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Abbreviations

ALICO: American Life Insurance Company

BCC : Bulgarian Consolidation Company

BGL : Bulgarian Lev Old

BGN : Bulgarian Lev New

BIB : Bulgarian Investment Bank

BNB : Bulgarian National Bank

CBA : Currency Board Arrangement

CBG : Commercial Bank of Greece

CEE : Central and Eastern Europe

CEH : Consolidated Eurofinance Holding

Cf. : Confer

CMEA : Council for Mutual Economic Assistance

CPI : Consumer Price Index

DEM : Deutsche Mark

DSK : State Saving Bank

EBRD : European Bank for Reconstruction and Development

ERM II : Exchange-Rate Mechanism

EU : European Union

EMU : Economic and Monetary Union

HICP : Harmonized Index of Consumer Prices

IMF : International Monetary Fund

GDP : Gross Domestic Product

p. : Page

UBB : United Bulgarian Bank

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1. Introduction

The main objective of this thesis is to analyze and evaluate the development of the Bulgarian banking sector, specifically between 1990 and 2010. Major changes took place in Bulgaria at the end of 1989 and the beginning of the 90s. The Bulgarian banking sector was also part of these changes. The country changed its economy from a centrally-planned to a market economy after the collapse of the communist regime.

It is worth mentioning that when the Bulgarian banking sector is analyzed, the changes in the Bulgarian banking system should be taken into account, due to the fact that they cannot be analyzed separately.

The degree of development of the banking system can serve as an indicator of the overall economic condition in the country. The history of the Bulgarian banking system in the 90s is a concentrated expression of the history of transition from centralized to market economy.

The liberalization and reorganization of the banking system was one of the main tasks of the first democratic government in 1990. A change from one-tier to two-tier banking system was necessary for the transition to a market economy. This cannot be instantaneous act, but a long and difficult process, because it requires the establishment of new institutions and educated staff. In many ways, the transition is a cultural process that requires people to overcome decades of stereotypes, which explains the slow nature of that transition, accompanied by deep crises.

This thesis is comprised of four parts: The first part focuses basically on the situation of the banking sector prior to the introduction of the currency board arrangement (1990-1997). It includes an overview of the banking sector prior to 1990, the new banking regulation and legislation, the state and the private banking sector, the foreign banks in Bulgaria, the problems of the banking sector and the banking crisis from 1996-97. The second part of the thesis focuses on the currency board arrangement in Bulgaria and the privatization of the state-owned banks. The solution to the financial crisis from 1996-97 was the introduction of the currency board, which stabilized the banking system. The third part of the thesis reviews the structure of the Bulgarian banking sector after joining the EU. The impact of the Global Financial Crisis on the banking sector will be shown as well as the current situation in the sector. Bad loans over the last 20 years will also be analyzed. The fourth part shows the future challenges in front of the banking system- the joining of the European Monetary Union and the five criteria that should be fulfilled for that entry.

2. The Bulgarian Banking Sector (1990 -1997)

2.1. Historical overview prior to 1990

There are four major periods in the development of the Bulgarian Banking Sector.[1]

The first period refers to 1875 till 1918, the second one from 1919 till 1944, the third one from 1945 till 1989 and the last fourth from 1990 to date. A number of historical and economic events characterized each of these periods.

The first period is characterized by the opening of branches of the Imperial Ottoman Bank in Bulgaria in 1875, which was also the first bank in the country and four years later the establishment of the Bulgarian National Bank (BNB). From this moment BNB became the key bank in Bulgaria. Other Bulgarian as well as foreign financial institutions were operating during the first period, but the role of the foreign banks on the market were limited.[2]

The Bulgarian banks dominated also during the second period (1919-1944), despite the increasing number of foreign banks. This period was characterized by the arrival of a communist regime.

During the third period prior to 1990, all domestic private banks were nationalized and the entrance of foreign banks to Bulgarian market was banned. Bulgaria had a one-tier banking system in the 70s and only three banks: the Bulgarian National Bank (BNB), the Bulgarian Foreign Trade Bank and the State Savings Bank. The field of activities and functions of these three banks was clearly defined. The Bulgarian National Bank had the responsibility for all banking functions in Bulgaria. Individual accounts could be opened only in the State Savings Bank, and the Bulgarian Foreign Trade Bank was responsible for all foreign exchange operations. The 80s were characterized by the establishment of seven sector-specific commercial banks which were state-owned, and each was allowed to lend in strictly defined area.

The purpose of this paper is to analyze and evaluate the development of the Bulgarian banking sector (1990-2010) after the fall of the communist regime (fourth period).

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[1]Cf. Koford and Tschoegl, (2003), p. 3
[2]Cf. Koford and Tschoegl, (2003), p. 4

2.2. Introduction of the two tier banking system after the fall of the regime in 1989

Following the end of the communist regime in Bulgaria, reforms in the Bulgarian banking sector began in 1990. The first step was the reestablishment of the commercial banks. After the fall of the regime, the seven sector-specific commercial banks were allowed to lend credit to all sectors of the economy - transformation to universal banks. From the branches of the BNB fifty nine new commercial banks were formed. The banking system in Bulgaria changed from one-tier into two-tier banking system, with the BNB on the one tier and the commercial banks on the other tier. Something typical for most of the new established commercial banks was the fact that their size was small and their poor lending performance negatively affected the whole banking sector.[3]

2.3. New banking regulation and legislation

The changes made in 1990 in the constitution of the Republic of Bulgaria allowed the firms to have their own property and eliminated the state monopoly in the financial system. But till the end of 1990 the bank activity was regulated from Act 56. From 01.01.1990 the functions of the BNB were no longer those of a commercial bank. The BNB was the Central Bank and its branches became stock companies with 100% capital owned by the BNB. The seven sector-specific commercial banks had the rights to create their own branches in the country and to accept deposits.[4]

The process of financial liberalization began in 1991. The government liberalized the trading conditions with foreign currency in the country and allowed individuals to have such currency and foreign deposits in the banks.[5]

[3]Cf. Ignatiev, (2005), p. 43
[4]Cf. Ignatiev, (2005), p. 43
[5] Cf. Ignatiev, (2005), p. 43

Two laws came into effect in 1991 and in 1992. The first one was the Law on the Bulgarian National Bank and one year later the Law on Banks and Credit Activity. The law in 1991 regulated the independence of the BNB and the regulatory and supervision functions of it. The BNB's main goal was the maintenance of the internal and external stability of the national currency. For this purpose the BNB was granted the status of a modern central bank with monetary and regulatory powers. The BNB was given the right to develop and to implement the national monetary and credit policy, as well as the right to establish and maintain the international currency reserves of Bulgaria. "The Law on the Bulgarian National Bank" was clearly defined and specifies the relationships between BNB on one side and the country and the commercial banks on the other.[6]

The BNB had the right to collect information, to monitor the activities of the banks, to conduct periodic inspections and audits of the banks and to impose restrictions and penalties for disclosure violations.[7]

The process of the financial liberalization continued also in 1992. On 18th of March 1992 came into effect the Law on Banks and Credit Activity. It determined the relationship of commercial banks and the BNB as a central bank. The law regulated the conditions for licensing new banks, the relationship between the banks and their customers, and gave commercial banks the right to acquire up to 10% of the equity of non-financial companies. The adoption of the Act created conditions for accelerating the development of the banking system.[8]

In spite of the changes made in the legal framework, the banking sector in Bulgaria experienced worsening problems. One reason was the change in the environment connected with the collapse of the CMEA[9] markets, accompanied by high inflation in 1991 due to price liberalization.

The situation in the Bulgarian banking sector reflected this in the real sector of the economy. Many Bulgarian companies suffered from the collapse of the CMEA markets because of the higher dependence on the CMEA markets compared to the other Satellite states. Among the CEE countries, Bulgaria was with the highest dependence on cheap raw materials from the Soviet

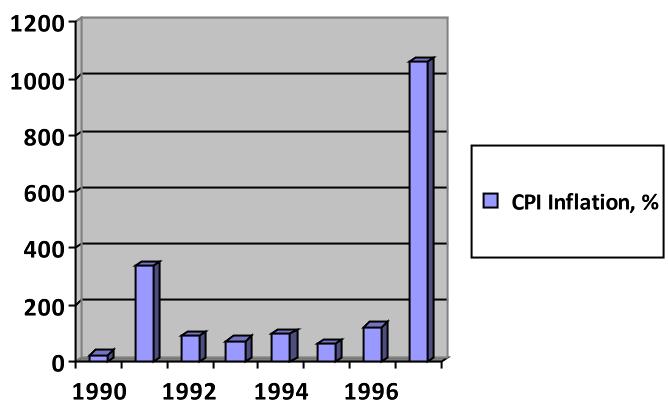
[6] Cf. Ignatiev, (2005), p. 44
[7] Cf. Ignatiev, (2005), p. 45
[8] Cf. Ignatiev, (2005), p. 45
[9] The common market of the former Eastern bloc

Union. After the collapse of the CMEA market, Bulgaria had to buy these raw materials from the world markets at a higher price. Bankruptcy occurred because of the slow adaptation of many companies to the new market conditions. It was impossible for mainly state-owned companies to meet their obligations to the banks. The number of the non-performing loans increased due to this fact.

Another reason for the bad situation in the banking sector was the higher inflation together with the significant devaluation of the BG lev (BGL), after the adoption of floating exchange rates at the begin of 90s.

As can be seen from the figure 1[10] below the inflation jumped to 338.5% in 1992, fell to 91.3% and 72.9% in 1992 and 1993 and soared to 1058% in 1997.

Figure 1: Inflation in Bulgaria in the period 1990-1997



The heavy debt burden of Bulgaria was another very important factor for the worst situation in the banking sector. In 1990, the outstanding foreign debt was over USD 10 million (87% of GDP).

[10] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/discussion_2011_84_en.pdf

2.4. State-owned banking sector

At the beginning of the reforms in the banking sector in Bulgaria in 1990-1991, the banking system inherited the financial structure of the centralized economy. The characteristic of this centralized economy was the state monopoly in the banking sector – the dominance of the state banks in the banking sector. The lack of financial markets, financial products and services was also inherited. The banks within the centralized economy had played the role of "accounting agents" of the government. The credits which were given to the state companies were "soft" – often in the form of a subsidy. The banks during the communist regime had been financing and not crediting institutions. The only way to invest except with cash was through savings in banks. The banks in the beginning of the 90s could be structured in three groups.

In the first group were big sector-specific state-owned Bulgarian banks financing different sectors of the economy – Mineral Bank, Balkan Bank, Biochim, Transport Bank, Stroybank, Economic Bank, Elektronica, Agricultural and Cooperative Bank also Bulbank, DSK and Post Bank. The main part of the assets of the banking system was in these 11 banks. This structure of sector-specific banks is typical for the centralized economy.

The former branches of the BNB were transformed into fifty nine new commercial banks. Most of them were with small initial capital and a very small share of the assets of the banking system. Their total share did not exceed 15% of the assets of the banking system.

The last group contains the private commercial banks. During the first years of the 90s (1990-1993) the number of the private banks and their assets' share of the banking system was relatively small, but it was increasing because of the process of licensing of new private banks.[11]

Some negative features characterized the banking sector in the early 90s:

- Sector specification of the big banks, which was a prerequisite for the concentration of a credit risk. Since the time of the centralized economy in Bulgaria, the big commercial state-owned banks had served state-owned companies. After the reforms at the beginning of the 90s a big part of the credits were given again to the state-owned enterprises.

[11] Cf. Ignatiev, (2005), p. 46

- A big number of small-sized state-owned banks - former branches of the BNB were without a perspective for a development, because of poor management and their small size. These banks were in the worst situation when the reforms began. Due to their low capital adequacy there was a possibility for a moral hazard. Their possibilities for a diversification of the credit risk and a collection of information for potential new customers were very low. The higher competition in the banking sector minimized their inflow of resources and threatened them with insolvency.

- More than 50% of the state-owned banks were undercapitalized and were not able to cover the capital adequacy requirement of 8% in accordance with the Basel criterion and the Law on Banks and Credit Activity.

- There wasn't any clear legal banking regulation to provide a strong banking activity at the beginning of the reform.[12]

There were some institutional changes in the period between 1991 and 1995 in the banking sector without any privatization. At the end of 1991 the government took the decision to create the Bank Consolidation Company (BCC). This was one of the measures of the government against the big number of state-owned banks. In February 1992 the BCC was registered in the Court and its aim was to encourage the formation of larger state-owned banks through mergers and to eventually privatize these banks. The BCC became the owner of all state-owned bank shares, which were owned by state enterprises until that moment. The government became an owner of 49% of the equity of the BCC. The other main shareholders in the BCC were the BNB with 41% and Bulbank with 10%. Both the BNB and Bulbank exchanged their shares for shares of the BCC. None of the three shareholders had 50% or more of the shares and this was the reason why none of them undertook the decisive role to develop the program of the BCC. But in the first years the leading role was in the hands of the BNB.[13]

The BCC didn't make any changes in the management of the state-owned banks, and didn't control very strictly the management of these banks till the end of 1994. There wasn't any relationship between the results and the payments to the management and the staff. The

[12] Cf. Ignatiev, (2005), p. 47
[13] Cf. Ignatiev, (2005), p. 47

management of many state-owned banks was characterized by unnecessary bureaucracy, lack of qualified staff and bad quality of the banking services. At the beginning of the reforms (1990-1993) there were some cases for successful but also unsuccessful privatization of some state-owned banks done with the help of the management of these banks. More of the state-owned banks even after the consolidation process were managed by the same management, such as in the period of the centralized economy. Consolidation frequently was made by coupling financially distressed and relatively solvent institutions to avoid bankruptcy.[14]

The control package of shares of the BCC was taken by the government in 1995 and some changes were made in the management of the state-owned banks. The process of consolidation was very slow because the management of the former BNB branches was without stimulus, or because of the fact that the BCC was not very insistent.

The United Bulgarian Bank (UBB) was established after the consolidation of 22 state-owned banks at the end of 1992, but the process of consolidation actually was enacted one year later. Express Bank was established also after the consolidation of 12 other banks. Another new bank was Hebros Bank, which was established after the consolidation of 8 other banks. Sofia Bank was established after the consolidation of 3 banks. After these successful consolidations, the process got slower. Serdika was established after the consolidation of 3 other banks in 1994. The process of consolidation finished in 1995 with the merger of Sofia Bank, Serdika and Biochim – Biochim Bank. The table 1[15] below shows the structure of the banking sector in Bulgaria in the period 1990-1996.

[14] Cf. Ignatiev, (2005), p. 48
[15] Cf. Ignatiev, (2005), p. 49

Table 1: Structure of the Bulgarian banking sector 1990-1996

	1990	1991	1992	1993	1994	1995	1996
Commercial banks, from them:	71	79	60	42	44	46	49
State-owned	69	70	48	27	18	13	16
Private	2	9	12	15	22	27	25
Foreign banks and branches	0	0	0	0	4	6	8
Consolidated banks	0	0	22	29	9	3	0

Source: BNB

As can be seen from the table, the number of state-owned banks decreased from 70 in 1991 to 13 in 1995 as a result of a number of mergers. The very slow development of the process of consolidation (about 4 years) was one of the reasons for the unsound development of the state banking sector – concentration of the credit risk, weak management, and undercapitalization.[16]

Until the beginning of the banking crisis in Bulgaria (1996-1997) the state banking sector was the main operator in the Bulgarian banking system. Its relative share in the assets of the banking system was 77% at the end of 1995.

