Center for the Study of Democracy

THE REFORM IN THE BULGARIAN BANKING SYSTEM

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THE BANKING SYSTEM UP TO THE OUTSET OF THE REFORM 1

ECONOMIC AND POLITICAL ENVIRONMENT OF THE REFORM 2

LEGISLATIVE FRAMEWORK OF THE BANKING REFORM 3

MONETARY POLICY - THE SPECIAL PRIORITY OF THE BNB AND ALSO THE BASIS FOR MONETARY STABILITY 4

THE INSTRUMENTS OF MONETARY POLICY 5

FOREIGN CURRENCY POLICY 8

BANK SUPERVISION 9

The economic reforms that were launched in Bulgaria following the democratic changes in late 1989 are meant to carry out the transition from a centrally planned, to market oriented economy. The banking reform is one of the chief preconditions for the organization of a financial system that conforms with market economy principles, which can facilitate the overcoming of the crisis and restoration of macroeconomic stability. The process of institutionalization of the banking system in the country was supposed, within a relatively short period of time, to settle several critical groups of questions. Most notably these were: to lay the foundations of the money and foreign exchange market; to secure stability and trust in the financial institutions; to encourage competition between them. The highlight of the reform of the financial and credit system was the transformation of the Bulgarian National Bank from an instrument of centralized planned management and a banking monopoly, into a central banking institution in a position, through its independent monetary policy, to guarantee the stability of the national currency and the viability of the banking system in Bulgaria.

THE BANKING SYSTEM UP TO THE OUTSET OF THE REFORM

In the time of socialist management of the economy in Bulgaria, the monopoly of the socialist state on banking burdened the central bank of the country with all of the basic banking functions. Apart from typical activities such as issuing national currency notes and financing the government, the Bulgarian National Bank also took on the functions of the nationalized commercial banks in the sphere of supplying credit for business and economic activities. In certain periods there used to exist, parallel to the BNB, other banking structures with equally pronounced state-regulatory functions, such as the Bulgarian Investment Bank. In the period 1950-1981 the Bulgarian banking system was essentially a one-tier system, although the operations related to deposits and credits for the general public were concentrated in the State Savings Bank, and the international banking transactions in the Bulgarian Foreign Trade Bank.

Under the conditions of socialist planned economy, the function and role of the BNB -was radically different from its present one. As an appendage to the system of central planning and management of the economic processes, the central bank was supposed to meet the needs of the budget for direct financing, virtually automatically, and to provide credits to state-owned enterprises under practically fixed (in fact negative) interest rates, without taking into account either macroeconomic stability, or the possibilities for maintaining the equilibrium of the balance of payments. In this way, the BNB was turning into a generator of over-liquidity, which became one of the major factors for the acute economic crisis.

The process of breaking down the monopoly of the Bulgarian National Bank on all banking operations and activities began as early as 1981, with the founding of the Bank for Economic Initiatives - Mineralbank. In 1987 another seven new "branch" banks were created, narrowly specialized in crediting different sectors of the economy. Up to the outset of the reform, these banks were operating on semi-market principles - they attracted the free resources exceeding the national plan and extended short and mid-term credits to small and medium-sized enterprises. In 1989 the year of the political changes - 59 new commercial banks were created on the basis of the former branches of the Bulgarian National Bank. Subsequently, in 1991, the first private banks in the country began to appear.

ECONOMIC AND POLITICAL ENVIRONMENT OF THE REFORM

The institutionalization of the new financial system is taking place in a context of serious instability of economic and political conditions in the country. The accumulated fall in the real size of the gross domestic product for the period 1990-1993 amounts to 30 per cent. The fall in output in the public and cooperative sectors accounts for the dramatic increase in unemployment, which by the end of 1993 had reached 626,000, or 16 per cent of the country's labour resource. With the liberalization of prices on February 1, 1991, the inflation potential accumulated in the course of decades swept the market, and by the end of the same year the price index had reached 434 per cent (the highest inflation in Eastern Europe, with the exception of warring Yugoslavia). Consumer prices rose more than 16 times over the last three years.

