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FINANCIAL SECTOR ASSESSMENT

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FINANCE AND MARKETS GLOBAL PRACTICE
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An IMF and a World Bank team visited Bulgaria in October 2016 and January 2017 to conduct an assessment under the Financial Sector Assessment Program (FSAP).[1]

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GLOSSARY

AQR	Asset quality review
BCP	Basel Core Principles
BDIF	Bulgarian Deposit Insurance Fund
BNB	Bulgarian National Bank
BRRD	Bank Recovery and Resolution Directive
BSD	BNB Bank Supervision Department
CAEL & CAMELOS	BNB supervisory risk rating system
CBA	Currency Board Arrangement
CET1	Basel capital measure – Common Equity Tier 1
DGS	Deputy Governor for Supervision
EBA	European Banking Authority
ELA	Emergency Liquidity Assistance
ESRB	European Systemic Risk Board
EWS	Early warning system
FSAC	Financial Stability Advisory Committee
FSAP	Financial Sector Assessment Program
FSC	Financial Supervision Commission
GC	Governing Council
GDP	Gross Domestic Product
IADI	International Association of Deposit Insurers
IAS	International Accounting Standards of the IASB
IASB	International Accounting Standards Board
IFRS	International Financial Reporting Standards of the IASB
MOF	Ministry of Finance
MOU	Memorandum of Understanding
NBFI	Nonbank Financial Institution
NPLs	Nonperforming Loans (used interchangeably with distressed assets)
SB	Supervisory Board
SPM	Supervisory Process Manual
SREP	Supervisory Review and Evaluation Process
ST	Stress test
TN	Technical Note

OVERALL ASSESSMENT AND MAIN RECOMMENDATIONS

The authorities have actively pursued restoring credibility in the financial system following the collapse of the system's fourth largest bank in 2014. The failure, due to fraud and insider abuse, raised questions about the viability of other banks and raised concerns about the supervision by the Bulgarian National Bank (BNB). To restore credibility, the authorities—in addition to requesting a Basel Core Principles (BCP) assessment in 2015 and this FSAP—conducted an asset quality review (AQR) for banks and balance sheet review for non-banks, initiated reforms to BNB supervision and introduced a new bank resolution function. Since 2014, the financial system has stabilized, reflecting significant capital and liquidity buffers. The authorities should increasingly concentrate on reforms to further develop the financial system, alongside safeguarding its stability.

It is important that the authorities continue in their efforts to strengthen the banking sector. The authorities' AQR/stress test exercise in 2016 identified weaker capital buffers in three banks. The FSAP stress test showed more pronounced effects, though broadly in line with that of the authorities, reflecting differences in approaches. For the AQR identified banks, it is important to undertake prompt BNB action if bank commitments are not met, and prioritize recovery and resolution plans as part of a broader contingency planning. In addition, work remains towards strengthening supervision since the 2015 BCP assessment. This includes strategic decisions to be made by the BNB Governing Council on prudential policy objectives, the escalation of supervisory action, and early intervention measures; further resources for the Bank Supervision Department; objective benchmarks for risk indicators and recalibration of rating schemes; and, formalization of the Supervisory Review and Evaluation Process. On the corporate governance front, the BNB should *inter alia* take measures to enhance the role of the Supervisory Board and independence of internal audit, review the process of approval of related-party exposures, and develop new operational manuals to improve supervision of corporate governance. Finally, while the financial safety net and crisis management arrangements are based on sound foundations, further effort is needed to fully develop the financial safety net's components. This includes strengthening the early intervention framework, and defining joint BNB-Ministry of Finance (MoF) strategies for liquidity assistance.

A more targeted strategy is needed to address high nonperforming loans (NPLs), which could help reinvigorate the economy. The BNB's macroprudential mandate could be extended to introduce supervisory review approaches to exhort more robust provisioning, NPL accounting write-offs, and improved collateral valuation practices. The BNB should also work with other national authorities, the banking industry, and investors to improve the market for NPLs and collateral enforcement.

A number of reforms are necessary to support the prudent development of the pension and insurance sector. The Financial Supervision Act should be amended to improve the Financial Supervision Commission's (FSC) independence and effectiveness. FSC should expand and equip the insurance supervision team charged with the implementation of Solvency II, and FSC supervisory activities need to be more efficient and risk focused. The authorities could also consider, over time, ways to help the insurance industry diversify its risks and to improve the yield of private pension funds.

Table 1. Bulgaria 2017 FSAP– Key Recommendations and Time Frame

Recommendation	Time[2]
Financial Sector Oversight and Regulation	
Ensure adequate staffing and resources of all financial oversight authorities and arrange significant training and capacity building for staff (MoF, BNB, BDIF, FSC, ¶22, ¶26, ¶35, ¶61).	NT
Strengthen the legal and operational framework for legal protection for current and former staff of all financial oversight authorities (MoF, BNB, FSC, BDIF, ¶33, ¶61).	NT
Banking Sector Supervision and Regulation	
Adopt a multi-year Action Plan with detailed activities to continue strengthening BSD (BNB, ¶17).	NT
Implement a comprehensive supervisory strategy for the target banks under the AQR (BNB, ¶24).	I
Introduce regulation (based on Article 45) on related parties setting criteria to typify circumvention (e.g., including the inability to identify ultimate beneficial owner, inter-alia) (BNB, ¶21).	I
Based on 2017 inspections, enforce remedies to concentration and related party risks (BNB, ¶24).	NT
Banking Sector Corporate Governance	
Enhance the role of the SB by: (i) stricter definition of independent SB members; (ii) majority of independent SB directors; and (iii) elevating the audit committee function to an SB level (BNB, ¶29).	NT
Review the process of approval of related-party exposures and other large exposures by requiring SB monitoring of these transactions (BNB, ¶29).	I
Review the appointment process of the head of internal audit to ensure that it is appointed by and reports to the SB (or to the audit committee, if it becomes a subcommittee of the SB) (BNB, ¶30).	NT
Develop new operations manuals to improve supervision of CG by the BNB to allow a segregated analysis and rating of key functions (management, SB, int. controls, risk and ownership) (BNB, ¶32).	I
Insurance and Pensions Supervision and Regulation	
Amend FSC Act to improve FSC's independence, effectiveness, and transparency (FSC, MoF, ¶33-34).	NT
Expand and equip the insurance supervision team charged with Solvency II implementation (FSC, ¶36).	I
Review the methodology employed by the FSC for both offsite and onsite reviews to improve efficiency, remove duplication, and to make it more risk-based (FSC, ¶40-41).	I
Arrange for thematic onsite reviews of all the general insurers focusing on premium pricing, and of the market conduct of insurance intermediaries (FSC, ¶44-45).	I
Nonperforming Loans Oversight and Strategy	
Implement a comprehensive strategy for NPL reduction, including the use of supervisory review tools. The strategy should enforce (i) robust provisioning in 2017 (under IAS 39) and in 2018 (under IFRS 9), building on BCBS efforts and related supervisory guidance; (ii) oblige write-offs of NPLs where collection is unlikely; (iii) issue supervisory guidance setting out minimum requirements for EWS, and minimum collateral valuation practices; and (iv) enhance supervisory reporting and disclosure (BNB, ¶52-56).	I
The BNB should work with other national authorities, the banking industry and investors to improve the NPL market and remove existing impediments (BNB, MoJ, ¶57).	NT
Financial Safety Net and Crisis Management	
Prioritize RRP for (1) the banks for which the 2016 AQR and stress test indicated capital shortfalls, and (2) the majority domestically owned D-SIBs (BNB, ¶61).	I
Ensure a smooth and decisive transition from early intervention into resolution (BNB, ¶61).	NT
Consistent with the CBA, define joint BNB-MoF strategies for liquidity assistance to banks, supported by a comprehensive toolkit (BNB, MoF, ¶61).	I
Under the oversight of the FSAC with an expanded mandate and membership, strengthen the crisis management framework (FSAC, MoF, BNB, FSC, BDIF, ¶61).	NT

[2] Immediately (I) is within one year, near term (NT) is 1–3 years.

I. MACROFINANCIAL SETTING

A. Macroeconomic Developments

1. **The economy has been resilient to shocks in recent years.** It weathered the global and Euro-area financial crises, spillovers from the Greek crisis in 2015, and the failure of a large domestically owned bank in 2014. The GDP grew by 3.4 percent in 2016; unemployment has gradually declined, although it remains high; and the current account has turned into (a sizable) surplus in 2016. The fiscal balance improved significantly in 2016, and public debt is still among the lowest in Europe, despite increases in recent years. Nonfinancial corporate sector debt remains high, although a significant share consists of intra-company debt. The Currency Board Arrangement (CBA) has generally anchored macroeconomic stability. Though the CBA has added to liquidity risk in times of financial system stress, this has proved manageable.

B. Financial System Structure and Developments

2. **Bulgaria's financial system is bank dominated, with an important presence of subsidiaries and branches of foreign banks (see Annex I).** Financial system assets amount to 115 percent of GDP and the banking sector assets amount to 102 percent of GDP. There are 27 banks, of which 13 are subsidiaries and 5 are branches of foreign banks. Foreign-bank presence accounts for 74 percent of total bank assets as of June 2016. There are nine domestically owned banks, with a combined bank asset share of 23 percent (including the third largest bank). Included among the nine banks are one state-owned bank and one municipality-owned bank that, together, represent just 3 percent of total bank assets. The top five banks represent 59 percent of total bank assets.

