From Transition to Accession

Developing Stable and Competitive Financial Markets in Bulgaria

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FOREWORD

The Poverty Reduction and Economic Management Unit in the World Bank's Europe and Central Asia Region has been undertaking a series of analytical works on issues pertinent to the economies in the region. These issues include transition issues; issues of economic integration pertinent for the Central and Eastern Europe countries which are candidates for accession to the European Union; poverty issues; and other economic management issues. The analytical work has been conducted by staff of the unit and other Bank staff, as well as specialists outside of the Bank.

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Acronyms and Abbreviations

BGN	Bulgarian Lev
BNB	Bulgarian National Bank
BOP	Balance of Payments
BORICA	National Card Payment System
CBA	Currency Board Arrangement
CD	Central Depository
CEEC	Central and Eastern European Countries
DIF	Deposit Insurance Fund
EBRD	European Bank for Reconstruction and Development
EU	European Union
FDI	Foreign Direct Investment
GDP	Gross Domestic Product
IMF	International Monetary Fund
MoF	Ministry of Finance
OTC	Over The Counter
RTGS	Real Time Gross Settlement System
SSB	State Savings Bank
TBs	Treasury Bills

INTRODUCTION

Bulgaria is recovering from a severe economic and financial crisis that followed more than over a half-a-decade of macroeconomic mismanagement and too timid attempts at restructuring the economy and transitioning from plan to market. The last three years have witnessed a rapid turnaround in both achieving macroeconomic stability and implementing a solid economic transformation program. As a candidate country for accession to the European Union (EU), Bulgaria, in the years ahead will need to establish stable, well-regulated and competitive financial markets and institutions. This entails adapting its legislative framework to the norms and standards of the EU. In this context, the objectives of this paper are to (a) review developments in the financial markets after the 1996-97 economic and financial collapse; (b) assess where the sector stands in restructuring, adjusting to a currency board environment, and harmonizing its regulatory framework with the EU; and (c) identify the key outstanding financial sector policy issues to consider while meeting EU accession objectives.

In the first section, we set our analysis of Bulgaria's financial sector in the context of the broader macroeconomic developments and the interaction between the real, public, and financial sectors. Bulgaria's overall performance improved sharply following the introduction of the Currency Board Arrangement (CBA) in July 1997. Inflation has stabilized in the low single-digit levels, positive output growth has resumed, and the fiscal stance is sound. During its two and one-half years of existence, the CBA has gained credibility, thanks to its sound fiscal performance and the high level of reserves it has maintained. Notwithstanding these achievements, a widening current account deficit, driven by a deterioration in exports raises concerns for the future. Clearly, external sustainability will to a large extent depend on the pace of industrial restructuring, export performance, and the magnitude and composition of foreign direct investment flows.

Banking sector soundness has improved drastically, thanks to the banking sector consolidation and the tightening of regulation and supervision which followed the CBA introduction. Although the banking sector is gaining credibility, monetary aggregates as well as credit and deposit indicators suggest that the public's trust in the banking sector has not been fully restored yet. Similarly, typical of a postcrisis context, a conservative stance by commercial banks toward lending demonstrates their high degree of risk aversion and their low capacity for credit risk assessment. These shortcomings are compounded by the intensification of the industrial restructuring process, marked by substantial firm exit and new entry, which makes for an uncertain customer base with short or absent credit history.

In the second section, we review the institutions and rules of the banking sector. On the whole the banking sector is liquid and profitable, and the sector's risk-based capital adequacy is above international standards. Banking supervision and regulations have been considerably strengthened, contributing to the significant reduction of violations of major requirements such as capital adequacy, open foreign currency position and loan concentration to individual borrowers. The top 12 banks, some of which are still largely state owned, dominate the sector, but the privatization process is fairly advanced and is expected to be completed by 2001.

As the third section indicates, the rest of the financial sector is underdeveloped. Although the regulatory and supervisory foundations are now largely in place, capital markets are still either inactive or nontransparent. Some financial institutions such as finance companies and

investment holdings are still unregulated. Furthermore, noncompetitive state provision of financial services in the insurance sector has not yet been fully eliminated. Further strengthening of the regulatory framework and supervisory bodies is necessary; implementation and enforcement need to be enhanced, and privatization of the provision of financial services needs to be continued.

The financial infrastructure, discussed in the fourth section, is evolving to catch up with technological improvements. Diversification of payment instruments is underway. The efficiency of liquidity management within the banks and systemwide in the payment system is expected to be enhanced with the conversion to the real-time, gross settlement system. The requirements of external auditing have been introduced. Bulgaria's accounting principles are evolving to meet EU requirements and the adoption of the IAS (International Accounting Standards) "chart of accounts" is underway. The assimilation of the standards by the banks and the enterprises will probably take some time, however.

As we emphasize in the fifth section, Bulgaria needs to complete the privatization of the financial services industry and vigilantly focus on the maintenance of the hard-won stability of the financial system. Still too small in size and equity, the banking sector needs to enhance its credibility, streamline its operational expenses, increase its core banking earnings from lending rather than relying on low-risk government securities and strengthen its managerial and technical capabilities to be able to play fully its intermediation role and effectively contribute to growth. This is also key for EU accession, which requires the presence of stable, competitive, and open markets, as well as the necessary institutions to support them.

These requirements are driving the financial sector restructuring agenda in Bulgaria. Most of the regulatory and legal framework enhancements to harmonize with EU Financial Sector Directives have been made. The established institutional infrastructure needs to be strengthened to effectively implement the legislative and regulatory framework created for EU compliance. This in turn requires enhancing the skills and capability of the supervisory and judicial bodies as well as the financial institutions operating in these markets. Improvements are also needed in the legal, accounting, and judiciary areas to support efficient and competitive markets. We complete this section with a matrix of the key measures recommended to strengthen the operation of Bulgaria's financial markets.

In conclusion, the accession agenda should aim to maintain the stability of the financial system while developing EU-standard rules and institutions. In this respect, considerable progress has been achieved in harmonizing the regulatory framework of financial services. Future strategic action plans need to concentrate on building institutional capacity, implementing and enforcing rules, and increasing competitiveness in the provision of financial services.

MACROECONOMIC AND MONETARY DEVELOPMENTS

Why a Currency Board?

The early 1990s in Bulgaria were marked by various factors: the disruptions associated with the start of the transition; adverse external shocks, including the Gulf and Yugoslav crisis; stop-and-go stabilization policies; and a slow pace of structural reforms. Economic activity declined significantly between 1990 and 1997, with the cumulative fall in real output reaching 34 percent. The weak macroeconomic performance of the first half of the decade culminated in a severe economic crisis in 1996 and early 1997. The banking sector was central to the crisis.

The banking sector was plagued with nonperforming loans, resulting from lending to loss-making state-owned enterprises, weaknesses in governance, and unsound credit policies to finance consumption, income transfers, price subsidies and inefficient production. Nine out of the ten state-owned banks accounting for more than 80 percent of banking sector assets, had negative capital in 1996. About half of the private banks were technically bankrupt. Early palliative attempts to restructure the sector included bank closures or recapitalization, signing of Memorandums of Understanding, and limited changes in regulatory and legal framework. As the runs on banks demonstrated, these measures proved insufficient to restore confidence. Indeed, the credibility of the package, of which the conservatorships imposed by the Bulgarian National Bank (BNB) in May and September 1996 were a major element, was undermined by the absence of an adequate regulatory framework, and the failure to implement key supportive policies such as privatizing state-owned banks and enterprises, and closing loss-making enterprises. The banking crisis toll amounted to the closing of 17 banks (or about one-third of the banking system). The consolidated costs of bank restructuring for the government and the central bank during the 1991-98 period amounted to the equivalent of 75 percent of GDP (Tang, Zoli, Klytchnikova, 2000).

On the macroeconomic front, as the banking crisis unfolded, liquidity injections from the BNB to support the weakening banking sector increased. Concurrently, the BNB attempted to sterilize liquidity through open market operations and, in a vain attempt to support the exchange rate, conducted interventions on the foreign exchange market. The open market operations resulted in interest rate hikes that aggravated the servicing of the domestic debt, while the foreign exchange interventions further depleted the scarce foreign exchange reserves. The escalating political turmoil and rising budget deficit made monetary control impossible. In the face of escalating debt service costs, and in order to avoid default on the domestic debt, the growing budget financing needs were met by central bank credit. The monetization of the deficit, a rapidly depreciating currency, and growing political unrest stimulated inflationary expectations, and by March 1997, inflation had soared to an annualized rate of more than 2000 percent.

Under these circumstances, a consensus developed that another money-based stabilization attempt would be equally unsuccessful and that stabilization would need simple disciplinary rules and a fixed exchange rate. In late 1996, discussions began on the adoption of a currency board arrangement (CBA) as a cure to the problems of soft budget constraints and commercial bank financing that kept loss-making enterprises afloat, and the lack of fiscal discipline that led to hyperinflation. Actually, the change in political leadership, the introduction of the CBA in July 1997, and the subsequent implementation of sound

macroeconomic and structural policies succeeded in restoring confidence, lowering inflation, and resuming Real gross domestic product (GDP) growth, which averaged 3 percent in 1998-99.

A Currency Board Arrangement (CBA) tailored to Bulgaria's specifics

Bulgaria's CBA is a narrow currency board that ensures full coverage of the monetary base, and convertibility at the official exchange rate at any time and without limit, and severely limits the conduct of monetary policy. The CBA introduced under the July 1, 1997, BNB law fixed the rate of the Bulgarian lev (BGL) to the "peg" currency, the Deutchmark (DM), at 1,000 BGL per 1 1000/DM.[1] The law also described the restrictions on the financial relations between BNB and the state (including state agencies), and between BNB and the banking system.

The BNB was reorganized after the Bank of England model into an "Issue Department" and a "Banking Department." The Issue Department holds all BNB's monetary liabilities—bank notes and coins, deposits from banks and nongovernment entities, government deposits and the Banking Department deposit. These liabilities are backed by assets in foreign exchange and gold. The Issue Department invests BNB's foreign assets, subject to the restrictions in terms of quality and liquidity explicitly stated in the Law on BNB. The Banking Department holds all other assets and claims on the central bank and acts as a fiscal agent of Bulgaria with the International Monetary Fund (IMF).[2] The Banking Department is responsible for enforcing reserve requirements and monitoring developments in the financial markets and the payment system.

A number of features, tuned to Bulgaria's specific situation at the time of the adoption of its CBA, distinguish its arrangement from a pure currency board. First, because of the banking crisis and the fragility of the banking sector, Bulgaria's CBA has retained some limited traditional central banking features. It imposes on commercial banks minimum reserve requirements, and it allows for a limited role of lender of last resort. For this purpose, the CBA was established with some excess coverage (more foreign exchange than needed to cover the monetary liabilities of the central bank). The corresponding funds, kept as the Banking Department deposit with the Issue Department, can be used to make collateralized loans to commercial banks in case of an acute liquidity crisis.

Second, in view of the magnitude of past fiscal difficulties, the Bulgarian CBA, while ensuring fiscal discipline, includes specific budgetary financing features and contingency management mechanisms. Hence, the BNB law allows for "on-lending" of IMF purchases by the BNB to the Government for the budget. In addition, to enhance fiscal credibility, a Fiscal Reserve Account (FRA), held in the Issue Department, was established. A floor on its balance is maintained throughout the year to cover the realization of potential contingencies. Indeed, by consolidating all central government and major extrabudgetary funds deposits, ensuring their full foreign exchange cover, and maintaining a comfortable floor on its own balance to cover main contingencies,[3] the FRA adds to the credibility and stability of the

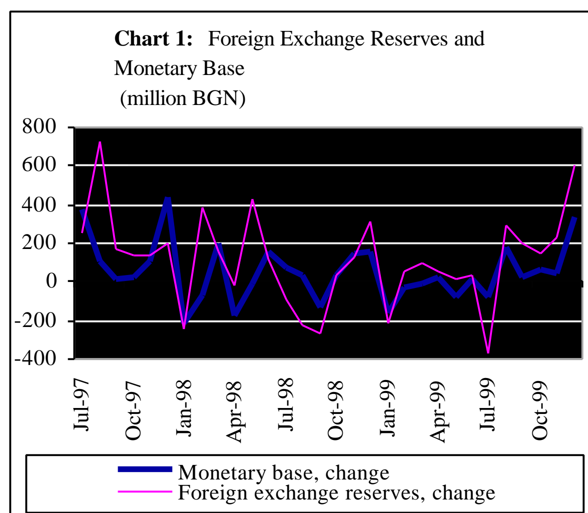
[1] In July 1999, 1000 BGL were changed to 1 BGN. The rest of the paper is based on this new Bulgarian lev, where 1 BGN= 1 DM.

[2] IMF credit is channeled through the Banking Department to be used by the Government or deposited to the Banking Department account at the Issue Department, without affecting the foreign reserve cover.

[3] Unaccounted for costs of structural reforms, higher debt service, or lower than programmed external financing.

government fiscal position.

Third, under a pure CBA model, the only liability of a currency board is the monetary base. Hence, changes in foreign reserves will affect the money supply, providing for an automatic adjustment mechanism to ensure balance of payments (BOP) equilibrium.[4] Under the Bulgarian CBA, changes in foreign exchange reserves linked to IMF loans and foreign debt payment obligations do not affect the monetary base. This specific structure of the Bulgarian CBA balance sheet has important macroeconomic consequences. Given the magnitude of these flows, the arrangement presents the advantage of reducing the volatility of the money supply (see chart 1). At the same time, however, it eliminates the direct connection between BOP disequilibrium and adjustment in the money supply, undermining a smooth operation of the automatic adjustment mechanism—a key feature for currency board long-term sustainability.



Source: Bulgarian National Bank

The CBA has gained credibility but what about sustainability?

Foreign exchange indicators. Foreign exchange reserves have remained high since the inception of the CBA, consistently exceeding the equivalent of six months of imports. Official reserves in percent of currency board liabilities and official debt service increased from 90 percent at the end of 1997 to 116 percent at the end of 1999. Other selected foreign exchange indicators signal adequate coverage of the monetary base, broad money, and quasi money (Table 5, Appendix I). For example, the ratio of foreign exchange reserves to the monetary base, which indicates the capacity of the CBA to meet possible banking sector currency or fiscal difficulties, increased from 1.64 in 1997 to about 2.07 by the end of 1999. Another indicator, the ratio of foreign exchange reserves to quasi money, which measures the degree of coverage of the part of the money stock that could be easily converted into cash and could increase the demand for reserve currency, has exceeded one (1) since 1997. If it becomes less than one, this ratio would indicate that the CBA may experience difficulties in meeting the increased demand for reserve currency caused by the transformation of quasi-money into cash.

External sustainability. To assess external sustainability, we review below external balance developments and their underlying factors (internal and external shocks) and the external gap financing sources (foreign direct investment, or FDI, and debt). Driven by a sharp fall in exports, Bulgaria's current account balance moved from a surplus equivalent to 4.2 percent of GDP in 1997 to a deficit of 0.5 percent of GDP in 1998 and 5.2 percent of GDP in 1999.

[4] A balance of payments (BOP) deficit causes an outflow of foreign exchange reserves, reducing the money supply and thereby raising interest rates and causing a contraction in output and prices. The combination of capital inflows in response to the higher interest rates, increased export competitiveness because of their lower prices, and lower demand for imports resulting from the output contraction will restore BOP equilibrium.