The country's foreign and domestic indebtedness creates further difficulties under the conditions of transition. At the end of 1993 the state budget deficit amounted to about 10 per cent of GDP. The foreign debt is a particular burden on the economy. In the mid-1980s Bulgaria took considerable credits which subsequently became increasingly difficult to pay off, due to ill-advised investments and adverse trade conditions on the international market. In March 1990 the government unilaterally suspended loan payments. This measure made it impossible for Bulgaria to receive fresh investments and this became one of the chief obstacles to the success of the economic reform. Presently the receivables of our foreign creditors from the London and Paris Club, together with interests, exceed USD 12 billion which constitutes 145 per cent of Bulgaria's gross domestic product.

The political instability of institutions also contributed substantially to the aggravation of the economic situation. Under the conditions of transition from totalitarianism to democracy, Bulgaria held parliamentary elections twice over a period of four years, and there were several serious governmental crises, leading to four changes of cabinet. The frequent cabinet changes seriously impeded and delayed the course of the reforms. Each new government, supported by a fragile and frequently fluctuating political majority, undertook changes in the institutions, taking turns in ultimately modifying the basic parameters of the economic changes and thus creating further instability.

LEGISLATIVE FRAMEWORK OF THE BANKING REFORM

An essential role in the early stages of the reform was played by the Bulgarian parliament, which adopted a number of legislative acts abolishing the former banking legislation and laying the foundations for modern banking. The Bulgarian National Bank Law was passed in mid-1991, and the Banking and Creditation Law was adopted in March 1992. These two major acts of the Bulgarian parliament set up the legislative framework of the new financial and credit system in the country. Presently the banking system in Bulgaria is a two-tier one, and is composed of a central banking institution - the Bulgarian National Bank - and commercial banks built up on a share-holding basis. In fact, the commercial banks are universal and may engage in both trade and investment operations. The new structure of the financial system is complemented by newly established non-banking institutions - financial and brokerage houses and foreign exchange offices.

The BNB Law restored the independence of the central bank and concentrated its functions to maintaining the stability of the Lev and regulating the banking system. These measures turned the BNB into one of the chief centers of the economic reform.

The management of the Bulgarian National Bank is carried out by a Governor, Governing Board, and Plenary Board. The Governor is elected by the National Assembly for no more than two five-year terms and is responsible for the operative management of the bank, and its representation in the country and abroad. The Governing Board presided by the Governor includes three deputy managers and five heads of departments in the BNB. It takes all of the more important decisions in the sphere of monetary and foreign currency policy, bank control, and the issue of notes. The Plenary Board of the BNB includes the members of the Managing Board and six other distinguished representatives of financial theory and practice. It is concerned with the global problems of financial reform in the country; it passes the budget of the bank and its annual report.

The independence of the BNB is a characteristic element of the new status of the central bank and is upheld by the Law in two chief respects. First, the Bank is a sovereign institution and is independent of the Council of Ministers in the pursuit of its policy. Second, the stability of the BNB is guaranteed by the fact that the Governor, the Deputy Governor and the members of the Governing Board can only be relieved of their duties by an act of the National Assembly under extreme circumstances - "if they have been convicted of premeditated crime of general character or prevented from Reforming the functions for more than one year".

MONETARY POLICY - THE SPECIAL PRIORITY OF THE BNB AND ALSO THE BASIS FOR MONETARY STABILITY

The BNB Law sets forth as the main functional priority of the central bank to maintain "internally and externally stable national monetary unit by means of developing and enacting national monetary and credit policies".

The radical change of approach in determining monetary policy was the prime aim of reform in the banking sector. Previously monetary policy was an element of the centrally planned management of the economy. Now it has become a major instrument to ensure the macroeconomic stability of Bulgaria with the central bank independent of the executive power.

The maintaining of an externally and internally stable national currency in the short run under the conditions of global economic crisis and the transition from planned to market economy is a difficult task. It requires the specific blending of monetary and foreign currency policy instruments together so as to restrict the rising supply of money and thus to curb the inflational processes in the country to the possible extent.

The new two-tier banking system started functioning in a macroeconomic environment characterized by essential disbalances, most significantly the existing monetary over-liquidity generated by the practically limitless bank financing of the budget deficit previously accumulated under the old regime. In 1989 the M2 money aggregate exceeded by 9.3 per cent the gross domestic product produced. In late 1993 this ratio went up to 83.2 per cent, while normally it should be within the range of 30 to 70 per cent.