3. **Some banks experienced liquidity outflows following the 2014 collapse of a systemic bank, which was taken into conservatorship and later closed by the BNB.** As liquidity pressures threatened to spread, the authorities announced urgent measures to regain stability. Liquidity assistance was provided by the government with the EC's approval, as the BNB's capacity to provide lender-of-last-resort liquidity was constrained by the CBA.[3] Though the

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[3] The BNB does not have a liquidity window. The legal framework prohibits it from intervening in the money markets and extending credit to banks, except upon emergence of a liquidity risk that may affect the stability of the banking system. The BNB may extend emergency liquidity assistance only to solvent banks; in lev; with a maturity no longer than three months; and up to the amount of excess of gross international reserves. The assistance must be

program was available to all banks, the only user of liquidity support was the largest domestically-owned bank (the third largest in the system at the time), which lost 10 percent of its deposits in a single day. The BNB revoked the bank's license in November 2014. Its depositors were subsequently reimbursed by the Bulgaria Deposit Insurance Fund (BDIF), which needed to draw on official support.

4. **System-wide banking sector soundness indicators have improved since 2014.** Tier 1 and total capital adequacy ratios were high at 21.2 percent and 22.7 percent, respectively, as of June 2016. The liquid asset ratio steadily increased to 37 percent in 2015 from 26 percent in 2014, then slightly decreased to 31 percent by mid-2016. Overall, banks remain profitable with Return on Assets (RoA) reaching 1.8 percent in Q2 2016. There was a sharp but unevenly distributed increase in banks' profits in the first half of 2016, driven by reduced operational and provisioning expenses and an increase in non-recurring items. Overall, the banking sector remains relative heterogeneous with some banks performing poorly compared to the average.

5. **The AQR and stress test exercises completed in August 2016 confirmed a well-capitalized system overall, but indicated capital shortfalls in three banks.** The three banks represented 12 percent of total banking system assets. The AQR exercise provided a deep assessment of bank impairment practices, loan data quality, and valuation processes. It resulted in adjustments to banks' corporate portfolios due to reclassification of EUR1.9 billion of exposure as nonperforming loans and adjustments to loan-loss provisions. Corrections and capital shortfalls most affected three domestically-owned banks (one is systemic). The systemically important bank needed to build capital of around EUR105 million. The capital shortfalls for two smaller domestic banks, amounted to EUR19 million. The smallest of the three banks has already raised capital through the conversion of debt into equity. For the two others, including one systemic bank, bank owners and managers are working to implement recovery plans, including the raising of additional capital, subject to formal BNB oversight. The authorities aimed to have the banks achieve the capital targets by mid-2017.

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fully collateralized by highly liquid assets (including gold and foreign currency). Given these limitations, the BNB has taken conservative macroprudential measures to mitigate systemic liquidity risks. The main tool to manage liquidity is the minimum required reserve. The BNB has the mandate to set (i) the required; (ii) the remuneration on the excess of the RR; and (iii) the consequences of failing to meet the requirements. In addition, relative to the euro area, the BNB requires banks to have higher minimum liquid asset ratios based on expected maturities of assets and liabilities per specified time bands. The BNB can also set minimum liquidity and reserve requirements for individual banks.

6. **Credit growth has been subdued and the NPL levels are high.** The banking system is deposit funded (83 percent of liabilities) and assets are dominated by lending, with 51 percent of loans denominated in foreign currency (predominantly in euros). The sector is relatively under-leveraged (loan-to-deposit ratio), and lending to the corporate sector has stagnated - although the flow of loans has been gaining strength more recently. Based on the BNB's measure, the NPL level at end-June 2016 was 19.7 percent of loans. Using the EBA's NPL measure, Bulgaria's banks had NPLs of 13.7 percent.

C. Nonbank Financial Institutions Context

7. **The Nonbank Financial Institution (NBFI) sector is relatively small.** The insurance industry is small and dominated by subsidiaries of foreign firms. The industry has been growing slowly over the last five years, with assets reaching 4.3 percent of GDP as of June 2016. There are 44 companies operating in the market, which is high, given the low level of premiums. The main risks written in the non-life insurance market are Motor Third-Party Liability (MTPL) and Casualty and Collision (CASCO). The most favored distribution channel is through brokers. There are over 400 brokers operating, which is also high for the size of the market. The capital markets remain relatively underdeveloped. Market capitalization of the Bulgarian Stock Exchange was around 10 percent of GDP at end-2015. There were 350 equities traded in the two-tier system. The trading volume is low at EUR1 million per day and price discovery is somewhat problematic.

8. **The pension system is a traditional three-pillar system.** The pension system assets amounted to 11 percent of GDP as of June 2016. Pillar I, administered by the National Social Security Institute, is an earnings-related pay-as-you-go scheme, with 2.8 million contributors and 2.2 million pensioners. The government provides significant support for the payment of pensions—it is estimated that the government contribution is approximately 50 percent of the pensions paid. The government has made a number of parametric changes that will be phased in over the next decade. The rationale for these is changes in the demographics of Bulgaria, with a declining workforce, fertility rates below the replacement rate, and significant increases in the longevity for both men and women. Given the magnitude of the expected demographic changes, it would be prudent for the government to have an independent review of its projections of the sustainability of Pillar I. There are two types of funds in Pillar II—professional funds for workers in higher risk occupations and universal funds for other workers in the formal sector. In 2015, the authorities introduced the possibility of annual shifts between the Pillar II private pension funds and the Pillar I pension fund. While this possibility may improve the funding of the first pillar in the short run, it has the potential to reduce future pensions for contributors,

increase the liabilities of the public system in the longer run, and reduce the diversification of the retirement income streams for contributors. There are 11 voluntary funds with 600,000 members and BGN 850 billion in funds under management.

9. **The FSC has undertaken a balance sheet review and stress test exercise relating to both the insurance and pension sectors.** The project was carried out under the guidance of a Steering Committee comprising representatives from the FSC and European Insurance and Occupational Pensions Authority (EIOPA) as voting members, as well as representatives from the Ministry of Finance (MoF), the BNB, European Commission, and European Securities and Markets Authority (ESMA) as observers and advisers. The review examined all 18 Pillar II funds and 9 Pillar III funds on the pensions side with the total sample representing over 93% of the assets of the funds. The review concluded that the assets were available and held by custodians as required by the law. Investments complied with the regulatory requirements, as did transactions with related parties. The results indicated sustainability of the supplementary pension insurance sector. Some minor adjustments, amounting to BGN 33 mln or 0.3% of the assets reviewed, were recommended. On the insurance sector, the review concluded that 13 insurers had insufficient capital to cover the Minimum Capital Requirement or Solvency Capital Requirement as at end-June2016. The aggregate deficiencies were not large compared with the total capital of the insurers, the total amount of the MCR deficit being BGN 25 million, and the total amount of the SCR deficit being BGN 50 million. Subsequently, from the 13 companies, 7 insurers have already undertaken the necessary actions to increase their own funds to the required level.

II. Stability Risks and Resilience

A. Key Risks and Vulnerabilities

10. **The banking system is characterized by significant capital buffers in the aggregate and generates steady profits, but remains vulnerable to shocks.** The main vulnerabilities of banks are high NPLs, concentrated exposures in several banks, and relatively high corporate sector indebtedness. Despite strong economic growth recently, the NPL ratio remains persistently high with most NPLs consisting of loans that are over one year past due. Loan portfolio concentration, including to related parties in some domestic banks, could potentially pose a risk, and there is a need to analyze and stress test large individual exposures separately.

11. **There are several risks that, if realized, would have the potential to have significant impact on the banking system** (Annex II). These include: (i) protracted slowdown of European

growth; (ii) change of investor sentiment toward emerging markets resulting in financial stress; (iii) increasing geopolitical tensions related to countries in the region; and, (iv) asset price uncertainty over NPLs.

B. Stability Analysis[4]

Bank solvency stress tests

12. **Resilience of the banking system was assessed through "top-down" stress tests.** The analysis covered the 17 largest banks in Bulgaria, accounting for 95 percent of industry assets. Stress tests utilized supervisory data on balance sheets as of June 2016, and were based on macroeconomic scenarios consisting of a "baseline" and a severe but plausible "adverse" scenario spanning a three-year period (June 2016 to June 2019). The baseline scenario is based on the October 2016 World Economic Outlook projections, while the adverse scenario assumes a V-shaped GDP profile, with a combination of declining external demand and investor confidence, and asset price uncertainty over NPLs. These developments result in a cumulative deviation of approximately 12 percentage points over two years from the baseline scenario. These numbers correspond to approximately 2 times the standard deviation of the two-year cumulative growth rates observed during the 2006–2015 period. Under this adverse scenario, banks are likely to experience significant deterioration in their credit portfolios. The banking system's average NPL ratio increases by approximately 8 percentage points between the 2016Q2 and 2019Q2, with corporate and mortgage loans experiencing the highest increases compared to their starting points.[5]

13. **Stress test results suggest system-wide bank capital would show resilience in the adverse scenario, with weaknesses in some banks.** On a system-wide basis, the aggregate CET1 ratio falls to around 15 percent by the end of the stress period (June 2019) which is significantly higher than the regulatory minimum of 4.5 percent. Similarly, the system-wide leverage ratio falls from 11 percent to 8 percent, and remains comfortably above the 3 percent level. However, the bank-level results show that five banks will fall below the regulatory minimum CET1 ratio of 4.5 percent, as well as below the referenced 3 percent leverage ratio. The capital shortfall in the third year of the simulation scenario period would amount to 1.8

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[4] For additional details, see the Fund's FSSA and the "Technical Note on Risk Assessment and Stress Tests of the Banking System."

