CONTEMPORARY TENDENCIES IN THE DEVELOPMENT OF THE FINANCIAL SECTOR IN BULGARIA IN THE CONTEXT OF THE REGULATIVE CHANGES IN THE EU

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Abstract

The development of the financial sector in Bulgaria in the period (2007-2014) has been influenced by the slowdown of economic growth and the transmission of the impact of the Global and European sovereign debt crisis. The contraction of credit activities of the banks as a main financial intermediary has reflected the extension of the economic stagnation and has deepened the incompatibility between the savings and reduced investments with the negative macroeconomic follow-up effects as crisis in the real sector, unemployment and the stagnation of incomes. The role of the financial sector in the Bulgarian economy remains high and the ongoing EU and especially the EMU reforms for guaranteeing better stability of the financial sector present a new set of challenges to the banks and investment intermediaries to function in favor of stimulating the economic growth. The reforms in the financial sector in the EU present a challenge and a chance for Bulgaria to adjust to the requirements for the EMU entry. The reforms undertaken in Bulgaria's financial sector are on the agenda also with regard to the preparation to join the EMU.

Keywords: financial crisis, credit crunch, banking activities, investment intermediaries, financial stability, EU reforms in the financial sector.

JEL Classification: G12,G28,G32,G33.

Introduction

The financial sector of Bulgaria has undergone important changes since the accession to the EU in 2007. In compliance with the EU law for the banking and nonbanking activities regulative reforms have been successfully introduced to implement the Single market for the financial services and the accession to the European financial space.

The financial sector's activities have been important drivers' of economic growth and play important role for Bulgaria as a member state of the EU. There are economic reasons to deepen the financial integration of Bulgaria at present on the basis of the level of the achieved forms of penetration of the investments from the EU in the financial sector. The Bulgarian banking system is characterised by the predominance of foreign banks which are subsidiaries of EU banking groups.Their market share is 73 percent while less than a quarter of the market share (23 percent) is held by domestic banks. Approximately a quarter of the market share, 24 percent, is held by Greek-owned subsidiary banks. Altogether there are 28 banks in Bulgaria (excluding one recently failed bank), of which 6 are branches. Banking establishments from outside of the EU represent less than 1.5 percent of the banking system.

Taking into consideration the present situation with the reforms in the EMU (Economic and Monetary Union) of the EU and the road map for building the Banking and Capital Union we consider the issues of the financial sector's development in Bulgaria closely related to the progress of undergoing reforms. There are two reasons to consider the issues of the financial sector's development of Bulgaria in the framework of the ongoing reforms in the EMU.

On one hand, the preparation for the EMU for Bulgaria has been inseparable part of the engagements of joining the EU in 2007. The compliance to the EMU new requirements is the framework to which Bulgaria has to adjust its own financial sector. In the pre-accession period until 2007 the common view has prevailed among scholars and politicians in Bulgaria that the time of the adoption of the euro should be as soon as possible after the date of the country's accession to the European Union, namely in the second half of 2009 or on 1 January 2010 at the latest. This view

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was completely consistent with the common position of the Bulgarian Council of Ministers and the Bulgarian National Bank (BNB) as stated officially on November 25 of 2004.

But nowadays this priority has to be considered with regard to the EU strategy of deepening of the EMU as a Monetary, Banking and Capital Union. There is a need to conceive that the EMU has acquired new institutional and regulatory features that raise the requirements for the preparation to enter and adjust to it as a regular member country of the EU. The hypothesis is discussed that the delay of Bulgaria's joining the EMU may present a challenge of higher costs of compliance to the more advanced form of "differentiated integration" of EMU in the EU and its institutional architecture.44

The paper involves the discussion of three main aspects as follows: 1) the impact of the macroeconomic performance of Bulgaria on the activities of the financial sector; 2) discussion of the present state of the financial sector in Bulgaria; 3) the financial sector's regulatory reforms and the prospects for the EMU. Conclusions are summarized for the EMU's deepening as a challenge and opportunity for further enlargement.

1. The Macroeconomic Performance of Bulgaria in 2007-2015 and its impact on the financial sector

During the last decade, Bulgaria has achieved macroeconomic stability and positive GDP growth but under the impact of the Global financial crisis and the European sovereign crisis the economic performance has worsened since 2009. The financial sector has played an important role to mobilise and channel properly the credit resources and the non-financial firm debt and household debts have been useful drivers of economic growth until 2009.

The financial intermediaries have made possible the growth of investments and the achievement of higher overall rates of growth by that time. Since then the sharp reduction of economic growth has made private deleveraging a barrier which has been more difficult to overcome due to the deterioration of the international and internal business environment and the low demand of new credits. The Bulgarian economy has been hit by the severity of the European sovereign crisis and recession in the Euro area which has been followed by a subsequently weak recovery up to mid 2015.

The economic growth for the period (2000-2008) has been kept on stable upward track record due to the increased aggregate supply and consumption, fiscal consolidation, the foreign capital inflows as a substantially increased external source of finance and the maintenance of the monetary discipline through the sustainability of the Currency Board since 1997. GDP growth rate for the period (2005-2008) has averaged annually 6.4%. Compared to other EU member states Bulgaria has experienced since the start of the new millennium high rates of economic growth which have raised the expectations as well as doubts for the continuity of the "catch up" type of growth after joining the EU (Angelov, 2006).

The growth of domestic and foreign capital investments has been concentrated predominantly in construction, real estate, tourism and services which contributed to overheating the economy. During the period 2005-2008, Bulgaria's GDP grew by a relatively rapid pace but since 2009, the GDP contracted by 5% and a slowdown of economic growth followed (Figure 1). The financial sector and foreign investments have been strong drivers of economic growth during this period.

The foreign direct investments from the EU have presented the biggest share of the total inflow of FDU in Bulgaria traditionally but especially since the end of the 90s when the privatization began. The abrupt fall of FDI as a result of the Global and European sovereign crisis in the period 2009-2012 has had a very negative effect on the Bulgarian economy and is indicative of the complementarities that have already being created with partners from the EU (Fig.1).

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[44] As stated in the Article 1(3) Treaty of European union (TEU) and the Treaty on the Functioning of the European Union within or outside the Treaties of the EU in the field of European economic and monetary policy the differentiated integration is the cooperation of some but not all EU member states.

