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TECHNICAL NOTE—COOPERATIVE BANKS AND CREDIT UNIONS

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TECHNICAL NOTE

COOPERATIVE BANKS AND CREDIT UNIONS

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Glossary

ABs	Affiliating Banks
AMV	Asset Management Vehicle
BA	Banking Act
BCP	Basel Core Principles
BGF	Bank Guarantee Fund
BGF Act	Act on the Bank Guarantee Fund, Deposit Guarantee Scheme, and Resolution
BPS	Bank of Polish Cooperatives
CMG	Crisis Management Group
CRR	Capital Requirement Regulation
CU	Credit Union
DGF	Deposit Guarantee Fund
D-SIBs	Domestic Systemically Important Banks
FSAP	Financial Sector Assessment Program
IFRS	International Financial Reporting Standard
IPS	Institutional Protection Scheme
MoF	Ministry of Finance
NACSU	National Association of Co-operative Savings and Credit Unions
NBP	National Bank of Poland
NPL	Nonperforming Loan
P&A	Purchase and Assumption
PFSA	Polish Financial Supervision Authority
OSII	Other Systemically Important Institutions
SGB	Cooperative Banking Group
SME	Small- and Medium-Sized Enterprises
SRR	Special Resolution Regime
WOCCU	World Council of Credit Unions

EXECUTIVE SUMMARY

This technical note reviews the cooperative bank and credit union sectors. It focuses on: (i) the situation of the two sectors that are both in states of transition; (ii) the regulatory and supervisory arrangements; and (iii) the safety net and resolution regime within the context of the crisis management framework. In addition, key perspectives are provided as to the sustainability of institutional models and the sectors within a modernizing and competitive banking sector.

This note was prepared using information from the authorities and market participants that was received in the first semester of 2018 at the time of the visit of the authors. Although in some instances there is subsequent improvement in the performance of some cooperative banks and credit unions, the authors believe such changes do not modify substantially the main conclusions and recommendations made.[1]

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. Combined, cooperative banks and credit unions represent less than 8 percent of deposit takers, though more importantly they serve about 18 percent of the population.

Cooperative Banks

The supervisory arrangement for cooperative banks is evolving to a "supplementary" supervision model. Under EU legislation,[2] 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.[3] 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).

The IPSs perform internal control functions that complement supervision by the Polish Financial Supervision Authority (PFSA),[4] 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

[1] Most figures in this text were collected during the FSAP Missions in January/February 2018 and in April/May 2018. This technical note provides in some instances other updated figures as of June 2018 as provided by the authorities usually in footnotes.

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

[3] 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.

[4] See Art 22i of the Act on the Functioning of Cooperative Banks, their Association and Associating Banks from year 2000.

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.

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 need to affiliate back within an existing network;[5] (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.

The two existing IPSs and their affiliating banks 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 focused 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.

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 the PFSA, the IPSs (as applicable), and the BGF undertake resolution activities that limit spillovers, namely the use of purchase and assumption transactions.

Credit Unions

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.

[5] In this case, the number of cooperative banks that had been seeking to establish their own affiliating bank had decreased to 42 entities by August 2018. Moreover, of these, more than 30 cooperative banks have applied to be accepted into an existing IPS (some already successfully).

The capital adequacy of the credit union sector at end-January 2018 remains below the regulatory minimum of 5 percent, reflecting the troubled situation of larger credit unions.[6] 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.[7]

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.

Policymakers 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).

Table 1. Poland: Main Recommendations

Recommendation	Agency	Time
Cooperative Banks		
Strengthen the supplementary internal control and safety net arrangements for cooperative banks to address elevated risk with (i) those cooperative banks that will remain outside an IPS or need to reestablish within an existing network; and (ii) for the existing two networks, their affiliating banks have legacy issues of weak asset quality and capital	PFSA, MoF, ABs, IPS	I
Develop a strategy for the cooperative bank sector to promote further integration/ consolidation of the sector to reduce vulnerabilities, gain economies of scale, and strengthen solvency of the sector, including promotion of services through the affiliating bank networks	PFSA, NBP, MoF, Affiliating Bank Networks, National Associations	NT
Focus the scope of activity of affiliating banks to the provision of services to their members	Regulator (MoF /PFSA)	NT
Enhance member participation by making the signing of shares financially more attractive and by facilitating member participation in cooperative bank decision making/elections	Regulator (MoF /PFSA); National Association	MT

[6] Following some restructuring actions after the April/May 2018 IMF visit, the PFSA reports to us that at mid-2018, average credit union capitalization increased to 4.4 percent. In addition, the PFSA reports that for the group of 25 mostly smaller credit unions also at mid-2018, all have a capital adequacy ratio above the 5 percent requirement.

[7] The PFSA after this analysis reports some improvement in capital for some credit unions, though the sector average remains below the regulatory minimum.

Table 2. Poland. Main Recommendations (concluded)		
Credit Unions		
Develop and implement a restructuring strategy focused on (i) resolving non-viable credit unions through exit; (ii) evaluating measures to consolidate viable credit unions through mergers with other credit unions or banks; and (iii) strengthen recovery of nonperforming loans (NPL)	PFSA, MoF, NASCU	NT
Strengthen the credit risk management capacity of viable entities	PFSA, NACSU	MT
Policymakers to weigh the practicality for retention of a separate credit union sector and instead transitioning viable credit unions into the cooperative-commercial bank system	MoF, PFSA, NACSU, NBP, BGF	NT
Further evaluate the capital requirements for credit unions* to ensure appropriate consideration of risk and a level playing field—including evolving the capital requirement for credit unions to a harmonized 8 percent minimum	MoF, PFSA	MT
Supervision		
Strengthen the supervisory capacity of PFSA by increasing (at least during a transition period) the available resources to oversee the cooperative banks and credit union sectors	MoF, PFSA,	I
The quality of the IPS internal control and audit practices will need to be strengthened to align with PFSA supervisory requirements. Moreover, each affiliating bank should meet higher capital requirements	PFSA	NT
Revise the reporting requirements and supervision methodologies for cooperative banks and credit unions to ensure proportionality as far as feasible under applicable EU regulations	PFSA	MT
Evaluate the definition of criteria for auditors of the different institutions; if feasible establish a short list of qualified auditors for the different types of entities, considering their complexity	Regulator (MoF /PFSA)	NT
Further enhance the monitoring by IPS, align methodologies with PFSA	PFSA	MT
Further enhance the monitoring of all cooperative banks—including through a shortening in the supervisory inspection cycle—until relevant capacity is established in the Institutional Protection Schemes	PFSA	NT
Identify additional cooperative bank capital instruments that are compatible within the EU CRR	MoF, PFSA	NT
Unify accounting standards among sectors and institutions*	PFSA	MT
Finalize the process of evaluation of credit unions	PFSA	NT
Eliminate the apparent duplication of supervisory functions and credit union reporting to NACSU and PFSA*	PFSA, NACSU	NT
Safety Nets		
Ensure that all protection schemes complementing the BGF (e.g., the IPS, NACSU) can provide the same level of support in terms of liquidity and solvency funds while requiring adequate monitoring. There should be greater harmonization of the liquidity and solvency support funds as to relative size, capacity, and accessibility	Regulator (MoF /PFSA/NBP)	MT
Require recovery plans for networks (including the possible need to address multiple distressed cooperative banks simultaneously); and "significant" credit unions and cooperative banks undergoing rehabilitation	PFSA, BGF, MoF	I
Remedy legal and other impediments to use resolution tools in context of affiliating banks, cooperative banks, and their IPS networks	MoF, BGF	I

