BULGARIAN BANKING SECTOR

OVERVIEW

Focus on the Interest Rates

Analysis by ELANA Trading

Sofia, April 2013

Banking Sector

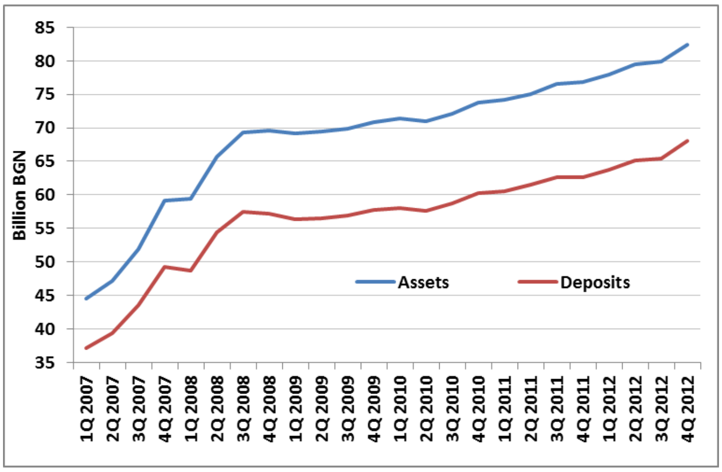
Bulgarian banks finished the controversial 2012 with substantial losses in December for the first time during the last ten year. The main reason is the rising level of impairments for bad loans. During the total 2012, profits in the banking system were positive and only a few banks operated on loss. The double increase of impairments in December as compared to the average monthly level was not a problem for banks. The quality of credits, excluding consumer loans, did not improve substantially last year. The decrease of profits in the banking system is not only a function of non-performing loans but also of rising deposits. This is why we expect a continuing trend of interest rates decrease in 2013 and gradual write-off of bad loans.

Deposits are leading to growth in assets

Banks tolerate the growth of deposits

The stable growth of deposits is the driving force behind the rising assets, which increased by more than BGN 5.4 billion in 2012. Banks may control the level of loans, although the deposits are function of the uncertainty in the economy and the safe-heaven attitude of savers in Bulgaria. The deposit glitch should lead to increase in lending activity but it is not sufficient condition for change of market conjuncture.

Graph 1



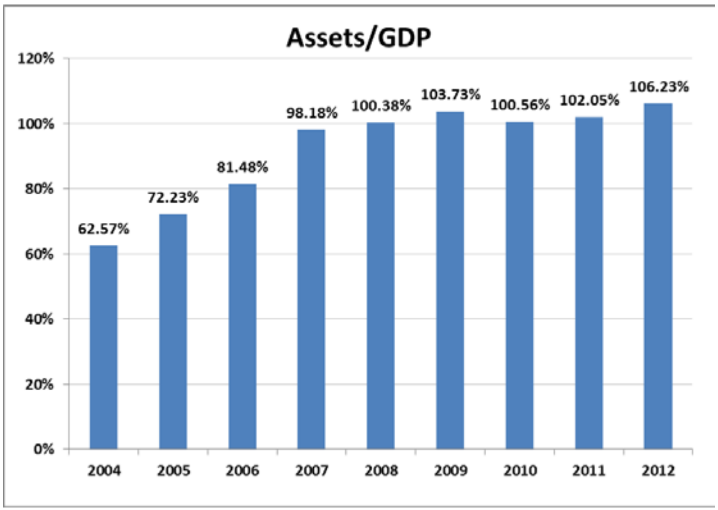
Source: Bulgarian National Bank

The assets in Bulgarian banking sector added BGN 2.5 billion in the fourth quarter only. The growth resumed after a brief pause during the summer months of last year. Gross credits represent 78% of assets, which is the lowest level since summer of 2007.

BGN '000	2005	2006	2007	2008	2009	2010	2011	2012
Total Assets	32 850 884	42 194 864	59 089 503	69 560 455	70 867 899	73 725 696	76 811 182	82 415 660
Total Gross Loans	24 222 552	31 393 273	45 875 596	56 938 525	59 852 752	61 508 298	64 352 181	64 725 969
As Percentage of Assets	73.73%	74.40%	77.64%	81.85%	84.46%	83.43%	83.78%	78.54%
Total Loans to NFIs and Other Clients	18 379 092	22 770 569	37 950 637	50 189 461	52 449 151	53 854 013	56 043 694	57 840 617
As Percentage of Assets	55.95%	53.97%	64.23%	72.15%	74.01%	73.05%	72.96%	70.18%
Total Claims on Financial Institutions	5 843 460	8 622 704	7 924 959	6 749 064	7 403 601	7 654 285	8 308 487	6 885 352
As Percentage of Assets	17.79%	20.44%	13.41%	9.70%	10.45%	10.38%	10.82%	8.35%

