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PROJECT INFORMATION:¹

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COUNCIL CONTRACT NUMBER: 812-30
DATE: February 5, 1998

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¹ The work leading to this report was supported in part by contract or grant funds provided by the National Council for Eurasian and East European Research, made available by the U. S. Department of State under Title VIII (the Soviet-Eastern European Research and Training Act of 1983, as amended). The analysis and interpretations contained in the report are those of the author(s).
BANK LENDING IN BULGARIA AND HUNGARY:
Policy Lessons for Bulgaria from Hungary’s Experience

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Abstract

Bank lending in both Bulgaria and Hungary has gone through a difficult transition that included several major banking crises involving large numbers of bad loans and the collapse of many banks. Hungary’s transition started earlier and has involved a more market-oriented economy. As they learned from their mistakes, Hungarian bankers and policymakers have adopted new systems of credit policy both for individual banks and as larger social institutions. In contrast, the Bulgarian banking system is now just coming out of a deep collapse and is largely unreformed. In this paper we identify some policy lessons from the Hungarian experience that may be useful to the reform of the Bulgarian banking system.

We identify these lessons with four levels of the banking system: problems with credit policy; problems of bank incentives and organization; problems of banking regulation and the legal system; and lastly, problems with larger social attitudes. Each shows some successful policies in Hungary that Bulgaria could readily adopt.

1.0 Introduction

The transition to a market economy has been extremely difficult for the financial system. Banks in every country have made too many bad loans, and both they and the larger economies have suffered as a result. However, some countries’ banks seem much farther along in the transition than others. In particular, Hungary made early steps toward a market system beginning in 1968, and has also more recently moved rapidly to place its banks under market discipline. Bulgaria, in contrast, began the move to a market economy only in 1991, and its banking system is only now beginning to face market discipline.

In this paper we describe elements of the business environment, of bank internal structure, and of bank lending policies that led to bank failures or successes in each country. We would like to draw

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some policy suggestions for banks and bank regulators in Bulgaria from a comparison of these two experiences and from some of the changes we have observed in Hungary. Since policy does not occur in a political vacuum, we conclude by applying some ideas from the New Institutional Economics on how Bulgaria might most effectively carry out policy change.

Between the spring of 1996 and early 1997, the Bulgarian banking system largely collapsed under the weight of bad loans. While one reason was poor government policy, the banks were also responsible for a wide variety of bad lending practices. Hungarian banks went through similar difficulties in 1990-91 and also 1993-94. In each crisis, the government and bank regulators imposed major changes on the banks. Presumably the bankers themselves and the banks as institutions learned something from these experiences.

In Spring 1997 we interviewed bankers in Bulgaria and Hungary in detail about their lending practices. We also talked to a number of leading economists and bank regulators. The detailed results of our research in Bulgaria are in Koford and Tschoegl (1997a, 1997b). We describe our general findings in four sections under the following headings: problems with credit policy; problems of bank incentives and organization; problems of banking regulation and the legal system; and problems with larger social attitudes.

Before we turn to these headings, we want to note the fundamental but surprising apparent fact of recent years: bad decisions carried no adverse consequences. Suppose that a bank made a loan and the borrower failed to repay it, who would suffer? In established market economies, both the banker and the borrower bear the consequences. In early transition economies, in contrast, it seems that neither banker nor borrower saw any cost to them personally. Now in Bulgaria an intermediate case seems to have developed in which the banker is in trouble, but the borrower is home free. (Bulgarians talk admiringly of “credit millionaires” who live well from money they have borrowed and who thumb their noses at the bankers while driving through town in their Mercedes Benzes.) In market economies, banks that give bad loans will go bust. Situations where either borrowers or lenders do not suffer the consequences of socially harmful decisions are unstable. Therefore structures must change to impose costs on bankers and borrowers for bad loans.

There were political or institutional (or, perhaps, cultural) reasons why the banking system allowed bad loans, which we explore. Even so, resources are scarce and banks cannot make large losses without imposing high costs on other parts of society. In section 5 we show how crises caused by bad loans can lead to the political will to move to a more efficient, market-oriented, banking system.

