

*Chapter IX*

**CORRUPTION IN THE FINANCIAL SECTOR**

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**1. CORRUPTION IN THE FINANCIAL SECTOR BEFORE THE CURRENCY BOARD**

In economic theory, corruption is related with studying the so-called rent seeking behaviour. It is exactly when behaviour is in this way inclined that corruption exists. The term rent is a shorter name for economic rent and it means something else extra (above the usual for using the best alternative), payable to someone for something, the purchase of which is limited due to its natural character or human ingenuity.

**1.1. Corruption determinants**

The economic analysis of the corruption determinants is based on the principal-agent theory. “Principal” is every person who formally exercises property rights or suchlike, which enable him to control access to a certain resource. “Agent” is a person or a group of persons entrusted with execution of specific functions relating to disposal of this property or resource. As an example, the electorate can be treated as a principal that elects politicians to be agents.

Basically, there are three fields of institutional structure, which control the appearance of corruption:

- The possibility of monopolistic power wielded by officials;
- The degree of discretion that officials are permitted to exercise;
- The degree to which there are systems of accountability and transparency in an institution.

The availability of monopoly over certain activity on the part of a public institution is a key prerequisite for emergence of corruption without theft. Apart from the monopoly, a particular official will be in a still more favourable position for taking a bribe, for instance, in case he is delegated with the right to assess distribution of a certain benefit.

The problems, which the principal faces due to asymmetry of information impede the efficient accounting and reporting of the activities, accomplished by the agents. The degree of settlement depends on the way the institution is set up.

**1.2. National peculiarities**

The peculiarities of institutional organisation in individual countries play a basic role in both the causes of different forms of corruption and the limitation of possibilities for its spread. In most states the political structure is a key element in the evolution of corruption. The latter does not only depend exclusively on the degree of political centralisation and the extent of accountability, but also on the channels through which political control is exercised or particular institutions are

influenced. Where institutions do not function under the conditions ensuring high degree of control over governmental officials, so that if they tolerate or participate in graft their dismissal ensues, corruption flourishes.

There are four elements of paramount importance, which are herewith discussed in detail. Three of them relate to the structure of society.

- The relationship of the government with the civil service;
- The relationship of the government with the judicial structures;
- The relationship of the government with the civil society.

The fourth element treats the development strategy worked out by the government.

#### *1.2.1. The government-civil service relationship*

This is the established relationship among the political leaders and the officials in the state administration structures. As to the administration officials, the reward structure is traditionally one of the basic determinants of corruption. If senior officials are paid competitively in comparison with the private sector and the reward is associated with achievement of certain results in their work, the potential profit resulting from corruption is rather low to compensate for the high risk. If, however, the remuneration is considerably under the level received in the private sector, then possibilities for corruption are the decisive incentive for taking a public post. As to the officials of lower administrative ranks, if the absolute amount of remuneration does not outstrip the amount necessary for their families to elude poverty, the incentive for corruption will be still greater. This problem is even more salient in the countries where stabilisation programmes are carried out. Usually the governments prefer to reduce wages instead of cutting down the number of employees in the public sector. Unfortunately the government in Bulgaria follows this approach.

The economic theory of corruption states that from an individual point of view each person will try to evaluate the net profit from a certain action, comparing the gross income from bribes, and the future profit from the establishment of long-term relationship, including potential expenses from the risk. This comparison has a different order depending on the nature of activity. For instance, for an incidental bribe on a high level, it is most probable that the required amount conceals the obvious value of the economic expenses, making them appear lower. Unlike this situation, corruption is possible on large scale at lower bureaucratic levels where the reward structure and the system of incentives are of great importance as well as opportunities for additional employment on a part time basis in the non-official sector.

#### *1.2.2. The government-judiciary system relationship*

The judiciary system is of great importance for limitation of corruption at each level as it observes the activities of the state officials and politicians in terms of their conformity with the law, as well as making them responsible for any illegal actions. There are three prerequisites for implementation of this role:

- The degree of division of powers;
- The effect of the whole system for observation of the law and security;

- Mutual assistance and joint actions of the security and justice authorities.

