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РЕФОРМИТЕ В БАНКОВИЯ НАДЗОР В БЪЛГАРИЯ

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REFORMS OF BANKING SUPERVISION IN BULGARIA

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Abstract

The aim of the paper is to present the dynamics in the banking supervision of Bulgaria. The international trend to extend the scope of banking supervision is reflected in the national policy for development of banking system. The recommendations in the European directives create an environment for the restructuring of banking supervision in individual Member States to scope extension to non-financial information and good corporate governance practices.

The results of the paper reach a new wave, which is aimed at modernizing and restructuring both the banking system, as well as the banking supervision. The dynamics of adapting banking supervision to the new reality differs for home and host countries. For the banking system of Bulgaria, which is predominantly represented by subsidiaries of European banking groups, the supervision authority is restructured towards non-financial information, including good practices of corporate governance.

Keywords: *supervision culture, corporate governance, non-financial information*
JEL Codes: *E58, G28, G34*

1. Introduction

The financial markets in Eastern Europe are characterized by service provision through subsidiaries of cross-border banks (European Bank Coordination Vienna Initiative, 2012). Subsidiaries of banking groups from Austria, Italy and France have significant share of the banking market. These subsidiaries represent an insignificant part of the banking group's activity and significant activity in the host country's economy (Sariiski, 2010). Coordination between supervisors from home and host countries is therefore more complicated due to the sub-subsidiarity of subsidiaries in the banking group and a focus on financial stability in Eastern Europe.

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The characteristics of Bulgaria's modern banking system are mainly determined by membership in the European Union. The benefits of such membership are not fully utilized due to some country specific factors: Bulgaria is not a member of the euro area and much of the European directives are implemented through local regulations; the majority of banks are concentrated in foreign ownership and are not public companies. As in most eastern European countries, and in Bulgaria, the banking sector is dependent on external influences, as evidenced by the transfer of the crisis through us through foreign banking groups.

Due to the fact that it is not a member of the euro area, at the present stage of the reforms Bulgaria does not participate in the decision-making process and has no elected member on the board of the European Central Bank. Bulgarian banks are unable to use liquidity support from the Bulgarian National Bank (due to the currency board arrangement) and the European Central Bank (due to lack of euro area membership), as well as the European Stability Mechanism and the European Restructuring Fund.

Changes in the European Union's supervisory framework since the start of the global financial crisis have reduced the operational capacity of the supervisory authority (International Monetary Fund, 2015a). For Bulgaria, whose currency is not the euro, there is an opportunity to participate in the single supervisory mechanism by establishing closer cooperation with the European Central Bank. In a request for closer cooperation, the Bulgarian National Bank assumes responsibility for adopting EU’s directives and for complying with the instructions of the European Central Bank.

The new reality has increased the requirements and expectations for the supervision. They are imported into Bulgaria under the European Union's legislative and convergence program (International Monetary Fund, 2015a).

According to the new reality, we have formulated research hypotheses to be tested:

H1: The reform of banking supervision in Bulgaria is determined by membership in the European Union;

H2: The development of cross-border banks in the euro area determines the dynamics of banking supervision in Bulgaria.

The structure of the paper covers two parts. In the first part we present the reform of banking supervision in Bulgaria; the second part contains the components of the development of banking supervision.

2. Reforming banking supervision in Bulgaria

The banking system in Bulgaria is characterized by the dominant presence of foreign banks through subsidiaries and branches, which is why they represent a channel for the transfer of potential risks from the home countries (Bulgarian National Bank, 2015a). The Bulgarian National Bank monitors the relations and operations of subsidiaries and branches of foreign banks by taking precautionary measures to counteract potential external risks. The prevalence of foreign ownership in the banking system defines Bulgaria as a host state and the corresponding type of supervision (International Monetary Fund, 2015a).

The scope of supervision in Bulgaria is limited to national frameworks and is inconsistent with the degree of integration of European banking markets. The opportunities for the country to control the activities of its subsidiaries are limited only to bilateral agreements between the Bulgarian National Bank and the supervisors of their parent banks (Nedelchev, 2018). Given the presence of the European Union banking groups represented by their subsidiaries and their importance for the stability of the group, the participation of the Bulgarian National Bank is limited to the application of European directives in national regulations.

Foreign subsidiary-banks follow the corporate governance practices of the parent bank, which does not always lead to the transposition of good practices in corporate governance (International Monetary Fund, 2017a). Corporate governance of foreign subsidiaries remains a challenging subject and a key issue for supervisors. The challenge is always to achieve the right balance between a parent bank and a subsidiary bank. This includes cases where the subsidiary bank is not material to the banking group but is of systemic importance in the host country. Such a situation is the banking system in Bulgaria - most of the policies, including risk management, internal control, credit policy and large exposures of foreign banks, are controlled by the parent bank. The boards are made up of parent bank managers and play a procedural role in validating group policies rather than playing a leading role. Due to this fact, oversight in Bulgaria has as its main function to keep the balance between the interests of the subsidiary bank and the banking group.