Many of the state-owned banks in the early 90s experienced losses and were undercapitalized. This undercapitalization was due to the soft budget constraints, by which the state-owned enterprises transferred their losses to the banks. Also some of the state-owned banks gave credits to the private sector that had the same moral hazard as the state one.

For strengthening the state-owned banks and the solution of the problem with the bad credits, the government and the BNB decided to take some actions. In 1993 came into effect the Law on

[16] Cf. Ignatiev, (2005), p. 48

Settlement of Non-performing Credits. The BNB financed the state-owned banks, which had difficulties. All these actions created unrealistic expectations, e.g. that in the future the losses of the banks would be covered by the country, which in turn led to an increase in the domestic debt.[17]

The total number of banks operating in Bulgaria decreased from 79 in 1991 to 46 in1995 (Tab.1). The bad loans were the milestone in the development of the banking sector. As mentioned above, the Law on Settlement of Non-performing Credits came into effect in 1993. The government issued the so-called ZUNK bonds, which aimed to cover non-performing credits negotiated prior to 31 December 1990. The level of bad loans increased because of the misguided credit policies of the banks to a degree, which was a precedent compared to any other European transition economy.[18]

The government pressed the state-owned banks to give loans to weak enterprises which were unable to repay. Many of these loans weren't secured.

The table[19] 2 below shows that more than 74% of the bank loans in 1995 were non-performing.

Table 2: Classification of Bank Loans in 1995 by Size of Banks (%)

Banks	Performing	Substandard (30 days overdue)	Doubtful (90 days overdue)	Uncollectible
Large	17,3	64,3	3,9	14,5
Small and Medium	49,0	28,6	4,8	17,6
Total for the banking system	25,9	54,5	4,2	15,4

Source: BNB, Annual Report, 1995

[17]Cf. Ignatiev, (2005), p. 48
[18] Cf. Miller, Petranov, ((2001), p. 12
[19] Cf. Miller, Petranov, ((2001), p. 12 or
http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_1995_a2_en.pdf p.142

It is important to point out that at the beginning of the 90s the conditions were very good for starting up private banks in Bulgaria, because the financial resources needed to set up a bank were not high and the origin of the funds was not important. Many banks were established on borrowed money.

2.5. Private banking sector

The process of licensing of new banks and the increase of the relative share of the private banking sector in the banking system was simultaneous with the process of consolidation. The number of private banks increased from 2 in 1990 to 27 in 1995. This can be seen from table 1. Many of these banks were created because some private groups needed access to the credit market. This was one of the explanations for the large number of new banks, which was in fact too high for the banking market. The relative share of the assets of the private banks to the total assets in the banking system increased from 3.1% and 6.4% in 1992 and 1993 to 22.4% in 1994.[20]

The increase of the share of the private banks had a contradictory effect to the development of the Bulgarian banking system. It led to a higher competition in the banking sector in the fields of the credit market and the currency trade, however the quality of the services was the same as before. More of the private banks were very closely related to its borrowers, which led to a rapid increase in large and domestic loans. Subsequently, the proportion of bad loans increased in private banks, which was the main reason for deterioration of their financial situation and increasing distrust of depositors to them. Due to this reason the share of the assets of private banks decreased as a result of the banking crisis in 1996 to 8.7%.

The narrow commitment of private banks with borrowers had a negative influence on the development of the banking system. Some borrowers in Bulgaria controlled the activities of the private banks and used them for uncontrolled borrowing, According to Koford and Tschoegl, the domestic loans and asymmetric information (e.g. the inability of the banks to distinguish between good and bad borrowers) were some of the characteristics of the banking system during

[20]Cf. Ignatiev, (2005), p. 51

this period. Many of these private banks were established on borrowed money – one of the highest incentives for moral hazard. The banking supervision and monitoring, which should have restricted the asymmetric information, were in a process of development during that time.

The increasing number of private banks and their relative share in the period 1990 – 1995 acted in contradiction to the goals of the consolidation process in the banking sector. The fragmentation of the banking sector increased. The private banking sector had the same behavior of moral hazard as the state one.[21]

According to Enoch, Guld and Hardy, the private banking sector had a negative net value of 13,9 million BGL at the end of 1995.[22] The financial liberalization minimized the oligopolistic profit, the banking system was fragmented and there was an incentive for some owners of private banks to redirect their capital in case of a bad development of the banking business.[23]

2.6. Foreign banks in Bulgaria

The entry of foreign[24] banks in Bulgaria between 1990 and 1995 was blocked by some legislative acts. The lack of foreign competition was one other reason for the unstable banking sector. During the early 90s, as can be seen from table 1 above, there weren't any foreign banks in Bulgaria. The restriction of the entry of foreign banks was because the Bulgarian banks needed time to become fully competitive. The problem for the authorities and experts was how much to restrict the entry of foreign banks, because these foreign institutions had more experience and expertise, although they could put competitive pressure on the local Bulgarian banks. Foreign banks were allowed to open branches in Bulgaria in 1994. The first foreign branches opened in the same year. These were the Greek Xios Bank and the Dutch ING-Bank. Their branches were situated in Sofia. Till the end of 1995 another two foreign banks opened

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[21] Cf. Ignatiev, (2005), p. 52
[22] Cf. Enoch, Guld, Hardy, (2002), p. 9
[23] Cf. Enoch, Guld, Hardy, (2002), p. 11
[24] A bank is categorized as a foreign bank if over 50% of the equity capital is owned by a foreign legal entity or individual; otherwise, banks are categorized as Bulgarian.

branches, and three others received the licenses from the BNB to open new banks in the country. These new banks were restricted to perform mostly international settlements.[25]

Raiffeisen Zentralbank established a subsidiary in 1995 and Ionian Bank and Bayerische Hypotheken- und Wechsel-Bank each opened a branch in the country in 1996.

Representative offices were opened by some other foreign banks. In 1996, ABN AMRO of the Netherlands, the Agricultural Bank of Greece, Creditanstalt Bankverein from Austria, and Macedonia Thrace Bank from Greece opened offices in Sofia.[26]

Egnatia Bank from Thessaloniki opened a short-lived representative office. Two joint ventures started operating. Bulgarian Investment Bank (BIB) was one of these joint ventures. Its shareholders were the European Bank for Reconstruction and Development (EBRD; 35 per cent), UBB (15 per cent), Biochim (11 per cent), Hebros Bank (5 per cent), Banque Nationale de Paris (BNP; 15 per cent) and others. A 20 per cent direct stake and an 11 per cent indirect stake in the bank was taken by Commercial Bank of Greece (CBG), as well as the management of the bank.

Later, the name of BIB was changed to International Commercial Bank and then to Commercial Bank of Greece (Bulgaria) after the buyout of the other owners by CBG.[27]
BNP-Dresdner (Bulgaria) was formed by Banque Nationale de Paris (40 per cent), Dresdner Bank (40 per cent) and EBRD (20 per cent).

Foreign banks were still a minor part of the banking sector until 1997. Their share of the assets in the banking system increased to 4.9 per cent, but this was still a very low percentage compared to that of the state-owned banking sector.

Foreign banks also were present and exerted an influence through contracts. Many of them worked as consultants to Bulgarian banks through twinning arrangements.[28]

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[25] Cf. Miller, Petranov, ((2001), p. 11
[26] Cf. Koford and Tschoegl, (2003), p. 20
[27] Cf. Koford and Tschoegl, (2003), p. 20
[28] In a twinning arrangement the foreign bank sends staff to the host-country bank to introduce western banking and technology and to train staff. The incentive for the foreign bank is the possibility that if it wishes to it may be allowed to take a stake in its twin

A project was funded by PHARE and ABN AMRO, twinned with Biochim Bank. Allied Irish Bank twinned with UBB. The ABN AMRO-Biochim twinning was only for six months because the foreign managers were dismissed.

The period between 1990 and 1996 was characterized by low number of foreign banks and their subsequent withdrawal from the banking market, low capital coverage of banks, and negative numbers on owned equity. This led to the subsequent collapse of the Bulgarian banking system (hyperinflation and a currency crisis).

2.7. Structure of the banking system

Another important separation of the banks in Bulgaria in the beginning of the reforms was in "resource" and "creditor" banks. The resource banks were DSK, Bulbank, UBB and Post Bank and the creditor banks were all other banks (some state-owned and all private banks). This separation wasn't rational, because it led to a higher concentration of credit risk. The highest profits were by DSK, Bulbank and Post bank, whereas many creditor banks reported significant losses. Population held a major part of their deposits in DSK, Bulbank, UBB and Post Bank because of the legal deposit guarantee for DSK and the high confidence in these financial institutions. As a result, these banks naturally became a "resource" banks.

The private banks did not receive such a degree of trust from the public, which led to the separation in "creditor" and "resource" banks. Some of the state-owned "creditor" banks and the private banks were attracting deposits primarily from businesses and wealthy citizens, who were particularly sensitive to risk. Upon the first signal of poor financial conditions of these banks, they withdrew their funds.

For a more detailed analysis of the processes in the banking system in the period 1990-1996, a measure called "index of concentration"[29] is used. This measure shows whether the banking sector is fragmented (a high number of commercial banks have a relative equal market share) or concentrated (a few banks which allocate a bigger market share).

[29] Herfindahl- Hirschman index

The analysis of the movement of the Herfindahl-Hirschman index calculated for the banking market on the basis of the sum of the assets of the commercial banks shows a dynamic development of the banking sector.

The table[30] shows the changes in the structure of the banking sector between 1992 and 1996.

Table 3: Structure of the banking sector

Measure	1992	1993	1994	1995	1996
Concentration of the assets	0,33	0,3	0,15	0,11	0,27
Assets of the private banks/total assets	3,1%	6,4%	15,6%	22,4%	8,7%

As can be seen from table 3, in 1992 and 1993 the value of the index was 0.33 and 0.3 respectively, which indicated that the banking sector is concentrated. In 1994 and 1995 the index decreased to 0.11, a sign that the banking sector was fragmented and with higher competition.

It can be summarized that there were two opposing trends in the dynamics of the banking system in the first half of the 90s. One of them was the process of consolidation of state banks and the other was the growth in the private banking sector. This growth led to a higher fragmentation of the banking system and the positive effects of the consolidation were offset. The concentration of the banking system recovered after the banking crisis. [31]

2.8. Problems within Bulgarian banks

The problems of the banking sector were predominantly in the first half of the 90s. The legal and regulatory framework allowed banks to engage in loss-making lending. The non-performing loans increased. A bigger part of these non-performing loans was given to state-owned

[30] Cf. Ignatiev, (2005), p. 55
[31] Cf. Ignatiev, (2005), p. 56

enterprises. The government gave instructions to the state-owned banks and they financed those unprofitable enterprises.

The state-owned banks and the private ones with liquidity problems were refinanced by the BNB. The BNB spent approximately 15% of GDP in 1995 for the financial refinancing of such banks. 91 billion BGL was given to First Private Bank by the BNB, another 50 billion to Agrobusiness Bank, and 35 billion to the Bank for Agricultural Credit.

One of the reasons for the financial crisis between 1996 and 1997 was that the BNB financed banks with liquidity problems. Bank management was confident that the state would help its own banks and enterprises to avoid confrontation with depositors and future voters. Due to this reason, the state-owned banks were motivated to give credits to state-owned enterprises even if they were unprofitable.

From the beginning of the reforms it was clear that after the financial liberalization the second step would be structural reform – privatization, liquidation of loss-making enterprises and the attraction of foreign investments.[32]

Privatization was also the basis for the problems in 1996 and 1997. It started in 1990 but there weren't any real results for the economy in the first half of 90s because of the slow tempo. All of the unprofitable state-owned enterprises were financed by the state-owned banks and if those enterprises had been privatized they wouldn't have caused such a big burden for the banking system.[33]

Another problem for the banking system was the bad management. Most managers from the time of the centralized economy had never worked in a market environment before and couldn't understand the principles of commercial banking law. The relatively weak contacts between the Bulgarian banking sector and the international banking community were also a big problem. Many bank managers were without an appropriate economic or legal education as well as organizational capabilities.[34]

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[32] Cf. Ignatiev, (2005), p. 74
[33] Cf. Ignatiev, (2005), p. 58
[34] Cf. Ignatiev, (2005), p. 57

Furthermore, the banks not only controlled the operations very weakly, but also the investment expenses. Big banks established new branches without any real assessment of the market opportunities. Most of those branches were unprofitable and operated at a loss. Some banks created new payment card products, without considering that these products required a large economy of scale that was not in reach of a single Bulgarian bank. The characteristics of the expenses showed the lack of market and financial discipline in the banking system.[35]

The BNB declined the basic interest rate because of the fall of the inflation in 1993. The inflation increased again and the savings were converted into hard-currency by the households. The Bulgarian currency started to lose value against the US-dollar and lost over 50% of its value in March 1994. On 29th December 1995 the Bulgarian currency lost again 6.52% against the US-dollar in comparison to 30th December 1994[36]. The inflation was 121.9% at the end of 1994. The so called exchange-rate crisis was followed by a short-lived recovery, due to the revenues from the export of natural resources, services and agriculture. The situation in the banking sector worsened. The interest rate was reduced from 100 % in 1995 to 34 % in January 1996.[37] The consequence was the shifting of portfolios away from the domestic currency and back into hard currencies. The result was a sharp decrease in the foreign currency held by the BNB in 1996. The confidence in the lev declined. As can be seen from the table[38] below, the foreign currency reserves decreased in 1996 to 518 million US-dollars, which represents more than a 50% decline when compared with 1995.

