EMERiCs
신흥지역정보 종합지식포탈

Korea Institute for International Economic Policy

Bank Failure, Systemic Risk, and Institutional Deficiencies in Bulgaria: The Case of KTB's Collapse

Kiril Tochkov (Associate Professor of Economics, Texas Christian University)

Date: 2015.05.15

I. Introduction

Bulgaria's transition from a socialist planned economy to a market-based democracy has been a long and tortuous process. Serious structural reforms and a privatization program for large-scale industrial assets began mostly in the late 1990s and only because the country experienced a severe banking crisis that shook the political system and devastated the economy. In the early 2000s, Bulgaria was already in the process of accession to the European Union (EU). After eight Central and Eastern European countries joined the organization in 2004, the talks between Bulgaria and the EU intensified and the country was ultimately admitted as a member state along with Romania in 2007. In contrast to the difficult transition of the 1990s, the economy boomed in the first decade of the new millennium. This was largely related to the EU accession. In anticipation of eventual membership in the EU, Bulgaria enjoyed large inflows of foreign direct investment and European funding that fueled the economic expansion even before 2007. Macroeconomic stability played also an important role in this process. Low government debt and deficit levels, a flat tax rate of 10% on corporate income, a fixed exchange rate, and a stable financial system have proved attractive to foreign investors. Furthermore, the banking system in Bulgaria is largely dominated by subsidiaries of foreign-owned banks, which flooded the country with cheap credit in the years leading up to the global financial crisis of 2008. The result was a boom in consumer spending that had a favorable impact on the economy as a whole.

The global crisis that reached Bulgaria in 2009 brought the economy to a halt. However, even during the following few years, the country seemed to weather the crisis relatively well, especially when compared to neighboring Greece which collapsed under the weight of its debt and caused an EU-wide crunch. Neighboring Romania had to request assistance from the IMF, while the Baltic countries implemented brutal austerity policies that led to a sharp recession. Hundreds of thousands of consumers in Hungary and in other Central and Eastern European countries were facing bankruptcy because they had borrowed in foreign currencies during the boom years to take advantage of low interest rates. When their home currencies collapsed during the crisis, they were not able to pay off their credit anymore. Bulgaria was managed to avoid most of these scenarios. This was mainly the result of the currency board that operates in the country, which maintains a fixed exchange rate to the euro and imposes limits on expansionary government policies. The low levels of government debt (less than 20% of GDP) created enough room for the government to implement some expansionary fiscal policies and prevent the economy from slipping into a sharp recession. In terms of fiscal prudence, the Bulgarian government compared itself favorably with Germany (known for its conservative spending habits) and even supported the German-led austerity drive across the EU.

Although macroeconomic indicators painted Bulgaria as a beacon of economic stability on the Balkans, this image, in fact, concealed chronic institutional issues that became apparent when KTB, one of the largest commercial banks in Bulgaria, collapsed in the summer of 2014. As during the early transition, Bulgaria's problems took longer to get exposed, but when this happened, it revealed an ugly picture of corruption, negligence, criminal activities, regulatory failure, institutional decay, lack of transparency, and a cozy relationship between government, business, and the media. The collapse of KTB and its consequences are symptomatic for the current state of a small country at the periphery of the EU and call for a thorough investigation of the causes and interests involved in this process. The main goal of this short paper is to provide an overview of the bank's collapse itself, of the broader political, economic, and institutional environment in which it occurred, and of how the state responded to this event. KTB failed in the summer of 2014 and it is still too early to conduct a thorough scientific analysis of what happened. Much of the information about the case is still incomplete and no serious scholarly publications on the topic have been published yet. Accordingly, this report relies on the knowledge of the author as a long-time observer of the Bulgarian economy, on publications in the foreign and Bulgarian media, on preliminary reports released by government institutions, and on conversations with other economy watchers from Bulgaria.

The paper is structured as follows. The next section describes briefly the banking system, the currency board, and the system of financial regulation in Bulgaria. Section 3 chronicles the rise and fall of KTB, while Section 4 represents an attempt to analyze the events in a broader context. Section 5 summarizes the arguments and offers some concluding remarks and recommendations.

II. The Banking System and the Currency Board in Bulgaria

The modern banking system in Bulgaria emerged in the aftermath of a severe financial crisis that occurred in 1996-97. In the first half of the 1990s, the state was still heavily involved in the economy. In the absence of large-scale privatization, most major industrial enterprises were still controlled by the state, while the financial system was dominated by state banks. On the verge of bankruptcy, the inefficient and loss-making state-owned enterprises relied heavily on credit provided by the state banks. The share of non-performing loans in the banking system rose rapidly and in the absence of deposit insurance schemes, the increasing lack of confidence in the financial institutions led to deposit withdrawals that turned into massive bank runs in 1996. As a result, about a third of all commercial banks failed, while the economy went into a tailspin. Hyperinflation, a collapsing currency, and food shortages created a political crisis that ended when a new rightist government came to power in 1997 and in negotiations with the IMF agreed to adopt a currency board.

