Bulgarian National Bank

TO

EXECUTIVE DIRECTORS

OF BANKS

TO

MANAGERS OF FOREIGN

BANKS' BRANCHES

RE: Recommendations of the European Systemic Risk Board on foreign currency lending (THE EUCP/2011/1)

DEAR EXECUTIVE DIRECTORS AND MANAGERS,

In 2011 the European Systemic Risk Board (ESRB) conducted a review of the level of foreign currency lending and the effect of associated risks on the credit institutions and financial stability in the European Union. The analysis indicates that foreign currency loans are very typical of the Central and East European countries where there is an accumulation of loans mainly in the non-financial private sector. It also mentions a number of other factors for the rise in foreign currency lending, such as the easy access to funding ensured by the parent banks abroad and the better interest rate conditions offered on foreign currency loans compared to those in national currency. Later on, the depreciation of the national currencies in some countries in this region against the Euro and the other major currencies (the Swiss Franc and the US Dollar) resulted in an increased debt burden for the debtors having foreign currency loans, hence in more non-performing loans. This is especially valid for the unprotected/unhedged debtors who

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are unable to protect themselves against foreign exchange risk as their incomes are in national currency while they have a debt in foreign currency. The outpacing growth in foreign currency lending as opposed to the dynamics of foreign currency deposits contributed to building foreign exchange gaps which pose a considerable risk in some Member States. Furthermore, the geographic and financial relatedness of the economies in this region may give rise to potential negative effects and their cross-border spill-over.

Based on this analysis and bearing in mind its importance for keeping the financial stability in the EU, the European Systemic Risk Board (ESRB) developed and published a series of recommendations intended for all Member States. The recommendations cover various areas since they concern both the credit institutions and supervisory authorities in the EU. These aim to constrain the excessive growth in foreign currency lending and to enhance the resilience of the European financial system. The measures include improving the process of assessing and managing ongoing and potential risks related to foreign currency lending, particularly with regard to loans to unprotected/unhedged borrowers.

The recommendations take account of the specifics of the relevant currency and foreign exchange regimes and of the local economic and financial situations in the Member States. To the extent the currency arrangement in Bulgaria is based on the legally pegged exchange rate of the Bulgarian Lev to the Euro, the BNB believes that for the credit institutions operating in Bulgaria the risks of granting foreign currency loans come from exposures denominated in Swiss Francs, US Dollars, and Japanese Yens. On the other hand, in the light of the analysis of the volumes of foreign currency loans in the banks' portfolios, the BNB believes that these loans do not cause a significant risk to the stability of the Bulgarian banking system.

As the mentioned recommendations concern all EU Member States, we recommend that credit institutions should get well familiar with the document, which can be found at the following address:

http://eur-lex.europa.eu/LexUriServ/LexUriServ.do?uri=OJ:C:2011:342:FULL:BG:PDF.
This is also necessary because some of the measures need to be implemented directly and their implementation needs proper preparations requiring the collection and processing of additional data on foreign currency lending. Therefore, banks and foreign banks' branches will be informed about the forthcoming changes in the supervisory reporting, which will take effect as of the beginning of next year.

When applying the measures of the ESRB, credit institutions should pay special attention to the recommendations in *group A 'Risk awareness of borrowers'*, *recommendation 2 in group B 'Creditworthiness of borrowers'*, *group D 'Internal risk management'*, and the part of *recommendation 1*, *group E 'Capital requirements'*, which concerns them. Appendix 1 (an integral part hereof) is based on the ESRB's document and includes a description of the specific measures to be implemented by credit institutions in connection with foreign currency lending. In all cases the implementation of the measures should take into consideration the size of each credit institution, with a focus on unprotected/unhedged borrowers.

In 2012 the evaluation of the implementation of these recommendations' will be included in the supervisory review, whose results the BNB should report to the ESRB in compliance with the requirements specified in the document. Therefore, by 31 January 2012, you need to present to the Banking Supervision Department information on the measures taken to fulfil recommendations I.1 , II.1 and III.1 in the Appendix.

RESPECTFULLY YOURS,

BNB DEPUTY GOVERNOR, HEADING
BANKING SUPEVISION DEPARTMENT

Appendix 1

Recommendations for credit institutions based on the ESRB Recommendations on foreign currency lending

I. Improving risk awareness of borrowers

1. Informing customers of risks associated with foreign currency lending in a way allowing them to take informed and prudent decisions. As a minimum, the scope of information should cover the potential impact of changes in exchange rate and interest rate levels of foreign currencies on instalments payable in the national currency.
2. Offering BGN-denominated loans for the same purposes, for which foreign currency loans are extended, as well as financial instruments (financial hedge) to compensate for / mitigate exchange rate/interest rate risk.

II. Adequate assessment of creditworthiness of borrowers

1. Updating internal lending rules by adopting more stringent requirements and criteria (including with regard to debt/income and debt/collateral ratios) with the purpose of granting foreign currency loans to borrowers of proven creditworthiness. Taking into account the repayment structure of the loan and the borrowers' capacity to successfully withstand adverse developments in exchange rate and interest rate levels.

2. Offering relieved conditions for servicing overdue foreign currency loans (including existing ones) through their renegotiation and/or restructuring in accordance with the legally established rules provided that there is a legal possibility and a declared wish on the part of borrowers.

III. Improving internal risk management framework

1. Updating internal risk management and control policies and systems associated with foreign currency lending in a manner proportionate to the size and complexity of a credit institution.

2. Regular review and evaluation of the level of risks associated with foreign currency lending and their coverage by adequate capital. As a minimum, the scope of the review and evaluation should cover the internal risk pricing and internal capital allocation.

IV. Adequate capital requirements for exchange rate risk coverage

1. Holding adequate capital to cover risks accompanying foreign currency lending, including risks stemming from the non-linear relation between credit risk and market risk. Conducting regular stress tests for capital adequacy.