Information

about the main balance sheet items of Corporate Commercial Bank AD (KTB) as of 30 September 2014 and of the results from the assessments of the bank's assets, prepared by the audit firms Ernst & Young Audit OOD, Deloitte Bulgaria OOD and AFA OOD

I. Information about the main balance sheet items as of 30.09.2014

The balance sheet of the bank as of 30.09.2014, before posting of the results of the analyses and assessments assigned to the audit firms Deloitte Bulgaria OOD, Ernst & Young Audit OOD, and AFA OOD is presented in the following analytical table:

(book value in million BGN)	**30.06.2014**	**30.09.2014**
ASSETS		
Cash and cash balances held with central banks	**144**	**331**
Securities	**775**	**598**
including:		
Government securities – Bulgarian	381	207
of which: pledged in favour of the state budget	112	113
Loans and receivables	**5 541**	**5 606**
including: corporate ones	5 500	5 522
Other assets	**435**	**128**
TOTAL ASSETS	**6 896**	**6 662**
LIABILITIES		
Deposits from credit institutions	**154**	**224**
Deposits from financial institutions	**343**	**363**
including Liabilities under a corporate securities issue	*220*	*239*
Deposits from budget-supported organizations (secured with government securities)	**96**	**100**
Deposits from non-financial corporations	**1 220**	**1 199**
including:		
from state-owned and municipal corporations	352	378
from other public corporations	34	35
from private corporations	813	766

Deposits from individuals and households	**4 304**	**4 371**
Including		
from residents	4 068	4 132
from non-residents	210	213
from NGOs	26	26
Other liabilities	**56**	**2**
Total funds attracted from customers	**6 173**	**6 260**
Subordinated debt	**202**	**205**
Capital	**521**	**198**
TOTAL LIABILITIES AND CAPITAL	**6 896**	**6 662**

The main changes in the bank's balance sheet reflect repayments received in the period, interest accrued but not paid on the bank's assets and liabilities, reclassification of exposures and consolidation of funds.

The bank's highly liquid assets (funds in accounts held with the central bank and in cash) as of 30.09.2014 were BGN 331 million. The BGN 187 million increase compared to 30.06.2014 is the result of transferring into accounts with the BNB of funds held in correspondent accounts with commercial banks and receipts from principal and interest repayments.

Impairment costs arising from revealed losses and reclassification of exposures were accrued in the period, as follows:

1. The biggest losses result from the accounting transaction effected on 20 June 2014 reflecting the cash withdrawal of BGN 206 million against the obligation assumed, and defaulted on, by BROMAK OOD to repay the funds on 30.06.2014, which was posted as an asset in the form of this receivable. For it there are practically no clear grounds, neither for its actual occurrence, nor for its real collectability by the bank. Therefore, its value is zero in accordance with the asset recognition standards under the International Financial Reporting Standards (IFRSs).
2. During the period under review, another such transaction was found out. As a result of lending of government securities in the amount of EUR 80 million to Technology Center – Institute of Microelectronics AD (TC-IME AD), which it is neither in the position to repay (or reimburse), nor alternatively to pay the remuneration due, the amounts reported as part of an investment portfolio of government securities were reclassified into a receivable from TC-IME AD. As the company is under bankruptcy proceedings and the probability of collecting this receivable is minimal, it was impaired 100%.
3. The book value of the loan portfolio as of 30.09.2014 reflects impairments amounting to BGN 148 million, which were determined on a portfolio basis in accordance with the impairment loss determination policy in effect until 20.08.2014.

The practice of determining losses from impairment of exposures was based entirely on the concepts of BNB Ordinance No. 9, revoked in April 2014. After its revocation no actions were pursued by the bank to establish a new policy for determining impairment losses in line with the rules of International Accounting Standard 39. The impairment loss determination policy applied by the bank allowed for reporting low impairment costs, as the loans were reported as “standard without arrears”, without clear information of the sources of the funds used for repayment; hence they were formally assessed on portfolio basis with minimum expectations of impairment losses. A test conducted in the bank taking into consideration actual arrears indicates that the formal application of this policy would have resulted in loan portfolio impairment losses amounting to BGN 4 757 million as of 30.09.2014.

With a view to eliminating the established weaknesses in the bank’s policy for determining losses from financial asset impairment and the methods for its implementation, the conservators have taken steps to update and supplement the bank’s policy for determining losses from impairments of financial assets. Thus, a fairer and more reliable measurement of the real rate of return on individual credit exposures, made on individual basis at that, taking into account all valid and enforceable items of collateral, is achieved. This further development of the policy was combined with a number of activities for broad-based updating of existing information - financial, non-financial and legal, about borrowers, investments, and issued guarantees, as well as of the collateral provided in favour of the bank.

