THE EUROPEAN DEBT CRISIS AND THE CHALLENGES TO THE BANKING SECTOR IN BULGARIA

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Abstract

European Sovereign crisis fostered the consolidation and the supervision on European banks financial institutions. Practical steps have been undertaken towards strong regulation at EU and at national level. In some way, Bulgarian banks did not fell the European sovereign debt crisis. The banks had a comfortable liquidity buffer, and did not experience liquidity shortages in the last years. The banks succeeded in clearing loans portfolio and to monitor the rising of risks costs. Despite the difficult economic and financial environment, Bulgarian banks remained stable, liquid and well capitalized, well above the regulated minimum of capital buffers of 13.5%.

The banking sector (with the exception of CCB) announced the net profit of 373 million euro in 2014, with 80.5 million euro more than in 2013. Even the collapse of CCB did not significantly change the stability of the banking system.

However challenges for Bulgarian banking sector remained as economic growth continued to be slow, which in turn limited the growth of loans and non performing level. After CCB collapse, concerns have rising regarding the asset quality in the banking sector and the reliability of the financial sector. Collapse of CCB increased doubts about banking and reporting practices and the adequacy of the Supervision of BNB over banks, since it became evident that the proper valuation of bank assets needed to be revised.

Keywords: economic growth, economic convergence, catching up process, EU structural Funds

JEL Classification: F15,F21, F63

Introduction and main goals

European sovereign debt crisis affected severely financial and economic stance of heavily indebted euro zone countries. So the gaps in the banks balance sheets were to be helped by the State and the international organizations. The European Central Bank (EC) proceeded towards important changes in EU monetary policy in order to counter the increasing fragility of the European Banking sector and to resolve in some way the sovereign debt crisis. Theses processes were supposed to affect also EU countries non members of the euro area. Therefore the first goal of the article will be to explain how the European sovereign debt crisis disrupted economic and financial stability of the euro zone. And the second one will focus on the influence of the debt crisis, if any, on Bulgarian banks' behavior.

The European Sovereign Debt Crisis – implications on EU countries financial and economic recovery

The European Sovereign Debt crisis has been the result of the impact of many complex factors. One group of factors were related with the effects of financial globalization, the failure of financial regulations since the 80s, the deepening of banks' transactions with securitized financial instruments (credit derivatives), and with an easy access to credit lines, especially after 2000. All this tempted the international universal banks to engage deeper and deeper in some risky and no transparent lending operations on the capital markets. Other group of reasons embedded in the very same philosophy and practical implementations of the Economic and Monetary Union (EMU) (according the Maastricht Treaty of 1992) under which EU member states were obliged to conduct single monetary policy with a common currency, but they reserved themselves the right to implement a fiscal policy according their own political views and decisions.

However the 3% of the GDP budget deficit (under the Maastricht Treaty) for a number of euro zone members became difficult to respect since 2000 the threshold of budget deficits.

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Trough the combined application of financial techniques, including balance sheet accounting, structured currencies loans and credit derivatives, EU countries with higher indebtedness tried to reduce the debt burden. Despite the efforts, the financial crisis (2007-2008) and economic downturn accentuated significant deterioration in the public finances in EU countries with high debts.

The European sovereign debt crisis begun with the collapse of Iceland's banking system. and it spread to EU South European countries. Greece was particularly vulnerable since Greek public debt revealed to be much higher than the officially declared data. For example Spain's sovereign debt before the onset of the crisis was roughly the same as Germany's as a percentage of economic output, but Spain had high unemployment rate and with no signs of fast economic recovery, and its banks liquidity deteriorated.

The states that were adversely affected by the crisis faced a strong rise in interest rate spreads for government bonds as a result of investor concerns about their future debt sustainability. The long-term interest rates of Greek government bonds with maturities of close to ten years on secondary market increased from 5% (October 2009) to near 30% (January-November 2011) and to more than 27% (September 2012).

It was estimated that Germany have made more than 9 billion euro out of the crisis as investors preferred to acquire safe bonds even at near zero interest rate as German federal government bonds. By July 2012 also Netherlands, Austria, Finland benefited from zero or negative interest rates. Belgium and France benefited from short term government bonds with a maturity of less than one year.

