

## **Ivan Iskrov: Review of 2014 as a starting point of reflection on the challenges ahead in Bulgaria**

Speech by Mr Ivan Iskrov, Governor of the Bulgarian National Bank, before the Association of Banks in Bulgaria on the occasion of the Banker's Day, Sofia, 4 December 2014.

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Ladies and Gentlemen,

I'm happy that we are together again on our professional holiday – on the celebration of the Banker's Day, Saint Nicholas Day. Keeping the tradition, this year again, with the BNB Governing Council members we are marking the occasion with you – the management representatives of the banks in Bulgaria. Please accept our presence here as an expression of acknowledgement of your work and professional attitude in running your entrusted institutions. Also, today we would like to underscore our appreciation of the efforts and contribution of many of you here for safekeeping the financial stability in our country.

The banks deserve congratulations for the positive results the sector has achieved amid a very unfavourable market, media and political backdrop in 2014. At the same time, let us use the recapitulation of this year as a starting point of reflection about the challenges that may lie ahead.

The passing year has proved one of the toughest for the banking system in Bulgaria since the time of the big crisis in 1996–1997. The reasons for this have been several and I would conditionally divide them into two groups.

Within the first group fall all those challenges in 2014 that were not at all unexpected. We have commented these challenges in previous years.

Thus, for instance, the forecasts that this year also the economic growth would not accelerate, have materialised. That has held back the quality of bank assets from improving more tangibly. Accordingly, loan demand from enterprises and households has stayed weak. As a result, for yet another year, the banks' profitability has been subdued and their possibilities for income from lending, i.e. their core activity, have remained limited.

Also expected were the tasks related to the transposition into the Bulgarian legislation of the Capital Requirements Directive and the Capital Requirements Regulation adopted in 2013 by the European Parliament and the Council of EU. This time last year in my statement before you I qualified this as a kind of a "supervisory revolution" and the largest one-off change to have occurred in our supervisory framework over the last more than 15 years. Earlier this year, amendments were adopted in the Law on Credit Institutions and in the regulatory framework, including by dropping out a few key BNB ordinances, Ordinance No 9 being one of them which governed the specific provisions for credit risk. In place of the specific provisions allocated until then, the banks made additional accounting provisions under the International Financial Reporting Standards (IFRS), thus reducing the book value of loans past-due by more than 90 days.

The second group of challenges, with which 2014 will undoubtedly be remembered, includes those events that put the very resilience of the banking system to the test. A point was even reached where questions were raised in the public space about the BNB effectiveness, in particular the banking supervision thus far exercised.

The events in question started with the severe liquidity attack against several banks in the middle of the year. 2014 will go down in history also with the huge misappropriations of depositors' money, malpractices of governance and breach of regulations revealed in the second half of the year in the fourth largest bank in the country – "Corporate Commercial Bank" AD (KTB).

The KTB case was finally resolved with the effective application of the statutory guarantee on deposits. By coincidence, exactly today, 4 of December 2014, the long-awaited payment of guaranteed deposits with KTB has started. The depositors in this bank had no access to their deposits for a very long time. The central bank truly wished to see the KTB issues resolved in the shortest time possible. Unfortunately, as it is well known, with a large part of the documentation missing and the absence of legal means for quick restructuring of KTB, voluminous actions were needed to restore the credit files in KTB. Gathering this information was a necessary condition for the independent auditors to perform a complete analysis and assessment of KTB assets. Without such analysis and assessment, the actual status of KTB's capital position could not be determined and, respectively, the BNB Governing Council could not have the legal grounds to adopt the necessary decisions.

On 12 December, CB Victoria will also open for business and its depositors will have access to all their deposits there.

The very scale and power of manifestation of the problems in 2014 were unprecedented and unpredictable. The banking sector in Bulgaria, however, had the huge advantage of meeting the critical times prepared and in excellent condition – just as it coped to meet the global crisis several years before. Our banks had managed to accumulate high liquidity and capital buffers owing to their sound governance and the BNB's focused conservative policy over the years. The available buffers plus the measures taken since June by both the BNB and the government, as well as by the banks, helped safeguard the banking and the overall financial stability in the country. This way, the KTB crisis remained an isolated case and did not affect the operation of the rest of the banking sector.

