BEHAVIOR OF THE BANKING SYSTEM IN THE CONTEXT OF POSTCRISIS ECONOMIC DEVELOPMENT OF BULGARIA

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Abstract

The paper aims to reveal the peculiarities of the development of the Bulgarian banking system and the factors that determine its development. The banking crisis of 1996-1997, the introduction of the Currency board has pushed forward the consolidation of bank capital. Foreign banks have taken on most of the Bulgarian banking market. The Bulgarian banking system is looking stable, with a high liquidity ratio and low inherent risks. Nevertheless, the closure of one Bulgarian bank proved that credit institutions in Bulgaria required close monitoring by the regulator. Will the stabilization of Bulgarian banking sector be insured with the perspective to join the European Banking Union?

Keywords: banking system, financial system of Bulgaria, crisis

JEL classification: F36, G21

Bulgarian banking sector – financial results and evolution

The slowly overcoming of the debt crisis in Europe and the direction of centralized supervision of the European banking system by the ECB raised the question about the stability of the Bulgarian banking system. In 1996-1997, 18 Bulgarian banks were declared insolvent, as that was a banking collapse unprecedented in Europe. After the banking crisis (1996-1997) fewer banks remained in Bulgaria (32), but with a better management. The assets of all Bulgarian banks combined were USD 26.2 billion, or 80% of GDP.

The Currency board, introduced in 1997 continued the dependence of Bulgaria on the IMF. The standard instruments of the monetary policy can not be applied under a Currency board regime that is why the Bulgarian National Bank (BNB) used a combination of administrative and control measures to regulate the money supply. Banks were required to adopt financial buffers in order to maintain more stringent requirements in terms of reserves, also higher risk weights standards that were above the minimum required by EU financial structures and the Basel Committee on Banking Supervision. BNB, (in the context with the stand-by arrangements with the IMF, which ended in 2007) has taken strong measures to contain the growing of lending, to strengthen the banking supervision, and to promote prudential regulation and to build capital buffers.

During the global financial crisis, those requirements were used as a counter-cyclical measure for to allow banks to use part of its liquidity reserve. The severe prudential policy strengthen the banking system, but it also stimulates non-bank lending under the terms of international inter-enterprises loans, of asset-backed securities and the expansion of leasing operations. (leasing portfolio was below 5% of GDP in 2011). The Bulgarian banking system holds up well the challenges and the economic downturn in Bulgaria due to the economic crisis. The banking sector has shown resistance towards the sharp drop of the international capital flows, as well as against the increasing funding costs for the banks. However, the impact of the crisis was severe and imbalances accumulated in the Bulgarian economy laid hidden threats to the functioning of the Bulgarian banking system.

The Bulgarian banking system withstood against the impact of the debt crisis of 2008 -2010 in South European EU countries. It was mainly due to its underdeveloped structure of offered financial services and because of the almost defunct derivatives trading. The sovereign debt crisis in Greece had not a real negative impact on Greek subsidiaries operating in Bulgaria. This was due to the fact that subsidiaries of Greek banks in Bulgaria have no exposure in Greek private or government debt securities. Fresh capital has been exported by subsidiaries in Bulgaria towards the main banks settled abroad.

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The BNB implemented strong banking supervision, requiring the provision of allowances as a barrier against the occurrence of unpredictable events of different sort and sources. The commercial banks are obliged to maintain buffer capital above the statutory capital adequacy. Special bodies were created in order to maintain banking stability like the “Guarantee Fund claims” (since 1998) and the “Reserve Bank to the Guarantee Fund”, which is a mechanism for the providing of short-term liquidity. Furthermore, the Regulation No 11 of the BNB is focused on liquidity management. The fiscal reserve account created under the auspices of the IMF is the most important tool to counter act the moral hazard of the state and to ensure that the accumulated reserve in BNB provides the basic foundation of the Currency board.

The commercial Banks in Bulgaria were almost entirely privatized by foreign monetary institutions. Foreign banks are mainly coming from Austria, Italy and Greece. It is assumed that foreign subsidiaries have introduced some best practices in banking and improved the quality of the financial services. The three largest banks in Bulgaria are “DSK” owned by OTP Bank of Hungary, “Bulbank”, owned by the UCI (Unicredito Italiano) and “United Bulgarian Bank” (UBB), owned by the National Bank of Greece. Citibank is the only bank from the United States that focuses on corporate, not individual customers.