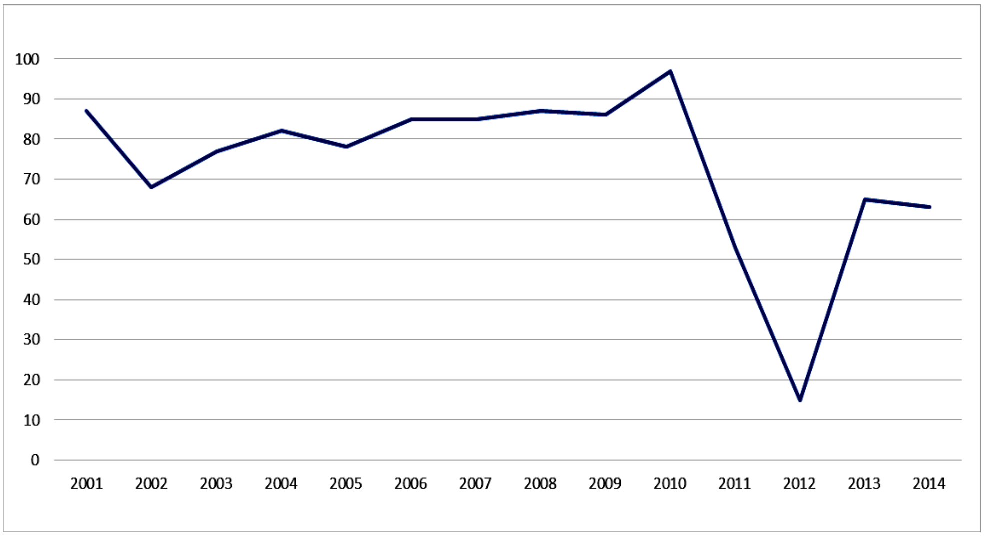


Fig.1. *FDI from the EU as % from the total FDI in Bulgaria (flow of net transactions) in %*

Source: Eurostat

Since 2010 began a gradual recovery of the Bulgarian economy, but at a very slow pace. In 2010, growth was only 0.7%, in 2011 rose to 2% and in 2012 was only 0.2%. In 2013 and 2014 the economic growth remained rather modest at the rate respectively of 1.1 and 1.7%. For achieving the pre-crisis level of growth it has taken five years. In 2015 the rate of growth has increased to 2.9% and higher rate of about 3% has been forecasted for 2016.

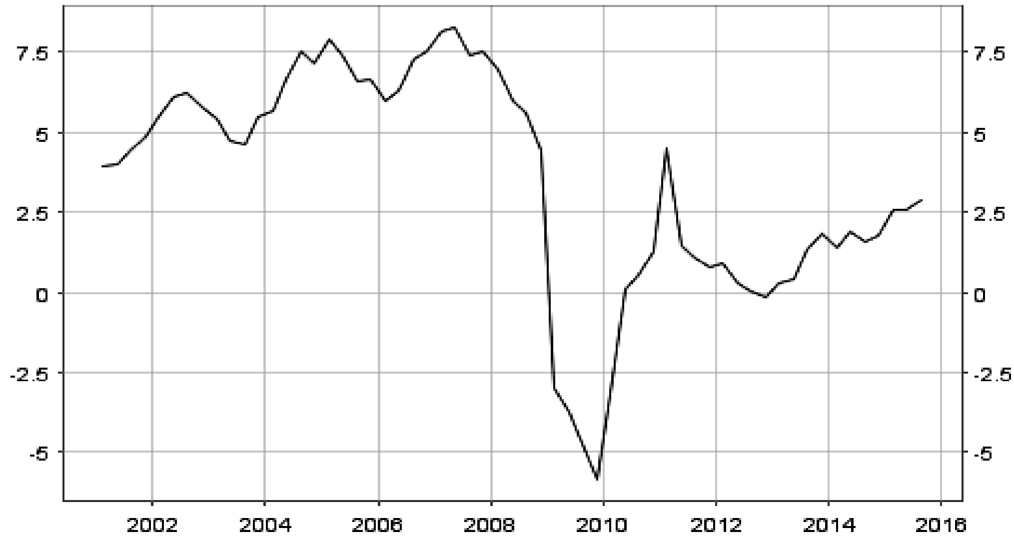
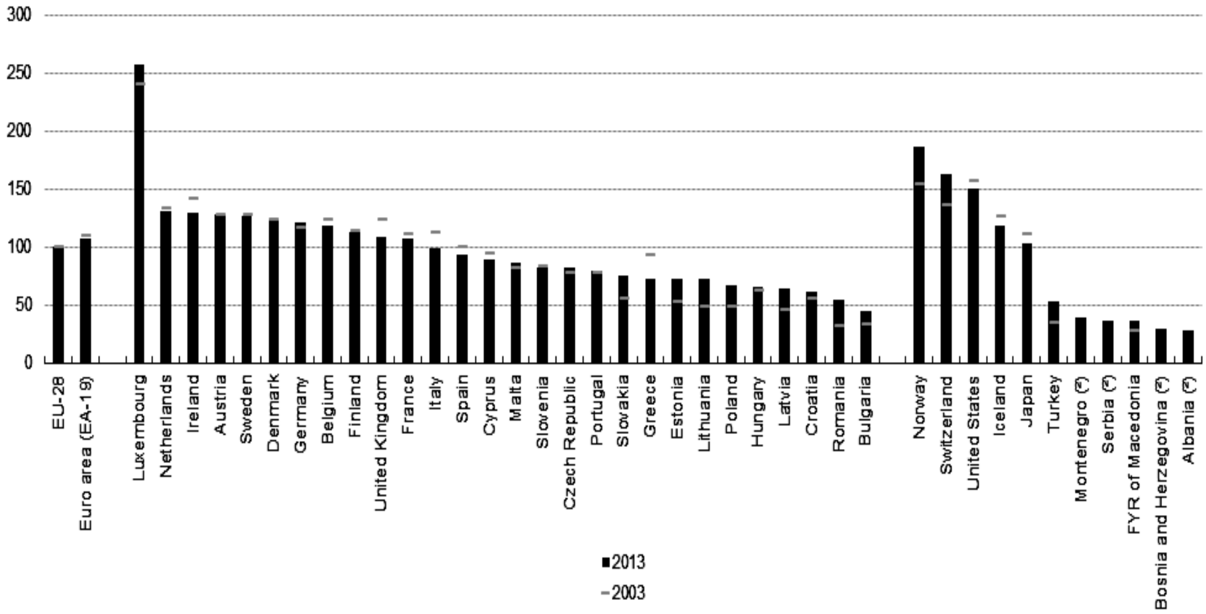


Fig.2. *The Annual Rate of Growth of the GDP of Bulgaria for 2002 -2014 (market prices, %)*

Source: European Commission (Eurostat) National accounts of Bulgaria.

Macroeconomic performance has allowed to maintain stability but the rate of growth has remained low in recent years. The unsatisfactory growth record has been accompanied by relatively modest fiscal deficits, low inflation and a stable currency. Growth has been deprived of new capital inflows from abroad as direct and portfolio investments have fallen considerably as result of the Global and the European sovereign crisis. The economic growth has become largely dependent on domestic factors and only to some extent driven mainly by growth in services and manufacturing, the latter aided by an expansion in exports of labor-intensive goods.

The need of raising growth is considered a necessary prerequisite to diminish the gap between the GDP per capita of Bulgaria and the average GDP per capita of EU-28. Bulgaria records the lowest level of this indicator among the EU Member States as its GDP per capita amounts to 53% below the EU average. Besides Bulgaria has achieved a very small increase of the GDP per capita from 2003 to 2013 compared to other EU countries. This trend has inluenced negatively the aggregate demand. This indicator reflects the need of structural policies to raise the incomes' level and national wealthfare by economic growth that has to allow for better real convergence with the EMU (Fig. 3).



