EXPECTED IMPACT OF THE COVID-19 PANDEMIC: FINANCIAL SECTOR IN BULGARIA

Measures to curb the spread of COVID-19 are growing into a large-scale real sector crisis virtually worldwide. Our expectations for the decline of the Bulgarian economy in 2020 range in 2-10% between optimistic and pessimistic scenarios. The government has set a pessimistic scenario for a 3% decline in GDP this year when updating the state budget.

A number of economic sectors will face payment disruptions and receivables cycle extension. We expect delays in debt obligations service to grow along with the duration of the crisis unless forbearance is elongated. Job losses, especially in the services sector as well as in some of the manufacturing sub-sectors, will increase. Shrinking incomes will also lead to limited consumption, some increase in defaults on households' loans, and could enhance the risk for financial institutions. We expect a serious impact on the cash flows of both individuals and legal entities.

The leading central banks will once again play a crucial role in ensuring adequate liquidity and alleviating market turmoil, but we believe that the impact mechanism of monetary policy on the real sector is already restrained. The **Federal Reserve** has held a series of emergency interventions in recent weeks, with the **European Central Bank** announcing a new EUR 750 billion Pandemic Emergency Purchase Program (PEPP) intended specifically for addressing the effects of the COVID-19 pandemic.

On the 19 of March 2020, the **Bulgarian National Bank**, within its mandate, announced a package of measures aimed primarily at further strengthening the capital and liquidity of banks in the context of the COVID-19 pandemic. The measures are estimated at BGN 9.3 billion. They include capitalization of the profit generated in the banking system in 2019; a cancellation of the increases of the countercyclical capital buffer, scheduled for 2020 and 2021; a commercial banks' foreign exposures reduction[1]. The BNB will guarantee the smooth operation of the currency board, cash circulation, payment systems, and banking supervision.

The European Commission, in turn, approved a Temporary Framework for State aid measures to support the economy in the current COVID-19 outbreak[2], considering that the entire EU economy is in serious difficulty. Five types of assistance are envisaged to ensure the continuity of lending and the provision of the necessary liquidity for businesses to meet their immediate working capital and investment needs:

1. Aid in the form of direct grants, repayable advances or tax advantages;
2. Aid in the form of public guarantees on bank loans;
3. Aid in the form of subsidised interest rates for loans of enterprises;
4. Aid in the form of guarantees and loans channelled through credit institutions or other financial institutions;
5. Short-term export credit insurance.

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[1] As of the end of 2019, net foreign assets amounted to BGN 124 billion, or 47% of total net assets, according to BNB monetary statistics.
[2] The full text of the framework is available at:
https://ec.europa.eu/competition/state_aid/what_is_new/sa_covid19_temporary-framework.pdf

Commercial banks in Bulgaria have already taken measures at an individual level, including traditionally applied forms of renegotiation, such as using grace periods to pay off loans. There are opportunities to defer payments on all credit segments to the non-financial sector (households, micro-enterprises, SMEs, etc.), as well as for extensions on credit card limits. Remote electronic banking channels provide safe and affordable banking services in the context of social isolation and that is why they got their importance increased. The banks in the country work individually with their clients – natural or legal persons, in order to find the most suitable solutions for overcoming possible emergent difficulties in servicing their contractual agreements, according to the Executive Board of the Association of Banks in Bulgaria[3].

On the 31 of March 2020, the **European Banking Authority** (EBA) provided clarity on measures to mitigate the impact of COVID-19 on the EU banking sector. The EBA has called to bank institutions to refrain from the distribution of dividends, maintain sound capitalization, and a conservative approach to the extraordinary remuneration policies. Banks will need to focus on monitoring and assessing the impact of the COVID-19 epidemic, ensuring business continuity and access to reliable information.

Two days later, EBA announces its **Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis** (EBA/GL/2020/02)[4]. The guidelines set the framework and the basic requirements for the banks, but not the specific details. In the case of Bulgaria, the details are to be offered by the commercial banks operating at the market by the 10 of April 2020. In this regard, the BNB will approve a form of non-legislative moratorium after this deadline. This means that payment relief initiative comes from an institution as part of an industry- or sector-wide moratorium scheme agreed or coordinated within the banking industry or a material part thereof, possibly in collaboration with public authorities (*see APPENDIX 1*).

The **Bulgarian Development Bank** is preparing to put in place the guarantee mechanism that will allow those affected to receive financial support in response to the rapidly developing epidemic situation. The mechanism, approved by the government, provides for a state guarantee for interest-free loans of up to BGN 1 500 per month. Employees who are temporarily placed in an unpaid leave will be able to benefit from them. BDB will, therefore, be capitalized with BGN 700 million, of which BGN 500 million for bank loan portfolio-guarantees and BGN 200 million for interest-free consumer loans for citizens.

