

Bulgarian National Bank

**ANNUAL
REPORT • 2005**



BANQUE NATIONALE DE BULGARIE



Bulgarian National Bank

ANNUAL REPORT • 2005

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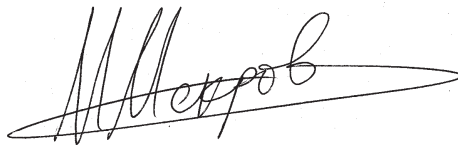
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The cover shows an engraving of the BNB building
from the 1938 banknote with a nominal value of 5000 levs.

Honourable Chairman of the National Assembly,
Honourable People's Representatives,

*Under the provisions of Article 1, paragraph 2 and Article 51 of the Law
on the Bulgarian National Bank, I have the honour of presenting the Bank's
2005 Annual Report.*

A handwritten signature in black ink, appearing to read 'Ivan Iskrov', with a long horizontal flourish extending to the right.

Ivan Iskrov
Governor
of the Bulgarian National Bank

BNB Governing Council



Sitting from left to right: Tsvetan Manchev, Emiliya Milanova, Ivan Iskrov, Dimitar Kostov*
Standing from left to right: Statty Stattev, Garabed Minassian, Nikolay Nenovsky

* By a Resolution of the National Assembly of 20 April 2005 (Darjaven Vestnik, issue 36 of 26 April 2005), upon expiry of Bojidar Kabaktchiev's term of office, Dimitar Kostov was elected member of the Governing Council and Deputy Governor of the Bulgarian National Bank as from 11 June 2005.

Governing Council

Ivan Iskrov

Governor

Emiliya Milanova

Deputy Governor

Banking Supervision Department

Tsvetan Manchev

Deputy Governor

Issue Department

Dimitar Kostov

Deputy Governor

Banking Department
and Fiscal Services Department

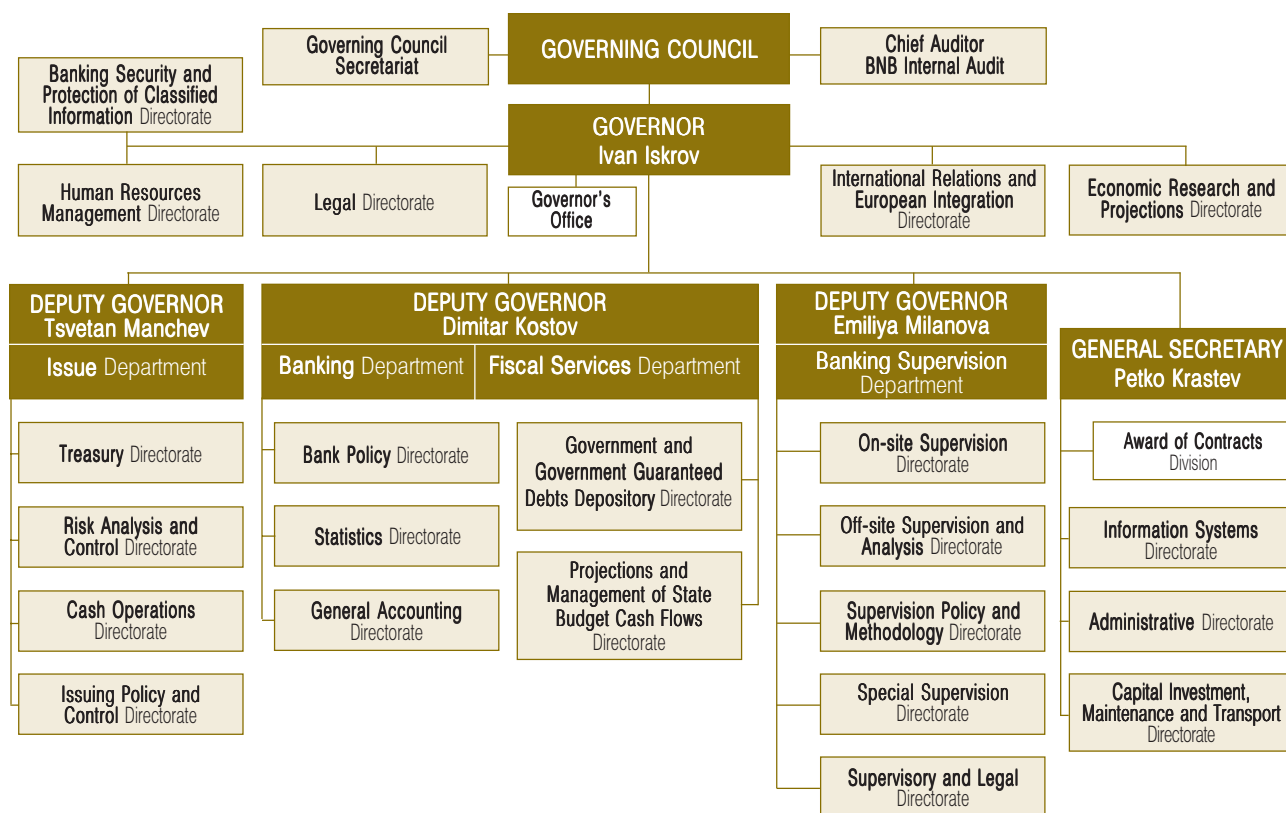
Garabed Minassian

Nikolay Nenovsky

Statty Stattev

Organizational Structure of the BNB

(as of January 2006)



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Abbreviations

ATM	Automated Tellers Machine
BEA	Bureau of Economic Analysis
BIR	Base interest rate
BIS	Bank for International Settlements, Basle, Switzerland
BISERA	Banking Integrated System for Electronic Transfer
BLS	Bureau of Labour Statistics
BNB	Bulgarian National Bank
BORICA	Banking Organization for Payments Initiated by Cards
BSE	Bulgarian Stock Exchange
CEFTA	Central European Free Trade Association
CIF	Cost, Insurance, Freight
CM	Council of Ministers
EBRD	European Bank for Reconstruction and Development
EC	European Commission
ECB	European Central Bank
ECOFIN	Economic and Financial Council
EFTA	European Free Trade Association
EMU	Economic and Monetary Union
ESCB	European System of Central Banks
ESROT	Electronic System for Registration and Service of Trade in Government Securities
EU	European Union
FLIRBs	Front-loaded Interest Reduction Bonds
FOB	Free on Board
GDDS	General Data Dissemination System
GDP	Gross Domestic Product
HISP	Harmonized Index of Consumer Prices
IFO	Institute of Economic Research, Germany
IFI	International Financial Institutions
ILO	International Labour Organization
IMF	International Monetary Fund
LBNB	Law on the Bulgarian National Bank
MF	Ministry of Finance
NLO	National Labour Office
NSI	National Statistical Institute
OECD	Organization for Economic Cooperation and Development
OPEC	Organization of Petroleum Exporting Countries
RINGS	Real-time Inter-bank Gross-settlement System
SBL	State Budget Law
SDR	Special Drawing Rights
TAIEX	Technical Assistance Information Exchange Instrument
TFP	Transitional and Final Provisions
VAT	Value Added Tax
WB	World Bank (International Bank for Reconstruction and Development)
ZUNK	Bulgarian abbreviation of the Law on Settlement of Non-performing Credits Negotiated prior to 31 December 1990 (LSNC)

Summary

Bulgaria's economy enjoys sustainable and comparatively high GDP growth which reached 5.5 per cent in 2005. A favourable internal environment and optimistic expectations added to accelerated domestic demand and capital inflow. Investment in fixed assets, the most dynamic component of domestic demand, posted 19 per cent growth over 2005 and was the major factor behind the boost in technological level, productivity, and efficiency. Average annual inflation went down by 1.2 percentage points on 2004 to 5 per cent irrespective of significant rises in world fuel prices and domestic food prices.

Gross international reserves grew by EUR 516 million at market value over 2005, including EUR 146.64 million in revenue from international reserve management, to reach EUR 7372 million by the year's end, despite the increase in the balance of payments current account deficit and EUR 1.3 billion in early government debt repayments. Since currency board rules stipulate that the BNB has to exchange national against foreign currency (euro) at the fixed exchange rate¹ set in the Law on the BNB, the increase in BNB international reserves is an important condition for money supply growth. In 2005 monetary aggregate growth rates remained comparatively high, reflecting household income growth, enhanced transaction demand for cash, the higher volume of bank deposits, and buoyant lending. Annual broad money growth reached 23.9 per cent.

Regulation and supervision of commercial bank operations are important BNB functions.² Growing bank lending in recent years has threatened the banking system with risk accumulation. As early as 2003 the BNB started enforcing measures to curb lending and reduce potential risks. As a result, the growth in bank claims on the non-government sector stabilized at some 50 per cent *per annum* in nominal terms since 2004. Given this high rate, the BNB initiated additional measures to ensure lending growth adhered to the rate of growth of assets, borrowed funds, and mainly capital, and to reverse the downward capital adequacy ratio trend to a level corresponding to banking system risk profile. By the end of 2005 banks' indicators gave grounds for a belief that the measures were successful and the objective was realized, with bank claims on the non-government sector slowing their growth to 32.4 per cent against 48.6 per cent at the end of 2004. The quality of banks' assets was maintained and the share of non-performing loans remained low at 2.2 per cent (loans past due over 90 days). Slower lending growth allowed banks to reorganize and improve their credit management information and human resources.

The BNB supported effective payment system implementation and operation and oversaw payment systems.³ To minimize risks in the national payment system the central bank operates the Real-Time Gross Settlement System (RINGS), which processed 70 per cent of the value of payments effected over the year. The system is characterized by low risk, as shown by the lack of any payments rejected by the close of any system day due to insufficient funds on participants' accounts over the past year.

The major task of payment systems oversight is to limit systemic risk and increase system reliability and efficiency. The March 2005 Law on Funds Transfers, Electronic Payment Instruments, and Payment Systems provides for licensing payment systems operators and regulates BNB oversight functions.

The Treaty of Accession of Bulgaria and Romania to the European Union was signed on 25 April 2005 and Bulgaria received acceding state status. Upon Treaty signature, the BNB Governor gained observer status on ECB General Council meetings and on the informal gatherings of the Council of Ministers of EU member states on financial and economic issues (ECOFIN). BNB representatives were invited as observers onto 12 ESCB committees and 22 committee working groups, onto the European Banking Committee, onto the Committee of the European Banking Supervisors and the Contact Group to it, and onto other EU and EC committees. Alongside discharging its Law on the BNB duties, the Bank had to prepare actively for ESCB membership, and continue work on other forms of EU integration (harmonizing legisla-

¹ Article 30 of the Law on the BNB.

² Article 2, paragraph 6 of the Law on the BNB.

³ *Ibid.*, paragraph 4.

tion, and participating in working groups and discussions on documents associated with EU membership).⁴

In view of the above duties, in April the BNB Governing Council adopted a Road Map which clearly sets out the tasks and responsibilities of relevant structural units and sets aside the funds necessary for successful Bank integration into the ESCB. The internal restructuring and distribution of tasks and responsibilities was effected without staff increases. BNB staff in 2005 numbered 932 against a budgeted number of 1007 (in 2004 the budgeted number had been 1012). Training, improving staff educational levels and qualifications, and developing an incentive system to enhance efficiency were BNB priorities. Work under twinning covenants between the BNB and the French and Dutch central banks aimed at improving BNB organization and preparing for increased responsibilities related to integration. Preparations for central bank integration into the ESCB started with a project on improving the BNB's information and communication technology infrastructure.

Amendments to the Law on the BNB were a most important step to harmonize central bank legislation with *acquis communautaire*. They transposed into national law the compulsory requirements of the Treaty Establishing the European Community and the Statute of the ESCB and ECB for BNB participation in the ESCB as a central bank of an EU member state with derogation.

The BNB report for 2005 contains the results of the accomplishment of BNB tasks and functions. The report on BNB budget implementation for 2005 and the consolidated financial statements accompanied by the international auditor's report include spending on Bank operations and an assessment of the manner of funds management.

⁴ The BNB takes part in these working groups: Freedom to Provide Services, Free Movement of Capital, Economic and Monetary Union, Statistics, Protection of Consumers and Their Health, Financial Control, Lisbon Strategy.

I. The Economy in 2005

Bulgarian National Bank policy is in line with the primary objective set out in the Law on the BNB: to maintain price stability through ensuring national currency stability. Decisions taken by the BNB in performing its functions are based on a profound analysis of the state of the national economy and its financial system and of trends in them, while monitoring risks ensuing from international developments. In 2005 BNB policy was pursued amid dynamic international conditions and a fast-developing domestic economy.

GDP growth came to 5.5 per cent in 2005. The favourable internal environment and optimistic expectations of future developments in Bulgaria underpinned enhanced domestic demand and capital inflow. Investments in fixed assets, the most dynamic component of domestic demand, rose by 19 per cent in real terms and became an important factor in raising the technological level, productivity, and efficiency of the economy.

Average annual inflation fell by 1.2 percentage points on 2004 to 5 per cent. Inflation was affected by international price rises in crude oil and other major commodities. Among internal factors pushing prices of some major foods were summer floods which hit farming over significant tracts of Bulgaria.

Capital inflow, which has primarily determined economic development dynamics over the recent years, was not affected by international interest rate rises over the year, and the financial account surplus reached EUR 2874.6 million. The 2005 upward trend in the balance of payments current account deficit intensified. However, excepting the holiday period in the third quarter, its dynamics matched expectations.

Factors influencing the current account in 2005 may be classified into permanent and temporary. Rapid rises in domestic demand in line with increases in household and company incomes were a permanent feature driving the relatively high growth of goods and services imports. Investment demand reflected positive expectations associated with pending membership of the Republic of Bulgaria in the European Union.

In the third quarter of 2005 the current account balance worsened as a result of the simultaneous effect of several factors. Disrupted petrol supplies from the Gulf of Mexico caused by Hurricane Katrina resulted in panic and considerable crude oil price rises between August and September. Due to temporary problems like technology updates at smelting companies, total goods exports slowed down. Summer floods between June and August hit a significant part of the country and led to reduced farming exports and lower-than-expected summer tourism revenues. The temporary nature of the above factors was confirmed by the balance of payments data at the end of the year when export growth was restored and import rates slowed down.

Another important trend in Bulgaria's economy over recent years involved accelerating growth in bank credit to the private sector. To curb risks to the banking system, the BNB initiated a number of successive measures which in 2004 succeeded in reversing the trend, helping to stabilize the growth rate of claims on the non-government sector at around 50 per cent annually in nominal terms. Estimating this rate as high, in early 2005 the BNB undertook further measures to curb credit growth and maintain the banking system and credit portfolio quality in good condition.

In April 2005 *Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks* was amended by setting additional minimum reserves for more aggressive lenders. These reserves are equal to double the excess of all loans over the quarterly growth set in the Ordinance and reported on the basis of average daily volumes. The amendment began to bear fruit in the second quarter, when annual growth of claims on the non-government sector contracted to 41.8 per cent. Several banks exceeded credit growth thresholds and deposited additional required reserves. To raise the efficiency of BNB restrictions on lending, in November the BNB approved further amendments to Ordinance No. 21 providing for a progressive scale for determining additional required reserves whereby exceeding credit growth rates set in the Ordinance will become significantly dearer.

In addition to the above amendments, the year saw changes to other BNB Ordinances with a view to guaranteeing the good quality of banking system indicators, maintaining credit portfolio quality, and curbing risks to the system.

In the first half of 2005 *Ordinance No. 8 on the Capital Adequacy of Banks* was amended to exclude current profit from the capital base and introduce monthly capital adequacy reports. Also set were supervisory requirements for banks to reclassify restructured exposures into a lower-risk group under *Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss*. The condition was set that thus restructured exposures had to satisfy all criteria for the said lower-risk group over not less than six months.

Rapid growth of credit to households over the past three years led to expectations of a drop in banks' consumer portfolio quality. A similar trend emerged in early 2005 with respect to mortgage loans to households. To reverse it, the BNB further amended Ordinance No. 9 in November, introducing more conservative requirements for loan provisioning.

To reduce the liquidity and currency risks in the banking system, Ordinance No. 21 was amended with regard to the currency structure of reserves. The euro became the sole foreign currency in which banks may maintain reserve assets on accounts. The stipulation that reserves on the deposit base in foreign currency could be covered only with foreign currency was abolished.

The BNB measures brought results by the close of 2005, with credit growth matching that of assets, borrowed funds and primarily capital, and capital adequacy stabilizing at a level corresponding to the system's risk profile. Annual rates of banking system claims on the non-government sector slowed to 32.4 per cent *vis-à-vis* 48.6 per cent at the end of 2004.

1. The International Situation

The world economy developed at comparatively high rates in 2005, with a slight slowdown in the first half compensated by an upsurge in the second half. Differentiation in growth rates by region was sustained. Weak domestic consumption, low investment rates and slowing exports were the major factors for decreasing euro area growth to 1.3 per cent (2.1 per cent in 2004) and the EU-25 rate to 1.6 per cent (2.4 per cent in 2004). High US growth rates in the first six months of 2005 were followed by a slowdown in the second half primarily due to significant damage by hurricanes Katrina and Rita which hit the US south coast. Asian countries reported high growth rates with China, India, and Japan leading.

Major Macroeconomic Indicators (average annual change)

(%)

	Growth			Inflation			Unemployment		
	2003	2004	2005	2003	2004	2005	2003	2004	2005
USA	2.7	4.2	3.5	2.3	2.7	3.4	6.0	5.5	5.1
EU-25	1.2	2.4	1.6	1.9	2.1	2.2	9.0	9.1	8.7
Euro area	0.7	2.1	1.3	2.1	2.1	2.2	8.7	8.9	8.6
Newly acceded countries	3.8	5.0	4.0	1.9	4.1	2.5	14.3	14.2	13.4
Japan	1.8	2.3	2.8	-0.3	0.0	-0.4	5.3	4.7	4.4
China	10.0	10.1	9.9	1.2	4.0	1.8	:	4.2	4.2

Note: Inflation in newly acceded countries has been computed by weighing harmonized indices of individual countries' consumer prices based on EU-25 countries weights in HICP.

Source: Eurostat, Bureau of Labour Statistics, Bureau of Economic Analysis, Statistics Bureau of Japan, National Bureau of Statistics of China, BNB computations.

Energy and major raw materials prices continued rising in 2005, driven by increasing consumption, especially in fast-growing Asian countries. Brent crude rose by 42.1 per cent reflecting both greater demand and limited extraction capacity. Metal markets reported a 26.4 per cent increase in prices. Food prices underwent no change on the prior year except for fourth quarter wheat rises (due to poor autumn sowing weather in the Ukraine and Russia) and sugar rises (due to increased demand for sugar cane used in ethanol making).

The inflationary pressure of crude oil price spikes over the first half of 2005 was alleviated by the base effect, since the same period of 2004 saw similar price rises. In the second half oil prices grew rapidly due to supply problems caused by Hurricanes Katrina and Rita. Inflation in developed countries hit record values in September: 2.6 per cent in the euro area and 4.7 per cent in the USA. No significant fuel price rise knock-on effects were reported in these countries due to their relative energy independence.

The US Federal Reserve System continued its policy of gradual increases in interest rates, with the federal funds interest rate reaching 4.2 per cent by the end of the year. In December the ECB raised the interest rate on refinancing operations to 2.2 per cent (25 b. p.) for the first time in two and half years. In view of the consistent Federal Reserve policy of raising federal funds rates and uncertainty about ECB policy, the yield curves of USD and EUR-denominated government securities exhibited similar historically atypical behaviours toward contracting spreads between the yields of securities of various maturities and straightening yield curves.

Stock markets showed favourable trends, with risk premiums and fluctuations remaining historically low. The Dow Jones EURO STOXX50 index rose by 21.3 per cent, with the Dow Jones STOXX EU ENLARGED15 rising 49.7 per cent. In the USA, the NASDAQ Composite index went up by 3.1 per cent and Dow Jones Industrial fell by 0.6 per cent. American financial markets were adversely impacted by interest level rises, high fuel prices and damages caused by Hurricanes Katrina and Rita in the southern states.

2. The Bulgarian Economy

Economic Activity and Inflation

Bulgarian economic growth reached 5.5 per cent by end-2005. Gross domestic product *per capita* grew by 10.2 per cent from EUR 2515 to EUR 2771 in 2005.

Over the year domestic demand developed dynamically, accelerating on 2004. The greatest contribution to GDP growth came from individual consumption (5.7 percentage points) followed by investment in fixed capital (4 percentage points). Import growth rates stayed high prompted by domestic demand, while exports slowed down as a result of temporary factors, especially in the third quarter. The negative contribution of net exports to growth amounted to 5.8 percentage points (over 2004 the negative contribution of net exports came to 1.9 percentage points).

GDP Growth by Expenditure Element

(%)

	2004	2005
GDP	5.7	5.5
Individual consumption	4.9	7.4
Collective consumption	6.7	2.2
Gross fixed capital formation	13.5	19.0
Exports	13.0	7.2
Imports	14.1	14.6

Source: NSI.

Household incomes were the major factor behind increasing individual consumption. They picked up as a result of the 2 per cent rise in employment on 2004⁵ on the one hand and to higher *per capita* incomes from employment, entrepreneurship and property sales on the other. A major income source, employment pay, grew by 2.8 per cent on average in real terms. The number of full-time employees went up by 2.7 per cent and the real increase in wages and salaries came to 5.6 per cent. Compared with the previous year, 2005 household budget data showed a 9.4 per cent nominal increase in income from sources such as entrepreneurship but excluding employment.

Another important indicator of the positive business climate was average unemployment, which fell by 1.9 percentage points in 2005 to 10.1 per cent.⁶ The number of unemployed people registered at labour offices by the close of December 2005 totaled 397,300 which equates to 10.7 per cent of economically active people, with unemployment dropping by 1.4 percentage points on December 2004.⁷ The year saw 79,300 people in government employment incentive programmes; however, it was the private sector which contributed most to cutting unemployment.

Investment in fixed capital grew, reporting the highest real growth since 2001 at 19 per cent. Significant investment acceleration was posted by *industry* and *transport and communications*. High returns on Bulgarian investment attracted foreign capital which is a major source

⁵ NSI workforce survey.

⁶ NSI workforce survey. ILO definition has been applied.

⁷ Employment Agency data.

of investment project finance. In addition to private investment, government capital expenditure continued to grow, reaching 4.9 per cent of GDP.

Manufacturing, financial intermediation, construction, and trade contributed most to economic and gross value added growth in 2005. Agriculture registered a dramatic decline after floods in the third quarter.

Gross Value Added Real Growth

	2004	2005
Agriculture	3.0	-8.6
Industry	5.8	7.3
Services	5.7	6.6
Total (base prices)	5.4	5.1

(%)

Source: NSI.

Industrial buoyancy resulted from higher external and domestic demand, with oil processing, non-ferrous metals, food and drinks, machines and equipment, household appliances, and chemicals to the forefront. In 2005 the upward trend in industrial capacity utilization was sustained, reaching 65.7 per cent in the fourth quarter.

Industry was driven by enhanced domestic demand, with industrial sales on the home market rising rapidly. Nevertheless, the differing demand and supply profiles of home goods were maintained, resulting in increased imports. Imported materials and energy occupied some 31 per cent of intermediate consumption. Amid enhanced industrial activity, this relatively big share pushed up the imports of these intermediate products. Therefore, bigger imports of materials and energy contributed most to the high import rates of 2005. Imported goods satisfied almost 80 per cent of national investment demand. As a result, imports of investment goods increased at highest rates over the year. Imports of consumer goods satisfied about 12 per cent of domestic consumer demand. Thus, the rates of consumer goods imports were lower than those of other commodity groups.

The growing share of investment in GDP resulted in an improvement of the economy's technological level, productivity, and effectiveness. New investment contributed to the sustained favourable trend in the *unit labour cost* indicator, a key measure of Bulgarian economic competitiveness. In most economic sectors, labour productivity grew faster than pay. Improving industrial effectiveness brought about the relatively high growth rates of goods exports.

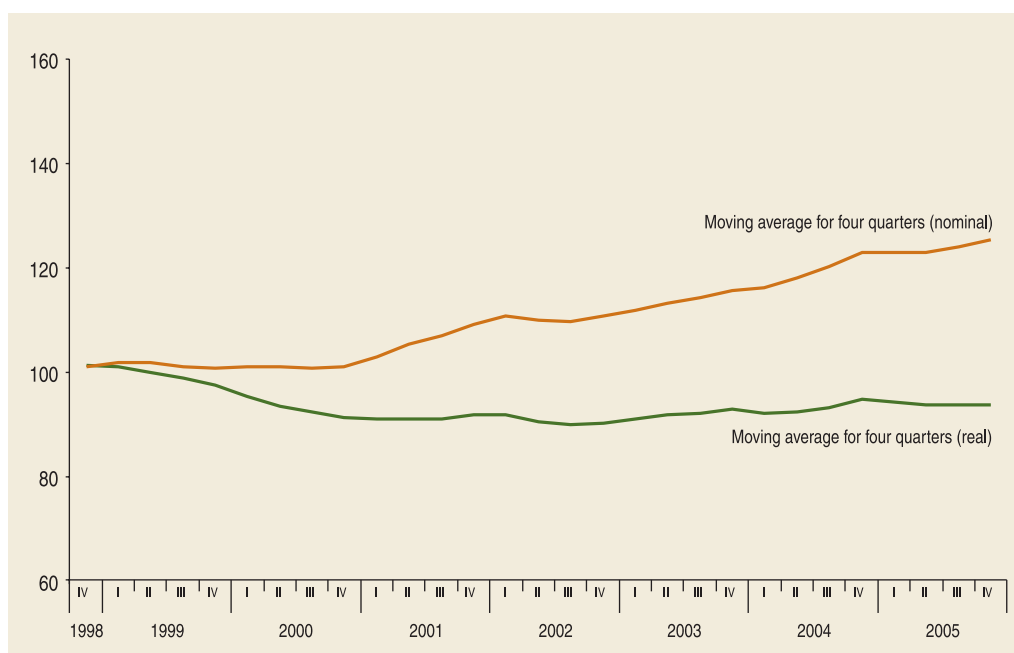
Labour productivity was one of the factors behind falling inflation. Under its influence, among others, annual inflation for 2005 averaged 5 per cent: 1.2 percentage points less than that in 2004. Considerable fluctuations of world crude oil prices and their dramatic rises in August resulted in fuel price rises in Bulgaria and affected indirectly the prices of other commodities. Summer floods damaged farm produce, raising concerns about considerable shortages, and food prices posted an increase instead of a seasonal decrease in the summer. In addition to the above factors, power and heating prices went up, the inflationary contribution of administratively priced goods and services to average annual inflation coming to 1.3 percentage points.⁸

World crude oil price rises pushed fuels up by 10.6 per cent on the domestic market, affecting transport, and owing to higher transportation costs most goods and service groups' prices went up.

The major contribution of food to inflation was not only due to the 6.7 per cent annual price rise in this group but also to its relatively big 38 per cent share of the consumer basket. Rising food prices reflected indirectly appreciating fuel and concerns about farm produce shortages due to widespread flood damage to crops during the summer. The prices of unprocessed foods went up by 10.3 per cent by the end of 2005.

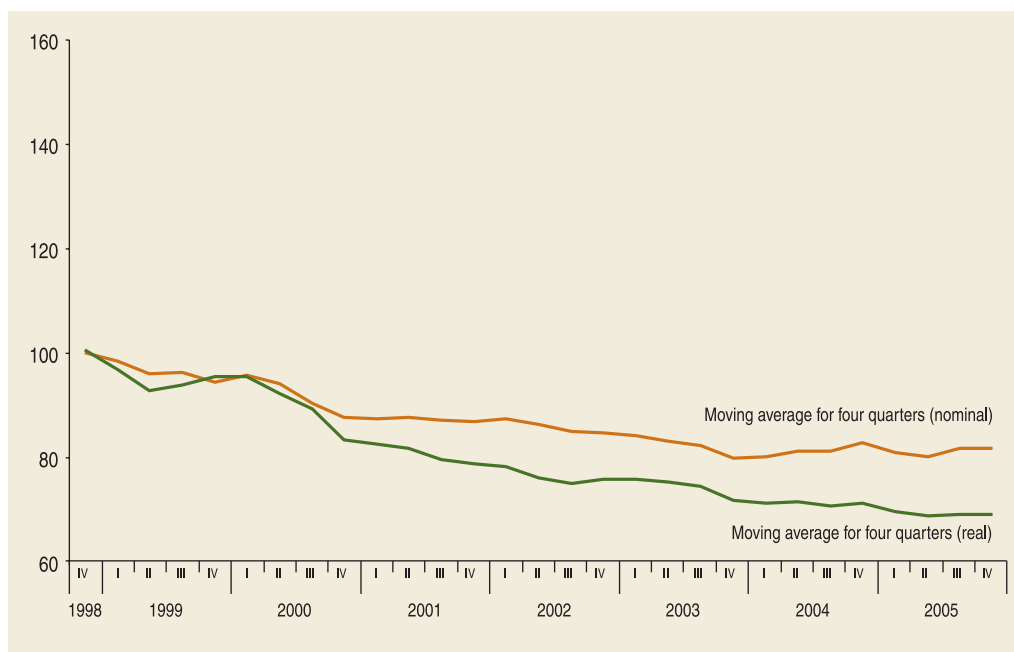
⁸ Following the Bulgarian Telecommunication Company privatization finalized by the end of 2004, telephony was deleted from the administratively set price group in early 2005.

