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***FLASHES FROM THE PAST:
THE ORIGIN AND DEVELOPMENT OF BANKING
SUPERVISION IN BULGARIA***

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RESUME

The study aims to outline the specifics related with the emergence and development of banking supervision in Bulgaria. The analyzed time period is divided into three parts, which reflect development of the Bulgarian state. The first period focuses on the development of banking supervision in the newly created Third Bulgarian State (1883-1944) and reflects different aspects of its institutionalization. The second period (1944-1989) focuses on changes in the banking supervision after the nationalization of the banking sector and the imposition of centrally planned economy in Bulgaria. Analysis of the third period (after 1989) focuses on the problems of the banking system and bank supervision in transition to market relations.

Keyword: banks, bank supervision, Bulgarian national bank, history

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THE ORIGIN OF BANKING SUPERVISION IN BULGARIA (1883-1947)

The concept of banking supervision has traditionally been associated with controlling the activities of commercial banks and its compliance with all regulatory documents and requirements in force in Bulgaria. In practices around the world, the national central bank or a special body is usually responsible for the implementation of effective banking control and supervision.

The establishment of specialised banking supervision in Bulgaria is characterised by its evolutionary development and institutionalisation. In the following expose this process will be traced and the focus will be placed on the presence of supervision and control of banking rather than on the institution engaged in this activity. The use of this approach is mainly caused by the specific features of the development of Bulgarian banking system.

Legislative regulation of the banking supervision in Bulgaria is directly related to the establishment of the Bulgarian National Bank. For the first time this issue was mentioned in Chapter XVII (regulating the role of the government commissioner in exercising control over the

banking) of the Statute of the Bulgarian National Bank adopted in 1883¹. In the Establishment of the Bulgarian National Bank Act, adopted on 27th of January 1885, it was explicitly specified the right of the government to supervise and inspect the activity of the bank and the exact observance and enforcement of laws, statutes and regulations². The accepted viewpoint was largely due to the lack of a functioning banking system and the lack of a national central bank. During the considered period, the Bulgarian National Bank implemented dominantly operations related to the commercial banking and much later it was established as the central bank of the country.

The Bulgarian National Bank Act, adopted on 6 February 1906, further fixed the commitments for banking supervision and the Minister of Finance was engaged mostly with these³. The Minister of Finance shall stop the operations which are contrary to the law and regulations adopted for the bank activity. The supervisory activity may be carried out either by the Minister of Finance or by specially appointed government delegate.

For the beginning of the differentiation of the banking supervision within the BNB we could speak since 1907 with the adoption of the Law on Craft Credit which determined the bank as a central governing body of the newly formed credit craft associations⁴. Besides the commitments for refinancing and providing methodological assistance (preparation of

¹ See. "The Statute of the Bulgarian National Bank adopted by the third National Assembly" in Bulgarian National Bank, Bulgarian National Bank - Collection of documents (1879-1900), vol. 1, Sofia, 1998, p. 132.

² See. "Letter from the Vice-Chairman of the Fourth Ordinary National Assembly to the Minister of Finance for approving the Establishment of the Bulgarian National Bank Act" in Bulgarian National Bank, Bulgarian National Bank - Collection of documents (1879-1900), vol. 1, Sofia, 1998, p. 213.

Although the state (represented by the Minister of Finance) was responsible for supervising the activity of the BNB, the bank had been on parliamentary control by specially appointed for this purpose Inquiry Committee. See: "Report of the Inquiry Committee to the Fourth Ordinary Assembly in Reviewing the Accounts of the Bulgarian National Bank" in Bulgarian National Bank, Bulgarian National Bank - Collection of documents (1879-1900), vol. 1, Sofia, 1998, p. 173.

³ See. "The Bulgarian National Bank Act adopted by the XIII National Assembly" in Bulgarian National Bank, Bulgarian National Bank - Collection of documents (1901-1915), vol. 2, Sofia, 1999, p. 32.

