

Part One

DEVELOPMENT OF THE BANKING SECTOR IN BULGARIA

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Structure of the banking sector

During the era of centrally-planned economy in Bulgaria has existed state monopoly over the banking system. There was one state bank-BNB- with a network of branches, acting more like a control agent than either a central bank or a commercial bank. Till 1981 only two other banks existed in Bulgaria - State Saving Bank¹, which held the total amount of deposits of the Bulgarian population, and Foreign Trade Bank (at present Bulbank), which performed all international banking transactions.

First reforms in Bulgarian banking sector began in 1981 when Mineralbank was established for providing credits to small and medium-size enterprises which were newly created. More serious impact on the development of the banking sector in Bulgaria had the establishment of seven new banks in 1989. The main goal of these banks was to provide credits in different branches.

The real banking sector reform in the country started in 1989 when the communist-era central banking was swapped for modern two-tier banking system with typical central bank and commercial banks, most of them established from the previous branches of the BNB. The legal framework for the functioning of the banking system was created with the passage of the Law on the Bulgarian National Bank (1991) and the Law on Banks and Credit Activity (1992). In 1990 BNB licensed 61 banks.

The total number of banks in Bulgaria in 1990 was 70.

The newly established commercial banks in Bulgaria were divided into several groups:

1. Large state-owned banks which were specialized in financing the bigger industrial branches

This group of banks consisted of Bulbank, Postbank, Mineralbank, Balkanbank, Economic Bank, Biochim, Electronica, Stroybank, Transport Bank, Agricultural and Cooperative Bank, State Saving Bank. This banks held the significant amount of total assets of the banking system. State Saving Bank held approximately 75 % of deposits of the population.

During the period 1994-1995 eight from nine large banks with assets for more than 30 bln. leva were state-owned. At the end of 1995 these 9 banks (without State Saving Bank) held 74.9 % of all financial assets in the system.

¹ Although State Saving Bank didn't have the statute of a bank it was considered to be a bank.

Table 1: Bank Assets Structure

	State-owned	Private	Foreign	Total	k
Oct. 1996	84.8%	12.6%	2.6%	100.0%	0.74
Nov. 1996	85.2%	12.2%	2.6%	100.0%	0.74
Dec. 1996	86.3%	11.1%	2.6%	100.0%	0.76
Jan. 1997	88.3%	8.8%	2.9%	100.0%	0.79
Feb. 1997	89.0%	7.8%	3.2%	100.0%	0.80
Mar. 1997	88.4%	7.8%	3.8%	100.0%	0.79
Dec. 1997	67.1%	14.8%	18%	100.0%	n.a.

Given Table 1, the Bulgarian banking system is obviously still dominated by state-owned banks. The concentration ratio² ($0 < k < 1$) for bank assets is approximately 0.75 in the months immediately preceding the currency board. The value of the ratio suggests that in the short run the state will play a leading role in the banking sector. As the currency board provides foreign exchange coverage for only part of the money supply and does not cover all deposits, the state must guarantee the solvency of state-owned banks to ensure the normal functioning of the banking system. The relative shares of the state-owned banks in the total assets of the banking system show that potential liquidity problems for each of them can be a source of systemic risk (Table 2). The values of k based on the individual shares of the seven banks also support this conclusion.

Table 2: Asset Structure of State-owned Banks³

Bank	Oct. 96	Nov. 96	Dec. 96	Jan. 97	Feb. 97	Mar. 97
Bulbank	41.1%	45.4%	50.4%	49.0%	56.0%	55.3%
SSB	17.0%	14.5%	13.0%	8.4%	5.4%	7.9%
Biochim	6.8%	6.4%	6.1%	8.5%	6.8%	7.4%
UBB	7.5%	6.9%	6.2%	10.5%	10.1%	6.9%
Postbank	3.6%	3.4%	3.2%	4.0%	3.5%	3.7%
Expressbank	4.8%	4.5%	3.8%	4.1%	4.3%	3.7%
Hebrosbank	3.9%	4.1%	3.7%	3.8%	3.0%	3.4%
Total	84.8%	85.2%	86.3%	88.3%	89.0%	88.4%
k	0.21	0.24	0.28	0.27	0.34	0.33

² The concentration ratio used here is based on relative shares of, respectively, state-owned, private, and foreign banks in total bank assets. It is similar to Herfindahl-Hirschman-type indices often used by regulatory bodies in industrial economies to determine the degree of market monopolization.

³ Information on particular banks is confidential according to BNB regulations and the Law on Banks. This is an estimate by IME. No data is available for the period after March 1997.

2.Small and medium- sized commercial banks

Most of them were created out of former BNB branches. By the end of 1995 their assets were estimated to be below 30 bln. leva. They held approximately 25.1 % from the total assets in the banking system.

3. Private banks

Establishment of private commercial banks began in 1991 and this process was especially active till 1993. There was a very liberal regime for commercial banks licensing and low start-up capital requirements which ensured easy entry to banking. As shown in table 3 there was no case of revoked licenses till 1996 (except one in 1992). Additionally there were no special requirements for the origin of the funds used as a start-up capital and many private banks started their activities with borrowed funds. During this period legislative base of the banking in Bulgaria was imperfect and allowed establishment of private banks which goal was to provide credits to their major shareholders and/or to persons, connected with these shareholders. This was a perfect scheme for siphoning money through BNB`s and State Saving Bank's refinancing.

Private banking sector expansion had two major impacts on the banking sector. First, increased numbers of banks favored competition among them, although there was no significant improvement in their performance and service quality. The negative effect was dramatically increasing amount of big credits and the share of bad debts in private banks as a result of the fact that most private banks were closely connected with their debtors - shareholders and related to them individuals and firms (both state-owned and private).