Unit Labour Cost, Total for the Economy (1998 = 100)



Source: NSI, BNB.

Unit Labour Cost in Manufacturing (1998 = 100)



Source: NSI, BNB.

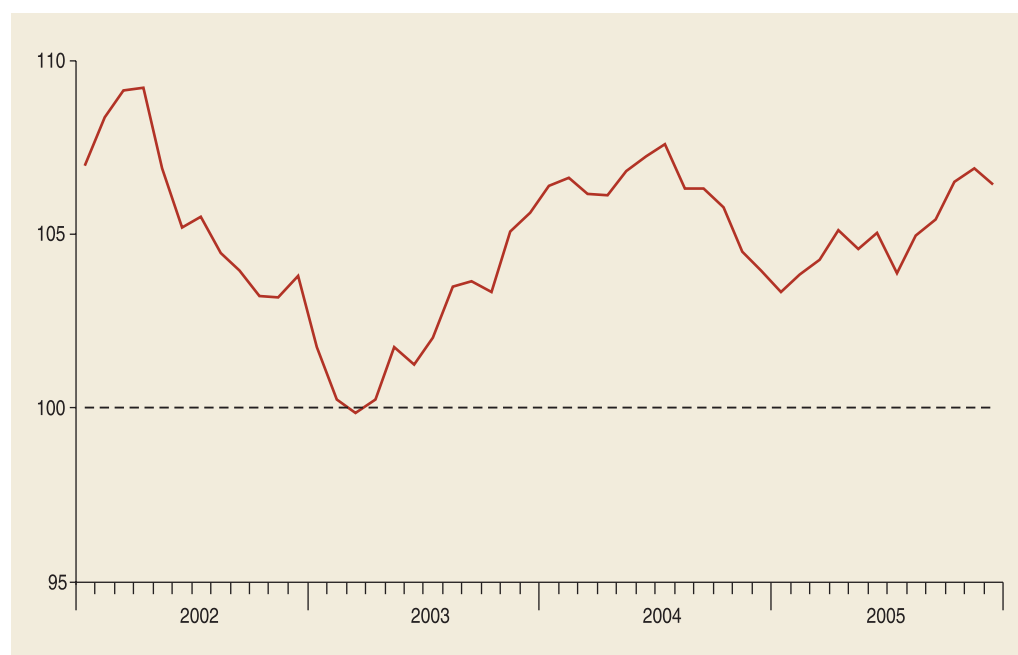
Year-end Inflation and Contribution to It

(percentage points)

	2004	2005
Inflation (%)	3.98	6.45
Contribution		
Foods	0.35	2.57
Non-foods	1.36	1.84
Public catering	0.15	0.35
Services	2.17	1.68
Administered-price goods and services	2.89	1.24

Source: NSI, BNB.

Consumer Price Index (on an annual basis)



Source: NSI, BNB.

The Balance of Payments

The balance of payments current account deficit for 2005 came to EUR 2530.7 million (11.8 per cent of GDP), up by EUR 1399.5 million compared with the previous year's deficit of EUR 1131.2 million (5.8 per cent of GDP). The trade balance worsened considerably during the year, and particularly in the third quarter, reaching EUR -4369.1 million.⁹ The balance of services (EUR 667 million), the income balance (EUR 247 million) and the balance of current transfers (EUR 924.5 million) for 2005 were positive.

Factors affecting the current account in 2005 can be classified as permanent and temporary. Domestic demand, which picked up fast in line with increased household and company incomes, was one of the constant factors maintaining relatively high goods and service import growth. Positive expectations related to Bulgaria's pending EU membership affected investment demand.

In the third quarter of 2005, however, the current account balance worsened reflecting the concurrent impact of several factors: the disruption of Gulf of Mexico oil deliveries after the Katrina hurricane led to panic and a jump in international crude oil prices in August and September; exports slowed due to temporary delays reflecting technological updates in the metallurgy sector; floods between June and August affected a significant part of the country, cutting agricultural goods' exports, and most likely hitting summer tourism revenue. The temporary na-

⁹ A detailed analysis of factors behind the worsened trade balance in the third quarter of 2005 is presented in the BNB's *Economic Review* quarterly (1/2006).

ture of the above factors was confirmed by the balance of payments data for the close of 2005. The year's end saw a recovery in export growth and slower import growth.

The financial account surplus for 2005 comprised EUR 2874.6 million. The balance of payments financial account reported a EUR 36.2 million fall from that for 2004 but it was in excess of the current account deficit by EUR 344 million. *Foreign direct investment* (EUR 1789 million), *loans: other investment – liabilities* (EUR 1044.1 million), and *other assets* (EUR 534.9 million) contributed most to the surplus. Net direct investment into Bulgaria covered 73 per cent of the current account deficit. In the period under review the decrease in portfolio investment liabilities by EUR 749.4 million due to external government debt repayments in 2005, including advance payments on the external government debt to private creditors (full buyback of Brady bonds) and the IMF impacted adversely the financial balance.

The overall balance for 2005 was positive to the tune of EUR 569.3 million, worsening by EUR 830.3 million compared with 2004. In 2005 EUR 116.1 million was received in support of the balance of payments as exceptional financing from a World Bank loan. Net repayments to the IMF totaled EUR 361.2 million. International reserves increased by EUR 324.2 million (changes due to valuation adjustments excluded).

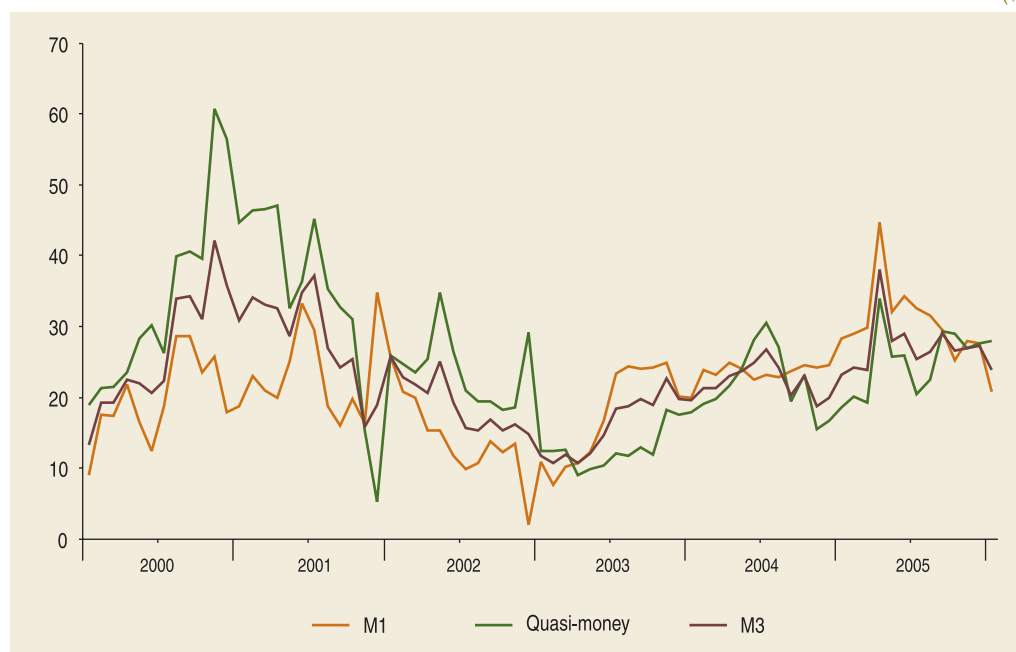
In 2005 the bulk of financial flows on the balance of payments was debt. By the year's end gross external debt reached EUR 14,530.3 million, up EUR 1958.7 million (15.6 per cent) on 2004. Debt growth was entirely down to the private sector whose foreign obligations went up by EUR 3238.9 million (52.7 per cent) while public sector obligations fell by EUR 1280.2 million (19.9 per cent) as a result of the policy of cutting government external debt. The gross external debt to GDP ratio went up slightly from 64.2 per cent in 2004 to 67.7 per cent in 2005.

Public Finance

In 2005 the primary surplus came to 4.8 per cent of GDP¹⁰ and the cash surplus comprised 3.2 per cent of GDP, up by 1.5 percentage points on the prior year. Total revenue and grants accounted for BGN 18,012.2 million (42.9 per cent of GDP) and expenditure came to BGN 16,678.5 million (39.8 per cent of GDP). Buoyant economic growth and enhanced domestic demand underlay the higher tax revenue (by 13.4 per cent), contributing to the realized cash surplus.

Monetary Aggregates (Annual Growth)

(%)

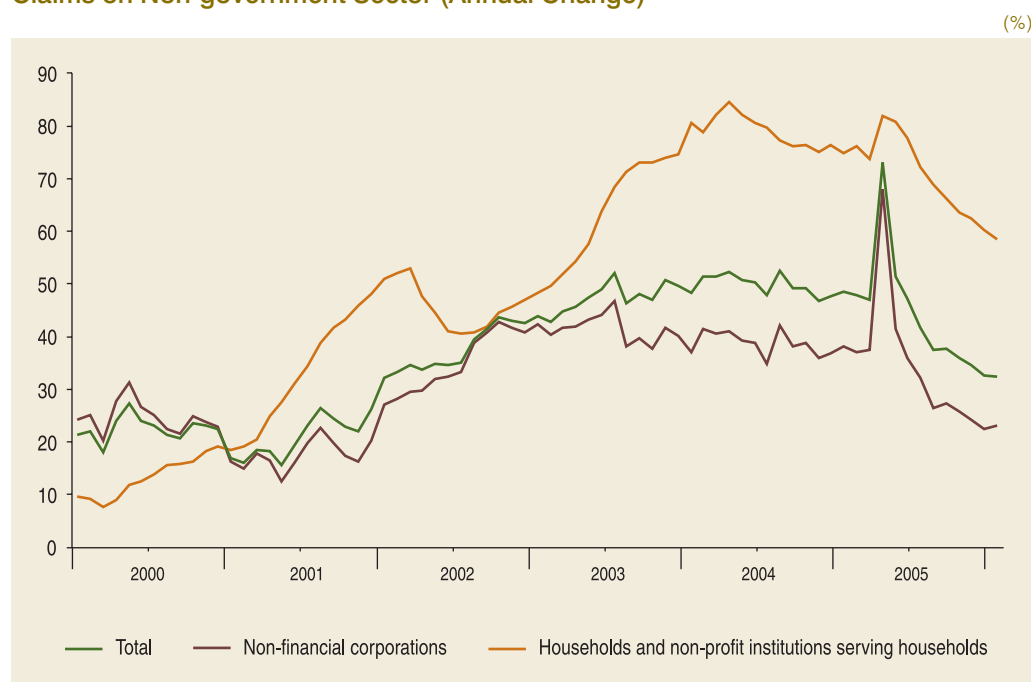


Source: BNB.

¹⁰ Excluding expenditures made by Public Investment Projects EAD.

In 2005 the government bought back its debt in Brady bonds amounting to USD 1544.6 million and a portion of its liabilities to the IMF. Despite these sizable payments, the fiscal reserves went down by just BGN 299 million totaling BGN 4511.6 million. The cash surplus and privatization revenue of BGN 1441.1 million were the major factors behind the sustained relatively high level of the fiscal reserves. As a result of external debt advance repayments, the government and government guaranteed debt to GDP ratio fell by 8.7 percentage points coming to 31.9 per cent by the close of the year. The decrease in this ratio reflected the dynamics of the domestic government debt which dropped by 8.5 percentage points over the year reaching 25.1 per cent of GDP.

Claims on Non-government Sector (Annual Change)



Source: BNB.

The Financial Sector

Monetary aggregates growth rates stayed comparatively high in 2005 reflecting increased household income, intensified demand for transaction cash, increased banking system deposits and buoyant lending. Broad money annual growth reached 23.9 per cent by the end of the year. Under intensified demand for transaction cash, the M1 monetary aggregate grew by BGN 2145.1 million (20.8 per cent), including currency outside banks by BGN 767.6 million (16.6 per cent) and overnight deposits by BGN 1377.5 million (24.3 per cent). Quasi-money went up by BGN 2789.3 million (27.9 per cent), deposits with maturities of up to two years by BGN 2555.3 million (32.2 per cent), and those redeemable at up to three months' notice by BGN 234 million (11.3 per cent).

BNB measures intended to limit bank credit expansion in early 2005 brought initial results in the second quarter. Over the review period claims on the non-government sector rose by BGN 4566 million, a slowdown of growth to 32.4 per cent against 48.6 per cent by the end of 2004. Claims on non-financial corporations went up by BGN 2145.7 million (23.1 per cent), and claims on households posted an increase of BGN 2554 million (58.4 per cent). Banks' strong interest in extending longer-term credits and the real sector need for long-term finance continued changing the maturity structure of credits, with the share of credits with over one year's maturity increasing to 75.9 per cent by the end of the year.

Following the significance of banks' foreign liabilities as a source of funds in the prior year, in 2005 banks' motivation to borrow funds from non-residents was curbed by BNB measures aimed at more moderate credit growth. Household and non-financial corporate deposits, which grew by BGN 2724.5 million (30.2 per cent) and BGN 1715.4 million (34.5 per cent), were an important source of funds for banks. Over 2005 the rate of growth of commercial banks' claims on the non-government sector approached the growth rate of deposits.

The total volume of transactions in the interbank market in 2005 grew by 72.6 per cent on the previous year. With the removal of the requirement that reserves due on the deposit base denominated in foreign currency ought to be covered with foreign currency, banks increased the euro share in their reserves, releasing lev funds for short-term money market investments. Deposits comprised 95.4 per cent of the turnover, outright transactions in government securities 2.9 per cent, and repo agreements 1.7 per cent.

The annual interest rate on the interbank money market stayed stable at 2 per cent, with its monthly average fluctuating between 1.9 per cent (in January) and 2.2 per cent (in December). The interest rate increase at the close of the year reflected the ECB decision to raise interest on main refinancing operations by 25 basis points.

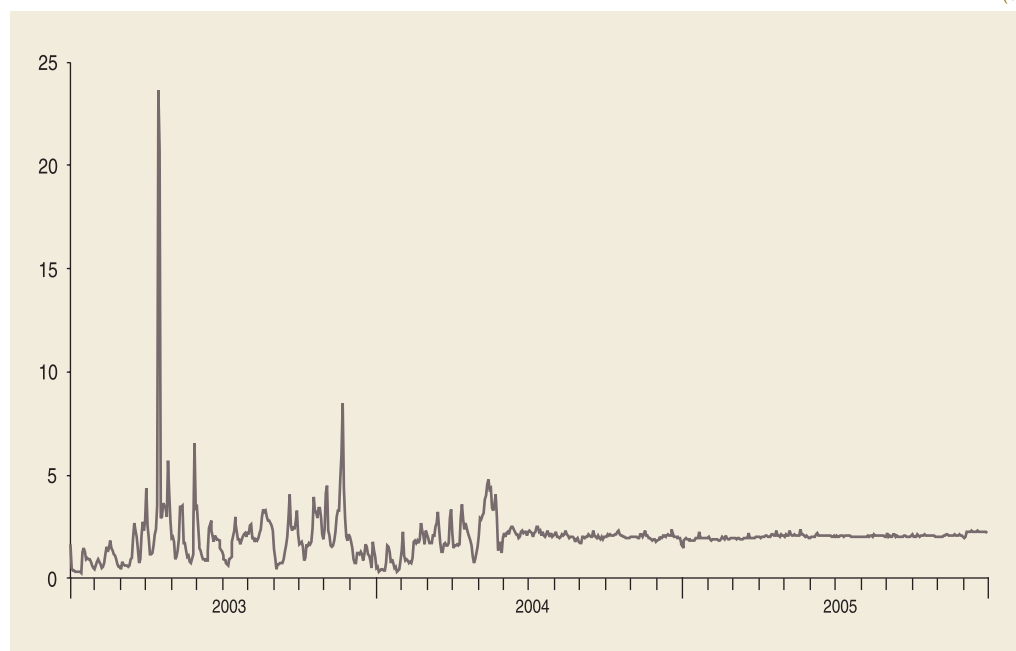
Foreign currency market turnover continued increasing in 2005 to reach some EUR 50 billion.¹¹ Compared with 2004, total turnover grew by more than a third, prompted largely by the dropping of commission on BNB non-cash transactions in June 2004. Turnover increases were reported in both trading areas: interbank (transactions with the BNB) and final customer trading.

In accordance with Ministry of Finance issuing policy, three-month discount treasury bills and three, five and ten-year fixed rate treasury bonds were issued over 2005. The December 2004 launch of the LEONIA index underlay the methodological change in computing the base interest rate.¹² This allowed a cut in three-month discount government securities to six issues a year instead of monthly, the total nominal value of placements (BGN 95 million) falling by 34 per cent on the previous year. Unlike 2004, no twelve-month and seven-year government securities were issued. The sale of three-year government securities exhibited a 50 per cent growth to BGN 150 million nominal value, the sale of five-year remained at BGN 100 million and that of ten-year rose by 87.5 per cent to BGN 150 million.

Outright transactions in domestic government securities between banks (including investment intermediaries approved as primary dealers) in the secondary government securities market totaled BGN 1589.4 million (down 20.9 per cent on 2004). BGN-denominated bond turnover fell by 22.1 per cent to BGN 1429.5 million as a result of the decreased volume of short-term bond transactions. EUR-denominated bonds rose by 0.4 per cent to BGN 159.3 million, while the trade in USD-denominated bonds issued under ZUNK exhibited a dramatic fall to BGN 0.6 million.

Average Interest Rate on Interbank Money Market

(%)



Source: BNB.

¹¹ The turnover includes banks' (including BNB) transactions in foreign currency against levs with a spot value date, same value date, or next business day value date.

¹² The new methodology was adopted by the BNB Governing Council on 16 December 2004 by Resolution No. 149 and came into force on 1 February 2005. It calculates the base rate as the simple mean of LEONIA values for business days over the past month, the computed value taken as the base rate for the coming calendar month.

On international financial markets Bulgarian government EUR-denominated eurobonds maturing in 2007 closed the year at 105 per cent of nominal value. EUR-denominated global bonds maturing in 2013 exceeded 124 per cent, and USD-denominated global bonds maturing in 2015 were quoted at 121 per cent at the close of the year. In addition to market conditions, price movements also reflected Bulgaria's boosted credit rating. On 17 August Fitch Ratings, and on 27 October Standard & Poor's, raised Bulgaria's long-term credit rating in foreign currency from BBB- to BBB.

The activation on the secondary market of compensatory instruments which started in November 2004 continued in early 2005 until the BTC share public offering. Between 27 January and 1 February the public was offered 34.8 per cent of the state share of BTC against compensatory notes and bills. This brought a record volume of compensatory instrument swaps for shares (BGN 662 million). The compensatory instrument market volume came to BGN 550.9 million realized mostly in the first quarter of 2005.

Corporate and municipal bonds continued to be traded on the OTC market with subsequent registration on the stock exchange. The total volume of *bourse* trade in bonds doubled on 2004 at BGN 278.7 million. The volume of primary market equity traded on the Bulgarian Stock Exchange, Sofia came to BGN 5.5 million from shares and BGN 1.7 million from rights on shares. Secondary market equity doubled on 2004, volume reaching BGN 2101.6 million on the stock exchange and BGN 17.8 million on the OTC market. This record turnover mainly reflected the fact that BTC shares were accepted for trading on the stock exchange unofficial market alongside the privatization of residual state shares.

The Bulgarian Stock Exchange, Sofia second official price index, BG40, was launched on 1 February 2005. At the start of the year the shares' price indices on the Bulgarian Stock Exchange, Sofia rose considerably to the technical limits of 130 points, 900 points and 225 points for BG40, SOFIX and BSE FFBH respectively. Following record highs (932.44 for SOFIX and 232.92 for BSE FFBH on 25 February, and 133.36 for BG40 on 10 March), indices fell back moderately in the first quarter, stagnated in the second and third quarters, and went up in the fourth quarter. June saw the only deviation when Neftochim was removed from the register of public companies which was accompanied by a 50 per cent fall in its shares and temporary pressure on overall price levels. In September SOFIX approached its early year level and BG40 hit a new record of 140.87 points on 30 September. The BSE FFBH index was discontinued, its last value being 228.29 points on 21 September.

Overall share price rises and the inclusion of new companies in *bourse* trading increased the market capitalization of companies traded on the Bulgarian Stock Exchange, Sofia which came to BGN 8434 million (20.1 per cent of GDP) by the end of 2005.

II. Gross International Reserves

Gross international reserves are managed in compliance with the requirements set out in the Law on the Bulgarian National Bank and opportunities offered by world financial markets. BNB gross international reserves include the assets on the Issue Department's balance sheet.¹³ The excess of gross international reserves over monetary liabilities forms the *Banking Department Deposit* item or the net value in the Issue Department's balance sheet.¹⁴

In compliance with the Law on the BNB, the management of gross international reserves is within the purview of the Deputy Governor heading the Issue Department. The Investment Committee plays an important role in mapping out international reserve management strategy and assessing related risks and results. BNB experts sit on the Committee which has an advisory input into decisions by the Deputy Governor heading the Issue Department.

Some amendments to the Law on the BNB adopted in early 2005 refer to international reserve management. The value of monetary gold is to be reported at market rates instead of fixed price; with regard to currency risk, limits on open foreign currency positions are changed to ensure that absolute values of open currency positions in currencies other than euro, SDR, and gold may not deviate by more than 2 per cent from the total monetary liabilities denominated in these currencies.

1. The Amount and Structure of Gross International Reserves

By 31 December 2005 the market value of gross international reserves came to EUR 7372 million, an increase of 7.5 per cent or EUR 516 million on 2004.¹⁵ This change reflected net reserve inflows of EUR 170 million, earnings from assets to the amount of EUR 147 million, and valuation adjustments of EUR 199 million.

The currency structure of gross international reserves changed in the review period, with the share of assets denominated in euro increasing at the expense of assets in other currencies (US dollars and Swiss francs).

Currency Structure of Gross International Reserves

(%)

Currency	Issue Department balance sheet assets	
	2004	2005
Euro	83.2	88.4
US dollars	5.4	3.5
Gold	7.2	6.6
Special Drawing Rights	1.6	0.6
Swiss francs	2.6	0.9

Note: Average data for the period.

Source: BNB.

¹³ Article 28, paragraph 3 of the Law on the BNB defines comprehensively what assets comprise gross international reserves: monetary gold; Special Drawing Rights; banknotes, and coins in freely convertible foreign currency; funds in freely convertible foreign currency held by the BNB on accounts with foreign central banks or with other financial institutions, with respect to which obligations are assigned one of the two highest ratings by two internationally recognized credit rating agencies; debt instruments held by the Bulgarian National Bank and issued by foreign countries, central banks, other foreign financial institutions, or international financial organizations, with respect to which obligations are assigned one of the two highest ratings by two internationally recognized credit rating agencies; the balance on accounts receivable and accounts payable on Bulgarian National Bank forward or repurchase agreements concluded with or guaranteed by foreign central banks, public international financial organizations or other foreign financial institutions whose obligations are assigned one of the two highest ratings by two internationally recognized credit agencies, as well as Bulgarian National Bank futures and options which bind non-residents and which are payable in freely convertible foreign currency. The Law stipulates that these assets are estimated at market value.

¹⁴ According to Article 28, paragraph 1 of the Law on the BNB, "the aggregate amount of monetary liabilities of the Bulgarian National Bank shall not exceed the lev equivalent of gross international reserves," and the lev equivalent shall be determined on the basis of the fixed exchange rate.

¹⁵ Since early 2005 gold is estimated at market value which renders weekly and monthly Issue Department balance sheets published in 2005 incomparable with those published over previous years when the gold price was fixed by the Law on the BNB.

Gross International Reserves and Banking Department Deposit



Source: BNB.

Major Reasons for Changes in International Reserves

A) Reserve currency purchases and sales:		
• Net purchases from commercial banks, incl.:		EUR 1408 million
Euro purchases from commercial banks		EUR 1419 million
Euro sales to commercial banks		EUR 6994 million
• Net purchases at tills		EUR 5575 million
		EUR 11 million
B) Significant flows on commercial bank and government accounts:		EUR 1238 million
<i>To increasing international reserves</i>		
• Revenue from privatization of state-owned enterprises (privatization effected in 2004)		EUR 602 million
• Net revenue on commercial bank accounts with the BNB for maintaining minimum required reserves		EUR 394 million
• Revenue from disbursed external loans		EUR 175 million
		SDR 11 million
• Revenue from domestic debt issues		EUR 17 million
<i>To decreasing international reserves</i>		
• Government external debt service (incl. early external debt repayment)		USD 1777 million
		EUR 728 million
		JPY 2.1 billion
		SDR 26 million
• Net withdrawals from minimum required reserve accounts of banks		USD 99 million
		CHF 52 million
• Domestic debt payments		EUR 14 million

The increase in euro-denominated assets reflected mainly net purchases of reserve currency from commercial banks to the amount of EUR 1419 million. However, the increase was also due to currency structure changes in liabilities. Pursuant to amendments to Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks in force from April 2005, commercial banks may maintain minimum required reserves only in the national and reserve currencies (lev and euro). For this reason, at the close of the first and beginning of the second quarter commercial banks withdrew all available funds in

Swiss francs and US dollars from their foreign currency accounts with the BNB. This changed the structure of BNB monetary liabilities, with the share of those denominated in levs and euro exceeding 95 per cent of all liabilities on average. Decreases in USD-denominated assets were also ascribable to the significant early external debt repayments in US dollars effected by the Ministry of Finance. The relative share of assets in gold went down due to the increase in international reserves over the reporting period.

During 2005 insignificant changes occurred to the structure of assets by financial instrument. The share of assets in cash and those invested in securities increased at the expense of the contracted share of deposits with foreign banks. In 2005 over 75 per cent of assets on average was invested into securities.

Structure of Gross International Reserves by Financial Instrument

(%)

Instruments	2004	2005
Vault cash*	8.0	11.7
Deposits**	14.6	10.2
Securities**	74.5	75.5
Gold in the vault	2.9	2.6

* Financial instruments with a maturity of up to three days.

** Including instruments in foreign currency and gold.

Note: Average data for the period.

Source: BNB.

The structure of assets by residual term to maturity underwent more significant changes reflecting the BNB decision to change benchmarks of assets in euro. The share of assets with residual terms to maturity of over one year increased, while that of assets with residual terms to maturity of up to one year went down. Nevertheless, the weight of short-term maturity assets remained the highest for the period, assets invested in this sector averaging 59 per cent of international reserves.

Structure of Gross International Reserves by Residual Term to Maturity

(%)

Maturity sectors	2004	2005
Up to 1 year	82.6	59.1
From 1 to 3 years	12.3	15.8
From 3 to 5 years	4.4	12.8
From 5 to 10 years	0.7	11.7
From 10 to 30 years	-	0.6

Note: Average data for the period.

Source: BNB.