The taken macro- and micro-measures in Bulgarian banking system helped to withstand the global financial crisis. However, in 2014, two banks with local capital went bankrupt and put the banking system in a crisis situation. Due to doubts about the viability and normal functioning of the banking system, the banking supervision is subject to criticism (International Monetary Fund, 2015a).

After a series of international recommendations by a joint team of the International Monetary Fund and the World Bank (International Monetary Fund, 2015a) and at the national level by the Bulgarian National Audit Office (Bulgarian National Audit Office, 2015), as well as the policy measures taken in the management of the Bulgarian National Bank, there are some improvements in supervisory policies. The modern framework of banking supervision is based on findings and recommendations of the assessment of the effectiveness of banking supervision and the audit of the efficiency and effectiveness of banking supervision (Bulgarian National Bank, 2015b). Restructuring of banking supervision in Bulgaria started in 2015 with the adoption of „Plan on Reforms and

Development of Banking Supervision Exercised by the Bulgarian National Bank“. The reform of banking supervision is aimed at aligning national and international practices (Basel Committee on Banking Supervision, 2012). From the beginning of 2016, reports on established supervisory problems, supervisory measures and their implementation are reviewed on a quarterly basis by the Governing Council of the Bulgarian National Bank (Bulgarian National Bank, 2016). The significant progress made in improving banking supervision has been enforced (European Commission, 2018). Notwithstanding the progress made, banking supervision continues to be in convergence with international good practices (European Commission, 2017).

The assessment of the application of international banking supervision principles shows improvement for Bulgaria. Of the 29 principles of the Basel Committee, nine principles have been identified as compliant, 12 as largely compliant and 8 as being materially non-compliant (International Monetary Fund, 2017b). Parallel to the dynamics of improving banking supervision is the lagging behind: inadequate management of the Bulgarian National Bank exercising supervisory functions and insufficient coordination and exchange of information with other institutions related to the supervisory function.

3. Development of banking supervision in Bulgaria

The international assessment for the banking supervision in Bulgaria has been highly rated (compliance and partial compliance) with classical supervision criteria for compliance with certain financial ratios. The practice of the past two decades has shown that limiting supervision to financial discipline is one of the causes of the global financial crisis. In the new reality, the scope of supervision is extended to non-financial information, incl. good practices in corporate governance. This conclusion is corroborated by the findings and recommendations of the International Monetary Fund and the World Bank for the reform of banking supervision in Bulgaria - international organizations find largely non-compliance with the criteria for non-financial information and the internal management of banks. Total five principles for effective banking supervision (Basel Committee on Banking Supervision, 2012) are assessed as materially non-compliant: Principle 2 Independence, accountability, resourcing and legal protection for supervisors, Principle 6 Transfer of significant ownership, Principle 11 Corrective and sanctioning powers of supervisors, Principle 14 Corporate governance, and Principle 27 Financial reporting and external audit.

In the new reality, the scope of banking supervision in Bulgaria extends to non-financial information and internal governance of banks:

3.1. Fit and proper assessment of shareholders

In licensing and during ongoing monitoring an assessment is carried out of shareholders with a certain share of ownership (with three and more percent direct holding of shares as well as through related parties). The purpose of the assessment is to determine the ability of shareholders to fulfill their role as a principal. The fit and proper assessment of the shareholders is carried out by the Special Supervision Directorate of the Bulgarian National Bank. The methodology and the results of the assessment are available only to the monitoring international organizations.

The assessment for shareholders holding more than 3% of the shares or of the voting rights is carried out on an annual basis by sending letters from the Bulgarian National Bank requiring shareholders to confirm their activity and provide information from their audited financial statements (International Monetary Fund, 2015a). The supervisory activity of the Bulgarian National Bank over the shareholders includes the collection of information on the names and addresses of the persons who have subscribed directly or indirectly 3 or more than 3% of the voting shares, all persons who have subscribed 10 or more than 10% (major shareholders) and especially for the 20 largest shareholders.

Once the shareholders have been determined, the Bulgarian National Bank assesses the suitability of the shareholders' qualifications and professional experience over the last five years, as well as the reputation of the shareholders with significant interests. The assessment also includes supervisory actions to determine shareholders' reliability with regard to providing additional financial support, and whether the financial capacity of major shareholders corresponds to the scale and activity of the bank itself.