Obviously, the political system under which politicians exercise strong control over the judicial system is a prerequisite for the emergence of corruption without adequate punishment. In Bulgaria the judicial system is formally independent from the political one, but the practice shows that the latter has channels, however indirect, for exerting pressure. For the nature of corruption the effect of the application of the law is of great significance. When control over the judicial system on the part of the politicians in the background of the effective application of laws is at hand, the probability of centralised corruption is greatest and the possibilities at a lower level are limited. In case the law is not applied properly and the security system does not function well then decentralised corruption develops rapidly. Furthermore, the prosecutors and the police are a major factor so far as they can engage in corruption. Following the degree of their engagement in such actions they will tolerate the spread of corruption on a large scale. The contrary has not been observed in any society.

### *1.2.3. The government-civil society relationship*

To understand the importance of this channel for the limitation of corruption, the role of non-governmental organisations and media should be investigated. Unfortunately, until 1997 the non-governmental organisations did not actively take part in limiting corruption. Moreover, such organisations were obviously established to actively execute pro-government functions and subsequently receive income for this purpose. Mass media like radio and television were under strong political control. Certain elements of the press were captive to interests of the owners, who were in direct contact with the ruling authorities. In this connection the influence of the press was limited to several newspapers, without mass circulation at that. Thus the channels of the civil society did not succeed in realising its restraining role against graft.

### *1.2.4. Governmental strategy for development*

The economic environment is an important factor for the development of corruption through the adopted development strategy and the instruments of its accomplishment. The general theory states that the more liberal economic system based on market-oriented behaviour and insignificant role of the state creates the least prerequisites for corruption in comparison with the economies using centralised distribution of resources with domination of the state. Under otherwise equal conditions, greater control by bureaucrats over the economy creates problems for effective observation and control.

The state in Bulgaria has traditionally had a dominating role. It's not only a historical fact but also a public inclination, which unfortunately makes it hard to eradicate in a short period of time. The more rapidly the state withdraws from a number of sectors, the financial one included, the faster the prerequisites for corruption will disappear. This results in the importance of the privatisation and liberalisation processes.

## **1.3. The banking system**

One of the most important features of the bank sector is the high degree of regulation. The interference of the state is undoubtedly necessary to guarantee stability of the monetary system, competition, and certainly not least, protection of the users of bank services. The problems arise in the way these intentions are implemented. Usually they are achieved through a licence regime, restrictions on the distribution of share capital, geographic limitations of bank operations, and restrictions on risk-taking.

The situation in Bulgaria in terms of regulation of the banking system before the introduction of the currency board shows the existence of *serious negative elements*: the monopoly of the Bulgarian National Bank in certain operations (see below), considerable discretion of the Managing Board (MB) of the BNB and the low level of monitoring and control.

*1.3.1. The monopoly of the National Bank*

BNB was given monopoly rights regarding:

- Issue and suspension of licences for trade banks, finance houses, exchange bureaus and brokers;
- Emission of reserves and refinancing grants;
- Control of information on the state of banks and other financial intermediaries, on government securities possessed by the banks, etc.;
- Imposing supervision over financial intermediaries;
- Opening procedures for bankruptcy of a trade bank;
- Calculation of monetary aggregates;
- Adoption of by-law regulations for control, including the rules for forming the rate of exchange, techniques for calculation of reserve requirements, minimum prices for securities issued as per ZUNK, liquidity, capital adequacy, provision forming, refinancing against securities.

Together with the Ministry of Finance, the BNB grants permits for currency remittance abroad.

Consequently, a conclusion can be made that the Bulgarian National Bank was given monopoly rights, the scope of which is considerably larger than is theoretically necessary. For instance the monopoly over the information about the condition of the banking system. It was an open secret in financial circles that certain banks had liquidity and capital gaps, but no information whatsoever could be received, as the central bank maintained a stone-faced silence. The centralisation of a great amount of information about the condition of the banking system, and the low degree of publicity during decision-making creates the possibility for its non-regulated announcement, and thus, corruption.

