inspections. The data are compared by inspectors during on-site examinations.
- The quality control of the most important post-inspections products (like official reports, post-inspection recommendations) realised by the deputy director of the on-site inspections department (DIB) and director of DIB;
- Issuing, in the one-year cycle, guidelines for examiners regarding risk areas which describe the priorities of examination in a given year and topics that should be precisely examined during inspections at banks.

Principle 27: Financial Reporting and External Audit

64. One of the recommendations of the report with respect to Principle 27 is the following: '*Promote the adoption of IFRS by all banks for individual financial statements*'.

65. In the opinion of the PFSA, the Polish Accounting Standards (PAS) are adequate for cooperative banks and small commercial banks. Application of PAS does not pose any problem for cooperative banks, especially as IFRS 9 is ambiguous in some areas. It should also be noted that the cost of adoption of IFRS could be very high and not justified by any possible benefits for those institutions. Given the above, in our opinion, such a recommendation is not appropriate (also in the context of the principle of proportionality).

Principle 29: Abuse of Financial Services

66. The FSAP report recommendation regarding Principle 29 comprises the following recommendation: "Combine sanctions from both the PFIU (fines) and the PFSA in case of grave or recurrent violation of the AML/CFT Act".

67. The PFSA would like to emphasise that from a legal perspective it is not possible to combine the PFSA and PFIU sanctions.

68. With regard to the FSAP recommendation regarding the combining of sanctions from PFIU and PFSA, it should be underlined that the new AML/CFT act indicates that the PFSA is responsible for sanctioning AML/CFT breaches after on-site visits. It is impossible to combine sanction from the FIU and the PFSA because of this provision of the new law, but also due to fundamental laws of any "continental law" legal system "ne bis in idem", which forbids the authorities to sanction twice for the same (it is reflected in Article 2 of the Polish Constitution). Any sanction imposed by the PFSA will be final and the banks cannot be sanctioned twice. Should this happen it would be a valid reason for the court's dismissal of one or both sanctions.