The primary objective of the supervision assessment is to reduce the risk of actions from major shareholders and to determine their impact on bank operations. A further objective of the assessment is to determine the suitability of the main shareholders as well as the actual owners in view of the existence of holding groups. This includes identifying and evaluating other persons who may have a significant impact on the stability of banks. The assessment consists of determining the transparency of ownership structure and sources of initial capital as well as the ability of shareholders to provide additional financial support if necessary.

3.2. Suitability assessment of members of management body

To address the negative effects of the global financial crisis, the Basel Committee decided to review its manual for boards (Basel Committee on Banking Supervision, 2010). The key role of supervisors is to make sure that corporate governance policy is in line with good practices.

Bulgaria and other 13 EU countries apply ex-ante assessment of the suitability of the members of the management body, while the ex-post assessment is carry out of by nine countries and eight countries use a combination (European Securities and Markets Authority, European Banking Authority, 2017). This assessment approach has the advantage of reducing the risk of subsequent release of members of the management body and seniors, as well as allowing for consultation between competent authorities across countries and sectors. The use of ex ante assessment leads to higher costs for banks and, as a further disadvantage, the impossibility of replacing members of the management in critical situations.

The Legal and Administrative Services Directorate of the Bulgarian National Bank conducts an assessment of the suitability of the members of the managing bodies of the banks. Criteria of relevance include experience, suitability, qualifications, abilities, reliability, reputation and integrity (lack of criminal background), academic education (minimum a Master degree) and professional experience (at least 5 years of professional experience in a managerial position in a bank or a comparable with a bank company) to the members of the boards. National practices do not require, when assessing suitability, to have knowledge of the bank's core business as well as its risks.

In the practice of the Bulgarian National Bank for approvals for board members, a declaration is submitted and a questionnaire on suitability and reliability is completed. In addition to the questionnaire, an interview may be held by the Deputy Governor in charge of the Banking Supervision Department or additional documents may be required. When conducting a reliability and suitability assessment, the Bulgarian National Bank consults the database of the European Banking Authority for administrative sanctions.

National legislation provides that each bank's internal audit department informs the Bulgarian National Bank of breaches or unconscientious practices in the management of the bank which have led to, or may result in, significant damage to the bank, incl. the suitability and reliability of a member of the management body or seniors.

3.3. Determining the remuneration of seniors

The main conclusion of the global financial crisis is the ineffectiveness of self-regulation (Larosière, 2009). Voluntary practices with supervisory policies are also applied at the same time in the new reality. Their complementarity generates a private case of public good by supervising the proper implementation of self-regulation.

Such a combination of „soft“ and „hard“ legislation is used to form the remuneration of seniors of banks. To reduce „appetite for risk“ and to prevent future crises, policies have been introduced internationally in determining a variable part of remuneration (Regulation 575/2013).

Since 2010, each bank in Bulgaria has to adopt its own remuneration policy for seniors. Variable part of remuneration is tied to performance and risk-taking. The structure and the deferred payment of the variable part of remuneration create preconditions for balancing the interests between the seniors and the stakeholders, incl. the shareholders.

The Bulgarian National Bank has no legal possibility to restrict remuneration in banks (International Monetary Fund, 2015a). The Bulgarian National Bank analyzes the trends and practices of remuneration in the banking system by providing the results of this review to the European Banking Authority.

3.4. Introduction of a new supervisory authority

The dynamics in Bulgaria's banking sector is determined by external factors of mandatory nature (Kazandjieva-Yordanova, 2017). Following the recommendations of the International Monetary Fund a step for strengthened the overall report system has been launched (International Monetary Fund, 2015b). Like the other Member States in the European Union, Bulgaria creates control over the registration and functioning of external auditors in its territory. In 2008 a Commission for Public Oversight of Statutory Auditors (Directive 2006/43/EC) was established. The main tasks of the Commission for Public Oversight of Statutory Auditors are to establish rules and procedures for conducting quality audits of statutory auditors as well as for evaluating the activity of auditing committees in public interest entities and monitoring the market of audit services.

Auditors from other Member States of the European Union as well as from third countries are only licensed to practice in Bulgaria after obtaining permission from the Commission for Public Oversight of Statutory Auditors. Unlike banks that are on a notification regime with a „single license“ in the European Union, the auditors are on a registration regime in the host country. This practice is accepted across the European Union to remove barriers to statutory auditing of business entities in a host country by a home country auditor (Directive 2014/56/EC). This contributes to the integration of the audit market in the European Union.

3.5. Extending the composition of the supervisory authorities

The architecture of financial supervision in Bulgaria includes the Bulgarian National Bank and the Financial Supervision Commission (International Monetary Fund, 2017a). Due to implementation of state rescue plan for First Investment Bank in Bulgaria was implemented The German model of adding a new supervisory authority, the Ministry of Finance, considering the use of public funds in rehabilitation.

