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BULGARIA

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INTERNATIONAL MONETARY FUND

Monetary and Capital Markets Department

BULGARIA

BANK SUPERVISION

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February 2019

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GLOSSARY

AQR	Asset Quality Review
BMA	Business Model Analysis
BNB	Bulgarian National Bank
BSD	Banking Supervision Department
CAMEL	Bank Rating System (C = Capital Adequacy; A = Asset Quality; M=Management; E = Earnings; L = Liquidity)
EBA	European Banking Authority
ECB	European Central Bank
GC	GC
HHI	Herfindahl Index
ICAAP	Internal Capital Adequacy Assessment Process
ICT	Information and Communication Technology
ILAAP	Internal Liquidity Adequacy Assessment Process
IMF	International Monetary Fund
KRI	Key Risk Indicator
LCI	Law on Credit Institutions
MCM	Monetary and Capital Markets Department
NPL	Nonperforming Loan
OCR	Overall Capital Requirement
SME	Small and Medium Enterprises
SREP	Supervisory and Review and Evaluation Process
SSM	Single Supervisory Mechanism
TA	Technical Assistance
TSCR	Total SREP Capital Requirement

PREFACE

An MCM TA mission visisted Sofia during the period July 16–20, 2018 to assist the Bulgarian National Bank (BNB). Mr. Filip Gijsel, a short-term Bank Supervision advisor for the Monetary and Capital Markets Division (MCM) of the IMF, worked with the Deputy Governor of the BNB in charge of Bank Supervision and the relevant Directors of the Banking Supervision Department (BSD) on the formalization and implementation of a comprehensive Supervisory and Review and Evaluation Process (SREP) that includes an explicit and detailed supervisory Pillar 2 capital requirement, as described in the draft SREP manual that is currently being finalized.

The advisor met with the Directors of the Offsite Supervision Directorate, Onsite Supervision Directorate, Legal Directorate and Supervisory Policy Directorate, and with senior staff members of these directorates. He wishes to express his appreciation to the management and staff of the BNB, for their time and transparency in discussing the issues.

EXECUTIVE SUMMARY

This mission reviewed the formalization and implementation of a comprehensive SREP that includes an explicit and detailed supervisory Pillar 2 capital requirement. The BNB SREP is based on EU-wide common procedures, processes and methodologies, and the draft SREP Manual includes recently proposed changes to the Guidelines issued by the European Banking Authority (EBA). This report therefore focuses on its actual implementation into appropriate and proportionate supervisory assessments and into focused actions and planning.

During the SREP process in 2016 and 2017, the BNB has not identified the need to impose additional capital requirements as per Pillar 2. This assessment has been communicated in all EU-colleges but has not for all banks been summarized in a standardized SREP framework.

The prominent presence on the Bulgarian market of banking groups under direct supervision by the Single Supervisory Mechanism (SSM) causes that SSM processes for the SREP already have a predominant place in the activities of the BSD. The prospect to a regime of "close cooperation with the European Central Bank (ECB) on the supervision of banks" will lead to the introduction of the harmonized procedures and methodologies developed in the SSM for most supervisory processes, including the SREP for all banks, and to the application of a common decision process for most administrative acts.

Unsound banking practices or regulatory breaches cannot be compensated by complementary capital charges. Loan loss provisions and capital charges for loans created as a result of such practices cannot be created and judged on the basis of the common standards. These loans should be isolated in the SREP process and, even when they are performing or not risking to create breaches to risk concentration rules, subject to adapted additional capital requirement for operational (reputational) risk and credit risk, as an interim measure while the deficiencies are addressed.

Proportionality is included in the supervisory approach. The BSD should however limit descriptive quarterly reporting and formally apply the multi-year supervisory cycle based on a minimum engagement, as defined by EBA and put into practice in most EU jurisdictions. This will increase its efficiency and strengthen supervisory efforts in the areas were most results can be expected.

The 2018 SREP will more actively focus on dynamic Key Risk Indicators for credit risk.

Although prudential measures have been taken to strengthen the monitoring of NPL exposures, and to introduce prudent rules for provisioning, the development of global tools to strengthen the supervisory toolkit is still underway.

BSD has developed a methodology for the combined risk assessment and subsequent definition of an additional capital requirement for credit risk. This method is based on the level of NPL's, their aging, their coverage, the relative importance of single large exposures, and the risk level of sector concentration. It incorporates the main risks specific to the Bulgarian banking sector, and rightly gives an important weighting to the quality of risk management and internal control. This approach is close to methods chosen in other countries and fits well to the profile of the Bulgarian banking sector. It will soon be presented to the GC (GC) for immediate implementation during the current SREP cycle**.**

Past onsite inspections and other supervisory work have not yet resulted in a clean-up of inconsistencies and deficiencies in the Internal Capital Adequacy Assessment Process (ICAAP) developed by most banks. Especially for the local banks, the reported ICAAP numbers have not yet achieved the level of reliability that they can easily be used in the SREP calculations, and this while the global ICAAP levels are lower than expected. The new supervisory expectations on stress testing offer a good opportunity to plan well-prepared discussions with the institutions and to include the effectiveness of the ICAAP numbers in the scope of the review

Individual outcomes of the top-down stress tests carried out by the Macroprudential Supervision and Financial Stability Directorate can make a valuable contribution to the SREP. It allows the assessment of the quality of internal control in the institution and its capacity to timely produce complete and reliable data.

When approved, the current draft rules of order of the GC will clearly specify its scope of responsibilities in supervisory matters and the criteria used in the assessment of the motions presented by the Deputy Governor. The BSD should take advantage of the submission of the draft SREP manual for approval, to inform the GC on the consistency of the overall yearly SREP, to globally present the key drivers and supervisory anchor points of the constraint judgments on credit risk in the 2018 review, and to give a global preliminary overview of the expected decisions and its impact on the sector-wide capital requirements.

Proposals for supervisory measures can usefully be substantiated. A comparison to peers or to prudent supervisory anchor points, the expected outcome of the measure, the expected date the situation will be submitted for evaluation, and the possible next steps if the measure is not effective should be added to the proposal.