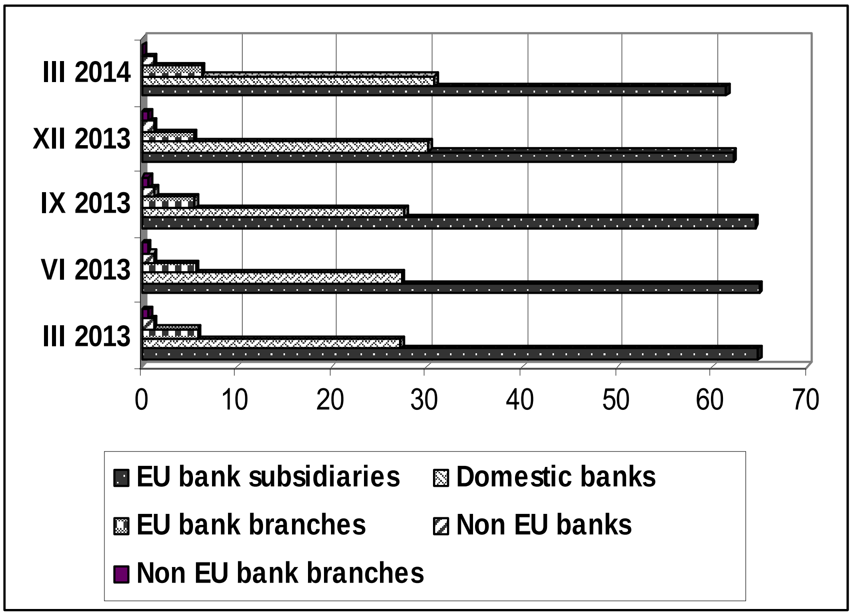

Figure 1. Market shares of Domestic and Foreign Banks (%)

Source: Data from “Banks in Bulgaria (January-March 2014) Bulgarian National Bank p.9”.

The increase in size and financial strengths of Bulgarian banks was due to the growing private sector, the increasing credit demand and the competitive pressures of the market. With the exacerbation of competition between banks increased also the positive development and the consolidation of the banks’ capital. For example, in 2005 the Italian Unicredit Bulbank acquired Austrian HVB (Bank Biochim and Hebros). Thus was creating the largest financial group in the country with almost 25% of the bank market share. EU bank subsidiaries hold more than 60% of the bank market share and domestic banks hold more of 20%. (Fig. 1) In the beginning of 2014 the relative market share of Bulgarian banks rose slightly. Domestic banks contributed almost entirely to the growth, their market share reaching 30.8% in March 2014. The market share of the EU subsidiary bank group decreased to 61.5 %. EU bank branches increased their share in assets (to 6.3 %), while that of non-EU bank branches decreased to 0.1 % The market position of non-EU banks remained at 1.3 % The fragmentation of the market is high, as the 3 biggest banks hold about 80% of the market. (Figure 1)

Table 1

Total Assets, Total Gross Loans, Total Claims on Financial Institutions in BGNs and Loans as % of Total Assets and Claims as % of Total Assets

	2005	2006	2007	2008	2009	2010	2011	2012	2013
Total Assets in blns BGN	33	42	59	70	71	74	77	82	86
Assets to GDP (%)	72	82	98	100	104	105	102	106	110
Total Gross Loans in blns BGN	24,2	31,3	45,9	56,9	59,9	62	64,4	64,7	68,1
As % of Assets	73,56	74,52	77,77	81,29	84,37	83,78	83,64	78,9	79,19
Total Loans to NFIs and Other Clients in blns BGN	18,4	22,8	38	50,2	52,4	53,9	56	57,8	58,5
As % of Assets	55,76	54,29	64,41	71,71	73,8	72,84	72,72	70,49	68,02
Total Claims on Financial Institutions in blns BGN	5,8	8,6	7,9	6,7	7,4	7,7	8,3	6,9	9,6
As % of Assets	17,58	20,48	13,39	9,57	10,45	10,41	10,73	8,41	11,16

Source: BNB

In 2013 bank assets rose by 0.9 %.The increase of total bank assets was due to the strong upward trend of bank deposits. Despite the emergence of positive GDP growth of Bulgaria in the last 2 years the uncertain political environment continued to have an unfavorable impact on the economic climate, which is preserving the higher saving rate of households and firms. Households do not have many opportunities and relevant information to invest in securities. After the crisis they are much more cautious and prefer to save because they are too uncertain about the future. In 2005-2013 the average ratio of total loans to non financial agents (NFA) to total assets is around 80%. The total claims on financial institutions (FI) as a percentage of assets is decreasing in 2008 – 2012 in comparison with previous periods, but in 2013 the ratio began to grow, which was due to accrued inter banks operations.

