Bulgarian Banking Sector Development, Post-1989

GALLINA ANDRONOVA VINCELETTE*
Central European University, Budapest

ABSTRACT

The article points to two major reasons for the delay of the reforms in the Bulgarian financial sector. First, the unwillingness of the state to facilitate its own retreat: powerful insider groups were fully capable of misallocating the flows of resources within the existing institutions of the banking system, leading to the state’s never-ending (in scope and time) micro-involvement in the banking industry. The failure of the state to execute the macro-aspect of the reform process, i.e. to provide for the establishment of the institutional environment and its rules in the sphere of banking and finance, allowed for the insiders to prey upon it. This brings us to the second reason for the delays, spelled out broadly as inconsistency in following the market creed for the development of the banking industry in Bulgaria. The lack of continuity in the reform policy process provided for an unstable institutional environment in the sector. Adequate banking sector regulation and supervision, decentralization, privatization and fair competition were not among the assets of the financial sector transformation in Bulgaria in the 1990s.

1. Introduction

Looking at the development of the financial sector in Bulgaria, the real reforms started only in 1997, after the introduction of the currently-operating currency board in the country. The way the previous reformist governments had handled the reform in the sector could be characterized mildly as passivity or financial policy mismanagement, without comprehensiveness in the reform initiatives. Privatization, consolidation, decapitalization, and other similar initiatives that intended to be market driven were introduced, but quite

* Acknowledgements: I benefited from insightful comments based on an earlier version of this article, presented at the CEU Political Science Department Doctoral Seminar in November 2000.
sporadically and in an inconsistent manner. In addition, the regulatory system in the sector was inadequate, allowing personal deposits and state funds to be misallocated towards shady organizations.

All this resulted in a collapse of the Bulgarian banking sector at the end of 1996, when 14 out of the 35 registered commercial banks failed. The overall cost to the government of restructuring and, earlier, bailing out banks between 1991 and 1998 reached the equivalent of about 75% of GDP (Ulgenerk and Zlaoui 2000: 3). The crisis could hardly have been surprising for the policymakers in office, considering the lack of genuine attempts to reform the financial industry in the years prior to 1997. No domestic way, or will, was found to turn back the steep downhill fall of the financial sector in Bulgaria.

In early 1997, international financial institutions (IFIs) had to step in and put a firm condition before the Bulgarian politicians to introduce a currency board and stabilize the national economy. The measures taken in 1997 were drastic, but necessary. More than seven years of mimicking and massively delaying the reforms brought nothing more than a considerable decline in economic activity (see Table 3), hyperinflation, and financial crises within radically malfunctioning state institutions. The International Monetary Fund (IMF) provided more than 1 billion USD in support of the board to basically distance the government from control of the monetary policy in the country and to stop hyperinflation. The Bulgarian currency was fixed to the DM, the volume of currency circulation was linked to the hard currency reserves, and the currency board undertook the monetary policy management. Inevitably, however, one asks: why was the reform in the financial sector so long delayed, given that the signs of the financial crisis were visible well before the crash of the banking system?

Our aim here is to explore the reasons for the delays of the reforms in the Bulgarian financial sector. We claim that prior to 1997, no comprehensive program for the development of the financial sector in Bulgaria was initiated. Two major reasons were behind it. First was prolonged state involvement in banking sector operations. The massive delays in reforming the sector resulted from the unwillingness of the state to facilitate its own retreat. Powerful groups formed and took advantage of the regulatory and institutional chaos in the country. Precisely these insider groups were fully capable of misallocating the flows of resources within the existing institutions of the banking system, leading to the state’s never-ending (in scope and time) micro-involvement in the banking industry. For their “success,” however, it was necessary to pacify the state. Manipulating the interests of the state from inside made it possible to siphon off its resources and deal with state structures by acting in a state-abusive way.

The failure of the state to execute the macro-aspect of the reform process, i.e. to provide for the establishment of the institutional environment and its rules in the sphere of banking and finance, allowed the insiders to prey upon it. This brings us to the second reason for the delays, spelled out broadly as
inconsistency in following the market creed for the development of the banking industry in Bulgaria. The lack of continuity in the various reform attempts provided for an unstable institutional environment in the sector. Adequate banking sector regulation and supervision, privatization and fair competition were not among the assets of the transformation process in the country.

The case study is structured as follows. The next sections review the policies in the years before the crash of the banking system at the end of 1996. They highlight the structure and operation of the banking sector in the early years of transition, elaborate on the malfunctioning of the industry caused by delays in the reform process, discuss the unsuccessful attempts at bad-debt resolution, and synthesize the reasons for the collapse of the system in 1996. Following that is a discussion of the major shift in policy with regard to the financial sector in Bulgaria, including the introduction of a currency board, regulatory changes, and rapid banking privatization. The last section summarizes the lessons from the case study.

2. The Story of Banking Art in Bulgaria Prior to 1997

Banking Sector Structure and Operation

Like the other CEE countries, after the fall of the communist regime Bulgaria tried to move the Bulgarian National Bank (BNB) away from the inherited, planned model of centralized management, allocation and monetary functions, and toward a system of financial intermediation of a Western type. The first step in the transition to the new system was to liberalize the entry of new banks into the Bulgarian financial sector. By the end of 1990, there were 70 commercial banks, of which seven sectoral, two specialized (the State Savings Bank and the Foreign Trade Bank), and 59 commercial banks emerged from the branches of BNB (see Table 1).

