

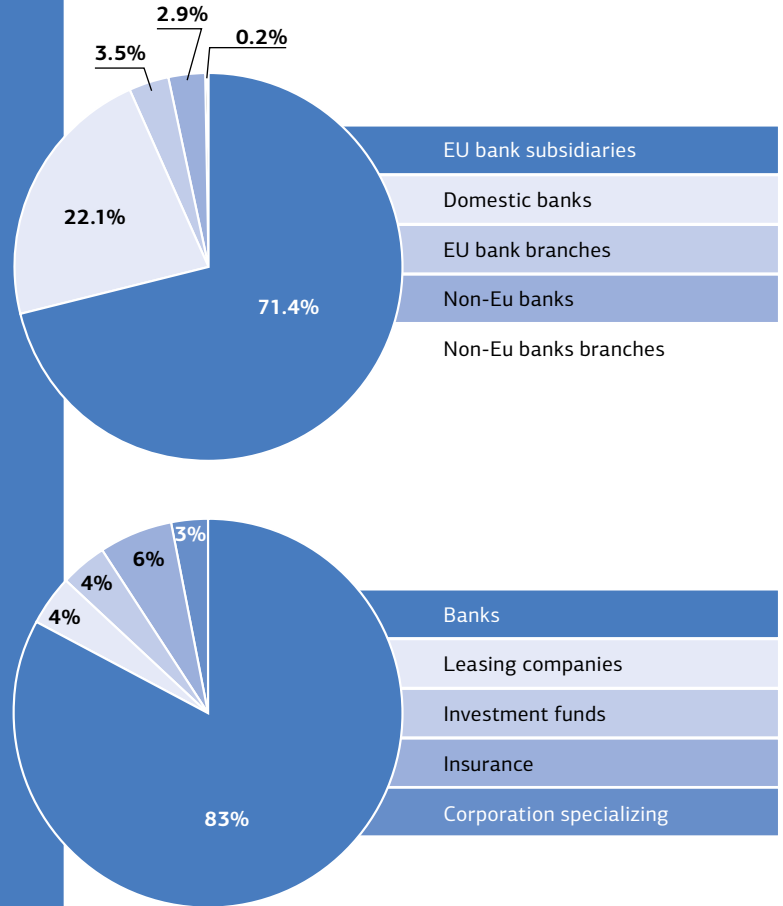
# Overview of the financial sector in Bulgaria



The financial system in Bulgaria is dominated by banks which account for 83% of the total financial sector assets. Other financial institutions such as insurance, leasing, investment funds are rather small and do not have a significant impact on the overall health of the financial system. So, the present analysis will focus on commercial banks.

Commercial banks in Bulgaria are mostly foreign owned. Domestic ownership in banks comprises only 22% of the total banking sector assets. EU participation in the banking sector assets is 75%.

Figure 1. Structure of the financial system and banks ownership as of September 2020



Source: Bulgarian National Bank, *Banks in Bulgaria*, July – September 2020

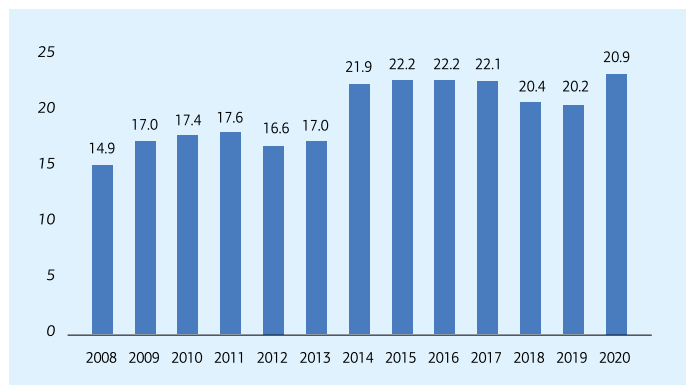
The financial depth in Bulgaria is not high relative to peer countries. The loan to GDP ratio as of the end of 2020 stands at 53%. Market concentration is not high in the Bulgarian banking system. The 5 largest banks hold 66% of total banking sector assets and none of these banks have a market share of more than 20%. In July 2020 Bulgaria joined the European Banking Union, which means that The European Central Bank (ECB) now supervises the five largest banks directly. Overall the Herfindahl-Hirschman's index of concentration for the banking sector in Bulgaria as of September 2020 stands at 11% which points to the low level of market concentration.

Loans account for around 53% of the total banking sector assets in Bulgaria, which is on the lower end compared with other BSTBD member countries and regional peers. Liquid assets account for around 30% of the total assets. Banks fund their assets mostly with deposits that correspond to 90% of the total liabilities and are considered as a more stable source of funding relative to a capital market.

Banks are well capitalized in Bulgaria. After the global financial crisis of 2008 capitalization of Banks increased in many countries including Bulgaria. As a result, the capital adequacy ratio has been above the required minimum of 8% for many years already and

it grew further in 2020. By the end of 2020 CAR reached 22.9%. High capitalization points to the strong shock absorbing capacity of the system.

