

# Banks' Lending Activity in Bulgaria (2008-2012)

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## Summary:

Bulgaria's economic development over the past years has been the result of the global and national economy crisis alike. The decline in business activity and the sputtering revival have affected the state and the dynamics of lending and the interest rates are one specific factor of very high importance in this respect. In the middle of 2013 there were 24 commercial banks and 7 branches of foreign banks which performed in Bulgaria. The number of performing banks is not in direct proportion to the extended loans. On the one hand, the banks' activity is characterized with slow and sluggish growth rate – between 1 – 3% annually since 2010. The reasons for that are: banks have strong requirements to extending credits of companies and of householders business's unsatisfactory investment activity based on pessimistic expectations, low household incomes which affects the demand for credit. On the other hand, under the current circumstances the commercial banks estimate relatively higher risk premiums on interest rates, thus limiting the opportunities for using borrowed capital.

**Key words:** commercial bank, credit, demand for credits, financial markets, interest rate, supply of credits.

**JEL classification:** E43, E44, E51.

Bulgaria's economic development over the past years has been the result of the global and national economy crisis alike. The decline in business activity and the sputtering revival have affected the state and the dynamics of lending and the interest rates are one specific factor of very high importance in this respect. The banks' activity is characterized with slow and sluggish growth rate – between 1 – 3% annually since 2010. The reasons for that are: the stringent requirements banks have when extending credits to companies and citizens, business's unsatisfactory investment activity based on pessimistic expectations, low household incomes which affects the demand for credit. The aim of this paper is to define the main factors which influence banks' lending activity based on demand for and supply of borrowed capital, and determine the significance of interest rates among them. The research topic of this paper is the loan cash flows in the economy and their respective interest rates. Descriptive analysis has been used mostly which is based on official data provided by the Bulgarian National Bank and the National Institute of Statistics. The paper focuses on the developments from 2008 until 2012.

## 1. Demand for Borrowed Capital

The development of the world economy in the first decade of the new

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millennium was controversial. After years of sustainable growth, 2007 marked the beginning of the crisis on the financial markets in the USA, which soon turned into a global one. From 2008 until 2013 Bulgaria experienced crisis and depression periods combined with periods of modest recovery. The data in Table 1 show a drastic drop in growth rates in 2009, followed by slow recovery and again a slump in the level of real GDP in 2012. The unemployment rate was constantly growing and reached 12% of the workforce in 2012. The country's export shrunk in 2009 which further aggravated the conditions in which the domestic business had to perform. Since 2010 export has been fluctuating but as a whole has been on the rise thus turning into one of the driving forces of GDP growth. Public finance has not been balanced and the fiscal policy conducted by the respective governments has not had an explicitly stimulating nature, which further deteriorated the situation in the country.

Table 1. Main Economic Indicators, 2008-2012

Indicator	2008	2009	2010	2011	2012
<b>GDP, bln. BGN, Current Prices</b>	69,295	68,322	70,511	75,265	77,582
<b>GDP Real Growth Rate, %</b>	6,2	-5,5	0,4	1,8	0,8
<b>Inflation, Average Annual Level, %</b>	7,2	1,6	4,4	2,0	2,4
<b>Unemployment, %</b>	5,6	6,8	10,2	11,2	12,3
<b>Export, bln. Euro</b>	20,559	16,615	20,725	25,635	20,793
<b>Import, bln. Euro</b>	27,848	19,489	21,472	25,322	24,415
<b>External Trade Balance, % of GDP</b>	-10,5	-4,2	-1,1	0,4	-9,1
<b>Deficit/Surplus in the State Budget, bln. BGN</b>	1989,9	626,1	-2822,8	-1582,2	-357,4
- % of GDP	2,9	0,2	-4,0	-2,1	-0,45
<b>Gross external debt, bln. Euro</b>	37,246	37,816	37,042	35,431	35,912
- % of GDP	105,1	108,3	102,7	92,1	90,5

Source: BNB, NSI

Under these unfavourable conditions, combined with an identical situation in the main EU trade partners, processes typical of an economic crisis have been observed in the field of lending – high interest rates and reduced volume of loans granted. Banks' activity has maintained a slow and

sluggish growth rate – between 1 – 3% annually since 2009.

