

**Mortgage Financing in Bulgaria:  
Developments, Housing Market and General Background<sup>i</sup>**

**Tzveta Dimitrova, IME  
Daniela Vladimirova, DSK Bank  
Dr. Krassen Stanchev, IME (editor)  
Martim Dimitrov, IME**

---

<sup>i</sup> This paper is especially redrafted for the needs of the USAID Pension Reform Project and CARANA Corp. Round Table on Mortgage Bonds Horizon as Long Term Investment (October 23, 2000, Sofia). Tsveta Dimitrova and Daniela Vladimirova wrote the original version of the paper with IME contribution as a Country Paper for the OECD Workshop on Housing Finance in Transition Economies, which was held in Paris, on June 19-20, 2000. Along with IME, OECD has the copyrights for that early version. The current version is completely reedited and updated; the only missing data are on the housing industry developments in the recent years, which become available when the paper was ready for print. The copyrights of this version belong to IME and the authors.

# **Mortgage Bond Law and Mortgage Financing**

## **Law on Mortgage Bonds**

In early October 2000, Bulgarian parliament passed the Mortgage Bond Law. It was initiated by IME and the Association of Commercial Banks, drafted by IME and submitted to the legislature by Mr. Nikola Nikolov, chairman of the Economic Policy Committee. The drafting team utilized approaches adopted by other transition countries, notably Poland and Hungary and reflected upon the experiences of Czech Republic, Germany and Denmark. It benefitted from the critical knowledge and advice of Mark Reidy, professor of Mortgage Finance at the University of San Diego, former president of the American Mortgage Bankers Association as well as from the collaboration and support of many Bulgarian bankers and representatives of non-banking financial industry.

The key peculiarity of the Bulgarian approach is that the primary mortgage market has been left on its own natural development trends, avoiding government guarantee schemes and creation of specialized institutions, e.g. mortgage bank. It can be explained with background reasons and attitudes. Another peculiarity is the exclusion of the land market from the mortgage bond framework.

The purpose of the law on mortgage bonds is to establish the legal framework for issuing of this instrument on the Bulgarian financial market whereas its parameters and the requirements for its issuing and trading should comply with the European tradition and practice with respect to the financial markets globalization.

The law on mortgage bonds gives every bank licensed by the Bulgarian national Bank the right to issue securities ("mortgage bonds") backed by its portfolio of credits secured by one or more first-ranking mortgages over real property. The basic parameters of the mortgage bonds as debt instruments were set in this draft:

### Mortgage Bonds Collateral

Mortgage bonds collateral are mortgage credits /main collateral/ or assets with zero risk weight in accordance with the classification set in a regulation of BNB /substitute collateral/. The substitute collateral should not exceed 30 per cent of the issuing bank's liabilities on the outstanding mortgage bonds. Mortgage loans are used as a collateral up to 60-80% of the mortgage appraisal value of the real property (the exact per cent depends on the type of the property).

The purpose of these limitations is the collateral risk minimization. The credits are used as a collateral at a value lower than the mortgage appraisal value. The main collateral/substitute collateral ratio requires a better management of the maturity structure of the bank's claims on mortgage loans and the liabilities on mortgage bonds in terms of decreasing the risk evolving from the temporary disbalances in cash flows and worsened liquidity.

### Collateral Register

The issuing bank is obliged to keep a register of the issued mortgage bonds collateral. The bank constitutes a special pledge<sup>1</sup> on the claims stemming from the credits included in the register. The register includes different pools of credits used as a collateral for separate mortgage bonds issues. The access to the register is set in bank's internal regulations, which do not insult the bank secret. The bank is obliged to

manage and report separately the assets included in the collateral register and may not impose any other burdens on them.

The purpose of these regulations is to secure the claims of the mortgage bonds creditors and to assure them accurate information for the collateral's composition and its quality. The separate reporting of the collateral isolates these assets of the bank from the others and decreases this portfolio's risk for it is composed of claims with lower risk (collateralized with a real property).

#### Mortgage Appraisal of the Real Property

When appraising the real properties, which secure credits, used as mortgage bonds collateral the bank should apply the methods listed in the draft law - method of comparative sales, method of revenue valuation and method of material value. Appraisers should satisfy strict qualification requirements. The bank sets internal rules for the conducting and keeping documents for the appraisals. New appraisals are made in certain cases when credits are classified in a higher risk grade.

These provisions require the application by the issuers of common rules for real property appraisal as well as the application of the most proper methods. One of the purposes of the draft law is to decrease the risk connected with the property appraisal in order to minimize the mortgage bonds risk itself. So they are stable and the bank has the possibility to refinance its activities at lower price than it would be if it had issued common bonds.

#### Issuing of Mortgage Bonds

The law envisages that mortgage bonds will be issued under the existing legislation as described above. Additional requirements are set to the prospectus/the offer to subscribe to the issue including internal rules of the issuing bank (set in this law) as well as the main characteristics of the collateral portfolio.

#### Preferential Claim on Collateral Assets in Case of Insolvency

The draft law sets preferential regime for claims of mortgage bonds creditors in accordance with the usual European practice. In case of insolvency of the issuer the claims on credits included in the collateral register are separated from the common assets of the bank. A trustee, appointed by the courts, separately manages these claims. He or she acts simultaneously to the assignee that is appointed by the court in case of insolvency of the bank. The trustee has the rights and obligations of the assignee in respect of the assets included in the collateral register.

The law does not change in any way the existing legislation in respect of the mortgage regime, the regulations of the Bulgarian National Bank or the common order of bond issuing. Moreover, the creation of this instrument known for more than 200 years in the European practice is possible because of the good regulation of mortgages and the application of supervisory requirements which are unified with EU standards. The purpose of the law is the minimization of risks beared by the banks in their credit activity and respectively risks beared by bond creditors as well as decreasing costs of mortgage financing and allowing easy access to mortgage credits as a long-term source of financing for a broader range of people and companies.

## Market Demand for Bonds

Currently the bond market in Bulgaria is equal to the government securities market. So far, only few companies dared to issue corporate bonds. These are Prosoft AD, Kaolin AD, Energija AD and the Black Sea resort Albena. All of the bonds are issued on the domestic market and are not traded on the stock exchange (they were placed privately). Additionally, on the domestic market were issued bonds of the Svistov Municipality and on the foreign market - small issue of eurobonds of the Sofia Municipality.

Here are two examples of issues, which were placed successfully:

- Prosoft AD issued 5-year corporate bonds in nominal value of BGL 300,000. The issue value is equal to the face value of the bonds (the company took over all charges for the Securities Commission, marketing, etc.). A "buy-back" option is included in the contract. The interest rate is the base interest rate of the Bulgarian National Bank + 6p for the first three years and the base interest rate of the Bulgarian National Bank + 6.5p for the last two years.
- Kaolin AD issued bonds with total volume of BGN 2,500,000 and 10% interest rate.

The issue of Svistov Municipality was not very successful. The total volume is BGL 371,000 and only about half of it was placed. 18% of the issue were acquired by municipal firms which actually had to gain from the money collected by the Municipality from the issue.

So the main issuer of bonds in Bulgaria is still the Government.

Investors in Bulgaria could acquire government securities on the primary or the secondary market.

On the primary market they can buy securities on the auctions organized by the Bulgarian National Bank. Only the so-called "primary dealers" (approved by the Bulgarian National Bank and the Ministry of Finance) may participate in the auctions. These are banks or investment intermediaries (as defined by the Law on Public Offering of Securities). Investment intermediaries may participate with:

- Competitive orders – for their account or for the account of their clients  
Or
- Non-competitive orders – on the account of their clients, which are not banks or investment intermediaries.
- The Bulgarian National Bank determines before the auction the share of the government bonds offered for competitive and non-competitive orders.

The Bulgarian National Bank buys back the government securities before its day of maturity on decision of the Minister of Finance on auctions, too. The issue which is to be bought back could be replaced by a new issue of government securities or the face value and the interest could be paid to the holder. Only competitive offers are being accepted.

Main players (buyers) on the market are the banks, the insurance companies, the newly created Fund for bank deposits guarantee, pension companies, individual investors.

With so many players on the government securities' market and having in mind the government's policy towards decreasing of the domestic debt it is no surprise that the return from government securities falls constantly. All government securities regardless of terms and maturity are placed. But soon a hunger for alternative investment opportunities is expected. Many new pension companies, a huge State Healthcare Institute and the Fund for bank deposits guarantee have been established. Funds accumulated by these institutions will have to be invested in low-risk securities. A USAID research within the Pension reform project confirms these expectations. It says that only in the year 2000 \$18,4 million will be accumulated and by the year 2004-\$64,3 million.

The potential buyers of mortgage bonds are almost the same - voluntary, universal and professional pension companies, life insurance companies, investment companies and individual investors. In the transitional and final provisions of the draft law on mortgage bonds there are some changes to other laws provided. These changes are an attempt to facilitate the possibility of all these provisional players to invest in mortgage bonds.

## **Mortgage Loans**

### **History of the mortgage market in Bulgaria**

Until 1989 it was only the State Savings Society (now the DSK Bank EAD) that provided mortgage loans. The recipients of loans were natural persons only and the bank financed the building and purchasing of housing, the acquiring of shares in real properties for the purpose of their complete buy-out, acquiring of sites for building. In most cases it was the state or municipalities that were the sellers as they had the legal obligation to build and sell homes to the population. The complete government control over the process of building and sales of housing, the financing of the purchases and the return of credits eliminated the danger of losses resulting from insolvency and abuse. During that period of time the bank gained substantial experience with clients in mortgage loans made for the purpose of buying homes. There were also considerable government subsidies expressed in writing off by the state of part of the debt under certain conditions, crediting mostly long-term customers, etc. Interest rates were very low (3 per cent simple annual interest). Loans could be paid back within 30 years.

After 1990 the state stopped subsidizing and facilitating natural persons in the purchase and building of homes both as builder and seller and in terms of financial facilities. The DSK EAD Bank kept its credit products on offer but the high inflation which resulted in extremely high interest on such loans (reaching 300 per cent) reduced substantially demand in the credit market. The financial stabilization after 1997 stabilized interest rates but the population's buying power was already too low to bring back demand. The bank was no longer in a position to do long-term planning and reduced the term of mortgage loans to 9 years. The reason for this can be found in the structure of the deposits. These are mainly redeemable "on sight" and it is only thanks to its empirical experience with non-depreciative remaining assets that the bank can afford to offer such long-term loans.

Following the adoption of the Banks and Credits Act in 1992 commercial banks in Bulgaria became able to legally finance the commercial activity of businesses. This is actually the larger mortgage market in the country. It underwent

the same stresses as the home mortgage market. This is generally a very short-term market. The usual term of business mortgages is between 12 and 36 months. The reasons for this are the banks' inability to make long-term planning because of a changing economic environment and the rather short term of the deposits used to finance crediting operations.

Unfortunately, Bulgarian National Bank does not require the banks which extend mortgage credits to report separately on their volume. Additionally, the reporting requirements are being change almost every year so it is impossible to give comparable data for the period 1995-1999. We can only outline the development of the housing loans market and give data for 1999 and partially for 1998.

Since the beginning of 1998 (when a tendency towards macroeconomic stabilization was witnessed) the demand for credits increased significantly. The individuals and firms were willing to take credits although they knew that their property will be mortgaged in favor of the bank, the interest rate is relatively high and the bank can increase it unilaterally (such clause is still included in the credit contracts). On the other hand, as described above, the supply of credits in the Bulgarian banking system is limited.

Currently all housing credits are mortgage credits and no other form of housing financing is being used. People who are not willing to mortgage their property usually gather money from relatives and friends and/or use their own savings.

The "monopolist" on the housing financing market is DSK Bank. In 1998 outstanding residential mortgage credit in DSK Bank was 70,709,000 denominated leva (about USD 42,214.328), which accounted for about 90% of the residential mortgage credit in the whole banking sector.

The other very active player on the market is Bulgarian - American Credit Bank. In 1999 both banks have extended mortgage loans accounting for about USD 103,316,384 (See Table 17). Out of them 56.7% are housing loans. However, housing credits account for 54% of DSK Bank's portfolio and only 6.9% of the BACB portfolio. The volume of housing loans extended by other banks is negligible.

### **Types of Mortgage Loans Extended by DSK Bank and BACB** (% of respective bank's portfolio)

<b>Bank</b>	<b>Housing Loans</b>	<b>Corporate Loans*</b>	<b>Consumer Loans**</b>
<b>DSK Bank</b>	<b>54%</b>	<b>19%</b>	<b>27%</b>
<b>Bank</b>	<b>Housing Loans</b>	<b>Hotel Loans</b>	<b>Others</b>
<b>BACB</b>	<b>6.9%</b>	<b>29.3%</b>	<b>63.8%</b>

\*For purchasing of tangible fixed assets

\*\* Mortgage consumer loans of DSK Bank are only 10% of the total volume of consumer loans in the bank's portfolio.

Housing and consumer loans are extended only to individuals. Consumer loans of DSK Bank are not necessary mortgage loans. For housing loans both banks consider this a must. Corporate loans of DSK Bank are two types - for purchasing of tangible fixed assets and for working capital (this loans are not necessary secured by mortgage<sup>2</sup>). The hotel loans of the BACB are extended to owners of small and medium-sized hotels and are secured by a mortgage.

### **Legal framework**

## **Ownership rights on real estate**

Bulgarian law differentiates between material and non-material property. Real property belongs to the so-called material property.

The evolution of social relations has contributed to making parts of the Earth's crust a certain kind of property and at the same time to have separately in existence and to set apart as a separate type the buildings and plants that are on the surface of the Earth. Such a differentiation has also been accepted in Bulgarian law. It also permits one building to consist of several floors so that each floor or dwelling may constitute an individual real property.

Bulgarian law recognizes a limited number of property rights. Persons may institute only such property rights as are provided for by the law and the content of which is defined by the law. These property rights are ownership, user rights, superficies rights, and servitude. Some of these are also referred to as "limited property rights".

The right to own property is constitutionally guaranteed in Bulgaria. Private property is inviolable. Under Bulgarian law anyone can be the owner of real property. This is true of natural persons, corporate bodies and the state. Foreign persons may own real property within the country with the permission of the Ministry of Finance. Foreign persons can, however, acquire long-term user rights over buildings used for transacting business inside the country. Foreign diplomatic missions own real estate for the purpose of performing their diplomatic functions. The state enjoys exclusive ownership rights over certain real properties and no other person apart from the state may acquire such properties. These material properties are the rivers, lakes, seas, natural resources, certain facilities with a bearing on national security, etc.