As a result of the low entry barriers into banking sector the number of private banks increased significantly - from 2 in 1990 to 26 in 1995. Their assets to total assets of the banking system were 3.1 % in 1992, 6.4 % in 1993, 15.6 % in 1994 and 22.4 % in 1995. In 1996 private banks`assets to total banking sector assets decreased to 9% due to loss of public confidence in private banks. In 1997 it increased to 16.6%.

During 1996 the number of foreign banks has also increased (Table 3). Apparently, the state has chosen to encourage the activity of foreign banks as a possible way to secure the liquidity of the banking system.

Table 3: Commercial Banks in Bulgaria

	1990	1991	1992	1993	1994	1995	1996	1997
Year-end Total	70	78	59	41	45	47	35	34
incl. Foreign	0	0	0	1	3	5	7	9
Licensed during the year	61	8	2	7	10	4	2	2*
incl. Foreign	0	0	0	1	2	1	2	2
Consolidated banks	0	0	22	29	9	3	0	0
Banking groups following consolidation	0	0	1	4	3	1	0	0
Revoked licenses during the year	0	0	1	0	0	0	14	4

Source: BNB

* operative licenses (in 1996 these two banks had already got permission for some banking operations)

Another conventional division of Bulgarian commercial banks is into resource-providing and credit-providing banks. Resource-providing banks are characterized with extend of deposits in the interbank money market. Typical resource-providing banks are State Saving Bank, Bulbank and Bulgarian Post Bank. These banks reported the greatest profits in the banking sector. Most of the other state-owned banks and almost all private bank are credit-providing which means that they borrow funds from the interbank money market and extend credits to the real sector.

Table 4: Capital of commercial banks

	Banks with assets over 30 bln. leva ⁴		Banks with assets bellow 30 bln.leva		Total banking system (in bln.leva)	
	1994	1995	1994	1995	1994	1995
Capital	36	39	9	25	45	64
Profit	1	4	1	1	2	5
Reserves	27	33	4	5	31	38
Losses	7	20	3	9	10	29
Claims on rights to equity subscription	0	0	1	6	1	6

Source: BNB

The share of total losses attributable to a certain bank does not depend on the volume of assets. In 1993-94 loss-making state banks were more than the private ones and their total losses were

⁴ Excluding SSB

larger as well. Nine commercial banks (four large state banks, three small ones and two small private banks) accounted for 79.1% of total losses in the banking system in 1993 and for 87.2% in 1994. In 1995 the large private banks followed suit and the number of loss-making private banks went up.

Table 5: Balance profit and losses of commercial banks (mln.leva)

	1991	1992	1993	1994	1995	1996	1997
Profit	7201	2903	1896	8702	4646	181	406
Losses	1845	2291	4172	10056	29181	63	37
Net Profit	5356	612	-2276	-1354	-24535	118	369
Number of banks with losses	2	6	11	15	23		
including private banks and foreign banks	0	0	5	7	15		

Source: BNB

*BNB considers this information confidential. IME made representations to the Bank Supervision Department of BNB in hope that they will place needed data for 1996 and 1997 at our disposal.

**Loss-making banks for 1997 belong to Group II and Group III.

Commercial bank losses entail decapitalization of the banking system which is evidenced by the nine largest loss-makers. In 1993 losses exceeded own capital for all small banks in the sample and one large bank, i.e. all they had a negative net worth.

The decapitalization of the banking system intensified in 1995. Already 19 banks recorded negative net worth at the end of the year - total LEV 96.5 billion (the capital adequacy requirements excluded), or 11.3% to GDP. State commercial banks would receive 74% of the total amount required for the recapitalization of the banking system. Bank decapitalization and the fact that provision requirements are not observed indicate that the banks' capital cannot protect the creditors' claims if banks incur current losses. Hence the growing instability in the deposit market in 1994 which faced the threat of a total disintegration in 1995. Commercial bank losses are largely due to bad loans.

Bad loans

There were two major sources of bad loans in Bulgarian banking sector: the non-performing loans extended to the SOEs in the pre-transition period, and the credit expansion of the most of the banks, and especially the private ones, after 1990.

1. Bad loans inherited from the centrally-planned economy. After the price liberalization, most of the enterprises, like in other CEE countries, appeared to be ineffective and started to mount losses. Also, Bulgaria was strongly dependent on the former COMECON markets. Another problem was that most of these loans were denominated in hard currency, and therefore were not swept by the initial inflation and currency devaluation. All these factors led to debt arrears to the banking sector. As these loans were extended largely on the basis of administrative planning and not on market principles, the government felt it was its responsibility to remove this burden from the banks' balance sheets.

Series of measures have been undertaken starting in 1991, to resolve the problem. The common denominator of all measures was a sort of a triangle operation for replacing bad loans with state bond issues on the asset side of the banks' balance sheets, and replacing bank credits with state claims on the liabilities side of the enterprises' balance sheets. Partially this was implemented through the special bond issues in 1991 and 1992 which covered the non-performing loans of some 120-130 enterprises. Finally, the "Law on the Settlement of Non-Performing Credits Negotiated Before 31 December 1990" (LSNC) was adopted in December 1993. Under this law, the state issued bonds to replace all remaining debt (negotiated before 1991) which is in arrears more than 180 days. The BGL denominated ZUNKs (named on the Bulgarian abbreviation) amounted BGL 32 billion (appr. \$ 1 billion in end-1993), and the USD denominated ZUNKs amounted to \$1.8 billion. Thus they turned out to be major item on the asset side of the balance sheets of several big state banks, especially Mineralbank and Economic Bank. As the yield of BGL denominated ZUNKs was only 1/3, 2 and 2/3 of the BNB basic interest rate for the first two, second two and third two year periods respectively, this caused serious disproportion in the asset/liabilities yield ratio.