[5] See the associated technical note: Bulgaria—Risk Assessment and Stress Tests of the Banking System.

percent of the annualized GDP. Although this is a modest number, of the five banks falling below the regulatory minimum at the end of the simulation period, three become technically insolvent.

Bank liquidity stress tests

14. **The FSAP team assessed risks due to the potential volatility that banks' funding sources might display.** For this purpose, the FSAP team used three methods to capture liquidity risks: liquidity coverage ratio (LCR), the net stable funding ratio (NSFR), and a cashflow-based liquidity stress test.

15. **Stress tests confirm the general strength in bank liquidity, with vulnerabilities limited to a few banks.** The stress test suggests that most banks had enough buffers to withstand a significant shortage of liquidity in the short term. For the system, the liquidity coverage ratio (LCR) remained above the 100 percent threshold, even in the extreme scenario with only one bank performing below standard. The system-level net stable funding ratio (NSFR) level drops to 125.2 percent, which is well above the 100 percent standard; however, three banks underperform with a shortfall of 1.2 percent of GDP at the extreme scenario of 50 percent of less stable deposits outflow. The third stress test was performed using the temporal structure of cashflows generated by different liabilities and banks' assets. The results indicated that vulnerabilities were limited to a few banks. Three banks could be vulnerable to cash outflows in the very short term (7 days) with a combined shortfall of 0.7 percent of GDP. Only one bank may be vulnerable in the longer term (90 days), with a shortfall of 0.5 percent of GDP. No bank would be vulnerable within a one-year time horizon.

Connectedness tests

16. **Spillover risks from banking system exposures are minimal**. Local banks are funded mostly by domestic deposits and do not depend on significant foreign or wholesale funding. Similarly, foreign-owned banks' reliance on parents for funding is minimal, i.e., they are predominantly funded by domestic deposits. Interbank borrowing activity is limited and the Bulgarian banking system displays little vulnerability to direct (balance sheet-based) spillovers. Nevertheless, a loss of confidence might affect the banking system via indirect channels of deposit withdrawals as was experienced during the 2014 bank collapse.

III. BANKING SECTOR OVERSIGHT AND RISK MITIGATION

A. Microprudential Oversight

17. **There is progress in response to the recommendation of the 2015 Basel Core Principles (BCP) Assessment**. The BNB has endorsed and is implementing a plan through a series of multi-year actions that aims to address the issues identified by the 2015 BCP report.[6] The FSAP sets out some further enhancements to specify activities, timeline, expected products, and outcomes from their use. The prioritization of the 2016 AQR and stress test exercise put heavy pressure on limited supervisory resources and delayed the implementation of some planned BCP recommendations. Nevertheless, a set of new policies, manuals, and ordinances are expected later in 2017-early 2018. There is, however, still room to further enhance the governance model of supervision, risk-assessment practices, and the response to the risk accumulation; notably, regarding local risks. Assessing the needs and allocating reasonable incremental supervisory resources is crucial, including the provision of tools to support and manage the risk-assessment process.

18. **A new BNB governance model is in place which aims to enhance the effectiveness of supervision.** As part of the reforms initiated in 2015, the Banking Supervision Department (BSD)'s activities will be governed by new formal policies, which will be adopted by the Governing Council (GC) based on the guidelines of EBA/GL/2014/13. The GC is now better informed on banking risks and the progress made in addressing them through a new quarterly report. The BSD is also subject to an annual internal audit. The decision-making process for supervision is streamlined with a more active role assigned to the Advisory Council (AC) in advising the deputy governor in charge of supervision (DGS). Under the new arrangement, the AC provides a collective opinion on supervisory matters, including on enforcement, so that the DGS can take informed decisions. It is noteworthy that the DGS remains, by law, the sole authority responsible for supervision, except for the GC's authority to grant and withdraw licenses, and to introduce special supervision measures. The FSAP supports the governance arrangement now in place, but there is a need to reinforce accountability to ensure prompt and effective risk response.

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[6] See the associated Technical Note "Stocktaking of Progress Achieved in Strengthening Banking Supervision" includes a further table of recommendation with suggestions on the action plan.

19. **The BNB needs to improve accountability and effectiveness by addressing three key areas.** First, there is the need to formalize a strategy on how to achieve the BNB's mandate by further detailing a set of prudential policy objectives (the objectives should set out an action plan, accountability framework—including completion of manuals, and the SREP and pillar 2 capital approaches, and response procedures to ensure early remediation of risk).Second, there is the need to adopt by the GC an explicit framework and procedures to enable an assessment of delivery on the selected policy objectives (See the Basel Committee's Report recommendations on the impact and accountability of banking supervision). Lastly, there is the need to adopt formal policies regarding the conditions under which the GC and the DGS will escalate their response and intervention measures, including specifying the severity of enforcement actions.

20. **To strengthen the BSD's reliability, the GC should adopt a strategic tool to promote the effectiveness of the risk-assessment process and the policy response adopted.** First, a process should be put in place to align the risk tolerance of the GC and the response and escalation stance of the BNB. This could be achieved, for example, by adopting a method to combine the risk profile and the systemic impact of each institution. This method may be used to guide the supervisory response and escalation stance expected ex ante from the BSD. In parallel, the combined effectiveness of the GC and the BSD should be assessed ex post by the success of their response strategies in containing or resolving the risks that have been assessed (per institution, risk, or across the industry).

21. **The reinforcement of the organization and resources of the BSD is also underway.** A new Offsite Directorate has been established and segregated from the Onsite Inspection Department. Inspection teams have increased to six. A new Analysis of Market Behavior and Risk Division has been created to permit greater focus on AML/CFT issues. Cooperation and information sharing with key domestic partners has been improved by signing three new Memoranda of Understanding. New staff has been recruited, although the desired levels are yet to be reached. The BNB has recently launched an external assessment of the adequacy of its IT systems, both for banking supervision and failing bank resolution activities. Moreover, key ordinances await drafting to adopt EBA standards, which are soon to be published, such as the development through regulations of the LCI Article 45 on related-party transactions (e.g., use of targeted reviews of suspect loans, and specific policy setting out controls, registers, and record

keeping), including the revision of the supervisory processes and their supporting manuals, which are already under review.[7]

22. **The BSD's capacity to meet the expectations of the GC and the DGS should, however, be reinforced, considering its engagement model.** The intensity of the BSD's activities and its annual operational objectives should be reviewed, considering the changes in the governance model and the objectives endorsed by the GC and the DGS. Once the engagement model and the activities through the supervisory cycle are determined, a reasonable estimation of the workload and available skills set and needs (i.e., number of staff and specialists) will be necessary to continue the initiated recruitment plan. In addition, the BSD will need to implement an appropriate curriculum and training program, and to adopt an attractive remuneration system. In search of effectiveness and efficiency synergies, the BNB should consider providing to the BSD more modern software tools. This would support a more integrated, efficient, and auditable risk assessment and response process, aligned to and consistent with the risk tolerance of the GC.

23. **Besides amending the Banking Supervisory Process Manual to support the new governance model, work has already begun to update several key procedures.** The process and procedures for onsite inspections are being reviewed with the aim to become a handbook for supervision by risk, and which would be better aligned to the EBA's standards. Nevertheless, there is need to recalibrate the current risk-assessment methodology by developing key benchmark risk indicators, and by setting up more granular criteria and control points for guiding consistently the assessment of central functions which are essential to internal governance. There should be means to coordinate the offsite and onsite risk assessments (CAEL and CAMELOS) for a combined rating, leading to an explicit response and escalation policy that is clearly related to the early intervention, and recovery and resolution planning policies and practices. Moreover, there is need to formalize a comprehensive Supervisory and Review and Evaluation Process (SREP) that would include an explicit and detailed supervisory Pillar 2 capital requirement as the BNB Act empowers the BNB to impose Pillar 2 capital requirements, including adequate ways to factor in concentration and untreated hidden risks, rendering the current practices fully consistent and compliant with the standards promoted by the EBA in EBA/GL/2014/13.

[7] See Appendix III to the associated TN.

24. **The BSD intends to use its 2017 supervisory plan of activities to follow up on the outcomes of the 2016 AQR and banks' progress in complying with its requirements.** The Onsite Inspection Directorate has already adopted a plan of inspections to probe progress, with set targets for relevant banks. This appears to follow a reasonable risk scope, including on concentration and related-party risks. The Offsite Inspection Directorate is also monitoring required targets through more frequent ad hoc reporting requirements per the orders delivered to the banks. To support the work of these two directorates, the Policy Directorate is strengthening its tools to profile interconnections and relationships, and is considering the most feasible alternatives to adopt the suggestions of the FSAP mission. Key to the enforcement of the required targets (in particular, for the three banks with capital shortfalls) will be (i) higher loan loss provisions and NPL write-offs (i.e., implementation of the NPL strategy); and (ii) a well-calibrated Pillar 2 capital add-on requirement, including by the adoption of more demanding standards than those of the forthcoming EBA standards.