⁴ See: Bulgarian National Bank, 120 years Bulgarian national Bank, Sofia, 1999, p. 60.

draft statutes and account books), the Bulgarian National Bank together with the local judges had the responsibility to implement control on the activities of these associations. This law for the first time charged the BNB with the responsibility to provide sufficient publicly available information to enable the implementation of public control on the activities of these associations. This was done by publishing a special statement of the bank for the development and condition of craft credit in the country and the state of any of these associations.

The provisions of the Bulgarian National Bank Act of 1906 were further worked out in detail with the Supervision Regulations, adopted in 1908. Supervision over the bank's activity was undertaken directly by the Minister of Finance through approving the decisions of a management board, as well as indirectly – by the government delegate and bank's inspectors (government officials appointed by the Head of State) and the Audit Commission.⁵ Government delegate's responsibility was to monitor the proper implementation of the Bulgarian National Bank Act, and other laws in force, regulations and ordinances directly related to the bank's activity, as well as the timely and correctly implementation of Management Board's decisions approved by the Minister. The Government delegate also had to check all accounts and operations of the bank as well as participate in the meetings of the Management Board and Discount Committees. As a representative of the Minister of Finance and in accordance with assigned responsibilities, the Government delegate might give an opinion on legality of each Management Board's decision before the vote and insist on cancellation of the already taken decisions if he considered that the decisions were not in accordance with regulations.

If the Government delegate's responsibilities were related to the

⁵ Opt. cit., p. 63

supervision of the legality of the Management Board's actions and decisions, the responsibilities of the inspectors would be to monitor the correct implementation of the laws, regulations and other ordinances as well as the Management Board's orders and decisions. This had to be done via conducting inspections and audits. Although the inspectors were directly subordinated to the government delegate, they might report on important issues directly to the Minister as well as take orders directly from him.

Significant changes in the manner of supervision of the Bulgarian National Bank occurred in 1911 with the adopted "Law on Amendment of the Law on the Bulgarian National Bank", which removed the government delegate position and assigned the control of banking to a special Control Board. The newly formed Control Board consisted of three members who were appointed and dismissed by a decree of the head of the state on the proposal of the Minister. The members of the Control Board had to monitor the proper implementation of the law and regulations on the BNB. It also had to make inspections on management, branches and agents by the appointed inspectors⁶. The rights of the newly formed Control Board, related to participation in taking management decisions in the bank, were limited to the right of an advisory vote in the meetings of the Board. With the changed regulations in 1925, the number of members of Control Board was increased to four and Board control did not affect operative management activities of the bank. But this control was a post factum control over the bank operations and decisions.

The Law on Amendment of the Law on the Bulgarian National Bank was particularly important also because for the first time the

⁶ See: "Minutes of the Meeting of the Control Board of the BNB with the Decision to Adopt Draft Regulations for its Activity" in Bulgarian National Bank, Bulgarian National Bank - Collection of documents (1901-1915), vol. 2, Sofia, 1999, p. 32.

foundations of prudential regulations in banking were laid. The Law enacted the establishment of a special fund for doubtful debts (by 5% deductions from the net profit of the bank) which aim was to cover the losses of the bank. Thus the foundation of credit risk management in commercial banking was laid, as far as the Bulgarian National Bank did not have the status of a distinct central and emission bank and still performed also commercial operations.

Although from the current point of view, the Central Control Department for legal claims of BNB, established in 1914, could hardly be regarded as a specialised authority for banking supervision, the department fulfilled some of the functions specific to this type of institutions⁷. This gives us reason to consider it as the next step in the evolution of banking supervision in Bulgaria and its institutional differentiation.