2. Gross International Reserves Risk and Income

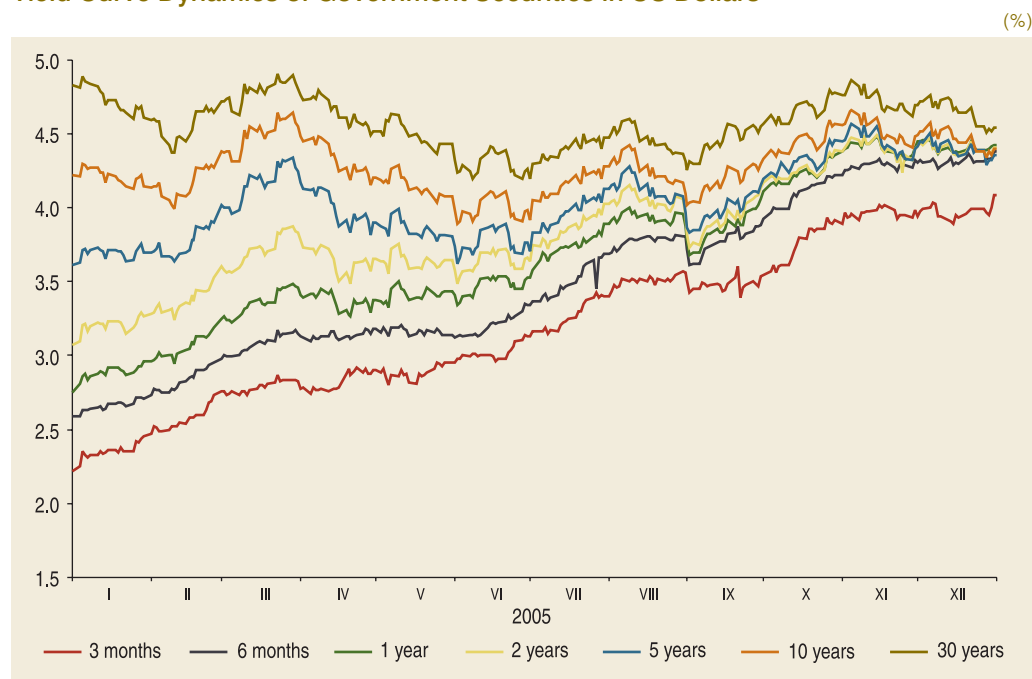
The Market Environment

In 2005 the US Federal Reserve System continued gradually raising federal funds interest rates in eight steps by 25 basis points. While clearly formulating future intentions of changes, this monetary policy helped subdue uncertainty and decrease risk premium on financial markets, thus avoiding dramatic fluctuations in government bond prices. The yield on two-year treasury notes which depend on expected federal funds interest rates increased over the year by approximately 120 basis points. Long-term interest rates rose by a mere 20 basis points despite the appreciation of short-term resources over the same period. The yield curve slope tended to flatten which was seen in the spread for securities in the two to ten year maturity sector narrowing to zero by the end of the period. Possible explanations for this atypical behaviour include sound inflationary expectations, markets' confidence in Federal Reserve System anti-inflationary policy, and expectations of a decreasing medium-term rate of US economic growth.

Throughout most of 2005 the ECB made no changes to its monetary policy despite the growing expectations and related market fluctuations. Low economic growth was an important reason for putting off the ECB decision on an increase in interest rates on refinancing operations since inflation measured by the harmonized index of consumer prices stayed at the reference level of 2 per cent over the whole period. After euro area and EU economic indicators be-

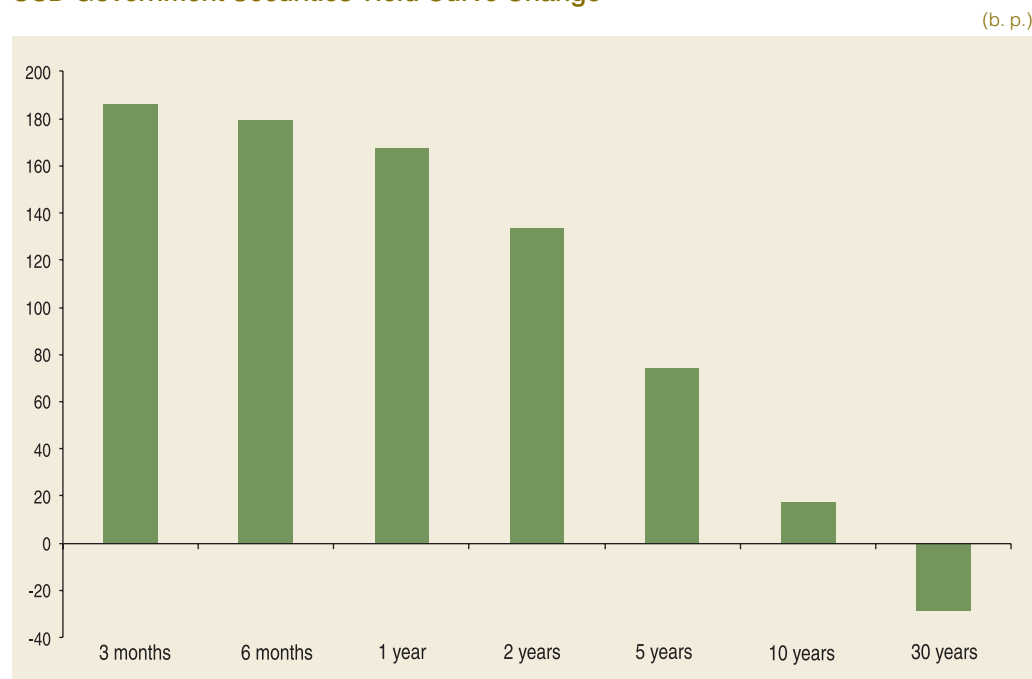
gan improving in summer 2005 and economic growth accelerated over the third quarter, in December the ECB raised the refinancing operations rate by 25 b. p. with the intention of counteracting possible inflation knock-ons of higher crude oil prices. In October ECB representatives' official statements suggested, though ambiguously, that a change may be expected in the policy. Market participants reacted immediately and the securities yield in the up to two year sector rose by more than 40 b. p. over the fourth quarter. Similarly to the US yield curve, the euro area government bond yield in long-term maturity sectors rose by a mere 10 b. p. underpinned by market expectations of low future inflation and relatively moderate economic growth.

Yield Curve Dynamics of Government Securities in US Dollars



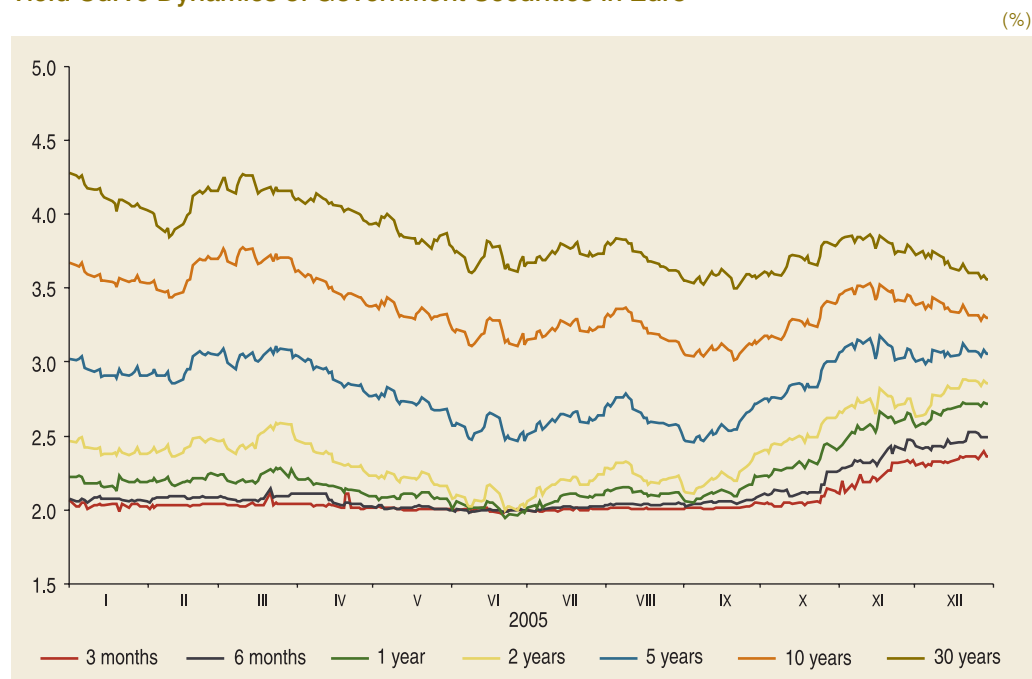
Source: BNB.

USD Government Securities Yield Curve Change



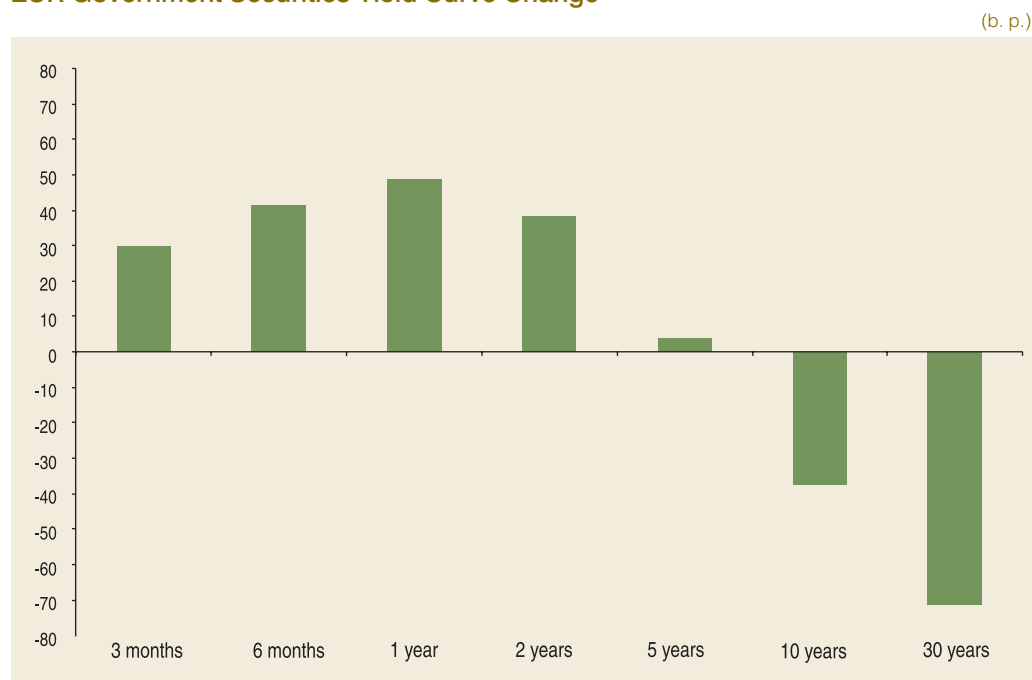
Source: BNB.

Yield Curve Dynamics of Government Securities in Euro



Source: BNB.

EUR Government Securities Yield Curve Change



Source: BNB.

In 2005 the US dollar appreciated by some 12 per cent against the euro, reflecting the simultaneous effect of several factors such as the growing differential between US and euro area money market interest rates, large financial inflows into the US economy (especially from Asia), and stabilizing US current account deficit over the first eight months of the year under review. Between September and December the USD/EUR exchange rate remained almost unchanged.

US Dollar Price in Euro



Source: BNB.

In 2005 the gold price rose by more than 20 per cent in US dollar terms. The change was most clearly pronounced in the third quarter when a significant increase in investment demand and its open positions was reported. Most investors' decisions were motivated by increased inflationary expectations associated with petrol price rises, greater gold demand by China and Russia, and expected moves in the USD/EUR exchange rate. According to some observers, gold appreciation was due to high global liquidity and demand by institutional investors not obliged to comply with special investment constraints but taking risks on speculative strategies¹⁶ for investing in alternative, more profitable asset classes.

One Troy Ounce Gold Price in US Dollars



Source: BNB.

¹⁶ Hedge funds.

One Troy Ounce Gold Price in Euro



Source: BNB.

Major Risks Associated with International Reserves

Over the reporting period international reserve **interest rate risk** measured by reserves' average modified duration was 1.69. It increased on 2004 (0.57) due mainly to the new benchmark introduced in early 2005 and the subsequent restructuring of portfolios.

The amendments to the Law on the BNB imposed the requirement that absolute values of open foreign currency positions in currencies other than euro, SDR, and monetary gold should not deviate by more than 2 per cent from the market value of monetary liabilities in these currencies which set limits to international reserve **currency risk**.¹⁷ In the reporting period open currency positions remained limited, with the open gold position posing the major currency risk to the Bank.

Credit risk was managed by setting minimum credit ratings and maximum exposure to the respective asset classes. Funds invested in assets with the highest credit rating (AAA) averaged 70.5 per cent during the period under review. The Bank's exposure comprised an annual average of 23.5 per cent of total assets.

Operational risk was managed in strict compliance with, and control over, relevant business procedures for international reserve management.

Profitability and Efficiency

Over 2005 earnings from BNB international reserves came to EUR 146.64 million: an asset profitability of 2.1 per cent. Positive earnings from currency imbalance¹⁸ to the amount of EUR 150.42 million were mostly attributable to the open position in gold and resulted from the increase of the gold price in euro. Interest paid on Issue Department balance sheet liabilities amounted to EUR 39.48 million. As a result of these three components, net earnings from international reserve management in 2005 were EUR 257.57 million, or 3.7 per cent profitability.

¹⁷ An open foreign currency position is the difference between the value of assets and liabilities in any currency other than euro.

¹⁸ Earnings from currency imbalance is the sum total of the effects from exchange rate movements on open foreign currency positions of assets and liabilities.

Profitability of International Reserves

(million EUR)

Quarters	Investment earnings (1)	Earnings from currency imbalance between assets and liabilities (2)	Expenditure (interest) on liabilities (3)	Earnings, net (1)+(2)+(3)
I	27.45	13.46	-8.35	32.55
II	94.58	43.68	-11.74	126.51
III	13.31	42.03	-9.56	45.78
IV	11.30	51.26	-9.83	52.73
Total	146.64	150.42	-39.48	257.57
Profitability, share of assets,%	2.12	2.12	-0.56	3.71

The change in the net value corresponding to the *Banking Department Deposit* item in the Issue Department balance sheet resulted from two major factors. First, the net income from international reserves contributed to the net value rise by EUR 257.57 million, or a profitability of 37.9 per cent. Second, the contribution to the state budget for 2005, worth EUR 76.21 million, led to a decrease in the net value.

Risk and Profitability of Portfolios

Portfolio	Portfolio base currency	Profitability		Risk		Information coefficient***
		Absolute (%)	Relative (basis points)*	Absolute (%)	Relative (basis points)**	
Investment 1	EUR	2.18	-2	1.00	13	-0.14
Investment 2	EUR	2.30	12	1.05	9	1.41
Liquidity	EUR	2.04	5	0.09	3	1.91
Liquidity	USD	2.77	10	0.27	13	0.71
In gold	XAU	0.02	2	0.17	17	0.14
External manager A	EUR	2.54	-1	0.96	27	-0.05
External manager B	EUR	2.50	20	1.16	39	0.51

* The positive relative profitability of an individual portfolio is the profit compared with benchmark profitability. If the profitability were negative, it would be shown as a loss of profit in portfolio management.

** The relative risk to the benchmark is an indicator of the deviation degree of risk characteristics compared with those of the benchmark resulting from active portfolio management.

*** The *information coefficient* is the ratio between the expected relative profitability of an individual portfolio and its relative risk. A rule of thumb is that values over 0.5 indicate efficient portfolio management.

International reserves are split into portfolios by currency, each portfolio with a specific investment goal and benchmark. To diversify management styles and reduce operational risk, in early 2005 two investment portfolios were split for management by different teams. In the review period a portion of international reserves has again gone under external management (8.6 per cent by end-2005). Beside additional diversification, using external managers helped exchange expertise in investing on international markets.

III. The National Payment System

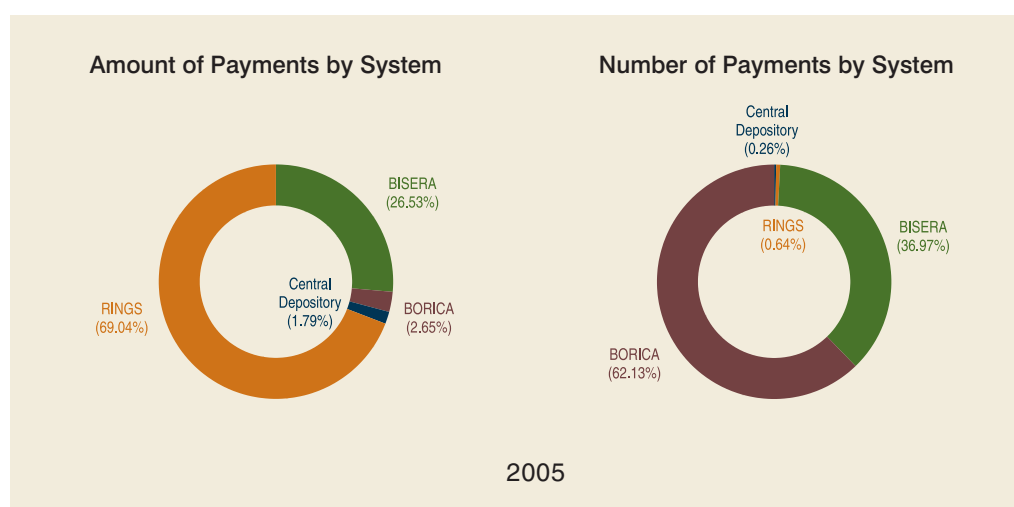
Pursuant to the Law on the Bulgarian National Bank, the Bank supports the development and operation of efficient payment systems and oversees them. The BNB is mandated to oversee individual systems for settlement of payments and securities and to judge their effectiveness. Adequate systemic risk management is of great importance to the proper functioning of the national payment system.

Under the current legal framework, participants in the national payment system are the Bulgarian National Bank and all commercial banks; the BISERA system for servicing customer payments initiated for execution at a designated time operated by Bankservice AD; the BORICA (Banking Organization for Payments Initiated by Cards) system managed by BORICA EOOD,¹⁹ the System for Servicing Payments on Transactions in Book-entry Government Securities operated by the Central Depository AD; the System for Servicing Payments on Government Securities Transactions operated by the BNB; and the RINGS (Real-time Interbank Gross Settlement) system operated by the BNB.

In 2005 the sale of 63.8 per cent of BNB shares in BORICA EAD to 25 commercial banks was completed and BORICA was transformed into a public equity company (AD).

The number of commercial banks participating in the national payment system decreased to 33 in 2005 after the banking license of the International Bank for Trade and Development was revoked (June) and the National Bank of Greece closed its branch in Bulgaria, and its transactions were taken over by the United Bulgarian Bank (December).

Distribution of Payments in Bulgaria



Source: BNB.

With the progressively growing number and value of non-cash payments processed by the system, the inability of a large bank to fulfill its obligations is a potential source of financial instability for the entire banking system. Therefore, the central bank makes efforts to implement and improve the infrastructure for processing large payments with a view to limiting payment risks. Over the year some 80 per cent of payments were processed by RINGS although only 0.6 per cent of payments were effected through this system.

¹⁹ BORICA is also a Member Service Provider (MSP) of MasterCard Europe and a Processor Company of Visa International.

1. RINGS (the Real-Time Interbank Gross Settlement System)

In 2005 RINGS payments numbered 782,736 totaling BGN 163,831 million. Compared with 2004, daily average payments increased by 34.3 per cent, their amount rising by 27.3 per cent. Over the year, 48.6 per cent of payments were processed by noon and 75.4 per cent by 2:30 p.m. As regards busiest system time, 92.4 per cent of RINGS payments were effected by 2:30 p.m. The increase in these indicators on 2004 shows upward trends in using the system for transfers in real time and for processing payments earlier in the day, which subdues the risk of non-effected payments by the end of the system day.

Over the period no payments were rejected by the close of a system day due to insufficient funds on any participant's account which is indicative of low risk with RINGS. This, coupled with high system liquidity, precluded recourse to the Reserve Collateral Pool established as an interbank insurance mechanism to guarantee settlement of system operators' orders. In the period under review RINGS offered 99.8 per cent availability²⁰ against 99.7 per cent in 2004. This value is in line with TARGET (the system for processing large euro area payments). Operational problems were handled under contingency rules and procedures.

A new version of RINGS software with improved functionality and enhanced facilities required by the BNB and other system users (banks and system operators) was tested during the year and its launch in 2006 is pending as a part of the project on upgrading the system's technical platform and software.

2. Changes in the Legal Framework

The main objective of the Law on Funds Transfers, Electronic Payment Instruments, and Payment Systems adopted in late March 2005 and in force from October is to provide payment system stability and protect participants in the payment process, and customers in particular. The Law regulates relations in electronic payment instruments and systems and ensures harmonization of Bulgaria's legal framework in this sphere with *acquis communautaire*: an important step in the process of integrating Bulgaria's payment infrastructure with that of European states.

In compliance with the Law's provisions, on 30 September the BNB adopted two new Ordinances related to it: Ordinance No. 3 on Funds Transfers and Payment Systems and Ordinance No. 16 on Electronic Payment Instruments. The two Ordinances rest on the provisions of the Law, accumulated experience, and statutory instruments proposed by the EU. They outline the payment process and infrastructure, ensuring sufficient flexibility for the intensive development of non-cash payments and public developments stemming from it.

Ordinance No. 3 regulates the main requirements for the payment systems' operations and functions and risk management rules. It contains detailed prescriptions on terms and procedures for granting licenses to system operators and lists required documents. Special attention is paid to system operators' accountability and to the control they exercise over payment system participants. Changes were made to the documents used in the payment process.

The new BNB Ordinance No. 16 regulates for the first time some electronic banking aspects, especially in the context of electronic banking payment applications as remote access payment instruments. The Ordinance differentiates between electronic money issue and deposits and defines report forms related to electronic payment instruments.

In April 2005 the BNB passed Ordinance No. 13 on the Application of International Bank Account Numbers and Bank Identifier Codes.²¹ IBAN is an international bank account identifier used in cross-border transfers. It allows straight through customer payment processing and increases the effectiveness, speed and quality of international and local payments. In view of the compatibility of Bulgarian payment systems, the project will promote their modernization, improve payments in the budget sphere, and improve bank service. The introduction of an international bank account format corresponding to that used in the EU will ensure synchronization of payments and settlement infrastructures with European ones.

Launching IBAN is a sizable project involving all payment systems' participants and their customers. A Coordinating Council on IBAN Implementation convened to ensure deadlines set in Ordinance No. 13 are met and to coordinate institutions. RINGS participants, the Association of Commercial Banks, and the Ministry of Finance are members.

²⁰ The time during which the system was serviceable as part of total time.

²¹ The Ordinance shall come into force on 5 June 2006.

A National Council on Payment Systems representing various institutions engaged in the payment process was convened in April 2005. Its major objectives are to devise a strategy for payment system development, organize and coordinate Bulgaria's financial integration into the euro area as regards payments, and assist the Single European Payments Area (SEPA) project. The Council will combine the interests of participants in the payment process, coordinate the various payment systems bodies, make proposals and develop terms of reference for innovation in payment systems, set requirements for integrating national payment systems into international standards, and propose legislative change.

3. Payment Systems Oversight

Limiting systemic risk and improving the reliability and efficiency of Bulgarian payment systems was the major goal of payment systems' supervisors. They monitor constantly the various national payment systems and assess the compatibility of the national payment system with the principles, standards, and recommendations of the Bank for International Settlements, the International Organization of Securities Commissions, the European Central Bank, and the European System of Central Banks. On this basis, the BNB makes recommendations for improving individual payment system operations. The year under review saw oversight inspections of:

- the system for servicing customer payments initiated for execution at a designated time (BISERA)
- the system for servicing bank card payments within Bulgaria (BORICA);
- the system for servicing payments on transactions in government securities (SSDSK);
- the system for servicing payments on transactions in book-entry government securities (the Central Depository).

The results showed high compliance with international standards and practice. Actions to further convergence mostly concern improving operator aptitude and adjusting the requirements for euro system participation.

IV. Commercial Bank Reserves with the BNB

Amendments to Ordinance No. 21 adopted in 2004 and 2005 with regard to banks' minimum required reserves and increasing the deposit base boosted the total volume of minimum reserves while retaining the rate at 8 per cent of the deposit base.²² Average reserves due in 2005 rose by 169.4 per cent on the 2004 average, with borrowed funds, subject to minimum required reserves, rising by 138.9 per cent (in levs) and 149.8 per cent (in foreign currency).²³

Following the statutory amendments, banks revised their minimum required reserves policies, with banking system excess reserves falling to 84 per cent on the prior year due to more precise management of funds on accounts with the BNB (on which no interest accrues). Lev-denominated reserve assets more than doubled on the previous year, their absolute amount exceeding settlement needs threefold. Foreign currency reserve assets increased by 158.7 per cent. The range of fluctuations in foreign currency (euro) minimum reserves contracted significantly, in individual months making up between 35 per cent and 49.2 per cent of required reserves (as a proportion of total borrowings in foreign currency).

Over the year two banks admitted minimal non-compliance with the requirement to maintain reserves and four banks used over half of their reserve assets on individual days. Sanctions to the amount of BGN 2072 were imposed on them pursuant to BNB Ordinance No. 21.

Violations of restrictions to credit growth brought 11 banks sanctions to deposit additional minimum reserves, four of them for the whole period. In the first base period (coinciding with the second quarter of 2005) additional reserves of BGN 216 million were deposited by five banks. In the second period eight banks deposited reserves of BGN 383 million, and in the third base period (for which the sanction was effectively imposed as from 4 February 2006) eight banks submitted BGN 684 million of additional reserves.

²² Amendments to Ordinance No. 21 are discussed in detail in Chapter I.

²³ For more details on banks' behaviour in response to amendments to Ordinance No. 21 see the BNB *Economic Review* quarterly, May and August 2005.

V. Cash in Circulation

The Bulgarian National Bank has a monopoly on banknote and coin issue in Bulgaria.²⁴ Banknotes and coins issued by the Bank are legal tender and are mandatorily acceptable as payment at full face value without restriction. The BNB prints banknotes and mints coins, and safeguards uncirculated and withdrawn banknotes and coins.

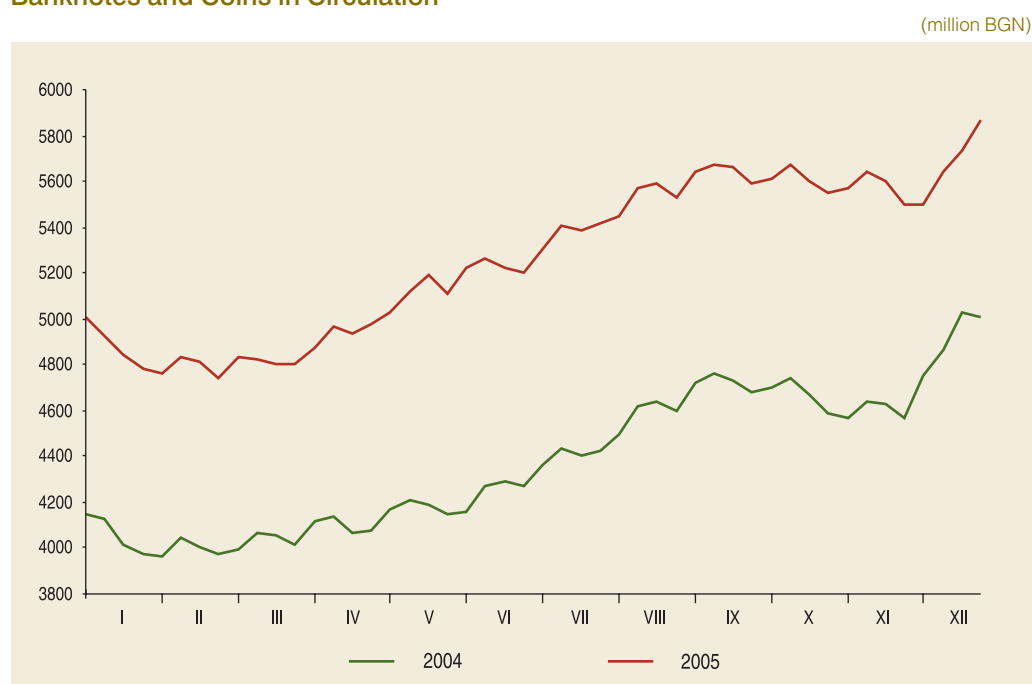
Amendments to Article 27 of the Law on the BNB adopted in January 2005 specify BNB powers and duties in the fight against counterfeiting and distributing non-genuine banknotes and coins in national and foreign currency. In early 2005 the BNB and the ECB signed a bilateral agreement to protect the euro against counterfeiting. This provides for exchanging complete, up-to-date, and comparable data on non-genuine and altered euro banknotes.