The communication of the SREP to the banks mentions the amount of the Pillar 2 capital add-on. As the method of the benchmarking or the anchor points is internal, it is not communicated. It is however common practice among supervisors that it be completed by a brief overview of the main findings during the review process, a motivation for the individual risk assessments that have led to scores 3 and 4, and a formal communication of the overall score.

The yearly approval by the GC of the BSD action plan offers an opportunity to communicate the overall outcome of the review process. This can include the main findings and scores, the most important supervisory expectations and global supervisory priorities.

Table 1. Key Recommendations

Area	Recommended Action	Time Frame	Implementing Department/ Directorate
Principle	Loan loss provisions and capital charges for loans granted as a result of unsound banking practices cannot be created and judged on the basis of common standards. These loans should be isolated in the SREP process and, even when they are performing or not risking to create breaches to risk concentration rules, be subject to adapted additional capital requirement for operational (reputational) risk and credit risk.	Sept 2018	Onsite Directorate/ Offsite Directorate
Organization	Formally apply the multi-year supervisory cycle, based on a minimum engagement, and specify to GC that SREP is captured in this cycle of maximum three years.	June 2019	BSD
Organization	Further specify the interaction between directorates and clarify the contributions to the overall assessment of governance and internal control.	Sept 2018	BSD
Business Model Analysis	Invite relevant banks to indicate how and when they test the reliability and feasibility of their business models, by comparing the BMA numbers to data available in budgets and past accounts, and to the data that result from capital planning and ICAAP.	Sept 2019	Offsite directorate
Credit risk	Continue the strengthening of the supervisory toolkit, focused on NPL's and collateral value.	Dec 2019	BSD
Credit risk	Implement the use of a predefined set of Key Risk Indicators (KRI) on credit risk in yearly SREP.	Sept 2018	Offsite directorate/ Onsite
Credit risk	Complete the analysis on the global outcome of the new methodology for the definition of additional capital requirements for credit risk and present the outcome and an overview the expected SREP decisions to the GC.	Immediately	BSD
Operational risk	Introduce assessment of operational risk.	Sept 2019	Offsite directorate/ Onsite
ICAAP	Give high priority to the start of a series of well-prepared meetings with all banks on the effectiveness of their ICAAP outcome.	Sept 2018	Offsite / Onsite Directorate
Stress testing	Use individual outcome of top-down stress tests as input on quality of internal control in the SREP.	Sept 2018	Financial Stability

			Directorate
Decision taking	Justify proportionality by systematic peer review and horizontal analysis and complement information to GC with comparison to peer and to anchor points.	Sept 2019	BSD
Decision taking	Always substantiate motivation and expected effectiveness of proposed decisions.	Sept 2018	BSD
Communication	Combine the yearly approval by the GC of the BSD action plan, with an information on the overall outcome of the review process, the main findings and scores, the most important supervisory expectations and global supervisory priorities.	Sept 2019	BSD
Communication	Complete individual communication of the SREP outcome to banks with overview of main findings and weaknesses, and communication of final score.	Dec 2018	Offsite Directorate

I. INTRODUCTION, SCOPE, AND SUMMARY OF WORK DONE

A. Introduction

1. **The purpose of this assignment is to review the formalization and implementation of a comprehensive SREP that includes an explicit and detailed supervisory Pillar 2 capital requirement.** This process is described in the draft SREP manual (the manual) that is currently finalized in the BSD, is in line with IMF and World Bank missions in 2015, 2016, and 2017 on the observance of the Basel Core Principles by the BNB. This report therefore will avoid rewording of earlier observations and recommendations and the reader is invited to take account of the contents of previous reports.

2. **The main procedures and processes in Banking Supervision and the rights and obligations of the BSD of the BNB are laid down in the Banking Supervisory Process Manual that was approved on February 9, 2017 by the GC.** The procedures and processes with regard to the SREP, by far the most important process in Banking Supervision, is specified in a manual, that will be subject to approval by the GC and form integral part of the Banking Supervisory Process Manual. This approval is expected in the coming months.

3. **Pursuant Directive 2013/36/EU, national regulations with regard to the SREP are harmonized in all EU countries.** All competent authorities are implementing the SREP on the basis of common procedures, processes and methodologies, and convergence is promoted by common Standards and Guidelines issued by the EBA. The consistent and comprehensive implementation of this common framework is regularly assessed by EBA, mainly through bilateral visits and calls, the last of which took place in the second semester 2017. Pursuant the EBA Regulation, the BNB has informed the EBA to comply to these guidelines. As the EBA Guidelines directly apply in all EU countries, it is not mandatory to include all aspects in a national manual. The BNB manual therefore is essentially conceived to outline the concrete actions that are expected from all participants in the supervisory process, and to guarantee the same quality in the work of every officer. The manual fits to this purpose and offers detailed guidance and extensive references to Bulgarian laws and regulations issued by the BNB. There is however no need to strive to a complete copy of the EBA guidelines in the internal document or to publish it. In public communication on the SREP process, the BSD can directly refer to the EBA Guidelines. As the manual does not describe in detail how the SREP process is managed, it is not an instrument to guide the Directors in their work.

4. **In October 2017 new EBA draft Guidelines were issued for consultation.** These Guidelines are more explicit and offer more detailed guidance, they include recent changes in EU regulation, standards and guidelines, and a specific chapter on supervisory stress testing was added. The EBA draft guidelines are expected to be finalized soon and to be applied in the 2019 cycle of SREP and joint decisions. The manual has already been adapted to include these changes in the EBA Guidelines and this report is written on the basis of the version of the manual received on July 4, 2018.

5. **During the mission, the BNB was informed that The Bulgarian Government requested to enter into close cooperation with the ECB on the supervision of banks, as defined in article 7 of the Council Regulation 1024/2013 of October 15, 2013.** The cooperation with the SSM will inevitably lead to substantial changes in the internal organization and the processes in the BSD. The introduction of the harmonized procedures and methodologies developed in the SSM for most supervisory processes, including the SREP for all banks, and the application of a common decision process for most administrative acts, will without doubt create additional workload in the transition period, especially in the Offsite Directorate. The further course and timeline of this request, for which no precedents exist, is not clearly established.