(¹) Break in series.
(²) 2003: not available.
Source: Eurostat (online data code: tec00114)

Fig.3. *EU Member States:GDP per capita at current market prices, 2003 and 2013 (EU-28 = 100; based on PPS per inhabitant)*

The European commitments of Bulgaria for macroeconomic convergence with EMU are an integral part of the Accession Treaty to the EU. With the efforts for the implementation of Maastricht criteria for EMU Bulgaria has achieve progress towards macroeconomic nominal convergence (criterion on price stability, sound public finances, exchange rate, short-term and long-term interest rates).

The price stability has been a target of the Bulgarian Government and central bank's policies since the pre-accession period. For the period (2004-2008) the price criterion was not accomplished as the inflation was higher than the referent value threshold. The structural readjustment and credit expansion related to the higher rates of growth caused higher rates of inflation in the period (2004-08). The economic decline has caused a reversal of this trend since 2009 onwards by the recorded relatively stable process of deflation (Fig.4).

The domestic factors contributed to higher average inflation until mid2009 included: adjustments in administratively regulated prices, the harmonisation of excise duties with EU levels by increasing them in several stages upon and after joining the EU, oligopolistic type of the markets for a number of goods and services etc. The group of goods and services with administratively controlled prices had a positive contribution to overall annual inflation in contrary to the deflationary trends.

The external factors play a role in the domestic price formation due to the high openness of the Bulgarian economy and the high degree of import dependencies that exercise relatively big influence of the import prices. These prices rose steeply in 2004-2008 but recorded a steep annual decrease of 14% in 2009. Energy and food prices have been a major component of imported inflation especially if it is taken in consideration that these commodities have large share of the Bulgarian basket of the Harmonised index of Consumer Prices (HICP).

Their influence on the price level in Bulgaria is big as after the fall of the international prices of oil, energy resources and foods has been reflected in the deflationary trends in Bulgaria. After the average monthly inflation became negative in August 2013, the decline in consumer prices on an annual basis accelerated in 2014, and the decrease in HICP at the year-end amounted to 2%. The average annual inflation rate for 2013 was also negative at -1.6. The sharp fall in inflation in 2009 was partly a result of lower commodity prices and the contraction in economic activity. In 2010 and 2011 the inflation gradually picked up again, to 3 and 3.4% respectively, largely reflecting a increase of the commodity prices and increases in the excise duty on tobacco.

foods, etc. and the deflation trends from abroad further decline in the rate of inflation. The deflation continued in 2015 creating risks of deepening of the deflationary trends (Fig. 4).

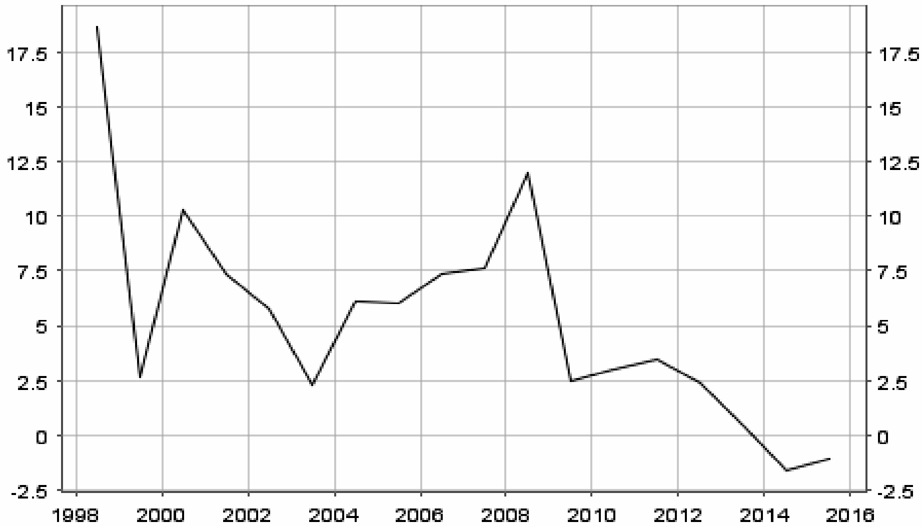


Fig.4. *Inflation in Bulgaria: Overall index HICP*

Source: Eurostat, 2015 (Bulgaria – HICP – Overall index, Annual rate of change, Eurostat, Neither seasonally nor working day adjusted, UnitPercentage).

The historically low level of inflation (within the range of -0.8 to 0.9%) in 2013 has been considered in the Convergence Report of 2014 as building risks of increasing inflation in Bulgaria (ECB, 2014). Such a forecast has not come true in 2015 least but not last because of the ongoing fall of the international prices of food, oil and energy resources. During 2014 a stable process of deflation was observed as half of the dynamics of consumer prices went in decline.

After inflation became negative in August 2013, the decline in consumer prices on an annual basis accelerated in 2014, and the decrease in HICP at the year-end amounted to 2%. The average annual inflation rate for 2014 was also negative at -1.6%. The annual average inflation, measured by CPI, in the last 12 months (January - December 2015) compared to the previous 12 months (January - December 2014) was -0.1%. The deflation continued in 2015 and at annual basis in December 2015 compared to December 2014 was -0.9 %. The official forecast in the Convergence Program of Bulgaria for the period 2015-2018 (MoF,2015) previews negative inflation trends to be replaced by a rather moderate rate of inflation for 2016 (HICP being 1,6% to 2% on annual basis)(MoF, 2015). The main risks of further deflationary trends remain due to the uncertainty of the medium term trends of international prices of crude oil, gas, services and foods. At the same time, a delayed recovery of domestic demand may alsol limit increases in prices of goods and services.Evidently the impact on Bulgaria of the weak recovery in the Euroarea and the EU has continued and creates concerns for the low demand of new credits due to the fall of aggregate demand.

But as regards the adoption of the euro the problem of the pro-inflationary factors and their evaluation is an important issue of the forecast of medium and long term inflation trends and the ongoing readjustment of the Bulgarian economy to the global trends. Many new EMU countries have experienced a rise of inflation after joining the EMU.In a monetary union, there are a number of factors that exercise upward pressures on inflation and due to this inflation may become self-sustained and give rise to an abrupt adjustment. Since the nominal interest rate is fixed at the union level, any shock bringing inflation above the union average will reduce the real interest rate and fuel further inflationary pressures, in a self-reinforcing mechanism for instance by stimulating credit expansion.

However, also being out of the EMU has its risk of adverse impact of the pro-inflationary trends through the channels of imported inflation. These risks may be even higher for a country that is ou of the EMU if one takes into consideration the exchange rate risks related to impact of the import prices in euros and import prices in US dollars. A rising euro in the first halfof 2014 added to the growing world deflationary impact. The depreciation of the euro in the second half of 2014 was a prerequisite for limiting deflation in some groups of goods, such as manufactured goods and food.