In addition to all these measures, facilitating access to liquidity is yet to continue. The banking sector continues to operate and remain key to economic development.

We consider that, among other government measures for the period of the state of emergency in the country[5], the following are of particular importance for the stability of the financial sector:

- ✓ The enforcement proceedings are suspended;
- ✓ All announced public sales and introductions into possession announced by public and private bailiffs shall be suspended;

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[3] The full text of the message is available at: https://abanksb.bg/en/press-en/message-from-the-executive-board-of-the-association-of-banks-in-bulgaria/

[4] The full text of the guidelines is available at: https://eba.europa.eu/regulation-and-policy/credit-risk/guidelines-legislative-and-non-legislative-moratoria-loan-repayments-applied-light-covid-19-crisis

5 According to the *Law on Measures and Actions during the State of Emergency announced by a decision of the National Assembly on 13 March 2020*.

- ✓ Preservations will not be imposed either to individuals' bank accounts or to salaries and pensions.
- ✓ The sanctions for late payment on the obligations of individuals, including interest and late payment penalties, will not apply.

Current Status of the Bulgarian Financial System

The main players in the **Bulgarian financial system** are the banks and non-bank financial institutions, the latter including insurance companies and other institutions specialised in lending. We closely monitor the development of banking and insurance companies rated by the Agency (*see ANNEX 1 and ANNEX 2 at the end of the document*) on the basis of specific performance indicators.

The sector of ***Financial and Insurance Activities*** accounts for 7% of Bulgaria's GVA, about 80% of which is generated by the banking sector's activity. The last has been contributing by 0.2 percentage points to the GVA growth over the last 5 years. A total of 67 000 people are engaged in the sector or 2.1% of the total number of employees in 2019. Commercial banks play a major role in financial intermediation in the country, with the banking system assets corresponding to 96% of GDP. **Liquidity** provisioning is one of the main functions of the financial system, in addition to directing cash flows and resources to businesses, activities, and projects; and managing risk within the system.

BCRA is of the opinion that **the Bulgarian banking system** has the resources to overcome the shock, based on its development over the past few years. Liquidity is significant, supported by the growth of the deposit base and we do not expect any turmoil in this regard. We expect a deterioration of the financial result at the systemic level, yet not critical, in case the duration of the measures is up to 3 months. Bulgarian banks remained profitable even in the conditions of persistently low-interest rates after the global financial crisis (*see the following table*).

Table 1: Bulgarian Banking System – selected indicators: 2015 - 2019

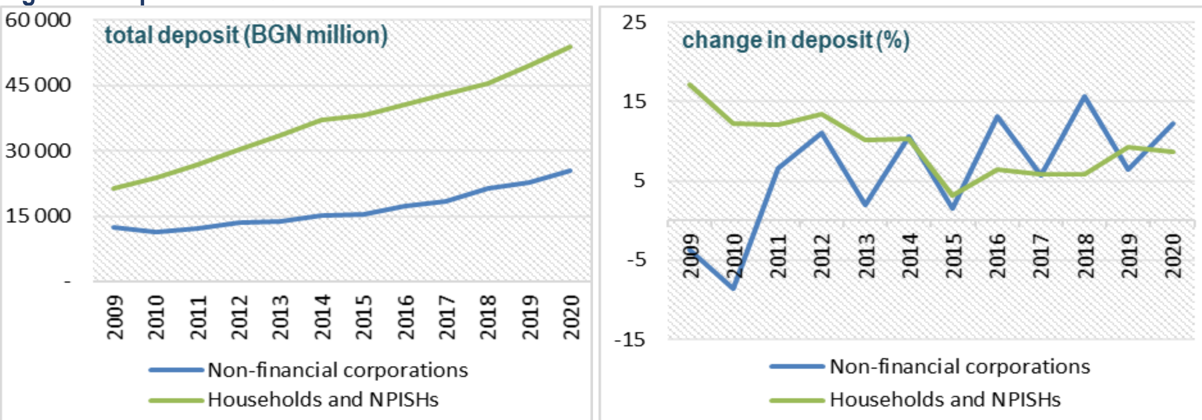
BGN million	2015	2016	2017	2018	2019
Loans and advances, gross carrying amount	75 964	77 517	81 548	89 029	**94 455**
Non-performing loans	11 026	9 961	8 292	6 795	**6 120**
Net interest income	2 771	2 805	2 675	2 742	**2 746**
Net fee and commission income	890	921	996	1 066	**1 106**
Net operating income	1 275	974	1 035	1 150	**1 067**
Net financial result	898	1 262	1 174	1 678	**1 675**
%					
NPL ratio	14.5	12.9	10.2	7.6	**6.5**
Deposit growth rate (non-financial sector)	8.7	7.0	5.8	7.9	**8.6**
Loan to deposit ratio	78.1	73.5	71.5	72.0	**72.2**
T1 capital ratio	20.5	20.9	20.9	19.4	**19.5**