B. Macroprudential Policy Framework

25. **In the absence of independent monetary policy, the BNB actively applies macroprudential tools to address systemic risk.**[8] In the context of a booming economy during 2001–2008, the BNB implemented measures aimed at curbing rapid credit growth. Higher reserve requirements (RR) were used extensively, differentiated by sources of funding. Most measures aimed to exhort the banks to be more conservative in their lending (e.g., through lower loan-to-value ratios, stricter lending requirements), and to maintain higher capital (e.g., limiting dividends if capital and provisioning buffers are not sufficient, and asset quality indicators are not adequate). More recently, macroprudential measures helped contain spillovers from Greece caused by Greek bank subsidiaries. In 2014, the Law on Credit Institutions was amended to give the BNB a clear macroprudential mandate and well-defined objective. The macroprudential framework operationalizes recommendations put forth by the European Systemic Risk Board (ESRB) where applicable, and is designed to be in line with other EU frameworks.

26. **The BNB has adequate powers, but more resources are needed to enhance its ability to act.** The Law on Credit Institutions provides the BNB with adequate powers and access to information, and designates individual institutions as systematically important.

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[8] Responsibilities for macroprudential policy are split. The BNB is the designated macroprudential authority for banks and the FSC for nonbanks. The Financial Stability Advisory Council (FSAC) is an advisory committee that brings together the two macroprudential authorities and the Ministry of Finance (Chair).

However, tailored design and timely identification and assessment of systemic risks may require additional efforts and resources to close data gaps and develop techniques for monitoring systemic risk. Transparency and accountability could also be improved. A clear communication of policy decisions would include explanation of: (i) the overall objectives of macroprudential policy; (ii) the reasoning for macroprudential policy decisions and how specific measures are expected to work; and (iii) ex-post assessment of their effectiveness.

IV. Banking Sector Corporate Governance

27. **The corporate governance regulatory framework has seen a positive evolution over the years since Bulgaria's accession to the EU.** EU directives and regulations have been transposed into the domestic framework, aimed at: i) strengthening the supervisory board function (i.e. minimum qualification requirements for supervisory board members and enhancement of the work of the supervisory board by requiring the creation of technical subcommittees such as the risk, nomination, and remuneration); ii) enhancing the independence and effectiveness of the key internal control functions (audit, risk, and compliance); and iii) improving the quality and disclosure of financial information (i.e. implementation of IFRS standards). The benefits of these regulatory developments have not, however, always been welcomed by banks, sometimes perceived as a compliance burden.

28. **Despite these regulatory improvements, the implementation of corporate governance norms is uneven across the sector.** There are diverse corporate governance practices, with variations largely correlated to the ownership structure - foreign, domestic private and state-owned. The most developed practices are observed in foreign bank subsidiaries, particularly in the area of internal controls and risk management. These banks have implemented their head office practices, but this does not always translate into best corporate governance practices. Domestic private banks have a highly concentrated ownership structure, exercised through few individuals or through corporations (that sometimes make the identification of ultimate beneficial owners more difficult for the regulator and the public in general). In these banks, despite the structures on paper, the differentiation of the roles played among shareholders, SB members and MB members is more difficult, de facto, leaving much of the real management of the institution heavily influenced by the controlling shareholder(s). Finally, the state plays a minor role in the sector through one bank with a focused developmental objective (financing SMEs). As in the case of domestic private banks, the governance of this bank is highly aligned with the objectives of the major shareholder.

29. **The SBs in Bulgaria do not have the authority or the position to fulfill the full scope of their duties.** To fulfill their mandate[9], supervisory boards require technical competencies and skills and, more importantly, independence from the shareholders and from management. Supervisory boards in Bulgaria are composed of skilled professionals, but lack independence. The ownership of both domestic and foreign banks is highly concentrated, and the majority shareholder has the final word on the appointments of key supervisory and managerial functions (including internal controls). This potentially compromises the duty of care assigned to both the SB and senior management and creates an environment whereby management is beholding to the controlling shareholder. In such an environment, clear segregation of duties and introduction of much more independent boards would help to strengthen the management team and refocus and expand their responsibilities and accountability to all stakeholders, including the depositors, the public in general, the regulator, as well as the shareholder. Some banks, mostly those that are listed on the Bulgarian Stock Exchange and a few foreign, have included independent directors in their respective SBs. However, the local definition of independence (i.e. not being an employee bank or not owning more than 25% of the shares of the bank) falls short of international standards making their independence questionable and blurring the effectiveness of key committees (risk, audit, remuneration and nomination). The role of SBs in Bulgaria needs to be elevated to align it with the practices of other European countries. These boards need to evolve from a "policy approving body" to an "oversight body" and be more involved in strategy, management oversight, risk governance, and monitoring of related party lending and other large exposures.

30. **The audit function is not in compliance with global good practices.** The Law on Financial Audit requires all public interest companies (including banks) to set up an audit committee. This committee must be presided and composed by "outsiders" to the bank which usually are professionals with accounting backgrounds. The committee is appointed by and reports to the shareholders assembly. The members of this committee do not go through the fit and proper test of BNB, like regular supervisory board members. These "outsiders", who are members of the audit committee, can potentially create problems with confidentiality and accountability issues since they are not bound by the same duties as supervisory board members. The internal audit function also presents important accountability failures. The head of internal

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[9] According to the Basel Corporate Governance Principles, SBs are tasked with the roles of directing and overseeing the bank strategy, overseeing management's performance, ensuring financial performance and soundness, ensuring the effectiveness of key control functions (audit, risk, compliance) and setting the risk appetite.

audit is appointed by and reports to the shareholders meeting, breaching the well accepted principle that "internal audit serves as the eyes and ears of the supervisory board." The lack of independence of the boards and the blurred accountability lines of the audit function, particularly present in domestic banks, have weakened the oversight function of the SB. Beyond the existing macroeconomic challenges, the breakdown of the oversight chain, as well as weak risk management practices, could have also contributed to the deterioration of the credit portfolio of certain banks since 2014. Furthermore, banks are now required to receive dual independent audits. This reform is not welcomed by the industry nor the audit profession. The impact of this initiative remains unclear at this time, particularly in the case of differing opinion of auditors or accountability in case of breach of duty.

31. **Risk management has become the key priority for all banks after the KTB failure in 2014**. The independence and effectiveness of this function are in the process of being strengthened in several banks. Many banks have recruited or are in the process of recruiting Chief Risk Officers (CRO). In some instances, banks have elevated the role of the CRO and these are now members of the management (MB) and are reporting to the SB in accordance with good practices. Many banks have also created risk committees at the SB level. Despite these improvements, implementation of good risk management practices remains uneven. Risk management departments of some banks still provide opinions on lending decisions or sit on the credit committee with voting responsibility for credit proposals, compromising the independence of this function.

32. **The effectiveness and consistent application of good corporate governance requires BNB's strong commitment.** As of today, the supervision of corporate governance by BNB has been exercised on two fronts: i) through the fit and proper test conducted on SB and MB members; and ii) during the onsite and offsite supervisory process, part and parcel to the examination of the respective bank activities which represent key components of corporate governance. However, supervisory oversight and understanding of the status of governance practices in the sector can be further strengthened. The supervisor could employ the use of horizontal (or targeted) examinations whereby it conducts governance reviews in each bank (or a set of key banks) as a single supervisory examination or event. This would provide the supervisor comparative insight from bank to bank, allow it prioritize the key governance issues in the sector, and help define the supervisory response required in each institution – and overall. BNB is currently in the process of reviewing its manuals and procedures to enhance the supervisory process of corporate governance and to segregate supervision of these functions per the standards of EBA. An enhanced mechanism of supervision in this area and effective

enforcement will contribute to the harmonization of practices and standards of corporate governance of banks in Bulgaria.

V. INSURANCE AND PENSIONS SUPERVISION

The Financial Supervision Commission

33. **The FSC Act should be amended to provide statutory indemnity to the FSC, the persons appointed under Article 3 of the FSC Act, and staff.** Both the International Organization of Pension Supervisors and the International Association of Insurance Supervisors mandate that the supervisor, its directors (or equivalent appointees), and staff must not be held personally liable for supervisory actions taken in good faith. Further, these persons need to be indemnified from paying the costs of defending any action taken against them. The provision of legal protection is to allow the parties to perform their duties without fear of being sued or having to pay the costs of defending legal actions.

34. **Chapter 7 of the FSC Act needs to be amended to give the FSC the power to fund its budget through levies against supervised entities.** Chapter 7 outlines the sources of revenue available to the FSC to fund its operations. The main source is the state budget. This compromises one of the principles of effective supervision, being independence from government and the supervised industries, as it allows the government to control the FSC budget and deployment of resources. The supervised entities should pay the largest portion of the costs of the FSC by way of supervision levies; therefore, the FSC must be given the statutory powers to raise levies.

