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Research Update:

Bulgaria Ratings Lowered To 'BB+/B' On Fiscal Risks From State Support Of Banks; Outlook Stable

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Overview

- Liquidity support to weakened domestic banks has pushed up Bulgarian general government debt.
- In our view, persistent deflation and an overhang of impaired private sector debt represent future risks to growth, financial stability, and budgetary outcomes.
- We are therefore lowering our long- and short-term sovereign credit ratings on Bulgaria to 'BB+/B' from 'BBB-/A-3'.
- The stable outlook balances the risks we see from potential vulnerabilities mounting in the financial sector against still-low levels of government indebtedness.

Rating Action

On Dec. 12, 2014, Standard & Poor's Ratings Services lowered its long- and short-term foreign and local currency sovereign credit ratings on the Republic of Bulgaria to 'BB+/B' from 'BBB-/A-3'. The outlook is stable.

Rationale

The downgrade reflects:

- Our view of a weakened domestic banking system, which has obligated Bulgaria to directly and indirectly support the third- and fourth-largest banks.
- The risk that further state support to the domestic financial sector might be required.
- A broader deterioration in general government finances--owing to weak growth and persistent deflation--which could require higher borrowing over 2014-2017.

In June this year, Bulgaria's fourth-largest bank--Corporate Commercial Bank (KTB)--suffered large deposit withdrawals and was placed under special supervision by its regulator, the Bulgarian National Bank (BNB), Bulgaria's central bank. Shortly afterwards, Bulgaria's third-largest bank, First Investment Bank (FIB), also experienced large deposit withdrawals prompting the Bulgarian government to provide it with exceptional liquidity financing. Five months later, KTB's licence was revoked and subsequently, the government provided a loan of Bulgarian lev (BGN) 2 billion (2.5% of GDP) to the Deposit

Insurance Fund (DIF). The loan funded the DIF's shortfall for the repayment of KTB's obligations to its guaranteed depositors. Taken together, state support to the financial sector has totaled 3.5% of GDP in 2014.

On top of its support of the financial sector, we expect Bulgaria's underlying general government deficit will widen to 3.5% of GDP, from 1.2% in 2013. Overall, we project that the government will issue the equivalent of 11% of GDP in debt this year, the highest increase in gross debt since Bulgaria established its currency board in 1997. Some of this financing will remain in its fiscal reserve, which at end-October totaled BGN7.6 billion or 9.4% of GDP excluding EU receivables. We anticipate the fiscal reserve will decline in early 2015 as about one fifth of the funds are earmarked to redeem a sovereign bond (issued in 2002) in January.

Reflecting our view of Bulgaria's financial stability, and our expectation of weaker domestic demand and lower net export growth, we have lowered our forecast for 2014-2017 average real GDP growth to 1% from just under 2%. Since the onset of the global financial crisis, the convergence of Bulgarian incomes toward European averages has slowed considerably. Further, following our expectation of output and price growth, we expect per capita GDP to remain where it is currently, at around $7,500 (€5,500), over the forecast horizon. This would leave Bulgarian per capita GDP at just below one-sixth of Germany's. From 2010 up until 2014, exports had been growing at an average annual rate of nearly 10% in real terms. However, this export performance has not led to a recovery in business investment or meaningfully reduced overall unemployment levels.

Challenges to Bulgaria's banking system and a deterioration of the fiscal position have been exacerbated by a sustained deflation of consumer prices which in October were 1.5% lower than in October 2013. Domestic demand has also been depressed by parent banks' net withdrawals of funding from their Bulgarian subsidiaries and banks' increasing external assets. Between 2009 and 2013, 93% of financial sector external debt on average has been rolled over per year. The direct link between money growth and balance-of-payments inflows under the currency board has magnified the impact of these recent balance-of-payments outflows on the economy, particularly on prices.