The expected slow- down of the deflation rate and the reversal of the trend in 2016 may be due to the higher international prices in EUR terms, as a result of the depreciation of the Euro against the US dollar. This will compensate for the expected price decrease of the main groups of commodities in dollars.

These interdependences underline the role of structural and price realignment that Bulgaria has still to undergo in order to join the EMU.The main approach to circumvent higher inflationary trends by domestic policies is further diminishing the administratively regulated prices, increase market competition and stimulate aggregate supply and investments by carrying out structural reforms.

As a factor that has an impact on the level of inflation may be regarded the money market interest rates and the long term interest rates. As seen on Fig.5 the money market interest rates in Bulgaria have followed the trend of the macroeconomic adjustment since 2006 by passing through higher level of rising the price of credit during the deepening of the Global crisis and European sovereign crisis which placed pressure on the market liquidity. In the post crisis period the slowdown of the Bulgarian economy was combined with the availability of savings attracted as deposits and thus the own banking resources have increased in supply. This trend combined with the fall of the demand for new credits has caused accelerated slowdown of interest rates. This is also an inseparable part of the overall deflationary trends since 2009 onwards.

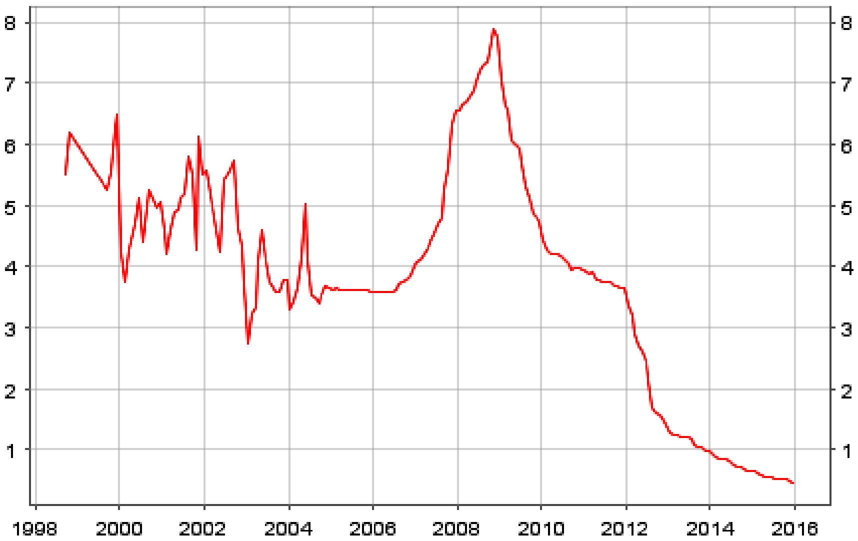


Fig.5. *Money market interest rates in Bulgaria in (2000-2015) (3 months (80-100 days) maturity, denominated in Bulgarian lev)*

Source: Eurostat, NSI of Bulgaria: Money market interest rates

Another indicator influencing the inflation and inflation expectations is the criterion of convergence of the long term interest rates on the Bulgarian Government debt. The level of these interest rates is indicative for the convergence with the EMU as Bulgaria has had average long-term interest rates that were – to different degrees in separate year – much below the reference value for the interest rate convergence criterion since 2010. As seen on Fig.6, the long term interest rates on the Bulgarian Government securities have fallen considerably which may also be a factor to lessen the pro-inflationary impact of both servicing the debt as well as resorting to issuance of new debt.

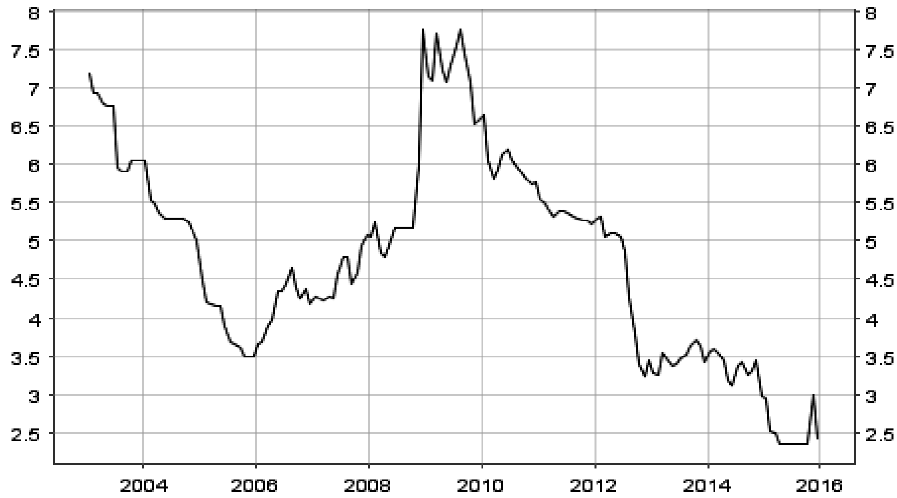


Fig.6. *Bulgaria, Long-term interest rate for convergence purposes*

Source: Eurostat, National accounts statistics.

The low inflation rate in Bulgaria will be challenging in the medium term, given the limited scope for active monetary policy under the existing currency board arrangement Due to the fact that the GDP per capita in Bulgaria is significantly lower than in the euro area, it is difficult to foresee the exact size of the inflation effect resulting from the structural adjustment that is underway. On the Government agenda is to introduce an increase of the minimal wage from 2016 onwards as well as the liberalisation of the market for electric supplies which may cause higher inflation.In medium term the economy is expected to grow at a higher rate and as the income convergence proceeds, price level convergence is to continue. The outcome will depend also on the choice of the model of growth of the Bulgarian economy (Minasijan, 2011). This, in turn, would manifest itself in terms of higher domestic inflation, given the fixed nominal exchange rate..

As a new EU member state Bulgaria has no opt-out choice as regards the EMU and thus has the status of a Member State with a derogation. The convergence with the EMU requirements has been most pertinent by the gradual process of alignment of Bulgaria’s fiscal policy with EU requirements.Objectively the economic growth in terms of positive rates since 2004 has made possible to maintain the public finances adequately and to achieve a budget surplus since 2004 up to 2009. At the same time complex political and economic reasons justify the postponement of Bulgaria's participation in ERM II as the Convergence report points out to the need of decreasing the external imbalances and improve the labour market. In practice, the deterioration of the indicator for government deficit for 2009 up to 4.3% of the GDP led to the imposition by the European Commission to Bulgaria a procedure for excessive deficit (see Fig. 7). In the subsequent years, and currently by adhering to the new rules and requirements to the government finances, Bulgaria has again restored the compliance with Maastricht criterion by adhering to consolidation of fiscal policy and improving the discipline of execution of the state budget.

