



# BULGARIA

## FINANCIAL SECTOR ASSESSMENT PROGRAM

### TECHNICAL NOTE—FINANCIAL SAFETY NET AND CRISIS MANAGEMENT

July 2017

This Technical Note on the Financial Safety Net and Crisis Management for Bulgaria was prepared by a staff team of the International Monetary Fund. It is based on the information available at the time it was completed in June 2017.

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June 2017

# TECHNICAL NOTE

## FINANCIAL SAFETY NET AND CRISIS MANAGEMENT

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This Technical Note was prepared by IMF staff in the context of the joint IMF-World Bank Financial Sector Assessment Program (FSAP) in Bulgaria led by Michael Moore (IMF) and Ilias Skamnelos (World Bank). The Note contains technical analysis and detailed information underpinning the FSAP's findings and recommendations. Further information on the FSAP can be found at <http://www.imf.org/external/np/fsap/fssa.aspx>

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## Glossary

Banking Act	Law on Credit Institutions
BCP	Basel Core Principles for Effective Banking Supervision
BDIF	Bulgarian Deposit Insurance Fund
BGN	Bulgarian Lev
BNB	Bulgarian National Bank
BNB Act	Law on the Bulgarian National Bank
BRF	Bank Resolution Fund
BRRD	EU Bank Recovery and Resolution Directive
CIRD	Credit Institutions Resolution Directorate
CRD	EU Capital Requirements Directive
CRR	EU Capital Requirements Regulation
CSE	Crisis-Simulation Exercise
DIF	Deposit Insurance Fund
DIS	Deposit Insurance System
DIS Act	Law on Bank Deposit Guarantee
EBA	European Banking Authority
EBRD	European Bank for Reconstruction and Development
ECB	European Central Bank
EIF	Early Intervention Framework
ELA	Emergency Liquidity Assistance
ESCB	European System of Central Banks
ESFS	European System of Financial Supervision
ESRB	European Systemic Risk Board
EU	European Union
FIB	First Investment Bank
FSAC	Financial Stability Advisory Council
FSAP	Financial Sector Assessment Program
FSC	Financial Supervision Commission
IADI	International Association of Deposit Insurers
IMF	International Monetary Fund
KTB	Corporate Commercial Bank
MCM	Monetary and Capital Markets Department, IMF
MoF	Ministry of Finance
MoU	Memorandum of Understanding
MREL	Minimum Requirement for Own Funds and Eligible Liabilities
NRA	National Resolution Authority
Resolution Act	Law on the Recovery and Resolution of Credit Institutions and Investment Firms
RRP	Recovery and Resolution Planning
SRB	EU Single Resolution Board
WBG	World Bank Group

## EXECUTIVE SUMMARY

**The Bulgarian financial safety net comprises four domestic authorities.** The Bulgarian National Bank (BNB) is the monetary authority, and the prudential and resolution authority for banks. The Financial Supervision Commission (FSC) is the prudential and resolution authority for investment firms, and the prudential supervisor for other nonbank financial institutions. The Bulgarian Deposit Insurance Fund (BDIF) provides deposit insurance and manages the deposit insurance fund (DIF) and the bank resolution fund (BRF); it also appoints and oversees bank bankruptcy liquidators. The Ministry of Finance (MoF) is politically responsible for financial sector policies. The Financial Stability Advisory Council (FSAC) complements these authorities and brings together the Minister of Finance (chair), and the heads of the BNB and the FSC.

**Since the 2008 IMF FSAP Update, Bulgaria's financial safety net and crisis management arrangements, including bank resolution and contingency planning, have improved.** In 2015, to implement pertinent European Union (EU) rules, Bulgaria introduced a resolution regime for banks and investment firms; designated resolution authorities for said financial institutions; and established mechanisms to fund resolution measures.

**In 2014, Corporate Commercial Bank (KTB)—Bulgaria's second largest domestically owned bank and the fourth largest bank system-wide—went bankrupt due to fraud and insider abuse, raising concerns about the BNB's supervision.** The KTB's collapse followed a temporary massive deposit run-off, with system-wide consequences. Within days, the KTB lost 20 percent of its deposits, and First Investment Bank (FIB)—the largest domestically owned bank and the third largest bank system-wide—lost 10 percent of its deposits. While government liquidity support helped the FIB, the BNB—after valuations found significant impairment deviations—concluded that the KTB's capital was negative. In the absence of a comprehensive bank resolution regime, the KTB's insolvency triggered bankruptcy procedures. The ongoing liquidation of the KTB is a protracted and costly process, which underlines the need for less costly and less disruptive resolution strategies.

**Despite the improvements, the financial safety net and crisis management arrangements face crucial challenges because none of their components is fully developed.** The early intervention framework (EIF) lacks quantitative escalation policies and procedures, and does not ensure a smooth and decisive transition from early intervention into resolution. For all practical purposes, there is no bilateral emergency liquidity assistance (ELA) facility due to lack of funds and because of policy choices that impede effective liquidity assistance. The DIF is burdened with loans and would be insufficient to cover payouts to the depositors of the smallest mid-sized bank, unless the BDIF would take on an additional sizeable loan and/or collect extraordinary premiums; and the BRF just recently started collecting premiums. The bank resolution regime has not been operationalized, and for none of the 13 majority domestically owned banks has recovery and resolution planning (RRP) been finalized. The complementarity of the bank bankruptcy and bank resolution regimes is not ensured. The agency-specific and national contingency planning—including all four financial safety net participants—has yet to be updated to fully incorporate the introduction of the bank resolution regime.

**To ensure operational capacity to rapidly deploy recovery and resolution tools, further actions are needed to strengthen the safety net and crisis management arrangements.**

- **The BNB is updating its early intervention framework and is developing a resolution (planning) manual, which offers an opportunity to ensure consistency between the two.** The mission recommended that the authorities ensure a smooth and decisive transition from early intervention into resolution, with problem-bank metrics that apply consistently through regular supervision, early intervention (including recovery actions), and resolution.
- **For none of the 13 majority domestically owned banks has RRP been finalized.** The mission recommended that the BNB prioritize the RRP for the majority domestically owned domestic systemically important banks (D-SIBs)—and the banks for which the 2016 asset quality review (AQR) and stress tests indicated capital shortfalls. The mission also recommended that the BNB adopt alternative resolution strategies for foreign-bank subsidiaries that operate in Bulgaria, in case the resolution colleges cannot agree on a common approach.
- **In light of the key constraints on official liquidity support, the mission recommended that the authorities define strategies for liquidity assistance to banks, consistent with the currency board arrangements (CBA) and EU state-aid rules.** This would require a three-pronged approach: (1) increasing the funds for liquidity support; (2) enhancing banks' ability to meet collateral requirements; and (3) ensuring that the authorities can act decisively—yet at their discretion—on liquidity support requests.
- **The mission recommended that the authorities strengthen the financial crisis management framework** by (1) expanding the FSAC's mandate (including contingency planning) and membership (including the BDIF), and (2) updating agency-specific and national financial crisis preparedness, including a national crisis communication plan, and regular single- and multi-agency financial crisis simulation exercises (CSEs), particularly with EU authorities with jurisdiction over the groups to which seven out of nine foreign-bank subsidiaries belong.
- **The mission stressed the importance of an effective bank bankruptcy regime.** The mission recommended that the bank bankruptcy regime and its application be comprehensively assessed and strengthened as needed to ensure, particularly, that (1) bankruptcy proceedings can be started when the bank is failing or likely to fail, and there is no reasonable prospect that any alternative private sector measure would prevent its failure within a reasonable timeframe; and (2) the bridge bank tool is available under the bank bankruptcy regime.
- **Establishing and maintaining the new RRP framework requires particular expertise and additional resources to achieve and maintain adequate staffing levels.** The mission recommended that the authorities ensure (1) that all financial oversight authorities are adequately staffed to expedite RRP and, more generally, to fulfil their responsibilities, including on a cross-border level; and (2) that their staff is well trained in the use of the time-tested, cost-effective sale of business and bridge institution tools, and the new bail-in tool.

- **While the legal framework gives the financial authorities’ officials, staff, and agents some legal protection, none of the agencies has operationalized this protection.** The mission recommended that the authorities strengthen the legal protection framework, including indemnification for legal costs; and complement this with operational arrangements to make legal protection effective, covering such issues as the choice and (timing of) payment of legal representation, protection against self-incrimination during internal investigations while building a case to defend the agencies, and liability and legal aid insurance covering realistic monetary amounts commensurate with the high financial stakes at play in resolution cases.

*“What is quite unlooked for is more crushing in its effect, and unexpectedness adds to the weight of a disaster...This is a reason for ensuring that nothing ever takes us by surprise. We should project our thoughts ahead of us at every turn and have in mind every possible eventuality instead of only the usual course of events.”*

Lucius Annaeus Seneca  
Roman statesman and Stoic philosopher

*“Plan beats no plan.”*

Timothy Franz Geithner  
Former US Secretary of the Treasury  
and President/CEO Fed New York

**Table 1. Bulgaria: Recommendations on Financial Safety Net and Crisis Management**

Recommendations and Responsible Authorities	Time 1/
1. Ensure a smooth and decisive transition from early intervention into resolution, with problem bank metrics that apply consistently through regular supervision, early intervention (including recovery action), and resolution (planning). (BNB; ¶23)	I, C
2. Prioritize RRP for (1) the banks for which the 2016 AQR and stress test indicated capital shortfalls, and (2) the majority domestically owned D-SIBs. (BNB; ¶25)	I
3. Develop alternative resolution strategies for foreign-bank subsidiaries that operate in Bulgaria, in case the group resolution colleges cannot agree on a common approach. (BNB; ¶25)	NT
4. Define strategies for liquidity assistance to banks, including (1) increasing the funds for liquidity support; (2) enhancing banks' ability to meet collateral requirements; and (3) ensuring that the authorities can act decisively—yet at their discretion—on liquidity support requests. (MoF, BNB; ¶29)	I
5. Develop metrics to compare liquidation costs and resolution actions particularly using the sale of business and bridge institutions tools. (BNB, BDIF; ¶30)	I
6. Comprehensively assess and strengthen the bank bankruptcy regime and its application, to ensure that (1) its triggers complement the resolution regime, and (2) the bridge institution tool is available under the bank bankruptcy regime as well. (MoF, BDIF, BNB; ¶32)	NT
7. Continue implementing the timeline agreed with the World Bank Group for the disbursement-linked outcome indicators to strengthen the BDIF, and include in the contingency plan for resolution measures the policies and procedures that will inform the establishment of bridge institutions. (BDIF; ¶35)	MT
8. Under the oversight of the FSAC with an expanded mandate (including contingency planning) and membership (including the BDIF), strengthen the crisis management framework, including agency-specific and national financial crisis preparedness, a national crisis communication plan, and regular single- and multi-agency financial crisis simulation exercises, complemented with cross-border exercises, particularly with EU authorities. (FSAC, MoF, BNB, FSC, BDIF; ¶37)	NT, C
9. Ensure adequate staffing and resources for all financial oversight authorities and train staff in the use of resolution tools, particularly the time-tested sale of business and bridge institution tools, and the new bail-in tool. (MoF, BNB, BDIF, FSC; ¶39)	I, C
10. Strengthen the legal and operational framework for legal protection for current and former officials, staff, and agents of all financial oversight authorities, including indemnification for legal costs; complemented with agency-specific internal arrangements to ensure legal aid, liability indemnification, and protection against self-incrimination. (MoF, BNB, FSC, BDIF; ¶41)	MT
1/ C = continuous; I (immediate) = within one year; NT (near term) = 1–3 years; MT (medium term) = 3–5 years.	