Source: Bulgarian National Bank

Graph 2



Source: Bulgarian National Bank, National Statistical Institute

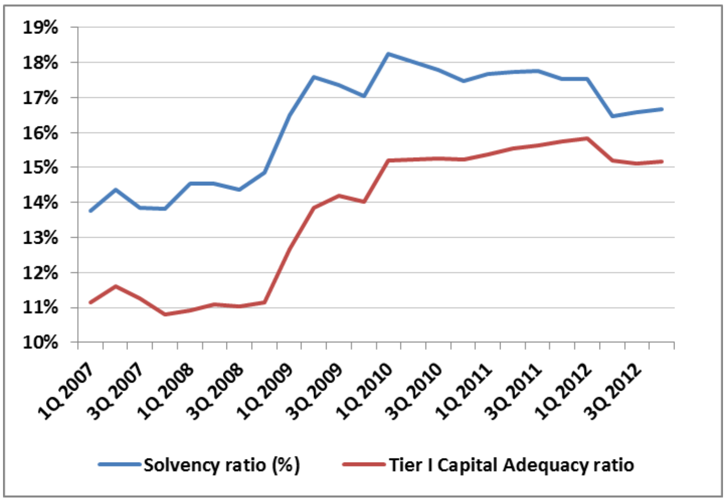
The ratio assets-to-GDP will increase slightly

The economic growth in the country was largely powered by the credit activity of banks. Since 2007 onwards, the level of assets is relatively constant with respect to the nominal GDP. The saving rate of the population is relatively high, as deposits of the private parties grow faster than the rest. Strong increase in the assets-to-GDP ratio could appear only after structural changes in the banking sector such as shifting the focus on investment banking sector. However, this is not a very likely scenario and we expect only a slight increase in 2013.

Banking capital is withstanding the bad loans

The high level of equity, together with the accumulated provisions and profits, prevented the financial system from bankruptcy of banks due to non-performing loans.

Graph 3

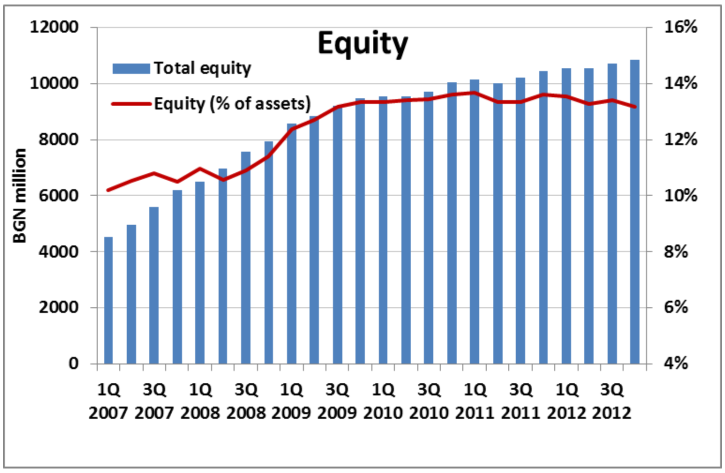


Source: Bulgarian National Bank

Banks are secured with sufficient amount of capital

The capital adequacy of the banking system remains very good but both ratios declined last year. The change is due to the slow improvement of the tier one equity of banks as comparing to the requirements. Some banks were given recommendations from the central bank to raise capital in order to improve their capital adequacy.

Graph 4



Source: Bulgarian National Bank

Assets are growing faster than equity

During the post-crisis years, the equity of banks followed the growth of assets, maintaining a stable share of 13.5%. The change in the trend is already in place as the equity began to lag behind the increase of assets. Banks attract deposits and are the preferred place for savings. At the same time, the equity is under the pressure of deteriorating profits. Our forecasts are mainly for decrease of equity-to-assets, followed by a pressure on interest rates.

BGN '000	2005	2006	2007	2008	2009	2010	2011	2012
Total Equity	3 446 356	4 388 784	6 208 461	7 930 886	9 456 575	10 032 261	10 448 465	10 850 070
Issued capital	1 212 322	1 502 447	2 093 523	2 623 631	3 323 381	3 454 942	3 742 320	3 841 993
As Percentage of Equity	35.18%	34.23%	33.72%	33.08%	35.14%	34.44%	35.82%	35.41%
Revaluation reserves	216 304	262 878	248 915	137 295	275 406	258 938	248 820	353 889
As Percentage of Equity	6.28%	5.99%	4.01%	1.73%	2.91%	2.58%	2.38%	3.26%
Reserves	1 433 367	1 812 727	2 507 058	3 569 346	4 818 076	5 373 529	5 560 468	5 776 585
As Percentage of Equity	41.59%	41.30%	40.38%	45.01%	50.95%	53.56%	53.22%	53.24%
Income from current year	584 235	807 590	1 143 558	1 386 749	780 192	616 663	586 141	566 842
As Percentage of Equity	16.95%	18.40%	18.42%	17.49%	8.25%	6.15%	5.61%	5.22%

Source: BNB; Calculations: Elana Trading

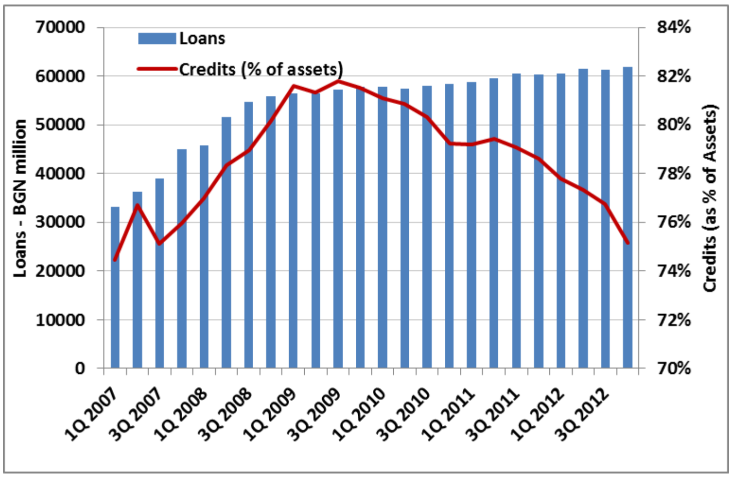
The equity of Bulgarian banking system continued its positive trend last year. The increase is mainly due to the accumulated profits as capital raise was an exceptions rather than regular policy of banks since the crisis in 2008. The income from current year is at its lowest level for the last eight years. We don't expect profits to have substantial contribution to capital in 2013.