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

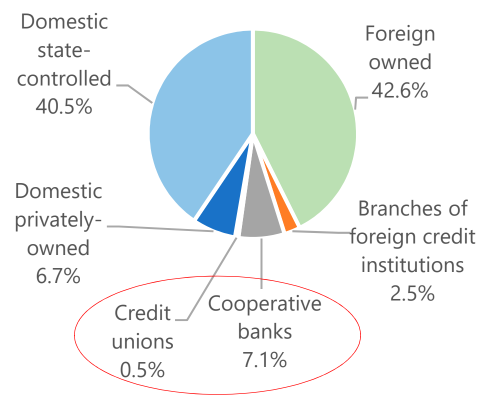
* These regulatory / supervisory suggestions for credit unions would lose importance if the decision is made to transition the viable credit unions into the cooperative-commercial bank system as suggested above.

INTRODUCTION

A. Financial System Context

1. Cooperative banks have been part of the banking system for over 150 years, while credit unions emerged more recently around 1990. In 2018, the nearly 600 cooperative banks and credit unions (CUs) serve about 7.5 million people, equivalent to about 18 percent of the population. Cooperative banks are important lenders to agriculture and small- and medium-sized enterprises (SME), while credit unions mainly provide consumer finance, for which their services are important for pensioners. Combined, cooperative banks and credit unions represent less than 8 percent of deposit takers and are not viewed as systemic.

Share of Deposit Takers
June 2018



Source: PFSA

COOPERATIVE BANKS

A. Background and Financial Performance

2. In the 1990s, the cooperative sector experienced significant consolidation, yet there are still 550 cooperative banks (see Figure 1). The sharp decline was a consequence of a closure of poorly performing cooperative banks and consolidation compelled by an increase in the minimum capital requirement.

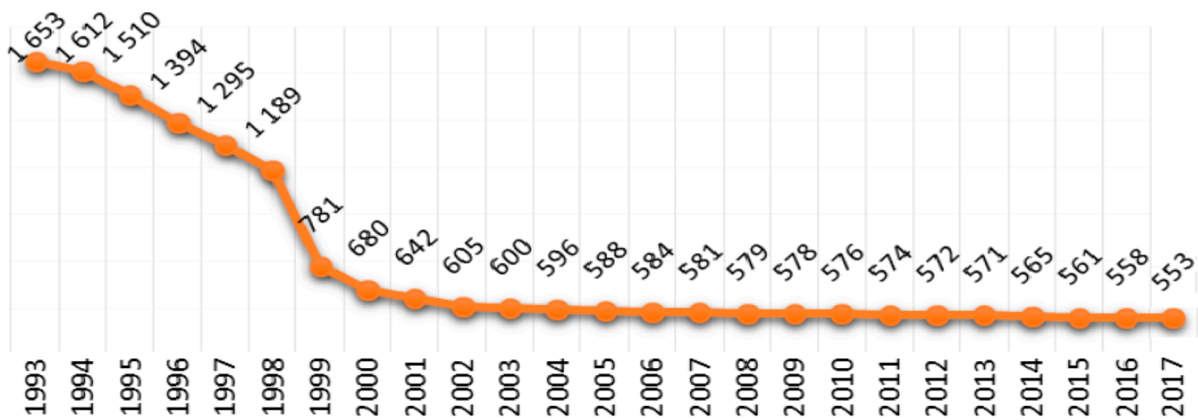
3. Cooperative banks are organized according to the Cooperative Bank Act, December 2000. The act establishes two tiers of **cooperative** banks: (i) those with capital above the equivalent of five million euro that comply with the standards applied to commercial banks to operate nationally as independent entities; and (ii) those with minimum capital between the equivalent of one and five million euro (which may only operate regionally) as well as all those above five million that do not comply with all applicable standards to operate as independent entities and that must belong to an "affiliating bank" network.

4. The affiliating bank is a commercial bank owned by the member cooperative banks.[8] Currently, there are two affiliating bank networks. The two affiliating bank networks further provide

[8] According to Cooperative Bank Act, other entities (different from affiliated cooperative banks) can own shares of an affiliating bank. Independently on the percentage of shares owned, their voting rights are capped at 24 percent of all votes. However, in both banks, other entities own only small (much less than 24 percent) number of shares.

financial and non-financial services to their participating cooperative banks that include general management support, liquidity management, and branding.

Figure 1. Poland: The Number of Cooperative Banks, December 2017



Source: Polish Financial Supervisory Agency.

5. The overall situation of most cooperative banks is that they remain well capitalized, with moderate levels of NPLs largely in line with the overall banking system, though with weak profitability (see Table 2)**.** It is noteworthy that NPLs are higher among larger cooperative banks, reflecting their engagement with enterprise borrowers, the consequences of the absorption of weaker (and/or failing) cooperative banks, and a lower level of connection with their local communities. Larger cooperative banks represent around 65 percent of the cooperative bank sector assets but only 40 percent of its members. At end-2017, there were 162 cooperative banks with a capital base above 5 million, though only 2 operate independently reflecting that most would not comply with the supervisory requirements for a stand-alone bank.

6. Most small cooperative banks show better financial performance indicators (higher capital and lower NPL ratios) than larger cooperative banks. Reflecting closer ties to their local communities and lower exposure to enterprise loans. Despite this, smaller cooperative banks have the disadvantage in that they lack scale for access to technology and third-party services, which affects their competitiveness.