A proof of this is the depositors' behaviour who continued to entrust their savings to the banks despite the occasionally irresponsible public speaking against the banking sector and the incessant public attacks on the BNB. Only household deposits picked up by BGN 2.8 billion (7.8%) annually to October, exceeding the stock of deposits in May (the last month before placing KTB and CB Victoria under special supervision). This clearly indicates restored confidence in the system.

Besides, the banking system is about to end the year with excellent capital adequacy and liquidity indicators. I say the banking system, meaning all banks, excluding KTB and CB Victoria. As at September, the total capital adequacy ratio stood at 22.16%, and only Tier 1 capital ratio was 19.91% (just to remind you that the EU provisions in the New Basel Capital Accord, also known as "Basel III", require 8% total capital adequacy and 6% tier 1 capital ratio, respectively). The liquid assets-to-liabilities ratio in the banking system as at October reached 29.75%.

In 2014 the share of non-performing exposures past-due for more than 90 days has continued to stabilise. At the end of October this year, at system level, their book value was 10.62% of the system's loan portfolio book value (i.e. practically the same as at the end of 2013 when their share was 10.28%). The balance-sheet share of non-performing exposures reflects the already provisioned risk through the impairments already made. The provisioning level itself is high, with a total of BGN 5–6 billion provisions in the form of impairments allocated by the banking sector under IFRS until October.

The banking system continues to generate profit, which is a source of additional capitalisation and is thus a reserve for maintaining stability. We expect the sector to end 2014 at a positive financial result of circa BGN 700 million (i.e. above last year's result). This performance applies to the whole system without the bank whose license was revoked and CB Victoria which is still under special supervision.

All these indicators and results are especially rewarding because they have been achieved in a very harsh year!

At the same time, however, nobody entertains the illusions that the hardships and trials to the banks in our country are over. Because most likely in 2015 as well the banking community

will work in a testing business environment, where I do not rule out the possibility of new attempts to deliver blows against the sector, motivated by the intertwining economic, political and media interests, such as those we saw against the Bulgarian banking system right after KTB and CB Victoria were placed under special supervision.

The passing 2014 year has shown how dangerous to society, as well as useless for their authors, such attacks can actually be. Remember how, right here before you, a year ago I called your attention to the fact that we could expect political tension to rise and the topic of banks to be turned into an object of pre-election campaign and party bickering. Regrettably, this unpleasant prediction has come true. Throughout the past year we were not spared statements by party representatives who administered negative public judgments and pronounced the gloomiest of predictions about the banks in the country. The air of political insecurity bred all sorts of populist acts, including irrational legislative proposals with regard to both the banks and the BNB.

Could it be, however, that in 2015 we would witness a radical change in the thinking and actions of the political representatives and media circles towards more prudence and better awareness of the key role the banking sector has for the financial stability, economic growth and welfare of society? I don't know. But I do hope very much it would be so.

Dear Colleagues,

Outside the issues related to the national specifics of the environment the banks operate in, I would take the opportunity to note some forthcoming amendments in the regulatory framework in 2015 relating to the introduction of new uniform European norms and practices with a direct impact on the work of credit institutions in Bulgaria.

In 2015 the Bank Recovery and Resolution Directive in the EU will come into effect, aiming to introduce EU-wide rules and tools for the Member States to deal with banks in trouble and to take timely and adequate measures to rescue viable institutions. This directive is going to be transposed in the Bulgarian law by means of new legal provisions and amendments to the existing legal framework (e.g. the Law on Credit Institutions, the Law on Bank Bankruptcy, and the Law on the BNB). Strategic decisions need to be made on establishing relevant competent authorities tasked with the responsibility of resolving banks and investment firms, on setting up resolution funds, and on the drawing up by the supervised entities of adequate plans for recovery or controlled restoration of their viability by restructuring.

In connection with the new EU capital framework CRD4, in 2014 the BNB began to implement the new reporting framework for supervisory purposes (the so-called FINREP and COREP), consisting of over 100 separate reporting forms. The additional supervisory reporting will meet the accumulated information needs of the Banking Supervision Department and will tackle the most sensitive sources of risk in banks' portfolios.