Table 1: Bulgarian Banking Sector Structure, 1990–1996

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>Total banks, end of year</td>
<td>70</td>
<td>78</td>
<td>59</td>
<td>41</td>
<td>45</td>
<td>47</td>
<td>35</td>
</tr>
<tr>
<td>Of which Foreign banks</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>3</td>
<td>5</td>
<td>7</td>
</tr>
<tr>
<td>Licensed during the year</td>
<td>61</td>
<td>8</td>
<td>2</td>
<td>7</td>
<td>10</td>
<td>4</td>
<td>2</td>
</tr>
<tr>
<td>Of which Foreign banks</td>
<td>0</td>
<td>0</td>
<td>0</td>
<td>1</td>
<td>2</td>
<td>1</td>
<td>2</td>
</tr>
<tr>
<td>Consolidated banks</td>
<td>0</td>
<td>0</td>
<td>22</td>
<td>29</td>
<td>9</td>
<td>3</td>
<td>0</td>
</tr>
</tbody>
</table>

Source: Yonkova, Aleksandrova and Bogdanov 1999: 19.

However, the large number of banks in the early years of transition in Bulgaria did not provide for high quality financial intermediation. Banks started
experiencing negative equity with a high share of non-performing loans. In addition, a major drop in industrial output due to structural reforms carried with it the inability of the borrowers (mainly state-owned enterprises) to meet their obligations to the banks (Bristow 1996). Banks began to encounter liquidity problems, amassing bad loans towards projects with low returns. The government established the Banking Consolidation Company (BCC) in 1992 in an effort to decrease the number of undercapitalized commercial state-owned banks (73% in 1991) by merging them into a smaller number of supposedly more financially viable banks with better perspectives for privatization. The consolidation process started right away, when 22 state-owned banks were consolidated into one bank: the United Bulgarian Bank, and another 12 were united into the Express Bank. By 1995, there were 11 state-owned consolidated banks (Dobrinsky, 1994: 343).

At first sight, the expansion of the number of banks in Bulgaria should have provided for improved competition. In reality, the very liberal licensing regime of the commercial banks and the low capital requirements only brought about their proliferation in the years between 1991 and 1993, but the state never ensured an adequate regulatory framework for their financial intermediation (see Table 1). For example, in addition to the low capital requirement for licensing commercial banks, no regulatory prerequisite for the origin of the funds existed in the early 1990s. Regardless of the low barriers to entry, the Bulgarian banking sector was not attractive to foreign participants. An utterly uneven balance between domestic and foreign participants confirmed the lack of credibility in the reforms and the inconsistency of their implementation.

After the consolidation, the Bulgarian banking sector consisted of 35 commercial banks, among which were both small, private, newly-established banks and state-owned banks. No state bank had yet undergone a privatization procedure at that time, even though banking privatization was on all governments’ financial reform agendas.

Table 2: Structure of the Bulgarian Banking Assets (in %)

<table>
<thead>
<tr>
<th>Period</th>
<th>State-owned Banks</th>
<th>Private Banks</th>
<th>Foreign Banks</th>
</tr>
</thead>
<tbody>
<tr>
<td>October 1996</td>
<td>84.8</td>
<td>12.6</td>
<td>2.6</td>
</tr>
<tr>
<td>November 1996</td>
<td>85.2</td>
<td>12.2</td>
<td>2.6</td>
</tr>
<tr>
<td>December 1996</td>
<td>86.3</td>
<td>11.1</td>
<td>2.6</td>
</tr>
<tr>
<td>January 1997</td>
<td>88.3</td>
<td>8.8</td>
<td>2.9</td>
</tr>
<tr>
<td>February 1997</td>
<td>89.0</td>
<td>7.8</td>
<td>3.2</td>
</tr>
<tr>
<td>March 1997</td>
<td>88.4</td>
<td>7.8</td>
<td>3.8</td>
</tr>
<tr>
<td>December 1997</td>
<td>67.1</td>
<td>14.8</td>
<td>18</td>
</tr>
</tbody>
</table>

Source: Yonkova, Aleksandrova and Bogdanov 1999: 16
Regardless of the comparatively large number of banks, the market was very concentrated (see Table 2). In the months preceding the introduction of a currency board in Bulgaria, the levels of the state assets in the banking system never fell below 85%. At least in the short term, and as long as the ownership configuration remained unchanged, the state was to control the operational side of the financial intermediaries (Yonkova et al. 1999: 16). And even though several different governments held power in the period prior to the 1996 financial crisis, each with strong market intentions, the financial industry remained almost untouched by genuine reform actions. Under such conditions, and in the absence of powerful market agents on the banking scene, the intermediation process was to be directed by one source: the state.

But why was it so difficult for the state to lead a policy process that would facilitate its retreat from the financial industry? One reason is that there was no politically represented domestic interest in discarding the status quo. The intermediation of financial resources was easy to control and direct, and politicians preferred to have unlimited access to credits which they allocated according to their own priorities. The lack of supervisory initiative on the side of the BNB, in addition to poor regulation, allowed for a continuous execution of such lending practices, which were never subjected to project evaluation, monitoring or accounting standards.

The policy process to establish a functioning institutional environment in the financial industry in Bulgaria had completely stalled. The state owned most of the banking assets, but it never managed them in a self-adhering way. That is, the interest of the people in office and the managers of the banks was held higher than that of the state. Bureaucratic structure and lack of prudent banking regulation allowed for extraction from the sector either in the form of credits or ownership, even though the official ownership transformation had not started.

