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The COVID-19 Challenge and the Sustainability of the Bulgarian Banking Sector

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Abstract: *The paper examines the effects and the challenges posed by the COVID-19 pandemic on the banking sector in Bulgaria. The research describes the response from the global and European regulatory authorities. An emphasis is placed on the national regulatory measures and the condition of the banking system in Bulgaria. Financial soundness and sustainability indicators about the banks operating in Bulgaria on aggregate basis are analyzed. The recent developments regarding the position of the banking sector and lending dynamics are also viewed. Conclusions and a brief discussion about possible future challenges and prospects are made, in terms of a potential subsiding of COVID-19.*

1. INTRODUCTION

After the Global Financial Crisis of 2008-2009, the Basel Committee on Banking Supervision launched the post-crisis regulatory reform with the publication of the so-called Basel III standard (BIS, 2010) in December 2010. It was implemented in the European Union (EU) through the Capital Requirements Regulation and the Fourth Capital Requirements Directive. In 2017, the Basel Accord of 2010 was extended by a document published by the Basel Committee on Banking Supervision entitled *"Basel III: Finalizing post-crisis reforms"*. Thus, the Basel III reform, often referred to as Basel IV (BIS, 2017), should be implemented by the EU Member States by January 2023.

The post-crisis regulatory reform agenda, which began with Basel III, addressed many of the shortcomings of the pre-crisis regulatory framework revealed in the wake of the Global Financial Crisis. In 2008 and 2009, banks were not capitalized enough to withstand the worst shock to the financial system since the Great Depression. The increase in banks' regulatory capital since then is a projection of the efforts of policymakers to support the banking system and increase its resilience. Since June 2011, the level of Common Equity Tier 1 (CET1), the highest quality capital of banks, in the EU is constantly increasing and at the end of 2020 exceeded 15,6%, which is far below the minimum required 7%. The development in the leverage ratio is quite similar, currently over 5,8%, which is again well above the minimum requirement of 3%.

The strong capital position of the European banking sector is one of the key factors in ensuring that the spread of the coronavirus in the spring of 2020 does not significantly affect the banking sector. Thanks to the high level of CET 1 and the support measures provided by regulators and supervisors, banks are able to maintain lending to the economy without having to restrict lending standards and the flow of credit to their customers, which did not allow further worsening of the economic recession.

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To a large extent, the developments for the banking sector in Bulgaria are similar. The main purpose of the paper is to examine the impact of COVID-19 on the banking sector at EU level and in Bulgaria. The study describes the regulatory response at the global and European level. The main emphasis is placed on the national regulatory measures and the sustainability of the banking system in Bulgaria.

2. THE REGULATORY RESPONSE

In 2008, following the shock of the Global Financial Crisis, the regulatory and policy response was perceived as insufficient and overdue. Now the response to the unprecedented crisis posed by the COVID-19 pandemic is timely, significant and swift. And more importantly, the European institutions and regulators have coordinated a common action plan in different areas, using a diverse range of tools. As a result, the brief increase in market volatility was quickly contained.

With regard to monetary policy, in March 2020 the ECB announced a comprehensive package of measures (ECB, 2020a), including quantitative easing, as well as performing additional long-term refinancing operations in the March-June 2020 period. Significant liquidity under favorable conditions in the most severe months of COVID-19 shock was provided. In June 2020, the envelope of the Pandemic Emergency Purchase Program (PEPP) was increased by €600 billion to a total of € 1.35 trillion (ECB, 2020c).

In terms of regulations, in a very short time, EU legislators have undergone the so-called "quick fix"[2] on changes to capital requirements regulations. It entered into force at the end of June 2020 and allowed a reduction of certain risk weights for certain banks' exposures, which automatically increased their capital adequacy. On the other hand, also in March 2020, the Single Supervisory Mechanism (SSM) provided temporary capital and operational reliefs allowing banks to continue lending without undermining their capital ratios (ECB, 2020b).