The Constitution is the primary source of the right to own property in Bulgaria. The current law, which regulates the property regime, is the Property Law. Other enactments pertaining to property, and to real property in particular are: the Territorial and Urban Development Act and the regulation on its implementation, Regulation No. 5 of Building Rules and Standards, the Regulation on the Management of Order and Supervision of Multi-dwelling Buildings, the State Property Act, the Municipal Property Act, the Obligations and Contracts Act, the Code of Civil Procedure, the Concessions Act, the Vienna Convention, The Notaries and Notary Business Act, the Ownership and Use of Farm Land Act and certain other pieces of legislation and regulations. These are the legal instruments, which generally define and regulate the regime of ownership of real property.

## **Registers of real property: nature of rights over real estate**

For a property transaction to be valid the party transferring property rights should be the owner of the property. Therefore there should be a way to prove ownership rights over real property. That is why it has been the purpose of the law to facilitate as much as possible the verification of ownership. All deeds for real estate are recorded in special registers kept by the district courts, by recording judges in particular, and until recently by the public notaries.

As early as September 1, 1910, a system of recording deeds was established with the Privileges and Mortgages Act (repealed). This system was mostly borrowed from Belgium and Italy. Though it is no longer in force, this act laid the foundations of a good system and tradition in Bulgaria.

Recording is done for the purpose of publicizing deeds so that third parties may obtain information in respect to real properties that are of interest to them. The laws, which regulate the recording regime, are the Property Law, the Notaries and Notary Business Law, the Regulation of Recording, the Obligations and Contracts Law, the Civil Procedures Code and some other regulations.

The following system for making records and keeping registers has been adopted in Bulgaria:

1. Incoming and outgoing mail register: used to record all letters, announcements, notices and replies pertaining to the notary's business;
2. List of notary files: provides a chronological description of all notary cases. Every year starts from number 1;
3. Register of notarized last wills and testaments and their annulment. Recording is done on the day of making the last will or on the day of its annulment;
4. Register of last wills and testaments submitted for safekeeping. Information about last wills, their announcement and return is recorded in this book;
5. Register of contest and certification of signatures, dates and copies of documents. This register may be kept jointly or separately by items depending on the volume of records;
6. Alphabetical indices: these are kept only for notary cases and last wills;
7. Register for certifying the content of private documents;
8. Notary Invitations Register;
9. Register of Deeds: formed by the collection of all deeds legalizing transfer of ownership rights;
10. Records Register; formed by the collection of notarized copies of contracts, affidavits, applications, and distributions of property among heirs by the courts;
11. Register of deeds on contract mortgages;
12. Register of Legal Mortgages: applications are recorded in the order they are received;
13. Register of Prohibitions: carried out at the request of executive judges;
14. Incoming Register: kept and ended each day. It shows the daily number of records and notes;
15. Filing Register: this is the most important book in respect to records because it is a true mirror of the legal status of real properties;
16. Alphabetical index: Directly linked with the list of notary files and is kept simultaneously with it.

The organization described above has established a streamlined recording system and hence a system of announcing documents and circumstances related to the ownership of real property and the transactions involving such property. This provides maximum guarantees of the people's legal rights and interests.

## **Regulation of mortgages**



Bulgarian law recognizes contracted and legal mortgages. The first is a mortgage, which arises upon the signing of a mortgage contract executed in the form of a deed. Both the one who owes the debt and a third party may use an object as collateral for the creditor. The deed contains certain data such as information about the credit recipient, the amount of the loan and especially information about the property, which services as collateral.

With the legal mortgage the law provides the direct submission of collateral for certain creditors for the purpose of guaranteeing their receivables, for instance when banks credit the purchase of real estate, and in court distributions of estates for equalizing shares of heirs. In certain cases where the state is the creditor, the right to legal mortgage is also instituted.

Recording is an important element of the mortgage. A mortgage is instituted through its recording. This provides for the mortgage to become known. This strengthens the mortgage regime and provides protection to third parties acting in good faith. Recording is done in the notary registers, ex-officio by the recording judge for the area where the property is located. Recording is done in an established order.

Mortgages are struck at the request and with the consent of the creditor and also pursuant to court rulings. Striking may also occur at the request of the buyer of the property who has purchased it at public auction.

Mainly Law on Contracts and Obligations, the Notaries and Notary Business Act, the Regulation on Recording, the Civil Procedures Code, etc regulate the mortgage regime.

### **Forced realization of mortgages**

If the debtor should fail to fulfill his obligations to the creditor and the credit is secured by collateral, the latter may require the forced sale of the real property for the purpose of redemption of the debt from the price of the collateral.

Execution of the request in respect to real estate is governed by the Bulgarian civil procedure of forcible execution. The Code of Civil Procedure regulates this process. The real property is sold at public auction. The sale is public because an unlimited number of persons may participate in the sale as bidders. They are invited to take part by the executive judge by special announcements. The public sale continues for one month and is held in the office of the executive judge. That is where participants place their bids and where a buyer is finally selected. The person who has made the highest legal bid is announced as the buyer. This act alone does not make the winner automatically an owner. The winner of the sale receives the right to become an owner and is given five days to pay the price to the account of the executive judge. Following payment, the executive judge assigns the property to the announced buyer by issuing an assignment order. Assignment has legal consequence in respect to the property and transfers ownership rights over the real estate to the announced buyer. The assignment order is recorded in the notary registers and is equivalent to a deed under the Property Act and the Regulation of Recording. This ensures the rights of the new owner who has acquired the property as a result of forced action against the previous owner. The executive judge uses the money raised from the public sale to satisfy the creditor and returns any leftover amounts to the debtor.

Quite often a debtor will have used one piece of real property as collateral with a number of creditors. In such cases a distribution is made to satisfy all creditors. This distribution hence indicates a number of creditor claimants in one executive procedure

and insufficiency of the moneys raised from the execution. Distribution is done by order of the executive judge who identifies the receivables that may be subject to receipt, the manner in which the creditors are satisfied and the amounts of money allocated for full or partial satisfaction of each creditor.

The executive judge carries out the distribution by placing first the privileged creditors followed by the creditors at large. He first allocates whatever money is necessary for fully satisfying the first credit in the order of privileges. Any leftover amounts are used to redeem the second loan. If the amount raised should prove insufficient, only the highest-ranking creditors are satisfied while the remaining privileged and creditors at large are not satisfied. If any moneys is left for the creditors at large, these are satisfied in proportion to the amounts due to them /Article 133 of the Law on Obligations and Contracts /. Proportional satisfaction is also applied to several loans of equal privilege /Article 136, paragraph 3 of the Obligations and /Contracts Act/. It should be noted here that the Civil Procedures Code as part of executive procedure regulates the public sale regime, while the distribution of the amounts raised can be found in the Obligations and Contracts Law referred to in the Code.

The actions described above constitute the procedure of forced execution in respect to mortgaged properties and the satisfaction of one or several creditors. There is a stable legal mechanism for instituting mortgages and their realization in Bulgaria. Regrettably, the absence of a well-developed real estate market leads to overburdening of this process and its emptying of content. Still, the legal framework is an efficient and appropriate basis for guaranteeing loans.

## **Purpose of mortgage loans**

A mortgage loan as a term in European financial practice is a credit guaranteed by collateral (real property).

Bulgarian law does not provide an express definition of “mortgage loan” but banking practice has assumed a similarly broad definition. Besides, the property of a third party may be used as collateral for the loan.

Defining a credit as a mortgage loan does not depend on the use to which the borrowed money is put, neither does it depend on the kind of person who receives the loan (natural person or corporate body). A mortgage loan can be:

- A loan to buy a home, or land for building a home, office space, an industrial building, etc.;
- A loan to build a house;
- A loan to reconstruct or improve a home;
- A loan to purchase shares in housing properties for the purpose of acquiring the entire properties;
- A loan to meet current needs of individuals (the so-called "consumer loans");
- A loan to obtain operating capital for businesses;
- Investment business loans;
- Loans to furnishing offices of the self-employed (physicians, notaries, lawyers, etc.).

Often the practice of approving mortgage loans to businesses and private individuals involves the use of collateral that is additional to the real property, such as personal property, guarantees by third parties, use of securities and bank deposits as collateral. If the value of the real property used as collateral less the insurance margins

covers in full the amount of the loan, the loan is still considered a mortgage loan irrespective of the variety of supplementary collateral used. In most cases, however, when Bulgarian banks credit businesses, the value of the real property is insufficient and other items are used as supplementary collateral. Two approaches are possible in this situation:

- To consider a mortgage loan that part of the loan which is covered by the value of the real property,

or,

- To finance the recipient of the credit by two loans: a mortgage loan in an amount equal to the appraised value of the real property and a second loan guaranteed by other means.

The absence of legislation to regulate the issuing of mortgage bonds has prevented Bulgarian banks from structuring their portfolios in such a manner as would enable them to use this long-term financing tool.

#### The Response of the mortgage bond regulations

The Mortgage Bonds Law clearly indicates that "mortgage loans" are loans secured by first-ranking mortgage on real property. At the same time an insurance margin is adopted not exceeding 20 to 40 per cent, i.e. the value of the loan does not exceed 60 to 80 per cent of the appraised value of the real property, which serves as collateral.<sup>3</sup>

This broad definition of the notion of mortgage is exceptionally appropriate due to the fact that it allows for a broad range of potential clients and emphasizes the low risk of loss to the creditor. The purpose of the loan always reflects the methodology of the appraisal of the property. The methodology indicates whether the anticipated income to be used for paying back the loan is the result of revenues from the use of the property or from other sources of income, or from a combination of both.

### **Client's profile**

Defining mortgages as independent of the purpose of the loan enables a broad range of business clients - natural persons and corporate bodies - to finance their projects with loans secured by mortgages over real property.

A study of the mortgage portfolio of the DSK Bank (the leading mortgage retail banking institution) demonstrates the following:

**The natural persons** using mortgage loans are individuals with stable income aged 30 to 50. This is explained by the need that arises at that age to acquire a home, to use consumer credit for furnishing a home, to start or expand the business of self-employed individuals. In most cases these are people working in stable and profitable commercial companies, people with good self-owned businesses, lawyers, notaries, self-employed consultants. The available data shows the exceptionally high return rates of these loans which is explained by their personal commitment to the bank and the traditional Bulgarian commitment of owners to their properties. Overdue payments on the mortgage loans of this client group amount to less than one per cent. Practically 99 of all loans are serviced regularly /incidental delays of 60 days are excluded/ and sale of the collateral for the purpose of satisfying the creditor is seldom applied.

**The businesses** using mortgages mostly are:

- Very small businesses needing operating or investment capital. These companies do not employ more than 10 people on average.

- Small and medium-size businesses under the definition provided in the Law on Small and Medium-size Enterprises which use loans as operating and investment capital.

For these two types of credit-recipients, banks face among the lowest risks to their receivables (the lowest percentage of delayed payments) because of the personal commitment of their owners.

- Companies building housing and office projects, travel companies and ones running hotels;
- Companies building or operating infrastructure-related businesses.
- Municipalities using loans for various purposes /healthcare, education, social projects, urban development and public works, conservation of the environment and for acquiring long term assets/. Municipal private property is used as collateral to secure these loans.

### **Terms and conditions**

Banks have largely unified the terms and conditions of the mortgage loans. This is the result of substantial legal regulation by means of laws and regulations of this aspect of the operations of the banking institutions. The regulatory provisions of the Law on Banks and the regulations issued by the Bulgarian National Bank are mandatory for the crediting businesses. The goal set in the restrictive provisions is to limit risks to banks in the course of their crediting operations. It should be noted though that the provisions are most liberal in respect to first mortgage on a piece of real property with appraisable market value which exceeds by 25 per cent the amount of the loan. These mortgages have a risk weight of 50 per cent and are included in the risk component of the balance sheet in an amount equal to half of their balance sheet value. Of lower risk weight are only the assets of the bank invested in available (cash) funds, “on sight” funds in the bank’s checking accounts, receivables from the government and receivables from foreign banks, organizations and countries on the special list of the central bank.

In order to get a mortgage loan approved by the bank, the credit applicant should generally meet the following requirements:

1. Good creditability. It is assessed by the ability of the applicant to fulfill his obligations in respect to the loan transaction under the terms of the contract so as not to threaten his financial situation and not to affect the interests of other persons.

Natural persons prove their creditability by indicating the sources and amount of their incomes for a preceding period of time and the anticipated sources of income for the period of payback of the loan. The individual should have sufficient funds left to ensure his support after deducting the monthly mortgage payments from his income.

The credit rating of businesses is proven by an analysis of the information in their accounting documents for a past period of time and an analysis of the forecast cash flows expected from the expansion of operations or the development of a new operation.

2. Positive rating of the individual credit risk of the applicant, i.e. the likelihood of him failing to fulfill or of him getting into a situation where he cannot fulfill the terms of the credit contract.

3. The value of the collateral should match the amount of the loan.

There is no legal regulation of the methodology of the appraisal. The law does place, however, certain requirements in respect to the persons who are doing the assessment. They should possess licenses to engage in such activity and should operate independently of the bank. The appraisal of the property must also provide indication of the methodology used. It is often the practice of banks to have their own experts re-examine appraisals made by outside assessors.

4. A mandatory element of the mortgage contract is the requirement that the client provides supplementary collateral if the market value of the real property used should drop below the required minimum corresponding to the amount of the loan.

5. There is a practice in the Bulgarian banking market for banks to allow credit users early redemption of loans. There are just a few banks, which charge fees for early redemption of loans, and such fees cover a portion of the loss of interest by the bank.

6. The following sequence is observed in redeeming loans:

- in case of regular service of the loans: fees, regular interest, principal;
- if payments become overdue (interest and/or principal) and/or in the case of violations of other contractual obligations: fees, interest overdue (interest that has become due), penal interest over the overdue principal, overdue principal;
- for credits collected by court order: fees, interest awarded by the court, legal interest on the principal, principal.

## **Pricing**

The elements, which form the price of the mortgage credit are as follows:

### 1. Interest costs

As credits carrying the lowest risk of loss mortgage loans have the lowest interest rates. It is usual practice for banks to set interest rates of loans depending on the purpose of these loans. The interest rate covers the price of the monetary resource deposited increased with the profit required from the credit transaction. A risk supplement is added to this base interest rate which in the case of mortgages is the lowest possible.