Evidence from price and wage indicators does not suggest an exchange rate misalignment. Bulgarian wages are among the lowest in the region and its labor markets are quite flexible. The pattern of productivity-based dollar wages indicates that while Bulgaria is undergoing a productivity-driven appreciation, a sizable difference still exists between the actual and the estimated equilibrium wage, implying that competitiveness is not at risk (Garibaldi, Dimitrov and Stoyanova, 2000).

The deteriorating export performance is, in fact, attributable to a number of internal and external shocks. Ongoing enterprise privatization and restructuring is causing a number of inefficient enterprises to phase out or overhaul their operations, temporarily reducing activity and exports. In addition, a weak international environment marked by a global financial crisis and low commodity prices has led to significant lower demand for Bulgaria's products. Finally, the Kosovo conflict blocked transit routes to Western Europe, raising transport costs and causing losses in export markets. While there are signs of a recovery of exports following the end of the Kosovo crisis, a sustained improvement in the trade balance will require an intensification of the restructuring of the enterprise sector and major improvements in the overall investment climate.

In meeting its external financing requirements (see Table 2, Appendix I), Bulgaria is highly dependent on FDI inflows (50 percent in 1999) and loans for balance of payment support from international financial institutions (38 percent). Offsetting FDI flows, equivalent to 4.4 percent of GDP in 1998 and around 5 percent of GDP in 1999, helped finance the current account imbalance, which, therefore, did not pose a threat to external sustainability. Nevertheless, in the years ahead, external sustainability will hinge upon the pace of enterprise restructuring, a rapid recovery of exports, and sustained direct foreign investment. The composition of FDI is also likely to be a key determinant for external balance in the years ahead. In 1997-98 FDI flows were largely privatization-related. With privatization of the largest enterprises planned for completion by 2001, Bulgaria needs to attract substantial FDI in new export-producing facilities to finance future current account deficits. Actually, in the absence of a strong export rebound, large volumes of debt and investment-related capital flows could disproportionally leak out to finance investment goods imports and debt repayments, and further worsen external imbalance.

Sovereign debt,[5] the second main source of external financing, also raises a concern for external sustainability. Out of a public debt amounting to the equivalent of 82 percent of GDP in 1998, more than 80 percent is foreign, nearly a half is in Brady bonds, and the rest is mostly owed to international financial institutions. Most debt instruments are long term, with a floating interest rate, and denominated in U.S. dollars. Interest rate risk in public debt portfolio raises some concern as the share of floating debt in both internal and external debt portfolio was more than three-quarters at the end of 1998. The drop in London Interbank Offer Rate (LIBOR) in 1997-98 lowered debt service costs. Increases in LIBOR in the future would reverse this trend.

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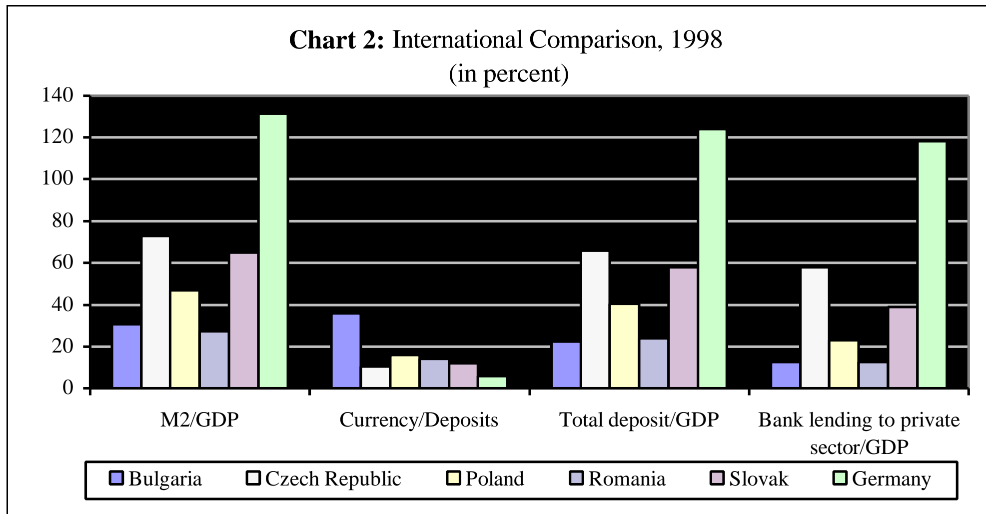
[5] For a more detailed discussion of sovereign debt, see "Managing Fiscal Risk in Bulgaria," The World Bank, Policy Research Working Paper 2282.

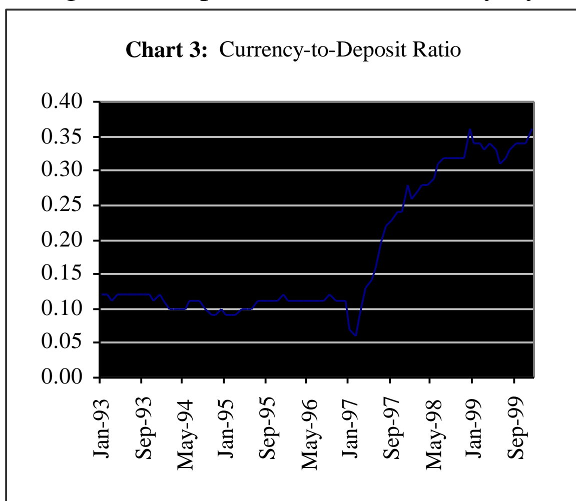
Monetary aggregates and financial intermediation are still low

As chart 2 illustrates, monetization and intermediation in Bulgaria are low compared to other transition economies and Germany. Not surprisingly after a major banking crisis and as our analysis below indicates, they are also far below precrisis levels.[6]



Note: M2 includes currency outside banks and demand deposits (M1) and quasi-money (time deposits,savings deposits and foreign currency deposits).
*Source:*International Financial Statistics

Broad money. Monetization as measured by broad money (M3) as a percent of GDP remains weak compared to its precrisis level (Table 7, Appendix I). Following the banking sector crisis, in 1997, the ratio of broad money to GDP fell to 25 percent, less than half its 1995 level. This ratio has stabilized at about 28 percent of GDP, which indicates remaining low confidence in the banking sector. Developments reflect economic agents' preference for cash holdings, low deposit rates, and a fairly dynamic informal sector. While initially the crisis affected almost equally lev and deposit holdings, as both fell sharply, by the end of 1999 lev currency holdings had recovered close to their precrisis level. Demand, time and saving deposits, however, do not show strong signs of recovery. In line with the low level of deposits, the currency to deposit ratio reached 36.3 percent in 1999 almost triple its 1995 level (see Chart 3), while the money multiplier dropped from 4.5 in 1995 to 2.7 indicating low lending activity.



Source: Bulgarian National Bank

The banking crisis was also accompanied by increased currency substitution. The share of foreign exchange in broad money

[6] Precrisis levels should, however, be interpreted with caution. Soft budget constraints, politically-driven lending, fraud, and weak governance contributed to high intermediation levels.

picked from 27 percent in 1995 to 50 percent in 1996. Reflecting a gradual revival of confidence in the Bulgarian lev, it did, however, decline to about 39 percent in 1998 and has since remained fairly stable. As we will see below, the banking crisis has modified the behavior of the key actors. Both depositors and commercial banks are being cautious. As a result, with total assets about 36 percent, loans about 22 percent and deposits about 27 percent of GDP, size alone limits the potential contribution of the banking sector to economic development. (Tables 5-7, Appendix I).

Deposits. The crisis of the banking sector has affected confidence as can be seen from the sharp drop in the level of deposits and their changing composition in terms of currency and maturity structure (Table 9, Appendix I). Demand time and saving deposits fell to about 21 percent of GDP in 1997 from 52 percent of GDP in 1995. The maturity structure of deposits has shortened, with demand deposits prevailing over savings and time deposits, and the relative share of foreign exchange deposits soaring to 53 percent of total deposits in 1999 from 30 percent in 1995 (Table 3, Appendix I) .

Domestic credit. The majority of bank assets are in low-risk domestic and foreign securities and placements (Table 10, Appendix I). Commercial bank loans represent less than one-third of banks' total assets. Indeed, the banking crisis and subsequent developments resulted in a drastic fall in domestic credit which dropped to the equivalent of 19 percent of GDP in 1999 from 67 percent in 1995. A radical change in the composition of credit also took place (Table 11, Appendix I). First, the share of foreign exchange denominated credit increased from 34 percent of total domestic credit in 1995 to 75 percent in 1999, with the private sector and the central government holding, respectively, 53 and 32 percent of total foreign exchange-denominated credit.

Second, lending to the public sector at large has sharply dropped. Hence, claims on the government sector declined from 32 percent of GDP in 1995 to 2 percent in 1999 (Table 11, Appendix I). Not surprisingly claims on nonfinancial state-owned enterprises also declined from 22.3 percent to 3.5 percent of GDP during the same period. The implementation of the reform of the state-owned enterprises resulted in a number of closures of nonviable companies, and the isolation program eliminated easy access to commercial bank credit. In addition, under the CBA, which provides only a limited, lender of last resort facility, commercial banks adopted a more conservative stance toward loss-making enterprises and state-owned enterprises undergoing restructuring and privatization.

In contrast to the sharp decline in lending to the public sector, the share of banking sector claims on the private sector registered a slight increase from 12.7 percent of GDP in 1995 to about 13.5 percent in 1999. This level, however, remains by all standards very low. It is attributed to the banks' preference for low-risk liquid assets following the crisis and to the ongoing economic restructuring, which, because of substantial firm exit and new entry, is making for an uncertain customer base with limited or absent credit history. In

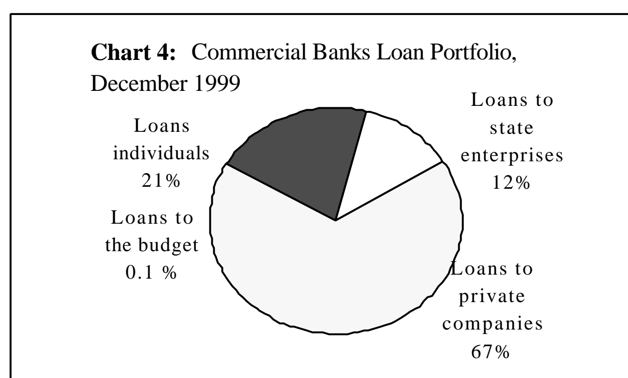


Chart 4: Commercial Banks Loan Portfolio, December 1999

Source: Bulgarian National Bank

addition, in view of the high-liquidity requirements in a currency board environment with a limited lender of last resort function and with Bulgaria's shallow short-term money markets, banks may feel obliged to maintain high liquidity. They may need to face unexpected large claims such as bunching of withdrawals or the nonrenewal of credit lines by other intermediaries.

Other possible factors for these low lending levels include tighter banking regulations and supervision, stricter state guarantee policy for enterprise borrowings that reduce moral hazard, and a weak legal and judicial environment that reduces the probability of recovering losses in case of default. As a result, however, of the sharp fall in lending to the public sector at large, the private-sector share in the commercial banks' loan portfolio has become dominant (Chart 4).

Box 1 below further elaborates on private sector credit.

Box 1: Why is Private Sector Credit So Low in Bulgaria

Bank lending to private sector is low in Bulgaria by any standard. It amounts to only 12 percent of GDP, compared with 17 percent for transition economies, 49 percent in the United States and 120 percent in the United Kingdom. Financial intermediation is low even when controlling for Bulgaria's stage of development: based on a cross-country regression, a country with Bulgaria's per capita GDP is expected to have a 17 percentage point higher ratio of credit to the private sector to GDP. This is not due to low bank liquidity: deposit-to-loan ratios are high, but banks tend to hold bonds instead of extending loans.

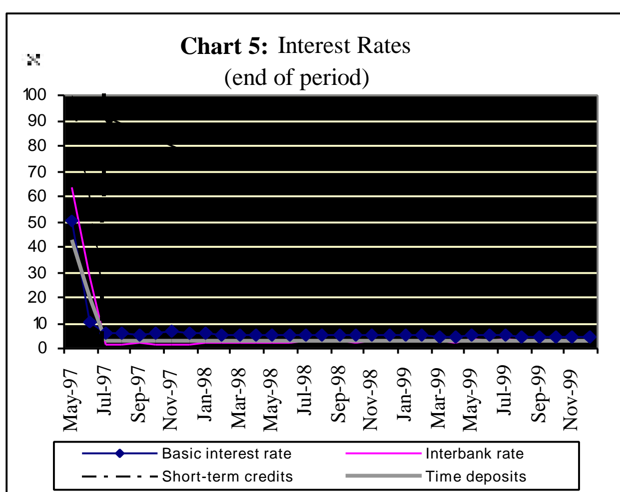
Several factors account for the low level of credit to the private sector:

- *The banking crisis in 1996–97***.** As in other countries that went through a banking crisis, banks in Bulgaria became cautious about making loans during and after the crisis. Before the crisis, lending to the private sector had been quite high (20 percent of GDP in 1995), but much of it was based on unsound banking practices and weak supervision.
- *Economic restructuring.* Many old customers have ceased or reduced operations, or have become uncreditworthy under the restructuring that has taken place since the crisis. New customers from the emerging private sector typically do not have a credit history or appropriate collateral, and transparent financial information is often lacking.
- *Lack of competition in the banking sector***,** *despite a relatively large number (35) of banks).* The banking system is dominated by a small number of large banks, all of which were state owned until 1998. Interest margins are high and banking services inefficient, and banks have not felt pressure to cut costs.
- *An imperfect legal environment.* The resolution of financial disputes is often slow, and contract enforcement is weak. Collateral is hard to seize, and bankruptcy and liquidation procedures remain fraught with ambiguity and uncertainty. A legal provision that criminalizes the extension of loans without "proper security," even in the absence of fraudulent intent, acts as a deterrent for bank officials.

  Source: IMF

*Interest rates***.** As could be expected from a successful stabilization, interest rates fell sharply following the introduction of the CBA (Chart 5). Interest rates have remained fairly stable since then. In a pure CBA, interest rates fluctuate, depending on changes in the money supply induced by fluctuations in foreign exchange reserves. In Bulgaria, interbank lending and deposit rates continue to follow the base interest rate, which is determined by the yield on the three-month treasury bills issued weekly by the Ministry of Finance (MoF). The supply of treasury bills (TBs), is limited because of government low-financing needs and the high stake in keeping domestic debt-servicing low, while demand is high because of the high liquidity of commercial banks and their cautious attitude toward lending. Hence, interest rate developments are taking place in a shallow and insulated domestic market of government securities, with its idiosyncratic supply and demand characteristics.

Reflecting the risks associated with an economy struggling to recover, lending rates in 1999 were high, 12.4 and percent; and deposit rates low, 3.24 percent (Table 12, Appendix I). Although a record low since 1993, the average lending spread (about 9 percent in 1999) is still high by international standards.



Source: Bulgarian National Bank

The high lev short-term lending spreads over the lev time deposit interest rates are primarily due to the banks' reluctance to lower interest rates to their borrowers. Lack of credible competition, the large provisioning expenses during 1997-98, and a limited borrower base that was highly dependent on the banking sector contributed to the resistance to lowering lending rates to bring them in line with inflation. The banking sector earnings during 1997-99 (Table 13, Appendix I) depended on noninterest income since the high operating expenses added as much as 6 percent to the cost of funds in large state banks, exceeding the net interest income of the sector. Spreads are expected to decline further as competition increases with privatization; reserve requirements are lowered in June 2000 from 11 to 8 percent; and, as some of the large banks start to expand their business services and products, especially to the retail-consumer banking areas.