7. While cooperative banks have expanded at a rate above inflation, more recently there has been a shift in lending towards housing finance, which has grown by 17 percent between June 2016 and June 2017, while enterprise lending has remained flat. While the enterprise loan portfolio shows a poorer performance with an NPL ratio of 15 percent, housing loans seem to perform better with an NPL ratio of 2 percent. These differences are explained on the one side by likely weaker underwriting standards of the enterprise loans and the young stage of development of the housing portfolio on the other.

Table 2. Poland: Performance of Cooperative Banks by Size
(as of end 2017)

Capital (CET1)	Number of entities	Average Regulatory Capital ratio (in percent)	Average Return on Assets (in percent)	Average NPL ratio (in percent)	Average of Loan Growth (in percent)
< EUR 1 million	4	-1	-2.95	15.14	-0.21
EUR 1–5 million	387	22	0.59	4.51	5.71
EUR 5–10 million	114	18	0.59	6.24	4.61
> EUR 10 million	48	16	0.68	9.91	3.08
Total:	553	17	0.57	5.41	5.21

Source: Staff calculations using NBP and PFSA data.

8. **The vast majority of cooperative banks meet the regulatory capital requirements but raising capital from members or external sources when needed is complicated by applicable regulations and the dividend policies of cooperative banks.** For cooperative banks, earnings retention is the most important source of capital generation. The holding of shares is not attractive for members, as most cooperative banks chose not to pay dividends[9] while shareholders face higher risks than depositors. The volume of cooperative bank share capital has decreased from PLN 736 million in 2013 to PLN 513 million as of September 2017, while the number of share-holding members declined from 1.04 million to 970 thousand. Moreover, member shares in cooperative banks cannot be counted as regulatory capital but in the case of those cooperative banks that adjust their statutes to limit the withdrawal of shares so that they can be used to cover losses, if needed. To reverse the decline in member share-holdings, the cooperative banks and their networks will need to improve the attractiveness of share ownership by achieving greater efficiency and improving on services. As a further measure to expand capital sources, other common equity tier 1 capital instruments for cooperative banks should be authorized.[10] Such instruments could be used for pre-emptive recapitalization of individual cooperative banks or to facilitate mergers of weak though still solvent cooperative banks.

9. **There is limited appetite for mergers between cooperative banks, unless prompted by the supervisor/IPS, but the lack of scale affects performance and stability.** Recent mergers have been the result of the prompting of healthier cooperative banks to absorb ones in trouble, in limited cases with some financial support from the IPS. Nevertheless, there will need to be greater economies of scale for the sector, and the authorities and industry will need to identify incentives towards consolidation. While the performance of larger cooperative banks relative to the smaller cooperative banks is not stellar, the cost structures for cooperative banks generally remain too high

[9] According to PFSA's dividend policy most cooperative banks (with satisfactory financial standing and SREP score) may pay dividend. Most banks, even those fulfilling all capital requirements, do not take advantage of it and retain all earnings.

[10] CRR Article 29 introduces the possibility of alternative capital instruments that qualify as common equity tier 1 for mutual, cooperative banks, and other similar institutions. Instruments could include qualifying debt convertible into capital.

(particularly compared to commercial banks). While some economies of scale are achievable through the affiliating bank networks (e.g., internal control and back-office functions), ultimately, necessary higher efficiency will require cooperative banks to consolidate.[11]

Affiliating Banks

10. The cooperative banks when grouped according to their affiliating bank networks are in better condition than the affiliating banks individually (Figure 2). One of the affiliating banks has sustained losses that has required their member cooperative banks (who are also their shareholders) to provide capital support. At this juncture, the business model of the two affiliating banks is in transition towards lower risk return activities. While the two affiliating banks appear stable, they exhibit weakness compared to most commercial banks. Moreover, if confronted with a severe event or development, there would be a spillover to the network of cooperative banks, for which the individual recovery plans are underdeveloped. The two affiliating banks as members of an IPS are not required to prepare individual recovery plan, however one of the affiliating banks is subject to a group rehabilitation plan with the PFSA. In the case of the affiliating bank under a rehabilitation plan with the PFSA, the support through the IPS solvency fund in the form of a subordinated liability was essential. In any event both affiliating banks require continued close monitoring as they continue a path to stronger solvency.

11. The affiliating banks show lingering signs of distress caused by past weak lending practices. In contrast to commercial banks, whose corporate loan portfolio is mostly healthy, the corporate loan portfolio of the affiliating banks has caused significant losses. Initially, the strategy of the affiliating banks was that corporate lending would bolster their income, sometimes carried out in syndication with one or more affiliated cooperative bank, however, poor underwriting in many cases led to high defaults. At end 2017, NPLs were more than 10 percent of loans for the two affiliating banks (see Figure 2).

[11] Considerations like these led to the operational merger of the Rabobank network in the Netherlands into one consolidated bank early in 2016. Although operations have been fully merged and their management centralized, the participation of the members in the shareholders' assembly continues to be carried out through delegates that are elected in local assemblies.

Figure 2. Poland: Performance of Existing Affiliating Bank Networks

Performance of Cooperative Banks by Current Network Affiliation
(as of end-2017)

Combined Cooperative Banks According to Network Affiliation *	Number of Entities	Average Regulatory Capital Ratio (in percent)	Return on Assets (in percent)	NPLs to Loans (in percent)	Asset Growth (in percent)
Cooperative Banking Group (SGB) Network	199	20.07	0.58	4.44	8.03
Bank of Polish Cooperatives (BPS) Network**	352	21.10	0.57	5.93	8.21
Independent Cooperative Banks	2	15.90	0.52	11.47	6.82
Total	553	20.70	0.57	5.41	8.14

* Excludes the affiliating bank.
**The data shows the inclusion of the cooperative banks according to historical member affiliations within the BPS network, 47 of the cooperative bank members have proposed to form a third network, and an approximate dozen have not yet met obligatory requirements for affiliation.

Stand-Alone Affiliating Bank Soundness Indicators
(as of end-2017)

Affiliating Bank	Total assets (PLN billion)	Percent of Banking System	Capital Adequacy Ratio (in percent)	NPL Ratio (in percent)	NPL Coverage Ratio (in percent)	Return on Equity (gross in percent)	Return on Assets (gross in percent)	Cost/ Income Ratio (in percent)
SGB	19.47	1.30	14.62	15.51	38.05	0.97	0.05	60,32
BPS	23.69	1.60	10.83	12.10	43.80	2.06	0.07	70.77

Source: SGB, BPS, and staff calculation using NBP and PFSA data.

