

# Status and prospects of the Bulgarian banking system in the conditions of a united European market

## Main features of the Bulgarian banking system

Theoretical debates postulate, and empirical data confirms, that the pace of development of financial intermediation and the financial sector in general is more rapid than the pace of development of the economy in general, the relationship between them being positive. That rule is also valid in the reverse direction – the delay in the development of the financial-credit sector as a whole leads to a greater lag in the development of a given country. Such dependences are characteristic of countries in which capital markets are poorly developed or missing and where intermediation between borrowers and lenders is effected mainly by credit institutions.

The Bulgarian banking system has a two-stage nature characteristic of most market economies. On the first level, the Bulgarian National Bank (the central bank) is located with the main objective of maintaining price stability through securing the stability of the national currency by conducting monetary policy in accordance with statutory requirements;<sup>1</sup> it also supervises the activities of other banks in the country for the purpose of maintaining the stability of the banking system, etc.<sup>2</sup> A variety of universal banks is located on the second level, operating on competitive principles<sup>3</sup> these are the main suppliers of external financing for economic agents.

In recent years, the favourable external and internal environment appeared to provide a good basis for the growth of the banking sector and for maintaining its stability. By 1 January 2007 – the date of the full membership of Bulgaria of the EU – the main indices characterising the condition of the system were as follows: assets amounting to BGN 42.2bn (€21.6bn), reflecting a growth of 28.3% compared to the preceding year; and a realised profit amounting to BGN 786m – up by 37.2% on the preceding year. Despite the strengthening competition on the credit market in terms of interest rate levels for credit and the increase in the price of borrowed funds, the return on assets and the return on equity report quite good values: respectively 2.15% and 23.7%. In comparison, the average return on assets in the EU is about 1.2% and approximately 1.6% on equity. The improvement of the quality of the credit portfolio is also reported, the percentage of regular credit having increased from 92.3% at the end of 2005 to 93.9% at the end of 2006.

The Currency Board introduced after the unprecedented scale of the financial crisis in 1997 laid the beginnings of a new stage of economic development in Bulgaria. The crisis provided a stimulus for the process of the reform of the banking sector.<sup>3</sup> A

- 1 The monetary policy of the Bulgarian National Bank is limited because of the Currency Board which has operated in the country since 1997. The exchange rate is fixed by law at a level of €1 = BGN 1.95583.
- 2 The Bulgarian National Bank Act, 2006.
- 3 See Ignatiev, P (2005): *Bank crisis in Bulgaria* Sofia: Siela.

substantial part of state-owned banks was taken private by strategic EU foreign investors, among which are leading names in the financial business, such as UniCredit, NBB, SG, OTP, EFG Eurobank, etc. The positive effect of privatisation is significant – bank management improved; investments in new technologies and know-how increased; and competition in the banking sector gradually increased, hence the variety and quality of services. According to the requirements of rational banking activity, concerning in particular the licensing of new banks on the domestic market, the Bulgarian National Bank abided by a cautious licensing policy, requesting from candidates convincing arguments that, arising from its presence, the new financial institution should contribute to the improvement of banking intermediation, adding new value to the market through the offer of innovative products. Therefore, in recent years, licences have been issued only to foreign branches and subsidiaries. In this regard, the entering of Citibank, Deutsche Bank, ING, BNP Paribas, ALPHA Bank, etc. on the Bulgarian market is a sign of a stable and sustainable banking system with the potential for the future development and deepening of credit intermediation.

As at the end of 2006, about 75% of assets in the banking system are managed by financial institutions with residences in member countries of the EU.

### Role of foreign banks

In recent decades, the structure of banking systems worldwide has been undergoing deep changes. The entrance of foreign banks is a dominant and characteristic feature of that process, foreign banks (or domestic banks with foreign participation) in a number of countries have been becoming major players in domestic financial markets.<sup>4</sup> It is assumed that the increased presence of foreign banks, especially in developing countries, is a result of the financial liberalisation processes of local economies but, in some countries, banking crises and the consequent necessity of resources for the recapitalisation of the banking system has helped the accelerated entry of foreign players.