Nonetheless, “quiet” privatization became popular in the early years of transition. Regardless of the fact that no legislative procedure for selling off the shares of the banks existed, four banks increased their capital through the issue of new stock, and sold them right away to private individuals, closely related to the insiders’ circles (Dobrinsky, 1994: 334). The process obtained a political nuance, given the fact that the Central Bank and the State Savings Bank (SSB) provided the resources needed to finance the capital expansions of the four banks.

A problem became apparent in Bulgaria’s banking structure, where an adequate regulatory and institutional environment did not emerge, and the privatization of the state-owned banks did not start until 1997. Failure to exercise its macro-functions in reforming the financial sector placed the state in a dangerous situation, which involved government presence on every level of decision-making. It took seven years to work out a procedure to prevent the government from continuously pouring funds into insolvent banks and
economically non-viable projects, for example. A glaring example for the inability of the state to facilitate its own retreat from the banking industry was the Plovdiv-based Agrobusiness Bank, which had been bailed out on several occasions by the BNB prior to 1997 even though more than 50% of its non-performing credits had been extended to companies owned by the bank's managers. The financial obligations of this bankrupt bank are still on the BNB balance sheet after the decision of the Central Bank to purchase the failed bank for 1 Lev (Capital 1998/5). Similar stories depict the failures of Elit Bank, the Business Bank of Petrich, and Dobroudja Bank, among others which continuously received financing from the state to cover their debts (Capital 1998/3 & 5).

Interestingly, however, the capital for refinancing the non-performing credits in the commercial banks was injected prior to the crash of the banking system in the fall of 1996. This fact clearly indicates the will of the Bulgarian policymakers to cover up for insolvent financial institutions and their inability to pursue comprehensive reforms. The most oft-cited reason is that the governments of Bulgaria, afraid of angry depositors questioning the foundations and techniques of their governance, did not want to reveal the problem in the commercial banks (Capital 1998/5). Indeed, revealing the problems of the unstable banking system was postponed for as long as possible, until the end of 1996 when the financial sector collapsed. The aftermath is that some 20% of the overall bad debt in the Bulgarian bankrupt banks was covered by the state through extended liquidity.

Asked to comment on the reasons that led to the collapse of the banking system in 1996, bankers in the country pointed almost exclusively to the political micro-management and the inconsistency of Bulgarian banking reform. Various governments had tried to “fix things” in the sector without actually undertaking a policy reform process to lay the institutional foundations that the banking industry needed for its independent intermediation of financial resources. Virtually every government retained a general commitment to economic transition to markets. However, important controversies surrounding such policies as privatization, regulation, subsidies, capital injections, and foreign investment participation did not reflect the commitment of the policymakers to pursue market reforms. As a result, regardless of its political orientation, the government kept control of the banking industry and used it for its own short-term aims of supporting the loss-making real sector, the budget and the overall allocation of financial resources.

More examples could be brought forward, ranging from the mismanagement of the interest rate from the Central Bank, to the pressure of the government to extend funds to troubled banks, to the delayed banking privatization. However, one thing becomes obvious in the reform policy process in the country: neither continuity nor consistency in executing market reforms was an element of the sporadic attempts to develop the financial industry in Bulgaria.
The Beneficiaries

Why didn’t the policy process manage to establish the desirable financial structure in Bulgaria? In answering this question one needs first to reveal who benefited from the disruptions in the policy process.

Apparently, the easy access to liquidity from the state institutions (BNB or SSB) provided for irresponsible lending to insiders. It was a lucrative business, which served a wide range of interests and created an unprecedented number of credit millionaires. A list of credit millionaires was published by the BNB, containing individuals and firms to which large credits were given. The credit millionaires were individuals and companies related to the banks, big state-owned enterprises, or the organized, private economic groups with extended political connections like Multigroup, Orion, Euroenergy and others. Included among the “leading” bad debtors were firms owned by these very same private banks. Most often cited were the cases of Agrobusiness Bank, International Bank for Investment and Development, Elit Bank and Mollov Bank.

In another group of “credit millionaires” were the banks themselves. Credits up to billions of Leva were extended to the private banks to provide some liquidity on their balance sheets: First Private Bank got 91 billion Leva from the BNB, Agrobusiness Bank 50 billion, the Bank for Agricultural Credit 35 billion Leva and Balkan Bank 35 billion Leva, all prior to 1996 (Capital 1998/3). The refinancing of the troubled commercial banks came straight from the BNB in the form of preferential loans prior to 1997. For example, the number of Lombard loans in 1994 reached 80% of total loans to commercial banks; unsecured loans and overdrafts made up 84% of all loans to the banking sector in 1995.

A third branch siphoning off liquidity from the state were the state-owned enterprises (SOEs). Due to structural changes, these suffered massive deterioration of output and profitability, and were absolutely unable to repay their debts to the commercial banks in the foreseeable future. But crediting was not stopped to these enterprises. The government had to cut direct subsidies to the SOEs, but at the same time it found a convenient way to keep them alive, by channeling financing from the state-owned banks. The companies were required only to “focus on political lobbying in expectation of the next restructuring campaign” (Keremedchiev and Gradev 1999: 72). As a result of the moral hazard of highly politicized financial resource intermediation, the government harmed its credibility in the effort to restructure the economy.