Countries with high sovereign debts had difficulties to raise fresh financial resources at affordable rates in the capital markets. At the same time, banks in many of the indebted countries had come under pressure, as bank deposits have fled to countries with stronger economies. In many of the indebted countries, their banks have been much larger in size given the large volume of cross border financial transactions, than the financial potential of their own economies. Governments lack fresh financial resources to refinance the banks in shortages of liquidity.

Concerns arose about the European banking system because of the persistent imbalances between the euro zone countries. Indebted countries were forced to search for a financial assistance from third parties and especially from the European Central Bank (ECB). In 2010, the EU, the ECB, the euro zone countries and the International Monetary Fund (IMF) took rapid action to provide with fresh financial resources countries, experiencing difficult financial position.

One of the measures taken was the establishment of European emergency measures specifically for the eurozone. They were used to provide assistance programmes for Greece, Ireland, Portugal, Spain and Cyprus. In 2010, seventeen eurozone countries created European Financial Stability Mechanism (EFSM), which was a first line of an emergency fund and was set up to contribute for avoiding the spread of contagion of sovereign debt crisis throughout Europe.

The European Financial Stability Facility (EFSF) was the second rescue fund delivered for the euro zone. This fund was intended to provide financial assistance to euro zone member states that had lost access to the capital markets and to cover their financial shortages. The Emergency measures were used to provide assistance programmes for Greece, Ireland, Portugal, Spain and Cyprus. Conditional and structural reforms had to be implemented by countries receiving the loans. The financial assistance programs were coupled with requirements for the implementation of severe austerity measures of reducing public expenses.

On May 2, 2010, the first Greek bailout package amounted at 110 billion euro was provided by EU and IMF to help the Greek government to pay its creditors. On July 21st, 2011 a second rescue package was granted with a total volume of 130 billion euro under the same conditions for the implementation of another set of austerity measures.

Followed Greece, Ireland reacquired a bailout in November 2010, with Portugal next in May 2011. Italy and Spain were also vulnerable, with Spain requiring official assistance in June 2012 along with Cyprus. By 2014, Ireland, Portugal and Spain, due to various fiscal reforms, domestic austerity measures and other unique economic factors, all successfully exited their bailout programs requiring no further assistance. The road to full economic stabilization was still underway. Cyprus, too, reported a slow but steady ongoing recovery, averting further financial crisis thus far.

On June 2012 euro zone member states took decisions to assist European banks shaken financially by the sovereign debt crisis. Loans were provided by the European Stability Mechanism directly to the banks in order to avoid an increase of sovereign debts, and this credit line was also approved by the European Central Bank (ECB). This reform immediately reflected positively in yields of long term bonds issues of Italy and Spain which started to decrease. At the end of 2011 and 2012, ECB provided to EU banks loans with a maturity of 3 years for recapitalizing the banking system. (1000 billion euros increased by around 500 billion euro balance sheets of euro zone member states' central banks). The liquidity injections gave impetus to activate Government bonds market.

By the end of 2012 ECB acquired 280 billion euro of debt bonds under the program of recapitalization and as a consequence its balance sheet increased by 9%. The long term refinancing operation increased undoubtedly the credit risk of ECB operations, given that European banks had little opportunities to start servicing their debts and that the economic recovery in the euro zone countries continued to be morose.

Indebted countries were obliged to implement a set of combined quantitative and qualitative monetary policy instruments. Non conventional monetary policy instruments (quantitative easing "QE") have been used in order to stabilize the economic and the financial situation. The Central bank implemented "QE" by purchasing financial securities from the commercial banks and other financial institutions, and aimed to raise the prices of financial assets, to lower their yields and to increase the money supply. This monetary policy differed from the well known monetary policy of open market when for keeping the target of inter bank interest rates, the central bank purchased or sold short term government bonds. Though, when short term interest rates approached low levels, the "QE" was not quite effective and monetary authorities preferred to use "QE" for stimulating economic growth by purchasing long term bonds. Thus they decrease long term assets interest rates and tried to influence the level of yields. Debts were converted into fresh financial resources through the financial institutions.

