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The Indebtedness to the Banking sector in the New EU Member States from Central and Eastern Europe: the Challenges of the Debt Management, Post-crisis National Policies and EU reforms in the financial sector

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Abstract

The paper aims at revealing factors and causes for the indebtedness to the banking systems in the new EU Member States of CEE during the ongoing Global financial crisis. Following the basic understanding that the debt reduction process is crucial in the search for an exit from the crisis, the paper discusses the main features of indebtedness to the banks and specifies the risk profiles of the banking systems of the countries under review. The countries' prospects for the post-crisis period are considered. By discussing the methodological approach for the evaluation of the indebtedness to the banking systems the paper underlines the varieties of approaches to nonperforming loans in the new EU member states of CEE and the need of improving the quality of the bank assets' reporting and supervision. On this basis of comparative analysis the anti-crisis measures undertaken in separate CEE countries are discussed. Bulgaria's experience with the non performing loans and the impact of indebtedness to the banks are revealed as an outcome of the crisis.

Key words: indebtedness, nonperforming bank assets, bank assets, risk assets, liquidity, capital adequacy, solvency, profitability, contagion, boom/bust cycle, procyclical
JEL Classification:G01,G21,G28,G32,G33.

1. Introduction

The nonperforming bank loans have increased as a share of the consolidated indebtedness of the new EU member states from Central and Eastern Europe (CEE) since the end of 2007. The adverse trend of credit quality deterioration has not yet come to an end. Some forecasts had envisaged non-performing loans to reach their peak for the countries under review by the end of 2013 (Unicredit, 2012). The non performing loans exhibit some common features in the period concerned irrespective of the country of their origin and thus they reflect common factors and causes for the indebtedness to the banks in the period (2008-2012). The common features may be considered as a result of: 1) the consequences of the credit boom in the beginning of the decade; 2) the influence of the Global financial and economic crisis and 3) the level of the international interdependence of the newly emerging financial markets on flows from and to the developed markets. However, the CEE countries (CEEC) may also be looked upon as 'united' in the diversity of the trends which characterise their non performing loans. There have been observed some diversities of the degree of indebtedness, sector concentration and risk profile of the indebtedness as well as different policy approaches to the indebtedness and risk management in separate countries. The evaluation of the opportunities and threats to the debt reduction process in different countries takes into account the risks experienced at present by the banking systems in CEE and their prospects and peculiarities for the post crisis development.
The object of the paper is to implement a common methodological approach for the evaluation of the indebtedness to the banking systems in the new EU member states of CEE

and on the basis of the comparative analysis of the non performing loans to sort out the general and specific factors for the indebtedness. Following the basic understanding that the debt reduction process is crucial in the search for an exit from the crisis, the paper tests two hypothesis in order to specify the risk profiles of the banking systems of countries under review as well as the countries' prospects for the post-crisis period.
The two hypothesis tested involve the following statements: 1) the indebtedness to the banking systems of the CEEC has different features which have moulded the varieties of the present risk profile of each banking system under review. These specific features cause the differentiation of risk profile among the countries concerned; 2) the banking sector in the CEEC shows a strong procyclical tendency at present that aggravates the difficulties of the credit crunch and the negative influence of inadequate financing of the economies as an outcome of the crisis. The higher the risk profile of the banking system may be, the more difficult seems to be the exit from the crisis of the national economy. The resort to external financial official support in some countries has been a consequence of worsening of the risk profile of their banking system and the crisis trends of the real sector.
The approach applied in the study involves as follows: 1) an analysis of factors and causes for the deterioration of the credit quality of the assets in the banking systems under review; 2) comparative analysis of the indebtedness to the banks for the period (2008-2012) with the purpose to assess the influence of the Global crisis and the procyclical impact of the banking sectors; 3) analysis of the non performing loans in Bulgaria and the prospects for post crisis revival.

2. The Concept of Nonperforming Loans as an Issue for the Better Management of the Banks' Assets Quality

The concept of non-performing loans (NPLs) to the banking sector has varied considerably in different countries depending on the banks' regulatory framework. The boom-bust cycle since the beginning of the new millennium, and especially in 2003-2008 has contributed to the rise of high non-performing loans (NPLs) in various countries in Central, Eastern and South Eastern Europe (CESEE). The high credit growth gave rise to an unsustainable boom that ended abruptly with the Global financial crisis of 2008/09. The crisis times that followed have caused unsustainability of debt servicing to the banks with accumulated underlying problems of insolvency of debtors on banks' books. By 2012 the NPLs have reached on average some 11 percent of total bank credits due in the CEEC but with high differentiation of this indicator for the separate CEEC concerned. A number of countries have encountered great difficulties with nonperforming loans as is the case of Latvia and Lithuania with a level of above 25 per cent of nonperforming bank credits.
The need of improvement of statistics of the NPLs is acknowledged as instrumental for the overcoming of the debt crisis. The IMF has made an effort to collect and disseminate internationally comparable financial soundness indicators (FSIs), which include NPLs. In principle they should conform to the definitions set out in the IMF compilation guide (IMF, 2006), but in practice many countries find themselves unable to fully comply and the NPL definition in the IMF guide leaves room for interpretation.
There are a number of differences in the treatment and reporting of NPLs among the CEEC countries. But there are also similarities. On one hand, the official statistics do not reflect the real situation as the banks have the right to resort to cleaning their asset portfolio by selling the NPLs to debt collecting agencies in order to avoid increased obligations for provisioning of the NPLs. On the other hand, data deficiencies and possible underreporting of bad loans in some countries might mean that the true NPLs problem is even bigger than official statistics

suggest. This may hamper considerably the management of the banking systems in crisis times.
As the NPLs increase banks‘ funding costs and interest margins they become a bottleneck to the new credit supply and thus to the revival of economic growth. On the credit demand side, the bad loans diminish the chances of already indebted households and businesses not only to consume and invest but also to regain access to new credits.
The difficulties encountered in comparison of statistical data of the CEEC in particular as regards the NPLs levels remain an issue of concern not only for the international comparisons but to the policy makers. In recent years the international official institutions have undertaken work to improve statistical data and make possible international comparisons by introducing common approaches. Until now some consensus has been reached at international level for norms and definitions for the reporting – also at the national level– of asset quality and in particular nonperforming loans. Some initiatives for international harmonization in this direction (e.g. the Vienna Initiative Working Group on NPLs) are set to work to achieve further progress not only in improving the reporting but in further implementation of good practices for the resolution of NPLs. (the European Banking Coordination “Vienna” Initiative, 2012).
First, the most widely known NPLs definition, which is based on the IMF Financial Soundness Indicators (FSIs) Compilation Guide, is simple and clear: “principal or interest 90 days or more overdue”. The IMF strives to present cross-country comparative time series of NPL and other prudential indicators on the FSI website. Yet the availability of the national data is not sufficiently good enough, the FSI website as yet lacks comprehensive data coverage, and comparability is in fact restrained.
Second, the Institute of International Finance (IIF) has proposed credit quality categories. As nonperforming loans are identified the following three least trustful categories respectively the “substandard – doubtful – loss making” loans (the s-d-l rule). From point of view of the protraction of the present crisis, this classification seems to reflect more adequately the cautious policy of the banks to their debtors as regards the management “technology” of the non performing loans. By postponement of declaring insolvency of the heavily indebted firms and other clients, the banks undertake their part in the crisis management. This is a way to stand against further process of their deleveraging because of banks’ losses that raise the burden of provisions.
Third, some studies consider that national supervisors’ NPLs definitions mostly relate to the commonly used credit quality categorization of bad loans (Barisitz, 2011). At the same time the deepening of the NPLs problems as regards their resolution underline the necessity of widening the criteria and the requirements for their reporting as pertinent for better bank supervision and management.
Fourth, as regards the CEEC, the NPLs definitions vary considerably according to the national loan classification schemes. In general the weaknesses of nonperforming loans involve as such a delay in debt repayments, the degree of losses incurred on the bank as well as other factors related to the types of resolution of the NPLs.
In a recent comparative study of nonperforming loans in Central and South East European countries a NBL threshold is proposed with priority given to the 90days+ rule. By comparing the national categorization schemes some adjustments of a given NPL definition have been proposed (Barisitz, 2011). In several cases (Czech Republic, Poland and Slovakia), the 90days+ rule is in line with the s-d-l rule. Where the two rules clash (Croatia, Hungary and Serbia), the suggestion is that “90days+” overrides the “s-d-l” (at least for deriving a narrowly defined NPL volume), depending on the intermittent variability of content that can fill up categories of loan classification from country to country. Where reference to 90days+ is not