Apparently, no politically-represented domestic interest in following the roadmap to market reforms in the financial industry existed in Bulgaria. The policy process, which aimed to provide not only enhanced micro-efficiency in the banking system, but also working market institutions, never gained momentum in the country. The inability to pursue and implement market initiatives credibly resulted in the deformation and capture of the state, giving a strong advantage to power groups for acquiring both property and position on the financial scene.
Bad Debt Resolution Attempts

The channeling of financial resources to insiders was not the only activity that disrupted the reform policy process in the financial sphere. Another important obstacle was the repeated re-capitalization of the banking sector by the government. The most striking attempt on the part of the Bulgarian government to solve the problem of bad loans is the experience with the ZUNK bonds, whose initial goal was to dry up the large sources of budget deficit. The ZUNK bonds were issued in accordance to the Law on the Settlement of Non-performing Credits to replace bad loans in bank portfolios. The ZUNKs were 25-year government securities, issued to cover non-performing credits accumulated by enterprises prior to 1990. The exchange of enterprise loans for government securities directly affected the government budget by creating an obligation to pay interest on the bonds. However, the ZUNKs paid only part of the base interest rate. This was a clear attempt to finance part of the government debt at less than market interest rates (Nenova et al. 1997: 24). The commercial banks, which owned the ZUNKs, started to accumulate losses and experience liquidity problems.

The ZUNKs did not solve the bad loan problems in Bulgaria. The main reason, perhaps, was the mismatch between the return and maturity of these bonds and the banks’ liabilities, and the government’s initiative to cover this difference. Apart from the losses from keeping ZUNKs on the banks’ balance sheets, this also led to an alarming liquidity draw down of two big state-owned banks (the Mineral Bank and the Economic Bank) which held the majority of the ZUNK bonds. The condition of these banks became dire. In 1994 the BNB had to expand refinancing to these banks to such an extent that it became difficult for the Central Bank to maintain control over its monetary base. The banks were bailed out in mid-1995 at the expense of huge Central Bank refinancing, which, consequently, had an adverse effect on the budget deficit. Regardless of the expensive refinancing both banks were among the first to be closed in 1996.

There were many other obstacles to the ZUNKs, however. The main motivation behind the ZUNK bonds was to use them as a tool for future privatization. By purchasing the ZUNKs, investors could partially pay for their obligations in the privatization deals. However, Bulgaria had an undeveloped bond market, in addition to lacking a dynamically working stock exchange. Another obstacle came from government attempts to regulate ZUNK prices by imposing restrictions on both minimal price level and privatization eligibility.

Apart from the government’s inability to tackle the non-performing credits problem, the banking sector did not remain passive. Bad management of credits extended by the Bulgarian commercial banks worsened the situation in the early 1990s. Lack of expertise precluded banks from properly screening, evaluating and monitoring projects. Further on, difficulties in managing the loans
came from uncertainty and corruption at every level of the economy. The privileged access to credits harmed financial discipline and the development of new private businesses (World Development Report, 1996: 99).

Also, the lack of bankruptcy legislation outside the financial sector complicated the issue of bad debt. Major problems existed in the institutional and economic environment such as the long duration of court hearings, gaps in legislative norms and low asset liquidity, which made bankruptcy procedures unattractive to creditors, particularly if a bailout by the state could be expected, such as in the case of state firms with high employment. If these firms were unable to service their debt, banks knew that the state would back them up and not hold them liable. These practices created incentives for banks to extend financial resources to state-guaranteed borrowers (OECD 1997: 90–102).

Thus, the process of banking sector recapitalization and preparation for privatization was difficult mainly because of the huge amount of bad debts, but also because of the “never-ending practice,” in the words of an interviewee, to grant economically non-viable, politically motivated preferential credit. The recapitalization of the banking system and the funds coming from the BNB and the Savings Bank in the forms of credits were excellent vehicles for providing liquidity in these “loose” banks.

The Hit

In 1996, Bulgaria entered into an economic and financial crisis which seemed impossible to resolve for many years to come. As deficits multiplied, being transferred from firms to banks through bad debts and eventually to the government budget through bailouts or monetization, in April 1996 the Bulgarian currency started falling and finally collapsed in February 1997. The year 1996 showed almost six-fold depreciation, with the currency dropping from some 70 Leva per US dollar in January to almost 500 Leva per dollar by year’s end. Moreover, at the beginning of 1997 the depreciation accelerated further, reaching unprecedented levels of about 3000 Leva per dollar in February 1997, while foreign exchange reserves dried out (see Chart 1).

The loss in confidence of both the Bulgarian Lev and the commercial banks inflamed the banking crisis. Rumors about the inability of the banks to serve their liabilities, mainly the hard currency deposits, had already begun to spread by 1995. Several reasons for this failure in the reform policy process can be mentioned. First, no prudential regulation on foreign exchange positions existed, while numerous commercial banks had switched to higher-yield Lev-denominated assets in early 1995 and continued to hold significant hard currency deposits. In 1995, authorities decreased the basic interest rate from 98% in March to a mere 39% in August. This led to a tremendous decrease in the return on Lev-denominated assets, which consequently reduced the ability of the commercial banks to serve their deposits (see Mietkowski 1997: 6).
Another reason for the fall of the system was the inability to manage the non-performing credits in the banking sector, as described above. Third, at the end of 1995 deposit insurance did not exist, meaning that in case of a banking failure the depositors bore the harm themselves. At the same time, the government was actively discussing a new bank bankruptcy law. Finally, confidence in the banking system was shaken further due to the collapse of a few financial pyramids in 1995.

