MOODY'S
INVESTORS SERVICE

BANKING SYSTEM PROFILE

Bulgaria

A concentrated and competitive banking system, dominated by large foreign-owned banks. Risk-management processes have improved with a regulatory and supervisory framework that is continuously evolving in accordance with EU regulations and standards.

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Summary Opinion

The Bulgarian banking system is concentrated, with most of the system's assets owned by large Western European institutions with a strong presence in South Eastern Europe. Competition in the market remains strong, particularly given Bulgaria's current economic downturn, as all the banks find it increasing*ly* difficult to find good-quality lending opportunities to grow their business.

Following many years of rapid banking system growth of around 30%-40%, Bulgarian banks' loan portfolios expanded by a modest *4.5%* during 2009, mainly reflecting the weak economic conditions in the country. The domestic operating environment has been negatively affected by the global financial crisis, which led to: (i) lower inflow of foreign direct investment (FDI) in the country; (ii) lower credit demand; and (iii) banks taking a more cautious approach towards lending.

Nonetheless, we view positively the involvement of foreign banks in the domestic banking system during the recent years. This has contributed to improved risk-management processes and to the banks' franchise development through, better quality of service and greater product innovation. Additionally, it has strengthened the sector in terms of improved corporate governance practices and enhanced transparency, although we believe there is still scope for improvement in these areas, especially for *some* banks that remain under the control of domestic investors.

Overall, we consider that the Bulgarian regulatory system is well-established with a good level of supervision exercised by the banking regulator, the Bulgarian National Bank (BNB). The regulatory and supervisory framework is continuously evolving in line with EU's regulations and standards. We consider the BNB to be an independent body that exercises its policies to ensure banking system stability. Its ability, however, to act as a lender of last resort and provide direct support to the Bulgarian banks, is limited by the currency board, which has been in place since 1997.

Bulgaria has implemented several reforms, since January 2007 when it joined the EU. The country has shown a strong reform momentum since the previous assessment in July 2009, as pointed out by the most recent report published by the European Commission in July 2010. However, further steps are needed to comply with best practices and higher governance standards.

Bulgaria has a deposit-insurance guarantee scheme, which provides coverage to an adequate portion of private-sector customer deposits in the country. Additionally, the *L*aw on Bank Deposit Guarant*ee* includes provisions for different tools that can be used to prevent banks from defaulting.

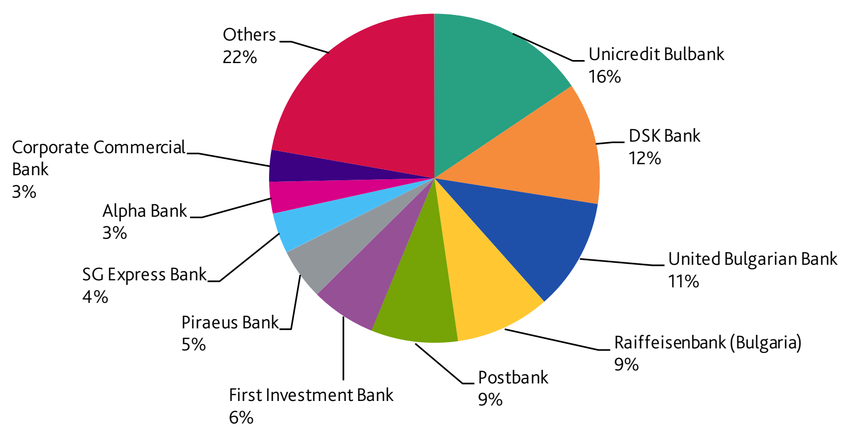
Banking System Structure

The Bulgarian financial system comprises: (i) 30 commercial banks (24 locally-incorporated entities and six foreign banks' branches); and (ii) *219* non-banking financial institutions such as leasing, finance and investment companies, brokerage and money-exchange houses. Commercial banks dominate the system and are supervised by the BNB.

As Exhibit 1 shows, the system is highly fragmented with the top five banks controlling 55% (as of 30.09.2010) of banking system assets, while the top 10 account for 77%. Almost all the banks are privately held, with most being foreign-owned by Western European groups. We estimate that around 82% (as of 30.09.2010; 82.4% as of 30.06.2010) of the banking system assets is under foreign-investor control.