Two main ways through which this has been done are known from practice: firstly, the acquisition of an existing domestic bank; and, secondly, an independent presence through an office or a branch. The separation of these two ways is of substantial significance as entry to a foreign market through independent representation increases the number of banks and the rate of competition (usually, it leads to a greater fragmentation of the system); while the acquisition of operating banks is, in most cases, effected through mergers and takeovers which may reduce the number of credit institutions and the rate of competition (usually, it increases concentration).<sup>5</sup>

Logically, the question arises here as what motivates banks' decisions to expand their activity beyond the limits of the country of their establishment. The traditional notion in that direction is that banks enter foreign markets to follow their clients. Accordingly, the internationalisation of banking systems is a result of increasing foreign direct investment in the non-financial sector. Despite the existence of such a correla-

4 We refer hereinafter to: Inter-American Development Bank (2005) *Unlocking credit* Chapter X pp. 129-139.

5 In recent years, the notion that a positive relationship exists between the concentration rate and the stability of the banking system is gaining an upper hand. See: Beck, T. A. Demirgüç-Kunt and R. Levine (2005) *Bank Concentration and Fragility: Impact and Mechanics* NBER Working Paper No. 11500.

tion, it is stated in specialised academic publications that it is not possible to ascertain whether foreign direct investment gives rise to the entry of foreign banks, whether the entry of foreign banks is the reason for foreign direct investment, or whether the relationship between them is determined by other factors that could not be reliably assessed by econometric equations.

Another theory suggests that foreign banks enter countries where they can see profitable opportunities for their activity combined with a good institutional and macroeconomic environment. In harmony thereof, Focarelli and Pozzolo (2001) find out that foreign banks tend to enter countries characterised by high economic growth, low inflation, a high capitalisation of the stock market and a less efficient domestic banking system. That research provides evidence which supports the notion that foreign banks enter a given market not to follow their clients but rather to take advantage of profitable prospects in the domestic economy.

From the specific economic policy point of view, the substantial question remains as to whether foreign banks play any useful role by supporting the deepening of credit intermediation and credit stabilisation or whether their presence does not have as much of a favourable effect. Normally, the potential advantages are related to the improvement of the functioning of the payment system, risk management and the implementation of technological innovation and more modern monitoring approaches. As regards countries of the so-called group of developing markets, some authors add higher efficiency and the decrease of non-performing loans to such advantages.

Potential concern over the presence of foreign banks is related to the possibility that they would be the first to 'close the doors' in the case of a crisis – leaving the market, giving rise to a leakage of capital which would, other conditions being equal, lead to a pro-cyclical behaviour of credit and an increase in economic volatility. In addition thereto, there exists another assertion according to which the substantial presence of foreign banks may oust (or crowd out) the activity of domestic banks because of the availability of good reputation and competitive advantages. Taking in consideration the assumption that foreign banks lend mainly to big companies, any crowding out of domestic banks from the market would be problematic because it could lead to a curtailment of access to credit funds to small and medium sized companies operating in the country which are especially dependent on bank financing. Finally, foreign banks may import negative shocks from the countries of their main business location. Actually, such evidence does exist: an outstanding example is the abrupt increase in real estate prices in Japan at the beginning of the 90s which led to a contraction of the credit facilities of Japanese banks in the USA.

### **Condition and prospects before Bulgarian banks**

Increased competition in the Bulgarian banking market as a result of the entry of foreign banks, as well as resulting from the integration of Bulgarian banks in an over-competitive European financial market after the accession of the country to full membership of the EU, imposes on banks the need to seek ways to create new forms of competitive advantage. In the conditions of the internet and the development of information and communications technologies, the competitiveness of Bulgarian banks may be underpinned by the development of new distribution channels for banking services – i.e. electronic ones – as well as by the implementation of business information systems to facilitate and strengthen the customer-bank relationship.

Development of electronic channels for the distribution of banking services has certain advantages and positive effects for banks as well as for consumers. The positive effects for users are as follows:

- 24-hour access to banking services
- facilitating the selection of banking services that meet the needs of various clients
- a decrease in the prices of banking services, while retaining at the same time the quality of the services offered, mostly from the perspective of saving time as a result of the elimination of personal visits to bank branches.

For the bank, the advantages of virtual bank branches and electronic banking are expressed in:

- much lower expenses
- a practical versatility as regards the territorial scope of banking activity.

In Bulgaria by the end of 2006, 91% of all commercial banks had websites while 77% rendered e-banking to their clients; these figures specifically for the branches of foreign banks were that 83% of all commercial banks had a website while 50% rendered electronic banking services to their clients (see Table 1).

**Table 1 – Online presence of Bulgarian commercial banks and the development of electronic banking in the Bulgarian banking system**

Indexes	Number of banks	Banks with website	Banks with e-banking
1. Banks with full licences	29	27	24
2. Branches of foreign banks	6	5	3
3. Total for the banking system	35	32	27

Source: author's calculations

A majority of the banks have, in addition to electronic banking, developed the MultiCash system which provides the possibility to monitor via the internet the condition of and movements in bank accounts and progress on transfer orders, to receive updated reference information on currency exchange rates and interest rates and to facilitate currency purchases and sales and securities transactions.