What can be done about intermediation?

It is important to recognize that Bulgaria may be on for a "long game" here. The devastating effect of hyperinflation and the easy access to a secure home for savings in nearby industrial countries mean that it will take time for depositors to place their savings in Bulgaria and for the privatized banks to become more active in lending to local entrepreneurs. Adverse conditions in former markets of the former Soviet Union and the volatile security situation in the neighboring former Yugoslavia mean weak entrepreneurial confidence, which also weakens the demand for credit, thereby limiting the opportunities for banks. Thus, while financial depth is not deteriorating, it has so far shown no great recovery and remains well below that of comparator countries. Cash holdings have been more resilient than deposits in local banks, and the dollarization rate has remained high with half of the banking sector's assets and liabilities and more than half of the deposit base denominated in foreign currency.

Under these circumstances, the broad thrust of policy - that is sound fiscal policy; the tightening of bank regulations to converge to EU standards; and the privatization of the banks, including to qualified foreign firms - has been correct but it needs to be sustained and deepened. The bank privatization process in particular, through the increase in competition and the diversification of product and services that it is likely to bring, is key to improving the longer-term performance of the sector. In addition to the measures directly targeting the banking sector, a whole range of economic management and business environment-related policies need to be implemented. In this respect, enhancing creditors' rights and enforcing

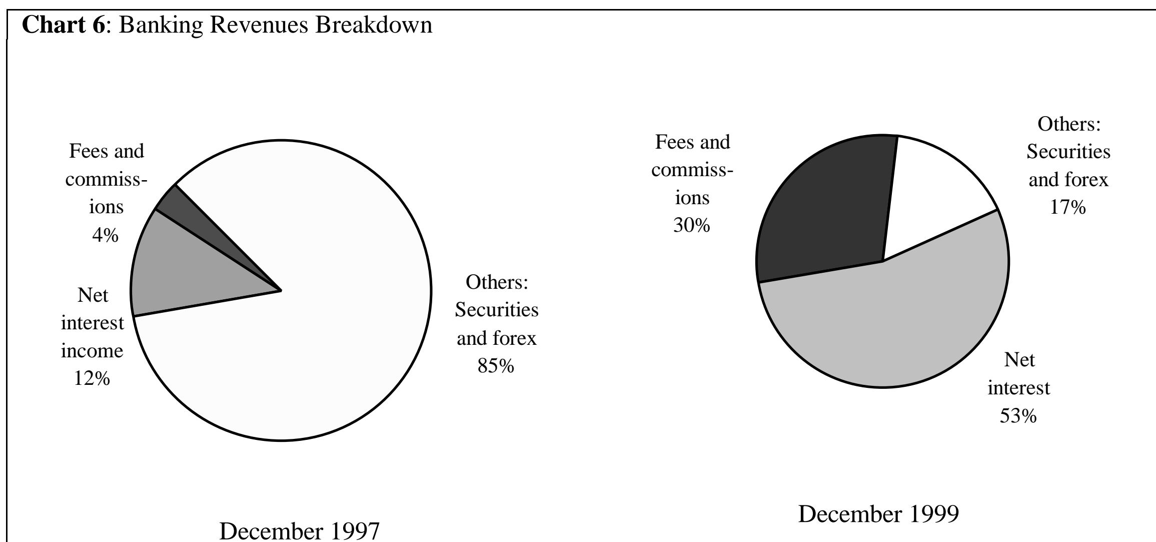
contracts; removing obstacles to the use of land as collateral; and, strengthening banks' risk assessment and management skills would go a long way toward changing commercial banks' lending behavior.

The foundations for a stronger banking sector are gradually being established

The overall soundness of the banking sector has improved considerably with the closure of unprofitable banks and the substantial strengthening of the regulatory and supervisory functions. Total risk-weighted capital adequacy increased from 10.2 percent in June 1997 to 41.8 percent by December 1999 (Table 14, Appendix I). After the large-loan loss provisions made in 1997 and 1998, the average pretax profit on total assets soared from about 0.9 percent the year before 1997 to more than 5 percent since 1997 (Table 8, Appendix 1). The performance of the sector as a whole hides, however, a substantial variance in the performance of individual banks (Figure 1, Appendix I). As of the end of September 1999, nine small banks have recorded losses of varying size according to the BNB's published data. Furthermore, the sector as a whole is not provisioning for loan losses as is required. (Table 15, Appendix I), which implies that profits could be somewhat overstated.[7]

The banking sector's earning base has evolved, however. The CBA has eliminated the potential for large earnings from "own-account," speculative, foreign exchange activities. Hence, during the last two years, the share of earnings from securities and foreign-exchange-related activities declined from 85 percent of bank earnings in 1997 to 17 percent in 1999. Now the banking sector relies more on core banking earnings: fees and commissions and net interest income. Net interest income increased to 54 percent of total banking sector revenues in 1999 from 12 percent in 1997. Total interest income for the sector remained stable in 1998-99, whereas interest expenses declined by about 10 percent (Chart 6). Stable interest

Chart 6: Banking Revenues Breakdown



Source: Bulgarian National Bank, ING Barings

[7] The theoretical provisions in table 11 have been calculated on the basis of the entire loan without subtracting the highly liquid collateral from the amount of the loan, as provided under BNB Regulation 9, article 13. This is a conservative but safer approach, given the uncertainty about the liquidity of collateral at present in Bulgaria.

income reflects banks' preference for low-risk, low-return securities rather than loans, while the decline in interest expenses reflects the postcrisis shift toward short-term, liquid, noninterest-bearing, demand deposit instruments. High operating expenses not covered by net interest income are offset through fees and commissions and other noninterest related banking activities.

Given the ongoing restructuring within the sector, it is too early to judge the potential for future profitability and growth of the banking business in Bulgaria. However, in the coming years, as Bulgarian banks increase the mobilization of domestic resources to maintain their market presence and therefore face higher interest expenses, they will need to boost their interest income. They will also need to lower their high operating costs relative to their present income-generating capability. The high interest rate spreads are not helping the recovery, either. The sector is facing here a chicken and egg problem, as the high spreads are needed to cover the bank's operating expenses, given that the scale of their loan portfolio is so low and their business operations are not yet diversified enough to generate stable noninterest income. The preference for very high solvency on a risk-weighted basis also makes banking an expensive business since low-risk, low-return securities clearly do not generate sufficient revenues. Increased competition from privatization will probably lead bank managements to reassess their risk management and earning strategies.

Eventually, long-term profitability will depend on the banks' resource mobilization capability and their ability to generate profit from lending and lending-related core business activities in corporate or retail banking operations. The small size of the Bulgarian economy, a slow recovery in the real sector, or increased competitive pressures[8] from foreign banks and branches could raise sooner rather than later the issue that prospective market opportunities are too limited to support some of the existing banks.

INSTITUTIONS AND RULES OF THE BANKING SYSTEM

Banking is the dominant sector

At the core of the Bulgarian financial system is the banking sector, comprising some 35 commercial banks, with total assets of about 8 billion BGN (as of December 1999). In addition, there is a small but growing insurance sector (30 insurance companies), with total financial assets of about 0.3 billion BGN, several finance houses, some investment holding companies (which evolved from voucher privatization funds), a handful of embryonic private pension funds,[9] together with several dozen independent broker-dealers. The Bulgarian stock exchange trades only a handful of shares[10] on the official market. Overall stock market capitalization is estimated to be about 1.1 billion BGN although the actual figure for the number of nonstate shares available for trade at the Bulgaria Stock Exchange (BSE) is estimated to be half of this amount.

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[8] Using bank level data for 80 countries in their study titled "How Does Foreign Entry Affect the Domestic Banking Market?," Claessens and others find that larger foreign ownership share of banks reduces the profitability and the overall expenses of domestically owned banks. Their results suggest that foreign bank entry improves the functioning of national banking markets, with positive welfare implications for banking consumers.

[9] There are to date no authorized mutual funds or fund management agents.

[10] Though the number has recently increased because of the listing of several holding companies converted from voucher privatization funds.

The sector is largely state-owned

As of September 1999, Bulgaria had 28 banks and 7 foreign bank branches (Table 16, Appendix I). Out of the 28 banks, 12 have majority (more than 51 percent foreign ownership) or near-majority foreign ownership. Of the total banking sector assets, state banks hold close to 54 percent, Bulgarian national banks 4 percent, and foreign shareholder banks or branches about 39 percent.

As Table 1 below indicates, state ownership of banking sector assets is still among the highest in the region, second only to Romania (75 percent) and far above Estonia (7.8 percent), Latvia (8.5 percent) and Hungary (11.8 percent). But this picture is likely to change dramatically with the privatization of two of the largest state-owned banks, Bulbank and Biochim, by the end of 2000.

Table 1: Privatization in the Banking Sector in Selected Countries in Europe

Comparision with Central and Eastern European Countries

1998	*Asset share of state-owned banks (%)*	*Asset share of foreign-owned banks (%)**	*Number of banks*	*Of which majority foreign- owned*
Belarus	59.5	2	37	3
Bulgaria[11]	59.5	37	36	21
Croatia	37.5	4	60	11
Czech Rep.	18.8	13	45	13
Estonia	7.8	28	6	2
Hungary	11.8	62	40	27
Latvia	8.5	71	27	15
Lithuania	45.3	41	10	5
Moldavia	0	14	23	7
Poland	48	16	83	31
Romania	74.6	6	36	16
Russia	42.2	7	1476	29
Slovak Rep.	50	19	24	8
Slovenia	41.3	6	34	3
Ukraine	Na	Na	227	12
Germany*	52	2.4	3392	
France*	31		570	
Italy*	36	5.3	911	

Source: Lanoo, European Bank for Reconstruction and Development (1999), European Central Bank (1999), CEPS; and World Bank estimates. Data market with (*) and for the asset share of foreign-owned banks are for 1997.

[11] Following the conclusion of the privatization of Expressbank and Hebros Commercial Bank end-1999, the share of state-owned banks declined to 50 percent and the number of majority foreign-owned banks increased to 20.

The top 12 banks dominate

The bulk of the banking system is in the hands of 12 banks, five of which are state-owned. The top 12 banks hold 85 percent of banking sector assets, 87 percent of total deposits and 80 percent of total loans (Table 17, Appendix I). The largest bank is Bulbank, the former foreign trade bank, with a 27 percent market share. It is primarily a wholesale bank specializing in foreign exchange business. This bank, which has a substantial shareholding in United Bulgarian Bank (UBB) (one of the other large banks), and two other banks (one local and one foreign), are to be privatized by mid-2000.

Next in size is the State Savings Bank (SSB). Its deposits (about 15 percent of the total) remain fully state guaranteed, though this will end in 2000. The present deposit insurance fund premium payments and reserve requirements fully apply to the SSB, and it does not otherwise benefit from fiscal preferences. In 1998, SSB was granted a commercial banking license, although it is not allowed to accept foreign currency deposits. It has recently been given additional freedom and has quickly moved to expand small-scale lending to households and microenterprises. Until BNB stopped incremental lending under a Memorandum of Understanding in October 1998, SSB made about 400,000 loans averaging about 1,200 BGN per borrower. By mid-1999, the amount outstanding on these small loans exceeded 55 percent of its total assets. For the present, SSB has more than 90 percent of the household loan market. SSB also has the most extensive branch network in Bulgaria, with 331 primary and secondary branches and about 1,700 other offices (about half of them in post offices).[12]. There are plans to privatize SSB in 2001.

Two other large banks, UBB and the Bulgarian Post Bank, were privatized in 1997 and 1998, respectively. EBRD and Bulbank are UBB's largest shareholders; Bulgaria's Post Bank is being actively repositioned by a joint venture between the Allianz Life Insurance Company (ALICO) and the European Financial Group, with banking interests in Greece and elsewhere. Both banks operate at low loan to deposit ratios in the region of 20 to 30 percent. Bulgaria's Post Bank has a very large network with around 120 large and small branches and access to almost 2,000 post offices for providing basic banking services. In 1999, Societe Generale acquired 97.9 percent of Expressbank, and Regent Pacific Group signed a contract for 97.6 percent of Hebros Commercial Bank shares. These were both primarily regional banks. The government also intends to divest from Biochim Bank in 2000.

The rest of the banks have diversified ownership structures and strategies

The remaining small and medium-size banks vary widely in size, profitability, and style of business.[13] Many have capital and reserves barely meeting the minimum paid-in capital requirement of 10 million BGN. These are not all exclusively private banks, nor are they now all majority Bulgarian owned. Indeed, of the three largest banks in this group, Sofia municipality has a majority share in the Municipal Bank, three foreign concerns now hold 72 percent of First Investment Bank, and the State Agricultural Fund has a 50 percent share in

[12] With more than 6,000 staff and manual processing systems, SSB is also inefficient. Overhead and services costs contribute 6.27 percent to the cost of borrowing from the bank.

[13] January 1999 saw the failure of one of the banks formerly in this group—Credit Bank. Already weak, the Russian default dealt this bank a fatal blow, as it had been holding Russian government securities. Its depositors received compensation from the new Deposit Insurance Fund.

the Central Cooperative Bank.[14] These banks also face strong competition in corporate and investment banking activities from the branches of the foreign banks.

Overall, the banking sector is gaining credibility

As of December 1999, the Bulgarian banking sector has high solvency and liquidity. Overall, risk-weighted capital adequacy under IAS is about 42 percent (Table 14, Appendix I), far above the required 10 percent. Classified loans (below standard) have declined to 13.8 percent of total loans from 17.6 percent at the end of 1997 (Table 11, Appendix 1). The majority of the past earnings have been used to build up loan loss provisions. The required provisioning and capital adequacy standards are maintained above the minimum internationally recommended guidelines.

Having weathered the crisis of 1996-97, the banking sector will face its next challenge in the coming years. Improvements in the real sector, increased competition from privatization, and the need to sustain profitability will all make it important for the banks to enhance their risk management skills and increase the range of services and products they provide. Given the large market share of the top 12 banks, some of the small banks may find it necessary to either specialize in niche markets or merge with others to continue to be viable.

A self-financing Deposit Insurance Program is in place

From January 1999, the previous blanket deposit insurance, which had been introduced during the 1996-7 crisis, was replaced by a self-financing Deposit Insurance Fund (DIF). The fund collects a levy of 0.5 percent on end-of-year deposits of the banking system and undertakes to cover 95 percent of the first 2,000 BGN of any deposit and 80 percent of the remainder up to a maximum payoff of 6,900 BGN for each depositor.[15] As of June 1999, DIF has assets of about 30 million BGN.[16] Failing other calls on its resources, it will accumulate funds at a rate approaching 25 million BGN a year at the current insurance levy rate. This rate (already high by international standards) can be increased to 1.5 percent, and if it proves inadequate can (subject to parliamentary approval) be augmented by borrowing from the government.[17]

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[14] The government intends to reduce State Fund for Agriculture holdings in Central Cooperative Bank to below 33 percent by mid-2000.

[15] No estimate is currently available of what the average percentage payout from the actual distribution of deposits would be, although the figure could be as low as 40 percent or even less. The present insurance coverage also differs from a common-sense reading of the relevant legislation, which would have limited the payoff to 4,300 BGN. However, the drafting contained an ambiguity, and the higher amount was paid in the case of the Credit Bank liquidation, which had to be dealt with only days after the new DIF came into effect

[16] After a payoff of 10 million BGN to the failed Credit Bank depositors. DIF's legislation limits its permissible investments to Bulgarian cash and government investments, and at present invests almost all its resources through reverse repurchase operations. DIF also covers foreign as well as local currency deposits. Although payoff is made on foreign currency deposits in BGN the rate of exchange used is the date of initial payoff, thereby passing exchange risk to the DIF.

