# The Bulgarian Banking System and the Housing Market

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# The Bulgarian Banking System and the Housing Finance Market

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## Abstract

Bulgaria, like most Eastern European countries, is experiencing major political and economic changes. Over the medium- to long-term, this process should lead to greater political freedom and economic prosperity. Over the short-term the country is experiencing political uncertainty and economic turmoil. Like most sectors of the economy, the housing industry has experienced severe dislocation. This report explores one aspect of this sector--housing finance. This paper discusses the current state of the banking and housing finance systems, explores housing finance issues that must be addressed over the short- to medium-term and briefly suggests areas in which the system might benefit from technical assistance.

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## Executive Summary

Bulgaria, like most Eastern European countries, is experiencing major political and economic changes. Over the medium- to long-term, this process should lead to greater political freedom and economic prosperity. Over the short-term the country is experiencing political uncertainty and economic turmoil. Like most sectors of the economy, the housing industry has experienced severe dislocation. This report explores one aspect of this sector--housing finance. Other aspects of the housing industry are reviewed in additional Urban Institute reports. This paper discusses the current state of the banking and housing finance systems, explores housing finance issues that must be addressed over the short- to medium-term and briefly suggests areas in which the system might benefit from technical assistance.

**The Banking System**

Currently, the banking system consists of a central bank--the Bulgarian National Bank (BNB), the Bulgarian Foreign Trade Bank, the State Savings Bank (SSB), eight specialized commercial banks, 63 common commercial banks and two private banks.

In addition to performing most functions common to western central banks, the BNB provides refinancing of credits issued by the commercial banks. Bulgarian Foreign Trade bank is responsible for foreign payments, settlements and borrowing. Until 1989, the State Savings Bank had a monopoly on household deposit mobilization and housing and consumer lending. It remains the dominant player in these areas. Bulgaria's eight specialized commercial banks were each established to lend to a specific industry. All Bulgarian banks are now free to function as universal lenders but these institutions remain highly concentrated in their traditional sectors. The country's 59 originally common commercial banks (CCBs) were established from BNB branches. Virtually all CCBs are quite small and are focused by geographic region. Bulgaria has two functioning fully-private banks and one more which will open shortly. In addition there are three banks which are joint ventures with banks in other countries.

Most commercial bank stock is owned by the BNB and state enterprises. The BNB has designed a merger and sales program whereby all commercial banks will be merged into seven to ten large institutions and their shares sold to private domestic and international investors.

Total bank credit outstanding amounted to 115 billion levs in June, 1991--down 60 percent in real terms from December 1990. Public sector enterprises accounted for 60 percent of bank credits and the government 33.9 percent. For all banks excluding the BNB and SSB, resources amounted to 322 billion levs in July 1991, down by about 21 percent in real terms from December, 1990. Loans from foreign banks and institutions accounted for 58 percent of bank liabilities in July, 1991.

**Banking Sector Issues**

Issues include negative real interest rates, asset quality, capitalization, deposit insurance, the branch network, reliance on BNB resources, foreign currency exposure and staffing.

Currently banks are paying a rate of approximately 54 percent on deposits. Banks typically have a 300 to 500 basis point spread between their deposit and lending rates. Sources place inflation from 300 to 440 percent for only January to June, 1991 (World Bank, 1991; Mladenov, 1991; BNB 1991c) and Mladenov (1991) states that the August rate was almost 140 percent on an annualized basis. Thus, it is indisputable that current rates are highly negative.

Banks have two principal sources of losses. The first is non-performing loans to "sick" state enterprises and the second is the losses banks incurred through levs devaluation when they borrowed in foreign currencies and made loans in levs. BNB staff estimate system-wide non-performing loans at approximately 17 billion levs--approximately 15 percent of outstanding bank credit as of June 1991.

The banking system's branch network is grossly inadequate to service the private sector which will spring up over the medium term; furthermore, it is insufficient to mobilize the household savings which will be needed to meet the new firms' demand for credit. Finally, such a small branch network inhibits competition. Bulgarian banks have borrowed in foreign currencies but lent almost exclusively in levs--creating a serious foreign exchange rate risk. In November, 1990, banks' foreign exchange rate risk was such that a 1 percent nominal devaluation would have increased average bank liabilities by 4.8 percent more than assets.

Banks are alarmingly undercapitalized. Commercial bank capital was an alarmingly-low 0.9 percent of assets in June, 1991.

The Bulgarian government insures deposits in the State Savings Bank but not commercial bank deposits. This system creates an unfair advantage for the SSB.

The banking system lacks the computers and telecommunications equipment and the personnel which the system's growing size and complexity requires.

**The Housing Finance System and the State Savings Bank**

Although all banks are legally able to undertake housing finance, in practice virtually none have done so. The SSB believes that no other banks are engaged in mortgage lending and that it has over 95 percent of the housing construction market. At the end of 1990, the State Savings Bank accounted for 46 percent of total banking industry deposits, 39 percent of offices and 14 percent of assets. BNB management maintain that the bank merger process will probably not affect the integrity of the SSB.

SSB assets totaled almost 29 billion levs in August 1991--a real decline of approximately 83 percent from August, 1987. Loans to other banks accounted for 66 percent of assets in August, 1991. The SSB receives the overwhelming majority of its resources--78 percent--from household deposits.

In 1990 profits dropped were 187 million levs--a decline of 40 percent in real terms from the year before.

The bank makes short-term construction loans to municipalities and ministries, mortgage and major repair loans to households and combined construction and mortgage loans to individuals and cooperatives which build their own homes.

Given Bulgaria's current wage structure, mortgage products, interest rates and construction costs, most families can no longer afford loans covering a significant portion of housing costs.

Lending was quite stable until 1990. Lending in 1987 can be taken as representative of the period. In 1987, the SSB issued 57,515 housing loans of which 54,278 were for home purchase.

Lending in terms of number of loans issued and volume was extremely high in 1990 reflecting the government's massive sale of state-owned housing at pre-1990 prices and deregulation of the inter-household real estate market. The total number of housing loans that year was 166,461 and volume was 2 billion levs. The volume of short-term construction loans declined significantly over the year. In first semester 1991, mortgage lending continued to exceed 1987 figures (if 1991 figures are annualized) due to the continued sale of homes at pre-1990 prices. Nevertheless, these sales were well below the peak reached in 1990. Short- and long-term construction lending plummeted. First semester 1991 real housing loan volume was only 26 percent of volume in the first semester of 1987.

The SSB has several advantages which should enable it to retain its hegemony in the market. Being the country's only housing lender from the 1950s to 1989, it has tremendous name recognition. Second, the SSB has more branches and places of business than all other banks combined, with the exception of the nascent Bulgarian Postal Bank. Third, the SSB is the only Bulgarian bank whose deposits are insured by the government. This allows it to pay lower rates on its deposits and pass these savings to borrowers. Finally, other lenders may be reluctant to enter the market until an adequate foreclosure law is developed. Indeed, as default risk grows, the SSB may also find the lack of an effective foreclosure law an increasingly important disincentive to pursue mortgage lending.

**Issues in Housing Finance**

Like banks throughout Bulgaria, the SSB has interest rates on deposits and loans which are extremely negative in real terms. Nevertheless, given the equal-monthly-installment mortgage product, these rates are too high for most households to afford.

Even more damaging to housing affordability than the increase in interest rates is the fact that housing prices rose 10 to 17 times from spring, 1990 to fall, 1991--well above general inflation.

All SSB loans made after January 28, 1991, currently carry an interest rate between 49 and 58 percent. These loans were made on flexible interest terms. Nevertheless, as of August 1991 the firm had approximately 2.8 billion levs in mortgage loans made before January 28 which currently carry a fixed 10 percent interest rate and 1 billion in consumer loans which carry a fixed 17 percent rate. The difference in monthly revenues between the interest the SSB earns on these loans and the interest it would earn if the loans carried current market rates is 123 million levs. Deflated to December 1990 prices and annualized, this figure represents approximately 160 percent of the SSB's net profit for all of 1990. This huge transfer is being financed via cross-subsidization by other borrowers and is not recorded as an on-budget subsidy, thereby masking its true size.

The SSB's systems of underwriting and collection are almost unchanged from the period when risk assessment and diligent collection were unnecessary. Thus, they are entirely inadequate for the current housing finance environment.

The Bulgarian housing finance system could benefit greatly from the introduction of alternative mortgage instruments such as the dual-index mortgage and the price level adjusted mortgage. These products would radically increase borrower affordability and lender protection in Bulgaria's current chaotic macroeconomic environment. The system could also benefit from training in internationally-accepted underwriting and collection procedures.

## Introduction

Bulgaria, like most Eastern European countries, is experiencing major political and economic changes. Over the medium- to long-term, this process should lead to greater political freedom and economic prosperity. Over the short-term the country is experiencing political uncertainty and economic turmoil. In Bulgaria's October 1991 election, the coalition of opposition parties received only one percent more of the popular vote than the former communist (now socialist) party. Yet, even this narrow victory was a major achievement as it was the first time the socialists did not receive a majority of the votes. The former oppotiion is expected to form a government in November, 1991. The nation is experiencing high and very erratic inflation. Monthly inflation ranged from a low of 0.8 percent to a high of 122.9 percent. Inflation for only January to August 1991 was 386 percent (Mladenov, 1991). Gross domestic product per capital declined by 12.6 percent in real terms in 1990 and unemployment is over 10 percent and increasing.

Like most sectors of the economy, the housing industry has experienced severe dislocation. Construction prices are increasing faster than inflation, the state rental stock has been almost entirely liquidated and housing lending has come to a virtual standstill. This report explores one aspect of the housing sector--housing finance. Other aspects of the housing industry are reviewed in additional Urban Institute reports. This paper discusses the current state of the banking and housing finance systems, explores housing finance issues that must be addressed over the short- to medium-term and briefly suggests areas in which the system might benefit from technical assistance.