Table 4: Gross foreign reserves held by the BNB, excluding gold

	1991	1992	1993	1994	1995	1996	1997
Gross foreign reserves (end-period, million $)	311	902	664	1,042	1,274	518	2,478

[35] Cf. Ignatiev, (2005), p. 57
[36] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_1995_a1_en.pdf , p 76
[37] http://www.stat.bg/bg/indicator/471/
[38] http://www.freepatentsonline.com/article/Comparative-Economic-Studies/20655285.html

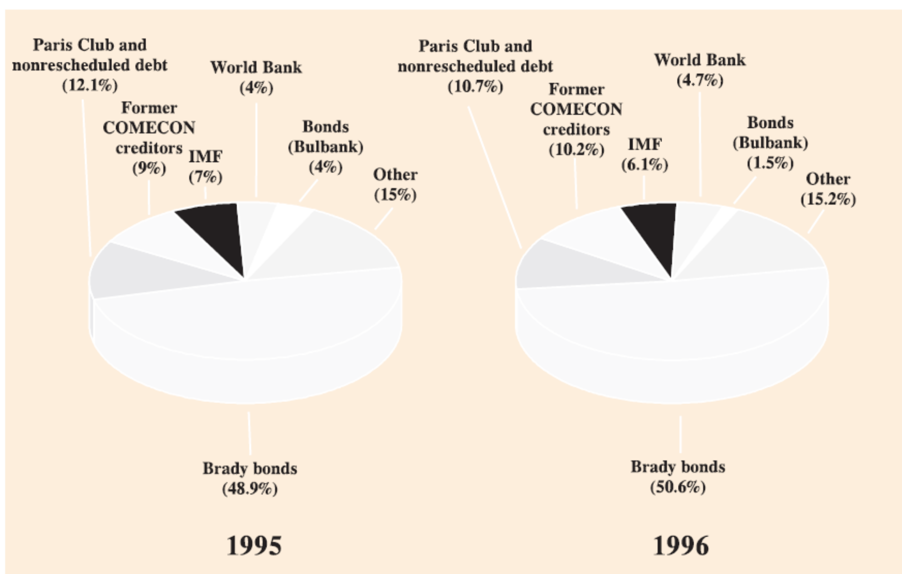
Many commercial banks had problems due to the interest rate cut. They shifted to lev-denominated assets because of the high rate in the beginning months of 1995. These banks had also substantial hard currency deposits which were without any adequate hedging. The lower interest rate limited the ability of the banks to serve those deposits.

Another factor causing the crisis in the banking sector was the collapse of several financial pyramid schemes. A lot of people lost their money and confidence in the banking system decreased. During that time there wasn't a deposit insurance to cover the losses in the case of a bank bankruptcy.[39]

One other factor which was driving the banking sector towards a crisis was the repayment of the gross foreign debt. Its amount was USD 1,048.8 million and should have been repaid in 1996. The figure[40] below shows the structure of the gross foreign debt by creditors in 1995 and 1996.

Figure 2: Gross foreign debt

GROSS FOREIGN DEBT



* Gross foreign debt by creditor (percent of gross foreign debt).
Source: BNB.

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[39] Cf. Ignatiev, (2005), p. 60

[40] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_1996_en.pdf ,p. 42

The gross foreign debt compared to gross domestic product ratio, which indicates the relative foreign debt burden to GDP, increased by 20.4 percentage points in 1995 and reached 99.1% in 1996. "The gross foreign debt to exports of goods and services ratio, indicating the country's ability to provide revenues from exports of goods and services to service foreign debt, also worsened. It reached 158.8% in 1996 from 151% in 1995. The foreign debt service to exports of goods and services ratio, reflecting the portion of export revenues earmarked to cover foreign debt service, exhibited similar behavior. It reached 17.2% in 1996 from 13.9% in 1995. Deterioration of the above indicators proves that foreign debt service in 1996 was more burdensome for the Bulgarian economy than in the previous year. This conclusion is also backed by the foreign debt service to gross domestic product ratio which increased from 7.3% in 1995 to 10.8% in 1996."[41]

2.9. The Banking Crisis between 1996 and 1997

The financial crises of the developing countries include three main parts – banking, currency and a debt crisis. This study will be focused on the banking crisis in Bulgaria in the period between 1996 and 1997. There were some factors that contributed to the demise of the Bulgarian currency and the whole system. They can be summarized as the following[42]:

- The heavy gross foreign debt burden together with the slow tempo of privatization and falling exports;
- The collapse of several financial pyramid schemes in 1995 and the lost confidence in the banking system;
- The bad management and the inappropriate financial supervision and regulation of the banking sector after financial liberalization;
- The refinancing of the BNB for commercial banks with liquidity problems;
- The support of the government for unprofitable state-owned enterprises.

[41] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_1996_en.pdf , p. 43
[42] Cf. Ignatiev, (2005), p. 89

The beginning of the banking crisis was on 30th October 1995 when the BNB purchased for 1 lev 90% of the shares with voting rights of Agrobusiness Bank. On 06 March 1996 the BNB acquired for free more than 50% of the shares with voting rights of the Bulgarian Agricultural Bank and revoked the license of the Crystal Bank and the Private Agricultural and Investment Bank. The deposits of the clients in those two banks were frozen. As a result of the subsequent massive panic, depositors withdrew their deposits from the other banks in 1996.[43]

The savings of the people were converted into foreign currency because they tried to keep their intrinsic value. This caused a fall in the value of the lev (BGL) in April 1996 and the Bulgarian currency reached its lowest level in February 1997. The Forex (Foreign exchange) reserves went down to unprecedented levels. From April 1996 the inflation became hyperinflation.

In May 1996, the government made some changes in the Law on Banks and Credit Activity. Those changes governed the procedure for declaring the insolvency of the banks. The Law on State Protection of Deposits came into effect which secured the deposits of the clients. Memoranda of understanding were signed between the BNB and 19 banks. Those memoranda foresaw a ban on granting new loans, starting the collection of old loans, reducing interest rates on deposits, reducing operating costs and sale of assets.[44]

However, even those measures failed to restore the confidence in the banking system. DSK and Bulbank were also affected by deposit withdrawals. The banking panic deepened and spread its effect to the securities market. Furthermore the relatively “healthy” banks were threatened. In September 1996 the BNB put another 9 banks under special supervision and asked the court to declare them bankrupt. Due to the severe budget situation there wasn’t any possibility for a recapitalization of the closed banks.[45]

The Banking panic caused a currency crisis. The refinancing and the monetizing of the budget deficit led to inflation. The Bulgarian currency lost its value from around 70 lev per US-dollar in January 1996 to about 3000 lev per US-dollar in February 1997. The Central bank couldn’t intervene any more to support the Bulgarian currency. The size of the withdrawals at the time of the panic were enormous for the capacity of the Bulgarian economy. Only the sum of the

[43] Cf. Ignatiev, (2005), p. 82
[44] Cf. Ignatiev, (2005), p. 82
[45] Cf. Ignatiev, (2005), p. 83

withdrawn foreign deposits was 890 million US-dollars. In 1996, the gross foreign reserves decreased by 754 million US-dollars (7.7% of the BIP), of which 661.6 million US-dollars occurred within the first 6 months.[46]

At the end of 1996, it was clear that the agreement with the international financial institutions couldn't be met and the country wouldn't receive the expected external financing. The panic on the deposit and the currency market continued to grow and even DSK was "affected". The government began discussing the proposal of the international financial institutions to introduce a currency board system.[47]

The next chapter will discuss in details the measures that were taken by the Bulgarian government in order to overcome the crisis and to stabilize the banking sector and the whole economy.

[46] Cf. Ignatiev, (2005), p. 85
[47] Cf. Ignatiev, (2005), p. 85

3. The Bulgarian Banking Sector after 1997

3.1. Establishment of the currency board

The severe banking crisis form 1996-1997 was a result from the measures undertaken by the different governments. Instead of increasing the stability of the banking sector, the sector was experiencing a collapse. The caretaker government aimed to rescue the country with manifold measures. The establishment of a currency board regime was the major point in those measures. When the crisis peaked, it was obvious that the country would not be able to overcome it on its own and international help would be needed for the stabilization of the financial sector and the recovery of the real sector. The caretaker government asked the international institutions for support. A decision for the introduction of a currency board was taken. As the idea for the introduction of a currency board in Bulgaria was already discussed and rejected in 1991, this can be concluded as a controversial step. Due to the fact that many currency boards were not successful in the countries in which they were introduced (for example Hong Kong and Singapore), the introduction was rejected in 1991. The attitude towards the currency board in 1996 was marked by mistrust and disapproval. The opinion of many economists was that the currency board arrangement was not the best solution for Bulgaria. There was a widely spread idea at that time that without accepting the currency board arrangement, the Bulgarian government would not receive the financial aid from the IMF which it badly needed. Certainty, there were also views that the currency board was the best solution for Bulgaria. According to some economists, the introduction of the currency board was not only seen as a stabilization measure, but also as a tool to force financial discipline, due to the fact that the lack of financial discipline, together with inefficient regulation and legislation, were the main reasons for the economic crisis.[48]

A short overview of the main characteristics and of the various types of currency boards will be made in order to understand better the way it functions and its role for the economy in Bulgaria.

[48] Cf. Avramov, (1999), p. 7

3.1.1. Historical overview

The origin of currency boards dates from the nineteenth century when currency boards were used in the British colonies in order to transform sterling into a form best fitted for local use.[49]

Sachon gave a definition of a currency board. According to his definition, a currency board replaces the functions of a country's Central Bank and fixes an exchange rate between domestic currency and a selected foreign currency.[50]

A currency board system is characterized by three main elements[51]:

- The exchange rate between domestic currency and a selected foreign currency is fixed;
- Automatic convertibility;
- Long-run commitment to the system

The credibility is another very important feature of a currency board. Notes and coins can only be issued if they are fully backed by a foreign reserve currency. Thus, the money supply in the economy is connected to the foreign exchange reserves of the country. There isn't any possibility for the government to finance state-owned enterprises, banks or state deficits. It should be mentioned that the currency board can't determine the quantity of notes, coins and deposits in the currency board system. The overall money supply is determined by market forces, which in turn contribute exclusively to the credibility of the currency board.[52]

Williamson wrote in his book[53] "What Role for Currency Boards?" that currency boards bring four advantages to the country in which they are presented.

- Convertibility is assured;
- Macroeconomic discipline is increased;

[49] Cf. Schuler, (1996), p. 10
[50] Cf. Sachon, (1998), p. 12
[51] Cf. Gulde, (1999), p. 12
[52] Cf. Ignatiev, (2005), p. 100
[53] http://www.piie.com/publications/chapters_preview/20/2iie2229.pdf or Williamson, (1995), p. 13

- A guaranteed payments adjustment mechanism is provided;
- The creation of confidence in the monetary system, promotion of trade, investment and growth.

3.1.2. Types of currency board arrangements

There are two main types of currency board arrangements – orthodox and non-orthodox currency boards. The orthodox currency board, also called first generation currency board, rejects all forms of monetary policy. The currency board alone has the responsibility for the monetary policy. In the simplest version by examining the balance sheet of a currency board, it can be seen that the liquid foreign reserves are on the asset side and notes, coins and net worth on the liability side. Domestic assets are not included in the balance sheet. Also a characteristic of this type of currency board is that the Central Bank can't exist independently. Another important characteristic is that the currency in circulation is fully covered by foreign reserves under a fixed exchange rate.[54]

The non-orthodox currency board, also called second generation currency board (different forms of hybrid between currency board and Central Bank), allows monetary policy. This type of currency board is more flexible. Another important characteristic is that the existence of a Central Bank is allowed. The non-orthodox currency board leaves space for flexibility in the discretion of decisions. By the second generation currency board the limited functions of the Central Bank to act as a lender of last resort were preserved.[55]

The pros and cons of those two main types of currency board arrangements haven't been studied yet.

3.1.3. The currency board in Bulgaria

In Bulgaria we have a second generation currency board, which has all main characteristics of a classical orthodox currency board. The exchange rate of the Lev to the Deutsche Mark, and

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[54]Cf. Ignatiev, (2005), p. 98
[55] Cf. Ignatiev, (2005), p. 99

later to the Euro (1.9553 lev for 1 euro) is fixed. All monetary liabilities of the BNB are fully backed by a foreign reserve currency (the Deutsche Mark and later the Euro). Another characteristic of the currency board in Bulgaria is the impossibility to finance government spending. On the other hand the currency board arrangement in Bulgaria is more flexible than the classical orthodox currency board. There are many reasons for this fact. One of the most important was the desire to ensure efficient functioning of the board in view of the severe banking crisis from 1996-1997 and the weak banking system. The main features of the Bulgarian currency board will be reviewed here[56]:

- An interesting fact for the Bulgarian currency board is that a new monetary institution wasn't built up. The existing central bank was used and the BNB was divided into three departments: Issue Department, Banking Department and Banking Supervision Department.

- The second feature of the Bulgarian currency board is the existence of the Banking Supervision Department. The main task of this department is the licensing and supervision of commercial banks. For example, the classical orthodox currency board doesn't regulate the commercial banks, but in Bulgaria the currency board determines the minimum reserve requirement ratio, the liquidity management, the risk exposure of the banks etc. The main reason for that feature was the weak banking system due to the financial crisis of 1996.

- Another very specific feature of the Bulgarian currency board compared to the orthodox one is its lender of last resort function. This function derives from the complicated situation in the Bulgarian banking sector at the time of the introduction of the currency board. The lender of last resort function is strictly limited and can be used only in case of systematic risks. Because of the clear procedure set up in the law, the BNB can give credits only to solvent banks which desperately need liquidity, but only against collateral. Only through this method can the abuse of the principles of the orthodox currency board be eliminated. The BNB hasn't used the lender of last resort function yet.

[56] Cf. Ignatiev, (2005), p. 101

- Another interesting fact characterizing the Bulgarian currency board arrangement can be found under Article 45 of the Law on the Bulgarian National Bank which was issued on 10th June 1997. According to Article 45 the BNB has the right to extend credits to the government or any state agency, instead of purchasing special drawing rights from the IMF.

The Bulgarian currency board is unique compared to the already existing current boards due to those features listed above. It is flexible enough to carry out its assignments in the post-crisis financial sector in the country.

After discussing the main features of the Bulgarian currency board, it will be interesting to make an analysis regarding how the situation in the country was affected by the currency board implementation. It should be highlighted that the main task of the currency board in Bulgaria was to efficiently reform the monetary policy in order to restore confidence in the financial system and to stop the development of inflation. The hyperinflation in 1997 derived from the lack of financial discipline before the board implementation. At that time, institutions that were responsible for the regulation and the supervision, together with the central bank, lost their credibility and weren't able to secure or even to contribute to the stabilization of the economy. This demonstrates why it was very important to set up a framework for a rule-bound monetary policy where the national authorities couldn't intervene and increase the monetary base, thusly creating inflation. The currency board arrangement eliminated the pressure on the banking system which was typical in the past, and contributed to the improved macroeconomic discipline, which was a big achievement of the currency board. In the period before the collapse of the banking system in Bulgaria, the commercial banks were financed by the BNB. The state-owned enterprises received loans from those banks, however the chance to redeem the money was almost zero. As can be seen from the previous chapter, the bad loans increased and the government replaced those non-performing loans with government bonds. Thus the government debt increased. The end of this practice came with the introduction of the currency board. This introduction had a positive effect on the whole banking system. The factors which led to the end of this practice were different. The Bulgarian currency board can't hold domestic debt, government debt and can't provide banks with refinancing.

The imposition of financial discipline, the stability and the transparency were the greatest success of the Bulgarian currency board. The confidence in the financial system was restored by the currency board.

The macroeconomic stability was one of the necessary conditions for the decrease in the asymmetric information in the banking system. The results from the currency board in Bulgaria proved the statement that disinflation, stable and low interest rates, and the fixed exchange rate created favorable conditions for investment activity, economic growth and a sound banking environment. At the same time, it should be emphasized that this stability was needed but was not a sufficient condition for the development of the banking sector. In order to achieve this goal, a structural reform of the banking system was needed - privatization of state-owned banks, liquidation of undercapitalized banks and attraction of foreign investors to the banking sector.[57]

3.2. Introduction of a new updated legislation and regulation

After the financial crisis from 1996-97, the priority of the government was the process of updating the banking legislation.