[17] Another alternative is for the authorities to revert to a fixed lower payout amount. Finally a few countries, for example Canada, authorize the deposit insurance agency to issue "own bonds" to finance liquidity needs. This could increase market discipline over the operation of the fund to the extent that no government guarantees are provided.

Governed by board representatives of the Government, the BNB and the Association for Banks, the DIF has no responsibility for bank supervision and cannot refuse to admit a bank to the scheme. DIF is dependent on the BNB for the conduct of its operations. Its Law on Deposit Guarantee Fund outlines close cooperation between the two institutions. However, experience so far indicates that the DIF's relations with the BNB need to be clarified. More responsibility should be placed on BNB to supply DIF with information essential for its operations on the distribution of deposits and the state of the banks. Recently, BNB and DIF have submitted to the parliament a "Draft Law on Bank Bankruptcy, which strengthens and clarifies DIF's powers with respect to the conduct of bank liquidation and its capacity to handle bankruptcy. The same draft law also lays the necessary foundation for the speedy resolution of future bank failures.

Banking regulation and supervision have been considerably strengthened

Following the crisis, bank regulation and supervision—both the regulation itself and the intensity of supervision and enforcement—have been strengthened. The Law on the Bulgarian National Bank was issued on June 10, 1997, replacing the previous law issued in 1992. Adopting a universal banking model, the law clearly defines the permitted activities of the banks, the entry conditions, prudential regulations, and the supervisory authority of the BNB over the banking sector. Various changes are being made to the Law on Banks to strengthen prudential regulations and the supervisory issues related to the BNB. Appendix II lists BNB regulations since mid-1997. Box 2 summarizes Bulgaria's main prudential requirements for banks.

Box 2: Bulgaria: Summary of Main Prudential Standards

Minimum capital: 10 million DM
Capital adequacy (risk-weighted): 12 percent by end of 1999
Tier I capital or risk-adjusted assets (see EC Directive 89/647): 6 percent
Single party, large exposure (more than 10 percent of bank capital): 25 percent of own funds
Large exposure aggregate: 8 times bank's own capital
Aggregate exposure to a single party: 10 percent of capital
Aggregate equity in nonfinancial companies: 75 percent of capital
Open forex position: 30 percent of capital per currency; 60 percent of capital for aggregate-Euro excluded
Minimum required reserves: 11 percent of the entire deposit base (to be changed to 8 percent by July 2000)

Source: Bulgarian National Bank

Since the adoption of the new banking law and related prudential requirements, the incidence of violations of major requirements, such as capital adequacy, open foreign currency position[18] and loan concentration to individual borrowers, has been reduced significantly.
Further work is ongoing to improve the prudential framework in areas such as introducing trading book or market risk capital allocation and requirements; employing consolidated supervision upon the adoption of accounting rules for consolidated bank accounting; and refining the guidelines on loan classification and provisioning.[19] A Central Credit Registry also became operative in October 1999.

Bulgaria's compliance with Basle Committee Core Principles Banking Supervision is well advanced. Out of the 25 core principles, Bulgaria is in full compliance with 15, largely compliant with 8, materially noncompliant with 1, and noncompliant with 1. The planned changes to conform to EU Directives such as introducing (a) consolidated reporting of certain prudential ratios, (b) stricter rules for the valuation of certain types of collateral, (c) rules and capital charges for market risks, and (d) policies for country risk exposure of the Bulgarian banks; and concluding agreements with foreign supervisors are also expected to improve Bulgaria's compliance to the core principles. One remaining related improvement would be for the banks to introduce and maintain integrated policies and procedures for institutional operations and risk management (IMF 1999).[20]

Parallel to the developments in the legal and regulatory framework, BNB's off-site and on-site supervision capability is improving with the support of donor technical assistance. In the past, the supervision was of a mechanistic nature, concentrating on compliance to prudential ratios. Qualitative analysis of the banks is being introduced and BNB is in the process of adopting CAMELS[21] rating methodology. Some reporting requirements for the off-site supervision have been expanded and an early warning reporting and evaluation system has been developed. The BNB supervision department should now adopt the early warning system and periodically publicize CAMELS' ratings to enhance market-based discipline. However, until the banks completely integrate IAS standards in their reporting, the off-site supervision data collected may not be sufficient to detect the early warning signals. Hence the requirement to have all banks adopt IAS standards should be implemented rapidly and enforced, and their externally audited IAS annual financial statements should be made public.

[18] This is restricted to 60 percent of capital (in either direction), and the open position effectively carries a 12 percent capital charge. Note, however, that holdings of euro currencies are not counted as foreign currency for the purpose of this calculation. (US$-denominated Zunk bonds are excluded from the calculation of the open position; capital is treated as denominated in BGN)

[19] BNB Regulation 9 on the asset classification and provisioning guidelines is stricter in the recommended specific percentage provisioning requirements and the timing of the overdue interest and principal allowed than the accepted international norms. For example:

standard—3-5 percent
watch—31-60 days, 25 percent
substandard—61-90 days, 50 percent
doubtful—91-180 days, 75 percent
loss—181 days plus, 100 percent

However the specific provisions are on a "net" basis after deducting the value of the collateral, depending on the type of collateral. Work is ongoing to refine the collateral definitions and assessment methodology.

[20] IMF (August 1999) Report on the Observance of the Standards and Codes - Bulgaria.

[21] The S in CAMELS stands for "systemic"-- evaluating the impact of macroeconomic developments on the banks. CAMEL (Capital Assets Management Earnings Liquidity).

UNDERDEVELOPED NON-BANKING FINANCIAL SYSTEM

The insurance industry is undergoing consolidation under new regulations

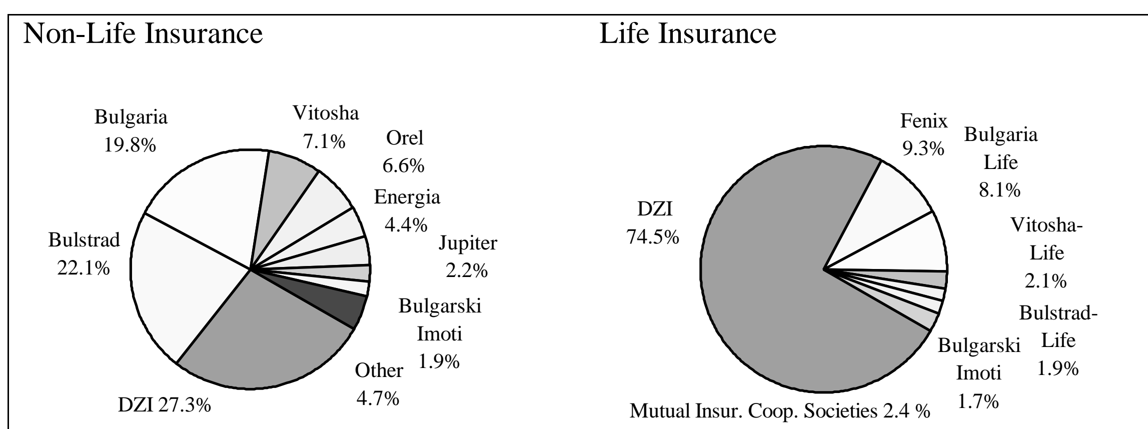
Until 1997, the insurance industry consisted of the two state insurance companies (Bulstrad for insuring trade and commodities transactions and the State Insurance Institute [DZI] for domestic insurance) and about 112 unregulated shareholder and mutual insurance companies reporting to the MoF. The Insurance Business Act in force since January 1, 1997, mandated that the insurance companies participate in a licensing process through the newly established Insurance Supervision Directorate. Since then, stricter minimum capital and other prudential requirements have also been imposed. As a result, by the end of 1998, 85 insurance companies were closed, while 27 continued operations. The Directorate of Insurance is liquidating the closed companies.

As of June 1999, Bulgaria had 23 shareholder and 4 mutual insurance companies. Ten of these companies offered life insurance products in addition to general insurance. The minimum capital is 3 million BGN for a general insurance and 2 million BGN for a life insurance company. The premium income during 1998 has been about 204 million BGN from general insurance products. Life insurance is a very new product and 1998 premium income was about 23 million BGN. The state-owned insurance companies, Bulstrad and DZI, dominate the market. Together they control 49 percent of the non-life insurance while DZI alone controls 74 percent of the life insurance market (chart 7). Total assets of the insurance industry are still insignificant. The ratio of Gross Premium to GDP did not exceed 2 percent in 1999, compared to 3.5 to 13 percent of the GDP in the EU. The low level of insurance activity is due to the poor performance of the insurance companies in honoring their obligations in the past, the public's lack of awareness of new insurance products, and the country's low level of income.

And increasingly attracting foreign investors

Foreign insurance companies have been entering Bulgaria through acquisitions into offshore small Bulgarian insurance companies. The trend toward acquisition of shares in the largest companies is more recent. The second largest state insurance company, Bulstrad, is now 51 percent owned by TBI, an Israeli-German company, and EBRD; the rest of the shares are held by Bulbank (the largest state-owned bank) and the MoF . With more than 33 percent of the shares owned by the state, the MoF still has blocking rights on management decisions. Although a definite timetable is not available, the state is expected to divest from DZI, the largest insurance company, in 2000. Two companies with foreign capital, American International Group (AIG) Life Bulgaria (part of the U.S. based AIG group) and QBE international (an Australian concern) received their licenses in 1999. As a result of privatization and foreign investment, a consolidation of the insurance market is likely to take place in the years ahead.

Chart 7: Insurance Premium Market Share, 1998



Source: Insurance Supervision Directorate

Capital markets institutions and regulatory framework are established

The legal and regulatory framework for the operations of the capital markets consists of the 1997 Regulation on the Structure and Activities of the Securities and Stock Exchanges Commission, and the Law on Public Offering of Securities passed in December 1999 and in force as of January 31, 2000. The key capital market institutions are the Bulgarian Stock Exchange-BSE Sofia, a Central Depository (CD) and a Securities and Stock Exchange Commission (SSEC).[22]

The SSEC is the regulator for the stock market activities and its responsibilities cover (a) issuing and revoking licenses for the securities market investment companies, the intermediaries and the exchanges, including the Over The Counter (OTC) market; (b) approving the public offer prospectuses and tender offers for block share purchases or exchanges; and (c) registering public companies and related stock market institutions.

The Bulgarian Stock Exchange was established in 1997 following the consolidation of the several stock exchanges that had proliferated in the 1990s. It is segmented into official and free markets, and all of the transactions in both markets are recorded through the Central Depository.

The official market is divided into segments A, B (parallel), C (provisional) and the bond market. The listing requirements get less stringent going from A to C (see Box 3). All of the companies listed in the official market are required to have their prospectuses approved by the SSEC starting in 1999.

[22] The authors have benefited from the World Bank sponsored paper on ‘Bulgaria’s Capital markets in the Context of EU Accession’ prepared by Center for the Study of Democracy, Sofia, Bulgaria.

Box 3: Listing Requirements in the Sofia Stock Exchange

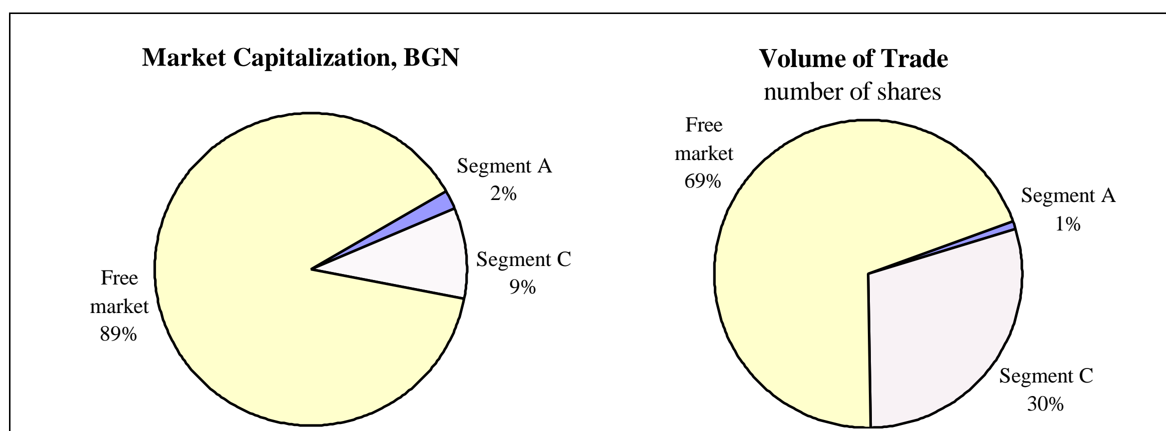
Segment A Minimums: 5 years of audited financial statements, 2 million BGN market capitalization, 500 shareholders with 25 percent public offer, and positive financial results for the last three years.

Segment B (parallel) Minimums: 3 years of audited financial statements; 1 million BGN market capitalization, 250 shareholders with 10 percent public offer, and positive financials for the last fiscal year.

Segment C (provisional) Minimums: 1 year of audited financials, 500,000 BGN market capitalization, and 250 shareholders with 10 percent public offer.

In an attempt to encourage the listing of privatized companies, the free market was added to the exchange. For the free market, the requirements are limited to a prospectus and free negotiability of shares. Actually, most of the privatized enterprises prefer to stay in this market (Chart 8). Although most privatized enterprises can qualify for the C and B segments of BSE, there are no pending applications for listing. This could be due to the fee and audit requirements as well as lack of investor awareness of the benefits to be derived from being listed on the official market.

Chart 8: Bulgarian Stock Exchange, 1999



Source: Bulgarian Stock Exchange

Every transaction in the exchange has to be conducted through an authorized intermediary that is a member of the BSE. In June 1999, there were 105 investment intermediaries including commercial banks. Of these, 73 are members of the BSES and have trading posts.

The CD was established as a joint stock company in 1996. Under the present regulations, all public companies have dematerialized shares and the shareholder registrations books are kept with the depository. The CD also acts as a transfer agent since it clears all transactions on both the free and the official markets. The shareholders of CD are several commercial banks,

BNB, and the MoF. The BNB and MoF have the power to veto the general meeting of shareholders.

Members of the CD include investment intermediaries, investment holding companies, the stock exchange, and some foreign depository and clearing institutions. Membership is important since only members can interact directly with CD to register transactions. When transactions are conducted off the exchange, the intermediaries present the documents for the transfer of titles to the CD. The settlement of the off-exchange transactions is the responsibility of the parties themselves. Clearing and settlement for the transactions conducted on the BSE must be made within three days. The CD administers a Guarantee Fund that is used for preventive measures and compensation of damages arising from its activities.

But markets are inactive and nontransparent

The capital market in Bulgaria was founded with the first wave of mass privatization completed in June 1997. Shares representing 25 percent of ownership (for large companies) to 90 percent (for small ones) of 1, 050 companies were offered at auctions in which individuals participated through preassigned voucher books. The privatized companies were given the choice to be listed in various markets of the BSE.

Although a large number of companies are listed on the BSE, many of the small companies have not traded at all. The estimates for total market capitalization for the listed companies are about 1.1 billion BGN (Table 17, Appendix I). The value of the shares not held by the Government and available for the trading on the BSE is estimated at about half this amount. Despite restrictions, the volume and amount of trading of the listed companies off the exchange exceed the BSE trades by at least 30 percent. The larger volume of off-exchange trading could be due to a number of factors, including a lack of investor knowledge and sophistication, difficult access to the exchange because of the high commissions of the intermediaries or their inaccessibility, and unfavorable tax treatment of capital gains on private securities.[23] The preference for off-exchange trading, in which the exchange prices of the shares are not publicly known or recorded, raises questions about the transparency of the market pricing.