EXHIBIT 1

Market share by Assets of major Bulgarian banks (June -2010)



Source: Bulgarian National Bank

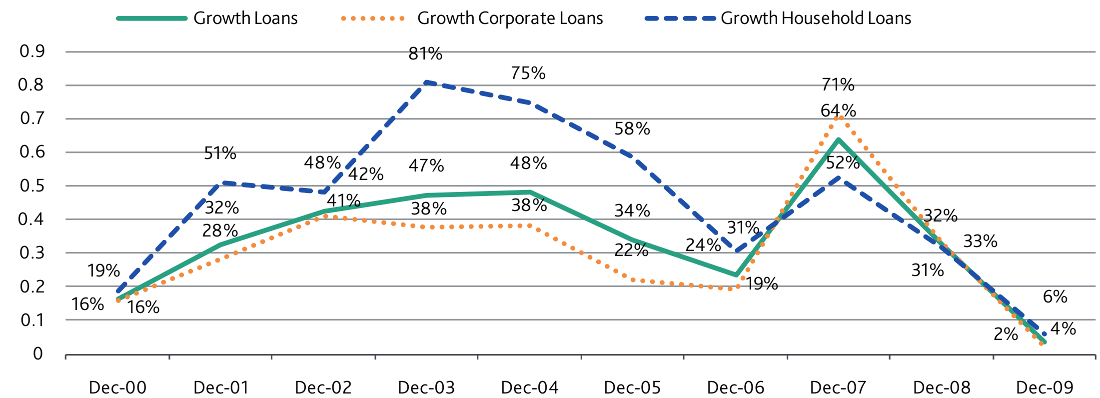
The largest bank in the system is Unicredit Bulbank (part of the Unicredit group) with a market share of around 16% in banking system assets, followed by DSK Bank PLC (Baa3/P-3/D+), which is the largest rated bank and part of OTP Bank Hungary, with a share of around 12% in banking assets. United Bulgarian Bank (owned by National Bank of Greece) and Raiffeisenbank (Bulgaria) EAD (which is part of Raiffeisenbank International) (Baa3/P-3/D+) are the third and fourth largest banks with market shares of 10.9% and 9.3%, respectively.

Starting from a low base, banking system loans grew rapidly from the beginning of the decade reflecting the prosperous macroeconomic conditions before 2008 and the high level of FDI in

Bulgaria. However, the global crisis and ensuing weak economic activity in Bulgaria since the end of 2008 resulted in a slowdown in credit activity. Banking system gross loans grew by only a modest 4.5% (excluding these to credit institutions) during 2009, to € 26.8 billion at end-2009 from € 25.6 billion at end-2008.

EXHIBIT 2

Credit growth by segment (Dec-00 – Dec-09)



Source: Bulgarian National Bank

Bulgarian banks' strategic focus in recent years has been to expand their retail banking activities, as these typically add higher-yielding assets to their balance sheets. As a result, retail loans accounted for approximately 36% of total system loans at end-2009, compared with 27% at end-2003. Mortgage finance, in particular, has been actively targeted by the banks given the lower risks traditionally associated with this segment, as opposed to consumer lending, which is typically unsecured. As a result, housing loans grew rapidly in the past few years and accounted for 17% of total loans in December 2009.

That said, we note that corporate and SME banking continued to comprise the largest portion of lending activity in the country. As can been seen in Exhibits 3 and 4 , corporate lending (including SMEs) accounted for 62% of total loans as of end-2009.

EXHIBIT 3

Systemic loans by segment (Dec-03)

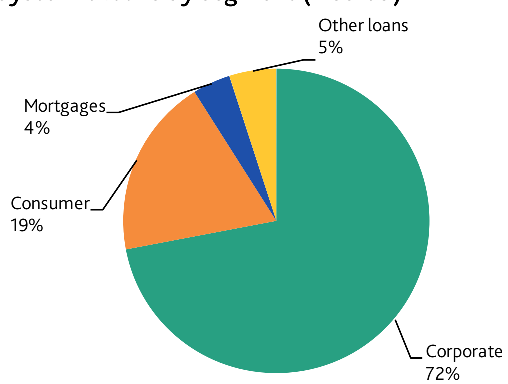
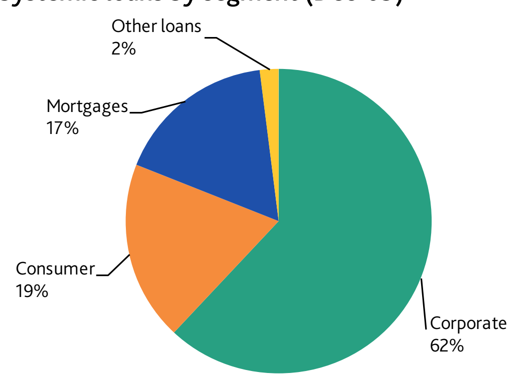