B. Transition of the Cooperative Bank Sector

12. The cooperative bank sector is in transition (see Table 3). There are two existing networks that have met the conditions established by Law. The larger of the 2 schemes is anchored by Bank of Polish Cooperatives (BPS) and affiliates 303 cooperative banks, most of which are expected to remain in the network. The difference to its current 352 members includes those cooperative banks that had proposed to form the third network (which was not authorized by the PFSA) and the 2 cooperative banks applying to become independent. The second network is anchored by SGB and affiliates 199 cooperative banks.

Table 3. Poland: Affiliations of the Cooperative Bank Sector in Transition
(as of April 2018, in millions of PLN)

Affiliation	Number of Cooperative Banks	Aggregate Assets**	Average Assets per Cooperative	Average NPL Ratio (in percent)	Total Number of Depositors
BPS*	303	67,864	224	5.8	3,506,895
SGB	199	46,997	236	4.4	2,422,666
Proposed affiliating bank ***	47	8,735	186	6.2	446,545
Independent	2	4,725	2,363	11.5	241,968
Applying to be independent	2	1,991	995	14.1	176,154
Grand Total	553	130,310	236	5.4	6,794,228

* This figure includes a small group (two to three) of cooperative banks that are likely to remain outside a network.
** Does not include assets of the affiliating commercial bank.
*** The proposed third affiliating bank subsequently was declined authorization in the licensing process.

Source: Staff calculation using NBP and PFSA data.

13. Prominent in the transition period is the need for contingency arrangements. Key aspects and risks from the transition are:

- **Some cooperative banks that have not yet committed to an IPS network are large and/or weak and may not be able to rejoin.**[12] These cooperative banks may not meet eligibility requirements because they are either too large or too weak relative to the limited size of resolution/liquidity funds available in the existing IPS networks.

- **Despite having comparatively high NPL ratios, the two existing independent cooperative banks and the two entities applying to operate independently meet all requirements concerning capital, including obligatory capital buffers, liquidity, quality of assets and organizational arrangements.** While none of the cooperative banks individually are systemic, their larger size does present a vulnerability to the cooperative bank sector.

- **Contingency arrangements as needed should be prepared.** The dozen cooperative banks slated to remain outside of an IPS raise concerns. Possible actions for the two groupings are: (i) some cooperative banks could achieve independent status, which itself would require PFSA approval with associated further challenges; (ii) some cooperative banks may restructure including consolidation with an existing cooperative or commercial bank; or (iii) there could be a resolution using the appropriate technique under the special resolution regime (SRR); for example, the purchase and assumption.[13]

[12] This particularly refers to those cooperative banks that earlier sought to establish a new affiliating bank, that subsequently was not authorized.

[13] Further discussion of the SRR is provided in an accompanying FSAP technical note, *Crisis Management and Financial Safety Nets*.

C. Supervision

Official Institutions

14. Cooperative banks are supervised by PFSA, their deposits are insured by the BGF and could draw on liquidity support from the National Bank of Poland (NBP). Through dedicated legislation, the PFSA has the formal responsibility for cooperative banks in the same manner as commercial banks. The PFSA is responsible for supervising recovery planning, the taking of early supervisory intervention measures, and deciding if an entity is considered failing, likely to fail, or is insolvent. The BGF, consistent with EU obligations, is the official institution that oversees the deposit insurance arrangements and is the resolution authority for cooperative banks, affiliating banks, and credit unions. The NBP, as the monetary authority, acts as provider of emergency liquidity assistance, and is, together with the PFSA, BGF, and MoF, a member of the Financial Stability Committee that in turn is responsible for macroprudential policy.

15. The PFSA's supervisory approach is risk based, with most bank supervision resources prioritized to larger commercial banks. Migrating banking supervision from the NBP in 2008 to the PFSA, widening the supervisory perimeter to include credit unions in 2012, and strained funding as allowed by the government's budget has weakened the ability of PFSA to deliver supervision promptly and sufficiently. Consequently, the PFSA's prioritization of resources to larger commercial banks and the objective towards relying more on the supplementary supervision by the IPSs, reflects that the PFSA is strained.

16. The onsite supervisory presence of inspections for cooperative banks lacks depth while the frequency of on-site inspections is too low. Cooperative banks are inspected on site depending, among other factors, of their SREP score and the time elapsed since the previous inspection. The actual experience is that the inspection frequency takes on average between six and eight years. For the affiliating banks (i.e., BPS and SGB), which are commercial banks, the inspection presence is annually, though with limited scope (targeted examinations are performed), covering all risk aspects over a three-year period. For these, the PFSA supervisory presence reflects their generally weaker condition, though the shortage of staff resources has resulted in a still longer inspection cycle on average, as well as a lower loan review sample than otherwise is appropriate.

17. To improve the adequacy of supervision, the resource constraints at the PFSA need attention. Key administrative issues affecting the effectiveness of supervision are further identified in the Basel Core Principles (BCP) assessment.[14] That assessment identified deficiencies at the PFSA including, among others, the inability to set a budget which has resulted in a shortage of financial resources, and a high work load on the current staff. Given the PFSA's resource constraints, the conclusions reached regarding credit risk governance in the cooperative banks seem insufficient to

[14] See Poland Detailed Assessment Report of Observance of Basel Core Principles for Effective Banking Supervision prepared as part of the FSAP.

assess the actual reliability and effectiveness of their credit risk management capabilities, including to detect and to address signs of loan forbearance and potential insider abuse, and related-party lending.[15]

Affiliating Bank Models

18. The IPSs provide some internal control functions that the PFSA seeks to better align with its own supervisory and stability objectives. After the establishment of the IPS schemes, PFSA has been monitoring closely the quality of the internal control activities conducted by the schemes, questioning particular findings of the IPS reports. Efforts to strengthen the IPSs remains a work in progress. This close oversight, combined with the PFSA's sanctioning powers, should strengthen the internal controls within the IPS networks. In addition, through the PFSA's supervisory process, the activities and business model of affiliating banks should be refocused towards lower credit risk in favor of services provided to member cooperative banks in exchange for fees. Credit activities could be limited to loans in participation with member cooperative banks subject to strict loan underwriting mandates.