In order to increase the volume of trade on the BSE, plans for listing private and public sector bond issues are underway. The present primary supply of state and municipal bonds is not sufficient to support an active secondary market. The first corporate bond issue was offered to the public in August 1999. The present low level of trading in the BSE is handled by seven or eight intermediaries conducting about 75 percent of the turnover. With such a low turnover, it is difficult to foresee the future viability of many of these intermediaries as well as the BSE.

[23] Income from government securities and bank deposits is tax exempt while income from dividends and capital gains on private securities is taxed.

There are also some unregulated yet active financial institutions

Finance companies

These unregulated companies are involved in diverse activities from leasing to portfolio management and investment advice. As of the end of 1998, there were around 40 finance houses with total balance sheet assets of US$62 million. Eight of these finance houses had assets greater than US$1 million or more. The assets of these eight totaled US$57 million, representing 92 percent of the finance house assets. The largest finance house had US$46 million in assets with a 75 percent market share.

Private defined contribution pension funds

The Law on Supplementary Voluntary Pension Insurance adopted in July 1999 and the newly established State Insurance Supervision Agency (SISA) will be regulating these funds. At present, there are about six to seven private pension funds that could fall under the coverage of this law. These pension funds have about 300,000 outstanding contracts with total assets of about US$15 million.

Investment holding companies

The majority of the privatization funds established under the first mass privatization program converted to investment holding companies whose shares could be traded on the BSE. At present 76 out of the original 81 privatization funds have been incorporated into investment holding companies. Only two are listed on the BSE. Some of these holding companies are also part of the above finance companies.

However, the regulatory framework bank for the majority of the non-bank financial institutions and markets is in place

The Law on Securities, Stock Exchanges and Investment Companies (LSSEIC) of 1997 established the SSEC to ensure the protection of investors and to speed up the development of the securities market. The new Law on the Public Offering of Securities effective January 1, 2000 has brought the regulations framework of Bulgaria's securities markets in line with EU requirements.

In line with international practice, the Law on Insurance defines two-tier insurance supervision. The Insurance Directorate is responsible for the day-to-day monitoring of the activities of the insurance companies. The National Insurance Council, composed of several ministers and representatives of the Insurance Directorate and the Association of Insurers, is authorized to give policy directives and to issue or withdraw insurance licenses based on the recommendations of the Insurance Directorate. In 1998, the supervision of insurance activities had concentrated on relicensing and eliminating insurance companies, so 1999 will be the first year in which the insurance industry has been operating under the regulations and supervision of the Insurance Directorate.

THE EVOLVING FINANCIAL INFRASTRUCTURE

Payment instruments are diversifying

According to the Law of the Bulgarian National Bank, the organization, maintenance, and development of the payment system are the obligation of the BNB. The legal framework for the payment system is determined within the regulations set by the BNB. The present system distinguishes the following payment instruments: credit transfers, direct debits, checks, letters of credit, and debit cards.

The majority of retail transactions and nearly all salary payments are still conducted in cash in Bulgaria.[24]. Noncash retail payments are routed through the current or demand accounts with the banks. The most widely used means of noncash payment are credit transfers of the enterprises for payment of salaries, taxes, duties, and so forth. More than 95 percent of the interbank clearing volume are instructions of this nature. Banks also perform direct debits to customer accounts under instructions to pay for electricity, water, telephone, and heating bills. Check usage is minimal. As of the end of 1998, ten banks were issuing debit cards to their depositors.[25]

The National Card Payments System (BORICA) handles the clearing and settlement of the debit cards. At the end of December 1999, there were 534 point of sale (POS) terminals and 287 automatic teller machines (ATM) throughout the country. BORICA, Ltd. is wholly owned and operated by BNB.[26] BORICA administers ATM and POS transactions and performs the maintenance of the terminals, gives “on-line” authorizations of card payments, and is authorized by its members as a settlement agent for the domestic cards. In addition to BORICA, the Bulgarian Post Bank also operates its own POS terminal network through its 50 terminals.

Prepaid (smart) cards are issued by telecommunication companies and gasoline stations. Their use has increased rapidly. The existing public coin telephone network has been largely replaced by a wide network of smart card telephones of Betkom and Bulfon. In addition to telecommunications, Shell and Petrol Bulgaria offer prepaid gas cards. Postal instruments for money transfers are used in the villages without bank branches. Postal instruments are used for payments of pensions, subscriptions, taxes, or transfers to other individuals. BNB estimates the volume of such transfers to be negligible. A few banks are also offering Western Union services.

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[24] There are no reliable statistical data on the use of cash (local and foreign currency). However, BNB supports this tendency of high use of cash citing the 57.4 percent currency outside the banks in M1 at the end of 1997 and 61.6 percent at the end of 1998. The BNB payment department has also indicated that the majority of the ATMs are used for cash withdrawals.

[25] Several Bulgarian banks are offering VISA, EUROPAY and in the process of offering MasterCard international debit cards, using the clearing system of these international cards over phone lines. Domestic credit cards are not yet common in Bulgaria.

[26] The credit and debit card payments in Bulgaria come under BNB Regulation 16 for card payments. For international receivables-payables, the banks are using the rules and regulations of their international card operators.

Planned conversion to real time-gross settlement is necessary

Noncash payments in Bulgaria are settled through the National Settlement System (BISERA[27]),which has 5 branches and 28 regional offices. Participants with direct access to BISERA are members, as are the branches of those banks that do not have an internal payment system. The CD and BORICA, both acting as settlement agents for their members, also have direct access to BISERA.

Payments are settled individually, following the sequence of the incoming queues. If there are insufficient funds in a current account of a bank needed to execute the first order in payment, that payment remains in the payments' queue for the next settlement. After execution of the settlement, the system generates payment messages for the receiving bank and confirmation messages for the sending bank. It also generates messages for the BNB, which debits the current account of the sending bank and credits the current account of the receiving bank. A payment is considered final when it is settled in the BNB at 8.30 a.m. the next day. Payment instructions sent by the banks are irrevocable.[29] Overdrafts on the current accounts and partial payments are not allowed.[30]

BISERA currently is a designated time, gross settlement system operated at "t+1" value date. It also does not recognize "large value" payments (mostly interbank and public-budgetary). Under this system the members and the BNB receive the results from the settlement process by the next day between 6:00 and 8:30 a.m. The systemic risk is controlled since the payments are not processed but kept in a queue until sufficient balances are maintained. However, the present system makes liquidity management difficult for the banks and for overall systemic control by the BNB.

The BNB should introduce BISERA 4, which will be the future Real Time Gross Settlement System (RTGS) of Bulgaria. Under this system, the settlement accounts of the members will be kept by RTGS and all payments instructions will be sent through BISERA. The payment orders will be processed periodically with specific cut-off times for batches. Monitoring and the management of the queues of the incoming payments will aim to manage the liquidity in the system and spot illiquidity on a real-time, on-line basis. Each commercial bank will have the possibility of monitoring its position on a real-time, on-line basis, instead of waiting until the end of the day under the present system. BNB will also have on-line access to the overall functioning of the system.

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27 BISERA, established in 1992, is an electronic system with two basic functions: clearing of the electronic messages comprising the banks' payment instructions, and settlement of the payments. In 1995, BORICA was established to process credit card clearing. The Government Securities Depository was established in 1992 and the Central Depository in 1996.

28 BISERA, established in 1992, is an electronic system with two basic functions: clearing of the electronic messages comprising the banks' payment instructions, and settlement of the payments. In 1995, BORICA was established to process credit card clearing. The Government Securities Depository was established in 1992 and the Central Depository in 1996.

29 The settlement system forms an incoming queue of records of all interbank payments, which include the waiting payments from previous days and the newly initiated ones. Payments are queued according to their priority, based on a "first-in, first-out" principle. The payments of requests for cash receive the highest priority, followed by ATMs and all other payments.

30 Since February 1999, BNB has shifted to a reserve-averaging method for the reserve requirements and the banks are allowed to use all of their reserve balances to meet the incoming payment orders.

Non-EU accounting and auditing standards

The Bulgarian Accounting Principles are evolving to meet EU-IAS requirements. The discipline of external auditing is in place, as all public entities are expected to be externally audited annually by registered and licensed auditors. Bulgarian banks are in the process of adopting IAS chart of accounts and standards. In 1999, they began reporting to BNB under IAS. A sketchy review of their reports indicate that the banks have not yet absorbed the IAS standards. Except perhaps for the foreign joint ventures and banks, the assimilation of the IAS charts and standards is expected to take some time.

All of the banks and regulated financial institutions are expected to have their annual accounts audited by an external auditor under Bulgarian accounting standards. Several of the banks have also started having their accounts audited under IAS by internationally accepted firms. However, slow progress is being made in the adoption of better accounting standards by enterprises, which makes the quality of banks' portfolios more difficult to assess. Furthermore, important differences have been noted between national and international accounting applications and external auditing is perceived to be weak. As for the nonbank financial institutions, suitable charts of accounts and standards have been prepared, pending applications upon the passage of the necessary regulations.

Improving contract enforcement

Bulgaria has the necessary legal framework for enterprise bankruptcy and insolvency. Insolvency and liquidation procedures, however, are not yet being implemented. Amendments to the Commercial Code are necessary to speed up and improve the processes.

In the banking sector, the liquidation of the closed banks is still ongoing and the procedures are lengthy, notwithstanding the costs. Amendments to the Banking Law in 1999 are expected to accelerate the liquidation of these banks. The Draft Bank Bankruptcy Law recently submitted to the parliament is expected to speed up the resolution of future nonviable banks. In connection with the Special Pledges Law, changes to the bankruptcy and banking laws will be necessary to accelerate the court procedures for the sale of collateral and ensure a normal functioning of the special pledges and loan registry set up in 1999. Furthermore, one feature of the Criminal Code that penalizes the extension of loans without "proper security" needs to be clarified so as not to penalize reasonable lending practices.

The capacity and the skills of the judicial system to enforce the laws that lay the foundations of the operations of the market economy is crucial. Key participants in the judiciary process need training to adapt to the changing legal infrastructure for a market economy.

EU ACCESSION: KEY ITEMS ON THE AGENDA

As stressed in the 1999 European Bank for Reconstruction and Development (EBRD) transition report, the central lesson of ten years of transition is the importance of institutional development. The existence of an independent central bank, supervisory authorities, a regulatory framework and a market infrastructure are crucial for the proper functioning of financial markets. The 1995 EU White paper lays down the sequencing of harmonization by distinguishing between first and second stage measures for the financial sector (see Appendix III). The key measures for financial markets are (a) free movement of capital, (b) free

provision of financial services, and (c) the creation of institutions capable of ensuring the stability of prices and financial markets (Lannoo 1999).

An overall EU accession strategy in the area of financial services should aim to establish a well-regulated, stable, and competitive system operating under market-based rules, with clear rules for entry and exit. Despite the progress accomplished in the past two years to improve financial markets operation and institutions, Bulgaria's financial markets are still in the process of developing and are not functioning as efficiently and effectively as needed to support future economic growth. Postponing the restructuring of the real sector for most of the decade was clearly an important impediment to the development of the financial market. Now that the restructuring process is taking hold and the key institutions and rules are established, the authorities need to continuously evaluate their adequacy, and whether there is proper governance, supervision and transparency in and over their operations.

Regulatory harmonization

Regulatory harmonization to the EU Directives is seen as the means to establishing the overall operating rules within the EU common market of financial services. Appendix III summarizes relevant EU Directives for regulatory harmonization of financial market operations for associate as well as member countries. Before accession, a country needs to have these directives fully in place or come to an agreement for transition periods during its accession negotiations. As Table 2 below indicates, Bulgaria is among the most advanced Central and Eastern European Countries (CEEC) in adopting EU Banking Directives.

Bulgaria has largely implemented Stage I Directives regarding capital movements and banking. The Banking Law of Bulgaria and the subsequent BNB Regulatory Decrees integrate many of the EU Directives related to the capital adequacy, large exposures, deposit guarantee (which is lower than EU-recommended standards), money laundering, and home-country supervision. Improvements are needed in harmonizing the regulations to the directives in both Stages 1 and 2, especially in annual and consolidated accounts, supervision on a consolidated basis, and capital adequacy (asset classification and provisioning, and market risk capital).

The Bulgarian authorities may consider asking for a transition period for increasing the threshold for the coverage of the deposit guarantee. The threshold for deposit guarantee in the EU is at 20,000 Euro against a current threshold of 5,000 DM in Bulgaria. As seen in Table 2 below, a similar strategy has been adopted by the other accession countries. The lower deposit guarantee threshold in Bulgaria for a certain time period could be justifiable, given the country's low income level and an accumulation of the deposit insurance premiums in the newly installed self-financing DIF, which will remain relatively limited due to low deposit mobilization by the banks.

Table 2: Implementation of Banking Directives in CEEC (as of mid-1999)

As of mid-1999	*Czech Republic*	*Estonia*	*Hungary*	*Poland*	*Slovenia*	*Lithuania*	*Latvia*	*Bulgaria*	*Romania*	*Slovakia*
First Banking Directive	Partially	Fully	Fully	Fully	Fully	Fully	Fully	Fully	Almost fully	Partially
Own Funds Directive	Largely	Fully	Fully	Fully (except on 1 item)	Fully	Fully	Fully	Fully	Almost fully	Fully
Solvency Ratio Directive	Largely	Fully, SR is 10%	Fully	Fully	Fully	Fully	Fully	Fully	Almost fully	Fully
Deposit Guarantee Directive	Partially, min. 14,000 Euro, only local currency	Transitional period to reach EU level.	Min 4000 Euro, transition will be needed	Almost fully	Fully by 2001	Fully. Min 15,000 Euro by 2001, 20,000 by 2005.	Present level is 800 Euro. Transitional period to reach EU level.	Present level is 5,000 Euro. Transition will be required	Present level is 2,300 Euro. Fully by 2005	Partially
Ann. and Cons. Accounts Directive	Partially	Fully	Almost fully	Fully	Almost fully	Fully	Fully	Fully	Partially	Partially
Consolidated Supervision Directive	Partially, exp. 2002	Fully	Partially	Very partially	Fully by 2000	Fully	Fully	Not yet	Partially, by 2000	No
Large Exposures Directive	Fully	Fully	Almost fully	Fully	Fully	Almost fully	Fully	Fully	Fully	Partially
Capital Adequacy Directive (CAD I and CAD II)	Fully (by 2000)	Almost fully	Not yet, exp.1999	Partially, by 2002	Partially from mid-2000	Partially	Partially	Partially	Not. By 2000	Not. By 2005
Money Laundering Directive	Partially (anonymous accounts)	Fully	Partially (anonymous accounts)	Partially (anonymous accounts)	Fully	Fully	Fully	Fully	Fully	Partially (anonymous accounts)
BCCI Directive	Partially	Fully	Partially	Partially	Fully	Partially	Partially	Almost fully	No	Partially. By 2003.
Netting Directive	No	By end 1999	No	No, by accession	Possibly	No		No	No	Partially. By 2005.