THE INSTRUMENTS OF MONETARY POLICY

Under conditions as disbalanced as these the BNB was obliged to adopt a highly restrictive monetary policy to reduce the high supply of money. The major restrictive instruments employed by the central bank can be provisionally divided into two groups: direct, and market-oriented. The credit ceilings and the tax exempt minimum obligatory deposit reserves of the commercial banks at the BNB fall under the direct category. The market-oriented group includes the interest rates on the Lombard and discount credits that are used by banks are for refinancing, as well as the BNB's participation in the open market (including the foreign currency one). All of these means are used by the central bank to affect indirectly the forming of liquidity levels to meet its predetermined objectives.

At the outset of the finance reform and initially with the creation of the two-tiered banking system, the BNB tended to rely more heavily on direct instruments for control, as it attempted to affect promptly the liquidity of certain commercial banks and the system as a whole.

The credit ceilings were the major instrument of the Bulgarian central bank's policy adopted to drastically restrict the commercial banks' credit expansion of early 1991. These ceilings were applied to leva credits only because with the moratorium on the country's foreign debt payments the foreign currency crediting practically dried up due to the lack of fresh foreign currency resource. The credit ceiling for each commercial bank was determined as a percentage of the total indebtedness residual on the credits by the end of the previous period. This direct credit expansion instrument served as the basis for the stabilizing program of the financial sector developed in cooperation with the International Monetary Fund and proposed to bring within acceptable limits the net internal assets of the banking system. The credit ceilings were subject to further regulation every trimester with the maximum possible amount of net credit for the non-government sector considered being equal to the ultimate amount of net internal assets adjusted by the expected for the period amounts of net credit to go to the government. In due time a point was reached when the major monetary policy instruments and their restrictive effects on the liquidity of the banking system contradicted the market aims of the reform. The governing board of the BNB decided to reduce the use of direct levers in the money supply market, and in late July 1994, under the conditions of relative money market stability, removed the credit ceilings.

Another instrument employed by BNB to regulate the money supply directly is the minimum obligatory deposit reserves. At an earlier stage of development of the banking system the central bank made use of the minimum obligatory reserves in terms of a specific liquidity reserve - that is they acted as guarantees for the normal functioning of the money supply. At this stage, the BNB uses them as a direct regulator of credit resources. Since the beginning of 1990 the commercial banks have their minimum reserves accounts opened at the central bank who is to receive 5 per cent of the commercial bank's accumulated primary deposits. Interests are not being calculated on these deposits and they become a sort of taxation for the commercial banks. The initial restrictive policy gaining force, in late 1990 the BNB raised the amounts of the minimum obligatory reserves to 7 per cent. During the first three months of 1994 the relative stability of the foreign exchange lev rates was upset to counter the disbalanced foreign exchange market, where the demand for foreign currency went radically up, and BNB's requirement for the minimum obligatory reserves climbed up to 8 per cent. This was a restrictive measure undertaken to curb the current liquidity of the lev. After July 1994 with the removal of credit ceilings BNB again raised the minimum obligatory reserves to 9 per cent, to later increase it to 10 per cent in early September. The increase of the minimum obligatory reserve deposits of the commercial banks was only a temporary measure to counter the ousted credit ceilings. It was also there to highlight the market character of the measures undertaken by the BNB and so starting September 1st a 12 per cent annual interest is being calculated on the minimum obligatory reserve deposits. The technicals proper of determining the sizes of the minimum obligatory reserve deposits largely depend on the development of the banking system and mostly on the system of payments in particular. Since the reform was launched they have been calculated once monthly as based on the balance for every commercial bank and funds are set aside in a separate account at the BNB. Settlement having been introduced in the central bank since mid-1992 the commercial banks were permitted to use overdraft of their BNB payments accounts amounting up to the reserves previously deposited by them (including those in foreign currency up to the amounts of the foreign currency parts of their obligatory reserve deposits). In this way a substantial transition was effected from direct to indirect managing of the liquidity of the banking system. Here the interest rate on the overdraft, which is considerably higher than the base interest rate is employed by the BNB to regulate quickly and relatively efficiently the money supply in terms of short-run dynamics. Under the extreme conditions of lev liquidity being restricted to shrink the demand for foreign currency and to prevent the interest rates from plummeting, the interest rate on the overdraft was raised up to 150 per cent, which is itself some 2.5 times the base interest rate.