6. **The BNB has categorized the institutions under supervision into four groups, based on size, structure, scope of activities and complexity.** Out of the 11 institutions in the first category, covering the institutions that are identified by the BNB GC as O-SIIs and counting globally for 84 percent[1] of total assets, seven have a working SSM college, led by the ECB. In only two of these colleges, the Bulgarian subsidiary represents more than 5 percent of group capital. The SSM processes for the SREP therefore have a predominant place in the activities of the BSD and for this reason the BNB manual is also inspired by SSM procedures for significant banks. It anticipates the impact of the harmonization of the SREP approach for less significant banks within the SSM.

7. **While capital positions globally are adequate, and soundness indicators have improved, partly as a result of the 2016 Asset Quality Review (AQR), nonperforming loans (NPLs) remain high in Bulgaria, with notable differences between the banks.** Overall, Loan Loss Provision coverage is lowering, partly because of a general tendency of higher reliance on collateral but also—in a limited number of cases—due to banking strategies to reduce the level of NPLs by sales and write-offs. Credit risk remains by far the most important risk driver in the Bulgarian financial sector. It is notably higher than in most other EU countries. The precise outcome of the introduction of IFRS 9 on the level of provisions is yet to be analyzed. As a consequence of the continuous presence in the market of "high NPL Banks," predominantly owned by local shareholders, particular attention needs to be given to the possible impact on this business model of upcoming EU regulation and EBA guidelines on the management of nonperforming and forborne exposures and on the introduction of statutory prudential backstops.

8. **During the SREP process in 2016 and 2017, which coincided for an important part with the extensive and intensive AQR, the BNB has not identified the need to impose additional capital requirements as per Pillar 2 over the internal capital measured by the banks and approved by their senior management.** For that reason, the BNB has not communicated a specific Total Supervisory Capital Requirement (TSCR) and Overall Capital Requirement (OCR) to the banks. This assessment has been communicated in all EU-colleges but has not for all banks been summarized in a standardized SREP framework. In one non SSM EU Group, the 2017 joint capital decision on group level includes a Pillar 2 capital add-on for all subsidiaries, essentially covering the high credit risk profile of each entity in this group.

[1] All numbers on December 31, 2017, unless otherwise indicated.

9. **With a notable exception for one larger local bank, all total capital ratios are comfortably above the OCR ratios.** In eight out of nine larger banks however, the internal capital need specified in the ICAAP is far below this OCR. The sum of ICAAP estimates in that group is only 56 percent of the available capital. On the level of the global market, this ratio even drops to 53 percent. The way in which the banking sector judges its own capital situation is therefore very different from—and significantly less prudent—than the assessment by the authorities.

B. Scope

10. **As regulations and guidelines are harmonized on EU level, this report focuses on the SREP implementation to ensure that draft rules and procedures lead to appropriate and proportionate supervisory assessments and focused actions and planning.** It must be taken into account that the recent changes in the EBA guidelines, the increased attention to business model analysis (BMA) and the extension of the guidelines to supervisory stress testing, will only come into effect in the 2019 SREP cycle. This leaves room to timely develop or adapt supervisory tools and benchmarks.

11. **After discussion with the management of the BSD it was concluded to specifically pay attention to micro stress testing in the ICAAP and SREP process, supervisory benchmarks, especially in relation to credit risk, supervisory reactions, and an efficient and proportionate decision process, and on the communication of SREP outcomes to the banks.**

12. **This mission aims to contribute to the quality and efficiency of the SREP process, and more specifically that**:

- The current process complies with the standards imposed by the EBA and that have been laid down in the manual, taking into account the special characteristics of the Bulgarian financial sector and the characteristics of each institution.
- Banks develop an internal process to determine their optimal capital level in the light of their risk profile and capacity, submitting the report to the supervisor.
- Supervisors review the submission on capital adequacy assessment by banks and develop a process to determine and apply any additional capital requirements that are necessary.
- Supervisor tailor the supervision of individual banks based on the evaluation of each bank's internal capital adequacy assessment.

C. Summary of Work Done

13. **The advisor has reviewed the draft guidelines for the implementation of the Supervisory Review and Evaluation Process (Pillar 2 of Basel) that has been prepared by the BNB, based on the standards and guidelines issued by the EBA.** He discussed the content of the manual with the Directors of onsite inspection and the offsite directorate who cooperated on the drafting, and in a "walk through" followed the steps that lead to the establishment of a final SREP capital and liquidity assessment. He then organised in-depth analysis and discussions

on the assessment system and process, and on the different SREP elements, on implementation and decision process, planning and proportionality and on the communication to the banks.

14. **This report does not provide an overview of the content of the manual, nor does it deal with previous recommendations outside the scope of the SREP.** It aims to give sufficient context to understand the motivation and possible impact of the recommendations that are brought forward. It is in this respect "exception based."

II. THE SREP PROCESS AND MANUAL

A. Principles

15. **The SREP is a key supervisory process and offers a condensed overview of the activities, concerns and future actions of the supervisor.** Even in jurisdictions where the banking sector has made significant progress in strengthening internal control and risk management, these concerns are still valid. Even when overall ratios are adequate, high global risk scores remain recurrent and some individual scores require enhanced supervisory scrutiny for most banks.[2]

16. **Unsound banking practices or regulatory breaches cannot be compensated by complementary capital charges.** EBA guidelines[3] explicitly refer to the possibility to set additional capital requirements to cover the risks posed by deficiencies in control and governance, as an interim measure while the deficiencies are addressed. In recent years public opinion in Bulgaria was shaken by press publications on unsound banking practices, involving excessive loans to parties related to the bank's shareholders and other privileged clients, opaque structures, and shell companies with unidentified ultimate beneficiary ownership.

17. **Loans that have not been granted on the basis of well-developed internal procedures, counterparties whose financial situation is unclear, questionable, or unreliable information on the financial capacity of the ultimate owners, or uncertainties on the profitability of the projects that are financed, all lead to diminished transparency, and therefore to additional credit and operational risk, when compared the risk associated to peer loans that were granted on the basis of standard procedures and a prudent decision process.** When credit risk on these "irregular or imprudent" loans deteriorates, the uncertainties associated to them will inevitably lead to long, complex and costly restructuring or work out processes, and a lower realization value of the guarantees or collateral can be expected.