The currency board, which is still in place today, established a fixed exchange rate regime by pegging the Bulgarian currency to the deutsche mark and later to the euro, which helped reestablish the financial stability in the country. The Bulgarian National Bank (BNB), the central bank authority, was reorganized and put in charge of the currency board. BNB's image benefitted from the popular support for the currency board and the institution emerged as the new guardian of financial stability in the country. The currency board compelled the government to exercise fiscal prudence but it also eliminated any kind of discretionary monetary policy. The other major function of the central bank besides maintaining the currency board was the supervision of commercial banks.

The regulation of the banking sector did not seem to present any major challenges. After the 1996-97 crisis, almost all Bulgarian banks were privatized attracting strategic foreign investors. By the mid-2000s, close to 80% of the assets in the banking system were owned by foreign banks. These were mostly large experienced multinational financial institutions that guaranteed certain standards of corporate behavior. Moreover, thanks to their scale and liquidity, these banks were able to funnel large amounts of financial capital into the Bulgarian corporate and consumer markets fuelling the aforementioned consumer credit boom. These developments created the impression that the Bulgarian banking system was one of the most financially sound and stable ones in Central and Eastern Europe. The global crisis of 2008 and the Greek debt crisis of 2010 did not seem to have a major impact, even though several major Greek banks were active in Bulgaria. Obviously, the generous capital flows from parent banks to their Bulgarian subsidiaries ceased and there were some concerns that the debt crisis in the EU might compel the parent banks to even withdraw capital from the country. But before the collapse of KTB in 2014, there were no indications that banks in Bulgaria could be in trouble.

III. The Rise and Fall of KTB

The Corporate Commercial Bank, better known by its Bulgarian initials as KTB, was founded in the mid-1990s but rose to prominence only over the past couple of years when it exhibited an extremely rapid growth of its assets. By early 2014, KTB was already the fourth largest bank in the country by assets and the second largest domestically-owned financial institution. The brisk expansion was the consequence of two separate but related sources of financing: the government and private clients. A large number of state-owned or state–controlled enterprises were keeping their money in deposits in KTB, despite the fact that the interest paid was relatively low. This allowed the bank to benefit from large inflows of money at low cost. Private clients, on the other hand, were lured by offering significantly higher interest rates than other banks. The fact that a large share of the funds of state-controlled enterprises was concentrated in a single bank suggested that the institution had a cozy relationship with influential political figures and parties. Several proposals requiring state-owned enterprises to diversify their deposits across various financial institutions were either blocked or ignored. Political support came at a price. Former prime-ministers, current ministers, and other influential government officials from various parties were clients of the bank and enjoyed preferential treatment, such as interest rates on deposits of between 6% and 10% at a time when other banks were offering 4-5%.

The large financial inflows helped KTB to almost triple its assets within four years. More importantly, the bank was now able to participate in all major corporate and privatization deals in Bulgaria. However, this was done by providing credit to companies that were connected to the majority shareholder of KTB, Tsvetan Vassilev. By law, the share of credit extended to firms that are controlled by or benefit major shareholders is not allowed to exceed a quarter of all credits. KTB violated this rule and tried to conceal such conflicts of interest. The financial resources were used not only to expand into various sectors of the economy. Vassilev invested generously in various sporting initiatives that ranged from owning a football club to building a stadium. He also purchased a TV channel and even seems to have financed political campaigns.

The confluence of financial resources, economic interests, political connections, and media dependency turned KTB into a key factor in Bulgaria. Accordingly, the breakdown of the bank in June 2014 came as a shock and had major repercussions. The major cause for the bank's failure seems to have been a rift between Vassilev and Delian Peevski. The latter is a young oligarch with considerable political and economic clout in the country who also has a number of popular media outlets under his control. A large-scale campaign against Vassilev and the KTB was launched in May 2014. Vassilev was accused of trying to assassinate Peevski and the Attorney General's Office, which is typically slow to react, initiated an instantaneous investigation.

Although the accusations proved to be completely baseless and the charges had to be dropped, the damage was already done. State-controlled enterprises started withdrawing their deposits and as news about problems in the bank started spreading, a bank panic ensued. In a matter of days, billions of Bulgarian lev (1 Euro = 1.95 Bulgarian lev) were pulled from KTB and other domestic banks creating the risk of contagion. Soon, KTB did not have sufficient liquidity and asked the BNB for permission to cease operations temporarily. The bank was initially placed under the oversight of the BNB and in

November its license was revoked which cleared the way for the deposit insurance scheme to pay back depositors.