The banking sector's overall liquidity appears to have accommodated the banks winding down their external debt positions by $4.6 billion between 2008 and 2013, while also increasing assets held abroad by $6.8 billion over the same period (according to international investment position data). Net outflows from the financial system during the five years to 2013 have cumulatively constituted more than 20% of 2014 GDP. We expect that Bulgaria's financial account will remain in deficit until 2015, and that this will continue to depress domestic credit conditions, and hence the money supply, and prices.

We view the situation as challenging for the following additional reasons:
- European parent banks appear less willing and able to support their Bulgarian subsidiaries, with deflationary implications especially pronounced within the context of the currency board regime. Deleveraging

of parent banks in Bulgaria has been recurrent and large-scale.
- Bulgaria's pre-crisis growth model, which relied upon net external borrowing and net foreign direct investment (FDI) to drive growth in the nontradables sectors, has yet to be fully replaced with a plan to revive more diversified growth in the economy on a sustainable basis; and
- The fallout from the above may put additional pressure on the government to spend more to support growth.

Previously, we did not factor in any benefits of the South Stream pipeline project into either our growth or fiscal forecasts. (The project would have brought Russian gas to Eastern Europe, through Bulgaria, with expected transit fees of about 1% of government revenues.) Therefore, the project's recent cancellation has not had an impact on our ratings on Bulgaria.

We see the general government deficit narrowing gradually to 3% of GDP by 2017; this differs from the government's target of 2% of GDP because we assume weaker nominal GDP growth. As a result, we expect that general government debt will increase by an annual average of 4.3% of GDP in 2014-2017, materially higher than our previous expectation. We also think that net general government debt will rise to just below 30% of GDP in 2017, from 12% in 2013. We expect the currency composition of government debt will not materially differ over this period; about 70% of government debt is currently denominated in foreign currency.

External auditors' comprehensive assessment of KTB's accounts has revealed poor lending standards, optimistic asset valuations, unrealistic loss recognition, and inadequate disclosure practices. Impairments based on the auditors' analysis have indicated that KTB has negative equity of about BGN4.5 billion (5.7% of GDP).

We believe that supervisory lapses helped contribute to the systemically important KTB's problems. While the new government is seeking to reform the supervisory framework, it remains to be seen whether deeper governance issues will be addressed. In the interim, while our general debt forecast does not explicitly include future government support to banks, we believe the risk of additional support is material. We note that, given the currency board arrangement, BNB can only provide liquidity support to the banking system to the extent that its reserves exceed its monetary base. Even then, support can only occur under certain conditions and at short maturities against liquid collateral. As of September 2014, BNB reserves covered monetary liabilities by 1.8x.

Bulgaria's exchange rate regime and high euroization (about 60% of loans are non-lev denominated) restrict Bulgaria's monetary flexibility while limiting BNB's ability to act as a lender of last resort. In this context, we believe that the BNB's limited success in stimulating credit growth in the face of anemic domestic demand and in effecting a reduction in the banking sector's gross nonperforming loans--about 17% of its total loan book--reflect a weakened transmission channel for monetary policy.

Bulgaria's political environment has remained in flux, with five governments and two general elections since early 2013. Parliamentary elections held in October yielded a minority coalition of GERB (the Citizens for the European Development of Bulgaria) and the Reformist Bloc, the latter itself a grouping of five parties. The government relies on outside support from the Patriotic Front (an alliance of two parties) and the Alternative for Bulgarian Revival. With the numerous changes in power over the last two years, there have been several policy reversals, including on fiscal policy, which have weighed on business and consumer confidence.

The new government faces the tasks of rebalancing government finances, resolving KTB, addressing deeper governance issues, un-freezing suspended EU funds, devising a credible strategy for the energy sector, and stimulating growth--all against a backdrop of muted external demand, foreign bank outflows, sluggish domestic credit growth, and high unemployment. Given that the government relies on extra-coalition support to pass legislation and is itself composed of several factions, we think policy uncertainty may persist.

Outlook

The stable outlook balances the risks we see from potential vulnerabilities building up in the financial sector against still-low levels of government indebtedness.