The purchase of government bonds was proportional to the capital allocation of each euro zone member states in the ECB. However, smaller amounts of the delivered sums have been dedicated for Greece, considered as a very vulnerable economy. Risks minimization under this program was estimated at 20% of the awaited decrease of risk factors.

The decline in long-term interest rates of debts instruments at the markets in the indebted countries was uncertain and as a consequence, it was a signal that capital markets have not reacted tangible (at least currently) in response to applied monetary policy.

German officials were concerned that implementing policies of monetary relief could adversely affect the restructuring of EMU economies. However, for avoiding risks of incurring possible losses by the ECB, Bundesbank supported the purchase of debt bonds by central banks. A unanimous conception prevailed that the purchases of Greek debt securities could be canceled, if the political situation in Greece worsened and did not comply with policies advised by the main creditors of Greece.

A change in monetary policy has been implemented in the euro zone in March 2015 and in September 2016. ECB started to acquire 60 billion euro per month. ECB officials expected that with the purchase of 1.1 billion euro it will be possible to restore the ECB balance sheet at the 2012 levels. ECB took upon itself the task "to determine the interest rates depending on the objectives of monetary policy towards price stability“.

The shift of ECB policies towards restructuring its balance sheet will give reason to strengthen financial and economic stance of European banks and the euro zone as a whole. First, the credibility of ECB will be restored and increased. Second, the decrease of the exchange rate of the euro will be a good precondition for the further amelioration of euro zone countries trade balance and especially to increase the export. Third, It will have a positive impact on economic recovery, fostering economic recovery and decreasing unemployment. The impact on the interest rate by ECB policies is awaited to influence positively opportunities for lending to business and to influence price level.

Now, ECB interest rate continued to be at its lowest levels. The interest rate on the main refinancing operations (MRO), which provide liquidity to the banking system, the rate on the deposit facility, which banks may use to make overnight deposits, the rate on the marginal lending facility, which offers overnight credit to banks from the Euro system at December 9 2015 were as follows of 0.05%, (-0.30%), and 0.30%. ECB continued to limit the rate of refinancing operations to banks (LTRO).

The European sovereign debt crisis revealed that a deeper integration of the banking system was needed. A single rulebook was formed for all financial institutions in EU 28 Member States. The single rule book was the foundation on the Banking Union. On the basis of the European Commission roadmap, the EU institutions established a Single Supervisory Mechanism and a Single Resolution Mechanism for banks. With Single Supervisory Mechanism (SSM) (from October 2014) a new system of financial supervision was introduced by ECB and by EU monetary authorities. The objectives of SSM were to provide security and stability of the European banking system and to strengthen European financial integration in Europe.

Non euro area EU member states received the right to participate in SSM activities, although they were obliged to cooperate closely with ECB and to conclude a Memorandum, in which they are explaining how the cooperation will be achieved under the mutual task of supervision. ECB concluded Memorandums with every one of EU country, where there are headquarters of at least of one world most famous and important monetary and financial institution.

ECB introduced strict criteria for the assessment of risk assets. On March 2014, ECB launched stress tests on European banks. Main requirements were to increase the proper bank capital (equity), which was an additional buffer for the protection of banks from bankruptcy. At the end of 2014, ECB introduced “Asset Quality Review”. For each granted loan, banks were obliged to increase the amount of risk-weighted assets (RWA). This figure was 12% in Bulgaria and 8% in the euro area.

According OECD data, about 200 banks in the euro zone needed to attract 400 billion USD to cover the level of leverage. The fact that European banks must increase equities was supposed to affect negatively their market values. As of April 2014, the negative effects of the sovereign debt crisis decreased and Euro banks liquidity position improved. The monitoring of 137 euro zone financial institutions showed the followed results: The pressures exerted by the sovereign debt crisis were reduced (-8% from 5% end-2013). The direct exposures to sovereign debt were reduced (-11%, -7%).