These facts sent fearsome signals to the public and depositors ran to withdraw their savings or convert them into hard currency in order to keep their value. The first two banking establishments that experienced a massive deposits withdrawal were the Crystal Bank and the Private Agricultural and Investment Bank, in April 1996. When the public found its deposits frozen, it began to fear for the safety of deposits in other banks and started a run on these, too. The withdrawn funds moved to the foreign-exchange market, making foreign currency a scarce commodity (Mietkowski, 1997: 8).

The withdrawals further distressed the commercial banks, depriving them of much-needed liquidity. The BNB responded with an acceleration of the refinancing of commercial banks in an attempt to prevent an overall collapse of the banking system. This monetary expansion additionally exacerbated the situation in the forex market, by essentially making the authorities absorb the additional Lev liquidity that they themselves had created through the stepped-up depletion of reserves (Chart 1). The public’s expectations were further
destabilized by the fact that the state was pursuing such mutually inconsistent policies at this point. Moreover, the decline in foreign currency reserves compromised the credibility of any possible attempts by the state to guarantee hard currency deposits (OECD 1997: 33).

Massive government mismanagement and lack of continuity in the pursued approach to banking sector development had led to its collapse. Apparently, the financial sector in Bulgaria had had to hit bottom before the government became willing to initiate a sound banking reform.

3. The Currency Board Arrangement

The response of the Bulgarian political system to the economic instability in January 1997 led to an unprecedented overthrow of the ruling socialist government. The caretaker government of Sofyanski, supported by the international financial institutions, introduced a currency board as a way to create conditions for financial stabilization. It would produce a rapid and credible anti-inflationary effect and restore the reform policy process in the country. The board also functioned as a tool to create legitimacy in the new policy course, while at the same time delivering unusually fast results.

The exchange rate became a nominal anchor of the stabilization policy, while the Bulgarian Central Bank lost discretion over some monetary policy instruments. With the sole aim of restoring the credibility of the institution, the monetary authority committed to the principles of the currency board. The underlying proposition of the board was “the rule for money creation,” that is, the authority defines a narrow monetary aggregate and backs it fully with the foreign exchange reserves at a chosen fixed exchange rate. In many cases, foreign reserve of 105 to 110% are maintained in order to provide a margin of protection for the local currency. The key mechanism of operation of currency boards comes from the rule that any fluctuation in the chosen monetary aggregate must originate from changes in the reserves, and not from the discretion of the monetary authority. The money supply of the country becomes endogenous to the economy.\(^{10}\)

The implemented board had some peculiar features, however. Specifically, the Bulgarian currency board attained the functions typical for a central bank in imposing minimum reserve requirements on commercial banks, and in operating as a lender of last resort. Also, an Issue Department was created within the BNB to manage the excess coverage of the currency board arrangement, and extend it to the commercial banks only in case of severe liquidity problems (Miller 1999: 19).\(^{11}\) The law postulated a maximum constraint on the possibilities of refinancing the banking system with the funds at the Issue Department.

There is one more deviation of the Bulgarian currency board from the more conservative board arrangements. The government has a deposit at the
Issue Department which can be used only for financing the budget deficit, or negative differences in net financing by the BNB.\textsuperscript{12} These two possibilities give leeway to the government to cover its deficit. However, considering the fact that the revenues from the privatization of state-owned enterprises will be exacerbated soon, and the funds from the IFIs are only on a conditional basis, the government has no other source of revenue to rely upon but the growth of the real economy. Using the Issue Department deposits for covering budget deficits may question the financial discipline that the board implies, and again create conditions for moral hazard. It all boils down to the credibility of the commitment of the politicians to respect the currency board arrangement for stabilizing Bulgaria’s economy and for stimulating its growth.

The early results signaled improvement. The currency board arrangement managed to bring both inflation and interest rate levels to single-digit numbers (see Table 3). The output growth and exchange rate for the period marked a significant improvement, too. In addition, the interest rate spread had drastically decreased after the introduction of the board, too, from 86.33\% as of December 1996 to 6.07 in March 2000.\textsuperscript{13} Banks have been operating with a very good capital-adequacy ratio, which came up from about 11\% in 1996 to 26.86\% at the end of 1997, about 23\% in 1998, and reached the level of 41.8\% at the end of 1999.

However, the positive expectations did not fully materialize, considering the level of deposits in the banking system, for example. It is worth pointing out that they have not restored their pre-crisis levels yet (see Chart 2 below). Moreover, the behavior of the Bulgarian commercial banks is still quite passive after the crash of the system (see Nenovsky and Hristov, 1997; Yotzov et al. 1998). Since the tightening of the financial constraints, commercial banks have tried to restore financial intermediation, however with increased cautiousness. The amount of reserves increased two-fold in just a year, from approximately 10\% to 20\% of total assets. At the same time, liquidity in the banking sector has been quite high, but credit activities have not been fully restored. The ratio of total loans to GDP was at its lowest levels in 1998 at 20.7\%, and in addition, loans to the private sector had severely declined (see Table 3).