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4 We will gladly provide the questionnaire we used to any interested readers.
2. Problems with Credit Policy

In making a loan, the bank officers must determine whether the borrower will be able and willing to repay the loan. The first factor involves the firm's expected cash flow over the future and the value of the use to which the firm will put the loan. The second factor requires that the banker assess the borrower's "character."

Most Bulgarian bankers indicated that these tasks were very difficult to accomplish. Financial statements and business plans were not reliable. There were borrowers who intended to defraud the banks, and borrowers who -- if their businesses did poorly -- would be willing to grab the available cash and "run away." Although Bulgarian banks followed a variety of methods of evaluating borrowers, ranging from very bureaucratic checking to almost no evaluation, these methods were not very effective at preventing high levels of default.

These problems had also existed in Hungary in the early 1990s. They changed after the banking crisis, largely due to the introduction of foreign banks and their methods, either by takeover of Hungarian domestic banks or by de novo entry. It seems that large banking organizations have great difficulty in making the change to competitive credit market conditions. So many things must change: rules, work practices, reporting relationships, patterns of interaction and coordination, and even people. An existing organization and its workers will resist these changes. Thus, successful change of existing banks has tended to require the appearance of an aggressive outside actor. Only an outsider could impose new systems under the credible threat of closing the bank or firing those employees who fail to adapt. New banks began with a clean slate. They established systems, chose the (mostly young) workers they wanted, trained them intensively according to their standards, rewarded them according to foreign pay standards, and monitored their work intensively using foreign employees. Our observation is that new banks exhibited much more progress towards modernization than did established banks that tried to modify themselves through internal initiatives.

To see why drastic restructuring is necessary, we describe some effective methods used to determine creditworthiness in effective banks -- largely in Hungary, but also including some foreign-controlled banks in Bulgaria. These add up to a system, and we show how an "old" bank will have great trouble reforming itself without severe and intensive external pressure.

A would-be borrower must present a reason for needing the loan (a "project") and show that the firm has sufficient profitability and assets to support the loan. These involve financial statements and a business plan. However, financial statements in Bulgaria, and in all transition countries, do not fully reveal the true financial situation of a firm. The environment is very dynamic, and it is difficult even for the best (say, "Big Six") accountants to evaluate fully a firm's assets, receivables, and so on. Thus, a banker must use good judgment in evaluating this information.

Business plans are also not very informative, in the view of bankers. Many businesses are not familiar with business plans, and so have them designed by outside consultants. These plans are
general or even generic and fail to show the specific strengths and potential problems facing the business. Also, Bulgarian business plans fail to present the firm’s contingency plans for dealing with possible difficulties such as reduced sales, delayed delivery of supplies, or macroeconomic difficulties.

Overall, we found that Bulgarian bankers found these difficulties too great to overcome, and they felt that it was really not possible to determine which were the good-risk businesses. However, we found several banks based on international models that had excellent records and had succeeded in overcoming these difficulties. These banks made good use of the applicant’s financial statements. These banks took the view that financial statements should present a realistic picture of a firm’s assets and cash flow and that every borrower should care about these matters. Then one banker reported that while many borrowers did not understand financial statements well, those borrowers who showed strong interest in learning about their financial situation were better risks than those borrowers whose greatest interest lay in getting the loan. Detailed discussions would quickly and effectively reveal a borrower’s interest in the financial analysis and assessment of his business.

Another bank used the firm’s business plan to evaluate the borrower’s interest in the concrete details of the business. In discussing the strengths and weaknesses of the business, the owner was giving an idea of whether he or she really cared about the business. Some borrowers really understood and loved the mechanics of their business; others just wanted money and had sketched out what was at best a superficially plausible proposal. Clearly, bankers want borrowers who want the business to succeed, and not borrowers who just want money. Careful and multiple visits to a firm were also extremely useful. A good banker could generally observe whether the business was well-organized, whether the workers were doing their jobs, and whether the business seemed to be a going concern.