18. **Loan loss provisions and capital charges for these loans therefore cannot be created and judged on the basis of the common standards**. As suggested by the IMF 2017 stock

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[2] The last SREP cycle in SSM is a useful reference: 12 percent of the global institutions obtain a global score 4 on governance, 57 percent of the banks obtain score 3, and an additional 10 percent have score 4. For business model analysis these scores are 38 percent and 12 percent. Former Bulgarian scores on governance were equally high: 50 percent score 3 and 20 percent score 4.

[3] See par 368 draft EBA Guidelines.

taking mission, these loans should be isolated in the SREP process and subject to adapted additional capital requirement for operational (reputational) risk and credit risk.

19. **This singular treatment is justified for all material loans granted on unsound basis, even when they are performing, or when they do not risk to breach risk concentration rules.** On the same ground, specific provisions and capital requirements can be imposed to cover the operational risk associated with claims or ongoing money laundering enquiries that are the results of weak internal control or management fraud. In general, for some banks where the 2016 AQR revealed significant weaknesses in the documentation of certain categories of loans or guarantees, this "questionable" pre-AQR portfolio better be isolated and be treated on a different and more stringent basis in the SREP.

B. Process and Proportionality

Minimum Supervisory Engagement

20. **The BNB has categorized the institutions under supervision on the basis of the assessment of systemic risk posed by them to the financial system.** The first category covers the other systemically institutions, and categories two and three cover the other institutions incorporated in Bulgaria, based on their size. The fourth category includes the branches of foreign banks, institutions with the lowest supervisory intensity.

21. **Although the principle of proportionality is repeatedly mentioned in the manual, it is not explicitly included in the procedures.** Banks of all categories are monitored on a quarterly basis. Except for branches, the assessment of all individual SREP elements are yearly updated for all banks and the overall assessment is yearly produced. All institutions are informed by a yearly letter on the summary of the assessment, and on the requirement for own funds and to liquidity.

22. **The granularity of the assessment and its proportionality are not defined in the SREP manual, beyond the well-known reference to size, systemic importance, nature, scale, and complexity of the activities.** The RAS system of the BSD provides however clear lines to focus supervisory scrutiny to the main drivers of risk for every institution, and mechanical yearly "checking all the boxes" is avoided by detailed guidelines whose implementation is closely monitored. The division in categories is used as a basis for applying the principles of proportionality and drives in particular the intensity and granularity of the assessment, the level of organization as well as the supervisory expectations of the standards that institutions should meet. The BNB recognizes that the different elements do not have the same relevance for all institutions, and that it is appropriate to apply different degrees in light of depth and granularity of assessment, depending in the category the institutions is assigned to.

23. **By not formally applying the multi-year supervisory cycle, based on a minimum engagement, as defined by EBA and put into practice in most EU jurisdictions, BNB lacks an opportunity to increase its efficiency and strengthen supervisory efforts in the areas**

were most results can be expected. Under this minimum engagement approach, all institutions remain subject to continuous monitoring, and important negative evolutions always provoke immediate supervisory attention and measures. Under normal circumstances however, a complete update of all elements of the SREP, as well as the subsequent assessment of requirements to capital and liquidity, and detailed information sharing with the banks, is organized in a two-year or three-year cycle, for midsize or smaller banks without important outstanding supervisory concerns. In the intermediate years, where no in-depth and comprehensive assessment is made, the yearly formal decision on capital and liquidity requirements and the subsequent communication to banks, can be limited to the statement that the BNB updated its information and has no reason to review earlier assessments.

24. **This approach offers the additional advantage that supervisory attention may be paid to the imposition in smaller institutions of efficient and comprehensive measures that allow to strengthen the internal control environment, the full roll-out of which will take longer than one year.** Their implementation should therefore only be thoroughly assessed after a longer period of time. It further allows to focus the supervisory attention to those activities and institutions where most concerns exist, and leaves time for in-depth analysis, both offsite and onsite. This approach also ties in with the way EU supervisory colleges have organized their workplan.

25. **It is therefore recommended that BSD, when submitting for approval the annual workplan and the draft SREP manual to the GC, specifies that the SREP process is globally captured in a supervisory cycle of maximum three years**:

- All institutions are subject of the yearly BSD action plan, that provides for onsite and offsite analysis based on the size and nature of its activities and the quality of its internal control. These supervisory activities lead to an update of the assessment of the SREP element concerned, and—if specific concerns arise—might impact the supervisory action plan for the next year.
- KRI's for all institutions are monitored on a quarterly basis. Thresholds and triggers exist and identified weaknesses or unexpected developments provoke immediate supervisory attention and measures.
- A documented summary of the SREP assessment and an institution-specific action plan is yearly produced.
- Institutions in category one are subject to a yearly supervisory cycle.
- Update of the assessment of all individual SREP elements is – as a minimum - produced every two years for all institutions of category two, and every three years for all institutions in category three. This complete and in-depth assessment will be the main driver for the institution specific action plan for that can cover two to three years.
- In the intermediate years, the formal decision on capital and liquidity requirements, and the subsequent communication to banks, will be limited to the statement that the BNB updated its information and has no reason to review earlier assessments.

- When an institution in category 2 and 3 is informed by a letter on the summary of the assessment, and on the requirement for own funds and to liquidity, the letter point out that, if no elements arise after the has updated its information and when BNB has no reason to review earlier assessments, a subsequent full assessment sill only be communicated in two or three years.

Interaction Between Directorates

26. **One of the consequences of the great predominance among Bulgarian banks, of EU banking Groups, whose home supervisor is the SSM, is that the SREP calendar for these banks is to a large extend determined by the SSM.** Specific deadlines are created for the different steps set in the Joint Supervisory Teams, and for the contribution that is expected from the BNB in that respect. Therefore, high demands must be made on the efficiency of the interaction between the directorates of BSD during the process of assessment of the individual SREP elements. This is especially the case for the assessment of internal governance and control mechanisms, where different directorates are expected to significantly contribute to the overall assessment.[4]

27. **In order to enhance efficiency, the interaction between directorates should therefore be specified, along the following lines of cooperation:**

- To each score of an individual risk a short motivation of the judgment, and proposed supervisory measures are joined.
- The offsite directorate has the clear responsibility to prepare the final assessment and to timely collect the information form other directorates. This directorate therefore creates the internal calendar.
- The onsite directorate has final responsibility for the scores that directly relate to activities or areas that were subject of onsite analysis during the current supervisory cycle and can contribute to the assessment of other scores that indirectly related to this onsite analysis.
- Other directorates are informed about the final date of the overall assessment and contribute when appropriate.
- Formal meetings with the internal and external auditors of the concerned institution will certainly be a useful contribution to this overall assessment.