## 1. The Banking System

Until 1987, the Bulgarian banking system consisted of only four banks and was extremely simple. Since that time, both the number of banks and their role in the economy has expanded significantly. Furthermore, the recent and ongoing changes in Bulgaria's economic system have had a significant impact on the banking system and have created a number of issues for the sector. This section first briefly addresses the historical evolution of the banking system. The current state of the sector is explored next. This section closes with a review of the most pressing issues the system must deal with in the short- to medium-term.

### 1.1 Historical Evolution of the Banking System

Contemporary banking history in Bulgaria began with the nationalization of the industry by the Banking Law of 27 December 1947 which gave the government an exclusive monopoly over the nation's financial system. Until 1981, Bulgaria had a very simple financial system which consisted of only three banks: The Bulgarian National Bank (BNB), The State Savings Bank (SSB) and the Bulgarian Foreign Trade Bank (BFTB). The BNB, under the control of the Council of Ministers, issued money, implemented the state's banking policy, regulated all other banks in the country, coordinated foreign economic relations, and participated with its own assets in banks and firms both in Bulgaria and abroad (Giorov & Koleva, 1990:2). The State Savings Bank had a monopoly on household deposit mobilization and housing lending. The BFTB handled all foreign exchange operations including payments of imports and exports, and foreign credits and management of foreign exchange reserves.

In 1981 the authorities created a fourth bank designed to finance enterprise activities which were not included in, or were in excess of, the official planning targets. In 1987, the government undertook a banking reform which created seve[illegible]w specialized commercial banks (SCBs) each restricted to lending in a particular economic sector (transport, agriculture, electronics, etc.). They were intended to provide credits in both levs and foreign currency; participate with their own assets in companies, firms, and joint ventures; accept savings, time, and call deposits; and provide current banking and financial services to companies (Giorov &

Koleva, 1990:2).

In 1989, the government created 59 common commercial banks (CCBs) out of the former branches of the BNB. At the same time, the state abolished specialization and all banks were allowed to function as universal banks.

## 1.2 The Current State of the Banking System

Since 1989, several new banks have been formed including three private banks. One new joint venture is a Bulgarian-U.S. institution, another is a Bulgarian-Russian bank. Currently, Bulgaria has 75 commercial banks and a Central Bank. In addition, the BNB has recently created interbank domestic and foreign currency markets and a market for Government bonds and treasury bills.

Table 1.1 summarizes the status of the banking sector. As the table indicates, The BNB is by far the largest bank in terms of capital and also has one-fifth of the system's total assets. The SSB has 39 percent of the system's places of business, 46 percent of system deposits and 14 percent of total assets. The Foreign Trade Bank has nearly one-fifth of system assets. Together, common and specialized commercial banks have virtually all of the system's BNB credits. Although there are currently 65 common commercial banks, the largest 5 have 56 percent of total CCB assets, 44 percent of deposits and 93 percent of places of business. Virtually all, 2,237, of common commercial bank's offices are representative facilities in post offices controlled by the Bulgarian Postal Bank.

Table 1.1
Summary of the Banking Sector by Type of Institution

| Banks | Number of Banks | Places of Business | Percent of Total Banking Industry (Year End 1990) Deposits | BNB Credit | Capital | Assets |
|---|---|---|---|---|---|---|
| Bulgarian National Bank | 1 | 5 | 15.8% | 0.0% | 56.5% | 20.5% |
| State Savings Bank (1) | 1 | 1,585 | 46.2% | 0.0% | 2.8% | 13.9% |
| Foreign Trade Bank | 1 | 2 | 10.1% | 1.2% | 13.1% | 24.4% |
| Specialized Commercial Banks | 8 | 51 | 11.2% | 60.8% | 16.1% | 15.7% |
| Common Commercial Banks (CCBs)(1) (2) | 65 | 2,397 | 16.8% | 38.0% | 11.4% | 25.5% |
| Total | 76 | 4,040 | 100.0% | 100.0% | 100.0% | 100.0% |
| Largest 5 CCBs(3) | na | 93.3% | 44.4% | 31.8% | 24.6% | 56.3% |
| Smallest 5 CCBs(3) | na | 0.2% | 1.0% | 0.6% | 3.4% | 0.7% |

(1) Information reflects the creation of the Bulgarian Postal Bank from 2,237 representative offices of the SSB. In reality, the Postal Bank is still in the process of formation.
(2) There were only 59 CCBs in 1990 when the "Percent of Total Industry" information was collected. Since that time approximately 6 new CCBs have been formed including the Bulgarian Postal Bank which will account for 93 percent of the CCBs' places of business.
(3)Indicates the proportion of the variable which applies to the largest (smallest) 5 common commercial banks. The largest and smallest banks are defined in relation to each variable, e.g. deposits, capital etc.

Source: Thorne, 1991

Most commercial bank stock is owned by the BNB and state enterprises. The BNB in conjunction with the World Bank has designed a merger and sales program whereby all commercial banks will be merged into seven to ten large institutions and their shares sold to private domestic and international investors.

The State's new program calls for the BNB and all state enterprises to transfer their shares in banks to a state-owned holding company in exchange for shares of the holding company. This company will then control the majority of shares for most banks and will undertake to consolidate the entire banking system into seven to ten large banks. This process is scheduled to begin in October, 1991 and be completed by the end of February,

1992. At that point, the holding company will perform a revaluation of bank assets and liabilities. When this process is completed, the company will begin to sell shares in the banks to private domestic and international investors and will use the revenue generated to repurchase its own shares. In this way, the holding company will liquidate itself (BNB Report on Banking Reform, 1991). It is anticipated that the SSB and the BFTB will be excluded from the merger process.

Given the magnitude of this undertaking's impact on the banking system, most banks are postponing all major decisions and expansion of activities until the process is complete.

1. Banking Sector Regulation. The National Bank of Bulgaria has established a number of regulations for banks. New banks must have a minimum capital stock of 50 million levs for Bulgarian ventures and USD 20 million for foreign banks. The reserve requirement is 7 percent of deposits and the minimum capital to asset ratio is 5 percent. The BNB limits outstanding commercial bank lev-denominated loan volumes. The ceiling as of September 1991 was 132 percent of total outstanding loans (in nominal terms) as of year end 1990 (Mladenov, 1991). Parliament has yet to approve a Banking Law and other important financial sector acts of legislation. Since these laws are not yet in force, bank supervision is not fully operational. Nevertheless, the BNB has established a Bank Supervision Department.

2. Domestic Credit. Table 1.2 shows the distribution of banks' outstanding loan volumes between state-enterprises, the government, private sector firms and households in December, 1990 and June, 1991. Bank credit amounted to approximately 115 billion levs in June 1991 up from 70 billion levs in December, 1990 (BNB 1991c:30). However, most of that increase was due to the increased lev value of extant foreign currency denominated loans. Indeed, when measured in foreign currency, foreign exchange loans increased by only 4 percent over the period (BNB 1991a:9) and total real outstanding credits declined by about 60 percent.[1] In June, public sector enterprises accounted for 60 percent of total outstanding credit, down slightly from 63 percent six months earlier. Outstanding foreign currency loans remained essentially constant in foreign exchange but increased radically when denominated in levs (BNB 1991a:10-11). The government's share of total credit increased from 26 percent

[1] Based on an inflation rate over the period of 317 percent (Mladenov, 1991).

to 34 percent of the total. Outstanding credits to the private sector grew by a factor of 2.9 from January to June but still declined by approximately 39 percent in real terms and accounted for only 1.7 percent of total credits in June. Outstanding credits to the population declined precipitously even in nominal terms due to prepayment of many outstanding mortgage loans.

Table 1.2
Volume, Distribution and Growth of Bank Credit

| | Year End 1990 | | June 30, 1991 | | | |
|---|---|---|---|---|---|---|
| | Volume in MM Levs | % of Total | Volume in MM Levs | % of Total | Nominal % Change over 1990 | Real % Change over 1990 |
| Debtor | | | | | | |
| State Sector Enterprises | 43,976 | 63.2 | 69,554 | 60.3 | 58 | -62 |
| Government | 18,198 | 26.2 | 39,101 | 33.9 | 115 | -49 |
| Consumers | 6,608 | 9.5 | 4,699 | 4.1 | -29 | -83 |
| Private Sector Enterprises | 767 | 1.1 | 1,959 | 1.7 | 155 | -39 |
| Total | 69,549 | 100.0 | 115,313 | 100.0 | 66 | -60 |

Source: BNB 1991c

3. Commercial Bank Resources. Nominal commercial bank resources[2] increased by over 300 percent from January through July, 1991 due almost entirely to the increased lev value of foreign currency denominated liabilities. If the exchange rate is held constant foreign currency resources declined by 1.2 percent (BNB 1991c:14). In real terms, total bank resources probably declined by about 21 percent.[3] In July 1991, credits from foreign banks and institutions accounted for approximately 58 percent of commercial banks' liabilities up from 34 percent six months earlier. This implied heavy and rapidly increasing reliance on

[2] Bank resources are composed of liabilities plus equity. The following discussion excludes the BNB and the SSB.

[3] Based on an inflation rate of 352 percent over the period (Mladenov, 1991).

foreign capital sources is misleading because, as discussed above, virtually no new foreign currency borrowing took place over the period. Furthermore, the liability is primarily held by the BFTB which had 94 percent of the banking sector's foreign currency debt in 1990 (Thorne, 1991:4). Enterprise and company deposits accounted for one-quarter of resources. Inter-bank borrowing declined sharply in real terms over the period due to a deliberate attempt by the BNB to reduce commercial banks' reliance on its refinancing and the period's highly negative real interest rates. Capital accounted for only 1 percent of banks' resources down from 3.3 percent seven months earlier. Table 1.3 details commercial banks' sources of funds.