Furthermore, the European Commission (EC) has announced a recovery plan for Europe, including a €750 billion instrument, the amount of which will be raised through the capital markets (EC, 2020).

According to EBF calculations (2020), banks in Europe receive a capital relief of about 200 basis points on average from their average level of CET 1, which was used to absorb the initial hit of the crisis, allowing the banking system to start 2021 without disruption in its resilience and sustainability.

3. BANKS AND THE COVID-19 CHALLENGE

At the end of the second quarter of 2020, an increase in capital adequacy was observed in the Bulgarian banking system as a result of some regulatory changes. The first one was due to the so-called "quick fix". The second measure was the real increase of the equity of the banks due to the ban imposed by the Bulgarian National Bank (BNB) on dividends payments. This measure ensured that an additional BGN 1.3 billion (€665 million)[3] would be retained in the Bulgarian

[2] Regulation (EU) 2020/873 of the European Parliament and of the Council of 24 June 2020 amending Regulations (EU) No 575/2013 and (EU) 2019/876 as regards certain adjustments in response to the COVID-19 pandemic

[3] The Bulgarian currency – the Bulgarian lev (BGN) – is pegged to the euro with a fixed exchange rate of 1.95583 BGN for 1 EUR since the 1st of July 1997

banking system. According to the BNB estimates, cumulatively the two measures increased the level of the capital adequacy of the banking sector in Bulgaria by about 4 percentage points (Hristov, 2020).

At the end of 2020, the CET 1 for the entire banking system increased to 21.69% from 19.44%, as it was at the end of the first quarter of 2020. At a system level, the total capital adequacy ratio rose to 22.74% from 20.45% for the same period.

The capital adequacy ratios of banks in Bulgaria are above the average levels for the banks participating in the Single Supervisory Mechanism, which, according to the ECB, at the end of 2020 were 15.62% for CET 1 and 19.51% for the total capital adequacy ratio. The dynamics of the ratios could be observed in Figure 1.

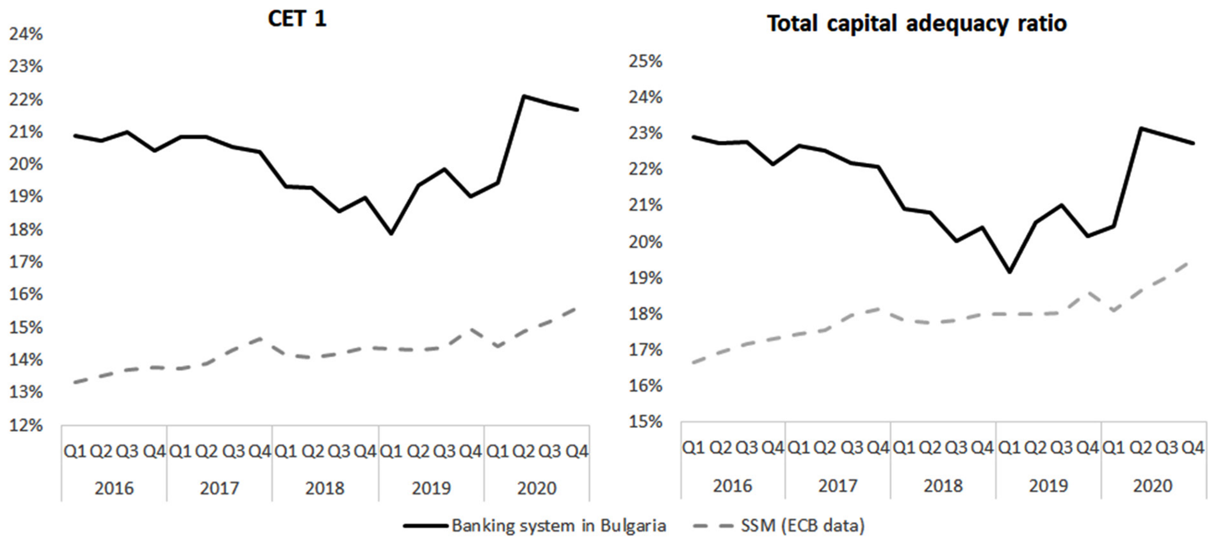

Figure 1. CET 1 and total capital adequacy ratio for the banks in Bulgaria and for the banks participating in the Single Supervisory Mechanism