C. Business Model Analysis

28. **With a few exceptions, most Bulgarian banks share the same business model, and mainly develop lending activities in the local market, thereby approaching retail, Small and Medium Enterprises (SME), and corporate market**. The relative importance of each of these markets can vary considerably. The interest rate margin is by far the most important source of

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[4] See also par.37

income. Several banks carry out specialized credit activities in separate subsidiaries, and this must be taken into account in the BMA.

29. **The BNB uses a set of KRI to calculate recurrent profitability and efficiency and to score the viability of the business model for all banks**. In addition, the offsite directorate conducts surveys on the quality of the business models of subsidiaries of EU groups in preparation if the annual college meetings. It has also evaluated the business model of most other banks of group one and two on the basis of policy documents and reports. This review provides sufficient insight into the main characteristics of the business model but, as their reliability has not been tested, this only rarely gives ground to a well-motivated assessment and further supervisory reactions.

30. **The BMA was included in the scope of the onsite inspections conducted in a limited number of banks**. This revealed that the business model framework needed upgrading and that the institutions should align this work to the accounting, budgeting processes and to the establishment of the ICAAP and Internal Liquidity Adequacy Assessment Process (ILAAP).

31. **Scores on the viability and the sustainability of business plans are however not generally available**. Although no indications have been found that business models need fundamental changes to be sustainable, little evidence was found that business models offer all the guarantees expected in the supervisory guidelines.

32. **Relevant banks may be invited to indicate how and when they test the reliability and feasibility of their business models.** They can do so by comparing the BMA numbers to data available in budgets and past accounts, and to the data that result from capital planning and ICAAP. It can also be pointed out to banks that the outcome of this test is expected to be discussed within management and on the supervisory board. It can be asked to transmit the minutes of these meetings to the supervisor. High NPL-banks can be asked to review the impact of upcoming EU regulation on high NPL and prudential backstops on their business plan and internal structure. Banks can be invited to integrate an expected change of ownership in their approach. This information will globally facilitate the SREP scoring and indicate in which areas further supervisory attention is needed.

D. Governance

33. **The chapter in the manual on the assessment of internal governance and institution-wide controls is modelled on the approach included in the Draft EBA Guidelines**. The manual has indeed been recently adapted to reflect even more precisely the various steps in the assessment as proposed by EBA. This methodology is however new to the BSD. To date the assessment of governance and internal control has been carried out by the onsite directorate when concluding an inspection. The scoring is based on the CAMEL-approach.[5] As it needs a

[5] CAMEL: C = Capital Adequacy; A = Asset Quality; M=Management; E = Earnings; L = Liquidity

new inspection to update earlier scores, in case of most smaller institutions, where inspections are carried out at long intervals, scores are outdated.

34. **A global conversion of the CAMEL scores into adapted scores based on the new methodology, learned however, that the overall results did not deviate from the assessment made by the competent supervisors**. The overall score level is in line with the expectations. Close to half of the credit institutions obtain a global score 3 and to 18 percent a score 4 was assigned. This global conversion thus offers a reasonable starting point for a more detailed analysis on the lines of the new approach.

35. **The BSD cannot only rely on the onsite inspectors to form a judgment on the internal governance and control mechanisms of an institution**. The assessment of the organisational structure, of the functioning of the management bodies, and of the quality of key risk control functions is also linked to the ongoing offsite work, like assessing the recovery plans or analysing internal audit planning etc. Other directorates can also contribute, as regulatory compliance is part of internal governance, and the "fit and proper" assessments of board members and managers are intimately linked to the global assessment of the governing bodies of the institution.

36. **It is recommended to further clarify the contribution of the different directorates to the overall assessment of governance and control.** Along each of the ten steps in the assessment of internal governance,[6] it should be indicated which supervisory activities normally results in an explicit contribution to the supervisory judgment. The accurate and permanently updated insight in the strengths and weaknesses of governance and control mechanisms is of paramount importance, and the shift to the approach presented in the manual cannot succeed without a sustained effort by all participants, therefore adequate and formal follow-up of the implementation seems inevitable.

E. Risk to Capital

Credit Risk

Benchmarking of Credit Risk

37. **Credit risk is the main risk driver in the Bulgarian banking system, and reliable benchmarking for capital coverage of that risk therefore is of paramount importance.** In recent years different measures have been taken to strengthen the risk management in credit institution and enhance the efficiency of the supervisory approach. The 2016 AQR has led to large value adjustments and has contributed to significant enhancements in internal control and risk management. New and more detailed reporting on non-performing and forborne loans gives better insight in the quality of the credit portfolio. In the post AQR area, NPL levels have

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[6] The ten steps included in point 4.2 of the manual are identical to the approach in Title 5, point 1 of the Draft EBA Guidelines.

lowered, but large difference can be noted between the banks, and some of them remain "high NPL-banks."

Strengthening the prudential toolkit is still underway

38. **The technical note from the 2017 IMF stock taking mission confirms that focus should go to underprovisioning and fair collateral valuation**. The note offers an overview of different interesting supervisory approaches. Not all of the suggested measures have been put into practice.

- The development of a tool, based on an internal PD estimate for Bulgarian Corporates, that would allow to capture – under the Pillar 2 requirements –excess idiosyncratic risk that is not fully covered under Pillar 1, has not been concluded, as insufficient historic data are available.
- The suggestion to complete the macroprudential supervisory review toolkit with a comparison of banks' treatment of NPL write-downs to a supervisory benchmark, in order to promote robust write-down practices for loans or portions of loans that are unlikely to be collected, was not realized.
- The suggestions to develop specific tools that help to identify possible underestimations and to analyze the impact of the introduction of IFRS 9, to enhance knowledge among bank supervision officers, board members and external auditors, and to introduce guidance and adapted prudential metrics, have all remained a dead letter.