explicitly made (Romania, Russia and Ukraine), the s-d-l criterion is retained, supported by reference to the “well-defined weakness”criterion, where applicable.

For the purposes of improving transparency in asset quality reporting a survey on NPL definitions and reporting standards was conducted under the European Banking Coordination “Vienna” Initiative. It highlights the prevailing heterogeneity among the CEEC and the variety of practices of the NPLs management. All 21 CESEE countries were invited to participate on a voluntary basis. Bosnia and Herzegovina, Bulgaria, Croatia, Estonia, Hungary, Kosovo, Latvia, Lithuania, Macedonia, Moldova, Montenegro, Romania and Slovenia fol. This corresponds to a response rate of 62 percent thus leaving room for devoting more attention to the varieties of national approaches on the issue.

In the present paper the CEEC experiences in NPLs can be distinguished according to *two dimensions, related to two periods:* the relative size of their NPLs (over total loans and GDP, respectively, in the credit boom phase from 2005 to 2007 and in the financial crisis phase from 2008 to 2010), and the dynamics of their NPLs. A number of countries feature relatively low NPLs, which, albeit higher than before the crisis, have remained in manageable proportions up to end-2010: Bulgaria, Croatia, the Czech Republic, Poland and Slovakia. Lithuania and Hungary clearly have had to cope with higher NPLs which certainly create concern. A small majority of the countries have witnessed a leveling-off (or a strong deceleration of growth) of their NPLs in 2010: the Czech Republic, Poland and Slovakia. In contrast, nonperforming loans have continued to increase in Croatia, Hungary and Romania, and particularly in Slovenia and Bulgaria. Pulling the two dimensions (level and dynamics of NPLs) together produces the following picture: The best positioned (low NPLs leveling off since 2010) is the “Central European trio” (the Czech Republic, Poland and Slovakia). Intermediary risk levels are borne by Croatia and Hungary (low but still substantially expanding NPLs), and by Bulgaria (medium level but stagnant NPLs following crisis-triggered uptick).

Bulgaria, Romania and Slovenia appear to be saddled with heterogeneous risks of indebtedness to the banks (of course it also depends on the weights attached to the types of risk). While Bulgaria still features a comparatively modest level of the total NPLs, these have not stopped expanding very swiftly through end of the period (2010-2012). Romania’s nonperforming loans are at a higher level, but their growth, while still important, has somewhat slowed down.

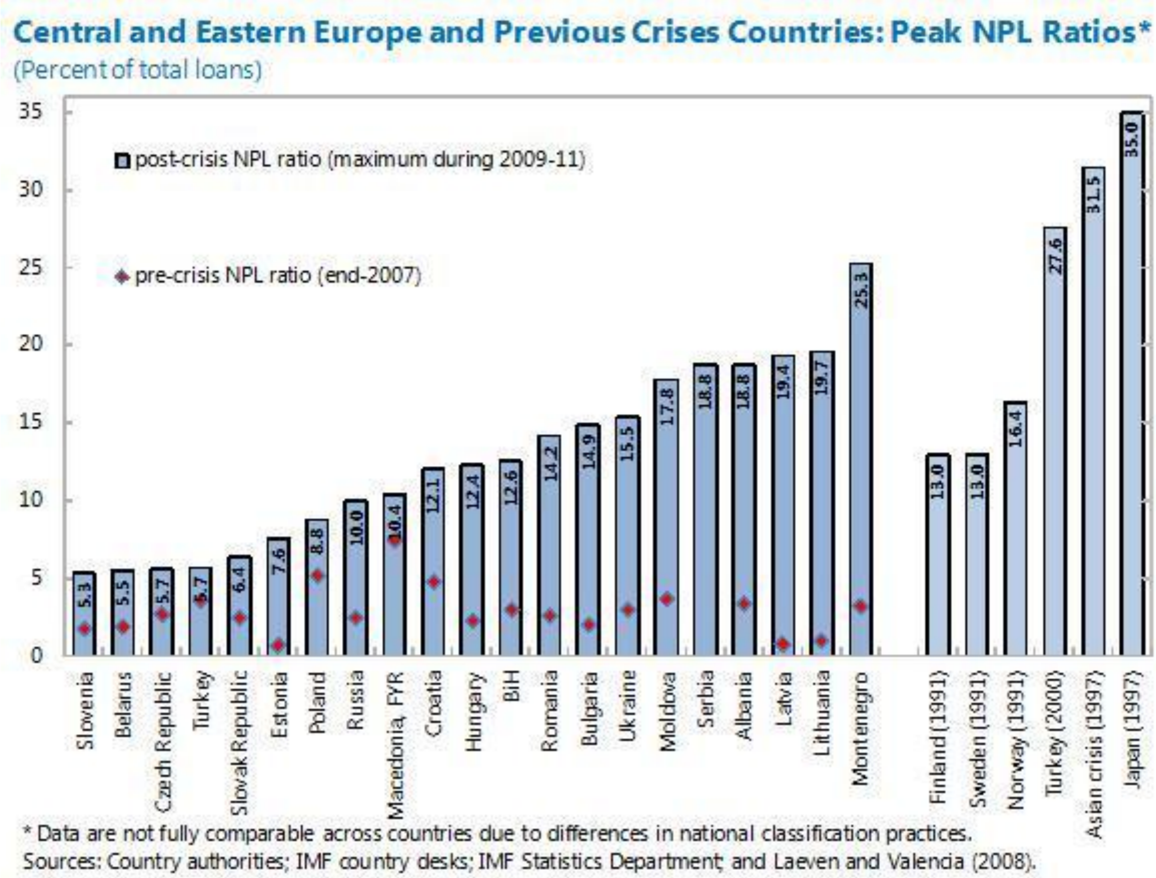
For the ten analyzed countries one could therefore conclude that NPLs’ problems – where they exist – relate either to high levels of bad credits or to persistently high rates of increase of bad credits; fortunately, both instances have not been observed simultaneously.

3. Factors and causes of bank indebtedness in Central and East European Countries

The outlook for the reduction of the burden of CEEC banks’ indebtedness in 2013 remains uncertain. It is quite possible to expect that nonperforming loans will continue to preserve higher rate of growth than the growth of the new credits. This is due to the fact that the economic revival in EU has been postponed and the overall European sovereign debt crisis and the EU entering since mid 2012 in economic recession have a deeper negative impact on growth than expected. The challenges which still encounter the CEEC involve the impact of factors and causes which are acting in the EU in general. These factors have common as well as some specific features in separate countries. Since 2008 some of these factors have undergone considerable changes so far.