Sources: European Commission (Karel Lannoo 1999)

The Bulgarian legislative framework for capital markets and institutions is broadly in line with the EU Directives following the passage of the Securities Law in 1999**.** SSEC has to rapidly issue detailed regulations in line with this law and in particular clarify minority shareholders' rights. As for the insurance sector, a thorough review of the existing insurance legislature is needed, in particular to make it compatible with the directives listed under Stage 2 for accession. The Bulgarian Insurance Law of 1998 recognizes some of the EU Directives and correctly separates the activities of the life and non-life insurance institutions. The Directorate for Insurance intends to set up a guarantee fund, which will require the development of market-based actuarial services.

Suitable and effective supervisory bodies

The EU Directives aim at ensuring the stability and reliability of the financial markets and participants. The directives stipulate supervision by competent authorities, but do not give direct guidelines as to the supervisory structure. The EU Law requires that the authorities (public or other) designated with the supervision of the financial markets have all the powers necessary for the performance of their duties. Consequently, different member states have developed different solutions for their supervisory structures. There is a trend in EU countries, toward splitting financial supervision from the central bank and moving toward single supervisory authorities. The increased complexity of financial supervision and growing conglomeration in mature markets may pinpoint the need for a single supervisory structure in the mature EU markets. But in Bulgaria, the present scarcity of resources, the need for institutional capacity building, and the fragility of the financial system may call for more flexibility in the design and evolution of supervisory structures keeping banking and nonbanking supervision separate for a while.

Bulgaria needs to develop its own proper and suitable supervisory bodies. The supervisory and regulatory structure for financial services is related to the currently evolving institutional structure for the provision of financial services. The institutional structure of financial market supervision in Bulgaria is summarized in Table 3 below.

Table 3: Supervisory and Regulatory Structure

Banking	*Securities Markets*	*Insurance and Private Pensions*
Banking Supervision Department of the CB	Commission on Securities and Stock Exchanges, appointed by government	National Insurance Council (for licensing) Directorate for Insurance (implementation of Law and Council's decisions) Department of Insurance in the MoF State Insurance Supervision Agency (supervise and regulate private pension funds)

Source: MoF/ Ministry of Finance

The present Law on Banks allows for a universal banking structure. However, since the securities market-related laws and regulations are in the process of development, it is not clear whether Bulgarian regulations will separate the capital requirements for securities' businesses from those for banks.[31] Furthermore, the present regulations do not give the SSEC sufficient supervisory power over the banks' activities in securities.

The increasing connection between bank and nonbank ownership indicates that financial services will eventually be provided through either financial holding companies or bank holding companies, or both. The overall size of the local financial markets and the low level of capital accumulation could justify this consolidation of financial services under several groups of related companies for Bulgaria. Such a trend would necessitate the need for closer consolidated supervision with closer cooperation between different supervisory bodies.

[31] The EU banking directives allow the banks to either be involved directly in securities business or through a subsidiary. The Capital Adequacy Directives related to the different approaches are in discussion, however.

Because the financial sector is still in its early stages of evolution in Bulgaria, the structure and capabilities of the supervisory bodies need to be tested and assessed. As for banking supervision, BNB's supervisory capability is being upgraded. However, cooperation between the BNB supervisory activities and the DIF needs to be enhanced by DIF's becoming more aware of the developments in the banking sector.[32]

Recent attempts to create different supervisory arrangements for different types of non-bank financial institutions might stretch the capacity of qualified manpower and also increase the costs of operation for these emerging financial institutions. In order to streamline costs and achieve better coordination of information for stronger supervision, careful thought should be given to consolidating their supervisory activities, under an umbrella institution. For example, immediate consolidation could be beneficial in the insurance sector where there seems to be overlapping roles for the National Insurance Council and the Insurance Supervision Department of the MoF. In addition, in view of the similarity between life insurance and private pension instruments, consolidated supervision and regulation may be warranted.

Foreign capital in financial services

The increasing foreign ownership in all aspects of the financial sector is expected to be supportive of the development of a self-regulated and transparent financial sector with institutional capability to compete in the EU single market. However, there should not be a presumption that foreign ownership automatically means institutional capability or transparency. Hence, care needs to be taken of the quality of the foreign investment, regardless of the home rule and mutual recognition of supervision principles under EU.

Privatization in financial services

At present, the state is the major player in the banking and insurance sectors. The presence of the state in the banking services will continue until the privatization of the large banks is completed. Plans to further privatize the large state insurance companies should be implemented. Together with the privatization of the large banks, the state has to formulate an exit strategy from all aspects of financial sector intermediation including divesting all its shares in different banks and insurance companies. Also, state policy and subsidized lending, such as in agriculture need to be made transparent and channeled outside of the banking sector.

Consolidation and exit

The key question in the coming years for the Bulgarian banking sector will be how to establish the institutional capability to contribute to growth and gain the credibility to integrate within the EU. This process needs to be closely supervised, given that the banking sector has not yet fully recovered from the shocks of 1996-97. The past two years have been a period of adjustment and consolidation. The banking sector has insufficient expertise and, overall, there is low level of intermediation. The banks need to upgrade their skills and diversify their products and services to become efficient competitive institutions.

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[32] Whether the banking supervision should be conducted under a central bank or under a separate recognized body—sometimes independent deposit insurance funds or agencies—is an ongoing debate in the financial sector regulatory and supervisory applications in different parts of the world.

This kind of environment may result in the orderly exit of the least viable. But experience shows that it can also encourage reckless behavior as bank owners or bank management "go for broke" when failure or exit is otherwise inevitable. The entry to EU will also bring more competition and potential consolidations and mergers among banks. The exit mechanisms in place are yet to be tested,[33] and contingency plans should be formulated to deal with banks that could not be privatized or become problematic, or both.

As part of this supervisory effort, the authorities could consider increasing the minimum capital requirements for the different financial institutions operating in Bulgaria. Higher minimum capital requirements, especially in the banking sector would allow for a more orderly and regulated process of mergers or exits of the weakest.

SOME POTENTIAL RISKS

Policymakers need to systematically evaluate the economic and financial market impact of adopting EU regulations. These directives, which reflect minimum conditions for operations in mature financial markets and developed economies, need to be carefully monitored when applied to less than mature markets and economies that are still developing and fragile. One example relates to the nature and magnitude of capital flows, in which large swings can be a source of macroeconomic instability, especially under a CBA. Hence the move toward full capital account liberalization should be gradual and carefully monitored.

Similarly, banks' open positions in BGN vs Euro need to be monitored. At present, the system appears to be long in Euro. Although not yet practiced in the market, under the present prudential requirements the Bulgarian banks may find it attractive to borrow in short-term Euro deposits and place in longer-term BGN assets to benefit from interest arbitrage to increase their earnings. Such arbitrage could potentially lead to a worsening of the external position.

The decision to tie the local currency to the DM rather than the dollar has clearly helped protect competitiveness in 1999. On the other had, the banks' sizable amount of US dollar denominated business will have led to substantial capital gains for depositors and losses by borrowers, when measured in lev. This underscores the need for extreme caution by banks and their customers in assuming cross-currency risk in the future as "what goes up can come down again".

At this point, the Bulgarian banking sector does not face major risks that could arise from large currency, interest rate, and foreign exchange mismatches. Most of the nonperforming loans are expected to have been restructured or provisioned prior to the privatization of the large state banks. Although the sector overall capital adequacy appears robust, some specific institutions may be fragile, as the losses reported from a number of banks indicate. In view of the size of its economy, the exit of the least fit is both desirable and unavoidable. Parallel to this, BNB has already withdrawn the licenses of two banks in 1999 and strengthened the exit mechanism for banks with the proposed Draft Bank Bankruptcy Law. Continuing careful and

[33] The orderly resolution of Credit Bank in early 1999, however, indicates institutional capability to absorb single bank failures without problems.

vigilant supervision is needed to minimize future potential adverse developments from failing banks.

Nonbank financial markets and institutions

The evolving nonbank financial sector in Bulgaria is underdeveloped and fragmented, although some of the necessary regulatory and supervisory infrastructure are being put in place. The capital markets are not developed sufficiently to be an alternative to bank credit markets. The newly established regulatory and supervisory bodies need training and skills' building. There are also areas of financial market activity (finance companies, investment holding companies) that need to be brought under the regulatory framework and submitted to proper supervision.

Unless capital markets develop, Bulgarian enterprises will continue to be dependent on the bank credit market. As the banking sector gets more institutionalized and sophisticated, efforts should be directed toward developing capital markets as well as related areas such as mortgage finance. A Draft Law on Mortgage Instruments is being prepared as a first step in that direction.

As for the equities markets, the second wave of mass privatization is expected to increase the supply of securities in the capital markets. The residual government shares from the first wave of privatization could be offered through the BSE to stimulate secondary market activity. Efforts to develop the newly emerging, private bond markets should continue to be encouraged. Furthermore, substantial efforts need to be deployed to address the present constraints to the development of capital markets, including the BSE trading system, integration into the BSE of the large off-the exchange (OTE) trading volume through electronic trading, and the undefined role and supervision of banks in their capital market operations. Other issues include transparency of trading information, weaknesses in company law, and different tax treatment of capital market instruments relative to bank instruments.

Accounting and auditing

The adjustments to the regulatory framework need the support of an institutional setup that has adequate accounting, auditing, and legal framework. The Bulgarian accounting and auditing standards are not yet fully developed to properly reflect the status of the financial institutions and their borrowers. Further work is needed to enforce external audit discipline as well as meet compliance with new accounting standards and applications in all areas of economic activity.

Legal framework to support EU standards

The legal framework for the operations of the financial institutions, especially in terms of property rights protection, Commercial Code, Criminal Code, bankruptcy, and pledge laws should be refined to strengthen contract enforcement. The problems of lack of transparency and complementary legal frameworks can be compounded by weak judicial institutions and processes that lead to long delays in conflict resolution, all of which could undermine the overall confidence level and investor interest in Bulgaria's financial markets and institutions.

Furthermore, the judiciary needs to be trained in financial-sector-related dispute resolution to operate efficiently and effectively under the evolving legal and regulatory infrastructure

Table 4: A Matrix of Financial Markets Development Measures

	Short Term *2000-1*	*Medium to Long Term*
Banking	Complete privatization of state-owned banks. Fine tune regulatory framework to be BASLE-EU compliant. Introduce rules and capital charges for market risk and stricter rules for valuation of collateral. Introduce consolidated reporting of banks and their subsidiary. Introduce guidelines on loan classification and provisioning to integrate qualitative risk analysis. Require banks to publish externally IAS-audited financial statements. BNB to periodically publicly announce CAMELS ratings of banks to strengthen market discipline.	BNB issue guidelines on c banks. Strengthen DIF institution information sharing with B BNB require banks to ado proper risk management. Strengthen the role of ban self-regulatory body and c rating and other superviso DIF to introduce risk-adju strengthen market discipli Increase minimum capital consolidation and exit.
Capital Markets	Pass legislation to regulate holding companies as financial institutions. Pass the Mortgage Instrument Act. Consider the use of the BSE for government securities' trading to stimulate the secondary market for securities. Central Deposit announce ownership and trade information on OTE transactions to increase transparency of pricing and encourage a move of OTE trading to the BSE. Complete implementation of electronic trading in BSE. Issue SSEC regulations supporting the Law on Public Offering of Securities, especially on minority shareholders' rights. SSEC and BNB clarify and agree on the supervisory arrangements for Bank intermediary activities.	Train judiciary in financial Enforce external audit und registered at CD. Explore possibility to link regional EU Country exch Introduce euro-clearing an encourage foreign particip Merge the supervisory and Financial Institutions unde

	Short Term *2000-1*	*Medium to Long Term*
	Offer residual government shares for first wave privatization through the BSE to stimulate secondary market activity. Establish tax neutrality between state and private security instruments for income received.	
Insurance	Sell Bulbank share in Bulstrad to private parties. Sell state shares in DZI to private parties. Review Stage I and Stage II legislation and compliance. Strengthen enforcement of mandatory car insurance.	Facilitate development of r Streamline and consolidate regulatory and supervisory

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APPENDIX I¾ TABLES

Table 5: Gross Foreign Exchange Reserves and Vulnerability Indicators

	1995	*1996*	*1997*	*1998*	*1999*
Gross forex reserves excluding gold (US$ million)	1,236	518	2,121	2,679	2,892
Vulnerability Indicators:					
Gross forex reserves exc. gold in months of imports of goods	3.2	1.3	5.4	7.0	6.9
Gross forex reserves exc. gold/monetary base	0.68	1.02	1.64	1.88	2.07
Gross forex reserves exc. gold/broad money	…	…	0.63	0.68	0.77
Gross forex reserves exc. gold/quasi money	…	…	1.09	1.28	1.44
Gross forex reserves exc. gold/Banking Department Deposit	…	…	7.4	5.9	6.6

Exc.: excluding

…: data not available

Source: Bulgarian National Bank, National Statistical Institute and World Bank staff estimates

Table 6: External Financing Requirements and Sources

(in US$ million)	*1997*	*1998*	*1999*
I. Financing Requirement	1,441	1,260	1,201
Current account deficit	-426	61	632
Medium and long-term amortization	436	482	275
IMF[1/] repurchases	88	183	124
Increase in official reserves	1,675	521	195
Other capital, net [2/]	-332	13	-25
II. Identified Financing Sources	919	808	740
Foreign direct investment	507	537	600
Of which from privatization	340	214	227
Portfolio investment	133	-180	-228
Project financing, medium and long term	124	442	288
Net export credit	155	9	80
III. Initial Gap (I - II)	522	451	461
IV. Disbursements and commitments from international financial institutions	522	452	461
IMF gross disbursements	482	312	286
IBRD[3/] adjustment support	40	140	175
V. Financing gap (III - IV)	0	0	0

Note: Table shows preliminary balance of payments data for 1998 and estimates for 1999.

1/ International Monetary Fund
2/ Includes the discrepancy between settlements and customs data in the trade account, short term capital investment, clearing account transactions, obligations deferred/rescheduled, changes in external arrears, and error omissions.
3/ International Bank for Reconstruction and Development

Source: Bulgarian National Bank, International Monetary Fund and World Bank staff estimates

Table 7: Monetary Aggregates

real, end of period (in Bulgarian Leva/BGN thousand)	*1995*	*1996*	*1997*	*1998*	*1999*
BROAD MONEY (M3)[1/]	583,660	318,424	215,600	233,851	245,222
BGN	424,897	157,717	121,599	142,251	149,295
FOREIGN EXCHANGE	158,763	160,707	94,001	91,600	95,927
M2[2/]	571,304	302,455	206,005	224,338	230,642
Money M1	107,885	57,505	82,045	100,178	99,963
Currency	61,615	30,733	47,074	61,750	65,294
Demand deposits	46,270	26,772	34,970	38,428	34,669
Quasi money	463,419	244,950	123,960	124,160	130,678
Time deposits	255,570	79,261	28,834	27,877	30,850
Savings deposits	57,819	19,832	8,129	10,364	12,938
Foreign exchange deposits	150,030	145,857	86,997	85,918	86,890
Money base (currency and banks' reserves)	129,138	60,002	77,886	84,626	90,791
Money multiplier	4.5	5.3	2.8	2.8	2.7
Currency to deposit ratio	11.8	10.7	27.9	35.9	36.3
Memo items :					
Broad money as % of GDP	56.9	44.4	25.0	28.1	28.9
Deposits as % of GDP	51.5	40.0	21.1	21.6	21.6
Exchange rate(BGN/$)	70.7	487.4	1,776.5	1,675.1	1,946.9
Consumer price index(December '95 = 100)	100.0	411.5	2,791.6	2,821.1	2,997.7

1/ M3 includes M2, money market instruments, and import and restricted deposits.
2/ M2 includes quasi-money and M1.