39. **Some of the suggested tools are partly included in the methodical and sector-wide assessment of credit risk that will be used in the 2018 SREP cycle and lead to a Pillar 2 add-on** (see par.49).

- A specific capital add-on for banks with a low coverage ratio for NPL's is introduced, but a comprehensive and automated tool that would allow the BNB to systematically compare all bank's level of the loan loss allowance relative to supervisory metrics, as a starting point for the BNB in assessing whether provisioning practices are robust, is not yet developed.
- Although a system wide periodic assessment of collateral valuation practices measured against BNB metrics, and calibrated to reflect a conservative valuation of the collateral, is still missing, a specific capital add-on will be applied to high NPL-banks that have low coverage ratios for loans that are more than one year past due.

40. **The Policy Directorate of the BSD has conducted an impact study on the expected introduction of EU regulation on prudential backstops.** This study analyses the impact of the introduction of an annual increase for the capital coverage of NPL's, and a gradual lowering of collateral value. The study calculated not only the introduction of more stringent rules for the new loan production, as currently foreseen in draft EBA and EU projects, but also the impact of these rules, when applied to the whole loan portfolio of all banks. The outcome of this static sector-wide analysis, delivers a very relevant indicator of the impact on every institution, of a stringent regime on provisioning and on the valuation of collateral, as it simulates the impact on

capital of the immediate and full introduction of valuation rules that are close to strict supervisory metrics.

Regulatory measures have been taken

41. **The BSD has taken action to strengthen the supervisory regime for Concentration Risk, Large Exposures, and exposures to Related Parties.** The scope of Article 45 of the Law on Credit Institutions (LCI) has been expanded, both in terms of counterparties as well as in terms of transactions and methodologies to value the exposure and its collateral. A regulation that further details the legal framework with regard to exposures to related persons has been approved by the GC in July 2018 and has come into effect on July 27, 2018.

More focus in quarterly monitoring and preliminary assessment

42. **All credit institutions and branches are monitored on a quarterly basis by Key Risk Indicator**s. Based on this monitoring, a quarterly review of their financial situation is prepared. This review is formalized in a quarterly report, written in a predefined format, and offering a standardized and comprehensive overview of all elements of the financial situation of the institution and the level and evolution of the main risk indicators.

43. **The draft SREP manual confirms this continuous monitoring**. It identifies the purpose of this ongoing quarterly monitoring as "…to identify changes in the financial conditions and risk profiles of credit institutions." The monitoring will therefore in the first place be used to identify the need for updates to the assessment of SREP elements in light of new material information outside of planned supervisory activities. Only when material changes in the risk profile of the institution or significant fluctuations in the indicators levels are identified in the monitoring process, a full report will be written. When no new elements are identified, only a short summary report will be produced.

44. **This necessary simplification and more focused setup of the quarterly reporting will free up time.** It will allow a more thorough analysis of the main sources of credit risk and the quality of the credit portfolio as part of the SREP.

Yearly analysis of nature and composition of credit portfolio

45. **As a first step in the 2018 SREP process, the BSD uses a predefined set of KRI's to identify the significant carriers of credit risk and to indicate for the purpose of further analysis and evaluation the most relevant gross risk volumes among the main categories of assets of the credit institution.** It thereby identifies key characteristics of the most relevant credit portfolio's:

- Consumer loans and growth of the portfolio
- Retail mortgage loans and the global loan to value ratio of this portfolio
- SME loans and NPL ratio of this portfolio

- Corporate loans portfolio and concentration on sector and on individual counterparties

This information is completed by KRI's covering:

- Level and evolution of the coverage ratio
- NPL level and part of the NPL-loans that are more than 360 days due in the total NPL portfolio
- Value and evolution of collateral value of foreclosed assets

The 2018 SREP cycle will also include additional information on the impact of IFRS 9 on provisions on the transition date, and its relative importance to total provisions.
This year's SREP will also take into account the information obtained during the study conducted by the Policy Directorate on the impact of a more stringent regime on provisioning and on valuation of collateral.

This anchoring assessment is fully in line with EBA Guidelines and SSM practices. Outliers on these KRI's to market averages or prudent supervisory benchmarks can provoke further offsite analysis on the quality of the loan portfolio, of its risk management and of mitigation and the level of total provisioning, and this information allows for more focused onsite inspections in the action plan based on the SREP.

Methodical assessment on NPL's, NPL coverage and on risk concentration

46. **BSD has developed a methodology for the combined risk assessment and subsequent definition of an additional capital requirement, based on the level of NPL's, their aging, their coverage, the relative importance of single large exposures, and the risk level of sector concentration based on the HHI index.** All these elements are available from the Finrep reporting, and the benchmarking assessment is made for all banks. The method consecutively compares the following indicators to prudently chosen anchor points:

- Level of NPL
- Level of coverage ratio
- For those banks that exceed the anchor point in both NPL- level and in coverage, additional benchmarking is foreseen to prudent levels of:
  - The part of NPL's longer than one-year overdue in total NPL
  - The coverage ratio for this specific category
- Sum of large exposures versus total eligible capital
- Sector concentration based on HHI index

When the anchor points are exceeded, a step-by-step add-on to risk-weighted assets for credit risk is created, that can evolve from 0 percent to 1.50 percent in 6 steps, counting each for 0.25 percent.

47. **For the banks with high NPL's and low coverage ratio, the outcome of this matrix is then combined with the separate assessment of the quality of credit risk management and internal control.** As scores 1 and 2 reflect a strong or adequate credit risk management, no add-on is foreseen. A "medium to high" risk score (score 3), reflecting a weak risk management, adds an increase of 1.25 percent to the add-on and in case of "high risk" (score 4 based on inadequate risk management), this increase is 2.75 percent.

48. **The outcome of the method creates a gradual add-on to the risk-weighted assets for credit risk,[7] and the total capital add-on is this diluted by the impact of the amount of non-credit risk related capital requirements.** As credit risk in general stands for 85 percent of total capital charges, the total capital add-on for banks that combine high risk volumes, above all anchor points, with sound risk management, can expected to be around 1.3 percent.