Two approaches are used in everyday practice for assessing interest on loans: compounded interest (redemption by annualized installments) and simple decursive interest (redemption of principal and interest on the loan calculated by the “staircase method”). With the “staircase” method interest is accounted on the remainder of the loan whenever there is a change in the amount of that remainder or whenever there is a change in the interest rate.

In the event of the principal becoming overdue or some other violation of the contract, the bank accounts penal interest on the amount overdue until the elimination of the violation. The penal supplement is a percentage added to the regular interest rate.

### 2. Fee for examination and appraisal of the collateral

This is a one-time fee collected upon submission of the application for the loan, which covers the bank's expenses for studying the client, the purpose of the loan, for appraisal of the collateral, for obtaining the opinion of a credit expert and other costs.

### 3. Loan service fee

This is usually an annual fee collected at the beginning of every period and covers the costs of the bank incurred for monitoring the current creditability of the client, his compliance with the provisions of the credit contract and for subsequent appraisals of the collateral.

### 4. Costs of property insurance

It is an usual requirement for the real property serving as collateral to be insured in favor of the bank against all insurance risks that could bring about its destruction or a depreciation of its market value. The insurance should be able to cover all receivables of the bank in respect to the loan. The insurance is renewed every year until full redemption of the loan.

### 5. Costs of instituting collateral

These costs include state fees for notarization and registration of the transaction and lawyer fees for preparing the deed.

## **Currency of mortgage loans**

As far as the kind of currency is concerned, it will be necessary to differentiate between mortgage loans depending on their use:

- Loans to private citizens (for purchasing or building homes and consumer credits). Because of certain restriction of the currency regime in force until January 1, 2000, payments inside the Republic of Bulgaria could only be made in the national currency. For this reason almost all loans to natural persons in the bank's credit portfolios are denominated in Bulgarian levs.
- Loans to businesses – small and medium-size enterprises and other businesses - the volume of the loans in foreign currency depends on the imports of raw and other materials by domestic businessmen for the needs of their businesses because it is financed from bank loans. There is no statistical data of the percentage of mortgage loans of all foreign currency credits.
- Loans to municipalities and public authorities: due to legal restrictions /the currency regime and the budget laws/, loans to such recipients are denominated in the national currency /the lev/.

Loans (including mortgage housing loans) extended by DSK Bank are only BGL denominated and loans extended by BACB<sup>4</sup> are denominated in USD.

## **Maturity**

The maturity structure of the loans in the banks' mortgage portfolios is determined by the purpose for which these loans are extended.

With mortgages to individuals /housing and consumer/ there is a presumption that these are repaid from the monthly income of the recipient. Thus, these loans are monthly redeemed in equal installments that include interest and principal (calculated using the formula applied to annuities). There is no grace period in respect to redemption of the principal.

A grace period in respect to redemption of the principal may be allowed for loans used to finance current operations. Usually agreement is reached on the period of time during which the loan is consumed (one-time or in parts under a plan). Redemption is made pursuant to redemption plans and usually include interest (simple decursive) and portions of the principal.

With loans for investment purposes or ones used to fund seasonal operations /construction, operation of hotels, etc./, the maturity structure of the loan varies depending on the financed investment project. A grace period in respect to redemption of principal may also be agreed upon. It is possible to concentrate redemption at the end of the agreed upon period of the loan, as well as to agree on redemption of the principal in one installment at maturity. Interest is paid on a monthly basis and is calculated as simple decursive interest.

### **Interest rates**

Generally, interest rates on loans in the Bulgarian banking system depend on the base interest rate of the Bulgarian National Bank. The base rate is determined on the basis of the income from short-term treasuries. Treasury auctions are held weekly and changes in their interest rates result in changes of the base rate. The stability of the financial system during the last two and a half years has resulted in stability (evidenced by the insignificant changes in treasury return) of the base rate. For the entire period it has fluctuated between 3.5 and 5 per cent. This has enabled banks to refrain from significant changes in the interest they charge on loans, or at least to refrain from changing rates as a result of changes in the base interest rate. Stability has also resulted in a reduction of the supplementary charges for general financial risk. The base rate charged by banks is now between 10 and 15 per cent. Various risk premiums are charged and can reach 10 per cent.

### **Policies and general bank procedures to process credit applications and expectations in respect to market demand in the future**

A bank's credit policy usually includes:

- Procedure for receiving and processing credit applications and the documents required by the bank
- Determination of a target client group
- Decision-making procedure in respect to approval of loan contracts
- Types of loans, manner of calculating interest, collateral (admissible collateral)
- Procedure for managing bad debt and for redemption from the collateral

Banks conduct their credit operations through their branch offices serving the respective region with reference to:

- Place of residence or registration of the business of the borrower
- Commercial or tax registration of the borrower
- Place of employment or usual place of doing business of the borrower

- Location of the financed object

Banks have usually shown themselves to be more likely to finance their regular clients. Loans are approved within one month of receipt from the client of the required documents. The documents themselves are standard bank forms. Especially trained individuals (credit inspectors) process the credit applications and provide opinion on them. The decisions to sign a loan contract are made by the credit board at the branch office depending on the powers vested in it (decision-making scale). It is usual for larger loans (amounts exceeding a pre-set limit) to be authorized by a decision of the central credit board. Loan transactions are based on a contract in writing between the bank and its client (a natural person or corporate entity).

Banks will not provide financing to clients:

- Who have been declared insolvent or are subject to insolvency or liquidation procedure
- Whose credit rating was found unacceptable by the bank
- Who are not able to provide adequate collateral
- Who do not possess or possess to an insufficient degree own funds for participation in the financed project.

The acceptable interest rate levels offered by the banking system have encouraged greater demand for loans. This factor, coupled by statistics showing that most Bulgarians own real property provide grounds to expect stronger demand for mortgage loans by individual clients and commercial enterprises. With due consideration to these basic conditions and pursuant to the analysis of the macroeconomic factors it can be assumed that:

- A considerable portion of the housing is located in villages, small towns and depopulating areas. This means that there is no market for such real property and banks are reluctant to take the risk of providing financing against collateral in such regions;
- A considerable portion of the housing in the major cities consists of prefabricated homes. The low lifespan of this type of housing and the considerable investment required for its maintenance (comparable to the cost of new housing) is nonconducive to strengthening the interest of the more affluent in obtaining loans for building or purchasing new homes;
- The migration from economically underdeveloped regions to areas with more stable economic development will certainly result in the migrant population looking for loans to buy or build homes in these areas;
- The need for new housing provides grounds to expect greater demand for mortgage credits by building contractors;
- The efforts to develop the tourism industry will certainly involve a stage of replacement and renovation of the resorts, which raises expectation of greater demand for mortgages among hotel operators and owners of tourist resorts.

The provisional strengthening of the demand for mortgage credits however, is subject both to the buying power of the individual clients and to the anticipated return of investments by business people.

## **Appraisals**



## Availability, qualifications and independence of the appraisers of real property

- Availability

Pursuant to Article 7, paragraph 2 of the Regulation of Appraisal of Objects Subject to Privatization, issued on April 26, 2000 the by Privatization Agency had issued the following number of licenses to natural persons for appraisal of:

—real property- 4,354;

—machinery and equipment- 2,051;

—rights over intellectual and industrial property and other relationships, impact on the environment and environmental damage- 241;

—Council of Ministers Decree № 97/March 14,.1997: other assets (works of art, antiques, precious metals and gems and real estate constituting monuments of culture)- 155;

—entire state-owned or municipal companies (irrespective of whether these are or are not transformed into commercial companies)- 2,229;

Licenses are also issued for appraising financial institutions.

- Qualifications

Licensed appraisers are natural persons with university education who know the general principles and methods for appraising real estate, have declared their acceptance of the Code of Ethics of the appraiser profession and have been licensed by the Privatization Agency.

Licensed appraisers should possess:

—practical skills and knowledge;

—professional training;

—technical knowledge.

They should appraise real estate pursuant to international standards and in the conditions of a market economy. The introduction of standards in the various areas of appraising has regulated the general requirements in respect to the appraising procedures.

In developing these standards the appraisal-monitoring group with the Privatization Agency has studied all available information on the international experience in this area and has selected the appraisal methods, which are most appropriate for the Bulgarian market economy.

It has been established that the most detailed studies of appraisal standards have been made in the areas of long-term assets and real estate.

The most important requirement in respect to the appraisal is to provide an accurate reflection of the market value of the property. The market movements and the risk of possible depreciation of the prices of real estate should both be taken into account.

Appraisers may carry out examination and appraisal of real estate prior to the submission of an application for a mortgage loan. They may also be employees of the bank, which provides the mortgage loan but must at any rate be licensed by the Privatization Agency.

The appraisers employed by such institutions are familiar with all relevant laws and regulations and with the banking standards.

All insured real and personal property is subject to appraisal.

### Appraisal, requirements in respect to appraisals

The criteria for applying methods of appraisal depend on the type of property, namely single family homes, apartments, leased private homes, commercial and office premises, industrial and warehouse buildings, agricultural property, undeveloped land, public buildings such as hospitals, schools, hotels; machinery and equipment; other assets (works of art, antiques, precious metals and stones); entire companies; financial institutions, investments, tax assessments, appraisal of compensation, appraisal for the purpose of expropriation, accounting appraisal of assets, and credit appraisal.

The appraisal should be confined within the limits of an amount which any buyer who is well informed of the local real estate prices and the current market in terms of the various sizes, qualities and standards, could be reasonably expected to pay for a given piece of real estate.

### Independence of appraisers, rights and obligations

In carrying out an appraisal, the appraiser should discharge his obligations and contracted duties in conditions of professional, legal and financial independence. To ensure that the appraiser operates independently and he cannot:

- enter into a relationship of illegal material dependence with his clients;
- participate in the managing boards of the clients;
- acquire property within the appraised real estate;
- disclose in any way whatsoever and for any reason whatsoever information about any property appraised by him and the appraisal itself to third parties.

The appraiser is obliged to provide information about the appraisal to his client and only to such third parties as his client may direct. He should be objective and unbiased and should not himself constitute a potential risk to his client's interests.

### Methodology

The appraisal method depends before all on the purpose of the appraisal (for what purpose an appraisal is made). A given property may be subject to tax assessment, or appraised for the purpose of insurance, sale, to serve as collateral or to secure a mortgage. It also depends on the type of the appraised property: real or personal, land, buildings, improvements, machinery, equipment, residential or non-residential, commercial, industrial, etc.

Practice has shown that only by choosing an appropriate method one can ensure that the goals of the appraisal of the property will be achieved. The appraisal of the property should be done using at least two appraisal methods. In appraising real estate for obtaining a mortgage loan with due consideration for local conditions, the most frequently employed methods are:

- Method of material value, i.e. what expenses would be incurred to create a new property of similar characteristics. Four components are subject to appraisal:
  - Land
  - Building improvements
  - Outside equipment
  - Other equipment

This method is applied to the appraisal of:

- Single family houses
- Apartments
- Public buildings /hospitals, schools, churches, libraries, etc./

- Appraisal for approving loans, for assessing improvements for the purpose of investing, tax assessment, etc.

- Method of revenue valuation, i.e. projects where start-up capital is invested for the purpose of obtaining revenues in the future.

This method is applied to:

- lots adapted for obtaining revenue
- homes for lease
- commercial properties /stores, catering establishments, etc./
- properties used for combined purposes
- hotels, stores and offices
- lots with garages
- industrial projects

- Method of comparative sales - this method can be considered as an alternative method in Bulgarian usage.

In it the value of a given property is established by comparing it directly to other properties, which are as similar to it as possible, which have been sold within a period of time that is close to the time of making the appraisal.

Market value is determined by a detailed study, verification and analysis of a large number of properties offered for sale. After a description of all elements of the comparison between the already sold property and the one which is subject to appraisal, an analysis is made followed by such corrections in the price as would reflect the monetary or percentage value of the differences found between the properties.

The application of the comparative method requires at least three reference properties which had been sold recently and which exhibit closeness to the appraised property in numerous parameters.

## **The Existing Systems Housing Finance**

As already mentioned above, in Bulgaria there are no specific contract saving schemes, building societies, mortgage banks, etc. However, on May 17, 2000 the Economic Committee of the Bulgarian Parliament voted on first committee hearings the draft law on mortgage bonds. It is expected that it will be passed soon and within several months the two major players on the housing financing market in Bulgaria - DSK Bank and BACB - will issue mortgage bonds. What is envisaged in the law?

### **Legal regulation of bonds as securities**

Bonds are regulated by the Commerce Act and the Public Offering of Securities Act and are subject to obligations and material law. Under the law, securities are transferable rights or documents, which materialize transferable rights. The Commerce Act does not provide a definition of bonds but its characteristics can be deducted from the texts of this law.:

- The bond as a security materializes the right to receive principal and interest
- The bond may be backed by funds available or not. When it is backed by property it gives rise to both an obligation and a material legal relationship: the right of ownership of its holder
- The bond may be issued to bearer or to a named individual
- The bonds issued by a company may have various face values.

The Commerce Act provides regulation of the general requirements in respect to the issuer which make him eligible to issue bonds. Of all commercial companies, only the joint stock company can issue bonds. There are requirements in respect to:

- The amount of the company's capital
- The volume of the bonds as a percentage of the company's own capital. Exceptions can also be made for issues guaranteed by the state or by banks (under the Commerce Act) and such issued by banks (the Banks Act).
- The history of the company. At least two annual accounting reports approved by the general meeting are required.
- The manner of resolving to issue bonds.

## **Issuing bonds**

### Under the Public Offering of Securities Law

One of the goals of the Public Offering of Securities Act is to regulate the issuing of securities (including bonds) in such a manner as to ensure transparency of the procedure and terms of the bond issue, adequate information for investors about the economic and financial state of the issuing organization, and reliability of the information. A further goal is to set the rules for securities trading in the so-called "regulated markets". The operation of a special commission, the State Securities Commission, is closely linked to attaining the goals of this law. One of the means to ensure observance of these goals is to require of the issuing organization to prepare a prospectus of the issue. The prospectus should include certain kinds of information and should comply with certain requirements in order to be approved by the State Securities Commission. The issuing company is not allowed to announce public subscription to the issue before the approval of the prospectus. The law provides for an opportunity for waiver of the prospectus if the securities are offered to institutional investors only.