Until 2007-2008 the GDP in Bulgaria was fueled also by the increase of the credit activity of banks towards households and firms. Since 2007 onwards the level of assets to the GDP growth is relatively a constant value. However that there is some increase of the ratio (Bank assets to GDP), more significant upward trend of this ratio could appear only if investment banks operations and foreign direct investments (FDI) could boost ahead the financing of the economy. Despite the emergence of moderate economic activity in Bulgaria and in EU countries, the recent rise of the geopolitical risk (further sanctions on Russia from the EU and USA) is likely to narrow the GDP growth perspective in the near future.

The Bulgarian banking sector seemed well prepared to counter the economic downturns of the economy. Even more, the evolution of the Bulgarian banking system was favorable according the BNB data. The banking sector went well during the crisis and continues to have strong overall capital buffers. In 2013 the stability of the banking sector seems well preserved after the consolidation of the banking sector.

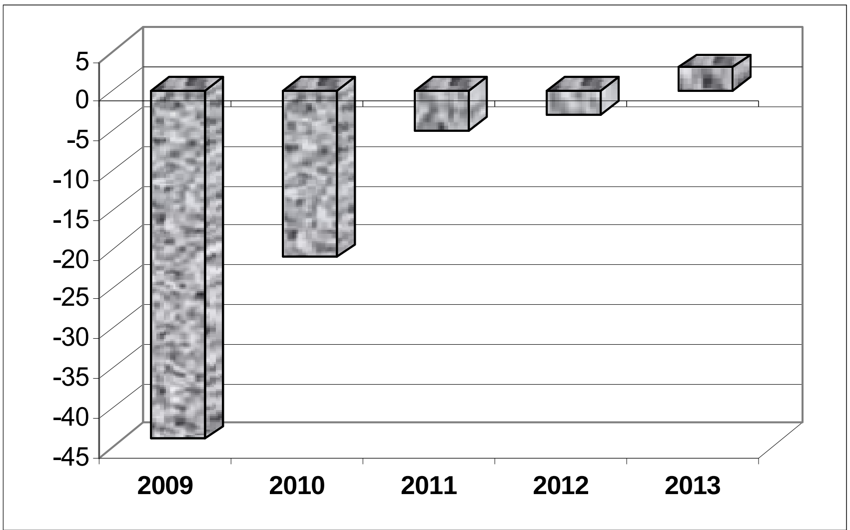

Figure 2. Net profit of banks in Bulgaria. In % y-on-y
Source: BNB

After a sharp decline in 2009-2010, in 2013 Bulgarian banks stabilised their financial results. For 2013, the profit of Bulgarian banks reached EUR 299.11 million, or increased by 3.2%. The contribution of transactions with securities to the bank profit declined slightly to around 1/3 of the total profit in comparison with 2012. (BNB) The decrease was due the increase of transactions with securities, as banks maintained long exposures at this segment of the market in Bulgarian Government securities. However significant variations existed in the amount of banks' profits, which was due to the drop in interest rates and the level of impairments. (Figure 2)

The capital adequacy ratio was 16.89% (as of September 2013) The adequacy of Tier I capital is 15.61%; The ratio of liquid assets to liabilities was 25.25%. The effects of earnings are that by the end of March 2014 they amounted to EUR 115 million and were higher than in the same period of 2013. It boosted the Return on equity (ROE) values to levels observed in early 2010. Return on Assets (ROA) was 1.03% (0.81%) in March 2013. Respectively ROE increase to 8.35% (6.40% in March 2013.) Cost to income ratio improved slightly to 53.4%.in 2013 compared with 2012. (BNB data)