On 20 October 2005 the BNB adopted an Ordinance on the Control over Quality of Banknotes and Coins in Cash Circulation. After coming into force on 30 March 2006, it tightened BNB powers over the reproduction of Bulgarian banknotes and coins and the retention and evaluation of suspected non-genuine or altered banknotes and coins. The Ordinance regulates terms and procedures to be applied by commercial banks and inland suppliers of services as regards exchanging mutilated or damaged Bulgarian banknotes and coins, using sorting and customer-operated machines.

Banknotes and Coins in Circulation (Outside BNB Vaults)

By the close of 2005 cash in circulation²⁵ came to BGN 5867.2 million nominal value, up by BGN 864.5 million or 17.3 per cent on the close of 2004.

Banknotes and Coins in Circulation



Source: BNB.

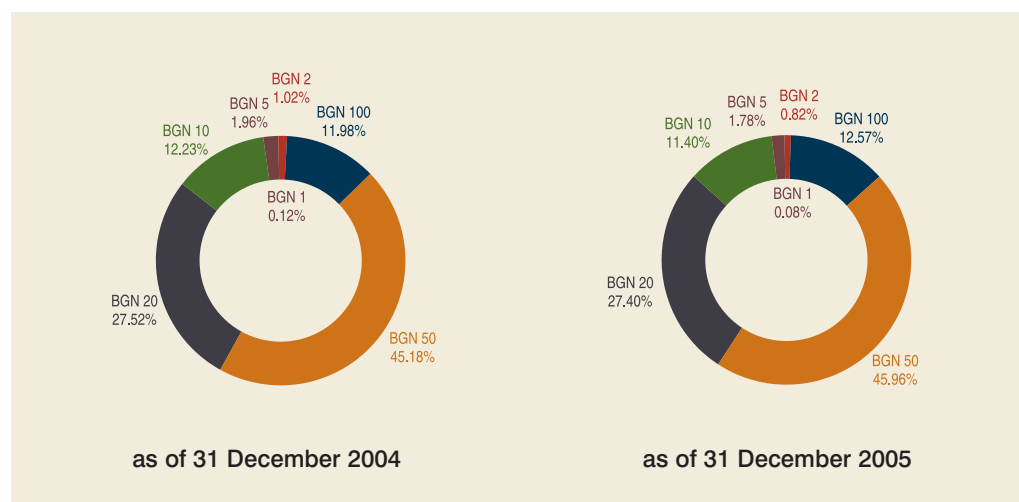
²⁴ Article 2, paragraph 5 of the Law on the Bulgarian National Bank.

²⁵ Banknotes and circulating and commemorative coins issued after 5 July 1999. Under resolution No. 110 of the BNB Governing Council, banknotes and coins in circulation whose exchange term has not expired and which have not been returned to BNB vaults were written off the Issue Department balance sheet liabilities on 7 October and entered onto the Banking Department balance sheet liabilities.

By the end of 2005, 253.9 million banknotes were in circulation, amounting to BGN 5774 million. Their number rose by 25.2 million or 11 per cent and their value by BGN 849.5 million or 17.2 per cent on 2004. By 31 December 2005 banknotes comprised 98.4 per cent of the total value of banknotes and coins outside BNB vaults. The average banknote in circulation by 31 December 2005 was worth BGN 22.74, up BGN 1.20 or 5.6 per cent. The recent years' upward trend in the average value of banknotes in circulation reflects the enhanced demand for higher denomination banknotes. The rising number of commercial bank ATMs prompted the use of 10, 20 and 50 lev denominations.

Denomination Composition of Circulating Banknotes

(share of total value, %)

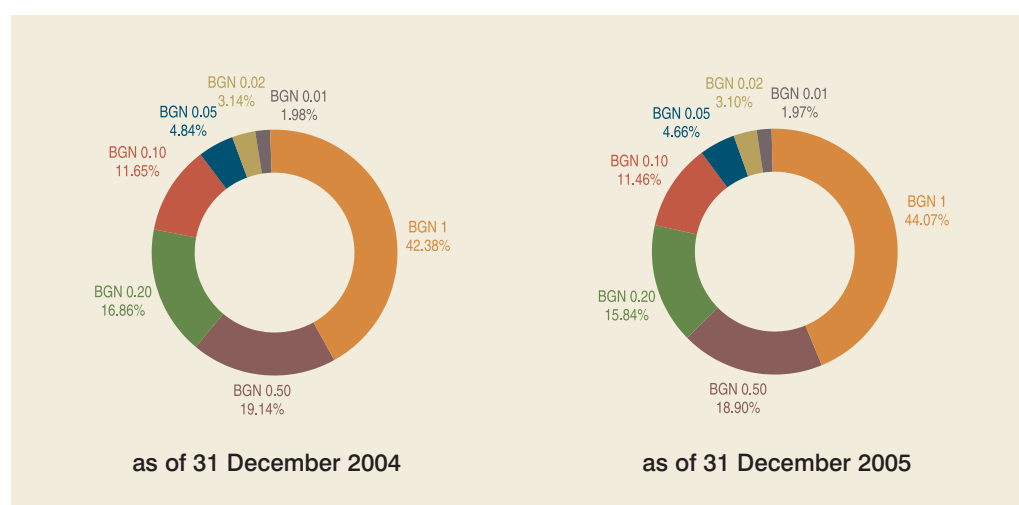


Source: BNB.

By the end of 2005 coins in circulation numbered 651.1 million, worth BGN 90.3 million. Compared with the end of 2004, their number grew by 96.5 million (17.4 per cent) and their value by BGN 14.7 million (19.4 per cent). As of 31 December 2005 circulating coins accounted for 1.5 per cent of cash outside BNB vaults. The average coin in circulation over the review period matched the 2004 level at 0.14 levs. Commemorative coins comprised 0.1 per cent of the total value of cash in circulation.

Denomination Composition of Circulating Coins

(share of total value, %)



Source: BNB.

Non-genuine Banknotes and Circulating Coins

Amendments to Article 27 of the Law on the BNB adopted in early 2005 set down a statutory interface mechanism between the central bank and financial institutions regarding withdrawals of retained banknotes and coins suspected as non-genuine or altered. The BNB National Analysis Centre performs authentication checks and evaluations of Bulgarian and foreign banknotes and coins suspected as non-genuine or altered and referred by financial institutions or the legal system.

Over 2005 non-genuine Bulgarian banknotes reported by the BNB numbered 2097. Non-genuine banknotes and coins seized prior to entering into circulation numbered 189, with 1908 having entered into circulation. Compared with 2004 non-genuine banknotes decreased by 198 in number or 8.6 per cent. Non-genuine banknotes of BGN 10 nominal value accounted for the largest share (32.9 per cent) followed by banknotes of BGN 50 nominal value (32.1 per cent) and banknotes of BGN 20 nominal value (28.3 per cent). Reported non-genuine banknotes of BGN 2 and 5 numbered 141 (6.7 per cent).

Evaluating foreign banknotes and coins retained within Bulgaria, in 2005 the Bank's National Analysis Centre retained 1939 euro banknotes, 28,623 US dollar banknotes, and 271 other foreign banknotes.

BNB Cash Operations

Cash operations conducted by the BNB included operations on supplying and retrieving banknotes and coins in the form of valuable packages to and from commercial banks, keeping uncirculated fit and unfit banknotes and coins, sorting, counting and destructing banknotes, counting coins, monitoring the authenticity and physical properties of banknotes and coins accepted by the BNB, servicing retail customers in lev and reserve currency, and selling commemorative coins at tills. Operations in lev and foreign currency by first level budget spending entities are effected at the Sofia Regional Cash Office.

On 15 September 2005 the BNB put in circulation its first commemorative banknote with a nominal value of BGN 20, issue 2005, with a circulation of 250,000. The banknote celebrated the 120th anniversary of the first Bulgarian banknote. In December 2005 a banknote with a nominal value of BGN 2, issue 2005, was put in circulation.

In compliance with its coin minting programme, the BNB put into circulation four commemorative coin issues.²⁶

Over 2005 the BNB processed 332.7 million banknotes and 99.8 million circulating coins worth BGN 4433.1 million: an 11.5 million (3.6 per cent) increase in banknotes and a 7.1 million (7.1 per cent) decrease in coins on 2004. Banknotes of 10 and 20 lev denominations, and coins of 1 lev and 10 and 20 stotinkas comprised the largest shares in the structure of banknotes and coins processed by the BNB. In 2005 banknotes retained in processing as unfit for circulation numbered 76.5 million, down 7.3 million or 8.8 per cent on 2004.

BNB purchases and sales of banknotes and coins from and to commercial banks totaled BGN 96,689.3 million. The Bank purchased 318.5 million Bulgarian banknotes and 29.4 million coins amounting to BGN 4460.8 million from commercial banks, an increase of BGN 192.5 million or 4.5 per cent compared with 2004. The BNB sold the banks 337.7 million Bulgarian banknotes and 132.6 million coins totaling BGN 5208.5 million, an increase by BGN 366.6 million or 7.6 per cent on 2004.

BNB purchases of reserve currency through its regional cash centres totaled EUR 2.9 million, including EUR 2.3 million from individuals and EUR 0.6 million from budget organizations. Reserve currency sales amounted to EUR 15 million, including EUR 8.7 million to individuals and EUR 6.3 million to budget organizations. BNB reserve currency purchases fell by EUR 34 million (92.1 per cent) on 2004.

²⁶ Information on commemorative coins is published on the BNB website.

VI. Maintaining Banking System Stability

1. State of the Banking System

In 2005 banking assets, held mainly by the big ten banks, totaled BGN 32,886 million, up by BGN 8016 million (32.2 per cent) on the end of the prior year. Increases in total deposits (by BGN 5898 million) and long-term borrowing (by BGN 831 million) were major inputs into balance sheet asset growth. Despite higher absolute nominal loan growth compared with the previous two years, the 33.2 per cent growth in 2005 was considerably lower compared with the prior year (47.2 per cent).²⁷ Intensive lending curbs over the year achieved the BNB's two main objectives: matching credit growth to that of assets, borrowings and especially of capital, and checking falling capital adequacy at a level consistent with system risk profile.²⁸

In the review period the *investment portfolio and claims on financial institutions* were the most dynamic balance sheet items, reporting considerably higher growth than loans after BNB credit restrictions. The growth of investment held to maturity and investment available for sale totaled 49.6 per cent (BGN 895 million) and deposits with banks and other financial institutions went up by 49.1 per cent (BGN 1925 million). As a result of directing free funds into short-term low-risk and relatively profitable financial instruments, by the close of 2005 claims on financial institutions reached BGN 5847 million, increasing their share in system assets by 2 percentage points to 17.8 per cent. The change was most clearly pronounced in time deposits with banks, including overnight transactions which increased by BGN 2202 million (74.4 per cent). In a year the share of claims on foreign banks in total claims on banks contracted from some 80 per cent to 64.5 per cent. Trading portfolio assets grew by just 1 per cent (BGN 19 million), their share in system assets declining to 6.2 per cent due to the requirement for reporting position risk under BNB Ordinance No. 8 on the Capital Adequacy of Banks in force from 1 July 2005.

Net loans (total portfolio less allocated provisions) remained the major balance sheet asset position with a share of 53.9 per cent against 53.6 per cent a year earlier. Bulgarian banks' lending and asset restructuring rates indicated credit values in the assets above EU averages. The share of claims on the private sector in the structure of assets ranked Bulgarian banks above credit institutions in over half the EU, although its value stabilized close to the EU average as a result of the imposed restrictions. The net credit portfolio grew by BGN 4401 million (33 per cent) on the end of 2004. Almost half the increase represents new commercial loans (BGN 2161 million). Some banks' drives to boost retail banking cut commercial loans in the portfolio structure to 63.1 per cent at the end of the reporting year against 71.3 per cent in 2003 and 68.3 per cent in 2004. In an average annual horizon the amount of loans newly extended to households (consumer and mortgage loans) picked up by BGN 2387 million. A low base explains the considerably higher growth of mortgage and consumer loans (101.3 per cent and 49 per cent respectively) compared with commercial loans (22.9 per cent). The currency structure of portfolio growth indicated a greater demand for lev loans (up by BGN 2345 million) followed by euro loans (up by BGN 2182 million) while newly extended loans in other currencies went down by BGN 126,000. At the close of 2005 lev loans continued to prevail at 52.2 per cent of the total, with euro loans coming at 43.7 per cent and loans in other currencies at 4.1 per cent.

The system's deposit base continued growing sustainably, by 30.2 per cent to BGN 25,428 million in a year, largely thanks to rising time deposits. Over the last 12 months financial institutions' deposits went up by BGN 2171 million (77.7 per cent) and funds attracted from non-financial customers by BGN 3727 million. As regards the internal structure of resources from non-financial institutions, over the year time deposits posted the highest growth (by BGN 2563 million or 34.9 per cent) followed by demand deposits (by BGN 799 million or 10.9 per cent), and savings deposits (by BGN 365 million or 17.8 per cent). The analysis of the currency structure of the total financial and non-financial customers' deposit base showed a

²⁷The insignificant difference in credit growth rates shown here and in Section I is due to methodological differences in determining credit portfolio scopes for supervisory and statistical purposes.

²⁸While banking system capital adequacy contracted by 5.6 percentage points between 2003 and 2004, in the reporting year the decline came to 1.3 percentage points. At the close of 2004 credits posted a 47.2 per cent annual rise, while the capital base grew just 7.9 per cent. After lending restrictions, their growth rates converged: 32.4 per cent for own funds and 33.2 per cent for credits.

trend similar to that of loans: lev deposits posted the highest increase (BGN 3427 million) followed by euro deposits (BGN 1940 million). As a result, by the end of 2005 borrowings in local currency occupied 47.5 per cent of the total deposit base, with those in euro at 34.3 per cent.

While short-term borrowings decreased by BGN 108 million (31.5 per cent), long-term borrowings strengthened their position as an alternative liquidity source and increased by BGN 831 million (54.8 per cent) over the year. The share of long-term borrowings among finance sources picked up from 7.1 per cent to 8.4 per cent (against 4.5 per cent at end-2003). Almost 84 per cent of long-term borrowings were denominated in euro.

Over a year the total amount of funds for financing (excluding capital) rose by BGN 6621 million (31 per cent). Over the same period the *own funds* balance sheet aggregate went up by BGN 731 million (26.8 per cent). The BGN 360 million increase in the system's reserves and the support of capital by new issues of ordinary shares (BGN 184 million) were the major contributors to this. Banking system profits at the end of 2005 reached BGN 573 million: up by BGN 152 million (36.1 per cent) on 2004.

Processes and factors underlying system risk profile moved dynamically. Assets retained their good quality despite the deepening problems in a part of the mortgage and consumer credit portfolio. Banks maintained placements with financial institutions assigned high ratings, preserving the good quality of their investment and trading portfolios. Despite market conditions changes as a result of lending restrictions, no substantial reorientation to higher risk instruments emerged. Though some institutions strove to diversify portfolios with less conventional products, as a whole placements in Bulgarian government securities and those of governments and central banks listed in BNB Ordinance No. 8 Appendices 1 and 2 prevailed.

Lending involved significant product innovation, intense competition for *individuals and households*, and rate cutting. The lending slowdown enabled institutions to reorganize credit information and human resources. The bulk of banks in the system showed moderate credit growth; however, following the first quarter of 2005 several institutions steadily increased their portfolios more rapidly than Ordinance No. 21 envisages.

Credit risk remained at a good and stable level in the corporate segment but worsened in consumer and mortgage loans. There were well-grounded concerns that growing household debt would sharpen sensitivity to shocks such as long-term interest rate movements, changes in house prices and rent levels, and income falls due to inflation. By the end of 2005 the share of classified loans in total loans to non-financial institutions was BGN 1420 million or 7.7 per cent (against BGN 974 million or 7.1 per cent in 2004) and the share of classified assets was 4.2 per cent (BGN 1421 million) of system gross assets (3.9 per cent or BGN 978 million in 2004). In essence, the system does not maintain classified assets outside loans which indicates the significance of credit and the quality of placements in financial institutions.

Banks managed to control risks related to income and expenditure management, achieving and maintaining good interest incomes and revenues from trading and investment portfolio operations. Operating expenditure rose at admissible rates. Asset provisioning and internal rules adequate to risk in most banks matched asset structure and quality. Good revenue from core operations was attained at the system level and by most banks. Irrespective of accelerating asset impairment over the last 12 months, their good quality, coupled with diversifying financial intermediation and controlling operating expenditure growth enabled most banks to ensure adequate returns on assets and equity. Return on assets reached 2 per cent (2.1 per cent in 2004), core ROA came to 2.6 per cent (it was the same in 2004), and return on equity (ROE) was 21.6 per cent (20 per cent in 2004).

The stable level of own funds maintained over the year resulted in covering major bank risks. The amount of own funds under BNB Ordinance No. 8 used for major risks' measurement totaled BGN 2985 million (against BGN 2321 million at the end of 2004). The reasons underlying the decrease in capital indicators which continued in 2005 were the gradual growth in the total risk component, the use of additional capital for covering market risk in banks' trading portfolios, and inability to use current profit for capital support. Capital adequacy dropped to 15.3 per cent against 16.6 per cent in 2004, with primary capital adequacy falling to 12.5 per cent against 14.4 per cent in 2004. Despite the positive capital position, the review period saw excessive optimism in asset risk evaluation, weaknesses in capital growth planning and management leading to late management reactions at some banks, and tracking capital adequacy requirements rather than seeking economic value. Some banks displayed over frequent capital position fluctuations around minimum admissible levels, with dips below regulatory minima.

Liquid asset levels matched the structure and maturity of borrowings, predetermining low liquidity risk. In the 2004 to 2005 period banking system liquidity remained good and the

system's adequate liquidity potential was shown not only by increases at most banks, but also by better component ratings compared with 2004. In 2005 commercial banks experienced no serious liquidity shortfalls, major balance sheet aggregates (assets, deposits and loans) contributing to improved key liquidity ratios. This high assessment of system liquidity was backed by sustainable core borrowing growth and converging rates of deposit and credit growth in line with regulatory moves. Institutions subject to intensified attention experienced no liquidity deficiencies thanks to, *inter alia*, competing with good liquidity managers for financial market access; higher sensibility to factors like media coverage or equity structure changes; problematic asset quality yielding unstable revenues; financing strongly dependent on non-core borrowings and considerable deposit concentrations.

System and individual bank sensibility to changes in market risk has been monitored since July 2005 under the new BNB Ordinance No. 8. Data support conclusions reached earlier by a less perfect methodology that market risk is not of key importance for system risk profile and that of most banks. System-wide, market risk capital cover was 3.8 per cent, with the structure dominated by position risk related to debt instruments (mainly government securities and securities from investment rated issuers).

Comparing Bulgarian banks with those in the EU on selected indicators shows the former in a favourable light.

The share of non-performing loans was 2.2 per cent (in Bulgaria this means loans past due over 90 days). This was lower than the EU average (2.7 per cent in 2004)²⁹ and was accompanied by higher risk provisioning. The latter reflected stricter Bulgarian classified loan provisioning criteria and a more conservative treatment of security in line with high liquidity requirements.

Comparing banking system profitability with the EU shows Bulgarian banks earning better and offering higher ROE. The major factor here was the high interest rate margin applied by local banks. Considerable lending growth combined with broadening financial services for individuals and small and medium businesses over recent years also contributed to high net interest incomes in Bulgaria compared with the EU's developed financial market. Though Bulgaria's banking system ranks with EU net non-interest income leaders, financial intermediation is insufficiently developed. The lower share of net non-interest income in the system's interest structure compared with other countries bears this out.³⁰ Crossover services at some banks (for instance insurance and banking) and expanding smart card business and miscellaneous services have not yet diversified fee and commission income sources in contrast with elsewhere in Europe.

As regards capital indicators, adequacy levels at local banks were higher. EU and Bulgarian banking supervisors aim at solvency a few percentage points above regulatory minima. EU banks reported 11.9 per cent capital adequacy for 2004 against the regulatory minimum of 8 per cent, while Bulgarian banks reported 16.6 per cent for 2004 and 15.3 per cent for 2005 against a 12 per cent minimum regulatory level.

2. Compliance with Prudent Banking Requirements

The BNB Deputy Governor in Charge of the Banking Supervision Department's Order RD 22/1084 of 14 June 2005 revoked the International Bank for Trade and Development's banking license due to insolvency. All other commercial banks adhered to supervisory regulations in 2005. Deviations from set requirements were noted in individual cases for short periods of time. Each case was subject to a profound analysis and corrective supervisory measures involving orders, letters, and warnings.

Capital Adequacy

Capital position was adequate to bank risk profiles which meant that capital adequacy indicators levels were above regulatory minima. Individual temporary falls below minimum admissible levels were reported, each case being analyzed and followed by prompt supervisory response. Analyses showed delayed reactions by the relevant banks' managements with regard to the amount and instrument of capital support. This shows certain weaknesses in capital planning and capital position management.

²⁹ EU Banking Sector Stability, ECB, October 2005.

³⁰ At the end of 2004 non-interest income was 32.8 per cent of total banking income against 43.4 per cent for the EU.

Large Exposures

Banks complied with regulatory requirements with isolated deviations from exposure limits. Such deviations carried no threat for the financial stability of individual institutions but prompted banking supervision reaction through ratings assigned under CAMELS/CAEL.

Internal Loans

Risk analysis associated with exposures to economically related persons showed no significant violations of regulatory provisions. Individual cases of business relatedness did come to light in the course of full on-site supervisory inspections, the banks in question being mandated to initiate corrective action. Significant supervisory resources went into analyzing business relatedness risks, with relevant supervisory instructions issued to individual banks.

Foreign Exchange Exposures

In 2005 the currency risk level in the banking system was low. All banks complied with currency position restrictions.

Investment in Fixed Assets

Investment in fixed assets at the banking system level and in individual banks stayed below admissible values, occupying an insignificant share of banking capital. Isolated cases of temporary deviations from admissible values were reported, with banks taking action to eliminate them.

3. Banking Supervision in 2005

Supervisory Policy, Ordinances, and Accounting Methodology

In 2005 banking supervision regulatory action was directed at initiating prompt and coordinated changes to banking's legal framework to arrest aggressive lending and introduce market risk in reporting capital adequacy.

The regulatory framework improvement programme included the new BNB Ordinance No. 8 on the Capital Adequacy of Banks (introducing requirements for measuring and reporting market risk) adopted in late 2004 and preparations to introduce Basel II (the International Convergence of Capital Measurement and Capital Standards: a Revised Framework) were in progress.

Due to high credit expansion rates in 2004 and early 2005, the BNB faced new challenges in its efforts to maintain banking system stability and create conditions for gradual credit growth in the economy. For this reason, Ordinance No. 8 was further amended. Backing the additional minimum required reserves for banks introduced by Ordinance No. 21, changes to Ordinance No. 8 exclude current profit from the capital base and introduce monthly capital adequacy reporting.

To enforce the new capital adequacy requirements, a package of report forms and instructions was prepared and tested by banks using data from 31 March 2005. The forms were improved and supplemented with instructions and new examples and introduced. In preparing banking supervision and banks to apply new Ordinance No. 8 capital requirements, Banking Supervision Department experts organized a training seminar and consultations on risk measuring methods and their capital coverage.

In compliance with introduced market risk capital requirements, Ordinance No. 7 on Large Exposures of Banks was also amended by including an additional provision on measuring and reporting large trading portfolio exposures to an individual customer or related persons. Subsequently, individual paragraphs of the Ordinance were amended and improved.

Over the first half of 2005 supervisory requirements for reclassifying restructured exposures into a lower risk group under Ordinance No. 9 were defined additionally by the condition that such exposures should meet lower risk criteria for six months before reclassification. Due to increased risk exposures of banks to individual borrowers in arrears over the fourth quarter, minimum specific provisions to cover impairment loss were raised from 10 to 20 per cent for watch exposures and from 50 to 75 per cent for substandard exposures.

In 2005 a BNB working group prepared a draft Law on Credit Institutions. It is intended to achieve a comprehensive compliance between Bulgarian legislation and European Directive 2000/12/EC relating to the taking up and pursuit of the business of credit institutions; 2000/28/EC amending Directive 2000/12/EC; Directive 2000/46/EC on the taking up, pursuit of and prudential supervision of the business of electronic money institutions; and Directive 2001/24/EC on the reorganization and winding up of credit institutions. The draft law introduces the concept of credit institutions, encompassing banks and electronic money institutions. The single license principle was defined to ensure mutual recognition of the right of credit institutions and their subsidiaries to trade within the European Union directly or through branches without additional permission from host country banking supervisors. The draft law revises and develops the legal

framework of the current Law on Banks by removing some irregularities established in practice and recognizing experience since 1997. At the same time, it is based on the provisions of the Law and follows its regulatory principles, ensuring coherence and consistency in banking legislation.

Over the past year another important Bill for supplementary supervision over financial conglomerates was developed jointly with Financial Supervision Commission experts and then sent for coordination and submission. It will bring local legislation into line with the requirements of Directive 2002/87/EC on the supplementary supervision of credit institutions, insurance undertakings, and investment firms in financial conglomerates. It is envisaged for supplementary supervision to be conducted at a financial conglomerate level and includes capital adequacy, intra-group transactions, risk concentration, and risk management provisions. The Bill introduces requirements for determining a financial conglomerate coordinator, as well as rules for interaction between supervision authorities of single financial institutions. Both draft laws are intended to come into force after Bulgaria's accession to the European Union.

As part of preparations to apply Basel II requirements, Banking Supervision Department experts developed a pilot scheme for applying areas of national discretion. In May the scheme was sent to the Association of Commercial Banks together with instructions for banks to prepare for coming operational risk requirements and advise of BNB intentions in this area. After publishing the final draft of the new European Capital Requirements Directive, a Banking Supervision working group began work on individual capital requirements texts in compliance with the new European supervisory framework. By the close of the year draft capital requirements for credit risk based on a standard approach and ones for operational risk were prepared. The working group representatives organized a seminar on internal capital assessment and supervision within the context of the second pillar of the new Basel supervisory framework.

In 2005 banking supervision representatives took part in international meetings promoting cooperation with authorities responsible for supervision on a consolidated basis within the context of the new Basel Capital Accord. Meetings were hosted by supervisory authorities from the Netherlands, Hungary, Germany, and Austria. Letters on draft national supervisory discretion were exchanged with the central bank of Greece. The meetings saw presentations on progress towards the new capital requirements in the relevant banking groups and on forms of international cooperation dependent on risk and capital requirement calculation. The meetings ushered in more active cooperation with other supervisory authorities within a specific scope and duty area.

Over 2005 Banking Supervision representatives participated in, *inter alia*, the regional workshops of the group of Banking Supervisors from Central and Eastern Europe (BSCEE), the European Banking Committee (EBC), the Committee of European Banking Supervisors (CEBS), the Groupe de Contact to CEBS, and the group on transposing the Capital Requirements Directive into national legislation. Discussions involved, *inter alia*, international supervisory cooperation, the fifth Quantitative Impact Study (Basel QIS 5), recognizing external credit ratings, approving internal rating approaches, modern risk and electronic money measuring methods, and improving deposit insurance schemes.

Efforts to enhance supervisory cooperation continued in 2005. Following negotiations between the BNB and Turkey's Bank Regulation and Supervision Agency, a bilateral supervisory memorandum was signed. It regulates exchanges of information between banks operating under the direction of the host supervisory body, as well as interaction and coordination in exercising control over them. The memorandum between the BNB and the Austrian Financial Market Authority was updated and significantly expanded. The BNB has now set up rules of cooperation with the supervisory bodies of practically all countries with operating banks in Bulgaria, as well as with countries in which Bulgarian banks operate through branches or subsidiaries.