Lending continues to fall behind

Loans are declining compared to assets

Bank loans as percentage of the total assets are at the level of 75%, which is comparable to the average in 2007, when the economy grew fast and banking credits were among main driving forces for it. The situation currently is different – landing activity is lagging the rising assets and it is too early to call for a stabilization of the ratio. It will require improvement in the business climate in the country and more active policy of banks toward new credits. The result should be a positive contribution from banks to the economic growth but it is unlikely to happen in 2013.

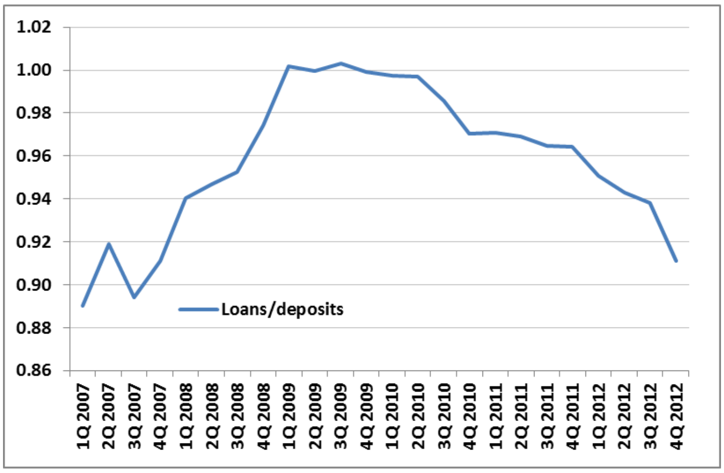
Graph 5



Source: Bulgarian National Bank

The increase of loans will continue in a small pace, although some changes in the structure will be much more significant. This trend is not suggesting an improvement of the economy or the profits of the banking system. On the contrary, the decline of the ratio of loans-to-assets is a clear sign of forthcoming pressure on the profitability of the banks.
Banks are in fact increasing their credits to large Bulgarian companies faster than the average growth, which is compensating the deleveraging of small companies and among households.

Graph 6

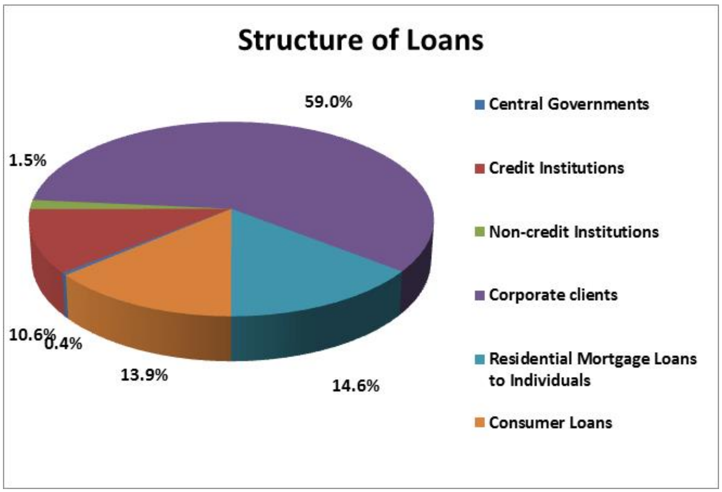


Source: Bulgarian National Bank

The level of deposits will grow faster than credits

The loans-to-deposits ratio is also in steep decline during the last year. The main reason was mentioned so far – rising deposits and limited credit activity of banks. The trend is not changing this year and our expectations are for continuation of current policies of banks at least during the first half of 2013. The economic situation is not favoring the risk taking of banks in an environment of limited investments and consumption.
Loans fell to 2007 level when compared to deposits. This is our main motive to expect changes in interest rates as the profitability will deteriorate due to rising interest expenses. We expect a larger decline of interest on deposits than rates on credits.

Graph 7



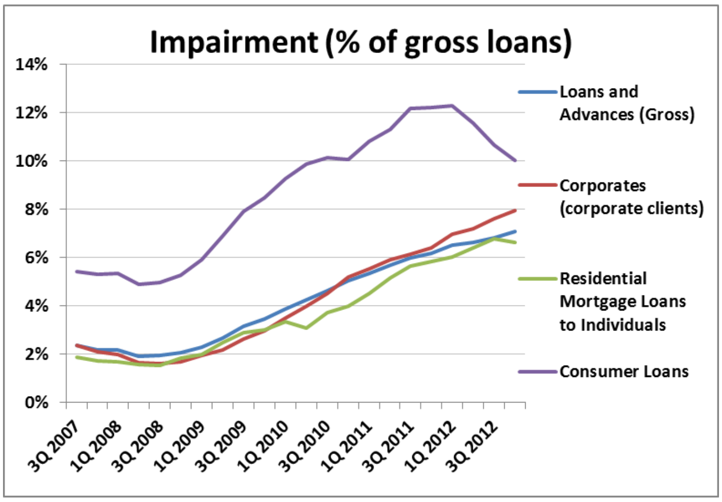
Source: Bulgarian National Bank

Corporate credits are gaining share

The changes in the structure of credits for the second half of the year was only limited as comparing to our previous analysis. It concerns credits to corporate clients and to other financial institutions. Corporate loans increased their share to 59% of total credits, whereas the decline of credits to banks was 3 percentage points and they represented 10.6% of the aggregate credit portfolio of Bulgarian banks.