The market for free capital as well as the markets for the remaining factors of production and consumer goods is influenced by two interrelated groups of factors. The first one is based on demand for borrowed capital from households and the business, the second – on their supply. The demand, and in some cases the supply of bank services, mostly related to lending depend on the interest rates, and the charges and commissions paid. The data in Table 2, which show the banks' lending activity with respect to households, outline one clear trend – high interest rates of new consumer and mortgage loans without a clearly defined trend towards decreasing. It affects the weaker consumer interest in using bank resources when economic agents make consumer and investment purchases. An exception here are the interest rates of new mortgage loans which having reached the peak of 15% in 2010,

went down reaching 6.64% in 2012, i.e. decreased by more than 50%. It is due to the fact that the high interests people have to pay when buying a house usually affect long-term loans and discourage the potential bank clients, who on their part perform in an extremely complex economic environment

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Table 2. Interest Rates on New Loans to Households (1), 2007-2013, %

Year	Interest Rates on New Loans to Households				Interest Rates on New Loan to Households with an Initial Rate Fixation			
	Consumer Loans (2)		Mortgages (3)		Consumer Loans (2)		Mortgages (3)	
	in BGN	in Euro	in BGN	in Euro	in BGN	in Euro	in BGN	in Euro
2007	10,96	7,96	8,38	7,34	9,95	8,23	6,74	8,76
2008	11,21	9,08	8,68	7,48	10,09	8,46	7,70	10,80
2009	13,76	12,39	8,16	7,95	11,23	-	-	14,82
2010	13,07	11,01	8,49	8,22	12,69	9,87	15,26	10,21
2011	13,07	8,95	8,78	8,07	11,93	13,59	-	12,78
2012	11,99	9,92	7,29	7,51	9,28	10,14	7,23	9,17
2013	12,83	9,73	6,83	7,29	9,43	10,46	6,64	10,44

(1) Data for average interest rates in May of that year

(2) Loans with maturities between 1 and 5 years.

(3) Loans with maturity over 10 years

Source: BNB

by increasing unemployment. Despite the risk of customer insolvency, banks are forced to decrease interests.

The economic environment in the country gives grounds for singling out a second factor influencing the demand for credit related to the level of household incomes and the possibility to provide for the family once the loan has been paid off. The majority of Bulgarian households experience to a different extent the impact of the crisis – decline of employment and of incomes. Figure 1 contains information

about the deteriorated financial state of the Bulgarian families since 2007 to date. This results in lower demand for bank services and loans, in particular. Figure 2 shows the distribution of incomes of those who took out mortgage loans in May 2013. The most active borrowers were the households with incomes between BGN 1 500 and 2 500. They represent 76.6% of those who took out loans, while the households with much higher incomes – over BGN 4 000 amount to only 4.9% of the total number of borrowers. This data, however, should be evaluated through the prism of the level of the average salary in the country – BGN 789 at the end of 2012 and its drop to BGN 778 at the end of the first quarter of 2013. In households with two

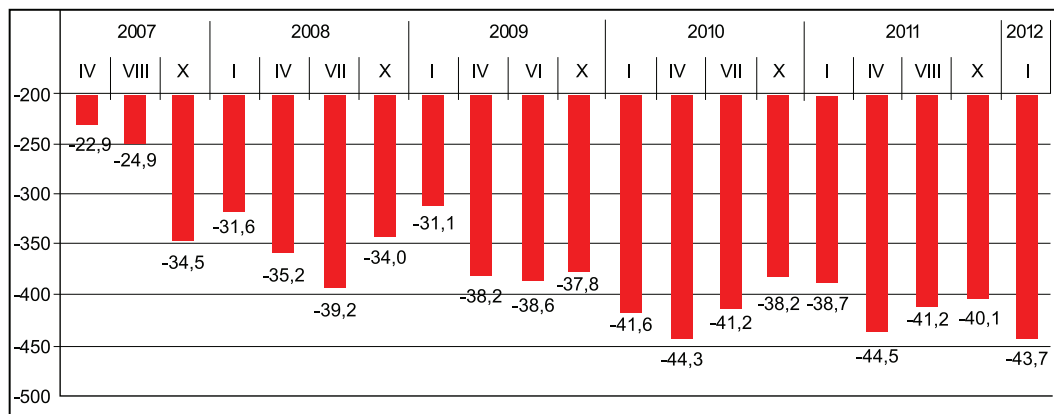


Fig. 1. Assessment of the Financial Position of the Bulgarian Households

Source: *Ikonomicheskoto razvitiye i politika v Bulgaria: otsenki i ochakvania*, 2012, Sofia, "GorexPress", p.56.

wage earners the average salary at the end of 2012 was 1 578. This is the floor for the group under consideration and the majority of Bulgarian households have either a bit lower or a bit higher incomes. Considering the increasing unemployment, the almost unnoticeable rate at which salaries increase in both the private and public sectors, this group – between BGN 1 500 – 2 500 – is not particularly representative of the group of people who take out mortgage loans.