Source: BNB, supervisory statistics

Deposits of the non-financial resident sector - enterprises; households and NPISHs - as of February 2020 account for 90.1% of the total deposits in the banking system. Banks' internal financing through deposits has grown steadily since the 2008 financial and economic crisis (*see Figure 1*). It has doubled in size over the last 10 years and tripled compared to its level at the previous crisis. Less than 100% or about 70-80% of this resource is returned to the economy in the form of loans, which is an indicator of low liquidity risk.

Accordingly, capital adequacy of the system measured by the narrowest indicator - Tier 1 capital adequacy, was reported at 19.5% at the end of 2019. This level exceeds significantly the regulatory requirement and we consider it a stable buffer in shock situations.

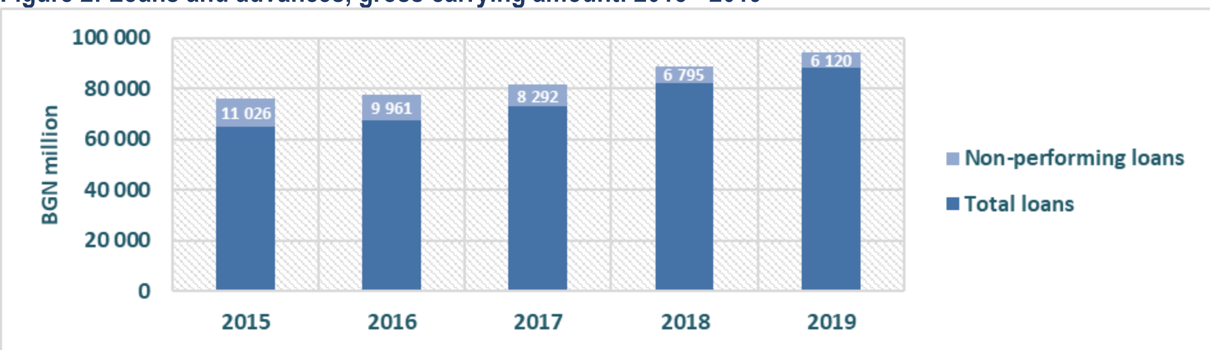
Figure 1: Deposit of NFS: 01.2009 - 02.2020



Source: BNB, monetary statistics

The credit quality, which we expect to reverse its positive trend, is currently well maintained. However, bank exposures to some of the sectors that we expect to be most affected are significant: Trade; repair of motor vehicles and motorcycles (16.0%) and Real estate activities (6.1%) have the largest and the third-largest exposures at the end of 2019, respectively. This we estimate as a risk to the collection of the loans provided towards these sectors.

Figure 2: Loans and advances, gross carrying amount: 2015 - 2019



Source: BNB, supervisory statistics

Specific indicators monitored for the banking sector

- ✓ NPL ratio (individuals and small businesses) and dynamics of arrears generation;
- ✓ Profit;
- ✓ Volatility of institutional portfolios of securities;
- ✓ Capital adequacy;
- ✓ Liquidity;
- ✓ Exposure to households and SMEs;
- ✓ High concentration of loans to most affected economic sectors as identified by BACR“[6].

[6] Accommodation and food service activities; Real estate activities; Transport; Manufacture of motor vehicles parts and transport equipment; Manufacture of machinery; Arts, entertainment and recreation.

The **insurance sector in Bulgaria** has been generating a 1% in GVA on average for the last five years. The insurance penetration measured as Gross Premium Income to GDP remains low (at levels close to 2.0% in the last two years). Insurance density is also low, despite a steady upward trend over the last five years. **Gross premium incomes and the value of assets managed by the sector** demonstrated a constant growth in this period.

The Financial Supervision Commission is the regulator of insurance in the country. In the current increasingly complex market environment, the FSC follows the guidelines for the operation of financial markets issued by the European Insurance and Occupational Pensions Authority (EIOPA) and the European Securities and Markets Authority (ESMA), which are aimed at the proper functioning of the markets, financial stability, and investor protection. The focus is on the continuity of processes, transparency and timely disclosure of information. The national competent authorities should be flexible concerning time limits for supervisory reporting and public disclosure.