The refinancing of the commercial banks stands out exemplary of the evolution of the monetary policy instruments adopted by the central bank. The reform of the banking system only just toddling with any whatever financial market missing BNB was compelled into refinancing the banks directly. Up to year 1991 most of the refinancing - over 90 per cent was performed through extending unsecured resources. The BNB took the first steps in the direction of creation of interbank market through the monthly auctions of interbank deposits it started holding in September 1991. The commercial banks could thus lend their temporarily free resources at the disposal of other banks. The State Savings Bank stood out as the major creditor at this stage providing over 50 per cent of all the available resources for these auctions. The emergence of the interbank market made it possible for the commercial banks to negotiate between themselves the extensions of temporarily free money resources. The central bank was to lay the grounds for Lombard and discount policies and it attempted that through issuing securities and developing a good market for them. It would thus try and run the secured collateral (non-inflational) refinancing of the banking system. Starting October 1991 BNB grants Lombard credits with interest rate equal to the base interest rate collateral against state securities issued by the Ministry of finance to cover the budget deficit. Its financing through treasury bonds and obligations is there to reduce and gradually eliminate the direct government crediting of the central bank. In 1992 30.9 per cent of the budget deficit was funded by state securities - a percentage to go up to 77.1 per cent during the following year 1993. A system had not been established yet to issue trade acceptances and to use them for payments and this largely hampered the extension of discount credits. This was the reason why BNB introduced the discounting of order drafts to be issued by a certain bank and guaranteed by another one with stimulating interest rate higher than the base interest rate. The central bank also declared intent to discount trade acceptances by interest rates close to the base rate. More than half of the funds extended to commercial banks by BNB in 1993 are on the Lombard and the discount credits. Regardless of the substantial progress made in the refinancing field with the slack secondary market of securities these credit forms still bear the character of direct central bank crediting. The use of the more sophisticated methods of refinancing, however, allowed the BNB to operate in the open market, where selling and purchasing securities at this stage it is able to influence through market means the dropping or rising liquidity levels.

FOREIGN CURRENCY POLICY

In the area of foreign currency policy BNB was after three major things since the beginning of the reform: to maintain the nominal foreign currency rates relatively stable; to prevent and settle down the fluctuations of the foreign currency rate levels; to increase the foreign currency reserves. The price liberalization starting off it went parallel with the liberalization of the foreign currency exchange mechanisms and the free foreign currency market came into existence based on the free (floating) exchange rates of the national currency to the major convertible currencies - the US dollar, the German mark and the Swiss frank. The average sell and buy market rates during a certain day serve as basis to form the BNB fixings (central rates) for the following day respectively. Bulgaria is the only former socialist country to introduce manipulated floating rates of its national currency to the major convertible currencies to date. These last three years experience proved that was a good solution under the conditions given of lacking serious foreign currency reserves and missing other stable mechanisms to control the foreign exchange rates. It •was shocking originally - the foreign currency market was liberalized February the 20th 1991 - and the lev shortly cheapened down to levels of over 28 leva for 1$ (compare the 2.8 leva/$ on the 1st of February). The rate was later stabilized, however, in terms of its dynamics and went relatively smooth until the last months of 1993. The nominal foreign currency rates were maintained relatively stable, and this is attributed both to the rise of the positive netting of the trade balance realized for the period and to the intervening central bank. The bank itself attempted to gag the speculative intentions and the market fluctuations, and at the same time to build up the country's foreign currency reserves. Up to mid-1993 BNB even periodically released public the figures of its interventions -this itself being a taboo for many a central banks. The late 1993 and early 1994 saw serious anxiety on the foreign currency market in the country with the record exchange rates being broken more than once. A variety of factors lie behind the devaluation of the national currency but a couple of them are fundamental. Special place among these is reserved for the drastic deterioration of the current account parameters of the payments balance for the last quarter of 1993 and the low foreign currency reserves levels because of the upcoming external debt payments.