The non performing loans have been deteriorating since 2008 in all countries under review. The availability of liquidity was reduced and the with slowing economic growth and upside rising risks of a recession by the beginning of 2012, the non performing bank loans as debt burden have increased in all CEEC adding up to the uncertainty of worsening economic performance. The Chart 1 presents a comparison of the ratio of NPLs to total loans in the CEEC and other East European countries with the same indicator for previous crisis countries in the 90s. The data are not fully comparable across countries due to different forms of reporting the NPLs. In 2009-2010 the share of the NPLs in the total volume of loans has been the highest in Lithuania (19, 7%) and Latvia (19, 4%), followed by Bulgaria (14, 9%), Romania (14, 2%) and Hungary (12, 4%). Together with Estonia all the above mentioned CEEC have raised considerably the share of NPLs during the crisis if compared to pre-crisis level of NPLs. Yet the volumes of NPLs in CEEC have grown at a lower rate during the crisis compared to Japan(in 1999), Turkey (in 2000) and region of South Eatern Asi and the Asian financial crisis (1999). .

Chart 1



Due both to the changes in the domestic and international environment at the contemporary stage there is a certain rearrangement of the indebtedness factors as compared to the beginning of the crisis in mid2007. While at the beginning of last decade the NPLs have risen due to the ‘easy money’ credit policies of the banks since the start of the financial crisis both domestic and foreign factors of reduced aggregate demand, deepening of the economic slowdown have contributed to the rising volumes of bank credit.

At that time the transmission channels of the financial crisis have been set in operation through *lower capital inflows* and in many countries of CEE there have been observed *very rapid capital outflows*. The insufficient inflow of capital resources has been worsening as a factor for reduced credit availability. The reduction of bank liquidity has caused unfavourable changes in the supply of credit as the banks were not any more easily supplied by credit resources from the domestic market and from abroad by their “mother” banks. As regards the new EU member states in Central and Eastern Europe full-scale credit crunch was generally averted in the 2008–2009 crisis thanks to a large extent to the Vienna initiative and EU/IMF support provided to the most affected countries. Thus the capital outflows and the reduced inflows of foreign capital have also played a role for the credit crunch by 2010-2011. As a whole, the availability of credit has been worsened and aggregate demand decreased worsening the repayment of due credits. (Jevčák, Setzer, Suardi, 2011).

The strong *collapse in equity and debt markets* has also brought to a higher demand of liquidity and less confidence in the financial intermediaries. The CEEC have experienced an internally induced credit burden, capital inflows reduced substantially and credit squeeze ever since that time has been ongoing.

The impact of the crisis in terms of *the credit squeeze* has taken its toll in 2012 especially, with only a gradual recovery followed by the new recession from mid2012 onwards.

The growth of the NPLs is inseparable part of *the credit 'boom-and-bust" trends* in the last decade at the financial markets of CEEC as emerging markets. Typical for this cyclical factor of indebtedness is the case with the indebtedness of the households.

In the context of a historically low households saving capacity, the robust expansion in CEE of household debt (+ 44 % per annum in the 2003–2007 period) has been accompanied by a stable downward trend in the accumulation of net financial wealth. Household demand for loans has also been high, closely accompanying rising consumer spending in all CEEC in the last decade. At the beginning of 2008 the financial crisis affecting international markets seemed rather remote to most CEE markets and it was disregarded by the households sector which has kept on increasing its indebtedness by 2010. As a result, the yearly growth rate for mortgages has been set to dive from 27 % in 2008, to 13 % in 2009 and 14-15% in 2012. The speed and the extent of the lending boom have, however, generated concern over recent years.

Spurred by the financial penetration gap and the long-term economic catch-up process, growth in household indebtedness has been particularly fast in Bulgaria, Romania and Croatia, where loans as a percentage of GDP increased between 3.5 and 5 % on an annual basis in the 2004 – 2007 period. Following the disruption caused by the US subprime crisis in mid- 2007 global liquidity conditions changed dramatically, triggering a general increase in the costs of refinancing for banks in combination with growing risk aversion. However, with the exception of the Baltic states where tightening lending requirements have already resulted in rapid deleveraging since the end of 2008, growth in household debt remained lively throughout the CEE region in the first half of 2009, increasing by around 16 % (compared to end2007). Signs of a more visible slowdown have started to emerge since 2009, following the gradual decline in consumer confidence and a general tightening in monetary conditions and cost of risk.

The credit squeeze has been particularly visible in the mortgage segment. Though there has been lower debt capacity for the demand of new mortgages, the real estate market has kept the price levels high. The house prices have been growing ever more slowly from the end of 2007. The change in trends is evident and, above all, unsettling for developers and other investors that have poured money into the market during the boom in earlier years.

In addition to the Baltic States, clear-cut signals of a decelerating the rate of growth of *credits in real estate activities* were observed in Bulgaria, Poland, Romania and Hungary. The burgeoning European sovereign debt crisis in the EU has contributed to a deeper economic slowdown in 2012 and worsening of the macroeconomic situation.

Despite a less supportive scenario in the short term, opportunities in the mortgage segment remain in the long term, particularly in less penetrated markets such as Romania and Slovakia, where low mortgage loan-to-GDP ratios (at 4 to 6 % in 2007) relative to the regional average (8.0 %) indicate room for growth in long term prospects. At the other alternative is the situation in Bulgaria where there is a small probability for further growth of the mortgages loans due to the overloaded debt capacity of households and businesses in the real estate market and lack of foreign inflows of capital. All over the region, slower growth is expected in the *mortgage segment* in particular, as further stabilisation in the residential real estate market and lower domestic income growth could prevent a major recovery on the demand side, while banks might continue to take a more selective approach to financing.

The boom-and-bust factor has influenced greatly *the consumer credit trends* where the growth of NPLs has been following closely the growth of credits in the last decade as “business as usual” for the banks. Some growth in household demand for *consumer credit* has continued since 2011 though credit squeeze has taken its toll in a number of countries under review.

The significant tightening in credit market conditions has been registered since the turbulences of September 2008 when there was probably a turning point for lending activity in most of the region, with signs of a marked deceleration becoming more visible, especially in Hungary, Romania and Bulgaria, as a result of a liquidity drought and rising cost of risk. Despite the slower economic growth since 2009, the increase in indebtedness throughout the Eastern Europe has remained in double figures last year, increasing by 21 % down from more than 41 % recorded in 2007.

Another factor contributing to the increased indebtedness of the private sector is the protraction of the Global crisis combined with the European sovereign debt crisis and economic recession all over Europe since 2010 until now. While at the beginning of the crisis the NPLs were related to households’ mortgages and consumer credits, by 2010 the rise of NPLs is a result of indebtedness and insolvency of businesses and companies, especially medium and small enterprises.

Overall, the impact of the crisis in terms of the credit squeeze has been stronger in 2012 with growth in household indebtedness. It is forecasted to slow further to around 10-14 % yoy on average in the region in 2013.The NPLs of companies have increased at a rate of 14-16 % yoy by 2012 combined with slower growth of new bank credits.