As a whole, however, the currency board arrangement extended a powerful message to the commercial banks and the government. The Central Bank committed to stop pouring funds into politically-driven lending and sheltering problem borrowers. Insider financing has become more difficult and government protection for questionable credit has been terminated. The currency board provided a new institutional environment for the functioning of the financial sector. Moreover, distancing the policymakers from the micro-management of the banking sector restored public confidence in the reform policy process.
Table 3: Selected Economic and Banking Indicators, 1995–1999

<table>
<thead>
<tr>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
<th></th>
</tr>
</thead>
<tbody>
<tr>
<td>GDP Growth</td>
<td>2.9</td>
<td>-10.1</td>
<td>-7.0</td>
<td>3.5</td>
<td>2.4</td>
</tr>
<tr>
<td>CPI, cumulative *</td>
<td>33.8</td>
<td>310.4</td>
<td>578.6</td>
<td>1.0</td>
<td>6.2</td>
</tr>
<tr>
<td>Nominal Exchange Rate Leva/USD*</td>
<td>67</td>
<td>178</td>
<td>1674</td>
<td>1760</td>
<td>1836</td>
</tr>
<tr>
<td>Basic Interest Rate, % *</td>
<td>38.59</td>
<td>435.03</td>
<td>6.95</td>
<td>5.17</td>
<td>4.54</td>
</tr>
<tr>
<td>Short-term credits</td>
<td>51.43</td>
<td>481.11</td>
<td>13.85</td>
<td>13.51</td>
<td>12.41</td>
</tr>
<tr>
<td>Time deposits</td>
<td>25.29</td>
<td>211.87</td>
<td>3.04</td>
<td>3.30</td>
<td>3.25</td>
</tr>
<tr>
<td>Marginal spread</td>
<td>20.86</td>
<td>86.33</td>
<td>10.49</td>
<td>9.89</td>
<td>8.87</td>
</tr>
<tr>
<td>Total Assets, % of GDP</td>
<td>113.6</td>
<td>207.6</td>
<td>43.3</td>
<td>34.8</td>
<td>36.4</td>
</tr>
<tr>
<td>Total Loans, % of GDP</td>
<td>47.8</td>
<td>115.3</td>
<td>22.2</td>
<td>20.7</td>
<td>22.5</td>
</tr>
<tr>
<td>Private sector loans, % of GDP</td>
<td>21.6</td>
<td>37.0</td>
<td>13.1</td>
<td>12.8</td>
<td>7.2</td>
</tr>
</tbody>
</table>

Source: BNB Statistics.

Notes: * end of year

4. What Else Needed to Be Done?

The financial environment in Bulgaria was considerably strengthened after the closure of the failed banks in 1997. The state could finally exercise its function as an initiator, leader and guardian of the systemic transformation in the financial industry from a socialist to a market system, without excessive micro-involvement. This function had two key aspects, which needed to be undertaken swiftly for the institutional viability of the emerging sector: the introduction of a prudent and respected regulatory framework and the privatization of the state-owned banks.

Regulatory Changes

Prior to the collapse of the banking sector, BNB practice consisted primarily of refinancing insolvent banks in order to keep them operating. However, this method proved only to increase the instability of the banking sector and the economy as a whole, as described above. It also provided the wrong incentives for banks in lending and risk-management. In addition, the BNB had a significant credibility problem at the time. Its regulations could not be effectively enforced due to the lack of skilled staff and competencies. This enabled banks to operate without taking too much notice of the regulatory requirements. Changes in the regulatory basis were urgently needed in several areas.

The lack of prudential regulations and supervision concerning foreign currency positions was one of the issues under review. It was this gap in the regulatory framework that had allowed banks to hold significant hard currency
deposits prior to the crisis. As the relative return on Lev-denominated assets decreased, due to indexation of the basic rate, many banks could no longer service these deposits (see above). The few regulations on foreign currency positions that did exist were largely ineffective because of they lacked suitable supervision, which comprised another problem of the regulatory framework in the period under survey. Also, the capital requirements were often set so high that banks could not possibly comply with them. The regulatory prerequisites thus lost all their potential force and sometimes even created counter-effects of irresponsible behavior.

To avoid the deficiency in the regulatory environment, the state carried out rather quick reforms. In June 1997, it established a new law on the BNB which significantly strengthened the supervision and enforcement of the regulation of financial intermediation. The Banking Law was also amended to introduce various regulatory requirements such as capital adequacy, loan concentration to individual borrowers, valuation of collateral rules, different accounting standards, and asset classification and provisioning guidance, among others. Table 4 summarizes the main prudential standards currently in force.

The enforcement of the new banking regulation and the significantly strengthened supervision improved the health of Bulgaria’s banking system. The resumed policy process also established the rules of the game in the financial sector and the institutions for enforcing financial contracts, guarding property rights, and allowing policymakers to minimize their ability to manipulate resources.

Table 4: Main Prudential Standards for Bulgaria

<table>
<thead>
<tr>
<th>Requirement</th>
<th>Requirement</th>
</tr>
</thead>
<tbody>
<tr>
<td>Minimum capital</td>
<td>10 million DM</td>
</tr>
<tr>
<td>Capital adequacy (risk-weighted)</td>
<td>12%</td>
</tr>
<tr>
<td>Tier I capital or risk adjusted assets</td>
<td>6%</td>
</tr>
<tr>
<td>Single party, large exposure (more than 10% of bank capital)</td>
<td>25% of own funds</td>
</tr>
<tr>
<td>Large exposure aggregate</td>
<td>8 times bank’s own capital</td>
</tr>
<tr>
<td>Aggregate exposure to a single party</td>
<td>10% of capital</td>
</tr>
<tr>
<td>Aggregate equity in non-financial companies</td>
<td>75% of capital</td>
</tr>
<tr>
<td>Open forex position</td>
<td>30% of capital per currency; 60% of capital for aggregate</td>
</tr>
<tr>
<td>Minimum required reserves</td>
<td>8%</td>
</tr>
</tbody>
</table>

Privatization of the Banking Sector

The fast privatization of the Bulgarian banking sector was based on the consensus for attracting strategic investors. New investors had to make a commitment to improve the performance of the banks they bought through steps toward technological modernization and capital flow. The BCC provided evaluation of the bidders and assistance in choosing the best buyers for the six state-owned banks on offer for privatization.