Source: BNB, ECB

According to Regulation (EU) № 575/2013, in the first quarter of 2020, a risk weight of 100% was applied to the Bulgarian government bonds denominated in euro, which led to an increase of the risk-weighted assets for the Bulgarian banks. Meanwhile, in relation to the COVID-19 pandemic, in the first quarter of 2020 the BNB announced measures for the banking sector (Bulgarian National Bank, 2020), including capitalization of the total banking system profit for 2019 in the amount of BGN 1.6 billion (€818 million). The BNB's decision considering banks not to distribute dividends offset the effect of the increased risk weight on the Bulgarian government bonds denominated in euro in the second quarter of 2020. The full capitalization of the total banking system profit is expected to be fully met by the banks after the relevant regulatory approvals (Association of Banks in Bulgaria, 2020). In addition to the capitalization of all profits in the sector, the measures of the BNB include a significant reduction in foreign exposures bearing higher-risk and the cancellation of the planned two increases in the Countercyclical Capital Buffer (CCyB).

According to the decision of the EC from April 2020 for the so-called "quick fix", part of the EC's actions in the banking sector, in response to the effects of the coronavirus, the Bulgarian government bonds denominated in euro were again equaled to those in local currency, which means an applicable risk weight of 0% to 2023. This would lead to a reduction of the weights of some risk-weighted assets of banks and, accordingly, to an increase in capital adequacy, thus building stronger resilience and underlining the sustainability of the sector.

According to BNB data, compared to the end of March 2020, the total risk exposures for the banking system decreased by BGN 6.1 billion (8.9%, €3.12 billion) to BGN 62.8 billion (€32.1 billion). The exposures for credit risk under the standardized approach were the main contributor to the decline (by BGN 5 billion (€2.56 billion), or by 10%), where the impact from the changes in the Capital Requirements Regulation was greatest. The share of risk-weighted exposures for credit risk in the total amount of risk exposures decreased to 90.9% at the end of June 2020 from 91.1% at the end of March 2020. The share of exposures to position, currency and commodity risk decreased to 0.5% at the end of the period from 0.6% (at the end of the first quarter of 2020), while the share of exposures to operational risk increased to 8.6% from 8.3% three months earlier, the BNB data showed. With regard to the amount of capital exceeding the capital requirements and certain capital buffers, the BNB reported a quarterly increase by BGN 1.4 billion (€716 million) to BGN 4.8 billion (€2.45 billion) due to the decline in the total amount of risk exposures and in the capital requirements and capital buffers, calculated on this basis.

The desired effect of these measures is related to maintaining the lending activity and providing relief to banks' borrowers - companies and households, through the approval of the Procedure for deferral of loan payments[4], proposed by the industry in April 2020. The BNB statistics confirm that this effect has been achieved so far (Radev, 2020). As of the end of 2020, not only we are not witnessing stagnation in lending, but loans to companies and households are increasing on an annual basis, by 3% and 8.2%, respectively. According to the ECB, credit growth in the euro area is 7% on an annual basis for corporates and 3.1% for households (ECB, 2020d). Credit growth dynamics could be observed in Figure 2.