Tighter bank credit conditions and lower appetite for debt are expected to limit both supply and demand in 2013, especially in South-Eastern European countries. Cooling income growth, coupled with negative wealth effects and still unchanged prospects for the exit from the recession have led to only modest growth in bank credit volumes in 2013 so far. Some re-acceleration in credit growth might take place from end2013, subject to a return in confidence and depending on an improvement in liquidity conditions at global level as well as following the expected EU exit from the recession and renewal of confidence in the EU governance.

Lower demand for bank credit has remained a bottleneck to investment and growth of the enterprises in CEEC through the period (2010-2012), keeping the growth in indebtedness to the banks as a crisis factor of concern to households and companies. This factor reflects indirectly the limited role of new credits that may be applied for refinancing of the indebted to the banks economic agents in order to proceed with the resolution of old debts. Even when implemented such credits have remained a very small part of new bank credits.

The level of the NPLs of households and companies to the banks in all CEEC may be looked upon as a barrier for overcoming of the debt situation and to returning to higher economic growth. This may delay the economic revival in most of the countries under review.

The economic crisis has caused *lower aggregate demand*. Some re-acceleration in growth could have taken place from 2010 onwards, subject to a return in confidence and an improvement in liquidity conditions at global level. But in stead, the less supportive macroeconomic environment in the Eurozone and in most of the East European countries and the negative wealth effects have worsened the NPLs in most all of the countries under concern.

The *indebtedness of companies to other companies* is an important factor that has also worsened in all countries under concern. Interfirm indebtedness has attained higher levels in all countries under review thus becoming a complementary barrier to the access to new bank credits. The existence of this type of non bank indebtedness explains the trend of higher rate of worsening the banks' position with NPLs of households being higher compared to the companies' insolvency to banks.

The common factor for the increased NPLs is the overall slowdown of economic growth in the EU and in the CEEC under review. As regards the real sector in almost all newly accepted EU member states it is evident that *the higher economic growt*h in the first half of the last decade has made possible the economic upswing. Thus most of the countries have benefited from enjoying a period of stable rising income, improving labour market conditions and easier access to credit. Rapid development in real estate markets also contributed to an increase in the willingness of households to borrow. With *slowing economic growth* and upside risks of a deeper recession in some countries, the debt burden for the private sector is likely to increase, enforcing the chance that rising number of economic agents may begin to face higher payment difficulties.

Specific factors for the rising indebtedness to the banks in some of the new EU member states have been the *currency rate fluctuations and FX risks.* In a number of countries in the region (i.e. Croatia, Hungary, Poland and Romania), foreign currency loans were increasingly popular, particularly using the euro and the Swiss franc. Although eligibility criteria for new loans have been tightened and lending in foreign currencies in some instances has been cancelled in reaction to the deepening crisis, the household sector (particularly in countries with flexible exchange rate regimes) still remains exposed to FX risks connected to unhedged currency positions. Households sector exposure to FX risks, mostly due to rising FX mortgage debt burden, also remains an issue to monitor reduced demand in some of the CEEC like Hungary and Lithuania.

The observed depreciation of local currencies is also leading to an increase in debt-servicing costs, which combined with the much gloomier prospects on income and a seasoning credit portfolio (i.e. an increasing share of maturing loans) might contribute to a major fall in credit quality, especially since mid2012 due to the renewed risks of recession in the EU. The collapse at the equity and debt markets has also contributed to the currency risk exposure of borrowers of such credits.

The indebtedness to the banks has rather quickly and unexpectedly become an issue the banks' crisis management since 2008. At the beginning of the last decade in the context of high international liquidity and low cost of risk, banks have supplied companies and households in CEE with new credit products to allow a quick convergence of their living and business standards toward those of their wealthier western neighbours.

The risks of liquidity crisis have been diminished greatly by the Government and central banks' policies at the developed markets. But *the availability of liquidity of the "mother" banks* has become an issue of concern for the bank management in a number of CEEC. This has had a negative impact on the availability of bank credit in the CEEC by reduction of credit lines from abroad especially as regards the situation in the subsidiaries or branches of the international banking groups acting in CEEC.

Despite still good economic performance, the accumulation of financial assets since 2008 has been affected by a strongly negative performance effect, as *stock markets throughout* the CEE region all tumbled by more than 50 % from the beginning of the 2009. Assets held in the form of listed shares and mutual funds have been hit the most by falling prices, forcing massive redemptions. The impact of capital market losses on wealth has been particularly strong for Croatian, Polish, Bulgarian, Romanian and Hungarian households, given the relatively higher weight of those asset classes in their portfolio compared to the rest of the region. Overall, household financial asset growth at regional level has recorded a significant deceleration in 2008, up by a marginal + 3 %on average (– 0.1 % excluding Russia) to reach 37 % of GDP (down from 41 % in 2007).

Real estate markets have contributed to the credit expansion and the increased share of non performing loans. Further stabilisation in the real estate market will lead banks to increasingly focus on short-term and unsecured lending, keeping growth in mortgages subdued relative to other forms of financing. A moderation in household debt is also anticipated in Central Europe driven by a general slowdown in economic activity and still tight lending requirements.

4. The anti-crisis policies in the banking sector related to NPLs

We may clearly distinguish between national and common policies in the EU as regards the NPLs. The issue of worsening the NPL by 2012 has become a focus of the discussion of the factors contributing to bank indebtedness in search of anti-crisis policies adequately responding to the difficulties of providing for stability of the banking sector.

The national regulators for the banking sector in the CEEC have been confronted with a rising number of non-performing loans. The development of NPLs may be presented as a share of total loans and as a ratio to GDP in the ten analyzed countries from end-2005 to end-2010. In spite of the differences in taking into account of a bad loan, all CEEC have been active in developing the bad loan's classification in order to carry out the supervision of the banks in the respective countries. In many of the new CEEC the classification of bad loans and the introduction of a better discipline are targeted to one goal – the stability of the banking system.

Other issues worth discussing are the downgrade requirement and the treatment of restructured loans. The former relates to whether a bank is required to downgrade all loans to a common debtor if any of these loans is classified as impaired – or not. The IMF FSI Compilation Guide gives no recommendation in favour or against a downgrade requirement, which, however, exists in all analyzed countries, except in Croatia and Hungary. In Croatia, the amount of loss for each claim that is "individually significant" is calculated. In Hungary, treatment of nondowngraded loans to the same debtor must be justified by corresponding risks. The treatment of restructured loans/replacement loans focuses on the issue whether these assets should be classified in the same quality category as prior to restructuring – or not; and if not, which treatment should be afforded. The IMF FSI Compilation Guide does not express a clear preference here, either.

While treatment of restructured loans is not uniform across CEEC, one can observe a tendency that after a transition period of a year, six months, three months or less, a restructured loan would be classified like a nonrestructured loan. So it appears to be predominantly an issue of the length of the transition phase. Whether this variation is substantial enough to appreciably impact possible NPL thresholds over time is unclear.

A specific feature of the 10 new member states of the EU (NMS10) is the high foreign ownership of their banking sectors. The share of foreign-owned banking assets exceeded 80% in six of the NMS10 by 2007, remaining below 50% only in Hungary and Slovenia, with parent banks predominantly located in the old EU Member States. The large foreign ownership of the banking sector facilitated absorption of foreign funds by providing access to more liquid international money and capital markets and by channelling foreign funds into domestic credit growth. At the same time, *the resulting substantial cross-border exposures in the banking sector* implied large scope for contagion and also a potential channel for rapid foreign capital outflows in the case of financial market stress.