We could lower the ratings if the domestic financial system requires further government support. We could also lower the ratings if funds on the financial account of the balance of payments continue to flow out without abating.

On the other hand, upward pressure on the ratings could build if governance issues are addressed effectively, boosting Bulgaria's growth potential, attracting higher FDI into the tradables sector, or if the economy expands faster than we anticipate such that general government finances consolidate more rapidly.

Key Statistics

Table 1

Republic of Bulgaria - Selected Indicators											
	2007	**2008**	**2009**	**2010**	**2011**	**2012**	**2013**	**2014**	**2015**	**2016**	**2017**
Nominal GDP (bil. US$)	44	53	50	49	56	53	54	55	51	51	52
GDP per capita (US$)	5,762	7,092	6,718	6,558	7,567	7,177	7,479	7,545	7,048	7,073	7,288
Real GDP growth (%)	6.9	5.8	(5.0)	0.7	2.0	0.5	1.1	1.2	0.5	1.0	1.5
Real GDP per capita growth (%)	9.0	6.5	(4.4)	1.3	2.7	1.1	1.7	1.7	1.0	1.5	2.0
Change in general government debt/GDP (%)	(1.3)	(1.2)	0.7	2.0	1.1	2.6	0.4	11.1	(0.2)	3.3	3.0
General government balance/GDP (%)	1.1	1.6	(4.2)	(3.2)	(2.0)	(0.5)	(1.2)	(3.5)	(3.5)	(3.3)	(3.0)

Table 1

Republic of Bulgaria - Selected Indicators (cont.)											
General government debt/GDP (%)	16.6	13.3	14.2	15.9	15.7	18.0	18.3	29.3	29.0	31.9	34.1
Net general government debt/GDP (%)	4.4	1.6	4.1	7.4	9.1	10.1	12.2	19.2	22.6	25.6	28.0
General government interest expenditure/revenues (%)	2.9	2.2	2.1	2.1	2.3	2.4	2.1	2.2	3.5	3.5	3.9
Other dc claims on resident nongovernment sector/GDP (%)	60.5	69.6	73.0	72.6	69.1	69.6	69.5	70.7	72.1	73.1	73.5
CPI growth (%)	7.6	12.0	2.5	3.0	3.4	2.4	0.4	(0.5)	0.0	0.7	1.0
Gross external financing needs/CARs plus usable reserves (%)	151.6	155.3	155.6	135.4	123.4	122.3	116.0	118.9	115.1	114.2	113.1
Current account balance/GDP (%)	(24.4)	(22.6)	(8.7)	(1.5)	0.1	(1.1)	2.1	2.0	1.8	1.7	1.4
Current account balance/CARs (%)	(38.1)	(35.3)	(16.4)	(2.3)	0.1	(1.5)	2.7	2.6	2.2	2.0	1.6
Narrow net external debt/CARs (%)	3.6	20.8	20.7	8.3	(2.3)	(8.3)	(10.3)	(13.6)	(18.0)	(18.3)	(18.8)
Net external liabilities/CARs (%)	131.7	141.6	193.6	149.5	108.0	107.5	100.9	97.9	99.8	96.5	91.8

Other depository corporations (dc) are financial corporations (other than the central bank) whose liabilities are included in the national definition of broad money. Gross external financing needs are defined as current account payments plus short-term external debt at the end of the prior year plus nonresident deposits at the end of the prior year plus long-term external debt maturing within the year. Narrow net external debt is defined as the stock of foreign and local currency public- and private-sector borrowings from nonresidents minus official reserves minus public-sector liquid assets held by nonresidents minus financial-sector loans to, deposits with, or investments in nonresident entities. A negative number indicates net external lending. CARs--Current account receipts. The data and ratios above result from Standard & Poor's own calculations, drawing on national as well as international sources, reflecting Standard & Poor's independent view on the timeliness, coverage, accuracy, credibility, and usability of available information.