Both of these bankers firmly believed that a good firm would want to learn about the realistic financial risks it was taking, and to learn more about the realism of the business plan. A firm that was trying to manipulate the banker to get money was not a good borrowing risk.

A third lender required several personal guarantees from people who knew the borrower well. The lender made a point of coming to know these people. In effect, the lender used the borrower’s peers to weed out those people the peers did not trust or those whom they felt were not competent.

3. Problems of Bank Organization and Incentives

The three methods described gave the lender some assurance that neither “phantom firms” nor those without viable businesses would get loans. However, the type of screening we describe is inherently subjective, and also would potentially be subject to abuse by credit officers. Several banks had policies that dealt with these problems. The first policy was a regular (quarterly) review of credits. Each bank lending officer would go through his or her lending portfolio, indicating which
loans were problems and why. The other lending officers would ask questions, review the
documents, and as a group they would analyze the source of the mistake. Each lending officer would
then learn from the good and bad ideas of the other lending officers. A lending officer who seemed
to be making poor decisions would have to endure repeated public examination by superiors and
fellow loan officers.

The second policy was regular and serious training. Every bank builds up experience and expertise
in lending, and careful discussion of that knowledge, for example in examining financial statements
or business plans, builds up the expertise of the lenders. Serious training in which the top officers
participate builds motivation to use this knowledge well. Training programs that include discussion
of case studies of recent failed loans, make the point that lending is not a matter of “going through
the motions,” but a serious business with real consequences.

The third policy was working in teams. When lending officers must make subjective decisions
about the merits of borrowers (rather than just fill in numbers and follow rote policies) there is a
serious chance for subjectivity and for abuse. Doing work in rotating teams greatly reduces the
opportunity for problems and forces lending officers to make a case that will persuade other
experienced bankers.

While these methods can increase the effectiveness of a bank’s lending, it should also be clear why
it is not easy to establish them in an existing bank. They require that bank lending officers be active
and even aggressive in examining borrowers’ businesses and questioning their claims. Bankers must
build an important kind of trust if borrowers will be candid and honest, and not feel insulted at these
types of questions. The banker must be friendly and cooperative, but also remember that the
relationship must serve the bank’s interests. Lending officers must also think that their ultimate
success comes several years after they make the loan. The good loan is not only one that does not
default; the good loan is one where the client is a successful business that maintains a continuing
relationship with the bank and that draws on other bank services. The lending officers must resist the
immediate benefits of making “easy” loans and avoiding “difficult” or unpleasant questions and
prefer the longer-run benefits of making fewer, but better loans.

Another difficult change is to expect regular constructive criticism from one’s peers and superiors,
and to be ready to critique their decisions. On occasion a banker will have to suggest that a
colleague is not acting ethically. Finally, the bank needs a climate of teamwork and cooperation in
working towards the bank’s goals.

We believe that this list of needed changes is hard to accomplish in a bank with different
approaches and rules of behavior. A new bank can establish these rules from the beginning, or a
bank can be “shaken up” by a powerful and determined external force that imposes a well-developed
alternative model.
4. Problems of Regulation and Interbank Institutions

Bankers' generally do not have to fear public scrutiny of their lending decisions as borrowers' affairs are private and confidential. Therefore, even with substantial internal checks, banks are always vulnerable to the danger of making loans that would not withstand serious external criticism. Often bankers become caught up in waves of excessive optimism about some type of loan. Therefore many countries have charged central bankers with the duty to question such excessive optimism by looking carefully through bankers' loan books and examining the overall pattern of loans and lending problems across the banking sector. While economists often emphasize that central bankers have the duty to avoid systemic bank crises, they also play a useful role as a monitor of individual banks. They can pool information and use their access to the records of many banks to learn more than any single bank can. Since their job is to critique, they can be skeptical about particular bank enthusiasms and can look for patterns of poor banking.

Most independent central banks develop an esprit de corps and a high level of expertise that help them carry out this role effectively. They must do this despite lower salaries than their counterparts in the private banking sector. Private bankers in Bulgaria criticized their central bankers for their lack of expertise and motivation; in contrast, Hungarian bankers felt that the the National Bank of Hungary was effective in its supervisory role.