Table 1.3
Commercial Bank* Resources
as of July 31, 1991 and December 31, 1990

| Source | | July 31, 1991 Value (MM Levs) | July 31, 1991 Percent of Total | December 31, 1990 Value (MM Levs) | December 31, 1990 Percent of Total |
|---|---|---|---|---|---|
| Capital | | 3,143 | 1.0% | 3,018 | 3.3% |
| Household Deposits | | 7,656 | 2.4% | 1,226 | 1.4% |
| Company Deposits | Total (a+b) | 80,870 | 25.1% | 25,485 | 28.1% |
| | a) In Levs | 20,427 | 6.3% | 15,283 | 16.9% |
| | b) In Foreign Currency | 60,443 | 18.7% | 10,202 | 11.3% |
| Inter-bank Borrowing | Total (c+d) | 32,138 | 10.0% | 23,875 | 26.3% |
| | c) In Levs | 28,540 | 8.8% | 23,405 | 25.8% |
| | d) In Foreign Currency | 3,598 | 1.1% | 470 | 0.5% |
| Foreign Sources | | 186,803 | 57.9% | 31,106 | 34.3% |
| Other | | 11,946 | 3.7% | 5,910 | 6.5% |
| Total | | 322,556 | 100.0% | 90,620 | 100% |

* Includes the Foreign Trade Bank. Excludes the State Savings Bank and the Bulgarian National Bank.

Source: BNB 1991b and BNB 1990.

4. Bulgarian National Bank Credits to Commercial Banks. The BNB provides resources to commercial banks for three principal purposes. The Central Bank makes deposits in commercial banks to cover bank losses from non-performing loans to state enterprises and the debt of companies which are in the process of converting from military to civilian production. In addition, the BNB makes refinancing available for up to 20 percent of banks' new lending (BNB 1991c:18). The interest rate the BNB charges on its refinancing was 4.5 percent at the end of 1990 (Thorne, 1991:24) and increased gradually to 54 percent as of August, 1991 (BNB No.4:12).

### 1.3 Types of Banking Institutions

As indicated above, Bulgaria's banking system can be divided into several groups. The State Savings Bank is primarily a consumer and mortgage lender and raises most of the system's deposits. The Foreign Trade Bank undertakes most foreign exchange transactions. The eight specialized commercial banks remain heavily focused by industry while the 59 original common commercial banks are generally very small and remain focused by geographic region. There are plans to merge the commercial banks into seven to ten larger institutions and sell their shares to the public.

1. The State Savings Bank. The State Savings Bank (SSB) is the second largest bank in terms of outlets--with 529 branches and 1,056 representative offices throughout Bulgaria. The firm controls approximately 14 percent of industry assets. Approximately 9.7 percent of SSB assets were mortgage loans at a 10 percent interest rate and an additional 3.4 percent were consumer loans at a 17 percent interest rate as of August, 1991. Until recently, the SSB had a monopoly on raising household deposits. While other banks are now mobilizing funds in this manner, the SSB still has a considerable competitive advantage both in terms of distribution system and saver habit. The SSB had 46 percent of total bank deposits[4] at the end of 1990 (See table 1.1 above.). The bank had 96 percent of lev-denominated household deposits and 75 percent of total household deposits as of June 1991 (BNB Bulletin No.3:15-

[4] Includes deposits by firms.

16). Traditionally, the SSB was limited to household and housing construction lending. Under current banking regulations, the SSB is permitted to engage in industrial and trade lending as well. While it plans to expand into these areas, currently it continues to lend only for housing and consumer purchases. The SSB is discussed in more detail in the next chapter of this report.

2. The Bulgarian Foreign Trade Bank. The Bulgarian Foreign Trade Bank (BFTB) is the largest Bulgarian bank in terms of assets - it had 24 percent of total industry assets in 1990. It is a complex institution with responsibilities which would be handled partly by the central bank and partly by commercial banks in the West. It is responsible for foreign payments, settlements and borrowing. The BFTB has 94 percent of Bulgaria's foreign debt (Thorne, 1991:4). As of July 1991, this liability for the total banking system amounted to 187 billion levs (BNB 1991b). Currently, the BFTB lacks the resources necessary to purchase the hard currency to service its debt and at prevailing exchange rates, the BFTB's obligations far exceed its assets. The Government through the BFTB has stopped payments on its foreign loans and it is currently not clear what share of these loans the state will honor. Negotiations with the IMF and commercial banks are underway to resolve this issue and reschedule the country's foreign debt. The BFTB employees some of the country's most experienced bankers.

3. Specialized Commercial Banks. The eight original specialized commercial banks (SCBs) were each established to lend to a specific industry. While all banks are now permitted to lend to all segments of the economy, these eight remain highly concentrated in their traditional sectors. The largest of the older banks, the Economic Bank, had assets of 12 billion levs at the end of 1988. This firm also has the highest concentration of state enterprises' non-performing loans. The remaining seven specialized banks had combined assets of only 9 billion levs (World Bank, 1991). Thorne (1991) estimates that SCBs hold approximately two-thirds of the banking system's non-performing loans to state enterprises. The banks are organized as stock companies with most shares held by the BNB, the BFTB and a few large state enterprises in the non-financial sector. The BNB holds 32 percent of their total stock. In addition, these banks hold significant shares in the 59 commercial banks spun off from the BNB.

4. Common Commercial Banks. Most of the new common commercial banks (CCBs) are quite small. Of the original 59 CCBs, thirty-two have no branches and the remaining 27 have one to three. As of December 1988, the largest had assets of 1.5 billion levs but some banks had total credits of no more than 30 to 40 million levs (World Bank, 1991). The largest 5 CCBs control 56 percent of total CCB assets, 44 percent of deposits and 25 percent of total capital (See Table 1.1). In general the firms have very small capital bases. As of year-end 1989, twelve had 20 million levs in capital, 28 had less than 10 million levs World Bank, 1991). Thorne (1991) estimates that CCBs hold approximately one-third of the system's non-performing state-enterprise loans. The BNB remains the principal investor in these banks. In all, the BNB owned 65 percent of their total stock. Furthermore, these firms remain highly dependent on the BNB for resources and lending decisions. Most of these firms focus by geographic region.

5. Private Banks. Currently Bulgaria has two functioning fully-private banks and another which will begin operation shortly. The largest and first to be established, appropriately named First Private Bank, is a stock company whose shareholders include private citizens, private companies, state-owned enterprises and foreign companies. It has over 100 million levs in equity and 30 branches.[5] In addition to the three predominately domestically-held firms, there are also two newly established, international joint ventures--a Bulgarian/American bank and a Bulgarian/Russian. A Bulgarian/Israeli bank is being developed. While the three firms have important public sector participation they are considered private ventures. Several public sector firms with some private ownership are attempting to negotiate the sale of their public capital in order to obtain over 50 percent private ownership and escape the impending bank merger reform. Private sector banks lend almost exclusively to private-sector enterprises.

### 1.4 Banking Sector Issues

The proliferation of banks and recent macroeconomic events have created a number of

[5] Many of which are very small two to four person outlets.

issues for the banking system. These include interest rate policy, asset quality, capitalization, branch adequacy, BNB reliance, deposit insurance availability, foreign currency exposure, and staffing and equipment issues. In addition, there are issues which the impending bank merger will address.

1. Interest Rates. Interest rates were slightly positive in real terms from 1986 to 1988. By 1989 they were - 4 to - 9 percent. In 1990, the real rate was - 36 to - 39 percent (Thorne, 1991:11).[6] Interest rates on deposits followed a similar trend as those on borrowings (Thorne, 1991:16). Currently banks are paying a rate of approximately 54 percent on deposits - although this varies depending on the length and amount of deposit. Banks typically have a 300 to 500 basis point spread between their deposit and lending rates. The real rates implied by these nominal terms are not easy to determine as there exists no thoroughly reliable data on Bulgaria's current inflation rate. Nevertheless, several sources place inflation from 300 to 440 percent for only January to June, 1991 (World Bank, 1991; Mladenov, 1991; BNB 1991c) and Mladenov (1991) states that the August rate was 7.5 percent--almost 140 percent on an annualized basis. Thus, it is indisputable that current rates are highly negative.

BNB management interviewed are acutely aware of this problem. Nevertheless, they have no plans to radically increase current interest rates. While in theory the BNB has the right to autonomously set interest rates, they maintain that they are prevented from enacting sharp increases by political and popular pressure. Furthermore, they believe such a move would have a disastrous effect on Bulgaria's already precarious economy. One manager stated that bringing interest rates up to positive levels would close down 80 percent of the economy. Another manager said that they hoped to use interest rate policy as a means of fighting inflation and were worried that if they indexed rates to price increases, inflation would be more difficult to quell.

2. Asset Quality. Banks have two principal sources of losses. The first is non-

[6] Furthermore, Thorne (1991) argues that until 1991, real interest rates did not accurately reflect the opportunity cost of funds because real rates are determined by comparing nominal rates to movements in the price index and this latter variable was kept artificially low. To compensate for this distortion, Thorne computes the real opportunity cost of domestic credit by calculating the cost in lev of borrowing from a German bank in DM. Thorne finds that this opportunity cost was 40 percent in 1988, increased to 92 percent in 1989 and then declined to 33 percent in 1990. During this period, domestic credit was available at rates from approximately 2 to 7 percent.

performing loans to "sick" state enterprises - most of which the BNB initially made and later transferred to commercial banks - and the second is the losses banks incurred through levs devaluation when they borrowed in foreign currencies and made loans in levs. The second type of loss was principally incurred by the BFTB as this bank accounts for 94 percent of the banking system's total foreign currency borrowings (Thorne, 1991:4).

Under Bulgaria's old economic system, banks had minimal worry regarding bad debts. Even if state enterprises could not repay their credits, banks could count on the government to bail out the firms. However, the situation has now changed and many banks have outstanding loans for which they will probably never be repaid. Table 1.4 below details Thorne's (1991) estimates[7] of non-performing loans by common and specialized commercial banks. As the table indicates, at the end of 1990, non-performing loans stood at 21.3 billion levs and accounted for slightly over one-half of commercial banks' outstanding loans. This figure was equivalent to 34 percent of GDP. BNB bank management interviewed put the volume of total non-performing loans at approximately 17 billion for December 1990. Since January, many firms have rescheduled their loans and have begun to repay. However, new loans have become non-performing over the period. BNB management felt that the total volume of non-performing loans in September 1991 was probably roughly equal to its volume nine months before.