Exposures to retail clients were 28.5% and their increase is small for the last six months. The retail credits were equally divided between mortgage and consumer loans. However, the negative trend of consumer credits is stable and they fell below BGN 9 billion. This is their lowest level since mid-2008.

Graph 8



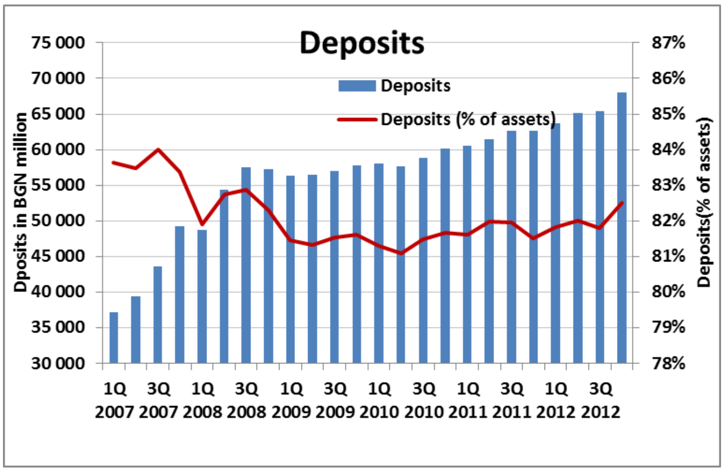
Source: Bulgarian National Bank

The risk of losses remains high

The quality of consumer credits are improving and the impairment fell to 10% of gross consumer loans. Nevertheless, they remain the most risky asset in the bank portfolios. Mortgage loans are also improving in term of impairment level, although it is only a slowdown in the increase but we expect to see a peak in impairments this year for this type of loans. Corporate credits will improve the last due to the economic uncertainty and the financial difficulties. The level of impairment is lower as compared to consumer loans but they have substantially higher volumes and are the main concern for the bankers. The risks of new losses are still high and we will see additional increase in non-performing loans and impairments.

Stable growth of deposits

Graph 9

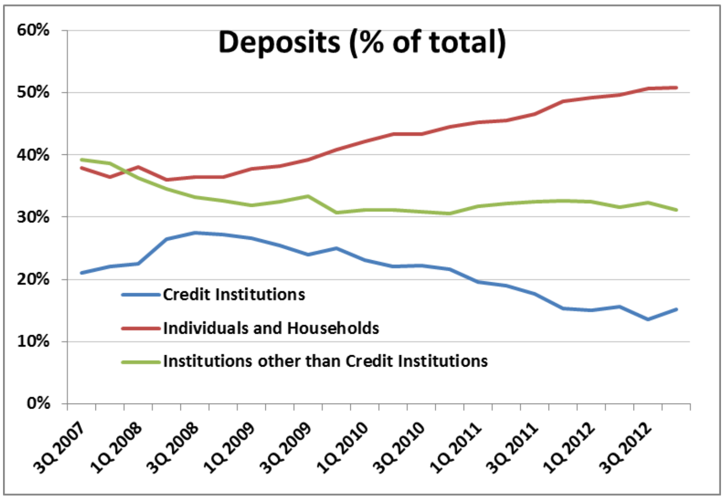


Source: Bulgarian National Bank

Record level of deposits

The end of 2012 was marked with solid increase of deposits to the level of BGN 68 billion. The nominal growth is outpacing the increase of assets as equity is lagging. The result is the highest percentage of deposits in the balance sheets of banks for the last four years. The trend looks stable and will force banks to cut interest rates on deposits this year. The calculations for the graph exclude the attracted liabilities other than deposits.

Graph 10



Source: Bulgarian National Bank

Deposits of households have the fastest growth

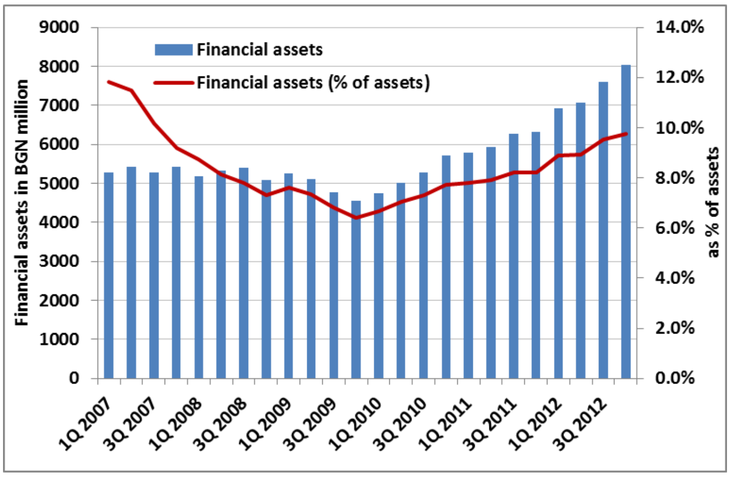
Deposits of households have already reached 50% of the total attracted funds. They are rising faster than other attracted funds in the system. The saving rate of Bulgarians is high. Deposits of households jumped 12.4% as compared to the meager 3% growth of corporate deposits in banks. The interest rates are less than the increase of deposits and we expect that total deposits will grow with double-digit percentage.