EXHIBIT 4

Systemic loans by segment (Dec-09)



Source: Bulgarian National Bank

Assessment of Operating Environment

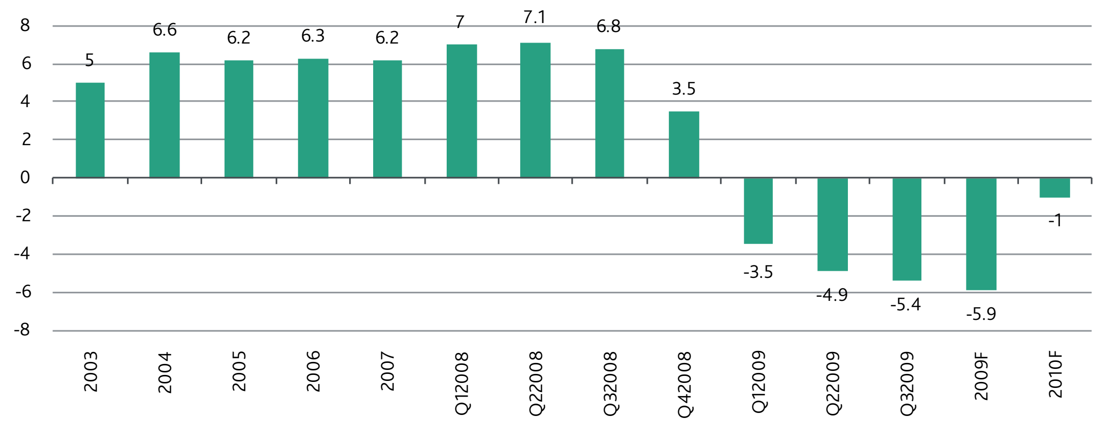
Economic Stability

Volatility of economic growth is correlated with less predictable asset quality and earnings. In assessing a country's economic stability, we consider the volatility of its GDP growth over a 20-year period. Bulgaria is similar to other developing markets in that it displays high volatility in its economic development (measured over the past 20 years).

Following several years of strong economic growth, the Bulgarian economy was strongly affected by the global economic conditions and entered into recession in 2009 (a decline of real GDP by 4.9%). As shown in Exhibit 5 below, it posted its third consecutive quarter of negative GDP growth of -5.4% year-on-year in Q3 2009.

EXHIBIT 5

Real GDP growth (% year-on-year)



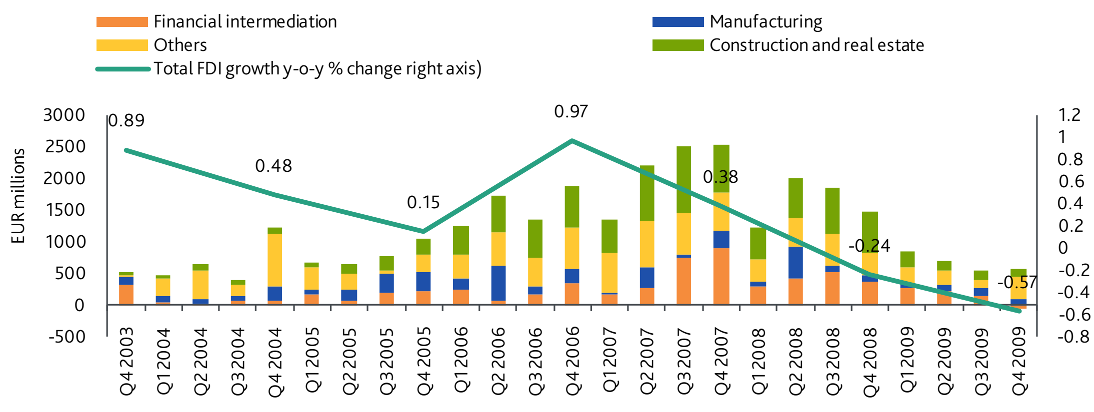
Source: Moody's sovereign.
* Estimates for 2010 could range between -1% to +1%

The decline has been mostly driven by the decrease in individual consumption and gross fixed capital formation. Also, industrial production fell and construction output was reduced significantly compared with 2008.

