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# BULGARIA: READING BETWEEN THE LINES OF THE BANKING SYSTEM ASSESSMENT

The Bulgarian National Bank (**BNB**) released the results of the banking system overview, which was initiated earlier this year. Pursuant to the report of the national regulator on the outcome of the asset quality review (**AQR**) and the stress tests, that was announced recently (**Report**), the domestic banking sector successfully passed this, first-of-its-kind, system–wide assessment. The tests in Bulgaria were extended throughout all 22 locally licensed banks, with the exception of the 6 branches of foreign banks operating in the country. As a result, the domestic exercise had a broader scope than its Eurozone counterpart, which only covered the banking institutions of systematic importance.

## FINDINGS

The local process combined an AQR, on the basis of ECB's methodology, followed by stress tests of the evaluated market players. The interpretation of the AQR results are that there are indications of a well-capitalized banking system and that the capital ratio is substantially above the regulatory minimum[1]. The same applies to the individual institutions with the exception of 2 banks with domestic shareholding which are close to the red zone. The results of the subsequent stress tests were further assessed as reconfirming the strong capital position of the sector and its resilience to shocks. Following the stress tests some banks shall be required to maintain the existing capital reserves, while others shall aim to restore this coverage and build capital, taking into account the adjustments of the assets triggered by the AQR.

## CRYSTALIZED NPLs

The AQR revealed that corrections to the bank assets will be required mainly due to reclassification into NPLs of performing exposures at the total value of approx. EUR 1.8 billion. Therefore, the affected banks will be required to set aside additional capital provisions. This could unlock the market for transactions with bad loans as the affected institutions will try to clean-up certain parts of their balance sheets. Acceleration might be expected specifically for the corporate NPLs. They represent the bigger proportion of the reclassified debts and reflect the hold-and-wait strategy of some of the local banks, which were reluctant to recognize bad corporate loans and respectively to dispose of them.

## DELAYED EFFECT

The Report announced that supervisory measures over the banks were imposed following the overview and they do not reveal any specific negative consequences. With regard to the AQR's results, the measures vary from recommendations on

[1] The Report indicates that the CET1 capital ratio of the Bulgarian banks is 18.9%, which is well above the 4.5% minimum required pursuant to the European Capital Requirements Regulation.

enhancing certain policies and operational rules to requirements for taking particular actions to decrease NPLs exposure. The required corrections to the assets need to be reflected in the banks' financial statements as of 31 December 2016. The banks will have to cope with the lighter measures, in terms of procedural improvement, by the end of the year, while for the reduction of the NPLs they have a window until 30 June 2017. Those that are expected to divest assets, including First Investment Bank and Investbank, will be subject to increased supervision, meaning additional on-site inspections and reporting. The institutions that appeared vulnerable following the stress tests might, at a later stage, be subject to limitations on dividend distributions or requirements for additional capital buffers. If these appear insufficient, the implementation of additional restrictions might be requested by the end of 2017. The announced supervisory measures are subject to immediate execution and cannot be appealed. Taking into account the grace periods envisaged for getting in compliance with the prescriptions, the final effect over the individual players is still to be seen. This may further hasten the banking consolidation if the corrections prove to be challenging for being managed by own funds and combined with out–of the country drivers such as the economic adjustment programme for Greece, may increase the M&A activity in the sector.

## LEGACY ISSUES

The overview was initiated following the implementation of the European regime dealing with preventions of the banking crises and limiting rescues of failing institutions by public funds. Along with the goals for EU harmonization, it aimed to clear up some domestic legacy issues around questionable transparency in the finance sector. On the contrary to what was expected, the Report does not disclose sanctions under the new recovery and resolution framework. By virtue of law such intervention can be imposed separately and independently to the announced supervisory consequences. The discretion for applying the new regime is again with BNB, this time acting in its capacity of the local restructuring authority. Unlike the supervisory requirements announced in the Report, the potential restrictions under the special regulation are subject to appeal by all persons with legal interest. Yet, as the practice of the Supreme Court demonstrated in the case of Corporate Commercial Bank, the right of appeal can be severely restricted, effectively barring creditors and shareholders from challenging unfavorable decisions. The refraining from specific intervention steps reassures the opinion of BNB on the overall stability of the banking sector.

The full text of the report of the Bulgarian National Bank is accessible here: http://www.bnb.bg/PressOffice/POPressReleases/POPRDate/PR_20160813_EN

*Sources used: BNB*

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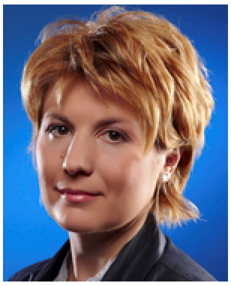

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