*1.3.2. Discretion of the Managing Board (MB) of the BNB in decision-making process:*

An important element of the existing system was the great power of the Managing Board (MB) of the BNB in decision-making about:

- Licensing of a new bank or non-banking institution. The MB could reject licences even when the applicant had met all legal requirements. For instance, article 14, para. 1, item 2 of the abolished law on banks and the credit system gave the BNB the right to reject a licence in case the activity which the applicant intended to perform did not meet the needs or interests of the Bulgarian economy.
- Permission required for shareholders to gain ownership over 5% or more of the capital;
- Refinancing grants; The MB could reject refinancing without explanation.

- Formulating regulations for fixing the central rate of exchange and intervention the currency market;
- Appointing and keeping a list of managers of the trade banks declared bankrupt.

Hence, the Managing Board had unlimited rights in granting permission for a certain action, for instance, issuing of a licence.

The incompleteness and vagueness of the by-law regulations, which control the liquidity and accounting of the trade banks created prerequisites for interpreting decisions merely on the basis of precedents.

### *1.3.3. Monitoring and accounting*

As per the law, the central bank is accountable to the National Assembly, although the actions in this respect also are confined to submission of an annual report, which has a rather formal role. Furthermore, it was inspected by independent auditors applying international accounting standards starting in 1996.

In the sector of trade banks, the necessary consolidation of the state property was carried out exceptionally slow, and this property was subdivided into 69 banks in 1990. The consolidation process was completed only in 1995 with the establishment of the megabank, Biochim. This circumstance rendered difficulties for the principal, the Bank Consolidation Company (BCC), in exercising effective monitoring over the large number of state banks. The internal control in the banks considerably weakened and the annual accounting reports were approved by expert-accountants only formally in most cases, while the reservations and rejections expressed on their part seldom received publicity. Audits using international standards started only after 1994. "Rescue" and "recovery" programmes were constantly carried out, each of them including the undertaking of debts on the part of the state or emissions of reserve money by the BNB. This created an exceptionally harmful inclination for financial agents to undertake risky operations due to the possibilities to shift the losses.

Because of the lack of clearly defined criteria for selecting bank-agents for cash execution of the state budget, as well as the impossibility for managers of state enterprises to choose on their own the banks to serve them, the means were often directed to the banks paying higher bribes. The adoption of the law for protection of deposits in bankrupt banks resulted in inequality among the creditors, while the state guaranteed 100% of the deposits of the citizens and 50% for those belonging to firms.

At present, after the crisis, the banking system is highly concentrated. About 70% of the assets are centralised in seven banks, which is not itself a drawback but combined with the predominant state ownership, it creates prerequisites for political influence over the banking system and increases the possibility of corruption. Political influence over banks is exerted through the BCC. It was especially strong in the period 1995-1996 when certain figures close to the governing majority were appointed to the supervisory boards of several banks, one of which went bankrupt while the other underwent a rescue programme.

## **1.4. Non-banking financial institutions**

The majority of the non-banking intermediaries arose spontaneously. The release of free enterprise in the country gave rise to exchange bureaus, finance houses, insurance companies,

stock exchanges and emitters of capital and debt instruments, which used the public method of investment. Until 1995, the exchange bureaus and finance houses excluded, the financial non-banking institutions were not subject to any regulations with the exception of the Commercial Act. Thus, in this part of the financial sector the state doesn't exercise any effective control.

There is no doubt that in the sector of the non-banking financial intermediaries there was far more negligence in the normative regulations. They can hardly be listed comprehensively, but the common denominator is that those adopted had no preventive character but rather filled in the gaps, which were already taken advantage of.

#### *1.4.1. Pyramid schemes*

The high incomes, which were promised, and in some cases guaranteed at the beginning in the form of interest rates, dividends or reverse purchasing, directed considerable financial resources to this spontaneous financial product. To this was added the low financial knowledge of a certain part of the population as well as the inclination to undertake risk in the other one. The profit from ordinary investments couldn't cover the engagements already undertaken and these companies started going bankrupt in avalanche fashion. Frequently, the owners or managers disappeared abroad, and a considerable part of the accumulated resources mysteriously preceded them.