Source: Bulgarian National Bank, NB, NSI and World Bank staff estimates.

Table 8: Overview of the Banking Sector in Bulgaria

	1993	*1994*	*1995*	*1996*	*1997*	*1998*	*1999*
Number of licensed banking institutions	42	42	44	47	34	34	35
of which: Majority state owned	25	18	12	12	7	7	8
As a percent of total assets				67.4	75.4	73.7	54.4
Majority foreign owned (number)		1	2	3	7	12	12
As a percent of total assets			0.3	1.1	15.2	19.1	33.6
Number of branches of foreign banks	1	2	3	4	6	6	7
As a percent of total assets		0.0	0.5	1.2	8.1	7.1	5.6
			(in percent of GDP)				
Total assets	238.0	170.3	113.6	207.6	43.3	34.8	36.4
Total loans	183.0	74.4	47.8	115.3	22.2	20.7	22.5
Loans to private sector	12.0	14.6	21.6	37.0	13.1	12.8	7.2
Total deposits	70.1	72.2	59.3	67.7	27.6	22.5	27.1
Foreign exchange deposits (in % of M3)	20.3	32.6	27.2	50.5	43.6	39.2	39.1
Foreign currency denominated			*(in percent of total assets)*				
Assets	32.4	46.5	38.8	62.8	58.0	55.4	56.3
Liabilities	64.5	45.9	37.6	49.8	49.9	44.4	46.2
Return on Average Assets (est.) pre tax	n.a.	0.9	0.8	0.8	5.8	6.5	n.a.
Risk-weighted capital asset ratio	8.1	8.6	4.7	5.5	26.9	36.7	41.8
Total operating costs/average assets		1.3	2.6	1.4	3.4	2.0	n.a.
Labor cost			1.0	0.5	1.5	0.9	n.a.
Other			1.6	0.9	1.9	1.2	n.a.
Classified loans (below std. - % of loans)	92.4	82.3	48.5	47.5	17.6	13.4	13.8
Provision for loan losses (percentage of above)	1.9	7.7	14.7	41	129	102.2	72.3
Broad money (M3) - % change	52.8	78.6	39.6	124.5	359.3	9.6	11.4
Private sector loans - % change	101.6	113.0	148.1	240.0	246.7	23.7	22.0

n.a.: not available

1/ incl. Expressbank which was sold to foreign shareholders in December 1999

Source: Bulgarian National Bank, International Monetary Fund, World Bank staff estimates

Table 9: Deposits in Percent of Gross Domestic Product

	1995	*1996*	*1997*	*1998*	*1999*
			% of GDP		
Total deposits	51.5	40.0	21.1	21.6	21.6
Demand deposits	4.0	3.0	2.6	3.9	4.2
Time deposits	25.9	16.0	3.7	3.7	3.7
Savings deposits	5.0	3.2	0.8	1.2	1.5
Foreign exchange deposits	15.4	16.1	12.7	11.4	11.1
Import and restricted deposits	1.2	1.6	1.3	1.4	1.2

Source: Bulgarian National Bank, National Statistical Institute and World Bank staff estimates.

Table 10: Commercial Banks Indicators

	1995	*1996*	*1997*	*1998*	*1999*
Number of commercial banks	44	47	34	34	35
Assets (BGN million)	1,087	3,631	7,361	7,594	8,186
Assets (US$ billion)	15.4	7.5	4.1	4.5	4.2
Total assets (%)	100	100	100	100	100
of which:					
Cash reserves	9.3	8.2	12.8	10.4	11.2
Securities (trading portfolio)	23.2	18.9	20.6	16.7	11.8
Securities (investment portfolio)			3.9	6.2	7.9
Claims on nonfinancial sector	42.3	45.8	15.2	24.3	29.6
Claims on financial institutions	12.1	19.3	31.5	32.9	32.4
Total liabilities	100	100	100	100	100
of which:					
Capital	6.6	5.1	4.3	7.9	10.9
Profits	0.5	5.0	5.0	1.7	2.5
Deposits from banks and financial Institutions	26.8	31.9	9.5	7.8	7.6
Deposits from nonfinancial Institutions	52.8	39.1	62.5	65.0	67.1

1999 Summary

Assets: 8,186 million BGN (US$ 4.20 billion)

Equity: 895 million BGN (US$ 459 million)

Loans: 2,419 million BGN(US$ 1.24 billion)

Deposit base: 6,112 million BGN (US$ 3.14 billion)

Source: Bulgarian National Bank, and World Bank staff estimates.

Table 11: Domestic Credit

Real, end of period (BGN thousand)	*1995*	*1996*	*1997*	*1998*	*1999*
Domestic credit	634,674	488,594	184,001	149,836	141,353
BGN	415,917	159,618	37,098	48,185	35,890
Foreign exchange	218,757	328,976	146,903	101,650	105,463
Claims on government sector, net	283,354	219,045	58,805	18,070	5,205
BGN	212,949	102,618	3,727	-7,863	-28,142
Foreign exchange	70,405	116,427	55,077	25,934	33,348
Claims on non-financial public sector	161,238	112,489	44,923	33,519	23,787
BGN	96,577	23,141	12,044	10,632	7,208
Foreign exchange	64,661	89,348	32,879	22,887	16,579
Claims on Private Sector	190,082	157,060	80273	98,247	112,361
BGN	106,391	33,859	21,327	45,417	56,825
Foreign exchange	83,691	123,201	58,946	52,830	55,536
Memo items :					
Domestic credit as % of GDP	67.4	61.5	28.8	20.7	19.0
Claims on general govt.	32.3	26.9	11.4	4.3	2.0
Claims on nonfinancial public sector	22.3	15.2	6.5	4.8	3.5
Claims on private sector	12.7	19.4	11.0	11.6	13.5
Exchange rate Lev/US$	70.7	487.4	1,776.5	1,675.1	1,946.9
Consumer price index (December 1995 = 100)	100.0	411.5	2,791.6	2,821.1	2,997.7

Source: Bulgarian National Bank and World Bank staff estimates.

Table 12: Interest Rates

(end of period)

(Annualized %)[34]	*1995*	*1996*	*1997*	*1998*	*1999*
Base interest rate	38.59	342.05	6.82	5.17	4.54
Interbank rate	44.01	442.19	1.58	2.86	2.62
Short-term credits	51.43	481.11	13.85	13.52	12.41
Time deposits	25.29	211.87	3.04	3.30	3.25
Marginal spread[35]	20.86	86.33	10.49	9.89	8.87

Source: Bulgarian National Bank and World Bank staff estimates

Table 13: Income Statement of the Banking Sector

(in million BGN)

	1997	*1998*	*1999*
Interest income	777	469	451
Interest expenses	547	144	130
Net interest income	229	325	321
Gains or losses on securities	4	-157	-20
Trading and revaluation on foreign exchange	1,388	-19	124
Commissions and fees	63	99	171
Loan loss provisions	-1,107	-336	-10
Income before Operating Expenses	578	585	606
Operating Expenses	267	375	394
Income before Extraordinary Items	311	210	212
Other financial revenue	247	-21	0
Extraordinary income	7	17	75
Income before Taxes	565	206	286
Net income	369	129	207

Source: Bulgarian National Bank

[34] Annualized interest rates are based on monthly weighted averages.

[35] Marginal spread is calculated as (1+il)/(1+id)-1.

Table 14: Capital Adequacy of Commercial Banks

		I. Major Banks[1/]			*II. Small and Medium-size Banks[2]/*			*III. Foreign Banks[3]/*		
		Capital base (BGN million)	Risk assets	Capital adequacy (percent)	Capital base (BGN million)	Risk assets	Capital adequacy (percent)	Capital base (BGN million)	Risk assets	Capital adequacy (percent)
	June	96	1,270	7.54	66	356	18.53	12	69	17.07
1997	Sep.	107	1,385	7.69	69	386	17.85	27	89	30.51
	Dec.	445	1,547	28.77	110	468	23.61	25	147	17.17
	March	433	1,899	22.80	134	537	24.91	37	233	15.98
1998	June	749	2,008	37.31	204	634	32.27	59	214	27.42
	Sep.	646	2,001	32.29	229	676	33.95	64	280	22.87
	Dec.	731	1,792	40.80	244	742	32.87	68	258	25.46
1999	March	799	1,785	44.80	239	595	40.16	71	286	24.70
	June									
	Sep.									
	Dec.									

Note: Since June 1999, banks are divided into five groups according to their assets.

1/ Group I includes the following banks: Bulbank, SSB, United Bulgarian Bank, Bulgarian Post Bank, Commercial Bank Biochim, Expressbank and Hebros C
2/ Group II includes: Central Cooperative Bank, Bulgarian Russian Investment Bank, First Investment Bank, Municipal Bank, First Investment Bank, Municip
Neftinvest Bank, Unionbank, International Bank for Trade and Development, Private Entrepreneurial Bank Texim, Evrobank, Tokuda Credit Express Bank, Bu
Corporate Commercial Bank, International Commercial Bank, Bulgarian Trade and Industrial Bank, and Rosseximbank.
3/ Group III includes: ING Bank, Bulgarian-American Credit Bank, National Bank of Greece, Societe Generale, and T.C. Ziraat Bank, BNP Dresdnerbank, Ra
Hypovereins Bank, Xiosbank.

Source: Bulgarian National Bank

Table 15: Actual and Theoretical Provisions in the Banking Sector

	1997		*1998*				*1999*		
	Dec	*Mar*	*Jun*	*Sep*	*Dec*	*Mar*	*Jun*	*Sep*	*Dec*
Loans (million BGN)	3,806	3,898	4,119	4,541	5,849	5,903	4,428	4,944	5,042
Standard (in percent)	78.8	80.7	83.9	84.9	87.3	86.6	83.1	84.4	86.2
Watch (in percent)	3.7	3.8	2.8	3.3	3.5	4.1	4.7	3.9	4.4
Substandard (in percent)	2.7	2.4	2.8	1.7	2.2	2.2	3.7	3.1	1.4
Doubtful (in percent)	2.0	1.8	0.6	0.5	0.6	0.7	0.9	1.2	0.9
Loss (in percent)	12.9	11.2	10.0	9.5	6.3	6.5	7.7	7.5	7.2
Provisions[1/] (theoretical)	19.8	17.9	15.8	15.0	12.2	12.6	14.7	14.2	13.1
Provisions (actual)	22.7	16.0	13.7	12.5	12.3.	10.9	11.8	10.7	10.0

1/ Based on 4 percent for standard, 25 percent for watch, 50 percent for substandard, 75 percent for doubtful, and 100 percent for loss.

Source: Bulgarian National Bank and International Monetary Fund staff calculation

Table 16: Size and Ownership Structure of the Banks, September 1999

	Rank by assets	*Total Assets* in BGN million	*Equity*
State-Owned Banks			
Bulbank	1	2,102.2	258.6
State Savings Bank	2	1,011.7	97.3
Commercial Bank Biochim	4	441.5	14.5
Expressbank [1/]	6	347.4	31.8
Hebros Commercial Bank	7	342.2	26.6
Central Cooperative Bank	12	177.3	16.6
Municipal Bank	13	129.9	15.2
Corporate Commercial Bank	32	20.8	12.9
Promotional Bank	35	10.1	10.0
State-Owned Banks Total		*4,583.0*	*483.6*
Foreign Majority Shareholders Banks			
United Bulgarian Bank	3	945.5	96.2
Bulgarian Post Bank	5	404.0	14.4
BNP Dresdner Bank	8	268.8	17
First Investment Bank	9	196.3	16.4
Raiffeisenbank (Bulgaria)	11	189.8	17.6
Bulgarian Russian Investment Bank	14	112.7	10.4
Hypovereins Bank	19	65.9	0.9
Evrobank	20	61.7	11.7
Bulgaria-Invest	21	60.8	11.4
Bulgarian-American Credit Bank	22	53.9	14.8
International Commercial Bank	28	28.8	8.1
Tokuda Credit Express Bank	33	16.1	8.1
Foreign Majority Share Banks Total		2404.3	227.0
Bulgarian Private Banks			
Rossexim Bank	15	79.2	18.7
Neftinvest Bank	16	79.2	29.4
Union Bank	17	71.7	14.6
First East International Bank	18	68.4	13.1
International Bank for Trade & Dev.	23	49.9	13.3
Balkan Universal Bank	31	21.6	10.0
Private Entrepreneurial Bank Texim	34	16.1	11.0
Bulgarian Private Banks Total		386.1	110.1
Foreign Bank Branches			
ING Bank	10	190.3	-2.4
Societe General	24	47.6	-6.2
Xiosbank	25	43.6	0.9
Demir Bank	26	41.3	13.5
National Bank of Greece	27	37.4	-4.0
Ionian Popular Bank of Greece	29	28.1	1.6
T. C. Ziraat Bankasi	30	24.1	9.3
Total Foreign Bank Branches		412.3	12.6
Total for the Banking System		7,785.9	833.1

1/ Expressbank was sold to foreign shareholders end-1999.

Source: Bulgarian National Bank

Table 17: Banking Sector Ranking: The Top Dozen

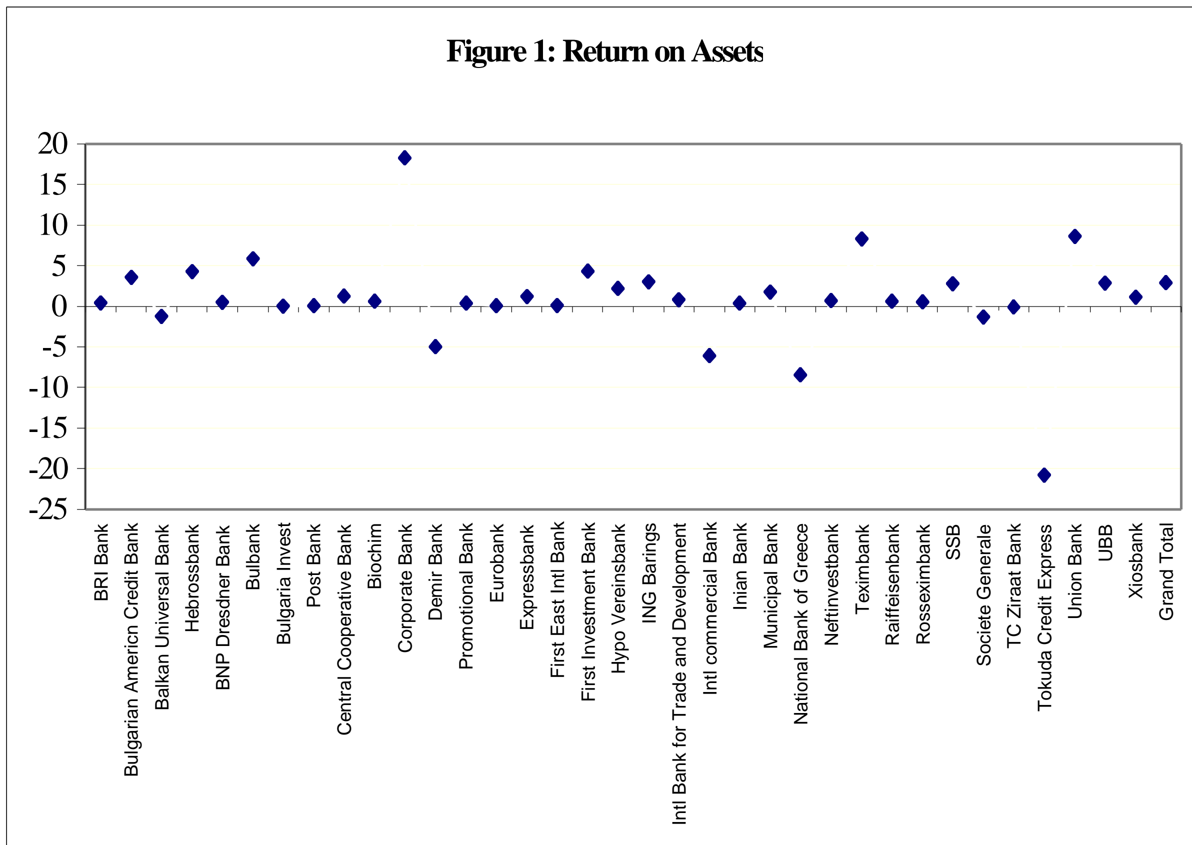
Bank	***Assets*** (BGN million)	***Bank***	***Loans*** (BGN million)	***Banl***
1 Bulbank	2102.2	1 State Saving Bank	518.8	1 Bulb
2 State Savings Bank	1,011.7	2 Expressbank	153.9	2 State
3 United Bulgarian Bank	945.5	3 Bulbank	146.3	3 Unit Bank
4 Biochim	441.5	4 United Bulgarian Bank	141.3	4 Bioc
5 Bulgarian Post Bank	404.0	5 Hebros Commercial bank	124.8	5 Bulg Bank
6 Expressbank	347.4	6 BNP Dresdner Bank	120.0	6 Expr
7 Hebros Commercial bank	342.2	7 ING Bank	108.8	7 Hebr Com
8 BNP Dresdner Bank	268.8	8 Biochim	99.9	8 BNP Bank
9 First Investment Bank	196.3	9 Bulgarian Post Bank	91.0	9 ING
10 ING Bank	190.3	10 First Investment Bank	87.2	10 Raif
11 Raiffeisenbank	189.8	11 Central Cooperative Bank	85.7	11 Cent Coop
12 Central Cooperative Bank	177.3	12 Raiffeisenbank	74.7	12 First Bank
12 Banks	6,616.9	12 Banks	1,752.3	12 B
Total assets	7,785.9	Total loans	2,185.5	Tota