2. Non-performing loans contracted after 1991. One of the factors which led to new "bad borrowing" was the government policy for replacing direct budget subsidies to the real sector with quasifiscal subsidies through new credit injections. There was no political will for closing the loss-makers until mid-1996, and they had to be kept alive through credit amnesties

which even deepened the crisis in the banking sector. The only state-owned bank to avoid new doubtful lending was Bulbank, which finally aggregated 91% of all standard loans in end-1996.

Table 6 Net domestic credit, bln BGL, 1992-1996

	1992	1993	1994	1995	1996	1997
<i>Net domestic credit, bln BGL</i>	254,0	396,3	543,2	628,5	1994,4	5136.5
BGL component	125,9	204,2	264,4	411,1	652,2	1035.6
foreign currency component	128,1	192,1	278,8	217,4	1342,2	4100.9
net claims on government	101,4	193,6	276,7	269,4	822,5	1909.9
claims on nongovernment sector	152,7	202,7	266,5	359,1	1171,9	3235.6
claims on nonfinancial public enterprises	134,8	166,7	189,9	169,0	525,6	1253.4
claims on private sector	17,8	36,0	76,6	190,1	646,3	1982.2

Table 7 Net domestic credit, annual % change, end of year, 1992-1996

	1992	1993	1994	1995	1996	1997
<i>Net domestic credit, annual % change, end of year</i>	51,9	56,0	37,1	15,7	217,3	157.5
BGL component	47,9	62,2	29,5	55,5	58,7	58.8
foreign currency component	56,0	49,9	45,2	-22,0	517,4	205.5
net claims on government	91,3	91,0	43,0	-2,7	205,3	132.2
claims on nongovernment sector	33,6	32,8	31,5	34,8	226,3	176.1
claims on nonfinancial public enterprises	33,1	23,7	13,9	-11,0	211,0	138.5
claims on private sector	37,4	101,6	113,0	148,1	240,0	206.7

Table 8: Structure of commercial loans 1995 - 1996

Types of loans	Group 1		Group 2		Group 3	
	1995	1996	1995	1996	1995	1996
Standard loans	51.65	43.67	52.34	33.41	11.16	0.21
Doubtful loans - A	41.15	33.89	31.87	22.42	85.31	86.04
Doubtful loans - B	0.61	1.39	5.94	7.59	3.53	6.45
Uncollectable loans	6.58	11.79	9.85	11.02	0	7.3
Loans not subject to provisioning	0	9.27	0	25.56	0	0

Source: BNB

* Group 1 includes 7 big state-owned banks, amounting 67% of the banking system in end-1996, with Bulbank and SSB included.

Group 2 includes 17 small and medium size banks, amounting 7% of the banking system

Group 3 includes 3 banks with foreign capital and 4 bank branches amounting 2% of the banking system; the remaining 24% stand in all banks under bankruptcy procedures initiated by the BNB and are not included in the table (Business Bank, Commercial Bank "Elit", Dobrudja Commercial Bank, Commercial Bank "Kapitalbank", Bank for

Agricultural Credit, International Bank for Investment and Development, Commercial Bank “Balkanbank”, Private Agricultural Bank “Agrobusinessbank”, Economic Bank, First Private Bank, Commercial Bank “Kristalbank”, Commercial Bank “Slaviani”, Commercial and Savings Bank, “Mineralbank”, Agricultural and Industrial Bank, Private Agricultural and Investment Bank by the end 1997.)

** Doubtful loans A - in arrears of less than 30 days

Doubtful loans B - in arrears between 30 and 90 days

Uncollectable loans - in arrears of over 90 days

Amendment to Table 8: Structure of commercial banks 1997(in conformity with BNB's New Regulation N 9 on Bank's Risk Exposures Evaluation)

(%)

Regular exposures	83
Irregular exposures	2
Exposures under scrutiny	3
Doubtful exposures	1
Losses	11

Source:BNB

Another problem stemming from the low capital requirements was that the financial sector was flooded by small undercapitalized private banks. An easy and cheap opportunity for purchasing implicit state deposit insurance was created, combined with the loose credit regulations. The share of big loans increased from 49% in 1994 to 61% in 1995 for the banks in Group 2. A great number of non-collateralized credits were extended, most of them later turned uncollectable. Additionally one and the same object was pledged at several institutions. Insider lending was also widely spread, though no figures are available yet.

In general, these small and poorly capitalized banks had strong incentives to exploit the “state insurance” by making siphoning deposits from the population to connected firms. This was possible only under the BNB always acting like a residence of last resort, providing refinancing to bad performing banks.

Consolidation of the banks

In 1991 the number of state-owned banks were 70, most of them were small with the statutory capital up to 10 mln leva (approximately \$ 500 000) with average annual volume of credits up to 250 mln.leva (\$ 12 mln). In the same year Bulgarian National Bank began preparation for

consolidation of banking sector in the country. The main objective of such consolidation was to prevent the banking sector from further fragmentation.

In 1992 Bank Consolidation Company was established. The statutory capital of the BCC was 933.206 mln leva. The BCC is a joint-stock company which major objective is to transfer the share of the state in the capital of commercial banks, to manage acquired stocks, to consolidate commercial banks with more than 50 % state-owned shares, to prepare and perform privatization of given banks.