II. Outcomes of the audit firms’ analysis and assessment

In fulfilment of BNB Governing Council’s decision of 31.07.2014, KTB conservators assigned the audit firms Deloitte Bulgaria OOD, Ernst and Young Audit OOD and AFA OOD to make analysis and assessment of main balance sheet items (including of a sample of loans, investment portfolio, securities, other assets, real estate) and bank guarantees issued by the bank, with a deadline 20.10.2014. The same decision assigned conservators to set up a task force to prepare the credit files for the purpose of audit assessment and to assist conservators in managing relations with borrowers.

In line with the scope specified in a Letter of Commitment, the above mentioned audit firms performed analysis and assessment of the main balance sheet items (including of a sample of loans, investment portfolio, securities, other assets, real estate) and bank guarantees issued by the bank. The analysis performed is based on the underlying principles of recognition and assessment of applicable IFRS. The assessment is based on the assets and bank guarantees entered in the bank’s records as of 30.06.2014 while reflecting all significant events with impact on the analysis as of 30.09.2014. For this purpose, the information collected by the bank and available was used by taking into account any additional relevant information as of other subsequent dates, but no later than 30.09.2014. The analysis and assessment were made under the assumption of preserving the bank as a going concern. The applied methods and techniques of determining and calculating the necessary credit portfolio depreciation are based on both IFRS and the good practices applied by the European Central Bank.

Already prior to the start of the audit firms’ work, the bank’s conservators organised a process of collecting additional information, the need of which was identified during the preliminary review of assets conducted by the same firms over the period 25.06.2014 – 08.07.2014. Borrowers were requested to furnish detailed lists for providing historical and forecasted information and those failing to submit the full set of information were reminded of this through a number of letters. Additional information was collected also as a result of additional meetings and conversations with borrowers whom conservators managed to contact. Furthermore, legal opinions on the validity of collateral items were prepared and, where necessary, also updated assessments of valid collateral items.

The outcomes of the analysis are as follows:

Balance sheet item	Value according to the bank's registers as of 30.06.2014	Value according to the bank's registers as of 30.09.2014	Necessary impairments based on the analysis and assessment
As per sample	*BGN million*	*BGN million*	*BGN million*
Loans granted to non-financial institutions and other customers (loan portfolio)	5 301	5 335	-4 057
Investments available for sale (investment portfolio)	380	376	-144
Securities (investments) held for trading (trading portfolio)	11	9	-0
Other assets	353	141	-3
Property owned by the bank	60	59	-18
Investment in CB Victoria	5	5	0
Sum total	**6 109**	**5 925**	**-4 222**

For the assessment purposes, KTB's assets were subdivided into the following groups: credit portfolio, investment portfolio (bonds and shares), portfolio of securities held for trading (bonds), issued bank guarantees and letters of credit, real estate (buildings and land) and other assets, including the investment in the subsidiary bank CB Victoria EAD. The work performed by the audit firms has produced the following summed up results:

The assessment of the bank's credit portfolio includes the exposures of 138 borrower firms with a total amount of BGN 5 335 million in liabilities as of 30.09.2014 or 96.6 per cent of the total corporate loan portfolio. The conclusions from the conducted analysis and assessment by the three audit firms are very similar and can be summarised as follows:

1. With regard to 14 borrowers with a total amount of exposures of BGN 441 million there are no indications of impairment or the impairment is minimal. Although in five of the cases no significant valid collateral items have been established, the firms' financial standing gives grounds to conclude that for this group impairments of BGN 46 million will be needed.
2. With regard to 29 borrowers with a total amount of exposures of BGN 888 million, operational activity has been established, the results of which do not sufficiently support the servicing of its loans. These companies have shown significant indications of deteriorating financial health (consistently declining incomes and/or profits; loss from activities; negative own funds, etc.) and/or businesses whose line and scope of activity are incommensurate with the amount and purpose of the extended loan; For four of the companies no valid collateral items have been identified. Overall for this group, the conclusion is that impairments of BGN 594 million are required.

3. A group of 6 borrowers with a total exposure of BGN 377 million can be identified as companies with operational activities with a high level of business dependency on few connected persons. Overall for the group, impairments of BGN 216 million are needed.
4. The largest group of 82 borrowers includes borrowers who are for the most part (67 cases) without operational activities of their own or of very limited operational activities and with incomes generated entirely or mainly by third persons. The total exposure of all companies from the group is BGN 3 434 million or 64 per cent of the loan portfolio.