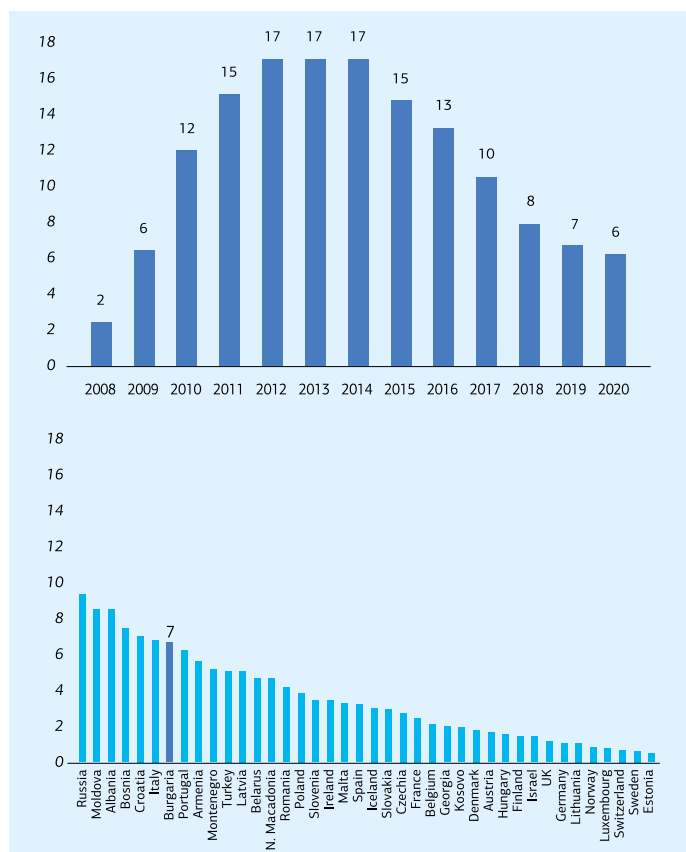
Figure 2. Regulatory capital to risk-weighted assets (%)



Source: : Financial soundness indicators, IMF database

The banking sector's health has improved significantly over the last 5-7 years. Following the global financial crisis, NPLs in the banking system increased and reached close to 17% of the total gross loans in 2012-2014. Since then NPLs steadily declined until early 2019, when the pace of the decline slowed down. The decline in the NPL ratio was a result of both actual improvements in the quality of the loan portfolio and strong credit growth. However, despite the significant reduction, NPLs are still at an elevated level compared to the peer countries in the broader region. It should be noted that due to the debt service moratoria announced by the authorities, the reported NPL ratio does not show an accurate picture of the quality of the credit portfolio. NPLs may rise somewhat after the loan moratoria are over.

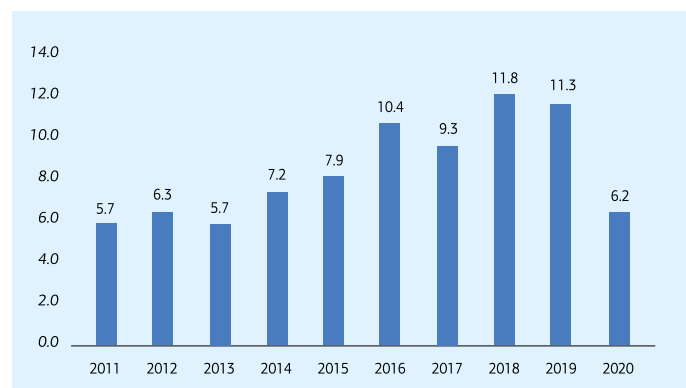
Figure 3. NPLs in Bulgaria for 2008-2020 and regional comparison as of end 2019 (%)



Source: Financial soundness indicators, IMF database

With the improvement in asset quality, banks' profitability also increased in 2016-2019. ROE for this period averaged 11%, which is similar to peer countries with the same credit rating. As was expected, ROE declined during 2020 but still stayed at a solid level of 6.2% by the end of the year.

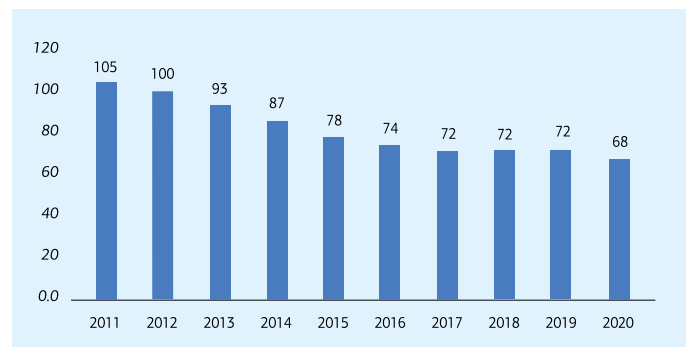
Figure 4. Return on equity for banking system in Bulgaria (%)



Source: : Financial soundness indicators, IMF database

The banking system maintains strong liquidity buffers. Liquidity Coverage Ratio (LCR) is well above the required minimum of 100% since 2017 and as of September 2020, it reached almost 270%. High liquidity buffers are driven by stronger growth in deposits relative to credits. As a result, the loan to deposit ratio has been decreasing over the last decade and this trend continued in 2020 as well with the ratio reaching 68% by the end of the year.