Supervisory Administration, Licenses, and Permits

Controlling banking regulatory requirements and dispensing supervisory measures and penalties form the Banking Supervision Department's basic workload. The year saw 28 supervisory measures imposed on 19 banks. Fourteen of them were instructions, including alleviations to two earlier measures and lifting restrictions due to full or partial attainment of rehabilitation goals. Over a short period five serious supervisory measures were imposed on the International Bank for Trade and Development. Since no rehabilitation was achieved, the bank's license was revoked due to insolvency. A series of supervisory measures (both formal and informal) affected four banks, one of them having three measures imposed during the year and the rest two measures each. Sixteen of the measures arose as a result of on-site inspections, three in response to customers' complaints, and the rest were prompted by regular reports and notifica-

tions prepared by the banks themselves. Most often measures were intended to correct matters such as violations of risk exposure classification requirements under BNB Ordinance No. 9, breaches of Ordinance No. 8, restrictions on banks' large exposures, and obligations to advise the BNB under Article 57. In six cases, supervisory measures ended with recommendations, no serious breaches having been established. Due to improved financial indicators, the introduced restrictions (*i. e.*, informing the BNB more frequently) were alleviated at two banks and completely lifted at one bank.

No banking licenses were issued in 2005. The application of a foreign bank from a non-EU member country to open a branch in Bulgaria through a subsidiary from a member country was declined since the said bank does not meet the requirement for prime rated banks.

Forty-five permits were issued under the Law on Banks. Most of them were under Articles 19 and 19b on acquiring 10 per cent or more of a bank's equity or on qualified participation in the capital increase, with the remainder on changes to banks' names and on acquiring qualified participation in non-bank companies. Also issued were 42 certificates of banking qualifications and professional experience for bank board nominees. Seventeen permits were issued under BNB Ordinance No. 8 for inclusions of subordinated term debt sums (debt/capital hybrid instruments) into supplementary capital reserves, as well as for transforming sums attracted under these conditions into a contribution to the bank's equity increase.

On-Site Supervisory Inspections

Risks by type of operation for individual banks were evaluated through scheduled on-site inspections and risk-based supervisory strategies. Objective approaches as well as inspectors' professional opinion and experience were applied to arrive at properly supported conclusions on the degree of risk in specific fields and on overall performance at inspected banks.

Twenty full supervisory inspections of five Group I banks, 13 Group II banks, and two foreign bank branches, were conducted in 2005. Of them, 18 were at domestic banks and the remaining two at foreign bank branches. CAMELS criteria allowed 13 of these banks to retain their previous ratings, four to raise and one to lower ratings, and one was assigned its first rating.

Most inspections comprised analyses and evaluations of risk indicators such as capital sufficiency and adequacy, shareholder support, asset quality and management systems, off-balance-sheet commitments, organization and management, the adequacy of internal rules to operation types and volumes and compliance with supervisory requirements, the amount and quality of earnings, the source of equity growth and operation maintenance, liquidity levels and management, and efficiency of internal control and information systems.

Given the sizable claims on non-financial institutions in bank portfolios, inspectors examined a large number of loans. In practice, exposures whose quality and classifications appeared critical to overall credit risk at individual banks were examined and analyzed.

Of 108 established statutory breaches, just 11 per cent did not concern lending. Prescriptions for improving the process accounted for 44 per cent of the 147 recommendations in inspectors' reports. Major violations related to classifying higher-risk loans in lower-risk groups, statutory breaches in large loans, breaches of statutory terms for announcing such loans to supervisory authorities, and incorrect reporting of loans bearing a consolidated risk to groups of economically related persons. Most lending recommendations addressed improving borrower monitoring, cutting lending to related persons and shareholders, and poor practice in documenting decisions on changes in loan parameters.

Though as a whole banks have detailed procedures and internal rules for measuring, monitoring, evaluating and controlling lending, weaknesses and deviations from good banking practice came to light. Some banks approved and extended large loans to companies with unproven creditworthiness or offshore companies with no reliable financial performance data. On occasion no analyses of the reasonableness of extending a loan and of the degree of risk appeared to have been made.

Some banks imprudently lent to companies financially bound with major shareholders and deliberately evaded upper internal loan limits. As a rule, such loans involve dubious security and repeated renegotiation of principal repayments immediately prior to deadlines. Most often decisions on them were not backed by realistic estimates of payment delays and by reliable financial insight on the likelihood of repayment. Very often funds from them were not spent for stated purposes. Instead, after performing a transaction series within a closed circuit of companies, they were transferred to legal entities closely related to owners of the lending banks.

Inspectors assessed systems for assigning internal ratings to bank debtors positively, yet noted that sometimes they were applied without reference to specific conditions. The models were intended for use mainly by parent banks and assumptions in their ratios and indicators

could not always predict borrowers' operations and development. Banks using such internal models were recommended to hone the matrices applied, make analyses in valuing ratings more precise, and build databases on industrial sector creditworthiness.

General inspection conclusions on bank management were positive. The balance between planned earnings and prudent capital-covered risk is currently monitored. To accomplish financial objectives and advance development strategies, efforts are directed into advanced human resource management models, staff assessment and motivation systems, with sizable investment to improve the ability to monitor business and identify risks. Remarks to some bank managements addressed mostly poor oversight, early warning of adverse changes in loan quality and avoidance of credit concentration, obsolete or poor rules and procedures, and insufficient management independence from bank owners.

Off-site Supervision

Off-site supervision aimed at early identification of risks at individual banks and for the whole system. In 2005 continuous monitoring of bank performance by quarterly and monthly financial analyses of any individual bank continued. Monthly supervisory profiles were applied where a bank was assigned ratings below 2 (good overall financial performance). Quarterly supervisory analyses focused mostly on trends in individual banks' performances and the dynamics of major indicators: assets quality, earnings, capital stability, and liquidity.

Quality analysis was seen to call for further improvement in financial stability indicators. To this end analysts' major instrument, the set of indicators for continuous bank monitoring known as the Uniform Bank Performance Report, changed. Analytical capacity was directed at designing and testing various bank supervision and behaviour models such as scenarios for curbing credit and the possible effects of supervisory regulation changes. Quarterly stress test models including major risks (credit, market and liquidity) improved. Significant funds went on monitoring credit risk dynamics, including new instruments for continual monitoring of credit risk scope and depth, implemented jointly with the Information Systems Directorate.

The ambition to increase supervision quality prompted new products. Quarterly reports on banks' operations and analyses of system performance are an integral part of preventive control over credit institutions and an important BNB management database. In compliance with the CAEL system, 135 quarterly analyses of 28 banks and six foreign bank branches were conducted, alongside 34 monthly reviews of institutions with ratings below 2. Processing of information available at the Banking Supervision Department and used to prepare full on-site supervisory inspections improved over 2005. This helped integrate off-site and on-site supervision into a single permanent and proactive supervision programme. Important issues affecting the overall state of banks and extending beyond the supervisory cycle were reflected in 68 supervisory memoranda prepared by inspectors. They enforced supervisory measures, prompted meetings with bank managements, and settled a number of methodological issues. Over the year under review 54 statements of opinion were prepared relating to capital increases, acquiring subsidiaries or interests, and using subordinated term debt and/or debt/capital (hybrid) instruments.

Data from off-site supervision went into preparing statements and analyses for domestic and foreign bodies, the *Commercial Banks in Bulgaria* quarterly, monthly press releases on the banking system, and the *Monthly Bulletin*. It regularly went to the IMF, the World Bank, the ECB, central banks, and foreign supervisory bodies. With regard to pending EU accession, significant effort went into exchanging and analyzing information and data on European banking and finances. This resulted in new financial stability indicators for more thorough bank risk monitoring and comparing trends in Bulgarian and European banks.

Special Supervision

The required transparency of commercial bank equity called for continuous monitoring and evaluation of banks' shareholders. Establishing changes in bank ownership, pinpointing shareholder economic relatedness, analyzing financial performance and fund sources, were the major special supervision tasks. They aimed at improving equity quality and ensuring timely support by major shareholders. Counter inspections were carried out in companies which were bank shareholders.

Consistent measures were enforced against money laundering and terrorism financing. Supervisory action established the degree of risk in commercial banks and financial houses. Efforts were intended to minimize risk, preserve reputation and normal operation, and avoid laundering money from illegal sources. Given banks' key role in these processes, they were given assistance to establish a special security regime. Adequate procedures to identify money laundering were highlighted as a major requirement. As regards established weaknesses, banks

and financial houses were asked to apply more thoroughly procedural customer identification and adopt additional requirements for non-resident customers.

In accordance with the agreement for technical assistance between the BNB and USAID, special attention was paid to improving supervisory practice for preventing the use of the banking system for money laundering and terrorism financing. Cooperation with bodies fighting financial fraud and money laundering was underpinned by expert assistance from legal authorities. A Bulgarian/US group for fighting financial fraud, including BNB experts, worked intensively.

Three inspections at banks in their capacity as custodians were conducted jointly with the Financial Supervision Commission to evaluate BNB Ordinance No. 36 organization and procedures on custody operations. Infringements found resulted in recommendations to managers mainly on the control functions of custodian banks and compliance with statutory constraints in investing corporate assets. Inspection conclusions included proposals for legislative changes for more effective implementation of statutory requirements and improving requirements from custodian banks.

Prosecutor's Office decrees enacted requests by international regulatory institutions and legal authorities for inspections at commercial banks to establish breaches of the Law on Banks, the Currency Law, and the Law on Measures against Money Laundering. Four corporates conducting banking operations without a license were inspected. Findings on cash operations, transactions, and the origin of funds went to the Investigation Service and the Prosecutor's Office.

Supervisory activity over 2005 included 16 target inspections of commercial banks, seven target inspections at financial houses, and target counter inspections at nine legal entities.

Under BNB patronage one domestic and one international Fighting Money Laundering and Financial Fraud conferences were held. Commercial bank representatives focused on improving international standards in the fight against money laundering.

Over the past year it was found that two financial houses did not meet the requirements of BNB Ordinance No. 26 and they lost their foreign exchange transactions permits.

The number of companies licensed by the BNB to act as financial houses increased by 6 per cent to 87 by the end of 2005. Of them, 30 per cent were authorized by the Financial Supervision Commission to act as investment intermediaries.

The BNB maintains a register of the entities advising the central bank of transactions under Article 1, paragraph 6 of the Law on Banks. By 31 December 2005 they numbered 84, with 24 of them having started operating as non-bank financial institutions in 2005.

VII. The Central Credit Register

Providing information on commercial bank customer indebtedness to the banking system, the Central Credit Register (CCR) is a major information source for commercial bank lending decisions.³¹ Data covers all loans irrespective of amount, except debit card overdrafts of up to BGN 1000 (provided they are classified as standard), loans to the government, loans to the BNB, and interbank loans. Commercial banks have online access to the CCR through a secure website. Authorized officer access is via digital certificates integrated into smart cards. The access fee is BGN 0.50.

By the end of 2005 CCR registered loans numbered 1,618,315 against 1,189,464 at the close of 2004, and the balance sheet exposure rose to BGN 18,365 million against BGN 13,586 million at the close of 2004. Loans to legal entities prevailed accounting for 64.6 per cent of the total balance sheet exposure of all loans, extended to 43,319 borrowers. The share of loans extended to individuals grew from 28.4 per cent in December 2004 to 34.1 per cent a year later, numbering 1,100,413.

Over the year commercial banks conducted 1,669,416 CCR indebtedness inspections, an average of 139,000 a month. Of the total, 1,425,248 were individuals and 244,168 were corporates. The great number of CCR certificates indicates the significance and reliability of information in the register.

³¹ The CCR is regulated by BNB Ordinance No. 22 on the Central Credit Register of Banks and statutory instruments.

VIII. The Fiscal Agent and State Depository Function

The Bulgarian National Bank is the state's official depository and the government's fiscal agent.

Under contracts with the Ministry of Finance negotiated under market conditions and at market prices, the BNB collects and submits periodical information on budget entities' accounts with domestic banks to the Ministry and acts as government debt agent.

To perform its fiscal agent and official depository function, the BNB has developed and continues developing the system for budget and fiscal reserve information service, the ASROAD automated system for registration and service of external debt, the GSA system for government securities sale and repurchase auctions, the ESROT electronic system for registration and service of trade in government securities, the SGS electronic system for settlement accounts of book-entry government securities, and the Register of Pledges. As government agent, long-term BNB tasks in developing these systems are regulated by an agreement with the Ministry of Finance drawn up in late 2005 in line with the Agreement between the Council of Ministers and the Bulgarian National Bank on Introduction of the Euro in the Republic of Bulgaria.

Budget and External Debt Information Service

Pursuant to Article 43 of the Law on the BNB and under standing joint instructions by the Minister of Finance and the BNB Governor, information on the budget, extra budgetary, accumulation, deposit, and letter-of-credit accounts of budget entities in levs and other currencies was regularly gathered from depository banks (24 including the central bank), processed by the system for budget and fiscal reserve information service and provided to the MF. In 2005 the average monthly balance of budget entities' accounts with the BNB was BGN 4520.7 million, with BGN 1054.1 million at depository commercial banks.

Alongside this, current and closing information on the fiscal reserve was collected and submitted to the MF on a daily basis over the reporting year. By the end of 2005 total balances on accounts included in the fiscal reserve and serviced by the BNB and depository banks came to BGN 4551.9 million³² against a minimum fiscal reserve of BGN 2500 million set by the Republic of Bulgaria 2005 State Budget Law.

To improve the information service of the MF by minimizing system and other risks, the reporting year saw commencement of a draft version of the system for budget and fiscal reserve information service which will facilitate primary data processing and help prepare various reports required by the MF for budget cash flow management. The new version's functionality will be consistent with forthcoming IBAN introduction, BIN codes dropping out and a payment type code being introduced.

Balances on all budget entities' accounts with commercial banks were secured by blocking domestic and external debt government securities held by the banks in favour of the Ministry of Finance.³³ To this end, the BNB compared daily data on the balances of budget entities' accounts with commercial banks covered by government securities with information on the total balances of budget entities' accounts reported by commercial banks. Average daily nominal values of blocked domestic and external debt government securities came to BGN 743.2 million, EUR 125.3 million, and USD 111 million.

In 2005 the system for registration and service of external debt registered 34 Bulgarian government foreign financial obligation agreements under which the BNB acted as agent for calculations and payments, totaling EUR 3563.7 million.³⁴ Payments numbered 87 worth EUR 1765.3 million, including repayments of EUR 1531.5 million and interest of EUR 233.8 million. The large amount of payments was ascribable to the early repayment of obligations to the London Club worth EUR 1372.7 million (USD 1619.4 million).

³² Balances on foreign currency accounts are recalculated in levs based on the official BNB exchange rate valid for 31 December 2005.

³³ Under paragraph 24 of the Transitional and Final Provisions of the Republic of Bulgaria 2005 State Budget Law and standing joint instructions by the Minister of Finance and the BNB Governor.

³⁴ Total debt is recalculated in euro based on the official BNB exchange rate for 31 December 2005.

Government Securities Trade Service

In 2005 government securities nominally worth BGN 524.3 million, including the lev equivalent of EUR 15 million,³⁵ were sold *via* the system for government securities sale and repurchase auctions. Of the 103 average bids *per* auction (against 88 in 2004) 38 were approved (against 34 in 2004). The reporting period saw a progressive upward trend in the volume of individual government securities issues intended to increase their liquidity and stimulate secondary market development. Demand for government securities exceeded supply, with a 3.45 average bid-to-cover ratio against 2.95 in 2004. An average of 21 primary dealers (20 in 2004) bid at the auctions.

In the review period the ESROT electronic system for registration and service of trade in government securities registered principal and interest payments of BGN 535.6 million³⁶ at maturity date, of which BGN 390.8 million was principal and BGN 144.8 million interest. Of them, payments on savings government securities amounted to BGN 2.8 million. The total of newly-registered government securities transactions plus payment registrations came to BGN 1064.3 million.

From the beginning of 2005 to 19 July 2005 the MF continued issuing government securities target issues earmarked for direct sale to individuals under the conditions matching those in 2004. The reporting period saw four BGN-denominated (worth BGN 741,300) and three EUR-denominated government securities issues (EUR 459,500). These were sold at BNB tills and by three primary dealers under MF contracts. Upon an issuer's decision, as of 19 July 2005, sales of this type of instruments were discontinued. However, the BNB continued to effect payments on circulating issues under the standing contract between the MF and savings government securities dealers, as well as to register reverse repurchases.

In 2005 secondary market trade in government debt instruments was marked by an increased interest in long-term government securities and lower volumes compared with 2004. Secondary market government securities transactions numbered 7890, worth BGN 13,336.1 million in nominal value. Structurally, transactions on government securities blocking and deblocking occupied the largest share (35.1 per cent), followed by those on behalf of customers (33.6 per cent), outright sales and purchases (19.8 per cent) and repo agreements (11.5 per cent). Trading was most active on new issue days.

In 2005 records of pledges and removal of pledges on government securities worth BGN 68.1 million (almost twice the volume of 2004) were entered into the Central Register of Pledges created by the BNB under the Law on Registered Pledges. Concurrently, transactions in government securities for securing budget funds with commercial banks came to BGN 4610.5 million, up 11.8 per cent on 2004. This largely reflects the experience accumulated by banks in managing financial collaterals and propensity to maintain government securities amounts matching entirely Ministry of Finance requirements.

According to the agreement with the MF, the past year saw further improvement of the system for government securities sale and repurchase auctions providing conditions to hold new mixed auctions of debt related management operations on reverse repurchase of government securities from one or several issues at fixed prices through payment and/or replacement with government securities from various issues, as well as replacement subscriptions. The system will be further developed to enable primary dealers to participate in replacement auctions with competitive bids on the account of their customers and introduce a limit on the amount of government securities to be acquired by a customer, irrespective of the number of primary dealers.

In 2005 work started to technically implement an updated version of the system for registration and service of trade in government securities based on business requirements and terms of reference developed jointly with the MF. For this purpose, an improved functional and technical specification was prepared together with manuals for external and internal users. The system will be launched in the first half of 2006 whereby a higher degree of automation and efficiency in processing secondary market securities transactions will be achieved. It will also improve communication infrastructure by introducing the ISO 15022 standard and using Internet-based applications. With modernizing the system, procedures on registration and settlement of transactions will be simplified by taking it from automated package processing to real-time processing of individual transactions in compliance with the DVP principle (Model 1) under the T+0 settlement cycle. System participants will have the opportunity to monitor settlement and current status of their registers.

³⁵ In compliance with the pre-announced monthly calendar of the MF, auctions were conducted under Ordinance No. 5 of the MF and BNB.

³⁶ The lev equivalence of government securities issues denominated in foreign currency is calculated on the basis of the BNB exchange rate valid for the day of payment.

The BNB updates annually information on systems for government securities registration and settlement replying to questionnaires of the specialized international financial institutions such as Association of Global Custodians (AGC Questionnaire), Thomas Murray and CPSS/IOSCO (Disclosure Framework). In addition to this, current self assessments are aligned with the nine ECB standards for use of securities settlement systems in Eurosystem credit operations and with the 19 CPSS/IOSCO recommendations for securities settlement systems. To perform successfully its functions, the Payment Systems Oversight Division was periodically furnished with information on assessment compliance with 12 of the recommendations for payment mechanisms in securities settlement systems.

Over 2005 the BNB collected BGN 1,224,600 of fees and commissions for its fiscal agency and government securities market services, including BGN 689,600 from the MF under standing agreements.

IX. European Integration and International Relations

European Integration

The Treaty of Accession of Bulgaria and Romania to the European Union was signed on 25 April 2005. As a result, from an EU candidate, Bulgaria became an accession country.

Upon Treaty signature the BNB Governor received observer status on the ECB General Council and at informal EU Council of Ministers meetings on financial and economic issues. BNB representatives were invited to sit as observers on the twelve ESCB Committees and the twenty nine Committee working groups, as well as to other EU Council and European Commission committees (the Economic and Financial Committee and its subcommittees). Banking Supervision Department representatives were invited to the European Banking Committee, the Committee of European Banking Supervisors, and its Contact Group.

European integration policy and measures were directed at preparing for European System of Central Banks (ESCB) membership. Concurrently, the BNB continued discharging its commitments on other forms of EU integration (legal harmonization, participating in working groups and discussions on documents associated with the preparation of EU membership).³⁷

Legal Harmonization

The BNB actively assisted Government efforts for the timely fulfillment of negotiated commitments with a view to accomplishing the major goal of acceding to the EU on 1 January 2007. To this end, the Law on the Bulgarian National Bank was amended in January 2005 for full compliance with in EU Treaty requirements and the Statutes of the ESCB and the ECB. The BNB will participate in the ESCB as the central bank of an EU derogation member, preserving currency board principles and rules.

Amendments to the Law on the BNB involved mainly reformulating BNB major objectives and providing of sufficient guarantees of central bank independence. The Bank's major objective is to maintain price stability through national currency stability and pursue monetary policy in line with the Law provisions. As additional guarantees of Bank independence, in exercising their powers and duties the Governor and Deputy Governors shall not seek or take any instruction from the Council of Ministers or any other body or office. The provision whereby the BNB sets its own budget additionally guarantees independence. Guarantees to the personal independence of the Governor and members of the Governing Council are also reinforced.

The March 2005 Law on Funds Transfers, Electronic Payment Instruments and Payment Systems and its statutory instruments BNB Ordinances No. 3 and No. 16 fully transposed *Directive 97/5/EC on Cross-border Credit Transfers*, *Directive 98/26/EC on Settlement Finality in Payment and Securities Settlement Systems*, and *Recommendation 97/489/EC Concerning Transactions Carried out by Electronic Payment Instruments*, and in particular the relationship between holder and issuer, discharging commitments negotiated with the EU to harmonize payment and settlement systems legislation with European law.³⁸

The new BNB Ordinance No. 8 on the Capital Adequacy of Banks, in force since 1 July 2005, fully transposed *Directive 93/6/EEC on the Capital Adequacy of Investments Firms and Credit Institutions (CAD I)* and *Directive 98/31/EC* amending the capital adequacy directive.

In April 2005 the BNB Governing Council adopted Ordinance No. 13 on the Introduction of International Bank Account Numbers (IBAN) and Bank Identifier Codes. The European Committee for Banking Standards and the International Standards Organization developed the IBAN concept, implementing it through ISO13616:2003. Ordinance No. 13 enforces the standard and *Regulation 2560/2001 on Cross-border Payments in Euro* adopted by the European Parliament and the Council of the European Union.

The review period saw significant progress in the full transposition of EU Directives into Bulgarian legislation in line with commitments. A BNB working group drafted the Law on Credit Institutions. The Law on Supplementary Supervision of Financial Conglomerates was drafted jointly with representatives of the Financial Supervision Commission and the Ministry of Finance. The Law on Financial Security Arrangements was prepared by an interinstitutional working group in which BNB representatives took part.

³⁷ BNB representatives participated actively in legal harmonization and the working groups on the following negotiation chapters: Freedom to Provide Services, Free Movement of Capital, Economic and Monetary Union, Statistics, Consumers and Health Protection, Financial Control, and the Lisbon Strategy.

³⁸ See also Chapter III, The National Payment System.

Preparing for BNB Membership in the European System of Central Banks

A major BNB priority involved erecting the legal framework, garnering information support, and creating institutional and administrative capacity to ensure its representatives' successful participation in ESCB Committees and working groups. A first step to ESCB membership was an Action Plan (Road Map) setting out major BNB commitments related to ESCB membership by the end of 2009. This notes immediate tasks and specifies time frames for discharging these commitments. Under the Action Plan the BNB prepared and adopted *Internal Coordination Rules* regulating Directorates' and employees' duties linked with the Governor's participation in ECB General Council and Governing Council sessions, and with BNB representatives' participation in ESCB Committees and working groups and in EU structures.

A training programme was designed to boost staff expertise. This addresses EU, ESCB and ECB legal frameworks and bodies, coordination between the ECB and national central banks, ESCB Committees, terms of reference, handling EU/ESCB/ECB/national central bank documents, communication and negotiation skills, teamwork, and conflict resolution.

BNB experts' participation in ESCB Committee and working group sittings gave them experience and knowledge of organizational and practical preparations for implementing legislation, methodology, and best practice in individual central banks, as well as of taking part in discussions on pending changes, new initiatives, and effective resource planning for change.

In addition to ESCB Committee and working group sittings, BNB representatives took part in sessions of other EU Council and European Commission bodies. The BNB Governor participated in the informal ECOFIN meetings, while BNB staff took part in sittings of the Economic and Financial Committee and its substructures, the Committee of the European Banking Supervisors and its Contact Group, the European Banking Committee, and EUROSTAT Committees and working groups.

Under the Twinning Covenant with the Dutch and French central banks and with a view to EU membership, on 3 and 4 October 2005 the BNB organized a seminar on *Economic and Monetary Union and Newly Acceded States: a Year after Accession*. Issues concerned central bank independence, the experience of new member states and their central banks as part of the ESCB, challenges in acceding to the Economic and Monetary Union. Deputy governors and directors of central banks and the ECB and representatives of the academic community delivered papers.

International Relations

Working with other central banks, international financial institutions, and other organizations, was an important part of BNB business in 2005. A new aspect of BNB international relations was providing technical assistance and consultancy to other central banks in various areas of central banking, relations with the Bank of Albania being most intensive in 2005. The BNB started discharging its new technical assistance donor duties, focusing mostly on technical cooperation.

At the May 2005 meeting of La Francophonie central bank governors in Marrakech, Morocco, the BNB was entrusted with hosting the 13th meeting, which takes place in May 2006 in Sofia.

The BNB Governor sits on the regular meetings of governors of central banks which hold Bank for International Settlements shares. The meetings are the major BIS mechanism for maintaining cooperation between shareholding central banks, and for discussing economic developments and prospects for the world economy and financial markets. BNB representatives took active part in BIS seminars and workshops, and in the regular meeting on technical assistance issues.

The past year saw the successful conclusion of the two-year Twinning Covenants between the BNB and the Banque de France and De Nederlandsche Bank on banking supervision, cash operations and automated banknote and coin processing, international reserve management, and economic research and forecasting. The main objective of the covenants was to prepare the Bank for ESCB participation.

In September BNB experts held a seminar on *The BNB Experience of the Road to the ESCB* in Tirana, Albania, organized with the support of the German Technical Assistance Fund (GTZ). Representatives of the Bank of Albania learned of Bulgarian institutional changes, administrative capacity creation, and legal harmonization with EU legislation. In October a Bank of Albania delegation visited the BNB to share BNB experience in payment systems, legislation, and European integration.

A Chinese State Administration of Foreign Exchange delegation visited the BNB in July. The Administration, a specialized body directly subordinated to the People's Bank of China, manages and controls foreign exchange operations and international reserves, draws up bal-

ance of payments analyses and statistics, and drafts foreign exchange market regulations. They discussed BNB organizational structure, currency board operation, and international reserve management.

The BNB received technical assistance to support preparations for ESCB participation in the context of bilateral cooperation with international institutions. TAIEX financial assistance helped accomplish six projects in monetary and banking statistics, quarterly financial accounts, and harmonizing interest rate statistics with ECB requirements. Expert assistance was rendered to the inter-institutional working groups drafting bills on financial conglomerate and financial collateral supervision.

The two-year Financial Sector Integrity project financed by the United State Agency for International Development (USAID) advanced significantly in the review period. Assistance focuses on three areas: fighting money laundering, improving financial sector regulation, and enhancing financial sector transparency. Seminars on derivatives, public relations, risk-weighted premium contributions and credit ratings, measures against money laundering and terrorism financing were held. Training and study sessions in Norway on US cash operations experience were organized under the Measures against Money Laundering Programme. Work on preparing an On-Site Inspection Manual with measures against money laundering started within the project. Developing a model of a modern cash centre, intended to improve current cash operations and meet ECB requirements, continued. In late 2005 a survey addressed consumer confidence in the Bulgarian financial sector within this project. Results will help organize training and awareness campaigns.

The BNB supported Government in its dealings with the IMF, the World Bank and the EBRD in setting out objectives and priorities in these institutions' Bulgaria strategies and helped successful implementation of agreements with them within its purview. Implementation of the two-year Stand-by Agreement approved by the IMF in August 2004 continued successfully in 2005. Signing the Third Programmatic Adjustment Loan (PAL III) Agreement completed the World Bank PAL programme, a major component of IBRD strategy for Bulgaria, and augured a new partnership strategy with Bulgaria, intended to support reforms required for the successful integration into the EU, use EU accession funds more effectively, and accelerate the convergence of Bulgarian incomes with EU levels. The EBRD Board of Directors approved the Strategy for Bulgaria for the 2006–2007 Period, in whose development the BNB participated actively.