### Under the Commerce Law

Where the offering of bonds does not constitute public offering under the Public Offering of Securities Act, it is carried out under the Commerce Act. Such an opportunity has no legal regulation but cannot be excluded where the offer is addressed to one or more persons and the terms of the loan are a matter of contractual autonomy. When the loan contract is concluded with a person or by closed subscription it does not have the characteristics of a public offering.

It should be noted that a number of laws regulating the operation of investment brokers, pension and insurance companies require of them to invest only in securities traded in the regulated markets. This means that inasmuch as these companies are representative of the institutional investors and are the most important buyers on the bond market, the issuing of bonds under the Commerce Act is almost impracticable.

## **Housing Sector Overview**

### **Current state of Bulgarian housing**

#### **Completed buildings**

The basic unit used in the monitoring conducted by the National Statistical Institute is the home. The residential building will not be the object of the present study because it is a technical carrier of the home (or homes) and is only regarded as a secondary unit for monitoring.

On December 31, 1998 there were 3,437,555 homes in the country. The data about housing were obtained from the census of housing, held on December 4, 1992, and has been updated every year by addition of the newly built homes and deduction of the homes no longer in existence.

For instance, there were 3,414,079 homes in 1994, while 6,815 homes were built in 1995 and 957 homes were demolished so that on December 31, 1995 there was a total of 3,419, 937 homes in the country.

The number of homes /3,419,937/ was last to be published so far in the National Statistical Institute publication of "The Housing Fund" in 1996, and the classification of homes is therefore based on that publication as follows:

- by type of structure;
- by number of rooms in a home;
- by form of ownership /public or private/;
- by residential and non-residential area /as of 1992 the area of kitchens is considered auxiliary area /;
- by the distribution of homes by number and area in cities and villages.

#### **Classification of homes by structure**

By type of frame and floor structure buildings are divided into ferroconcrete, brick and temporary.

Ferroconcretes are those buildings the support structure and floor of which are made of ferroconcrete, while the walls are made of brick or some other material. Brick structures are those the supporting walls of which are of brick and stone masonry while all belts, beams and floors are made either of ferroconcrete or of steel or wooden beams. Buildings, which have prefabricated floor systems, are also classified as brick if no other prefabricated structural elements are used in their construction. Temporary buildings are those that have a wooden frame of the outside walls filled with bricks, mud, woven tree branches, planks, etc.

A considerable part of the current housing is ferroconcrete - 38.9 per cent -including ferroconcrete buildings made of large prefabricated elements, to be referred to hereafter by their popular name of prefab buildings which account for 20.8 per cent and buildings with ferroconcrete frames, 18.1 per cent. Homes in brick structures make up the largest group accounting for 52.6 per cent of all homes. Despite the fact that the number of temporary structures has been dropping every year /a drop of 0.1

per cent was recorded in 1995/ 8.5 per cent of all housing is located in such buildings. Most homes /59.3 per cent/ in the cities are located in ferroconcrete buildings. In villages, 78.0 per cent of the homes are in brick buildings.

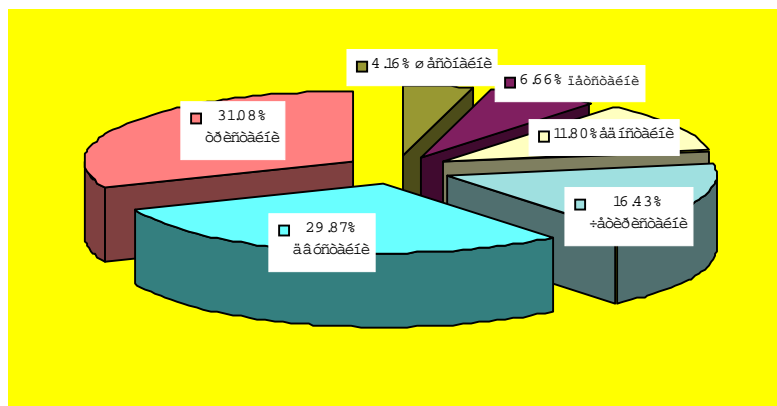
### Classification of housing in Bulgaria by structure and number of homes (by 31.12.1995)

	Homes by structure				
	Total	Prefab Buildings	Buildings with ferroconcrete frames	Brick	Temporary
Total number	3418837	710261	619226	1800597	289853
in cities	2147271	699503	57488	808014	64966
in villages	1272666	10758	44438	992583	224887

### Classification of homes by number of rooms

Homes in Bulgaria are classified by number of rooms as follows: one-room- 403,566 or 11.8 per cent of all homes, two-room- 1,021,585 or 29.9 per cent, three-room- 1,062,834 or 31.1 per cent, and four-room or larger- 931,952 or 27.2 per cent. Most homes consist of two or three rooms. Towns and villages differ in terms of number of rooms per home. In the cities most common are homes with two or three rooms, 36.3 and 30.7 per cent respectively, while in the villages homes with four or more rooms are most common (43.8 per cent of all homes).

### Classification of homes in Bulgaria by number of rooms (by 31.12.1995 година)



Number of rooms	one-room	two-room	three-room	four-room	five-room	six-room
Total homes	3,419,937	403,566	1,021,585	1,062,834	562,033	227,604

### Residential area

The usable area of homes is the sum of the residential area, the auxiliary area and the area of the kitchens and amounts to a total of 217,707,831 square meters for the entire country, including residential area of 141,920,408 square meters or 65.19 per cent of all usable area.

There has been an increase of usable area in the country by 0.3 per cent matched by a 0.3 per cent increase in residential area. In the cities, the residential area accounts for 62.00 per cent of the usable area while for the villages this percentage is 70.4.

The general index of the country's housing standard is the average residential area per person which amounts to 14.7 square meters in the cities and 21.4 square meters in the villages. The districts boasting the largest residential area per person are Montana with 19.2 square meters and Sofia with 18.8 square meters.

### Residential area in Bulgaria in m<sup>2</sup> and as percent of usable area (by 31.12.1995)

	<i>Usable</i>	<i>Housing</i>	<i>Auxiliary</i>	<i>Kitchens</i>
Total m <sup>2</sup>	217,707,831	141,920,408	47,116,415	28,671,008
%	<b>100</b>	<b>65.19</b>	<b>21.64</b>	<b>13.17</b>

Usable area including:

### Residential area in Bulgaria in m<sup>2</sup> and as per cent of usable area in cities and villages (by 31.12.1995)

	<i>Usable m<sup>2</sup></i>	<i>Residential m<sup>2</sup></i>	<i>Usable %</i>	<i>Residential %</i>
Total m <sup>2</sup>	217 707 831	141 920 408	100	65.19
in cities	135 108 567	83 748 628	100	61.99
in villages	82 599 264	58 171 780	100	70.46
%	100	100	-	-
in cities	62.06	40.99	-	-
in villages	37.94	59.01	-	-

Residential area per person was calculated using the population number for the end of the year.

The residential area includes the areas occupied by living rooms, bedrooms, dens, dining rooms, studies and libraries, guest rooms. Kitchens are not part of the residential area.

The auxiliary area includes all service rooms: rooms with an area of less than 7.5 square meters, corridors, bathrooms, restrooms, closets, etc., irrespective of their size.

## **Type of ownership of homes and availability of housing to the populations of towns and villages**

Most homes in the country are privately owned (92.6 percent). 89.6 per cent of all homes in the cities are privately owned while in villages 97.6 per cent of all homes are private. State-owned homes in cities account for 5.5 percent and in villages for as little as 1.1 per cent of all homes. The remaining homes are owned by companies and by public and cooperative organizations.

The residential area per person of the population was calculated using the number of the population at the end of the year.

There were 408 homes per 1000 people in 1995. The districts of Sofia and Montana had the largest number of homes per 1000 people, 449 and 444, respectively. Despite the concentration of housing construction in the cities, villages provided a better housing situation. While in the cities there are 379 homes per 1000 people, villages boasted 468 homes per 1000 people. The cities in the districts of Sofia and Rousse had the highest number of homes per 1000 people: 395, while the villages of the district of Sofia had the largest number of housing of all rural areas: 572 homes per 1000 people.

Each home is inhabited by an average of 2.48 people, or 2.64 people in the cities and 2.14 in the villages. The district of Plovdiv had the most people per home, while the districts of Sofia and Montana had the lowest number of people inhabiting a home.

### **Homes in Bulgaria by ownership and by location (by 31.12.1995)**

	Total number	Publicly owned number	Private number	Total %	Publicly owned %	Private %
Total	3 419 937	252 528	3 167 409	100	7.38	92.62
in cities	2 147 271	222 290	1 924 981	100	10.35	89.65
in villages	12 72 666	30 238	1 242 428	100	2.38	97.62

### **Housing by year**

#### **Homes by year, incl. usable, residential and auxiliary area in m<sup>2</sup>**

	1993	1994	1995	1996	1997	1998
Homes - total	3406	3414	3419	3427	3434	3438
Usable area	216465	217070	217708	218338	218943	219285
Residential area	141038	141447	141920	142323	142715	142931
Auxiliary area	75427	75623	75788	76015	76228	76354
Homes - in cities	2136	2142	2147	2154	2162	2162
Usable area	134034	134567	135109	135719	136376	136376
Residential area	82988	83346	83749	84141	84568	84568
Auxiliary area	51046	51221	51360	51578	51808	51808
Homes - in villages	1270	1272	1273	1273	1272	1272
Usable area	82431	82503	82599	82619	82567	82591
Residential area	58050	58101	58171	58182	58147	58163
Auxiliary area	24381	24402	24428	24437	24420	24428

Compared to 1993 housing in 1998 grew by about 32,000 homes. Residential area during that period grew by 1,893,000 square meters. Housing in the cities grew constantly in terms of number of homes and residential area between 1993 and 1997. 1998 was notable for absence of growth. In the villages, the number of homes grew between 1993 and 1995 then leveled off in 1996 and subsequently dropped and stayed



at a lower level. Residential area in the villages grew until 1996, then dropped in 1997 compared to the two previous years, then again growth picked up in 1998 when 16,000 square meters of residential area were added compared to 1997.

### **Quality and maintenance of housing**

Housing in Bulgaria is renovated slowly and is mostly rather old. Every year homes are removed from the total housing numbers for various reasons: complete amortization of the supporting structure, bad maintenance and delayed repairs (mostly temporary buildings - 8.5 per cent of all homes are in such buildings mainly in the villages), demolishing of old buildings to clear the way for new development, as a result of natural disasters and fires, etc.

Most brick buildings (which account for the largest share of all housing - 52.6 per cent) are in unsatisfactory condition. Namely, these homes in the cities are rather old. They were built at the beginning of the century mostly using wood beams or at best, the so-called Prussian structure (supporting double-T metal beams joined by bricks without supporting columns). These buildings are most often located in town centers and are notable for poor structural design, inadequate design of the floors and spaces and for functional inadequateness.

“Newer” buildings, built after the thirties and in the post-war years have ferroconcrete floors but they, as the buildings erected earlier, should be subject either to general overhaul or to demolition (because of new construction in city centers). Vastly increased reconstruction of ground floors in recent years, sometimes without observing any building standards, has made some of these buildings particularly dangerous.

In the villages the structural characteristics of the homes are better since they are generally newer. However, 75 per cent of all homes need repairs for improving the thermal insulation of the walls, which in 94 per cent of the buildings have a thickness of 25 centimeters. Sixty per cent of all walls have no stucco.

The media often show prefab buildings and imply directly or indirectly that these buildings can come down any time and that their lifespan is only 40 years. That prefabs are ugly is a fact as is their poor thermal and sound insulation. It is also a fact that they will not come crashing down. In Bulgaria, as in France, Germany and the rest of Western Europe, the upgrading of prefab buildings is much needed. This mostly concerns the cities since 98.48 per cent of all prefab buildings are located there, and particularly the City of Sofia, which has 28.71 per cent of all prefab buildings in the country.

There is hardly a prefab apartment building which does not have cracked walls, leaking pipes, damaged water insulation and a leaking roof.

A reconstruction of the ugly and peeling facades will improve not only their thermal insulation but will also enhance their water resistance, architectural image and increase their life.

Statistical studies of housing show that home improvement (repairs, maintenance and new construction) proceeds at a very slow rate.

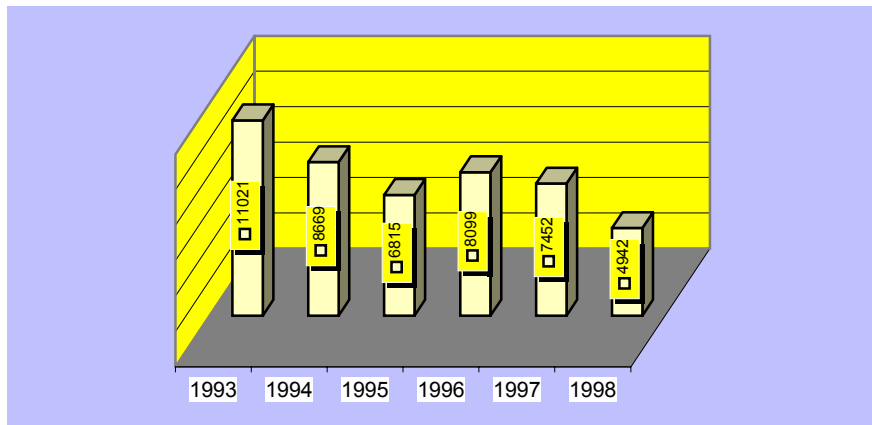
### **Housing built in recent years (analysis of the construction industry during the 1993-1998 period)**

To analyze the state of the building industry in Bulgaria, we are presenting its development over several years prior to 1998 (for which there are accurate statistical figures) by charts and diagrams.

In some of the diagrams /before 1995/ absence of data indicates that no data of the respective kind were available in the statistics for the year or the data available was presented in a manner that does not permit a comparison to be made.