Table 1.4
Thorne's Estimates of Non-Performing Loans as of end-1990

| | Total Commercial Banks | Specialized Commercial Banks | Common Commercial Banks |
|---|---|---|---|
| in Billion of Levs | 21.3 | 13.3 | 8.0 |
| As Share of GDP | 34.4% | 21.4% | 12.9% |
| As Share of Outstanding Bank Credits | 53.9% | 64.6% | 42.3% |

Source: Thorne (1991)

[7] Thorne arrives at these estimates by assuming that 80 percent of loans transferred by BNB to SCBs and 44 percent of loans transferred by BNB to CCBs were non-performing. It is not clear from the text how Thorne chose these figures.

As discussed below, many banks are also undercapitalized and cannot afford to absorb the losses which will result from these loans. However, the effect of these loans on banks' balance sheets is limited. The BNB has deposits in banks almost equivalent to the amount of these credits because the BNB established SCBs and CCBs by transferring the same amount of loans and deposits. The primary effect of these loans on the banking system is to severely damage the BNB's net worth and cash-flow because BNB funded its deposits in the commercial banks by borrowing from the SSB. Thus, while it has to pay interest on its SSB loans, it may not receive payment on its deposits to the commercial banks.

Banks have some non-performing assets in addition to those transferred to them by the BNB. The losses resulting from these loans are being handled by the banks on budget.

The state is considering allowing banks to write off 4 billion levs of credits and transferring an equivalent amount of resources to the firms from the government budget. This 4 billion would represent only 20 percent of Thorne's bad debt estimate.

3. Capital and Risk Management. The BNB (1991c:31) puts total bank capital at 4.4 percent of assets in June, 1991 but commercial bank capital[8] was an incredibly low 0.9 percent of assets in the same month (BNB 1991c:27). As a general rule and excluding the BNB, the larger banks have lower capital to assets ratios (Thorne, 1991:6). A new law requires all banks to have capital equal of at least 5 percent of their liabilities. Yet current international standards call for capital to be at least 8 percent of risky assets.

In another break with internationally accepted rules of banking, Bulgarian banks are allowed to purchase shares in non-financial firms. This type of investment can pose substantially greater risks than lending and can also create conflicts of interest for the banks. Yet, securities accounted for only 0.3 percent of commercial bank assets in July, 1991 (BNB 1991b). Thus, currently this is not an area of concern.

4. Deposit Insurance System. Currently the Bulgarian government insures deposits in the State Savings Bank but not commercial bank deposits. The original rationale behind this system was that households made deposits in the SSB whereas enterprises used the commercial banks and the latter customers were presumed to be more capable of looking after

[8] Excluding the BNB and the SSB.

their own interests and more able to absorb any loss in funds which might result from a bank failure. Although all savers are now free to make deposits in any bank, the Bulgarian government has no plans to modify the uneven deposit insurance scheme. Commercial banks pay higher rates of return on savings than the SSB[9] in order to attract resources. Given that the SSB and commercial banks will be increasingly competing for the same savers and borrowers, this system creates an unfair advantage for the SSB. However, over the short-term, this advantage does allow the organization to partially overcome its handicap of large outstanding loans at concessionary interest rates.

5. Bank Branch Network. The as yet nascent Bulgarian Postal Bank plans to have 160 branches and representative offices in 3,000 post offices by the end of 1992. Excluding the Postal Bank, there are only 160 offices of commercial banks. The SSB has 529 branches and 1,585 representative offices. This branch network is grossly inadequate to service the private sector which will spring up over the short to medium term. Furthermore, it is insufficient for mobilization of the household savings which will be needed to meet the new firms' demand for credit. Finally, such a small branch network inhibits competition. Most small cities have only one bank or bank branch. An indication of the stunted nature of Bulgaria's branch network is that in Western Europe there is one bank branch for every 1,500 to 3,000 people whereas the comparable figure for Bulgaria is one for every 20,000 people (World Bank, 1991).

6. Reliance on BNB Resources. While the State Savings Bank has historically been a net lender to the banking system, the remaining commercial banks, and particularly the eight specialized banks, have been highly dependent on the BNB for resources. As of year-end 1990, the SCBs' ratio of BNB credit to bank assets was 57 percent. The CCB's ratio was 22 percent (Thorne, 1991:4). The BNB is well aware of the unhealthy nature of this dependence and has restricted its refinancing to no more than 20 percent of banks' assets (Mladenov, 1991).

7. Foreign Currency Exposure. Since the mid-1980s, banks have borrowed extensively in foreign currencies and made loans in levs. Thus, these firms have assumed all foreign

[9] The differential is now as high as 10 percentage points for some types of deposits.

exchange rate risk. By November 1990 banks' foreign exchange risk as defined by Thorne (1991) was 4.8.[10] Thus, a one percent nominal devaluation at that time would have had the effect of increasing average bank liabilities by 4.8 percent more than assets. For the BFTB, this figure was 8.5 at the same time. The exchange risk for the banking industry represented 39 percent of GDP at that time and 54 percent of BFTB assets (Thorne, 1991:23). Virtually all of the banking system's foreign exchange rate exposure is concentrated in the BFTB. As of July, 1991, commercial banks' total foreign currency liabilities amounted to 251 billion levs - approximately 78 percent of their total assets. Approximately 75 percent of total foreign currency liabilities were to foreign institutions (BNB 1991b).

8. Staff, Training and Equipment. A large expansion in the branch network requires a concomitant growth in financial sector personnel. Yet even current bank employees are poorly trained to perform their roles in a liberalized financial system. Due to the highly controlled nature of Bulgaria's traditional financial sector, banks have not had to concern themselves with interest rate risk management, prudent underwriting practices, resource mobilization strategies, etc. Thus, current bank staff lack the skills and experience to undertake these tasks, much less the ability to train the large number of new employees the sector will need.

The banking system also lacks the computer and telecommunications equipment and personnel which the sector's growing size and complexity requires. Currently a joint stock company almost wholly owned by the BNB handles the electronic processing of the entire accounting system of most Bulgarian banks.

The BNB, with assistance from international donors, has recently established a Banker's Training Institute.

9. System of Payments. Bulgaria needs an expanded and more efficient payments system. Currently almost all transactions are accomplished with cash. Checks are rarely used and clearing takes considerable time. The clearing process is undertaken by the same firm which handles banks' electronic accounting systems and its equipment and methods are

[10] Thorne (1991:10) defines foreign exchange risk as "the ratio of total foreign exchange deposits to total enterprises' foreign exchange loans, that is, excluding General Government's foreign exchange denominated loans." This ratio measures the effect on bank net worth of a nominal devaluation.

outdated and inefficient. Furthermore, the demand for and use of credit cards, ATMs and bills of exchange will grow extremely rapidly in the short- to medium-term. Finally, the current heavy dependence on cash has led to a very high demand for base money. This could lead to swift acceleration in velocity of money and thus to inflationary pressures if individuals decide to reduce their cash holdings in response to expectations of future rapid price increases.

10. Additional Banking Issues Which the Bank Merger Process Should Rectify. Additional problems which the bank merger scheme should redress include conflicts of interest in bank ownership, banks' inability to exploit economies of scale, and industry and asset concentration.

(a) Bank Ownership. As mentioned above, bank stock is primarily held by the BNB, the BFTB, other banks and large, non-financial enterprises. BNB ownership of banks can create conflicts of interest for that institution between its duties as a bank regulator and its interests as a stockholder. Bank ownership by non-financial enterprises can also be dangerous in that firms can use their stockholder position to pressure banks into issuing imprudent credits.

(b) Bank Size. Many banks are too small to exploit economies of scale. Furthermore, most Bulgarian enterprises are large and require major loans but many banks are unable to offer very large credits without becoming dangerously exposed to a single client. The government agrees that there are too many banks. Their initial solution was to leave the merger process to the market. However, there is very poor information about the small banks, and financial institutions lack the capital to purchase each other. Also, many bank managers are reluctant to lose their autonomy. Finally, investors are reluctant to purchase the firms as many have poor quality assets. Thus, there has been minimal activity in this area.

(c) Industry Concentration. Bulgaria not only has too many banks relative to the size of its financial system but also the industry is highly concentrated. At the end of 1990, the BNB, SSB and BFTB together accounted for 59 percent of total system assets, 72 percent of deposits and 72 percent of capital. On average, each of the eight original specialized commercial banks accounted for less than 2 percent of total assets, deposits and capital while each of the 59 original common commercial banks accounted for 0.6 percent or less of these resources. Within the common commercial bank segment, the largest five of the original 59 accounted for one-quarter to more than one-half of assets, deposits and capital in 1990 while the smallest five accounted for less than 3.5 percent of these resources. The State Savings Bank owned 46 percent of all bank places of business, thereby giving it a significant advantage over other lenders in deposit mobilization and consumer lending. See Table 1.1 above.

(d) Asset Concentration. As mentioned above, traditionally, the SSB and the older commercial banks focused on specific market segments. While most banks are now attempting to diversify their assets, they remain dangerously concentrated in their traditional sectors. Furthermore, these firms lack experience outside their traditional investment habitats and could make serious mistakes as they attempt to diversify their holdings.

**1.5 Conclusion**

The Bulgarian banking system evolved slowly from the 1950s to 1990. Currently the system consists of several large, specialized banks and a number of very small firms. Virtually all firms are state-owned and most are dangerously undercapitalized. Currently about 60 percent of Bulgaria's outstanding bank credits are to state enterprises, one-third to the government and 5.8 percent to consumers and nascent private sector enterprises. Outstanding bank credits stood at 115 billion levs in June 1991. This represented a decline of about 60 percent in real terms since December 1990. Foreign liabilities and domestic liabilities in foreign currency amount to over three-fourths of total bank resources. Total bank resources declined by about 21 percent in real terms from December 1990 to July 1991.