19. Ensuring obligatory audits of annual financial statements conducted by external auditors are another measure to strengthen the affiliating bank model. The cooperative banks are free to determine their external audit firm, in many cases the adequacy of the audits have been an area of concern. It is frequent that the PFSA has had to require supplemental audits by a second external auditor to determine the solvency status of cooperative banks and/or to apply appropriate corrective actions. Related, is that for the two affiliating bank networks, BPS uses the International Financial Reporting Standard (IFRS), while SGB and all cooperative banks use local accounting standards. It is recommended that both affiliating banks report using IFRS to ensure the proper determination and comparability of the risks and financial health of their business.

20. The IPS system may contribute to moral hazard if there is insufficient regard paid to risks incurred by member cooperative banks. A strengthening of measures should include at the two IPSs the development of the staff capacity, standards, and a deeper review of control systems, information systems, and actual loan samples. The IPSs should have clear rules of operation to reduce implicit moral hazard, particularly around support arrangements for cooperative banks affiliating within an IPS network. Other related shortcoming identified in the BCP assessment include insufficient coverage of refinancing and restructuring of loans and treatment of related-party exposures.

[15] The BCP assessors were not able to access individual supervisory risk assessments, notably of the IPS, so as to fully understand the PFSA's composite internal ratings. Based on discussions, the risk ratings of cooperative banks do not appear to provide granularity and instead cluster on central medium risk observations. Individual supervisory risk assessments were presented to BCP assessors during the anonymized read-out sessions.

D. Financial Safety Nets and Resolution Framework

21. The safety net arrangement will vary for individual cooperative banks and associated networks according to three arrangements: whether the cooperative bank (i) is part of an affiliating bank network with a dedicated IPS; (ii) is part of an affiliating bank network under the Integrated Affiliation model;[16] or (iii) operates as an independent cooperative bank able to meet capital and supervisory requirements to operate standalone. Further to the IPS model are arrangements for the two existing affiliating banks.

22. Under the IPS model, member cooperative banks are required to contribute to both a solvency fund and a liquidity fund that as a first resort can be used to support a member bank experiencing stress. The liquidity fund derives from dedicated deposits placed by member cooperative banks in the affiliating bank. The amount of the deposit is agreed by a contract between the membership and each IPS, based on the members' insured deposits. Because of the existing support fund arrangements, the deposit insurance premium paid by the member cooperative banks to the BGF is 50 percent of what would normally be paid by commercial banks, independent cooperative banks, or cooperative banks that do not participate in an IPS. Nevertheless, the BGF remains the backstop for failures that result in: (i) an insured deposit payout and/or (ii) resolution transactions if the IPS in some manner declines or is unable to provide support to a member cooperative bank. The two existing IPSs have different contribution requirements to their respective solvency and liquidity funds, thus providing a different degree of safety for its affiliates.

23. The two IPS structures, which are still relatively new, have now been tested with the resolution of two failing cooperative banks (see Box 1)**, though not without additional risks.** Each resolution required the decision of the general assembly of the institutional protection scheme. In the transactions, the IPSs facilitated the merger of the failing banks with healthier cooperative banks. The transactions showed some promise of the IPS model. Key challenges to the model will be the possibility that the IPS is not able to participate because loss exposure is too great, or the general assembly chooses to not support the operation. There is no legal regulation that mandates participation. So far, the decision to participate in resolution was driven by the reputational effect of showing that the new system could work and not necessarily considering a cost of the resolution. That latter decision-making argument could increase the risk of moral hazard in those weak cooperative banks.

24. The law foresees the possibility of an Integrated Affiliation model, which allows cooperative banks to affiliate with an affiliating bank, but without an IPS.[17] The law requires that like the IPS model, the integrated affiliation model is to have support funds to provide for

[16] This is an arrangement foreseen in the law that requires PFSA approval, including the granting of a license for the establishment of a new affiliating bank. At the current stage, this model has not yet been implemented in practice.

[17] 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 in the 4Q2018 decided against licensing the affiliating bank.

liquidity and solvency of the member cooperative banks.[18] The support fund arrangement will be pursuant to a contractually binding Affiliation Agreement, though there will be no IPS. The FSAP supports a robust approval procedure including (i) ensuring that the timeline for building of the two support funds is credible; and (ii) cooperative banks eligible to join will need to achieve high prudential standards to reduce the risk that they will need to tap into their small support funds in the near term. The FSAP further supports that there be no reduction in the premiums paid to the BGF for deposit insurance because there is no IPS.

Box 1. Poland: Resolution Experience Under the IPS Model

Both IPS schemes have each resolved failing member cooperative banks in coordination with the PFSA and other official authorities. Each IPS employed a somewhat different structure for the resolution.

In the first case, the IPS assisted the acquiring bank's purchase of NPLs at book value through a loss sharing arrangement that reversed provisions to maintain capital levels through the acquisition process. The transaction was further supported with liquidity arranged by the IPS. In this operation, the NPLs transferred at book value after provisions were reversed, which was allowed because of guarantees provided by the solvency fund. The successor will realize value for the NPLs over time, with the solvency fund making up any valuation shortfall in the NPLs. Shareholders of the failing cooperative bank kept their participation in the shareholding of the merged bank. There are no bail-in tools at the level of the IPS, instead, the resolution costs will be absorbed by the solvency fund provided by member cooperative banks.

In the second case, the IPS facilitated the purchase of assets and assumption of liabilities (a P&A) of the failing bank by a healthy successor bank. In the transaction, NPLs were acquired at book value by an asset management vehicle supported by the solvency fund. The asset vehicle is owned by the IPS and holds the loss exposure from the transaction. The NPLs have been entrusted for recovery to a private asset management company. While a contract is set for performing this duty, the incentive to proceed efficiently to maximize the recovery of the problem portfolio is not clear. The IPS should also review their operational procedure to minimize the cost of the IPS intervention in the shortest term.

The decision of an IPS to support the recovery process is not exempt of risk. The participation of an IPS in a recovery process depends on a decision of its general assembly. The resolution approaches to date have been ad hoc without clear processes. Evident in the two resolutions, are incentives of higher moral hazard, as the costs of rescue have been borne by IPS.

25. While the IPSs generally are intended to be a source of stability, the large members and special characteristics add complexity for recovery and resolution planning. The PFSA and BGF address the IPS networks collectively and do not require standalone individual bank recovery plans for the member cooperative banks.[19] This collective treatment also includes the two affiliating banks that are classified as domestic systemically important banks (D-SIBs) due to their

[18] Cooperative Bank Act (December 2000) chapter 3B.