Stability of the financial sector and ensuring orderly credit conditions in emerging Europe are in the shared interest of the private sector and home and host countries. To this effect, principles to avoid disorderly deleveraging in emerging Europe were agreed by officials and private sector banks at Forum of the Vienna Initiative in 2012. The agreement aims to better

coordinate banking sector regulation and supervision and to contain negative spill-overs between the euro area and emerging Europe. It emphasises the central role of European institutions and the international financial institutions in facilitating this coordination. (Vienna Initiative, 2012).
These basic principles adopted at the meeting on 12/13 March, 2012 of the fourth Full Forum of the European Bank Coordination ("Vienna") Initiative aim at boosting coordination between host and home countries on cross-border banking activities. Contributing to the needed coordination are banking sector regulators and supervisors, central banks and fiscal authorities from host countries in emerging Europe and home countries of major cross-border banking groups. The forum has also incorporated representatives of the banks and officials from EU institutions, (the European Banking Authority, the European Systemic Risk Board), the International Monetary Fund, European Bank for Reconstruction and Development, European Investment Bank and the World Bank Group. The European Central Bank and Bank for International Settlements participated as observers.

The Vienna Initiative was originally launched in 2009 at the height of the global financial crisis to help maintain financial sector stability in emerging Europe, including by encouraging cross-border banking groups to maintain their exposure to the region and adequate solvency levels for their subsidiaries. The second phase of its activities is a response to renewed risks to the region stemming from the international environment.

The European institutions are to play a central role in supervisory coordination, macroprudential oversight and mediation among national authorities. International Financial Institutions as the IMF and the World Bank support the implementation of the agreed principles by their involvement in surveillance, data collection, policy advice and financial support.

Banking groups active in the region and national as well as European authorities should cooperate closely in efforts to maintain credit conditions consistent with sustainable economic growth. The pressure on European banks from governments and the market to move NPLs off their books has increased. Banks have not proved to be good traders or managers of NPLs but the situation has motivated the better management of bad loans. First, it is costly to hold NPLs with the banks which will have to gradually meet the new Basel III minimum international capital requirements. Second. NPLs have generated the NPLs market which has been most rapidly growing in the EU. Third, regulators in Europe and elsewhere realize that banks aren’t the best holders and servicers of NPLs and other intermediaries may serve the need of NPLs resolution.

The discussion of the impact of Basel III rules on emerging Europe and of the problems of the resolution of non-performing loans (NPLs) has been put on the present agenda of regulators and bankers. The Basel III highlights a number of implications of the new rules for emerging markets, particularly in the liquidity management area, and offers several recommendations to address them. The future regulation for Basel III may be expected to allow for better bank management of NPLs and diminishing the bank credit risks.

As regards the NPLs, possibilities exist for stimulating resolution to support economic recovery. The pro-active cooperative approach to deal with the NPL problem previews distinctive roles for each stakeholder: the relevant country authorities should press ahead with removing burdensome regulatory, tax and legal impediments to NPL resolution; the regulators have to tighten supervision appropriately so as to eliminate incentives to let NPLs linger;

banks should step up their collective effort to speed up NPLs‘ resolution; and alternatives for out-of-court debt restructuring and corporate rehabilitation negotiations between debtors and creditors should be explored. The key obstacles to NPLs’ resolution remain in the CEEC irrespective of the differences introduced in some CEEC during the crisis.

On one hand, the banks are reluctant to apply speedily NPLs resolution procedures. As underlined by some authors the individual banks neglect the positive side effects that accrue from resolving these loans, including on collateral values. Besides they encounter multiple regulatory and liquidity challenges which delay the NPLs resolution.

On the other hand, extracting the NPLs off banks’ balance sheets, foreclosing on delinquent creditors, or seizing and selling collateral isn’t exactly easy though there are credit collecting companies. Legal, judicial, tax, and regulatory systems are often poorly equipped to deal with insolvency and to facilitate efficient restructuring. Such is the case of the insolvency of physical persons, as an example. Though the insolvency procedures are applied in a market-oriented way by selling the assets set as a collateral by the indebted physical person, a number of issues have arisen making pending the necessity of adoption of new laws for the insolvency of physical persons.

5. The case of Bulgaria with regard to the indebtedness to the banking sector

Bulgaria has had nearly 90 per cent of the banking system in foreign ownership mainly presented by the large EU banking and financial groups. Since October 2008 the Bulgarian monetary authorities had to tackle the issues of co-ordination with the ECB and the Central Banks of the EU member states whose large banking groups have their subsidiaries and branches in Bulgaria. The need of close surveillance of the possible risks and channels of crisis transmission has been recognized as part of the risks of the high degree of openness and capital liberalization of the Bulgarian economy achieved before the entry to the EU.

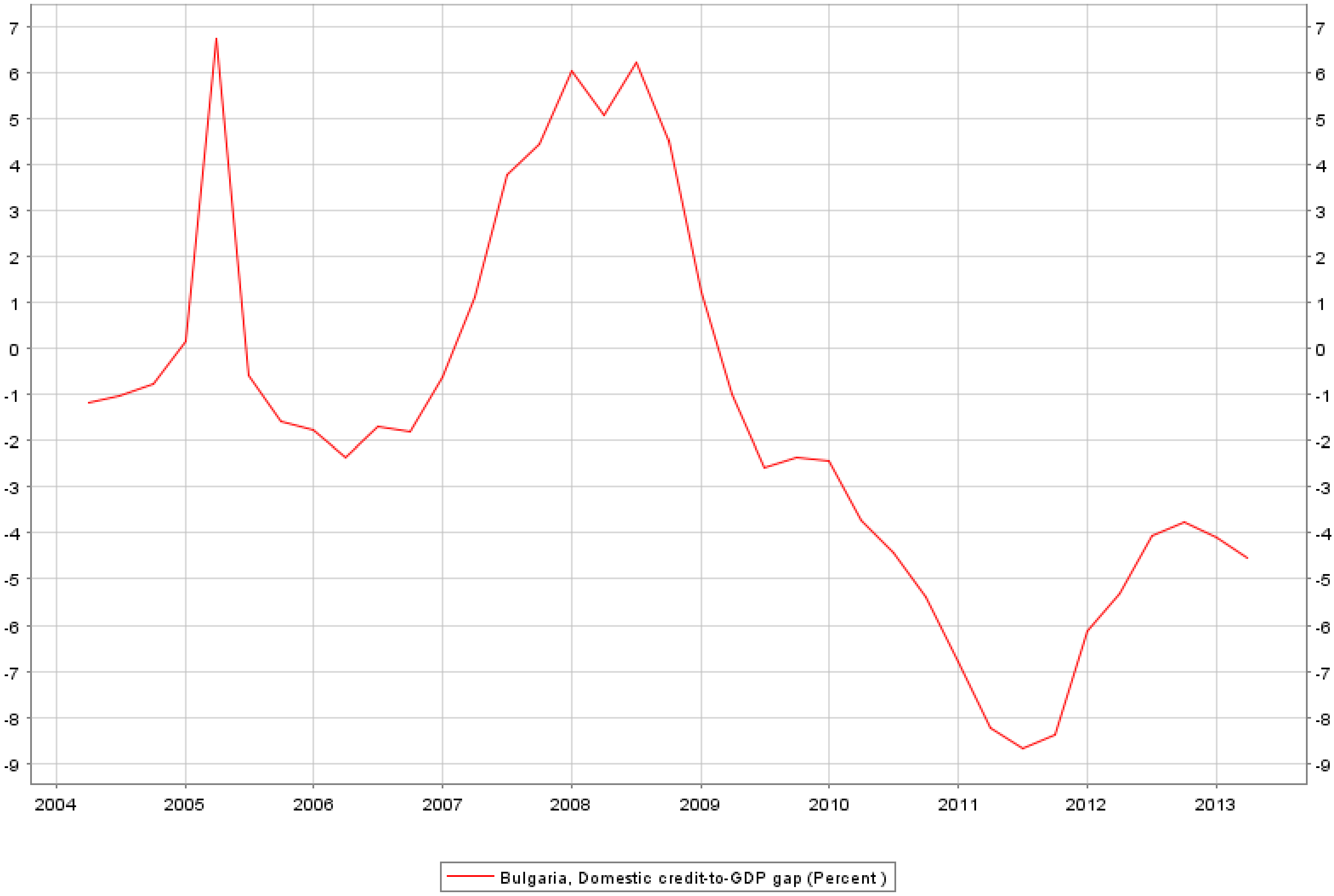
There are some *factors influencing the degree of indebtedness to the banking sector* in Bulgaria.