35. **Levies need to be set at levels that guarantee the FSC adequate resources and minimize reliance on penalties and financial sanctions as a source of revenue.** The FSC is significantly under-resourced to perform its core supervision functions, particularly in insurance supervision (where four persons undertake onsite inspections for nearly 50 insurers and reinsurers and 400 brokers). The level of industry levies should be sufficient to address the resource shortage throughout the FSC. The resource shortage is particularly concerning in the insurance division that is facing the challenges of adopting Solvency II. The level should be such that there is little reliance on fines and other financial sanctions to supplement income. There is anecdotal evidence that excessive fines and sanctions diminish the standing of the supervisor in the supervised entities, as the entities consider that the primary motivation of the supervisor is to supplement its budget. Internationally, there are two methods generally for charging levies – on assets (or in the case of pension funds on funds under management) and on transaction volumes (e.g. for insurers on premium written and pension funds on contributions

collected). While there is a degree of cross subsidization of smaller entities by larger entities in the former method, it is easier to implement and more transparent.

36. **Levies also need to be set at levels that provide for extensive staff training and capacity building, particularly in the Insurance Supervision Department.** Discussions with both onsite and offsite supervisors indicate a need for training. Training is particularly important for the officers involved in insurance supervision, as the adoption of Solvency II means that supervisors will be required to exercise complex judgments on a significant number of matters.

37. **The provisions in the FSC Act relating to the termination of the appointment of the persons appointed under Article 3 of the FSC Act need to be enhanced to improve transparency.** Persons appointed under Article 3 of the FSC Act must meet the eligibility requirements under Article 4, in particular 4(1) that includes, inter alia, having a good professional reputation and professional experience. The appointment of a person who no longer has a good professional reputation or lacks professional experience is terminated under Article 6. The FSC Act does not stipulate who can make judgments about the reputation or experience of a person and therefore can remove the person. Further, the Insurance Core Principles[10] require that "when the head of the supervisor or members of its governing body are removed from office, the reasons be publicly disclosed."

38. **The hierarchy for decision-making in the FSC needs to be reviewed and amended.** The current legal framework vests some powers in deputy chairpersons, which arguably should be vested in the Commission. For example, the power to authorize or approve public offerings is vested in the deputy chairperson of the Investment Activity Supervision Department. The way that powers are vested creates the potential for conflict if the Commission does not agree with decisions made by the deputy chairman. Under the current arrangements, the remedies available to the Commission are internal review or legal action. It would be preferable if all powers were vested in the Commission initially and the Commission delegate those powers as it saw fit.

39. **The organogram under consideration appears to be more efficient, but could be further improved.** The "department" under the control of the Secretary-General has a large number of diverse functions, some of which do not appear to relate to administration. The FSC could give consideration to reducing the number of functions in the department and reallocating those that are not related to administration.

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[10] Insurance Core Principle 2 Standard 2.

40. **In the medium term, the FSC should consider merging onsite and offsite supervision into one unit and assigning supervision of individual entities to selected supervisors.** Currently, there is a major imbalance in the teams performing onsite and offsite supervision—for example, there are about 10 officers doing offsite insurance inspection and 3 officers performing onsite. Combining the functions would partly address the imbalance.

41. **The offsite review of the pension sector can be enhanced, both for the pension companies and for the FSC.** At present, pension fund management companies and depositories provide daily details of the investment portfolio of the relevant pension fund. The role of the FSC staff in relation to these daily reports is to compare the submissions and ensure agreement between them. The law requires that pension funds use well-capitalized depositories that hold capital against operational risk and are subject to other prudential requirements. A more rational and efficient approach would be to ensure that the depository's systems are adequate and that spot-checks ensure they are being used.

Insurance

42. **The biggest issue according to the industry is lack of awareness of the need to manage personal risks.** The industry is of the view that people buy insurance only because it is compulsory (either as motor third-party liability or when a vehicle is being leased or being used as collateral). The industry considers that the lack of awareness needs to be addressed and appears willing to partner with the government to increase awareness and overall financial literacy.

43. **Lack of trust also seems to be a problem in the market.** Insurance is a product that is built on trust – the consumer having confidence that the insurer will and can pay when required. Previous bad conduct appears to have eroded some of the trust. The FSC should continue with its strategy of openness and transparency, providing the market with regular, accurate and relevant information about the insurance industry and the issues that occur.

44. **All of the insurance representatives met are concerned with the level of competition in the motor vehicle insurance market.** Both large and small insurers note the level of price competition and believe that some companies are substantially underpricing the risk. Underpricing is frequently associated with under-reserving for losses. The recent balance sheet review of insurers concluded that the level of technical provisions for losses exceeds what is required by a considerable margin. However, it is recommended that the FSC conduct a series of thematic reviews that focus on the adequacy of premiums when sufficient supervisory resources are available.

45. **The size of the broker distribution network poses a challenge for the FSC.** Brokers are currently in excess of 400. Market conduct and disclosure are important and, according to the insurance industry, are lacking in many of the brokers. The FSC will need to perform onsite inspections at a large number of brokers and enforce the new conduct of business requirements.

46. **The authorities could consider various options to help the insurance industry diversify its risks and to deal with losses arising from floods and earthquakes.** Nearly 80 percent of the premium written in the non-life market is attributable to motor vehicle. The authorities could consider expanding the number of compulsory products that apply to the larger population, such as property insurance, following the strengthening of FSC and careful deliberation. Furthermore, the authorities could look at market-driven solutions to deal with losses arising from floods and earthquakes. At present, the government provides some assistance out of its budget. There are many alternative arrangements, such as those in Romania and Turkey, which would provide better protection for residents and the government finances.

Pensions

47. **In the long term, the authorities need to consider relaxing some of the investment restrictions applying to Pillar II funds.** The returns on Pillar II funds have not been stellar and this is attributable in part to the very restrictive investment rules.[11] In the long term, some more investment risk will need to be permitted to improve returns. This can only occur after the FSC gains confidence in the securities market and, in particular, the integrity of price discovery.

48. **It is acknowledged that the FSC resistance to the industry's demands for multi-funds is the correct approach, but some work could commence on lifecycle funds.** It appears that the level of financial sophistication in the market is such that it would not be in the best interests of contributors to permit multi-funds. However, there is evidence to show that lifecycle approaches can have a positive effect on returns over the long-term. It is noted that early initiatives to introduce lifecycle funds were rejected by the authorities. It is appropriate to reconsider this issue now.

49. **The FSC needs to complete work on rules for the payout phase in the second pillar.** Although the majority of the first tranche of retirees will not retire until 2022 or 2023, it is possible that some contributors will take advantage of early retirement provisions. Currently, the rules relating to the payout phase are not complete. The rules need to determine the extent to

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[11] Refer to Art. 178 of the Social Insurance Act for investment limits.

which the account balances in the second pillar need to be annuitized, if any, and the types of annuities, their calculation, and which parties will be the providers.

VI. NONPERFORMING LOANS OVERSIGHT AND STRATEGY

50. **While the BNB has taken steps to promote reductions in NPLs in the banking system, NPL levels remain high.** These steps include the 2016 AQR, limiting dividend payments based on factors such as high NPL ratios, and continual monitoring of forbearance and NPL exposures by BNB, with follow-up during onsite supervisory reviews. Based on the BNB's own measure, the NPL level at end-June 2016 was a high 19.7 percent of loans, with most NPLs over one year past due. Using the EBA's NPL measure, Bulgaria's banks had NPLs of 13.7 percent against the EU weighted average 5.5 percent as of June 2016.

51. **Banks have generally high capital buffers in place, but loan-loss provisioning coverage needs improvement.** The BNB's prudential policies have pushed banks to retain earnings and toward achieving generally high capital and liquidity buffers. The generally adequate capital positions were largely confirmed in the recent authorities' AQR/stress test. In addition, the recent AQR was useful to establish common measures of asset quality, thereby promoting better risk identification. However, loan-loss provisioning coverage shows some weaknesses as loan provisions lagged the significantly higher NPL flow since the global financial crisis, and the loan-loss reserve to NPL ratio (coverage ratio) declined to 51.7 percent as of June 2016, from just over 100 percent in 2008 based on the BNB's own NPL measure.

52. **The BNB should adopt a comprehensive strategy to achieve a substantive reduction in NPL levels over a three- to five-year time horizon.** The strategy would be in keeping with the BNB's macroprudential responsibilities for maintaining bank and financial system stability and for mitigating systemic risk. The strategy should focus on more intensive prudential supervision to enhance bank practices in three main areas: (i) loan-loss provisioning (LLP); (ii) loan write-offs of NPLs, in whole or in part, where collection is unlikely; and (iii) collateral valuation. This effort would be supported further by enhanced supervisory guidance, supervisory reporting, and risk

disclosure.[12] Moreover, it should include efforts to improve banks' early warning systems (EWS) and develop the NPL market.

53. **Key to the effort will be a strengthened supervisory review.** Under this approach, as applied for loan loss provisioning, the BNB would still expect banks to follow International Financial Reporting Standards (IFRS), but would specify certain supervisory expectations using the BNB measurement metrics. For example, if the reported loan loss allowance is insufficient relative to the BNB supervisory metrics calibrated to encourage robust provisioning practices, then there would be additional supervisory scrutiny. A similar approach would also be taken for NPL write-downs and for collateral valuation through the application of additional BNB metrics.

