Bulgaria: Liquidate KTB, Now

By Steve H. Hanke
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The long-awaited audit of the Corporate Commercial Bank's (KTB's) assets has been released by the Bulgarian National Bank (BNB). In its wake, a debate has arisen about the future of the KTB: Should it be recapitalized? And if KTB is recapitalized, should the Bulgarian or the European authorities be responsible? However, it is clear from the results of the audit that, once the obscurity of the technocratic arguments is stripped away, there can be no debate. KTB should be liquidated as soon as possible, and whatever proceeds can be obtained in liquidation should be used to reimburse guarantees to depositors paid from the Bulgarian Deposit Insurance Fund (BDIF).

KTB should be liquidated because it is not, and apparently never has been, a commercial bank. Had KTB been operated according to commercial banking principles, it would be virtually impossible for KTB to destroy value on the scale witnessed by the independent auditors. As of September 30, 2014, the auditors estimate that 76% of the asset value in KTB's non-financial loan portfolio, which accounts for 80% of KTB's assets, has been lost.

Losing 76% on a commercial loan portfolio must be put into perspective. In making loans, commercial banks generally require a senior secured position. This means that in the event of default, the bank may take collateral from the borrower and use the proceeds from selling the collateral to recover the bank's principal, prior to any other creditor. From 2003 to 2012, Standard and Poor's found that European lenders recovered 78% of their principal, on average, from defaulted loans with these characteristics. Even where defaulted loans were not secured by collateral, European lenders averaged a 48% recovery rate. Compare these recovery rates to KTB's pathetic implied recovery rate of 24%, and it becomes clear that KTB was not operating as a real bank.

The KTB audit report tells a story in which KTB blatantly ignored the basic pillars of commercial lending. According to the report, there is little evidence that initial loan underwriting and subsequent credit monitoring ever took place at KTB.

If KTB's management were just grossly incompetent, it would be bad enough. But it appears they were also criminals. The BNB is forwarding the audit results to the Sofia City Prosecutor's Office. The auditors state that KTB lied to and misled BNB banking supervisors, and engaged in transactions with no evident commercial purpose. The suspicion of criminal activity is just another reason why KTB should be liquidated, now.

It is important to stress that there is no macroeconomic or "macro-prudential" reason to continue operating KTB. Because KTB never functioned economically as an intermediary for savings, liquidation of the bank will not prevent otherwise-qualified corporate borrowers from obtaining credit. Nor will KTB's disappearance send shock waves through the financial system, as its net position vis-à-vis the rest of the Bulgarian banking sector appears to be relatively small.

The authorities' primary focus now should be paying KTB's guaranteed depositors out of the BDIF and recovering those costs, to the extent possible, by seizing KTB's assets and winding down its operations.

If KTB were operating in the United States, there would be additional legal paths to pursue for recovery. Payments made by the bank in the period immediately preceding its insolvency could be recovered, and the directors and officers of the bank could be held personally liable for negligence. The authorities would be well-advised to make use of any corresponding legal remedies available to them under Bulgarian bankruptcy and corporate governance laws. These paths may be the best way to achieve recoveries in excess of those possible on the basis of KTB's pitifully inadequate assets.

Finally, the KTB episode should not be used as an excuse to tinker with the one transparent and faithfully functioning institution Bulgaria has: its currency board.

The best Bulgaria can do is to liquidate KTB, now.

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