The banking legislation changed radically in Bulgaria with the introduction of the currency board in 1997. In the same year the new Law on the Bulgarian National Bank came into effect, which replaced the last one from 1991, and the new Law on Banks replacing the Law on Banks and Credit Activity from 1992.[58]

The new Law on the Bulgarian National Bank defined the role and the structure of the central banks within the currency board agreement. Financial intermediations were also strengthened, regulated and supervised.[59]

The new Law on Banks brought stability to the banking sector and stopped the fraudulent practices of the past. This law developed further and improved the regulation of banking sector. The capital adequacy, the loan concentration to borrowers and some accounting rules were

[57]Cf. Ignatiev, (2005), p. 106
[58] Cf. Ignatiev, (2005), p. 107
[59] Cf. Ignatiev, (2005), p. 107

affected by the update of the Law on Banks. The new law was the main instrument of financial institutions – the commercial banks. Something typical for the second half of 1997 was the strengthening of the regulatory requirements and the strict enforcement of banking supervision. The confidence in the banking system started to restore due to those changes. Another reason for this higher confidence was the change of the banks' practices regarding the extension of credit to enterprises and companies. The banks' liquidity and solvency were drastically improved due to the implementation of the much more cautious approach after the financial crisis in 1997. Another very important law took into effect in 1999 – the new Deposit Insurance Law. In comparison to the old one, the provisions of the new law were stricter.[60]

More stringent requirements were introduced for the heads of banks. They should have an appropriate higher education, qualifications and professional experience, as well as their lack of participation in the management of a company or a bank which has been declared bankrupt. A very strict bank licensing requirement was introduced with respect to its shareholders and administrators.[61]

After 1997, many changes were made in the national accounting standards, due to the ambition to harmonize the Bulgarian legislation with that of the members of the European Union, because of the forthcoming accession of Bulgaria to the Union. The valuation of the collateral rules, the assets classification and the regulation of financial intermediation were affected by those changes. In 2000, the Bulgarian accounting standards corresponded to the international ones. A central credit registry was established in the first half of 1998, accessible to all banks, whose main task was to provide detailed information to all credit borrowers with loans above 10000 BGL. As a result of those changes, the asymmetric information in the banking sector decreased and transparency of the banking operations increased. Also in 2000 the Commercial Code was changed, together with the provisions of the new bank bankruptcy law, which guaranteed a much more flexible and speedy bankruptcy procedure. According to the new regulation for the licensing, the requirement for a minimum capital of a branch of a foreign bank was canceled. The conclusion is that the changes in the structure of banking sector were more extensive than in

[60] Cf. Ignatiev, (2005), p. 108
[61] Cf. Ignatiev, (2005), p. 108

any other area of the economy. The improvements of the legal and institutional framework were also considerable.

3.3. Privatization of state-owned banks and new foreign branches in the country

Another important factor for the stabilization of the Bulgarian banking sector was the decrease of the state share in the banking sector. One of the reasons for the financial crisis from 1996-97 was that the political actors interfered in the lending procedure of the banks until 1996. The government gave instructions to the state-owned banks to finance those financially troubled state-owned enterprises. As already discussed in Chapter Two, the non-performing loans increased, which contributed towards the collapse of the banking sector.

The main goal of the new government was the sale of the state-owned banks due to three main objectives:

- Attraction of foreign investors that would bring know-how , experience and their expertise;
- Elimination of the possibility of political interference and the implementation of the financial rules and regulations leading to better performance of the banks;
- Reduction of the budget deficit, due to the sale of the state-owned banks (increase in revenues).

The process of privatization of the Bulgarian banking sector was tardy. The beginning of the process commenced in 1992, with the establishment of the Bank Consolidation Company, The bad results from the reforms in the period 1991-1996 created the impression among foreign investors that the environment was hostile for them because of low transparency and the lack of an effective legal system. During this period the information for the Bulgarian economy was insufficient, which explains why the banking system was not attractive. In the first place there weren’t so many strategic investors. The period between 1993 and 1995 can be seen as an introductory phase of the privatization in Bulgaria. A sale of minority stakes of the Consolidation

Company in state-owned banks took place in this period. As a result of the bad economic situation and in particular that of the banking sector, not even a single bank was privatized till 1997. One of the reasons for the financial crisis in 1996-97 was the slow privatization.[62]

The first privatized state-owned bank was United Bulgarian Bank (UBB). This happened in 1997, when a consortium of three investors (the European Bank for Reconstruction and Development, Bulbank and Oppenheimer) acquired 99.63% of the third largest bank in Bulgaria. The price of the bank according to the privatization deal was 3 million dollars. Before the privatization, the government exempted the bank from income taxes on foreign exchange rates of banks which were subject to privatization that year. Thus UBB was recapitalized and this fact contributed to the successful privatization. After the sale of UBB, the total assets of the state-owned banks dropped to 67.7% in December 1997. Despite the domination of the state-owned banks, the first privatization deal was a breakthrough with an expectation to boost the privatization of the other state-owned commercial banks. In 2000, just three years after the privatization, 89.9% of the shares of UBB were acquired by the National Bank of Greece at the price of 207 million dollars. There are a few explanations for the seventy fold increase in value in just 3 years. On one hand, this fact can be explained with the restructuring and the reorganization of the bank, which in turn increased the value of the UBB. On the other hand, there were critics that the state didn't manage to calculate the fair selling price. The question arises whether it was impossible for Bulgaria to carry out the reform of UBB and to sell it later at a better price. In 2004 the United Bank of Greece possessed 99.9% of UBB. [63]At the moment UBB is the second largest bank in Bulgaria measured by shareholders' equity and a market leader in the government securities market.

The share of the assets of the foreign banks in the banking system increased from 19.1% in 1997 to 32.3% in 1998. One of the reasons for that increase was the successful privatization of Bulgarian Post Bank. In September 1997, twenty potential buyers wished to participate in the privatization of Bulgarian Post Bank. Finally, Nomura International, the National Bank of Greece, Evrobank and the American Life Insurance Company (ALICO) submitted their bids at the end of 1997. The Bank Consolidation Company (BCC) reviewed the bids and chose the offer

[62] Cf. Ignatiev, (2005), p. 122
[63] http://www.ubb.bg/en-US/FCK/229

of Nomura International. The BCC and Nomura couldn't agree on some important issues and this led to a withdrawal the nomination of Nomura. The BCC began to negotiate simultaneously with the National Bank of Greece and ALICO. The BCC was sharply criticized and was accused of backstage schemes. The tension surrounding the deal came from the fact that this was the fourth largest bank in the country. The BCC received two offers: the joint bid of ALICO and the Greek Consolidated Eurofinance Holding (CEH) and the bid of the National Bank of Greece. The bid of ALICO and CEH was found to be better and the privatization deal was finalized. ALICO and CEH acquired 78.23% of the total equity of Post Bank at the price of 38 million dollars. In the case of Post Bank it was a successful deal for the state because of the good purchase price and the additional conditions negotiated with ALICO and CEH.[64] An increase of the bank capital of 20 million dollars for the next year was negotiated, as well as 10% of the profits to be paid to the Bulgarian state over the next five years.[65] Despite the privatization of Post Bank, the foreign ownership in the banking sector remained low – 32.3% of the total assets till the end of 1998.

In the same year a license to Ziraat Bankasi was given, which was the first Turkish bank since the exit of the Ottoman Bank. The Bayerisch-Bulgarische Handelsbank GmbH was renamed to HypoVereinsBank Bulgaria. Corporate Commercial Bank (domestic subsidiary of Bulbank) was wholly acquired by Bulbank and Litex Bank was sold to local investors in Lebanon. In 1999, Demirbank, the second Turkish bank since the exit of the Ottoman Bank, established a subsidiary. During the next 2 years, the Trading Bank of Greece, City Bank and Procredit Bank were licensed. The International Orthodox Bank Sveti (St.) Nikola bank was renamed to Neftinvestbank. With the permission of the BNB, Refco Capital Markets, part of the Refco Group, acquired 20% of the shares of Bulgarian-Russian Investment Bank.[66]

In 1999, Expressbank, one of the major players on the banking market in Bulgaria was privatized. The bank was founded in 1993 and the state possessed 93% of the capital. The BCC took the decision to hire a consultant that would develop a strategy for the privatization deal because of the unsatisfactory bids in 1997. Deloitte & Touch together with HSBC Investment Bank gave their advice regarding the sale of Express bank. In 1999, Société Générale (France),

[64] Cf. Jotev, (1998), p. 7-8
[65] Cf. Koford and Tschoegl, (2003), p. 24
[66] Cf. Koford and Tschoegl, (2003), p. 25

acquired 97.5% of Expressbank's capital at the price of 39 million dollars. After its privatization, the Expressbank was renamed SG Expressbank.[67]Even after this privatization the state-owned banks continued to dominate.

The next state-owned bank which was privatized was Hebros Bank. The procedures of its privatization began in 1998. The Bulgarian Consolidation Company chose Barents Group to carry out a study and to develop a strategy for the privatization deal. The BCC expected that the deal would be finalized by March 1999. Eastern Europe and Bulgaria in particular weren't attractive at that moment for the foreign investors due to the financial crisis in Russia and the highly volatile international financial markets. Hebros Bank was privatized at the end of 1999 for 24 million dollars by Regent Pacific Group[68]. The buyer – an emerging market investment management company, acquired 97.6% of the bank assets. Since March 2005 Hebros Bank is part of Bank Austria Creditanstalt.[69]

The next state-owned bank which was privatized was Bulbank. This was the largest Bulgarian bank with 27% market share. The privatization procedure of Bulbank started in 1998. Advisors on the privatization deal were Creditanstalt Investmentbank, Credit Suisse First Boston and Arthur Andersen. They were chosen and appointed by the European Union. Interesting facts surrounding the privatization were the criticism and the resistance of the management of Bulbank towards the deal. The Greek consortium "Kanvas" accused the BCC of unfair treatment. In spite of that, the bid of UniCredito Italiano and Alianz Holding was approved in 1999. They acquired 98% of the shares of Bulbank at the price of 313 million dollars. Bulbank sold its shares in Corporate Commercial Bank (99.9 %), UBB (35%) and HypoVereinsBank Bulgaria (49%) in 2000. Bulbank was already prepared for the expected privatization. On 2nd October 2000 the privatization was completed. UniCredito Italiano acquired 93% and Alianz Holding 5% of the shares.[70]UniCredit Italiano is one of the largest Italian banks. The conflict between the government and the Chief Executive Director of Bulbank came from the low selling price and a change in the Informative Memorandum. In 2006, the process of merger between Bulbank, HVB Bank Biochim and Hebros Bank began. The General meetings of shareholders of Bulbank, HVB

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[67] Cf. Koford and Tschoegl, (2003), p. 25
[68] Cf. Koford and Tschoegl, (2003), p. 25
[69] http://www.hkexporter.net/bank/bulgaria/hebrosbank-bulgaria.html
[70] http://www.unicreditbulbank.bg/en/About_the_Bank/History/index.htm

Bank Biochim and Hebros Bank decided to merge the three institutions in 2007. The legal merger between Bulbank. HVB Bank Biochim and Hebros Bank took place on 27th April 2007. The merged institution's name is UniCredit Bulbank.[71] It can be concluded that the major changes in the banking sector in Bulgaria happened in 2000 after the privatization of Bulbank and Hebros Bank. The share of the assets of the state-owned banks in the banking system decreased significantly to 18.8% by the end of 2000.

Biochim Bank was the next state-owned bank which was privatized. In the period 1999-2000 Biochim Bank was recapitalized. The negotiations for the privatization of the bank with investors repeatedly ended in failure due to the bad conditions offered by those investors. The Bank Consolidation Company decided to choose an independent foreign manager who would secure proper management of Biochim Bank until the privatization process finished. The tasks of the manager were the restructuring of the bank and to increase its appeal to strategic investors. The new manager of Biochim Bank was from the financial company Glendale from Great Britain. He should have managed the bank for the next two years, however just six months later the BCC terminated the contract with Glendale, giving the explanation that the investment climate in the Bulgarian banking sector was good and there was no need to wait eighteen months in order to start with the privatization of the bank. Biochim was acquired in July 2002 which was two years after the termination of the foreign manager. One version for the dismissal of the foreign manager was the fact that credit to several state-owned enterprises was refused. This was a sign that the confidence in the system was undermined. The privatization procedure of Biochim started in January 2002 with the announcement of the requirements to potential buyers. The potential buyers were required to be commercial banks or consortiums with 100 million BGL of their own funds and a minimum of five years corporate history. The starting bid was 95 million BGL for 99.59% of the shares. Three offers were received - from Bank Austria Creditanstalt, from a consortium between Hebros Bank and Charlemange Capital Ltd and from a consortium between Mezhprombank and Roseximbank. The best offer was that of Bank Austria Creditanstalt for the price of EUR 82.5 million. This bid was accepted and the Bank Consolidation Company made the transfer of its shares.[72]

[71] http://www.unicreditbulbank.bg/en/About_the_Bank/History/index.htm
[72] Cf. Ignatiev, (2005), p. 125

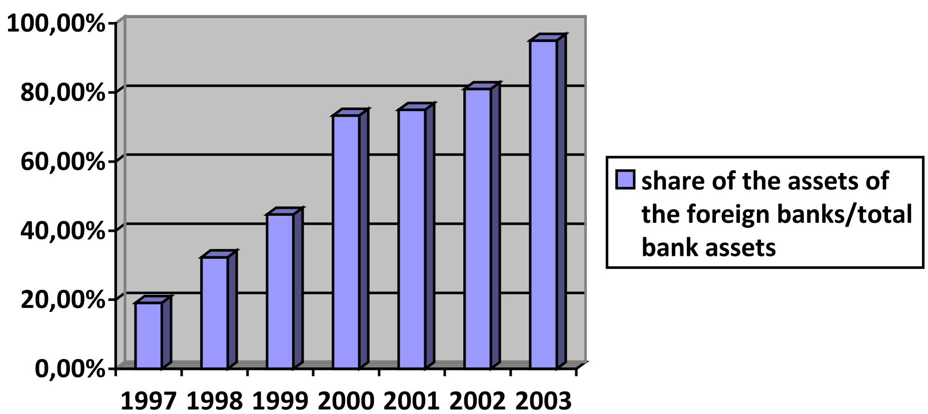
In 2003, the privatized Biochim Bank was renamed to HVB Bank Biochim. On 21st November 2005, HVB Bank Biochim and Hebros Bank became members of UniCredit Group.[73]

ProCredit Bank was established in 2001 by a consortium of foreign development agencies and Commerzbank. The newly established bank specializes in microfinance and lending to small and medium enterprises.[74]

The last state-owned bank which was privatized was DSK. During the communist era DSK was the only bank for deposits. In 1998, it was transformed into a commercial bank. The privatization procedure began in 2002. Bids were submitted by Austrian Erste Bank and by OTP - one of the largest Hungarian banks. OTP acquired DSK for the price of EUR 311 million in 2003. The privatization of DSK brought foreign ownership of Bulgarian bank assets to about 95% in 2003. On 31 December 2010, the total assets of DSK in BGN were 5 430 148 000.[75]

The following figure[76] shows the changes in the banking sector in Bulgaria - the changes in the assets of the foreign banks compared to the total bank assets in the country.