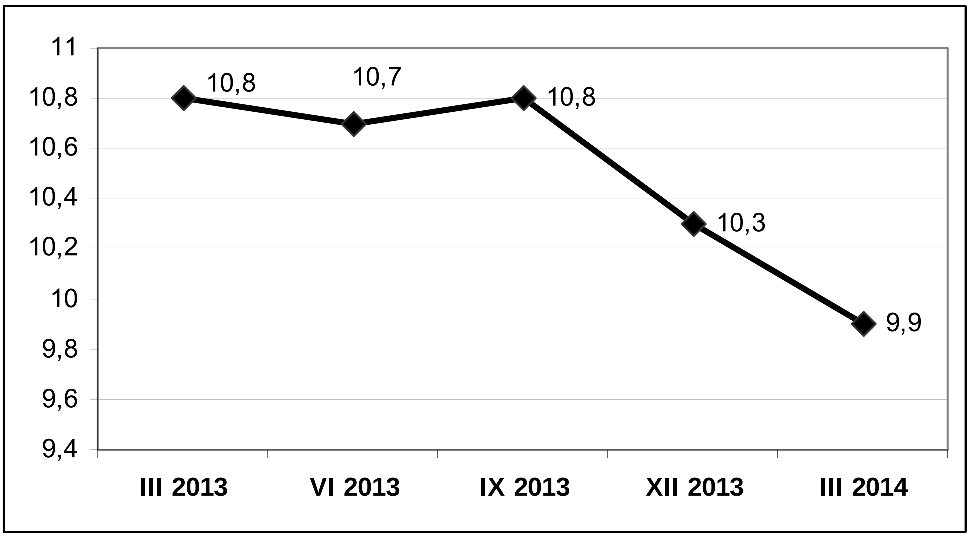

Figure 3. Share of net non performing loans in net loans (Excluding those to credit institutions)
Source: BNB

Gross non-performing exposures amounted to 17.20% against 16 62% at the end of 2012. In the first quarter of 2014 the capital buffer stock strengthened coupled with the retention of adequate liquid buffers. Net non performing loans are declining. (In October 2013 non-performing loans over 90 days are 10.66% at the end of 2013 of the credit portfolio of banks, compared to 10.62% at the end of 2012) For 2013 and 2014, both classified loans and those past due over 90 days posted a decrease. In March 2014 classified exposures declined by 1.7% compared with the end of 2013.The share of gross problem loans and their impairments played a major role for the continued decline in the net amount of loans past due for more than 90 days. Their share in the net credit portfolio fell to 9.9% (against 10.3% 3 months earlier). (Figure 3) Non-performing loans have stabilised and remain well provisioned. Credit growth has resumed in some tradable sectors" (BNB). The external financing of subsidiaries in Bulgaria is reduced and they rely on internal sources of financing. The squeeze of bank credits towards households and firms increased the offered liquidity on the inter bank money market. *However, domestic banks are expanding their portfolio faster compared to foreign banks subsidiaries, which was a sign of higher risk exposure. The systemic importance of local entities has increased following their gains in market share, including two acquisitions of foreign-owned banks in the country in 2013.*

The credit expansion by a limited number of domestically owned institutions required close monitoring by the regulator, which has so far proved to be a conservative one in order to identify risks and take corrective measures early enough when risks begin to emerge. It seems that the Bulgarian banking system continues to be in a more favorable position compared with other EU countries banking system. The Bulgarian banking system is looking stable, with a high liquidity ratio and low inherent risks. In 2013 the Bulgarian banking sector seems that it has managed to preserve financial stability and no financial sector related imbalances could be identified. (European

Economy p. 17). In a country struggling with corruption, a weak judiciary and unstable government it seems that only the Bulgarian banking sector diverges with the economic stagnation.

Nevertheless, the Bulgarian banking sector was qualified by Standard& Poors like a country with good indicators, but with a "moderately unstable" banking system. The quality of the balance sheets of some domestic banks seems doubtful in the frame of a very aggressive market penetration at the internal and neighboring markets.

The attack of the Bulgarian banking system came from outside the banking system. For a very short time a deliberate and systematic attempt was made to destabilize the Bulgarian banking system.[47] The BNB took control of Commercial Corporate Bank (CCB) and the clients of banks rushed to withdraw their deposits. The depositors withdrew also around EUR 400 millions from First Investment Bank (FIB). The European Commission approved to extend an emergency credit line of EUR 1.7 billion to support financially the local Bulgarian banks. BNB has taken measures to further increase the liquidity and safeguard the banking system.

The closure of CCB by BNB was due to specific reasons related with the suspension of its operations after more than 20% of deposits were withdrawn, causing a liquidity gap. About EUR 4 billions in all has been stranded in CCB which exacerbate the unfavorable financial situations of many Bulgarian companies and individuals. As a result some businesses are having trouble making payroll and many families have to scrape by without access to cash. The BNB, which is supervising CCB, was not sure how to proceed, whether to nationalize the bank with taxpayers' money or to look for a foreign investor. The waiting of cash money from CCB could kill many enterprises. More than 80 000 jobs could be lost if CCB go bankrupt. Now, the closure and the bankruptcy of CCB is a real fact since in November 2014 it was voted by the Bulgarian Parliament. The issue in the Bulgarian banking system is that the deposits may be a problem to be financially covered. Amendments to the Law on Deposit and Insurance (November 2014) provide in case of financial and liquidity problems of a bank; people to have the rights to access their deposits within 7 days. The depositors of CCB will have the right to be paid within 20 days in accordance with EU rules. But CCB may also default on its debts in bonds.