Vassilev who fled to neighboring Serbia accused his former business partner Peevski as well as government officials and the media of a smear campaign aimed at bringing KTB down. But an external audit showed that the bank had a capital shortfall of around 2 billion euros and confirmed the fact that a large share of the credit was allocated to firms linked to Vassilev.

IV. Causes and Determinants of KTB's failure

The collapse of KTB exposed the shady business practices of a commercial bank that had turned from a small institution in the early 2000s to the fourth largest lender in an EU member state. But the more important question is what allowed KTB to continue using these practices over an extended period of time without being detected and sanctioned. It appears that corruption, intimate links between politics and business, support from tainted media outlets, and weak regulation were responsible for creating an environment in which KTB could thrive.

The recently released logs with the names of visitors to the office of Vassilev show that about a third of them were current and former politicians from across the political spectrum. Many of these politicians, such as the former prime minister Ivan Kostov, had deposits in the bank offering preferential conditions, such as annual interest of up to twice the going market rate. There is no doubt that such practices as well as more traditional methods of bribery were employed to secure political support for Vassilev and his forays into different business ventures. Furthermore, the fact that the finance minister at the time along with the CEOs of state-owned enterprises had also visited Vassilev on a regular basis suggests that the concentration of the deposits of state companies in KTB was not a coincidence or the result of market-based allocation. Another third of Vassilev's visitors were journalists, many of whom exhibited strong support for KTB and its majority shareholder in their publications.

The BNB as the main regulator of commercial banks bears most of the responsibility for the crisis. Weeks before the collapse of KTB, the governor of BNB was making public assurances that the bank is sound and that it was not facing any problems. After the bank run and KTB's failure, BNB officials were slow to react and looked incompetent when they failed to provide detailed information on what had been going on in the bank. After almost a year since these events, the governor of BNB still refuses to step down and take responsibility for the lax control of the banking sector. A video showing the governor and Vassilev hugging each other and singing together in an informal atmosphere at a private party indicate a conflict of interest for the regulator. Moreover, the director of the Bank Supervision department at BNB who was exposed to have withdrawn her own money from KTB after business hours and shortly before announcing that the bank will be placed under special oversight has also not resigned despite the obvious conflict of interest. These facts have severely damaged the image of the BNB and show the lack of moral qualities among government officials in Bulgaria.

V. Conclusion

Bulgaria has been slow to implement economic reforms during the 1990s when the country was adopting a market economy. But after experiencing a debilitating financial and economic crisis in 1996-97, a new reform-minded government initiated a privatization program, adopted a currency board, and worked towards EU membership. Over the 2000s, the Bulgarian economy prospered as the country benefitted from a stable exchange rate, fiscal prudence, foreign investment, and the accession to the EU. One of the hallmarks of this period was the stable banking sector which was dominated by foreign banks and provided domestic consumers and firms with access to cheap capital from abroad.

However, the global economic crisis of 2008 exposed weaknesses in the financial system that led to the failure of KTB, the fourth largest bank in Bulgaria, in June 2014. For years, KTB had used murky practices to provide its majority shareholder with the necessary funds to expand his business empire, his political support, and his hobbies. Deposits of major state-owned enterprises were used as a major source of cheap money and the loans went to companies linked to the majority shareholder in violation of the law. Politicians were bribed to gain influence and preferential access to the privatization of state assets. Media outlets were corrupted in order to conceal murky business deals and gain public support for the bank and its owner. Close personal relationships with top regulatory officials ensured that the supervision was superficial at best.

The collapse of KTB was initiated as a result of an emerging conflict between KTB's majority shareholder and powerful oligarchic and political interests. But KTB's business practices were also unsustainable and would have likely led to a similar outcome sooner or later. The fact that one of the largest banks in a member state of the EU could have prospered in such a way over several years shows major defects in the political and regulatory systems. Accordingly, Bulgaria would benefit from a fundamental restructuring of its judiciary and regulatory institutions. Such deep reform measures require pressure and support from the EU. For instance, BNB has resisted the accession of Bulgaria to the Single Supervisory Mechanism, which would allow the European Central Bank to monitor the banking sector. But the failure of BNB to detect and prevent the implosion of KTB has shown that external supervision conducted by EU institutions is vital in ensuring the financial stability in Bulgaria. Judging from past experience, institutional reforms will be slow and insufficient but it is to be hoped that the KTB collapse will serve as a lesson and an incentive to adopt policy measures that would help prevent similar crises in the future.