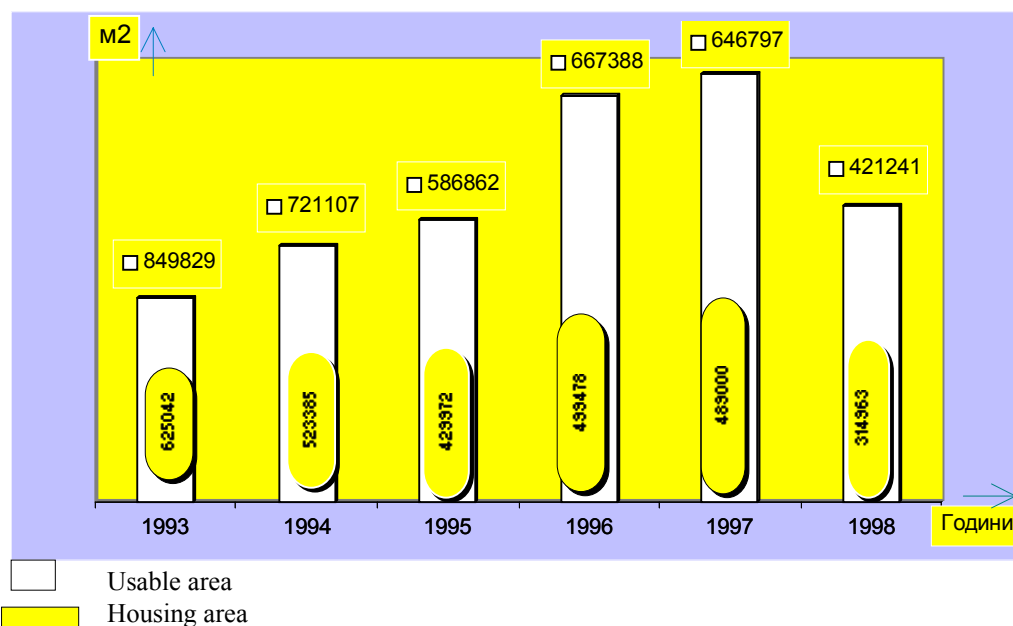
- Housing construction

**Completed Homes (in number, by years)**

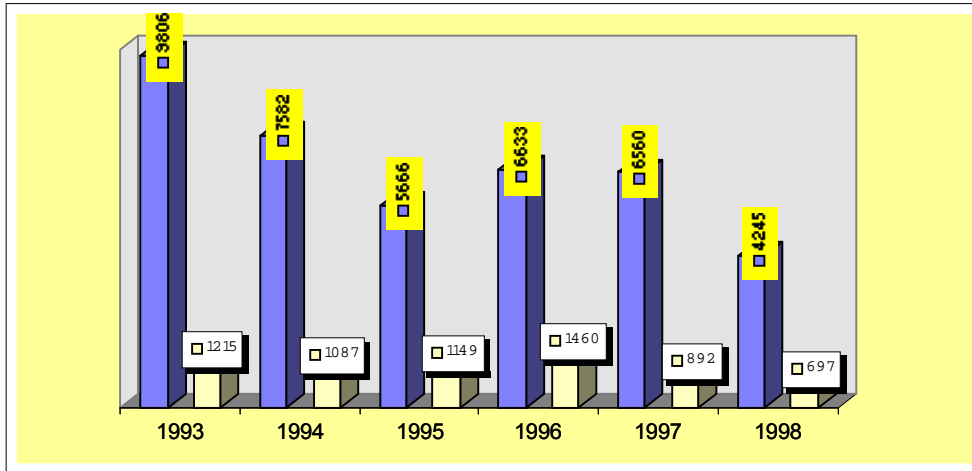


- Housing area

**Usable area (incl. residential area) in m<sup>2</sup> in completed homes**

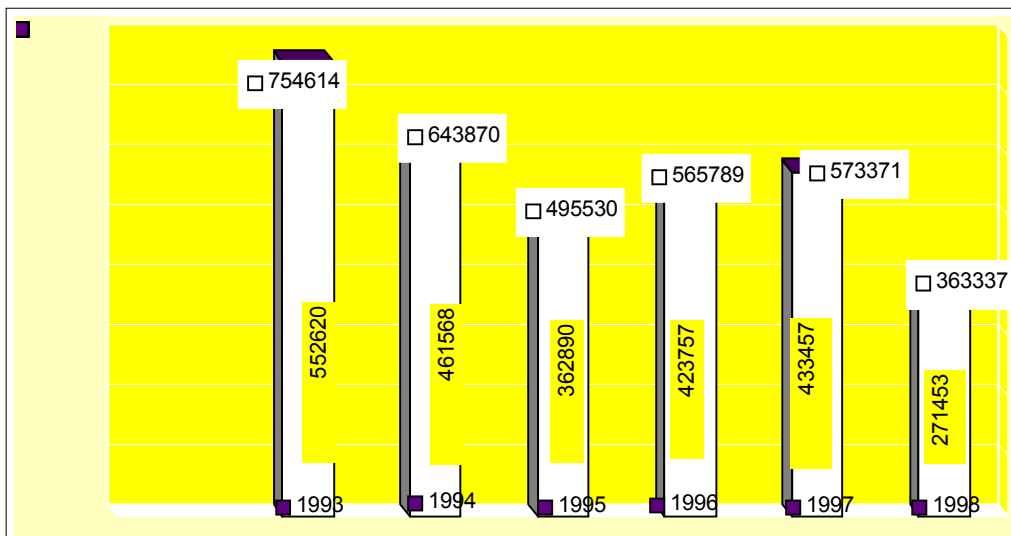


### Completed homes, by years in cities and villages



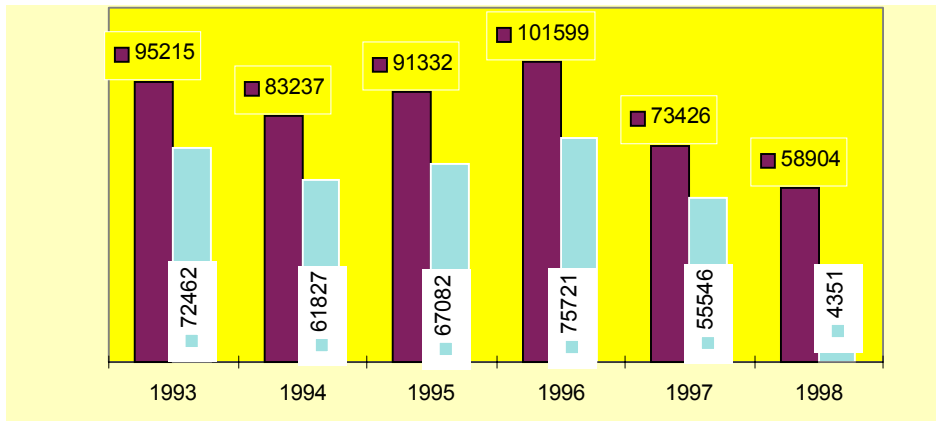
In cities  
 In villages

### Usable (incl. residential) area in completed homes in cities, by years (in m<sup>2</sup>)



Usable area  
 Housing area

### Usable (incl. housing) area of completed homes, by years in villages (in m<sup>2</sup>)



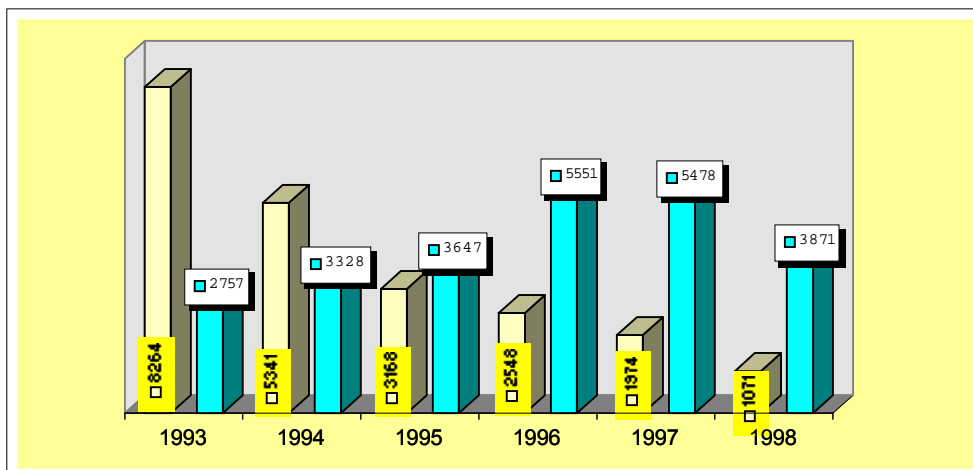
Usable area  
 Housing area

### Ownership

The diagrams below show the completed homes by form of ownership, i.e. who owns the homes.

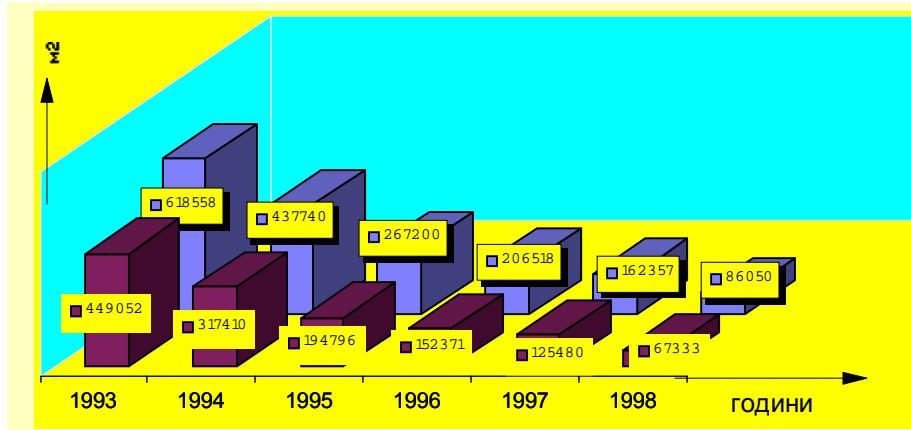
“*Public construction*” means that the housing is owned by the state, the municipalities or is cooperative property, while “*private construction*” means private ownership (natural persons or corporate entities).

### Numbers of completed homes by form of ownership (public and private) and by years



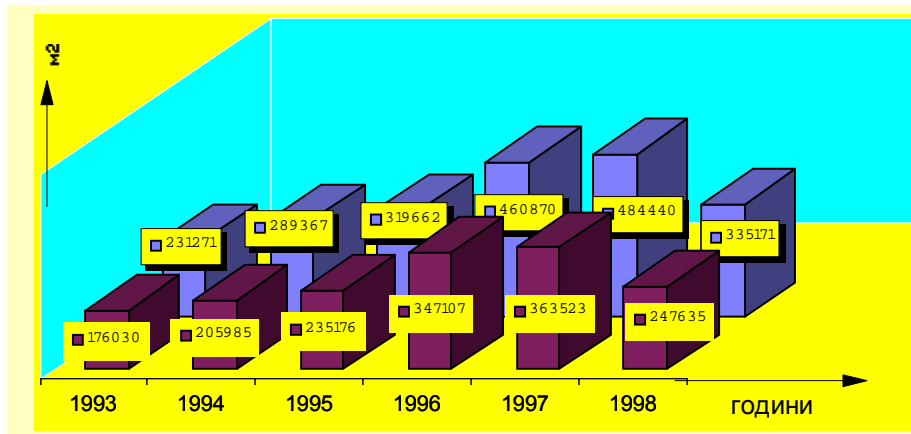
Public construction  
 Private construction

### Usable (including residential) area of the completed homes in public construction



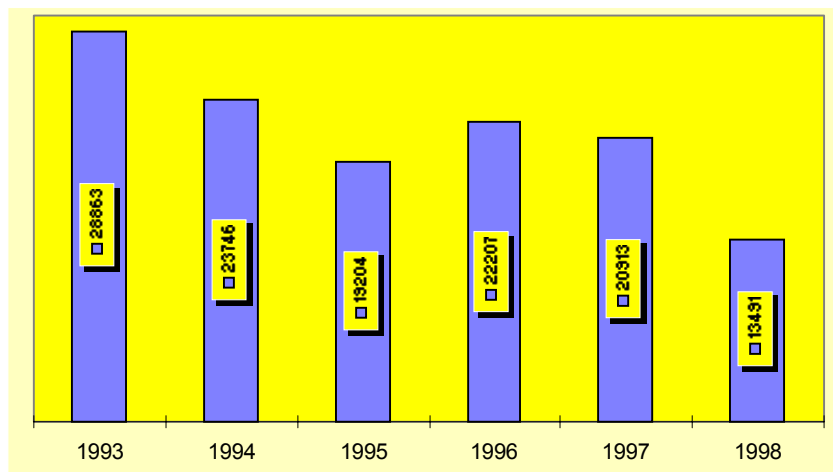
■ Usable area  
■ Housing area

### Usable (including residential) area of the completed homes in private construction



■ Usable area  
■ Housing area

### Residential rooms in the completed homes by years



### Number of completed homes (incl. by type of structure) by years

Type of structure	By years
-------------------	----------

	1993	1994	1995	1996	1997	1998
Total	11021	8669	6815	8099	7452	4942
Ferroconcrete	9478	7190	5134	5560	4407	2955
Brick	1532	1469	1674	2539	3042	1987
Temporary	4	6	5	-	-	-
Others	7	4	2	-	3	-

**In cities**

Total	9806	7582	5666	6639	6560	4245
Ferroconcrete	9078	6820	4760	5087	4116	2691
Brick	724	759	905	1552	2444	1554
Temporary	1	2	1	-	-	-
Others	3	1	-	-	-	-

**In villages**

Total	1215	1087	1149	1460	892	697
Ferroconcrete	400	370	374	473	291	264
Brick	808	710	769	987	598	433
Temporary	3	4	5	-	-	-
Others	4	3	1	-	3	-

**Completed homes by type of structure, by years and as % of total homes**

Type of structure	By years					
	1993	1994	1995	1996	1997	1998
Total	100	100	100	100	100	100
Ferroconcrete	86.00	82.94	75.33	68.65	59.14	59.79
Brick	13.90	16.95	24.56	31.35	40.82	40.21
Temporary	0.036	0.07	0.08	-	-	-
Others	0.064	0.04	0.03	-	0.04	-

**In cities**

Total	88.90	87.46	83.14	81.97	88.03	85.90
Ferroconcrete	82.37	78.67	69.85	62.81	55.23	54.45
Brick	6.57	8.755	13.28	19.16	32.80	31.45
Temporary	0.01	0.023	0.01	-	-	-
Others	0.027	0.011	-	-	-	-

**In villages**

Total	11.02	12.54	16.86	18.03	11.97	14.10
Ferroconcrete	3.36	4.27	5.49	5.84	3.90	5.34
Brick	7.33	8.19	11.28	12.19	8.03	8.76
Temporary	0.03	0.05	0.073	-	-	-
Others	0.03	0.03	0.015	-	0.04	-