Government plans call for substantial banking sector modifications over the next year or so. The new system which will result should consist of seven to ten large, diversified, privately-owned firms and a number of small banks which did not participate in the merger process. The merger program is expected to correct a number of the financial systems current ills. Nevertheless, the merger program does not address the banking sector's very negative real interest rates, large volume of non-performing loans, foreign exchange rate exposure, limited bank branch network, inadequately trained personnel and a number of other issues.

## 2 The Housing Finance System and the State Savings Bank

The State Savings Bank (SSB) was created in 1951 to act as a financial intermediary to accumulate savings from the population and make short term consumer loans. In 1957, the SSB became the nation's mortgage lender while the BNB handled housing construction loans. In 1986, the BNB transferred its housing construction lending to the SSB. The SSB was the only bank authorized to make housing loans until 1989. In 1989, the SSB, along with all other Bulgarian banks, received permission to participate in a wide variety of banking and financial sector activities including accepting deposits from enterprises, undertaking commercial and agricultural lending, selling securities and auctioning bonds.

Although all banks are legally able to undertake housing finance, in practice virtually none have done so. The SSB believes that no other banks are engaged in mortgage lending and that it has over 95 percent of the housing construction market. At the end of 1990, the State Savings Bank accounted for 46 percent of total banking industry deposits and 14 percent of assets. BNB management maintain that the bank merger process will probably not affect the integrity of the SSB. The BNB considered carving up the SSB into a system of Savings and Loans. However, SSB management strenuously opposed the idea and for this and other reasons it appears unlikely that the measure will come to pass. Nevertheless, the SSB recently lost 2,237 of its 3,293 representative offices to a newly created Bulgarian Postal Bank. This should significantly weaken the SSB's monopoly on household deposit mobilization and lending.

To date, the SSB has provided housing loans to almost 100 percent of applicants. In the past, families did not apply for loans unless they had permission from the municipality to buy or build a unit and had complied with SSB's savings requirements. When these conditions were met, loan approval was automatic.

## 2.1 State Savings Bank Branch Network

The SSB has 238 branches, 291 subsidiary offices and 1,056 representative offices.[11] Excluding the Postal Bank, the SSB has 88 percent of banks' total offices, if the Postal Bank is included, it has approximately 39 percent of the total (Table 1.1). The SSB has no plans to increase its current outlet network although it is planning a reorganization in which some of its branches will be downgraded to subsidiaries.

## 2.2 State Savings Bank Assets

SSB assets totaled almost 29 billion levs in August 1991, up from 22 billion in August of 1987. In real terms assets declined by approximately 83 percent.[12] Household loans increased from 14 percent to 24 percent of total assets over the period. Lending to the BNB accounted for 72 percent of total assets in 1987. This figure declined to 6 percent by 1990 but lending to other banks increased from 0 to 60 percent of assets over the period. This trend reflects the fact that in the past the BNB borrowed from the SSB and lent these funds to commercial banks whereas now the SSB and commercial banks transact directly. The SSB has no foreign currency denominated assets. Table 2.1 delineates the SSB's asset portfolio.

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[11] Subsidiary branches do not keep their own separate accounts and do not have the right to issue housing loans, although they do issue consumer credits. Representative offices are little more than windows at post offices, state enterprises, cooperatives etc. which accept deposits, loan applications etc. but do not perform substantive tasks.

[12] Inflation was approximately 64 percent in 1990 and 386 percent from January through August 1991. Thus, compound inflation for January 1990 to August 1991 would be about 697 percent. Inflation was quite low from 1987 to 1989 and for the purposes of this exercise, we have assumed that it was zero.

Table 2.1
Assets of the State Savings Bank
For August 1991 and August 1987

| | August 1991 | | August 1987 | |
|---|---|---|---|---|
| | Volume (Billion LV) | % of total | Volume (Billion LV) | % of total |
| Loans to Households | 6.89 | 23.9 | 3.11 | 14.4 |
| Loans to Other Banks | 17.31 | 60.1 | 0.00 | 0.0 |
| Loans to BNB | 1.84 | 6.4 | 15.48 | 71.5 |
| Loans to Non-financial Firms | 0.23 | 0.8 | 0.26 | 1.2 |
| All Other Liabilities | 2.53 | 8.8 | 2.80 | 12.9 |
| Total | 28.80 | 100.0 | 21.65 | 100.0% |

Note: These figures may not be completely accurate due to some ambiguities in aggregating.

Source: The State Savings Bank

### 2.3 State Savings Bank Resources

The SSB receives the overwhelming majority of its resources--78 percent--from household deposits. The share of household savings in total resources has declined slightly from 83.5 percent four years ago. Nevertheless, the SSB retains over 94 percent of the banking industry's domestic currency household deposits and 75 percent of total household deposits. Other deposits, including deposits of firms and municipalities, have increased very significantly over the period from 1.1 to 14 percent of total funds. Equity has declined reflecting the fact that the firm has experienced financial difficulties due both to the dramatic decline in real lending and its portfolio of outstanding loans at subsidized interest rates. The SSB has no foreign currency liabilities. Table 2.2 details the SSB's resource portfolio.

Table 2.2
State Savings Bank Resources
For August 1991 and August 1987

| Source | August 1991 | | August 1987 | |
|---|---|---|---|---|
| | Volume (Billion LV) | % of total | Volume (Billion LV) | % of total |
| Household Deposits | 22.57 | 78.4 | 18.07 | 83.5 |
| All Other Liabilities | 4.04 | 14.0 | 0.23 | 1.0 |
| Equity | 2.19 | 7.6 | 3.35 | 15.5 |
| Total | 28.80 | 100.0 | 21.65 | 100.0 |

Note: These figures may not be completely accurate due to some ambiguities in aggregating.

Source: The State Savings Bank

## 2.4 SSB Profitability

From 1987 to 1989, SSB net profit increased by approximately 10 percent per year and stood at 243 million levs in 1989. However, in 1990 profits dropped by almost one quarter in nominal terms to 187 million levs. In real terms the profit decline was approximately 40 percent. Return on average equity (ROE) was about 1 percent in 1987. Equity figures for other years were not available. The SSB's "tax rate"[13] is 80 percent of net profits compared to approximately 55 percent for commercial banks.

## 2.5 Housing Finance Loan Products

Until 1991, the SSB's housing lending was fairly consistent in terms of volume of lending and financing terms. Since that time however, many programs and practices have changed considerably. The bank makes short-term construction loans to municipalities and ministries, mortgage and major repair loans to households and combined construction and mortgage loans to individuals and cooperatives which build their own homes.

[13] The share of SSB profits appropriated to the budget

1. Construction Loans. Until 1989, the SSB lent only to municipalities for construction purposes and the BNB lent to other builders. Since that time the bank has lent to municipal councils for the construction of sale and rental units and to ministries and state-enterprises for the construction of housing for their employees. In the past, such loans were at 4 percent for four years for the full cost of the construction. Until recently, approximately 45 percent of annual short-term construction lending was to municipal councils and 55 percent to ministries and state-owned enterprises. Over the last six months, the municipalities have increased their share to approximately 60 percent. SSB management anticipate that over time, municipalities and ministries will cease to be involved in the construction of sale-housing and the currently state-owned construction companies will become private and account for the majority of lending in this sector.

Currently, construction loans are generally for 2.5 years and carry an interest rate of 55 percent or slightly higher. It is assumed that it will take the developer two years to build the units and an additional 6 months to sell them. The loan is disbursed in tranches as the developer requests it. During the first two years, the developer pays only the interest on the loan, over the course of the last six months, he repays the entire principal. Loans are for 100 percent of the cost of construction in the case of municipalities and 70 percent of construction for all other entities. Non-municipality borrowers must place a deposit equal to 30 percent of the cost of the project in a deposit account with the SSB. The SSB plans to extend the 70 percent loan-to-cost and 30 percent deposit rules to municipalities shortly.

2. Mortgage Loans. For home purchase the SSB had a standard mortgage which varied slightly with family composition. In general, the SSB gave credit to individuals to purchase dwellings with a maximum loan of 20,000 levs and a maximum term of up to thirty years at 2 percent annual interest. This was conditioned on the individual having had a housing-linked deposit with the bank of 30 percent of the cost of the unit for a minimum of six months. One percent interest was paid on such deposits, and at the end of 1989 there were 623,923 such deposits totalling 2,853 million levs. More attractive terms were available for young families and families with more children. Prior to the recent deregulation of housing prices, the maximum loan plus deposit was sufficient to purchase a standard state-constructed unit.

In general, loans were secured with a standard mortgage although in some cases additional collateral or co-signers were required. Loan payments were usually deducted by employers and in general repayment was affordable and not a problem. Foreclosure proceedings existed and have been used, but payroll deductions, affordable payments, and the fact that the municipality would be responsible for finding alternative housing for households in foreclosed premises, limited repossession. SSB staff interviewed said that the SSB had undertaken fewer than 10 foreclosure proceedings in the last 10 years.

The SSB is in the process of decreasing the term on mortgage loans from 30 to 20 years. These loans now carry an interest rate of 49 percent for families with housing-linked savings account balances of 30 percent of the house cost held with the SSB for at least six months. The SSB pays the seller the loan amount plus the buyer's deposit amount. If this less than the cost of the unit, the buyer must pay the difference in the form of a larger deposit. The SSB does not have a maximum payment to income ratio. The bank requires households to retain from the combined incomes of all members 65 percent of the minimum wage per person.[14] All income families earn over this amount can be used for mortgage repayments. The SSB no longer provides concessionary terms to larger families. The SSB sometimes requires borrowers to have guarantors[15] and/or mortgage additional property. The SSB's only mortgage product is a standard, equal-monthly-installments instrument.

