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THE ROLE OF REGULATION, ETHICS AND LEADERSHIP IN THE POLISH COOPERATIVE BANKING SECTOR

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Abstract. *The stability of the banking sector is of key importance at a worldwide level as it is proved by the financial crisis of 2007 and 2008. The structure of the Polish cooperative banking system did not change in a fundamental way after the global financial crisis. Focus on co-financing of local initiatives and social involvement has been always very important for the Polish cooperative banks. The Polish cooperative banks are a key intermediaries in direct payments' flow between EU funds and farmers. Yet, this banking sector had gradually undergone restructuring processes in order to adapt to the EU requirements. This study attempts to identify the role of banking regulation, ethics and leadership on the development of cooperative banks in Poland. The analysis of the activities of cooperative banks was based on information provided by National Bank of Poland (NBP), Polish Financial Supervision Authority (KNF) and literature review.*

Keywords: *cooperatice banks, banking regulations, leadership in banking.*

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Introduction

The global financial crisis clearly has had a profound impact on UE regulatory framework. At the level of the European Union, many European banks were bailed out by their national governments as a result of global financial crisis of 2007–2008, (Lannotta, Nocera and Sironi, 2013). Recapitalization of the banks as a form of anti-crisis measures has revived the debate concerning the proper banking regulations. In the context of banking regulations at the UE level, literature has suggested that the UE banking landscape changed into direction of a more integrated Banking Union (Beck and Casu, 2016). The European Union implemented new requirements concerning bank capital and risk monitoring in 2014. The commercial and cooperative banks in Poland are obliged to meet the capital requirements laid down in EU regulations (package Capital Requirements Directive IV/ Capital Requirements Regulation) and follow the guidelines of banking sector regulators on capital adequacy ratios. Polish Financial Supervision Authority applied additional capital requirements to all banks at the minimum level of the Total Capital Ratio at 12%, higher than the CRDIV/CRR standard of 8% in order to avoid micro- and systemic risks in the financial system. In order to strengthen the Polish cooperative banking sector two group of cooperative banking associations were created (Group of BPS and Group of SGB) and Institutional Protection Scheme for Polish cooperative banks was implemented. It was motivated by regulatory requirements and in order to stay ahead of commercial banks and credit unions competition (Soloma, 2017).

Literature review

Ethics has become an important topic of inquiry in a variety of disciplines, including management, sociology, psychology, finance and economics. For example, business relationship development implies that customers have confidence in their providers. This may be specifically true in the banking service context, where switching costs often prevent customers from terminating the relationship. The loss of public trust in banks as public trust institutions has been linked to financial institutions unethically selling risky products to customers and investors (Węcławski 2015). Ethical concepts require a holistic approach when dealing with decisions of bank customers. Zinkin (2014) identified some important ethical issues in banking:

1. The collapse of system integrity where risks are chopped into thin slices and then distributed between different players.
2. Failure of free markets' ability to make sensible and ethical decisions. For example, the higher expected rate of return by investors, force banks to create risky securities such as subprime securitization instruments.
3. Market malpractices and failures due to inefficient regulatory integrity.
4. The need for organizational integrity by creating self-discipline, values and culture as these core principles must be properly integrated in the bank. On the other side, ethics are effected by cultural norms, believes and values of the organization.

Results

Zinkin (2014) argues that personal ethical decisions in banking are shaped by rules, incentives and soft elements (Figure 1). It is useful to draw attention to mind-sets of soft elements. The nature of the mind-sets of company's sales personnel has been the subject of considerable discussion.

As Zinkin (2014) points out, different types of financial service have different mind-sets. For example investment bank "traders live in a win-lose world and seem to be motivated by the size of their bonus while retail bankers used to appreciate the importance of customer-centricity". This last approach adopted by the salesperson in financial services is seen as the key to understanding the degree of customer satisfaction with the relationship (Bejou et al., 1998).

There is also evidence to suggest that ethics and trust play an important role in the customer's evaluation of relationship quality. As noted by Bejou et al. (1998), the degree to which a customer trusts a particular salesperson will be positively influenced by the belief that the salesperson is operating in the customer's best interests. It should also be emphasized that the decisions of financial institutions customers are taken in conditions of risk and uncertainty. According to McKnight and Chervany (2002), trust is central to interpersonal and commercial relationships because it is crucial wherever risk, uncertainty, or interdependence exist. The consumer trust to the bank can be defined as the belief that the bank does not use its advantage, to act to client disadvantage.