## BACKGROUND

### A. Introduction

**1. This note elaborates on the recommendations of the 2016 Financial Sector Assessment Program (FSAP) Update concerning Bulgaria’s financial safety net and crisis management arrangements.** It summarizes the findings of the missions undertaken during October 2016 and January 2017 in Sofia, Bulgaria. The note is informed by analysis of the relevant legal, policy, and operational documents, the authorities’ elaborate responses to a lengthy questionnaire, and extensive discussions with them. While the note takes into account developments since the 2008 FSAP, the note is forward-looking, especially because key components of the arrangements are relatively new and under development. Table 1 summarizes the recommendations and several appendices complement the note. The author would like to recognize the frank discussions with the authorities in a cooperative spirit, without which this note would not have been possible.<sup>1</sup>

**2. The authorities have addressed some recommendations of the 2008 FSAP, which found that, while to a large extent all components of the financial safety net are in place, crucial limitations existed.** The 2008 FSAP took place at a time that the 2007–08 global financial crisis (GFC) had begun to affect Bulgaria. In 2009, GDP contracted with 5.1 percent—the first decline since the 1996/1997 crisis in Bulgaria. The FSAP noted that financial sector supervision and regulation had been effective in containing risks in the banking system, but that they would be tested by a slowdown of the economy. The authorities followed up on some of the FSAP’s recommendations to address the limitations that were identified; others remain work in progress.

- *Bank resolution toolkit beyond liquidation*—In mid-2015, the authorities vested the BNB with resolution powers and established a bank resolution regime with a comprehensive toolkit, by implementing the EU Bank Recovery and Resolution Directive (BRRD). This included allowing the BDIF to fund resolution measures through, particularly, the new BRF, and the existing DIF.
- *Cross-border cooperation*—With the implementation of the BRRD and revised EU legislation on bank supervision, Bulgaria has become part of comprehensive cross-border supervision and resolution cooperative arrangements—short of Banking Union membership.
- *Liquidity management*—In 2009, the BNB increased the granularity and frequency of reporting obligations for banks’ liquidity positions, introduced a minimum liquidity ratio, and enhanced requirements for banks’ liquidity contingency plans, including precautionary actions.
- *Work in progress*—The 2008 FSAP also recommended that the bank bankruptcy procedures be made more efficient, methodologies be developed for using fiscal space for liquidity support to banks, and the personal scope of legal protection for financial agencies be expanded.

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<sup>1</sup> The author (Atilla Arda, IMF) would also like to thank Pamela Lintner (World Bank Group; WBG) for her contributions.

**3. While Bulgaria remains outside the EU Banking Union, it is subject to the so-called EU single rulebook.**

In response to the GFC, the EU introduced the single rulebook, aiming to strengthen bank supervision, harmonize prudential rules, and establish a uniform bank resolution regime. Key components thereof<sup>2</sup> are (1) the Capital Requirements Directive (CRD) and the Capital Requirements Regulation (CRR),<sup>3</sup> which, together, constitute the so-called CRD IV package and aim to implement Basel III; (2) the BRRD, which, in most respects, is closely aligned with the Financial Stability Board (FSB) Key Attributes of Effective Resolution Regimes for Financial Institutions (Key Attributes); (3) the Deposit Guarantee Schemes Directive (DGSD), which mainly harmonized and simplified the existing directive for better protected deposits, faster payouts, and improved funding for deposit insurance systems (DISs); and (4) binding technical standards (BTS)—elaborating on the above-mentioned directives—prepared by the European Banking Authority (EBA).<sup>4</sup>

**4. The Bulgarian recovery and resolution framework is recent and remains untested.** The authorities have implemented the overhauled EU framework. This has resulted, notably, in the enactment of a new Law on the Recovery and Resolution of Credit Institutions and Investment Firms (Resolution Act) and Law on Bank Deposit Guarantee (DIS Act); complementary amendments to the Law on Credit Institutions (Banking Act), the Law on the Bulgarian National Bank (BNB Act), the Financial Supervision Commission Act (FSC Act), and the Law on Bank Bankruptcy (Bank Bankruptcy Act); the designation of BNB and FSC as the resolution authorities for banks and investment firms, respectively, and the creation of the BRF—complementing the existing DIF—and an Investment Firms Resolution Fund.

## B. Scope of the Note

**5. This note focuses on the banking sector.** The sector dominates the financial system with 86.7 percent of system assets (or 101.3 percent of GDP at end-June 2016), and financial system assets are 116.9 percent of GDP; the authorities advised that none of the nonbank financial institutions could be considered systemically important. Foreign-owned banks hold 76.6 percent of banking assets, with First Investment Bank (FIB), a domestically owned bank, being the third largest bank system-wide (9.6 percent). The banking system is deposit funded (83 percent of liabilities). The banking sector comprises 27 banks, including 9 foreign-bank subsidiaries, 5 branches of foreign banks,<sup>5</sup> 4 banks with majority foreign nonbank owners, and 9 banks with majority domestic owners.

<sup>2</sup> Additionally, the European Commission can adopt ‘delegated acts,’ which are non-legislative acts of general application that supplement or amend certain non-essential elements of a legislative act.

<sup>3</sup> EU directives are not directly applicable in EU member states and must be implemented through national legislation. EU regulations, on the other hand, are directly applicable in EU member states. This combination of legislative instruments aims to balance uniformity and national discretion.

<sup>4</sup> The BTS can be ‘regulatory’ or ‘implementing,’ and are legal acts that specify and aim to consistently harmonize particular aspects of an EU legislative text (directive or regulation). The European Commission adopts BTS by means of regulations or decisions; this makes them legally binding and directly applicable in all EU member states. The EBA can also issue (1) binding decisions in individual cases, and (2) nonbinding guidelines and recommendations.

<sup>5</sup> After the cut-off date of end-June 2016—for purposes of banking statistics for the FSAP—one branch was acquired.

**6. The note reviews the Bulgarian financial safety net and crisis management arrangements—including bank resolution and contingency planning—against Bulgaria-specific challenges and emerging international best practices and standards.** While the note does not reflect a formal assessment of compliance with any standard, it is particularly informed by the Key Attributes (as updated in October 2014 by the FSB), the Basel Core Principles for Effective Banking Supervision (BCP; updated in September 2012 by the Basel Committee on Banking Supervision), and the Core Principles for Effective Deposit Insurance Systems (updated in November 2014 by the International Association of Deposit Insurers [IADI Principles]). The note is further based on the IMF's technical assistance experience involving how to implement these standards most effectively. The note aims to help strengthen the Bulgarian financial safety net and crisis management framework, to address specific challenges that Bulgaria is facing.

**7. Financial safety net and crisis management arrangements are essential in addressing financial crises.**

- *Financial safety net:* is essential in minimizing the risk of severe financial crises. This note makes use of an expanded definition of the financial safety net. Traditionally, the financial safety net comprises three components: (1) prudential supervision; (2) deposit insurance; and (3) emergency liquidity assistance (ELA).<sup>6</sup> For purposes of this note, a fourth component is added to the definition of the financial safety net: the recovery and resolution of financial institutions. Arguably, 'recovery' could be considered an integral part of supervision as a component of 'early intervention,' while 'resolution' and 'resolution planning' are truly new concepts in dealing with failed institutions—at least in the overwhelming majority of jurisdictions. These concepts were developed in the aftermath of the GFC.
- *Crisis management:* is essential in mitigating the consequences of financial crises. This requires tools and procedures that allow the authorities to respond decisively when a crisis materializes. This builds on advance preparation and requires comprehensive tools and powers, sufficient funds, and efficient procedures for both domestic and foreign agencies. Advance preparation with contingency planning helps the authorities respond well to events occurring within their mandate. Effective contingency planning requires tools to monitor pertinent developments, awareness of policy and operational choices, and the advance decisions on the use of the authorities' powers, inter-agency cooperative arrangements between domestic agencies and with foreign agencies,<sup>7</sup> and financial crisis-simulation exercises to test contingency plans.

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<sup>6</sup> For purposes of this note, ELA refers to 'bilateral' (or 'idiosyncratic') ELA as opposed to 'systemic' ELA.

<sup>7</sup> We prefer the terms 'cooperative' and 'cooperation' over 'coordination' and 'collaborative,' because the latter could imply ex ante agreement on actions, which, arguably, could be deemed inconsistent with the concept of agency 'autonomy.'

## C. Financial Oversight Architecture

**8. The Bulgarian financial safety net comprises four domestic authorities:** the BNB, the FSC, the BDIF, and the Ministry of Finance (MoF)—these are complemented with the Financial Stability Advisory Council (FSAC). Appendix I elaborates on the governance structure. Bulgaria is represented in the EU Economic and Financial Affairs Council (Ecofin), but not in the Eurogroup. While Bulgaria is neither part of the Eurosystem nor the Banking Union,<sup>8</sup> its agencies are an integral part of many other pertinent European Union cooperative arrangements.

**9. The BNB is the monetary authority, and the prudential and resolution authority for banks.** It is an integral part of the European System of Central Banks—but not the Eurosystem—the European Systemic Risk Board (ESRB), the European System of Financial Supervision (ESFS), and the European Banking Authority (EBA). The BNB’s primary statutory objective is to maintain price stability; its secondary objective is to support the general economic policies in the European Union; and its tertiary objective is to support national sustainable and non-inflationary growth policies. Arguably, its regulation and supervision of banks—including macroprudential supervision thereof—and payment systems, and its resolution powers amount to an additional financial stability mandate. The BNB’s functions and related powers are elaborated upon in, notably, the BNB Act, the Banking Act, and the Resolution Act.

**10. The FSC is the resolution authority for investment firms, and—jointly with its sectoral deputy chairpersons—the prudential supervisor for all nonbank financial institutions.** It is an integral part of the ESFS, the ESRB, the European Securities and Markets Authority, and the European Insurance and Occupational Pensions Authority. The FSC’s statutory objectives—with equal standing—are (1) to protect the interests of investors, the insurance policy holders and beneficiaries, and the members of private pension funds; and (2) to ensure the stability of financial markets and their infrastructures. For this purpose, the FSC is primarily responsible for regulating and supervising investment and securities firms, management companies, reinsurance and insurance companies, and pension insurance companies as well as the private pension funds under their management. The FSC’s functions and related powers are elaborated upon in, notably, the FSC Act, the Insurance Code, the Social Insurance Code, the Public Offering of Securities Act, the Markets in Financial Instruments Act, and the Resolution Act.

**11. The BDIF provides deposit insurance and manages the DIF and the BRF; it also appoints and oversees liquidators in bank bankruptcy proceedings.** The Resolution Act authorizes the BDIF to fund resolution measures through, particularly, the BRF and the DIF. Moreover, if the bridge institution or asset separation tools were to be used, the BDIF would establish and own—under the BNB’s oversight as the resolution authority—the bridge institution or asset separation vehicle. The BDIF’s functions and related powers are elaborated upon in, notably, the DIS Act, the Bank Bankruptcy Act, and the Resolution Act.

<sup>8</sup> The BNB is not part of the EU Single Supervisory Mechanism, the European Central Bank (ECB) Supervisory Board, the EU Single Resolution Mechanism, or the EU Single Resolution Board (SRB).

**12. The MoF is politically responsible for Bulgaria’s financial sector policies.** As such, it sets the strategic direction for Bulgaria’s policies for financial stability and is the financial oversight agencies’ interface with the government. The MoF is in charge of using the government stabilization resolution tools and has the primary responsibility to prepare pertinent legislation that the government would submit then to the parliament. Moreover, the minister chairs the FSAC.