Figure 3: The share of the assets of the foreign banks to the total bank assets in the period 1997-2003 in Bulgaria



[73] http://www.hkexporter.net/bank/bulgaria/hvb-bank-biochim-bulgaria.html

[74] Cf. Koford and Tschoegl, (2003), p. 26

[75] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/pub_b_in_b_2010_12_en.pdf p. 93

[76]Cf. Ignatiev, (2005), p. 124

In 2000, after the privatization of Bulbank and Hebros Bank, the foreign share of the assets in the banking system jumped to 73.3%. In 2003, it reached 95% after the privatization of DSK, which was the highest value among the countries in Europe.[77]

The privatization of the Bulgarian banks was a challenging process. Seven state-owned banks were privatized in the period between 1997 and 2003. All the buyers were foreign investors or consortia with foreign participation. The success of the privatization in the banking sector was a key factor for the restructuring of the banking system and its development after the financial crisis. The high capital adequacy and the liquidity of the banking system were the main factors for restoring confidence of depositors in the banks. The opinion that the state was a bad owner was spread and the government took the decision that the privatization of the state-owned banks was the only way for a stable banking system. The government took a variety of measures – implementation of a currency board, establishment of new modern legislation and the privatization of the state-owned banks. All those measures stabilized the banking sector. The privatization of the state-owned banks brought know-how, technology and experience into the banks and led to an increase in their competitiveness. The government's influence in the process of granting credits to enterprises was eliminated. The government deficit was financed by capital inflow from privatization. There were some scandals surrounding the privatization deals and the institutions which were responsible to negotiate with the potential buyers were suspected of corruption. There were also accusations that the selling prices of the banks were very low. As a result of those facts, many deals were postponed and the privatization procedures were restarted later. The reforms in the banking sector brought stability, transparency, financial discipline and restored the confidence in it. It can be concluded that the reforms in the banking sector were most advanced in comparison with other sectors of the economy.

3.4 The situation in the banking sector after the privatization of the state-owned banks

The end of 2003 marked the expected completion of the trends that were going on through the year, which were an essential element of a qualitative new stage in the development of the banking system. The finalization of the privatization in the sector and the discussions about the management and policies of the BNB were far from the only important processes. However, they

[77] Cf. Ignatiev, (2005), p. 125

were a clear sign of both the lack of a state segment and the often ignored reality that to a large extent the management strategies and the overall development of the sector were not only conducted outside Bulgaria. In fact, the whole banking sector and, respectively, the financial stability and security were highly dependent on the global financial system and the world economy.

The commercial banks in 2003 in Bulgaria were divided into groups by asset size (foreign bank branches were classified into a separate group) as follows[78]:

- **Group I**: the first ten banks with the biggest assets - Bulbank, DSK Bank, United Bulgarian Bank, Biochim Commercial Bank, Bulgarian Post Bank, First Investment Bank, SG Expressbank, Hebros Commercial Bank, Raiffeisenbank, Bulgaria, Roseximbank.

- **Group II**: the other Bulgarian banks, including Economic and Investment Bank (former BRIBANK), BNP Paribas, Bulgaria (former BNP≠ Dresdnerbank, Bulgaria), Municipal Bank, Central Cooperative Bank, Allianz Bulgaria Commercial Bank (former Bulgaria-Invest Commercial Bank), Eurobank, Bulgarian-American Credit Bank, Corporate Commercial Bank, Unionbank, First East International Bank, Commercial Bank of Greece (Bulgaria) (former International Commercial Bank), Investbank (former Neftinvestbank), Procredit Bank, Encouragement Bank, International Bank for Trade and Development, Demirbank, Tokuda Bank, Texim Private Entrepreneurial Bank, WestEast Bank.

- **Group III**: branches of foreign banks in Bulgaria, including ING Bank N. V., Citibank N. A., National Bank of Greece, Piraeus Bank, Alpha Bank, T. C. Ziraat Bank.

Some changes would take place in the three groups of banks in the next years, due to mergers, acquisitions and entry of new credit institutions.

The table[79] below shows the liquidity of the commercial banks in Bulgaria at the end of 2003 (after the last privatization).

[78] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200312_en.pdf

Table 5: Liquidity of commercial Banks on 31th December 2003

LIQUIDITY OF COMMERCIAL BANKS AS OF 31 DECEMBER 2003
(under Regulation No. 11 of the BNB)

(BGN'000)

Position	Total
Group I	
Liquid assets, total	2 819 082
ASSETS, TOTAL – inflow	11 986 230
ATTRACTED FUNDS, TOTAL (DEPOSITS)	10 958 582
Coefficient of liquid assets	25.72
Adjusted coefficient of liquid assets to deposits	
Group II	
Liquid assets, total	876 214
ASSETS, TOTAL – inflow	3 463 573
ATTRACTED FUNDS, TOTAL (DEPOSITS)	3 155 161
Coefficient of liquid assets	27.77
Adjusted coefficient of liquid assets to deposits	
Group III	
Liquid assets, total	124 816
ASSETS, TOTAL – inflow	913 122
ATTRACTED FUNDS, TOTAL (DEPOSITS)	879 538
Coefficient of liquid assets	14.19
Adjusted coefficient of liquid assets to deposits	
BANKING SYSTEM, TOTAL	

At the end of 2004, the banking system assets were BGN 24,917,359,000 which was an increase of 43.85% (BGN 7,594,842,000 in absolute terms) compared to the end of 2003. Over the last three months of 2004, assets measured a record high growth of 15.63% (BGN 3,367,579,000 in absolute terms). It is important to notice that this was the highest increase in the system's assets within a period of three months taking into account asset growth rates since early 2004. This growth was even greater than the annual rates in most of the recent seven years. This was a good sign for the stabilization of the banking sector.[80]

The assets of the first ten banks (Group I) grew by the most substantial amount, contributing to 75% or BGN 2515 million to overall asset growth. Group II banks reported growth of 10.95%

[79] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200312_en.pdf
[80] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200412_en.pdf

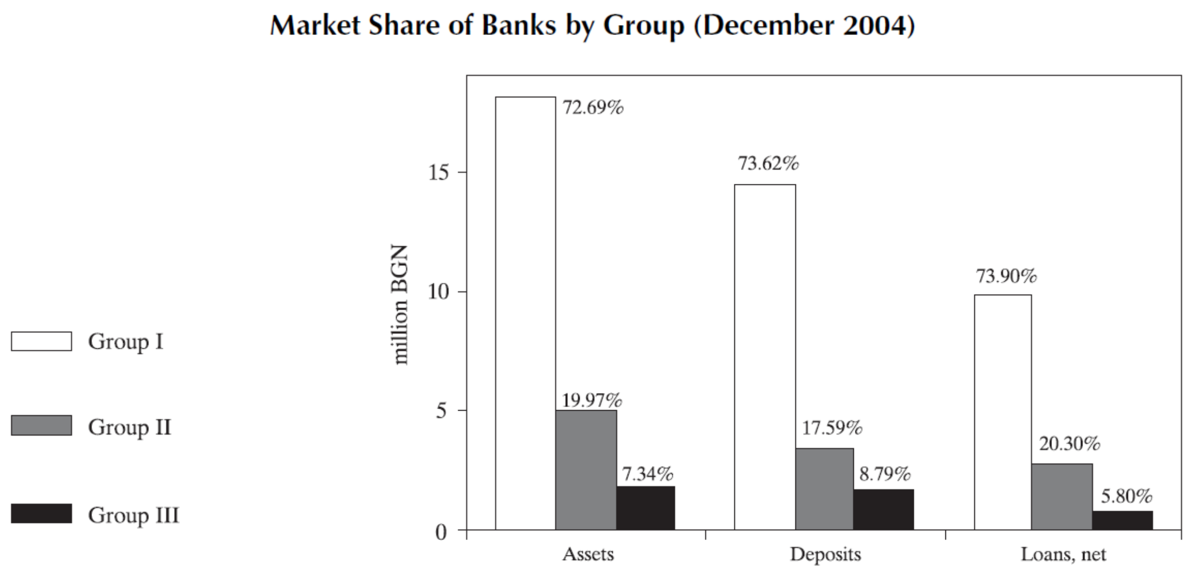
(BGN 491 million). Group III banks reported growth of 25% [81]due to expanded activities in one of the branches.

The profit of the banking system for the whole of 2004 was BGN 434 million, which was an increase of 36.03% (BGN 115 million), compared to that in 2003.

Group I banks generated 80.08% of the total banking system's profit in 2004. Group II banks generated 14.69% and Group III 4.23% in 2004.

The figure[82] below shows the market share of banks by group in 2004. It can be seen that the banking system was dominated by Group I banks.

Figure 4: Market share of banks by Group



An increase in the share in the banking profits was reported by the three largest banks (Bulbank, DSK Bank and UBB), although their share in assets decreased. DSK Bank continued to dominate in consumer, housing mortgage and savings loans. The Bulgarian Post Bank strengthened its

[81] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200412_en.pdf
[82] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200412_en.pdf

positions in other commercial loans, although its concentration level was low. The First Investment Bank sustained its high concentration in short-term borrowings.[83]

A strategy for the development of the Bulgarian National Bank in the period 2004-2009 was developed in 2004. It demonstrated the transition to full Eurosystem membership and that the BNB would act under the currency board arrangement until the country becomes a full member of the Eurosystem.

In the last quarter of 2004, a contract for the acquisition of Hebros Commercial Bank was signed by BA-CA (Bank Austria Creditanstalt) and HVB Bank Biochim. The new owner of 90% of the shares of Hebros Commercial Bank was BA-CA, with HVB Bank Biochim possessing the remaining 10%.[84]

The table below[85] shows the liquidity of the commercial banks in Bulgaria at the end of 2004. The development of the banking sector can be seen by the comparison of table 5 with table 6.

Table 6: Liquidity of commercial banks on 31st December 2004

Commercial Banks in Bulgaria

LIQUIDITY OF COMMERCIAL BANKS AS OF 31 DECEMBER 2004
(under Ordinance No. 11 of the BNB)

(BGN'000)

Items	Total	Overdue assets of 15 or more days/ assets in pawn	At sight up to 7 days	From 8 days to 1 month	From 1 to 3 months	From 3 to 6 months	From 6 to 12 months	Over 1 year
Group I								
Liquid assets, total	5 772 363	803 937						
ASSETS, TOTAL – inflow	17 354 507	934 455	5 564 988	1 301 116	856 741	1 140 922	1 987 673	6 503 067
BORROWED FUNDS, TOTAL (DEPOSITS)	16 096 268		4 352 709	2 910 546	1 327 275	1 022 425	1 616 556	4 866 757
Coefficient of liquid assets	30.87							
Adjusted coefficient of liquid assets to deposits			127.85	85.16	64.55	111.59	122.96	133.62
Group II								
Liquid assets, total	1 560 683	301 372						
ASSETS, TOTAL – inflow	4 734 572	410 808	1 705 061	209 852	269 784	392 614	657 813	1 499 448
BORROWED FUNDS, TOTAL (DEPOSITS)	4 304 211		1 051 466	698 862	465 797	536 264	552 824	998 998
Coefficient of liquid assets	29.26							
Adjusted coefficient of liquid assets to deposits			162.16	101.62	57.92	73.21	118.99	150.10
Group III								
Liquid assets, total	766 129	2 519						
ASSETS, TOTAL – inflow	1 812 382	4 257	879 326	94 151	142 446	132 888	206 860	356 711
BORROWED FUNDS, TOTAL (DEPOSITS)	1 753 318		946 956	179 032	175 744	140 509	78 112	232 965
Coefficient of liquid assets	43.55							
Adjusted coefficient of liquid assets to deposits			92.86	52.59	81.05	94.58	264.82	153.12
BANKING SYSTEM, TOTAL								

[83] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200412_en.pdf
[84] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200412_en.pdf p. 15
[85] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200412_en.pdf p. 46

In 2005, the foreign companies Growth Management Limited Hillside (10% of the shares of the bank) and Apex Fund Limited (also10%), acquired the 20% share of the European Bank for Reconstruction and Development in the form of capital from First Investment Bank.

In January 2005, the contract between Petrol Holding AD (the majority owner of Eurobank) and Piraeus Bank SA for the acquisition of Eurobank AD was signed. With the permission of the BNB in May 2005, Piraeus Bank SA acquired 99.66% of the capital of Eurobank.[86]

ProCredit Bank had a new majority shareholder in 2005. This was the ProCredit Holding AG, which increased its shares by 39.42% to 59.13% resulting from the transfer of the shares of Internationale Micro Investitionen AG (20.29%) and International Finance Corporation (19.13%).[87]

At the end of 2005 the net profit of the banking system was BGN 584 million, which was BGN 150 million (34.6%) more than in 2004.

In 2005, banking liquidity was better that that in 2004, as displayed by the table[88] below. Only the banks from Group III were less liquid than in the previous year, due to the fact that National Bank of Greece' branch was in the process of voluntary liquidation.

[86] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200503_en.pdf p.17
[87] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200512_en.pdf p. 15
[88] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200512_en.pdf p.54

Table 7: Liquidity of commercial banks on 31st December 2005

Commercial Banks in Bulgaria • October – December 2005

LIQUIDITY OF COMMERCIAL BANKS AS OF 31 DECEMBER 2005
(under Ordinance No. 11 of the BNB)

(BGN'000)

Items	Total	Overdue assets of 15 or more days/ assets in pawn	At sight up to 7 days	From 8 days to 1 month	From 1 to 3 months	From 3 to 6 months	From 6 to 12 months	Over 1 year
Group I								
Liquid assets, total	7 845 519	1 389 519						
ASSETS, TOTAL – inflow	23 362 404	1 636 472	7 695 561	1 870 085	862 997	1 102 531	2 599 906	9 231 324
BORROWED FUNDS, TOTAL (DEPOSITS)	21 612 375		5 842 309	3 540 749	1 622 184	1 231 697	1 919 416	7 456 020
Coefficient of liquid assets	29.87							
Adjusted coefficient of liquid assets to deposits			131.72	100.03	53.20	89.51	135.45	123.81
Group II								
Liquid assets, total	2 490 280	345 930						
ASSETS, TOTAL – inflow	6 589 536	442 963	2 591 314	375 205	301 640	481 462	801 111	2 038 804
BORROWED FUNDS, TOTAL (DEPOSITS)	6 074 510		1 681 914	902 323	632 191	900 500	778 522	1 179 060
Coefficient of liquid assets	35.30							
Adjusted coefficient of liquid assets to deposits			154.07	132.10	79.66	53.47	102.90	172.92
Group III								
Liquid assets, total	600 221	1 387						
ASSETS, TOTAL – inflow	1 764 845	4 116	832 210	100 018	119 810	79 237	86 004	547 566
BORROWED FUNDS, TOTAL (DEPOSITS)	1 699 161		745 666	245 080	334 479	88 869	22 831	262 236
Coefficient of liquid assets	35.24							
Adjusted coefficient of liquid assets to deposits			111.61	57.15	35.82	89.16	376.70	208.81
BANKING SYSTEM, TOTAL								

It is obvious that the banking sector functioned well after the changes made in the previous years. One of the indicators showing this were loans. In 2005, the non-performing loans increased by 0.23% to 2.24% compared with 2004, but they were still very low compared to the levels before the establishment of the currency board and the changes in the banking structure (privatization).[89]

In 2006 the net profit of the banking system was BGN 808 million. Profits increased by BGN 223 million (38.2 per cent) compared to the previous year. DSK continued to hold the leading market positions in consumer loans and savings.[90] There were 34 banks, which operated on the market in 2006 and only two of them – Tokuda Bank and Emporiki, reported a loss.