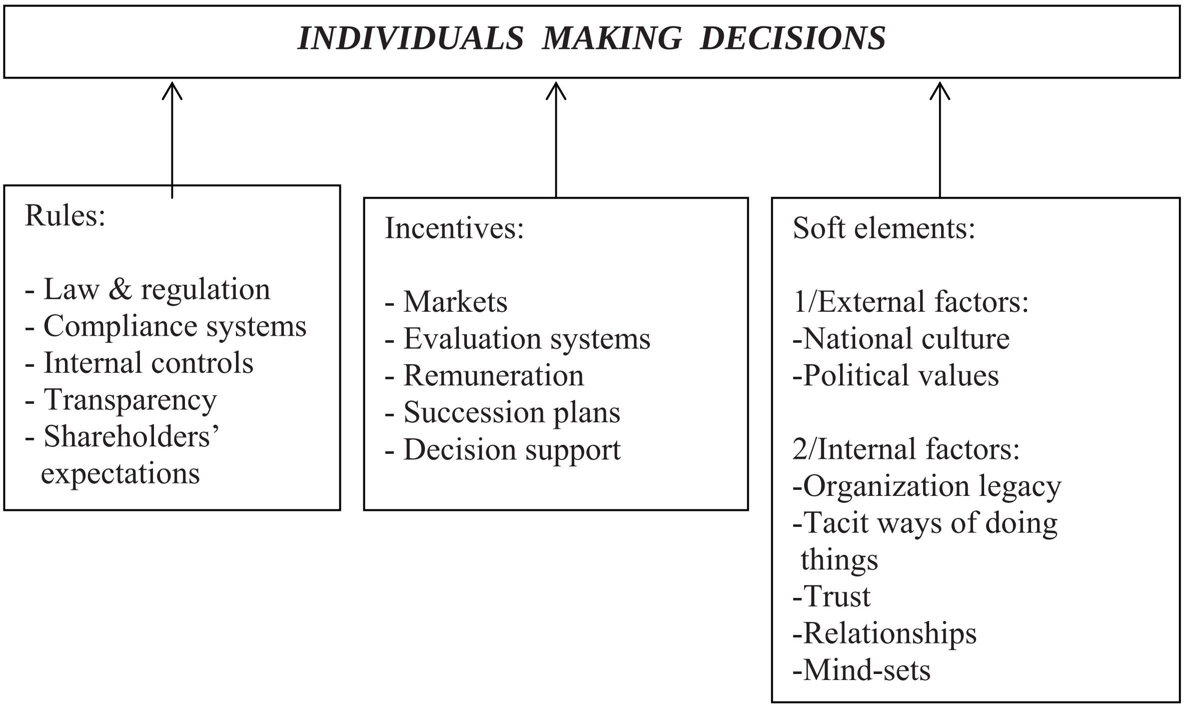

Figure 1. Framework for shaping ethical decisions in banking

Source: Zinkin (2014)

In case of bank choice by the customer, the trust plays an important role allowing to overcome the cognitive complexity as some new banking products are often becoming more complex and risky.

The most important role in conducting ethical operations play Bank's Management Board and Bank's Supervisory Board. For example, they are responsible for internal compliance regulations, the bank's principles of good practice, the rules of managing conflicts of interest, fair and clear view of the financial statements, their preparation in accordance with applicable regulations, proper accounting records and the report on the activities of the Bank, etc. As far as moral hazard operations are concerned, managers of cooperative banks may use the bank funds for purposes other than members' best interests. In this case, how important are ethical activities showed the Spółdzielczy Bank Rzemiosła i Rolnictwa w Wołominie (SK Bank) crisis in 2015. The Polish Financial Supervision Authority (KNF) decided to file bankruptcy proceedings against the SK Bank in November 2015. As a result, over 2 billion zlotys were paid out from Bank Guarantee Fund as the pay-out of guaranteed deposits.

In economics in the 1970s, the rational expectations hypothesis became the crucial part of theory and it was useful assumption in pushing applied work forward. The key features of this hypothesis are that all agents are rational, have perfect foresight and their expectations (based upon times series observations) are, on average, correct (Lucas, 1986). This hypothesis was promising approach in economic modeling. According to Hommes (2015), this assumption excluded all irrationality and market psychology from economic analysis. Yet, economy is a complex system, i.e. nonlinear expectations feedback system with many interacting consumers, banks enterprises and expectations and beliefs of investors about the future state of economy, etc. The more recent example is the decline of financial markets in 2008 was driven more by pessimistic expectations of investors then economics fundamentals. Recent research revealed that these large changes of global financial markets do not capture behavior under rational agent models (Hommes, 2015). Yet, the structure of the Polish cooperative banking system did not change in a fundamental way after the global financial crisis. The Polish cooperative banks are owned by their members. In Poland, commercial banks are shareholder based institutions. Differences in ownership form, have implications for strategies pursued and the business models, e.g. differences in lending relationships. Ferri et al. (2014) highlight that bank ownership affect lending behavior in many European countries. For instance, cooperative banks attempt to smooth financial conditions for their customers to maintain longer term borrower-lender relationships by conducting less procyclical loan supply policies, irrespective of the economic situation.