Banks’ exposures to Government bonds comparatively decreased, which contributed to the easing of credit standards, especially mortgage loans (-3%, -2%).The easing of the criteria for lending to business ameliorated (1%, 2%) due to the relative positive changes in the value of securities used for collaterals by banks. Consumer credits and other lending to households (2%, 0%) also showed signs of increase. (Eurobank lending survey).

The European debt crisis and Bulgarian banks

Bulgarian banking system withstood well at the European sovereign debt crisis because of: the comparatively lower technical level of offered financial services, and the very low trade with synthetic financial instruments and derivatives. The Bulgarian banking system was not affected either by the sharp drop in capital inflows nor by the increased financial costs in the euro zone. The drop in liquidity of international banking market influenced negatively the funding of foreign banks, localized in Bulgaria.

As a result, Bulgarian banks with domestic capital expanded their operations and their market share at the domestic Bulgarian market increased. The increase in size and financial strength of Bulgarian banking sector was due to the enlargement of the private sector in the economy, which increased the demand for credit, and the competition between banks to attract clients. The consolidation of banking capital increased.

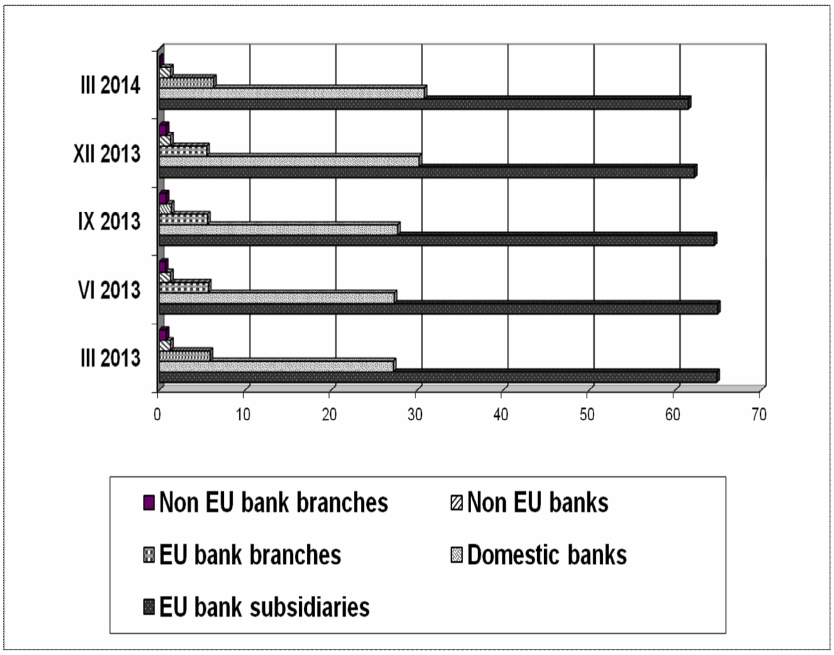

Fig.1 *Market share of domestic and foreign banks in Bulgaria (in%)*

Source: Bulgarian National Bank

The average annual rate of expansion of domestic banks amounted to 17.6%. Three domestic banks increased their loan portfolios by 22.5%. As a result, the share of domestic banks in total loans increased from 14.9% (March 2010) to 24.8% (March 2014) (16.8% in early 2008). Four domestic banks grew at an annual rate of over 10%, while foreign subsidiaries developed more moderately. The Corporate Commercial Bank (CCB) grew by 2.3 % per year.

The average annual rate of total loans and advances allocated by the Bulgarian banking system (between the First quarter of 2010 and First quarter of 2014) amounted to around 3.5%. The expansion was not the same for all Bulgarian banks. Greek banks decreased their market share by 0.9%, while the subsidiaries held by other EU banks increased their market share by 3.7%.

The debt crisis in Greece had no a real negative impact on Greek subsidiaries, which were located in Bulgaria. Subsidiaries of Greek banks in Bulgaria did not have exposures in Greek private or government securities. The relative share of Bulgarian banks reached 30.8% (March 2014). The market share of EU subsidiary banks decreased to 61.5%. Market fragmentation was high, since the 3 largest banks hold about 80% of the market. During the global financial crisis and European sovereign debt crisis, fresh financial resources have been transferred from foreign banks located in Bulgaria to their headquarters situated abroad.