- There is an interdependence between the banking sector and the capital market in Bulgaria which has contributed to the non performing loans since the end of 2008. The *capital inflows-driven boom* in Bulgaria in the period 2001-2007 has been replaced by *capital-outflows* and worsening slowdown of the economy under the impact of the Global financial and economic crisis. As an emerging financial market, Bulgaria was affected to a far greater extent than expected by the outflow of foreign capital from the capital market. The contraction of liquidity came as a result of a withdrawal of foreign investors from the Bulgarian capital market, slackening of the activity of institutional investors and investment intermediaries, postponement of part of the planned initial public offerings, as well as panic among small investors
- The global crisis in the last quarter of 2008 started to affect seriously the *real sector of the* Bulgarian economy as well. The withdrawal of foreign portfolio investments since the last quarter of 2007 (after considerably protracted period of investors’ strategies of “pump and dump”) has caused a sharp fall of the Bulgarian capital market indices. Throughout 2008 and still in 2012 the trading on the Bulgarian Stock Exchange has been adversely affected by the ongoing Global financial crisis, which confronted capital markets worldwide with challenges of unsuspected scale and magnitude. The crisis demonstrated indisputably that the globalization processes in the financial sector have advanced dramatically and exert tangible influence on the state and development of the national economies.

- As a result of global deleveraging and an increase in global risk aversion the Western *European banks have no longer been in the position to provide abundant new funding t*o their local subsidiaries in Eastern Europe by opening credit tranches or by raising money at the financial markets by the issues of bonds. This has not allowed a rise of the banking loans volume due to the higher risks related to investments.
- *The private sector credit growth has been slowed sharply.* The issue of increasing number of non performing loans has appeared and amendments in the banking procedures for the *management of bad loans* have been introduced in order to make possible the better servicing of the corporate clients by the banks by allowing for longer period of repayment of debts and possibilities to restructure credit debts. In Bulgaria this has been an issue of growing concern since mid 2008 as there has been a drop in the crediting and strong decrease of incoming foreign investments – not only in the construction and real estate acquisition but in all other sectors of the economy. As Chart 2 shows the ratio representing the Domestic Credit to GDP gap worsened sharply since mid2008 and after short improvement slowed down again since the last quarter of 2012.

Chart 2

Domestic Credit to GDP Gap in Bulgaria (in%)

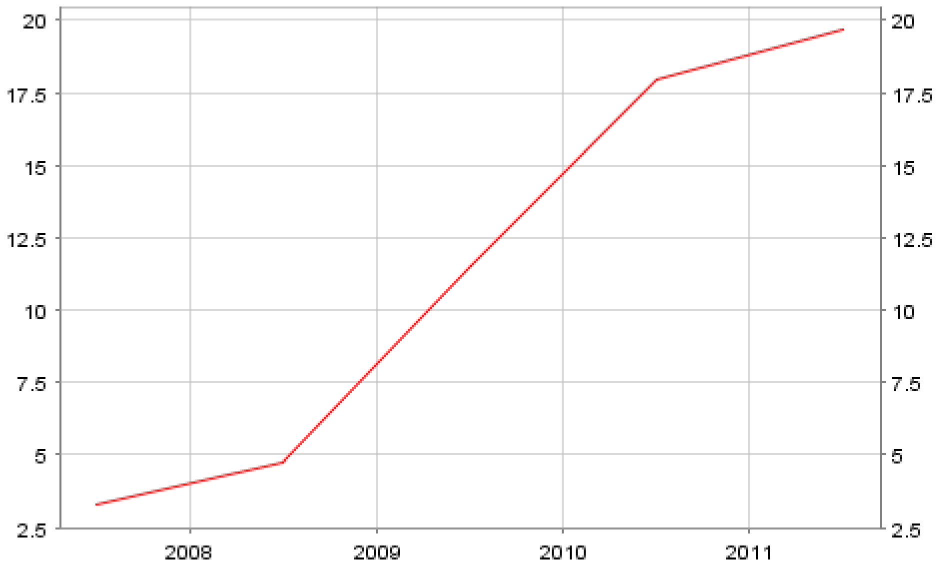


Source : European Central Bank (ECB) : RDF.Q.BG.EUR.4F.CR.DCGDPG.RO
[Risk Dashboard data]:2004Q1- 2013Q1

- *The credit boom as an upward trend until mid2008 has caused one of the present challenges to the Bulgarian banking secto*r. Due to the banking competition for acquiring a bigger market share, the banks have increased the credit volumes by *lowering the criteria for evaluating the creditworthiness* of the clients and thus have allowered credits to be provided at higher risk for their repayment. This has lead to worsening the quality of the credits and thus the risks of the banking assets increased. As a result the share of nonperforming loans in the credit portfolio of the banks has increased steadily. *This problem of exchanging the stability of the banks' portfolio management against acquiring higher market share by credit expansion at less strict observance of creditability criteria* has been observed in Bulgaria like in a number of other CEEC. As it is discussed by a number of authors the banks have been developing the credit market but taking higher risks with NPLs. (Jevčák, Setzer, Suardi, 2011).
- The rising share of nonperforming loans has become a disturbing trend due to the fact that *under the present conditions of delayed revival of the economic growth, the non performing loans will continue to grow*. By the end of 2008 the share of bad loans and the restructured loans was still below 3 per cent of the total credits' volume. Since then this share has kept on increasing up to 22.1 per cent in November 2011 and up to 25 per cent in April 2012 and 21 per cent in September 2013.
- The restructured loans of the banks present another challenge to the banking sector. In the banking sector these restructured loans increase the risks for the banks and are looked upon as "hidden" but possible future cases of indebted firms' insolvency. Their share in the portfolios of the Bulgarian banks has also increased since the end of 2008. Thus the prospects for the transition to future reduction of non performing loans as well as of return to higher rates of growth of new credits remain rather vague. Due to the rising difficulties in servicing the banks' debts of households and companies the worsening of the banks' assets portfolios has been combined with reduction of the rate of growth of new credits as seen in Chart 3.

Chart 3

Annual Growth of Non-performing and Restructured Loans in Bulgaria (as% from the total credit volume)



Source: ECB.
Note: The banking sector in Bulgaria includes the domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches reporting sector, All institutions - Gross total doubtful and non-performing loans [% of total debt instruments and total loans and advances.)