The process started in 1992 with consolidation of 22 banks in one - United Bulgarian Bank. 12 small commercial banks (Varna Commercial Bank, Gotze Delchev Commercial Bank, Transportbank, Kyustendil Commercial Bank, Smolyan Commercial Bank, Rilabank, Vazrazhdane Commercial Bank, Razgrad Commercial Bank, Cherven Bryag Commercial Bank, Silistra Commercial Bank, Devin Commercial Bank and Provadia Commercial Bank) were merged in Exspressbank.

In 1993 throughout merger of Vidin Commercial Bank, Lyaskovetz Commercial Bank and Gorna Orjahovitza Commercial Bank was established Balkanbank. Other commercial bank established through a commercial bank merger was Hebrosbank. It consolidated 8 banks: Agricultural and Cooperative Bank, Plovdiv Commercial Bank, Blagoevgrad Commercial Bank, Veliko Turnovo Commercial Bank, Vitosha Commercial Bank, Mezdra Commercial Bank, Troyan Commercial Bank and Chepelare Commercial Bank. Also Hemus Commercial Bank, Elektronika Commercial Bank, Sofia Commercial Bank and Kazanlak Commercial Bank were merged in a new bank, named Sofiabank. With the consolidation of Biochim Bank in 1995 the number of state-owned banks decreased from 70 in 1991 to 11 in 1995.

According to the agreements with the IMF and the World Bank by the end of June 1997 was finalized the first deal for privatization - of United Bulgarian Bank. As a result 35 % of bank's shares were acquired by EBRD and 30 % of shares were acquired by the American company Oppenheimer & Co. The remaining 35 % of shares are in possession of Bulbank.

Bank Consolidation Company(BCC) is looking for foreign investors for the other state-owned banks, which are to be privatized. In process of preparation for privatization are Expressbank, Bulbank and Hebrosbank. The negotiations between BCC and Nomura Bank regarding privatization of the Bulgarian Post Bank failed and the bank was sold to ALICO (a subsidiary of the American AIG) and the Greek Consolidated Eurofinance Holdings for \$ 38 mln.

In 1997 two banks with revoked licenses found their new owners. The former Jambol Commercial Bank was acquired by Bulgaria Holding and renamed to Bulgaria-Invest. The former Commercial Bank Mollov was sold to Istrokapital-Slovakia and renamed to Eurobank.

As long as agreements with IMF continue, respectively, international financial institutions' financing of the balance of payments, the banks' privatization is not likely to be reversible process. According to the newly discussed agreement between IMF and the Bulgarian government establishing a competitive banking system is being observed as a prior action. Originally the negotiations on Postbank had to be completed by the end of June 1998. Next step is appointing privatization advisors for Bulbank and Expressbank for which privatization a tender is foreseen in September 1998. Hebrosbank should be privatized in 1999 and Biochim - in 2000. The privatization process for SSB is more complicated. The implementation of the privatization strategy should begin in year 2000.

Banking crisis and development of banking sector 1996 -1997

The considerable share of unserviced liabilities by both SOEs and private enterprises contributes to the poor shape of the banking system as a whole. Commercial banks crisis in 1996 is largely due to the lack of prudential regulations and practices. The net loss of the banking sector in 1993 amounted to 5 billion BGL, and in 1994 it almost hit the 7 billion BGL mark; problems aggravated in 1995 when by mid-year the net loss increased to 30 billion BGL, and about 100 billion BGL by the year end.

Weak private sector, bad banking management, the over-supply on the banking market, credit risk concentration, negative structure of credit portfolios and increasing share of non-performing credits, decapitalization of the banking system and the following loss of confidence in the banking system, etc. lead to a turmoil in the banking system.

A precondition for the banking crisis was set in the beginning of reforms in 1990 when a process of establishing deeply fragmented banking system began with a large number of small state-owned banks specialized in providing funds to particular branches and regions. Almost all of them inherited significant amount of non-performing credits extended to the enterprises during the socialist-era. To a great extent their further decapitalization was due to the slow process of bank consolidation.

One of the most serious problems which led to the banking crises in 1996-1997 was the one with both non-performing loans extended to the SOEs in the pre-transition period, and non-performing credits granted after 1990 by the most of the banks, and especially the private ones. Some 50 % of all loans granted by state-owned banks to non-financial institutions are uncollectible. To a considerable extent this is due to the influence of the state on lending to strategically important state-owned enterprises. Furthermore, for most of the SOEs, the only way for servicing their debts and covering their losses became collecting new loans from

banks. The preservation of loss-making enterprises in the public sector was government policy during the whole period.

By the end of 1995 41 % of all loans granted by both state and private banks to non-financial institutions were irrecoverable. Only 39 % of total lending by private banks were regularly serviced.

The problem with most of the private banks stems from common practice of extending credits to related to bank`s top-level management persons and firms. Some of these banks were created for the only purpose of directing money (collected by both deposits from the population and through refinancing by the Central Bank) to the newly emerged private firms with no intention of collecting the loans back.

Deterioration of banks` credit portfolio also was due to the lack of effective legal framework concerning collection of credits from unfair borrowers and realization of securities. Moreover, no legal procedures for bankruptcy proceedings against insolvent SOEs were in place.

As a result of decapitalization of the banking sector only four banks reported profit in 1995. This state of the banks led to a loss of confidence in the banking system among depositors resulting in a widespread withdrawal of deposits from the banks.

As a result of the deep banking crisis from May 1996 until April 1997 eighteen banks were closed and put under special supervision by the BNB. In May 1996, the Banking Law was amended and for the first time since the beginning of the reform, a legal procedures for bank bankruptcy were introduced. In 1996, 14 banks which concentrated 24 % of total assets in the banking system were put under conservatorship. This is estimated to be the biggest banking crisis worldwide recently. From 27 private banks existing by the time, the 4 biggest ones were put under special supervision.