Fig.7. *Government Budget deficit (-) or sufitsit (+) of Bulgaria (% of GDP)*

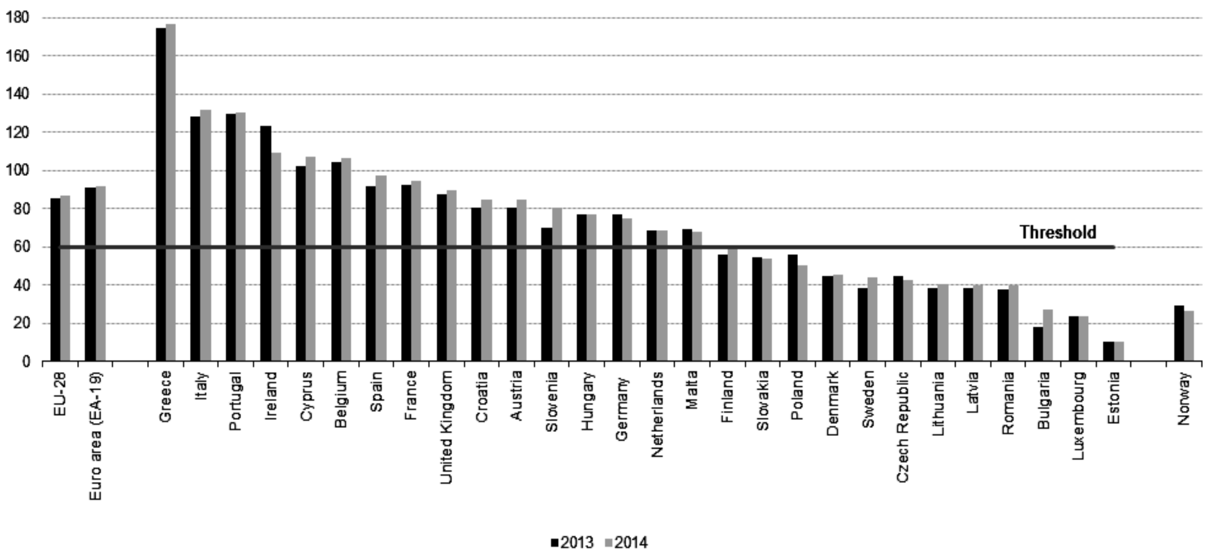
Source: Eurostat, 2015. Data for 2015-2016 are estimates.

In fact after a temporary deterioration in the budget deficit in 2009 there was a relatively rapid return to a trend of improving macroeconomic behavior in accordance with the Maastricht criteria. This has been set as a target in the Government fiscal policy also for 2015-2016. The Convergence Programme of Republic of Bulgaria for 2014-2018.

As regards the indicator for an average annual rate of growth of the public debt-to-GDP Bulgaria has had consistently consolidated its fiscal policy throughout the period (1998-2015) and fiscal discipline has been much strict if compared with other EU countries (Fig. 6). The need to provide state aid to meet the needs of the deposit guarantees repayments after the closure of Corporate commercial bank and the liquidity support for other 2 domestic banks in crisis has caused rapid increase of the Government debt-to-GDP ratio in 2014.The steep rise of this ratio in 2014 caused the assessment of Bulgaria as a country with imbalances by the European Commission's Alert mechanism for greater macroeconomic imbalances. By end of December 2015 the government debt-to-GDP ratio is 26.4%, with the share of domestic government debt being 8.5% and of external government debt – respectively equal to 17.9% of GDP. In the government debt structure, domestic debt at the end of 2015 amounts to 32.1%, and external debt - to 67.9% of the total debt. Any further rise of this indicator for the Government debt may present a challenge to fiscal policy sustainability.

The debt-to-GDP ratio is subject to the threshold of the Maastricht criteria on public debt..In spite of inceasing the government debt-to-GDP-ratio Bulgaria is still much below the reference value of the 60% of GDP which is the threshold of this criterion of Maastricht.The comparison with other EU member states, including EMU member states shows that Bulgaria's debt is below the reference value (Fig.8).

Another feature is the structure of this Government debt as being issued and sold abroad and in the country. The currency composition in which the Government debt has been issued is indicative for the high degree of Bulgaria's euroization.The debt currency structure as of end-December 2015 is as follows: 75.9% in EUR, 23.0% in BGN, 0.6% in USD and 0.4% in other currencies. As regards the currency composition of payments, since the beginning of 2015 the greatest is the euro-denominated share - 65.5%, followed by those in USD - 24.2%, in BGN - 10.1% .



(1) Data extracted on 21.04.2015

Fig.8. *Comparison of EU countries in Maastricht criterion indicator for share of public debt in GDP (%)*

Source: Eurostat (online data code: tsdde410)

The achieved good discipline in government finances of Bulgaria deserves to be acknowledged. As seen in Figure 7, Bulgaria's indicator for share of public debt in GDP is below the threshold of 60% of GDP – less than 30% of the GDP. Nevertheless, due to the fact that the unfavourable conditions of the European sovereign crisis in the Euro area countries have lasted longer than expected, there is an objective necessity to take account of the need to implement the reforms in the EU that are targeted to deepen the integration capacity of the EMU.

2. Main characteristics of the development of the financial sector in the period (2007-2014)

In the period (2007-2014) the financial intermediaries in Bulgaria and the bank-credit and capital markets are under the effect of slowing the pace of growth and speedier transmission of the negative effects of the global and the European debt crisis. The most direct result has been observed in the contraction of credit expansion and reducing the inflow of foreign investments. The overall impact of the crisis to reduce economic activity determines the sharp contraction of credit volume in 2010, continuing decline to zero in 2013 and the new fall by 7% in 2014. The increase of economic growth rate of Bulgaria to 2.9% in 2015 has not been supported by an increase of credit to the non-financial institutions.

The overall negative impact of the post-crisis slow recovery of the world and European economy contributes to the uncertainty in the business climate in Bulgaria and the low demand of new loans and investments. The most significant decline is observed as regards loans to non-financial institutions, which reflects the ongoing economic stagnation in the real sector. This credit crunch has also been to some extent a reflection of depleted debt capacity of companies in the real sector to apply for new loans. This has also confirmed the trend that along with the sharp reduction of new loans also a reduction of the deposits of non-financial institutions has been observed. To a lesser degree, but continuing trend is the decline in the volume of mortgage lending, reflecting the economic stagnation. Overall dominant trends in bank lending reflect the slow recovery as the deflation has contributed to lowering the interest rates on deposits but much smaller has been the reduction of the interest rates on credits. On the one hand, companies are reluctant to draw new credits and investment loans due to lack of favourable conditions for business development. Households are under budget constraint to demand for new loans mainly due to the need of coping with their high exposure to servicing former debt and the constraint to maintain current spending. The medium-term downward trend in mortgage loans since 2008, has been reflecting the overall decline in demand and the impact of the already accumulated debt of businesses.

Despite the growth of savings in the banking system (nearly 10% annual growth in deposits of non-financial legal entities and individuals and households) there has not been observed an increase in loan demand. Increased liquidity of banks favours undoubtedly the drastic decline of interest rates on deposits in 2014-2015.