**Housing and auxiliary usable area of completed homes in m<sup>2</sup> by years**

Type of area	By years					
	1993	1994	1995	1996	1997	1998
Usable	849829	727107	586862	667388	646797	421241
Housing	625082	523395	429972	499478	489003	314968
Auxiliary	244747	203712	156890	167910	157794	106273

**In cities**

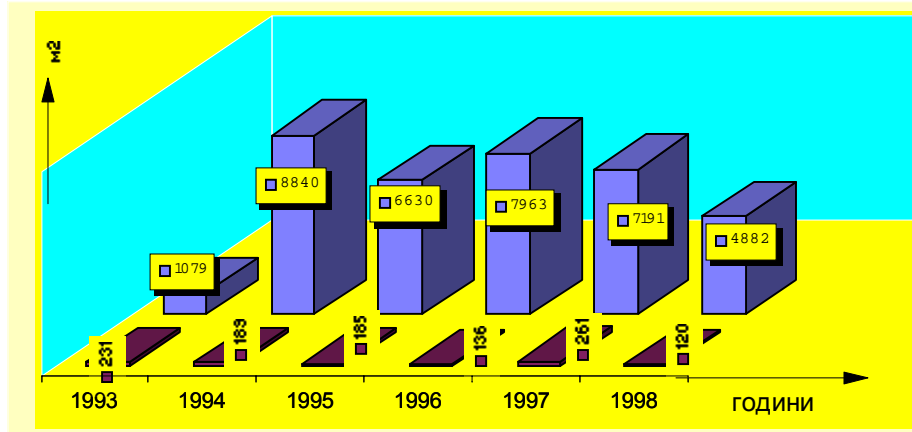
Usable	754614	643870	495530	565789	573371	363337
Housing	691839	461568	362890	423757	433457	271453
Auxiliary	62673	182302	132640	142032	139914	91884

**In villages**

Usable	92515	83237	91332	101599	73426	57904
Housing	72462	61827	67082	75721	55546	43515

Auxiliary	22753	21410	24250	25878	17880	14389
-----------	-------	-------	-------	-------	-------	-------

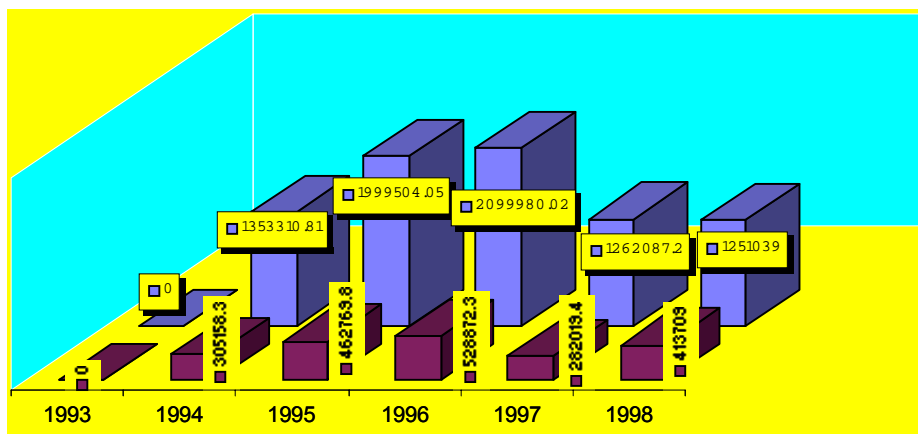
### New and expanded homes in the number of completed homes by years



- new built homes
- expanded homes

The development of the construction industry can also be gauged by the revenues of the contractors (public and private), and this approach is used below.

### Revenues in million leva by years raised from construction of new homes and maintenance and repair of residential and non-residential construction



- Construction of new homes
- Maintenance and repair of homes

The revenues of the contractors by years from 1994 to 1998 are presented in December 31, 1998 prices of building works for the purpose of ensuring comparability. No data are available for 1993.

### Analysis of housing construction in Bulgaria during the 1993-1998 period

The analysis of the available statistical data outlines several trends and leads to several conclusions.:

Housing construction has been dropping as has residential area both in towns and villages.

The decline is due mostly to reduced demand as a result of lower buying power and difficult access to housing financing.

### **Prices of construction works**

There has indeed been a substantial increase in the price of construction works and this tendency can only stop once we have brought prices in line with those in the European Union. Construction materials with biggest share of total costs are fuels and electricity. Fuels have already reached European level prices, while electricity is catching up. There has been a delay in the increase in the price of labor and machinery. Prices so far have been kept in check by lower quality, particularly by lower standards in respect to thermal efficiency. It is hardly a coincidence that all contractors are in a great hurry to put a coat of stucco on their structures craftily hiding their thermally inefficient designs. All studies indicate that the price of raw construction is declining and will stay at one level. To the contrary, finishing works and installations will go up in price mainly because of improved quality.

### **Prices of finished buildings**

Prices of completed housing have been going down as a result of the stagnation of the economy, of the people getting poorer and of the high exchange rate of the US dollar. This has placed the contractors in a very difficult situation since they now have a lot of unsold homes on their hands.

It is our view that prices of completed homes can fall below production cost at the end of 2001 or early in 2001.

Only larger apartments have so far retained their prices since they are purchased by the more affluent.

At this time the supply of real estate (homes) exceeds demand by about 30 per cent.

Demand is highest for small units, per square meter prices of which have fallen by about \$100 compared to 1999.

The housing market is influenced by:

- the state of the economy;
- political stability;
- location /city, area/;
- type of structure;
- age of the building;
- buying power and demand;
- absence of normal home loans.

The share of expanded homes in all newly built homes is relatively small both in towns and in villages. For example, the average percentage of this index was 2.1 in 1993, 2.8 in 1994, 2.71 in 1995, 1.68 in 1996, 3.5 in 1997 and 2.43 in 1998.



The share of ferroconcrete buildings as a percentage of all buildings erected during the same period was 65.73 per cent on average and the share of prefab buildings fell significantly and was offset by buildings with ferroconcrete frame. This is due to the closing of the building operations of the old home construction state-run enterprises. If prefabs at all appear in the statistics, it is because the construction of some such buildings had started earlier and was completed at a later date

The entry into the Bulgarian market of new construction materials, particularly for building outside walls will further increase the share of the housing with ferroconcrete frame. This will be encouraged further by Regulation 1 of the design of Thermal Insulation of Buildings adopted on April 26, 1999.

Given the quality of the domestically manufactured thermal insulating materials, in almost all cases (except where foam concrete of larger thickness is used) additional thermal insulation will have to be made using efficient insulation materials. Such materials are in ready supply in the domestic market even though most of them are imported.

Better thermal insulation will certainly increase the cost of construction but one should bear in mind here that these investments pay back their cost within 5 to 7 years from savings in heating.

It should also be noted that the Regulation would help improve living conditions in the buildings in summer months as well.

### **Ownership**

There is a lasting trend of reduction of long-term material assets in the public sector (state and municipal property) compared to the ones of the private sector, hence a reduction of the share of the public sector offset by an increase in the share of the private sector in all new housing. It is also a lasting trend for ownership of new buildings to decrease in the public sector and to increase in the private sector.

### **The Rules**

- There were no rules in the construction market during the past several years or at least no one was operating under any rules.

A positive trend was started with the updating of the Bulgarian legislation regulating investment orders for the purpose of bringing it in line with European law. The Public Procurement Law (PPL) was passed and is already in force so that any investor who spends public funding must use tender procedure under this law.

- There is mandatory observance of engineering standards.

A regulation was adopted about the licensing, functions and obligations of the persons carrying out technical monitoring and independent supervision of construction and design. The regulation established which buildings in terms of number of floors or purpose are subject to independent supervision and which ones to technical supervision, irrespective of who owns them.

Investors, particularly those who finance construction with public funds, are already aware that in appointing monitoring they must observe the goals described in Article 2 of the PPL, namely that they must ensure viable competition, transparency and conditions for optimum supervision regardless of whether the price of the project exceeds the figure under Article 7 of PPL. It is a different issue altogether that some of those as well as the large private contractors also control companies offering supervision services, which do not do their job conscientiously. This is happening even though the law prohibits any link between the two institutions. In such cases there is no real supervision and the end consumer is always the victim. This

phenomenon is known as corruption, people have fought against it for centuries and will probably continue to do so for centuries to come.

The price of supervision of housing construction amounts to 3 to 4 per cent of all costs, while that of industrial construction, to less than two per cent. This should not in any way make the price of new homes more expensive because efficient supervision can reduce cost overruns by as much as 90 per cent. One should not overlook also the added guarantees for better quality of the workmanship.

Currently there are several new laws concerning the housing sector on the Council of Ministers' legislative agenda. They aim at fostering the housing construction, the renovation and modernization of the housing in Bulgaria.

### **Industry organizations**

There is a growing awareness in the government of the need for industrial associations of the private companies which can be the government's partners, or when necessary, also its opponents. Such associations in Bulgaria are the Building Chamber, the Appraisers' Association, the National Association of Persons Performing Building Supervision, the Union of Architects in Bulgaria and the Union of Constructors in Bulgaria.

**In conclusion, construction, even of one building or home, is a public commitment and duty since these are designed to meet the needs of several generations. Housing is declining, old buildings are demolished, new buildings are not erected fast enough, high quality and timely repairs are rare and insufficient for preserving the available housing and for developing and improving it.**

Prices, as we mentioned above, will go up until they reach the levels of the rest of Europe. The quality of construction will also improve. It is an open question which one will have to reach European level first, prices or quality. One thing is certain, both will one day.

## **Analysis of the construction industry**

### **Availability and reliability of construction companies**

- There are now 1715 building contractors in Bulgaria each hiring five or more workers. Contractor here refers to building companies, mostly small, regardless of whether they are owned by the government, by municipalities or are privately held. The Building Chamber has registered over 12,000 contractors; there are unregistered companies, as well as others, which engage also in businesses different from construction.

- Private companies already account for over 90 per cent of all building firms.

- Private companies also do about 92 per cent of all construction work.

- They employ about 81 per cent of all construction workers. The data provided by the National Statistical Institute in respect to these indicators is inaccurate since private companies, particularly small firms operating in smaller cities, do not submit the required statistical reports and often other methodologies need to be applied.

The data about the operation of construction companies in Bulgaria is highly contradictory making it very difficult to carry out an overall assessment of their current performance.

For the purposes of this study we have used data provided by the National Statistical Institute, government department, municipalities and companies. Information about the companies was received on condition that we will not reveal their names and will not use that data against them.

### Number of firms and volume of construction works in billion Leva

Years	Number of firms (in thousands)			Volume of construction works (in billion Leva)		
	TOTAL	Including		TOTAL	Including	
		Private	Public		Private	Public
<i>1</i>	<i>2</i>	<i>3</i>	<i>4</i>	<i>5</i>	<i>6</i>	<i>7</i>
1993	1.520	1.388	0.132	55.44	23.47	31.97
1994	1.946	1.820	0.126	111.51	56.53	54.98
1995	2.240	2.111	0.129	19.70	84.94	52.06
1996	1.920	1.820	0.1	299.46	203.66	95.80

While examining this table one should bear in mind:

1. Volume /columns 6 and 7/ at current prices according to the National Statistical Institute has been reduced to December 31, 1996 prices.
2. Only companies whose revenues from construction exceed 70 per cent are considered building firms.

### Large companies. Potential for development

There is a forecast of consolidation among the construction firms, particularly of those acting as main contractors. Large-scale construction financed by major investors is expected in Bulgaria. While still slow in coming, it certainly will occur. Such investors will look for big companies with a proven record.

At this time there are 30 to 35 companies capable of handling construction work worth more than three million levs.

Starting from scratch in the building industry now is out of the question. Anyone having any money would be more likely to deposit it at 5 per cent interest rather than to set up a building company with all facilities using credit at a minimum rate of 15 per cent.

Studies show that building company facilities cannot be paid back within less than 12 years, i.e. they will sooner depreciate than pay off. Only companies which have already built such facilities or will be able to privatize them will survive.

### Main operations

Not a single company in the country has listed construction of new projects as its sole object of corporate activity in its incorporation filing. To the contrary, most companies (these are the smaller ones doing a lower volume of construction and hiring few, mostly temporary workers) have indicated repair and reconstruction of homes and residential buildings in their filings.

The building contractors classified by number of workers are as follows:

Staff	Per cent of all construction firms
over 1000	0.01
801 - 1000	0.04
601 - 800	0.05
501 - 600	0.05

401 - 500	0.09
301 - 400	0.19
201 - 300	2.11
101 - 200	1.02
81 - 100	3.67
61 - 80	8.10
51 - 60	6.94
41 - 50	12.63
31 - 40	8.30
21 - 30	11.09
11 - 20	19.64
up to 10	25.35

### **Distribution of long-term material assets by sectors**

The distribution of long-term material assets is as follows:

- public sector: 71 per cent
- private sector: 29 per cent.

The ratio does not correspond to the volume of construction carried out by the private and public sectors. The private sector uses mostly leased equipment and vehicles.

It should also be noted that these figures are no longer accurate since they do not reflect the privatization of GLAVBOLGARSTROY, the forthcoming privatization of TRANSSROY and the transformation of the military construction units into commercial companies.

### **Reliability of the construction companies**

For quite some time society has been preoccupied with the topic of building pyramid structures. No matter how harmful this phenomenon may be to the image of the industry, it certainly continues to exist. Of all building companies, no more than a hundred are engaged in fraud and are ruining the reputation of the industry. If one sets aside the small contractors who have been forced by circumstances to fail, there are no more than 30 pyramid structures, half of them in Sofia.

How and why did building pyramid schemes arise? The stage was set in 1990 and 1991. After permitting small-scale private retail businesses, the law opened the way for the emergence of the building contractor. A well-organized construction business can certainly be very profitable. For very many years there was a practice in the country for people to be required to deposit their money, sign a contract and wait for their homes to be completed. These were low quality homes, completed with long delays, yet they were one's only home. There was one detail that everyone overlooked in the general euphoria surrounding the long overdue liberalization, namely mostly the State Savings Bank, i.e. by a government bank, had previously done that financing. So something happened in Bulgaria, which did not occur anywhere else. Anyone who had come into some money by whatever means turned that money over to a building contractor to buy a real estate as protection against possible inflation. At least 90 per cent of the contractors were enterprising professionals with good intentions. They organized building firms, purchased or leased equipment, quickly drew almost identical architectural plans involving use of numerous terraces one on top of the other, got their projects approved as required by law and started building. No one asked them how they had gotten the start-up money because everyone knew that the money had come from the virtually interest-free crediting obtained by having

homebuyers pay in advance. No one can fault these contractors even now because formally they never broke a law. In fact, acting in good faith they issued deed on homes that never existed. There is something rather murky here. How come municipalities issued deeds for properties that existed only on paper? So far, prosecutors have preferred to keep quiet on this legal issue.