EFG Eurobank Ergasias S. A. bought 75.33% of the Bulgarian Post Bank's capital increase, and together with CEH Balkan Holdings Limited, a subsidiary of EFG Eurobank Ergasias S. A., held directly and indirectly 100% of the increased capital of the bank. CEH Balkan Holdings Limited had a share of 24.33 % of the bank's capital.

[89] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200512_en.pdf p.25
[90] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200612_en.pdf

34% of the capital of the Economic and Investment Bank was acquired by Valhamar Group Ltd (British Virgin Islands) through an own company-Novator Finance Bulgaria S.A.R.L.-Luxembourg. [91]

MKB Bank AD, Budapest, Hungary bought 9,247,059 ordinary voting shares equal to 60% of the capital of Unionbank AD in 2006. Nova Ljubljanska Banka AD, Slovenia bought 15,327,580 ordinary book-entry voting shares of the WestEast Bank's capital equal to 24.5% of the shares. With those new shares the total amount held increased to 97.01% by Nova Ljubljanska Banka AD. In December 2006, 91.2% of the shares of DZI Bank were acquired by Eurobank EFG Holding (Luxembourg) S.A.[92]

For the one-year period between 31st of December 2005 and 31st of December 2006, all banks with the exception of two and one foreign bank branch increased their balance sheet assets. The growth in the banking system resulted from the operations of the ten largest banks (BGN 7.1 billion or 29.3%) and Group II credit institutions (BGN 2.7 billion or 38.9%). The banks from Group III decreased their assets due to the reduction in the number of the foreign bank branches. The decrease was BGN 0.4 billion (23.9%). One-third of the growth in the banking system balance sheet resulted from three Group I institutions.[93] 73.6% of the bank assets were concentrated in the banks from Group I, more than 50 % of the granted credits were concentrated in DSK, OBB and Bulbank, and 59% of the net profits were from the operations of UniCredit Bulbank, DSK Bank, Raiffeisenbank (Bulgaria) and United Bulgarian Bank.[94]

The banks with a market share of 1-2%, of which there were 7 in 2006, worked under the pressure of the bigger banks. As a result of the increasing competition, the products offered to the clients were various and the quality of those were improved.

When the banking sector is described, some other facts should be pointed out under which the sector functions and develops itself. In 2006, shortly before Bulgaria's EU accession on 1st January 2007, the situation is much better than the expectations made a few years ago. The GDP was 6.1% in 2006 and the inflation decreased to 6.1% compared with the previous year. An

[91] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200603_en.pdf
[92] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200606_en.pdf p. 14
[93] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200612_en.pdf p.8

[94] Cf. Krainiska, (2010), p. 34

increase of EUR 1 billion to EUR 4104.5 million, or 16.4 per cent of GDP, of the foreign direct investment measured the period between December 2005 and December 2006. The increase of the investments was the reason for the increase of the labour productivity, as well as the moderate growth of the wages and the salaries. As a result of this, employment rose and the income of the households increased, which caused an increase in consumption. Per capita GDP amounted to EUR 3260, an increase of 15% compared with that in 2005. An interesting fact is that 81.2% of GDP in 2006 was generated by the private sector. The GDP was EUR 25027.44 million in 2006. [95]

The inflation level, which is a very important factor for the EMU candidates, should not exceed by more than 1.5% the average of the three EU members with the lowest inflation. For the last quarter of 2006 the inflation in Bulgaria was 5.7%. The banking assets increased by 28.3% till the end of the year. The banking sector's own funds also increased at rates close to those of assets and the share of classified loans to non-financial corporations was the lowest for the last nine years.[96]

The gross international reserves were EUR 8925.4 million at the end of 2006 or an increase of 21.07% compared with 2005. The banking assets were BGN 42,201 million, an increase of 28.3% compared with 2005. The main reason for this growth was the increase of the deposit base. BGN 27,560 million were deposits of nonfinancial institutions and BNG 5,628 million were funds of financial institutions.[97]

In 2006, the environment in Bulgaria for investment was very good because of the high rates of return, stable economic growth together with the low inflation. All these factors attracted many foreign investors. The economy was diversified with new businesses, products and technologies. Bulgaria was ready to be a member of the European Union.[98]

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[95] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2006_en.pdf p. 11
[96] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2006_en.pdf p. 10
[97] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2006_en.pdf p. 36
[98] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2006_en.pdf p. 14

4. The structure of the Bulgarian Banking Sector post EU membership

4.1 The structure of the banking sector and the consolidation process

Since 1st of January 2007, Bulgaria has been a member of the EU. The new challenge for the country and the Bulgarian banking sector in particular is its accession to the EMU. It should be mentioned that the income level in Bulgaria is only one third of the level in the EU countries. The accession to the EU, together with economic developments and changes in the political sphere, will likely have a direct impact on the banking sector situation. In general the banking sector was stable and expectations for the future were positive.

In the first quarter of 2007, the supervisory reporting of individual banks in Bulgaria was changed to (FINREP), a new Framework for Consolidated Financial Reporting, which was applicable to credit institutions in the EU, based on the international accounting standards/international financial reporting standards (IAS/IFRS).[99]

For the first quarter of 2007, the assets of the banking system were BGN 44,518 million, which was an increase of BGN 2323 million or 5.5% compared with the first quarter of 2006. At the same time, Eurobank EFG Holding (Luxemburg) S.A acquired additional 8.55% of the shares in DZI Bank and had in total 99.75%. The five largest banks continued to account for more than 50% of the assets in the Bulgarian banking system. An interesting fact was that HVB Bank Biochim and the First Investment Bank changed their positions according to the weight of assets. The First Investment Bank, the only Bulgarian bank in the Group I, was ranked fifth in 2007, which was the position HVB Bank Biochim occupied in 2006. The market shares of the EU institutions in Bulgaria increased by 2.2% to 77.5% and that of local banks decreased by 2.5% to 19.6% for the last 12 months. Two changes took place in the first quarter of 2007. BNB Paribas (Bulgaria) switched from the group of EU banks' subsidiaries to the group of EU credit institutions' branches and DZI Bank from the group of local banks to the group of EU banks' subsidiaries. In the first quarter of 2007 the number of the non-EU institutions didn't change

[99] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2007_en.pdf p. 7

(three banks and two foreign bank branches) and their percentage of the assets in the Bulgarian banking system was also unchanged – 2.9%.[100]

The banking sector in Bulgaria wasn't developed in terms of assets to GDP and loans to GDP ratios, as in most EU countries. Assets to GDP ratio was about 85% in Bulgaria in the first quarter of 2007 and around 150% in most EU countries at that time. Loans to GDP ratio was 46% in Bulgaria and around 125% in some countries from the EU.[101]

In 2007, Eurobank EFG Bulgaria became a bank from Group I with a market share of 7.41%. After the merger of the three banks of UniCredit Group - Bulbank, Hebros Bank and HVB Biochim, the banks from the Group I (UniCredit Bulbank, DSK Bank, Raiffeisenbank (Bulgaria), United Bulgarian Bank and Eurobank EFG Bulgaria) had 56.5% of the assets of the Bulgarian banking sector. The leader was UniCredit Bulbank with 15.34%, followed by DSK Bank with 13.28%. Raiffeisenbank (Bulgaria) held a market share of 10.12% and United Bulgarian Bank 10.37%.[102] As of 30th June 2007, the total assets in the banking system were BGN 45.727 million.[103]

During the third quarter of 2007, the banking system operated in the condition of strong competition. As of 30th September, the total assets in the banking system were BGN 51.900 million, which was an increase of BGN 13.2 billion (34 per cent) over the last 12 months.[104]

The rapid growth of loan portfolios during the year was partially compensated by the increase in the bank capital, which resulted in good capital adequacy of the system - 13.9% in September 2007. The banking system remained stable and an increasing number of households and companies had access to a growing number of banking services.

On 31st December 2007, the total assets in the banking system were BGN 59.100 million. This was an increase of BGN 7.2 billion (13.8 per cent) over the last three months and BGN 16.9

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[100] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200703_en.pdf p. 14-15

[101] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200703_en.pdf p. 15

[102] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200712_en.pdf p.7

[103] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200706_en.pdf p. 10

[104] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200709_en.pdf p. 7

billion more compared with 2006 or an annual growth of 40%.[105] The expansion of the banking business was financed mainly by deposits and the own funds of credit institutions. Credit institutions financed almost half of the reported growth in the banks.[106]

As can be seen from the table[107]below, the liquidity of all the three groups of banks increased, which was another sign for the development of the banking sector over the last 12 months.

Table 8: Liquidity of commercial banks on 31st December 2007

LIQUIDITY OF BANKS AS OF 31 DECEMBER 2007
(under Ordinance No. 11 of the BNB)

(BGN'000)

Items	Total	Assets in pawn/ overdue assets of 30 or more days	At sight up to 7 days	From 8 days to 1 month	From 1 to 3 months	From 3 to 6 months	From 6 to 12 months	Over 1 year
Group I								
Liquid assets	7 497 310	1 745 613						
Assets, total – inflow	32 516 524	2 226 929	9 197 497	2 411 971	1 260 364	1 837 527	3 410 060	14 399 105
Liabilities, total – outflow	29 260 480		12 195 242	5 089 517	2 016 650	1 400 916	2 130 372	6 427 783
Coefficient of liquid assets	25.62							
Coefficient of liquidity by maturity intervals			75.42	27.16	14.50	20.22	35.07	107.52
Group II								
Liquid assets	6 474 780	693 824						
Assets, total – inflow	22 134 451	956 767	7 650 283	987 673	1 340 100	1 130 698	2 215 538	8 810 159
Liabilities, total – outflow	20 316 267		6 848 530	2 852 557	2 233 926	2 065 352	2 964 775	3 351 127
Coefficient of liquid assets	31.87							
Coefficient of liquidity by maturity intervals			111.71	51.29	35.08	23.76	32.17	101.73
Group III								
Liquid assets	805 449	12 116						
Assets, total – inflow	2 849 152	17 685	1 289 709	182 873	91 709	163 412	375 076	746 373
Liabilities, total – outflow	2 751 915		2 007 751	306 521	74 958	43 371	115 687	203 627
Coefficient of liquid assets	29.27							
Coefficient of liquidity by maturity intervals			64.24	10.13	4.34	7.10	14.81	28.41

105 http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2007_en.pdf p.10
106 http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200712_en.pdf p.7
107 http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200712_en.pdf p.28

The market share of the Group I institutions increased by 0.5% to 56.5%. KBC Bank N.V. was the main reason for the increase in the number of the EU banks' subsidiaries, as well as for their market share increase of 3% to 75.3%. Greek capital had the largest presence - 5 banks with a market share of 23.63%. The number of the local banks went down to eight with a market share of 17.7%. The foreign credit branches and banks outside the EU didn't change their market share and performance during the last three months of the year.

The membership of Bulgaria in the EU brought to the country new guarantees for development of the economy. In 2007, direct foreign investments, one of the signs of success and development, represented 20.5% of GDP, which covered over 100% of the current and capital account deficits.[108]

The period between the last quarter of 2003 and the first quarter of 2007 was measured by the attempt of the banks to build up net of branches, to enlarge their market share and to strengthen their positions in the different market segments. Only by doing so could banks attract some big international financial groups. It was clear that the only way in front of the banks in Bulgaria to survive in the new environment after the accession in the EU was through consolidation. There were two consolidations in 2007. The first consolidation was the merger of Post Bank and DZI Bank. The owner of the two banks was Eurobank EFG Bulgaria. After the finalization of the deal, Eurobank EFG Bulgaria held a market share of 7.41% and 280 branches all over the country, and was one of the five biggest banks in the country (Group I banks).

The second consolidation deal was the merger of HVB Biochim, Hebros Bank and Bulbank, all of them owned by Italian UniCredit. The new financial institution becomes the biggest bank in the country, with total assets of BNG 7.5 billion and equity of BGN 1 billion. The new institution was named UniCredit Bulbank.[109]

The BNB became a member of the European System of Central Banks (ESCB) following the accession of Bulgaria in the EU. On 2nd January 2007, the payment due into European Central Bank (ECB) capital was received.

[108] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2007_en.pdf p.9
[109] Cf. Kraininska, (2010), p.35

The international foreign currency reserves were EUR 11,936.6 million or 41 per cent of GDP in 2007. 164% of the reserve currency or 202.1% of the short-term debt was covered by the international foreign currency reserves in 2007.[110]

It is worth mentioning that the development of the economy had a direct impact on the banking sector in particular. As living standards increased and the expectations for the future were positive, households, institutions and companies began to consume more. This led to higher investment levels and consequently to an increase of credit levels.

The average growth rate of credit was 24.6% in 2006 and 47.7% in June 2007. An explanation for the credit growth in the first half of 2007 was the attempt of the BNB to comply with the existing EU regulations by reducing the supervisory credit growth rate restrictions.

The BNB introduced credit ceilings in order to minimize the increasing credit levels. The maximum credit growth per quarter was 5%, and those banks which exceeded this ceiling should pay BGN 100-150 million per quarter. Another measure in September 2007, which was designed to minimize credit growth and was undertaken by the BNB, was the increase of the bank reserves from 8% to 12%.[111] The exchange of information about the clients among banks was another area which should be improved.

The economy in Bulgaria was in the phase of convergence after the recovery from the financial crisis in 1996-97 and the players in the market tried to increase their market share. The credit growth was a sign of increasing banking activity and competition but also was risky for the stability of the banking sector in particular, and consequently for the whole economy. That was the reason for the measures taken by the BNB, whose goal was to reduce the tempo of the credit growth.

Another problem for the banking sector was the gap between lending and deposit rates, which gave the possibility for arbitrage and could even destabilize the banking sector. The gap still exists despite the fall of the long-term interest rates, due to the better credit rating of Bulgaria and the high inflow of foreign direct investments.