#### *1.4.2. Insurance companies*

The lack of supervision in the insurance industry resulted in the legitimating of all big security firms as insurance companies. These very firms were previously deprived of licences for security services because of doubts about the legality of the income acquired from this activity. This enabled them to continue their strong-arm tactics and accumulate considerable resources.

#### *1.4.3. Financial houses*

These financial intermediaries have no real analogue in the foreign practice. While in some countries this is an intermediary dealing with consumer credit, in Bulgaria the licence for a financial house allows all bank transactions excluding accumulation of deposits and giving loans. For all that the required capital was far smaller than that necessary for a bank license. In this way an exceptionally wide perimeter for undertaking risks was created for the finance houses without adequate requirements for the amount of their own means. Thus they had advantages over banks, being subject to a considerably looser supervisory regime. Moreover, these intermediaries participated in the currency and monetary market alongside the banks, thus contributing to growing of the common risk in the financial system.

## **2. FORMS OF CORRUPTION IN THE FINANCIAL SECTOR**

Practice proves that in the period before the introduction of the Currency Board, the main scope of the financial sector corruption took place in the banking system.

### **2.1. Banking system**

Due to the considerable resources available in financial institutions, the scope and variety of corrupt acts are greatest in this sector. Without claiming full comprehension, we shall try to outline the major channels.

*2.1.1. Loans to connected persons*

This is a quite popular form of non-market usage of resources. It involves lower interest rates, denomination in an appropriate currency (most often Bulgarian leva, as it devalued rapidly), prolonged terms, lenient control on loan acquisition, etc. Furthermore, BNB regulations on internal and large loans could be easily avoided by having a front company as the borrower, which would keep some of the money and pass some back to the bank, thus making loans quasi internal. There was another popular form by exchanging guarantees for loans.

*2.1.2. Refinancing from the National Bank*

In the beginning of the 1990s, big state and private banks were selected for refinancing, in order to fund a certain sector or a particular company. As credit portfolios were increasingly under pressure, banks were in permanent liquidity crises. In compliance with the principle “too big to fail”, the BNB began recurrent refinancing. This form of usage of resources relied, to a large extent, on the political protection over the bank-borrower and/or the individual preferences of decision-makers. Refinancing was a logical part of the sequence where most credits became uncollectable, as well as a popular form for transferring losses to society by increasing inflation.

*2.1.3. Selective intervention by the BNB on the currency market*

When the BNB intervened on the currency market and affected it in a fundamental way, the currency receiver had the opportunity to resell on an extremely large spread, which guaranteed high profit. In this way, BNB’s inclinations toward certain agents usually meant realisation of solid profits for these agents.

*2.1.4. Non-market accumulation of budget and state enterprise funds*

Considerable flows of budget funds were transferred to banks of questionable stability in order to meet permanent liquidity needs, most of which after the banking crisis remained blocked.

*2.1.5. Transfer of quality assets to smaller financial institutions*

This type of transaction occurs when the donor bank is about to go under. These swap operations are deliberately performed in order to decrease the future amounts available for insolvency procedures.

*2.1.6. Selective release of information*

Possessing inside information concerning an agent or a parameter under the authority of the Managing Board of the BNB created advantages that could easily be realised.

*2.1.7. Transferring obligations of borrowers to debtors of unknown origin*

This practice started shortly before banks were put under receivership, and continued afterwards. It was aimed at avoiding compulsory collection of payments, though the amount of insolvency was decreased, which affected the interests of creditors.

*2.1.8. Mutual reduction of obligations between creditors and debtors of banks under receivership*

After announcing the banks were under receivership, because of the peculiarities of law, an extensive process started which involved deduction of obligations to banks for extended loans against deposits or current accounts of companies. This created conditions for violating confidentiality, in order to conciliate certain creditors and debtors of the bank.