Perhaps the best way to bring the BNB to a higher level is to combine the temporary importation of foreign central banking experts with serious training of new and existing staff. Recruiting some retired central bankers from western countries would be valuable in helping the BNB develop an overall climate of serious expertise.

At the same time, the BNB will have to recruit new bank examiners who know that their career will not let them get rich but does involve serious and important work. From private bankers we heard several accounts of the value to their banks of training courses that involved the bulk of a unit's specialists. It is necessary to give the training ultimately to most specialists, so that those with the training do not become a small isolated and rejected group. Yet the training must change people's way of thinking, and so cannot be a part of the usual office routine. Intense training for groups of specialists in a larger context that includes many other banking specialists seems the most appropriate policy.

Bankers can learn from each other through a wide variety of formal and informal institutions. However, our impression is that most Bulgarian bankers have few professional contacts with bankers in other banks. There is a distinct lack of trust between bankers in private and public banks. The following story (which we heard from two bankers) is symptomatic. Suppose that a banker has a borrower who is not paying back the loan and another banker asks about the credit-worthiness of the borrower. The response was that it would be good to recommend the borrower, because then the
bank had a chance of collecting its money from the second bank's loan. This shows a lack of the mutual information exchange that occurs routinely among bankers in developed economies.

The bank secrecy laws reinforced this lack of information. Furthermore, bankers had made no effort to develop that mutual exchange of information about borrowers and bad debts that the law did allow. For three years, debate among the banks has blocked the move to a central system; each bank wants information but is reluctant to provide useful information to its competitors. The establishment of a central collateral register has required the initiative of USAID and the IRIS Center of the University of Maryland.

We found that a climate of cooperative exchange of information prevailed in several small cities in Bulgaria and Hungary, but that informal exchange of information was developing most effectively among the foreign-controlled banks in Hungary. Hungary has bank secrecy laws similar to Bulgaria's and bankers indicated that they would not violate these rules by releasing data on borrowers. However, informal hints and suggestions were a practical alternative and had developed among some of the banks in Hungary. As in Bulgaria, the extensive job-hopping that had occurred in the market economy helped in the creation of a network of ties.

Bankers' associations are one effective way to transmit information effectively among banks. These associations give bankers the chance to learn the latest information, and also to become acquainted with their counterparts in other firms -- which should encourage informal information exchange. The associations should also help coordinate the banking sector's leadership and response on new banking rules. Weakening the rules on bank secrecy to allow banks to learn from each other about bad credit risks is a high priority. Banks should also be able to provide valid information to non-bank firms about bad credit risks. A bad credit rating increases the costs to borrowers of defaulting on their debts, and improves the flow of information about credit risk in the economy.

We should also emphasize the merits of a computerized credit record and a centralized collateral register. Making such a system work well seems very important. The Hungarian system was in existence but not fully operating when we carried out our interviews, yet it already was having positive results. Over time it seemed that the system was improving (although we heard severe criticisms of the lack of full information). We believe that Bulgaria will benefit substantially from starting such a system, and then having the BNB encourage banks to provide better information and to use the information more effectively.

One more system of credit information that could be highly useful is that which Dun & Bradstreet (D&B) provide in many countries around the world. D&B provide detailed information about the financial situation of huge numbers of firms, along with careful credit checks and real-time information on firms' payment and sales records. Such information would be extremely valuable to banks in both Hungary and Bulgaria, but D&B has not been able to develop an extensive database, basically due to firms' reluctance to provide information. The BNB could use its moral authority to
encourage the banks to feel that this is a reasonable approach to gain information by also providing information.