For the first time in the Bulgarian banking history, the Bank Deposit Guarantee Act, adopted on 4 January 1931, stipulated the establishment of special authority – Bankers Board which was responsible for supervising the activities of banks operating in our country. Although some of its functions were directly related to and resulted from the adopted law (review of bank statutes for accordance with the Bank Deposit Guarantee Act), the Bankers Board was also in charge with specific tasks regarding banking supervision (as giving an opinion for opening new banks or branches of foreign banks, as well as considering of the law violations and giving opinions of imposing any penalties). The Bankers Board consisted of five members⁸ with a three-year mandate appointed by a decree of the head of the state (and the chairman was

⁷ For more details on this issue see: **Avramov**, Y. Bank Control. New Star, Sofia, 2001, p. 144.

⁸ One representative of the Ministry of Finance, two representatives of the BNB and two persons pointed out by the banking section of the Union of Public Limited Companies and the Association of Bulgarian Provincial Banks. See. Bulgarian National Bank, 120 years Bulgarian national Bank, Sofia, 1999, p. 141.

obligatory a representative of the Bulgarian National Bank). The newly formed board had not institutionally separated yet and was a part of the Ministry of Finance but the manner of appointing its members and their mandates enabled it to be independent in taking and implementing its decisions.

The Bank Deposit Guarantee Act of 1931 for the first time dealt with issues related to the depositors protection in case of a bank bankruptcy and expanded the existing prudential regulation of the banking institutions' activity introduced by the Law on Amendment of the Law on the Bulgarian National Bank of 1911. The procedure of licensing of the new established banks, which collected deposits, included requirements for their legal form (joint-stock companies or companies limited by shares). Licences were granted by the Minister of Finance, having heard the opinion of the Bankers' Board⁹.

A requirement was also introduced for banks to maintain not less than 2/3 of the total amount of savings accepted by them in the form of highly liquid assets. To preserve the bank's solvency, it was envisaged that 10% of the bank's net profit to be set aside in the form of reserve capital and at least 1/5 of it had to be kept in the Bulgarian National Bank in the form of Bulgarian government or government-guaranteed securities traded on the local or international stock market. There was also a possibility for banks to create other reserve funds. The law also introduced restrictions on certain types of operations carried out for bank's own account. Not allowed were the financial transactions with members of the management and the control boards. Some restrictions

⁹ The Bank Deposit Guarantee Act used interesting approach in licensing newly created banking institutions. The new bank could perform all banking operations with the exception of savings collection. Authorization for the last operation could only be given by the Minister of Finance but not early than the establishment of the bank. Thus the new banks should have enough equity, good management and prove their viability before they began to attract the savings of the population. See Bulgarian National Bank, 120 years Bulgarian national Bank, Sofia, 1999, p. 141.

were imposed on the amount of credits granted to all members of the management and the control boards of the bank.

With the adoption of the Bank Deposit Guarantee in Private Banks Act in 1933, amended version of the Law of 1931, the number of members of the Bankers Board was increased to eight¹⁰. The law also contributed to the Board's independence and envisaged the Board to be financed by commercial banks and not as it was done before – by the Ministry of Finance. Specially appointed auditors (who had to be members of the Institute of Sworn Certified Accountants) were charged with the supervision of banking.

In connection with the global economic crisis and increasing number of bank bankruptcies, the new law included a special section regulating the procedure of bank liquidation. The initiative of starting the liquidation procedure was within the powers of the Bankers Board which through its decisions had to protect both the interests of the bank and the interests of its creditors and depositors.

The suspension of bank's payments as well as the loss of over 50% of its equity might be the reason for the request for initiation of a public liquidation procedure. The law envisaged also the possibility of suspension of public liquidation in cases where it turned out that the claims of creditors were fully guaranteed and there was a sufficient capital to restore normal functions as well as when bank's shareholders succeeded to attract enough new capital¹¹. Of course, in order to begin

¹⁰ The new Bankers Board included: one representative of the Ministry of Finance; the BNB Governor and two of its representatives appointed by the Managing Board; one representative of the private banks pointed out by the banking section of the Union of Public Limited Companies; one representative of the provincial private banks elected by the Association of Bulgarian Provincial Banks; and one sworn-in certified accountant designated by the Bankers Board. The Constant Presence was formed within the Board and it included: members of the Bankers Board; a representative of the Minister of Finance; a representative of the BNB; one representative of the private banks chosen by the Bankers Board. See. Bulgarian National Bank, 120 years Bulgarian national Bank, Sofia, 1999, p. 149.