[19] While recovery planning is addressed collectively, there is a separate resolution plan for each cooperative bank.

interrelationships with the cooperative bank network. Given the affiliating bank's designation as D-SIBs there should be individual recovery plans.[20]

26. In the event an affiliating bank were to fall into greater distress, the consequence for the member cooperative banks in the IPS would be severe.[21] The cooperative banks in the IPS are required to deposit 20 percent of non-financial clients' deposits in the affiliating bank. By end-2017, affiliating banks' total interbank deposits equalled 29 percent of total non-financial client deposits in cooperative banks. Meanwhile, interbank deposits financed as much as 71 percent of the affiliating banks' assets. The deposits establish the liquidity fund and are not covered by the BGF. That generates a risk of liquidity shortage in the safety net of cooperative banks members of the failing affiliating bank.

CREDIT UNIONS

A. Background

27. Credit Unions emerged as a new type of financial service provider in the wake of the economic transformations starting in 1990. Initially employee focused, credit unions served key industries to provide deposit and loan services (mainly consumer loans). In the initial stages, credit unions were strongly supported by a donor funded program executed by the World Council of Credit Unions (WOCCU), which provided substantial technical assistance for the definition of harmonized norms and procedures for the training of employees, management, boards of the newly founded entities as well as for the establishment of the National Association of Credit Unions (NACSU). In time, their membership was opened also to other people, allowing the emergence of credit unions with a geographical bond.

28. Credit Unions operate under the Cooperative Credit and Savings Unions Act from 2009, that was amended in 2012 and consolidated in 2017. According to this Act and in difference to Cooperative Banks, Credit Unions can collect funds exclusively from their members, extend loans to them, perform financial settlements and distribute insurance contracts. As of today, credit unions are not allowed to undertake non-credit risk activities such as cash handling or money transfer services, and their framework lags that of banks in terms of the use of electronic means (e.g., the opening of accounts via internet or the use of electronic signatures).

29. After a period of high growth accompanied by weak credit controls, the credit union sector has since undergone significant consolidation following the assignment of supervision to the PFSA. At end 2012, 55 credit unions with assets of PLN 17 billion served 2.6 million members; by September 2017, the industry had shrunk to 35 credit unions with assets of PLN 10 billion

[20] See Poland FSAP technical note Crisis Management and Financial Safety Nets for further discussion on this recommendation.

[21] See Poland FSAP technical note Stress Testing and Systemic Risk analysis, section on contagion and systemic risk analysis. The contagion analysis highlighted the interrelationship between the individual cooperative banks and their network affiliating bank.

providing services to 1.7 million members. The need for consolidation was necessary to address weak credit unions, which only became apparent once the PFSA took over supervision.

30. All credit unions must affiliate with NACSU, a cooperative entity set up by all credit unions. Among NACSU's objectives is maintaining the sector's financial stability through oversight functions and by providing for an industry-financed stabilization fund. NACSU represents the sector, provides policies and procedures, monitors the performance of each credit union, and undertakes reporting duties to the authorities. NACSU can provide support in case of liquidity or solvency problems, though its capacity is strained due to underfunding and the high concentration in larger credit unions. As of September 2017, the 3 largest credit unions comprised about 80 percent of the sector's assets and 65 percent of its membership. The largest credit union, whose size is twice that of the largest cooperative bank, manages alone around 55 percent of the sector's assets. Until 2012, NACSU was solely responsible for supervising all credit unions.

B. Financial Performance

31. The situation of the credit union sector is stressed as sector solvency continues to deteriorate and most of the larger credit unions no longer comply with capital requirements (see Table 4). At end-June 2017, only 26 credit unions with 15 percent of the system's assets complied with the Capital Adequacy Requirements (CAR) of 5 percent. Only 23 credit unions had positive income. The CAR for the industry is only 2.95 percent which is well below the 5 percent requirement. The sector does not generate a positive net income. Following the takeover of supervision, the PFSA mandated that 28 out of 37 credit unions prepare rehabilitation plans, 5 of the individual plans later were accepted, while 3 credit unions were placed into receivership. Only one of the five largest credit unions complies with the 5 percent CAR and only two report positive net income through end-June 2017.[22]

Table 4. Poland: Regulatory Capital Ratio of the 35 Credit Unions Operating in September 2017
(In percent)

	Dec-14	Dec-15	Dec-16	Sep-17
Regulatory Capital Ratio	4.50	5.60	3.20	3.00
Return on Assets	0.50	-0.01	0.04	0.01

Source: Polish Financial Supervisory Agency.

32. As in the case of cooperative banks, individuals owning shares of credit unions is less attractive and member shares are not always recognized as part of capital, which affects solvency. The credit unions confront severe challenge in instances of weakness towards convincing prospective members to contribute capital, which is exposed to loss relative to deposits. As a

[22] The PFSA now reports that at June 2018, the sector average capital adequacy increased to 4.4 percent, though it remains below the regulatory requirement.

consequence, the volume of share capital has decreased as generally the only source of capital is retained earnings.

33. The financial performance of credit unions remaining in the market is hampered by poor loan quality (see Table 5) **and recovery practices, as well as past mergers of weak credit unions without sufficient restructuring.** Prevalent are practices of loan "evergreening" through the roll-over of otherwise NPLs with the extension of further credit for interest accrued and unpaid. In addition, collateral appears difficult to execute due to the current legal procedures. While there has been some improvement to loan underwriting, corrective efforts have fallen short. Noteworthy is that the quality of loan portfolios at small credit unions is also showing higher deterioration, while that of medium and large credit unions is slightly improving.

Table 5. Poland: Evolution of the NPL Ratio for Credit Unions
(In percent)

	Dec-14	Dec-15	Dec-16	Sep-17
All Credit Unions	26.6	19.9	19.9	16.3
Small Credit Unions*	18.5	22.8	26.2	28.5
Medium and Large Credit Unions	26.7	19.9	19.8	16.2

*Credit Unions with assets less than PLN 20 million.
Source: Staff calculations from data of the PFSA.