X. Statistics

The BNB gathers and distributes information on monetary and interest rate statistics, monetary aggregates, BNB and commercial bank analytical reporting, international reserves, the balance of payments, gross external debt, foreign direct investment, the international investment position, the template on international reserves and liquidity, and imports and exports. Priority was given to harmonizing statistics with EU requirements, and to preparing for European System of Central Banks membership. A meeting with ECB Statistical Department experts specified statistics tasks and goals to this end.

Changes to monetary and interest rate statistics were brought to the attention of commercial banks at an early 2005 seminar where progress was reviewed and plans for future developments were outlined. Banks were acquainted with the methodology for cashflow statistics and the pending introduction of monthly report forms and future requirements in interest rate statistics.

The year saw the development and launch of the Cashflow Statistics subsystem within the operating monetary statistics information system, as well as the start of data transfer from commercial banks. Report forms and methodological instructions on deposit and credit statistics by economic activity were also developed in compliance with monetary statistics principles. The format and scope of the *Monetary and Interest Rate Statistics* weekly improved. New indicators were created in interest rate statistics to enhance their maturity structure.

Work on methodological instructions for interest rate statistics which are fully compliant with ECB Regulation 18/2001 continued with Banque de France consultations within the Twinning Covenant with the BNB. Over 2005 the methodology for computing long-term interest rates was developed to meet the Maastricht criteria.

The BNB started preparing a quarterly financial accounting methodology for the system of national accounts. Implementing the requirements of ECB Regulation 501/2004, working tables for transiting the General Government institutional sector from the Ministry of Finance accounting system to the ECB and Eurostat tables were designed. Implementation began of the first stage of the BNB project on compiling information from non-bank financial institutions. A methodology for statistics of persons performing leasing activities was also developed, with first data received. This project is joint with the Bulgarian Association for Leasing.

With regard to a balance of payments geographical breakdown consistent with ECB Regulation 15/2004, a meeting with commercial bank representatives addressed the major requirements and key elements of the new system for compiling and processing balance of payments data transaction by transaction. Instructions were prepared, banks providing first test data for 2005.

To improve balance of payments statistics, a new methodology was developed by the BNB jointly with the NSI to estimate goods imports at FOB prices, as well as receipts and payments on freight services. The methodology uses a differentiated estimation approach dependent on importer country, type of goods, transportation used, and carrier nationality. Another methodology was designed to estimate unofficial current account flows related to Bulgarians unofficially employed abroad. Licensed tour operators were surveyed to this end. New reporting forms on bank portfolio investment were introduced along with pilot security by security database.

Compiling and publishing Bulgaria's external debt meets IMF, World Bank, Eurostat and other international institutions' methodological requirements. Work started on compiling quarterly tables on the international investment position.

The methodology for computing nominal and real effective exchange rates was improved further and brought into line with ECB principles. A geometric weighted average was used to calculate effective exchange rates, with a basket of 19 countries and weights based on industrial goods trading with third countries between 1999 and 2001.

In 2005 Bulgaria joined the BIS Key Economic Indicators project and started sending data on 41 indicators on a monthly basis. A table of macroeconomic indicators was prepared and periodically updated, with the most recent data available on the BNB website.

XI. Research

BNB economic research, analyses of processes in the Bulgarian economy, and macro-economic forecasts support the Bank's management in decision making and formulating economic policy. In 2005 research focused on developing macroeconomic models for analyzing and forecasting trends in the Bulgarian economy and on nominal and real convergence programmes.

Under the Twinning Covenant with the Dutch central bank, Dutch experts assessed the macroeconomic forecasting model used. Their recommendations were taken into account by the end of 2005. Short-term (quarterly) forecasts based on the forecasting model are published in the BNB quarterly *Economic Review*. The publication presents arguments supporting the forecasts and analyses of the external environment, domestic monetary and credit aggregates, their link with the development of the real economy and their bearing on price stability.

A simulation macro model was developed with the assistance of the Bank of Canada aimed at making more thorough macroeconomic consequence assessments of changes in fiscal and monetary policy. This was also assessed by experts of the Dutch central bank who made recommendations for its improvement.

BNB analysis and forecasting is supported by specialized research assessing the development of individual processes and economic sectors. In early 2005 a Research Plan for the 2005/2006 period was approved, with major *foci* being the development of macroeconomic modeling and forecasting, a methodology for assessing the results of Bulgarian membership of the EU, Exchange Rate Mechanism II, and the euro area, and improving the system of indicators for monitoring financial sector stability. Bulgarian banking and monetary system history is also a research subject. At the close of the year a Banking and Financial History Research and Publishing Programme was launched, covering the BNB and the Bulgarian banking and monetary system. Research results are presented at BNB seminars attended by relevant experts from other institutions, and scientific and non-government organizations.

Research conferences organized by the BNB over the past three years helped extend Bank relations with other central banks' research teams and with Bulgarian and foreign research establishments. The 2005 conference focused on economic modeling and forecasting. Experts from research bodies and central banks from Austria, Canada, Germany, Greece, Italy, and Spain, as well as representatives of Bulgarian government bodies and academic circles took part in the conference and read papers.³⁹ Delegates included regional central bank and monetary authority experts from Albania, Greece, Kosovo, Macedonia, Serbia, Slovenia, and Turkey.

The Guest Researcher Programme supports BNB research and helps establish fruitful cooperation with Bulgarian and foreign experts, especially ones interested in economic modeling and forecasting, financial system stability, the convergence of the Bulgarian economy into the euro area, lending and asset prices, harmonizing banking regulations with EU requirements, payment systems development, and the history of the Bulgarian banking and monetary system.⁴⁰ Over 2005 seven Guest researchers helped develop a macroeconomic simulation model and reviewed BNB monetary policy and currency circulation between 1912 and 1928, Bulgarian bank competition, lending to small businesses, and potential product and staff development.

³⁹The conference programme and papers are published on the BNB website.

⁴⁰The Guest Researcher Programme is published on the BNB website.

XII. The Information Infrastructure

In 2005 BNB information technology policy was guided by the Information and Communications Technology Development Strategy.

Strategy priority projects on a new basic bank information system and an international reserves management system started. Proceeding in parallel, the two projects bring the Bank's financial, accounting, and administrative organization into line with leading European bank practice and meet high control and accountancy standards.

Work continued on information infrastructure developments such as building a single depository for Banking Supervision Department data, and on modernizing ESROT. The second stage of design on the Flow Statistics information system ended. The cash implementation of the State Budget information system was supplemented with new government securities auctions applications. RINGS hardware and software platforms were modernized and updated. The Policy and Procedures for BNB Information Systems Security project is in progress, aiming to develop and improve security and create a safe environment for banking operations and processes consistent with international standards.

From June 2005 the BNB is a full member of the ECB and ESCB electronic data exchange system CEBAMAIL. Its infrastructure has been installed by BNB and ECB experts and rules on administering and using it are set out. Documents from the ECB, central banks, and EU bodies are protected by a safe access control system and a system for logging incoming and outgoing documents, reference, and search tools. Complying with BNB rules, they form the first stage of building a uniform infrastructure for managing such documents.

XIII. Human Resource Management

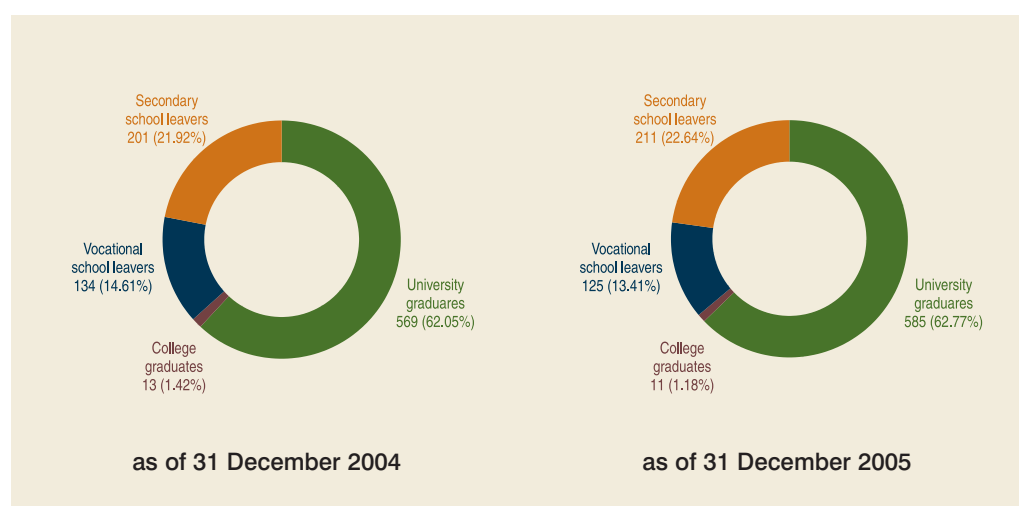
The BNB introduced human resource management rules compliant with European standards and practice in 2005. Relevant BNB experts and managers drafted and coordinated the new rules. The approved management mechanism includes Rules on BNB Staff Assessment, Rules on BNB Staff Recruitment, Internal Rules for Employees' Remuneration, a BNB Staff Code of Ethics, Internal Rules on BNB Training, and Internal Rules on Raising the Educational and Professional Qualifications of BNB Staff. These fundamental internal documents dovetail with the BNB's human resource management strategy and underlie the system of staff motivation and career management. They make annual employee assessment, employee training plans, material incentives, and individual career development interdependent. The stress is on employees' personal contributions and professionalism, and on injecting a sense of ownership of Bank policy.

2005 saw operational changes in the BNB organizational structure to improve function in line with the Law on the BNB. The average number of Bank staff in the reporting period was 932, against an establishment of 1007. By 31 December 2005 women numbered 601 and men 331.

Despite the growing responsibilities of BNB staff and new tasks stemming from BNB representatives' observer status on ECB committees and working groups and other EU bodies, internal restructuring and the division of responsibilities was effected without increasing their number. Efforts focused on training employees and enhancing their capability of fulfilling ESCB requirements. Recruitment aimed to improve staff educational attainment and qualifications, and age structure. In 2005 the share of university graduates employed by the BNB went up from 62 per cent to 62.8 per cent.

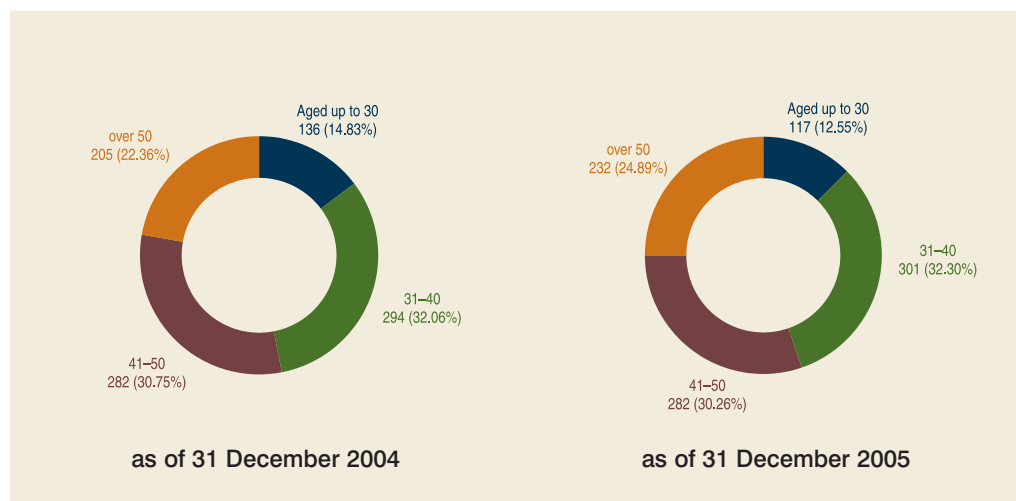
Consistent with the new internal rules and the new challenges associated with BNB preparation for ESCB membership, a programme to raise staff educational and professional qualifications was implemented in 2005. This covered macroeconomics, monetary policy, asset and risk management, banking supervision, monetary and banking statistics, bookkeeping, banking and financial law, human resource management, and internal audit.

Staff Qualifications and Educational Structure



Source: BNB.

Staff Age Structure



Source: BNB.

In 2005 171 BNB employees attended short-term courses and seminars organized by foreign banks and institutions and 36 employees participated in various forms of distance learning. Specialized short-term seminars and courses were attended by 41 employees. A management course was held for various grades of BNB managers. Twenty three employees took Bachelor's or Master's degrees, some of them getting a Master's degree in a second subject. Language teaching reflected language level expectations, with 73 per cent of officers reaching or surpassing the minimums relevant to their positions. With a view to improving computer skills, 268 officers were tested, with only 67 of them needing additional instruction which they went on to receive.

The Bulgarian National Bank supports graduate development. In 2004, its 125th jubilee year, the BNB offered three one-year scholarships to students reading for Bachelor's, Master's, and Doctor's Degrees.⁴¹ Students from domestic and foreign universities applied for 2005/2006 scholarships, with two winning scholarships for Bachelor's and one for Doctor's degrees.

Every year the Bulgarian National Bank provides training to graduates. Trainees are selected from last-year students reading for Bachelor's or Master's degrees and willing to participate in banking and finance research projects. In 2005 24 trainees researched international market analysis, investment portfolio management, risk analysis, issuing policy, banknote distribution, the Bulgarian capital market, and payment systems.

BNB experts participate actively in the training of future national banking system staff by lecturing at universities, and in raising Bulgarian bank employees' qualifications by lecturing at the International Banking Institute.

⁴¹ Information on application terms and past scholarships is available on the BNB website.

XIV. Facilities Management

BNB facilities management comprises estate acquisition, disposal, and refurbishment; maintaining property and keeping it in line with central and local government requirements; stores management; deliveries; and transport. This is part of general BNB administration.

The BNB mainly trades from owned premises and properties. This ensures the level of security and protection required of a central bank. Property and related long-term asset spending involves mainly maintenance and refurbishment of the BNB Building and regional BNB cash centres.

Under the BNB Property Construction, Refurbishment, and Maintenance Strategy for 2004 to 2009, the BNB disposed of unused property to cut costs. An unfinished building in Montana, timber bungalows in Hisarya, and a building in Burgas were auctioned. Nine apartments in Varna and Pleven were sold to long-serving Bank staff. The BNB transferred title over the Vila Lyulin and Vila Vitosha recreation homes at Bankya to the Ministry of Finance and transferred title to the Rosenec Recreation Home in Burgas to the Ministry of Healthcare.

In 2005, the BNB acquired a property in the Karo area of Sofia after the BNB Printing Works and the Ministry of Finance Printing Works were merged and restituted its title to parts of a building at Ploshtad Slaveykov 6A in the city centre.

The BNB Road Transport Development Strategy, 2004 to 2009 foresees the gradual roll-over and reduction of the BNB vehicle fleet. Six cars were purchased by the Bank in 2005, while 13 used vehicles were granted *gratis* to flood-hit central government and local authority bodies.

XV. Internal Audit and Control

In compliance with Article 22 of the Law on the BNB, internal audit at the Bulgarian National Bank is exercised by a Chief Auditor appointed by the BNB Governing Council pending approval by the President of the National Audit Office. Bank actions and policy aim at creating and maintaining a reliable risk control and limitation system. It is within the Chief Auditor's purview to examine the quality of internal control systems and risk management, and assist Bank management in improving them.

In 2005 a team of 11 internal auditors working under an annual audit programme assessed risks for designated items. The Chief Auditor reported the results of checks and the management of significant risks directly to the Governing Council.

The reporting period saw 20 scheduled and one unscheduled audits. The BNB Chief Auditor and the Internal Audit Directorate monitored important projects and participated in consultations and discussions. Major BNB functions like monetary policy, maintaining cash circulation, government agency, and information, analytical and administrative activities were audited. Key recommendations included improvements to internal control systems to limit risk and guarantee compliance with statutory requirements and established policy and procedures. These were followed up.

The auditors from the BNB team were trained under the Institute of Internal Auditors' (IIA) international programme for Certified Internal Auditors (CIA). Over the period under review one internal auditor successfully finished training and acquired the CCSA (Certification in Control Self-Assessment) and CIA qualifications.

In line with pending Bulgarian accession to the European Union, the BNB adopted Rules on Internal Audit Procedures adapted to ESCB Internal Audit Committee policy and procedures.

Audits in 2005

BNB functions	Audits in 2005	Type of audit
Monetary policy	TurboSWIFT information system	IT audit
Monetary policy	Cash circulation accountancy and control	IT audit
Maintenance of cash circulation	Coin blanks and produced coins	Operational, financial, compliance
Maintenance of cash circulation	Production of banknotes. Cost	Operational, financial, compliance
Maintenance of cash circulation	Spoilage destruction	Compliance, execution
Maintenance of cash circulation	Maintenance of cash circulation	Recommendation follow-up
Maintenance of cash circulation	Withdrawal from circulation and destruction	Operational
Maintenance of cash circulation	BNB reserve objects	Compliance
Government agency	Service of agency agreements with the MF	Operational, financial, compliance
Government agency	Negotiation, management and service of SDR purchases and repurchases	Operational, financial, compliance
Government agency	Single Account service	Operational, financial, compliance
Government agency	Confirming the balances on WB accounts	Financial
Information and analytical	Confirming Bulgaria's state budget position in IMF	Financial
Information and analytical	BNB financial statements	Financial
Information and analytical	Balance of payments and external debt	Operational, compliance, IT
Information and analytical	Macroeconomic statistics	Operational, compliance, IT
Information and analytical	Monetary and banking statistics. Reports	Operational, compliance, IT
Administrative	Selection of suppliers	Operational, financial, compliance
Administrative	Concluded and executed delivery contracts	Operational, financial, compliance
Administrative	Annual inventory	Operational, compliance
Administrative	Money laundering control and prevention	Operational, compliance

XVI. BNB Budget Implementation

The BNB budget for 2005 was adopted by the BNB Governing Council on 28 October 2004 and approved by the 39 National Assembly on 18 December 2004.

1. Operational Expenditure

In 2005 BNB operating expenditure totaled BGN 55,602,000, or 89.8 per cent of the annual budget. Currency circulation cost BGN 17,510,000 or 87.1 per cent of projections. Banknote and coin production cost BGN 16,568,000, including BGN 12,896,000 or 92.4 per cent of budgeted spend on printing. Circulation and commemorative coins worth BGN 3,672,000 were released, including commemorative coins of BGN 390,000. Funds were spent on banknote and coin processing consumables, spares for servicing currency in circulation, designing new banknotes and coins, banknote destruction machines, and renting premises at the BNB Printing Works for issuing purposes.

Expenditure on materials, services, and depreciation totaled BGN 18,732,000, or 87.2 per cent of budgeted funds. Materials came to BGN 1,113,000, including BGN 427,000 on inventories, BGN 319,000 on stationery, and BGN 239,000 on fuel and spares for the BNB transport fleet.

Hired services cost BGN 10,136,000, or 84.9 per cent of budgeted funds. Bloomberg, Reuters, SWIFT, internet and other services came to BGN 895,000. Software charges and fees totaled BGN 1,244,000. Equipment maintenance came to BGN 759,000. Property and refuse collection levies totaled BGN 1,173,000. Electric bills were BGN 336,000 and mail, telephone, and telex services came to BGN 524,000. The Bank spent BGN 2,236,000 on a security contract with the Ministry of the Interior. Expenses on building repairs and maintenance totaled BGN 536,000.

Depreciation expenses amounted to BGN 7,483,000, accounting for 87.2 per cent of annual projections.

Salaries, social and health costs were BGN 16,368,000, or 99.1 per cent of budget. In accordance with the requirements of IAS 19 *Income of Hired Persons*, the Bank reported in its budget BGN 1,056,000 worth of current obligations to staff for retirement and unused paid leave.

Social expenditure totaled BGN 1,747,000, or 94.3 per cent of annual budgeted funds.

Other administrative costs totaled BGN 1,027,000, or 60.4 per cent of projections. The Bank spent BGN 58,000 on inland travel and BGN 471,000 on foreign travel. The staff expertise improvement and training programme cost BGN 335,000. Bank representation and protocol costs were reported under this indicator.

Expenditure on BNB employees' participation in forums related to BNB membership of the ESCB totaled BGN 218,000, of which BGN 18,000 on training. The cost of BNB representatives' participation at ESCB commission and committee sessions was BGN 156,000.

2. The Investment Programme

Under Section II, projected investment funds totaled BGN 14,366,000, of which BGN 13,478,000 or 93.8 per cent was spent.

Funds went mostly on computerization under the Information and Communications Technology Development Strategy. The total was BGN 7,437,000, or 95 per cent of budgeted funds. This purchased computer workstations, servers and local networks, communication devices, and peripherals. This spend pertained both to the planned renewal and development of the Bank's information and technology infrastructure, and to new equipment for projects underway. Software spending covered new off-the-shelf and specialized software and upgrades to existing programmes.

Construction, refurbishment and modernization spending came to BGN 4,698,000, or 100 per cent of the budget. Funds went mostly on design, deliveries, and construction of the Primorsko recreation base, and on finishing a new building for the Fiscal Services Department.

Spending on constructing, refurbishing, and modernizing BNB properties was in line with the Governing Council's Buildings Construction, Refurbishment and Maintenance Strategy 2004 to 2009.

The Bank spent BGN 375,000 (70.2 per cent of annual budgeted funds) on security equipment with a view to expanding and modernizing existing security systems.

Under the Road Transport Development Strategy 2004 to 2009, the Bank purchased four special purpose and two general purpose vehicles.

The Bank spent BGN 413,000 on office furniture and equipment, including air conditioners, printing machines, cleaning machines, and fittings for the Primorsko recreation base.

Furnishing the BNB office in the ECB building cost BGN 5000.

Implementation of the BNB Budget, 2005

Indicators	Report 2005 (BGN'000)	Budget 2005 (BGN'000)	Implemen- tation (%)
Section I. BNB operational expenditure	55 602	61 930	89.8
Currency circulation expenditure	17 510	20 100	87.1
Materials, services and depreciation expenditure	18 732	21 489	87.2
Salaries and social security expenditure	16 368	16 511	99.1
Social activity expenditure	1747	1852	94.3
Other administrative expenditure	1027	1701	60.4
BNB expenditure on membership in ESCB	218	277	78.7
Section II. Investment programme	13 478	14 366	93.8
Expenditure on construction, reconstruction and modernization	4698	4700	100.0
Expenditure on BNB security equipment	375	534	70.2
Expenditure on special automobiles	550	550	100.0
Expenditure on BNB computerization	7437	7825	95.0
Office furniture and equipment	413	410	100.7
BNB expenditure on membership in ESCB	5	347	1.4

XVII. BNB Consolidated Financial Statements for the Year Ending 31 December 2005

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**INDEPENDENT AUDITORS' REPORT
TO THE GOVERNING COUNCIL OF
THE BULGARIAN NATIONAL BANK**

We have audited the accompanying consolidated balance sheet of the Bulgarian National Bank and its subsidiaries as of 31 December 2005, and the related consolidated statements of income, changes in equity and cash flows for the year then ended. These financial statements are the responsibility of the management. Our responsibility is to express an opinion on these consolidated financial statements based on our audit.

We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statements presentation. We believe that our audit provides a reasonable basis for our opinion.

In our opinion, the consolidated financial statements give a true and fair view of the financial position of the Bulgarian National Bank and its subsidiaries as of 31 December 2005 and of the results of its operations and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

KPMG Audit Plc
KPMG Audit Plc

London
27 April 2006

KPMG Bulgaria OOD
KPMG Bulgaria OOD

Sofia
27 April 2006

Statement of Responsibilities of the Governing Council of the Bulgarian National Bank

The Law on the Bulgarian National Bank requires the Governing Council of the Bulgarian National Bank to prepare financial statements for each reporting period to present the financial position of the Bulgarian National Bank and the results of its operations for the period.

The financial statements prepared by the Bulgarian National Bank are based on the accounting principles approved by the Governing Council in compliance with International Financial Reporting Standards.

The Governing Council of the Bulgarian National Bank is responsible for maintaining proper accounting records, which disclose with reasonable accuracy at any time the financial position of the Bulgarian National Bank. It has a general responsibility for taking such steps as are reasonably open to it to safeguard the assets of the Bulgarian National Bank and to prevent or detect fraud and other irregularities.



Ivan Iskrov
Governor of the BNB

Consolidated Income Statement for the Year Ending 31 December 2005

(BGN'000)

	Note	31.XII.2005	31.XII.2004
Interest and similar income	6	381,281	294,280
Interest expense and similar charges	6	(80,975)	(74,469)
Net interest income		300,306	219,811
Fee and commission income		5,745	4,803
Fee and commission expense		(3,312)	(3,252)
Net fee and commission income		2,433	1,551
Other net financial income/ (expense)	7	213,348	(34,292)
Other operating income	8	40,366	34,591
Total income from banking operations		556,453	221,661
Administrative expenses	9	(69,196)	(66,990)
Net income from banking and subsidiaries' operations		487,257	154,671
Transfer (to)/from special reserves		(170,160)	88,465
Net income from banking and subsidiaries' operations after special reserve transfer		317,097	243,136
Appropriations and transfer to reserves			
Proposed contribution to the budget of Republic of Bulgaria		150,162	149,050
Transfer to other reserves and minority interest		166,935	94,086
		317,097	243,136


The income statement is to be read in conjunction with the notes set out on pages 68 to 84 forming part of the financial statements.

Consolidated Balance Sheet as at 31 December 2005

(BGN'000)

	Note	31.XII.2005	31.XII.2004
ASSETS			
Cash and deposits in foreign currencies	10	3,430,616	2,932,527
Gold, instruments in gold and other precious metals	11	1,102,092	807,566
Investment in securities	12	9,823,829	9,597,580
Equity investments and quota in IMF	14	1,551,185	1,451,818
Receivables from the Government of the Republic of Bulgaria	13	1,094,356	1,699,118
Property, plant and equipment and intangible assets	15	171,397	172,836
Other assets	16	28,732	41,986
Total Assets		17,202,207	16,703,431
LIABILITIES			
Notes and coins in circulation	21	5,867,213	5,020,242
Due to banks and other financial institutions	17	2,485,207	2,038,219
Liabilities to government, government institutions and other borrowings	18	4,295,273	4,907,297
Borrowings against the Republic of Bulgaria's IMF participation	19	1,438,739	1,354,627
Borrowings from general resources of IMF	20	1,094,356	1,699,118
Accruals and other liabilities	22	22,573	14,292
Total Liabilities		15,203,361	15,033,795
EQUITY			
Capital	23	20,000	20,000
Reserves	23	1,975,640	1,646,543
Minority interest	24	3,206	3,093
Total equity		1,998,846	1,669,636
Total liabilities and equity		17,202,207	16,703,431

The Governing Council approved the financial statements set out on pages 63 to 84 on 20 April 2006.



Ivan Iskrov
Governor of the BNB

Consolidated Statement of Cash Flows for the Year Ending 31 December 2005

(BGN'000)

	Note	31.XII.2005	31.XII.2004
Net cash flow from operating activities			
Net income from banking operations		487,257	154,671
Adjustment for non-cash and non-operating items:			
Dividend income		(4,451)	(4,247)
Depreciation	9, 15	13,010	15,338
(Profit)/loss on disposal of property, plant, equipment and intangible assets		38	(7,254)
Revaluation of property, plant, equipment and intangible assets		(2,310)	-
Impairment of property, plant, equipment and intangible assets		1,061	-
Donation of non-current assets		-	537
Profit of associates		(5,242)	-
Other non-monetary movements		(6,223)	(303)
Gains/(losses) on working capital arising from market movements		(81,702)	107,996
Net cash flow from operating activities before changes in operating assets and liabilities		401,438	266,738
Change in operating assets			
Decrease in gold and other precious metals		(225)	479
(Increase) in securities		(358,217)	(1,422,855)
Decrease in receivable from government		711,161	82,959
(Increase)/decrease in other assets		11,997	(1,128)
Change in operating liabilities			
Increase in due to banks and other financial institutions		445,554	1,048,055
Increase/(decrease) in government deposits and current accounts		(709,944)	1,014,868
(Decrease) in borrowings from IMF		(711,161)	(82,959)
Increase in currency in circulation		846,971	756,020
Increase in accruals and other liabilities		8,394	4,833
Net cash flow from operating activities		645,968	1,667,010
Cash flow from investing activities			
(Purchase) of non-current assets, net		(10,753)	(6,031)
Dividends received		4,451	4,247
Proceeds from sales of Borika shares		6,223	-
Minority interest		-	3,093
Net cash flow from investing activities		(79)	1,309
Cash flow from financing activities			
Payment to government		(149,050)	(170,867)
Net cash flow from financing activities		(149,050)	(170,867)
Net increase in cash and cash equivalents		496,839	1,497,452
Cash and cash equivalents at beginning of period		2,951,493	1,454,041
Cash and cash equivalents at end of period	10, 16	3,448,332	2,951,493

The accompanying notes on pages 68 to 84 form an integral part of these financial statements.