#### **D. Collapse and Liquidation of Corporate Commercial Bank (KTB)**

**13. In 2014, Bulgaria’s second largest domestically owned bank went bankrupt due to fraud and insider abuse, raising concerns about the BNB’s supervision.**<sup>9</sup> At end-2013, the KTB was the fourth largest bank system-wide in terms of assets (8.4 percent, or 9.4 percent of GDP), third in terms of net profits, and first in terms of deposit growth thanks to an aggressive strategy since 2011, with deposit interest rates well above the competition; the KTB had sizable exposures to state-owned enterprises. Its capital ratio stood at 12.6 percent—above the BNB’s 12 percent requirement, but below the 16.9 percent system average; at 0.2 percent, its reported NPL ratio was also well below the 16.9 percent system average. Shortly after acquiring Credit Agricole’s Bulgarian subsidiary (Commercial Bank Victoria [CBV]) the KTB was put under conservatorship, then declared bankrupt.

**14. The KTB’s collapse followed a temporary massive deposit run, with system-wide consequences, due to rising concerns about the bank’s solvency, including public allegations of fraud and connected lending, and media speculation about a concerted attack on the bank by powerful interests.** Within days, the KTB lost BGN 1.2 billion (ca. EUR 600 million) or about 20 percent of its deposits. On June 20, 2014, the BNB put the KTB under conservatorship; two days later, the CBV followed suit. Consequently, payments to their depositors were suspended, including access to guaranteed deposits. Within a week, liquidity pressures spread in the banking system: First Investment Bank (FIB)—the largest domestically owned and the third largest bank system-wide—lost about 10 percent of its deposits in one day and was forced to close on Friday, June 27.

**15. Government liquidity support prevented broader spillovers.** On Saturday, June 28, the authorities submitted to the European Commission (EC) a liquidity assistance scheme for banks of up to BGN 3.3 billion (ca. EUR 1.65 billion), or 4 percent of GDP, comprising five-month state deposits at market conditions placed at solvent banks. The EC found the scheme consistent with EU state-aid rules.<sup>10</sup> On Monday, June 30, the FIB and other banks reopened without deposit restrictions and with only limited additional withdrawals. The FIB was the scheme’s largest beneficiary, with a state deposit of BGN 1.2 billion.<sup>11</sup>

<sup>9</sup> A detailed timeline and financial information can be found in the BNB publication titled, “Event and Actions Undertaken in Relation to Corporate Commercial Bank AD and Commercial Bank Victoria EAD” (October 27, 2014; [http://www.bnb.bg/PressOffice/POPressReleases/POPRDate/PR\\_20141027\\_EN](http://www.bnb.bg/PressOffice/POPressReleases/POPRDate/PR_20141027_EN)). The BNB 2014 Annual Report and the public individual banking data, and the public results of a 2015 parliamentary inquiry provide additional information.

<sup>10</sup> State aid SA. 38994; [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=3\\_SA\\_38994](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_38994).

<sup>11</sup> On November 28, 2014, the FIB repaid BGN 0.3 billion. The balance was extended for a maximum of 18 months, with the EC’s approval, which was based on a restructuring plan, including steps to restore liquidity and to improve

**16. BNB valuation found significant impairment deviations and concluded that the KTB's capital was negative.** On June 25, 2014, the BNB-commissioned independent external auditors started a review of the KTB's assets and liabilities. Preliminary results issued on July 11 noted significant shortcomings in the KTB's financial documentation. This necessitated a more comprehensive revaluation and delayed the KTB's planned reopening by July 21. During the revaluation and pending the BNB's decision on the KTB's license revocation, deposits remained frozen without payments to insured depositors.<sup>12</sup> The final results, which were published on October 22, identified impairment deviations in the amount of BGN 4.22 billion, of which BGN 3.4 billion—64 percent of the KTB's loan portfolio—in loans extended to newly created companies without operations and staff, and with missing risk assessment documentation. After recognizing the impairment deviations, the KTB showed a negative capital of about BGN 3.75 billion. On June 5, 2015—after amendments to the Bank Bankruptcy Act—the BDIF proposed that the KTB liquidator commission a forensic audit.

**17. Following the KTB's insolvency, the BNB withdrew its license.** In the absence of a comprehensive bank resolution regime, liquidation was the only available resolution tool under the Bank Bankruptcy Act.<sup>13</sup> After revoking the KTB's license on November 6, 2014, the BNB started bankruptcy proceedings at the district court, and on December 4, the BDIF made guaranteed deposits available to depositors. On December 12, the CBV restarted its unrestricted banking operations after it had sold parts of its loan portfolio to shore up its liquidity position.

**18. The liquidation of the KTB is a protracted and costly process.** The BNB's decisions on the KTB were heavily disputed in courts (with 113 plaintiffs); all cases but one—which is pending—were unsuccessful. On March 25, 2015—nine months after the start of conservatorship and almost five months after the license withdrawal—the court appointed an interim liquidator. On April 22, 2015, the court started bankruptcy proceedings against the KTB and declared it insolvent as of June 20, 2014. The next day, the BDIF appointed the interim liquidator as the liquidator, and on November 13, 2015 the BDIF replaced the liquidator. After a one-year review (August 2015–September 2016), the valuers appraised the KTB's assets' market value at BGN 1.4 billion on April 22, 2015; this serves as the basis for the liquidation balance sheet. From the day the KTB was put into conservatorship (June 20, 2014), almost all borrowers stopped servicing their debts. Making these loans current proved difficult, and continues to be a major challenge for the liquidator due to lack of collateral and cumbersome court procedures. The liquidator has also started court proceedings against the KTB's former management, officers, and auditor. In mid-October 2016, the liquidator

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the FIB's corporate governance structure and risk-management policies (State aid SA.39854; [http://ec.europa.eu/competition/elojade/isef/case\\_details.cfm?proc\\_code=3\\_SA\\_39854](http://ec.europa.eu/competition/elojade/isef/case_details.cfm?proc_code=3_SA_39854)) and repaid on May 26, 2016 (<http://www.minfin.bg/en/pubs/1/9506>).

<sup>12</sup> Bulgarian legislation allowed payouts to insured depositors only in case of license revocation. ECB Recommendation EBA/REC/2014/02 noted that this was inconsistent with the then applicable EU deposit guarantee schemes directive (Directive 94/19/EC).

<sup>13</sup> There was insufficient political support for *ad hoc* legislation to deal with the KTB's collapse without liquidation.

submitted to the BDIF a liquidation plan, which the BDIF approved in November. In December 2016, the liquidator started executing the liquidation plan.

## SOUND FOUNDATIONS AND CRUCIAL CHALLENGES

**19. While the overhaul of pertinent EU rules has helped enhance Bulgarian arrangements, including RRP (Appendix 2), they are untested.** Particularly, Bulgaria has designated resolution authorities, subjected all banks to RRP,<sup>14</sup> and introduced a comprehensive resolution toolkit, including the four mandatory tools (sale of business, bridge institution, asset transfer, and bail-in) and the two optional, last-resort government stabilization tools (equity support and temporary public ownership) (Appendix 3). The authorities are operationalizing the new toolkit and building recovery and resolution capacity. The high deposit coverage—more than 74 percent of deposit values is covered—calls for a highly effective bank resolution regime to mitigate moral hazard. Bulgaria is not a member of the Banking Union but it does benefit from it; the ECB and the SRB are the supervisory and resolution authority, respectively, of the parents of seven out of nine foreign-bank subsidiaries that operate in Bulgaria, which considerably streamlines cross-border cooperation. The parent banks of the two other subsidiaries are established in Germany and Hungary.

**20. The combination of potentially conflicting functions offers both advantages and challenges.** This manifests itself within both the BNB and the BDIF.

- **The BNB has taken steps to separate potentially conflicting functions.** Arguably, the combination of supervision, resolution, and lender-of-last-resort functions could offer synergies. In certain resolution scenarios, however, the BNB can end up sitting at the negotiation table representing three potentially conflicting interests: as the resolution authority selling assets, as the buyer's supervisor, and as the ELA provider, and, thus, as a creditor. The stability of the financial system as a whole could be an additional, overarching interest. EU rules require separation among the three functions. While ultimately the BNB Governing Council makes all decisions on ELA and resolution, and—following up on the 2015 BCP assessment—it will also be more involved in supervisory decisions, the BNB has taken steps to separate these functions at the decision preparation stage. In November 2015, the BNB established a Credit Institutions Resolution Directorate (CIRD), reporting to the BNB Governing Council through the deputy governor responsible for the Issue Department; and the Supervision and Banking Departments report to two different deputy governors. The BNB has adopted rules for the CIRD's operations<sup>15</sup> and has established information exchange arrangements between the CIRD and other BNB units (Table 2). The mission stressed the importance of ensuring that all perspectives be fully represented in the Governing Council.

<sup>14</sup> The BNB can choose between simplified and comprehensive RRP depending on the complexity of a bank.

<sup>15</sup> [http://www.bnb.bg/bnbweb/groups/public/documents/bnb\\_law/au\\_lf\\_rci\\_internal\\_rules\\_en.pdf](http://www.bnb.bg/bnbweb/groups/public/documents/bnb_law/au_lf_rci_internal_rules_en.pdf)

- **The BDIF has yet to develop procedures to address potentially conflicting functions.** Where the bridge institution tool is used, the BDIF would be both sole owner of the institution and insurer of the institution's depositors.<sup>16</sup> As the shareholder, the BDIF would have a fiduciary duty toward the bridge bank; as deposit insurer, the BDIF would have responsibilities toward the bridge bank's depositors. The BDIF should develop procedures to address this legal potential conflict, possibly in its resolution contingency plan, which it is developing.

**21. The collapse of Bulgaria's fourth largest bank provided an opportunity—albeit a bad one—to renew Bulgaria's experience in bank bankruptcies, and depleted the BDIF.** In 2014, the KTB became insolvent, which started a protracted and still ongoing bankruptcy procedure. It was the first banking collapse of this size since the 1990s. The BDIF oversees this procedure, including the liquidator's activities, and it was also responsible for paying out KTB depositors, which depleted the BDIF.<sup>17</sup> This has allowed the BDIF to apply and enhance its payout and liquidation capacity, which it is using to update its manuals for payouts and liquidations (late 2017). This experience will also be useful in developing less costly and less disruptive resolution strategies as a more viable alternative for relying on bank liquidation with conventional depositor payouts.

**22. There are significant financial and legal restrictions on liquidity support to banks.**

Liquidity management has been strengthened, including with a minimum liquidity ratio, and regulatory capital, and liquidity is high on average. Furthermore, the CBA anchors financial stability. However, as became evident in 2014, the CBA poses a severe liquidity constraint, particularly, for majority domestically owned banks. The BGN is fixed to the euro.<sup>18</sup> Therefore, BNB liquidity support can only be funded from the BNB's excess international reserves, which stood at about BGN 2 billion at end-2016. The government can lend to the BNB using the Fiscal Reserve Account (FRA) to strengthen the BNB's liquidity support capacity. While the projected FRA balance for 2017 is BGN 6.2 billion, the 2017–2019 fiscal forecast prescribes a minimum FRA level at BGN 4.5 billion, reducing available funds. Moreover, government financial support is subject to EU state aid and parliamentary approval, adding to the decision-making time.

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<sup>16</sup> Sole ownership by the BDIF seems inconsistent with Article 65(2) of the Resolution Act, which allows transfer of equity—after bail-in—to the bridge institution, which would suggest there might be other shareholders in the institution.

<sup>17</sup> Covered deposits totaled BGN 3.7 billion, while at end-October 2014, BDIF funds stood at BGN 2.1 billion. The MoF agreed to lend the BDIF up to BGN 2 billion of which BGN 1.7 billion was used. The payouts (up to BGN 196,000, or EUR 100,000) started on December 4, 2014—through about 1,500 branches of nine selected banks—when 32.16 percent of deposits was disbursed to 25,000 depositors, increasing to 55.10 percent within three days, and 86.51 percent by end-2014 to 89,291 depositors. By end-2016, 99.59 percent was disbursed to 111,468 depositors.