54. **As banks prepare for the adoption of IFRS 9, they will need to adapt provisioning practices to better recognize loan deterioration using forecasts.** Estimates of the impact from IFRS 9 are that loan-loss allowances may increase by 18–33 percent from current levels. Under IFRS 9, there will be a rebuttable presumption that loans past due by 30 days or more will have experienced "a significant increase in credit risk," thus requiring the recording of provisions based on lifetime expected credit losses. The BNB should prepare now with supervisory guidance to ensure that banks are making appropriate preparations with systems and processes, as well as by enhancing their EWS.

55. **The BNB should issue supervisory guidance to banks setting forth robust collateral valuation practices, including on the use of internal and external valuation experts.** Since the highest NPL ratios are in the construction and real estate sectors, and collateral-based lending is extensively practiced, the proper valuation of collateral pledged against loans is essential to a sound NPL reduction strategy. The AQR results and discussions with market participants highlighted that a uniform, conservative set of rules for collateral valuations at banks is necessary to avoid unsound and divergent practices. The issuance of clear and conservative valuation rules will help reduce the significant NPL pricing gap observed in Bulgaria, and thus could contribute to improved NPL markets consistent with the NPL reduction strategy.

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[12] The supervisory reporting should include both: (i) cash basis (actual received interest income); and (ii) accrued interest income, since IAS 39 and IFRS 9 allow for the accrual of interest income for NPLs and impaired loans, which can provide disincentives for NPL reduction.

56. **The BNB should promote improved risk information for investors and risk disclosure in line with the recommendations of the Financial Stability Board's (FSB) Enhanced Disclosure Task Force (EDTF).** Improved credit risk management will require strengthened bank systems for the timely collection of internal loan and collateral data, and this data could also be useful to potential investors in NPLs. In addition, the global financial crisis highlighted the importance to market confidence of reliable valuations and useful risk disclosures. The FSB's EDTF's recommendations for improved bank risk disclosures and extensive examples of leading disclosure practices are designed to provide timely information that is useful to investors and other users, and which could contribute over time to improved market confidence in financial institutions. Together, these initiatives could foster better NPL markets through improved information needed for potential investors.

57. **The BNB should work with banks, other national authorities, and other stakeholders to improve the NPL market infrastructure**. The Bulgarian NPL market is developing, but remains shallow and improvements are needed to promote further use of NPL sales as an important option for meaningful NPL resolution. Potential improvements include: (i) a standardization of information about NPLs and related collateral (in effect, an extension of the AQR exercise); and (ii) the removal of certain legal impediments in the areas of collateral enforcement, insolvency regimes, and out-of-court settlement, as indicated in the World Bank Insolvency and Credit/Debtor Regimes ROSC in 2016.[13]

VII. Financial Safety Net and Crisis Management

58. **The Bulgarian financial safety net comprises four domestic authorities.** The BNB is the monetary authority, and the prudential and resolution authority for banks. The FSC is the prudential and resolution authority for investment firms, and the prudential supervisor for other nonbank financial institutions. The BDIF provides deposit insurance and manages the deposit insurance fund and the bank resolution fund; it also appoints and oversees liquidators in bank bankruptcy proceedings. The MoF is politically responsible for Bulgaria's financial sector policies. The FSAC complements these authorities and brings together the Minister of Finance (chair) and the heads of the BNB and the FSC.

59. **In 2014, Bulgaria's fourth largest bank collapsed**. The collapse followed a massive deposit run-off with system-wide consequences particularly for larger domestically-owned banks. In

[13] See Bulgaria—Insolvency and Credit/Debtor Regimes ROSC, prepared by a World Bank team in 2016.

the absence of a comprehensive bank resolution regime, the insolvency triggered bankruptcy procedures for the bank's liquidation. The ongoing liquidation remains a protracted and costly process. This experience will be useful in developing less costly and less disruptive resolution strategies as more viable alternatives to relying on bank liquidation with conventional depositor payouts.

60. **Since the 2008 FSAP, but mostly since the 2014 bank collapse, Bulgaria's financial safety net and crisis management arrangements, including bank resolution and contingency planning, have progressed.** In response, Bulgaria has introduced a resolution regime for credit institutions and investment firms; designated resolution authorities for financial institutions; and established mechanisms to fund resolution measures. Despite some progress, the financial safety net and crisis management arrangements face crucial challenges:

- The resolution regime includes a comprehensive resolution toolkit: the four basic tools that are mandatory under EU rules (sale of business, bridge institution, asset transfer, and bail-in) and the two last-resort government stabilization tools (equity support and temporary public ownership). The regime, however, has yet to be fully operationalized and pertinent staff trained in the use of the time-tested sale of business and bridge institution tools, and the new bail-in tool.

- The combination of supervision, resolution, and lender-of-last-resort functions within the BNB could offer synergies at both the contingency planning and crisis management stages. In certain resolution scenarios, however, the BNB could end up sitting at the negotiation table representing three potentially conflicting interests: as the resolution authority selling assets, as the supervisor of the buyer, and as the liquidity provider, and, thus, as a creditor. Similarly, where the bridge institution tool is used, the BDIF would be both sole shareholder of the institution and insurer of the institution's depositors. The BNB is mitigating these conflicts at the stage where decisions are prepared and should ensure that all perspectives are fully represented in the GC, where the ultimate decision making rests. The BDIF, too, will need to develop governance measures to mitigate its conflicts of interests.

- The bank collapse in 2014 depleted the deposit insurance fund. It is expected that by 2024, both the DIF and the Bank Resolution Fund will have reached their target levels, providing the BDIF a total reserve of 3 percent of covered deposits.

- There are significant financial and legal restrictions on liquidity support to banks. As became evident in 2014, in times of liquidity pressure on banks, the CBA poses a severe

liquidity constraint, particularly, for majority domestically owned banks; strict collateral requirements further constrain the BNB's ELA. Government financial support is subject to EU state-aid procedures, and approval from the European Union and the national parliament, which adds to the decision-making time.

61. **To ensure operational capacity to rapidly deploy recovery and resolution tools, actions are needed to strengthen the safety net and crisis management arrangements:**

- Recovery and resolution planning (RRP) for most domestic systemically important banks (D-SIBs) is still ongoing. The BNB should prioritize RRP for the banks that the 2016 AQR and stress tests indicated capital shortfalls, and the domestically owned D-SIBs—foreign authorities oversee the RRP for the groups to which Bulgarian foreign-bank subsidiaries belong. The BNB should also define alternative resolution strategies for foreign-bank subsidiaries that operate in Bulgaria, in case the group resolution colleges cannot agree on a common approach.

- The BNB is updating its early intervention framework and is developing a new resolution (planning) manual that offers an opportunity to ensure consistency between the two. The authorities should ensure a smooth and decisive transition from early intervention into resolution, with problem bank metrics that apply consistently through regular supervision, early intervention (including recovery actions), and resolution (planning). Additionally, (i) pertinent staff should be trained in the use of the time-tested and cost-effective sale of business and bridge institution tools and the new bail-in tool; and (ii) metrics should be developed to compare liquidation costs and the use of said resolution tools.

- Considering the constraints on official financial support, the authorities should define strategies for liquidity assistance to distressed banks based on a three-pronged approach: (1) increasing the funds for liquidity support; (2) enhancing distressed banks' ability to meet collateral requirements; and (3) ensuring that the authorities can act decisively on liquidity support requests. The strategies should be defined jointly by the BNB and the MoF, and supported by a comprehensive toolkit. Considering the 'private solutions first' principle, the authorities could contemplate an industry-funded liquidity support arrangement (an ELA-like fund) at the BNB. The fund could be complemented by higher retained BNB profits. The MoF could be vestedwith statutory authority to borrow and lend for financial stability purposes through the BNB, with the BNB following similar conditions as typically applied to central bank ELA. To ensure that collateral requirements under the BNB's lending ordinance can be met—and excess foreign exchange reserves be used also for ELA—the

mission recommended vesting in the MoF a statutory authority to extend guarantees to the distressed bank.[14] Furthermore, the authorities could arrange swap lines with international financial institutions such as the Bank for International Settlements (BIS) and major central banks such as the European Central Bank (ECB). Decision making could be better supported with, among other things, solvency and viability assessment methodologies,[15] which should be included in a contingency plan for liquidity support, and pre-assessment of collateral held by banks with a high-risk profile.

- The authorities should strengthen the financial crisis management framework by: (i) expanding the FSAC's mandate (including contingency planning) and membership (including the BDIF); and (ii) updating agency-specific and national financial crisis preparedness, including a national crisis communication plan, and regular single- and multi-agency financial crisis simulation exercises (CSEs), complemented with cross-border CSEs, particularly with EU authorities with jurisdiction over the groups to which seven out of nine foreign-bank subsidiaries belong.