At the beginning of 1996 BNB revoked the licenses to conduct bank transactions of Crystalbank and Private Agricultural and Investment Bank. In addition BNB put them under conservatorship along with Mineralbank, First Private Bank, and Agrobusiness Commercial Bank. The court instituted bankruptcy procedures against these 5 banks. By the end of 1996 another 9 banks were placed under conservatorship. Among these banks were Balkanbank, Mollov Commercial Bank, Businessbank, Slavyani Commercial Bank, Trade and Savings Bank, Yambol Commercial Bank, Dobrudja Commercial Bank, Elitebank.

In addition to these measures bank supervision department took several measures against the 19 banks aimed at macroeconomic and financial stabilization, including a ban on payment of dividends without the BNB`s permission, a ban on the extension of new loans, measures to collect loan repayments, limits on interest rates on deposits, cut of operational costs.

At the beginning of 1997 BNB placed under conservatorship International Bank for Investments and Development and set application to the court with the petition to institute bankruptcy procedures against Elitebank, Kapitalbank, Bank for Agricultural Credit. Mineralbank, Trade and Savings Bank, Slavyani Commercial Bank, Bulgarian Agricultural and Industrial Bank, Crystalbank, Private Agricultural and Investment Bank went bankrupt after court's decision.

33 banks (including State Saving Bank and foreign banks branches) survived, but some of them are small and private and still have to overcome some serious problems concerning their solvency. One of the most serious problems for small banks is to meet new requirement for the minimal level of banking founding capital, which have to reach 10 bln. BGL (5.4 mln. USD) by the end of June 1998. For most of them the only solution is in attracting foreign investors.

The financial condition of commercial banks has improved to a great extent since the beginning of 1997. As a result of depreciation of the lev and the brief hyper-inflation the capitalization of banking system has been improved. The depreciation of local currency helped banks to restructure their portfolio. However some banks are still reliant on ZUNK bonds.

Following the new Banking Act which replaced previous Banking and Credit Act and the Basle Accords, BNB issued Regulation N 8 dealing with capital adequacy and minimal founding capital requirements. All banks in Bulgaria are obliged to have 8 % capital adequacy ratio at the end 1997, 10% capital adequacy ratio at the end of 1998 and 12% at the end of 1999.

For the first three months after introduction of currency board banks have significantly improved their capital adequacy and their liquidity. Banks can be divided into four groups.

The first group consists of UBB, Expressbank, Bulbank, Bulgarian Post Bank, SSB, Biochim, Hebrosbank and represent 76 % of banking system assets. At the end of June 1997 their total capital adequacy was 8.3 %. Only two of these banks have capital adequacy ratio below 8 %. Net capital of this group is 187 bln.leva.

The second group of banks includes Municipal bank, Unionbank, First Investment Bank, Corporate Bank, Bulgarian Commercial and Industrial Bank, International Orthodox Bank, Creditexpress, First East International Bank, Trakiyabank, Bulgaria-Invest Commercial Bank, Teximbank, Credit Bank, Balkan Universal Bank, Central Cooperative Bank, Bulgarian - Russian Investment Bank, International Bank for Commerce and Development. These 16 banks hold 10 % of total banking system assets. Their total capital adequacy was 18 % at the end of June 1997 and only four of them reported capital adequacy below 8 %.

Four foreign banks and five branches (ING Bank, Bayerische-Bulgarische Handelsbank, BNP-Dresdner Bank, Raiffeisenbank, Xiosbank, National Bank of Greece, Eurobank, Bulgarian

Investment Bank and Ionian Bank) form the third group and represent 4.5 % of banking system in Bulgaria.

The four group consists of 10 banks which were put under conservatorship.

Table 9: Bank regulations under BNB Regulations # 8 on the capital adequacy

	I Group(%)			II Group(%)			III Group(%)		
	1996	June 1997	end-1997	1996	June 1997	end-1997	1996	June 1997	end-1997
Total capital adequacy ratio	19	8	31.41	8	18	23.66	15	19	18.55
Primary capital adequacy ratio	18	7	23.07	13	14	16.97	18	14	16.92
Assets risk component	24	22	25.97	61	45	39.25	43	52	45.88
Net capital\balance assets	4	3	8.16	5	8	9.29	-9	7	8.51

Source: BNB

At the end of August 1997 the capital adequacy of the biggest and most important banks in Bulgaria (Bulbank, Biochim, UBB, Hebrosbank, Expressbank and Post Bank) was 8.54 %. Their capital base was 105.844 bln. BGL at the end of June 1997. At the same time the total capital base of the banking system was 181.962 bln.BGL.

One of the long run problems faced by Bulgarian banking system seems to be to make an adequate profit from bank`s activities. At the moment the average profitability of banks` portfolios is considerably below the interest rates levels since a part of the banks` assets (bad loans, buildings, etc.) pay no income. In addition banks are very conservative in their lending activities. Banks still consider lending a very risky activity because the business environment did not improve significantly as well as the fact that the execution of creditor`s rights is slow and banks face problems in collecting the non-performing loans. Furthermore, according to Banking Act banks are restricted to extend a “big loan”, exceeding 25 % of bank`s own capital which is very low.

This additionally contracts the quality and variety of bank services which for most of Bulgarian commercial banks are extremely restricted and include taking deposits, extending very short-term credits and intermediation in the payments in Bulgaria and abroad. It is expected that future development of the capital market will have serious impact on commercial banks. Development of the capital market can create additional opportunities for banks to diversify their services by new intermediation in the trade with securities.

