

Bulgarian National Bank

11 November 2014

**Mr. Francesco Mazzaferro,
Head of Secretariat
European Systemic Risk Board
Kaiserstrasse 29
60311 Frankfurt am Main
Germany**

Subject: Set up of capital conservation buffer and systemic risk buffer

Dear Mr. Mazzaferro,

The successful finalization of the legislative package CRD4 is a cornerstone of the stable and impeccable future functioning of the European single market in financial services, provided by credit institutions and investment firms. With the joint efforts of colleagues from all Member States we have managed to lay down the foundation for a more stable and sustainable European banking system, which is a crucial prerequisite for not only avoiding similar financial crisis, but to also ensure a stable and robust recovery of the EU economy as a whole.

Nevertheless, the introduction of the new prudential requirements for credit institutions has different impact on financial systems of single Member States and this is quite natural – not only their financial systems differ in size, structure and complexity but they are also at different stages of development and maturity, which calls for a more conservative and careful appraisal of potential risks and vulnerabilities. Bulgaria, with its relatively young market economy is not an exception – after managing to recover from a severe banking and economic crisis back in the 90s and the successful accession to the European Union, we opted for a more stringent supervisory approach regarding credit institutions than many other Member States, which subsequently proved to be a great success, especially in the absence of an active monetary policy tool under the functioning Currency Board Arrangements.

Against this background, unlike the general impact of the new regulatory framework in the EU leading to more conservative prudential regulations and strengthening of the level and quality of capital, the implementation of the CRD4 package has a loosening impact on the

the Bulgarian banks. This is due to the introduction of reduced capital requirements and a to a reduction in the risk-weighted assets, mainly stemming from:

1. The introduction of a **8% Total capital ratio** instead of the decade-long locally applied minimum ratio of a 12% minimum total capital ratio;
2. The Single rulebook leads to de-recognition of the locally applied Regulatory framework for **Specific loan loss provisioning**, which has led to an elimination of the corresponding deductions from regulatory capital and sudden improvement of the credit quality of bank portfolios (not backed by respective improvement in their fundamentals);
3. **Increased maximum limit for retail exposures** - from EUR 250 000 under CRD3 to EUR 1 million under CRD4, resulting in a significant increase of the number of exposures fulfilling the criteria of 75% risk-weight instead of the previously required 100%;
4. Further reduction of risk-weighted exposure by a factor of 0.7619, which affects **exposures to SMEs**. Due to the specificities and relatively small size of predominant part of the local corporate market, this leads to a significant alleviation effect in banks portfolios, reducing the currently applied 100% risk weight virtually to 76% (for the SMEs classified as “Corporate”), as well as from 75% to 57% (for the SMEs classified as “Retail” under current framework).
5. **Recognition of commercial mortgages** as eligible collateral (not recognized as a mitigation technique under the previous capital framework), which leads to a 50% reduction in the risk weight of exposures that meet the relevant criteria;

The difference in capital requirements stemming from the introduction of CRD4, shows that the total capital adequacy ratio and the capital adequacy for Tier I increase respectively from 16.9% to 21.7% and from 16% to 19.2% for the banking system in Bulgaria. The overall reduction in risk-weighted assets of the Bulgarian banking system exceeds EUR 300 million, with a corresponding increase of the regulatory capital of EUR 1,271 million, and of Tier I capital: EUR 800 million. If we exclude the effect of the Specific loan loss provisioning, the reduction in risk-weighted assets would be around EUR 1,400 million.

Such a significant increase in the capital figures stems only from the change in Regulatory framework and is not supported by an improvement of the quality of banks’ loan portfolios and balance sheet exposures. Therefore, the BNB has undertaken all necessary measures permitted in order to preserve the buffers already built in the banking system, as well as to provide the necessary safeguards and loss absorbing capacity of banks against future deterioration in credit portfolios.

Taking into account the above mentioned facts, as already communicated to the ATC in the written consultation conducted in May 2014, the **BNB is introducing in 2014 a mandatory capital conservation buffer of 2.5%**, in accordance with CRD4, Art.129, that will help to preserve a part of the already built-up capital reserves in the system. Since the

capital position of the Bulgarian banking system consists of predominately CET1 instruments, the capital conservation buffer has already been built-up at full and there are no grounds to allow the release of such buffer from 01-Jan-2014 and to require again its building up starting from 01-Jan-2016. Bulgarian banks traditionally operate above the required regulatory minima, so at a systemic level the prompt implementation of capital conservation buffer in 2014 is not a challenge. The simulations done by the Banking Supervision Department testify that the own funds level of the system remains high in 2014, after the introduction of CRD4. Due to all these circumstances, the prompt introduction of the capital conservation buffer will allow Bulgarian banks to pay out material parts of their 2014 annual profits as dividends if they wish to.

On the other hand, in accordance with the options presented to national authorities in Art. 133 of CRD IV, the **BNB is introducing a systemic risk buffer of 3% for all credit exposures located in Bulgaria with its first reporting due by all credit institutions as of 31 December 2014.** Apart from the solid micro-justification for the preemptive introduction of the Capital Conservation Buffer, that also applies as an argumentation for the introduction of systemic risk buffer, there are also several very important and relevant macro-prudential arguments that are worth mentioning. More details about the systemic risk buffer could be found in the attached hereto notification template.

In general, the BNB plans to utilize the flexibility given to competent authorities in the CRD IV package with regard to capital buffers, in order to intervene in a timely manner when it comes to the question of preserving the soundness of local financial systems and thus to strengthen the resilience not only local financial markets, but also of the single European market.

Best regards,



Nelly Kordovska

Acting Deputy Governor

Banking Supervision Department

Attachment: Template for notifying the ESRB of the intended use of systemic risk buffer (SRB).