The demand for credit is influenced by the general economic situation which is illustrated by the above given factors such

the property market, household electronics and retail trade as a whole, as well as the related possibilities to pay by debit and credit cards. The increase in property prices which made it impossible for the majority of the households to buy homes with their own money, was typical of the time prior to 2008. Over the past five years there has been an unambiguous trend towards oversupply both on the market of new homes and on the one of already lived-in homes. This has led to a drop in prices of between 20 and 50%. Despite that, the household activity is not very high, considering that banks

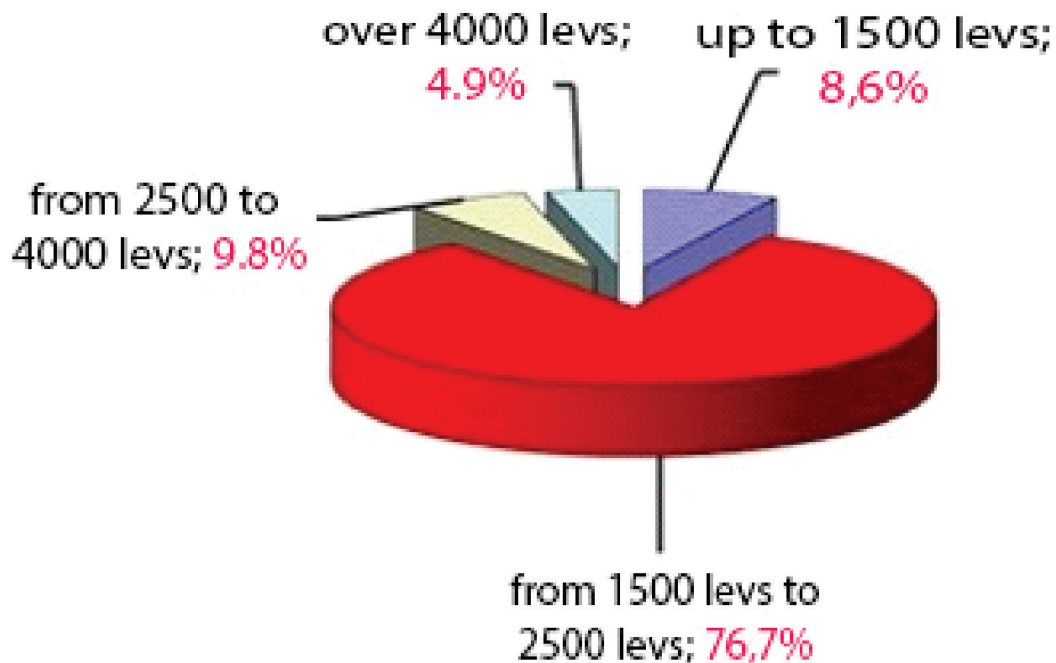


Fig. 2. Monthly income of households that have acquired a mortgage loan - May 2013

Source: Economy.bg, 24.06.2013

as risk premium on interest rates and low household incomes. It also influences the state of the markets. In particular, this affects the market of homes and of consumer goods. Specific processes happening in Bulgaria are stagnation and contraction of

have decreased their interest rates on new mortgage loans – Table 2. In general, the loans granted to households declined in the period between 2008 and 2012, as it can be seen from Table 3. While mortgage loans increased, though at a lower rate, consumer

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Table 3. Credit to households (1) bln. BGN, 2008 – 2012

	2008	2009	2010	2011	2012
<b>Overdraft</b>	1,986	2,015	1,808	1,636	1,566
<b>Consumer Loans</b>	7,268	7,773	7,554	7,438	7,269
<b>Mortgages</b>	7,744	7,773	8,709	8,873	8,943
<b>Other Credits</b>	0,998	0,942	0,899	0,937	0,916
<b>Total</b>	18,078	19,124	18,971	18,883	18,694

(1) Data for December of that year

Source: BNB

loans with 5-year maturity and overdrafts decreased significantly.