   These are companies and holding companies whose core activity lies primarily in the investment business and in many cases are without own staff or other operational activities. Many of them are newly set up (i.e. established no earlier than 12 months before the first loan was extended) or companies whose purpose is acquiring interests and shares in other companies. In the majority of the credit files of borrowers in this group, no detailed business plans were found out or other information supporting the economic efficiency of extending the loans, expected cash flows of borrowers or sources of loan repayment. For most of the credit files no documents are available certifying whether the loan was utilised according to the purpose described in the loan agreement.

   Collateral on these loans are pledges of tangible assets, future receivables with payments on the borrower's bank accounts with the bank, shares of acquired enterprises or commercial enterprises. As a result of the legal analysis, the prevailing portion of these collateral items proves either with omissions when established or nonexistent, which makes them impossible to sell. As of 30.09.2014, as a result of the analysis of borrowers in this category, the ratio of debt coverage with valid collateral, given their recoverable value, is just around 2%.

   According to the balance sheets of borrowers in this group, where available, a large portion of these report substantial claims on third persons or investments in other enterprises. In the course of work on the analysis and the assessment, conservators requested many times detailed information on these assets in order to estimate the borrowers' potential to realise them and thus ensure the necessary cash flows to service the loans. Despite the multiple requests by the bank for further information on these assets, borrowers did not supply all requested information or any information at all.

   Loans of BGN 1 394 million to borrowers in this group were renegotiated many times and the terms of their repayment were extended. Servicing of the prevailing portion of these loans, in terms of both principal and interest, was halted with the bank's placement under conservatorship and as of 30.09.2014 there were significant arrears.

   Based on these significant deficiencies of the loans in this group, the lack of important information needed for credit risk assessment, and the bank's inability to obtain such information during the analysis and evaluation, the auditors came to the conclusion that there was no evidence confirming that the bank exercised or could get control over the benefits of these companies' assets. Therefore, according to the auditors, those loans had to be fully impaired, taking into account the valid items of collateral, if any. They concluded that there were good reasons for that group of loans to be charged a considerable impairment of BGN 3 021 million.
5. Another group of borrowers with similar ability to service their loans was that of 5 companies which, though operating, did not achieve results enabling them to

service their loans, and the valid items of collateral, if any, were of limited value. That group's exposure of BGN 172 million would require impairment of BGN 166 million.

6. Two companies formed a separate group because insolvency proceedings had already been initiated for them, and the expected loss was estimated at BGN 14 million.

Altogether, at 30.09.2014 the total gross book value of the loans in the sample amounted to BGN 5 335 million, and the loan impairment for them was estimated at BGN 4 057 million.

The securities portfolio was also analysed and assessed based on the applicable IFRSs for recognition and assessment, and on the available and collected additional information on securities markets and issuers. Fourteen exposures in corporate securities were evaluated, with an active market for five of these. Out of the ones with no active market, four were measured at fair value based on a model and three others were measured at fair value reduced by depreciation. In the cases where the issuers were borrowers too, the auditors also took into consideration the quality assessment of their credit exposures to the bank. The conclusion from the audit firms' reports was that securities' impairments of BGN 144 million was needed.

As for the other assets covered by the audit firms' review, including real estate and bank guarantees, the auditors concluded that an impairment of BGN 30 million was needed there, in accordance with the applicable IFRSs.

III. Conclusions

On the basis of the bank's balance sheet and the outcomes of the analysis and assessment of major balance sheet items (including a sample of loans, an investment portfolio, securities, other assets, real estate) and bank guarantees issued by the bank, the following conclusions can be drawn:

Many omissions were found out after the bank was placed under special supervision, but made before that:

- In the lending process no detailed checks of loan applicants were made, with incomplete analyses of business plans and estimates for the projects to be funded.
- There was no control over the establishment and ongoing oversight of the agreed collateral. The analysis indicated that a significant number of collateral items had been established with omissions or were non-existent which made them impossible to sell. The coverage ratio of the bank's loan portfolio with valid collateral is around 13 percent.
- There is no ongoing surveillance and control over the borrowers' businesses and the purposeful use of the granted loans. Loans were repeatedly renegotiated without evidence of substantiating the need for that.
- The documentation kept in the credit files is not maintained in a way to allow the bank to manage its receivables so as to obtain the economic benefits from them.
- In its activities the bank followed unconventional to the banking system wrong business practices, carrying out complex operations with the aim to conceal the nature of deals and transactions. One such example is the specific way of lending intermediated by 'special purpose vehicles', holding companies, and

other similar companies in order to finance the purchase of assets, which is inconsistent with the sound and standard banking practices.

- The financial and supervisory reports submitted by the bank’s management before the bank was placed under special supervision were untruthful and misleading.

The bank’s management has not followed prudent and conservative banking practices.