Court enforcement of banking law is an important and necessary element of infrastructure. The recent changes in the law seem a substantial improvement. In particular, giving the BNB the right to close down bad banks is critical. Still, many important reforms involve “small” issues -- do the courts work effectively to ensure that banks can collect bad debts or seize collateral? If banks can more easily collect the assets of a firm that has defaulted, it will be easier to make loans. Bulgaria and Hungary had the same experience after communism -- the new laws became far more protective of debtors. Hungary has now seen the flaws in this approach and is moving the law and practice back toward a balance. Bulgaria should follow. Probably the most effective way to influence judges is through training such as courses in Western Europe and visits from judges from Western Europe. Another route that policy makers should explore is encouraging the use of private and binding arbitration by banks and debtors. Arbitration can provide a speedy alternative to inefficient or biased courts. It would also provide a positive example to the regular courts.

5. Cultural Attitudes

Banks make decisions in a larger environment, in which the “atmosphere” of the society makes a large difference. We would like to point to several large atmospheric issues that cause problems for bankers and for an efficient banking system.

One issue is society’s sensitivity to “the shadow of the future” and the long run. In lending, both the bank officer and the borrower are more likely to have good loans if they think about the long-term future. Reputation, a successful continuing business, more loans, and promotion in the bank, all depend on successful repayment of the loan. However, loan officers who think only about the immediate future see benefits to making large numbers of loans (that will go bad only later), to taking bribes for loans, and for taking risks in business that may not pay off later. An unstable environment in which “anything can happen” encourages a short-term approach. Bulgarians often respond to questions about the long-run future with the response that “anything can happen.” or “two weeks is a long time.” Creating a more stable business environment that starts to influence people’s approach to business is therefore an important atmospheric factor.

A second overall perception is that “crime pays.” Most people in Bulgaria feel that they are personally honest, but that those who engage in crime do well. That perception surely leads many people to be less personally honest than they might be. Since perceptions are very important in this respect, it would be very desirable for the BNB and the bankers’ association to work with public prosecutors to ensure the punishment of bank fraud and not just of bank robbery. While the benefit to any one banker from such prosecution may be small, the aggregate benefits to the banking sector are much larger.
A final “cultural” issue, perhaps relating to the heritage of Communism, is hostility toward sharing information, particularly when doing so might lead others to consider one an “informer.” Good information is extremely valuable in judging the quality of businesses, of future business prospects, and of judging business ability and character. An effective market system encourages the free flow of information about these factors. Bulgarians and Hungarians have been reluctant to share information. However, we observed some real progress in Hungary; the European Union is requiring the adoption of standards that most Hungarians strongly support -- basically because the standards are “European.” The bankers and banking authorities invariably referred to “European” or “international” standards in describing the success of regulation, accounting rules, and the like. The payoffs to the Hungarian banking system from following “European practice” seem to have been large. This suggests that a similar approach would be a useful model for Bulgaria. The Hungarians were trying to join the EU, and so had a very strong incentive to follow its standards. As the number of Hungarian bankers and officials following the European Union rules grew, these rules became the “normal” way to do things. If the Bulgarian government or the BNB were to begin a policy of moving to EU standards, this should have a strong positive effect. EU standards require openness with respect to information, the following of good accounting rules, fairly transparent banking rules, and an overall environment of the rule of law. In its recent report on Bulgaria’s readiness for admission to the EU, the European Commission has pointed out many specific things that the Bulgarian government must do before it will be properly prepared. This provides Bulgaria with an important “road map” that it may follow on international standards of openness and information. The successful adoption of EU standards would largely solve the problems that the Bulgarians have regarding the culture of information.

6. Using Crisis to Make Good Policy

Bulgaria has had great trouble in making serious (but painful) changes over the past six years of transition. The earliest move to a market economy involved a sort of “euphoria.” Then when pain appeared, people were reluctant to accept more pain. This is a very logical pattern. While everyone may generally agree that society will have to suffer some pain, everyone hopes that it will be others who suffer the pain. However, at present, everyone has been suffering terribly from a policy of delay. Psychologists point out that when conditions suddenly become intolerable, people will then take the steps needed to get out of that intolerable situation.

Bulgarians also know that other similar countries have been doing better than Bulgaria, and as they would like to have the advantages of that success, adopting their methods may be a natural way to succeed. Success is better than disaster, and so this should be the time for Bulgarians to make their needed changes.
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