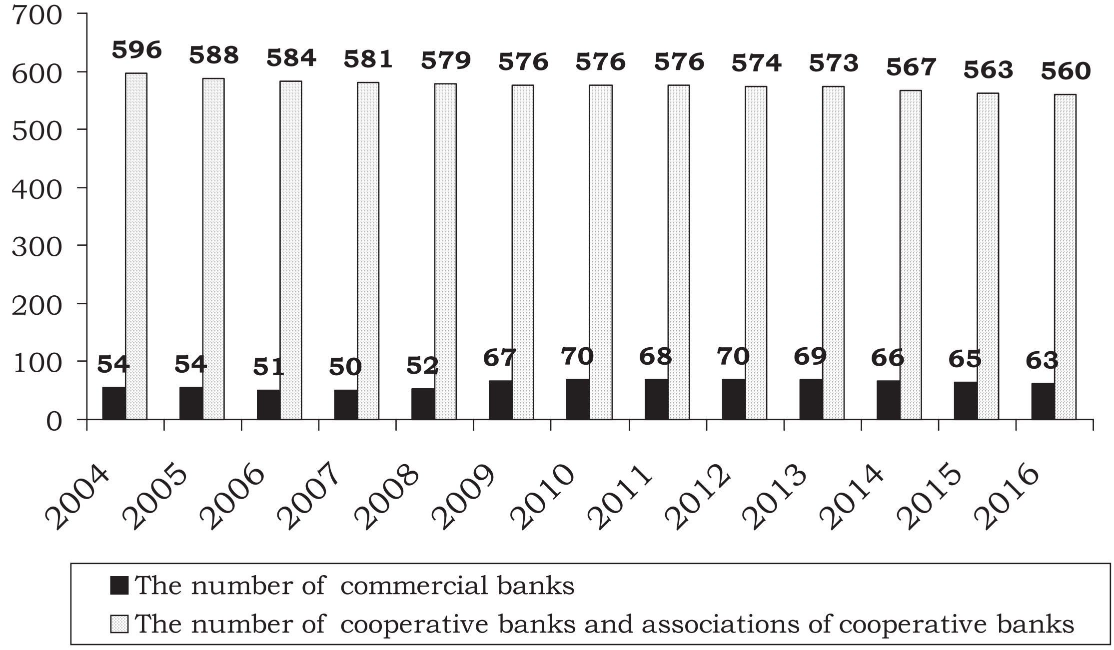

Figure 2. The Polish banking sector structure in the years 2004-2016

Source: Own elaboration based on the data of Polish Financial Supervision Authority and National Bank of Poland

The quality of institutional infrastructure and regulatory structures in the financial sector plays a major role in fostering the development of the banking sector in transition countries like Poland. According to Haselmann et al. (2016) the story of banking in Central and Eastern Europe region is a process of institution building and evolution of foreign bank ownership. Early in the transition period to a market economy, foreign strategic investors in commercial banks in Poland brought modern technology, improved banking practices (e.g. implemented credit scoring models) and they were treated like source of direct capital investment. Furthermore, foreign commercial banks owned a majority of bank assets by 2000. Moreover, lending to households expanded much more rapidly than lending to any other sector. At the end of 2016, 63 commercial banks and 560 cooperative banks carried on operations in Poland (Figure 2). The Polish cooperative sector is represented by two associations of cooperative banks (Group of BPS and Group of SGB) and 556 cooperative banks in association structures. Only, two banks operate outside of these association structures.

In 2016, cooperative banks served customers through a countrywide network of 4100 branches (*Raport o sytuacji banków w 2016*, 2017). Cooperative banks' market share for the total bank branches in Poland is 38%. The Polish cooperative banking sector has historically financed entrepreneurship development processes of communes in which they function. After Poland's accession to the EU in 2004, the agrarian policy of the state has been directed to the harmonization with the European Union general agricultural policy. In the early years of a market economy in Poland all entitles, including farmers and banks, had to adapt to new rules. According to Marks –Bielska (2016), two contradictory trends appeared within the agrarian transformations – towards concentration and towards fragmentation, eg. some farmers divided their farmland. The average area of agricultural land per 1 farm, is gradually increasing, and in 2014 reached to 10.3 ha (*Agriculture and food economy in Poland*, 2015). The cooperative banks have gradually undergone restructuring processes in order to adapt to the EU requirements. In the last decade, the main reason for the decreasing number of cooperative banks in Poland are consolidation processes, mergers and acquisitions (Figure 3).