The fact is that in conditions of global crisis the growth of domestic savings has allowed to avoid adverse effects of certain reduction of cross-border lending liquidity resources of subsidiary foreign banks in Bulgaria. This reflects the general trend observed in the global economy to increase the role of domestic savings as a possible source of credit resources of banks emerging from the crisis (Global Financial Stability Report, 2015). There is a process of reduction of interest rates on deposits, which in mid-2014 and the first half of 2015 has dramatically been introduced in the banking system. The growth of deposits testifies to the sinking aggregate demand but stimulating sufficient liquidity to cash-loan market.

Table 1.

Dynamics of loans and deposits in the banking system in Bulgaria for the period (2008-2014) (in%)

	2009/2008	2010/2009	2011/2010	2012/2011	2013/2012	2014/2013
Mortgage loans	8%	4%	1%	1%	-1%	-1%
Consumer loans	7%	-4%	-2%	-2%	2%	-1%
None-financial institutions loans	3%	4%	6%	6 %	0%	-10 %
Total Loans	4%	2%	4%	4 %	0 %	-7 %
Deposits of individuals and households	12%	13%	14%	12 %	9 %	4 %
Deposits of non-financial institutions	-6%	3%	11%	3 %	7 %	-2 %
Total deposits	4%	9%	13%	9 %	9 %	2%

Source:BNB

Although credit growth has been significant in Bulgaria for nearly a decade with extremely high annualized rates, a time exceeding 50%, it has since declined with the onset of the Global financial crisis. Banks' long term funding has declined in relation to total liabilities, even while funding from parent banks to domestic subsidiaries has increased. For the banking system as a whole, resident bank deposits declined by 21% between the third and fourth quarters of 2008, but have recovered ever since. Domestic interbank market borrowing also declined but has rebounded in 2009. In part due to global conditions, bond market funding for banks declined substantially since the first half of 2008, while third party (non parent) foreign banks and investors reduced most funding to the domestic banking sector.

At the same time parent bank funding increased by 24% from midyear 2008 through the first quarter of 2009, reflecting a strong commitment of foreign bank shareholders to Bulgarian subsidiaries. These funding shifts and other developments have been reflected in increases in the aggregate loan to deposit ratio .The need to strengthen transparency provisions in corporate law has been considered to ensure a full and reliable identification of interconnected exposures with banks, shareholders and owners, to assure that changes in funding sources count on the proper accounting of liquidity and solvency requirements on a more consolidated scope.

The second adjustment of the financial sector has been in the period (2009-2015).The Bulgarian National Bank (BNB) actions have helped to ensure financial stability in the banking sector. The BNB has taken measures to increase the banks' capital and liquidity cushion by releasing existing prudential “buffers”, for example by lowering the reserve requirements and working with parent banks to ensure credit lines to foreign-owned subsidiaries remained available and profits.are recapitalized. The BNB intensified its monitoring, strengthened stress testing capabilities45 and reviewed the crisis management framework as a contingency measure.46

The overall negative impact of the post-crisis slow recovery of the world and European economy contributes to the uncertainty in the business climate in Bulgaria and the low demand of new loans and investments. The most significant decline is observed as regards loans to non-financial institutions, which reflects the ongoing economic stagnation in the real sector. This decrease is to some extent a reflection of depleted debt capacity of companies in the real sector for new loans. This has also confirmed the trend that along with the sharp reduction in new loans is observed decrease in deposits of non-financial institutions. To a lesser degree, but continuing trend is the decline in the volume of mortgage lending, reflecting the economic stagnation.

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[45] The BNB conducts stress tests on a quarterly basis in order to analyse. Several types of risks, but the most relevant and quantitatively significant to the Bulgarian context are credit risk and liquidity risk. Market risks only constitute a small share of the capital requirement.

[46] On November, 27, 2008, the BNB Governing Council adopted amendments to Ordinance No. 21 on the minimum required reserves maintained by banks with the central bank: (i) effective December 1, 2008, the minimum required reserves on all attracted funds of the banks are decreased from 12 percent to 10 percent;

(ii) effective January 1, 2009, the minimum required reserves on funds attracted by the banks from abroad decreased from 10 percent to 5 percent; and (iii) effective January 1, 2009, no minimum required reserves is imposed on funds attracted from the state and local government budgets. Currently the BNB considers there is enough liquidity in the banking system and a further reduction of required reserves is unlikely to reduce interest rates.

Fig.9. *Annual growth rate of banks' loans to non-financial institutions in Bulgaria (in%)*

Source: Eurostat. Bulgaria, MFIs excluding ESCB reporting sector - Loans, Total maturity, All currencies combined - Domestic (home or reference area), Non-Financial corporations sector, Annual growth rate, data Neither seasonallynor working day adjusted.

Overall dominant trends in bank lending reflect also the deflationary trends that contribute to lowering the interest rates on deposits and to a smaller extent on credits. The risk of deflation and the reduction of demand are negatively influencing the business expectations and thus add up to the credit crunch. On the one hand, companies are reluctant to draw new credits and investment loans; on the other hand, households are limited to demand for new loans mainly as already have high exposure to servicing debt and current spending mortgage loans since 2008, also

Despite the growth of deposits of savings in the banking system (nearly 10% annual growth in deposits of non-financial legal entities and individuals and households) there is not an increase in loan demand and new loans. Increased liquidity of the banks makes easier the drastic decline of interest rates on deposits. In the presence of the growth of deposits in the banks the competition increased among the banks. The fact is that in conditions of global crisis the growth of domestic savings allow to avoid adverse effects of certain reduction of cross-border lending liquidity resourcesfrom abroad for subsidiary foreign banks in Bulgaria. This reflects the general trend observed in the global economy, i.e. by increasing the role of domestic savings as a possible source of credit resources of banks to stimulate the credit (IMF, 2015). There is a process of reduction of interest rates on deposits, which since mid-2014 has accelerated across the banking system. The growth of deposits testifies to the sinking aggregate demand of goods and services and risks of the deflationary trends.The consequence of these trends is a small reduction of the net interest revenues from loans to banks and to a less extent the reduction of the net revenues from commercial credit (Fig. 10).