The interest rates have fallen essentially since March 1997, reaching only 5.5 % annually in August 1997. They are likely to remain low due to the methodology for defining the base interest rate. BNB just reports every week the base interest rate at the base of the average yield obtained by the government securities with 3 months maturity at the last auction. Now this market is considered to be with the biggest volume. The other possibility for defining basic interest rate may be the interest rate on the interbank market. Obviously, the volume of interbank transaction will remain lower than the volume of short-term government securities market in near future.

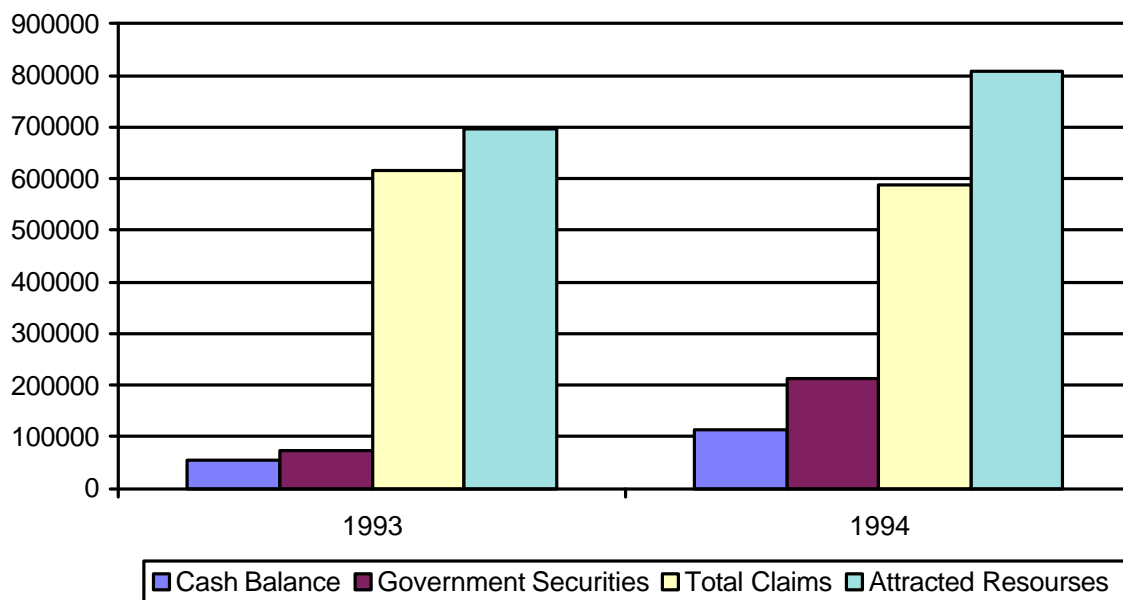
At the same time the inflation rate is still high and the real interest rates are negative. The negative real interest rates threaten the incentives for saving and deposit base. A clear evidence for this is the fact that in September 1997 the currency outside banks exceeded total amount of time and saving deposits.

The lack of enough opportunities for placement of banks` resources is resulting in orientation towards keeping mainly high liquidity assets - cash, assets on banks accounts and government securities. At the end of August last year the six biggest resource banks reported 22.8 bln. BGL profit. Seven small and medium-sized banks sustained losses. The foreign-majority-owned banks and branches of foreign banks also were loss-making (they hold less than 5% of bank assets and an insignificant part of banking capital).

Liquidity of the banks

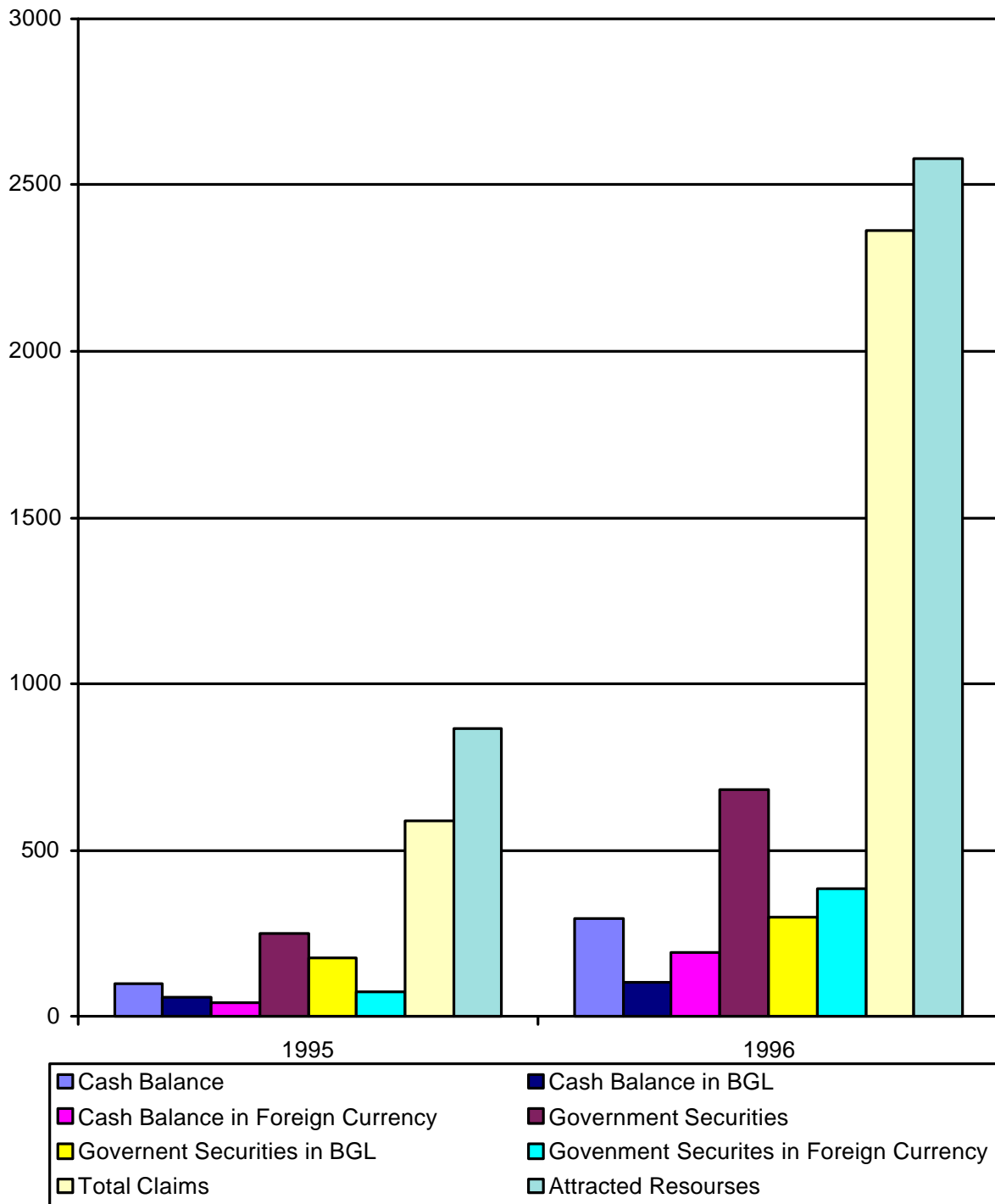
The data in the balance-sheet of the commercial banks in Bulgaria can be compared after 1993.