The three supervisory authorities (the Bulgarian National Bank, the Financial Supervision Commission and the Ministry of Finance) cooperate and exchange information through the Consultative Council on Financial Stability. Established as an advisory body, its members are the Minister of Finance, the Governor of the Bulgarian National Bank and the Chairman of the Financial Supervision Commission. Its main role is to define the financial stability policy. The Consultative Council on Financial Stability has advisory and coordinating functions (International Monetary Fund, 2015a).

3.6. Control over external auditors

In order to prevent future international crises, rotation policies for external auditors were adopted. In individual EU countries, the rotation time varies from five to seven years. Such an approach aims to end the vicious practices of establishing long-term relationships and merging the interests of banks and auditors. With the introduction of a cooling-off period, the relationship between an auditor and a bank becomes subject to supervision by the competent authorities.

As a supervisor, the Bulgarian National Bank has limited control over the work of external auditors. One of the control options is that external auditors submit to the Bulgarian National Bank a report on the reliability of the internal control systems as well as on the compliance of the supervisory reports prepared by the bank. An additional control option is for the BNB to include in its inspection reports questions addressed to the external auditor.

The powers of the Bulgarian National Bank lack the ability to determine the scope of external audits of banks (International Monetary Fund, 2015a). Observing the rotation times of the external auditors does not fall within the competence of the BNB, but that of the Commission for Public Oversight of Statutory Auditors. An addition deficiency of the legal framework, concerning the external audit and the supervisory authority, is the unusual practice of the lack of working meetings between them.

These facts are a cause for concern considering the fact that an audit company conducts audits of more than half of the banks, including the audit of the Bulgarian National Bank. The audit company in question has allowed a state of bankruptcy for Corporate Commercial Bank, which has absorbed over 2 billion leva (2.8% of Bulgarian GDP which is equal to the share of healthcare and medical care) from taxpayers.

4. Conclusions and Recommendations

The modern form of banking regulation should be seen as a new form of financial integration. For Eastern European countries, the integration process started at a time when coordinated policies of supervisors were not implemented. Due to differences in supervisory practices and ongoing supervisory reforms, the integration has taken place with the development of cross-border banking groups. Their activities require higher supervision costs and reforms.

Our results partially confirm the first hypothesis (H1) - EU membership has led to substantial reforms in national banking supervision policy. For the sake of competitiveness, EU plans for the development of the banking sector in new territories have been taken. These plans were followed by major political changes in Eastern Europe and the adoption of market principles, including authorizations to conduct banking activities by foreign groups. The modernization of banks to cross-border activity has set new requirements for banking supervision in the EU and the need to adapt it to the new reality. The shared responsibility between home and host supervisors does not justify political trust and social expectations. For the countries of Eastern Europe, the opening of national markets for foreign banks was one of the requirements for EU membership and the beginning of reforms of banking supervision. For completeness of the analysis, it is recommended to carry out such a study in other East European countries and to compare the data.

Our study found extension the scope and composition of banking supervision. An additional element to confirm the second hypothesis (H2) is that the adaptation of banking supervision to banking structures takes place in the euro area only. For Bulgaria, as well as for other non-euro area countries, cross-border banks have introduced banking supervision reforms. In most cases, these reforms are a reflection of the adaptation of euro area banking supervision to the new reality. In Bulgaria, reforms are a mechanical reaction from euro area directives and regulations that are not suitable and not intended to local conditions. This fact is partly explained by the fact that quantitative results are being achieved instead of qualitative reforms in banking supervision. We recommend in future analyses of banking supervision for non-euro area countries to apply approaches in compliance with local conditions and to restrict the use of international criteria that are designed for home supervisors.

Our data reveal a specific situation for Bulgaria: external factors formed the banking system in which, of the one part the banking structure defines the BNB as host supervisor and of the other part the bank structure determines a lack of good practices mainly in the local banks over which only the BNB is supervisor authority. This finding can be accepted in the light of the fact that Bulgaria is dominated by subsidiaries of cross-border groups where the base is a large investment and the traditional methods and principles of stock exchanges or international organizations are not matter. In this situation, only audit standards are leading and should be analyzed as defining good practices.

Reforms in banking supervision were taken after a decline in public confidence in generating public goods. The only case of placing a bank under special supervision is due not to a supervisory inspection but to public events and a signal from the management of the bank itself. For the bank in question, Corporate Commercial Bank, all sources of information generated positive data - compliance with financial ratios, audited reports, nominated for a corporate governance award. As a result of bankruptcy of only one bank start reforming banking supervision - policy measures taken and recommendations made by international organizations have adapted the supervision towards the new reality by extending supervision scope and structure to non-financial information, including good practices of corporate governance.

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