Yet, the still-pervasive mistrust of communications over the internet is a problem for the development of electronic channels for the distribution of banking services, especially regarding the processing of documents and financial operations. This is obvious in that the conduct of money and banking transfers via the internet occupies only third place in Bulgaria among preferred online services (17% of preferred online services), after the purchase of mainly printed materials and books (50%) and foodstuffs, flowers and gifts (33%). One must also bear in mind that citizens are more sceptical than businesses towards the usage of electronic financial services. The reason for this is that most consumers, in contrast to businesses, define personal contact as more efficient. We should point out that every second individual between 18 and 29 years of age, and every third one between 30 and 39, using the internet in Bulgaria are inclined to try the utilisation of financial services and the ordering of money and bank trans-

fers, without much being embarrassed as to whether it could compromise their security and damage their finances.

Competitiveness of the banks, on the Bulgarian as well as on the European market, may guarantee a strengthening of the customer-bank relationship through the implementation of a customer relationship management system. That means a re-orientation of the marketing of banking institutions from transaction marketing to relationship marketing. The main idea of the concept of relationship marketing is that what determines the market success of an organisation over a continuous period of time is not only satisfying customers' needs, but also the building of long-term partnerships between customers and the organisation based on mutual trust and co-operation. The major principles of relationship marketing are:

- the collection of information on customers which is as full and as updated as possible
- the satisfaction of customers' individual preferences
- individualisation of relationships with customers
- intensive dialogue with customers.

Marketing in Bulgarian banks in recent years has also been built up on such principles, the penetration of foreign banks having activated the process of seeking the most efficient tools through which banks acquire, bind and build up loyal customers. According to the research of *CIO* magazine, banks in Bulgaria in 2006 increased their expenditure on the building of business information systems for customer relationship management by about 25%.

One of the tools in binding customers, intensively developed by all banks and which appears to be an integral part of the customer relationship management system, is a service policy. The objective is not only the better servicing of customers but also a greater differentiation of banking services. For customers, a good service policy and a good service means a rendering of consultation on the selection of banking services and a competent individual recommendation corresponding to the complexity of the products and the risks related thereto. According to a study carried out by *International Service Check* in March 2007, the competency of officers in three-fifths (59%) of the thirteen Bulgarian banks visited was evaluated as excellent while it was average in the remaining 41%.<sup>6</sup> Foreign lending institutions have competitive advantages as regards the building of a good service policy as they are able to utilise the experience of many other countries and also because they have greater financial resources at their disposal. Due to these reasons, it was a foreign bank that, in 2006, found one of the most original solutions for prompt and competent consultancy for consumers concerning the selection of financial services: this was Raiffeisen Bank, which offers its clients meetings with a mobile banking consultant on a free of charge basis.

A good banking service policy should mandatorily encompass internet banking. However, the most important thing about internet banking is that ways must be found to facilitate customers' contact with the bank in order that the customer may receive competent assistance. One of the most frequently used tools of internet banking to facilitate contact between the customer and the bank is a database of most frequently

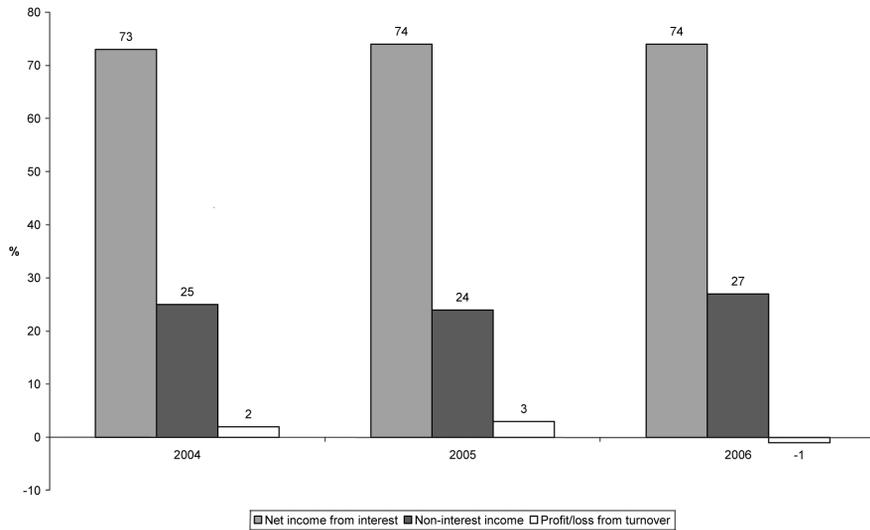
6 Full information on the study can be accessed from [www.international-service-check.com](http://www.international-service-check.com).

asked questions (FAQs).<sup>7</sup> A FAQs database is a simple and cheap way for the customer to view answers to questions that have arisen during the process of searching for an appropriate banking service. Another way to facilitate contact between the customer and the bank is the call centre. The advantage of this is expressed in the possibility of integration with interactive voice response software through which routine procedures, such as the presenting of reference information, the current balance of the customer, etc., may be automated upon the acceptance of requests to the call centre. Due to the greater experience and financial resources, it was again a foreign bank operating on the territory of the country – ProCredit Bank<sup>8</sup> – which, in 2006, established the witty advertising slogan for its call centre, namely: ‘Call your money!’.