C. Supervision

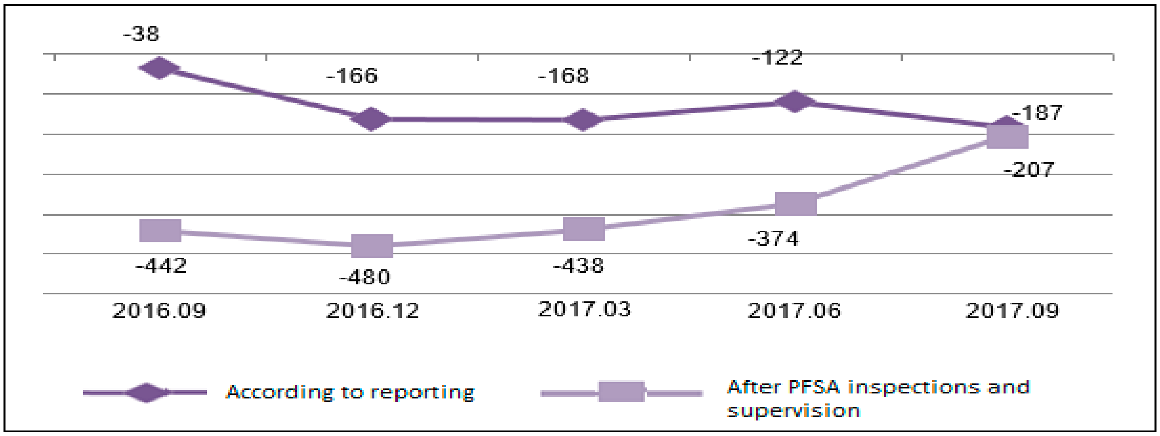
34. In 2012, the PFSA took over the supervision of credit unions, which was previously provided by NACSU. Since 2013 the on-site examinations in CUs have been performed by PFSA examiners, who completed at the end of 2016 the examination of all credit unions. The review by the PFSA revealed significant deficiencies in the valuation and the performance of the loan portfolios of these entities (compared to the NACSU valuations), which resulted in a substantial need for new loan loss provisions and adjustment to equity positions (see Figure 3). In time, these discrepancies have been reduced such that the valuations to measure capital adequacy (shortage of funds) are now more aligned.

35. The capital regime for credit unions should be aligned with the sector's risk profile and better conform to a harmonized 8 percent international standard. While the current 5 percent minimum capital ratio requirement may have fostered competition in financial services, it has eroded the sector's financial stability.[23] Credit unions can only accept deposits from their members, which in principle, should promote closer monitoring by the membership, however, the loss experience remains elevated and that a higher minimum should be required. The lower capital requirement was already noted in the Technical Note on Credit Unions included as part of the 2012 FSAP. A new

[23] There is no minimum amount of capital required (in contrast, cooperative banks must comply with the EU minimum equivalent of EUR 1 million if part of an affiliating bank network or EUR 5 million if standalone).

regulatory approach to credit union capital requirements in line with that required of cooperative and commercial banks seems appropriate.

Figure 3. Poland: Shortage of Capital in Relation to the Capital Requirement
(In millions PLN—CUs Operating at end-September 2017)



36. In the past, credit unions have followed their own standards in accounting, while audits have not been reliable, leading to a situation of diminished transparency. While steps have been taken to curb poor audit practices, auditors of credit unions (and those of financial institutions generally) do not need to meet PFSA accrediting requirements, which should change.

37. The current supervisory roles of NACSU and PFSA may overlap and their information requirements for CUs diverge, generating additional work for CUs to comply. While the PFSA has the main supervisory responsibility over the sector's entities, NACSU maintains according to the CU Act a supervisory function. The association of credit unions can contribute to strengthen the supervision process and efficiency in the system, by facilitating the centralization of some common activities and the strengthening of the internal control systems. Duplications should be avoided, particularly in the reporting system. In this sense the supervisory functions of NACSU should be limited to the internal control auditing function, to help PFSA in its supervision.

38. The recovery of the nonperforming portfolio of the credit unions should be improved. In past credit union resolution cases, the institutions that have acquired failing credit union assets have recovered substantially more value of the transferred portfolio. Based on this, there appears scope to improve the solvency of credit unions (as well as resolvability) through a strengthening of NPL collections practices.

39. Although there is some level of collaboration between the PFSA and NACSU, it seems advisable that a joint action plan be defined to enhance the performance and capitalization of the sector. Specific coordinated measures to achieve this objective should include prominently actions for the recovery of overdue loans (as opposed to the sale of faulty loan portfolios), which would directly improve the level of capitalization of the involved credit unions. Following the experience in other countries, a loan recovery strategy should be based on a detailed analysis of the

affected loan portfolios differentiating by client segments, including incentives for the staff of the affected credit unions towards prioritizing the recovery of those loans that appear easier to collect.

D. Financial Safety Nets and Resolution Framework

40. The Credit Union Act of 2009 as amended in 2012 and 2017, and the Bank Guarantee Fund Act of 2016 together with two EU Directives provide the deposit insurance and resolution framework.[24] Before 2013, credit union deposits were covered by the Credit Union Mutual Insurance Society, which was established in 1995. Since 2013, the BGF covers the deposits of credit unions and is the resolution authority for failing credit unions. This framework allows the BGF to facilitate the takeover of failing credit unions by other credit unions or by banks using the various BGF's various resolution tools, including insured deposit transfers and purchase and assumption transactions following a least cost criterion.[25] The range of tools available for BGF are like those available to other insurance deposit funds, including support for P&A transactions.

41. The BGF manages two Deposit Guarantee Funds (DGFs) for failing credit unions, while NACSU manages a stabilization fund to support weak but potentially viable credit unions. There is a dedicated DGF for credit unions that can be buttressed by the DGF for banks, which has happened. The cross subsidy among the funds has occurred because the DGF for credit unions proved insufficient. The NACSU's stabilization fund, which is intended to be 2 percent of the sector's assets, is based on ex-ante contributions from credit unions and NACSU´s net profits. If NACSU refuses to provide support to a weak credit union, usually this results in its failure. The BGF is able to act without the consent of the credit union shareholders.

42. The early intervention of credit unions usually requires financial assistance of BGF, which is available only by application of the failing institution. As of now the restructuring of credit unions is possible after individual notification approved by EU, as there is no State Aid Scheme which allows BGF assistance in self-restructuring processes of the CU. This assistance is available upon application of the troubled credit union and should be in line with credit union's recovery plan. Assistance can be implemented as a subordinated loan or guarantee. The financial assistance should not exceed the costs of fulfilling the BGF statutory or contractual mandate regarding deposit guarantee. This financial support is used to remove insolvency threats. However, there is not any indication for the availability of liquidity support to the acquiring entity after the process, if it were needed.

43. Since the PFSA assumed responsibility for the supervision of the credit union sector, several credit unions have exited the market through orderly liquidation or assisted mergers. For the former, the liquidation is pursuant to a court supervised judicial process that includes the payout by the BGF of insured deposits and the BGF taking over the depositors' claim. For the assisted

[24] Prior to that, the deposits made at credit unions were guaranteed by the Credit Union Mutual Insurance Society that was established in 1995.