Criticism towards the privatization procedures had two main sources. First, concerns about transparency and bias in choosing the buyers for the banks were raised with regard to the privatization of almost all of the state-owned banks. Second, the question of unemployment in the banking industry gained attention in a period where the average levels of unemployment in the country exceeded 15%. Regardless of this criticism, the privatization of the sector freed the banks from state ownership and political credit manipulation, even though the actual speed of banking privatization never met the target of the government to privatize the six state-owned banks by the end of 1998. The record shows that as of 2000 only five Bulgarian banks were privatized: United Bulgarian Bank (UBB), Bulgarian Post Bank, Express Bank, Bulbank and Hebros Bank. Let us briefly review their experience.

The UBB was privatized in 1997 among the European Bank for Reconstruction and Development (EBRD) (35%), the Greek National Bank and other small shareholders, for the amount of 3 million USD. Three years after the deal was completed, the EBRD sold its share to the National Bank of Greece. For the entire package of 89.9% of the shares in the bank, the Greek bank paid 207 million Euro (Capital 2000/27). The remaining 10% are still with the EBRD, but the majority buyer has the call option to purchase the remaining package of shares for the same price in two years. The skyrocketing difference in the value of the bank only three years after its privatization is a clear indicator of the enhanced performance of the institution.

Similarly, the four other commercial banks were sold to strategic investors. In 1998 Allianz and the European Financial Group purchased the Bulgarian Post Bank, a bank with a well-developed branch network. In 1999 both Express Bank and Hebros Bank were sold to foreign strategic investors (Societe Generale and Regent Pacific group, respectively), thus drastically reducing the state ownership in the sector.

The sell-off of Bulbank was finalized in the summer of 2000, after lengthy negotiations with various bidders. The reason was the attractive financial and market position of the bank. It is the largest bank in Bulgaria with 2,102 million Leva in assets and 27% market share (Ulgenerk and Zlaoui 2000). Also, the bank reported 29% growth in net profit before privatization. Bulbank was sold for 360 million Euro to the Italian consortium UniCredito, which acquired 93% of the bank, and to Allianz with 5%.
These privatized banks are currently the leading financial institutions in the country, with a clientele mainly of corporate private businesses, but also state enterprises and a small portion of individual clients. Even though the total loans of the banking system have not reached their pre-crisis levels, the privatized banks have been increasingly engaged in improving the quality of their loan portfolios. For example, the major flow of credits in 1998 at the UBB was towards the trade sector (38.1%), followed by loans in the chemical sector (13.3%), transportation (11.8%), agriculture (9.2%), food processing (8.2%), and metals (7.1%). A recent trend in the loan provisions shows a major decline in loans to heavy, traditionally state-owned industry. This shift in the loan portfolio indicates an improved rationale in making credit decisions, and a commitment among banks to avoiding unreasonable or subsidized “insider” crediting.

Two more state-owned banks await privatization: Biochim Bank and the State Savings Bank. Biochim Bank’s privatization procedure has started, but it is not very clear what type of investor will be chosen, or when (Capital 2000/30). Given the improved conditions of the Bulgarian banking sector and the good profit (5.7 million Leva) of the fourth biggest bank for 1999 (395.5 million Leva in assets), an array of foreign investors has expressed interest in the privatization of Biochim (Sega 2000/08/14). The BCC still has not made a choice among them.

The SSB is the second biggest bank in the country (997.4 million Leva in assets), holding about 15% of the total deposits in the country and more than 90% of the household loans, as well as the most extensive network of branches (Ulgenerk and Zlaoui 2000:14). The major clientele of the bank are traditionally the household depositors, but it has also engaged in actively financing state-owned companies at a local level. The latter fact has provoked much deserved criticism and attacks against the management of the SSB, for it conflicts with the goals of a primarily retail banking institution for households and small businesses. Plans for its privatization are still in the form of intentions.

To sum up, with the introduction of the currency board in Bulgaria, genuine reforms in the financial sector had begun. The pace has been remarkable: macro-economic stability is a fact with low levels of inflation, stable currency, and a banking sector gradually freed from both private and state-owned loss makers. The greatest achievement, however, is the ability to impose financial discipline and distance the state from the micro-management of the banking industry.

5. Lessons from the Bulgarian Experience

The decade after the fall of the communism did not bring many changes in the transformation of the financial intermediation industry in Bulgaria. Even though the shift from the command and centralized allocation of resources was made towards a system with a separate central bank and commercial banks, other reforms aiming to make the sector operate according to market principles failed
Massive delays, a high level of politicization and abuse of the system from the inside were instead characteristic of the transformation process. Failure to commit to the market character of the reform initiatives, their delays and their sporadic nature left the country behind the rest of the CEE region in its quest to develop a well-functioning system for intermediation of financial resources prior to 1997.

The article outlined two main reasons for the failure of the policy process aiming at the development of Western-type financial intermediation. First, no continuity could be traced in the financial sector reform process in Bulgaria. Secondly, and relatedly, the state, through its policies, never facilitated its own retreat from the sector or provided for the establishment of an institutional environment similar to that of developed economies.