Consolidated Statement of Changes in Equity as at 31 December 2005

(BGN'000)

	Capital	Minority interest	Revaluation reserves from:			Other reserves	Total
			non-current assets	monetary assets	commemorative coins		
Balance at 1 January 2004	20,000	-	106,299	863,665	11,138	683,739	1,684,841
Transfer of unrealized gold revaluation loss	-	-	-	(24,632)	-	-	(24,632)
Transfer of net foreign exchange losses	-	-	-	(3,067)	-	-	(3,067)
Transfer of net revaluation losses of securities	-	-	-	(61,192)	-	-	(61,192)
Revaluation of non-monetary assets	-	-	261	-	-	-	261
Other transfers	-	-	(2,060)	-	(297)	420	(1,937)
Payment of the prior year contribution to the Budget of Republic of Bulgaria	-	-	-	-	-	(170,867)	(170,867)
Current year contribution to the Budget of the Republic of Bulgaria	-	-	-	-	-	149,050	149,050
Profit for the year after the contribution to the Budget of Republic of Bulgaria	-	-	-	-	-	64,086	64,086
Other special reserve	-	-	-	-	-	30,000	30,000
Minority interest	-	3,093	-	-	-	-	3,093
Balance at 31 December 2004	20,000	3,093	104,500	774,774	10,841	756,428	1,669,636
Revaluation of equity investments	-	-	1,397	-	-	-	1,397
Transfer of unrealized gains on the revaluation of gold	-	-	-	295,067	-	-	295,067
Transfer of net loss on futures	-	-	-	(341)	-	-	(341)
Transfer of net foreign exchange gain	-	-	-	6,097	-	-	6,097
Transfer of net loss on the revaluation of securities	-	-	-	(131,627)	-	-	(131,627)
Other transfers	-	43	(393)	-	(10,003)	923	(9,430)
Payment of the prior year contribution to the Budget of the Republic of Bulgaria	-	-	-	-	-	(149,050)	(149,050)
Current year contribution to the Budget of the Republic of Bulgaria	-	-	-	-	-	150,162	150,162
Profit for the year after the contribution to the Budget of the Republic of Bulgaria and minority interest	-	70	-	-	-	77,865	77,935
Other special reserves	-	-	-	-	-	89,000	89,000
Balance at 31 December 2005	20,000	3,206	105,504	943,970	838	925,328	1,998,846

The accompanying notes on pages 68 to 84 form an integral part of these financial statements.

Notes to the Consolidated Financial Statements

1. Statute and principal activities

The Bulgarian National Bank (the 'Bank') is 100 per cent owned by the Republic of Bulgaria.

The Bank is the central bank of the Republic of Bulgaria. The operation of the Bank is governed by the Law on the Bulgarian National Bank, which has been effective from 10 June 1997.

Under this law, the primary objectives of the Bank may be summarized as:

- Maintaining the stability of the national currency;
- Exclusive right to issue bank notes and coins;
- Regulation and supervision of other banks' activities and
- Facilitation of non-cash payments through establishment and operation of efficient and effective payment systems.

The principal operations as a result of this law may be summarized as:

- The Bank may not provide credit to the state or to state-owned institutions other than credit for purchase of Special Drawing Rights (SDR) from the International Monetary Fund (IMF) in accordance with terms set by law;
- The Bank may not lend to commercial banks except in the case of liquidity risk threatening to affect the stability of the banking system;
- The Bank may not deal in Bulgarian government securities;
- The Bank may not issue Bulgarian levs in excess of the Bulgarian levs equivalent of the gross international foreign currency reserves;
- The Bank must prepare its accounts in accordance with the International Financial Reporting Standards;
- Under terms agreed upon with the Minister of Finance, the Bank acts as agent for public debts or for debts guaranteed by the State, and
- The Bank acts as a Central Depository of government securities.

2. Statement of compliance

The financial statements have been prepared in accordance with International Financial Reporting Standards and interpretations issued by the International Accounting Standards Board (IASB).

3. Basis of preparation

The financial statements are presented in Bulgarian levs (BGN) rounded to the nearest thousand. The financial statements are prepared on a fair value basis for financial assets and liabilities held for trading, available-for-sale assets and derivative financial instruments, except those for which a reliable measure of fair value is not available. Other financial assets and liabilities and non-financial assets and liabilities are stated at amortised cost or historical cost.

The accounting policies have been consistently applied.

The preparation of financial statements in conformity with IFRSs requires management to make judgment, estimates and assumption that affect the application of policies and the reported amounts of assets and liabilities, income and expenses. Estimates and judgments are continually evaluated and are based on historical experience and other factors, including expectations of future events that are believed to be reasonable under the circumstances.

4. Basis of consolidation

Subsidiaries

Subsidiaries are the enterprises controlled by the Bank. Control exists when the bank has the power, directly or indirectly, to govern the financial and operating policies of an enterprise so as to obtain benefits from its activities. The financial statements of the subsidiaries are included in the consolidated financial statements from the date that control commences until the date that control ceases. All receivables and payables, income and expenses as well as intragroup profits resulting from transactions between Group companies are eliminated unless they are immaterial. The minority shareholders' proportionate share in the net assets of the Group's majority-owned subsidiaries is disclosed separately from capital and reserves under the item Minority interest.

Associates

Associates are those entities in which the Bank has significant influence, but not control, over the financial and operating policies. The consolidated financial statements include the Group's share of the total recognized gains and losses of associates on an equity accounted basis, from the date that significant influence commences until the date that significant influence ceases. Share of associates' net results subsequent to acquisition is disclosed as other operating income in the income statement and is added to the carrying value of the investments in associates.

5. Summary of significant accounting policies

a) Income recognition

Interest income and expense are recognized in the income statement as they accrue, taking into account the effective yield of the asset or an applicable floating rate. Interest income and expense includes the amortization of any discount or premium, and other differences between the initial carrying amount and the amount at maturity calculated on an effective interest rate basis.

Fee and commission income and expense arises on financial services provided by the Bank and are recognized when the corresponding service is provided.

Other financial income and expense includes gains and losses arising from disposals and changes in the fair value of financial assets and liabilities held for trading and available for sale assets.

(b) Financial instruments

i) Classification

For the purposes of measuring financial instruments subsequent to initial recognition, the Bank classifies the financial instruments into four categories:

Financial instruments at fair value through profit and loss are those that the Bank holds for the purpose of short-term profit. These include investments that are not designated for any particular purpose and effective hedging instruments and liabilities from short-term sales of financial instruments. Net receivables under derivatives held for trading (positive fair value), as well as options purchased, if any, are reported as trading assets. All net liabilities under derivatives held for trading (negative fair value), as well as options written, if any, are reported as trading liabilities.

Loans and receivables are loans and receivables created by the Bank through providing money to a debtor other than those created with the intention of short-term profit taking.

Held-to-maturity financial assets are assets with fixed or determinable payments and fixed maturity that the Bank has the intent and ability to hold to maturity.

Available for sale financial assets are all assets that cannot be classified in any other category and are classified as available for sale, as well as any new asset intended for this purpose at its initial recognition.

ii) Initial recognition

The Bank recognizes financial assets at fair value through profit and loss, financial assets held to maturity and financial assets available for sale on the settlement date. From the date it commits to purchase the assets, any gains and losses arising from changes in fair value of the assets are recognized.

The Bank manages foreign reserves in line with the prudential investment principles and practices as per the requirements of the BNB Law. Investments in securities can only be in liquid debt instruments issued by institutions with high credit rating. On 1 January 2005 the Bank's management changed the classification of its portfolio of available-for-sale securities to securities at fair value through profit and loss. The change in securities portfolio classification is in compliance with the requirements of the revised IAS 39 - Financial Instruments: Recognition and Measurement in effect as of 1 January 2005 which allows the reclassification from available for sale to financial instruments at fair value through profit and loss as a one off transfer.

iii) Measurement

Initially, financial instruments are recognized at cost, which includes transaction costs.

Subsequent to initial recognition, all financial instruments at fair value through profit and loss, and all available for sale financial assets are measured at fair value, except that any instrument that does not have a quoted market price in an active market and whose fair value cannot be reliably measured is stated at cost, including transaction costs, less impairment losses, if any.

All non-trading financial liabilities, originated loans and receivables and held to maturity assets are measured at amortized cost less impairment losses. Amortised cost is calculated on the effective interest rate method. All premiums and discounts, including initial transaction costs, are included in the carrying amount of the related instrument and amortized based on the effective interest rate of the instrument.

iv) Fair value measurement principles and disclosures

The fair value of financial instruments is based on their quoted market price at the balance sheet date without any deduction for transaction costs. If a quoted market price is not available, the fair value of the instrument is estimated using pricing models or discounted cash flow techniques.

Where discounted cash flow techniques are used, estimated future cash flows are based on management's best estimates and the discount rate is a market-related rate at the balance sheet date for an instrument with similar terms and conditions and characteristics. Where pricing models are used, inputs are based on market related measures at the balance sheet date.

The fair value of derivatives that are not exchange-traded is estimated at the amount that the Bank would receive or pay to terminate the contract at the balance sheet date taking into account current market conditions and the current creditworthiness of the counterparties.

The futures are measured at fair value using market prices quoted on active markets.

In accordance with IAS 32 the Bank discloses the fair value information on assets or liabilities for which published market information is readily available and where the fair value is materially different from their recorded amounts.

The fair value of cash and cash equivalents, deposits, other receivables and liabilities is approximately equal to the book value given, because of their short-term maturity.

v) *Gains and losses on subsequent measurement*

All gains and losses arising from a change in the fair value of financial instruments through profit and loss and those available for sale are recognized in the income statement and then transferred to a special reserve account as required by the Law on the BNB.

Gains and losses arising from changes in the fair value of available-for-sale financial assets are recognised directly in equity, until the financial asset is derecognised or impaired at which time the cumulative gain or loss previously recognised in equity should be recognised in profit or loss. However, interest calculated using the effective interest method is recognised in the income statement. Dividends on available-for-sale equity instruments are recognised in the income statement when the entity's right to receive payment is established.

vi) *Derecognition*

A financial asset is derecognized on the value date after the Bank loses control over the contractual rights that comprise that asset. This occurs when the rights are realized, expire or are surrendered. A financial liability is derecognized when it is extinguished.

Available-for-sale financial assets and financial assets at fair value through profit and loss that are sold are derecognized on the settlement day. Gains and losses at derecognition are determined individually for each asset.

vii) *Automatic securities lending agreements*

Investments lent under automatic securities lending agreements are reported in the balance sheet and are valued in accordance with the accounting policy applicable to assets held for trading, respectively assets for sale. Investments lent under automatic securities lending agreements continue to be recognized in the Bank's balance sheet.

Income arising from the securities lending agreements is recognized on an accrual basis over the period of the transactions and is included in interest income.

viii) *Impairment of assets*

Financial assets are reviewed at each balance sheet date to determine whether there is objective evidence of impairment. If any such indication exists, the asset's recoverable amount is estimated.

(c) *Gold and other precious metals*

Gold and other precious metals are valued at market value based on the official London closing Bullion Market price at the balance sheet date.

(d) *Equity investments*

For the purposes of measuring the equity investments subsequent to initial recognition, they are classified as available for sale financial assets and are reported at fair value.

Details of investments held are set out in note 14.

(e) *Property, plant, equipment and intangible assets*

Property, plant, equipment and intangible assets are stated in the balance sheet at their acquisition, respectively cost as modified by any revaluation, less accumulated depreciation and impairment losses.

i) *Subsequent expenditure*

Expenditure incurred to replace a component of an item of property, plant and equipment that is accounted for separately is capitalized. All other subsequent expenditures are capitalized only when they increase the future economic benefits embodied in the item of property, plant and equipment. All other expenditures are recognized in the income statement as an expense as incurred.

ii) *Depreciation*

Depreciation is charged to the income statement on a straight-line basis over the estimated useful lives of items of property, plant, equipment and intangible assets. Land is not depreciated. The depreciation rates used are as follows:

Buildings	2% – 4%
Equipment	3% – 20%
Computers	33.3%
Fixtures and fittings	6.7% – 20%
Motor vehicles	8% – 25%
Intangible assets	15% – 33.3%

Assets are not depreciated until they are brought into use and transferred from assets in the course of construction into the relevant asset category.

iii) Calculation of recoverable amount

The recoverable amount of the Bank's property plant and equipment is the greater of the net selling price and value in use. In assessing value in use, the estimated future cash flows are discounted to their present value using the Bank's incremental borrowing rate that reflects current market assessments of the time value of money and the risks specific to the asset. For an asset that does not generate largely independent cash inflows, the recoverable amount is determined for the cash-generating unit to which the asset belongs.

iv) Reversals of impairment

In respect of property, plant and equipment, an impairment loss is reversed if there has been a change in the estimates used to determine the recoverable amount. An impairment loss is reversed only up to the amount of the asset's carrying amount before recognizing of impairment loss.

f) Foreign currencies

Income and expenditure arising in foreign currencies is translated to Bulgarian leva at the official rates of exchange on the transaction date. Monetary assets and liabilities denominated in foreign currencies at the balance sheet date are translated at the official exchange rate ruling on that day. Foreign exchange gains and losses are recognized in the income statement, and are then transferred to or from a special reserve as permitted by the Law on the Bulgarian National Bank, refer note 5 (i) below. Foreign currency denominated non-monetary assets and liabilities are valued at the exchange rate on the date of acquisition or at latest determination of fair value.

Open forward foreign exchange contracts are marked to market.

The exchange rates of major foreign currencies at 31 December 2005 and 31 December 2004 were:

Currency	31.XII.2005	31.XII.2004
US Dollar (USD)	1 : BGN 1.65790	1 : BGN 1.43589
Euro (EUR)	1 : BGN 1.95583	1 : BGN 1.95583
Special Drawing Rights (SDR)	1 : BGN 2.36959	1 : BGN 2.22995
Gold (XAU)	1 troy ounce : BGN 847.489	1 troy ounce : BGN 628.091

g) Taxation

The Bank is not subject to income tax on income from its main activities.

Tax on the profit from subsidiaries for the period comprises current tax and deferred tax. For the subsidiaries, current tax comprises tax payable calculated on the basis of the expected taxable income for the period, using the effective tax rate or the current one on the balance sheet date. Deferred tax is provided using the balance sheet liability method on all temporary differences between the carrying amounts for financial reporting purposes and the amounts used for taxation purposes.

h) Loans from International Monetary Fund (IMF)

The borrowings from the IMF are denominated in Special Drawing Rights (SDR). Any unrealized exchange gains or losses are accounted for in accordance with note 5(i).

i) Capital and reserves

The capital represents the non-distributable capital of the Bank.

In accordance with the Law on the Bulgarian National Bank, the Bank is required to transfer to reserves 25 per cent of the annual excess of revenue over expenditure. Special reserves are established as follows: the net gains and losses arising from the revaluation of assets and liabilities denominated in foreign currencies or gold; or upon a decision of the Governing Council.

After transfers to reserves, the balance of the revenue over expenditure is credited to the account of the state budget. In accordance with IAS 10 "Events after the balance sheet date", this contribution is treated as a dividend payment to the state and is held in a reserve account until paid.

j) **Cash in hand and deposits in foreign currency**

Cash and cash equivalents consist of cash in hand, current accounts and time deposits with maturities of less than three months.

k) **Standards, interpretations and amendments to published standards that are not yet effective and are relevant to the Bank's activities**

IFRS 7 Financial Instruments: Disclosures (effective from 1 January 2007) The Standard will require increased disclosure in respect of the Bank's financial instruments. It supersedes IAS 30 Disclosures in the Financial Statements of Banks and Similar Financial Institutions and is applicable to all entities that prepare financial statements in accordance with IFRSs. This Bank considers that the significant additional disclosures required will relate to its financial risk management objectives, policies and processes.

Amendment to IAS 1 Presentation of Financial Statements – Capital Disclosures (effective from 1 January 2007). As a complimentary amendment arising from IFRS 7 (see above), the Standard will require increased disclosure in respect of the Bank's capital. This amendment will require significantly more disclosures regarding the capital structure of the Bank and group.

Amendment to IAS 39 Financial Instruments: Recognition and Measurement – The Fair Value Option (effective from 1 January 2006). The amendment restricts the designation of financial instruments as "at fair value through profit or loss". The Bank believes that this amendment should not have a significant impact on the classification of financial instruments, as the Bank should be able to comply with the amended criteria for the designation of financial instruments at fair value through profit or loss.

Amendment to IAS 39 Financial Instruments: Recognition and Measurement and IFRS 4 Insurance Contracts – Financial Guarantee Contracts (effective from 1 January 2006) The amendment requires guarantees that are not insurance contracts to be measured at fair value upon initial recognition. The Bank does not anticipate any impact on the financial statements from the amendment.

6. **Interest income and expense**

(BGN'000)

	31.XII.2005	31.XII.2004
Interest income		
- on securities	325,856	256,119
- on deposits	55,425	35,160
- on other	-	3,001
	<u>381,281</u>	<u>294,280</u>
Interest expense		
- on deposits	74,065	71,571
- on other	6,910	2,898
	<u>80,975</u>	<u>74,469</u>

Interest expenses on deposits paid to the Government are BGN 68,599 thousand at 31 December 2005 (31 December 2004: BGN 55,690 thousand). Interest expenses on deposits of other state organisations are BGN 5,466 thousand for 2005 (2004: BGN 7,382 thousand).

7. **Other net financial incomes/(expenses)**

(BGN'000)

	31.XII.2005	31.XII.2004
Net gains from operations in securities	43,062	47,780
Net gains from operations in foreign currency	1,090	6,819
Net revaluation losses on futures	(341)	-
Net revaluation losses on securities	(131,627)	(61,192)
Net revaluation gains/(losses) on foreign currency assets and liabilities	6,097	(3,067)
Net gains/(losses) from revaluation of gold and precious metals	295,067	(24,632)
	<u>213,348</u>	<u>(34,292)</u>

8. Other operating income

(BGN'000)

	31.XII.2005	31.XII.2004
Net income from disposal of non-current assets	3,069	7,254
Turnover of subsidiaries	17,213	21,318
Income from associated companies	5,242	-
Income from sales of coins	1,069	1,272
Dividend income	4,451	4,247
Other income, net	9,322	500
	<u>40,366</u>	<u>34,591</u>

Other income includes income from the derecognition of the old coins and notes issued before 5 July 1999 in the amount of BGN 8,270 thousand (old notes for BGN 3,696 thousand and old coins for BGN 4,574 thousand - ref. note 21).

9. Total administrative expenses

(BGN'000)

	31.XII.2005	31.XII.2004
Personnel costs	23,285	21,415
Administrative expenses	29,723	26,527
Depreciation	13,048	15,338
Other expenses	3,140	3,173
Donation of non-current assets	-	537
	<u>69,196</u>	<u>66,990</u>

Personnel costs include salaries, social and health security under the provision of local legislation at 31 December 2005. The number of employees of the Bank and its subsidiaries was 1,257 at 31 December 2005 (31 December 2004: 1,302) including BNB staff of 932 at 31 December 2005 (31 December 2004: 917).

In accordance with the requirements of Labour Code on termination of the labour contract of an employee, who has become entitled to retirement, the Bank is obliged to pay him a compensation amounting to double his gross monthly salary. If the employee has been employed in the Bank for the last ten years, the amount of the compensation due is six times his gross monthly salary.

Based on actuarial calculations the Bank has accrued retirement compensation liabilities to the personnel in the amount of BGN 764 thousand and unused annual leave of BGN 291 thousand.

Administrative expenses include the administrative expenses of the BNB. The BNB personnel costs amount to BGN 18,115 thousands of BGN 11,292 thousand, the BNB depreciation of BGN 7,483 thousand. Included in the total administrative expenses are the currency in circulation expenses which amounted to BGN 17,510 thousand at 31 December 2005 (2004: BGN 16,775 thousand).

10. Cash and deposits in foreign currencies

(BGN'000)

	31.XII.2005	31.XII.2004
Foreign currency cash	10,153	8,050
Current accounts with other banks	8,887	161,555
Deposits in foreign currency	<u>3,411,576</u>	<u>2,762,922</u>
	<u>3,430,616</u>	<u>2,932,527</u>

Cash and deposits in foreign currencies with correspondents are disclosed as follows:

(BGN'000)

	31.XII.2005	31.XII.2004
Euro area residents		
In EUR	2,068,506	940,442
In other foreign currencies	261	890,505
	<u>2,068,767</u>	<u>1,830,947</u>
Non-euro area residents		
In EUR	1,072,203	889,340
In other foreign currencies	289,646	212,240
	<u>1,361,849</u>	<u>1,101,580</u>
	<u>3,430,616</u>	<u>2,932,527</u>

11. Gold, instruments in gold and other precious metals

	31.XII.2005		31.XII.2004	
	Troy ounces'000	BGN'000	Troy ounces'000	BGN'000
Gold bullion in standard form	513	434,798	513	322,238
Gold deposits in standard form	687	582,145	608	381,781
Gold in other form	17	14,480	-	3,217
Other precious metals	-	2,924	-	35
Other instruments in gold	80	67,745	160	100,295
		<u>1,102,092</u>		<u>807,566</u>

Gold deposits in standard form include gold held with correspondents. This gold earns interest at rates between 0.01 per cent and 0.07 per cent per annum.

The other instruments denominated in gold are held to maturity and earn interest between 1.00 per cent and 1.31 per cent per annum.

Gold in other form includes part of the gold commemorative coins from sale, which were transferred from other assets upon a decision of the Governing Council.

12. Investment in securities

(BGN'000)

	31.XII.2005	31.XII.2004
Securities at fair value through profit and loss		
Foreign treasury bills, notes and bonds	9,823,829	9,597,580
	<u>9,823,829</u>	<u>9,597,580</u>

Debt securities comprise both euro and USD-denominated coupon and discount securities. The coupon interest on the euro denominated securities is 4.6 per cent and the coupon interest on the USD-denominated securities is 4.07 per cent.

As at 31 December 2005 the value of securities pledged as collateral on futures transactions amounts to BGN 19,620 thousand.

The securities issued by foreign governments and other issuers with credit rating graded by at least two of the three credit rating agencies – Standard & Poor's, Fitch Ratings, or the corresponding Moody's ratings are disclosed as follows:

(BGN'000)

Issuers' rating	31.XII.2005	31.XII.2004
AAA	7,114,166	8,092,657
AA+	1,806,876	628,051
AA	781,628	710,687
AA-	121,159	166,185
	<u>9,823,829</u>	<u>9,597,580</u>

13. Receivables from the Government of the Republic of Bulgaria

The value of the receivables from the Government of the Republic of Bulgaria at 31 December 2005 is SDR 461 833 thousand (31 December 2004: SDR 761,953 thousand).

The receivables from the Government have been matched to the Government's borrowings from the IMF which are repayable according to the repayment schedules of the agreements (refer note 20). As at 31 December Bulgarian Government has repaid EUR 160,000 thousand ahead of the repayment schedule of the Extended Fund Facility of IMF.

The receivables are repayable as follows:

(BGN'000)

Year	31.XII.2005	31.XII.2004
2005	-	397 087
2006	557 328	503 426
2007	185 894	414 786
2008	185 894	228 317
2009	123 930	116 626
2010	41 310	38 876
	<u>1 094 356</u>	<u>1 699 118</u>

14. Equity investments and quota in the IMF

(BGN'000)

	31.XII.2005	31.XII.2004
Republic of Bulgaria's quota in the IMF	1,517,110	1,427,875
Equity investments in international financial institutions	23,706	22,309
Equity investments in domestic companies	10,369	1,634
	<u>1,551,185</u>	<u>1,451,818</u>

The Republic of Bulgaria's quota in the IMF is SDR 640,200 thousand. BGN 78,199 thousand of the Republic of Bulgaria's quota in IMF represents the Reserve tranche held with the IMF. The IMF pays remuneration (interest) to those members who have a remunerated reserve tranche position at 2.48 per cent annual floating rate paid quarterly.

The equity investments in international financial institutions include the equity investment in the Bank for International Settlements (BIS), Basle. Twenty five per cent of the equity investment in BIS Basle is paid up. The current value of these shares is SDR 10,000 thousand (ref. note 29 (i)). The capital subscribed but not paid in, has an option to be paid in within three months upon a decision of the BIS' Board of Governors.

None of the equity investments in international financial institutions exceeds 10 per cent of the issued share capital of those entities.

In April 2005 the Bank sold 63.76 per cent of the equity of Borika AD to commercial banks in the country.

As a result of the sale, as at 31 December 2005 the Bank holds 36.24 per cent of the equity of Borika AD and has significant influence on the financial and operational policy of the associated enterprise.

The significant equity investments in Bulgarian institutions may be analyzed as follows:

Name of institution	Holding, %	Principal activity
Associated companies		
Bankservice	36	Interbank clearing
BORICA	36	Servicing bank card payments
International Bank Institute	42	Financial training and research
Central Depository	20	Agent for corporate securities

15. Property, plant, equipment and intangible assets

(BGN'000)

	Land and buildings	Equipment	Motor vehicles	Fixtures and fittings	Assets in progress	Other	Intangible assets	Total
Cost or valuation								
At 1 January 2005	116,006	79,628	3,821	3,496	6,456	364	10,963	220,734
Additions	582	1,846	125	84	13,446	-	8	16,091
Disposals	(2,221)	(1,555)	(280)	(34)	(258)	(1)	(2)	(4,351)
Transfers	4,251	6,021	474	433	(12,311)	13	1,119	-
Revaluation	2,310	-	-	-	-	-	-	2,310
Disposal of Borika's assets	-	(5,094)	(145)	-	-	(72)	(1,563)	(6,874)
At 31 December 2005	120,928	80,846	3,995	3,979	7,333	304	10,525	227,910
Depreciation								
At 1 January 2005	(6,694)	(33,434)	(2,505)	(1,559)	-	(112)	(3,594)	(47,898)
Charge for the period	(2,977)	(7,719)	(339)	(405)	-	(43)	(1,527)	(13,010)
On disposals	278	1,502	278	29	-	1	2	2,090
Impairment	-	(1,061)	-	-	-	-	-	(1,061)
Disposal of Borika's assets	-	2,557	38	-	-	24	747	3,366
At 31 December 2005	(9,393)	(38,155)	(2,528)	(1,935)	-	(130)	(4,372)	(56,513)
Net book value at 31 December 2005	111,535	42,691	1,467	2,044	7,333	174	6,153	171,397
Net book value at 31 December 2004	109,312	46,194	1,316	1,937	6,456	252	7,369	172,836

Intangible assets include software, licenses and other intangible assets utilized by the Bank in its operations.

16. Other assets

(BGN'000)

	31.XII.2005	31.XII.2004
Balances with local banks	-	23
Balances of subsidiaries held with local banks	17,716	18,966
Precious metal commemorative coins for sale (ref. note 11)	802	10,841
Inventories (including spare parts)	6,328	6,640
Accounts receivable	1,044	4,716
Prepaid expenses	535	591
Other	2,307	209
	<u>28,732</u>	<u>41,986</u>

17. Due to banks and other financial institutions

(BGN'000)

	31.XII.2005	31.XII.2004
Demand deposits from banks and other financial institutions		
- in BGN	1,456,691	1,288,478
- in foreign currency	1,028,516	749,741
	<u>2,485,207</u>	<u>2,038,219</u>

The Bank does not pay interest on demand deposits from banks and other financial institutions. Included in demand deposits is BGN 2,239 million representing the required reserves, which all local banks are required to maintain with the Bank as part of their current accounts (31 December 2004: BGN 1,507 million).