¹¹ Typical for the latter case was the fact that the law provided special concessions for shareholders in the form of relieving the bank from any duties, special taxes collected by the government authorities, stamp duty etc. See. Bulgarian National Bank, 120 years Bulgarian national Bank, Sofia, 1999, p. 150.

the suspension of liquidation procedure, a positive opinion of the Bankers Board was necessary.

BANKING SUPERVISION DURING THE SOCIALISM (1947-1989)

All regulations in force until the end of 1947 in the field of banking were repealed with the adopted at the same year Act on Banks. The transfer of the ownership in the hands of the state also entrusted it with the function of controlling the activities performed by banks through the relevant state and financial control authorities. In 1969 with the Council of Ministers' Decree on the organization of the banking system it was established the "Inspection Department" in the Bulgarian National Bank.¹² This department carried out supervisory functions on the Bulgarian Industrial Bank, Bulgarian Agricultural and Commercial Bank, Bulgarian Foreign Trade Bank. The recovery of the banking supervision lasted until the end of 1970 when the BNB acquired the other three banks.

The next attempt to recover banking regulation and supervision in Bulgaria was in the early 1980s. In 1983 the Council of Ministers adopted norms for regulating the business activity of the BNB and the other banks¹³. In 1986 the Council of Ministers adopted Rules for business activity regulation for the first time in the last forty years for the establishment of commercial banks in conditions of the planned economy. The restoration of a contemporary two-tier banking system and hence the restoration of banking supervision started with the Decree

Thus, in the Law on the protection of savings deposits in private banks it was laid down the view that a living bank was much more valuable than a dead bank i.e. the legislator highly assessed the role of bank intermediation for the normal development of the economy and gave bank shareholders sufficient incentives to overcome financial difficulties due to external factors, not due to the bad management or abuse.

¹² Avramov, Y. Bank control. New Star, Sofia, 2001, p. 147.

¹³ Bulgarian National Bank, 120 years Bulgarian national Bank, Sofia, 1999, p. 227.

for the banking system's reconstruction adopted on 3rd June 1987.

By the adopted normative act the BNB was responsible for controlling compliance with the standards and requirements for banking activity. This function the BNB implemented by distance supervision (on the base of regular reporting, statistical and other data submitted by commercial banks) and if necessary - through inspections and audits. Where weaknesses and violations were identified the BNB had to impose appropriate penalties and mandatory prescriptions and in the worst cases – submit a proposal to the Ministry Council for the reorganizing and liquidation of a commercial bank. As a supervisory body the BNB was authorized also with the establishment of the necessary banking regulation, including prudential requirements for implementing banking activity. These prudential requirements included: percentage cover of credits disbursed to equity; management of risk assets and bank liquidity; establishing special reserve funds and rules related to granting and management of credits.

Thus with the adoption of the Decree on the reorganization of the banking system in 1987, the foundations of contemporary banking supervision in Bulgaria were laid. Some of the accepted formulations (such as the possibility of liquidation) were too advanced for the conditions of the socialist economy.

With the adopted in 1989 Rules for Banks, the rights and obligations of the commercial banks were detailed and banking activity was regulated. As for banking supervision, the new rules allowed, in systemic violations of banks, the Bulgarian National Bank to propose measures for dismissing the management, control bodies and in particularly severe cases – precede compulsory liquidation by the relevant district court.

BANKING SUPERVISION IN THE TRANSITION TO A MARKET ECONOMY (AFTER 1989)

Fundamental changes in the banking supervision in Bulgaria occurred with the adoption of the Bulgarian National Bank Act in 1991. The BNB shall be responsible for banking supervision and regulation of other commercial banks' activities in order to maintain the stability of the banking system. The adoption of the law was the beginning of the contemporary banking in Bulgaria and introduction of world's leading practices in this area.