In 2015 it is expected that the EU-wide banking supervision rules will become more and more common in banking practices. Numerous technical standards, developed by the European Banking Authority (EBA) and adopted by the European Commission, are going to be put in place. In supervising the subsidiaries of euro area banks, the BNB is going to cooperate actively with the Single Supervisory Mechanism (SSM) which started in November 2014.

Last but not least is the BNB's intention to initiate an asset quality review of the entire banking system, which will cover all banks operating in Bulgaria. This will also be a key requirement if the government should decide, at some point, to start talks with the ECB for joining the SSM. The methodology of this review will be based on the highest standards already developed and applied by the ECB in the recently completed asset quality review in the euro area largest banks prior to their transition to the SSM. This review will be carried out with the help of an independent external consultant. It should start not later than the end of next year, depending on how the implementation of the new Bank Recovery and Resolution Directive advances, including the creation of the respective resolution fund. I assure you that

the BNB is going to get commercial banks familiar, at an early enough stage, with the main elements of the methodology of the forthcoming asset quality review, so that each bank could budget the relevant costs (by analogy with the euro area where banks have borne the costs of their asset quality review).

Dear friends,

The passing 2014 will regrettably be remembered for the vicious public pressure on the BNB. The central bank was under systematic and orchestrated attacks behind which one could see narrow corporate interests and political dependencies. Such focused, fierce and continuous attacks against the central bank are unheard of in today's advanced societies, and are certainly far from the European norms. Information about who paid for these attacks and whose money was spent on them is already becoming public knowledge. Even more interesting details may continue to come out in the months ahead. Then, I hope, it will become quite clear even to the public at large who has in fact defended the public interest and who has acted against it.

This multi-month campaign against the central bank (which by the way is still going on) has consumed impressively large financial, media and political resources. All of you have also observed the biased attempt of nationally representative organisations to misrepresent the BNB's actions and, ostensibly by accident, to divert the attention of the Bulgarian public from those who has abused people's trust and deposits. But all along while it was solving the case of KTB and CB Victoria, the BNB did not allow to be misled and deviate from the letter and spirit of the law. If somebody believed that by using Jimmy Hoffa's<sup>1</sup> methods they would force a strong institution like the BNB, with an earned reputation nationally and internationally, to circumvent the law or to obey personal or group interests, they were obviously mistaken.

In this regard please let me share a few general observations relating to the topic of frauds in KTB, the responsibility of the banking supervision, and the role of the central bank.

The KTB case can be compared with a series of cases in other countries. Over the last years alone in the EU and USA there were dozens of failed banks and banks in which frauds for billions of euros were discovered.

However, it should be noted that in all those cases no central bank was pressurised to take the full responsibility and to be scapegoated, unlike the continual public attacks here against the BNB. In other countries the responsible institutions and politicians have always held the understanding that the central bank's authority is of paramount importance for the calm of depositors and the stability of the banking system as a whole. All across the world that authority, and the independence of the central bank, are considered to be a long-term asset of the country. Consequently, central banks' actions have not been compromised under the pressure of temporary economic or political emotions.

All said so far does not mean that the BNB has no intention to draw conclusions for improving the efficiency of the banking supervision. Quite the opposite, the BNB has already undertaken serious steps in this direction.

Back in the summer we publicly announced a number of measures and actions for reviewing the supervisory framework and practices. I wish to remind you that as early as in July we sent an official letter to the EBA inviting them to carry out an independent review of the quality, capacity, practices and procedures of the BNB's Banking Supervision Department. In August we sent another letter to the International Monetary Fund (IMF) requesting them to organise a mission of the IMF and World Bank in Bulgaria under the Financial Sector Assessment Program (FSAP). On recommendation of the IMF, World Bank and EBA, the

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<sup>1</sup> James Riddle ("Jimmy") Hoffa (1913–1975), a famous American labour union leader who in the 1960s was charged with and then convicted of ties with organised crime, corruption and financial fraud.

Banking Supervision Department is now already working to assess the compliance of the supervisory practices in Bulgaria with the “Basel Core Principles”<sup>2</sup> for effective banking supervision as a first stage of the FSAP.

In addition, the BNB has already drawn up and proposed to the Members of Parliament a draft of amendments to the Law on the BNB and the Law on Credit Institutions, designed to rectify some weaknesses in the legal framework and to allow the BNB Governing Council to have more control over the banking supervision functions.