<sup>18</sup> Since July 1, 1997, the BNB has operated a currency board arrangement. From July 1, 1997 to July 5, 1999, the Old Lev (BGL) was pegged to the Deutsche Mark at BGL 1,000 per Deutsche Mark; then, the Lev was pegged at BGN 1 per Deutsche Mark. Since January 1, 1999 the Lev has been pegged to the euro at BGN 1.95583 per euro.



Table 2. Bulgaria: Supervisory Actions and Information Exchange

	Conditions	Action	Information within BNB	BNB → BDIF
<b>Supervision</b>				
1	Noncompliance with prudential requirements (including reach own funds +1,5%).	Supervisory measures <sup>1/</sup> or early intervention measures, including activating recovery plan <sup>2/</sup>	<b>Information from SD to CIRD for all banks</b> <ul style="list-style-type: none"> <li>• stress test &amp; SREP results w/significant risks to financial stability;</li> <li>• triggering MaPP tools;</li> <li>• crisis prevention measures;</li> <li>• non-compliance w/capital and liquidity requirements;</li> <li>• non-compliance w/early intervention measures;</li> <li>• rapidly increasing NPLs, indebtedness, or loan concentrations;</li> <li>• bank's notification of failing or likely to fail and BSD's actions;</li> <li>• resolution-related materials &amp; Supervisory College decisions; and</li> <li>• activities &amp; finances w/substantial impact on resolvability.</li> </ul> For banks with SREP #4, or #3 with #4 components: detailed/updated information <sup>3/</sup>  For banks that are subject to early intervention measures and have been asked to update resolution plan or prepare resolution: <ul style="list-style-type: none"> <li>• info for updating the resolution plan;</li> <li>• info for preparing resolution measures; and</li> <li>• info for resolution valuations.</li> </ul>	<ul style="list-style-type: none"> <li>• certain supervisory measures;</li> <li>• early intervention measures;</li> <li>• special administration; and</li> <li>• problems that may trigger the deposit insurance system (likely) use of resolution tools and BDIF funds.</li> </ul>
2	Possible unavailability of deposits plus resolution requirements <i>not</i> met.	Special supervision <sup>4/</sup>		
3	(1) Significant financial deterioration; (2) Serious legal Infringements; or (3) Early intervention insufficient.	Removal of management <sup>5/</sup>		
4	Removal of management insufficient.	Temporary administration <sup>6/</sup>		
<b>Resolution and Liquidation</b>				
5	(1) Bank failing or likely to fail; (2) No prospect to prevent failure through private sector or supervisory measures, early intervention, or equity write-down or conversion, and (3) Resolution in public interest.	Decision on the application of resolution tool and possibly special management <sup>7/</sup>	<b>Joint report CIRD and BSD</b> <ul style="list-style-type: none"> <li>• Assessment of a bank failing or likely to fail.</li> <li>• Assessment of a bank's business reorganization plan.</li> </ul>	<ul style="list-style-type: none"> <li>• Resolution measures</li> </ul>

**Table 2. Bulgaria: Supervisory Actions and Information Exchange (continued)**

	Conditions	Action	Information within BNB	BNB → BDIF
6	(1) Systemic crisis; (2) Prior 8% bail-in; and (3) Regular resolution tools inadequate.	Government stabilization tools <sup>8/</sup>		
7	(1) Noncompliance with certain prudential requirements; or (2) unavailability of deposits; or (3) insolvency without likely failure.	License revocation and forced liquidation <sup>9/</sup>		<ul style="list-style-type: none"> <li>• bank's insolvency notification;</li> <li>• license revocation;</li> <li>• bankruptcy proceedings; and</li> <li>• unavailability of deposits.</li> </ul>

Source: IMF and WBG staff

Notes:

BSD: Banking Supervision Department.

CIRD: Credit Institutions Resolution Directorate.

ICAA: internal capital adequacy analysis / ILAA: internal liquidity adequacy analysis.

1/ Art. 103–103a Banking Act.

2/ Art. 44 Resolution Act.

3/ (1) Detailed supervisory measures, early intervention actions, and follow-up actions by banks (including on recovery); (2) updated annual risk assessment and CAMELOS rating, and quarterly analytical report and CAEL rating; (3) complete SREP indicators; and (4) most recent ICAA/ILAA reports and follow-up actions.

4/ Art. 115–121 Banking Act.

5/ Art. 45 Resolution Act.

6/ Art. 46 Resolution Act.

7/ Art. 51 and 54 Resolution Act.

8/ Art. 85 and 57(8) Resolution Act.

9/ Art. 36 and 126 Banking Act.

## ACTIONS TO STRENGTHEN OPERATIONAL CAPACITY

### A. Early Intervention, and Recovery and Resolution Planning

**23. The BNB is updating its EIF.** The BNB advised that it follows EBA Guideline EBA/GL/2014/13 on common procedures and methodologies for the supervisory review and evaluation process (SREP). The BNB has assigned all banks its own risk assessment (CAMELOS) ratings; the risk assessments and the BNB's review of banks' recovery plans constitute a mutually informative continuous process. The CRD IV package and the BRRD have strengthened the EIF (Appendix 4). By mid-2017, the BNB intends to adopt response and escalation policies consistent with EBA Guideline EBA/GL/2015/03, which links early intervention measures to SREP outcomes. The mission recommended that the BNB ensure a smooth and decisive transition from early intervention into resolution, with problem bank metrics that apply consistently through regular supervision, early intervention (including recovery actions), and resolution (planning).

**24. The first round of recovery and resolution planning is progressing.**

- *Recovery planning*—The ECB (seven banks) and the Hungarian and German authorities oversee—through supervisory colleges—the ongoing group recovery planning including the nine foreign-bank subsidiaries; at this time, the BNB does not see a need for individual recovery plans for the subsidiaries. In August 2016, the BNB instructed the nine banks with majority domestic owners and the four banks with majority foreign nonbank owners, to remedy shortcomings in their draft plans, which it had received in February—it has yet to review the revised plans. The BNB expects that all 22 recovery plans will be approved by mid-2017. The mission noted that the critical challenge for a credible recovery plan for the larger majority domestically owned banks is their highly concentrated shareholding structure, which constrains raising capital from the existing shareholders.
- *Resolution planning*—The BNB expects that by mid-2017 from the nine resolution colleges of which it is a member, eight—seven under the SRB and one under Hungarian leadership—will adopt the resolution plans for the groups to which the foreign-bank subsidiaries belong.<sup>19</sup> The BNB expects that the plans for all groups will be based on single point of entry strategies and that the colleges will set indicative minimum requirements for own funds and eligible liabilities (MREL) for the groups; the BNB will develop an MREL policy to ensure sufficient loss-absorption capacity at the foreign-bank subsidiaries. The BNB is determining the critical functions of the majority domestically owned banks and the banks with majority foreign nonbank owners. For these 13 banks, soon, the BNB will start developing a resolvability assessment methodology; by end-2017, it expects to have adopted comprehensive resolution plans, prioritizing these banks based on their risk profiles.

<sup>19</sup> Neither the ECB nor the BNB consider the ninth bank to be systemic. No timeline is available for its resolution planning under leadership of the German authorities.

**25. The mission recommended that the BNB prioritize the RRP for the majority domestically owned D-SIBs and the banks for which the 2016 AQR and stress tests indicated capital shortfalls.** Mid-November 2016, the BNB designated 10 banks as systemically important.<sup>20</sup> This was based on the BNB ordinance on macroprudential capital buffers.<sup>21</sup> Supervisors oversee the banks' recovery planning in addition to their regular duties, and the BNB is developing the skillset of the newly established CIRD. While recognizing capacity constraints, the mission recommended that the RRP for the majority domestically owned D-SIB be prioritized—the authorities should also continue to monitor whether other banks develop critical functions, which would merit prioritizing their resolution planning in particular.<sup>22</sup> Similarly, the authorities should prioritize the RRP for banks that have failed the 2016 AQR and stress tests. The mission also recommended that the authorities adopt strategies in case the resolution college cannot agree on a common approach and EBA mediation is not available for core resolution decisions (Table 3).

## B. Official Financial Support

**26. Liquidity support before, during, and after resolution is critical for crisis management.**<sup>23</sup> Central bank ELA to distressed banks is a key component of effective crisis management to prevent escalation, regardless of whether the recipient is put into resolution or not. Moreover, resolution plans will need to specify liquidity and collateral management strategies for the preferred resolution strategy. While, under the BRRD, resolution *planning* cannot assume liquidity support, in an *actual* resolution it cannot be ruled out that, notably, bailed-in entities may need significant liquidity to regain market trust, including, potentially, access to central bank ELA or government liquidity assistance through lending or guarantees. This is covered in a 2013 European Commission Communication<sup>24</sup> and will also be addressed in the SRB's resolution manual. A recent FSB guideline notes that liquidity support in resolution may be provided by resolution and deposit insurance funds, resolution authorities, central banks, and/or governments.<sup>25</sup>

<sup>20</sup> [http://www.bnb.bg/PressOffice/POPressReleases/POPRDate/PR\\_20161212\\_EN](http://www.bnb.bg/PressOffice/POPressReleases/POPRDate/PR_20161212_EN)

<sup>21</sup> [http://www.bnb.bg/bnbweb/groups/public/documents/bnb\\_law/regulations\\_capital\\_buffers\\_en.pdf](http://www.bnb.bg/bnbweb/groups/public/documents/bnb_law/regulations_capital_buffers_en.pdf)

<sup>22</sup> The FSB's Guidance on the Identification of Critical Functions and Critical Shared Services (July 16, 2013; [http://www.fsb.org/wp-content/uploads/r\\_130716a.pdf?page\\_moved=1](http://www.fsb.org/wp-content/uploads/r_130716a.pdf?page_moved=1)) rightfully notes that D-SIB designation for macroprudential purposes—as is the case in Bulgaria—does not necessarily identify specific critical functions, nor does it cover all activities that might be deemed critical from an RRP perspective, which requires a more granular view.

<sup>23</sup> The mission recognized BNB efforts to establish a sound first line of defense to mitigate liquidity shortages through its reserve requirements (RR) and the liquidity coverage ratio (LCR). The RR are set at 10 percent for non-government domestic funds, five percent for foreign deposits, and zero percent for government funds. The BNB advised that all banks maintained a 20 percent ratio at end-2016. The LCR is set at 20 percent.

<sup>24</sup> Communication from the Commission on the application, from August 1, 2013, of state aid rules to support measures in favor of banks in the context of the financial crisis ("Banking Communication"): <http://eur-lex.europa.eu/legal-content/EN/ALL/?uri=OJ%3AC%3A2013%3A216%3ATOC>.

<sup>25</sup> Guiding principles on the temporary funding needed to support the orderly resolution of a global systemically important bank ("G-SIB"), FSB August 18, 2016: <http://www.fsb.org/wp-content/uploads/Guiding-principles-on-the-temporary-funding-needed-to-support-the-orderly-resolution-of-a-global-systemically-important-bank-%E2%80%9CG-SIB%E2%80%9D.pdf>. Under the BRRD, liquidity support during resolution is expected to be provided, primarily, by resolution funds.