Even though it is country-specific, the experience of Bulgaria can offer powerful development lessons. First, continuity in the policy process is needed to establish the right institutional environment in which the financial sector can operate, and which prevents informal arrangements amongst politicians and banking managers for appropriating funds from within the system. The Bulgarian example of banking reform attests that in a world of little monitoring, supervision or prudent banking regulation, the political insiders find it advantageous to follow procedures that allow them to maximize rents extracted as red tape. Employing state intervention, the policy process did not bring efficient financial intermediation of resources. Exercising micro-management over the banking sector where property rights were in the hands of the state proved damaging in this case.

Second, the benefits of privatization and clearly defined property rights affirm the appropriateness of a modern banking structure in Bulgaria. After distancing politics from banking in 1997 and implementing a model of fast banking privatization, the government for the first time committed itself to sacrificing short-term benefits (both in the form of rents and privatization revenues) in order to obtain the medium- to long-term efficiency gains of intermediation by private means. In a tradeoff between revenues and speed, the forward-looking gains from quick privatization should be favored in order to establish the foundations of efficient intermediation so vital for the overall economic development of transition countries.

However, banking privatization without decentralization, prudent regulation and supervision appears to be a faulty approach to reforming the sector, providing advantage only to a few, politically-centered interest groups and internalizing the benefits of the market. Thus, defining the institutional autonomy of government institutions (such as the Central Bank and the Ministry of Finance) and their interests proves crucial for presenting the true interest of the state, and in addition, freeing the state from the predatory demands of insiders.

In a nutshell, the policy process for developing the financial sector in Eastern European countries is ultimately related to the involvement of the state in
the micro- and macro-management of the financial industry. This case study makes the point that reforms in the financial sector are most successful when the reform policy process is done in an environment free of political involvement in the resource intermediation and rents extracted from the system. The state may be involved in the macro-management of the financial sector through policies such as privatization, regulation and overall institution building. State micro-management of the financial system, however, needs to be minimized, so that financial intermediaries can fully utilize their technology to channel funds into productive investments.

References:


BNB, data available at: www.bnb.bg.


Capital (weekly newspaper), issues no.3/98, 5/98, 27/00, 30/00.


*Sega* (daily newspaper), issue from 8 August 2000.


1 The required capital for licensing of a commercial bank in 1991 was approximately 500,000 USD.

2 First East International Banks, Cristal Bank, Business Bank and Dobrich Bank were privatized through this procedure.

3 A survey was carried out in major Bulgarian commercial banks in May 2000. Twenty-seven interviews were taken from bankers working at private or recently privatized commercial banks as well as in state-owned banks in two major locations, Sofia and Pernik.

4 For an informative political review see e.g. Kitschelt et al. (1999).

5 “A credit millionaire is an individual or a firm that has made money by failing to service bank loans.” From *Capital* 1998/3.

6 Four loan categories exist for the purposes of refinancing: Lombard loans, discount loans, overdrafts and unsecured loans.

7 ZUNK is the Bulgarian abbreviation of the Law on the Settlement of Non-performing Credits.

8 There are two types of ZUNK bonds: denominated in Bulgarian Leva and denominated
The former ZUNK bonds amounted to 23 bln Leva, and the latter to 1.8 bln USD. The ZUNK bonds pay interest twice a year. The yield of the Leva-denominated bonds amounts to 1/3 of the primary interest rate in the first two years, 1/2 of the primary interest rate in the third and fourth years, 2/3 of the primary interest rate in the fifth and sixth years, and equal to the primary interest rate during the remaining years up to the maturity date. The ZUNK bonds denominated in USD pay six month LIBOR. Both kinds of bonds pay principal after the fifth year in twenty equal installments. Both are eligible to be used in privatization deals of the SOEs. See APIS, “Law on the Settlement of Non-performing Credits,” Collection of Bulgarian Laws Vol. 7: Financial Law (Sofia: Sofia Press, 1995).

The situation of these two banks developed in the following manner: eventually, the Ministry of Finance replaced the ZUNK bonds with government securities paying full market interest and the BNB stopped the refinancing of Mineralbank and Economic Bank; the new securities had a maturity of 7 years, a 4-year grace period, and carried a yield equal to the BNB’s central rate (see Baliozov 1995).

For more on currency boards see Hanke et al. 1993; Schuler 1996; Ghosh et al. 1998.

In 1997 the currency board arrangement was established with foreign exchange reserves exceeding the monetary liabilities of the BNB, referred to as excess coverage. Jeffrey Miller reports that the deposits at the Banking Department of the Issue Department within the BNB amounted to 140% of the reserves in June 1999. (Miller 1999, p. 19).

Funds are generated through trenches from the international financial institutions to Bulgaria and privatization revenues. As of July 2000, for example, the value of government deposits at the Issue Department of the BNB reached 2.9 billion Leva, and this is about 45% of the assets of the Issue Department (data from Capital 2000/32).


For example, a Greek group bidding for Bulbank claimed to have made a better offer than the one by the chosen bidder for the bank, UniCredito and Allianz. See Capital (May 2000).

Unemployment level at the end of 1999 was 16%, and as of the end of the first quarter of 2000, 18.4%.

Societe Generale acquired 97.9% of Express Bank, and Regent Pacific Group 97.6% of Hebros Bank.

1 Bulgarian Lev = 1 DMark.