Because all of you here are well aware of the facts, but they were cunningly ignored and avoided by those who were attacking the BNB. Since June 1997 by law the BNB Governing Council has been the body that adopts all banking regulations (i.e. the ordinances defining the norms and requirements for banks’ activities). However, supervision is exclusively entrusted to the deputy governor in charge of the Banking Supervision Department (no matter what his or her name is), who acts separately and independently. The crisis with KTB, and not only that one, clearly demonstrated that such immense concentration of power and responsibility in one official is a mistake of legislation. And we want to change this. Because bearing responsibility is not possible without having the relevant powers.

Whatever happens ahead, the events in 2014 will not rewrite the BNB’s history of proven success in recent years. It is a fact that, thanks to the consistent efficient work of the central bank, including the banking supervision, during the global financial crisis not a single bank went bankrupt in Bulgaria. In other countries, even in the EU, problems with banks led to public costs running into hundreds of billions of euros. The Bulgarian citizens and taxpayers were saved from all that. The long-standing achievements of the BNB, and BNB’s banking supervision in particular, should not be forgotten or erased easily – even if it turns out that some omissions may have been made in the KTB case.

It is also a fact that since June to date the BNB, the government and the commercial banks (under the strong leadership of the BNB) have successfully confined the negative effects on the rest of the banking sector after placing KTB and CB Victoria under special supervision. Making huge efforts, we continue to safeguard the financial stability in Bulgaria. In an extremely unfavourable situation of unprecedented public pressure, ferocious criticisms and direct attacks against the central bank, the BNB has once again managed to do its best.

The good news is that this year the BNB has practically stood a real and very heavy stress test. We have passed an exceptionally serious stress test of our independence. We have proved how our country, business and society have a strong institution they can rely on as a pillar of stability and for protecting the long-term public interest, an institution that does not give in to pressure and opportunistic interests.

On a day like this, when we normally weigh up past events, our thoughts could go further back in time, long before the worries of this passing year. Some events can often be more wisely judged when looked at from a longer historical perspective. If we take such a look back into the 135-year history of the BNB, we would see many examples demonstrating the strength of our central bank and its insusceptibility to coteries’ intrigues and shallow trivial debates (which only absorb energy from the public creative resource, before vanishing in time).

But our history has witnessed obscurantist episodes too, when the BNB was suppressed to obey political or other temporary interests. The implications of such interventions have always been tragic for the country. Here is one brief example. On the famed date of 9 September 1944 the BNB Governing Council set a “buying” rate for the Soviet rouble (15 leva for 1 rouble) after being instructed on the telephone by the then Minister of Finance. Two days later, on 11 September 1944, the government ordered the BNB to stop buying the

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<sup>2</sup> Basel Core Principles for Effective Banking Supervision of 14 September 2012.

roubles, and instead the BNB was obliged to pay out to the Soviet armed forces passing through our country “the amounts they needed at their request” and those amounts were to be accounted for as a debt of the country.<sup>3</sup>

We do hope such times would never again return in Bulgaria. Bolshevik enthusiasm and decisions made under street pressure are the most dangerous approach when it comes to public policies regarding the monetary regime, banking supervision or financial stability.

Today, once again we are called to stand up for the professionalism and independence of the central bank – with responsibility and concrete actions.

The public interest requires that the reputation of the central bank be respected and its institutional independence and continuity in its work be safeguarded. The strength of institutions in a country is a pre-condition for stability and economic growth, while the weakness of institutions is the first sign of forthcoming economic or financial failure of a country. It is not a coincidence that in the countries which usually serve us as an example of democracy and prosperity, the strong public institutions by rule outlive the individuals and the political parties too.

Dear Colleagues,

Finally, please allow me to convey the best wishes on behalf of the BNB Governing Council and me for success of the banks run by you and for professional and personal achievements of all of you in the coming year of 2015. Happy Banker’s Day, dear colleagues!

Thank you for your attention!

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<sup>3</sup> See “Archives are speaking”, Bulgarian National Bank; a compendium of documents, volume IV, 1930–1947, pp.1018–1019. (These archives are publicly accessible on the BNB’s website.)