<b>Table 3. Bulgaria: Decision Making when Colleges Cannot Agree on a Common Approach</b>		
<b>Key Resolution Decisions</b>	<b>If NO JOINT DECISION can be reached, decision taken by:</b>	<b>EBA Mediation</b>
<b>RECOVERY</b>		
<b>Group recovery plan</b>	<b>Parent supervisor<sup>1/</sup></b>	For parts binding <sup>2/</sup>
<b>Group recovery plan measures at subsidiary level</b> (e.g., material deficiencies; enable recapitalization, change structure, funding etc.).	<b>Host supervisor(s)<sup>3/</sup></b>	For parts binding <sup>4/</sup>
<b>Need for individual entity recovery plan</b>	<b>Host supervisor(s)<sup>5/</sup></b>	–
IGFSA agreement	<b>Parent supervisor<sup>6/</sup></b>	Binding
IGFS actual support	Supervisor of providing entity <sup>7/</sup>	Assistance <sup>8/</sup>
<b>RESOLUTION</b>		
<b>Group resolution plan</b>	<b>Parent RA</b> on group plan <sup>9/</sup>	Binding but <b>fiscal impingement clause<sup>10/</sup></b>
	<b>Host RA(s)</b> on subsidiary plans <sup>11/</sup>	
<b>Group resolvability assessment</b>	<b>Parent RA</b> on measures at group level <sup>12/</sup>	Binding but fiscal impingement clause <sup>13/</sup>
	<b>Host RA(s)</b> on measures at individual level <sup>14/</sup>	
Remove impediments to resolvability for the group	<b>Parent RA</b> on the measures to be taken at group level <sup>15/</sup>	Binding
	<b>Host RAs</b> on measures to be taken at individual level <sup>16/</sup>	
<b>MREL at consolidated level</b>	<b>Parent RA<sup>17/</sup></b>	Binding <sup>18/</sup>
<b>MREL at subsidiary level</b>	<b>Host RA(s)<sup>19/</sup></b>	Binding <sup>20/</sup>

<b>Table 3. Bulgaria: Decision Making When Colleges Cannot Agree on A Common Approach (continued)</b>		
<b>Resolution action for parent</b> that includes a group resolution scheme	Only for financial stability reasons: <b>host RA</b> take decision for its subsidiary	Assistance
<b>Resolution action for subsidiary</b> and the action likely triggers the resolution of other group members	(for financial stability reasons): Own decision of <b>host RA</b> <sup>21/</sup>	Assistance
Source: IMF and WBG staff.		
<p>1/ Art. 8(3) BRRD.</p> <p>2/ Only on measures to direct the institution to reduce risk profile, enable recapitalization, changes to funding strategy Art. 8(7) BRRD.</p> <p>3/ Art. (8)4 BRRD.</p> <p>4/ Only on measures to direct the institution to reduce risk profile, enable recapitalization, changes to funding strategy Art. 8(7) BRRD.</p> <p>5/ Art. 8(4) BRRD.</p> <p>6/ In addition, shareholder agreement is required, Art. 20 BRRD.</p> <p>7/ Art. 25 BRRD.</p> <p>8/ If the supervisor of the receiving entity objects to a limitation, Art. 25.</p> <p>9/ Art. 13(5).</p> <p>10/ Art. 13(9).</p> <p>11/ Art. 13(6).</p> <p>12/ Art. 13(5) and Art. 16(3).</p> <p>13/ Art. 13(9) and 16(3).</p> <p>14/ Art. 13(6) and Art. 16(3).</p> <p>15/ Report from group RA and consolidating supervisor and the EBA to parent bank and RAs of subsidiaries; Art. 18(6) BRRD.</p> <p>16/ Art. 18(7) BRRD.</p> <p>17/ Joint decision drafted by group RA, 45(9) BRRD; parent RA sets MREL at parent level, may be waived Art. 45(11) BRRD.</p> <p>18/ Art. 45(9) BRRD.</p> <p>19/ Sub RA may waive individual requirement for a subsidiary (Art. 45(10)) BRRD.</p> <p>20/ Art. 45(10).</p> <p>21/ Art. 92(3)/(4) BRRD; if the parent enters into resolution without triggering effects on the group; simple decision by the parent RA.</p>		

**27. For all practical purposes, the BNB has no ELA facility.** The BNB Act authorizes the BNB to extend liquidity to individual banks in emergency situations and under strict conditions.<sup>26</sup> Considering the CBA, discretionary BNB liquidity support is limited to the BNB's excess foreign currency reserves. While the excess reserves have consistently increased (from BGN 5.3 billion at end-2010 to BGN 6 billion at end-2016), the BNB advised that valuation adjustments, special drawing rights, and gold revaluations should be excluded, resulting in a balance of about BGN 2 billion at end-2016 representing 3.2 percent of banking sector deposits.<sup>27</sup> A BNB Ordinance elaborates on BNB lending but the BNB advised that this was not intended to be used; no procedures are in place for prompt decision making on liquidity support.

**28. As an alternative to BNB ELA,<sup>28</sup> the government can provide liquidity support—as it did in 2014—but this is limited and subject to EU and parliamentary approval.** The government can lend to the BNB using the fiscal reserve account (FRA) to strengthen the BNB's liquidity support capacity. While the projected FRA balance for 2017 is BGN 6.2 billion, the 2017–2019 fiscal forecast prescribes a minimum FRA level at BGN 4.5 billion, which limits resources for financial support to about BGN 1.7 billion.<sup>29</sup> Additional government borrowing would require parliamentary approval;<sup>30</sup> and any government liquidity support would need the European Commission's approval—both would lengthen the decision-making time.<sup>31</sup>

**29. The mission recommended that the MoF and the BNB develop jointly strategies to strengthening the capacity to provide liquidity support, based on a three-pronged approach:** (1) increasing the funds for liquidity support; (2) enhancing distressed banks' ability to meet collateral requirements; and (3) ensuring that the authorities can act decisively—yet at their discretion—on liquidity support requests. Appendix 5 lists several options to fund liquidity support. Considering the 'private solutions first' principle, the authorities could contemplate an industry-

<sup>26</sup> Article 20(2) ("In case any systemic risk for the stability of the banking system arises") and Article 33(2) ("Upon emergence of a liquidity risk that may affect the stability of the banking system"): (1) Liquidity risk could affect the banking sector's stability; (2) the recipient is solvent; and (3) the recipient can fully collateralize the BNB loan with gold, foreign currency, or other highly liquid assets. If these conditions are met, the BNB may provide a loan with a maximum three-month maturity under the terms and procedures set out in BNB Ordinance No. 6 on 'Extending Collateralized Lev Loans to Banks:' this type of loan is a last-resort measure; a minimum 10 percent haircut on collateral; only euros, U.S. dollars, and Swiss francs. The ordinance also allows as collateral securities issued or guaranteed by the Bulgarian state, and prime-rated securities or guarantees issued by foreign governments and central banks.

<sup>27</sup> Without said exclusions, excess reserves represented 9.6 percent of banking sector deposits at end-2016, down from 13.7 percent at end-2010. To compare: during the 2014 bank-run, the FIB lost 10 percent of deposits in one day; KTB lost about 20 percent within days.

<sup>28</sup> The BDIF is not authorized to provide liquidity support and cannot be considered a viable alternative.

<sup>29</sup> Bulgaria 2016 Article IV Consultation, IMF Staff Report (<https://www.imf.org/~media/Websites/IMF/imported-full-text-pdf/external/pubs/ft/scr/2016/ cr16344.ashx>).

<sup>30</sup> In anticipation of the 2016 asset quality review, parliament authorized the government to borrow for liquidity and capital support to banks within the overall BGN 5.3 billion limit for new debt in 2016. This expired at end-2016.

<sup>31</sup> The 2014 experience with liquidity support to the FIB does show that EU approval can be obtained relatively quickly.

funded ELA fund at the BNB. The fund could be complemented by higher retained BNB profits, and the MoF could be vested with standing or recurring statutory authority to borrow for financial stability purposes and—using also the FRA—to lend on to the BNB for liquidity support to banks, following the same conditions as typically applicable to central bank ELA.<sup>32</sup> To ensure that collateral requirements under the BNB’s Lending Ordinance can be met—and excess foreign exchange reserves actually be used also for ELA—the mission recommended vesting in the MoF a standing or recurring authority to extend guarantees to the distressed bank.<sup>33</sup> Furthermore, the authorities could seek swap lines with international financial institutions such as the Bank for International Settlements (BIS) and major central banks such as the ECB.<sup>34</sup> Decisive decision making—at the authorities’ discretion—could be better supported with, among other things, solvency and viability methodologies,<sup>35</sup> which should be included in a contingency plan for liquidity support, and pre-assessment of collateral held by banks with a high-risk profile.

## C. Resolution and Liquidation

**30. A fully operationalized bank resolution regime should significantly reduce the need for liquidation and payout to depositors.** To implement the BRRD and the new Resolution Act, the authorities will gradually develop internal procedures and methodologies; and the BNB is identifying D-SIBs’ critical functions that will need to be continued with resolution. The mission recommended that the authorities focus on time-tested sale of business and bridge institution tools. These tools have been successfully used in economies and financial systems similar to Bulgaria, and have proven to be cost-effective. The mission noted that the BRRD and the Key Attributes—and the Resolution Act—prescribe the least-cost principle, helping to economize the BDIF’s limited resources. The mission recommended that the authorities fully explore the advantages of the resolution tools compared to costly and protracted bankruptcy procedures, and—to help inform speedy and effective decision making—develop metrics to compare liquidation costs and resolution actions particularly using the sale of business and bridge institution tools.

**31. While the bank bankruptcy regime is rather comprehensive, concerns have been raised about its ineffectiveness.** Bank Bankruptcy Act is modeled after the corporate bankruptcy regime. In 2014, the World Bank assessed the latter against pertinent international standards.<sup>36</sup> The

<sup>32</sup> See ‘The Lender of Last Resort Function after the Global Financial Crisis,’ IMF Working Paper, No. WP/16/10: <https://www.imf.org/external/pubs/ft/wp/2016/wp1610.pdf>

<sup>33</sup> Back-to-back asset swaps against banks’ relatively liquid assets could be used to avoid unsecured government exposure to distressed banks. If needed, the BNB could act as the MoF’s fiscal agent for these transactions.

<sup>34</sup> At 51 percent, bank loans are highly euroized.

<sup>35</sup> Important flexibility could be created if the BNB could deem a bank solvent if it has a credible recovery (and resolution) plan in place, which would foresee that capital requirements are met in the near term. For an example of such flexibility, see the December 2015 changes in the Bank of Canada’s ELA policy: <http://www.bankofcanada.ca/markets/market-operations-liquidity-provision/framework-market-operations-liquidity-provision/emergency-lending-assistance/>. A government guarantee to the BNB could further protect the BNB’s balance sheet.

<sup>36</sup> The World Bank Principles for Effective Insolvency and Creditor/Debtor Regimes and the United Nations Commission on International Trade Law (UNCITRAL) Legislative Guide on Insolvency Law.



assessment concluded that the corporate bankruptcy regime is rather comprehensive, but not effective in practice; the culture of out-of-court collective negotiation and agreement (workouts) is insufficiently developed, and the regime is strongly biased toward liquidation. Legislative proposals to strengthen the regime have been submitted to the parliament. While the assessment did not cover the bank bankruptcy regime, private sector representatives voiced similar concerns to the FSAP mission, emphasizing shortcomings in the institutional framework (particularly, courts and insolvency administrators) and ineffectiveness of the mechanisms for sale of assets (particularly, piecemeal, groups of assets, or going-concern).

**32. The mission recommended to ensure the bank bankruptcy regime’s effectiveness.** The KA and the BRRD acknowledge that national bankruptcy regimes should complement resolution. Moreover, under the BRRD, liquidation is the default while resolution is the exception only if this is in the public interest. The mission stressed the importance of an effective bank bankruptcy regime, particularly because liquidation might be needed (1) for sizable parts of larger banks, which are left out of resolution measures; and (2) when the public-interest condition prevents using resolution tools. The mission recommended that the bank bankruptcy regime and its application be comprehensively assessed and strengthened as needed to ensure, particularly, that (1) bankruptcy proceedings can be started when the non-public interest conditions for resolution are met (that is, (likely) failure and no reasonable recovery prospect); and (2) the bridge bank tool is available under the bank bankruptcy regime.