Given Bulgaria's current wage structure, mortgage products, interest rates and construction costs, most families can no longer afford loans covering a significant portion of housing costs. For example, the average income in Sofia is currently approximately 935 levs per month. A two-income family with two dependents earns 1,870 levs per month in income and an additional 320 levs per month from the state for child allowances. The SSB's regulation requires them to save 1,612 levs per month for all non-mortgage expenses. Thus they can devote 578 levs per month to mortgage payments--an amount equal to 28 percent of their total income. With this cash flow, they can afford to take a 20 year loan at a 49 percent

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[14] Currently the minimum wage is 620 levs per month and the minimum living standard per person is 65 percent of that--403 levs. This amount is widely considered to be inadequate.

[15] Guarantors are financially liable for the debt if the borrower defaults.

interest rate for 21,000 levs. This is equivalent to only approximately 21 percent of the cost of a non-subsidized 50 square meter unit priced at 2,000 levs per square meter or 42 percent of the cost of the same unit sold by the state priced at 1,000 levs per square meter.

Over the last year, SSB's loan sizes have not kept pace with increases in unit costs. The SSB's maximum loan size is still only 20,000 levs. In the future, the SSB will issue loans for from 70 to 100 percent of the cost of a unit based on the state-determined price of 1,000 levs per square meter. If costs exceed 1,000 levs per square meter--as they will for all privately constructed and/or sold units--the borrower will pay directly to the seller the difference between the loan and the actual cost. If borrowers keep a deposit equal to 30 percent of the state-determined home price in the SSB's housing-linked savings account scheme for at least six months they will be eligible for loans at a 49 percent interest rate. If they do not make a housing-linked deposit of at least this amount they will pay an interest rate of 54 percent on loans for up to 70 percent of the state-determined cost of the unit and a rate of 57 percent on the portion of the loan which is from 70 to 100 percent of the state-determined cost. Beginning in January 1992, borrowers will be required to keep deposits in housing-linked accounts for at least one year to be eligible for the lower interest rate.

Nevertheless, it is unlikely that this new system will have a significant impact on housing affordability because, as indicated above, few families will be able to service loans for amounts significantly above the current loan ceiling.

3. Long-term Construction Loans. For individual families or cooperatives who wish to build their own units, the SSB makes combined construction/mortgage loans called long-term construction loans. The SSB scrutinizes the plans for these units before the loans are authorized. The credits are disbursed in three stages as construction proceeds. SSB agents visit the construction sites periodically to make sure that construction is proceeding in a timely fashion. During the construction period, interest is capitalized. When construction is completed (a maximum of four years after the first tranche of the loan is disbursed) the loan becomes a standard 20 year mortgage with mortgage interest rates and terms. As is the case with mortgage loans, the maximum loan size for this product is 20,000 levs but is being increased to 70 percent of the regulated price of units.

4. Other Housing Finance Products. The SSB also lends, with a maximum of 10,000

levs and a term of 20 years for repairs and upgrading. The firm plans to increase this maximum loan size to 70 percent of the cost of the project.

### 2.6 Volume of Lending by Type of Loan Product

Lending was quite stable until 1990. From 1985 to 1989, the total number of housing-related loans issued varied from 53,000 to 60,000. Lending in 1987 can be taken as representative of the period. In 1987, the SSB issued 57,515 housing loans of which 54,278 were for home purchase. The number of home purchase loans was equal to approximately 85 percent of the number of units produced in that year. SSB's total housing lending volume was 893 million levs. Housing loans accounted for approximately 62 percent of SSB's retail lending in that year. Total home purchase loans accounted for 36 percent of SSB retail credit volume and short-term construction loans accounted for approximately one-fourth of volume.

Lending in terms of number of loans issued and volume was extremely high in 1990 reflecting the government's massive sale of state-owned housing at pre-1990 prices and deregulation of the inter-household real estate market. The total number of housing loans that year was 166,461 and volume was 2 billion levs. These loans accounted for 68 percent of total SSB retail lending. For 1990, home purchase lending accounted for 61 percent of total retail loan volume. The volume of short-term construction loans declined significantly over the year and accounted for only 6.6 percent of loans. In the first half of 1991 housing loans accounted for approximately three-fourths of SSB retail lending volume. Mortgage lending continued to exceed 1987 figures (if 1991 figures are annualized) due to the continued sale of homes at pre-1990 prices. Nevertheless, these sales were well below the peak reached in 1990. Short- and long-term construction lending plummeted. From January through June 1991 total housing loans were 27,396 and volume of these credits 386 million levs. A very rough estimate of the real decline in lending volume from 1987 to 1991 is that in real terms first semester 1991 housing loan volume was approximately 26 percent of volume in the first semester of 1987.[16] Table 2.3 provides information on SSB household loans sanctioned .

[16] Inflation was approximately 64 percent in 1990 and approximately 317 percent in the first half of 1991. We assume that inflation was almost negligible from 1987 to 1989.

since 1987 by type of loan. Trends for each type of lending are discussed in more detail below.

Table 2.3
SSB Household Issued by Type of Loan
1987 to 1991

| | 1987 Number | 1987 % tot vol | 1990 Number | 1990 % tot vol | 1991 Number January to June | 1991 % tot January to June |
|---|---|---|---|---|---|---|
| Mortgages | 34,438 | 24.0% | 127,811 | 45.9% | 25,567 | 36.9% |
| (Rental as % of total) | 55.9% | 55.3% | 73.9% | 69.4% | 83.9% | 74.9% |
| Long-term Construction | 19,840 | 12.2% | 34,585 | 15.3% | 1,644 | 5.2% |
| Total Home Purchase | 54,278 | 36.2% | 162,396 | 61.2% | 27,211 | 42.1% |
| Repair and Upgrade | 2,749 | 0.4% | 3,576 | 0.3% | 63 | 0.0% |
| Short-term Construction | 488 | 25.2% | 519 | 6.6% | 122 | 32.4% |
| Total Housing | 57,515 | 61.9% | 166,491 | 68.1% | 27,396 | 74.5% |
| Consumer | 418,423 | 38.1% | 337,147 | 31.9% | 39,045 | 25.5% |
| Total | 475,938 | 100.0% | 503,639 | 100.0% | 66,441 | 100.0% |

Source: SSB Records

1. Mortgage Loans. Table 2.4 examines mortgage lending from 1987 to 1991. Mortgage lending was relatively stable from 1985 to 1989. Taking 1987 as a typical year, there were approximately 34 thousand loans sanctioned yearly over the period and a yearly volume of approximately 347 million levs. Loans for the purchase of rental units accounted for slightly over one-half of total mortgage loans. The remaining 46 percent of loans was accounted for almost entirely by the sale of state-constructed new units. Average loan size was approximately 10 thousand levs.

Table 2.4
Mortgage Lending
From 1987 to 1991

| | 1987 | 1990 | 1991 January to June 30 | Real % Change 1987 to 1990 | Real % Change 1987 to 1991* |
|---|---|---|---|---|---|
| Total # Mortgages | 34,438 | 127,811 | 25,567 | 271 | 48 |
| # Former Rental Units | 19,235 | 94,436 | 21,445 | 391 | 123 |
| # All Other Units | 15,203 | 33,375 | 4,122 | 120 | -46 |
| Total Volume (MM Levs) | 347 | 1,376 | 191 | 210 | -67 |
| Volume Former Rental Units | 192 | 955 | 143 | 288 | -56 |
| Volume All Other Units | 155 | 421 | 48 | 112 | -82 |
| Average Loan Size ('000 LV) | 10.1 | 10.8 | 7.5 | -17 | |

* To facilitate comparison, 1991 figures are compared to first semester 1987 figures.

Source: SSB Records

In 1990 the number of mortgage loans sanctioned increased by over 270 percent, reflecting the massive state sale of its rental stock at highly subsidized prices[17] and the fact that many people took advantage of the deregulation of the inter-household housing market to sell their second units. The number of loans issued to cover the sale of rental units in 1990 was 94,436--391 percent greater than the number issued in 1987. The enormous increase in this lending was due to the fact that the state made these units available for sale and families took advantage of the opportunity to purchase them at very low prices while construction

[17] The state sold its rental housing stock at from 137 to 170 levs per square meter although the free market price for housing was approximately 400 levs per square meter in January 1990 and increased to from 1,800 to 3,000 levs per square meter by September, 1991.

costs were increasing precipitously.

From 1987 to 1990, the number of loans issued to cover the sale of non-rental units increased by 120 percent and its composition changed almost completely. In 1987, loans issued in this category were almost exclusively for the sale of newly constructed state units. However, none of these units were sold between March 1990 and October 1991 because rapid construction price increases over the period made it very difficult to establish a realistic sales prices. Thus, the units financed under this category in 1990 and 1991 were almost entirely units sold by one household to another. The number of these sales financed by the SSB increased from almost none in 1987 to probably over 25,000 in 1990. This explosive growth was due to the fact that prior to 1990, households were not allowed to own more than one home and one vacation unit. Nevertheless, many families clandestinely owned additional dwellings. Also prior to 1990, families selling units to each other were required to charge a state-mandated price. Both the prohibition against ownership of multiple dwellings and the control over inter-household sales were lifted in 1990. Many families took advantage of this market deregulation to sell their units. Thus, while construction prices increased several-fold over the course of the year this did not slow loan demand as the state sold its rental stock at pre-1990 prices and many private units which had been "hidden" entered the market.

Over the course of 1991, housing prices continued to rise and mortgage interest rate increased from 2 percent in December, 1990 to 49-54 percent by August, 1991. Not surprisingly, lending volume declined sharply in 1991 and 84 percent of loans were for rental units--which the state continued to sell at pre-1990 prices. The total number of non-rental units sold dropped to only 4,122 in the first six months of 1991--on an annualized basis only one-quarter of the number in 1990 and about one-half of the figure in 1987. All of these loans were for inter-household sales as no new state-constructed units were sold. Total first semester 1991 volume of mortgage loans was only about one-third of its volume in first-semester 1987 in real terms. Average loan size dropped sharply from 1990 to 1991 reflecting the reduced affordability of mortgages as the interest rate rose. It is anticipated that mortgage sales for second semester 1991 will be significantly below those of the first semester. The state rental stock available for sale is exhausted everywhere but Sofia and even in the capital it is almost entirely depleted. While the government plans to renew its sale of newly constructed units, escalating costs and prohibitive interest rates will make these and all other units very difficult to afford. See the Housing Finance Loan Products section above.