Table 1

Indicators of the banking system as of September 2014.

	Banks with Bulgarian capital	Banks total
Total assets, million Euros	**12.613**	**45.302**
Increase since December 2009,(In %)	**113.3**	**24.9**
Net credits and claims million Euros	**8.797**	**34.572**
Increase since December 2009, (%)	**102.7**	**16.8**
Households deposits million Euros	**10.382**	**38.005**
Increase since December 2009, %	**101.6**	**22.2**
% of the total assets	**82.3**	**83.9**
Equity, capital adequacy	**12.5**	**16.0**

Source: Bulgarian National Bank

The table shows clearly that the total assets of banks with Bulgarian capital increased since the end of 2009 significantly, and the same trend was valid for households' deposits and net credits, offered by Bulgarian banks.

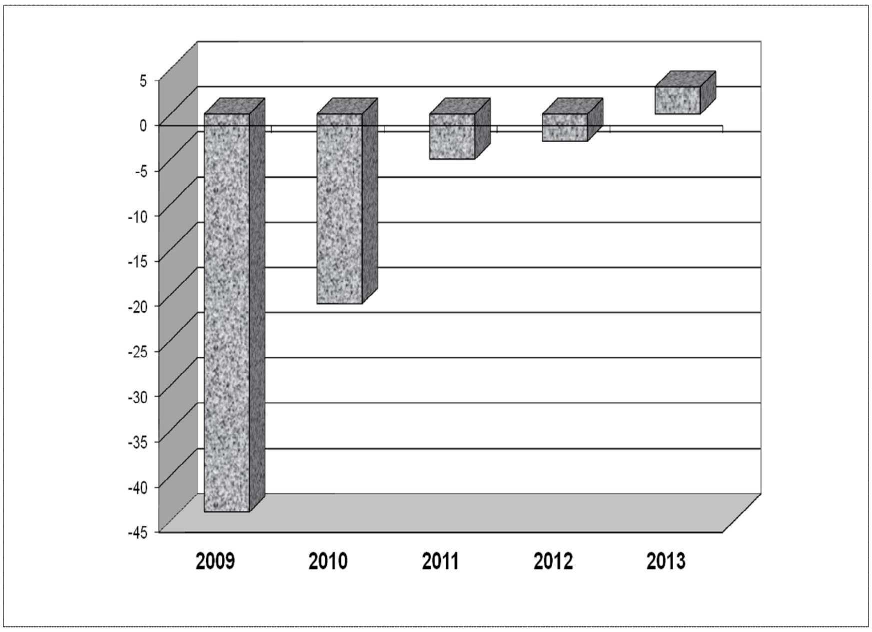

Fig. 2. *Net profit of banks in Bulgaria. In %*

Source: Bulgarian National Bank

In 2009, profits of Bulgarian banks decreased by 45%, but thereafter banks stabilized their benefits and towards 2013 profits started to increase, because of the applied aggressive banks' policies and by experiencing different techniques and channels to increase their profits.