## D. Depositor Protection and Resolution Funding

**33. An April 2015 World Bank assessment of the Bulgarian DIS against the IADI Principles found that the DIS is relatively well developed; it also revealed areas where improvements are necessary:**<sup>37</sup> (1) the lack of a public awareness assessment and strategy; (2) the KTB’s failure demonstrated that the framework for early detection of problem banks and timely intervention and resolution was insufficient; (3) coordination and information exchange between the BDIF and other financial safety net players need strengthening; (4) court proceedings prevented the BDIF from receiving recoveries from the KTB’s estate, while the BDIF had already started pay-outs; and (5) following the KTB payout, the BDIF has been depleted and should be replenished expeditiously.

**34. The BDIF is on course to reach its target levels by 2024.** In 2014, it had to draw on a government loan of BGN 1.7 billion to fund the massive payout to KTB depositors.<sup>38</sup> At end-2016, the DIF stood at about BGN 380 million and the BRF at about BGN 178 million—both below their target levels of 1 percent and 2 percent, respectively. The current DIF would be sufficient for depositor payouts in case of the simultaneous collapse of the four smallest banks, or, for example,

<sup>37</sup> The findings are summarized in World Bank Report No: PAD1540, particularly in section VI.B. <http://documents.worldbank.org/curated/en/404021468197359853/pdf/PAD1540-PAD-P154219-R2016-0032-1-OUO-9.pdf> Annex 2 of the report describes the BDIF in more detail.

<sup>38</sup> The BDIF is authorized—for both the DIF and the BRF—to take out loans, including through securities or from the government; it can also assess extraordinary premiums from banks.

of the largest and the third smallest small bank; it would be insufficient to cover payouts if the smallest mid-sized bank were to fail, unless the BDIF would take on an additional sizeable loan and/or collect extraordinary premiums.<sup>39</sup> At the current rate for premium collection, and all other things being equal, the DIF and BRF would be at their target levels in 2024 as required by law.<sup>40</sup>

**35. The authorities are strengthening the BDIF with support from the World Bank and the EBRD.** To replenish the DIF and, eventually, to repay the more expensive government loan, the BDIF secured two loans of EUR 300 million each from the World Bank (February 2016) and the EBRD (March 2016) respectively.<sup>41</sup> The World Bank loan is subject to disbursement-linked outcome indicators, which are informed by the 2015 assessment; the conditions focus on financial resources (through premium collection, asset recoveries, and a loan or backstop facility to complement the World Bank loan), public awareness (assessment and strategy), cooperation between the BNB and the BDIF (with an updated Memorandum of Understanding (MoU), and by sharing AQR results), and a BDIF contingency plan (for payouts and resolution).<sup>42</sup> The mission supported the timely realization of the outcome indicators and recommended that the contingency plan for resolution also includes the policies and procedures that will inform the establishment of bridge institutions including governance structures to mitigate the potential legal conflict between the BDIF's responsibilities as shareholder of the bridge institution and insurer of its depositors.

## E. Contingency Planning and Crisis Management

**36. The authorities are updating the crisis management framework.**

- Since 2003 the FSAC has been bringing together the Minister of Finance (who chairs the meetings), the BNB governor, and the FSC chairperson. The FSC Act mandates the FSAC with cooperation among its members through information exchange to maintain financial stability. For this purpose, its primary tasks are to monitor financial system developments and to coordinate its members' actions in the face of an imminent or actual financial crisis, while respecting the autonomous execution of their agencies' mandates. The FSAC is supported by the Permanent National Financial Stability Group, with members at the deputy level.
- In 2009, the FSAC adopted a national financial crisis action plan, which elaborates on the FSAC's mandate and its cooperation with the BDIF. The national plan assumes agency-specific contingency plans, and the FSC has adopted its own plan. The authorities intend to update the national and the FSC plans for the post-BRRD era, and to complement these with plans for the

<sup>39</sup> The BDIF set the lower and upper limits for mid-sized banks at one and five percent, respectively, of total banking sector assets.

<sup>40</sup> A fully funded DIF (about BGN 470 million) would be sufficient to payout the depositors of the smallest mid-sized bank. A fully funded BRF would have been about BGN 940 million.

<sup>41</sup> For the World Bank project description see footnote 32. For the EBRD decision, see <http://www.ebrd.com/news/2016/ebd-supports-bulgarian-deposit-insurance-fund.html>

<sup>42</sup> Annex 3, Table 7, of the above-referenced World Bank report.

BNB and the MoF. By end-2017, the BDIF intends to have in place a contingency plan for resolution funding, complementing the updated payout plan.<sup>43</sup> In October 2003, the BNB and the FSC signed a bilateral MoU, detailing their cooperative arrangements, which the authorities intend to update. In August 2016, the BNB and the BDIF signed an updated MoU, which prescribes “joint contingency plans for the scenarios which require coordinated joint actions, including crisis communication plans.”

- While Bulgaria is not a Banking Union member, it does benefit from the BRRD’s cross-border resolution and crisis management arrangements (Appendix 6). Moreover, the ECB and the SRB are the group supervisory and resolution authorities, respectively, for seven out of nine foreign-bank subsidiaries operating in Bulgaria, which streamlines cross-border cooperation considerably.

### **37. The mission encouraged further strengthening of the crisis management framework.**

- *FSAC Composition:* As prescribed by the IADI, the BDIF should become an FSAC member.<sup>44</sup>
- *FSAC Mandate:* The FSAC’s mandate should explicitly include the responsibility to actively oversee national contingency planning. The FSAC would remain a platform for inter-agency cooperation; the agencies would continue to use their respective powers autonomously.
- *National Preparation:* The updated national crisis management plan should describe event-specific cooperation on, for example, liquidity support—either by the BNB or the MoF—a run on a bank, supervisory interventions, and liquidation and resolution actions. Where needed, the plan should differentiate between, for example, D-SIBs and other banks, and between foreign-bank subsidiaries and majority domestically owned banks.
- *Agency Preparation:* Under the FSAC’s auspices, all agencies, including the MoF (particularly for using the government financial stabilization tools) and the BDIF (particularly for funding resolution actions), should develop agency-specific contingency plans, ensuring timely, expedient, and less costly bank interventions, and be supported by effective communications. These plans should support the national crisis management plan and detail the respective agencies’ specific actions in, particularly, the events mentioned above.

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<sup>43</sup> Contingency plans for financial sector contingencies would build on the agencies’ pertinent handbooks and manuals, such as for emergency liquidity assistance, resolution actions, and payouts. Contingency plans would exist in conjunction with the agencies’ business continuity plans that address operational failure of the agencies.

<sup>44</sup> Core Principle #6: “The deposit insurer should be a member of any institutional framework for ongoing communication and coordination involving financial safety-net participants related to system-wide crisis preparedness and management.” 2016 Assessment Handbook: “...The DI, irrespective of its mandate, should be a member of such inter-agency bodies...Systems where the DI is excluded from such bodies will be [non-compliant].”

- *Crisis Communication*: The updated national crisis management plan should specifically focus on communication and ensure, among other things, that officials stay on message, that unconventional actions are explained, and that facts neutralize speculations.<sup>45</sup>
- *Crisis Simulation Exercises (CSEs)*: The FSAC should oversee regular CSEs, which could be single- or multi-topic, involve one or more agencies (including the BDIF), and be domestic or cross-border. The CSEs could be comprehensive or focus on particular issues, such as information sharing and decision making. Cross-border CSEs should focus on EU agencies.

## F. Staffing Capability and Legal Protection

**38. The authorities are building the RRP capacity.** Because the resolution regime is new, none of the RRP staff has pertinent experience. The BNB's Off-Site Supervision Directorate oversees banks' recovery planning without additional staffing resources. The BNB's newly established CIRD's main tasks are to participate in resolution colleges, to assess banks' resolvability, and to develop their resolution plans. For this, the CIRD has seven professional full-time equivalents (FTEs): Head (one); Resolution Planning and Execution (four); Methodology and Reporting (one); and Legal Services (one). The CIRD aims to have 16 FTEs. The FSC's newly established Restructuring of Investment Firms Directorate has 4 FTEs and aims to have 10 FTEs responsible for the 19 firms, of which 6 firms with comprehensive resolution plans, including 1 for which the FSC is the home resolution authority; comprehensive recovery plans for the 19 firms are assessed by the 10 supervisors. The BDIF has 23 FTE staff, including three vacancies that it intends to fill in 2017. The MoF Financial Markets Regulation Directorate has 13 FTEs, including 2 representatives in Brussels, and of whom about 4 FTEs work on financial stability issues, including the FSAC Secretariat, MoF representation in resolution colleges, and the upcoming EU presidency.

### **39. The authorities should ensure adequate staffing levels and training for RRP.**

Establishing a new resolution framework requires additional resources, including for training and developing resolution strategies for categories of banks, which, if found effective, could then be used to develop a resolution handbook. The development of the first RRP (including through nine supervisory and resolution colleges, and with annual updates) is a resource intensive process. These additional resources are concentrated in the newly established CIRD within the BNB. To some extent, other BNB units, the BDIF, the MoF, and the FSC, too, will need extra resources. The mission recommended that all RRP staff be trained in resolution actions to fully appreciate the advantages of the resolution tools compared to costly and protracted bankruptcy procedures. Particularly, the cost benefits of time-tested sales of business and bridge institution tools should be explored in workshops tailored to the Bulgarian context. Such training should be done before developing resolution strategies, plans, and handbooks. Staff should also be trained in using the bail-in tool.

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<sup>45</sup> Building blocks from effective crisis communications include: (1) high-level objectives, including clarification of the authorities' mandate; (2) key policy objectives, including assessment of the crisis and focus on stability; (3) target groups, including the general public, depositors, market-participants, and financial press; and (4) tools, including conventional media, social media, and news releases. The effectiveness of crisis communications will also depend on the agencies' communications in normal times.

**40. While the legal framework gives the financial agencies' officials, staff, and agents some legal protection, none of the agencies has operationalized this protection.** The agencies' organic acts provide that they, and their officials and staff, shall not be liable for damages they may have caused in the execution of their mandate, "unless they have acted with intent." The authorities clarified that the quoted clause should be read to mean "unless they have caused the damage with intent." Additionally, the Resolution Act, limits the liability of the supervisory and resolution agencies and their staff; temporary administrators; and bridge institutions and asset management companies, and their management bodies and senior management. Pertinent legislative provisions do not explicitly extend this protection to former staff and officials; and the legislative provisions do not ensure that the legal costs of the agencies' (former) officials and staff are compensated when they have not acted in bad faith, while this, too, is prescribed by pertinent international standards (Appendix 7).<sup>46</sup> Moreover, the authorities advised the mission that none of the agencies has policies, procedures, or other private or public arrangements in place to operationalize legal protection.

**41. The mission recommended strengthening the legal protection framework.** It noted the high number of court cases against the agencies and stressed that international experience demonstrates that stakeholders are more litigious when recovery and resolution powers are exercised, which are more intrusive than supervision. The mission recommended (1) that existing legislative clauses include (former) officials, staff, and agents of the agencies and the MoF, including, also, the indemnification for legal costs; and (2) operational arrangements to make legal protection effective, covering such issues as the choice and (timing of) payment of legal representation, protection against self-incrimination during internal investigations while building a case to defend the agencies, and liability and legal aid insurance covering realistic monetary amounts commensurate with the high financial stakes at play in resolution cases.