BANK SUPERVISION

Bank supervision is among the prime functions of the central bank under the new conditions of transition from planned to market economy. In our circumstances of shortage of trained staff, methods and material provision the Bulgarian legislators decided this kind of activities to be performed by the BNB, regardless of the precedent cases in other countries an independent of the central bank state institution to do the job. Bank supervision has set as its purpose to create the necessary preconditions for the emerging and the proper functioning of the different units of the finance and credit system. The BNB Law authorized the central bank to enact "the regulation and control over the activities of the commercial banks in view of maintaining the stability of the banking system". Three major groups of activities fall under the heading of bank supervision. These go as follows: the creation of normative basis adequate to the reform; the licensing of new banks and non-bank financial institutions and the controlling of their activities.

The primary task of the BNB in the bank supervision field at the earliest stage of the reform was the timely passing of systematic acts to supplement the existing laws and thus regulate the emergence, the activities and the control over the new participants in the financial market. In shortest possible terms the central bank developed and its governing board passed the following major legislative acts: Regulation concerning Licensing for Bank Activities; Capital Adequacy Regulation; Large and Public

Credits Regulation; Regulation concerning Asset Classification and Provision; Liquidity Regulation; Internal Control Regulation. These served as the new legislative basis for BNB to both regulate the expansion processes in the banking sector and also ensure its stability. In 1990 no less than 70 commercial banks were already in existence. A considerable number of them were founded in the course of the preceding year as based on former branches of the BNB around the country. Most banks of this kind held low sizes of owned assets - from 7 to 10 min leva; were run by staff with low qualifications; and suffered the poor financial conditions to do with the bulks of residual bad credits. All these characteristics come together to make up only strongly unreliable banking institutions. So BNB had to raise the issue of capital adequacy in terms of new normative acts needed and required a higher amount of 200 min leva owned capital to grant the banking license for operating within the country and of 500 min leva for operating abroad as well. The already existing banks were given deadlines to either increase their owned capital or participate in the consolidation process. This process itself was aimed at the optimization of the banks with more than 50 per cent state participation. The criteria having been set for the volume of capital, the prime creditation activities and the proper human resource specific consolidation projects were carried out to bring together 50 small into 5 big universal commercial banks adequately meeting the modern requirements for structure and quality of banking. During years 1991 to 1993 another 18 commercial banks were licensed by BNB (most of which with prevalent private or foreign capital participation) and so were more than 2,000 non-bank financial institutions like financial brokerage and investment houses, bureaux d'exchange and brokers. The above developments gave impetus to competition and made the monetary and foreign currency markets work most possibly efficiently. To take precautions against the abuse of small deposit assets and to guarantee the stable banking system BNB launched a series of direct control and auditing activities to investigate the hard cases of neglecting basic normative requirements. The bank supervision focused emphatically on direct auditing and more particularly on the impaired liquidity due to granting over-normative credits. The activities of the foreign exchange offices and the financial brokerage houses were also subject to control and auditing. Considerable violations were found in the activities of the bureaux d'exchange in the first half of year 1994. This led to some 700 of them being made to terminate their activities as denied licensing rights. The BNB imposed administrative sanctions on a limited number of banks, too, who were reportedly breaking the central bank's regulations as bank supervision demonstrated. In spite of the pronounced inexperience and the traditions missing in the performing of this kind of activities time passing the bank supervision proves more and more helpful in guaranteeing the stability of the banking sector and building up the public confidence in the financial and credit institutions in the country.

The economic reform in Bulgaria started off to find an upset and fragmentary banking system. For the last three years of unfolding changes the BNB has set it as its goal and more or less has managed to attain certain financial and institutional stability. The process of stabilization turns out to be fundamentally dependent on the fact that BNB resumed its functions as the independent banking institution to effect the state policies in the sector of finance and credit. By the adoption of the modem normative basis and the high licensing criteria for the new participants in the interbank market the central bank has produced a well-developed structure for the system of finance and credit, which in its turn acts as important catalyst to the processes of transition to market economy. This is definitely the direction BNB puts efforts into through blending direct and indirect monetary policy instruments to maintain a stable lev and control the inflation in the country. At the same time the changes in the central bank rely substantially on the progress of the reform in general. The delay of the privatization processes and the high budget deficit will in the short run fundamentally interfere with the BNB's attempts to follow a more efficient stabilization policy.