**2.2 Non-banking financial intermediaries**

Within the non-banking financial sector there were two main groups, as follows:

- Insurance companies with joint state and private ownership -- a traditional practice for transferring huge financial resources from state owned companies, which possessed assets that are at low risk. This created favourable conditions for the insurer to make considerable profits.
- Intermediary financial operations with intermediate participants like financial brokerage houses, which collect a great share of the positive result. Until 1996, most banks were practically surrounded by one or several financial brokerage houses, which performed purely parasitic functions.

**3. CONSEQUENCES OF CORRUPTION IN THE FINANCIAL SECTOR**

**3.1. Public sector**

The general economic consequences of public sector corruption are:

- Slowing-down economic growth, as a result of decreased private investment,
- Deformations in the structure of government expenditures -- the share of expenditures for investments in public projects increases at the expense of those for health care and education,
- Insufficient distribution of the talents of society,
- Decreased efficiency from foreign aid, losses in tax collection and interference with income to the state budget,
- Plunge in quality of public services in general.

**3.2. Financial sector**

There are a lot of new issues in the financial sector apart from the already mentioned consequences of corruption.

*3.2.1. Efficiency of savings' distribution*

Corruption in the financial sector leads to inefficient distribution of savings. Bribery is used to get a loan, for instance, due to the obvious incapacity of the proposed credit project to meet criteria on standard basis, or due to the obvious unwillingness for such a loan to be extended at all. In both cases there is inefficiency, as first of all a smaller share is invested in the project in question, if ever that occurs. The example illustrates how resources are invested in unworthy projects, and how expenditures are increased for the transaction.



Bulgarian experience gives the impression that most resources are accumulated through theft. This has been the worst consequence of corruption, as savings have been used for expensive limousines, offices and other luxuries. In this way, the low amount of investment, being such in the first place, has been constantly diminished. In its urge to support banks “in difficult situations”, BNB regularly issued reserves, which generated inflation.

### *3.2.2. The problem of available resources*

The decrease in the available resources in the sector is an immediate consequence of turning a great number of loans into bad ones, as well as decreasing the total resources available in the country. Therefore, borrowers are supposed to compete for smaller amounts of resources, at higher interest rates, and in turn incur a higher possibility of difficulties in repayment. All other conditions being equal, low-return sectors are injured the most.

### *3.2.3. Chronic generation of losses*

The pressure on bank credit portfolios, caused by the obvious theft of resources, brings about a total de-capitalisation. In the cases of the more affected banks, the amount of income generated was not sufficient to back the necessary provisions, which caused their inevitable bankruptcy.

### *3.2.4. Banking system instability*

Due to the periodic incapacity of banks to make payments within the specified time, the settlement system was constantly anticipating payments, which disordered the liquidity of the comparatively more stable banks. These banks were confronted with the prospect of experiencing liquidity strains too. Liquidity crises cause distrust in banks as protectors of savings, and might easily provoke attacks on behalf of depositors. As a result of the general increase in risk, the stability of the banking system was endangered.

### *3.2.5. The national debt problem*

Due to the systemic instability of the financial sector, the government started interventions through different types of “rescue programmes”. All of them involve procurement of obligations, which increase the national debt, and thus contribute to tax hikes.

### *3.2.6. Macroeconomic instability*

Besides instability in the financial sector, corruption may cause a complete macro-economic destabilisation. It occurs when the economic agents are concerned about general economic climate developments in the future, when the mobile foreign portfolio investments are withdrawn, which would automatically cause dislocation of the settlement balance, and consequentially to a devaluation of the national currency.

## **4. MEASURES AGAINST CORRUPTION IN THE FINANCIAL SECTOR**

As a formula, the system of corruption could be expressed in the following way:  $C = M + D - A$ . Corruption is equal to Monopoly plus Discretion minus Accountability. All measures against

corruption should be directed to disrupting this status quo, where officials in power benefit along with certain private companies, while society itself suffer.