- Establishing and maintaining the new RRP framework requires particular expertise and additional resources to achieve and maintain adequate staffing levels. The authorities have yet to develop internal procedures and methodologies to operationalize the RRP framework, and to develop—and regularly update—RRPs for a great number of institutions. Furthermore, higher staffing levels are needed to accommodate the inclusive and consultative nature of the EU framework, including through supervisory and resolution colleges in many of which the authorities are participating. The authorities should ensure: (i) that all financial oversight authorities are adequately staffed to expedite RRP and more generally to fulfil their BRRD responsibilities, including on a cross-border level; and (ii) that their staff is well trained in the use of the time-tested and cost-effective sale of business and bridge institution tools, and the new bail-in tool.

- While the legal framework gives the financial authorities' officials, staff, and agents some legal protection, none of the agencies has operationalized this protection. The authorities are

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[14] Back-to-back asset swaps against banks' relatively liquid assets could be used to avoid unsecured government exposure to distressed banks. If needed, the BNB could act as the MoF's fiscal agent for these transactions.

[15] Important flexibility could be created if the BNB could deem a bank solvent if it has a credible recapitalization plan in place, which would foresee that capital requirements are met in the near term.

faced with a high number of court cases against them (in the aftermath of the 2014 bank collapse) and international experience demonstrates that stakeholders are indeed more litigious when recovery and resolution powers are exercised—these tools are more intrusive than supervision. Consequently, the authorities should strengthen the legal protection framework, including with operational arrangements to make legal protection effective, covering such issues as the choice and (timing of) payment of legal representation, protection against self-incrimination during internal investigations while building a case to defend the agencies, and liability and legal aid insurance covering realistic monetary amounts commensurate with the high financial stakes at play in resolution cases.

ANNEX I. MACROFINANCIAL PROFILE AND TRENDS

Annex Table 1. Bulgaria: Selected Economic and Social Indicators, 2013–22

(Annual percentage change, unless noted otherwise)

	2013	2014	2015	2016	2017	2018	2019	2020	2021	2022
							Proj.			
Real GDP	0.9	1.3	3.6	3.4	2.9	2.7	2.5	2.5	2.5	2.5
Real domestic demand	-1.9	2.6	3.5	1.6	3.1	2.8	2.5	2.5	2.5	2.5
Public consumption	0.6	0.0	1.3	0.5	3.2	3.4	1.7	1.7	2.1	2.1
Private consumption	-2.5	2.7	4.5	2.1	3.0	3.0	2.8	2.8	2.6	2.6
Gross capital formation	-2.1	4.2	2.2	1.0	3.4	1.9	2.1	1.9	2.3	2.4
Private investment	-2.6	0.3	-3.7	1.3	2.6	2.0	2.0	2.0	1.9	2.0
Public investment	11.4	14.0	21.4	-16.2	8.7	2.5	3.2	2.5	4.0	4.1
Stock building 4/	-0.5	0.2	-0.1	1.1	-0.1	0.0	0.0	0.0	0.0	0.0
Net exports 4/	2.8	-1.3	0.1	1.8	-0.2	-0.1	0.0	0.0	0.0	0.0
Exports of goods and services	9.6	3.1	5.7	5.7	3.5	3.9	3.8	3.9	3.9	3.9
Imports of goods and services	4.3	5.2	5.4	2.8	3.9	4.0	3.8	3.9	3.9	3.9
Resource utilization										
Potential GDP	1.5	1.6	2.3	2.5	2.4	2.5	2.5	2.5	2.5	2.5
Output gap (percent of potential GDP)	-2.4	-2.7	-1.4	-0.5	-0.1	0.0	0.0	0.0	0.0	0.0
Unemployment rate (percent of labor force)	13.0	11.5	9.2	7.7	7.1	6.9	6.7	6.6	6.5	6.5
Price										
GDP deflator	-0.7	0.5	2.2	1.1	1.0	1.8	1.9	2.1	2.1	2.1
Consumer price index (HICP, end of period)	-0.9	-2.0	-0.9	-0.5	1.7	1.8	2.0	2.1	2.1	2.1
Fiscal indicators										
General government net lending/borrowing (cash basis) 1/	-1.8	-3.6	-2.8	1.6	-1.3	-1.0	-0.5	0.0	0.0	0.0
General government primary balance 1/	-0.9	-3.0	-2.0	2.4	-0.4	-0.2	0.4	0.8	0.9	0.9
Structural overall balance (percent of GDP)	-0.9	-2.7	-2.3	1.8	-1.2	-1.0	-0.5	0.0	0.0	0.0
Structural primary balance (percent of GDP)	0.0	-2.0	-1.5	2.6	-0.4	-0.2	0.4	0.8	0.9	0.9
General government gross debt 2/	17.2	26.4	25.6	27.8	24.5	24.1	23.4	22.4	21.4	20.4
Monetary aggregates 3/										
Broad money	8.9	1.1	8.8	7.6	6.1	5.9	5.9	6.0	6.1	6.1
Domestic private credit	0.3	-7.7	-1.6	1.8	4.9	6.5	6.8	7.1	7.2	7.2
Exchange rates regime										
Leva per U.S. dollar (end of period)	1.42	1.61	1.79	1.86	...	...	...	...	...	...
Nominal effective rate	2.5	2.9	-1.3	...	...	...	...	...	...	...
External sector										
Current account balance 1/	1.3	0.1	-0.1	4.2	2.3	2.0	1.7	0.9	0.1	-0.8
o/w: Merchandise trade balance 1/	-7.0	-6.5	-5.8	-3.9	-4.3	-3.9	-3.6	-3.6	-3.6	-3.8

Sources: Bulgarian authorities; World Development Indicators; and IMF staff estimates.

1/ Percent of GDP.

2/ In projection period, largely reflects issuance and repayment of eurobonds.

3/ Due to the revocation of the banking license of KTB, the bank is excluded as a reporting agent from the monetary statistics data starting in November

4/ Contribution to GDP growth.

Annex Table 2. Bulgaria: Financial Soundness Indicators

(In percent)

	2008	2009	2010	2011	2012	2013	2014	2015	Jun 2016	Dec 2016
Regulatory capital to risk-weighted assets	14.9	17.0	17.4	17.6	16.6	17.0	21.9	22.2	22.7	22.2
Regulatory Tier 1 capital to risk-weighted assets	11.2	14.0	15.2	15.7	15.1	16.0	20.0	20.5	21.2	20.9
Capital to assets (Based on Tier 1 capital)	11.4	10.8	10.5	10.8	10.1	10.4	11.6	12.0	12.3	11.6
Nonperforming loans net of provisions to capital	3.5	15.1	28.0	36.9	38.9	36.2	43.5	49.8	47.2	44.7
Nonperforming loans to total gross loans	2.4	6.4	11.9	15.0	16.6	16.9	16.7	14.6	14.4	13.2
Return on assets	2.1	1.1	0.8	0.6	0.7	0.6	0.8	1.1	1.8	1.4
Return on equity	19.5	9.8	7.8	5.7	6.3	5.7	7.2	7.9	13.1	10.4
Interest margin to gross income	75.1	74.8	74.1	73.2	68.8	68.5	67.4	66.2	68.6	69.2
Noninterest expenses to gross income	50.1	49.9	49.1	50.6	52.1	54.0	49.9	47.3	42.1	44.0
Liquid assets to total assets	19.0	18.9	20.9	22.0	22.4	23.4	26.1	31.1	30.8	32.4
Liquid assets to short-term liabilities	26.4	26.6	30.0	29.1	30.0	30.6	33.7	40.2	39.9	41.0
Large exposures to capital	76.5	65.2	90.6	111.6	115.1	119.7	64.3	51.4	55.3	58.2
Trading income to total income	2.8	4.4	5.4	5.0	7.4	5.8	7.0	7.9	12.0	10.3
Personnel expenses to noninterest expenses	37.9	37.1	36.4	36.5	36.7	36.7	37.1	36.3	42.2	41.7
Customer deposits to total (noninterbank) loans	83.9	83.0	87.8	95.4	100.2	107.4	115.5	127.7	130.2	134.7
Foreign-currency-denominated loans to total loans	57.2	58.7	61.3	63.7	64.0	61.2	57.0	50.0	48.4	45.1
Foreign-currency-denominated liabilities to total liabiliti	60.0	64.4	58.6	54.8	51.8	50.2	49.0	42.6	43.2	41.7

Source: IMF IFS

Annex Table 3. Bulgaria: Structure of the Financial System

(Assets in billion LEV)

	2012			2013			2014			2015			2016 1/		
	Number	Total Assets	Percent of System Assets	Number	Total Assets	Percent of System Assets	Number	Total Assets	Percent of System Assets	Number	Total Assets	Percent of System Assets	Number	Total Assets	Percent of System Assets
Local banks	9	21.8	23.9	9	24.4	25.5	9	20.2	20.8	9	20.6	20.5	9	20.7	20.2
Foreign banks	15	55.0	60.4	15	55.7	58.2	13	58.9	60.8	13	63.5	63.1	13	65.6	64.1
Foreign branch	7	5.6	6.1	6	5.4	5.7	6	6.0	6.2	6	3.4	3.3	5	2.3	2.3
Total bank system	31	82.4	90.4	30	85.6	89.4	28	85.1	87.8	28	87.5	86.9	27	88.7	86.7
Insurance companies	33	3.1	3.4	45	3.3	3.4	46	3.6	3.7	44	3.8	3.7	44	3.8	3.7
Non life	17	2.0	2.2	29	2.1	2.2	30	2.2	2.2	29	2.4	2.4	29	2.3	2.2
Life	16	1.1	1.2	16	1.2	1.3	16	1.4	1.5	15	1.4	1.4	15	1.5	1.5
Pension insurance companie	9	5.7	6.3	9	6.8	7.1	10	8.2	8.4	10	9.4	9.3	9	9.9	9.6
Total non-bank system	42	8.8	9.6	54	10.1	10.6	56	11.8	12.2	54	13.2	13.1	53	13.7	13.3
Total financial system	**73**	**91.2**	**100.0**	**84**	**95.7**	**100.0**	**84**	**96.9**	**100.0**	**82**	**100.7**	**100.0**	**80**	**102.3**	**100.0**
(in percent of GDP)		111.8			116.7			115.9			116.6			115.0	

Source: BNB, FSC.