[110] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2007_en.pdf p.9
[111] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2007_en.pdf p.10

It can be concluded, that the Bulgarian banking sector finds itself in a stage of preparing for the next challenge, namely the membership to the EMU. 83% of the banks in Bulgaria are owned by foreign financial institutions and the current trend is consolidation. Only through this method can be gained more market share, new clients and the competition of the other banks on the market in the EU can be resisted. An interesting fact is that after 1st of January 2007, banks from the other 26 states of the EU can operate in Bulgaria without having a license from the BNB. The Central Bank should be informed of their intentions for the entry into the Bulgarian market. The same rule is valid for the Bulgarian banks, which want to open branches in the other EU states. The dynamics within the banking sector increase the competition among the market players.

4.2. The Bulgarian National Bank's role in the preparation's process of the banking sector in Bulgaria: the establishment of competition of the single European financial services market

The framework in Bulgaria changed after the accession to the European Union. The most prepared sector for this accession was the Bulgarian banking sector. The main role the BNB played was with its policy, which gave stability and sustainability to the system. The first task of the BNB was to ensure fair competition conditions for all market players. The new regulations brought this equal treatment to banks. Another problem in front of the banking system in Bulgaria was information sharing. After taking into effect the Code of Ethics, the banks were obliged to share all information about their clients. The BNB prepared the whole banking sector for the accession of the country into the EU and the new challenge is the accession to the EMU. A lot of different measures for credit growth restriction in the period 2006-2007 were undertaken by the BNB. In 2006, various acts took into effect, which guaranteed the stability of the banking sector. In 2007, the BNB passed a resolution according to which the old indicator of inflation (the Consumer Price Index (CPI)) would be replaced with a new one (the Harmonized Index of Consumer Prices (HICP)). The inflation level is the main problem for the country in order to adopt the Euro. The HICP is an indicator for the price stability and its implementation was a sign for the harmonization of the Bulgarian banking system with that of the EU. It can be concluded that the banking sector in Bulgaria is fully harmonized and fulfilled all the requirements of the EU. The banking supervision is very important for the stability of the banking system as a whole.

The BNB in cooperation with the European System of Central Banks organized several workshops and projects, with the goal of forecasting bank reserves and to analyze different risk management processes.[112]

The end of a two-year twinning project between the BNB, the National Bank of Italia, the National Bank of Netherland and the National Bank of France (managed by the Banque de France) was in 2008. Significant progress was achieved in several areas, such as payment systems, statistics, accounting, research and forecasting, financial market monitoring and risk management. Improvement in the existing systems and structures and development of staff skills to ESCB requirement was also achieved by the BNB.[113]

4.3. The impact of the Global Financial Crisis on the Bulgarian Banking Sector

The global financial crisis has its impact on the whole economy of Bulgaria and on its banking sector in particular. In this part of chapter 4, some interesting facts about the economy and the banking sector in the country can be seen. The global financial crisis began in 2008 with the liquidity shortfall in the United States banking system. The crisis in the United States “infected” the whole world and in particular the countries with a developed economy. “The collapse of the U.S. housing bubble, which peaked in 2007, caused the values of securities tied to U.S. real estate pricing to plummet, damaging financial institutions globally.”[114]

The macroeconomic stability of Bulgaria during the global financial crisis was guaranteed by the currency board. Under the currency board all BNB monetary liabilities are covered by foreign reserves. The Central Bank is required to sell or buy euro against levs at a set exchange rate. The currency board is very beneficial for Bulgaria in the current global crisis. Significant devaluation of some currencies could be seen in 2008 among the EU countries with floating exchange rates, which led to worsening internal environments.[115]

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[112] Cf. Kraininska, (2010), p.40

[113] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2008_en.pdf p.12
[114] http://en.wikipedia.org/wiki/Financial_crisis_of_2007%E2%80%932010
[115] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2008_en.pdf p.10

The currency board in Bulgaria should be removed after the entry of the country into the euro area. Keeping the currency board until that entry is a priority of the BNB. The last 12 months of 2008 were characterized by more intensive supervisory activity, due to the trends in international financial markets and to the global financial crisis. This was the way how financial resources accumulated by banks can be preserved and strengthened. Due to the changing environment, Banking Supervision gives banks the possibility to overcome the financial crisis.[116]

The profits of the banking system in 2008 were BGN 1374 million, or an increase of BGN 223 million compared with 2007. Despite the high annual result, the trend was that quarterly profits went downwards, especially in the fourth quarter, due to the growing price of liabilities.[117]

The gross international reserves increased by EUR 789 million to EUR 12,738 million in 2008 compared with 2007. In the first nine months of 2008, the BNB gross international foreign reserves increased, while the last three months of the year were characterized by a decrease of EUR 2 billion resulting from the reduction of the minimum reserves and the spending of the government at the end of 2008.[118]

The growth of the economy in Bulgaria (real Bulgarian GDP growth) was 6% in 2008. At the end of the second quarter the growth was 7% while the third quarter was characterized by a slowdown in individual economic sectors. The fourth quarter showed a decrease of the annual real GDP growth to 3.5%, due to the worldwide spread of the global financial crisis in real sectors.[119]

The next table[120] shows the liquidity of the three groups of banks on 31st of December 2008.

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[116] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2008_en.pdf p.10
[117] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2008_en.pdf p.11
[118] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2008_en.pdf p.11
[119] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_2008_en.pdf p.15
[120] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200812_en.pdf p.21

Table 9: Liquidity of banks on 31st of December 2008

LIQUIDITY OF BANKS AS OF 31 DECEMBER 2008
(under Ordinance No. 11 of the BNB)

(BGN'000)

Items	Total	Assets in pawn/ overdue assets of 30 or more days	At sight up to 7 days	From 8 days to 1 month	From 1 to 3 months	From 3 to 6 months	From 6 to 12 months	Over 1 year
Group I								
Liquid assets	6 286 674	1 706 381						
Assets, total – inflow	38 667 722	2 607 998	8 913 563	1 879 111	1 703 451	2 664 095	6 736 849	16 770 653
Liabilities, total – outflow	34 556 443		11 779 486	7 223 328	3 680 029	3 160 790	2 197 080	6 515 730
Coefficient of liquid assets	18.19							
Coefficient of liquidity by maturity intervals			75.67	17.91	13.62	18.59	47.02	112.58
Group II								
Liquid assets	6 082 771	925 057						
Assets, total – inflow	25 109 810	1 344 277	7 034 011	837 900	1 333 846	1 669 660	2 957 900	11 276 493
Liabilities, total – outflow	22 913 822		7 105 038	3 072 253	2 505 257	2 550 850	3 231 737	4 448 687
Coefficient of liquid assets	26.55							
Coefficient of liquidity by maturity intervals			99.00	25.25	24.10	23.38	31.34	97.59
Group III								
Liquid assets	899 207	5 952						
Assets, total – inflow	3 698 568	108 974	1 411 594	274 137	153 382	150 894	324 282	1 384 279
Liabilities, total – outflow	3 641 554		2 579 874	471 188	190 258	126 012	98 049	176 173
Coefficient of liquid assets	24.69							
Coefficient of liquidity by maturity intervals			54.72	12.81	6.93	6.56	13.84	57.33
Banking system, total								
Liquid assets	13 268 652	2 637 390						

nking Supervision Regulation

By comparing both tables (tab. 8 and tab. 9), it is obvious that the liquidity of the banks from the three groups in 2008 is higher than that in 2007, a sign for the development of the banking sector even in a period of a global financial crisis.

In the first quarter of 2008, the total banking system assets were BGN 59.5 billion, or an increase of 33.6% compared with March 2007. The same trend can be seen in the second and third quarter of 2008, where the increase was 39.2% and 33.6% compared with the second and third quarters of 2007. The fourth quarter of 2008 was characterized by a sharp decrease in banking system asset growth. At the end of 2008, the total banking assets were BGN 69.6 billion or an increase of BGN 0.2 billion on September 2008.[121]

A decrease of 9.2% of the foreign direct investments characterized the period between 1st January and 31st October 2008, compared with the same period in 2007. The foreign direct investments for the first ten months in 2008 in Bulgaria were EUR 4,868 billion or 14.3% of the GDP compared with EUR 5,364 billion, or 18.6% of the GDP for the same period in 2007.[122]

"Despite the deepening negative trends, caused by the financial crisis in a number of EU Member States, end-September 2008 data indicate that the banking system in Bulgaria stayed stable, adequately capitalized and with sufficient liquidity. However, within the review period (mostly in September) credit institutions in Bulgaria started reorganizing their activity which resulted in further rises in prices of domestic market resources, changes in interest rates on loans and overall tightening of credit standards. This, in turn, affected the decline in the growth rate of loans."[123]

In 2009, when the global financial crisis continued to deepen and broaden, the real GDP in Bulgaria dropped by 5%. Priority of the BNB was to maintain the stability in the banking system. From 1st January 2009, the banks should keep 5% (before 10%) reserves of foreign funds at the BNB and 0% (before 10%) reserves in central and local government funds. With those changes the BNB returned BGN 1.2 billion to the banks and they could reduce their obligations to non-residents.[124]

The banking system in 2009 was stable. As a result of the anti-crisis actions by the BNB, major financial indicators were good. The banks' profit generating potential and good liquidity were preserved. The profit of the banking sector in 2009 was BGN 752 million. The quality of the loans worsened and this caused the strongest pressure on revenues. 6.4% was the share of the doubtful loans (90 days overdue) - still a manageable level. The gross operating revenues increased by 2.35% that of 2008.[125]

[121] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200812_en.pdf p.7
[122] http://www.novinite.com/view_news.php?id=100148
[123] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200809_en.pdf p.7
[124] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/anual_report_2009_en.pdf p.11
[125] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/anual_report_2009_en.pdf p.12

In the first quarter of 2009, the total banking assets declined insignificantly (0.5%) compared with the last quarter of 2008, which could be interpreted as a sign for the degree of confidence in the banking system. UniCredit Bulbank, the largest bank in the country, had a market share of 16.05% and the market share of the Group I banks (UniCredit Bulbank, DSK Bank, United Bulgarian Bank, Raiffeisenbank (Bulgaria), and Eurobank EFG Bulgaria).was 56.3% on 31 of March 2009.[126]

In the second quarter of the year, the market share of the Group I banks increased by 1.1% to 57.4%. The market shares of the EU credit institutions subsidiaries increased by 1% to 76.1%, while that of the local credit institutions decreased to 16.5%.[127]

The third quarter of 2009 was characterized by a significant slowdown of the annual growth rates of bank assets and loans. The total bank assets were BGN 69.9 billion or an increase of 0.6% on the second quarter. The market shares of the five largest banks in the country increased by 0.5% to 57.9% in the third quarter, causing an increase of 76.6% of the market share of EU credit institution subsidiaries.[128]

The trend which characterized the first three quarters of 2009, were also retained in the fourth quarter. The total banking system assets marked an insignificant increase of 1.4% on September, reaching BGN 70.9 billion at the end of 2009. The table[129] below is evidence for the negative impact of the global financial crisis on the banking sector in 2009.

[126] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/pub_b_in_b_2009_03_en.pdf p.7
[127] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/pub_b_in_b_2009_06_en.pdf p.7
[128] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/pub_b_in_b_2009_09_en.pdf p.7
[129] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/pub_b_in_b_2009_12_en.pdf p. 21

Table 10: Liquidity of banks on 31st of December 2009

LIQUIDITY OF BANKS AS OF 31 DECEMBER 2009
(under Ordinance No. 11 of the BNB)

(BGN'000)

Items	Total	Assets in pawn/ overdue assets of 30 or more days	At sight up to 7 days	From 8 days to 1 month	From 1 to 3 months	From 3 to 6 months	From 6 to 12 months	Over 1 year
Group I								
Liquid assets	7 277 413	1 394 930						
Assets, total – inflow	39 940 094	3 401 546	8 308 321	3 021 374	1 756 184	2 395 161	5 672 994	18 786 060
Liabilities, total – outflow	35 109 637		11 061 129	5 944 469	3 889 273	4 319 772	4 402 528	5 492 466
Coefficient of liquid assets	20.73							
Coefficient of liquidity by maturity intervals			75.11	33.62	17.71	18.81	37.63	118.71
Group II								
Liquid assets	5 302 564	870 250						
Assets, total – inflow	25 242 985	2 077 325	6 334 222	890 462	1 321 159	1 627 000	2 783 822	12 286 320
Liabilities, total – outflow	22 428 143		5 355 667	2 604 552	3 666 504	2 282 989	3 538 627	4 979 804
Coefficient of liquid assets	23.64							
Coefficient of liquidity by maturity intervals			118.27	67.97	26.84	26.38	33.09	110.00
Group III								
Liquid assets	778 297	312						
Assets, total – inflow	3 491 423	198 467	1 116 780	157 831	120 547	236 077	173 494	1 686 694
Liabilities, total – outflow	3 471 502		2 394 150	249 091	147 715	83 294	369 070	228 182
Coefficient of liquid assets	22.42							
Coefficient of liquidity by maturity intervals			46.65	7.71	5.33	10.30	7.02	63.49
Banking system, total								
Liquid assets	13 358 274	2 265 492						

Taking into account the numbers from the tables 8, 9 and 10, it is obvious that the global financial crisis had also a significant negative impact on the banking sector in Bulgaria in 2008 and 2009. The level of development in the economy and the banking sector in particular has slowed down. But it is also true that the banking system is stable even during the global financial crisis, the reason behind this being the currency board and the new banking legislation and regulation. A very important step for the stability of the whole system was the measure taken by the BNB to reduce the percentages of the foreign fund reserves and the local government funds, which were kept at the BNB. This reduction gave the banks the possibility to reduce their obligations in a period of a global financial crisis.

The development of the banking sector continued in 2010. The amount of the banking sector assets was BGN 73.7 billion, or an increase of 4.1% compared with 2009. The profit of the banking system in 2010 was BGN 600 million. The market share of the Group I banks decreased by 3.5% to 54.5% over the last 12 months, while that of small and medium institutions increased to 40.7%. The market share of EU subsidiary banks dropped to 73.7%. 4.1% was the market share of EU bank branches. An increase of 3.3% to 19.3% by domestic institutions characterized the last twelve months. The number of the banks was unchanged – 30.[130] Bad loans (non-performing loans) increased significantly by 5.5% from 6.42% in 2009 to 11.92% in 2010, a value similar to that in the middle of the 90s. Despite these problems the banking system is stable. Banks maintain a sufficient liquidity and take adequate measures to deal with the situation.

4.4. Analysis of bad loans over the last 20 years

The changes in the levels of bad loans during the last 20 years in Bulgaria will be analyzed in this part of chapter 4. This analysis will be done to show that the banking sector is stable and has developed positively over that period. Chapter 2, 3 and 4 shows the situation in the Bulgarian banking sector in the period 1990-2010.

We will now focus on the changes which occurred after the privatization of the Bulgarian banks, and the impact of foreign branches and subsidiaries upon the levels of bad loans, analyzing how percentages change with their influence.

The problem with so-called "bad loans" in any banking system has an important place and it is given great importance, due mostly to the effect that these loans have on key performance indicators of each commercial bank - liquidity, profitability and level of credit rating.