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<sup>46</sup> The 2015 BCP Assessment notes "the discretion of the [BNB] Governing Council as to whether legal costs incurred by staff, should they be subject to a lawsuit, will be covered by the BNB. A decision has been made in respect of members of the Governing Council and it is presumed that staff would, in practice be covered but no formal decision has yet been taken."

## Appendix I. Governance Structure of Bulgarian Financial Agencies

### The BNB governance structure comprises three decision-making bodies:

- The **Governing Council** is the BNB's main decision-making body. It sets the BNB's overall strategy, adopts the budget and legal instruments that guide the BNB's policies and operations, approves the annual report including audited financial statements, and is responsible for its organization and structure, including its internal control systems—the chief internal auditor reports directly to the Council. The Council also decides on key individual cases: (1) (de)licensing of banks, payment system operators, payment institutions, and electronic money institutions; (2) special supervision; (3) resolution actions; and (4) triggering payouts by the BDIF. The Council comprises the governor, three deputy governors, and three non-executive members; all Council members serve six-year terms. The governor and the deputy governors are appointed and dismissed by the parliament, to which they swear an oath at the time of their appointment; the non-executive members swear an oath to and are appointed and dismissed by the president. The affirmative vote of four members is needed for a Council decision.
- The **governor** directs and oversees BNB's operations unless a statutory responsibility is vested in a deputy governor. The BNB's Secretary General and the following directorates report to the governor: Legal, International Relations, Human Resources Management, Public Relations, and Banking Security and Protection of Classified Information.
- The three **deputy governors** are each responsible for one of the BNB's departments: (1) Issue Department; (2) Banking Department; and (3) Banking Supervision Department. The deputy governor responsible for the Banking Department also oversees the Fiscal Services Department; and the Credit Institutions Resolution Directorate reports to the Governing Council via the deputy governor responsible for the Issue Department. Each department comprises several Directorates.

### The BDIF governance structure comprises two decision-making bodies:

- The **Management Board** is the BDIF's supreme decision-making body. It adopts the BDIF's budget, audited financial statements, and the rules on the BDIF's operations, organization, and structure, including its internal control systems, and appoints the BDIF's external auditor. The Board decides on all the BDIF's powers vested in it by the DIS Act, the Bank Bankruptcy Act, and the Resolution Act, including determining and collecting the regular and extraordinary DIF premiums, collecting BRF premiums as set by the BNB, investing the DIF and BRF funds, and financing of resolution actions on the instruction of the BNB through the BRF and DIF—BDIF ordinances require the BNB's approval. The Board comprises five members, all serving four-year terms: the chairman, appointed by the Council of Ministers; the vice chairman, appointed by the BNB Governing Council; one member appointed by the association of banks; and two members appointed jointly by the chairman and the vice chairman. The affirmative vote of three members is needed for a Board decision, except for decisions based on the Resolution Act, which require four affirmative votes.

- The **Chairman of the Management Board** is the BDIF's chief executive officer and responsible for the BDIF's day-to-day operations. In the absence of the chairman, the vice chairman or another Board member substitute for the former. The BDIF's seven departments report to the chairman.

**The FSC governance structure comprises two decision-making bodies:**

- The **Commission** is the FSC's supreme decision-making body. The Commission comprises five members, each serving a six-year term: the chairperson; three deputy chairpersons responsible for investment activities, insurance, and social insurance, respectively; and one other member for policy and research. All Commission members are appointed by the parliament for six-year terms; the chairperson proposes candidates for the other seats on the Commission. The affirmative vote of three members is needed for a Commission decision. On key policy decisions relating to individual entities, the Commission decides on the proposal of the deputy chairperson responsible for the sector in which the entity operates.
- The **chairperson** is the FSC's chief executive officer, chairs the Commission's sessions, and is responsible for the FSC's day-to-day operations. The chairperson coordinates the activities of the deputy chairpersons, and is responsible for personnel and the preparation and execution of the FSC's budget.
- The **deputy chairpersons** are vested with supervisory authority in their respective sectors.

## Appendix II. Recovery and Resolution Planning

**Recovery and Resolution Plans (RRPs) have evolved as a key component for contingency planning and crisis management.** Particularly, the BRRD and the Key Attributes establish a comprehensive framework for RRP to guide the recovery of an institution or to facilitate an orderly resolution while minimizing official financial support.<sup>47</sup> A Recovery Plan would be developed by a financial institution to identify options for restoring its finances and viability when faced with distress. The resolution authority would prepare a Resolution Plan based on information provided by the institution. The plan would be intended to facilitate orderly resolution to protect systemically important functions without severe disruptions or losses for taxpayers. The KA allows the authorities to execute alternative strategies deviating from RRP.

**All banks in the European Union, no matter their size, are subject to recovery and resolution planning requirements.**

- Recovery plans are prepared by the banks and assessed by the competent supervisory authority. They are also shared with the relevant resolution authority, which may identify any actions in the recovery plan that could adversely affect the resolvability of the institution, and make recommendations to the supervisory authority accordingly. Ensuring resolvability falls within the competence of the relevant resolution authority, which is empowered to take actions against a bank to ensure its resolvability.
- Resolution planning entails formulating a Preferred Resolution Strategy (PRS), conducting the Resolvability Assessment Process (RAP), and documenting a resolution plan for each institution.<sup>48</sup> While the resolution authorities may ask banks to help in drafting and updating the resolution plan, the ultimate responsibility for the plan rests with the resolution authority, and the supervisory authority must be consulted during the preparation of the plans.

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<sup>47</sup> Key Attribute 11 and Appendix I, Annex 4. The October 2014 version of the KA also covers financial market infrastructures (FMIs), FMI participants, insurers, and the protection of client assets. The BRRD recognizes that not all banks may need comprehensive RRP, and allows for simplified plans at the discretion of the national authorities.

<sup>48</sup> The EBA's final draft RTS on the content of resolution plans and the assessment of resolvability (EBA/RTS/2014/15).



## Appendix III. Resolution Toolkit

**Bulgaria has implemented the BRRD’s mandatory resolution tools—namely, the sale of business tool, the bridge institution tool, the asset separation tool, and the bail-in tool—and the optional, last resort government financial stabilization tools.** The tools are complemented by the authority to appoint a special manager, and the imposition of stays on rights to terminate contracts or execute collateral. Broadly speaking, the resolution framework introduced by the BRRD is consistent with the Key Attributes.

### Bail-in Tool

**In addition to the power to write down or convert capital instruments (which is available at the point of non-viability and in resolution), the BRRD includes a bail-in tool.** The BNB may write down and/or convert into equity the bank’s liabilities. This tool is most likely to be relevant to the resolution of systemic banks in the context of a single point of entry resolution strategy (which would aim to recapitalize the bank and maintain it as an ongoing entity). The bail-in tool could also be used to support other resolution tools, for example, to convert to equity or write down the principal amount of claims or debt instruments that are transferred to a bridge institution under a multiple point of entry strategy.

**Flexibility to exclude liabilities from the scope of the bail-in tool, for financial stability or operational reasons, is constrained.** Departing from strict *pari passu* treatment of creditors, the BRRD allows for liabilities to be excluded from bail-in; for instance, for operational reasons or to prevent contagion. Consistent with good practice, the BRRD prescribes that no creditor should be worse off as a result of resolution, than if the bank had entered bankruptcy proceedings at the time the decision to commence resolution was taken (the “No Creditor Worse Off” or “NCWO” principle). The BRRD establishes that in the event that the NCWO principle is breached, the resolution fund should compensate the relevant creditor(s). The BRRD also specifies that the resolution fund can only be used to cover the costs resulting from excluding some creditors from bail-in under exceptional circumstances, and if the shareholders and creditors have collectively first absorbed losses of at least 8 percent of total liabilities, which could reduce flexibility to deal with systemic cases, at least until adequate loss absorbency is in place.

### Sale of Business, and Bridge Institution Tools

**The sale of business tools and the bridge institution tools allow for the transfer of a failed bank or its activities to a private or public sector purchaser, respectively.** Under the sale of business tool, the BNB may sell the failing bank’s shares, or its assets, rights, and liabilities to a private sector purchaser. As with all resolution tools prescribed by the BRRD, the consent of shareholders or third parties is not required to execute the transfer. The BNB may also transfer the shares of the failing institution, or some portion of its assets (together with liabilities that are less than or equal in value to the assets transferred), to a special-purpose, temporary bridge institution. A bridge institution would be established by the BDIF under the Commerce Act and would be wholly

owned by BDIF (funded by the BRF) while operating under the BNB's direction. The bridge institution would be authorized to conduct banking activities pending its sale to a third party, or until such time as when it is wound down.

### **Asset Separation Tool**

**The BRRD also provides for the asset separation tool.** The BNB may transfer assets, rights, and liabilities from the failing bank to a separate asset management vehicle under the BDIF's ownership and the BNB's direction. Such a separation may help the authorities realize greater value from the assets. The asset management vehicle must manage the assets with a view to maximizing their value by selling them or winding them down. The asset separation tool may only be used in combination with other resolution tools.

### **Government Stabilization Tools**

**The Bulgarian authorities have chosen to implement through Bulgarian legislation the BRRD's optional, last resort government financial stabilization tools.** The BRRD provides for two types of government stabilization tools that the national authorities may use as a last resort in resolution, where use of the mandatory resolution tools would not suffice to avoid significant adverse effects on the financial system or otherwise protect the public interest:<sup>1</sup>(1) the public equity support tool allows a member state to participate in the recapitalization of a bank by temporarily providing capital in exchange for Common Equity Tier 1 instruments, Additional Tier 1 instruments, or Tier 2 instruments; and (2) the temporary public ownership tool allows member states to temporarily acquire a bank's shares. The use of either tool is subject to the state aid rules and the mandatory 8 percent contribution to loss absorption by the bank's shareholders and creditors.

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<sup>1</sup> The SRM Regulation does not make these tools available to the SRB.

## Appendix IV. Early Intervention Powers

**Resolution frameworks depend critically on the effectiveness of the supervisor’s early intervention.** The framework for dealing with problem banks should establish a progression of increasingly stringent powers to deal with everything from relatively minor issues of non-compliance to insolvency. This “ladder” of increasingly intrusive measures (such as a prompt corrective actions framework) should not require that less intrusive measures must be applied before more intrusive actions are taken. Instead, the supervisors should be authorized to expedite the progression of interventions. International standards prescribe such a framework, including the following components:<sup>1</sup> (1) clear triggers for the timely exercise of powers at an early stage of financial deterioration in a manner that helps reduce arbitrariness and promotes transparency; (2) broad range of effective powers available to help restore weak banks to sound financial conditions; and (3) a clear path to orderly resolution when the financial institution appears unlikely to return to viability.

**The supervisor’s extensive array of early intervention powers includes the power to direct a bank to implement a recovery plan.** Under the BRRD, a broad and increasingly intrusive set of powers becomes available to the supervisor as different thresholds are crossed.<sup>2</sup> The supervisor may, for example, direct an institution to change its business strategy or implement elements of its recovery plan where the institution no longer meets, or is likely to breach in the near future, the prudential requirements set out in CRD IV or the CRR (for example, due to a deteriorating liquidity situation). Where these powers are insufficient to reverse the deterioration or remedy infringements, the supervisor may remove or replace one or more members of an institution’s senior management or management body. Finally, the supervisor may appoint a ‘temporary administrator’ to carry out all or part of the management functions of the institution, when, among other factors, removal or replacement of management would be insufficient to remedy the situation.