1/ Through June 2016

ANNEX II. RISK ASSESSMENT MATRIX

Source of Risk	Relative Likelihood (*high, medium or low)*	Impact if Realized *(high, medium, or low)*
1. Protracted period of slower European growth.	**High** Bulgaria's exports are highly dependent on Euro-area markets. There would be direct negative influence through trade and investment channels.	**High** Low potential growth, high structural unemployment and low FDI, continued fiscal pressures. External shocks will lead to lower income for corporate sector as well as households. Fixed exchange rate will be maintained, thus external shocks will materialize in lower public spending, corporate sector income, and household wages. In the stress tests, this risk will be modeled through lower GDP growth and higher unemployment shocks, which lead to higher NPLs.
2. Financial stress in emerging markets.	**Medium** Adverse effects on banks and corporates due to increased investor risk aversion, which leads to higher risk premiums.	**Medium** Increased country risk premium, leading to wider spreads for the sovereign, funding pressures for banks, higher borrowing costs for nonfinancial corporates, and lower FDI. In the stress tests, this risk will be modeled through wider spreads for the sovereign (losses on domestic mark-to-market securities) and higher funding costs for banks.
3. Intensification of geo-political tensions related to Russia, Ukraine, and Turkey.	**High/Medium** Negative spillovers from trade and investment channels increase in country risk, sovereign rating downgrade.	**High/Medium** Adverse effect on economic activity and social tensions leading to the higher country risk premiums and potential sovereign rating downgrade by one to three notches. This risk will be modeled through a stand-alone sensitivity shock (sovereign downgrade).
4. Asset price uncertainty over NPLs.	**High** Delayed recognition of NPLs, and loan foreclosures. Impediments to releasing collateral associated with NPLs, including judicial bottlenecks and administrative costs.	**Medium** Collateral prices decline. The need for higher provisions lowers bank profits and capital; investment and growth prospects are in turn weakened. In the stress tests, this risk has been modeled through higher provisioning rates for banks.

ANNEX III. IMPLEMENTATION OF 2008 FSAP RECOMMENDATIONS

Recommendations	Status
Crisis management	
Establish clear principles and objectives in allowing discretion over the use of a part of the Fiscal Reserve Account for emergency bank liquidity assistance. Create fiscal buffers in the fiscal reserve account for potential solvency support, in case of systemic problems.	**MoF:** It should be noted that the 2008 FSAP recommendations were made in the absence of a framework for recovery and resolution of credit institutions. -Directive 2014/59/EU of the European Parliament and of the Council establishing a framework for the recovery and resolution of credit institutions and investment firms (BRRD) sets clear rules for the provision of public liquidity and capital assistance to banks (Article 32, para 4 (d), items i to iii). These provisions were transposed into the Bulgarian legislation in Article 51, (3) and (4) of the Law on recovery and resolution of credit institutions and investment firms (LRRCIIF). -With a view to the asset quality review and stress test of the whole banking system in Bulgaria, the 2016 Law on the State Budget of the Republic of Bulgaria provided that if within the limit set out for new government debt (BGN 5.3 billion), new government debt could be assumed to finance programmes and instruments for financial stabilisation and provision of extraordinary public financial support under the LRRCIIF. -Chapter XIV of the LRRCIIF contains clear and detailed rules and conditions for the application of government stabilization tools—government equity support and temporary government ownership tool. These tools can only be applied in the event of a systemic crisis as a last resort and under strict conditions. With a view of the above, the MoF in cooperation with BNB is considering strategies for timely provision of financial resources for short term emergency bank liquidity assistance in line with and under the conditions of the LRRCIIF.
Banking Supervision and Regulation	
In line with EU practice, consider moving to a governance structure for BNB to discharge its bank supervisory responsibilities with the BNB Board taking key decisions and limiting discretionary powers of the Deputy-Governor in charge of the Banking Supervision Department.	**BNB:** The concentration of power for supervisory action in a single individual, the deputy governor for supervision, was a conscious decision designed to ensure responsibility and accountability. Checks and balances have been put in place in the sense that not all powers are reserved by the deputy governor. -Decisions such as licensing, revocation, conservatorship must be made by the full Governing Council based on a joint motion by the governor and deputy governor. -Also the Governing Council has responsibility for issuing the regulations of the BNB, including those regulations pertaining to supervision. Since the fourth quarter 2015, a quarterly report is submitted to the BNB Governing Council containing information on the current supervisory monitoring of banks and the identified problems.
Banking Supervision and Regulation	
Enhance BNB's capacity to carry out macro-scenario stress testing at the system level and bank level, with special emphasis on credit, foreign exchange and liquidity risks.	**BNB:** After 2009, several different types of stress tests (in 2011, 2014, and 2016), covering credit, market, and interest rate risk, have been implemented. Liquidity risk top-down simulations are also performed on a regular basis, and credit risk is tested each year. As part of the 2016 comprehensive assessment of the Bulgarian banking system, a bottom-up macro-scenario stress test was carried out (details available on the BNB website).
Securities and Capital Markets	
Strengthen capacity of FSC to monitor and enforce the securities laws by increasing FSC staff numbers and enhancing their skills through	-Since its participation by law in the EU authorities ESMA/EIOPA. Since the 2008 FSAP, the FSC has participated in training programs of ESMA/EIOPA, Institute of Public Administration and Joint Vienna Institute. In addition, the FSC has two secondments in the EC and the ESMA. -From January 1, 2008 until August 29, 2016, the FSC has increased its staff by 17 experts.

training and secondments with other regulators.	
Build an effective on-going FSC oversight program of the stock exchange and securities clearing and settlement.	-Because of the coordinated activities between the Bulgarian Stock Exchange and the FSC, access to the new settlement system is granted to an extra observer with the purpose of oversight of the trade on the stock exchange. -Following consultations with the Bulgarian Stock Exchange, the FSC published an action plan in October 2010, identifying priorities for coordinated supervisory activities to be undertaken and for capital markets development. -Onsite inspections have been conducted on the Bulgarian Stock Exchange and on the Central Depositary, with focus on the clearing and settlement systems.
Upgrade the securities clearing and settlement system for the private debt markets to meet international standards.	The Central Depositary JSC is the only central depository which provides settlement services for the private debt market. The depositary institution has taken organizational measures for its alignment with the European requirements and the future issuance of license to the institution in accordance with Regulation (EU) № 909/2014. CDAD establishes and operates a system for the settlement of transactions in financial instruments in accordance with Art. 109a of the LPOS. CDAD is responsible for registration of financial instruments in accordance with Art. 127 of LPOS.
Pension Fund and Insurance Sectors	
Redesign the regulatory framework for the pay-out phase for retirement products.	In the period 2012–2016, the FSC prepared a conceptual framework concerning the improvement of the regulation on the private pension funds, including the pay-out phase and a new draft law proposing the necessary amendments in the Social Insurance Code. Following the public consultation on the draft law, the Ministry of Finance decided to put this group of amendments for more detailed discussion with the Ministry of Labor and Social Policy.
Increase scope for price competition by increasing disclosure of net risk-adjusted performance, reviewing the rules related to switching and the automatic assignation rule.	-In accordance with the requirements to the advertising and information materials, the pension insurance companies are required to disclose annually on their websites information on the investment results of the pension funds they manage, including Sharpe's ratio. -The FSC publishes on its webpage statistics on pension insurance companies and the funds managed by them, including data on amounts of fees and deductions, investment performance and benefits paid. -The pension insurance companies started to disclose the real rate of return (adjusted for changes in prices due to inflation) achieved in the course of management of the pension funds and to disclose more frequently (on a quarterly basis instead of annually). -The newly introduced rights of the members of the universal pension funds also stimulate the competition in the sector. -A gradual decrease was introduced of both the deduction from each contribution and the investment fee. The fee for switching participation from one mandatory pension fund to another was repealed. -The draft law amending the Social Insurance Code proposes that members of the mandatory pension funds can switch their participation to another pension fund of the same type more frequently after the conclusion of the first social insurance contract and the fee for switching participation from one voluntary pension fund to another is repealed.
Introduce investment options in the mandatory funds through life style or life cycle funds.	The FSC prepared amendments in this respect in the period 2012–2016, but they were not supported by the Ministry of Finance, and were subsequently removed from the draft law.