A new type of guaranteed deposits were introduced, at the amount of 250 000 BGN (EUR 127.821), but the security will be temporary. This type of guarantees will cover only deposits associated with special events. Thus Bulgaria honors its commitment to the European Commission (EC) to change the Law, so as not to delay for months the access of banks' clients to their deposits. It is a way to escape to the EC sanctions. Despite the disturbances in the banking sector, Bulgaria managed to sell EUR 1.49 billion of 10 years Government bonds (June 26th) attracting strong demand from international investors whose bids more than doubled the amount on sale. The 2,9% annual coupon was the country's "lowest ever" in an auction.

The European supervisory mechanism and the position of Bulgaria

From 1 January 2007 (with the accession of Bulgaria to the European Union) BNB participates in the European System of Central Banks. Bulgaria also participates in the work of the European institutions under the Directive on Recovery and Resolution of credit institutions. Bulgaria's position in this regard is the following: The recapitalization of monetary institutions with domestic fresh liquidity sources must be done with financial instruments from which are subtracted deposits (bail-in). The balance between the general framework regulation and the flexibility rules for a longer period has to be implemented in order to adjust to the new rules for restructuring. Bank close cooperation should be taken with the appearance of cross-border banking crises. The proposal for flexibility has been accepted by ECOFIN in the use of internal financial resources for the recapitalization of banks and it will be introduced by 2018. In 2014, Bulgaria adopted the Capital Requirements Directive and the Capital Requirements Regulation (adopted June 2013). These provisions have been introduced by Basel III.

Under the Basel III rules the capital must be improved and its commitment to the inherent risks. The requirements of supervisory standards at European and global level are increasing As a consequence, the Ordinance №9, which regulated the specific provisions for the credit risk dropped. The European Single Supervisory Mechanism will manage the attainment of a maximum financial harmonization and equal treatment of EU institutions.

[47] "According to the authorities, criminals tried to disrupt the system by sending e-mails and text messages urging people to withdraw their funds from several large banks" (The Economist 2014)

Bulgarian authorities did not intend to join the European Supervisory Mechanism (ESM) (or the First pillar of the European Banking Union) of the euro area. The arguments of BNB against the entry into the European Banking Union were as follows: a) The country would take risks if it joins ESM, before joining the euro area, because there will be a significant transfer of national supervisory power to EU regulators. b) Bulgarian banks will not have the possibility to be financed in fresh liquidity resources from the ECB, nor to receive a capital support from the European stabilization mechanism at the onset of a crisis situation. c) Countries, outside the euro area, will not have the rights to participate in the vote for the taking of final decisions during the exercise of the Supervisory tasks. Actually the Government announced changes in its position in July 2014 in order to strengthen the banking and financial discipline after the closure of the CCB. There was a declaration by the Bulgarian official bodies that the country must accept the conditions of the European Banking Union and join it in due time..

However the economic situation in the country is not yet balanced after the crisis. The country has limited prospects for future business development and the generation of profits is uncertain, so those are strongly constrained factors for a future development.. The economic and the industrial risk is still prevailing, which is an obstacle for the strengthening the banking sector.

The failure of CCB sets Bulgarian banking system under stress and uncertainty. Bulgaria's banking system is still unable to shake off of the effects of the deep economic crisis, which had an extremely negative impact on per capita income and the solvency of the firms. Doubtful loans have risen and they continue to threaten the stability of some banks, despite the signs of certain overcome of household and companies indebtedness. The trouble has pushed Bulgaria, the EU's poorest country, down in the ranking of the international financial community. The turbulence in the Bulgarian banking sector delays the prospect of being accepted in the exchange rate mechanism (ERM) II and start the preparation to join the euro area. "Bulgaria's longstanding goal to join the euro area is hardly being helped."(The New York Times") There are some signs that the emerging banking crisis in Bulgaria has been overcome with the strengthening of supervision and the strict application of EU norms and rules. There are also some expectations for improvement of the Bulgarian economy, which proved to be optimistic, amid the continuing stagnation, which will help to stabilize Bulgarian banking sector, so that they participate actively and properly in the financing of the economy.

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