#### **4.1. Specific measures**

Practice shows that it is expedient to concentrate on certain fields where measures are expected to have immediate effect.

- Deregulation of financial markets is very important for the effective functioning of intermediaries. Most important is simplifying the operational rules and abolishing unnecessary restrictions, which provide fertile ground for corruption. However, reducing financial sector administration is not a sufficient condition for controlling corruption. The transformation from state-owned to private does not alter inclinations for rent-seeking behaviour. With relation to this, how the financial deregulation is conducted appears to be of great importance.
- Limiting the administrative influence over law and the discretion factor in decision-making will certainly impede the practice of bribery. In legal theory, the essence of such an act is expressed by the term “bounded competence”.
- Privatisation of the financial sector is a means to interrupt the political control over the population’s savings, a lucrative target of corruption.
- Introducing more rigid requirements for the internal control of financial institutions, as it is the first impediment, which the various forms of corruption and non-market approaches encounter.
- Enforcing more sanctions against graft, which will increase the alternative expenditures in rent-seeking behaviour, as well as the amount of the bribes on offer, but if it is combined with the measures mentioned above, it may have a preventive effect. Penalties should be severe not only for those who offer bribes, but also for those who accept them.
- Improving the efficiency of the court system regarding implementation of the legislation.
- Introducing transparency in records. In this respect, steps for introducing an open system for the information provided by trade banks in compliance with the regulations seems to be of great importance. The practice reveals that transparency, at the moment a problem occurs, has quite a disciplinary effect, even stronger than supervision initiated by the central bank.

#### **5. CONCLUSION**

In addition to what has been already said, the following more important conclusions can be drawn, as well as suggestions for further specific measures against corruption in the financial sector.

##### **5.1. Conclusions**

The starting point is the question concerning the main prerequisites for corruption in the financial sector before the introduction of the currency board and what level the fight against corruption has achieved.

###### *5.1.1. Prerequisites.*

The main conclusions of the reasons for corruption in the financial sector are:

- Inappropriate methods regulating the process of licensing banks, exchange offices and financial houses;
- Incompleteness, vagueness, and even lack of regulations for operation and supervision of some segments of the financial sector;
- Solid state engagement through political interference in financial sector management, through rescue programmes for certain institutions and easily accessible refinancing.
- Lack of equality.

#### *5.1.2. Achieved results*

Although it is insufficient, certain progress has been made in the fight against corruption. Particular attention should be paid to:

- The creation of public understanding for the necessity that the governing authority should consider corruption as a social problem that affects without exception the three branches of power in the country;
- The reforms in the financial field, which is a step in the right direction, although it won't completely solve the problems;
- The abolition of BNB discretion in conducting monetary policy after the introduction the currency board, as the stress is laid on the supervision policy, where considerable changes took place in the regulations;
- The change in the regime of extending loans to trade banks, as the terms, conditions and pledges for loan-extending are thoroughly regulated;
- The stricter regime for credit operations in the area of trade banks, increased requirements for capital adequacy and liquidity, which enforces the stability and security within the system.

#### **5.2. Tendencies of future initiatives**

Corruption in the financial sector is part of the corruption in the country. The preventive measures should concentrate on the adoption of an intact strategy. The development of such strategy demands realisation of the political will on the part of those who govern the country. It should initiate reforms in state governance. The state must not be an administrator, but simply an arbiter of economic life, including the financial sector. A significant step, in this respect, is the policy for destroying existing monopolies.

##### *5.2.1. Possible elements of the strategy*

The strategy of the fight against corruption should include the following important measures:

- Prosecutions of major figures that are notorious for corruption;

- Participation of citizens in the process of diagnosing corruption by obtaining information through various forms -- telephone hotlines, public agencies, training programmes, etc.;
- Establishment of a coordination center on a national level, which is to be responsible for the preparation and implementation of the strategy against corruption;
- Identifying the parts of the administration most exposed to bribery or similar acts;
- Studying the international experience in this field;
- Creating a programme for material stimulation of the performance of administration officials.