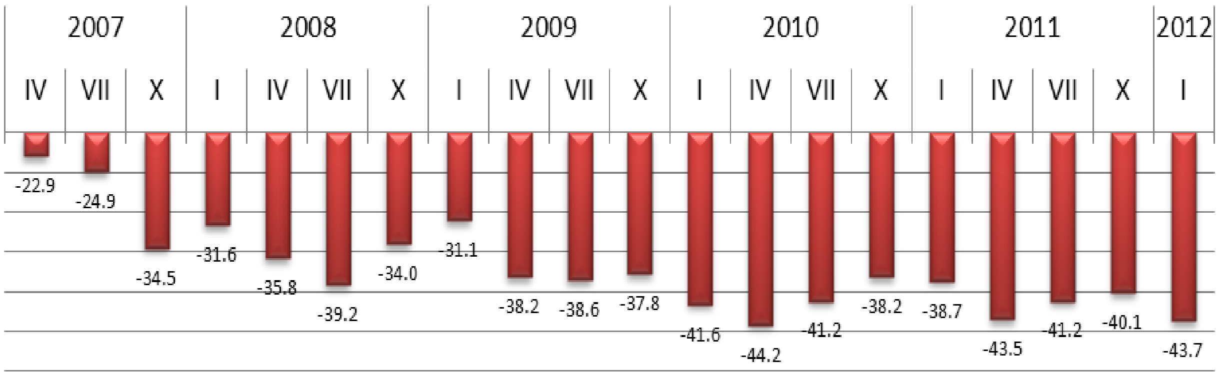
- At *present Bulgaria has the lowest rate of growth of new credits in South Eastern Europe*. In 2010-2011 this share is averagely 2.15 per cent as annual rate of growth while in Romania – it is 3 per cent, in Croatia it amounts to 5 per cent etc.

- The *sharp reduction of the rate of growth of new credits after 2009* has reduced the access to new credits as well as the profitability of the credit activities and thus the efficiency of the banks' operation as a whole is reduced. For the period January 2009 to November 2011 the ratio of credits to deposits is reduced to 1.25 though it remains higher than the average for Central and Eastern Europe. The necessity to compensate for the reduced profitability of credit activities of the banks forces them to search for other sources of covering the expenditures for the rates of interests on the deposits. The ratio of the expenditures for payment of the intersts on deposts to the attracted resources has fallen since 2009.

- *The growth of the GDP of Bulgaria is 0.8% in 2012 being slowed down further from the 1.8% in 2011.* The economic recovery depends on the internal demand in combination with the corporate sector's deleveraging and weak housing market recovery. Moreover, escalation of the euro zone debt crisis has caused uncertainty in the already quite tight monetary conditions at home. As a factor that might not be neglected has become the situation related to the subsidiaries of Greek banks in Bulgaria- their ongoing restructuring and shrinking of credit activities. While pressure in the EMU related to the bank restructuring plan in Greece is likely to remain in the near term, for the situation in Bulgaria seems *possible to observe a very slow growth of new credits.* This may *worsen the future bank policies for restructuring the bad loans or their servicing.*
- The households' indebtedness to the banks has reached a very high level. This level of indebtedness might serve itself as a reason for lower demand of new credits as the creditability of clients has become rather risky. As Chart 4 shows that the worsening of the indebtedness of the households presents a rather difficult case for the management of the non-performing loans.

Chart 4.

Financial Status of the Households in Bulgaria as Level of Bad Loans (as % of total bank credits of households)



Source:National Statistic Office of Republic of Bulgaria

- The reduced bank credit activities of the banking sector in Europe have unfavorable impact on *the economic revival* (Ernst & Young , 2013). As some authors underline it is quite possible that the present financial crisis may remain combined with revival without credit growth (Bijsterbosch, B. & T. Dahlhaus, 2010). Thus the *process of reduced credit growth and deleverage of the banking sector* is becoming more complicated not only in the countries of the Euro area but in the rest of the EU countries as well.

- The impact of the Greek crisis has been rather strong in the Bulgaria's banking sector. The assets of the Greek banks in Bulgaria have fallen by 10, 8% on annual basis and their market share decreased with 4 points – up to 23, and 7%. In spite of the strong capital inflows from Greece these money resources may cause higher uncertainty in the Bulgarian banking sector as their future movement may be redirected to other destinations abroad while their pending rewarding with higher interest confronts the banks with the challenge to manage their assets better, including the credit portfolios.

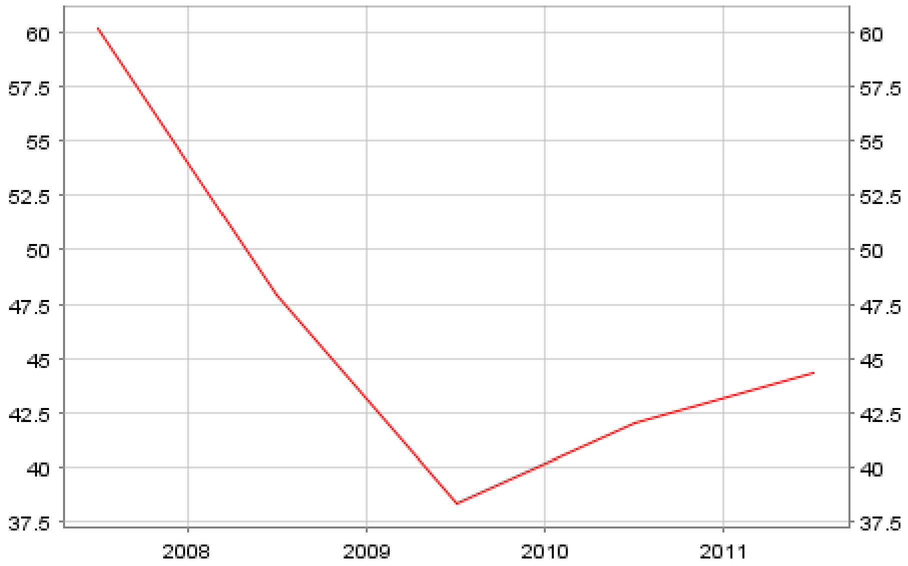
The Global crisis has worsened the conditions and prospects of achieving the adequate positioning of Bulgarian economic agents at the EU market as the recession in the EU member states has been aggravating the negative consequences for the economic integration.
As regards the financial and capital flows the situation has become rather unfavourable since mid 2009 as the credit crunch has influenced the banking sector in Bulgaria and thus the access to credit has worsened both for the business and the households. The credit restraints have become a bottleneck to the economic growth. Additional burden to the business is presented by the higher rates of interest at which the banks are providing any new credit resources.
The size, nature and persistence of the capital inflows have complicated macroeconomic policy implementation since 2001 and contributed to some macroeconomic vulnerability in the pre-crisis period. Policy tensions often surfaced when multiple policy objectives were pursued (lowering inflation, maintaining the fixed exchange rate target of the BGL to the Euro and the sustainability of fiscal surplus under the Currency Board regime) while opening the capital account. Large and persistent capital inflows in the period 2003-2007 put appreciation pressures on the domestic currency and led to periods of monetary expansion when appreciation pressures were resisted by administrative restrictions on credit creation by the