Identify highlighted abbreviations here.
Source: Bulgarian National Bank

Table 18: Bulgarian Stock Exchange

		Official Market				*Free Market*		
		Segment A Market capitalization (in bn leva)	No. of traded shares (1,000)	Segment C Market capitalization (in bn leva)	No. of traded shares (1,000)	Market capitalization (in bn leva)	No. of traded shares (1,000)	Block Trade No. of traded shares (1,000)
1997	Oct.					0.3		
	Nov.							3,394
	Dec					0.2	6	4,377
1998	Jan.	102	97			634	18	2,182
	Feb	90	51			1,104	899	3,922
	Mar	99	107			1,211	668	525
	Apr	94	92			1,781	1,060	529
	May	83	195		1	2,791	1,793	1,413
	Jun	70	80	68	5	2,593	2,452	
	Jul	74	19	130	183	2,218	1,257	
	Aug	66	6	70	95	1,942	1,085	
	Sep	71	23	123	161	1,565	877	
	Oct							
	Nov							
	Dec	50	16	193	445	1,412	1,120	336
1999	Jan.	51	13	150	3	1	531	446
	Feb	46	5	162	207	1,436	393	2,575
	Mar	48	16	163	119	1.452	515	1.310
	Apr	44	19	155	282	1,384	172	433
	May	36	1	144	167	1,347	286	481
	Jun	31	848	103	134	1,324	166	1,213
	Jul							
	Aug	18	2,161	106	146	1,364	320	317
	Sep	19	1,129	140	113	1,203	165	1,286
	Oct	16	611	134	286	1,010	414	501
	Nov	9	1.05	135	288	1,121	586	74
	Dec	14	1.35	130	306	1,154	1806	2,273

Source: Bulgarian Stock Exchange



Source: ING Barings calculated as of September 1999

APPENDIX II—LIST OF BNB PRUDENTIAL REGULATIONS SINCE MID-1997

Regulation 4 on the Foreign Currency Position of the Banks

Regulation 5 on the Government Securities

Regulation 6 on Lender of Last Resort Conditions for the Banks

Regulation 7 on the Big Exposures of Banks

Regulation 8 on the Capital Adequacy of Banks

Regulation 9 on the Risk Classification and Provisioning Requirements

Regulation 11 on Liquidity Management and Supervision of Banks

Regulation 16 on the Requirements to the Activity of Exchange Bureaus

Regulation 20 on the Issuance of Certificates for Qualification

Regulation 21 on the Minimum Reserve Requirements

Regulation 22 on the Central Credit Register of Banks

Regulation 23 on the Terms and Procedure for Payment of Insured Amounts on Deposits with Banks with Revoked Licenses

Regulation 26 on Foreign Exchange Transactions of Brokerage Financial Houses

Regulation 27 on the Registration by the Bulgarian National Bank of Transactions Between Residents and Nonresidents

Regulation 28 on Transborder Transfers and Payments

Regulation 29 on the Terms and Procedure for the Submission of Reports and Declarations on the Liabilities of Residents to Nonresidents

Regulation 30 on the Export and Import of Lev and Foreign Exchange Cash, Precious Metals and Precious Stones

Regulation 35 on the Procedure for Auction Sale of Movables Placed as Collateral with a Bank

APPENDIX III—SUMMARY OF EU DIRECTIVES FOR THE FINANCIAL MARKETS

The EU's Directives[36] were related to the financial sector aim to create a uniform market with free movement of financial capital and services. The EU White Paper[37] identifies the key measures in each sector and suggests a sequence in which the legislative and regulatory approximation could be achieved to integrate the applicant countries' financial markets to EU expectations. The White Paper also highlights and describes the structures that will be necessary to make the legislation effective.

The main purpose of the proposed regulatory approximations for the financial sector is not so much to build up the financial systems of the countries but more to co-ordinate the minimum requirements for different types of institutions. These regulations are needed to create a uniform minimum standard and a more level playing field for operating in the EU's market. At a minimum, the White Paper expects that there are efficient banking and payments systems operating in those countries that want to integrate their financial systems with the EU.

The full regulatory harmonization and membership aims to allow the member country financial institutions to operate under a single license throughout the EU where their supervision is under home-country rules. This implies that the EU members should have similar regulations and equally compatible supervisory bodies.

The legislative approximation prescribed in the White Paper for the accession countries also presupposes the existence of the basic legislative environment for the establishment and operations of the companies (financial or otherwise), suitable accounting rules and applications, and clear rules for corporate governance and external auditing of the companies.

The White Paper recommends the adoption of the EU Standard Directives in two stages without a set timetable. The associate governments are also allowed to mix the sequencing of the Stage 1 and 2 measures if necessary. Table 1 attached to the appendix lists these directives.

The directives chosen for the first stage are those which introduce the basic principles for the establishment of the financial institutions while the measures in the second stage aim in particular to strengthen the prudential regulation to bring the credit institutions up to prescribed EU standards. Stage 2 Directives also establish the importance of self-regulation through the home-country rule and

[36] "The European Parliament and Council Directives" are drawn up in cooperation with the European Commission (EC) and the EU's Council of Ministers (in which all member countries are represented) and adopted by the latter. Each directive creates a legal obligation for the member states to adopt new laws or to change their existing legislation to conform to the directives. These directives override any national legislation and are enforced by the EC and ultimately by the European Court of Justice. The member countries may not enforce over and above the minimum level stipulated in the Directives upon entities from other member countries. They are allowed to impose stricter conditions, however, on their own constituents. These directives were issued during the late 1970's to mid-1990s.

[37] White Paper-Preparation of Central and Eastern Europe countries for integration into the internal market of the EU. Commission of the European Communities.Burssels.3.5.1995.

single license. The White Paper does not necessarily expect the accession countries to adopt the home-country rule and single license concept until full membership.

The Capital Liberalization Directive (Council Directive 88/361 EEC of June 24, 1988) calls for removing controls on all capital flows within the EU, and for the most part, on capital flows between an EU member and any third country.[38] The countries that are in first line of succession to join the EU (Poland, Slovenia, Hungary, Estonia) have signed separate Europe Agreements covering different time tables for the free movement of capital and removal of all exchange and payments barriers. Prior to formal discussions on accession, Bulgarian authorities are taking measures for the capital account liberalization through the recently approved Law on Payments and Foreign Exchange to be effective January 2000.

Banking

The banking sector minimum requirements for operations in EU are defined under the First (1977) and Second (1989) Banking Directives and the respective supportive directives. The First Banking Directive defined common standards for the granting of banking licenses and introduced the principle of cooperation on the supervision of the banks. The First Banking Directive was supported by the Consolidated Supervision Directive of 1983, requiring that credit institutions be supervised on a consolidated basis. Accordingly, any credit institution owning 25 percent or more of another financial institution was to be supervised by the authorities in the owning institution's home state. The Bank Accounts Directive of 1986 harmonized the format and the content of the annual accounts of all of the financial institutions.

The Second Banking Directive establishes the guidelines for free movement of capital and the operations of institutions under a single license across EU. It sets up standards for the minimum capital for establishment of banks and credit institutions, single banking license[39] and home-country control,[40] and mutual cooperation and acceptance of supervision in home and host countries.[41] The Second Banking Directive is supported by the Own Funds and Solvency Ratios Directives. The Own-Funds Directive with its amendments sets up the standards and criteria for the compositions of capital.[42]

[38] The rules on the capital account movements laid down by this directive were replaced from January 1, 1994, by the new rules contained in the Maastricht Treaty.
[39] Any credit institution authorized in one member country can establish branches and provide services anywhere in the EU without requiring authorization from the host member state or the need for a separate endowment of capital.
[40] An institution is only authorized by its home country to provide banking services in any member state through branches or by providing services without a branch. Home country control also applies to the nonbanking financial institutions under certain conditions.
[41] The related concept to home-country control is "mutual recognition" of the supervisory authorities in one country to recognize the prudential equivalence of the other countries. The home country has the overall responsibility for solvency, while the host country supervises the liquidity of branches in its territory. Mutual recognition has also been extended to the financial companies under certain conditions.
[42] Recommended minimum is 8 percent of risk-weighted assets. However, countries can apply higher standards.

Large Exposures Directive defines the criteria for large (10 percent of own funds), connected lending (25 percent of own funds) and aggregate large (800 percent of own funds) exposures. Credit institutions are required to come down to these recommended levels by the end of 2001. The Capital Adequacy Directive defines capital requirements for banks, as well as nonbank investment firms.[43]

With regard to deposit protection, all EU credit institutions are legally required to join in a deposit guarantee scheme. The Deposit Guarantee Directive ensures a harmonized minimum level of deposit protection wherever deposits are located in EU. The maximum deposit guarantee for each depositor is ECU 20,000.

Capital markets

The EU has so far come up with eight key directives (with additional amendments) since 1977 in this area. The first directive (Stock Exchange) established binding conditions for issuing and listing of debt and equity securities on exchanges. Subsequent directives have refined listing and information disclosure requirements, the activities of the investment funds, transferability of securities, and notification requirements. These directives were to harmonize individual securities markets in the EU where basic principles like fair, accurate, and timely information disclosure and the equality standards with respect to investors and markets were set.

The Directive on Investment Services in the Securities Field allowed investment firms (brokers, portfolio managers, investment advisors, and so forth) to offer their services throughout the EU. The directive also established the single license rule, mutual recognition, and home-country supervision rules.[44] The 1993 Directive on Capital Adequacy establishes the possibility of using alternative definitions of capital for both nonbank investment firms and banks defined by their different types of risk.

Insurance

The insurance directives also follow similar directives in the banking sector of free trade and investment, mutual recognition and home-country control. The Life Insurance Directives require categorization of life insurance instruments, the separations of management and accounting of life and general insurance instruments, guidelines for solvency margins, and the establishment of a guarantee fund. The General (Non-Life) Insurance Directives deal primarily with solvency, supervision, and information disclosure on ownership issues.

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[43] The Second Banking Directive allows banks to engage in securities transactions and investment activities, in addition to core banking activities throughout the EU. The same directive also allows banks to invest in nonfinancial businesses, subject to constraints on bank's own capital.

[44] The directive also defined the basis of access to regulated markets in members' states as directly (branch) or indirectly (subsidiary or acquisitions). Therefore, one could say that the directive eliminated a bank's need to set up a specialized subsidiary to carry out investment services, conforming to the universal-banking model of many European countries.

The attached matrix lists Stage I and II financial sector EU Directives.

	STAGE 1	*STAGE 2*
CREDIT INSTITUTIONS	First Banking Directive (77/780/EEC) On the coordination of laws, regulations, and administrative provisions relating to the taking up and pursuit of the business of credit institutions.	Second Banking Directive (8 77/780/EEC
	Own Funds Directive (89/299/EEC) On the own funds of credit institutions	Annual Accounts and Consoli (86/635/EEC) For banks and other fin
	Solvency Directive (89/647/EEC) On a solvency ratio for credit institutions	Capital Adequacy Directive 9 For investment firms ar
	Deposit Guarantee Directive (94/19/EC) Directive of the European Parliament and of the Council of May 30, 1994, on deposit guarantee schemes.	Large Exposures Directive (9 For all types of credit i
	Directive on Public Offer Prospectus (89/298/EEC) On the prospectus to be published	Consolidated Accounts Direct On the supervision of t consolidated basis
SECURITIES	Directive on Stock Exchange Listing	Investment Services Directive On investment services
	Directive on Stock Exchange Listing Particulars (79/279/EEC) On conditions for admission of securities to official stock exchange listings	Capital Adequacy Directive (Council Directive 89/117/EE On the obligation of b state and having their state regarding public documents.

	STAGE 1	*STAGE 2*
		Council Directive 80/390/EE On the coordination of the req and distribution of the listing exchanges
	Directive on Notification of Major Holding (88/627/EEC)	Council Directive 82/121/EE On information to be companies listed on t
	On the information to be published when a major holding in a listed company is acquired or disposed of	
	Directive on Insider Dealing (89/592/EEC) On coordinating regulations on insider dealing	
INVESTMENT FUNDS	UCITS Directive (85/611/EEC) On the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities	
INSURANCE	First Council Directive(73/239/EEC) On the coordination of laws, regulations and administrative provisions relating to the taking up and pursuit of the business of direct insurance other than life insurance	Third Council Directive 92/4 Directives 73/229/EEC and 8
	First Council Directive(79/267/EEC) Same as above but for direct life assurance	Third Council Directive 92/9 Directives 79/267/EEC and 9
	Council Directive 91/674/EEC On the annual accounts and consolidated accounts of insurance undertakings	

OTHER VARIOUS INSURANCE

Directive 87/344/EEC—on the coordination regarding legal expenses insurance

Directive 87/343/EEC—on Credit and Surety Insurance

Motor Insurance Directives—72/166/EEC and 84/5/EEC
Third Council Directive 90/232/EEC
90/618/EEC amending 73/239/EEC and 88/357/EEC making third-party motor vehicle insurance compulsory

Tourist Insurance—84/641/EEC

Community Co-Insurance—78/473/EEC-applies to large industrial and commercial risks

Two directives in Non-Life (88/357/EEC) and Life (90/619/EEC) bridge the gap between the first generation directives, having their focus on the facilitating the freedom of establishment for insurance companies, and the third generation directives which introduce a complete EU insurance system spanning both the freedom of establishment and the freedom to provide services.

Horizontal directive for the whole financial sector
Money Laundering Directive (91/308/EEC)
On prevention of the use of the financial system for the purpose of money laundering

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