Another important tool on which banks in Bulgaria are staking their responses and which they are developing for the purpose of binding their customers is the expansion of the product portfolio of offered services. According to Bulgarian National Bank statistics, financial intermediation expressed in terms of income from fees and commissions outside deposit and credit activity continues to occupy a lower share than the average for the European banking system<sup>9</sup> (see Figure 1). Therefore, scope for the development of financial services and opportunities for the realisation of higher non-interest income exists in our market. In this relation, credit institutions are staking themselves on the implementation of a number of innovative and, for the Bulgarian consumer, non-traditional financial services in view of filling the market niche which has been opened. At the present moment, the ‘ePay VoiceMultiCash’ system is under construction, which will ensure the possibility of paying electricity, central heating and GSM bills via a debit and/or credit card.

- 7 The FAQ database is built under a question-answer schema, the customer selecting a question and with the relevant prior formulated and reserved answer being shown. In order that the eService tool is most efficient, it is especially important that ‘the right questions’ are stored in the database, i.e. those which are most frequently asked by customers, for instance in the call centre or by e-mail.
- 8 On June 2001 in Frankfurt, a shareholding agreement was signed for the establishment of ProCredit Bank, a new micro-financing institution in Bulgaria. Currently, EBRD, Commerzbank, ProCredit Holdings and IPC GmbH are its shareholders.
- 9 Annual report of the Bulgarian National Bank, 2006, p. 45.

Figure 1 – Structure of business revenues of the banks in Bulgaria



Source: BNB *Commercial banks in Bulgaria, October-December 2006.*

So-called mobile banking is also in the process of development which will grant the possibility for customers, via the installation of software on the SIM card of their mobile phones, to make payments for smaller transactions, such as sales network bills, public utilities, parking charges, etc.<sup>10</sup> For the time being, fifteen banks have shown interest in building a mobile banking system in Bulgaria, as have the three GSM operators in the country.<sup>11</sup>

As a result of international agreements between the major banking groups, strategic co-operation agreements in the field of services for customers and companies, which enjoy wide popularity in developed countries, have also started to appear on the Bulgarian financial credit market. Proof thereof is the partnership agreement signed at the end of 2006 between Piraeus Bank Bulgaria and the Bulgarian branch of ING group. This provides that Piraeus Bank will render banking services, life assurance and pensions security products to citizens who are customers of the Dutch financial group while, for its part, ING will focus on corporate and investment banking.

10 According to a study by *Economist* magazine, shopping via mobile phones is developing dynamically in the USA, Asian countries and some European countries, the forecast being that mobile payments worldwide shall increase from \$3.2bn in 2003 to \$37bn in 2008 (see: 'The end of the cash era. Welcome the coming age of electronic money, but safeguard the anonymity of cash' *The Economist* 15 February 2007 [http://www.economist.com/opinion/displaystory.cfm?story\\_id=8702890](http://www.economist.com/opinion/displaystory.cfm?story_id=8702890) [accessed on 3 March 2007]).

11 At the end of June 2007, the Bulgarian National Bank expressed its consent for the licensing of the mobile settlements company SEP-Bulgaria, subject to the following technical requirements: depositing a registered capital of BGN 5m; finding a suitable building; and hiring qualified experts.

The scheme has been already tested in Greece, where the two financial groups have engaged in a strategic partnership since 2002 in the form of a joint partnership in bank insurance and asset management.

## Conclusion

There is no doubt that the processes of integration and the globalisation of the financial industry are inevitable. In view of the full EU membership of Bulgaria and the free access of European financial credit institutions to the domestic market,<sup>12</sup> the role of foreign banks and banks with foreign participation shall continue to build the contemporary appearance of the banking sector in the country.

Due to their experience in other countries and their greater financial resources, foreign banks are finding more attractive and better solutions to build strong competitive advantage, thus deepening credit intermediation and contributing to the development of various and innovative financial services which will stimulate the economic development of the country.

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[www.international-service-check.com](http://www.international-service-check.com)

- 12 According to the Credit Institutions Act (*State Gazette* No. 105 of 2006), any bank licensed in a member country of the EU may operate on the territory of Bulgaria simply after notifying the Bulgarian National Bank. The same is also valid for Bulgarian banks that wish to open a branch on the territory of a member country of the EU after notifying the respective central bank.