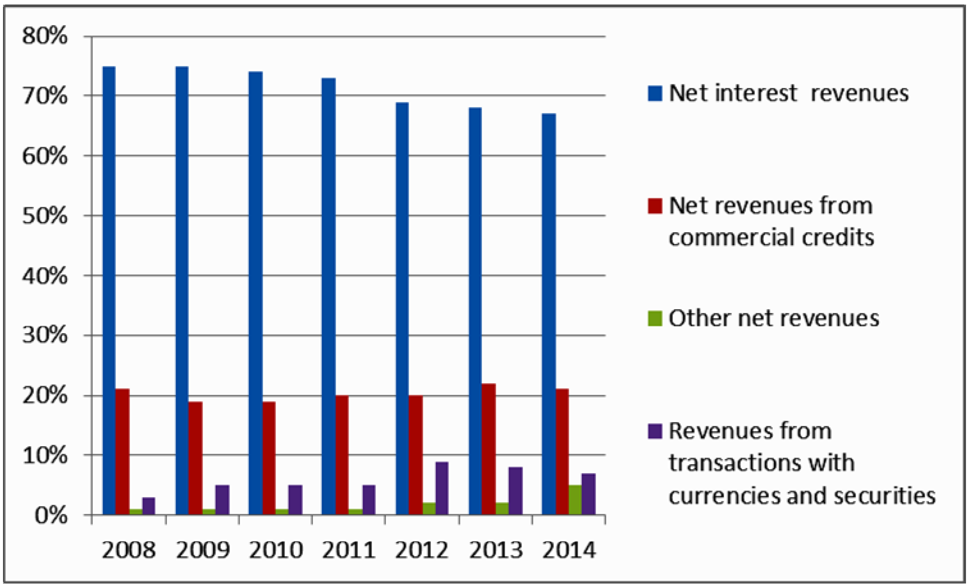

Fig.10. *The structure of the revenues of the banking sector in Bulgaria (in % of total revenues)*

On revenues and expenditures of banks reflect substantial changes driven by the impact of the financial and economic crisis. The strong increase in provisions reflects the problems of bad loans and the continuing difficulties in collecting receivables unattended loans. This is the most important factor that affects a substantial reduction in the annual profit of the banks in the period (2009-2013). From 2013up to now, there was a small increase in bank earnings compared to previous years, but slowdown of economic recovery did not allow to increase the net positive effect on banks. Since the crisis in 2008 there is a deterioration in the portfolios of commercial banks with the growth of non-performing loans (amounting to 20% of total volume of bank loans) which has made banks to be more selective in the assessment of the creditability of the clients. In the presence of the growth of deposits in banks the increased competition ending, especially in connection with the refinancing of other banks' customers. The consequence of these trends is the reduction of interest income from loans to banks and reduction of their expenses to pay interest on deposits.

3.The implementation of the reforms in the financial sector

In assessment of the impact of the European financial crisis on the Bulgarian banking system one may distinguish two periods of structural adjustment of the financial sector as follow-up of Bulgaria's accession to the EU.

Under the conditions of the Global crisis and its impact on the European banks the BNB as central bank of Bulgaria introduced important anti-crisis measures to support the liquidity management of the banks. 47 Bulgaria has harmonised its legislation with the EU law that has been urgently introduced in 2008 as regards the deposit insurance schemes. In compliance with the EU regulation the threshold for the deposit schemes guarantee has been raised and Bulgaria's Central bank has joined the Vienna initiative of the Central banks of the new EU member states.48 The banks' capital cushions have been kept adequate compared to other European countries: the average capital ratio for the system is reportedly close to one quarter above the regulatory minimum at around 16%.

Under these conditions the transposition of important EU directives in the banking sector of Bulgaria is inevitably associated with substantial changes which are to contribute to the preparation for the EMU entry.

The transposition of important EU directives in the banking sector in Bulgaria is inevitably associated with substantial changes. Some of them must be taken in response to the crisis from the middle of 2014 when after acute liquidity attack against several credit institutions have the need to take measures. With state aid was possible to overcome the liquidity problems of First Investment Bank the crisis and closure of the Corporate Commercial Bank have created tensions and threatened the stability of the banking system. The public cost of this crisis is not finalised yet.

On the other hand, essential interventions of state institutions have been undertaken after placing the Corporate Commercial Bank in 2014 under special supervision because of the abuses found, bad practices and violations of banking regulations and the subsequent withdrawal of its license by the Bank. Observed crisis is managed not only at the expense of accumulated bank buffers. By additional measures as well as by the BNB and the government aid is to avoid the spreading of negative effects on the rest of the banking system. The case of Corporate Commercial Bank has raised on the agenda many issues that concern the harmonization of the regulation of banks with

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[47] On November, 27, 2008, the BNB Governing Council adopted amendments to Ordinance No. 21 on the minimum required reserves maintained by banks with the central bank: (i) effective December 1, 2008, the minimum required reserves on all attracted funds of the banks are decreased from 12 percent to 10 percent;

(ii) effective January 1, 2009, the minimum required reserves on funds attracted by the banks from abroad decreased from 10 percent to 5 percent; and (iii) effective January 1, 2009, no minimum required reserves is imposed on funds attracted from the state and local government budgets.

[48]The Bulgarian Deposit Insurance Fund (BDIF) is a legal entity established by the 1998 Law on Bank Deposit Guarantee. The Fund protects depositors' funds in banks up to BGN 196,000 (EUR 100.000) as well as creditors' interests in bank bankruptcy proceedings .

the modern changes by implementation of Basel III and the EMU reforms as well as proper banking supervision. The bank supervision is another area of EU new regulatory and institutional reforms which is yet to undergo important changes in Bulgaria.

Due to the need to introduce newly Capital Requirements Directive and a Regulation on the capital requirements serious changes were made to the Credit Institutions Act and in the secondary legislation. For example, a fundamental change is the elimination of Ordinance № 9 of BNB, which lays down specific provisions for credit risk. In place of the appropriations to the change in the legal framework specific provisions, banks should carry out additional accounting provisions in International Financial Reporting Standards, aimed at reduction of the carrying value of loans in arrears over 90 days. All these changes have a particular impact on individual credit institutions at home and mid-term will lead to a further deepening of the process of harmonization of regulatory changes in the European financial space.

The recent changes to the EU framework have, however,limited some flexibility of the supervisory department of the BNB. Previously the BNB applied a minimum capital adequacy ratio of 12 percent, but this requirement is now capped at 8 percent under the Capital Requirements Regulation. In response, and at a period of heightened systemic stress, the BNB has “frontloaded” capital buffers so that the capital conservation buffer and the systemic risk buffer are both currently in force. The advent of the CRR and its implementing technical standards has also removed the BNB’s former power to set supervisory provisions against problem exposures. The BNB retains, however, the power to set higher capital requirements in respect of problem assets. At present the BNB is practicing close monitoring of the evolution of the relevant portfolios and is exercising what might be termed an “informal Pillar 2 approach.” The BNB does, however, need to be ready and able to apply additional capital requirements through Pillar 2 in future.49

In implementation of EU law, Bulgaria introduces the reforms undertaken in the EU, as regards the explicit consideration for the financial sector responsibility for sharing the losses by establishing a new regime for recovery and resolution of credit institutions and investment firms. The reform in the EU has to achieve in an accelerated mode the results similar to normal insolvency proceedings regarding the allocation of losses to shareholders and creditors, but improved management with a view to preserving financial stability and limit losses to taxpayers when the announcement of the bank/firm in bankruptcy would threaten the public interest and would constitute a threat to financial stability.

For this purpose, the transposition in the Bulgarian legislation of Directive 2014/59/EC by a special law creates legal prerequisites for a framework for the recovery and resolution of credit institutions and investment firms. The Directive aims to establish an effective framework at European level to deal with banking crises enough at early stage, so as to prevent the spread of the financial problems of individual credit institutions on the entire banking system, and to eliminate in as much need to use

At the present stage there are further changes in the regulatory framework which the banking system in Bulgaria will undergo to implement the new European regulations, standards and practices. The crisis has pushed the changes for the better to design prospective reforms by focusing on ensuring financial stability and in pursuing financial integration. The newly designed institutions and rules raise higher the requirements to comply with the EMU governance principles and institutions.