The market contraction is a prerequisite for the low investment activity of the business as the data in Table 4 show. This is a factor of demand for credit resource combined both with the drop in national and in global purchases. Loans represent a major source of funds for a number of companies, especially for the smaller units. Big companies have the possibility to borrow not only from Bulgarian banks, but also from foreign ones. The gross domestic debt of the country did not change significantly over the period under consideration (Table 1), rather there is a slight drop. Consequently, the national borrowed capital represents an important source of money resource for entrepreneurs.

system is a factor which stabilizes the boosts demand for BGN resource and for euro alike. The base interest rate is low, even below 1% currently – 0.02% as to 1 September 2013 but it is not the cost of refinancing by the BNB. It is the result of the transactions on the interbank market. The data about the interest rates on new loans show that the base interest rate is not in direct proportion with them due to the big spread.

The government's fiscal policy during the studied period is directed mostly at solving problems which have ensued from the deficit (2010) through public spending cuts. It does not affect directly the demand for credit resource, crowding-out effect of government spending is not observed, but the business is not stimulated to make domestic investments. The monetary and fiscal policy in the country is quite neutral in terms of the lending activity of commercial banks.

Table 4. Investment activity (1) of the business, 2008-2012

	2008	2009	2010	2011	2012
<b>Gross Fixed Capital Formations, bln.BGN</b>	26,015	20,063	16,138	16,510	18,487
<b>Rate of Change, %</b>	25,08	-29,67	-19,56	2,30	11,97

(1) Based on data on gross capital formation in GDP.

Source: BNB

The demand for free cash resource depends on the monetary and fiscal policy conducted in the country. The actual monetary regime in the country based on strictly pegging the Bulgarian lev to the euro, lack of significant discretionary measures on the part of BNB (Bulgarian National Bank), credibility of the Bulgarian currency and of the banking

## 2. Providing loan capital

There are several factors which determine the supply of loans by banks. They open up the opportunity to collect sufficient amount of capital mostly in the form of deposits. The resource attracted from the parent companies of the Bulgarian banks abruptly contracted during the crisis. Therefore, the commercial banks in Bulgaria rely on attracting capital from Bulgarian residents.

Generating funds in the banks is based on demand for deposits by the businesses and the households. In times of crisis and depression periods in the economy interest rates become the dominating instrument of the banks' deposit policy, while in times of economic recovery and growth other factors become predominant.

The interest rates combined with charges and commissions paid to service the accounts in case they are checking accounts – the bank's charges and fees policy - are a factor of primary importance when offering loan capital. When these are considered, banks could put off potential clients by increasing charges on services related to holding an account. The data provided in Table 5 show that there was an increase of interest rates on deposits with agreed maturity (from 1 day to more than 2 years) until 2010 and then there was a drop. The deposits for which an advance notice is applicable are an exception. In that case interest rates on both deposits in BGN and EURO increase for the entire period under consideration - 2008 – 2012.

there are no separate units in it which are experiencing serious difficulties regardless of the situation their foreign parent companies are in. This is a favourable factor in terms of attracting deposits in as far as the depositors should not be concerned about their money and should use the services of the Bulgarian banks.

Over the past few years we have witnessed some processes of broadening the needs of households and companies for various payment services, for profitable deposits, for internet banking and better services provided to bank clients. People's propensity to save and invest in different profitable instruments, other than deposits, is of considerable importance. In general, the reasons for households and businesses to look for deposits can be defined as related to the opportunities for saving time and resources. However, opening checking accounts brings low profits as it becomes evident from the data in Table 5 on overnight deposits. In 2012 the interest rates on these accounts for households were 0.60% and 0.43% for BGN and EURO deposits

Table 5. Interest rates (1) on deposits of households, 2008-2012, in%

Years	Overnight deposits		Deposits with agreed maturity		Deposits redeemable at notice	
	in BGN	in Euro	in BGN	in Euro	in BGN	in Euro
2008(2)	0,92	0,51	5,28	4,24	3,39	2,87
2009(2)	1,00	0,54	7,09	5,77	3,68	3,38
2010	0,76	0,51	6,47	5,63	3,49	3,44
2011	0,69	0,46	5,66	4,89	3,67	3,99
2012	0,60	0,43	5,31	4,68	3,55	4,18

1) Effective annual interest rate, annual average.

2) Calculations are based on quarterly data

Source: BNB

The supply of free funds reflects the stability of the banking system as a whole and of the individual institutions and their trustworthiness. The Bulgarian banking system is stable. Even in times of crisis

respectively, for the business the rates were 0.54% and 0.33% on average.

The supply of unrestricted financing by banks is faced with the competition of alternative non-banking credit institutions in the country. There is also very strong competition among the banks themselves. On the market of borrowed capital there



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is unrestricted funding provided not only by commercial banks but also by firms which offer fast credit, license companies and pawn shops. Despite the strict terms and conditions of the deal – for example, high interest rate and complex repayment requirements, these firms profit from the chance they have to get a loan quickly and easily. The sums are not usually high which makes borrowers believe that it is relatively easy to settle their debt relations. Households with relatively high and stable incomes take out bigger loans, whereas these alternative firms which extend loans rely on people with lower and not so stable incomes.