Figure 5. Total (Non-interbank) Loans to customer deposit (%)

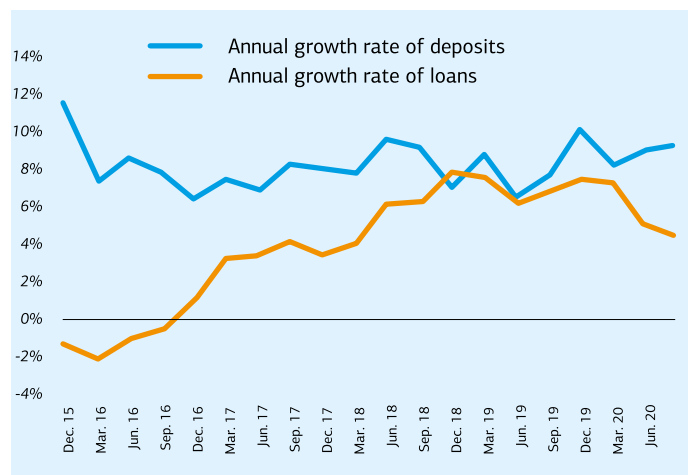


Source: Financial soundness indicators, IMF database

A significant part of the credit portfolio, around 30%, is Euro denominated, almost all of which is loaned to corporate borrowers. It should be noted that Bulgaria has a currency board regime since 1997 and the exchange rate of Lev is fixed with Euro. In 2020 Bulgaria joined the European Exchange Rate Mechanism (ERM II) with the aim of joining the Eurozone. Therefore, despite the large share of euro denominated loans in the banks' balance sheet, euroization is not perceived as a critical issue in Bulgaria.

Outstanding credit has been growing steadily over the last several years. Despite the pandemic, credit continued to grow in 2020, although in the second half of the year the pace of growth declined and reached 4.6% by end of the year. Loan growth in 2020 was mostly driven by lending to households, especially mortgages that contributed 2.1 percentage points, while corporate borrowers' contribution to the credit growth was 1.6 percentage points. The deposit growth rate, which averaged 8% per year during the last 5 years, increased to 10% by the end of 2020.

Figure 6. Annual growth rates of deposits and credits (%)

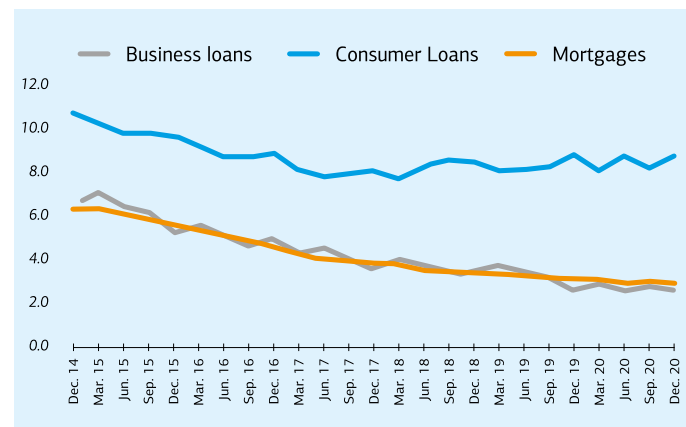


Source: Bulgarian National Bank

Banks' largest exposure is to the corporate sector with business loans accounting for 59% of the total credit portfolio. Out of this almost half is Euro denominated. Loans to households comprise 41% of the total credit portfolio with 20 percentage points invested in mortgages and other 21 percentage points in consumer loans. Both mortgages and consumer loans are almost entirely local currency denominated.

Interest rates have been on a declining trend in Bulgaria for the last 5 years. In 2020 the trend flattened but the rates remained at low levels compared to peers and other countries in the region. Annual interest rates for both corporate borrowers and mortgages are relatively low, a factor that works favorably for the long-term growth potential for the country.

Figure 7. Annual interest rates for different types of loans



Source: Bulgarian National Bank

The financial sector in Bulgaria is dominated by banks that are well capitalized with strong capital and liquidity buffers and promising profitability. The banking sector has demonstrated steady growth for the last years both for loans and deposits. A relatively low level of financial depth can serve as a favorable ground for strong growth potential in coming years. A relatively high level of NPLs is the major challenge for the banking system in Bulgaria. Despite declining almost three times since 2014 NPLs are still high. Moreover, the full impact of the pandemic is not yet reflected in the quality of the credit portfolio. After the loan moratoria will expire NPLs could rise further in case economic activity remains weak. So, maintaining asset quality will be a key issue for the banking sector in coming years.