Adopted a year later, the Act on Banks and Credit Activities further expanded and detailed commitments on banking supervision by the central bank related to statutory regulatory requirements. The control was exercised from distance – based on regularly reports of commercial banks and by audits and spot checks. In case of significant violations the BNB had to impose appropriate sanctions and prescriptions, and in particularly severe cases – dismiss the bank management, limit the scope of the bank's activities and as a last resort – had to withdraw the license for banking activities. In case of dismissing the bank management or withdrawal of its license, the management of the bank was assigned to a specially appointed by the BNB quaestor.

The Act on Banks and Credit Activities introduced the authorization of banking activity, which regulated procedures for issuing and withdrawing of banking license in the country. Some of the requirements related to the acquisition of a license were set of prudential rules for reducing the risk in the banking system. They were directly related to the origin and sufficiency of the bank's equity, requirements for liquidity, reserves, and professional education of the governing bodies. Particular attention was paid to the credit risk management including

restriction on large and linked credits as well as the requirements for special reserves to cover bad and doubtful debts.

The Act on Banks and Credit Activities envisaged the BNB establishing and adopting a detailed and comprehensive framework for any specific requirements for the activities of banking institutions. In the implementation of these provisions in the next year the central bank adopted ordinances regulating large and internal credits of banks (Ordinance 7), capital bank adequacy (Ordinance 8), credit classification and the establishment of compulsory special reserves (statutory provisions) by banks (Ordinance 9) and banks' liquidity (Ordinance 11).

With the beginning of banking crisis in Bulgaria an urgent change was adopted in the existing Act on Banks and Credit Activities, especially in the part of banking supervision and bankruptcy. By the regulation of the so-called special supervision of problem banks, banking supervision might impose a set of administrative measures to banks whose solvency was highly threatened¹⁴. If the measures did not lead to the improvement of the bank's financial situation and the bank became insolvent, the BNB might open insolvency proceedings. Despite the extended powers of the central bank in the banking supervision field, the measures imposed by the BNB to solve banking problems could hardly be characterized as rapid and decisive. Thus, it could lead to further deepening of liquidity problems in the banking sector and deepening of the banking crisis in the country.

The introduction of the Currency Board as a measure for the stabilization of the economy directly affected the central bank's activity in the field of banking supervision. With the adopted in 1997 new

¹⁴ Risk of insolvency occurred when the ratio of total capital adequacy of a commercial bank was below a certain minimum level or when due to the state of its assets there was a risk for the bank not to meet its obligations on the day they became due. See. Bulgarian National Bank, 120 years Bulgarian national Bank, Sofia, 1999, p. 261-262.

Bulgarian National Bank Act it was established a new department “Banking Supervision”, as a part of the bank’s structure. This department shall separately and independently exercise the supervisory functions. With the adopted in the same year Act on Banks, the issues related to the effective supervision on banking system were further detailed. Part of these measures included the legal protection of persons exercising supervisory powers for their prudent business decisions. Thus, they are subject to criminal prosecution only for intentional damages, as well as those damages caused by negligence. A new point is also the impossibility to appeal against the supervisory measures imposed by the central bank as well as the automatic withdrawal of a license in case of a bank’s insolvency.

The Law on Banks further deepens and develops the formulations of its predecessor – the Act on Banks and Credit Activities in the part of prudent requirements for carrying out of banking. Procedures for issuing and withdrawing of banking licenses are significantly improved and detailed. There are significantly higher requirements for qualification, the origin of the capital and audit control.

As part of the accession of Bulgaria to the European Union, the operative banking regulation is consistent with international standards and global best practice. The approach adopted by the European Union for banking supervision by the national authority over all banking institutions operating on its territory puts more demands on specialists working in this department. Furthermore, the processes of globalization and the integration of the world financial and banking markets will inevitably impose integration and close cooperation between all national authorities on banking supervision in order to prevent crisis in the banking intermediation or even these processes will lead to the establishment of a common international supervisor.

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