Liquidity 1993-1994 in mln BGL



A comparison of the total bank assets at the end of 1993 and 1994 shows that holding of government securities rose from 9% to 20% of the total assets. This increase was due to the implementation of the Law on Settlement of Non-performing Credits (LSNC) to cover the bad loans of the state enterprises. By the end of 1994 57.2% of internally held government debt was in the form of LSNC bonds. Government bonds were about 28% of the total assets. The banks act as agents who purchase these bonds. The ability to trade bonds on the secondary market increased their liquidity and they were attractive for the commercial banks.

Liquidity 1995-1996 in bln BGL



The relative shares of claims on non-financial institutions in total assets has increased from 34% in 1993 to 42% in 1994. It shows the extension of the loans to the business, this can be considered as a relatively low shares.

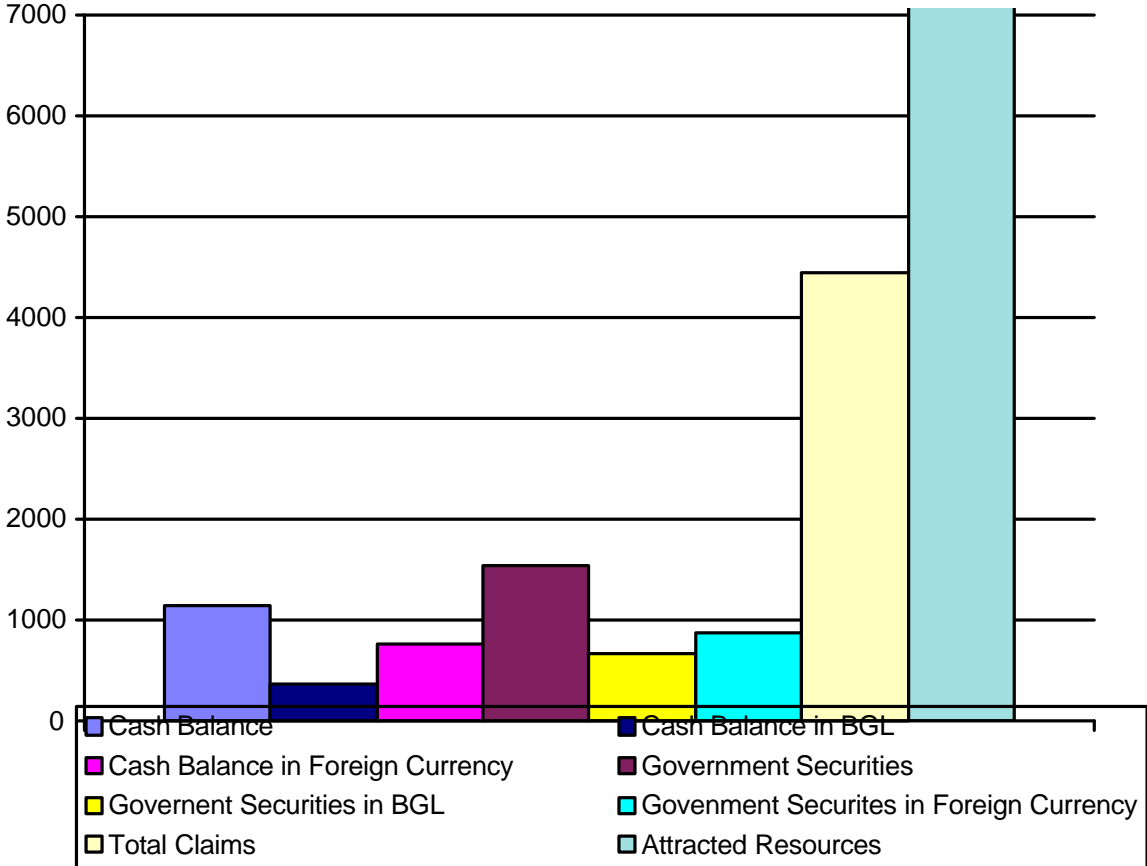
It should be noted that the share of attracted resources from financial institutions in total liabilities is substantial.