Ratings Score Snapshot

Table 2

Republic of Bulgaria - Ratings Score Snapshot	
Key rating factors	
Institutional and governance effectiveness	Neutral
Economic structure and growth	Neutral
External liquidity and international investment position	Neutral
Fiscal flexibility and performance	Neutral
Debt burden	Strength
Monetary flexibility	Weakness

Standard & Poor's analysis of sovereign creditworthiness rests on its assessment and scoring of five key rating factors: (i) institutional and governance effectiveness; (ii) economic structure and growth prospects; (iii) external liquidity and international investment position; (iv) the average of government debt burden and fiscal flexibility and fiscal performance; and (v) monetary flexibility. Each of the factors is assessed on a continuum spanning from 1 (strongest) to 6 (weakest). Section V.B of Standard & Poor's "Sovereign Government Rating Methodology And Assumptions," published on June 24, 2013, summarizes how the various factors are combined to derive the sovereign foreign currency rating, while section V.C details how the scores are derived. The ratings score snapshot summarizes whether we consider that the individual rating factors listed in our methodology constitute a strength or a weakness to the sovereign credit profile, or whether we consider them to be neutral. The concepts of "strength", "neutral", or "weakness" are absolute, rather than in relation to sovereigns in a given rating category. Therefore, highly rated sovereigns will typically display more strengths, and lower rated sovereigns more weaknesses. In accordance with Standard & Poor's sovereign ratings methodology, a change in assessment of the aforementioned factors does not in all cases lead to a change in the rating, nor is a change in the rating necessarily predicated on changes in one or more of the assessments.

Related Criteria And Research

Related Criteria

- Sovereign Government Rating Methodology And Assumptions, June 24, 2013
- Methodology For Linking Short-Term And Long-Term Ratings For Corporate, Insurance, And Sovereign Issuers, May 7, 2013
- Criteria For Determining Transfer And Convertibility Assessments, May 18, 2009

Related Research

- Sovereign Defaults And Rating Transition Data, 2013 Update, April 18, 2014

In accordance with our relevant policies and procedures, the Rating Committee was composed of analysts that are qualified to vote in the committee, with sufficient experience to convey the appropriate level of knowledge and understanding of the methodology applicable (see 'Related Criteria And Research'). At the onset of the committee, the chair confirmed that the information provided to the Rating Committee by the primary analyst had been distributed in a timely manner and was sufficient for Committee members to make an informed decision.

After the primary analyst gave opening remarks and explained the recommendation, the Committee discussed key rating factors and critical issues in accordance with the relevant criteria. Qualitative and quantitative risk factors were considered and discussed, looking at track-record and forecasts.

The committee agreed that the fiscal performance and flexibility and monetary flexibility had deteriorated. All other key rating factors were unchanged.

The chair ensured every voting member was given the opportunity to articulate his/her opinion. The chair or designee reviewed the draft report to ensure consistency with the Committee decision. The views and the decision of the rating committee are summarized in the above rationale and outlook. The weighting of all rating factors is described in the methodology used in this rating action (see 'Related Criteria And Research').

Ratings List

Downgraded

	To	From
Bulgaria (Republic of)		
Sovereign Credit Rating	BB+/Stable/B	BBB-/Stable/A-3
Transfer & Convertibility Assessment	BBB+	A-
Senior Unsecured	BB+	BBB-

Short-Term Debt	B	A-3

Complete ratings information is available to subscribers of RatingsDirect at www.globalcreditportal.com and at spcapitaliq.com. All ratings affected by this rating action can be found on Standard & Poor's public Web site at www.standardandpoors.com. Use the Ratings search box located in the left column. Alternatively, call one of the following Standard & Poor's numbers: Client Support Europe (44) 20-7176-7176; London Press Office (44) 20-7176-3605; Paris (33) 1-4420-6708; Frankfurt (49) 69-33-999-225; Stockholm (46) 8-440-5914; or Moscow 7 (495) 783-4009.