49. **This method is based on the assessment of the main risks specific to the Bulgarian banking sector, and rightly gives an important weighting to the quality of risk management and internal control.** It leads to acceptable capital charges for banks with high risk profile, and to dissuasive capital charges for banks that combine high risk volumes with very weak risk governance. It is therefore an encouragement to improve the quality of risk management. This approach is close to methods chosen in other countries, and internal simulation has learned that smaller adjustments to the anchor points do not lead to completely different results.

50. **At the end of this mission, the work on this methodology was in its final stage.** A preliminary impact study reveals that the gradual add-on to the risk weighted assets is 1 percent or higher for 6 banks, and 9 others are impacted with 0.5 percent or 0.75 percent, when the impact of the quality of credit risk management is neutralised. For three banks, with material weaknesses risk management and internal control, the Pillar 2 Capital add-on for credit risk will be above 2 percent, for five others the impact varies between 1 percent and 2 percent. This preliminary overall result seems acceptable. More methodological work will be necessary in the next weeks to justify the chosen levels and to calculate the sensitivity of the approach to an adjustment of their level. In preparation of a final proposal to the GC on the implementation in the SREP in 2018, together with the submission for approval of the draft SREP manual,

Interest Rate in Banking Book

51. **The draft SREP manual contains guidelines for the assessment of the interest rate risk in the banking book.** In addition to the qualitative assessment of the management of this risk, a quantitative assessment is also proposed, based on indicators relative to the change in economic value of the capital and the change in net interest income, due to an unfavorable change in the interest rates. The actual introduction of this indicator, and its calibration to the specific Bulgarian environment, will only be possible when from January 1, 2019 onwards, adapted reporting on interest rate risk in the banking book will be available.

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[7] according to EU practices**,**

Operational Risk

52. **As most banks share the same business model, predominantly based on interest rate margins, gross income and asset size are considered to be reliable indicators for operational risk for all banks.** Only two banks, both subsidiaries, take advantage from the use of the advanced measurement approach in the calculation of the regulatory capital requirements.

53. **The manual gives an overview of the most important elements of operational risk, but to date this risk was only assessed during onsite inspections.** Even if no inspection has been carried out recently, the offsite directorate has information about important losses to assess the operational risk. For the assessment of the reputation risk, reference can be made to information about complaints, money laundering cases or other inconsistencies with laws, regulations and sound practices. Sufficient knowledge of the ICT risk is vital to have a comprehensive view on operational risk. In cases where no information from a recent inspection is available, it might be useful to refer to a lack of information about ICT audits in the reports of the internal audit, as an indication that there is insufficient certainty that the ICT risk is adequately followed up.

Market Risk

54. **As the level of market risk is relatively low in the Bulgarian banking sector, the impact of this risk in the global assessment is limited.** A general assessment framework, including benchmarking of the exposure to market risk to total risk exposure and the contribution of return on financial assets to total profit, is available.

F. Internal Capital Adequacy Assessment Process and Internal Liquidity Adequacy Assessment Process and Interaction with SREP

55. **The supervisory review of the ICAAP and ILAAP[8] is executed as part on an onsite mission, in the framework of the contribution to a joint capital decision for an EU Banking Group, or as part of the overall assessment.** The onsite analyses mostly cover the larger banks. Apart from other identified weaknesses, most inspections identified deficiencies in the effectiveness of the ICAAP, as the evidence that the level of capital as defined under the ICAAP, is effectively used in the decision-making and management process, was often missing.

56. **The market-wide ICAAP estimate stands at 53 percent of available capital.** The banking sector judges its own capital situation therefore very differently from the level expected by the authorities. It is not a straightforward exercise to unambiguously link the outcome of the ICAAP numbers for each risk category, to Pillar1 references. For all categories a broad range of outcomes can be observed and for the leading credit risk indicator, seven banks present outcomes

[8] The overall short-term liquidity of Bulgarian banks is comfortable, and this risk is considered of less importance than the risks to capital and the predominant credit risk. This report therefore focuses on the quality of the ICAAP and its use in the SREP.

that are identical or lower than the pillar 1 calculations. The onsite inspections and other supervisory work have yet resulted in a clean-up of inconsistencies and – especially for the local banks - the reported ICAAP number have not yet achieved the level of reliability that they can easily be used in the SREP calculations.

57. **The recently introduced periodic assessment of the stress testing capacity of the institutions, and the analysis of the results of their stress tests, is expected to complement the information on the ICAAP planning and outcomes.** This stress testing reviews offer a good opportunity to systematically plan well-prepared discussions with the institutions and to include the effectiveness of the ICAAP numbers in the scope of the review. Starting from the reported numbers, these meeting should allow to identify the main drivers to the final outcome in each category of risk to capital, how the numbers fit into the decision-taking process and the capital planning, and how they relate to the regulatory capital requirements. If well planned, thoroughly prepared by all participants, and the substance of the findings confirmed by writing, these technical meetings will contribute to enhance the quality of the ICAAP reporting. This approach is less time consuming than onsite inspections and avoids the pitfalls of vague and evasive answers that are often submitted in reply to technical questionnaires.

G. Stress Testing

58. **The new chapter on supervisory stress testing, that can be found in the Draft in the EBA Guidelines, is faithfully included in the draft SREP manual.** Supervisory stress testing will not be developed before the 2019 SREP cycle, and the preparation of the process and the methodological choices has not started yet. The 2016 AQR exercise however has produced meaningful information on the vulnerabilities of the institutions, on the quality of their data and internal structures. The individual outcomes of the top-down stress tests carried out by the Macroprudential Supervision and Financial Stability Directorate can also make a useful contribution to the assessment of the quality of internal control in the institution and its capacity to timely produce complete and reliable data. The outcomes and a quality score by this Directorates therefore offer an important contribution to the SREP.

59. **In a first phase, the main focus of supervisory micro stress testing, should lay in the review and quality assessment of stress testing in the institution.** The result of top-down macro-economic stress testing of the banking sector can provide useful insights on the vulnerability of individual banks, and as a result of the critical importance of subsidiaries of EU Groups many institutions are covered by Group-wide supervisory stress testing programs. The outcomes of stress testing in local mid-size and smaller banks is predominantly influenced by the quality of the scenarios for the credit risk and collateral valuation. Monitoring the quality of these scenarios and the integrity of the results is a primary supervisory responsibility.