2. Long-term Construction Loans. In 1987, loans for long-term construction totaled 19,840. The volume of these loans was 176 million levs. In 1990, demand for these loans increased sharply probably due to the rapidly increasing importance of the private sector in the housing construction industry[18] and rumors that interest rates would increase soon. Real average loan size also increased reflecting rapidly increasing construction costs. Over the last year, the demand for this type of loan has plummeted. Given the extreme volatility in housing construction prices, families have been very reluctant to undertake construction projects since they have no way of ascertaining at the beginning of the project the total cost of the undertaking. Furthermore, most families can no longer afford the cost of building a unit and compounding this difficulty is that interest rates increased from 2 to 49-54 percent from January to June, 1991. The number of these types of loans sanctioned in the first six months of 1991 was about 17 percent of its level in first-semester 1987. From 1987 to 1991, the average size for these loans increased steadily but significantly lagged price increases reflecting the fact that high interest rates made larger loans unaffordable. Real lending volume for the first semester of this year is about 9 percent of its half-year 1987 level (table 2.5).

[18] See Hoffman, M., M. Koleva, M. Ravicz, & M. Mikelsons (1992), "Bulgaria: Shelter Sector Assessment."

Table 2.5
Long-term Construction
1987 to 1991

| | 1987 | 1990 | 1991 January to June 30 | Real % Change 1987 to 1990 | Real % Change 1987 to 1991* |
|---|---|---|---|---|---|
| Number | 19,840 | 34,585 | 1,644 | 74 | -83 |
| Volume (MM LV) | 176 | 459 | 27 | 104 | -91 |
| Average Size ('000 LV) | 9 | 13 | 16 | 17 | -45 |

* For ease of comparison, 1991 figures are compared with first-semester 1987 figures.

Source: SSB Records

3. Short-term Construction Loans. Table 2.6 details the SSB's short-term construction lending for 1987 to 1991. In 1987, the SSB made 488 loans totalling 364 million levs to municipalities, ministries and state enterprises for housing construction. By 1990, the total number of loans issued had increased slightly to 519 but total volume had declined by 57 percent in real terms. The increased number of loans coupled with the decline in average loan size may be explained by the fact that during 1990, the country's large construction companies were being broken into smaller enterprises and firms were no longer able to undertake large projects. If first semester 1987 figures are compared with 1991 results it appears that for 1991, the total number of loans issued will drop by about one-half while, in real terms, construction lending volume will probably be about 28 percent of its 1987 level.

Table 2.6
Short-term Construction Lending
From 1987 to 1991

| | 1987 | 1990 | 1991 January to June 30 | Real % change 1987 to 1990 | Real % Change 1987 to 1991* |
|---|---|---|---|---|---|
| Number | 488 | 519 | 122 | 6% | -50% |
| Volume (MM LV) | 364 | 199 | 168 | -57% | -72% |
| Average Size ('000 LV) | 746 | 383 | 1,377 | -60% | -45% |

* For ease of comparison, 1991 figures are compared with first semester 1987 figures.

Source: SSB Records

4. Repair and Upgrading Loans. Loans for repair and upgrading have always been a very small share of SSB's total loans. These loans numbered only 2,749 in 1987 and represented only 0.4 percent of SSB lending volume for that year. The number of these loans increased 30 percent in 1990 as many people took advantage of the low rates suspecting they would soon be raised. Lending for repair and upgrading has virtually ceased this year. For the first semester of 1991, the SSB issued only 63 of these loans.

Table 2.7
Repair and Upgrading
1987 to 1991

| | 1987 | 1990 | 1991 January to June 30 | Real % Change 1987 to 1990 | Real % Change 1987 to 1991* |
|---|---|---|---|---|---|
| Number | 2,749 | 3,576 | 63 | 30 | -95 |
| Volume (MM Levs) | 6 | 8 | 0.1 | -1 | -99 |
| Average Size ('000 LV) | 2.2 | 2.2 | 1.6 | -24 | -79 |

* For ease of comparison, 1991 figures are compared with first semester 1987 figures.

Source: SSB Records

## 2.7 Competition in the Housing Finance Market

Currently the SSB is doing almost 100 percent of Bulgaria's mortgage lending and probably over 95 percent of housing construction lending. Yet the SSB expects that as the commercial bank merger issue is resolved and prices and interest rates stabilize, commercial banks will move into housing finance. A limited amount of lending for non-housing purposes is being undertaken by the commercial banks using real property -- generally homes -- as collateral.

The SSB has several advantages which should enable it to retain its hegemony in the market. Being the country's only housing lender from the 1950s to 1989, it has tremendous name recognition. Second, as discussed above, the SSB has more branches and places of business than all other banks combined, with the exception of the nascent Bulgarian Postal Bank. Third, and also reviewed in chapter one, the SSB is the only Bulgarian bank whose deposits are insured by the government. This allows it to pay lower rates on its deposits and pass these savings to borrowers. Indeed, the SSB is currently making construction loans at a 55 percent interest rate while other banks are charging 60 percent or more. Finally, other lenders may be reluctant to enter the market until an adequate foreclosure law is developed. Indeed, as default risk grows, the SSB may also find the lack of an effective foreclosure law an increasingly important disincentive to pursue mortgage lending.

The SSB's only significant housing and consumer lending competitor for the short- to medium-term will be the Bulgarian Postal Bank (BPB). The BPB inherits the tradition of Bulgaria's Postal Savings Bank which operated from 1894 to 1951. The BPB has 60 million levs of equity held by two state-owned enterprises--the National Palace of Culture and the Committee for Information and Communication. The bank was registered in May, 1991 and has already begun to operate in Sofia. Over the next 18 months it plans to establish over 160 branches and representative offices in over 3,000 post offices. Thus, within a very short period of time this bank will have the country's most comprehensive branch network. As branches and representative offices are opened they will be fully computerized and linked to the system as a whole with real time communications facilities. The bank's deposit liabilities will not be federally insured but the firm is searching for an insurance agency to protect depositors.

The BPB plans to focus lending in agriculture, consumer products and tourism. Nevertheless, it intends to be a universal bank and will offer housing and consumer loans.

## 2.8 Issues in Housing Finance

Issues in housing finance include high interest rates, rapidly escalating housing costs, a large volume of outstanding SSB loans at extremely low interest rates and lending procedures and training systems which are probably inadequate to cope with the evolving mortgage environment.

1. Housing Finance Interest Rates. Historically, the State Savings Bank paid a 1 percent interest rate on deposits and made housing loans at an interest rate of 2 percent (World Bank, 1991). These rates were slightly negative in real terms to 1988. In 1989, the lending rate was -7.3 in real terms and it was -37.8 in 1990 (Thorne, 1991:11).[19] If in December 1990 SSB had paid a positive real rate of interest as its average cost of funds but continued to lend at the above-mentioned low rates, its loss from the resultant negative spread

[19] Thorne makes the argument that real interest rates did not measure the true opportunity cost of credit until 1991. See Chapter 1 Section 1.4.1 above.

would have been 357 million levs per month--2,288 percent of 1990 profits on an annualized basis.[20] In January 1991, the SSB raised interest rates on all existing and new mortgages to 10 percent and on outstanding consumer loans to 17 percent. In April, 1991 interest rates were raised to 45 percent for new mortgages. As of September 1991, interest rates on deposits varied by length of term and type of liability. The current interest rate on time deposits varies from 46 percent for one month deposits to 62 percent for one year deposits.[21] Housing-linked deposits earn an interest rate of 44 percent. Other deposits earn 38 percent interest. Housing lending rates on new loans stood at 49 percent for borrowers who had housing-linked deposit accounts and 54 percent for all other mortgage borrowers. Rates for short term construction loans were 55 percent.

[20] SSB had approximately 4.621 million levs of mortgage loans outstanding at a 2 percent interest rate, 1,822 million levs of outstanding consumer loans at a 3.5 percent rate and 305 million levs of outstanding short-term construction loans at a 4 percent rate. Inflation for 1990 was approximately 64 percent. Thus a cost of funds positive in real terms might have been 64 percent plus 2 basis points. SSB's net profit for 1990 was 187.3 million levs (SSB and BNB records and team analysis).

[21] The SSB has the right to change its interest rates on any of its deposits at any time.

Table 2.8
Current SSB Interest Rates

| Financial Product | | Interest Rate (%) |
|---|---|---|
| Loans Approved Before January, 1991 | Mortgage | 10 |
| | Consumer | 17 |
| Current Mortgage Loans | With Housing Linked Account | 49 |
| | Without Housing Linked Account | 54 |
| Short-term Construction Loans | | 55 |
| Time Deposits | One Month | 46 |
| | One Year | 62 |
| Housing-Linked Deposits | | 44 |
| Current Account Deposits | | 38 |

Source: SSB Records

These rates are extremely negative in real terms. Several sources place inflation from 300 to 440 percent for only January to June, 1991 and Mladenov (1991) states that the August rate was 7.5 percent--almost 140 percent on an annualized basis.

Despite the fact that lending rates are very negative in real terms, they are nevertheless too high for most households to afford[22] and have contributed to a very rapid decline in mortgage borrowing over the last eight months.