Bad loans according to the Regulation No. 9 of the BNB are those that are doubtful (90 days overdue) or uncollectible (180 days overdue).

[130] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/anual_report_2010_en.pdf p.39

At the beginning of the 90s, the percentage of the uncollectable loans was very high. On 31st of December 1992, the amount of the bad loans[131]was BGL 41 billion or 16.15%.[132]

In 1994, the uncollectible loans were 12% of the bank loans and one year later they increased by 3.4% to 15.4%. In 1994, the doubtful loans amounted 3.4%. They increased to 4.2% in 1995. The bad loans were 15.4% in 1994 and 19.6% one year later. That increase of the bad loans is a sign of deepening problems in front of the Bulgarian banking sector in the middle of the 90s. The lack of information sharing between the banks and the old legislation and regulations were the main reason for the higher percentage of bad loans in the middle of the 90s. An interesting fact is also that 52.6% of the bad loans were in foreign currencies in 1995 and 86.4% in 1996.[133] The BNB had the possibility to refinance the commercial banks only with levs, but many of those banks were with large foreign currency liabilities and they couldn't be saved in this way. The currency board arrangement was the way for the country to stabilize the banking sector. The financial discipline was improved after the introduction of the currency board arrangement in 1997. The privatization of the state-owned banks and the updated legislation and regulations was the main factor for the decrease of the bad loans in the years after 1997.

In the period between 1998 and 2007, the non-performing loans dropped significantly to very low levels. For example, in the period 2003 – 2004, the levels of the non-performing loans were between 3% and 2%.[134] In 2005, the non-performing loans increased slightly by 0.23% to 2.24%.[135]The entry of foreign branches und subsidiaries, together with the privatization of the state-owned banks, the introduction of the currency board and the updated legislation and regulations, led to the stability in the banking sector. The levels of the bad loans were similar to that one of the other EU countries.

The table 11[136] visualizes the loan quality by bank groups in the period 2005-2006.

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[131] A loan where repayments are not being made as originally agreed between the borrower and the lender, and which may never be repaid

[132] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/p_anualreports_1992_en.pdf p.111

[133] Cf. Ignatiev, (2005), p. 87

[134] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200412_en.pdf p.23

[135] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200512_en.pdf p.25

[136] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/c_bnb_p_banks_in_b_200612_en.pdf p.25

Table 11: Loan quality by bank group

Credit quality by bank group is as follow:

	December 2005	September 2006	December 2006
Group I			
Total (million BGN)	13 730	16 085	17 586
Standard (%)	92	92.3	94.6
Non-performing (%)	2.3	2.6	2.2
Group II			
Total (million BGN)	3 593	4 306	4 664
Standard (%)	92.5	92.9	92.3
Non-performing (%)	2.7	2.3	2.3
Group III			
Total (million BGN)	1 056	478	521
Standard (%)	96.2	96.4	96.8
Non-performing (%)	0.5	0.1	0.1

The non-performing loans dropped by all the three bank groups in 2006 compared with 2005. It can be seen from the table that the banks from Group III have the lowest non-performing loans. In 2005, they were 0.5% and 0.1% in 2006, which can be explained with the very good management of those branches of foreign banks and also with the fact that the total amount of their credit is much lower than that of Group I and II banks.

By the end of 2008, a serious decline in the market for most banking products was observed, especially lending. On one hand banks increased strong requirements for creditworthiness of its customers, on the other hand customers of the banks began to be afraid of credit products due to the instability of their jobs and lack of security in the income.

The global financial crisis expanded gradually in the Bulgarian banking system, leading to a gradual increase in the proportion of loans classified as non-performing. At the end of 2010, the total volume of all non-performing loans in the Bulgarian banking system reached 6.1 billion, or nearly 12% of loan portfolio.[137]

[137] http://www.bnb.bg/bnbweb/groups/public/documents/bnb_publication/pub_b_in_b_2010_12_en.pdf p.10

The comparison that can be made between indicators non-performing loans in Bulgaria and the EU is interesting. Bulgaria is in the top three in share of non-performing loans in the European Union. At the same time the indicator, which measures the stability of the system (the stability of the credit institutions) - capital adequacy, Bulgaria occupies one of the top places with 17.5%. According to International Monetary Fund (IMF), share of non-performing loans in Bulgaria was 11.9% of total loans in 2010. Only Lithuania and Latvia had a greater share - respectively 19.7% and 19%.[138]

According to experts, the stability of credit institutions is measured not by the share of the non-performing loans but from the level of capital and capital adequacy. Other factors such as accumulated reserves against possible losses and the ability to generate an income, which cover the cost of degraded credits are important. The Bulgarian banking sector had a capital of BGN 10.136 billion at the end of February 2011. At the end of 2010, the excess over regulatory capital - the capital buffer was EUR 2.8 billion. The banking sector so far throughout the global financial crisis generates positive financial results with the exception of a few banks. In late February, the profit of the banking sector was BGN 87.3 million.

Overall, non-performing loans remain a challenge for banks in the crisis in Europe. Moreover, much of the credit institutions on the continent should deal with raising additional capital to meet new regulatory requirements. The global economic crisis didn’t shake the stability of the Bulgarian banking system. In Bulgaria there were no defaults of banks.

Bulgaria is in front of a new challenge –its accession to the EMU. In the next chapter, we will see which criteria should be fulfilled for the realization of this joining.

[138] Cf. Stoichkova,/Kitanov, (2011), p. 7

5. Challenges to the Bulgarian Banking Sector

5.1. Maastricht Conversion Criteria relating to Bulgaria

Every country which wants to join the Eurozone should abide the rules of the Treaty Establishing the European Committee. Five criteria should be fulfilled before entry to the Economic and Monetary Union (EMU). These criteria are known as the Maastricht Conversion Criteria and those countries, which fulfilled these criteria, achieve a high degree of sustainable economic convergence.

The first criterion, which is the most problematic for Bulgaria, is that on price stability. According to Article 121 of the Treaty, each country must have a high level of price stability. This means that the average inflation rate over the last year should not exceed by more than 1.5% the average of the three member states with the lowest inflation.[139] In 2010, the average inflation rate in Bulgaria was 2.22%.[140] In June 2011, the three countries with the lowest inflation rates were Sweden (1.5%), the Czech Republic and the Netherlands (both 1.8%). The average inflation rate of the three was 1.7%, meaning that the reference rate would be 3.2% for a new member which wanted to joint to the Eurozone in June 2011.[141]

The second criterion states that the deficit of the budget should not exceed 3% of GDP one calendar year prior to the assessment.[142] In 2010, the Bulgarian budget deficit was 3.9% of GDP, which was still above 3%.[143]

The third criterion deals with ratio between the national debt and GDP, which should not exceed 60% of GDP. It is also possible for a country with a higher level of debt to join the Eurozone if its debt is steadily decreasing.[144] In 2010, the ratio in Bulgaria was 16.2%.[145]

[139] http://www.euro-dollar-currency.com/maastricht_criteria.htm
[140] http://www.indexmundi.com/bulgaria/inflation_rate_(consumer_prices).html
[141] http://www.tradingeconomics.com/euro-area/inflation-cpi
[142] http://www.euro-dollar-currency.com/maastricht_criteria.htm
[143] http://www.allvoices.com/news/7864456-bulgarias-2010-budget-deficit-better-than-expected-still-above-3
[144] http://www.euro-dollar-currency.com/maastricht_criteria.htm
[145] http://www.investingforbeginners.eu/investment_in_bulgaria-p0-i10

The fourth Maastricht criterion deals with the long-term interest rate. It should not exceed by more than 2% the rate of the three best performing EU countries in terms of inflation over the last twelve months.

The last Maastricht criterion deals with the exchange rate stability. The country should be a member of the Exchange-Rate Mechanism (ERM II) for at least two years before joining the Eurozone and during that time the national currency should not be devaluated. In the case of Bulgaria this criterion is fulfilled through the currency board arrangement.[146]

In 2010, the only Maastricht criterion, which Bulgaria didn't fulfill, was the one regarding the deficit of the budget. It should be pointed out that the fulfillment of the Maastricht criteria is a sign for the stability of the member state's economy and increase its living standards to similar levels of countries from the Eurozone. This is the next big challenge for Bulgaria and the banking sector in particular.

5.2. The Euro adoption

As already discussed, the next challenge for Bulgaria and the banking sector in particular will be the euro adoption. Bulgaria joined the EU in 2007 as a result of the achievements made during the last decade. The successful introduction of the currency board, the independence of the Central Bank (the BNB), the harmonization of the national legislation with the EU and the economic stability are the most important achievements.

The next big step in front of Bulgaria and the banking sector is the adoption of the euro as national currency. The period within which the euro should be adopted is not fixed. The member state should fulfill the Maastricht Criteria. In 2010, Bulgaria fulfilled four of five of the Maastricht Criteria. The criterion, which is still a problematic, is that one dealing with the budget deficit. The Bulgarian banking sector is prepared for this new challenge. According to experts, this sector in the most prepared out of all other sectors in the country. According to Moody's, the banking system in Bulgaria is stable with strong competition. Nowadays, the Bulgarian banking sector has the technology, the experts and the good management to overcome the stress from the adoption of the euro.

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[146] http://www.euro-dollar-currency.com/maastricht_criteria.htm

6. Conclusion

The banking sector isn't a simple mechanism and that is why it should be examined together with other factors, both internal political and economic. Bulgaria and its banking sector have achieved considerable progress over the last twenty years. This thesis reviews the reforms and traces the development of the Bulgarian banking sector over the last twenty years (1990-2010). Factors that stabilized the banking system, the currency board arrangement and the privatization of the state-owned banks are reviewed. The sector has changed significantly during that period. In the yearly 90s, there were a small number of private banks operating on the market and more than 50% of the state-owned banks were undercapitalized. The entry of foreign banks and branches was forbidden. The banking sector was characterized by chaos and instability, which led to the foreign exchange crisis in 1994-95 and the collapse of the Bulgarian banking sector in 1997. The liberalization of the banking sector in the 90s brought instability because of a lack of functioning supervisory authorities, a proper legislation and financial discipline. In order to overcome the collapse of the banking sector, the currency board arrangement was introduced, together with updated legislation and privatization of the state-owned banks, which led to stabilization of the banking sector. The amount of the banking sector assets has grown significantly since the introduction of the currency board arrangement in 1997. The entry of foreign banks brought know-how, strengthened the competition and brought back confidence to the banking sector. Nowadays, even after becoming a member of the EU, Bulgaria doesn't exit from the currency board, a sign that its introduction was the right decision.

Nowadays, twenty years after the fall of the Communism, the market share of the international financial institutions (foreign banks and branches) in Bulgaria is 80%. The changes in the banking sector after the introduction of the currency board, the privatization of the banks and the accession of Bulgaria to the EU in 2007 have had a positive influence on the whole banking sector. One of the achievements over the last twenty years is the financial discipline. The Bulgarian banking sector performs well nowadays. Bad loans (non-performing loans) in the period 1990-2010 are analyzed in the context of the development and the stability of the banking sector. The impact of the global financial crisis on the Bulgarian banking sector and the sharp increase of bad loans in the last three years hasn't shaken the stability of the Bulgarian banking system as it did in the 90s - a sign for the progress of the sector. There are no defaults of banks in Bulgaria - another sign for the stability of the banking system.

The challenges in front of Bulgaria were reviewed. The next big step is the joining of the Euro area, which means that the country should fulfill the Maastricht criteria. In 2010, Bulgaria fulfilled four of five Maastricht Conversion Criteria with the exception of the one dealing with the deficit of the budget, a clear sign for the progress during the past years. The banking sector is the most prepared one from all the other sectors of the country for that joining.

The Bulgarian banking sector has gone a long and difficult way since 1989 and its progress guarantees the country a functioning economy and successful future.

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Zusammenfassung

Das Ziel dieser Arbeit ist es, zu analysieren und zu bewerten die Entwicklung des Bankensektors in Bulgarien in der Zeit von 1990 bis 2010. Große Veränderungen gab es in Bulgarien am Ende des Jahres 1989 und Anfang der 90er Jahre. Der bulgarische Bankensektor war ebenfalls Teil dieser Veränderungen. Das Land verändert seine Wirtschaft von einer zentralen Planung zu einer Marktwirtschaft nach dem Zusammenbruch des kommunistischen Regimes

Es sollte erwähnt werden, dass, wenn wir den bulgarischen Bankensektor analysieren und bewerten, die Veränderungen in dem bulgarischen Bankensystem zu berücksichtigen sind, aufgrund der Tatsache, dass diese nicht getrennt analysiert werden können.

Der Grad der Entwicklung des Bankensystems kann als ein Indikator für die allgemeine wirtschaftliche Lage in dem Land zu dienen. Die Geschichte des bulgarischen Bankensystems in den 90er Jahren ist ein konzentrierter Ausdruck der Geschichte des Übergangs von der Plan- zur Marktwirtschaft.

Die Liberalisierung und Umstrukturierung des Bankensystems war eine der Hauptaufgaben der ersten demokratischen Regierung im Jahr 1990. Ein Wechsel von einstufigem zu zweistufigem Bankensystem war notwendig für den Übergang zu einer Marktwirtschaft. Dies kann nicht sofort geschehen, da das ein langer und schwieriger Prozess ist, bei dem die Schaffung neuer Institutionen und geschultes Personal notwendig sind. Dieser Übergang ist ein kultureller Prozess, der die Überwindung der Jahrzehnte von Haltungen benötigt, und erklärt die langsame Art des Überganges und die begleitenden Krisen.

Grundsätzlich gliedert sich die Arbeit in 4 Abschnitte. Der erste Abschnitt gibt eine Übersicht über die Situation des Bankensektors vor der Einführung der Currency Board-Regelung (1990-1997). Dieser erste Teil beginnt mit einer kurzen historischen Überblick über den Bankensektor vor 1990. Der Abschnitt gibt eine Übersicht über den Bankensektor vor 1990, die neue Banking-Regulierung und Gesetzgebung, den staatlichen und den privaten Bankensektor, die ausländischen Banken in Bulgarien, die Probleme des Bankensektors und die Bankenkrise von 1996-97. Der zweite Abschnitt gibt eine Übersicht über das Currency Board in Bulgarien und die Privatisierung der staatlichen Banken. Der Ausweg aus der Finanzkrise von 1996-97 war die

Einführung des Currency-Board, welches das Bankensystem stabilisierte. Der nächste Abschnitt gibt einen Überblick über die Struktur des bulgarischen Bankensektors nach dem EU-Beitritt. Die Auswirkungen der globalen Finanzkrise auf den bulgarischen Bankensektor sowie die aktuelle Situation im Bankensektor werden gezeigt. Die faulen Kredite in den letzten 20 Jahren werden auch analysiert. Der letzte Abschnitt zeigt die Herausforderungen der Zukunft vor dem Bankensystem - der Beitritt zur Europäischen Währungsunion und die fünf Kriterien, die für diesen Eintrag erfüllt werden sollen.

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