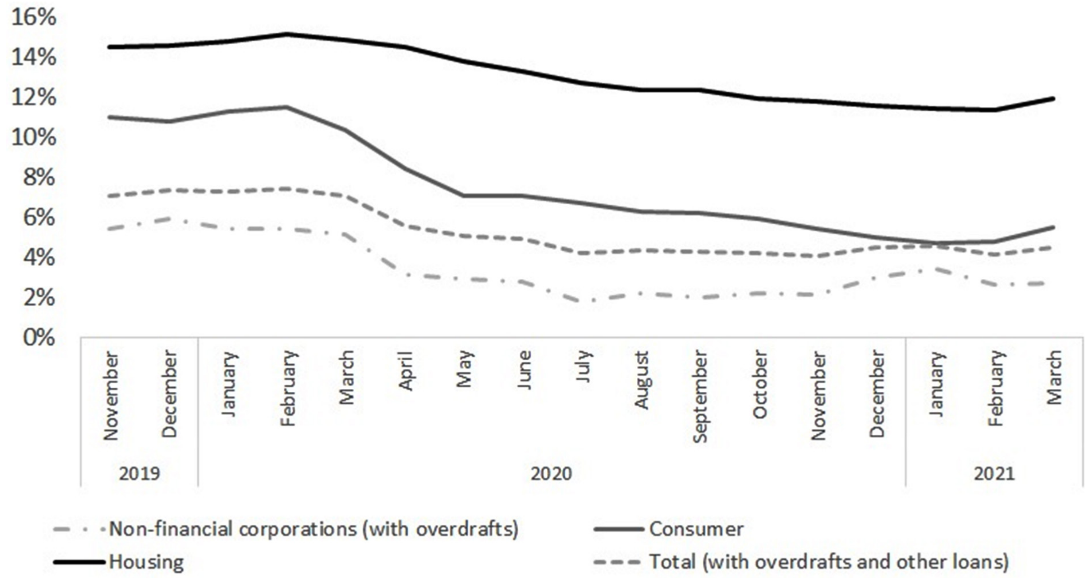

Figure 2. Credit growth dynamics in the period from November 2019 to March 2021 (annual rate of change) (%)

Source: BNB

4 Procedure for deferral and settlement of liabilities payable to banks and their subsidiaries – financial institutions in relation to the measures taken by the authorities of Republic of Bulgaria to limit the COVID-19 pandemic and its consequences

Since the European Banking Authority (EBA) provided the opportunity to use public and private moratoriums back in April 2020, banks in Europe have begun to reschedule loans to their customers affected by the crisis (EBA, 2020a). According to the EBA, at the end of June 2020, under the different moratorium schemes in Europe, loans of over €871 billion were rescheduled (EBA, 2020b). According to the EBF (2020), more than 5 million individuals and more than 2 million legal entities have benefited from the various rescheduling measures taken by the EU Member States.

In Bulgaria, the measure also benefited many individuals and legal entities affected by the pandemic. According to BNB data, at the end of 2020 nearly 130,000 requests of companies and households with a total value of nearly BGN 10 billion (€5.12 billion) were approved. The data includes deferrals, which expired at the end of the reporting date, as well as for voluntarily resigned borrowers who initially applied for the moratorium.

4. FUTURE RESEARCH DIRECTIONS

Future research directions would be related to the subsiding of the COVID-19 pandemic and to the analysis of the preparedness of the banking sector for driving the recovery phase of the economy. It has to be seen what would be the direction which the regulators could follow regarding keeping, amending or prolonging certain regulation reliefs. A more comprehensive econometric study could be developed, with the main aim to try to quantify COVID-19 effects on lending, savings and some financial positions of the banking sector.

5. CONCLUSION

The banking sector withstood the initial shock caused by the spread of COVID-19, in parallel with the restrictions imposed by governments to limit the negative impact on public health, through a much stronger position than in the 2008-2009 period. This is an evidence that 10 years since the introduction of the Basel III standards, policymakers, together with the banking sector itself, have been able to significantly improve the resilience through which banks better manage significant stress on the financial system.

The conservative approach of the Bulgarian regulator has also prepared the banks in Bulgaria to the maximum extent. Due to its solid capital position, lending to companies and households in the country not only did not decline, but even increased, which is a prerequisite for the leading role that banks play in the recovery phase of the coronavirus crisis.

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DISCLAIMER

The views expressed by the author in this paper are his own and do not necessarily represent the views of the Association of Banks in Bulgaria, neither engage the organization nor its members in either way.

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