banks (in 2005), and/or to a slowdown in the process of disinflation with greater current account deficits leading to impossibility to fulfil the Maastricht criteria for joining the EMU.
The inflows have especially raised policy challenges associated with a rapid expansion of banking sector credit financed increasingly by the inflows up to 2007.
The rapid growth of credit to the private sector in Bulgaria has contributed to the widening of current account deficits, by stimulating aggregate demand through higher imports and consumption. Growing external indebtedness of the private sector has become a significant concern in Bulgaria, as well as when banks borrowed abroad to fund lending growth and corporations switched to direct borrowing in response to the restrictions imposed on the banking system. For the period 1997-2007 evaluations demonstrate straightforward causal link between capital inflows and trade deficits for Bulgaria just as it is the case in some other European countries. The rising imports were dependent on capital inflows and domestic credit growth in the years before the Global crisis. The need to manage the macroeconomic impact of credit expansion induced the Bulgarian authorities to resort to more direct measures where indirect monetary instruments have been limited or ineffective in the presence of high eurozation (e.g., administrative measures and reserve requirements were implemented before and during the Global crisis). Financing the loans increasingly from abroad created balance sheet mismatches as banks lent the private sector in domestic currency by the foreign currency funds borrowed from abroad. Even where FOREX exposures have remained within permitted limits, the large FOREX linked component of the loans to borrowers with limited FOREX income or hedging have made a number of banks in Bulgaria increasingly more exposed to FOREX-related credit risks. Some deterioration in lending standards has also been observed as banks in Bulgaria competed for market share.
The composition of the capital inflows has also changed over time. The institutional development of the financial market in Bulgaria has been making progress due to the compliance with the requirements of joining the European financial space (Topf, B., D.Vavra, 2007). Initially, FDI made up the bulk of the inflows in Bulgaria with the role of portfolio investment gaining importance over time. The importance of portfolio inflows rose at later stages since 2003, along with the development of the capital markets. Such inflows were channelled primarily into debt securities, and only subsequently, and to a lesser extent, into equity securities. There has been a marked rise in inflows to the banking system (initially as FDI into the financial sector, followed by bank financing—under “other investment”) in Bulgaria.
Credit risk increased also through greater loan concentration in mortgage and household sectors in Bulgaria but no measures have been applied by the regulators to restrain the investments through credits of this sector which is most strongly hit by the fall of the prices of real estate.
In the pre-crisis period, especially since 2005 the Bulgarian authorities used a variety of public debt management measures to cope with the implications of the inflows on the liquidity in the financial system. The authorities shifted from foreign to domestic borrowing sources, bought back outstanding Brady discount bonds, etc. Besides, the Bulgarian government deposits were transferred to the Central bank and the Deposit Insurance Fund was instructed to invest its cash balances and maturing repos in government debt to deal with the liquidity problem.
The main challenge facing the banking sector still remains the necessity to absorb the increase of losses caused by nonperforming loans. There are substantial buffers built up in the banking system during the boom years, as well as there is a high capital adequacy ratio of 17%, which is well above the European Union's 9%. Nevertheless the unfolding of the economic and financial crisis in the EU since the beginning of 2010 has worsened the situation with the

nonperformning loans in Bulgaria and the provisions of the banks increased inevitably as seen in Chart 5.

Chart 5

The total loss provisions as % of total gross doubtful and non-performing loans in the banking sector of Bulgaria during the period (2007-2012)



Source: BNB.2012.

The total loss provisions are set by regulatory authorities in Bulgaria as % of total gross doubtful and non-performing loans in Bulgaria. The domestic banking groups and stand alone banks, foreign (EU and non-EU) controlled subsidiaries and foreign (EU and non-EU) controlled branches have the problem with the increasing volume of nonperforming loans as the crisis has become prolonged. The costs of the increased provisions have made banks reluctant to decrease the interest rates and operational costs they charge on their customers. This has continued irrespective of the low inflation and the improved credit rating of Bulgaria as the result of its improved fiscal discipline.
Table 1 below presents *the changing role of supply and demand factors* for the capital flows under the impact of the Global crisis. The intervention of the Bulgarian authorities thus far has been shaped under the pressure of the factors related mainly to the capital inflows. The capital outflows have appeared as negative consequences of the Global crisis but hopefully they may not gain importance if the crisis in Bulgaria has reached already the bottom line and economic upturn may bring a rising trend of capital inflows.

Table. 1. Domestic Factors Underlying the Capital Inflows in Bulgaria before and during the Global Crisis

Pull (Demand) Factors before the Crisis	**Pull (Demand) Factors during the Global crisis**	**Push (Supply) Factors**	**Push (Supply) Factors during the Global crisis**
- Liberalization of the foreign investment regime involving reforms in legislation, accounting, provision of information	- Deterioration of the business climate due to reduced external demand; -Credits' availability becomes an issue,	- Dominance of the banking system by several banks with higher market shares which ; - Increased competition	- Reduction of minimum reserve requirements of the banks from 11 to 8 % of the deposits coverage to

and improving the institutional framework in compliance with the EU law; - Increased confidence in the economy with political and economic stability (reduced external debt, low inflation); - Sound economic and financial policy framework and structural reforms; - High lending rates with limited perception of FX risks under the Currency board regime in Bulgaria; - Rapid growth of banking sector' credit financed increasingly by bank borrowing from abroad.	especially as regards the credits for the small and medium size business. - Deterioration of the business climate due to reduced external demand; - Considerable fall of industrial production and private consumption and reduction of incomes; - Retaliation of structural reforms; - Rising rates of deposits to attract savings to raise bank deposits; - Reduced demand of credits due to the rising indebtedness of households, companies and financial nonbanking intermediaries; - Reduction of minimum reserve requirements of the banks from 11 to 8 % of the deposits coverage to improve their liquidity since October 2008; - Cautious Involvement of Banks with the provision of credits to EU funds beneficiaries in favour of absorption of the EU funds by the private and public sector in Bulgaria; -A fall of incoming foreign investments and reduction of the overall credit volumes.	in the banking sector for attracting deposits by maintaining higher interest rates.	improve their liquidity since October 2008; - Banks' Involvement with the provision of credits to EU funds beneficiaries in favour of absorption of the EU funds by the private and public sector in Bulgaria; - Not only a fall of incoming foreign investments but reduction of the credit expansion and the nominal volumes of credit. -non-performing loans increase as a share of the total sum of loans.

As an outcome of the economic crisis, Bulgaria's balance of payments position seemingly improved since early 2010, due to contraction of the cumulative current account deficit. At the same time, however, that is hardly to be considered a sustainable trend, since it reflects the lack of capital inflows, stagnating domestic demand and reduced imports. Though remaining still at the periphery of the financial crisis in the EU, Bulgaria has been adversely influenced by the stress in the financial and real sector in its main partners – the advanced countries as the drop in the their financial markets has shaken confidence of the private sector, and global demand and trade and capital flows have declined sharply. The prospects for structural adjustment and returning to higher rate of economic growth may be regarded realistically as a possibility in the near future. Yet the NPLs may be expected to remain an issue of concern for the exit from the economic crisis.

Conclusion

The conclusions drawn from the analysis of the NPLs underline the specific features of the rising trend of the indebtedness to the banking system in all countries of CEE under the impact of the Global financial crisis. The European sovereign debt crisis has also influenced the credit crunch and the spread of contagion through the higher risks of the European banking groups as dominating by market share in the banking systems of the CEEC under review. The differences in the degree and the structure of the indebtedness to the banking systems in the CEEC have played a substantial role for the differences in the overall economic performance and anticrisis policy management in these countries. The differences among the EU member states under the present Euro area crisis will remain a challenge to the bank risk management due to the interdependence of banking systems through different channels as well as through the trans-border banking in the EU and the European financial and banking groups.

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