The degree to which the banks' branch network is developed affects the possibilities for an easy access to loan capital. In the period of upward development of the economy the Bulgarian banks established a broad branch network to meet the needs of the credit boom in the country (2004 – 2008). During the crisis between 2008 – 2012 the branches of the banking system as a whole shrank by 8.24% and the number of people employed – by 4.41%. The same trend was observed in the banks in the countries in the European Union. This resulted from the banks' desire to cut and streamline expenses and from the downturn trend in the development of the economies which led to a decline in the economic activity and lower demand for bank services. The following four banks are an exception: Corporate Commercial Bank (CCB), Societe Generale Expressbank, DSK Bank and Central Cooperative Bank. Reducing the number of branches is partially offset by the introduction of systems for alternative banking – online and mobile banking. Observations show that the daily low-cost operations are increasingly carried out on the internet, through ATMs and mobile banking. But in the case with big loans and deposits clients prefer personal agreements with bankers.

The opportunities the banks have to accumulate and offer unrestricted cash resource are affected by the regulatory organisation of the money sector – compulsory reserve requirements, securing bad loans, general information requirements in order to extend loans, interest rate ceilings etc. Actually, since 2008 BNB has not changed the volume of the reserve requirements and it is 10% of the deposit base (with some exceptions – attracted foreign capital – 5% and capital attracted from government and local budgets – 0%). The requirements which apply to bad loans are among the highest in Europe – 75%. This affects restrictively the banks' lending activity by limiting access to their free capital. In terms of capital adequacy, which is a kind of buffer against bad loans, Bulgaria's banking system comes fourth in the EU – 16.64% and the requirement is for 12%. Over the studied period the Bulgarian Deposit Insurance Fund increased the amount of protected sums to BGN 196 000. Deposits amounting to BGN 51.5 bln were liable to be guaranteed at the end of 2012. This consolidated the security of deposits in the banking system and led to an increase in the deposited amounts.

Lending is also affected by competition because the national economy is open to foreign financial sources. Bulgarian companies tend to borrow from foreign banks and other institutions, but the data about the gross foreign debt shown in Table 1 illustrate a downward trend. The main reason for that is the behaviour of Bulgarian companies which restrict the use of external resources. Their reduced business activity and the increase of the loan risk premiums contribute as well.

The problem with the asymmetric information about the borrowers' situation limits the lending activity of the commercial banks and thus the supply of free cash funds. It is connected with the possibility

of making the adverse selection or with the possibility that during the term of the credit the bank's client might not use the money in the desired way (moral hazard). The hazard which arises from the asymmetric information is enhanced by the increased share of bad and non-performing loans. At the end of 2012 the overdue loans (unattended longer than 90 days) were 16.63% of all the extended loans. They amounted to BGN 9.6 bln.

The tax policy of the government is also a kind of factor of the lending activity of the banks. Deposit institutions in Bulgaria pay 10% tax on profit and all other revenue they get. It is the lowest level in the EU and stimulates their core activity – lending. Banking services are free of VAT, but as of 2013 holders of time deposits are bound to pay a tax on the interest they receive on their deposits – 10%. Even the introduction of the tax on interests would affect significantly the supply of free cash resource.

### Conclusion

The lending activity of the Bulgarian banks, which corresponds to the situation in the economy as a whole, can be described as relatively moderate to sluggish. This limits the intensity of the processes of coming out of the crisis and depression phases but commercial banks are firms which profit from trading with cash. It is quite natural that when there is a high risk among their borrowers they would set a higher price and introduce other restrictive measures. The banks are not responsible for the situation in general. The causes are related to both ordinary market processes in the national economy and to the situation worldwide.

The lending activity of the commercial banks in Bulgaria is the result of the impact of a number of factors related both to the demand for borrowed capital and to its supply. Some of these factors are market-related – interest rates, incomes etc., others

are institutional – the macroeconomic policy of the government, the situation in the banking sector as a whole, the ownership of the lending institutions. During the period of economic decline, resulting from the crisis and the subsequent sluggish recovery, the interest rates remain the key element in creating loan flows. The degree of their impact is complemented by the revenues of business and households' incomes, the propensity towards saving, the investment activity and other factors which are of relatively secondary importance.

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