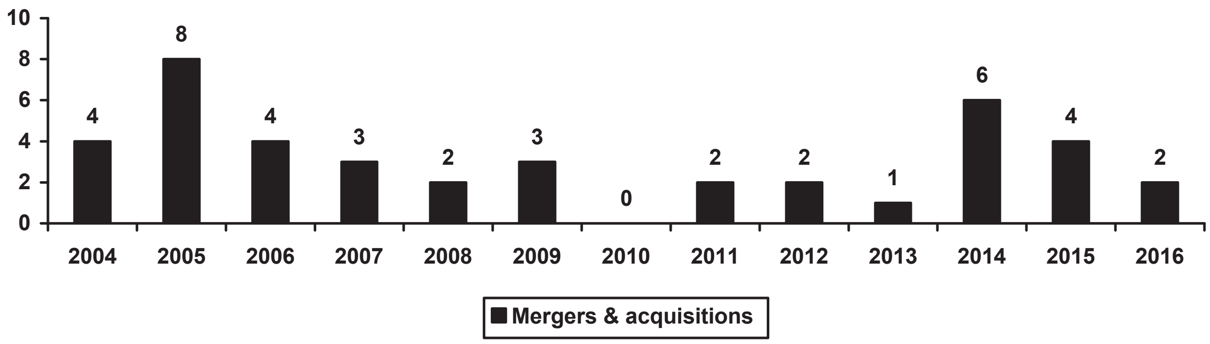

Figure 3. The number of mergers and acquisitions in Polish cooperative banking sector, 2004-2016

Source: Own elaboration based on the data of Polish Financial Supervision Authority and National Bank of Poland.

The majority of Polish cooperative banks met capital ratios standards, in accordance with the provisions of the Capital Requirements Directive (CRD IV) and the Capital Requirements Regulation (CRR). According to the data of Polish Financial Supervision Authority, only 28 cooperative banks (representing less than 2% of total assets of the banking sector) failed to carry out this minimum capital requirements at the end of 2016 (*Raport o sytuacji banków*, 2017). Managers of cooperative banks try to search for a balance between maximisation of local communities' access to banking services and fulfilment of fiduciary duties to shareholders and depositaries. Hence, about 90% of all banks in Poland are not strictly profit maximizing entities. Yet, Polish cooperative banks held approximately only 9% shares of the assets of the entire banking sector (Table 1).

Table 1. Assets of banks in Poland, 2008-2016 (PLN billion)

	2008	2009	2010	2011	2012	2013	2014	2015	2016
Cooperative and affiliating banks	76	82	96	106	116	130	135	140	153
Commercial banks	963	977	1 062	1 188	1 234	1 277	1 394	1 490	1590

Source: Source: Own elaboration based on the data of Polish Financial Supervision Authority (2017) and National Bank of Poland (2017)

Furthermore, Polish cooperative banks are often the only banking outlets available in small towns. The Polish cooperative banks are client-owned who own the nominal valued shares in a local cooperative bank. The main source of funding for cooperative banks are deposits from the non-financial sector. Cooperative banks serve mainly households, small and medium-sized enterprises, farmers and local governments. However, Szelęgowska (2011) notes that one of the weakness of cooperative banks is adverse trend in the age structure of banks' clients. There is also recognition in the literature that potential customers of cooperative banks are currently taking advantage of commercial banks because of convenience and wide range of services provided by low cost mobile banking outside of bank branches (Kawa 2016). The Polish cooperative banks play an important role in the socio-economic development of rural development. The availability of subsidized agriculture loans and cooperative banks' lending policies are an important source of funding for the agriculture sector. The Polish Population in 2017 amounted to 38.4 million people, of which 39.8% inhabited rural areas. The agriculture is an important sector of the Polish economy. The global value of agricultural holdings' production in Poland (in current prices) places Polish agriculture at 7th place in the European Union behind France, Germany, Italy, Spain, Great Britain, and the Netherlands (*Agriculture And Food Economy in Poland*, 2015).

Conclusion

This paper focuses on the impact of regulation, ethics and leadership on the structure and challenges of Polish cooperative banking sector. The authors state that an ethical framework for banks should include rules –based and principles based regulation. The majority of Polish cooperative banks met capital ratios standards set up by Polish Financial Supervision Authority. The availability of cooperative banks' loans is an important source of financing for the agriculture sector and the rural community. These banks usually have more loyal customers (who are also members) than customers of commercial banks.

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