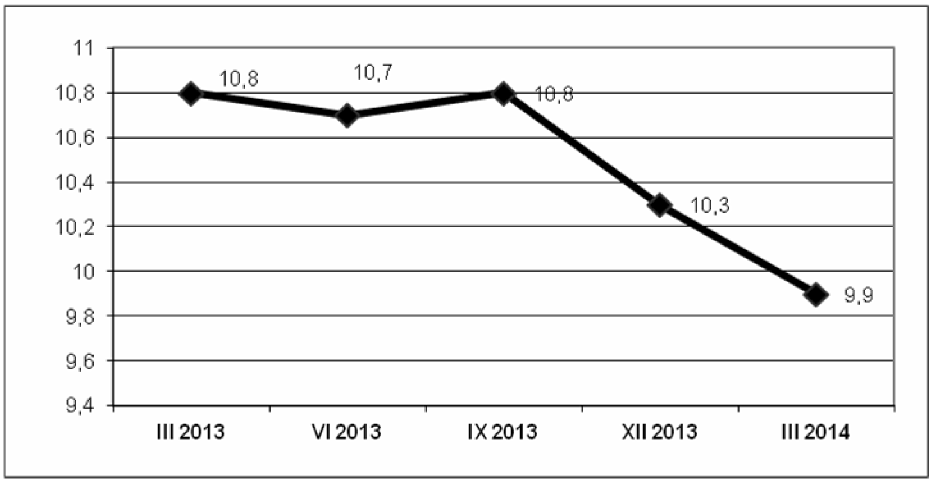

Fig.3*. Share of net non performing loans in total net loans. In%*

Source: Bulgarian National Bank

As of October 2013 non-performing loans over 90 days were 10.66% in the loan portfolio of banks, compared with 10.62% at the end of 2012). As of March 2014 classified exposures were reduced by 1 7%, compared with the end of 2013.

Notwithstanding this apparent bank stability, it was not convincing. At the end of June 2014, the Corporate Commercial Bank (CCB) and the Corporate Bank Victoria were placed under special supervision and that event fundamentally shook the confidence in the Bulgarian banking system. Bulgarian central bank (CB), which was responsible for the supervision of the CCB, was not sure how to proceed: whether to nationalize the bank with taxpayers' money or to search foreign investments for recapitalizing the vulnerable financial institutions. The insolvency procedures of the bank could not begin immediately due to number of legal obstacles. In CCB remained blocked 4 billion euro. BNB (BNB) revoked the license for the implementation of bank activity (in early November 2014) of CCB, after that an acute shortage of equity was found. CCB bankruptcy hit hardly number of Bulgarian companies and individuals. Over 80,000 jobs were probably closed because of the collapse of the CCB in November 2014.

First investment Bank (FIB), the 3rd largest bank in Bulgaria and the largest bank with a majority of Bulgarian capital also suffered of liquidity shortage and requested financial assistance from BNB. A credit line was allocated to FIB at the amount of 1.65 billion euro, approved under the State aid rules and the European Commission (EC). The EC approved the aid for FIB.The official monetary authorities used this clause and deposited 0.6 billion euros in FIB for five months. According this rule such a credit line can be allocated to all Bulgarian banks. The question remained why such an aid was not granted to CCB?

On the onset of the crisis, especially after thawing of the competition between banks for clients in 2009-2010, the volume of households and business savings in banks had steadily increased. Meanwhile, the bank lending, "frozen" during the crisis, was still at a low level, despite some attempts by financial institutions to stir the market. The increase in banks' deposits base helped high liquidity maintenance of the banking sector and repayment of deposits to clients after December 2014, which was blocked for a year in CCB. It further increased the available liquidity of banks. Thus, the liquidity of the banking system increased permanently, according to BNB and in January 2015 reached 31.78% (30.12% a month earlier).

Low ECB interest rates affected the Bulgarian inter bank market. If in the near past, the foreign banks brought out part of the surplus liquidity in their headquarters, now because of the ECB near to zero interest rates, the headquarters of banks deposited resources in its subsidiaries, localized in Bulgaria. Then banks in turn invested the liquidities in BNB. It remained more profitable for banks to keep liquidity in BNB at near to 0% interest rate. Thus the banks tried to sustain relatively the ratio between credits and deposits instead to send surplus funds in the headquarters at negative profitability. At the end of 2014 the total banking sector ratio of credits to deposits amounted to 84.78% (BNB).

Conclusions

European Sovereign crisis fostered the consolidation and the supervision on European banks financial institutions. Practical steps have been undertaken towards strong regulation at EU and at national level. In some way, Bulgarian banks did not fell the European sovereign debt crisis. The banks had a comfortable liquidity buffer, and did not experience liquidity shortages in the last years. The banks succeeded in clearing loans portfolio and to monitor the rising of risks costs. Despite the difficult economic and financial environment, Bulgarian banks remained stable, liquid and well capitalized, well above the regulated minimum of capital buffers of 13.5%.

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