There is a variety of cases but most of what have popularly become known as the building pharos were honest in their intentions and actions but were, like their clients, cheated by the business environment. As has happened in numerous other spheres of the economy, the government failed to send a clear warning to the small-time depositors or, in this case investors, that they are not giving their money to the state for safekeeping and should hence keep their eyes wide open.

A rather general statistic shows that during the 1991 - 1996 period, i.e. for six years, construction started of at least 35,000 homes in Sofia and the current district centers. No less than 24,000 of those homes were pre-paid by their prospective owners. 12,900 homes were completed and are occupied. So there is a real threat that about 8000 families will be left emptyhanded even though each of them has paid tens of thousands of dollars and even though each of them holds a deed, though the prices indicated in those deeds are miniscule.

At least 90 per cent of the building pharos was acting in good faith. They account for about 60 per cent of the 8000 homes referred to above whose future fate is unknown. These entrepreneurs started work on one or at most on three buildings simultaneously. They sold in advance half of the homes, gave a quarter of the homes as compensation to the landowners and left the remaining homes as a provision, to be sold and the proceeds to be used to finish the construction projects. The money collected was deposited in private banks at high interest. Contractors were able to withdraw funds and pay for materials and equipment whenever necessary. Some of them also built summer homes for themselves or sent their children to colleges overseas. At a certain time, however, the money kept in Bulgarian levs quickly melted as a result of bank failures and rising inflation. The machinery and equipment suddenly became useless. Workers, who had never had any retirement or unemployment insurance, left the businesses. No one would buy homes that were not completed while already purchased homes could not be completed and the owners of the land on which construction was started never got any real compensation. It is a fact that 5,500 families are now waiting for their homes to be completed. You cannot fool all of the people all of the time, so very few people are now prepared to pay in advance. The contractors described above were no real pharos. They themselves were victims as much as their clients to the delusion that private business is a never ending party.

The banks in Bulgaria hardly ever approve credits to contractors. If any credit is ever provided at all it comes at 15 to 17 percent interest and impossibly high requirements for collateral. The only way out at this time is investor advancing. If this was not practiced no more than five or six companies would be able to operate as main contractors in Sofia.

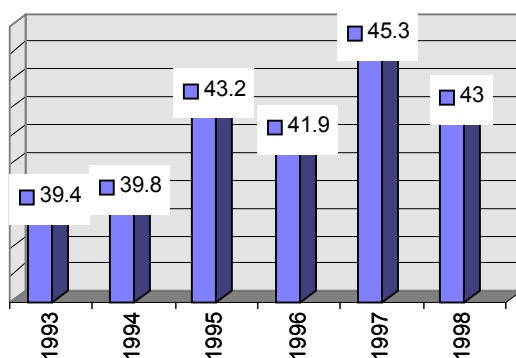
However, the laws and standards regulating the construction business are not outdated and cannot serve as an obstacle. It has in fact been found that these laws and standards are very close to their European equivalents. Some companies in Sofia are already operating using European standards. The rules for approving completed construction work in Bulgaria are in no way laxer than those used in Europe if properly applied.

**It can be concluded that in Bulgaria there are construction businesses, both reliable and offering good quality, which can operate successfully in an environment of healthy financing, observance of engineering standards and availability of viable independent technical supervision.**

## **Market of construction materials**

Data provided by the National Statistical Institute indicate that building materials account for an average of 42 per cent of all costs incurred by the construction companies in recent years.

**Costs for building materials as per cent of total costs of the construction companies by years**



There is a market for building materials which is consistent with the current rates of construction. An analysis of the largest exposition of building materials in recent years (Stroyko'2000) leads to the following conclusions:

- there is no deflation of prices and none can be expected. Most prices have held steady and there have been no price drops;
- demand has neither increased, nor dropped;
- the materials used in raw construction, with the exception of foam concrete, are of lower quality than those used in Europe;
- there is abundant supply of buildings materials in the market, both Bulgarian-made and more often imported;
- the availability of new types of materials will modernize construction repair works. Repairs and finishing works will become more expensive but will be done using higher quality materials, faster and with less pollution.

The Consumer Protection Act and the rules of the trade require of the producer to declare the technical parameters of his product and the technical standards to which it conforms. Similar obligations for producers and importers can also be found in the newly adopted Technical Requirements in Respect to Products Act.

Monitoring of compliance with these provisions, particularly of the safety of the use of building materials, will be enhanced by the employment of independent technical supervision both in the design and in the construction phases.

## Employment in the construction industry

The number of the workers employed in the building industry has dropped by more than 60 per in the last ten years but this does not appear to have had an impact on the labor market. To the contrary, skilled workers are in demand in almost all parts of the country. There is a shortage of skilled and conscientious workers. Foreign investors have even had to bring workers from other countries to perform simple tasks. At one time it was anticipated that the shrinking of the industry would rid it of unqualified or unskilled workers resulting in a radical improvement of the quality of construction. This has not materialized. Whatever skilled workers there were have either retired or changed trades. There is no unemployment of building specialists and there are two reasons for that:

- before 1990 many construction workers were kept in the business almost by force and these people were not builders either by tradition or by spirit;
- the demand for repair work is so great that despite everything that has happened in the economy and in society there has been a constant increase in both the value and number of repair jobs.

## Employment in the construction business in the public and private sector by years

YEAR	1993	1994	1995	1996	1997	1998
TOTAL	209,205	192,202	187,577	166,075	139,002	128,928
PUBLIC	138,278	110,437	93,929	81,308	59,513	45,637
PRIVATE	69,734	81,103	93,648	84,767	79,489	83,291

## People employed on labor contracts in the public and private sector by years

YEAR	1993	1994	1995	1996	1997	1998
TOTAL	n.a.	n.a.	n.a.	12,887	110,215	104,855
PUBLIC	120,053	107,429	91,215	80,591	58,702	59,218
PRIVATE	n.a.	n.a.	n.a.	48,296	51,513	45,637

## Movement of construction workers in the public and private sectors by year and percentage

Years	1997		1998	
	Public	Private	Public	Private
<i>Jobs cut because of liquidations</i>	5,213	3,382	5,745	3,333
<i>Hired</i>	15,035	24,185	43,253	29,999
<i>Percentage of jobs cut compared to new jobs</i>	34.67	13.98	13.28	11.11

If one is to compare the tables of the workforce employed in the construction industry, one can draw the following conclusions:

1. Even though there is no unemployment of skilled building workers, the number of people employed in the industry is shrinking daily. According to the National Statistical Institute, the industry has lost 195,000 jobs between 1990 and 1998.

2. The number of workers employed by private companies has dropped substantially because of the use of free-lance contracts or because of employment without contract.

3. Jobs have been reduced at a much lower rate compared to the drop in building orders indicating that despite rising unemployment productivity has not improved.

4. The ratio between jobs cut as a result of liquidation and newly created jobs is relatively higher in the public sector compared to the private sector.

There is indeed a recession in the building industry and it is not due to lack of the need for new construction. Even now there are quite a few building companies in Bulgaria, which emphasize on good organization and good quality. While there is a shortage of skilled workers there is no shortage of high quality machinery, equipment and materials for modern construction. It can be assumed that the crisis in the construction sector has persisted as a result of the absence of financing.

## Macroeconomic conditions

### Population

In the last five years the country population's decrease continued (as shown in Table 1).

### Population Data

by 31.12. of the respective year

<b>Year</b>	<b>Total</b>  thousands	<b>Active Population*</b>  % of total population	<b>Birth Rate</b>  per 1000 of the population	<b>Natural Increase</b>  per 1000 of the population
<b>1992</b>	8484.9	55.8	10.4	-2.2
<b>1993</b>	8459.8	56.0	10.0	-2.9
<b>1994</b>	8427.4	56.3	9.4	-3.8
<b>1995</b>	8384.7	56.6	8.6	-5.0
<b>1996</b>	8340.9	56.9	8.6	-5.4
<b>1997</b>	8283.2	57.3	7.7	-7.0



<b>1998</b>	8230.7	57.7	7.9	-6.4
<b>1999</b>	8190.9	58.1	8.8	-4.8

\* Male - 16-59 years, female - 16-54 years

Source: National Statistical Institute

The negative tendency towards total **decrease** affects not only the city but the village population as well. Compared to 1995, the city population decreased with 2% and the village population - with 3.1%. At the same time, the **city/village population ratio** remains almost unchanged during the last decade - in 1999 in the Bulgarian cities have lived 68.1% of the population. The **average age** of the population increases - from 37,5 in 1990 to 38,9 in 1995 and 39,2 in 1999. A positive sign is that in the last year the **birth rate** has increased slightly to 8.8 ‰.

Projections for the next years' birth rate and natural increase values can be made easily if we have in mind the two "baby booms" in Bulgaria - one after the World War I and then in the 70's. That is why the natural mortality rate is expected to remain high in the next years and the birth rate will go slightly up.

In 1999 the **unemployment rate** rose to 16.0 % as share of active population while the **monthly dollar wages** decreased to \$122.1 (see Table 2).

### Unemployment Rate and Wages

<b>Year</b>	<b>Unemployment Rate %, end of period</b>	<b>Monthly Dollar Wages*</b>	<b>Real Wages, 12-month**</b>
<b>1995</b>	11.1	127.4	43.1
<b>1996</b>	12.5	56.0	-29.8
<b>1997</b>	13.7	107.6	9.0
<b>1998</b>	12.2	127.8	10.8
<b>1999</b>	16.0	122.1	4.2

\* Average monthly wage in state enterprises and budget sector, end of period, excluding end-of-year bonuses

\*\* Percent change from same period of previous year

Source: National Statistical Institute

It is hard to make projections for the indicators in Table 2. The **unemployment rate** was in the last two years to a very big extent influenced by the structural reform in Bulgaria which included closure of loss-making state-owned enterprises, privatization of municipal and state-owned enterprises, etc. In many of the privatized enterprises the new owners dismissed many employees in order to keep the companies' competitiveness. We should have in mind also that in Bulgaria a big share of the economy is represented by the so called "gray economy". It employs many people without paying for them social and health security so these people are still officially unemployed. Unfortunately, the Bulgarian Statistical Institute does not measure the size of this informal sector and the very few attempts from different other institutions to do so were not very successful. The monthly Leva wages have increased and the **monthly dollar wages** - decreased in 1999. The decrease in USD was due to the

volatility of the exchange rate (because of the fixed exchange rate BGL/DEM every instability in the exchange rate DEM/USD reflects on the exchange rate BGL/USD).

### **Economical Data**

Bulgarian economic reforms started in February 1991. In 1996-1997, after seven years of delayed structural reforms, several failed attempts to implement a coherent stabilization policy and a chronic lack of financial discipline, Bulgaria experienced the most severe financial crisis since the start of reforms: a paralyzed banking system (one-third of the Bulgarian banking sector was closed), undermined credibility of key institutions, substantial depreciation of the Bulgarian currency and several months (December 1996 - February 1997) of record hyperinflation.

In 1996, real GDP contracted by 10.9%. Accumulated inflation for the year was 310%. The real interest rate on bank deposits was negative: minus 43% (even after the drastic increase in the base interest rate in late September, to 300% per year). The Bulgarian currency depreciated by 624% against the USD and foreign reserves fell below USD 440 million, the level needed for foreign debt servicing. By mid-1997 BGL deposits fell by 88% in real terms and their share of GDP fell from 41% (in 1995) to 13%, while foreign currency deposits fell by 40%. The central bank's monetary policy ceased to be at all effective. Domestic debt increased and the debt service to GDP ratio rose from 10.4% in 1995 to 17.3% in 1996. This was a logical end to an entire period of economic instability.

In the mid of 1997 the **currency board arrangement (CBA)** was introduced. According to the CBA the monetary base should not exceed the gross foreign reserves of the Central bank (Bulgarian National Bank). The exchange rate of the lev was fixed to the D-mark at a level of 1,000 BGL/DM, and from the beginning of 1999 the lev was fixed to Euro at 1,9558 BGL/Euro. The lev became automatically convertible into reserve currency. The monetary base (and thus currency issues) is fully covered by foreign reserves. Money supply is determined by money demand and is outside the BNB's control. This means that money supply became dependent on capital movements (inflows and outflows) and the balance of payments status. Thus money supply reflects the health of the financial sector. An independent monetary and fiscal policy was to be forgotten.

In mid-1999 the Bulgarian lev was re-denominated, with one new lev replacing 1,000 old ones.

Two years after the introduction of the currency board macroeconomic and financial stabilization are obvious. The annual rate of inflation (CPI) decreased sharply, from 578.6% in 1997 to 1% in 1998 and 6.2 % in 1999 (see Table 3).

**Annual Rate of Inflation, Exchange Rates BGL/USD and Basic Interest Rates**

<b>Year</b>	<b>Inflation CPI, %</b>	<b>Exchange Rate BGL/USD*</b>	<b>Basic Interest rate Annual, %</b>
<b>1995</b>	<b>32.9</b>	<b>0.071</b>	<b>38.5</b>
<b>1996</b>	<b>310.9</b>	<b>0.487</b>	<b>435.03</b>
<b>1997</b>	<b>578.6</b>	<b>1.777</b>	<b>6.95</b>
<b>1998</b>	<b>1.0</b>	<b>1.675</b>	<b>5.17</b>
<b>1999</b>	<b>6.2</b>	<b>1.947</b>	<b>4.8</b>
<b>2000**</b>	<b>3.5</b>	<b>n.a.</b>	<b>n.a.</b>

<b>2001**</b>	<b>3.5</b>	<b>n.a.</b>	<b>n.a.</b>
<b>2002 **</b>	<b>3.5</b>	<b>n.a.</b>	<b>n.a.</b>
<b>2003 **</b>	<b>3.1</b>	<b>n.a.</b>	<b>n.a.</b>
<b>2004 **</b>	<b>3.1</b>	<b>n.a.</b>	<b>n.a.</b>

\* Denominated Levs per USD

\*\* IMF Projections

Sources: National Statistical Institute, Bulgarian National Bank, IMF

**Interest rates** fell quickly after the introduction of the CBA, and remain quite low. The basic interest rate is formed on the basis of the return of the weekly auctions for 3-months state securities. As the investors prefer to buy state securities (and in Bulgaria there are no other securities to compete the government ones) the return falls and so does the basic interest rate. For the period 1998-1999 the lending and deposit rates were tied to the basic interest rate. Real lending and deposit rates were positive on average, consistent with the low or negative inflation rates. Bulgarian banks adopted extremely cautious lending policy. Banks' credit portfolios saw their most dramatic decrease over last few years, thus becoming one of the most serious impediments to economic growth in the country. The share of credit extended to the real sector in the total assets of the banking system dropped from 35.4% in mid-1997 to 28.3% in May of 1999. Conforming to banks' limited credit activities, the marginal interest spread remained high- around 10 %.