2. Housing Price Inflation. Even more damaging to housing affordability than the increase in interest rates is the fact that housing prices rose 10 to 17 times from spring, 1990 to fall, 1991. Up to March 1990, houses cost 136 to 170 lev per square meter for state-

[22] See Section 2.5.2 on mortgage loans.

constructed units and approximately 400 levs per square meter for self-help units.[23] The current free market price is from 1,800 to 3,000 lev per square meter.[24] While general inflation and wages have risen over the period, they have not kept up with housing cost increases. General prices have increased by about 700 percent from January 1990 to September 1991 (Mladenov, 1991).[25]

3. Outstanding SSB Loans at Subsidized Rates. All SSB loans made after January 28, 1991, currently carry an interest rate between 49 and 58 percent. These loans were made on flexible interest terms. While there is no formal indexing system, the SSB has the right to adjust the interest rate on these loans whenever it chooses. Nevertheless, as of August 1991 the firm had approximately 2.8 billion levs in mortgage loans made before January 28 which currently carry a 10 percent interest rate and 1 billion in consumer loans which carry a 17 percent rate.[26] These low-interest rate loans represented 71 percent of total outstanding

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[23] Privately constructed housing was far more expensive than state-constructed units because the latter were built by state-owned construction companies which were allowed to purchase materials at an artificially low price while private builders had to buy materials at an artificially inflated cost. Thus, the undistorted construction cost over the period would be between the state and private sector figures.

[24] Although municipalities charge approximately 1,000 LV per square meter.

[25] Thus, savers who made deposits on the assumption they would be able to obtain a loan which was large enough to buy a state apartment suddenly found themselves not only with the prospect of a major increase in the amount of their loan payments but with a maximum loan amount which was only sufficient to buy a small fraction of the housing it would have purchased earlier.

There are approximately 600,000 families in this situation. These households have been exerting a great deal of political pressure on the government to do something about the situation. An Act was recently passed by parliament which granted major subsidies to households which have had these savings accounts for ten years or more and are in proven housing need. There are 120,000 households who have had housing-linked savings accounts for at least 10 years. It is not yet clear how many of these would qualify for being in proven housing need. The Act calls for the government to pay each family an outright grant to cover from 66 to 95 percent of the cost of a house. Families would also be entitled to loans from the State Savings Bank at subsidized rates. A compensation fund of 19 billion levs would be established for this purpose. The measure is supported by both the socialists and the opposition coalition. Fifty percent of municipalities' housing budgets and 30 percent of ministries' and state enterprises' housing funds would be earmarked to fund the project as well as proceeds from future housing sales.

[26] These figures are estimates based on figures for lending as of December 31, 1990, loans disbursed from January to August 1991 and outstanding loans as of August 31, 1991. Before January 28, 1991, the interest rates were 2 percent for mortgage loans and 3.5 percent for consumer credits. When these rates were raised, approximately 40 percent of the volume of these outstanding loans was prepaid.

For families in proven need, the government is currently formulating a program to pay the difference between the installments families paid on the loans at the old interest rates and the payments they now make. Details of this program and its cost to the state have yet to be worked out.

loans to non-financial entities and 13 percent of total assets. The difference in monthly revenues between the interest the SSB earns on these loans and the interest it would earn if the loans carried current market rates is 123 million levs. If this figure is deflated to December 1990 prices and annualized, it represents approximately 160 percent of the SSB's net profit for all of 1990. Table 2.9 summarizes these findings. The difference between the interest income the SSB receives on these loans and the interest expense it pays on the same volume of housing linked deposits is 101 million levs--annualized and deflated to year-end 1990 prices--about 133 percent of SSB's 1990 profits and 0.8 percent of Bulgaria's 1990 NNP.

Table 2.9
Outstanding SSB Loans at Subsidized Interest Rates
As of August 31, 1991

| Type of Loan | Estimate of Outstanding at Old Interest Rates (MM Levs) | As a % of Total Loans | As a % of Total Assets | Monthly Income Foregone (MM levs) |
|---|---|---|---|---|
| Mortgage | 2,793 | 52.5 | 9.7 | 91 |
| Consumer | 992 | 16.6 | 3.4 | 32 |
| Construction | 0 | 0.0 | 0.0 | 0 |
| Total | 3,785 | 71.1 | 13.1 | 123 |

Source: SSB Records

The rate the SSB pays on its deposits varies from a low of 38 percent to a high of 62 percent and its average cost of funds is 46.4 percent. Thus, its cost of funds is significantly above the return it receives on its outstanding low-interest loans. The SSB is able to cover the losses it incurs on these loans via the spread it makes on its current lending. In particular, the firm lends to commercial banks and enterprises at 54 to 58 percent interest rates and these loans account for approximately 67 percent of its total assets. Thus, the SSB is paying a subsidy to some of its borrowers which, when figured on an annual basis, is greater than its entire 1990 profits. This huge transfer is being financed via cross-subsidization by other borrowers and is not recorded as an on-budget subsidy, thereby masking its true size.

A recent parliamentary Act gave the SSB the right to raise the interest rate on its low rate loans up to two-thirds of the current base interest rate.[27] The SSB has yet to do so because it faces heavy social pressure to keep these rates low and it fears massive defaults. Nevertheless, it plans to raise the rate slowly over time.

4. Lending Procedures. Historically, the SSB did no underwriting. The granting of housing loans was automatic assuming households met the housing-linked savings requirement described above and the state had given them the right to buy a home. The SSB did not even require borrowers to provide income information. Collection was virtually never a problem as housing loans were affordable and payroll deductions of monthly payments were common. SSB management reports that the bank has needed to start foreclosure proceedings on fewer than five loans in the last five years.

The SSB has no separate underwriting or collection departments. Underwriting is performed by "financial inspectors". At this point, the process consists exclusively of prospective borrowers submitting information on household income[28] for mortgages, income information and construction plans for long-term mortgages and construction plans for short-term construction loans. If income and plans are deemed acceptable, the borrower is issued a loan. If income is not acceptable, the SSB asks for two guarantors. Virtually no applicants are denied credit. The SSB plans to maintain the same system in the future except that families will be eligible for loans up to 70 percent of the state-regulated cost of the unit subject to income constrains. See section 2.5.2 page 25 above.

Virtually all borrowers pay monthly installments through salary deductions. The SSB's accountants handle payment processing. In the event of a borrower missing "five or six" payments, the accountants notify a financial inspector who follows up on the case. Each January the accountants make sure that each borrower has made 12 payments. If any payments are missing they inform financial inspectors who follow up. Financial inspectors have no formal collection guidelines.

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[27] The base rate is set by the BNB. It is 54 percent.

[28] The SSB does not verify this information.

5. Training and Systems. Most new SSB employees have University degrees. The SSB has a formal training program for new employees. They have not modified this program since the changes in Bulgaria's economic system and have no concrete plans for doing so.

The SSB's computer operations are handled by BNB-sponsored computer centers located throughout the country. These centers serve most banks in their respective regions. The SSB has entered into a contract with the British firms ICL and Kendal to develop the bank's in-house computer capacity. SSB computerization has begun and should be completed in three years.

## 2.9 Conclusion

For the first six months of 1991, housing lending totaled 386 million levs. The real volume of housing lending has declined precipitously over the last four years. The real volume of lending in the first half of 1991 was only about 22 percent of its level in the first semester of 1987. Furthermore, 37 percent of 1991 housing volume was for the purchase of rental units at artificially low prices. As this source of housing dries up, the demand for housing loans will likely decline even more. For the last six months, 42 percent of SSB's retail lending volume was for housing purchase loans and an additional 32 percent for short-term construction.

Currently, the housing finance system consists almost exclusively of the State Savings Bank which issues all mortgage loans and over 95 percent of housing construction credits. While in principal all banks are free to undertake these loans, in practice it is likely that few will do so in the near future given the current lack of demand and the fact that the SSB's virtual monopoly on household savings enables it to offer funds at more favorable terms than commercial banks. Nevertheless, the SSB is likely to face significant competition from the Bulgarian Postal Bank which, since it is being formed out of SSB representative offices, will have many of the advantages enjoyed by that firm.

The major issues facing the housing finance system are unaffordable housing costs, high and wildly fluctuating inflation rates contributing to very high interest rates, tremendous subsidies to borrowers paying below-market interest rates--which translate into massive losses for the SSB--and a dearth of trained banking underwriters and collection agents.

The Bulgarian housing finance system could benefit greatly from the introduction of alternative mortgage instruments such as the dual-index mortgage and the price level adjusted mortgage. These products would radically increase borrower affordability and lender protection in Bulgaria's current chaotic macroeconomic environment. The system could also benefit from training in internationally-accepted underwriting and collection procedures. While Bulgaria's current practices were acceptable in Bulgaria's pre-1989 housing environment, they are entirely inadequate today.

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## Annex
## International Donor Activity in the Macroeconomic and Financial Sectors

The World Bank, IMF, The European Economic Community (EEC), Japan and Britain's Know-How Fund are all providing technical assistance and loans to Bulgaria in the area of macro-economic and financial sector reform. The IMF is providing a stand by arrangement of 280 million SDRs for macroeconomic reform and a credit of USD 85.8 million to partially compensate Bulgaria for the rise in oil prices resulting from the Gulf crisis. The World Bank is providing a Structural Adjustment Loan for USD 250 million and, in conjunction with Britain's Know-How Fund and the EEC's PHARE organization, a technical assistance loan for USD 33.5 million (BNB Bulletin No.2). The banking sector portion of the technical assistance will include long-term assistance and training in banking supervision for the BNB, management advisory assistance to the commercial banks, a feasibility study for the creation of a new payments and clearing system and an in-depth study of the banking system after the bank merger process is completed. The EEC's PHARE organization will participate in the World Bank's technical assistance loan and will provide additional technical assistance in the areas of computerization of the banking system, technical assistance to commercial banks in the area of portfolio management and a feasibility study for the creation of a capital market. The EEC has given Bulgaria a loan of 150 million ECUs to help it cover its balance of payments gap and Bulgaria should receive an additional loan of 100 million USD from Japan's Export/Import Bank for the same purpose. The Financial Services Volunteer Corps intends to provide technical assistance to the financial system and the International Finance Corporation may provide assistance in the future.

Currently, no international donors are working explicitly in the area of housing finance or directly with the State Savings Bank or the Bulgarian Postal Bank.