FDI in Bulgaria also declined to 9.4% of GDP in 2009 following several years of strong capital inflows in the country (i.e. 29.4% in 2007 and 18.9% in 2008). We estimate that FDI fell by 66% between 2007 and 2009.

EXHIBIT 6

Foreign Direct Investment (2003-2009)



Source: Bulgarian National Bank

The global crisis led investors either to reduce or to postpone their investments. In particular, the reduced inflow of FDI in the real estate sector resulted in a significant drop in real-estate prices of between 15% and 25%, depending on the area and type of property. Any recovery in the market is expected to be delayed given the persistence of high global uncertainty. For FYE2010, Moody's sovereign team expects the economy to rebound slightly, but GDP growth is likely to remain between -1% and +1%.

Integrity and corruption

Moody's uses the World Bank Indicator on Control of Corruption, which ranks countries in terms of the degree to which public power is exercised for private gain.

Using this index, Bulgaria has a value of -0.12 and is ranked 54th among all countries.[1] Based on this measurement, Bulgaria scores a D according to Moody's internally devised mappings of the scores.

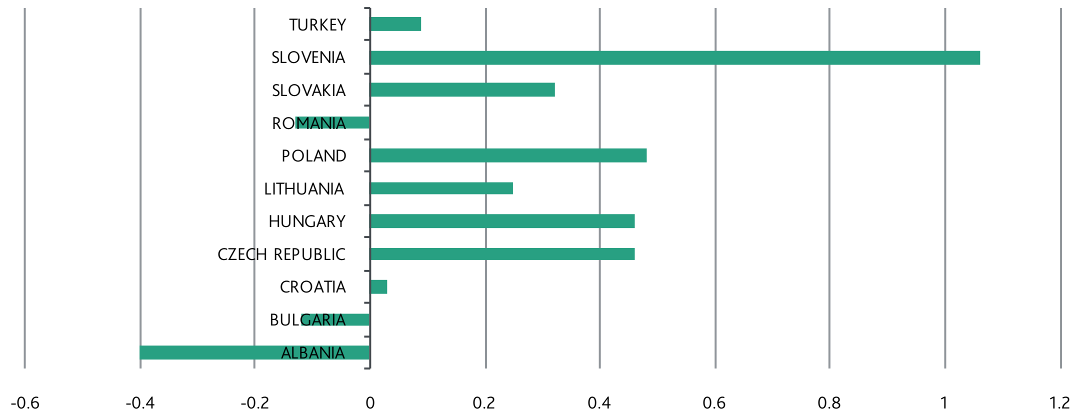
1 Governance is measured between -2.25 to +2.5, with the higher score corresponding to better governance standards and lower corruption. The ranking among other countries ranges between 0 and 100, with the 100 being the best country scoring a 100.

Exhibit 7 illustrates the corruption index of different countries in the South Eastern Europe.

EXHIBIT 7

World Bank Control of corruption index (end-2009)

Comparison among counties in South Eastern Europe



Source: World Bank

One of the pre-conditions for Bulgaria to become part of the European Union in January 2007, was that the government would step-up its efforts to improve the judicial system and fight corruption and organised crime. To this end, the European Commission together with the Bulgarian authorities established a mechanism in December 2006, called the "Co-operation and Verification Mechanism (CVM)" in order to benchmark the improvement of the country on these fronts.

As pointed out by the most recent report published by the European Commission in July 2010, Bulgaria has shown a strong reform momentum since the previous assessment in July 2009. However, further steps are needed to comply with best practices and higher governance standards.

In the banking sector, in our view, the theft and fraud prevention mechanisms applied at individual banks have improved in recent years, particularly with the complete privatisation of the banking system and the arrival of new foreign shareholders in the banks' capital structure. Furthermore, the Law on Measures against Money Laundering that has been in place since 1998, and amended before Bulgaria's entry into the EU, has also added to the improvement of the framework in the country.

BNB plays a crucial role for maintaining the trust of customers in the banking sector. Its actions are focused on providing appropriate tools for prevention, coordinating the activities between banks and law enforcement authorities, organizing open events for raising the public awareness on specific techniques for safeguards. The cooperation and increased exchange of information and expertise between the institutions involved in the prevention mechanism have increased the effectiveness of the control system.

The Legal System

A well-established and well-enforced system of contract law facilitates the banks' day-to-day operations. Banks' risk-management and mitigation tools rely on the predictable and fair functioning of the legal system. The time-value of money also puts a premium on the swift functioning of the legal system. Given these factors, we have chosen to score a country's legal system according to the time it typically takes a bank to foreclose on a residential mortgage.