**Foreign reserves** increased significantly (to DEM 5.2 billion in June 1999) which is prerequisite for a stable money market.

A 3-year agreement with the International Monetary Fund was signed and was expected to bring \$840 million in support of the balance of payments deficit. The same amount is expected to come from other international financial institutions.

After 1989, **real GDP** registered growth in four years (1994, 1995, 1998 and 1999). Since 1989, real GDP has lost more than one-third of its initial volume. In 1998 GDP showed some signs of recovery and 3.5% growth (the highest in the transition period) was registered, after a 6.8% decline in 1997(see table below). The Kosovo crisis, acceleration of structural reform and following public sector downsizing, considerable worsening of export performance as a result of slackening demand in EU and market shares losses in Russia, and further weakening of the performance of state-owned enterprises, contributed to the negative GDP growth rate (-0.7 % year-on-year) during the first quarter of 1999. For the first half of 1999 the real GDP growth rate was 0.5 %. For the entire 1999 the nominal GDP growth was 2.4 % (the initial government expectations were for 3.7 % growth) and is estimated to be 4 % in year 2000. Due to the depreciation of the national currency, the GDP (when denominated in USD) shows negative growth.

### Gross Domestic Product

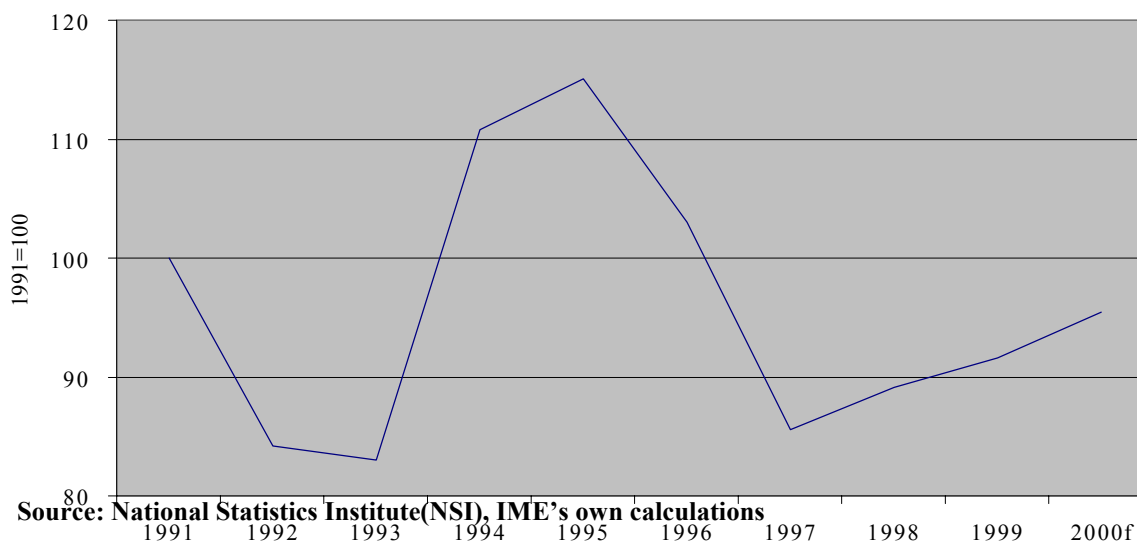
<b>Year</b>	<b>Nominal GDP (Mln USD)</b>	<b>GDP per capita USD</b>	<b>GDP Deflator Percent Change</b>
<b>1995</b>	13,106	1,563	64.1
<b>1996</b>	9,946	1,192	122.9
<b>1997</b>	10,173	1,228	948.7
<b>1998</b>	12,257	1,489	22.2
<b>1999</b>	11,698	1,510	1.8
<b>2000*</b>	12,924	1670	6.5
<b>2001*</b>	14,191	n.a.	3.7
<b>2002*</b>	15,695	n.a.	3.6

<b>2003*</b>	17,239	n.a.	3.2
<b>2004*</b>	19,012	n.a.	3.2

\*IMF projections

Source: National Statistical Institute

Real GDP per Capita Index (1991=100)



Source: National Statistics Institute (NSI), IME's own calculations

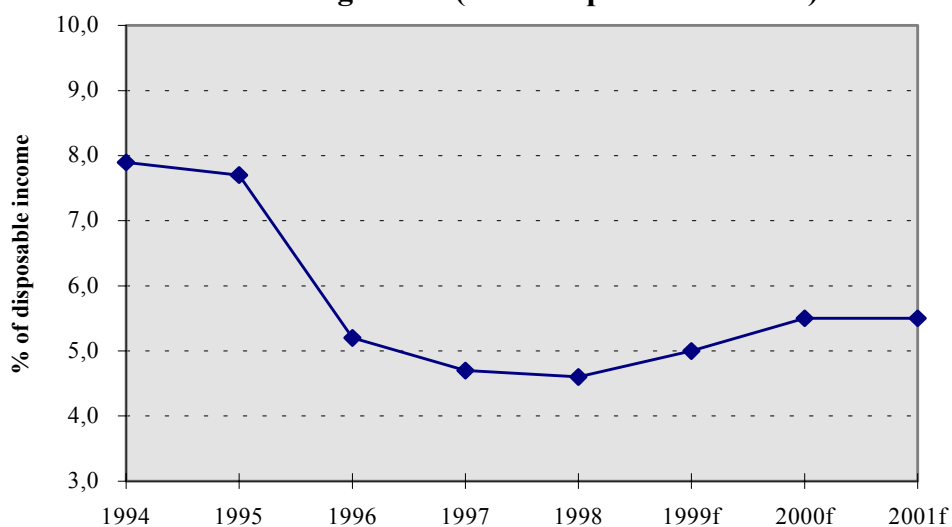
At the beginning of the transition period **GDP per capita** (in current year USD) showed an even more dramatic drop than real GDP, from US \$2,513 in 1989 to US \$946 in 1991. It should be noted, however, that until 1991 the exchange rate used for official statistics did not catch up with the market rate. In 1998 GDP per capita was US \$1,484 and in 1999 - \$1,510.

In 1993 the **population's deposits** grew by BGL 25.5 billion<sup>5</sup>, and by about BGL 18 billion in 1994. But throughout the entire 1991-1996 period, the interest rates on deposits were lower than the CPI. This has gradually undermined the purchasing power of savings, and depositors have suffered losses. The limited choice of financial instruments also discouraged savings.

1996 was crucial regarding domestic savings trends (see Table 5). The record negative interest rate on bank deposits (minus 43%) and sharp depreciation of Bulgarian currency<sup>6</sup>, combined with loss of confidence in the banking system and the domestic currency on the part of the general public and business, contributed to the process of converting savings into hard currency and keeping as much as possible in cash. It is estimated that deposit withdrawals from the banking system during the financial crisis in 1996-1997 totaled USD830 million. By mid-1997 BGL deposits fell by 88% in real terms and their share of GDP fell from 41% (in 1995) to 13%, while foreign currency deposits fell by 40%.<sup>7</sup>

Throughout the period 1992-1996, the ratio of savings to GDP was very low — 11% on average, compared with more than 30% in faster-growing economies.

### Savings ratio (% of disposable income)



In 1997, the population had BGL 1.452 billion in savings, no more than 8.5% of GDP. Since 1998, the BGL deposits of the population have been relatively stable. Moreover, they have shown a slight trend of increasing, due to low and even negative inflation, making the real interest rate a bit higher. The population's hard-currency deposits did not change significantly, either. This can be explained mainly by the stable domestic currency and the fact that the interest rate differential between BGL and DEM (USD) has stayed unchanged. In general, the weak inclination to save is a consequence of low interest rates, restrictive income policy and lack of sufficient confidence in banks.

### National savings trends (in % of GDP)

% of GDP	1995	1996	1997	1998	1999	2000 proj.	2001 proj.	2002 proj.	2003 proj.	2004 proj.
<b>Gross national saving</b>	15,1	8,6	15,8	14,2	11,2	14	14,6	15,7	16,2	16,2
<b>Foreign saving*</b>	-1.7	- 2.6	- 5.6	0.6	6.0	4.9	3.8	3.2	2.9	2.9
<b>Gross domestic saving**</b>	17,4	11	17	14,2	10,4	13	13,9	14,8	15,3	15,3

\* Foreign saving is equal to net imports of goods and nonfactor services.

\*\* Gross domestic saving comprise of government and non-government saving and reflects gross national saving less transfers from abroad and net factor income.

Source: BNB, IMF projections

### Gross Fixed Capital Formation (in % of GDP)

Year	Gross Fixed Capital Formation (in % of GDP)
1995	15.6

<b>1996</b>	8.4
<b>1997</b>	10.8
<b>1998</b>	11.6
<b>1999</b>	15.9

Source: BNB

Regarding contribution of the **private sector** to GDP, the private sector between 1992 and 1998 basically tripled. It was constantly growing and constantly replacing the government share in GDP. One of the main factors, contributing to the change in the ownership structure of gross value added (GVA) are privatization and liquidation of loss-making state-owned companies. The share of the private sector reached 63.7%, starting from almost zero in 1989. For the first half of 1999 private sector's share in GVA was 54 %. The private sector produces 75% more than the government-owned enterprises, while employing only 40% more. The predominant number (or 93 %) of all private companies are micro (with less than 9 workers). They account for 91.2 % of all (private and public) enterprises. Nevertheless that the group takes the biggest share of economy in terms of number of enterprises, these enterprises are not well capitalized and their total assets are only 18.8 % of total assets of the private sector. Most private companies are engaged in trade (60.4%), industry (12.25%) and services (8.86%). The fixed capital of small private firms is mainly financed from personal and family sources. Personal savings, family property or inheritance, assistance from acquaintances (or, presumably, non-institutionalized — informal — start-up credit) is the most often-used means of support for starting businesses.

At the same time, large **state-owned enterprises' performance** is on the decline. In 1998, a year with real GDP growth of 3.5%, sectors in which state companies dominated suffered severe declines in sales and profits. Sales in the oil-refining and chemical (basically fertilizer plants) industries shrank by some 27-28% in 1998 compared to 1997, those in the steel industry by about 10%, etc. Large state enterprises continued to accumulate bad loans.

In 1990, immediately after the beginning of the transition, the Bulgarian public sector was heavily indebted, as the **foreign debt** totaled over US \$10 billion. Then a moratorium on official foreign debt servicing was imposed, which lasted until 1994. The official foreign debt fell significantly after 1993, from US \$12.3 billion at the end of 1993 to US \$8.7 billion in mid-1999. This is virtually a 45-percentage-point decrease in foreign governmental debt as a percentage of GDP. The volume of the domestic public debt also decreased, from roughly US \$4 billion in 1993 to US \$1.7 billion in 1999.

Bulgaria is one of the most **open** transition economies. The level of openness of the economy was 48.8 % in 1996 and 36.5 % in 1998.

In 1998, Bulgaria signed Article VIII of the IMF Status of **Current Account Convertibility**. The existing restrictions on capital transfers were eliminated by that year. A currency is regarded as fully convertible when any holder is free to convert it at market exchange rate into one of the major international reserve currencies.

The new Currency Law was adopted in September of 1999 and entered into force in January 2000. It is a step to further capital liberalization. According to the law, residents and non-residents have the right to freely export up to BGL 20,000 (US \$10,000). Foreigners can export currency in amounts above this limit without permission from the Finance Ministry, after filling out a customs form. The permission of the BNB is still required for domestic citizens and foreigners for amounts above US \$10,000. Bulgarian citizens have the right to open bank accounts abroad. The law permits local residents to borrow or place funds abroad, and non-residents to have access to the Bulgarian capital market.

Since the bankruptcy of approximately one-third of the banking system in 1996-97, the **banking sector** is lately composed of 35 banks (including the branches of foreign banks), most of them small and private. Two of the largest Bulgarian banks are still state-owned and are crucial to the banking system's stability and overall performance. One of them, Bulbank, holds up to 30 % of total banking system assets. It will be privatized within several months. The other one - DSK BANK - which holds about 90% of the housing financing market, will remain state-owned until next year. The scale of the banking sector is low: the total assets of the banking sector in Bulgaria, which equaled about 43.4% of GDP in 1997, dropped to 34.9% of GDP in 1998.

The presence of foreign banks is modest in comparison with that in other transition countries. There is a lack of typical investment banks and mortgage banks operating in Bulgaria.

The **capital market** is still weak, and does not play a significant role in the allocation of free capital. The poor performance of the capital market is due mainly to the limited supply of state and privatized enterprise equities, lack of enough institutional investors, not properly protected minority shareholders' interests, unstable rules of trade on the capital market, insufficient number of the listed companies and high fees of the State Securities and Exchange Commission. Additionally, the tax system does not stimulate deals on the stock market. According to Corporate Income Tax Law, a 15% final withholding tax is imposed on dividends, all capital gains are considered to be taxable income and general taxes are levied. The intentions of the government (discussed lately) are to change the tax system in order to support the trade with securities.

---

<sup>1</sup> Following the order of the Special Pledges Law

<sup>2</sup> DSK Bank could not provide data on what is the share of the mortgage corporate loans for working capital in the overall corporate loans of that type.

<sup>3</sup> These percentages depend on the type of the property used to guarantee the loan.

<sup>4</sup> Loans extended by BACB are only mortgage loans

<sup>5</sup> In old levs.

<sup>6</sup> BGL depreciated by 624% against the USD.

<sup>7</sup> Yotzov, Victor, Nenovsky, Nikolay, Hristov, Kalin, Petrova, Iva and Petrov, Boris, "The First Year of the Currency Board in Bulgaria," Bulgarian National Bank, 1998, p. 18.