BGN '000	2005	2006	2007	2008	2009	2010	2011	2012
Total Assets	32 850 884	42 194 864	59 089 503	69 560 455	70 867 899	73 725 696	76 811 182	82 415 660
Total Deposits	25 412 517	33 188 318	49 271 146	57 246 776	57 834 931	60 211 232	65 606 584	70 701 795
As Percentage of Assets	77.36%	78.65%	83.38%	82.30%	81.61%	81.67%	85.41%	85.79%
Deposits of Financial Institutions	4 966 384	5 628 307	10 266 006	15 304 824	14 399 190	13 082 797	10 018 514	10 723 929
As Percentage of Assets	15.12%	13.34%	17.37%	22.00%	20.32%	17.75%	13.04%	13.01%

Source: Bulgarian National Bank

Deposits of the credit institutions represented 13% of the total assets, which is the lowest level for a decade. Part of these funds came from foreign banks but their level decreased substantial for several years after the crisis. They are no longer an essential source of finance for banks.

Graph 11



Source: Bulgarian National Bank

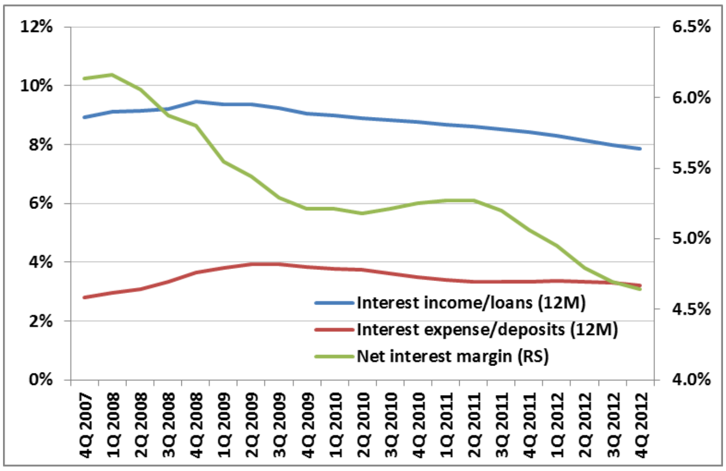
Banks invest their free cash resources in financial instruments

Banks increased steadily their financial assets during the second half of 2012 to the level of 10% of total assets, reaching the highest share since end-2007. The financial assets include those held for trading, those designed at fair value through profit or loss, the assets available for sale and investments held to maturity. Their total value is exceeding BGN 8 billion.

Financial Results

The banking system achieves net profit despite the large depreciation of assets. This is due to the high interest rates on credits and the relatively low level of impairment considering the bad loans.

Graph 12



Source: Bulgarian National Bank

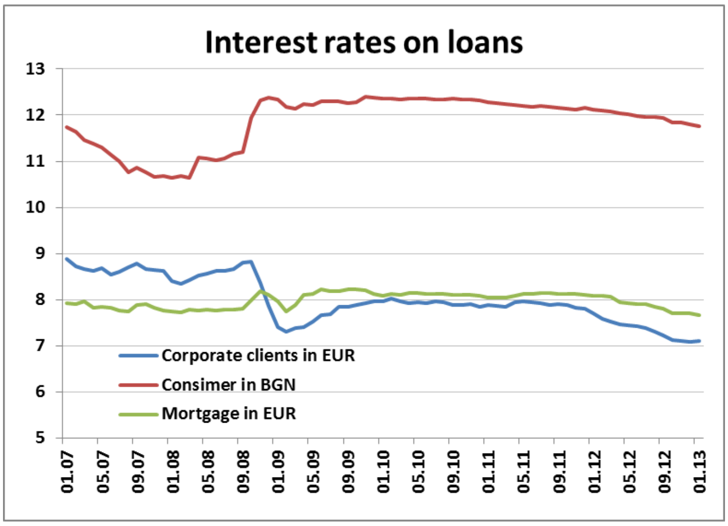
Interest margin is stabilizing

The value of the net interest margin shrank further over the second half of the year, although the decline is flattening. The main reason was lower interest income from loans. Banks are more aggressive in lowering rates on credits as compared to interest on deposits. The second half of 2012 is the beginning of period of stabilization of interest margins. Interest expenses are also declining but we expect that net interest margin will fall further during the first half of 2013.

The dynamics of interest rates

We expect that net interest margin will decline and stabilize on the level of 4.5%. Interest expenses will decline substantially to compensate the stable trend of declining interest income. Banks are forced to make changes in their interest rates policy.