In 1995, financial results of the major banks indicated surplus. The bank system seemed stable. Total claims increased with 300 % comparing with 1994 . Particularly the lev and foreign components of the claims on non-financial institutions rose approximately 3,5 times. The share of the government securities in total assets notes temporary tendency to grow.

Cash balance rose 195%. The lev component of cash balance increased 73% and forex rose 375%. The reason is high inflation rate and a number of banks failed. Government securities rose 172% but they increased also as a share in the total assets. The share of claims in balance sheet assets expanded to 65% in 1996 from 54% in 1995. This is a proof of worsened liquidity in the banking system. The relatively reduction of the liquidity in the bank assets - cash balance, government securities is a result of poor assessment of liquidity risk.

Funds attracted from nonfinancial institutions increased. Obviously the commercial banks were not able to attract funds from depositors and had to borrow from the interbank market. With a view to assessment of bank solvency the negative tendency in 1996 is the greater increase in the amount of the assets compared with the capital base.

Liquidity June 1997 in bln BGL



A positive trend in the bank system liquidity is observed during 1997. This is illustrated by the indicators "total claims /total attracted resources" and "total claims/total assets". The first

indicator ("total claims /total attracted resources") marks a decrease from 92% in 1996 to 62% in 1997. For the same period the other indicator ("total claims/total assets") changes from 65% to 58%.

A substantial decrease is also observed in the ratio "claims on banks and financial institutions/total attracted resources" (from 45% to 39%). This is an indicator for the limitation of the level of dependence of the banks from the interbank market.

The total attracted resources in June 1997 are 7127 billions BGL, i.e. they mark a growth of 176% in accordance with 1996. The relative share of the total attracted resources in the liabilities of the banks has increased from 71% in 1996 to 93% in June 1997.

On the basis of the data in the balance-sheet of the commercial banks it is obvious that there still exist limitations in the credits borrowing. This is a consequence of the economic crisis and the influence of the hyperinflation on the depreciation of the banks debts.

The resources attracted by the banks and the other financial institutions in 1997 show a low growth. Therefore the creditability of the Bulgarian bank system is not restored yet.

Refinancing of commercial banks

The major institutions to provide refinancing were BNB and SSB. BNB provided refinancing through credits or direct deposits, both in national currency and foreign exchange. Three-month foreign exchange loans were provided against pledge of commercial paper, mostly bills of exchange and promissory notes. In 1994 BNB announced its intention to end uncollateralized refinancing, causing a dramatic change in the refinancing structure. A big shift in Lombard loans caused the ZUNKs' issue under the LSNC, as they were accepted with 70% of their face value for collateral. The USD denominated ZUNKs were pledged against USD loans, in June 1994.

A special case in the history of refinancing deserve Mineralbank and Economic Bank. Accounting for 20% in the whole banking system, they also had concentrated a huge bulk of the non-performing loans. After the LSNC, the ZUNKs represented 69 and 64 percent of their assets, respectively. The low coverage of foreign exchange liabilities with foreign exchange assets (30%) in early 1994 caused liquidity problems during the fast depreciation of the Lev at the moment. After the USD ZUNKs were placed, and the real appreciation of the Lev later in 1994 and 1995, the situation turned to be just the opposite. Their share in the overall refinancing of BNB rose from 21% in 1993 to 60% in mid-1994. That prompted BNB to repurchase all BGL ZUNKs in their portfolios at par. This was not enough and in mid-1995 they again accounted for 65% of the total refinancing. In the beginning of 1995 BNB ceased interest on these loans, and finally wrote them off its balance. A second rehabilitation measure

was taken by replacing the USD denominated ZUNKs with 7-year BGL denominated bonds worth BGL 52 billion. Few months later a substantial amount of these bonds (BGL 42.9 billion) were transferred to BNB and SSB as repayment of debts under the condition that the refinancing will be stopped. The deterioration in their liquidity, however, made BNB break these rule and extend credit to them in early 1996. As there were merely no bonds in their portfolios to serve as a collateral, the refinancing was completely unsecured.

In 1995 and especially 1996 plenty of other banks started to rely extremely on refinancing injections. Given the lack of legal framework for bank bankruptcy and the lack of political will to close down loss-making illiquid banks, no single bank was allowed to fail until May 1996. That led to enormous increase in the unsecured refinancing, which amounted about 90% of all credits extended to commercial banks by BNB in December 1996.

That vicious circle was finally resolved an end by the Currency Board arrangement introduced on July, 1st 1997. BNB was prohibited to refinance commercial banks or to set deposits in them under no circumstances other than a “systemic risk” for the banking sector. Even though, the total amount of refinancing should not exceed the Banking Department deposit in the Issue Department of the Central Bank.

Table 10: Refinancing in nominal levels at the end of 1993 - 1996

	1993	1994	1995	1996
in BGL billion	15758	28561	20171	62336
in USD mln.				
direct loans	151.1	84.3	68.2	45.3
deposits	61	34.4	33.2	31.2

Source: BNB

Table 11: Structure of refinancing in local currency (% share of total)

	1993	1994	1995	1996
Lombard	28.7	78.9	5	9.8
Discount	21.7	4.6	10.4	0
Overdraft	7	16.1	27.9	0.2
Unsecured	n.a.	n.a.	56.7	90
Moratorium	10.8	n.a.	-	-
Other deposits	15.3	0.4	-	-
Auction	16.6	n.a.	-	-
Total	100	100	100	100

Source: BNB