The development of supervisory bottom-up stress testing form the 2019 SREP cycle on, will lead to key input for the SREP process. The outcomes of the first phase will usefully contribute to the efficiency of this crucial and necessary supervisory tool.

III. EFFICIENT AND PROPORTIONATE DECISION PROCESS

A. Intervention of the Governing Council in the SREP Decision

60. **Since a recent change in the Banking Act supervisory measures are no longer taken by the Deputy Governor heading the BSD, but all individual administrative acts are issued by the BNB GC on a motion presented by the Deputy Governor.** Fears that he introduction of this collective decision-maing body might add extra complexity to the supervisory escalation and decision process within the framework of the yearly SREP, are mitigated by clear functioning rules of the GC.

61. **When approved, the current draft rules of order of the Governing body will clearly specify the scope of responsibilities of the GC in supervisory matters and the criteria used in the assessment of the proposed motion.** The precise demarcation of the responsibility of the Council (issue the act) and the deputy governor (write and motivate the motion) will allow to avoid duplication of legal work. It is specified in the rules of order that the GC intervenes in the decision process for all joint capital decisions for EU supervisory colleges and issues the act that imposes specific Pillar 2 capital or liquidity requirements or other supervisory measures but does not intervene in the decision process when the letter with the global SREP assessment does not create new obligations for the credit institution. Only in cases where the annual letters to the bank, containing a summary of the overall SREP assessment, the quantity and composition of the own funds the institution is required to hold as well as requirements to liquidity, creates new obligation, by means of a Pillar 2 capital add-on or specific liquidity requirements, or when new supervisory measures are taken, this letter will be considered as administrative act.

62. T**he GC also approves BNB regulations and guidelines, as well as the manuals of the BSD and its yearly action plan.** The BSD should take advantage of the submission for approval of the manual, to inform the GC on the consistency of the overall yearly SREP, to globally present the key drivers and supervisory anchor points of the constraint judgments on credit risk in the 2018 Review, and to give a global preliminary overview of the expected decisions and the impact on the sector-wide capital requirements. This overview will clarify the proportionality and the efficiency of the approach, and as this information will also cover SREP outcomes where the Council will not directly intervene, it will facilitate the global decision process.[9]

B. Proportionate Decision Taking and Focused Planning

63. **The manual gives a complete overview of the legal references and motivation for supervisory requirements on capital and liquidity, and other supervisory measures and actions.** This overview systematically associates possible supervisory actions to regulatory breaches, deficiencies or observed weaknesses. It is a very useful instrument as it offers guidance to the supervisor on the way to formulate the findings and to motivate proposed reactions. The

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[9] The information on the global expected capital strengthening impact of the SREP 2018 assessments for all institutions from January 1, 2019 onwards, is also a useful input to the discussions on the level of macro-economic buffers.

Manual specifies that for banks globally rated 3, the supervisory measures are taken in the form of a decision by the GC, and for banks globally rated 4, it is imperative to take supervisory measures.

64. **The proportionality in the exercise of the supervisory powers is essential.** This is not only motivated by the extent of the identified shortcomings and weaknesses, or by the possible impact of not addressing the problem, it is in many cases, and especially in the area of credit risk management and collateral valuation, based on the benchmarking of the findings and shortcomings to prudently chosen supervisory anchor points. Systematic peer comparisons and wide scale transversal analysis are therefore inseparable from supervision of individual institutions, as they help to underpin supervisory judgment and motivate the consistency in the approach and the proportionality and effectiveness of the proposed reactions. When the GC is informed about the situation of an individual institution and on the supervisory concerns it raises, it is recommended to compare the relevant KRI's to peers and to prudent anchor points and to indicate how similar deficiencies at other institutions have been addressed or are being addressed.

65. **Efficient and intrusive supervision heavenly relies on the effectiveness of the proposed measures to rectify the identified shortcomings**. The manual offers comprehensive guidance for that purpose. Proposed decisions and motions for decision by the GC can be further substantiated by explicitly providing the following steps for supervisory reaction on an institution with global score 3 or 4.

- Summary of the findings,
- Motivation and anchor points for supervisory judgment,
- Identification of the supervisory measure and the expected outcome of the measure,
- Expected moment measure will come into effect and the moment the situation will be submitted to evaluate this outcome,
- Possible next steps if the measure is not effective at the expected moment.

If supervisory measures are announced in the letter confirming the SREP outcome, is equally recommended to inform the bank on the way and date the effectiveness of the measure will be evaluated and to indicate the possible consequences and additional measures or sanctions that can be taken consideration if the expected outcome is not sufficiently realised.

IV. COMMUNICATION TO BANKS

A. Individual Decisions

66. **The manual does not contain an example of a letter with the decision on capital and liquidity.** An example of such communication on the prudential requirements to capital and liquidity can be found in the EBA draft guidelines. This communication typically mentions the amount of the Pillar2 capital add-on but does not detail the specific method of internal

benchmarking or the anchor points that were used in the supervisory assessment. It is common practice that this letter be completed by a brief overview of the main findings during the review process, a motivation for the individual risk assessments that have led to scores 3 and 4, and a formal communication of the global score. The letter thereby not only gives an overview of supervisory measures, based on the SREP, but also indicates other supervisory expectations. As it expresses the view of the supervisor on the quality of risk management and control, it provides an indication of the supervisory actions in the short and medium term.

B. Global Communication on Process, Outcome, and Methodology

67. **Pursuant to Article 102 of the LCI the BNB has the legal obligation to discloses the general criteria and methodologies used in the SREP process.** The BNB is of the opinion that this provision is fulfilled, because it has publicly confirmed that its supervisory approach and methodologies are fully compliant with the guidelines issued by the EBA.

68. **Although this is far from a general rule, more and more authorities offer some openness on the most common findings and assessments during the SREP process, on the global outcome of the risk scores and the additional requirements to capital and liquidity, and on the main supervisory expectations for the near future.** The yearly approval by the GC of the BSD action plan, offers an opportunity to communicate on the overall outcome of the review process, the main findings and scores, and the most important supervisory expectations and global supervisory priorities. Extracts from this information to the GC can be made public or used in the relations with other authorities.