Graph 13



Source: Bulgarian National Bank

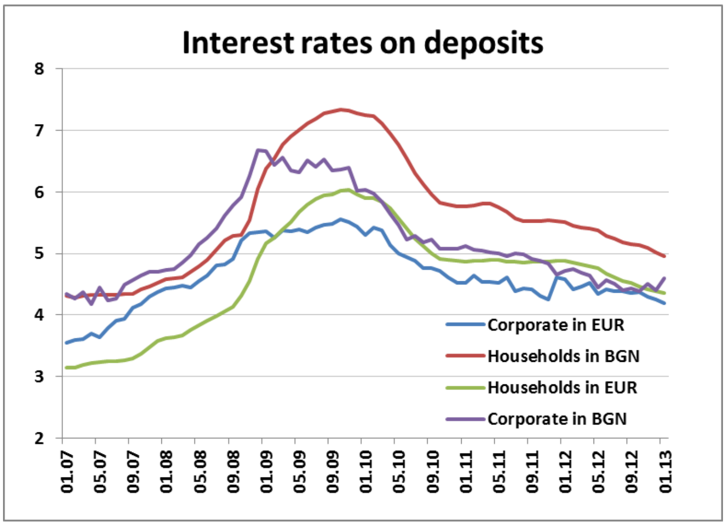
Banks reduce the interest rates for corporate clients

Interest rates on credits in euro for corporate clients are remaining at stable levels at the end of 2012. The decrease last year was 1 percentage point as banks continued to operate in very competitive market. Their efforts to attract new clients target solvent and profitable Bulgarian companies. At the same time, many existing loans have renegotiated terms and interest, including a grace period for the principal and the interest. The new conditions are decreasing defaults on corporate loans and banks are maintaining their cash flows as debtors are facing serious payment problems.
The decrease of interest to individuals is lower but the levels on consumer loans are substantially higher.

BGN '000	2005	2006	2007	2008	2009	2010	2011	2012
Total Assets	32 850 884	42 194 864	59 089 503	69 560 455	70 867 899	73 725 696	76 811 182	82 415 660
Interest Income	1 957 287	2 433 068	3 419 488	4 918 001	5 161 490	5 070 996	5 029 255	4 816 401
As Percentage of Assets	5.96%	5.77%	5.79%	7.07%	7.28%	6.88%	6.55%	5.84%
Interest Expenses	599 394	842 003	1 247 907	2 130 369	2 314 459	2 153 762	2 160 282	2 190 922
As Percentage of Assets	1.82%	2.00%	2.11%	3.06%	3.27%	2.92%	2.81%	2.66%
Net interest income	1 357 893	1 591 065	2 171 581	2 787 632	2 847 031	2 917 234	2 868 973	2 625 479
As Percentage of Assets	4.13%	3.77%	3.68%	4.01%	4.02%	3.96%	3.74%	3.19%

Source: Bulgarian National Bank; Calculations: Elana Trading

Graph 14

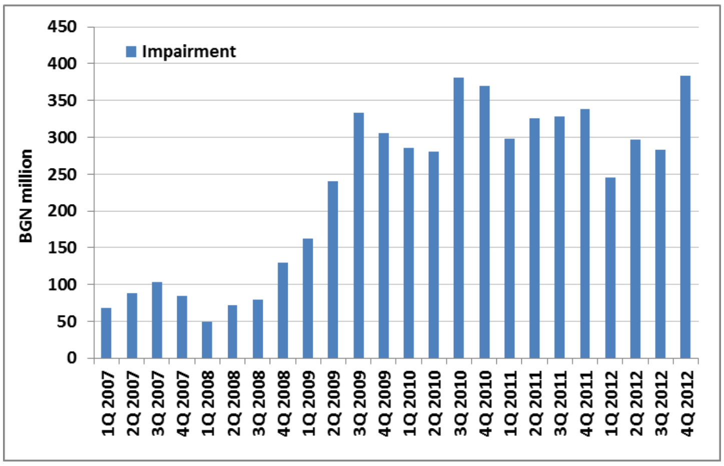


Source: Bulgarian National Bank

Decline of interest rates on deposits

The stability of interest rates on deposits persisted until the beginning of 2012. Rates posted a small but regular decline last year with the exception of rates on corporate deposits in BGN but the divergence is small and it is not expected that interest rates in local currency will be increased in near future. Household deposits in BGN have the higher interest rates and are in tight correlation with the level on deposits in euro for individuals. Levels are higher than 2007, when banks relied substantially on cheap resources from abroad.
The expected tendency of interest rates decrease in 2013 is a continuation of the current situation on the market and we don't expect a similar to 2010 plunge. Banks are still focusing on deposits to maintain their client base among households. Further decrease of interest rates to levels of 2007 will require at least 2 years.