18. Liabilities to government, government institutions and other borrowings

(BGN'000)

	31.XII.2005	31.XII.2004
Current accounts:		
- in BGN	341,011	700,583
- in foreign currency	426,176	419,252
Time deposit accounts:		
- in BGN	2,679,579	761,167
- in foreign currency	848,507	3,026,295
	<u>4,295,273</u>	<u>4,907,297</u>

Deposits and current accounts of government institutions with the Bank comprise funds held on behalf of state budget and other government organizations. No interest is payable on the current accounts. Government deposit accounts in US dollars earn interest between 1.84 per cent and 3.87 per cent. Government deposit accounts in euro earn interest between 1.72 per cent and 2.04 per cent and in BGN earn interest between 1.73 per cent and 2.13 per cent.

19. Borrowings against the Republic of Bulgaria's participation in the IMF

The borrowings against Bulgaria's participation in the IMF as at 31 December 2005 amount to BGN 1,435,020 thousand – SDR 605,598 thousand (at 31 December 2004: BGN 1,354,627 thousand – SDR 605,745 thousand).

Borrowings from the IMF are denominated in SDRs. Borrowings related to Bulgaria's IMF quota are non-interest bearing with no stated maturity.

20. Borrowings from general resources of the IMF

(BGN'000)

	31.XII.2005	31.XII.2004
Standby facilities	-	493,934
Extended fund facility	1,094,356	1,205,184
	<u>1,094,356</u>	<u>1,699,118</u>

The Borrowings from the general resources of the IMF bear interest at rates set by the IMF on a weekly basis, and as at 31 December 2005, the interest rate amounted to 3.74 per cent.

Borrowings from the IMF are guaranteed by promissory notes, which have been cosigned by the Government and the Bank. The total promissory notes outstanding as at 31 December 2005 were BGN 2,443,937 thousand (31 December 2004 were BGN 3,250,721 thousand) – refer to note 26(i).

21. Banknotes and coins in circulation

(BGN'000)

	31.XII.2005	31.XII.2004
Banknotes in circulation	5,774,024	4,938,398
Coins in circulation	93,189	81,844
Currency in circulation	<u>5,867,213</u>	<u>5,020,242</u>
Including:		
Old banknotes issued before 5 July 1999	-	13,875
Old coins issued before 5 July 1999	-	3,697

Old banknotes and coins reported above comprise those banknotes and coins that are still held by other parties or lost/destroyed and have not yet been exchanged for new levs. The BNB has set no deadline for their exchange. The Governing Council has decided that it is unlikely that these old notes and coins will be presented for exchange. Accordingly the liability to the coins has been taken to income statement and the liability per the notes taken in deferred income and will be recognised in the income statement over three years.

22. Accruals and other liabilities

(BGN'000)

	31.XII.2005	31.XII.2004
Salaries and social security payable	1,704	1,224
Deferred income	10,316	1,345
Other liabilities	10,553	11,723
	<u>22,573</u>	<u>14,292</u>

Deferred income include the amount of BGN 9,174 which represent the deferred income from the old banknotes which are not in circulation and the term for their exchange has not expired.

23. Capital and reserves

The capital of the Bank is determined in the Law on the BNB and amounts to BGN 20,000 thousand.

Non-current asset and commemorative coin revaluation reserves comprise the cumulative net change in fair values of certain groups of tangible non-current assets, equity investments and commemorative coins.

In accordance with the Law on the Bulgarian National Bank, net profit arising from the revaluation of assets and liabilities denominated in foreign currencies or gold is transferred to a special reserve account. The special reserve includes the monetary asset revaluation.

Other reserves include the transfers to reserves of 25 per cent of the annual excess of revenue over expenditure and reserves upon a decision of the Governing Council.

Upon a decision of the Governing Council, in 2005, BGN 89,000 was allocated to the special reserves for covering market risk losses.

24. Minority interest

BNB Printing Works AD is a joint-stock company with two shareholders: the BNB and the government represented by the Minister of Finance. The Bulgarian National Bank holds 95.6 per cent of the company's equity. The State, as represented by the Minister of Finance, holds 3,093 shares with par value BGN 1,000.

25. Monetary liabilities and gross international foreign exchange reserves

(BGN'000)

	31.XII.2005	31.XII.2004
Gross international foreign exchange reserves		
Cash and deposits in foreign currencies	3,430,616	2,932,526
Monetary gold and other instruments in gold	1,084,688	640,290
Debt securities investments	9,823,829	9,597,581
Equity investments and quota in IMF	78,198	73,263
	<u>14,417,331</u>	<u>13,243,660</u>
Monetary liabilities		
Banknotes and coins in circulation	5,867,213	5,020,242
Due to banks and other financial institutions	2,483,916	2,038,219
Liabilities to government institutions	4,120,515	4,395,046
Other borrowings	176,048	512,579
	<u>12,647,692</u>	<u>11,966,086</u>
 Surplus of gross international foreign exchange reserves over monetary liabilities	 <u>1,769,639</u>	 <u>1,277,574</u>

For the purposes of disclosing gross international foreign exchange reserves and monetary reserves in accordance with the Law on the Bulgarian National Bank, monetary gold is marked to market based on the official London Bullion Market closing price at the BNB balance sheet date. At 31 December 2004 the monetary gold was valued at the lower of BGN 500 per troy ounce or market value gold in accordance with the Law on the Bulgarian National Bank. The interest receivable and interest payable is included in 2005 within the value of underlying financial assets and liabilities.

26. Related party transactions

i) Bulgarian Government

International Monetary Fund

All the borrowings of the Government of the Republic of Bulgaria from the IMF are undertaken through the Bank. The Government's borrowings from the IMF, as shown on the balance sheet of the Bank, are matched by a receivable from the Government. For the Bank to eliminate any foreign exchange risk, the government receivable is denominated in SDR.

The interest on these borrowings is paid directly by the Government. Accordingly, no interest revenue is included in these accounts for the receivable from the Government, nor is any interest expense included on the Government's portion of the IMF borrowings.

The IMF quota is secured by promissory notes jointly signed by the Bank and the Government (ref. notes 19 and 20).

Government bank accounts

Government budget organizations and other government organizations have current accounts and time deposits with the Bank (ref. note 18).

Fiduciary activities

In accordance with the Law on the BNB and under terms agreed upon with the Ministry of Finance, BNB acts as a public debt agent. With regard to this role, BNB performs agent and central depository services related to the administration and management of government securities issued by the Ministry of Finance. The Bank receives income for providing these services. These securities are not assets or liabilities of the BNB and are not recognised in the consolidated balance sheet. The Bank is not exposed to any credit risk relating to such placements, as it does not guarantee these investments. At 31 December 2005, the par value of the total securities held in custody was BGN 2,843 million (31 December 2004: BGN 2,681 million).

27. Subsidiaries

(%)

Ownership interest	31.XII.2005	31.XII.2004
State Mint	100	100
BNB Printing Works (ref. note 24)	95.6	95.6

The net income from subsidiaries for the period comprise net profit of BGN 691 thousand from the State Mint and BGN 1608 thousand from the BNB Printing Works.

28. Risk management disclosures

The process of the BNB management of the gross international reserve looks to the security and high liquidity of the investment assets first, and then the intention of maximizing income in the context of the international market conditions. Its investment strategy depends mainly on the specific function of a central bank operating under a strictly regulated currency board arrangement and in accordance with the requirements of the Law on the BNB.

The major portion of BNB's foreign currency reserves is invested in low-risk discount and coupon bonds and in short-term foreign currency and gold deposits placed with first rate foreign banks. The remaining portion is held in SDRs, and in monetary gold kept in the Bank's vaults.

The foreign currency reserve risks are managed by an independent risk management unit. It is directly responsible for the strategic asset allocation and the determination of the foreign exchange reserves benchmark, and prepares and submits for approval the investment management limits. On an annual basis, through the Value-at-Risk of yield of the net value, the Bank's management sets the maximum allowable market risk. This measure of risk is a fundamental expression of the Bank's risk tolerance.

On a quarterly basis, an overall review is made of the changes in the market conditions, the amount and structure of foreign currency reserves, and if required, the investment limits and benchmarks are updated. The observance of underlying limits, rules, and procedures is monitored on a daily basis. Reports are regularly prepared on daily, weekly, monthly, quarterly or annual basis. These reports are prepared both for the needs of foreign currency reserves operating management, and for providing updated information to the Bank's management.

The Investment Guidelines set the framework within which the Bank's international reserves are managed. All approved financial instruments and asset classes in which the BNB may invest are approved in the document *Investment Guidelines and Benchmarks for the Management of the Gross International Reserves*. The same document defines the main portfolios and the benchmarks corresponding to them, as well as all limits for credit, interest, currency and operational risk. The document contains an exhaustive list of approved issuers and debt instruments which the BNB may invest in, and a list of foreign financial institutions acting as BNB counterparties.

In addition, rules of behaviour and procedures regulating the performance of the functions and tasks of the main structural units responsible for the foreign currency reserve management have been detailed.

In view of optimizing foreign currency reserves management, new financial instruments are periodically studied, analysed, and proposed for approval. When they are included in the respective portfolios, they contribute to the higher degree of diversification, allow for hedging of market risks and provide an opportunity for additional incomes.

a) Credit risk

The Bank is subject to credit risk through its trading operations and investment activities and in cases where it acts as an intermediary on behalf of the Government or other public institutions. The Bank assumes credit risk also in operations of purchase and sale of reserve currency with commercial banks. This credit risk is associated with the probability of insolvency or bankruptcy of a BNB's counterparty or debt issuer, in which the Bank has invested its own funds. Credit risk is limited by setting requirements for high credit ratings assigned by internationally recognized credit rating agencies.

From credit risk perspective the Bank can currently invest in the following classes of assets:

- Bonds and commercial paper issued by countries, central banks and state-guaranteed institutions;
- Bonds and commercial paper issued by supranational financial institutions, short-term foreign currency and gold deposits placed with supranational financial institutions;
- Commercial paper issued by commercial banks and short-term foreign currency and gold deposits placed with commercial banks;
- Secured Eurobonds – these are relatively new financial instruments issued in many countries in the euro area, of which bonds issued by German and French financial institutions of the type Jumbo Pfandbriefe and Obligations Foncières and Irish Asset Covered Securities are currently eligible for investment;
- Bonds issued by agencies and other financial institutions, which are not guaranteed by the state.

In 2005 the Bank included new financial instruments like bond and interest rate futures traded on the international regulated markets in the management of the foreign currency reserves. The Bank has started its participation in two new securities lending agreement programmes. The securities lending transactions are performed by the intermediation of a bank agent and the custodian of the securities.

For all instruments issued by states, central banks or state-guaranteed financial institutions there is a minimum exposure limit. This limit ensures that certain part of the foreign currency reserves will be invested in the most risk-free and highly-liquid class of assets. For the other asset classes there are maximum exposure limits both in terms of balance levels and by portfolio. All limits directly depend on the inherent credit risk of the respective class of assets.

An approved policy has been developed in the Bank with regard to the BNB counterparties involved in the gross international reserves management, which sets forth the rules for the selection, review and rating of counterparties, and any changes made to the list of counterparties. According to the current policy, the BNB uses the ratings of the following three internationally recognised rating agencies – Standard and Poor's, Moody's and Fitch Ratings.

Foreign financial institutions acting as BNB counter parties are divided into two groups:

- Financial institutions to which the BNB may have a credit exposure. These should have long-term credit rating higher or equal to AA- according to S&P and Fitch Ratings, or Aa3 according to Moody's by at least two of the above indicated agencies.
- Financial institutions with which the BNB may conclude DVP (Delivery Versus Payment) transactions for the sale or purchase of securities. They should have a short-term credit rating higher or equal to A-1 per S&P, F-1 per Fitch Ratings or P-2 per Moody's by at least two of the above agencies.

The investment limits of the BNB set a system of limits of maximum exposures to individual counterparties. The set limits are calculated on the basis of internal credit ratings and the share capital of the counterparty. The internal credit rating, on its part, is a function of long-term ratings by the above three credit ratings. In addition, based on the internal credit rating, limits are set for the maximum term of the deposits in gold and foreign exchange placed with commercial banks, and of the commercial paper issued by them.

b) Liquidity risk

Liquidity risk arises in the funding of the Bank's core activities and in the management of positions, and has two aspects, the first aspect being the risk for the Bank of being unable to meet its obligations when due, and the second aspect – the risk of being unable to liquidate an asset at a fair value within an appropriate time frame.

The Bank's customers are determined by the Law on the BNB. It attracts funds by means of a number of instruments – deposits/investment accounts, a structured indexed account (SIA), settlement accounts and other borrowed funds, established by law. The Bank strives to maintain a balance

between the maturity of borrowed funds and that of assets through investments in financial instruments with a range of maturities. The Bank is able to provide the required liquidity by investing in various types of instruments. This liquidity is provided on a daily basis, thus ensuring all BNB foreign currency payments. In addition, there are limits on the residual term to maturity for the financial instruments of those asset classes, approved for investment.

The Bank continually assesses liquidity risk by identifying and monitoring changes in funding required meeting its goals and targets set in terms of the overall Bank strategy. To ensure its future payments the Bank holds portfolios of liquid assets denominated in euro and US dollars as part of its overall liquidity risk management strategy.

The following table provides an analysis of the assets and liabilities of the Bank into relevant maturity groupings based on the remaining periods to repayment.

(BGN'000)

As at 31 December 2005	Up to 1 month	From 1 to 3 months	From 3 months to 1 year	From 1 to 5 years	Over 5 years	Total
Assets						
Cash and deposits in foreign currencies	3,194,792	235,824	-	-	-	3,430,616
Gold, instruments in gold and other precious metals	582,145	-	-	67,745	452,202	1,102,092
Investment in securities	592,982	1,926,517	2,231,059	2,354,527	2,718,744	9,823,829
Equity investments and quota in the IMF	78,199	-	-	-	1,472,986	1,551,185
Receivables from the Republic of Bulgaria	23,104	358,835	175,389	537,028	-	1,094,356
Property, equipment and intangible assets	-	-	-	-	171,397	171,397
Other assets	14,553	12,678	52	1,331	118	28,732
Total assets	4,485,775	2,533,854	2,406,500	2,960,631	4,815,447	17,202,207
Liabilities						
Banknotes and coins in circulation	-	-	-	-	5,867,213	5,867,213
Due to banks and other financial institutions	2,485,207	-	-	-	-	2,485,207
Liabilities to government, government institutions and other borrowings	4,273,419	21,854	-	-	-	4,295,273
Borrowings against Republic of Bulgaria's IMF participation	-	-	-	-	1,438,739	1,438,739
Borrowings from general resources of the IMF	23,104	358,835	175,389	537,028	-	1,094,356
Accruals and other liabilities	17,862	-	2,322	-	2,389	22,573
Total liabilities	6,799,592	380,689	177,711	537,028	7,308,341	15,203,361
Asset-liability maturity mismatch	(2,313,817)	2,153,165	2,228,789	2,423,603	(2,492,894)	1,998,846

(BGN'000)

As at 31 December 2004	Up to 1 month	From 1 to 3 months	From 3 months to 1 year	From 1 to 5 years	Over 5 years	Total
Assets						
Cash and deposits in foreign currencies	2,637,880	245,594	49,053	-	-	2,932,527
Gold, instruments in gold and other precious metals	74,425	240,132	117,350	50,169	325,490	807,566
Investment in securities	2,232,875	2,329,938	3,314,993	1,695,738	24,036	9,597,580
Equity investments and quota in the IMF	73,262	-	-	-	1,378,556	1,451,818
Receivables from the Republic of Bulgaria	7,247	55,043	334,797	1,263,155	38,876	1,699,118
Property, plant, equipment and intangible assets	-	-	-	-	172,836	172,836
Other assets	18,743	7,351	14,462	1,292	138	41,986
Total Assets	5,044,432	2,878,058	3,830,655	3,010,354	1,939,932	16,703,431
Liabilities						
Bank notes and coins in circulation	-	-	-	-	5,020,242	5,020,242
Due to banks and other financial institutions	2,038,219	-	-	-	-	2,038,219
Liabilities to government, government institutions and other borrowings	4,885,504	21,793	-	-	-	4,907,297
Borrowings against Republic of Bulgaria's IMF participation	-	-	-	-	1,354,627	1,354,627
Borrowings from general resources of the IMF	7,247	55,043	334,797	1,263,155	38,876	1,699,118
Accruals and other liabilities	9,069	-	3,067	-	2,156	14,292
Total liabilities	6,940,039	76,836	337,864	1,263,155	6,415,901	15,033,795
Asset-liability maturity mismatch	(1,895,607)	2,801,222	3,492,791	1,747,199	(4,475,969)	1,669,636

c) **Market risk****Market risk**

All trading instruments are subject to market risk, *i.e.*, the risk of impairment as a result of occurring changes in the market conditions. The instruments are evaluated on a daily basis at fair value which best reflects current market conditions, and all changes in them directly impact net income from banking operations.

The Bank manages its portfolios in response to changing market conditions. Exposure to market risk is managed in accordance with the risk limits formally set in the investment guidelines for managing foreign currency assets.

Interest rate risk

The Bank's operations are subject to the risk of interest rate fluctuations to the extent that interest-earning assets (including investments) and interest-bearing liabilities mature or reprice at different times or in different amounts. The Bank uses modified duration as a key measurement for interest rate risk. Modified duration measures the effect of the change of the market value of an asset (liability) in response to 1 per cent change of the interest rate levels. For each portfolio held by the BNB the interest rate is limited by a benchmark (model portfolio) and by the investment limits for a maximum allowable deviation of the modified duration of the portfolio from that of the respective benchmark. With regard to assets and liabilities with floating interest rates the Bank is exposed to the risk of change in the base, which serves to determine interest rates.

In 2005 the bond and interest rate futures were included in the allowed tradable financial instruments as part of the efforts of BNB to improve the efficiency of the foreign currency reserves' management. Futures are highly liquid financial instruments with low transaction costs and are used in cases when the financial instruments portfolios need to be rebalanced.

The periods of interest rate scale change are given below. The maximum period for all assets and liabilities under the scale is one year.

(BGN'000)

As at 31 December 2005	Effective rate	Total	Floating rate instruments	Fixed rate instruments		
				Less than 1 month	Between 1 month and 3 months	Between 3 months and 1 year
Assets						
Cash and deposits in foreign currencies	2.45	3,418,709	8,761	3,175,076	234,872	-
Gold, instruments in gold and other precious metals	0.15	649,835	-	582,141	-	67,694
Investment in securities	2.76	9,651,781	29,981	568,046	1,903,587	7,150,167
Equity investments and quota in the IMF	-	78,199	-	78,199	-	-
Receivables from the Republic of Bulgaria	-	1,094,356	1,094,356	-	-	-
Other interest-bearing assets	-	17,463	5,882	8,549	3,032	-
Noninterest-bearing assets	-	2,291,864	-	-	-	-
Total		17,202,207	1,138,980	4,412,011	2,141,491	7,217,861
Liabilities						
Due to banks and other financial institutions	-	2,485,207	-	2,485,207	-	-
Liabilities to government, government institutions and other borrowings	2.26	3,661,121	146,687	3,492,920	21,514	-
Borrowings from general resources of the IMF	-	1,094,356	1,094,356	-	-	-
Noninterest-bearing liabilities	-	7,962,677	-	-	-	-
Total	-	15,203,361	1,241,043	5,978,127	21,514	-
Assets/liability gap	-	1,998,846	(102,063)	(1,566,116)	2,119,977	7,217,861

(BGN'000)

As at 31 December 2004	Effective rate	Total	Floating rate instruments	Fixed rate instruments		
				Less than 1 month	Between 1 month and 3 months	Between 3 months and 1 year
Assets						
Cash and deposits in foreign currencies	2.11	2,921,429	161,352	2,466,702	244,479	48,896
Gold, instruments in gold and other precious metals	0.28	481,642	-	74,011	240,115	167,516
Investment in securities	2.19	9,414,191	9,994	2,214,813	2,271,578	4,917,806
Equity investments and quota in the IMF	-	73,262	-	73,262	-	-
Receivables from the Republic of Bulgaria	-	1,699,118	1,699,118	-	-	-
Other interest-bearing assets	-	18,567	13,206	3,000	2,361	-
Noninterest-bearing assets	-	2,095,222	-	-	-	-
Total	-	16,703,431	1,883,670	4,831,788	2,758,533	5,134,218
Liabilities						
Due to banks and other financial institutions	-	2,038,219	-	2,038,219	-	-
Liabilities to government, government institutions and other borrowings	1.89	3,924,358	146,687	3,756,157	21,514	-
Borrowings from general resources of the IMF	-	1,699,118	1,699,118	-	-	-
Noninterest-bearing liabilities	-	7,372,100	-	-	-	-
Total	-	15,033,795	1,845,805	5,794,376	21,514	-
Asset/liability gap	-	1,669,636	37,865	(962,588)	2,737,019	5,134,218

d) Currency risk

Currency risk exists where there is a difference between the currency structure of assets and that of liabilities. The Bank is exposed to currency risk through transactions with financial instruments denominated in currencies other than the base currency (euro) of the Bank.

As a result of the currency board arrangement in Bulgaria, the Bulgarian currency is fixed to the euro. As the currency in which the Bank presents its financial statements is the Bulgarian lev, the Bank's financial statements are impacted by movements in the exchange rates between the currencies outside the euro area and the lev.

The Bank's transactions give rise to foreign exchange gains and losses that are recognized in the income statement and may then be transferred to special reserves.

To minimize currency risk a limit is set to mismatches between the currency structure of assets and that of liabilities. The market value of assets in a currency other than the euro should not deviate by more than +/-2 per cent from the market value of liabilities denominated in the same currency.

The foreign currency exposures are as follows:

(BGN'000)

	31.XII.2005	31.XII.2004
Assets		
Bulgarian leva and euro area currencies	13,173,795	10,945,618
US dollars	285,148	1,364,847
Japanese yen	55	32
Pound sterling	494	320
SDR	2,636,920	3,168,274
Gold	1,099,117	807,530
Other	6,678	416,810
	<u>17,202,207</u>	<u>16,703,431</u>
Liabilities and equity		
Bulgarian leva and euro area currencies	14,385,697	11,877,736
US dollars	281,227	1,356,591
Japanese yen	-	-
Pound sterling	5	45
SDR	2,532,218	3,051,366
Gold	-	-
Other	3,060	417,693
	<u>17,202,207</u>	<u>16,703,431</u>
Net position		
Bulgarian leva and euro area currencies	(1,211,902)	(932,118)
US dollars	3,921	8,256
Japanese yen	55	32
Pound sterling	489	275
SDR	104,702	116,908
Gold	1,099,117	807,530
Other	3,618	(883)

29. Commitments and contingencies

i) *Participation in the Bank for International Settlements*

The Bank holds 8,000 shares of the capital of BIS, Basle, each amounting to SDR 5,000. 2 per cent of the equity investment in BIS Basle is paid up. The capital subscribed but not paid in is with an option to be paid in within three months following a decision of the BIS' Board of Governors. The contingent amount as at 31 December 2005 is BGN 71,088 thousand.

ii) *IMF quota and borrowings*

The IMF quota and borrowings are supported by promissory notes jointly signed by the Bank and the Government of the Republic of Bulgaria amounting to BGN 2,443,937 thousand (2004: BGN 3,250,721 thousand).

iii) *Capital commitments*

As at 31 December 2005, the Bank has committed to BGN 6,908 thousand to purchase non-current assets.

iv) *There are no other outstanding guarantees, letters of credit or commitments to purchase or sell either gold, other precious metals or foreign currency.*

30. Events subsequent to the balance sheet date

There are no events subsequent to the balance sheet date of such a nature that they would require additional disclosures or adjustments to the consolidated financial statements.

Major Resolutions of the BNB Governing Council

7 February	As of 10 March 2005 the Bulgarian National Bank put into circulation a silver coin with a nominal value of BGN 10, issue 2005, commemorating the Torino 2006 XX Winter Olympic Games, 'Short track'.
8 February	As of 28 February 2005 the Bulgarian National Bank put into circulation a coloured commemorative coin 'Baba Marta' with a nominal value of BGN 5, issue 2005.
22 February	Amendments to BNB Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks were approved.
17 March	<p>As of 25 April the Bulgarian National Bank put into circulation a partially gold-plated silver commemorative coin 'Bulgaria – European Union' with a nominal value of BGN 1.95583, issue 2005.</p> <p>National Council on Payment Systems chaired by the Deputy Governor heading the BNB Banking Department was established. Rules of Procedure of the Council and its members were approved.</p>
7 April	<p>Ordinance No. 13 on the Application of International Bank Account Numbers and Bank Identifier Codes was adopted.</p> <p>A package of documents associated with BNB preparation for membership in the European System of Central Banks was adopted: Action Plan (Road Map) for the accomplishment of BNB commitments in relation to its participation in the ESCB, Schedule for the accomplishment of tasks associated with BNB preparation for membership in the ESCB and in EU structures and bodies, Internal Rules for coordination of the preparation and the participation of BNB representatives in the meetings of the General Council and Governing Council of the ECB, the ESCB committees and working groups and in EU structures and bodies.</p> <p>As of 25 May 2005 the Bulgarian National Bank put into circulation a coin with a nominal value of BGN 0.50, issue 2005, commemorating Bulgaria's accession to the European Union.</p>
21 April	<p>The report on BNB budget implementation for 2004 was approved.</p> <p>The BNB Annual Report for 2004 was approved.</p> <p>The list of currencies for which the BNB publishes reference exchange rates to the Bulgarian lev was extended.</p> <p>A resolution for signing the contracts with commercial banks for purchase of BORICA EAD shares, endorsing temporary certificates, entering shareholders and convening General Shareholder Meeting of BORICA EAD was adopted.</p> <p>Amendments to BNB Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks were approved.</p> <p>Amendments to BNB Ordinance No. 8 on the Capital Adequacy of Banks were approved.</p> <p>Amendments to BNB Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss were approved.</p>
26 April	<p>BNB Staff Code of Ethics was adopted.</p> <p>Internal Rules for BNB Staff Assessment were adopted.</p>
26 May	<p>Internal Rules for Employees' Remuneration were adopted.</p> <p>Internal Rules for the Gross International Reserves Operations were adopted.</p> <p>Instructions on the procedure for assessing the need for banknotes and control over their production were adopted.</p>

- 9 June** Internal Rules for Circulation and Withdrawal from Circulation of Bulgarian Banknotes and Coins were adopted.
- 23 June** Amendments to BNB Ordinance No. 8 on the Capital Adequacy of Banks were approved.
Instructions on the procedure for assessing the need for circulating coins and control over production of circulating and commemorative coins were adopted.
Internal Rules for the Work with Documents in the BNB were adopted.
- 7 July** The Introduction of the International Bank Account Number (IBAN) and the Changes in the National Payment System Related Thereto project was approved.
- 15 July** Amendments to Ordinance No. 7 on the Large Exposures of Banks, Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss, Ordinance No. 12 on the Supervision on a Consolidated Basis, Ordinance No. 17 on Establishing the Amount of Bank Investment under Article 30 of the Law on Banks and Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks were approved.
- 28 July** Amendments to the Rules of Procedure of the Governing Council of the BNB were approved.
A programme for minting commemorative coins in 2006 was approved.
- 8 September** As of 15 September 2006 the BNB put into circulation a commemorative banknote with a nominal value of BGN 20, issue 2005.
- 29 September** Ordinance No. 3 on Funds Transfers and Payment Systems was approved.
Ordinance No. 16 on Electronic Payment Instruments was approved.
- 6 October** The Rules of Procedure of the Conciliation Commission on Payment Disputes were approved.
- 20 October** As of 6 December 2005 the BNB put into circulation a partially gold-plated silver commemorative coin 'Treasures of Bulgaria' with a nominal value of 10 leva, issue 2005.
Ordinance No. 18 on the Control over the Quality of Banknotes and Coins in Currency Circulation was approved.
- 10 November** Amendments to BNB Ordinance No. 21 on the Minimum Required Reserves Maintained with the Bulgarian National Bank by Banks were approved.
Amendments to BNB Ordinance No. 9 on the Evaluation and Classification of Risk Exposures of Banks and the Allocation of Provisions to Cover Impairment Loss were approved.
- 24 November** As of 6 December the BNB put into circulation a new banknote of BGN 2, issue 2005. The BGN 2 banknotes of issue 1999 continue to be legal tender and will be in circulation together with the new banknote.
- 8 December** The BNB budget for 2006 was adopted.
- 22 December** An Ordinance on the Format and Content of the BNB Balance Sheet was approved.
The Rules of Procedure of the Internal Audit in the BNB were approved.