[25] The PFSA is responsible for the decision to trigger of the start of a resolution process and the BGF is responsible for the resolution once it is underway.

mergers, the BGF (and in some cases the NFSCU) provide financial incentives to an acquiring bank (including a cooperative bank) or credit union. Such support is provided only to the acquiring entities and is conditioned on the PFSA's favorable opinion and that the transaction meets appropriate least cost criteria.

44. As the authorities have gained a better understanding of the situation of the credit union sector, the time required for resolution has decreased as well there has been greater use of less costly resolution techniques. Initially most failing credit unions resulted in their liquidation, including the payout of insured deposits, increasingly resolution of failing credit unions is via the purchase and assumption technique, which results in cost savings and a less disruptive resolution in comparison.

45. Complementing the measures to restore the health of the credit union sector, it is also recommended to assess options to facilitate the mobilization and signing of share capital more attractive for credit unions and their members. While the measures to be undertaken are like those proposed above for cooperative banks, the objective of this measure would be centered more around the mobilization of additional equity than on increasing member participation.

46. The risks and vulnerabilities of the system must be worked out. To address these shortcomings, the authorities should undertake a variety of measures to continue facilitating the exit of non-viable entities and to strengthen and consolidate viable entities.

47. There are few incentives for ex-ante resolution mergers in the credit union system. The mergers or takeovers of credit unions have occurred mainly in the middle of a resolution process with financial support provided by the BGF to payout insured deposits. Greater effort is needed to incentivize that other credit unions, except the larger ones, to merge while still viable to take advantage of economies of scale, mainly due to the granular shareholders and their limiting capacity to raise new capital.

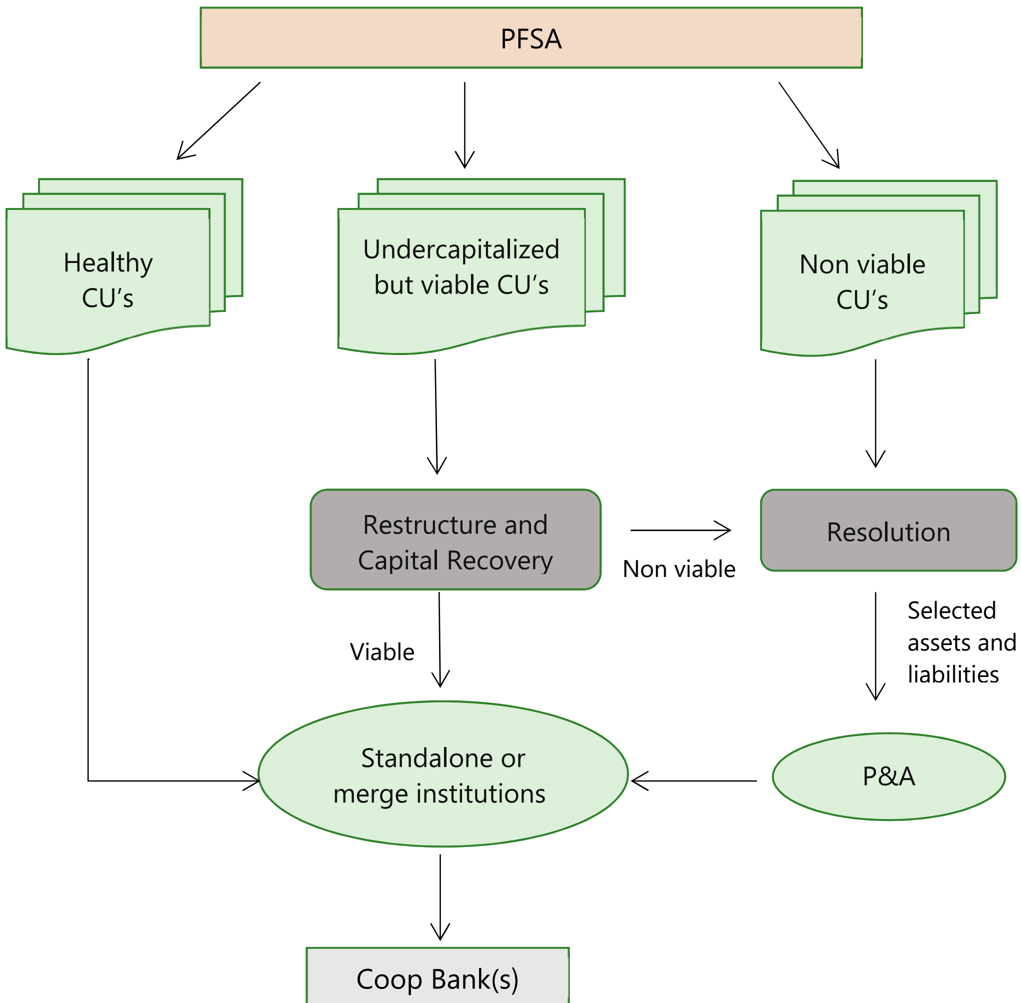
48. As the cost of deposit payout of credit union depositors is very high, other solutions should be promoted and the capacity of authorities for early detection strengthened. To reduce the high cost of resolutions, greater coordination of the supervisory authorities is needed—the PFSA needs to achieve greater awareness of deterioration likely to cause failure and initiate a resolution process more promptly. If the PFSA's abilities are limited by resource constraints and early detection is inadequate, then resolution costs will be higher.

49. The credit union sector requires restructuring towards the consolidation of viable entities and resolution of non-viable entities through exit—time for a new approach? (See Box 2.) While subsequent reform of the existing sector could be considered, including some form of recapitalization of weak credit unions and changes to the Credit Union Act 2009, the alternative could be a phase out of the entity type all together. Such an approach would acknowledge that the credit unions constitute less than 1 percent of deposit takers, with most of the sector deeply troubled. Policymakers need to decide whether a standalone credit union sector still remains

appropriate and, if not, define a strategy to transition viable credit unions to become or consolidate with cooperative banks.

Box 2. Poland: Contours of a Consolidation Strategy for the Credit Union Sector

The contours of a strategy. The authorities would segment the credit unions into three groups (i) those that are solvent and viable; (ii) those that could be viable with some restructuring; and (iii) those that are not viable and requiring resolution. The strategy would foster market solutions to promote consolidation by merging viable credit unions with other viable credit unions or banks (including eligible cooperative banks) and for non-viable credit unions their resolution through the application of the purchase and assumption tool to transfer deposits and performing loans to a successor credit union or bank.



Source: Staff.