Graph 15



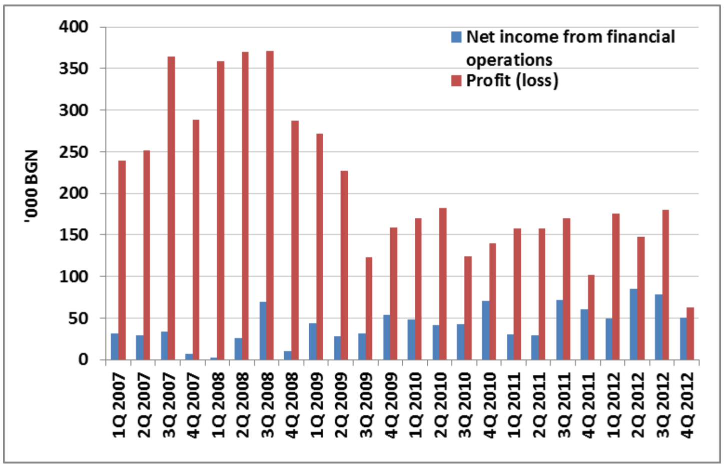
Source: Bulgarian National Bank

Impairments will remain high

Impairment costs increased significantly during the last quarter as compared to the average for the year. However, the reduction in impairment costs that was observed during the first quarter does not match a decline in the bad loans. Therefore, the observed decline was only temporal. Banks are usually increasing impairment costs at the end of the year, which has negative impact on the profits.

We expect that banks will maintain high level of impairment costs in 2013 due to the large share of non-performing loans. Impairment costs will decrease, following an improvement of credit quality, mainly in corporate loans. It will require better business climate and investments.

Graph 16



Source: Bulgarian National Bank

Banks count on financial profits

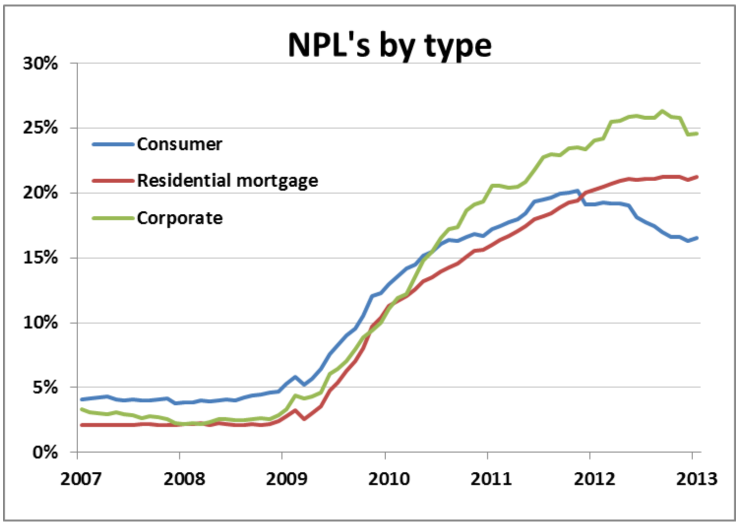
Bulgarian banks posted their worst quarterly financial results for a decade at the end of 2012. The profit is mainly due to operations with securities as banks have significant exposures in Bulgarian government securities. Bonds jumped last year, following the solid capital inflows from institutional investors. However, the profit margins of banks are continuously deteriorating due to strong increase of impairment costs and the decrease of net interest margins.

The percentage of assets invested in financial instruments is rising to 9.7% of total assets. Banks are big buyers of Government bonds that are substitution to the limited growth of credits to corporations and household.

FACTORS FOR DECLINE OF INTEREST RATES

The decline of interest rates on loans and deposits will have substantial effect on the economy, most probably a positive one for the growth during the next several years. This process has already started, although effects on the economy are not visible yet. However, the banking system is under the influence of factors that are inevitably leading to lower interest rates and change in the profit margins of banks.

Graph 17

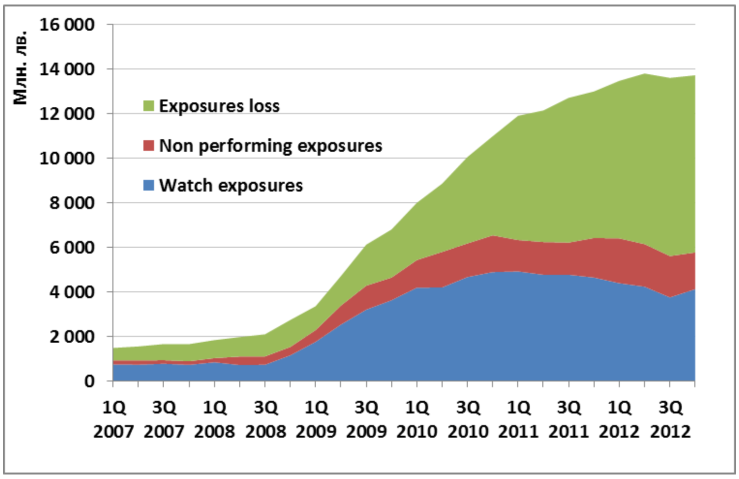


Source: Bulgarian National Bank

Peak of NPLs

The statistic for non-performing loans is suggesting that two of the main types of credits are peaking. Bad consumer loans reached 20% of gross loans at the end of 2011, whereas corporate credits peaked last year and are improving since then. Residential mortgage loans are still at their highest levels of NPLs, although the increase stalled and we consider it as a positive sign for future improvement of credit portfolios.