Also, in our view, there is a need of improvement of the weak loan enforcement and collateral foreclosure practices (and Bulgaria's inefficient judicial procedures) that have previously hindered the effective resolution of overdue exposures of Bulgarian banks after the loans become problematic. This means that certain loans that become delinquent would be kept on the banks' books for a long period of time, distorting the true asset-quality picture.

Although the Bulgarian authorities have taken measures to expedite foreclosure, it appears that the process is not applied consistently and delays can still occur. As pointed out by the European Commission the judicial system needs to be improved further in order to raise efficiency and accountability, while Bulgaria should strengthen further the legislation on asset forfeiture.

Based on the above, Bulgarian banks adjusted score is D for this factor.

Assessment of Systemic Support

Summary

Bulgaria's currency board that has been in place since 1997 limits the BNB's ability to provide support to a financial institution in times of distress. Nonetheless, in our view the authorities would be willing and able to provide support indirectly to the banks in order to safeguard the stability of the system in case of need. Hence, the systemic support indicator rating assigned to Bulgaria is Baa2, which is one notch above the sovereign's Baa3 rating.[2]

Bulgaria has a deposit insurance guarantee scheme, which provides coverage to an adequate portion of private-sector customer deposits in the country. Additionally, the Law on Bank Deposit Guarantee includes provisions with regards to the different tools that can be used to prevent banks defaulting.

Importance and Strength of the Banking System

The banking market is essential for the country's payment system. Although the Bulgarian banking system is less developed than those in other EU countries (as indicated by the standard measure of the contribution of banking assets to GDP), the financial intermediation in the country has grown over recent years, with total banking system assets reaching 107% of Bulgaria's GDP at end-2009, compared with 86% at end-2006.

The Bulgarian banks have been affected by the global and domestic economic downturn which resulted in higher non-performing loans on their balance sheets and higher provisioning expenses booked in their income statements. According to the BNB, non-performing loans (defined as loans 90+days overdue) reached 10.61% of loans at end-September 2010, compared with a lower ratio of 6.42% at end-2009. In addition, elevated credit costs lowered the banks' profitability levels which nonetheless remained adequate. That said, we note that despite higher credit risk, the Bulgarian banking sector remains resilient and has strong capital buffers to absorb credit losses. As of end-September 2010, Tier 1 and total CAR were high at 15.25% and 17.80%, respectively (14.03% and 17.04% as of December 2009).

2 For further details please refer to the Special Comment titled: "Financial Crisis More Closely Aligns Bank Credit Risk and Government Ratings in Non-Aaa Countries", which was published in May 2009.

Deposit Guarantee Schemes

Since 2008, Bulgaria has a deposit insurance scheme with a coverage of up to BGN 100,000 (approximately €50,000) for each deposit account. According to BNB, from the beginning of 2011 the coverage will increase up to BGN 196 000 (EUR 100 000). The scheme is run by a five-member management board, whose chairperson is elected by the council of ministers. All Bulgarian banks are members of the fund, including the foreign branches of foreign banks, in cases where either there is no deposit guarantee scheme in their home country or, if there is one, it is not applied to a bank's foreign branches.

Track record of Support

There is historical evidence demonstrating the BNB's direct intervention to provide support to troubled financial institutions. This took place during the Bulgarian banking crisis in 1996-1997, and before the introduction of the currency board in 1997 that aimed to bring stability to the financial system. Since then, the law has limited the ability of the BNB to extend *direct* liquidity support to solvent banks.[3]

Nonetheless, in our view BNB would be willing and able to provide support indirectly to the banks in order to safeguard the stability of the system in case of need. Evidence of indirect support was demonstrated in 2008, when BNB intervened and made a public statement about a Bulgarian bank that had incurred a deposit outflow due to market rumours. The regulator's statement, which confirmed the bank's solvency, stopped the market rumours and constrained the bank's outflow of deposits. According to the authorities, indirect support could include other means of support in case of need, in order to safeguard the stability of the banking system.

Assessment of Regulatory and Supervisory Environment

Moody's assesses bank supervision as good in Bulgaria, with established prudent measures and robust procedures and rule formalisation. The BNB is continuously taking steps to enhance its supervisory techniques and oversight and it is open to developments in EU regulations and standards. Detailed analysis of the banking system and consolidated data is made available and published by the BNB periodically. Nevertheless, in our view, higher disclosure of information about individually supervised banks would further improve the system transparency and raise the confidence level in the Bulgarian system.