In 2015 the BNB as Central Bank declared its readiness to review the quality of assets in all banks operating in Bulgaria. This review will be a key requirement if the government initiates a negotiating process with the ECB to join the single supervisory mechanism. The methodology of the review will

[49] Capital adequacy has been calculated under the EU Capital Requirements Regulation since January 2014, which permits a slightly more generous treatment for some risk weights than the previous BNB regime. As of December 2014, the system CAR stood at 22 percent, and the Tier 1 capital ratio was 19.9 percent. In Bulgaria, the majority of tier 1 is held in common equity and the system wide ratio was 19.5 percent. With the advent of the CRR, the BNB can no longer apply a minimum 12 percent CAR as it had formerly done. The BNB has however, imposed the capital conservation buffer of 2.5 percent since May 2014 and has also applied a capital buffer for systemic risk of 3 percent of total risk weighted exposures located within the country and calculated in accordance to Article 92 (3) of Regulation 575/2013/EC.

be built on the highest standards already developed and implemented by the ECB in 2014 in reviewing the quality of the assets of the largest banks in the euro area. The launch of the process will be a function of the progress and implementation of the new Directive on recovery and resolution of banks.

Agenda priority for 2015 has been to restore confidence in the BNB as Central Bank and in the institutional order that ensures the stability of the banking system. Not only the election of the Governor of the National Bank, but the implementation of comprehensive reforms in the financial intermediation are undertaken to ensure the sustainability of financial intermediation and its significant role in the economic development of Bulgaria.

The banks and investment firms are setting new the requests for the preparation and updating recovery plans containing measures and procedures for: 1) taking early action in case of worsening of their financial situation; 2) preparing the development and restructuring plans for the restructuring of a bank or investment firm; 3) compliance of the plans with the requirement to minimize losses to taxpayers and preserve critical core activity of the institution functions.

The establishment of a Fund for the restructuring of banks (which will be managed by the Board of the Fund for Guaranteeing Bank Deposits) and Restructuring Fund investment intermediaries (which will be managed by the Board of the Fund for Compensation of Investors) builds the necessary institutional structure in Bulgaria for conducting modern reforms in EU financial sector. In accordance with the requirements of the Directive, the Bulgarian Law on Resolution and Restructuring of Credit Institutions and Investment Intermediaries previews the following tools of restructuring: sale of business, bridging institution, separation of assets and sharing of losses. Two additional tools for restructuring are introduced: a tool for government capital support and tool for temporary state ownership, which are state tools for financial stabilization. Competent authority for deciding on the application of these instruments is the Council of Ministers on a proposal of the Minister of Finance.

The Bulgarian National Bank (BNB) has encountered difficulties with the banking crisis in 2014 but its actions have helped to ensure financial stability in the banking sector. The crisis began in June 2014 with two bank failures – the KTB and Viktoria Bank. Following runs on deposits, the BNB put the two banks into conservatorship. Soon after this intervention, a third domestic bank suffered a depositor run and was supported by emergency liquidity (state aid has been approved by the EC and provided successfully). The KTB crisis clearly demonstrated the lack of an institutional framework for crisis management, both in terms of a strengthened preventive role of banking supervision and for regulating the bank resolution processes.

With entry into force of the Law on Recovery and Resolution of Credit Institutions and Investment Firms in 2015, a regulatory framework governing such processes was established. The relevant organisational structures should be established for the resolution activities and drawing up of operational procedures for interaction with the Banking Supervision Department. The BNB has actively monitored and tried so far to mitigate the impact of the global financial crisis. Actions taken to increase banks' capital and liquidity cushion include releasing existing prudential "buffers", for example by lowering the reserve requirements and working with parent banks to ensure credit lines to foreign-owned subsidiaries remained available and profits are recapitalized. The BNB intensified its monitoring, strengthened stress testing capabilities and reviewed the crisis management framework as a contingency measure.

According to an independent external assessment of the effectiveness of the banking supervision in Bulgaria by a joint IMF – World Bank team in 2015 important findings and recommendations on the BNB banking supervision activities are made. The IMF and the World bank assessment indicate some issues of the insufficient degree of conformity of Bulgaria's supervisory practices with the Basel principles and point out how to improve the banking supervision.(IMF,WB, 2015).

In accordance with the Law on Resolution and Restructuring of Credit Institutions and Investment Intermediaries that was adopted in 2015 the BNB is granted a mandate to organize the Asset Quality Review of the banking system, including the check of the quality and the adequacy of the estimations used for the assets' valuations, collateral and the practices for devaluation and provisioning as instruments previewed by Law.[50]

The EMU has undergone important institutional and functional changes while the euro area tackles the crisis and reforms its policies and institution. It is acknowledged that the "in-or-out" of the EMU is a question that has become more complex (Rehn, 2013). The design of the EMU reforms is still shaping due to the different approaches of the member states to the issues and the political process (Ville et al., 2015). Surely the present state of the EMU (as considered to be "EMU 2.0.") raises the requirements and the mechanisms and instruments for a higher degree of common system of sharing the burden of making the EMU a more effective and robust functioning Union.

Conclusion

The financial sector encounters two main macroeconomic challenges to Bulgaria : (i) how to speed up and sustain higher GDP growth, and (ii) how to ensure that this growth translates into new employment opportunities. Success in both dimensions will depend on the country's ability to implement the necessary structural reforms in the real and financial sectors. The implementation of the requirements for the EMU entry at the present stage of its new design as EMU 2.0 may be demanding higher costs before being admitted to the full membership. But it is much more rational to get on track of preparation for the EMU entry at a time when the reforms in the EMU are to be introduced.

The adoption of the euro may take place in Bulgaria after several measures are fulfilled: 1)under the auspices of the BNB there is a need to carry out the Asset Quality Review and the stress test of the Bulgarian banking system;

2) an in-depth evaluation of the financial sector of Bulgaria by the IMF Financial Stability Assessment Program (FSAP) and the World Bank is to be carried out by the end of 2016;

3) an analysis of the necessary steps for the realization of the strategic goals is to be reported to all responsible institutions in order that decision be taken for Bulgaria's EMU entry;

The accession to the euro area has been a strategic goal for Bulgaria for more than a decade but since mid2015 it has entered the stage of undertaking operationally planned activities to make the right choice and engage resourceful means to achieve full integration to the European supervisory and financial architecture. The Single Market of the EU will be changing as the differentiated integration within the EMU proceeds further. Beyond this, it is equally crucial that the reforms will contribute to a more effective and robust functioning of EMU.

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[50] The review is going to be done in 2016 in direct cooperation with the European Commission and the European Banking Authority and it is going to be based on the methodology corresponding to the one that has been already applied by the European Central Bank at the start of the European Supervisory Mechanism in the euro area in 2014.

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