Графика 18



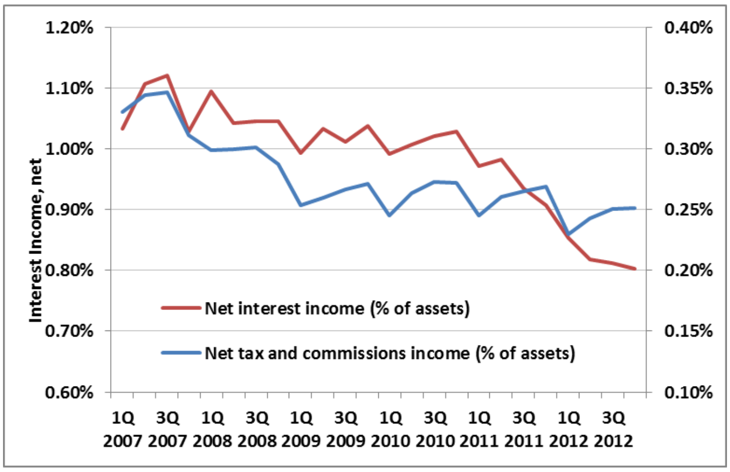
Source: Bulgarian National Bank

Only a temporarily worsening of loans

Watch exposures increased during the fourth quarter of 2012, following the economical hurdles that many sectors are facing. We expect a continuation of the current uncertainties during the first half of 2013 but in less degree. Banks are usually more active in write-off of bad loans at the end of the year. Loans past due 180 days has the largest shares of NPLs. Their increase is fueled by the stable deterioration of other types of

NPLs.
The improvement of banking sector and the economy can be seen in the stabilization of NPLs level and the decrease of watch exposures. This should loosen the pressure on the financial results of banks, although they will increase credits at least after a year.

Graph 19



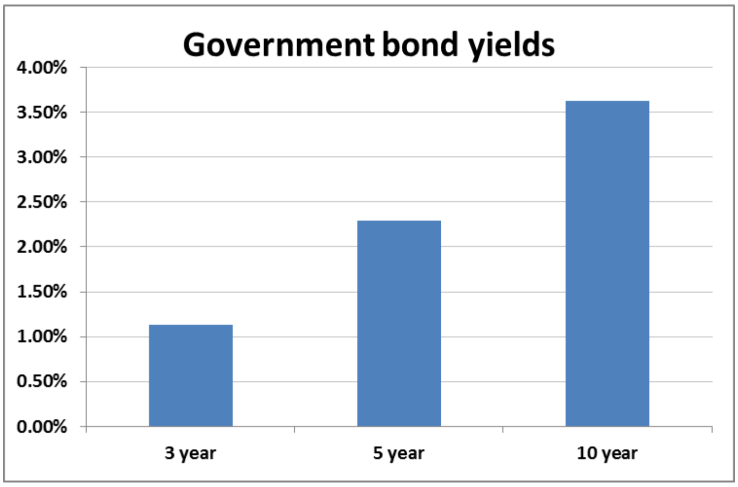
Source: Bulgarian National Bank

Banks should improve efficiency

Net interest income is decreasing from 1.1% of assets annually to 0.8%. This is not a big decline, nor is the decrease of income from fees and commissions. However, it is affecting the profitability of banks. Their long-term strategy should aim at improvement of both ratios to the levels of 2007-2008.

We expect that net income from fees and commissions will maintain in nominal values under the burden of slow economic growth. However, banks could start to increase gradually the fees on selected services. This should be a signal of policy change toward better profitability, followed by a change in interest rates.

Graph 20

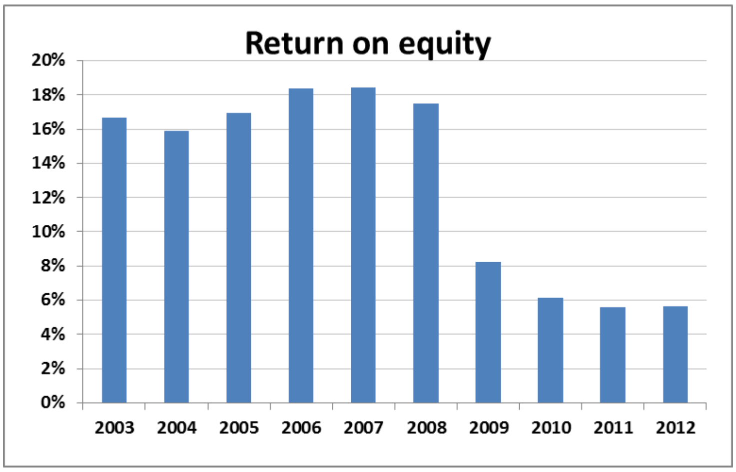


Source: Bulgarian National Bank

Government bonds have risk of losses

Banks rely substantially on investments in Bulgarian government bonds, which have 55% share of all securities or 6.6% of total assets. The yield to maturity on latest auctions for government bonds is substantially lower than average interest rates on deposits. Yields on auctions increased after the resignation of the government in February and banks have losses as compared to the low yields from the end of 2012. The risks at the moment are toward additional losses due to the high supply of bonds, the inflation and rising yields on international securities. This will push down the financial results of banks. The current situation on the bond market in Bulgaria is a factor supporting an increase of bank loans and decrease of interest rates on deposits.

Graph 21



Source: Bulgarian National Bank

The return on equity, calculated by the aggregate financial data of Bulgarian banks, was hardly changed during the last three years. The ratio is 6% and is substantially below the average level of 17% before the financial crisis. This is not a short-term factor for banks to decrease interest rates on deposits. However, they are probably not content with their results and will change interest rates more aggressively.

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HOLD	Market performance, +/-5% as compared to SOFIX and BG40
SELL	More than 5% lower as compared to SOFIX and BG40 performance

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