Independence

The banking law in Bulgaria provides the BNB with both financial and administrative independence to establish the regulatory framework and to monitor and carry a consolidated supervision to banks operating in Bulgaria. BNB's management and supervisory role is entrusted to a seven-member management board appointed by the President and the National Assembly. Its functions include the power to grant, refuse or withdraw the banking licence, establish the minimum reserve requirements to be held by banks and set the prudential regulations to which banks must adhere.

[3] Under the currency board regime and under current law provisions, the BNB may extend credit only to solvent banks and upon emergency of a liquidity risk that may affect the stability of the banking system. In such instances, the BNB may provide lev-denominated credits with maturity up to three months, provided these are fully collateralised by gold, foreign currency or other such high-liquid assets. Such support is limited to the amount of the excess of the lev equivalent of the gross international reserves over the total amount of the BNB's monetary liabilities.

Overall, we consider BNB to be independent and free from political influence or outside parties.

We believe, that its function of conducting its monetary and supervisory policy will become less challenging, as the country continues to implement reforms in order to comply with best practices and higher governance standards.

Regulatory Standards

In our view, the BNB has prudent regulatory standards in place that compare well with those in more developed markets. Following the banking crisis in 1997, the regulator set in motion a reform programme that included the introduction of the currency board and the establishment of a prudent regulatory framework. We consider the BNB to be an active regulator that is continuously implementing changes in line with the European Union standards, resulting in a significant improvement in the regulatory regime.

A set of prudential regulations and limits are firmly in place to classify and monitor Bulgarian banks' risk exposures. In particular, the regulatory definitions for non-performing loans and provisioning policies that banks need to apply with regard to problematic exposures, are in accordance with international best practices and compare well with those in developed markets. Also, credit risk concentration limits with regard to shareholders' equity are well in place, while each month, the BNB monitors the liquidity risk positions of the banks.

In our view, it is important for these prudent measures to exist particularly in markets where: (i) transparency levels are adequate, but there is room for further improvement; and(ii)strong local conglomerates account for a significant portion of the banks' corporate portfolios, creating sizeable concentration levels in the banks' books.

Meanwhile, the implementation of Basel II in January 2007 across the Bulgarian market reinforced the risk measurement framework for all banks and for all risk types. This is particularly important for smaller institutions that have been lacking the necessary tools and systems to measure some types of risks. The larger and mostly the foreign-owned banks would typically have more advanced risk management systems, having benefited from the know-how of their parents.

Supervision

The supervisory framework in Bulgaria is carried out on a consolidated basis and involves: (i) extensive annual on-site examinations from a team of examiners; (ii) off-site monitoring using data the banks provide monthly; and (iii) in-depth analysis of the trends, potential risks and threats to the banking system. In conducting its supervisory role, the BNB's focus is strengthened towards areas that pose the highest risk to each bank and the overall banking sector and draws its attention to the identification and control of banks' management teams.

The supervisor also uses an early warning system to measure the performance of banks relative to the capital adequacy levels, asset quality, earnings and liquidity. A series of stress tests is being carried out quarterly for each bank to measure the level of credit, market and liquidity risk that each institution assumes, based on different scenarios and parameters. These measures enable the BNB to ensure stronger supervisory oversight and maintain the banking system's financial stability.

Enforcement and Maturity of Regulatory Framework

The BNB has the power to impose penalties and sanctions on banks that fail to comply with laws and regulations. According to the law, in cases where certain offences[4] are carried out either by the bank, its administrators or its shareholders, the regulator can introduce several measures that include the power to constrain certain activities of a bank, oblige the institution to increase its capital levels, forbid transactions with customers that have close links with the bank, appoint a conservator, place the bank under supervision, or demand changes in its internal rules, among other things.[5] In our view, the law is fairly comprehensive and allows the regulator to execute its supervisory role and enforce its authority in a fair and constructive manner.

The Bulgarian regulatory and supervisory framework is continuously evolving. We expect that BNB's continuous adherence to EU standards and procedures and its openness to suggestions and recommendations from third parties will continue to improve the supervisory and regulatory framework in the country.

4 These are clearly stated in the Law on Credit Institutions under Section IV, Article 103, paragraph 1.

5 These are clearly stated in the Law on Credit Institutions under Section IV, Article 103, paragraph 2.

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