With regard to the activities of **investment firms** in the context of the crisis, the FSC decided as well on cancelling the planned increase in the level of countercyclical buffer applicable to credit risk exposures in the Republic of Bulgaria for the second, third and fourth quarters of 2020 by 1% and for the first quarter of 2021 by 1.5% at its meeting on the 24 of March 2020. The applicable countercyclical buffer of 0.5% remains in force.

Specifically, for **insurance companies**, EIOPA extends the period for a comprehensive solvency impact assessment for 2020 by two months to the 1 of June 2020. Companies should take measures to maintain their capital position in balance with the protection of the insured, following sound policies. This is also concerning their dividend and variable remuneration policies. EIOPA will continue to monitor the situation and take the necessary steps to mitigate the impact of market volatility on the sustainability of the insurance sector in Europe and the protection of its consumers.

In the initial phase of the crisis, we do not expect the insurance sector to be significantly affected. It is most dependent on motor insurance products therefore we do not expect that there will be a significant decrease in the business of insurers. The capital and liquidity positions of most of the insurance companies in the country are sufficiently high to cover the requirements of *Solvency II*.

At the next stage of the crisis development, a possible slow recovery of the Bulgarian economy, with relatively low economic activity and uncertainty about future household incomes, is expected to hinder the activity recovery and profits in the sector.

Specific indicators monitored for the insurance sector

- ✓ Sizes of: gross premium income, claims, insurance activities results, and financial results;
- ✓ Volatility of institutional portfolios of securities;
- ✓ Liquidity;
- ✓ Solvency – the levels of the SCR and MCR.

APPENDIX 1: Guidelines on legislative and non-legislative moratoria on loan repayments applied in the light of the COVID-19 crisis (EBA/GL/2020/02) – highlights

The conceivable measures in the EBA framework provide for a **payment relief for obligors affected by the COVID-19 pandemic** by allowing suspension or postponement of payments (of whether principal amounts, interest or of full instalments) within a **specified limited period of time**, allowing the obligors to return to regular payments after the situation is back to normal. EBA defined the moratorium as a general preventive measure that applies to a large group of predefined obligors and criteria for determining its scope (examples of such criteria include the exposure or sub-exposure class, industry sector, product ranges or geographical location).

It represents a tool to address short-term liquidity difficulties caused by the limited or suspended operation of **many businesses and individuals**. It is optional and should be based on an application from the obligor requesting it and presenting the extent to which the obligor’s financial position is affected by the COVID-19 pandemic.

The EBA stressed that especially in difficult economic circumstances, it was particularly important to ensure that risk was identified and measured in a true and accurate manner. **The application of a general moratorium is not a forbearance measure**, it should also not be considered distressed restructuring and the consideration of diminished financial obligation is not applicable. The moratorium should be based on an individual agreement with obligors, not on an assessment of their creditworthiness. The scope of application of the moratorium may be limited only to performing obligors, who did not experience any payment difficulties before the application of the moratorium.

A separate moratorium could be launched for a specific range of products, for instance, mortgage loans. This gives institutions the possibility of participating in different moratoria, depending on their business model where the moratorium applies to all exposures of that institution within the scope of the moratorium. Bank institutions should prioritise the assessment of the cases falling into this framework but they are also being encouraged by EBA to grant new lending for which the moratorium does not apply.

The moratorium envisages only changes to the schedule of payments, and no other terms and conditions of the loans, such as the interest rate, should be changed. The application of the general payment moratorium in itself **should not lead to a reclassification of the exposure** as in the existing regulatory framework where deferred or suspended loan repayments enforce additional costs and capital requirements for banks.

Banks should timely notify their national competent authorities providing all the information concerning parameters of the measures taken and expected effects as well as any economic loss resulting from the application of the moratorium on individual exposures and the associated impairment charges. Banks should fulfil these obligations in transparency and compliance with existing legislation. National competent authorities should respectively notify the EBA of any use of general payment moratoria in their jurisdictions and to publicize the measures taken.

APPENDIX 2: Banking institutions rated by BACR, ranked by asset size as of the 31 of December 2019 (BNB definition)

I group	II group
✓ DSK Bank ✓ United Bulgarian Bank ✓ Eurobank Bulgaria	✓ Central Cooperative Bank ✓ Investbank ✓ Bulgarian American Credit Bank ✓ International Asset Bank ✓ D Commerce Bank

APPENDIX 3: Insurance companies (non-life insurance business), rated by BACR, ranked by gross premium income size realized as of the 31 of December 2019 (FSC definition)

- ✓ IC Lev Ins
- ✓ DZI - General Insurance
- ✓ IC Euroins
- ✓ IC Armeec
- ✓ IC Allianz Bulgaria
- ✓ IC Bul Ins
- ✓ IC EIG Re