**In addition to the early intervention powers available to the supervisor, the resolution authority—which in Bulgaria are one and the same, that is, BNB—may write down or convert capital instruments to prevent the failure of a bank or an entity in the banking group.** The BNB may require the write-down of relevant capital instruments (that is, common equity Tier 1, additional Tier 1 or Tier 2 instruments) independently of resolution action, when one or more of the following circumstances apply: (1) BNB has determined that unless the write-down or conversion power is exercised, the bank or other entity in the group will no longer be viable; or (2) extraordinary public financial support (other than support available to mitigate a systemic crisis) is required by the bank or other entity in the group. The write-down or conversion power may be used independently or as part of a resolution action.

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<sup>1</sup> These include the Basel Core Principles for Effective Banking Supervision; Basel/International Association of Deposit Insurance Core Principles; and International Association of Insurance Supervisors.

<sup>2</sup> Title III, BRRD.

## Appendix V. Options for Liquidity Support

The currency board arrangements (CBA) constrain the BNB’s ability to provide emergency liquidity assistance (ELA). The BNB Act prescribes that a full foreign exchange cover for the BNB’s monetary liabilities and provides that BNB lending to banks “may be extended solely up to the amount of the excess of the lev equivalent of the gross international reserves over the total amount of monetary liabilities” of the BNB.

To increase funds for liquidity support to banks, the authorities could consider (a combination of) the following options, provided these are consistent with the CBA and European Union rules.

### Financial Sector Funding

1. An ELA Fund could be established at the BNB, for use at its discretion, funded with premiums paid for by all banks,<sup>1</sup> or, alternatively, 50 percent of the bank resolution fund—which has a target level twice what is prescribed by the European Union—could be repurposed for ELA.

### Public Funding

2. An ELA Fund could be established at the BNB, for use at its discretion:
  - a) funded with realized and distributable BNB profits; and
  - b) funded with a one-time government capital injection in the BNB.<sup>2</sup>
3. The government could be vested with standing or recurring statutory authority to borrow for financial stability purposes and—using also the Fiscal Reserve Account—to lend on to the BNB for liquidity support to banks, following the same conditions as typically applicable to central bank ELA.

### Miscellaneous

4. Credit lines with international financial institutions (such as, the Bank for International Settlements).
5. Swap lines with foreign central banks (such as, the European Central Bank).

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<sup>1</sup> Ecuador has such a fund.

<sup>2</sup> Kosovo uses a similar model (that is, a government sub-account at the central bank, which the latter can use at its discretion for ELA operations).

## Appendix VI. Cross-Border Arrangements Under the BRRD

**Reaching cross-border agreement on resolution plans and enhancing resolvability are crucial objectives.** The BRRD and the SRM Regulation establish a framework that facilitates coordination between Banking Union participants and other EU member states, such as Hungary and Bulgaria. Under the BRRD, the group level resolution authority (GLRA)<sup>1</sup> is responsible for the creation of a “resolution college” for any bank that has a presence in more than one member-state. The resolution college serves as a forum for members to discuss taking joint decisions on setting the MREL requirements, conducting the RAP, and adopting resolution plans with respect to a particular bank, among other things.<sup>2</sup> The BRRD dictates the membership of the resolution colleges, which include the GLRA and representatives of relevant national authorities.<sup>3</sup> The EBA contributes to the functioning of resolution colleges, including through guidelines on resolution colleges and mediating disagreements between college members. It has, however, no voting rights concerning any decision taken within a resolution college.<sup>4</sup>

**The BRRD takes a less comprehensive approach to coordination between EU member states and third countries.** Within the European Union, the BRRD focuses on coordinated resolution planning and implementation, including through resolution colleges and the SRB. With respect to third countries, the focus of the EU framework is on recognition of third-country resolution measures and, where not possible, the ability to take unilateral action against, for example, a local branch of a third-country bank (Table 2). To coordinate intra-EU resolution planning and implementation with respect to EU branches and subsidiaries of third-country banks, the BRRD provides for the establishment of “European resolution colleges.” The resolution authorities from the pertinent third country may request to be invited to participate as observer in the European resolution college. This means that members of a European resolution college could seek to agree on the resolution plan for an EU subsidiary of a third-country bank, without engaging with the third-country resolution authority and irrespective of resolution strategies or plans agreed at the group level (for example, through the CMG). A further complication is that the BRRD does not require member states to take into consideration the implications of their resolution measures on third countries.<sup>5</sup>

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<sup>1</sup> Under the BRRD, the GLRA means the resolution authority in the member state where the consolidating supervisor is located (Article 2(44), BRRD).

<sup>2</sup> Article 88(1), BRRD.

<sup>3</sup> Article 88(2), BRRD.

<sup>4</sup> Final draft RTS on resolution colleges (EBA/RTS/2015/03).

<sup>5</sup> In contrast, between EU member states, the BRRD imposes significant consultation requirements in addition to the resolution college requirements.

### Box 1. Recognition of Third-Country Resolution Proceedings

**For resolution measures taken within the European Union, the EU Winding-up Directive for Credit Institutions (Directive 2001/24/EC) introduced cross-border recognition.** This Directive provides for automatic, mutual recognition and enforcement of reorganization measures. BRRD-related amendments to the Winding-up Directive expanded “reorganization measures” to include also the use of the BRRD resolution tools.

**Articles 94–95 of the BRRD introduced a framework for discretionary recognition and enforcement of third-country resolution proceedings.** The decision to recognize a proceeding is taken jointly by members of the relevant European resolution college. Then, respective national authorities must seek enforcement in accordance with their national law. In the absence of a joint decision or in the absence of a European resolution college, each national resolution authority (NRA) must take their own decision as to whether to recognize and enforce a third country resolution measure. Where the SRB is the GLRA, it will make a recommendation to the relevant NRA—subject to ‘comply or explain’—as to whether to recognize and enforce the third country resolution measure.

**Only in certain circumstances may NRAs and the SRB refuse to recognize or enforce a third-country resolution proceedings:** (1) the third-country proceeding would have adverse effects on financial stability in the member state or another member state; (2) independent resolution action in relation to a EU branch is necessary to achieve one or more resolution objectives; (3) creditors, and particularly depositors, located or payable in a member state would not receive the same treatment as third-country creditors and depositors with similar legal rights under the third-country home resolution proceeding; (4) the recognition and enforcement of the third-country resolution proceeding would have material fiscal implications for the member state; or (5) the effects of such recognition or enforcement would be contrary to the national law.

**The BRRD contemplates ambitious advancements on cross-border recognition, beyond recognition through European resolution colleges.** Instead of decision-making through these colleges, which involves several actors, Article 93 of the BRRD provides an avenue for negotiating and concluding pertinent international agreements between the European Union and third countries, and in the absence of such an EU-level agreement, between EU member states and third countries.

## Appendix VII. International Standards on Legal Protection of Supervisory and Resolution Staff

*Key Attributes of Effective Resolution Regimes for Financial Institutions*; G20 and Financial Stability Board, Key Attributes, October 2014.

- **KA 2.6:** “The resolution authority and its staff should be protected against liability for actions taken and omissions made while discharging their duties in the exercise of resolution powers in good faith, including actions in support of foreign resolution proceedings.”
- **Annex 3: Client Asset Protection in Resolution, item 4.4(ii):** “...protection in law for resolution authorities, their employees or appointed administrators against liability for actions taken and omissions made while acting within their legal powers and discharging their duties in good faith.”
- **KA Methodology (consultative document, August 2013)**

### ***Essential criteria***

- EC 2.6.1 The legal framework provides legal protection through statute for the resolution authority itself, its head, members of the governing body, and its staff, against liability for actions taken or omissions made while discharging their duties in good faith and acting within the scope of their powers, including actions taken in support of foreign resolution proceedings.
- EC 2.6.2 The legal framework provides that the head of the resolution authority, members of the governing body, its staff, and any of its agents will be indemnified against any costs of defending actions taken or omissions made while discharging their duties in good faith or otherwise acting within the scope of their powers, including actions taken in support of foreign resolution proceedings.

### ***Explanatory notes***

- EN 2.6 (a) Protection from liability—Protection from liability should not prevent judicial review of the actions of the resolution authority (cf. KA 5.4) and any associated claims for damages.
- EN 2.6 (b) Agents of the resolution authority—For the purposes of EC 2.6.2, agents include any person, other than an employee, who carries out actions on behalf of the resolution authority under a contract for services. KA 2.6 does not require agents of the resolution authority to be protected by statute against liability for actions undertaken or omissions made when acting in good faith and within the scope of their agency on behalf of the authority. However, where no provision is made for such protection, the agents should be indemnified contractually by the authority for the costs of defending an action and for damages awarded.

**Core Principles for Banking Supervision;** Basel Committee on Banking Supervision, BCP, September 2012.

- **BCP 2:** “The legal framework for banking supervision includes legal protection for the supervisor.”
- **EC 9:** “Laws provide protection to the supervisor and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. The supervisor and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.”
- **BCP Methodology (2006):** “The law provides protection to the supervisory authority and its staff against lawsuits for actions taken and/or omissions made while discharging their duties in good faith. The supervisory authority and its staff are adequately protected against the costs of defending their actions and/or omissions made while discharging their duties in good faith.”

**Core Principles for Effective Deposit Insurance;** International Association of Deposit Insurers, IADI Principles, November 2014.<sup>1</sup>

- **Principle 11:** “The deposit insurer and individuals working both currently and formerly for the deposit insurer in the discharge of its mandate must be protected from liability arising from actions, claims, lawsuits or other proceedings for their decisions, actions or omissions taken in good faith in the normal course of their duties. Legal protection should be defined in legislation.”
- **Essential criteria:**
  - Legal protection is specified in legislation and provided to the deposit insurer, its current and former directors, officers and employees, and any individual<sup>2</sup> currently or previously retained or engaged by the deposit insurer, for decisions made and actions or omissions taken in good faith in the normal course of their duties.
  - Legal protection precludes damages or other awards against such individuals and covers costs, including funding defense costs as incurred (and not just reimbursement after a successful defense).

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<sup>1</sup> See also pages 57–59 of ‘A Handbook for the Assessment of Compliance with the Core Principles for Effective Deposit Insurance Systems’ (March 2016): [http://www.iadi.org/docs/IADI\\_CP\\_Assessment\\_Handbook\\_FINAL\\_14May2016.pdf](http://www.iadi.org/docs/IADI_CP_Assessment_Handbook_FINAL_14May2016.pdf)

<sup>2</sup> A contractual indemnity in an individual’s contract of employment or engagement with the deposit insurer and/or private insurance is not a substitute for legal protection defined in legislation or recognized in law.



## BULGARIA

- The operating policies and procedures of the deposit insurer require individuals with legal protection to disclose real or perceived conflicts of interest, and to adhere to relevant codes of conduct to ensure they remain accountable.
- Legal protections do not prevent depositors or other individual claimants or banks from making legitimate challenges to the acts or omissions of the deposit insurer in public or administrative review (e.g., civil action) procedures.

***Insurance Core Principles, Standards, Guidance and Assessment Methodology***; International Association of Insurance Supervisors, IAIS Principles, October 2011.

- ICP 2.10: “The supervisor and its staff have the necessary legal protection against lawsuits for actions taken in good faith while discharging their duties, provided they have not acted illegally. They are adequately protected against the costs of defending their actions while discharging their duties.”

***Objectives and Principles of Securities Regulation***; International Organization of Securities Commissions, IOSCO Principles, June 2010.

- **Methodology (2011) for Principle 2:** “The capacity of the Regulator to act independently will be enhanced by adequate legal protection for the Regulator and its staff when acting in the bona fide discharge of their functions and powers.”
- **Methodology, Key Issue 5:** “There should be adequate legal protection for regulators and their staff acting in the bona fide discharge of their functions and powers.”